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Staff Paper

**FACTORS AFFECTING SELECTION OF
ORGANIZATION FORM
For Family Owned Businesses**

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The inherent characteristics of the proprietorship, partnership, limited liability company, and corporation can be analyzed with the personal and business objectives in helping to decide which organization type is best for any given small business situation. One type of organization may be best for one individual while a neighbor may operate equally as well under a different structure with a different situation and set of objectives.

The sole proprietorship continues to be the most common form of business organization. It usually is the type of organization a beginning business will use especially if the operation is small. By its very nature, the sole proprietorship is well suited to small scale enterprises. It is the simplest and least regulated of all business types. There are no filing requirements for establishing and maintaining the business. The proprietor owns and operates the business as an individual. Records and planning are limited to those needed for reaching management objectives, filing personal income tax returns and complying with laws and regulations common to all business ventures.

Although the sole proprietorship is the logical starting organizational form and the basic reference point for comparing business structures, financial management issues and family objectives encountered in this period of rapidly changing business environment may make a partnership, limited liability company or corporation better suited in handling the future needs of the family operation. If family members are entering the business as a career choice, an evaluation of the business and legal structure is part of the succession and transfer issues to be addressed.

When the sole proprietorship form of organization no longer serves the needs of the family, personal and business reasons must be explored in determining whether objectives can better be served with a more formal and complex business structure. The following discussion covers factors which may be important in selecting an alternative business organization other than a proprietorship.

Multiple Owners

Multiple owners of a common business enterprise has evolved in family operations due to the ever increasing capital requirements, intense competition and larger scale economics of business enterprises. When two or more family members or unrelated parties want to enlarge their business, multiple ownership could possibly result in greater operational efficiency and net income than two separate operations. Increased capital requirements has made it more difficult for the younger generation to start an enterprise on their own. As a result, there is increased desire by the younger generation to enter into the ownership and management of their parent's business rather than starting their own operation. However, the older generation normally does not desire to sell the assets to the younger generation all at once nor can the younger generation afford to make the payments for a complete purchase. The assets are usually transferred between generations gradually over time. Therefore, there is a need for multiple ownership of the business, whereby the younger generation can gradually ease into the ownership and management while the older generation gradually withdraws.

Since a sole proprietorship by definition is organized and operated by one individual, the inter-generational transfer of a business over time requires a business organization that can accommodate multiple owners. The partnership, limited liability company and corporation are suited for this situation. The number of family members involved in the ownership of the business, and the flexibility they desire in changing the amount of the investment may

influence the form of organization. Since the ownership of stock does not impact the assets in the business, the corporate form has advantages over the partnership and limited liability company if a large number of owners are involved in the business and they want to have the flexibility to invest and disinvest in the organization by buying and selling the stock.

In some cases, separate proprietorships, but joint ownership of equipment and labor exchanges may be developed between parties rather than operate a common business venture. The parties need to be located near each other, so they can readily exchange labor and jointly owned capital items. Separate proprietorships may not be feasible for some enterprises because of the large capital investment in fixed facilities and equipment that can not be shared by more than one enterprise.

Limited Liability

In a proprietorship, the liability for personal and business actions are the same, since the individual acts for the business. When two or more individuals operate together in a common entity, they desire separation of legal liability and responsibility between personal assets and business assets, except to the extent of their capital investment in the business. The partnership carries forward the proprietorship characteristic of the personal and business obligation combined where the owner-operator of the business is responsible for the total obligations of the business in cases where the partners are unable to assume their share of the obligations.

There is an advantage in organizing the business as a limited liability company or a corporation to achieve separation of personal and business obligations. In these organization, the investor is limited to losses up to the value of the investment in the business, except if they personally sign to assume the business obligations out of personal assets. In some family operations, even when a limited liability company or corporation has been organized, it is

common for the major investor in the business to personally sign to guarantee payment of loans for the business as a requirement to receive business financing. But signing for the obligation for payment of loans does not extend the liability for product, accident, or other judgements against the business.

