Farmer's Guide to Sole Proprietorships and General Partnerships

LAST UPDATED:
January 27, 2016

FIRST PUBLISHED:
January 27, 2016

By: Rachel Armstrong, Erin Hannum, Laura Fisher and Lisa Schlessinger
www.farmcommons.org

TABLE OF CONTENTS

SECTION 1: SOLE PROPRIETORSHIP AND GENERAL PARTNERSHIP FUNDAMENTALS

Sole Proprietorships and General Partnerships At A Glance 3

Introduction 4

Basic Characteristics of a Sole Proprietorship and General Partnership 4

- Sole proprietorships and general partnerships are easy to create and manage
- The personal assets of the owners are NOT protected from the business' liabilities

Preparing a Partnership Agreement for a General Partnership 8

Implementing Good Practices for Your Sole Proprietorship or General Partnership 11

- Obtain required licenses and permits
- File the proper tax forms with the IRS

SECTION 2: JOINING FORCES WITH OTHER FARMERS 15

NORTH CENTRAL SARE Sustainable Agriculture Research & Education

This product was developed with support from the Sustainable Agriculture Research and Education (SARE) program which is funded by the U.S. Department of Agriculture -- National Institute of Food and Agriculture (USDA-NIFA). Any opinions, findings, conclusions or recommendations expressed within do not necessarily reflect the view of the SARE program or the U.S. Department of Agriculture. USDA is an equal opportunity provider and employer.

FARM COMMONS

Section 1:
Sole Proprietorship and General Partnership Fundamentals

DISCLAIMER: This guide does not provide legal advice or establish an attorney client relationship between the reader and author. Always consult an attorney regarding your specific situation.

AT-A-GLANCE CHART: SOLE PROPRIETORSHIPS AND GENERAL PARTNERSHIPS

General Concept	Sole Proprietorship	General Partnership
Name	"Your Name", unless register a different "DBA" (doing business as) name	"Your Name", unless register a different "DBA" (doing business as) name
Owners / Investors are called:	"Owner"	"Partners"
Persons who make management decisions are called:	"Owner"	"Partners"
Creation document is called:	None	None
Organizing document is called:	None	"Partnership agreement" (optional)
An owner's investment in the company is called:	"Contribution" or "investment"	"Contributions" or "investment"
An ownership share is called:	Not relevant, sole owner owns all	"Ownership interest" or "equity"
A payment of the company's profits to the owners is called:	Not relevant, as the personal assets and business assets are not separate. So all the profits that come in are one and the same.	"Distribution"
Is there personal liability?	Yes, there's no protection of personal assets from the business' liabilities	Yes, there's no protection of personal assets from the business' liabilities
How many participants can you have?	1	2 or more
Is an EIN necessary?	Not required	Not required
Who files the tax return?	Pass-through. Individual owner reports and pays taxes on the business' earnings when filing an individual tax return.	Pass-through. Partners each report and pays taxes on their share of the business' earnings when filing their individual tax returns.

Introduction

Sole proprietorships and general partnerships are the easiest business entities to set up and maintain. In fact, nothing is actually required to create them. You may already be operating one without even knowing it! For example, if you own your farm operation and you're not on an employer's regular payroll for the work you do, you are automatically a sole proprietor. If you and a friend or a group friends are doing it together, you are automatically a general partnership. It may very well be that you want to maintain this simplicity and are not at all interested in officially forming a business entity. This chapter highlights some risks involved in keeping your farm operation as a sole proprietorship or general partnership, as well as things you can do to protect your interests along the way.

"The sole proprietorship and the general partnership are the default entities if you don't choose and officially form another entity."

Basic Characteristics of a Sole Proprietorship and General Partnership

Sole proprietorships and general partnerships are easy to create and manage

The sole proprietorship and the general partnership are the default entities if you don't choose and officially form another entity. If there's just one person involved, it's a sole proprietorship. If there's more than one person involved, it's a general partnership. You don't need to do anything to actively form it. For the most part, there's no filings and no paperwork.

If there's just one person involved the default entity is a **sole proprietorship**. If there's more than one person involved, it's a **general partnership**.

However, some registrations, licenses and permits may be required. For example, if the farm operation wants to operate under a different name than the name of the owner(s), then it will need to file a name registration form with the county or state agency that manages what's called fictitious business names in your area. This is also called a "DBA" or doing business as. In addition, most cities and many counties throughout the country require all businesses–even small farm-based sole proprietorships–to register and get a business license or a tax registration certificate. The local agency may also require the business to pay a minimum tax. Also, if the farm operation has employees, it must obtain an employer identification number or EIN with the IRS. This is used for monitoring and paying required employment taxes. States may also require the farm business to get a seller's license before selling anything to the public, and the local planning board may require the farm business to have a zoning permit depending on the location of the farmland.

These are essentially simple forms that all businesses in a given area have to file. Other than that, the sole proprietorship and general partnership is ready to go.

