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BUSINESS FORM, STRATEGY AND CONTINUITY

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Selecting the right business form has far reaching implications on various levels in agriculture. Not enough time is spent on the selection of the business form which often leads to problems eventually.

It is necessary that the selection of the business form, as well as the way in which it is used in every particular situation, should be analysed scientifically and that all relevant factors which influence their choice should be taken into account simultaneously. Especially the practical implications are of importance. Therefore, this paper has a normative as well as a practical orientation. It is based on the author's experience as a consultant in this field.

Areas that will be scrutinised are aspects of strategic planning in companies, partnership, trusts and sole proprietorships.

Each of these will be dealt with from four points of view:

- Tax strategy.
- Strategy regarding continuity and inheritance.
- Financial strategy.
- Strategy regarding control and administration and sociological aspects of joint farming.

By way of introduction the more important aspects of each of the business forms will now be summarised.

COMPANIES

The private company is the most typical type of company in the agricultural sector. A private company requires at least one shareholder and may not have more than 50. Transfer of shares are limited. The public may not be invited to take up shares in the company.

A company is a legal entity. Although, as it is usually said, it has no body to kick and no soul to damn. It has the right to own assets, incur liabilities, join in contracts, and so on.

A company consists of its shareholders and its directors. The annual general meeting of the company is the most important organ of administration. Such a meeting must take place at least once a year. The meeting is empowered to take ordinary resolutions about the general business activities of the company by ordinary majority of votes. A special resolution is required for changing the constitution of the company and also for any

change in the rights attaching to any shares. 75 % of the votes of the shareholders present at a meeting is required to pass a special resolution. It is therefore clear that any shareholder who controls three-quarters of the voting shares in the company, has effective control over the company. This has important estate duty implications for the estate planner.

The daily activities of the company is controlled by the directors. In the agricultural company we usually find one director in effective control. Directors are elected at the annual general meeting of the company.

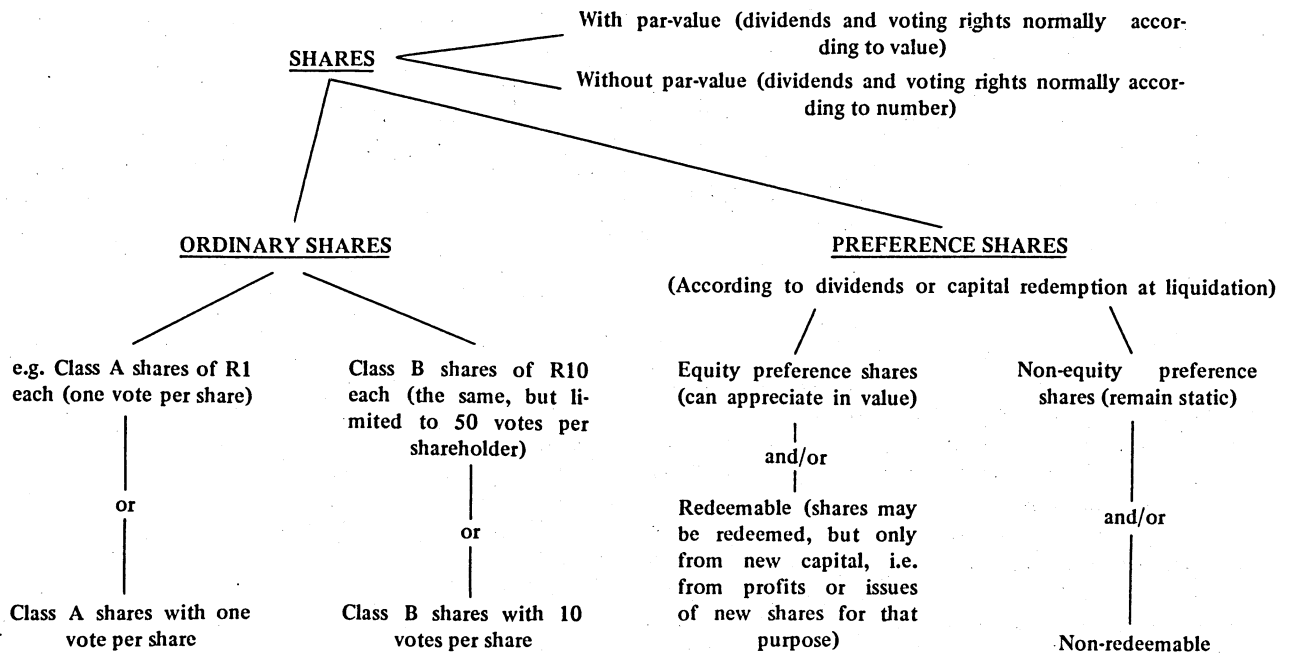
The rights that a member of a company has, depends largely on the type of shares he holds. A number of different types of shares can be issued as the schematic diagram below will illustrate.

