



**“Building for the Successful Transition of Your Agricultural Business” Fact Sheet Series**

# Starting, Organizing, and Managing an LLC for a Farm Business

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The Limited Liability Company (LLC) has become the entity of choice for many new businesses in Ohio. The LLC provides the flexibility and ease of startup of a partnership while providing the liability protection of a corporation. By combining the best attributes of a corporation and partnership, the LLC provides an attractive business entity for Ohio farms and farm businesses.

## What is a Limited Liability Company (LLC)?

An LLC is a legal entity created by Ohio statute. An LLC is considered to be a “person,” separate and distinct from its owner(s). The LLC owners, called members, can range in number from a single owner to unlimited owners. The LLC can be established to engage in any lawful activity under Ohio state laws.

## Why Form an LLC?

An LLC can provide the following to farm businesses in Ohio:

- An operating entity from which to run the farm business
- Liability protection for the LLC owners
- An estate planning tool to manage estate taxes and estate distributions
- A real estate holding entity
- A business succession planning tool
- Conforming to and managing Farm Service Agency program payments

## History

In relation to other business entities, the LLC is relatively new. The first LLC statutes were enacted in Wyoming in 1977 but initial use of LLCs was minimal. However, in 1988 the IRS allowed LLCs to be taxed as partnerships. This ruling made LLCs a very attractive business entity and opened the floodgates for LLC statutes in all 50 states. By 1996, every state and the District of Columbia had enacted legislation permitting LLC formation.

## Why is an LLC Unique?

Simply put, the LLC combines the best attributes of a corporation and a partnership. Prior to LLCs, new business were generally limited to a sole proprietor, corporation, or some type of partnership. Some business owners would opt for a sole proprietorship for simplicity and taxing structure, others would opt for a corporation and its liability protection and centralized management, while others would chose a partnership for its pass-through taxation and more informal structure.

## Primary Attributes of an LLC

### *Informal Organization Possible*

Ohio law allows the LLC members to determine the management structure of the company. The LLC members can choose between centralized management (corporation) or management by the members (partnership). Most

LLCs choose a partnership-like management structure as it tends to be easier to establish and manage, provides more flexibility, and allows for management by committee, management by a sole member, or management by a non-member manager.

### ***Flexible Tax Structure***

LLCs are subject to check-the-box tax regulations allowing the business owners to elect the desired status for federal tax classification. If no election is made, a single member LLC is taxed as a sole proprietorship and a multi-member LLC is taxed as a partnership. However, circumstances may be such that a corporate tax classification would be advantageous for the LLC. In that case, the owners merely “check the box” and elect a corporate tax classification. The “check-the-box regulations” make tax classification a very simple matter. This check-the-box election is made on IRS form 8832.

### ***No Restriction on Ownership***

Individuals, corporations, other LLCs, trusts, and estates may be members in an LLC. There must be at least one member of the LLC but there is no limit on the maximum number of members.

### ***Allocations and Distributions of Earnings may be in Different Proportion than Capital Contribution***

Allocations are the proportions of any item of gain, loss, deduction, or income that is attributed to each member. The allocation does not have to be in proportion to the members’ contributions. Allocations can be based upon per capita, ownership interest, or any other means of distributing allocations that the members agree to. Each year, an LLC taxed as a partnership will file an informational return (IRS Form 1065) with the IRS to show how the LLC’s income or losses have been allocated among the members.

## **Disadvantages of an LLC**

### ***Relatively New Entity***

As discussed previously, the LLC is a relatively new entity. Therefore, legal issues affecting LLCs have not had time to work their way through the judicial system. The issue that has the most potential of being interpreted by the courts is limited liability. It is widely believed that LLCs have the same liability protection for its members that corporations have for its shareholders. However, until an Ohio court rules on that very issue, it will only be speculation.