The personal assets of the owners are NOT protected from the business' liabilities

Nothing good seems to come without a trade off. This is the case here. Unlike with a C corporation or an LLC, the personal assets of the owner(s) of a sole proprietorship or general partnership are available to cover the debts and liabilities of the company. Basically, this means that if the farm business starts struggling and is not able to pay its debt, doesn't pay a supplier when the money is owed, or has to defend itself in a lawsuit brought by an employee, the creditor or court can legally come after the owners personally and grab hold of their assets. While bankruptcy laws for the most part protect primary homes, the creditors can most likely access personal bank accounts, cars, vacation homes, boats, and other such things of value. Some folks think they don't have any assets, so it's fine. But, a court judgment –whether related to debt to a creditor or damages to a defendant– can extend to future owned assets, including wages. Basically, if the creditor has received a judgment from a court that you owe money, the creditor can file papers to have a portion of your paycheck garnished (taken or withheld) to pay off your debt. However, the creditor cannot take the part of your paycheck that you need to support yourself and your dependents.

> "Unlike with a C corporation or an LLC, the personal assets of the owner(s) of a sole proprietorship or general partnership are available to cover the debts and liabilities of the company."

The sole proprietorship provides no protection over personal assets

An example here will help illuminate this risk. Let's say that Judy runs a small dairy farm over the summer. The seasonal dairy farm has been mostly a hobby for her, as she loves taking care of the cows and loves making cheese. She's a school teacher, so the schedule is perfect for her. The farm itself is about 2 acres that she leases from her neighbor. It's located just down the road from her house that she bought just a year ago. She has another house in the city that she hasn't been able to sell yet. Judy mostly sells her cheese at the local farmers' market and to two local restaurants. She's been in business for about two years and has two Brown Swiss cows and two Jerseys. This summer Judy decided to hire a part-time volunteer to help her with the milking, as she wanted to focus her efforts on refining her cheese recipes. Her friend's daughter, Katie, was in town from college, and was eager to help. Katie had some experience with milking cows, but it was years ago when she was a kid visiting her grandparent's farm. Judy encouraged

Katie to stick with the Brown Swiss until she got used to it, as the Jerseys were notorious kickers. One day, just two weeks into her volunteer gig, Katie got the guts to milk one of the Jerseys. Just as she finished and she walked around back, it kicked her right in the chin. Ouch! Turns out she lost about five teeth, and had to get reconstructive surgery of her jaw.

While Katie didn't make anything of it, when she was at the hospital filling out the paperwork, she reported that the incident occurred on Judy's farm while she was at work. Without her knowing, Katie's health insurance company did some investigation and filed a claim against Judy to recover cost of the medical bills, which were quite astronomical at $25,000! Judy didn't have that kind of cash, and she didn't have insurance to cover such claim. Katie's insurance company was relentless and took her to court. After a long and drawn-out trial, the judge entered a judgment against Judy for the full amount of the medical bills. Meanwhile, the state department of labor started to investigate Judy's farm operation. It concluded that Judy failed to treat Katie as an employee, and issued a fine and required her to pay back wages at the minimum wage rate and employment taxes.

"For general partnerships, not only are your personal assets available to cover the business liabilities related to your own actions, they also apply to committments your partner(s) made."

In this circumstance, the court could put a lien on Judy's house in the city since it's no longer her primary residence. Also, the court could garnish a percentage of Judy's wages from her school teaching job. If Judy had formed an LLC or a C corporation, these personal assets would have been protected from the business' liabilities. The reason this happens is because there's no distinction between the person and the business with the sole proprietorship form. They are one and the same. On the plus side, the individual farmer is the business. Some farmers prefer the authenticity and integrity that comes with such a personal identity with the farm operation. However, this means that everything you have is vulnerable.

The problem is magnified for general partnerships

For general partnerships, not only are your personal assets available to cover the business liabilities related to your own actions, they also apply to commitments your partner(s) made. This means that individual partners have joint authority and joint liability. When it comes to authority, each individual can usually bind the whole farm business to a contract or other business deal. As for joint liability, each individual partner can be sued for–and required to pay–the full amount of any business debt. So if you have more personal assets than your partner, you are particularly at risk. Your only recourse may be to sue the other partners to recover their share of the debt. But if they have no money, doing so would be futile. Recall, too, that a general partnership is the default entity and can be formed without you even knowing it. A court may decide, based on the fact that you have gone into business with another person, that you have a partnership over the farm operation's obligations.

"A general partnership can be formed without you even kowing it. A court may decide, based on the fact that you have gone into business with another person, that you have a partnership over the farm's obligations."

Again, an example can be helpful here. Let's say that Joe and John are brothers and they've been operating an organic vegetable farm for the past decade on a 20-acre farm property that was handed down to them and their two sisters by their parents. They haven't been turning much of a profit, but they get by just fine. John is also a math professor at the local community college and makes a pretty good living on the side. He teaches mostly in the winter, so he's able to spend a significant amount of time on the farm during the growing season. John also has a mountain house, and enjoys spending long winter weekends relaxing up there. Joe doesn't have a second job and just tries to live simply. Joe and John decide they should get a greenhouse so they can provide produce year-round. John puts Joe on the project and they agree that they have about $20,000 to spend on it. Joe goes online to do some research and gets a bit carried away. He chooses a 2,500 square foot greenhouse that costs $250,000. The greenhouse company offers a 10-year payment plan with a cost of $2,000 a month. The greenhouse arrives and Joe assembles it. John notices how amazing it is, and thinks, wow, that's quite a greenhouse for $20,000. He doesn't think to ask Joe anything else about it.

