

Important Farm Business Terms Defined – Business Structures

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A clear understanding of terms used in discussing farm business operations is important. The term “business structure” is used within the context of three broad categories: organizational structure, legal structure, and financial structure. This guide is intended to provide insight regarding each of the “business structure” decisions and the interdependence of these farm management choices.

Organizational (Management) Structure

Organizational structure (how decisions are made, and who is responsible for what) is an important long-term management issue that often does not receive the attention that it deserves. Stakeholders (family members, employees, and investors) need to know what their role is, what is expected, who makes decisions (now and in the future), who is responsible, and who is accountable. A well-defined organizational structure yields a framework for stakeholder interaction and assures that everyone involved in the organization understands the vision and mission of the organization, what is expected, and how decisions will be made. This is accomplished by providing an organizational climate that is conducive to open communication and problem solving.

The traditional, and still common, form of organizational structure is the hierarchical management structure where decisions are made in a top-down command-and-control fashion. Power and authority are retained at the top (within one individual), and most decisions are made or approved by the manager. A second general form of organizational structure is the bureaucratic system, where responsibility is diffused among various levels of the workforce. Each individual in the management chain is constrained by rules and procedures that strictly dictate the decision-making process. A human, or “people oriented” organizational structure spreads out the decision making responsibility among the individual employees and managers, or teams of employees and managers. A “hybrid” organizational structure might capture some elements of the people oriented organizational structure while providing some top-down direction from management.

Surveys have shown that the most successful family businesses exhibit shared decision making. For example, members of the incoming generation who perceive themselves as having significant influence in family decision making are nearly twice as likely to ultimately take over the farm. Many family businesses find it helpful to develop a graphical

organizational chart to clearly illustrate the decision-making framework for the business, and then to talk about how that organizational chart might change over time in order to accomplish the overall vision of the business.

Business Organization (Legal Form)

When family farm business owners see the term “business structure,” quite often the first thing that comes to mind is what type of legal entity the business is operating under. The legal form of the business can have significant implications for tax management, estate planning, business transition planning, and other important business objectives. Therefore, a significant amount of attention should be given to this management choice, especially when making significant changes in the farm business such as bringing in a new generation.

If you are considering a new venture or substantial changes to the existing business legal structure, remember that legal requirements and documentation for various business entity possibilities vary from state to state and over time as regulations change. Work closely with legal counsel, an accountant, and other management professionals that are well versed in this area to decide which structure(s) may be most appropriate for your situation and to assist in developing those legal structures.

When the stakeholder team of a business, or potential business, is considering the choice of legal form, the primary issues are: 1) access to capital, 2) liability, 3) management flexibility and control, 4) continuity, 5) taxation, and 6) legal filing requirements and other costs. The issue that is always at the forefront of the discussions (and perhaps rightfully so) is the issue of liability. A primary objective of most equity investors is to limit their personal liability. This is particularly true of investors who do not wish to participate in management. The choice of organizational structure should not be taken lightly, as it can be very difficult and costly to change once a business is operating under a particular structure. The following is an overview of the principle types.

Sole proprietorship

The sole proprietorship is the most common form of business organization for farms and ranches. The business is limited to the life of the owner, and the individual is responsible for all debts and obligations. Income is reported and taxed at individual rate. Primary advantages of the sole

proprietorship operating structure include ease of startup, as there are few formalities to go through to get the business going, and low maintenance costs as there are few legal filing requirements. Decision making and management control are centralized with the owner - manager. An individual can conduct business in any state, with few reporting requirements. Profits are taxed at the owner's personal rate, and business losses can typically be used to offset other income for taxation purposes.

Disadvantages include the fact that the sole proprietorship terminates with the death of the owner, and investment capital is limited to that available to the sole owner, making it difficult to obtain long-term financing and limiting growth potential, particularly as the operator ages. Business growth is limited to the abilities, skills, and interests of the sole owner. This "life cycle" disadvantage results in the sole proprietorship being the least effective structure for maintaining the overall farming operation at peak efficiency when transferring the business across generations. An additional important consideration is that the owner's personal assets are subject to any business liabilities. Finally, the sole proprietorship organizational form can be a hindrance to estate planning, however, if the farm operation will cease at the owner's death, this may be the simplest structure to liquidate.