A partnership is a possibility if one of the partners will assume all the risks for the business and other partners are limited in their financial obligations. In this case they could use a limited partnership business structure. However, if all owners desire to limited their liability between personal and business assets, the limited liability company or corporation will provide this feature.

Shared Management

The advent of larger businesses and multiple owners provides the opportunity for division of management responsibility among the partners, members or stockholder employees. Joint management decision making provides excellent on-the-job training experiences for management skill development of less experienced managers.

The partnership, limited liability company, and corporate structures are equally flexible in developing a management team that meets the unique needs for each business. There are many alternative ways shared management responsibilities can be arranged by management functions, enterprises or systems. Management depth within members of each generation in the family will help insure that family business continuity is preserved.

Since a sole proprietorship is owned and managed by one person, that individual has control over the management decisions and programs. In the other organizations, it is possible for one or more individuals who own a majority of the corporate stock and share ownership of a partnership or limited liability company to control the management decisions through the terms in the corporate bylaws or operating agreements at the exclusion of the minority owners.

But organizing the business management system with control by a few family members defeats the purpose of fostering growth and development of the younger members of the management team, so they gain management experience and skills that enhances their gradual transition into management decision making responsibility as the senior generation withdraws from those roles.

Of all the resources contributed to the business, management knowledge and ability is the most important resource. The idea that scientific methods of analysis could be applied to managerial activity does not replace the need for managers to gain experiences in management for growth and development to occur. Good managers have a definite "feel" for the situations facing them and the ability to intuitively size them up and make decisions. Scientific management teaches the skills of management, but the "art" of management performance is acquired by experience, study, and observation.

The sharing of management roles in the family business should be more than an apprenticeship system with the younger family members relieving their fathers and mothers of management functions. Of course, the sharing in management roles by family members should allow for growth and development of management ability, but it should also result in improved decision making and business performance based on the goals of the members involved in the business. Having younger family members enter the business extends the planning horizon for the operation, and strategic planning and implementation of decisions that take into account the extended time arisen for the business will have the input of the junior partners. The form of organization does not prevent shared management by a management team, but control by one or a limited number of family members can be forced into the organizational and operational documents if that is desired.

Income Sharing

Multiple ownership and management within a partnership, limited liability company, or corporation offers many avenues for distribution of income among the respective parties. Since the owner-operators in a partnership or limited liability company are self-employed, the sharing of income can result through a set salary or drawing accounts for the owner-operators and distribution of residual income at the end of the year. If partners or members lease assets to the business entity, lease payments compensate owners for their resources. The profits and losses from the business after all expenses including the owners drawing accounts are subtracted from revenue, can either be reinvested in the business or distributed to the owners in proportion to their share of capital ownership in the business.

The corporate structure can distribute income among stockholder-employees as salary, dividends or lease payments, depending on the contributions the individuals make to the corporation. Payments to stockholders must be reasonable and based upon services rendered. But there is substantial flexibility in sharing income among stockholders-employees. If the corporation pays its own income taxes (C-corporation), the residual income is locked into the business unless dividends are paid to the stockholders. Since the junior partners in the business usually do not have many shares of stock, the increase in the equity of the business accrues to the majority investors. A gift or sale of stock through a planned transfer arrangement can be developed which allows for the gradual capital ownership by the younger generation.

Capital Transfer

Capital transfer among common property owners in a partnership, limited liability company, or corporation is a significant concern where family members have decided to continue the enterprise as an operating unit beyond the retirement of the founder of the

business. With proper planning and implementation documents, the partnership, limited liability company, and corporate structure can be used to provide income payments in the retirement years for the family members, while the operating partners obtain salary distributions from the business and gradual transfer of property to family members which minimizes expenses and transfer taxes.