Once the $20,000 budget is exceeded at month 10, Joe stops making payments on the greenhouse. Six months go by, and after much warning, the greenhouse company files a claim in court. Ultimately, it gets a judgment against John and Joe, as the court concludes they were operating the farm business as a partnership. As such, Joe was authorized to purchase the greenhouse on behalf of the partnership, and John's assets are on the hook to cover the partnership's debts. The court puts a lien on the farm property, but it's not enough to cover the full debt. And, the farm property is also owned by their sisters, who are not part of the farm operation. The court finds out about John's mountain house and puts a lien on it to cover the debt. The court also garnishes a portion of John's wages from the community college. As you might imagine, John is quite upset with Joe. While he could sue Joe, it's not worth it because Joe doesn't have any personal assets. So, he must suck it up and pay for his partner's bad decision.

Becoming a partnership without even trying

The example of John and Joe is quite the cautionary tale. Now, recall that a partnership is incredibly easy to form–so easy, in fact, you can accidentally form one. How can that happen? Read more about the risks of "accidental" partnerships in part 3, chapter 3 of the *Farmer's Guide to Choosing a Business Entity* on Joining Forces with Other Farmers: Business Entity Issues to consider when a farm operation works with other farms.

There are ways to get around these concerns

"Insurance should be the first line of defense, even if you have a business entity such as an LLC or corporation."

While these concerns are real, and every farm operation that is operating as a sole proprietorship or general partnership should be made aware of them, they shouldn't be overstated. There are mechanisms to help protect the personal assets of owners that run sole proprietorships and general partnerships.

First, insurance should be the first line of defense, even if you have a business entity such as an LLC or corporation. Second, many debts can be restructured or discharged through bankruptcy. This is not a solution, it's simply a fact. It's also worth noting that while other entities such as the LLC, C corporation, and cooperative offer protection over the owners' personal assets, it's not absolute. If the owners do not uphold good business practices, such as properly capitalizing the entity, keeping personal assets separate from their business assets, and keeping good accounting records, creditors can still reach around the personal labiality protection provided by the entity.

Preparing a Partnership Agreement for a General Partnership

Sole proprietorships do not have organizing documents. This would be rather futile–there's just one owner, so she gets to make all the decisions for how to run the farm operation without having to refer to any instructions on voting and such. However, partnerships have the option to create a partnership agreement to outline the relationship. The partnership agreement allows the partners to establish the share of profits and losses that each partner will take, the responsibilities of each partner, and what will happen to the business if a partner leaves. If a partnership agreement is not in place, or if it is not thorough, state partnership statutes will fill in the blanks and determine what rules govern in such scenarios. The benefit of having a partnership agreement is that you can decide what is best for your farm operation and your relationship, rather than relying on your state's fallback rules.

"The benefit of having a partnership agreement is that you can decide what is best for your farm operation and your relationship, rather than relying on your state's fallback rules."

Key issues to consider and include in a partnership agreement

The following highlights some important topics that farmers should discuss with their business partners and ideally put into writing through a partnership agreement:

- Contributions to the partnership. It's essential that the partners decide and get in writing who's going to contribute what to the partnership, whether it's cash, property, or services, as well as the ownership percentage each partner will have. So if John had invested $60,000 and Joe and invested $40,000 then John would have a 60% ownership interest.
- Allocation of profits and losses. The partners may have different financial needs and different ideas for how and when the company's profits are divvied up. Will profits and losses be allocated to partners in proportion to their ownership percentage in the farm operation? Who decides whether and how much of the profits are handed out to the partners as distributions versus being reinvested back into the farm operation? These financial issues are particularly important to resolve early on, as they have a tendency to raise a lot of internal dispute.
- Partnership authority and decision-making. Without an agreement, any partner can bind the partnership without the consent of the other partner(s). For example, if a partnership agreement was in place that required both partners to agree before entering a significant debt on behalf of the company, John would have further protection against Joe's poor decision to purchase the $250,000 greenhouse. There's no perfect formula for partnerships. You may, for example, want to require unanimous vote for every decision. Or, if this seems too challenging, you can require unanimous vote for major decisions and allow each partner to make minor decisions on your own. If this is the case, you'll need to set a parameter for what is a major and minor decision. For example, entering a debt for more than $100,000 dollars is a major decision.
- Admitting new partners. What if new partners want to come on board?

The initial partners should agree to a procedure for this so it makes it easier when the issue arises.