General Partnership

In a general partnership two or more persons contribute assets and share in management of the business. Partners are jointly responsible for debts and obligations of the business. Income distributions, responsibilities, etc. are typically spelled out in a partnership agreement. General partnerships can be registered with secretary of state, but this is not required (in Kansas). Partnerships must file for a Federal Employer's ID number whether they have employees or not.

The primary of advantage of a general partnership relative to some of the more complex organizational structures is the ease of organization and the low initial cost of organization (simplicity). The general partnership is a quasi-entity that can own assets, enter into contracts, etc. Resources are drawn from all partners, expanding the resource potential, and the management base relative to a sole proprietorship. Income is passed through for tax purposes, so profits are taxed at the rates of the individual partners, and business losses are taken as personal tax deductions.

The liability issue is a primary concern when considering a general partnership. Liability is shared between partners, however, each partner is liable for all obligations against the partnership and may be held liable for obligations against another partner. Control and decision making are shared, and legally each partner can act on behalf of the business. This aspect has some advantages, however, it does underscore the importance of choosing partners with care as it is difficult to get rid of a "bad" partner. As with a sole proprietorship, there is no continuity of life beyond the partners. Depending on the details spelled out in the partnership agreement and associated buy-sell agreements the business may be forced into liquidation with the death of a partner. Due to these uncertainties, it may be difficult for the partnership to obtain large sums of capital. Finally, unlike some of the more complex organizational structures, there is no way to accumulate earnings within the partnership that are tax deferred.

Limited Partnership

A more formal class of partnerships (requiring formal partnership agreements and other documents meeting the requirements of the state where formed) include limited partnerships and family limited partnerships. The limited partnership is a formal agreement between one or more general partners and one or more limited partners. Limited partners have no voice in management and are viewed primarily as a source of capital.

A primary advantage is the limited liability feature. Each limited partner is liable for debts only up to the amount of his or her investment in the company.

Another advantage is the flexibility of this organizational structure. Limited partner interests can be sold at any time to raise capital, although once sold, there are limits on the ability to trade those interests. The life of the company is not tied to any one partner's mortality, so there is the possibility of "continuity of life." Profits are "passed through" to investors, so income is taxed at individual rates.

Disadvantages include the complexity and cost of formation and the advanced accounting and reporting requirements imposed by state regulations. There must be at least one general partner who is fully liable for partnership obligations.

The family limited partnership is a special form of limited partnership provided for by statutes in most states. The principle objective of a family limited partnership is to carry on a closely held business where management and control are important. The advantages and disadvantages are similar to those of a limited partnership, however, there are restrictions regarding who can participate as partners.

Corporation

The corporation is the most complex business structure that would typically be considered by an agricultural business. The corporation is a separate legal entity comprised of shareholders, directors, and officers. It is considered to be a separate taxable entity, however, it may be taxed under subchapter C or subchapter S.

The C corporation reports income and expenses on a corporate tax return and is taxed at corporate rates. Profits are taxed before dividends are paid. Dividends are also taxed to shareholders, who report them as income resulting in the "double taxation" of profits.

The S corporation is taxed in much the same way as a partnership. Profits are taxed at the shareholder's individual rate. Either type of corporation can enter into contracts, own property, and act as a separate legal entity.

A primary advantage of the corporate organizational form is that no shareholder, officer, or director can be held liable for debts of the corporation unless a law was breached. Additionally, interests in the business can be readily sold by transfer or sale of shares of stock. This simplifies the problem of obtaining capital and compensating resource owners, and facilitates estate planning.

Depending on whether the corporation is formed as a subchapter S, or a subchapter C, various levels of flexibility in tax planning are available. The entity can exist into perpetuity as long as regulations are met, and there are some advantages in the availability of pension plans, medical plans, and other benefit plans relative to other forms of business organization.

A primary disadvantage of the corporate structure is the initial startup cost, and ongoing administrative requirements. Fairly extensive articles of incorporation are required, and documentation is required in each state of business. Extensive record keeping and filing of reports is required on an ongoing basis. Furthermore, management control is vested in the board of directors and officers, so minority shareholders may feel left out. Under the subchapter C structure there is the possibility of double taxation of profits. It also is more difficult to use business losses to offset profits from other endeavors. Finally, the corporate entity can be the most difficult and costly to dissolve, making business exit difficult if circumstances change.

