

Types of Farm Business Organizations

Quick Notes...

Types of Business Organizations include:

- a) sole proprietorships
- b) partnerships
- c) corporations
- d) limited liability company

Factors to consider when selecting a type of business organization

- a) simplicity
- b) continuity
- c) liability of owners
- d) acquisitions of capital

Introduction

The choice of organization structure is a very important decision for agricultural producers. A decision that should be made only after carefully weighing both short-run and long-run effects and after discussion with an attorney or other qualified advisor. This article addresses some of the major considerations associated with choosing the legal business structure that best fits those needs.

Sole Proprietorship

Several factors influence a farmer's selection of one type of business organization over another.

These include simplicity, continuity, liability of owners, tax consequences, estate transfer concerns, and acquisition of capital. The sole proprietorship has always been and is likely to remain the most common form of farm business organization in Colorado, because it is the most simple to understand and use. In effect, an individual merely declares him/herself as a business. The person owns, funds, and operates the business, records its income and expenses, and accepts liability for any problems. The business income tax return is a part of the owner's personal income tax return.

A principal disadvantage of the sole proprietorship is that the ability to raise capital is limited to the reputation and net worth of the owner. Also, the business goes out of existence or becomes legally incapacitated upon the owner's death. There is no continuity.

Partnerships

The general partnership is an organization of two or more persons who operate as co-owners. The partners contribute to the business, share in its management, and divide any profit. Partnerships are usually created by written contract among the partners, but they can be legally recognized even without a written agreement.

Partnerships are separate legal entities that can contract in their own name, hold title to assets

as a partnership, sue or be sued. A partnership must file an income tax return each year, but this return is for information purposes only. The real income or losses of the partnership are "passed through" to each individual partner's income tax return.

In a partnership, each partner may be liable for any and all debts of the partnership. This means that no owner-partner can separate his or her own individual assets from those of the partnership. Liability is not limited to the business.

Another disadvantage of this form is the limited life of a partnership. If any partner dies, is incapacitated, or voluntarily leaves the partnership, the entire partnership could be dissolved. Any time a new partner joins, the old partnership is dissolved and a new partnership needs to be created. As with sole proprietorships, the ability and opportunities to raise capital rest solely on the financial resources of the partners.

The advantages of this form of organization are its simplicity in creation and the democratic methods it offers in operation. It allows, for example, one partner to contribute cash, one to contribute technical know how, yet another to contribute manual work. All three can share equally their profits and management of the partnership.

A limited partnership is a partnership with one class of general partners and another class of limited partners. The defining characteristic of this form is that the limited (or silent) partner is not liable as a general partner unless he or she actually takes part in the control or management of the business. The limited partner is an investor rather than an active partner, and is liable only to the extent of the investment.

In farming, two somewhat distinct types of limited partnership have arisen. Family, or closely-held, limited partnerships serve a

number of objectives. Parents contemplating retirement may wish to maintain their investment in a farm business, but limit their liability and be free of management concerns. To accomplish this, the parents can be limited partners in a business where younger family members are the general partner.

Acquisition of debt capital for a family or closely-held limited partnership is not much different than for a sole proprietorship. The lender may favor the former if there is an expanded equity capital base.

Large scale limited partnerships in agriculture provide tax shelters for the limited partners and generate tax shelters and profits for the general partner, commonly a corporation. The general partner normally provides only a small portion of the equity capital. In return for organizing and managing the partnership, the general partner normally gets an initial lump-sum management fee and a continuing management fee based upon the gross income of the business.

The joint venture is another variation of the partnership, usually more narrow in function and duration than a partnership. The law of partnership applies to joint ventures. The primary purpose of this form of organization is to share the risks and profits of a specific business undertaking.

Corporations

Three fundamental characteristics distinguish corporations from proprietorships and partnerships: (1) the way they are owned and managed, (2) their perpetual life, and (3) their status as legal entities separate from their owners and managers.

Corporations issue ownership shares in the form of common stock. The owners of this stock vote to elect a board of directors who manage the corporation for the shareholders. The corporation is not dissolved on the death of the owner.

A corporation is a separate legal entity that can own property, sue and be sued, contract to buy and sell, and be fined - all in its own name. The owners usually cannot be made to pay any debts of the corporation. Their liability is limited to the amount of money they have paid or promised to pay into the corporation.

There are two different types of corporations - the regular (subchapter C) and the hybrid (subchapter S). The major difference between the two is that the subchapter S corporation pays no income taxes. Rather, income from the business is allocated to stockholders who then report this income on their personal income tax returns. In contrast, subchapter C corporations pay a business income tax, and any after-tax dividends paid by the corporation must be reported by stockholders on their personal income tax reports.

Concern over this "double taxation" is a major reason some farmers and ranchers organize as a subchapter S corporations rather than subchapter C corporations.

To do so, the farm corporation must meet several requirements. (1) It cannot have more than 35 shareholders. (2) It may have only one class of stock. (3) It cannot have partnerships or other corporations as stockholders. (4) It may not receive more than 20 percent of its gross receipts from interest, dividends, rents, royalties, annuities, and gains from sales or exchange of securities.

In agriculture, these restrictions usually mean that only family or closely-held farm businesses can achieve subchapter S status.

Federal income tax rules for subchapter S corporations are similar to regulations governing partnerships and sole proprietors. However, corporations may provide certain employee benefits that are tax-deductible. Accident and health insurance, group life insurance, and certain expenditures for

recreation facilities all qualify. However, these benefits may be taxable to the employees and subsequently to the shareholders.

There is greater continuity for businesses organized under subchapter S than for sole proprietorships or partnerships. Upon death of shareholders, their shares of the corporations are transferred to the heirs and the subchapter S election is maintained.

Surveys suggest that the major reason farms incorporate is for estate planning. The corporate form allows for the transfer of shares of stock either by sale or gift. This is much easier than transferred assets by deed.

A chief advantage of the corporate form is the limited liability afforded the owners. Limited liability is a legal privilege bestowed by the state; this privilege may be withheld in the exercise of the state's police powers.

A Limited Liability Company

A limited liability company (LLC) statute in 1992 to provide another business organization option. The owners of a LLC are called "members," with (theoretically) no personal liability for the obligations of the LLC. However, like a partnership, a properly constituted LLC will be treated as a pass-through entity for federal income tax purposes. No federal tax, and presumably, no state tax, will be imposed on the LLC itself, the members include any income or loss on their own tax returns.

The affairs and conduct of the LLC business are governed by an operating agreement among its members. Ownership is represented by membership interest.

Management of an LLC may be vested in the members in proportion to their membership interests; however, the operating agreement may provide for the selection of managers by the members. The managers do not have to be

members, but, like members, they have no personal liabilities for the obligations of the LLC.

The LLC may be dissolved on the occurrence of certain events such as expiration of a period fixed in the operating agreement, unanimous written consent of the members, or the withdrawal of a member.

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