Regardless of how a business is organized it is possible to develop a sound estate plan. The capital transfer through the estate can be handled with jointly held property ownership, wills, and trust arrangements. The legal business structure does not in and of itself solve the estate transfer problem. But the unique characteristics of the organizational form offers a collection of income transfers, lifetime gifts and sale alternatives of stock or a share of the partnership or limited liability company that make the capital transfer somewhat easier.

The costs associated with the transfer of property from one generation to the next are the federal estate and gift taxes and state death taxes. Transfer of property by gift is one way of minimizing the death tax burden. Federal gift tax laws allow a person to make \$10,000 of outright gifts to each beneficiary each year without paying a federal gift tax. The annual gift tax exclusion can be doubled to \$20,000 if the gifts are made by a married couple to third persons even though only one owned the property.

Another advantage of making gifts is that they are valued at the time they are made. If appreciating assets such as real estate are held until death, the value of the asset may have increased, causing an increased death tax liability.

Buy-sell agreements are often used to help transfer capital ownership of business assets from one associate to the next. Such an agreement can establish a market for the business assets when an owner desires to withdraw from the business during lifetime, at death or upon the disability of an owner. This is accomplished by requiring the remaining partners or stockholders to purchase the ownership interest of the departing member and the business

associate or the estate is required to sell to the remaining owners. The contract normally specifies either an actual purchase price or a procedure to follow in determining the price.

Attracting Capital

The traditional sources of capital for small businesses are the equity provided by the family members, reinvestment of retained earnings, lease, and loans from numerous credit sources. In cases where the family desires to own and control a majority of the capital in the business, capital sources are the same regardless of organization type. The sole proprietorship may be the most limited in capital acquisition because only one family is involved in the operation. Multiple ownership through a partnership, limited liability company, or corporation allows the combining of funds from more than one family and operation of a larger business.

In recent years the capital requirements needed for agricultural businesses are outstripping the ability of the family unit or units to provide equity capital and attempts are being made to attract capital from outside the family. Investor capital can more than likely be attracted and held in a small business when a corporate or limited partnership business structure is used. The investor can achieve capital appreciation and income rights through the business structure. Although the limited partnership and corporation offer the alternative for raising capital from outside the family, the potential to raise substantial funds for closely-held family businesses is limited.

Federal Income Taxes

A sole proprietor's business pays no federal income tax itself. Instead, the taxable income of the business is combined with the proprietor's personal income and a tax is paid according to individual tax rates. Federal income taxes for a partnership and limited liability company are paid by the partners or members according to their investment in the operation.

The business files a partnership information return (IRS 1065) showing the income and expenses, the names of the partners and how the partnership earnings will be divided among the partners. The profits, losses, capital gains and losses, tax credits, etc. are allocated to partners according to the terms of the business agreement. The partners or members pay tax as individuals on their respective share of business income.

Federal income tax savings may occur if a business incorporates and becomes subject to federal income taxation under Subchapter "C" of the Internal Revenue Code. Being a separate taxpayer, the corporation can split income among the corporation, owner-operator employees and shareholders. The corporation pays individuals associated with the corporation for the contributions made by those people -- owner-employees a salary for their labor and management and shareholders a dividend for their capital investment. Residual income after all expenses are paid is taxed to the corporation at corporate income tax rates. Whether federal income tax can be lowered after incorporating depends upon the earning level, the tax rates for an individual and the corporation and the allocation of earnings.

When the corporation is owned primarily by the family, the tax objective is to minimize the family's total annual income taxes payable. This means that the total taxes paid by the corporation plus the personal income taxes paid on the stockholder-employee's salary plus any other personal income should be less than the total personal income taxes paid by the owners before incorporation.

This tax reduction can be accomplished by equalizing the rates at which income is taxed in the "hands" of the corporation versus those at which it is taxed in the "hands" of the individual stockholder-employees. Normally this is done by adjusting the salary of major employees and/or adjusting lease or rental rates of assets (primarily real estate) owned by stockholders.