There is virtually no limit to the number of classes of shares that can be issued. This offers the advantage that the share capital can be designed to meet the requirements of each individual case.

Companies can be used especially in the following situations:

- As a *property company* that takes transfer of fixed assets that are expected to increase in value. The advantage of the transfer is to freeze the growth in the estate duty value of the assets and therefore, to save estate duty. Property owning companies are, for technical reasons, usually not employed as operating companies as well. Typically the property owning company would lease its property to the owner or to another company.
- An *operating company* which carries on farming activities. This type of company is most often used to reduce income tax liability. It can also be employed where more than one person wish to farm together, but at the same time wish to retain their private assets.
- As a combination *property owning and operating company*. Here the company would own fixed property and will also carry on farming activities.
- An *investment company* (sometimes called a controlling company) where the company owns shares in various property and operating companies. This enables one person or one company to control a number of different

SCHEMATIC DIAGRAM OF TYPES OF SHARES



farming activities, each of which is carried on in a separate company.

PARTNERSHIPS

Unlike the company, the partnership is not a separate legal entity. The assets of the partnership are owned individually by the partners. A partnership is a contractual arrangement rather than a legal entity.

A partnership comes into being through a partnership agreement. Such an agreement may be written, oral, or even implied.

A partnership has to meet certain requirements. Each partner must make a reasonable contribution to the activities of the partnership. Such contributions may consist of money, goods, labour, managerial skills, or business leadership. The contributions to the partnership assets must be subject to the risk of partnership activities. All contributions of the partners should be applied to a common purpose. The purpose of the partnership should be the making of profit and the partners have to agree on a basis of profit-sharing.

In all, partners have to act towards each other in the utmost trust. Partnerships can be terminated in the following ways:

- By mutual agreement between the partners.
- The sequestration of one of the partners.
- The death of a partner.
- Resignation of a former partner or the joining of a new one.

When a partnership is dissolved, the assets of the partnership are often liquidated. The partnership contract will usually spell out how the

assets should be distributed in the event of dissolution.

TRUSTS

A legal arrangement that has become more frequent in agriculture is the trust. In the past trusts were often created as a bridging mechanism to take care of assets after the death of a testator until such time as the beneficiaries under his will are old enough to take full responsibility for their inheritance. Such trusts derive from a will and are called trusts mortis causa.

A trust may also be created during the life-time of the founder. It is then known as a trust inter vivos.

A trust is not a separate legal entity. The trust itself does not own any assets. All assets are owned by the trustees in their representative capacity. An inter vivos trust is created by means of a contract between the founder and the trustee or trustees. It can also be created by means of a contract between the founder and a beneficiary or one beneficiary and one trustee, although the latter does not appear frequently. Since a trust is nothing but a contract, there must be two contracting parties. The founder of the trust usually transfers the original property of the trust to it. When a trustee dies, the assets of the trust do not form part of his deceased estate. His death merely bring about a vacancy which has to be filled in the manner prescribed by the trust deed. The sequestration of the estate of a trustee may have serious repercussions, since some of the assets of the trust may form part of the insolvent estate of the trustee.

