

Risk Management

Basic Business Structures

Sole Proprietor, Joint Operating Agreements and Partnerships

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Most farming or ranching businesses are conducting business as sole proprietors. But as farms evolve and adapt to the changing economic environment, many producers are interested in exploring alternative forms of business organization. It is easier to analyze the way various business structures will address specific business objectives when there is a detailed business plan. Specifically, a resource inventory may identify capital needs as well as labor and management deficiencies that could influence the choice of business structure. Developing a SWOT (Strength, Weakness, Opportunity and Threats) analysis will identify potential liability issues that could be considered a weakness or threat to the operation. The choice of business entity operating structure can have both long-term and short-term consequences, so business managers should give the choice of business structure the same level of scrutiny they would use when analyzing any potential investment.

This publication describes some of the more basic business entity structures. All net income (loss) from these entities flows to the individual owners, who pay the income tax, self-employment tax and capital gains taxes.

Sole Proprietor

The simplest form of business organization is the sole proprietorship. No filings are required to initiate a sole proprietorship, thus there are

no cost or public disclosure issues. This form of business structure gives the owner/manager the greatest level of managerial control and the discretion to set his own limits on business activities. The sole proprietor and his personal resources, however, are fully exposed to all forms of liability. The life of the business is also tied to the proprietor. Thus, the sale of business assets or the death of the proprietor essentially terminates the business. A sole proprietor is typically limited to two sources of capital for the operation, personal assets and borrowed money. The need for additional capital often makes it necessary to consider another form of business.

Income tax management is often a major concern for small business operators. All earnings of a sole proprietor are subject to income tax and self-employment tax. With other business structures there may be additional taxable entities, so that tax liability is spread across more than one tax bracket. Sole proprietors are required to recognize all income from operations and the sale of property and pay tax on it the year it was earned. Sole proprietors enjoy the benefit of being able to “average” their farm and ranch income each year. They are also eligible to participate in a number of tax deferred retirement savings plans such as Individual Retirement Accounts (IRA), the Self Employed Pension (SEP), and the Savings Incentive Match Plan for Employees (SIMPLE). Sole proprietors



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can also use the Internal Revenue Service code section 179 expense election to deduct up to \$250,000 (for 2008) of certain capital asset purchases in the year they were purchased rather than depreciating them over the life of the asset.

Joint Operations

A joint operation (JO) is defined as two or more sole proprietors working together. How closely these proprietors work together is at their discretion. They may benefit financially by exchanging excess capacity in one aspect of an operation for the use of resources that otherwise might be inaccessible. No filings or public disclosure are required, but it is best to have a written operating agreement that defines the joint nature of the operation and explicitly states that no partnership exists or is implied. Control of management is retained by each individual to the extent that their decisions are not contrary to the operating agreement. Each proprietor maintains his own assets and depreciation schedule, and new capital purchases are made individually. For income tax management, each member of a JO has the same flexibility and options available to any sole proprietor. The financial resources of each proprietor of a JO are limited to his own debt or equity capital.

Because there is no joint ownership of any property, the accounting and termination of a JO is relatively simple. Generally, there are no tax consequences to terminating a JO. Each proprietor is able to leave the JO with his assets. However, the JO agreement should specify the methods that will be used to terminate the JO.

Each proprietor in a JO is subject to unlimited liability like any sole proprietor. Working with another individual without any kind of written agreement could be risky because the lack of a written joint operating agreement could be construed to imply a partnership arrangement. This may expose one individual financially to the financial problems of the other.

General Partnership

A partnership is a way of combining the resources, skills or talents of two or more people. It is a separate legal entity that must file its own tax return (Form 1065). However, net income (or loss) is allocated by classification to each partner (Form K-1) proportionate to the partnership agreement; and, income tax, self-employment tax and capital gains taxes are paid by the individual partners. Partners can then average their portion of farm income on their respective tax returns. No filings or public disclosure are necessary, but a written partnership agreement with buy and sell agreements, operating and management provisions, and liquidation agreements are strongly recommended.

Partnerships have flexibility in allocating income between partners through the use of “guaranteed payments.” Guaranteed payments to specific partners are subtracted from net income before the percentage allocation has taken place. Farm income passing through the partnership to the partners’ individual tax returns is eligible for farm income averaging. Tax deferred retirement plans also are available to partners. Regardless of how many partners are in a partnership, only one Section 179 expense deduction (see above) is available each year.

The accounting requirements of partnerships can be considerable. Partners have their own tax equity in the partnership, called capital accounts. Contributions into and withdrawals out of the partnership, along with the earnings (losses), are netted against these capital accounts. Under ordinary business practices, accounting can be very simple; but partial or total distribution of a partnership interest can be complex, especially if withdrawals from the partnership have exceeded taxable income. In that case, the tax consequences may be severe.

Partners are jointly and severally liable for the business actions of all other partners, which may actually increase the level of risk they are facing. Sources of capital available to the partnership will be contributions from partners and borrowings. Borrowings may be limited by the amount of collateral available to the lender, or by the personal guarantees of the partners.

Limited Partnership

A limited partnership is a partnership with at least one general partner and one or more limited partners. Limited partners can have no management responsibility and their liability is limited to their investment. General partners provide all the management and take all of the risks. Limited partnerships are taxed like general partnerships, except that income allocated to limited partners is not subject to self-employment tax.

Family limited partnership is the name commonly used when only family members are allowed as partners. Typically, some family members are general partners or an entity, a corporation or a limited liability company is created to be the general partner. Other family members would then be the limited partners. Family limited partnerships have been used to limit exposure to lawsuits, divorce, employee actions and risky investments. Limited partnerships are also used in estate planning. Often the family member with assets is made a limited partner. This person makes annual gifts of limited partnership interest to children and grandchildren. Because limited partners are not allowed any management over their investment (gift) and cannot control the business, discounting the value of limited partnership interest is accepted and may facilitate estate planning/transfer.

Summary

Business owners should consider many factors when choosing a business structure. Circumstances unique to a particular farm or ranch may dictate the choice of one form over another. The choice of business entity operating structure can have both long-term and short-term consequences. It is wise to seek professional advice from a certified public accountant or tax preparer, a legal advisor, a lender, and other resource people in both the planning process and the actual creation of the business entity.

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Partial funding support has been provided by the
Texas Corn Producers, Texas Farm Bureau, and
Cotton Inc.–Texas State Support Committee.

Produced by AgriLife Communications, The Texas A&M System
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Issued in furtherance of Cooperative Extension Work in Agriculture and Home Economics, Acts of Congress of May 8, 1914, as amended, and June 30, 1914, in cooperation with the United States Department of Agriculture. Edward G. Smith, Director, Texas AgriLife Extension Service, The Texas A&M System.