- Withdrawal or death of a partner. For example, let's say that John wants to leave the partnership with Joe. This raises a lot of questions, including what the time frame is for him to receive a return on his investment in the farm operation or his share of the company. He likely won't want to just leave it all for Joe. So what assets might he expect to receive? How should the value of the business be determined in such a scenario? For example, if the farm operation was valued at $100,000 and John leaves, then he could expect to receive $50,000 in some form, including future payments by Joe. If this is not all fleshed out in a partnership agreement, then we can expect that the brothers may get snared up it a serious argument.
- Resolving disputes. If you and your partner become deadlocked on an important issue, how is the issue resolved? Do you want to head straight to court? Often times farm operations prefer an alternative dispute resolution, such as mediation or arbitration. The partnership agreement is the place to designate this.

While some of these issues are challenging and most likely folks won't want to talk about them, it's best if partners take the time to work through them at the outset. Even if the state's default partnership laws would work fine, going through the process of creating a partnership agreement will help create shared expectations and clearer lines of communication as well as make things much easier should these challenging issues arise. Overall, a partnership agreement can help foster a stronger, more resilient farm business for the long haul.

"The issues and contents of a partnership agreement and the LLC's operating agreement are very similar."

Refer to the LLC chapter in this guide for further guidance and resources

A model partnership agreement is not provided in this guide, as most farm operations prefer the LLC structure if they're going to go through the trouble of creating an organizing document. The LLC is taxed the same way as the general partnership, and for all intents and purposes operates in a similar way. Also, the issues and contents of a partnership agreement and the LLC's operating agreement are very similar. If you decide to stick with a general partnership but decide to prepare a partnership agreement, refer the following chapter on LLCs (part 2, chapter 2 of the Farmer's Guide to Choosing a Business Entity. Section 1 of the LLC chapter includes a thorough discussion on what issues should be included in an operating agreement, which is for the most part the same for a general partnership. Section 2 of the LLC chapter includes two sample LLC operating agreements–Brief Operating Agreement for Married Couple Farm, LLC and Extensive Operating Agreement for Sun Sisters Farm, LLC–as well as a Checklist: Preparing Your Farm's Operating Agreement. These resources serve as helpful guides in preparing both an operating agreement and partnership agreement.

"Certain registrations, licenses, and permits may be required for sole proprietorships and general partnerships."

Implementing Good Practices for Your Sole Proprietorship or General Partnership

Obtain required licenses and permits

As mentioned above, certain registrations, licenses, and permits may be required for sole proprietorships and general partnerships. These include the DBA registration form with your state or county agency, should you choose to use a name other than the name of the owners. In addition, most cities and many counties require all businesses to register with and get a business license or a tax registration certificate, which may also require the business to pay a minimum tax. Also, if the farm operation has employees, it must obtain an employer identification number or EIN with the IRS. This is used for monitoring and paying required employment taxes. States may also require the farm business to get a seller's license before selling anything to the public and the local planning board may require the farm business to have a zoning permit depending on the location of the farmland. All these forms are pretty straightforward.

"The partnership itself does not pay any income taxes on the business' profits. Business income simply passes through the business to the owner(s)."

File the proper tax forms with the IRS

Neither a sole proprietorship nor a general partnership is a separate tax entity. It is considered one and the same as its owners. This is what the IRS calls a "pass-through entity." In effect, the partnership itself does not pay any income taxes on the business' profits. Business income simply passes through the business to the owner(s). Each owner will report his or her share of the profits (or losses) on his or her individual income tax return. Basically, the farm operation's profits or losses are combined with the total tax situation of the individual owner(s). Partners may end up paying different tax rates depending on their overall financial situation or tax basis. While this is not a tax guide, the following provides a breakdown of the key tax forms that must be filed. This is not a comprehensive list of tax forms needed by a farm business, as other forms may be required depending upon employment and other issues. Be sure to talk with an accountant or tax attorney to confirm you are filing all the forms required based on your farm operation.

Sole proprietorship tax filings with the IRS

The Individual owners must file Form 1040, *Individual Income Tax Return* along with any relevant schedules, which may include Schedule F, *Profit of Loss from Farming* and, if required, a separate Schedule SE, *Self-Employment Tax*, to pay self-employment taxes.

"If the farm operation is run by spouses that meet the criteria of a qualified joint venture, or they live in one of nine community property states, the spouses can choose to pay taxes as a sole proprietorship."

If the farm operation is run by spouses, there are other options. If the spouses meet the criteria of a qualified joint venture, or they live in one of nine community property states, the spouses can choose to pay taxes on the farm business' income as a sole proprietorship. If this is the case, both spouses would need to elect the qualified joint venture status on Form 1040. The spouses would then need to file relevant schedules, most likely including Schedule F and, if required, a separate Schedule SE. Otherwise, the spouses would file as a partnership, which is explained below. It's best to consult with your tax accountant or tax attorney before making this determination and decision, as there are financial implications.

In addition, the individuals must make quarterly estimated tax payments to the IRS each year. Finally, you will need to be sure to comply with your state's income tax requirements.

Can a husband and wife operate a farm business as a sole proprietorship or do they need to be a partnership?

Note that if the other person is spouse, it may still be considered a sole proprietorship. The IRS has a special test to help you answer this question, which is available online at the IRS website by searching for "Question: Can a husband and wife operate a business as a sole proprietorship or do they need to be a partnership?"