Limited Liability Company (LLC)

A limited liability company is a business entity that combines the limited liability of a corporation, with the flexible management options of a general partnership. Kansas was the fourth state to authorize this form of business entity in 1990. Advantages include the limited liability of the various parties involved, relatively flexible management options, and partnership tax status. Ownership and voting rights can be divided in “unconventional” ways relative to corporations. Depending on the way the company is set up, it can be perpetual, or there may be a limit on the life of the company.

Limited liability companies are complicated and expensive to form. They are subject to complex accounting and reporting requirements. Additionally, ownership interests are not as liquid as shares of stock in a corporation and are much more difficult to transfer making it a less attractive choice if estate planning is an imminent concern. Basically, depending on the founding documents, in most cases the majority of members must vote in favor of an ownership transfer of any kind.

Summary

With all the complex choices available (see Table 1.), considerable attention should be given to the legal organization structure of the agricultural business. There are no “blanket recommendations” as no single structure can meet the needs of all agricultural businesses in all situations. Many businesses consider changing the legal structure when making major changes to the business, when attempting to bring another generation into the farming business, or when going through the estate planning exercise.

General questions that need to be considered include: How much money do we need to raise now, and what are the sources of funding available? What is the possibility that we will need to attract capital for growth? What skills are needed in the business, and are there others currently

available that have those skills? How much am I willing to expose myself, and others, to the responsibility for debts and other obligations of the business? What structure will provide the appropriate level of flexibility regarding ownership and management control, taxation flexibility, and transition and estate planning?

Financial Structure

Inadequate financing, or an inappropriate mix of financing, can be a major contributor to the success or failure of a family business in accomplishing its long-term vision. In the context of the business planning process, there is a strong relationship between the legal structure and the range of available financing options. For example, venture capitalists and the general public are more likely to provide financing within a corporate type structure. Providers of long-term financing may in general feel more comfortable with a corporate structure, simply because of the life cycle nature of other business organizational structures where the business tends to follow the life cycle of the management/ownership team. Long-term investors like to see an organizational structure that facilitates continued growth, and provides a motivation for the business to remain on the “cutting edge.”

There are two major categories of financing available to businesses, debt and/or equity. Equity is a contribution of resources in exchange for an ownership stake. This can be cash or noncash, tangible or intangible. The ownership stake allows the investor to share in the company’s profits. A simple example of equity capital contribution is the contribution of owned land to a sole proprietorship farming operation. The “business” simply uses the land that is owned by the manager and profits accrue to the manager in return for his or her contribution of land to the business.

Debt involves borrowing resources from creditors with the stipulation of repayment of principle and interest in the future. Again, the resource can be cash or noncash, tangible or intangible. The reward to the provider of debt financing is the interest payment. Debt can be secured or unsecured. Secured debt is backed by some underlying asset of the business, meaning that if the debt is not repaid according to the agreed upon terms, the creditor may exercise the right to take title to the underlying business asset. Leasing can be viewed as a special case of debt financing, where the creditor (leasing company, landlord, etc.) agrees to provide the use of a resource or asset in return for an interest (lease) payment.

Organizational, legal, and financial structure decisions are serious long-term management choices that are inter-related. Managers need to weigh the advantages and disadvantages of the various alternatives when planning for the future of the farming business.

Table 1. Overview of Legal Form Choices

Type	Individual Liability	Continuity	Management control	Taxation	Capital acquisition
Sole Proprietorship	Unlimited	None	Proprietor	Individual	Very Limited
General Partnership	Unlimited	None	Partners	Individuals	Limited to Partners
Limited Partnership	Limited (for limited partners)	None	General Partners	Individuals	Limited to Partners
C Corporation	None (unless a law is broken)	Perpetual	Board	Corporate Level (possibly double)	Stock issue
S Corporation	None (unless a law is broken)	Perpetual	Board	Individual	Stock issue
Limited Liability Company	None (unless a law is broken)	Dictated by founding documents	Members	Individuals	Flexible Alternatives Possible

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