However, this can't be done arbitrarily. Salaries must be established at the beginning of each corporate fiscal year. They cannot be increased or decreased within the year to reflect changes in the financial success of the business. However, considerable flexibility can be obtained by establishing a bonus or profit-sharing agreement based on either the production or the income.

All salaries must be "reasonable" and paid only for work actually performed on behalf of the corporation. Among the factors considered in determining the reasonableness of a salary are the time and effort spent by the employee, the rates of pay by similar business organizations in the community for the same work, and the experience, age, and other abilities of the employee. If the salary is held to be unreasonable, the excess over that which is reasonable will be taxed as a dividend. Also, the corporation will not be able to deduct the excess salary as a business expense.

Leasing or rental rates must also be "reasonable". They must be similar to the rates of comparable property leased or rented in the community under similar circumstances -- i.e., they must meet the standards of an "arm's length" transaction.

Another tax advantage of incorporation is the increased business deductions available because the owners who work for the corporation become employees of the corporation. In addition to the employee's salary, the corporation can take a deduction for fringe benefits such as group life insurance plans, medical and hospital plans, pension and profit sharing plans, and others. It permits the corporation to use pre-tax dollars to pay for benefits received by a stockholder which the same individual not in a corporation would acquire by using after-tax dollars. This results in more after-tax total income available to the stockholder-employees.

A disadvantage of Subchapter "C" corporations is that double taxation is possible. It occurs when corporations pay dividends to their shareholders. The reason for this is that dividends are distributed from the corporation's after-tax income. And shareholders must

include dividends in their taxable income. Thus, shareholders are in effect paying taxes a second time on the same profits. A corporation is also at a tax disadvantage when the corporation is dissolved. The corporation will pay income taxes on the capital gain from the sale of the assets, and the shareholders will pay income taxes on the funds as they are distributed to the shareholders as dividends.

If a corporation elects to be taxed under the special tax option or Subchapter "S" method, it is normally not a taxpayer for income tax purposes. That is, the corporation itself is not taxed on any income. The income of the corporation "flows through" to the shareholders and each shareholder pays a tax on his or her prorated share of the corporation's earnings when he or she files his individual income tax return. All income is taxed the year it is earned whether or not it is retained or distributed. Subchapter "S" rules are similar to partnership rules in that an information return is filed annually on behalf of the corporation.

Thus, corporate earnings in a Subchapter "S" corporation are only taxed once -- to the shareholder. This avoids the double taxation possibility present with Subchapter "C" corporations.

However, just because federal income taxes may be reduced by incorporation it does not necessarily mean that all taxes and costs will be reduced. Rather, there are a number of increased costs and taxes present with corporations. All of these must be examined in arriving at the total savings possible by incorporation.

Payroll Taxes

After incorporation, the sole proprietor or partner finds their status changed from employer to employee. Therefore, after incorporation, the business will have at least one additional employee, if not more. This results in increased payroll taxes being paid by the business.

Stockholder-employees of corporations are also subject to Worker's Compensation charges on their salary and are entitled to benefits under the act. This is not true of sole proprietors, partners in a partnership, or members in a limited liability company.

A stockholder-employee's salary may also be subject to the unemployment compensation tax. Starting in 1978, agricultural employers are subject to the tax if they either a) paid wages of \$20,000 or more for agricultural labor during any calendar quarter in the current or preceding calendar year or b) employed 10 or more individuals in agricultural labor for some part of the day on each of 20 days during the current or preceding calendar year with each day being in a different calendar week.

Incorporation becomes a disadvantage when the addition of the stockholder employee's salary to the business payroll is enough to cause the employer corporation to be liable for the tax. Of course, it is possible for the corporation to lay off the employees during a slack period and collect benefits.

Another disadvantage to owner-operators who were self-employed prior to incorporation is the requirement that personal income taxes must be paid through withholding of income taxes and social security tax at each pay period, rather than as a lump sum on March 1 as permitted by self-employed agricultural business owners. A farm corporation employee is not a "farmer" for this purpose.