General partnership tax filings with the IRS

Tax filing requirements for general partnerships are similar to those for sole proprietorships. However, while the partnership does not have to pay taxes, it does have to file Form 1065, an informational return, with the IRS each year. This form sets out each partner's share of the partnership profits (or losses), which the IRS

"It's best to consult with your tax accountant or tax attorney to confirm that your tax and financial affairs are in order."

reviews to make sure the partners are reporting their income correctly. In addition, like the owner of a sole proprietorship, each owner of the general partnership must file their individual tax return, Form 1040, along with the required forms to report the business related income, including, most likely Schedule F and, if required, schedule SE.

In addition, the individuals must make quarterly estimated tax payments to the IRS each year. Finally, you will need to be sure to comply with your state's income tax requirements.

Again, this is not tax advice and the tax forms listed here are not comprehensive for all farm operations. It's best to consult with your tax accountant or tax attorney to confirm that your tax and financial affairs are in order.

FARM COMMONS

Section 2: Joining Forces with Other Farmers

Introduction

Farmers have always known the power of working together, and today's sustainable farm businesses are no different. Many farmers are exploring a wide range of options for working with other farm businesses in meeting shared objectives. Multiple farms might combine product for a single community supported agriculture program. Other farms might reach a broader base of buyers by cooperatively marketing their products. Some farms are interested in sharing the burdens of distribution by forming a company that delivers to multiple buyers. Still other farmers are forming collective enterprises to purchase equipment, manage labor resources, and help educate the next generation farmers.

"Although their objectives for working together may differ, any farm business that joins with another for common purpose faces a range of legal considerations."

Although their objectives for working together may differ, any farm business that joins with another for common purpose faces a range of legal considerations. These are not necessarily barriers to cooperative efforts; they simply require conscious attention and decision-making.

The goal of this chapter is to help farmers identify some potential legal issues that emerge when farm businesses work together. Our emphasis is on concerns relative to choosing and organizing a business entity. Although plenty of other legal concerns exist, we encourage farmers to check out our employment and insurance law guides to get a feel for those issues. Here, we identify and discuss unique concerns with "accidental partnerships," joining a business as an individual or an entity, and the importance of thorough organization documents.

Key Factors to Consider When a Farm Operation Works with Other Farms

Here, we identify and discuss unique concerns with "accidental partnerships," joining a business as an individual or entity, and the importance of thorough organization documents.

Farmers can accidentally form a partnership, leaving all partners exposed to elevated risks

Whether helping each other bale hay, sort livestock, or deliver product, farmers work together all the time. We know that these acts of kindness are part of being a good neighbor and are essential for a less isolated and more enjoyable rural life. The law honors neighborly relations and helping out another farmer does not necessarily mean that the two of you are at greater risk.

Yet, a couple of farmers who work together consistently to achieve a shared purpose may cross the line into forming a business together at some point. This is where our legal concerns arise. This distinction between simply helping each other out and forming a business enterprise matters. Businesses and individuals have different legal obligations; we need to know when a business exists and when it doesn't. For example, we know from the Sole Proprietorships and General Partnerships chapter of this guide that partners in a legal "general partnership" are mutually responsible for each other's obligations and liabilities. To know if the individuals have that shared responsibility (as opposed to individual responsibility for their individual actions only) we need to know if the individuals have formed a General Partnership.

"Partners in a legal 'general partnership' are mutually responsible for each other's obligations and liabilities."

The answer to whether folks have formed a general partnership should be pretty easy, right? Did they sign documents to form one? Did they say they formed one? If only it were that simple! Because no formal action is required to form a general partnership, we don't have any clear indicating factor when one has been formed. It's all about whether the people involved are acting or representing themselves as if they are a business. Any time we have to evaluate behavior or representations, things get pretty murky. What does it mean to "act" like you've formed a separate business with another farmer?

"Because no formal action is required to form a general partnership, we don't have any clear indicating factor when one has been formed."

For better or worse, our legal system is all about drawing lines in the sand and forcing gray areas into black and white boxes. Whether two or more farmers have formed a separate business is precisely one of those grey areas that lawmakers and courts have tried to define as black and white. Generally speaking, people have formed a partnership when they 1) act like co-owners of a business and 2) intend to carry on the business for a profit (as opposed to intending to create a nonprofit). More specifically, the question is settled according to the laws of each state and the courtrooms that define state law. Still, we can generalize across all states. Each state relies on some version of the four main factors below.

Below, we explain each factor and use an example to help illustrate how a court might apply the factor to a farm business. Imagine for a moment that we have two hypothetical farmers joining together to market a community supported agriculture option. The first farmer, let's call her Sally, raises poultry for meat and eggs. Our second hypothetical farmer is Mary; she grows vegetables. Sally and Mary offer a single CSA share that combines vegetables, eggs, and chicken in one convenient plan. Mary and Sally haven't done anything distinct such as signing a partnership agreement. Both operate their own farms and haven't given much thought to whether their business is a partnership or two independent businesses assisting each other.

