FARM COMMONS

Farmer’s Guide to Choosing a Business Entity

Part 3—Special Considerations

Chapter 2: To Diversify or Not to Diversify

Introduction

The most successful sustainable farm businesses often have several aspects to the farm operation. With multiple revenue and marketing avenues, the farm is better able to withstand disruption in one area of the business. Diversification can create opportunities to expand the business for incoming family members or partners. It can also create deeper engagement with existing customers by giving them new ways to engage with the farm business. Of course, profitability is always an excellent reason to diversify. For farms otherwise dependent on raw agricultural product sales, added value products and diversification can tap into more profitable revenue streams.

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Farm diversification comes in all shapes and sizes. An herb farm may decide to dry its product and create a line of teas or culinary products. A berry farm may expand into processing jams or frozen fruits. As customers seek new ways to connect with the source of their food, many farms are hosting educational classes, tours, and other farm events. Farmers with a wealth of experience are making their knowledge available to other farmers and organizations through consulting. Each of these are unique and important diversification opportunities.

Each of these diversification opportunities presents interesting legal questions for the farm business entity. One primary question many farmers face is whether to keep the new operation within the existing farm business entity or start a new entity. For example, Berry Farm, LLC may decide to create Berry Farm Jams, LLC. The production and marketing of strawberries occurs under the farm-related LLC, while the production and marketing of jams occurs under the jam-related LLC. In the alternative, Berry Farm, LLC might decide to create a subsidiary entirely owned by the farm with the name Berry Farm Jams, LLC. Or, all of this may be too much trouble and Berry Farm, LLC may simply choose to make jam within the existing farm entity.

Which is the right choice for Berry Farm, LLC? As with so many legal questions, there isn't a single correct answer. A farm considering diversification needs to analyze several different factors and come to a conclusion based on the unique characteristics of their existing farm and planned diversification. This chapter discusses the various factors farmers should consider, although it's not an exhaustive list. This chapter is designed to be read along with the *Farmer's Guide to Choosing a Business Entity* as other sections in the guide provide much more detail on the characteristics of several available business entities.

Farms considering adding value to their raw agricultural products have a lot of legal issues to consider aside from the choice of a business entity. Zoning rules, insurance, and labeling laws all come into play. Learn about managing these new obligations by reading the Farm Commons guide titled “Adding Value to Farm Products: Getting your legal ducks in a row”.

IntroductioKey Factrors to Consider When Deciding Whether to Create an Additional Entity

The time and monetary cost

The potentially high time and monetary costs of creating a separate entity are the primary drawbacks.

> “The cost of establishing and maintaining a separate entity is the first factor to consider.”

The cost of establishing and maintaining a separate entity is the first factor to consider. Nearly every state charges a fee for creating an entity and for annual maintenance. The new enterprise might need separate insurance policies, tax licenses, and other government or administrative permits like zoning or use permits. At the end of the year, each entity requires its own tax filings and perhaps its own fee for the preparation of those taxes. The initial and ongoing costs can add up quickly and are enough to give a farmer pause before creating another entity.

If you are trying to track down the application fee and annual fees for establishing a business entity, start with your state’s business entities registration office which is likely the Secretary of State. They usually handle the creation of business entities. Answers should be available by phone or at the agency’s website.

As farmers will understand from reading earlier chapters of this guide, filing the legal paperwork to create an entity isn’t enough to earn the protections it offers. An LLC, S corporation, C corporation, or cooperative is only legally resilient if the business owner follows best business practices: separate bank accounts, maintenance of separate books, and separate formation documents such as bylaws or operating agreements. If a farmer creates a separate enterprise to house a jam processing operation, for example, the farmer needs a new bank account, separate bookkeeping, and new bylaws or an operating agreement specific to the jam entity. Bookkeeping, accounting, and legal fees can essentially double with the creation of a second entity.

Create a plan to implement best business practices for the LLC, S corporation, and C corporation by reading through our chapters on these entities in this guide.

The cost and administrative burden of starting a second business entity might be the only drawback for the diversified farm business, but that doesn't mean that it is insignificant. To really understand its role in the decision-making process we need to weigh this drawback against the benefits gained from creating a separate entity.

Going through the processes of establishing a separate enterprise can a benefit itself! Maintaining a separate bank account, books, and governing documents such as an operating agreement or bylaws may help the farmer manage the diversified enterprise over the long term. Separate books and tax filings can make it easier to understand the enterprise's financial situation. Having to write an entirely new operating agreement or bylaws may motivate the owner and any business partners to think through the contingencies of the diversified enterprise itself. On the other hand, nobody wants to do paperwork just for the sake of it. If the farmer and any business partners aren't learning anything new through the process of drafting a new governing document or creating new operating procedures, perhaps it isn't worth the time. In short, don't assume that writing a new organizing document is a negative thing for your farm. Going through the process may lead to a more resilient business over time.

