

Figure 78.

## Legal Organization Options<sup>61, 62</sup>

**Sole proprietorship.** In a sole proprietorship, the business is owned and controlled by one person. This means that if a husband and wife or father and son plan to operate the business together, only one of them can hold legal title to the business. The primary advantage of sole proprietorship organization is that you are independent and free to make all business decisions without an obligation to partners or shareholders. The disadvantage of a sole proprietorship is that you are personally liable for any debt, taxes, or other financial and regulatory charges.

**Partnership.** Partnerships may be formed between two or more family members or third parties. Each partner is liable for all partnership obligations. One of the primary advantages of a partnership may be the infusion of business capital and other assets by one or more partners. Each partner pays taxes individually based on his or her share of income, capital gains and losses. There are two types of partnership: general partnerships and limited partnerships. In a general partnership, one or more partners are jointly responsible or liable for the debts of the partnership.

**Corporation.** Corporations are owned by one or more shareholders and are managed by elected directors. A corporation must be established in compliance with statutory requirements of the state of incorporation. In Minnesota, articles of incorporation and by-laws are legally required. The corporation, not its shareholders, are responsible for corporate debts and other obligations. One disadvantage of corporate organization is that its owners and family members are considered employees of the business and are therefore subject to labor laws and taxes.

**Limited Liability Company (LLC).** This organizational form offers owners limited liability like a corporation—investors are liable only for their investment in the business—but it may be classified as a partnership for tax purposes. Two or more business partners may form an LLC.

**Land trust.** A land trust is a legal entity that allows a land owner to transfer property to a trustee. While the trustee is the legal owner of the property, the beneficiaries are given possession and management of the land. This type of legal organization can be beneficial for estate planning purposes as it allows the beneficiaries to avoid probate upon death of the owner.

**Cooperative.** A cooperative is a legally incorporated business entity capitalized by its member patrons or owners. Dividends are paid out to its patrons. A cooperative is taxed on income at corporate rates, but patronage refunds are often tax-deductible to the cooperative. Many farmers are now using cooperative organization to acquire and provide machinery, livestock breeding and equipment maintenance, as well as marketing and advisory services.

## Organizational Structure: How will we legally organize and structure our business?

The legal organization that you choose for your business will have risk, finance, tax and estate planning ramifications. Legal organization is typically one of the first decisions made when structuring a new business.<sup>60</sup>

As a current business owner you might consider re-evaluating your organization strategy here to determine if one of the alternatives provide legal or financial benefits. As a new or potential business owner who is at the beginning of the business life-cycle, however, you have a range of organizational strategy alternatives to consider.

Traditionally, most farm businesses have legally organized as sole proprietorships or partnerships. This is still a common legal structure, but a growing number of today's farms are incorporating as Limited Liability Corporations (LLCs) or Cooperatives. These structures offer some financial protection, tax advantages, and other benefits. The Minars, for instance, considered three organizational alternatives: LLC, S-Corporation (a corporation in which the owner holds 100% of the shares), and Partnership. After researching each alternative and weighing the advantages and disadvantages of each, they decided to organize the processing business as an LLC. This structure enables them to gradually pass shares and ownership of the business on to their children in advance of retirement. *"We also hope that by making our children shareholders, they will have more of a long-term, vested interest in the business,"* explains Florence Minar.

<sup>60</sup> Planning the Financial/Organizational Structure of Farm and Agribusiness Firms: What Are the Options?, Boehlje and Lins, 1998 (revised).

<sup>61</sup> Ibid.

<sup>62</sup> A Guide to Starting a Business in Minnesota, Minnesota Small Business Assistance Office, updated annually.

## Worksheet 4.25 Business Organization

Use the space below to record information about the organizational alternatives that you are considering for the business. Your state's Small Business Association is an excellent place to begin your research. If you are planning a major reorganization of the business, be sure to consult a lawyer regarding necessary documentation and tax ramifications. Be sure to note advantages and disadvantages of each alternative as it pertains to your current situation, business vision and personal goals.