Factor: If individuals share profits from a common enterprise, a court is more likely to find that they have formed a partnership

Before we get further into this factor, let's outline a few basics. We are using the accounting definition of profit: business revenues minus business expenses. Profit goes beyond simply gaining a benefit. If one farmer helps another bring in the hay, the hay producer has benefited because he has more hay to sell, sooner. That's not the same as sharing in profit, though. The concerns of the individuals need to be economic, to an extent.

"If folks create a business plan together that calls for generating mutual profit, it looks like they're intending to form a shared business."

Profit must also be mutual. Let's use our example of Sally and Mary to illustrate this. Sally and Mary might distribute a single sign-up form that require CSA members to send in two checks, one to Sally for the eggs and chicken and one to Mary for the vegetables. In this situation, it looks like Sally and Mary may not generate a mutual profit. Each will keep their own books where they post individual revenues, deduct individual expenses, and earn a profit according to largely individual effort. This situation looks a lot less like a partnership.

By contrast, Sally and Mary might allow CSA members to write a single check, perhaps one written out to a farm name that is different from their own individual farm names. Sally and Mary might deposit this check into separate bank account from which they both draw to cover their expenses in producing chicken, eggs and veggies for the CSA. At the end of year, Sally and Mary might split any profit that remains. This, of course, looks a lot more like sharing profits from the common enterprise! There's still plenty of room to find that Sally and Mary have not formed a general partnership with this arrangement, but they are certainly closer than if they had taken separate checks.

Factor: If people intend, or appear to intend, to carry on a business together, a court is more likely to find they have formed a partnership

This factor is especially amorphous! What does it mean to "appear to intend" something? Although we can't define it, we can spot a few illustrations of an intention. If folks create a business plan together that calls for generating a mutual profit, it looks like they're intending to form a shared business. If they contribute investments to the business (or plan to do so), speak of each other as partners in their business, and both enter into commitments on behalf of the enterprise, it looks like they intend to have a business. Not doing these things (like not entering into any commitments and not making any investments) doesn't mean a business hasn't been formed, but having done them can serve as evidence.

Going back to our example of Sally and Mary, let's say that Sally and Mary discuss marketing efforts for their CSA. They agree that Sally will attend a CSA open house, distribute brochures, and take payments. While she's at the open house, Sally will also pick up some boxes from another farmer and pay for them with money Mary put into their shared bank account. In the meantime, Mary is meeting with a banker to talk about getting a modest loan for a distribution vehicle. Sally and Mary have agreed that Mary may sign a loan for up to $10,000 and that loan payments will be taken from the shared bank account. Each of these actions are signs that they think they are participating in business together. Both are acting on behalf of the other's interests–one in the sale of product and the other for a loan payment. Both are indicating an intention to pool money, with the future goal of generating profit from their mutual efforts.

"If people share common ownership of property or share control of the enterprise, a court is more likely to find they have created a partnership."

Keep in mind that whether an enterprise actually makes a profit, or even if the business plan has a reasonable chance of making a profit, isn't relevant. People can and do form failing, profitless general partnerships all the time! It's the plan and intention to work towards the profit together that reveals a general partnership.

Factor: If people share common ownership of property, a court is more likely to find they have formed a partnership

The common ownership of property is a pretty strong indication that two people have formed a partnership. For example, if Sally and Mary purchased the truck with shared funds, it's more likely they have formed a partnership. Not having any common ownership of property doesn't mean that a partnership hasn't been formed, however. Many businesses don't utilize property at all. Sally and Mary might form a marketing venture where they call restaurants on behalf of each other's farm business and sell their product together. This wouldn't require anything more than a phone. The court would look to other more relevant factors than common ownership of property to determine if Sally and Mary's marketing venture was a partnership.

Factor: If people share control of the enterprise, a court is more likely to find they have created a partnership

In a legal sense, sharing control of an enterprise generally means a shared ability to influence significant decisions on behalf of the business. Entering into debt, making accounting and tax decisions, acquiring property, and taking on investors or members are all significant decisions. When individuals have an opportunity to present their perspective and control the outcome of the significant decisions, they are more likely to have a partnership. This doesn't mean each partner has to have the authority to make unilateral decisions or even an equal say in the decision. Each partner might get voting power over entering into debt, acquiring property, etc, in proportion to their stake in the business—that still qualifies as sharing control. In contrast, if one person has no say over a matter at all, they have an employee/manager relationship rather than a partnership relationship.

Why does it matter if you've formed a "partnership," without fully realizing it?

"If you don't realize you have a partnership you may not be managing the risk of joint and several liability and you might not have drafted a partnership agreement."

Above, we outlined four different factors that a court will consider in determining if a partnership exists. But, have we fully explored what it means to have accidentally formed a partnership? If individuals don't realize that they have formed a general partnership then they likely haven't taken good risk management steps to accommodate their increased risk. Next, we will explore the increased risks and the management strategies farmers might adopt.