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Learn how a group of neighboring farmers benefitted from the process of drafting an operating agreement for their new cooperative marketing LLC at the Farm Commons website. Watch the short video profiling the experience of Pasture Perfect Poultry on our About page.

Different owners or investors

If the diversification venture has different owners or investors, there may be a benefit to forming a separate entity.

For most farm businesses, it's not essential to form a separate entity just because new stakeholders join the business for the diversification enterprise. The original farm entity could create a separate class of members or shareholders relative to the diversified enterprise only. The separate class or share type could have different contribution, distribution, and procedural rules that apply only to those folks. The existing bylaws or operating agreement could be revised to accommodate new shareholders or members. However, the process can inadvertently open up a can of proverbial worms and lead to a long, drawn-out revision process with many stakeholders.

Creating a new entity is often the fastest, easiest way to create a new framework for different owners or investors. A separate entity gets to start fresh and avoid discussion or compromise with existing stakeholders. New owners and investors may have such different needs that they want to create a new operating agreement or bylaws entirely.

If the farm entity files taxes as an S corporation, a new entity may be the only option if a new owner's needs are quite different than current owners. S corporations are only allowed one class of shares. S corporations offer less flexibility to accommodate various types of investors.

A "class" of shares refers to the rights and obligations of a specific type of shareholder.

To summarize, if the existing business is an LLC, C corporation, or cooperative, the organizational documents could be adapted to accommodate different classes of ownership/investment. If the existing farm business files taxes as an S corporation, the new owners/investors must receive the same return on their investment as existing owners/investors. Or, they must create a separate business entity.

Valuable assets or large investments

If the new diversified venture will bring in valuable assets or significant investment, there may be a lot of benefit to creating a separate entity.

"If one enterprise has assets that are particularly valuable, it may be wise to isolate those assets to a separate entity."

As farmers know from reading this guide, a business entity protects personal assets from business liabilities. The business' assets are still available to satisfy business liabilities. If one enterprise has assets that are particularly valuable, it may be wise to isolate those assets to a separate entity. For example, let's say that a vegetable farm is thinking of installing a commercial kitchen to produce peeled and chopped root vegetables. The processed vegetables will fetch a higher price and allow the farmer to expand into new markets. But, the commercial kitchen will require tens of thousands of dollars of equipment. If the farmer operated the processing kitchen within the farm business, the commercial kitchen assets would be available to satisfy liabilities that extend from the farm operation. In addition, a person with a legal claim against the processing operation could take the assets of the farm. For this reason, many business owners prefer to create separate entities to house businesses with assets of significant value. If the diversified operations are placed in separate entities, each of the entities and the owners are insulated from the business liabilities of the other.

At first blush, this factor seems very persuasive. Farmers might be thinking, "My farm assets are valuable, and I want to insulate my land and equipment from risk, so this is a major benefit." While this logic is sound, we don't need to take it too far. Any farmer's first line of defense against liability is insurance. Businesses carry insurance so that they don't lose their assets if they become legally liable. The insulation provided by a separate business entity generally only comes into play if the insurance policy is nonexistent or insufficient. More robust insurance coverage can create a stronger first line of defense. Then, after that step is been taken, farmers can consider whether a separate entity is worth the increased costs to create a secondary line of defense.

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Farmers are understandably concerned about losing their land to a legal liability. To help manage this risk, farmers generally prefer to keep their land under personal ownership. They don't transfer title to the land to the business entity. The reasons are both personal and practical. Legitimately, land often is a personal asset passed down from family member to family member. Unlike a potato planter or commercial processing equipment, people own land for personal use. In a farm business where the land is used for the farming enterprise the landowner personally leases the land to the business enterprise. If the farm is sued, the insurance policy will kick in as a first line of defense. If the insurance policy doesn't cover the loss or is insufficient, the creditor might look to business assets next. Then the second line of defense, our entity, kicks in because the creditor can't reach the land–it's a personal asset.

Any time a farmer adds a new aspect to the farm operation, he or she should check into the farm's insurance situation. Especially with activities like processing, education, and agri-tourism, the usual farm liability policy probably won't provide coverage. Getting good insurance coverage is essential to protecting the diversified venture's assets. Whether the existing policy provides coverage, what new policy might be needed, and how much coverage may cost all depend on very specific factors. Farm Commons has a resource to help farmers get a start in understanding their insurance options. Read Farm Commons guide *Managing the Sustainable Farm's Risks With Insurance: Navigating common options* at our website.