### Organizational Alternative 1 Limited Liability Corporation

**Ownership:** Shareholders  
**Tax rates:** Can be taxed as partnership or corporation.

**Filing requirements:** Articles of Incorporation filed with Secretary of State + filing fee; annual registration with Secretary of State; tax payments to IRS and MN Department of Revenue.

**Advantages:** We can pass shares of the business on to our children; no personal financial liability on part of partners; easy to dissolve.

**Disadvantages:** \_\_\_\_\_

### Organizational Alternative 2 S-Corporation

**Ownership:** Shareholders  
**Tax rates:** Individual shareholder income tax rates.

**Filing requirements:** Annual "Business Activities" report and registration; tax return to IRS and MN Department of Revenue.

**Advantages:** Can pass on shares.

**Disadvantages:** Difficult to dissolve.

### Organizational Alternative 3 Partnership

**Ownership:** Partners  
**Tax rates:** Individual partners' income tax rates.

**Filing requirements:** Annual federal and state "information" returns; sales tax return to IRS and MN Department of Revenue.

**Advantages:** \_\_\_\_\_

**Disadvantages:** Personal liability.



**Figure 79.**  
**Example from Cedar**  
**Summit Farm—**  
**Worksheet 4.25:**  
**Business Organization**

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The advantages and disadvantages of sole proprietorship, partnerships, LLCs and other legal business arrangements are described in Figure 78.

Use **Worksheet 4.25: Business Organization** to list the organizational alternatives that you would like to consider for your business. Next, use the space provided to research ownership authority, tax rates and filing requirements for each alternative as well as the advantages and disadvantages of each for your business. When doing so, remember that the legal and business arrangement that you choose must be compatible with your overall financial values and goals.



**Figure 80.**  
**Finance Alternatives**

**Capital leases.** A capital lease can be categorized as a property “rental agreement” when ownership rights are not transferred and as a “purchase” when the lease gains you ownership of an asset at a reduced purchase price at the end of the agreement. Capital lease purchase agreements can provide effective control and may reduce costs while building equity. Whether it reduces cost or risk in the long term will depend on the fine print of the agreement. It is always advisable to have a lawyer look over the details of any agreement that will have such a major impact on your financial future. For more information about how to calculate lease values and returns, see *Capital Leases* by Haefner and Doye in “Resources”.

**Contributed capital.** Most business owners have to invest some of their own equity in the business to get it up and running. This may be a basic requirement to getting your business started. Initial capital contributions may not be the end of your use of contributed capital to finance the business. Many farmers continue to inject money into the operation from off-farm income. This “subsidization” of the farm from off-farm sources is often looked at as a negative, and it can be if it is eaten up by farm losses. However, it can also be looked at as an alternative place to invest off-farm earnings. If your farm is profitable and your alternatives for financing replacement/improvements are between debt capital and contributions from nonfarm sources, you may decide that capital contributions are a sound investment.

**Debt.** Debt financing (for land acquisition, intermediate, and operating loans) is the traditional source of external

financing for most farm operations. As long as you are earning a higher return with borrowed funds than the interest rate, it is profitable to grow your business using someone else’s money. Commercial banks, insurance companies, Farm Credit Services, and the Farm Service Agency offer debt financing. Your long-range vision and goals probably say something about how much debt capital you are comfortable with. The major plus to using debt financing is control. When structured correctly, debt can be an effective way to eventually build equity as the debt is reduced. However, just because you are paying down debt, particularly intermediate term debt, you may not be increasing equity as assets may need to be replaced as fast as the debt is being paid off. Depreciation is a real cost. The more debt capital you use, the more your financial alternatives will be reduced.

**Operating leases.** Operating leases, such as traditional land rental arrangements, give you less control, and usually (but not always) come at a lower cost than ownership. They can be flexible and reduce risk. Don’t be afraid to try to negotiate some flexibility into an operating lease arrangement. Sometimes, the owner may hold all the cards and will not see the need to take on any of the risk faced by the operator. In other situations, you may be able to pass on some of the risk in return for higher lease payments during high-income times. Also, don’t forget to cultivate personal relationships with your landlords. Remember them at holiday times and provide them with information that shows you are doing a good job. Most successful operating leases rely on the fact that the owner is more comfortable with you managing his property than alternative renters, and therefore, is willing to give you a break in rental rates or terms.