If you don't realize you have a partnership you may not be managing the risk of joint and several liability

Earlier in this chapter we briefly discussed that if you have a general partnership you can be held personally responsible for liabilities that your partner incurs. (We go into much more detail about how this "joint and several" liability works in our chapter on general partnerships.) If you know that you may be potentially responsible for the decisions of your partner you might act differently. For example, you might choose to keep your businesses separate and avoid a partnership. Or, you might be more diligent about following up on matters and allocating responsibility clearly. Perhaps you will take a closer look at your insurance policy and make sure that you have coverage for whatever might happen within the general partnership. The bottom line is that if you don't know your current risks, you can't manage them.

For more on joint and several liability, see our chapter on Sole Proprietorships and General Partnership Fundamentals (part 1, chapter 1 in the Farmer's Guide to Choosing a Business Entity).

If you don't realize you have a partnership, you might not have drafted a partnership agreement

A partnership agreement is a document that individuals create to outline their mutual obligations and business operation procedures. Our chapter on LLC operating agreements goes into full detail about the content of these types of agreements. We will summarize by saying that a partnership agreement is essential to identifying how decisions are made, how partners enter and exit the enterprise, and outlining partners legal obligations to each other. When individuals have acknowledged that they have a partnership, they probably haven't thought about these decisions, let alone put them on paper.

Not having a partnership agreement gives individuals less control over their enterprise. If something goes wrong and a court is forced to make a decision about legal responsibilities, the court will rely on state law rather than the decision of both parties. The state law may or may not be best for the business.

If you don't realize you have a partnership, you might not have insurance for your increased risks

> "Any time a farm begins a new venture, the farmer should check with his or her insurance agent about coverage. You might simply need to add the partnership as an 'additional insured.'"

Insurance is any businesses first line of defense against liabilities. It's even more important than forming a business entity because business assets can still be lost if an enterprise doesn't have insurance. When farmers start working with others, they may assume the other farmer's insurance policy will cover for bad things. These kind of assumptions can come with terrible consequences if they are false. Any time a farm begins a new venture, the farmer should check with his or her insurance agent about coverage. Don't immediately assume a new venture will cause rates to go up- the partnership might be covered under existing policies. Or, you might simply need to add the partnership as an "additional insured" to the policy. The best solution may depend on whether a separate partnership has been formed or not, so determining where you stand is an important first step.

If you don't realize you have a partnership, you haven't considered creating a different business entity such as an LLC

Given the opportunity, most farmers don't choose to remain as a general partnership. The cost of creating a separate entity such as an LLC or a corporation are low compared to the benefits-- primarily, insulation for personal assets from business liabilities. Perhaps the biggest drawback to not knowing that you have a partnership is not realizing that it is time to form a more optimal business entity. Farmers have a lot to gain from a conscious choice about which business entity to operate under.

Fundamentally, there's nothing inherently wrong with having a general partnership and not realizing it. Problems occur if the increased risks to which the partnership is exposed materialize. Farmers can manage those risks. It's all about making a conscious choice of whether and how to manage that risk. Choosing to draft a partnership agreement or forming an LLC or corporation could be the right choice, but there is no single correct answer; it's all about the farmers' situation and preferences.

Farmers should decide if they are participating in the co-venture as an individual or as a business

If you read through this guide already, you know that LLC members and corporation shareholders aren't necessarily individual persons. Other businesses can be members of an LLC or shareholders in the corporation as well. For farmers considering joining forces with other farmers, the question of whether to participate as an individual or business entity arises. Like so many legal questions, there's no single correct answer. We have to assess several factors against the individual situation of those involved. To help illustrate the factors involved in making this decision, we will go back to our example of Sally and Mary and their cooperative CSA adventure.

> "For farmers considering joining forces with other farmers, the question of whether to participate as an individual or business entity arises."

If the new entity is an S Corporation, the farmer must participate as an individual

The first factor is relatively straightforward. If the new collaborative venture is already organized as a corporation, options may be limited. As discussed in the corporations chapter, a corporation can either file taxes as a C corporation or as an S corporation. If the new venture isn't planning on taking on outside investment or doing a public offering, it probably plans to file taxes as an S corporation. If an entity file taxes as an S corporation all shareholders must be individuals. Other LLCs and corporations may not be shareholders in S corporation. If the entity is already organized as LLC and has already chosen to file taxes as an S Corporation, the same applies.

Let's return to our example of Sally Smith and Mary Merry, two farmers who are creating a co-owned venture to distribute Sally's poultry and Mary's vegetables as a single CSA share. Sally currently raises her chickens and her eggs under her existing business, Sally's Farm, LLC. In her eagerness, Sally has already filed the paperwork to form the corporation Happy Peach Farm, Inc., the business under which she and Mary will market their CSA. Sally and Mary agree that Happy Peach Farm should file taxes as an S corporation; they want to avoid the double taxation of a C corporation. In this case, Sally can only join Happy Peach Farm, Inc. as Sally Smith. If she receives stock in Happy Peach Farm, Inc. in her capacity

> “As a participant in a multi-farm venture, you will have legal obligations that might require you to avoid competing with the multi-farm venture, to disclose certain things, or to refrain from voting on certain matters. ”

as a member of Sally’s Farm, LLC., Happy Peach Farm will lose its eligibility to be taxed as an S corporation. Sally can’t necessarily convert Happy Peach Farm, Inc. to an LLC, either. Depending on the businesses’ assets and accounting, doing that can have tax consequences. The best choice may be for Sally to join in her individual capacity as Sally Smith.