### ***Liability Veil Piercing***

Corporations are subject to a concept called veil piercing where the limited liability of the shareholder is challenged. A person or person(s) cannot use a corporation to commit fraud on others, have such complete control over the corporation that the corporation has no separate existence of its own, or cause injury or unjust loss from the shareholder’s wrong. If one of these conditions exists or occurs, the court may declare that the corporation and shareholder(s) are one and the same, or otherwise pierce the liability protection of the corporation. If this occurs, the shareholder(s) will have full liability for the debt and acts of the corporation.

LLC liability protection is based on corporate liability protection. Therefore, the concept of veil piercing would almost certainly apply to LLCs as well. However, no known Ohio cases have addressed this issue. Thus, some uncertainty remains with the extent of liability protection that an LLC provides its members. However, a properly formed and managed LLC will have very little chance of having its limited liability shield pierced. The most likely scenario where an LLC may have its limited liability veil pierced is where it is grossly undercapitalized from the outset and the members do not treat it as a separate entity by commingling funds and not documenting loans to the LLC.

### ***Additional Costs***

Forming an LLC costs money. The costs of setting up an LLC will include a registration fee with the Ohio Secretary of State (\$125) and may include attorney fees, accountant, and deed preparation. The total cost of establishing an LLC is totally dependent upon each situation and the professionals that are involved. However, larger, more complex LLCs can easily cost several thousand dollars in set-up fees. Before starting an LLC, always ask the attorney and/or accountant assisting with the project for an estimation of costs. It is important that the LLC be cost effective.

In addition to start-up costs, each LLC, other than a single member LLC, will need its own accounting system and tax return. Again, the costs of the accounting and tax returns depends on each situation but at minimum will likely be a few hundred dollars annually. Additional costs may also include setting up new bank accounts and the time needed to change account names with vendors.

## **Legal Requirements for an Ohio LLC**

A business entity does not become a valid LLC until certain requirements are met under Ohio’s LLC statute. The primary requirement is that the LLC must be registered with the Ohio Secretary of State. The application for

registration with the Secretary of State is an easy process that involves declaring a valid name and a statutory agent for the LLC.

### **Name**

Each business entity in Ohio must have its own unique name.\* Therefore, a new LLC must use a name that is different enough from any other Ohio business so that the names would not be confused. For example, if a business entity already exists by the name of Ohio Farms Inc., a new LLC could not be formed with the name of Ohio Farms LLC, as the names are too similar.\* However, a slight modification of the name, such as Ohio Dairy Farms LLC, would likely be approved by the Secretary of State. A business organized as an LLC must include “LLC”, “Ltd”, or “Limited Liability Company” in its name.

### **Statutory Agent**

The Secretary of State also requires the name and address of a statutory agent. The statutory agent is a person who is a resident of the state where the LLC is being organized and is authorized to accept service of process for the LLC. Any legal process or notice required by law may be served on the statutory agent. Essentially, the statutory agent is the contact person for the LLC. The statutory agent takes on no liability of the LLC for merely being the statutory agent. For example, if an LLC were to be sued, the court documents would be served on the statutory agent who would then be responsible for passing them on to the company. The statutory agent may be a member of the LLC but is not required to be a member. Often a non-member, particularly the LLC’s attorney, will serve as statutory agent. The statutory agent must sign the Articles declaring that he/she has accepted appointment as statutory agent.

### **Filing**

The application for formation must be filed with the Secretary of State along with a filing fee, currently \$125. The Secretary of State will review the application, and if there are no problems, declare the entity to be a valid LLC and issue Articles of Organization. The Articles of Organization is essentially a certificate declaring the entity to be in good standing with the state. The most common reasons applications are rejected by the Secretary of State are using a name already in use, attempting to use an out of state statutory agent, or not getting proper signatures.

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\*A new business entity may get permission from an existing business entity to use the same name. A signed permission form must be filed with the Secretary of State. For example, Ohio Farms Inc. could grant Ohio Farms LLC permission to use the “Ohio Farms” name.

