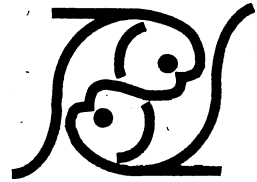

North Central Regional Aquaculture Center



In cooperation with USDA

Choosing an Organizational Structure for Your Aquaculture Business

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Introduction

There are approximately 2.3 million farms in the United States, ranging in size from small part-time farms to very large operations. Regardless of size, all farms are a form of business and can be organized or structured in several ways. Individuals involved in the business of fish farming need to be aware of the various organizational structures available to them, including sole proprietorship, partnerships (general and limited) and corporations (regular and subchapter-S).

The specific circumstances of the fish farm business dictate which of these structures is most suitable. For example, large farms with numerous employees and a large investment requirement may find it advantageous to consider a more formalized structure, such as a corporation. However, most farms are not in this category. In fact, 70% of the farms in the United States fall at the lower end of the income scale. This group is highly dependent on non-farm income. Overall net off-farm income has increased from 10% in 1960 to 42% in 1986. Nevertheless, these small farms or operations may still benefit from particular organizational structures.

This paper reviews the various forms of organizational structures which can be utilized in fish farming businesses and presents the advantages and disadvantages of each structure as they relate to such businesses.

Organizational Structures Sole Proprietorship

Most farms in the United States are organized as sole proprietorships. Under this structure the farmer is the sole owner, has legal title to the property, and is self employed. Management decisions are solely under the control of the farmer. Resources for the operation are limited to that available to the sole proprietor. With this organizational structure, personal and business assets of the owner are

jointly at risk in the operation. Liability is not limited to only that which is invested in the business. The farmer has total liability for all payments or actions, whether incurred personally or through the farm business. If aquaculturists are sued for a farm accident, their home and personal assets may also be in jeopardy. This is a risky situation for a farm business that may be a part-time venture. Especially, if a substantial amount of personal assets are involved.

Sole proprietorship is the simplest form of business organization as far as start-up and record-keeping are concerned, but it has its disadvantages. Sole proprietorship has been described as a hindrance to estate planning, farm transfer, and farm efficiency. However, if the farm operation will cease upon the death of the sole proprietor, it is the simplest structure to liquidate. Alternative organizational structures should be considered if "continuity of life" of the business is a concern.

Farm efficiency varies with the age of the sole proprietor. In the early years of an operation, efficiency is low, as assets are being accumulated. Mid-way in the operation, as the farmer's net worth and risk increase, the farm is at peak



**North Central Regional
Aquaculture Center
Publication No. 103**

USDA grant # 88-38500-3885

June 1992

operating efficiency. But as the years go on and retirement is considered, the operator usually becomes more conservative and is less willing to assume risk, thus efficiency generally declines. This cyclic pattern can be avoided by transferring the estate during the time of its peak efficiency. In most cases, however, transfer of assets such as land, buildings, livestock, machinery, etc., does not normally occur until the owner's death.

Landlord-tenant arrangements may be a practical alternative for older farm operators. Under this alternative, the landlord is still the owner of the property, but he receives income through rental. This option allows the conversion of farm income (earned) to investment income. Rental income is not considered "earned income"; therefore, it is not subject to social security tax, nor does it reduce social security benefits. The rental option is also attractive if several heirs are involved but not all are personally interested in continuing the operation.

Partnerships

Partnerships are the organizational structure of nearly 12% of the farm businesses nationwide. This arrangement is similar to a sole proprietorship, except that it consists of two or more persons as co-owners. In agriculture, parent/child partnerships have been popular.

There are two types of partnerships: general and limited. In a general partnership, each partner shares in the ownership, management, and liability of the farm business. Each partner is equally liable for any and all payments or actions of the business whether incurred personally or by a part-

ner. The individuals, not the partnership, are the taxpayers as is the case in a sole proprietorship. No legal agreements are required to establish a general partnership. This informal arrangement may be dissolved with the same ease with which it was formed. One co-owner may dissolve the partnership.

The main advantage of the partnership arrangement is the increase in resources brought to the business as additional partners enter into the operation. But, with this increase in resources, comes a loss of total management control.

Partnerships have disadvantages when considering estate planning and transfer. If a partnership is dissolved, property transfer becomes complicated. In the event, of the death of a partner, the survivors are generally required to liquidate the business and distribute the assets. If a partner is planning for the business to continue after his death, an agreement with that stipulation should be drawn up. That certainly would be the case in a parent/child partnership. However, if additional partners are involved, they are not obligated to accept an additional general partner, especially if the added partner is a minor.

A limited partnership is made up of both limited and general partners. The limited partners share in the business's profits and losses, but are not involved in management. The general partner views the limited partner as an additional source of resources without the obligation of sharing management decisions. The limited partner's risk and liability are only to the extent of their

investment in the business. Therefore, for limited partners, the business is an investment in which they have neither management responsibility nor the unlimited liability of a general partnership or sole proprietorship. The limited partner is essentially trading a voice in management for limited liability.

Generally, profits are not equally shared among general and limited partners in a limited partnership. The general partners are normally paid a salary for managing the operation, and the remaining profits are proportionally distributed. As is the case with sole proprietorship and general partnership, the individuals are still the taxpayers. Occasionally, a limited partnership may be perceived as a corporation by the U.S. Internal Revenue Service, and taxed accordingly. Care should be taken that the limited partnership does not have the corporate features of: 1) continuity of life, 2) centralized management, 3) transfer of partnership interests to another individual, and 4) limited liability. The feature of "continuity of life" is normally not applicable since a partnership may be dissolved by a general partner. A limited partner may terminate involvement without disrupting the business or partnership.

The limited partnership does require a formal legal arrangement that meets state requirements. It is required that the agreement be legally filed, normally with the Secretary of State or similar office.