The farm or farmer should join in whichever capacity they will act as within the new venture.

Should a farm choose to join a multi-farm venture as the farm or as the farmer? Sometimes, this question can be answered with common sense alone. The farmer should ask him or herself in which capacity he or she will actually be participating in business. Will the farmer be making decisions in the multi-farm venture on behalf of him or herself personally or on behalf of his or her existing farm business? A decision is on behalf of the existing farm business if it takes into account the farm’s overall business plan, growth strategy, financial situation, investor or partner preferences, or other business-specific factors. A decision is made on behalf of a farmer personally if it considers personal objectives such as retirement plans, personal income, other actual or planned business ventures, purely personal objectives, and other factors that aren’t related to the farm operation.

The question of personal or business capacity might seem pedantic, but it has real-world implications. As a participant in a multi-farm venture, you will have legal obligations to the business. These obligations might be spelled out in an operating agreement or they might be traditional legal obligations that apply regardless. These obligations might require you to avoid competing with the multi-farm venture, to disclose certain things, or to refrain from voting on certain matters that you have a conflict of interest. The member of an LLC or the officer/director of a corporation needs to be sure he or she understands these legal obligations and can fulfill them.

Anti-corporate farming laws may affect the farmer’s decision to join as an individual or as an LLC/corporation

If the new multi-farm venture 1) will operate a farm, own farmland, or lease farmland, and 2) is located in Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota and Wisconsin, all potential members should look closely at the state’s anti-corporate farming laws. These laws restrict the ability of LLCs and corporations to control farmland or participate in farming under certain conditions. Many of these laws only allow LLCs or corporations where all members/shareholders are individual persons (and not other LLCs or corporations) from farming or controlling farmland.

Anti-corporate farming laws aren't designed to trip up well-meaning collaborative farm ventures, but they can have that effect, especially if people aren't aware these laws exist. The laws often have wide exceptions so most businesses will still be able to conduct their operations. They just have to make sure they organize the business in certain ways or avoid titling farmland in the name of the business. Read our anti-corporate farming chapter for more information.

Joining as a business may make it easier to transfer ownership

If the member of an LLC or shareholder of incorporation is a business entity rather than a person, control of that membership follows the business rather than person. Farmers getting ready to transfer a business might find this convenient. For example, let's say our farmer Sally is looking at retirement in two years. Sally has a successor farmer lined up and they are going through the process of transferring ownership and managerial authority. Sally's successor is excited about the new CSA opportunity and plans to continue working with Mary. If Sally joins Happy Peach Farm, Inc. in her capacity as the member of her LLC, membership in Happy Peach Farm will transfer neatly to Sally's successor when ownership of Sally's Farm, LLC transfers.

Farmers may encounter other factors that affect their decision to join a multi-farm venture as an individual or as a business. Certainly, tax factors may play a role. Farmers should check with their accountant or tax preparer to understand any broader implications for the businesses financial situation. An attorney, insurance agent, and other professionals can also be helpful in the decision.

"Farmers may encounter other factors that affect their decision to join a multi-farm venture as an individual or as a business. Certainly, tax factors may play a role."

Pay close attention to developing strong business organization documents

Farmers reading this guide thoroughly will fully understand the role of strong business organization documents already! If you haven't yet, please give a close read to our section on LLC operating agreements as you consider drafting a partnership agreement, bylaws, or operating agreement. These documents are essential to setting up a strong working relationship between all partners to the business. Read the section on LLC operating agreements and review our sample document to pick up plenty of tips for preventing problems before they start.

"If a farmer doesn't carefully consider the nature of his or her participation in a mult-farm venture, problems can emerge down the road."

Next Steps

Multi-farm ventures are the key to sustainable growth for many farm businesses. Production, marketing, labor, and distribution ventures can all be made more efficient and more enjoyable when you join forces with others. These ventures can make the farm more resilient by opening up new markets and boosting profitability, but they can also make the farm more vulnerable. If farmers aren't careful about forming business partnerships, they can create more risk than they intend. Also, if a farmer doesn't carefully consider the nature of his or her participation or the detailed ground rules in the organizing document, problems can emerge down the road. By the time that happens, it might be too late to effectively resolve legal problems that could have been prevented.

This document is an excerpt from the full resource, Farmer's Guide to Business Entities. For much more information on business entities, please download the guide at www.farmcommons.org/resources.

CONNECT WITH US!

www.twitter.com/farmcommons

www.facebook.com/farmcommons

info@farmcommons.org

RACHEL REPONDS

Was this resource not quite what you were looking for? Do you still have more questions? Send your questions to Farm Commons and we will do our best to feature an answer in our blog. Read the most recent questions and answers in our "Rachel Responds" column.