### **Employer Identification Number (EIN)**

The EIN is to a business what a Social Security Number is to an individual. Every new LLC will need to file for and receive an EIN from the IRS. The only exception is an LLC with only one owner who will report the LLC’s income or loss on his or her own 1040 using Schedule C or Schedule F. Obtaining an EIN is a very easy process that can be done via telephone, fax, or on-line through the IRS.

### **The Operating Agreement**

The operating agreement is the equivalent of bylaws for a corporation or a partnership agreement for a partnership. It is an agreement among the members that governs the operating and management aspects of the LLC. Ohio law does not require an operating agreement but it is highly recommended that each and every LLC have one. If there is no operating agreement or the operating agreement is silent on a certain point, the Ohio Revised Code provides the default provisions.

The more thorough and robust an operating agreement is, the better. However, the following are certain minimum provisions that should be addressed in every operating agreement.

### **Management Structure**

As discussed briefly above, one of the primary advantages of an LLC over other business entities is the flexibility of the management structure. The LLC can be managed on a very formal basis like a corporation or managed on a more informal basis like a partnership. If there is no operating agreement or the operating agreement is silent on management structure, the default provision in the Ohio Revised Code provides that all members of the LLC will have management authority in proportion to their ownership.

#### **A. Centralized Management**

Centralized management is the management system used by most corporations. Shareholders or owners elect directors who in turn appoint a president, treasurer, and secretary of the company. This system takes management decisions and “centralizes” them to a few individuals to make decisions for the entire company. This is especially true for large corporations with many shareholders. While this management system is not typical for LLCs, an LLC may incorporate this system by requiring it in the operating agreement. The primary challenge with centralized management is the formal requirements of setting up the structure of the corporation, having shareholder and director meetings, and maintaining minutes from those meetings.

## **B. Member Managed**

The member managed system is the more common system when farm businesses choose to organize as an LLC. In this system, all the members of an LLC have a say in the management of the company. All critical business decisions require a member vote. Some decisions such as ordinary business transactions may only require a majority vote. Other decisions, such as the addition of additional members, may require a unanimous vote. It is very important to declare in the operating agreement which decisions require a vote and what portion of the members must affirm the vote. The majority of LLCs incorporate this management system as it provides each member with at least some say in management. This system can be burdensome in that many votes may need to be taken as management decisions are made.

## **C. Managing Member**

The managing member system allows the members of an LLC to appoint one or more members to act as manager for the LLC. The managing member will typically be responsible for the day-to-day operations of the LLC. Only the managing members have the authority to enter into contracts and other business arrangements on behalf of the company. However, the managing members typically do not have unlimited authority. Critical decisions such as dissolving the company, selling key assets, or adding additional members can still require an affirmative vote by all members. For example, a managing member may have the authority to purchase the production inputs for the upcoming crop year. However, the managing member would be required to receive permission from a member-wide vote if he/she wished to sell the company's real estate.

The managing member system has several advantages over the member managed system. First, it puts management into the hands of the member(s) who have the talent, skills, and desire to manage the company. Second, it allows those members to be inactive who do not want a managing role and thus benefit by not being subject to self-employment (FICA) taxes. Lastly, only a limited number of members have the authority to bind the company.

## ***Procedure for Liquidation and Dissolution***

The operating agreement should have a contingency plan if or when the LLC is dissolved. The LLC may be dissolved voluntarily by member agreement, upon the expiration of a specified length of time or upon a triggering event. Typically, the plan will call for outside creditors to be paid first followed by member creditors. After all debt is paid, capital contributions are returned to members

and any remaining capital is distributed to the members in proportion to their ownership.

## ***Arbitration and Mediation***

There will be times when members cannot resolve a conflict among themselves. In such an event, the operating agreement can force the parties to arbitration and/or mediate before resolving the conflict in the judicial system. Mediation and arbitration are often less costly and move more quickly than a lawsuit. The members can either agree to be absolutely bound by the mediation/arbitration or merely use it as a means of attempting to resolve a dispute before going to court. Arbitration and mediation clauses are designed to save both the members and the LLC time and money in the process of resolving disputes.