Making the Choice of Form of Operation

A business may start out as a sole proprietorship, for example, or as an "S" corporation to assure pass-through of early tax losses as the business becomes established, then later switch to another form as it becomes larger, more complicated and profitable. From the outset, all of the choices of operation involve concerns about risk, financing, control, continuity, and tax consequences.

Sole proprietorships and partnerships expose the owners to risk not only for their own acts and omissions, but for the mistakes of employees and agents. Liability insurance is, of course, available and each business covers a reasonable amount of the risk in this way.

The limited liability company and the corporate form, whether a regular "C" corporation or "S" corporation, theoretically limits the liability of the owners for the acts and omissions of others to their investment in the business. However, the owners may be called upon to guarantee and commit their personal assets to the obligations of their corporations. In any event, they cannot escape personal liability for their own wrongful acts and omissions.

The limited partnership offers limited liability to the limited partners, but at the price of surrender of basic control to the general partners. General partners in both limited partnership and a general partnership are without limited liability.

From a financial standpoint, in the early stages of a business, it is not likely to make much difference what form is chosen. A lender will want to have the individual partners, members, or shareholders on the note, whether as co-signers or guarantors. With the corporate form, it may be possible to sell stock to individuals who have funds to invest in the small family business, but the operation would have to have adequate earnings and growth potential for investors to consider it an acceptable risk. Outside investors will probably want a larger slice of the business than the family principals are prepared to give.

Control is best in a sole proprietorship, in a one-person corporation, or through a single general partner in a limited partnership. Once there is more than one controlling party, which is the case in family operations where a member joins the operation, a management team can be implemented so the junior member or members can gain experience and skills in making decisions.

As far as continuity is concerned, the corporate form is the only one offering continued existence in perpetuity. A partnerships and limited liability company may offer continued

existence for only limited periods, measured in lives, through the use of buy-sell and other contractual arrangements to reformulate a new organizational structure as members enter and leave the business ownership.

Risk, financing, control, and continuity concerns may vary to some extent from time to time. However, tax considerations are likely to change more frequently and, therefore, demand close attention, especially for small family operated businesses. Sole proprietors in a proprietorship, partners in a partnership, and members in a limited liability company are self-employed for tax purposes. They pay social security taxes as self-employed taxpayers and usually are not covered with worker's compensation and unemployment coverage. Business and personal incomes are combined and the taxpayer files under the appropriate individual tax rate schedule.

Owners of a corporation are employees of their corporation and pay income taxes, and social security like other employees of a business. The corporation probably will be subject to worker's compensation and unemployment coverage for the shareholder-employees. If the corporation is a "C", it pays its own income taxes, and the business income tax rates are determined from the corporate schedule. This can be an advantage for a business since the corporate starting rate at 15 percent will usually be less than the self-employed owners rate. The corporate income tax obligation for a "S" corporation is passed to the shareholders, who combine the business income with their personal income which is taxed at the appropriate individual tax rate schedule.

Need for Individual Analysis

The initial business organizational type for a small scale family business is usually a sole proprietorship. When circumstances surrounding the operation suggests a partnership, limited liability company, or corporation, an in-depth analysis needs to be done. An analysis of the

organizational characteristics and the objectives of the family is perhaps the most important, but still the most neglected phase of the process. The relative merits of partnerships, limited liability companies or corporations over a sole proprietorship is much too complex to make sweeping generalization. Therefore, the decision must be made on a case by case basis.

The major question is to decide if a more complex and formal organizational structure is the best answer for your particular situation. Usually there is no need to hurry the decision. It is a relatively easy and inexpensive process to incorporate or form a partnership, but may not be so easy and inexpensive to unincorporated or dissolve a partnership. Thus, if you are thinking about changing business organization, be sure to take enough time to weigh the advantages and disadvantages of each structure for your particular situation.