Decisions by trustees regarding trust assets are taken by a simple majority of votes, unless the trust deed specifies otherwise.

SOLE PROPRIETORSHIPS

By far the largest number of agricultural concerns in South Africa are carried on in the form of a sole ownership. A research project undertaken by the author during 1970/71 in the Winter Rainfall Region showed that 54% of the participants were then farming as a sole ownership, 32% through a partnership, 12% through a company and 1% in a trust.

In the past, tax considerations were probably the most important factor in the selection of the right business form. Most agricultural concerns in South Africa are not subject to a very high rate of income tax. The result is that most of them make use of the sole proprietorship. In those cases where the future heir takes up farming, he often does it as an employee or manager. This arrangement is later changed to a partnership or a company, or a lease arrangement to provide for the letting of the farm to the future heir may be drawn up. The sole proprietorship is the simplest business form for a farming operation.

STRATEGIC FACTORS IN SELECTING A BUSINESS FORM

It is not only of importance that the right business form should be selected right at the outset, but also that the business form should be adapted or even changed from time to time, where necessary. Such adaptation should be seen as a continuous process.

How each of the strategic factors influence the different business forms, will now be discussed.

COMPANIES

Tax strategy

A company is taxed at a fixed rate, irrespective of the size of its taxable income. The normal rate of taxation is 40% at present. To this must be added a surtax of 5% and a loan levy of 10%. The surtax and loan levy are calculated on the tax payable. This makes for a total tax impost of 46% of the taxable income.

Since the rate of company tax is higher than the marginal rate of tax of most individual tax payers, careful planning is required in this area. Up to an amount of about R22 000 per tax-year for married tax-payers, (depending on the deductions and abatements available) it pays a tax-payer to be taxed in his personal capacity. He would save tax if all further income accruing to him, over and above R22 000, is taxed through a company.

If the income of a company is derived from dividends, a further advantage exists. Dividends received by a company are not taxed in the hands of the company. The after-tax income of a company can be paid out to shareholders in the form of dividends. Should dividends be declared,

however, the shareholders will be taxed on the dividends they receive. If a tax-payer's dividend income exceeds R4 600 per year, one-third of it is free of income-tax. If the total taxable income of a tax-payer, including dividend income, is less than R4 600, a varying proportion of dividend income will be tax-free in his hands. If his total taxable income is less than R4 600 and more than R2 600, the dividend income will be tax-free.

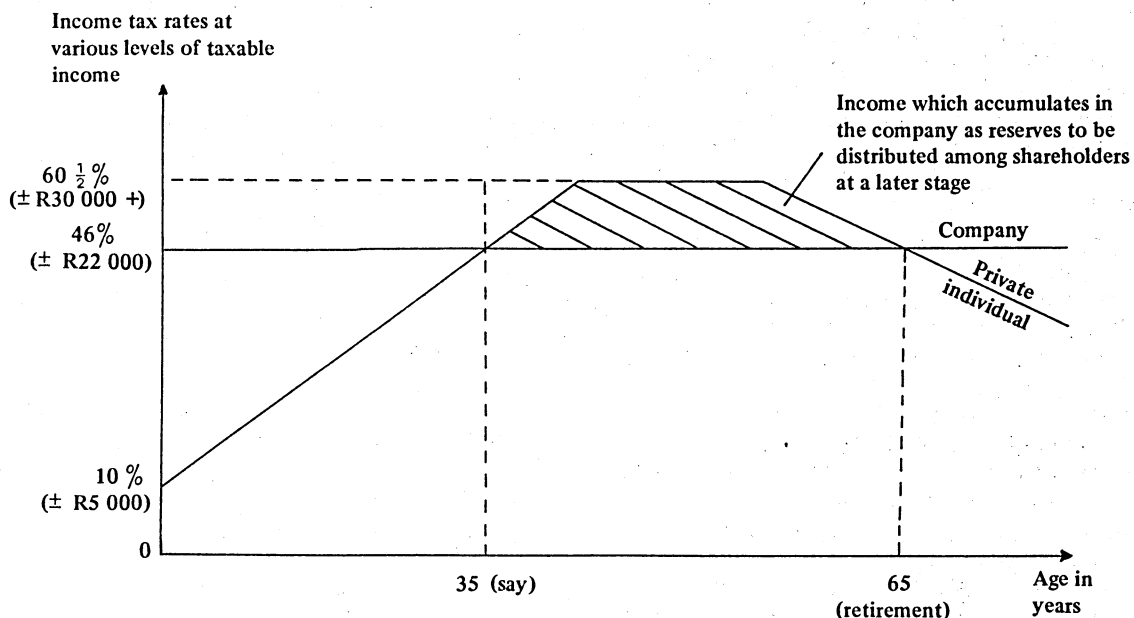
One commonly used strategy is to accumulate distributable reserves in a company and not to pay out a dividend. When the shareholder in the company retires, and his income is presumably lower, dividends can then be declared. This may lead to a lower tax-rate being applicable to the dividends being paid as illustrated in the diagram on the opposite page.