## ***Death of a Member***

In the event of a death of an LLC member, the operating agreement will determine where their interest is allowed to go. The operating agreement will often allow for the deceased lineal descendants to inherit their ownership without approval from other members. Spouses may be allowed to inherit the deceased ownership but there are risks with spouses being owners. The spouse may remarry and then divorce or predecease the second spouse. Now, the second spouse may receive the ownership in the LLC and what once was a family owned LLC now has a third party stranger involved in ownership. Other options for dealing with the deceased member's ownership is allowing the company to buy the interest from the estate, allow the other members to buy from the estate, or place the interest in trust.

If there is no operating agreement or the operating agreement does not address deceased members' interest, the Ohio Revised Code controls the disposition of interest. In that situation, the ownership interest may be transferred to anyone. However, if the person receiving the interest is not already a member of the LLC, they only become a full, voting member with the approval of the other members. Otherwise, the new owner is entitled to profit and losses from the LLC but has no say in management.

## ***Transferability of Ownership Interests***

Transferability of ownership interests refers to how ownership interests may be transferred and who may own interest in the LLC. State default rules allow LLC ownership interest to be transferred to any party, but unless they are admitted to the LLC as a member by unanimous consent of the other members, they are only entitled to an economic interest in the LLC. Someone having only an economic interest in an LLC, called an assignee, will

be entitled to any profits and distributions made by the LLC, but is not entitled to participate in management and may not vote in company matters.

Like other aspects of the LLC, the default rules regarding ownership interest may be overridden by an agreement among the LLC members. The agreement controlling transferability of ownership interest is typically called a buy-sell agreement and may be integrated into the operating agreement or may be a separately executed document. There are several key concepts that every operating agreement should address.

### ***Who May Become a Member***

The first and most important issue to address is eligibility for membership in the LLC. In some situations, the buy-sell agreement will have a very liberal policy of allowing new members so as to attract more investors and capital. In other situations, a very strict policy may be implemented to limit or even restrict entirely the admission of new members into the LLC. A typical LLC will fall somewhere in between. That is, having some restriction on additional members so that not just anyone can join the LLC but also not so restrictive that new members are essentially prevented all together.

Generally, closely held LLCs will tend to have more restrictive buy-sell agreements. There are several reasons for this. First, a closely held company will typically have a small number of members that have a great deal of control over the LLC. The control may be in the form of management rights and/or voting rights. Each time a new member is added to the LLC, the existing members' management and or voting power is diluted. The existing LLC members may restrict new members to protect their control over the company.

Second, closely held companies are often family businesses. The family/LLC members may go to great lengths to keep the company in the family, particularly if the underlying business and assets are tied to the family heritage. For example, a farm family that establishes an LLC to hold farmland that has been in the family for generations will likely make it very difficult, if not impossible, for anyone other than family members to have an ownership interest in the LLC.

### ***Options to Purchase***

Most buy-sell agreements will provide the members of the LLC and perhaps the company itself with an option to purchase another member's interest before it can be transferred to a non-member. This is yet another technique for limiting the ability of non-members to be admitted to

the LLC. For example, Member A dies and leaves all of his ownership interest in the LLC to his wife. The buy-sell provision provides that before the wife can take ownership as either a member or assignee, Members B and C as well as the company has an opportunity to buy Member A's membership units from his estate. If Member B, Member C, or the LLC buys Member A's interest, the estate will receive all the proceeds from the purchase.

The same process could be used if Member A received an offer from a non-member to buy his LLC interest, if Member A went bankrupt and creditors attempted to attach his interest, or if Member A divorced and his LLC interest was given or awarded to his wife. The concept of purchase options give the company and the other members first chance at purchasing other members' interest before being transferred to a non-member.