## Finance: How will we finance capital requirements?

The financial strategy you develop will depend on your choice of business organization and your values as they relate to risk, control, costs and maturity.

Historically, farm businesses have financed themselves internally through family equity—relying on debt only when internal equity was not adequate to finance growth of the business.<sup>63</sup> Today, however, external financing through debt, leasing, and outside equity is common.

If you anticipate the need for financing to pay for start-up, annual operating, or long-term capital expenses, you have several options to consider. Some common internal and external financing alternatives are described in Figure 80. Additional information is available in *Financing the Farm Operation* by Kunkel and Larison (see “Resources”). Pay particular attention to real estate financing. Land and

<sup>63</sup> *Planning the Financial/Organizational Structure of Farm and Agribusiness Firms: What Are the Options?*, Boehlje and Lins, 1998 (revised).

**Outside equity.** Most agricultural corporations are still family farms today. Using external equity capital has traditionally been a very unusual method of financing agricultural activities. More recently, however, there have been a number of creative approaches to attracting external capital. Often these business structures have been similar to networking, with a group of producers creating a business structure, such as a cooperative, to give them some sort of competitive advantage. Equity contributions from outside of agriculture are usually somewhat limited by corporate farming laws. Some states now allow the formation of agricultural Limited Liability Companies (LLCs) that offer some of the benefits of outside equity contributions while limiting the liability of the investor for the legal obligations of the business. If you are interested in these options, do some further research.

**Retained earnings.** Another way to finance your business that you are probably already using is retained earnings. You may not be consciously thinking about it, but most small businesses continually inject their earnings back into the operation. Of course this requires that there be earnings remaining after all costs and owner withdrawals. Using equity capital, either from farm or nonfarm earnings, to finance your business will gain you ownership with a great degree of control. The cost of equity capital is the return it could have earned in an alternative investment. The risk of using equity capital is that you could lose your equity if the business fails. So you might want to consider a balanced strategy that invests at least some of your earnings outside of the farm business.

**Shared ownership.** Experts will usually tell you that there is too much capital invested in production agriculture. One way to reduce your ownership cost may be to share ownership of expensive equipment that is only used for short portions of a year with a neighbor or someone else. Shared ownership gives you reduced control, but at half or less of the cost. Timing concerns usually limit the use of this option. One of the more creative solutions that is being used to some degree today is to share ownership with someone who farms in another part of the country where the cropping season is different. Again, you may be able to think outside the box and come up with a creative shared ownership strategy. Whenever shared ownership is used, you should put the agreement in writing to avoid future disputes.

**Strategic alliances/networking.** This may be a way of gaining control of some needs of your operation without having to own them. You may be able to gain access to a specific input into your production process by either investing in someone else's operation or by contracting with that operator. While the most visible use of networking in agriculture has been in large pork production operations, you may be able to think of ways to network with other operators or suppliers that are not as grand. Businesses have long relied on alliances and joint ventures to reduce individual costs or to guarantee access to inputs or markets. Such reliance on relationships may be vital to the sustainability of both parties.

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building investments typically account for the largest farm expense and have the potential to make or break your business. If your business' operations strategy necessitates land and building acquisition, be sure to thoroughly review your financing options with a lender, accountant, or attorney. If you decide to invest in land, you need to consider market price, the value of the land to you, financial feasibility, and the risk to cash flow. Complete **Worksheet 4.26: Farmland Affordability** to determine the maximum financially feasible price you should pay for land. You can view *Analyzing Land Investments* by Gayle S. Willett for additional suggestions and information (see "Resources").



As a beginning or young farmer, choosing a financial strategy and financing alternatives may seem intimidating, especially if you haven't had the chance to build a credit history or an asset base. Several well-known funding sources for beginning farmers are listed in Figure 81. As you review these finance sources, don't ignore