A shareholder may borrow the funds that have been accumulating as reserves in his company. However, one has to keep in mind that it is possible that the Department might in future begin to regard interest-free loans by a director from his company, as a fringe-benefit. As such, it may well attract tax.

The use of a company can therefore reduce the amount of tax payable by a tax-payer in a high income tax bracket. Whether this advantage will remain important in years to come, will depend on whether the Department succeeds in reducing the marginal rate of tax on individuals to bring it more in line with the company tax rate. If this happens, the tax advantages of companies will become less important.

Companies can also be useful as a vehicle for saving estate duty. An operating company, for example, may have various classes of shares. One class, typically preference shares, may be issued to the testator which gives him a measure of control over the company without increasing his estate duty liability. Growth in the value of the underlying assets in the company can then be channeled to ordinary shares which are issued to the future heirs of the company. The same can be used with a property owning company. Typically a farm may be transferred to such a company to ensure that the growth in the value of the farm falls outside the dutiable estate of the testator. This technique will have the disadvantage that 5% transfer duty would have to be paid on the date of transfer of the fixed property into the company. Further, the Land Bank value of a farm is typically not the main consideration in valuing the shares of a farm-owning company in a deceased estate. The sworn-appraisal has to be done which has to take into account the market value of the farm.

Another problem that may arise, is that of tax on undistributed profits. This is not a big problem at the moment, since tax on undistributed profits recently ceased to be of importance to companies that earn most of their income from non-dividend sources.



Strategy regarding continuity and inheritance

One big advantage of companies is that they have permanent existence until such time as they are liquidated.

A company is liquidated by a resolution of its members or by order of court. The assets are then normally liquidated and distributed among the members. In the event of a voluntarily liquidation, the shareholders may agree with the liquidator to distribute the assets to them without first realising these in cash. This can be done only after the creditors have been paid in full. In agriculture, farming concerns are often transferred to companies to ensure the continuity of the operating unit. When the testator dies, the company continues to exist to the benefit of the shareholders, which, in this case, would be the testator's children or heirs.

Individualism is an important characteristic of farmers. One therefore frequently finds the problems arise when shares in the same company are transferred to different children. This is especially the case where shares are transferred to children who do not farm themselves. One reason for the appearance of conflict is that most farmers, especially younger farmers, mainly concentrate on the accumulation of capital rather than the achievement of a high income. Considerations regarding tax and credit generating capacity, contribute to this. For this reason a relatively low income will be drawn from the company; most of the profits will be re-invested in capital improvements and expansion. This can lead to a conflict of interest between the active and the inactive shareholders in the company.