### ***Discounting***

Another aspect of the transfer of ownership interest is discounting. In closely held LLCs, discounting is often used to account for the lack of marketability, lack of control, minority holdings, or other factors that would affect the value of any member's holdings. The members may agree to a predetermined discount value that is included in the operating agreement. Discount values can be as high or low as the members wish but typically discount rates will be 10–30%. Sometimes the operating agreement allows for the discount to be determined by an appraiser at the time of a triggering event rather than having a preset discount in place.

To illustrate how discounting works, consider an LLC formed to hold real estate that restricts transfer of ownership interests to family members only. The real estate within the LLC has a fair market value of \$1,000,000. The five members, having equal ownership, have agreed to a 20% discount. If Member A wishes to sell his entire interest to Member B, B will pay A \$160,000 ( $\$200,000$  ownership interest @ 20% discount = \$160,000).

The discounting is appropriate because even though the FMV of the assets are \$1,000,000, the ownership interest of the LLC is not available to the open market. Only a very few buyers exist, usually the current LLC members and their families. Therefore, with such a limited pool of potential buyers, the value of any member's interest in the LLC is something less than fair market value.

It is important to note that while the discounting is binding upon the LLC members, the discounting is not binding upon the IRS. It is always possible that the IRS will use a different discount rate when calculating estate or gift tax liability.

Discounting can be used in closely held LLCs as a deterrent to transfer ownership interest to other parties. For example, a two member LLC holds land valued at \$1,000,000 with a 20% discount and purchase options for the members. If Member A attempts to sell his interest to another party, Member B can exercise her option and buy Member A's interest for \$400,000 (\$500,000 at 20% discount). Member A has essentially sold \$500,000 worth of land for \$400,000 to Member B.

### **Financing**

There may be times when an LLC member may wish to buy another member's ownership interest but does not have the money to pay the selling member. To prevent such a situation, the buy-sell agreement may contain a financing mechanism to make a purchase more feasible for the buyer. Example financing terms would be for the purchasing member to pay 10 percent down with the balance amortized over 10 years documented by a promissory note which may or may not be secured. An interest rate usually accompanies such purchase agreements. Often agreements state that the interest rate on the unpaid balance will be at the lowest applicable federal rate as published by the IRS. The financing mechanism is another means of keeping the LLC membership in the family or closely held group of persons by making it easier for the Buyer to finance the purchase. Additionally, the financing may deter a member from "cashing out" because of the less than advantageous financing terms for the Seller.

Using the above example in the discounting discussion, Member B exercises her option to purchase Member A's ownership interest for \$400,000. Member B also chooses to use the financing mechanism which is 10 percent down and the balance paid over 10 years. Now, Member B would pay \$40,000 in cash at the time of the sale and can pay the

remaining \$360,000 over the next ten years with interest being paid on the unpaid balance.

### **Farm Service Agency (FSA) Programs**

Some FSA program payments are affected by the type of business entity that the producer is operating under. Addressing this matter is far more involved than the scope of this publication will allow. It is critical that producers, particularly grain producers, seek legal advice regarding the impact of the chosen business entity on FSA payments. For example, organizing a grain operation as an LLC or corporation will limit FSA direct payments to only one payment limitation.

### **Seek Professional Advice**

The LLC provides an alternative and possibly attractive business entity for many Ohio farm businesses, in part because of its relative ease of establishing and managing. However, it is highly recommended to seek professional advice when setting up an LLC. A well-thought-out and drafted operating agreement can save a great deal of stress, frustration, and money by addressing at start-up, how future issues will be dealt with. Furthermore, the business structure of the farm business should be compatible with the producers' estate plans and business succession plans. Seeking advice from an attorney familiar with business issues, particularly farm business issues, is a good investment of resources.

Another professional that should be consulted is an accountant. The tax structure and financial management of the LLC is also a critical issue best addressed at business start-up. Taxation of businesses can be very complex and errors in taxation or financial management can be very detrimental to the business.

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