To summarize, farms looking at a farm operation and a diversified venture with disparate or distinct asset values might more strongly consider creating a second business entity insulate assets from potential liability. But, insurance and careful allocation of business and personal assets also help manage risks even if a separate entity is not established.

Uniquely risky ventures

If the new diversified venture is particularly risky, creating a separate business entity can be very beneficial.

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If the new venture will expose the farm to much greater risk than it has experienced in the past, it may be wise to isolate that risk within a separate entity. The processing kitchen is a great example here, as well. Processing food can introduce new vectors for contamination and increase the chance of a food safety incident. One of the benefits of diversifying a business is that it opens up new buyer and markets, but that too can expand risk. The same caveats as we described above about insurance being the first line of defense still apply, but creating a second entity is a good second line of defense here.

As a contrast, let's say a farmer is launching a new consulting venture. The risks inherent to advising other farmers about their business are quite low. There's not that many ways to injure people or property while sitting at a desk dispensing advice! Doing consulting under the umbrella of the existing farm business likely doesn't increase total risk exposure significantly. The farmer would still want to talk to his or her insurance agent to make sure the consulting activities are covered, but creating an entirely separate entity may not be an efficient choice.

Different employment law obligations

Farms that benefit from more lenient farm employment laws may have more to gain from forming a separate entity for diversified ventures.

Here's some background on the situation. In some states, farms are not obligated to follow the same employment laws as non-farm businesses. Farms up to a certain size may not need to pay the same minimum wage, provide the same workers' compensation coverage, or pay into unemployment insurance like a non-farm business. However, these exceptions only apply to farm activities. The distinction is a subtle but important one. It's not the farm business that gets the exception from employment laws–it's the farm activity. If the farm engages in non-farm activities (such as processing, education, and agri-tourism), those activities may need to follow non-farm rules.

Not sure how to move forward exploring your farm's employment law obligations? Read Farm Commons' guide titled *Farm Employment Law: Know the basics and make them work for your farm.*

"If the farm business is benefitting from more relaxed farm employment laws, it may want to protect those benefits by creating a separate entity for the diversified venture."

If the farm business is benefiting from more relaxed farm employment laws, it may want to protect those benefits by creating a separate entity for the diversified venture. By creating a separate entity, farm and non-farm labor are kept separate. This may benefit the farm by allowing it to preserve the less strict employment laws for the farm labor. Essentially, the employee is working for two different companies at that point-–two companies that follow different wage and benefit rules. If the two enterprises were mixed, the exemptions for the farm labor might be lost completely (generally if the non-farm labor comprises half or more of the employee's time).

Different states and the federal government handle farm and non-farm obligations quite differently. This resource will not explain those differences, It's just meant to point out that they exist and that diversification can change the farm's employment law obligations. Whether or not a specific farmer benefits from creating two entities depends on the state it's located within and its existing employment law obligations.

Different succession or transfer plans

If the farm and the diversified enterprise will be transferred to two different individuals or in two different ways, there may be more benefit to creating a separate entity.

Transfer of the business is one of the top reasons farms form business entities in the first place. By creating units of ownership such as shares or percentages of interest, the farm has a handy unit with which to transfer ownership as a whole (rather than transferring individual assets). Also, creating the operating agreement or bylaws can guide the succession process by laying out how decision making and authority transfer along with ownership.

Because the process of creating and defining the entity is often part and parcel of the business succession, it usually makes sense to create separate entities if the owners prefer that the separate enterprises and assets are passed on to different individuals. So, if a farm owner is already planning to transfer a new diversified venture to a different person than the farm as a whole, that's a good reason to create a separate entity right away. Then when the time comes to transfer it, a foundation is already in place. Naturally, if the envisioned transfer is many years down the line, creating a separate entity could be a bit premature if annual costs for registration, taxes, and accounting will pile up. The ultimate benefits and costs of creating a separate entity for succession planning purposes depends on the farm's timing, location, and expenses.

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How can creating an entity help a farmer transfer the business? Watch a short video on Highland Valley Farm and how they created an S corporation to transfer the business to the next generation. It's at the Farm Commons website on our About page.

Conclusion

Creating a separate entity for a new venture may be the right choice for many farm businesses. But, each situation is different and farms should make a careful decision by analyzing the above factors, among others. Farm Commons always recommends meeting with an attorney and an accountant before making significant choices like these.

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RACHEL REPONDS

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