When the active shareholder wishes to buy the shares of the inactive shareholders, another

problem sometimes appears. A company's assets

may not be ceded as collateral in order to raise funds to buy the company's shares. A company, therefore, does not offer a simple solution to the problem of distributing assets in a deceased estate.

Where the shares in one company are issued to more than one heir, it is desirable that the shareholders enter into a purchase and sale agreement in terms of which some of the shareholders would be entitled to buy the shares of other shareholders in case of the latter's decease. Different companies may be created for different heirs, but this should always be weighed up against the advantages offered by other business forms.

Companies that have high distributable reserves and accordingly also high debit director's loan accounts, can also create problems. If the will stipulates that the heir inherits the shares on condition that he takes over the debit loan account, it may have the result that he receives a negative inheritance created by the large contingent tax liability.

Financial strategy

To finance its permanent assets, a company requires sources of permanent or long-term capital. Most farming companies are financed by means of a small issued share capital, which is then complemented by long-term loans, either from one of the directors (a so-called credit loan), or from outside sources. Most banks that supply loan capital to a company require the directors of the company to sign as personal surety for the loans. The limited liability of shareholders and directors for a company's loans is therefore not an advantage should the company's affairs go wrong.

Strategy regarding administration, control, and sociological aspects of joint farming

A company has to meet certain formal requirements, such as an annual general meeting, the preparation of annual financial statements, and so on, which do not apply to partnership or sole proprietorships.

To save estate duty, a majority shareholder in a company should not have absolute control over the company. If he does, the valuation of his shareholding may be unnecessarily high in his estate. This can be a limiting factor in the use of the company in agriculture, since special resolutions are required to approve of loans to directors.

Companies do not influence the sociological aspects of joint farming, since the majority shareholder controls the appointment of directors and therefore effectively controls the company.

PARTNERSHIPS

Tax strategy

The profits of a partnership are distributed to the partners in terms of the partnership agreement. Each partner is taxed at his individual tax rate on his share of the partnership income. If the income from a farming concern is spread among three partners, the total tax payable by the three partners may well be lower than would have been the case had the income accrued to a sole proprietor.

If a father and a son carry on joint farming, the total tax payable by both of them will in most cases be lower if they are partners; than if the son works for the father. The general principle in joint farming should be to share the income as equally as possible. That would reduce to a minimum the total amount of tax payable by the partners.

Tax strategy should be planned very carefully before the dissolution of a partnership. If one partner pays a cash amount as the purchase consideration for this partner's share, this may have an unfortunate result. The seller may have sold his share in the profit for a lower amount than its actual value in the hope that he would receive a non-taxable capital receipt. Despite this, the partner may still be taxed on the total income from the partnership that accrues to him. Estate duty will be calculated on the market value of the share of each partner. If a father and son were partners on the father's farm, the value by which fixed improvements to the father's farm financed by the partnership has enhanced the value of the father's farm, will form part of the dutiable estate of the father. The partnership may possibly have the right to be re-imbursed, but such re-imbursements will probably have to be done in the same ratio as the sharing of partnership income. If the son is the heir of the father, he will be able to deduct his share from the dutiable value of his father's estate. This may lead to a saving in income in estate duty.

Strategy regarding continuity and inheritance

A partnership comes to an end when one of the partners dies. Not only does the partnership end, but the partnership account may be frozen for a length of time to the great inconvenience of the surviving partners.

When a partnership is bequeathed as a functioning unit, it is therefore desirable that the partnership contract should contain a continuity clause. Such clause should also appear in the wills of the various partners. The clause should stipulate that the partnership account should not be frozen after the death of one partner and that the surviving partner is entitled or permitted to continue carrying on business.

If one of the partners does not wish to bequeath his partnership to the surviving partner, it is also desirable that a buy-and-sale agreement should be drawn up. This agreement should make sufficient provision for the financing of the purchase price that will be paid by the surviving partner for the deceased partner's partnership interest.