Corporations

Fewer than 5% of the farming operations in the United States are incorporated. However, corporations are the most rapidly growing type of farm business organization. A corporation is a legal entity. The rights of a corporation are similar to those of individuals. Corporations can enter into contracts, own real and personal property, and sue or be sued independently of the stockholders. Ownership of a corporation is held as shares of stock which are claims on the net worth of the business. The two primary classes of stock are preferred and common.

Management and control of a corporation are shared among the following three groups: the stockholders, the board of directors, and the officers. Basic decisions are made by the stockholders, while the board of directors sets the policies for the corporation. The day-to-day decisions are made by the officers.

The individual may manage and operate the farm just as any business manager would, but does so as an employee of the corporation. Although the corporation is owned by the stockholders, the corporate structure provides a means of separating ownership from management and of protecting both parties from risks or liabilities associated with the corporation. Accordingly, unlike sole proprietorships or partnerships, stockholders are not personally liable for actions of the corporation. Liability is limited to the individual investments of the stockholders. A corporation is the best organizational structure as far as protection of personal assets is concerned. A corporation, like a partnership, provides a means by

which related or unrelated individuals may combine their funds and operate a business. However, in the case of a corporation, the organization is considerably more structured and legally binding.

A corporation can be organized to exist perpetually or for a term of years. It is legally created and can only be terminated through the legal process. Incorporation of a farm business can help to hold the farm together through generations. Death of a stockholder, including the head of the farm business, does not result in the dissolution of the business. Likewise, any stockholder can sell their shares without breaking up the business. The stock can simply be transferred to a new owner. Estate planning is also simplified, because stock shares can be transferred to heirs more easily than titles to land and buildings.

As far as organization and taxation are concerned, two types of corporations exist. They are the regular or subchapter-C corporation and the pseudo or subchapter-S corporation. When structured as a C corporation, the corporation is the taxpayer. Earnings and profits are distributed to the shareholders as dividends, and the dividends are taxed as ordinary income. Stockholders do not directly share in the losses of the corporation.

The subchapter-S corporation was authorized in 1958, especially for small businesses including agriculture. In order for stockholders to request subchapter-S classification, the following criteria must be met: 1) only one class of stock, 2) less than 35 initial stockholders, and 3) consent of all stockholders to the subchapter-S

choice. A husband and wife are treated as one stockholder. If a corporation ceases to meet the requirements of an S corporation, it is terminated. The corporation charter may also be revoked if it is the desire of greater than half of the stockholders. The primary difference between a C and an S corporation, besides the class of stock, is taxation. The S corporation is taxed as a partnership. Both profits and losses are passed onto the stockholders. As is the case with a limited partnership, the officers of the corporation are compensated before the remaining profits are distributed.

The corporation is the most involved as far as organizational costs and record keeping are concerned. Articles of incorporation are required, officers must be elected, and a board of directors formed. Most states require stockholders to meet at least once annually and annual fees and taxes may be imposed on the corporation. In many instances, federal, state, and social security taxes have actually increased following incorporation. Regulations concerning incorporation must be adhered to strictly; otherwise, the stockholders stand the risk of having "the corporate veil pierced." In that case individual stockholders are personally liable for the actions of the corporation.

Summary

The issues concerning the choice of organizational structure for farm businesses are: 1) resources, 2) liability, 3) management control, 4) continuity of the operation, and 5) taxation. The most suitable choice for a given farm business depends upon how one or more of these factors affect

the financial and personal well-being of the individuals involved.

In the case of sole proprietorship, the primary advantage is total management control. Resources are limited to that available to the sole proprietor. The sole proprietorship offers little protection of personal assets which are not a part of the operation. It is the least effective in maintaining the operation at peak efficiency. Transfer of assets and estate planning also are difficult.

The general partnership is similar to a sole proprietorship, but it involves more than one individual. The primary advantage of the general partnership over the sole proprietorship are additional resources. There is no further liability protection, and, in fact, risk increases because each partner is liable for the actions of the other. Additionally, management must be shared. This can be a disadvantage unless partners are involved in different aspects of the operation. It has no advantages over the

sole proprietorship concerning continuity or estate planning.

The limited partnership also provides additional resources. Its advantage over the general partnership concerns the issues of management and liability. A limited partner does not dilute the management of an operation. The departure of a limited partner does not affect the business as greatly as the departure of a general partner. More paperwork is involved in a limited partnership compared to a general partnership or sole proprietorship. It offers no advantages for estate planning or continuity of the operation.

The most formalized organizational structure is the corporation, either subchapter-C or S. Unless the operation is very large, most farmers wishing to incorporate will most likely choose the subchapter-S format. The primary advantages are limited liability of participants and continuity of the

operation. Since all profits are passed onto stockholders as income, there are few if any tax advantages. On the other hand, very large corporations may benefit from C corporation status. This is the only organization structure in which the individual is not the taxpayer. Tax laws have been designed to make the C corporation structure beneficial only for large operations with numerous employees and large capital requirements.

Fish farming is a business, and as is the case for any other business, individuals should use the organizational structures which offer them the most advantages. Because fish farming is such a diverse business activity, no single structure can meet the needs of individuals or for all situations. Therefore, individuals involved in the business of fish farming should weigh the pros and cons of the various organizational structures and make decisions that best meet their needs.

The contents of this bulletin reflect the opinions of the authors. It is not legal advice. Readers should consult with their legal and/or tax advisers concerning the applicability to their individual situations of the forms of organizational structures discussed in this bulletin

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Originally published at Iowa State University, Ames, Iowa.

Any opinions, findings, conclusions, or recommendations expressed in this publication are those of the author(s), and do not necessarily reflect the views of the United States Department of Agriculture,