Financial strategy

No specific strategy is required in planning the finances of partnerships. The partners each contribute finances from their own assets to the partnership on a basis as agreed between them.

Strategy regarding administration, management and sociological aspects of joint farming

In this regard, the partnership in comparison with other business forms, offers the best opportunity for participated management. But, since there is such a close relationship between the partners, it is possible for conflict and clashes to arise very easily.

TRUSTS

Tax strategy

The income of a trust is taxed in a very specific manner. The trustee pays income tax in his representative capacity on the income that accrues to the trust. He is taxed at the rate applicable to an unmarried tax payer.

Income that vests with the beneficiaries of the trust are taxed in their hands.

In the case of discretionary trusts, the trustees have in terms of the trust deed, the right to assign the income in whatever proportions they see fit to various beneficiaries. In that case they will usually assign the highest income to the beneficiaries with the lowest marginal rate. If the trustees are very competent at investing money, the beneficiaries may wish to lend back the money that have accrued to them for re-investment to the trustees.

Trusts are frequently used where a testator owns a farm or a company with large reserves. He then forms a trust and bequeaths the assets to the trust with his grandchildren as beneficiaries. The

testator's children are appointed trustees with discretionary powers to allocate the income of the trust as they see fit. The children of the testator therefore control the income from the assets and also the use that the assets are put to. But they are not taxed on the income themselves as they would have been if the property itself had been bequeathed to them.

This strategy was used in the trust inter vivos until fairly recently. But the recent change of Section 103 of the Income Tax Act will possibly make it a more risky mechanism. The effect of the changes in Section 103 are discussed in a later section.

Trusts can save estate duty. If assets are transferred at a reasonable value to a trust, the increase in the value of the asset after the date of transfer will accrue to the beneficiaries of the trust. In other words, it will fall outside the dutiable estate of the founder of the trust. This estate duty saving can be achieved only if the trustee(s) do not have the power to benefit from the income or capital of the trust. If the trustees did have large control, the growth in the value of the trust assets after the date of transfer may form part of the dutiable estate of the trustees. A trust has to be irrevocable. If it is not, once again the growth in the value of the assets of the trust will not fall outside the dutiable estate of the founder of the trust.

The transfer duty payable upon the transfer of fixed property into a trust, is the same as that applicable to individuals. In this regard the use of the trust is cheaper than the use of a company.

Strategy regarding continuity and inheritance

Since trusts can be made to continue for an indefinite period, even until after the death of a trustee (in which case a new trustee will simply be appointed to replace him) trusts offer a large degree of continuity to the agricultural concern. To make sure that the continuity is never endangered, it is important to provide for a suitable successor trustee to take over the administration of the concern in case of the death of the first trustee.

Trusts are generally used in wills to ensure the continuity of an agricultural concern and to safeguard the assets until such time as the heirs are old enough to accept full responsibility for their assets. Trustees are then appointed in the trust deed to carry on the farming activities until such time as the beneficiaries take up farming themselves.

Financial strategy

The founder of a trust inter vivos will normally be expected to supply additional security for liabilities of the trust. In trust mortis causa the trustees will normally be entitled to use the assets of the trust as security only for transactions involving the trust itself.

Strategy regarding control, administration and sociological aspects of joint farming

In those cases where assets are transferred to a trust to be controlled by the trustees, decisions of the trustees will normally be taken by simple majority vote. However, the trust deed may specify some other way in which decisions should be taken. Normally the trustees will be given wide discretionary powers to handle and administer the trust assets. Their control and contractual capacity in the regard to the assets of the trust can, however, be limited in the trust deed.

THE SOLE PROPRIETORSHIP

Tax strategy

The tax situation for a sole proprietorship is quite simple. The sole proprietor is taxed on all income that accrues to him and he is taxed at his private income tax rate. If a son farms with his father, the father may pay the son a salary and a bonus. The salary and bonus will be deductible from the taxable income of the father and will be taxed in the hands of the son. As in all cases, it would be a pre-condition that the salary must bear a reasonable relationship to the nature and quality of the work rendered.

Where a son hires a farm from his father, the rent can be determined in such a way that the taxable income of both father and son will be a minimum. In terms of the Estate Duty Act, all improvements effected by an heir on property that he will inherit in future with the permission of the testator during the testator's life, can be deducted from the testator's dutiable estate to the degree in which it has increased the dutiable value of the property provided that the heir paid for such improvements himself.

Strategy regarding continuity and inheritance

The degree to which continuity will be maintained in an agricultural concern that is run as a sole proprietorship, will depend on the efficiency with which the will was planned. It will also depend on the degree of competence of the heir who takes over the farming concern. There are many farmers who are loth to delegate responsibility to their future heirs. This results in insufficient managerial experience for the future heirs.

Financial strategy

No particular strategy is required in this regard, since all normal principles of financial administration apply.

Strategy regarding control, administration and sociological aspects of joint farming

In this arrangement the testator retains the largest degree of control over his assets. However, it frequently happens that the future heir does not have sufficient opportunity for exercising responsibility.

In those cases where the testator wishes to retain maximum control himself or where the personalities of the testator and the heir clash, it is usually wise to let the whole or a part of the farming concern to the heir. This will enable him to learn about independence and responsible decision-making on his own.

TAX STRATEGY IN DIFFERENT BUSINESS FORMS - SUMMARY

It is fairly easy to calculate what kind of business form or what combination of business forms will lead to the lowest possible liability for income tax in every specific situation.

The example below illustrates this. Assume that the taxable income from a agricultural concern is R30 000.

The following alternatives are possible:

- Company tax (if everything is taxed in the hands of the company) R13 800
- Private income tax (if everything is taxed in the hands of the individual) R10 098
- Combination of private income tax and company tax (the first R20 000 in the hands of the individual and R10 000 taxed in the company) R 9 418
- Income tax in a partnership between father and son (R15 000 is taxed in the hands of each of the two partners) R 5 610

We have said already that the estate duty aspect must always be taken into account when the right business form is selected. The stipulations of Section 103 of the Income Tax Act should also be borne in mind.

Section 103 of the Income Tax Act is aimed at all transactions, arrangements or schemes which has as one of its main purposes the reduction, postponement, or avoidance of tax. It is, therefore, aimed against tax avoidance (in other words the reduction of tax liability by making use in a legal manner of all concessions permitted by the Act). Another section of the Act specifies penalties for tax evasion (in other words making use of illegal methods to break the law and save tax).

Before he can apply Section 103, the Secretary of Inland Revenue has to be satisfied that the following conditions are met:

- There must be a scheme, arrangement or transaction, the main purpose, or one of the main purposes, of which must be the postponement, reduction or avoidance of tax.
- The transaction or scheme must lead right to abnormal obligations or create abnormal rights.
- The main purpose, or one of the main purposes of the transaction, arrangement or scheme must be the avoidance, reduction or postponement of any tax which is administered by the Secretary.

Section 103 was amended in 1978. It is, however, interesting to note that the Section is, even now, only applicable to income tax and donations' tax and not to any schemes aimed at reducing estate duty.

Before the Act was changed, the income tax saving derived from any scheme aimed at income tax saving, and only that, could be attacked; now a scheme to save any tax is vulnerable provided that there is an income tax saving.

The tax planner should, therefore, bear Section 103 in mind at all times.

IN CONCLUSION

Tax saving occupies a central position in the selection and use of the right business form. But it is not the only consideration. Continuity, method of inheritance, financing, control, administration and sociological aspects of joint farming play a central role. Still, choosing the right business form will not, by itself, provide continuity - plans should be made for successors to all key personnel.

No general rules can be formulated about the best type of business form. Conditions and laws change. Many factors have to be borne in mind. Without thorough knowledge of all the strategic aspects that determine the selection of a business form, as well as practical experience, guidance to farmers is difficult.