Section 2.4
Business Organization: Structure And Issues

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Section Summary

• Discuss business organization principles
• Describe different types of business organizational structures
• Show advantages and disadvantages of organizational structures
• Determine which structure is better for certain situations
Types Of Business Organizations

1. Sole proprietorship- individual owner, complete managerial control
2. Partnership- two or more owners share profit/loss
3. Corporation- legal entity created to conduct business
4. Limited liability company- hybrid of partnership and corporation
5. Cooperative/ New Generation Cooperative Cooperative- entity owned by members
Organizational Structure

• Formal way employee responsibilities are assigned

• Organization
  ‣ Hierarchy of authority
  ‣ Specific rules and regulations for work
  ‣ Standardized training
  ‣ Division of work

• Organizational structure can be summarized in a chart
Example: Organizational Chart

- Randy Gradishar
  President

  - Barney Chavous
    Marketing Manager

  - Louis Wright
    Production Manager

  - Jim Ryan
    Market B Manager

  - Rulon Jones
    Market A Manager
Keys To Organization

• Clear line of authority and responsibility
• Responsibility coupled with authority
• Report to one supervisor
• Accountability moves upward
• Delegate authority to the lowest practical level
• Line personnel separated from staff personnel
• Simple yet flexible structure
Four Options For Departmentalization

1. **Functional**: arrange according to function such as production, marketing, research

2. **Product**: divide according to type of product sold

3. **Geographic**: divide according to region

4. **Customer**: divide according to the relationship with the customer such as wholesale, retail or direct sale
Life Cycle Of The Firm

A firm goes through cycles across time:

- **Growth**: sales growth & equity building (often through sweat equity)
- **Maturation**: human resource & organization skills important; maintain customer base; hire and retain employees
- **Aging**: sharing & transferring wealth become important, as well as legal & organizational issues
Advantages Of Sole Proprietorship

- Owned by individual or household
- Easy to create
- Few forms to fill out, need only file with city or county clerk’s office
- Owner is management and therefore the decision maker
- Control of all money and profit made by the business
Advantages Of Sole Proprietorship

• Flexible, easy to respond quickly to day-to-day changes and decisions
• Fewer restrictions
• Free from bureaucracy
• Less government control and taxation
• Don’t have to file separate tax return for the business
Disadvantages Of Sole Proprietorship

- Unlimited liability, responsible for 100 percent of business debts and obligations
- May need additional insurance coverage which can be very costly
- Business existence is fragile; death, physical impairment or mental incapacitation of the owner can result in termination
- Difficult to raise capital or get financing
- Fewer partners mean less skill and knowledge
Tax Considerations For Sole Proprietorships

- Business income filed on the personal income tax form of individual owner or household
- Income is subject to the individual owner’s personal income tax rate

Three Types Of Partnerships

1. General: may be a simple arrangement or an oral agreement; no state registration required

2. Limited: one partner has unlimited liability for the debts of the partnership

3. Limited liability: partners have unlimited liability for their own actions, but not liable for the actions of other partners

Advantages Of Partnerships

• Easy to form, straightforward legal documents, less complicated than incorporation paperwork
• Partners directly share in profits
• Improved growth possibility
• Easier to attract capital than in a sole proprietorship
Advantages Of Partnerships

• Flexible, easier to execute decisions than a corporation but more difficult than a sole proprietorship

• Free from bureaucracy, fewer federal regulations and taxation
Disadvantages Of Partnerships

• Unlimited liability of at least one partner
• May need to purchase considerable insurance to protect the business
• Unstable, if any partner quits or passes on, the partnership is dissolved
• Still difficult to obtain large sums of capital and financing, especially for long-term
Disadvantages Of Partnerships

• All partners can be held liable for the decisions, activities and commitments of any one partner

• Buying out a partner or severing a partnership difficult unless method agreed upon in the beginning
Tax Considerations For Partnerships

- Actual partnership does not pay federal income tax

- Partnership income is taxable to partners at individual income tax rate of the partner

- Business losses may be offset against other personal income

Two Types Of Incorporation

1. C-Corporation:
   - owned by shareholders
   - shares may be publicly traded or privately held
   - considered separate entity for legal & tax purposes

Two Types Of Incorporation

2. S-Corporation:

- similar to C-Corporation but generally taxed as a partnership
- shareholders may deduct their proportionate share of corporation’s losses on their personal income tax return
- gain from asset sales subject to one level of taxation only

Advantages Of Incorporation

- Liability is limited
- Corporation is a separate, distinct legal entity from its owners
- Personal assets separate from business assets (able to protect personal assets)
- Lower tax rate on initial $200,000 annual taxable income

Advantages Of Incorporation

• Easier to accumulate large amounts of capital and financing

• Suitable for large-scale activity and more vertical integration

• Complete separation of ownership and control, especially when stockholders don’t care to participate actively in the business
Disadvantages Of Incorporation

• More expensive than sole proprietorship or partnership

• Higher administrative obligations; more paperwork required

• Double taxation: corporate profits taxed as corporate income & dividends or salary received from the stocks taxed as personal income

Tax Considerations For Corporations

- Corporation taxed on its own income, separate from individual shareholders

- Dividends and income passed on to shareholders also taxed on the personal income tax form of the shareholder (double taxation of corporate income)

Advantages Of Limited Liability Companies (LLC)

• Owners have limited liability, if problem occurs, will only owe as much as they have invested

• A sole proprietorship is able to become a limited liability company with no tax consequences or added tax compliance requirements

• Taxable income or losses of the business will generally pass through to the owners
Advantages Of LLCs

• An LLC can have corporations or partnerships as shareholders

• Able to claim tax losses in excess of investment on certain leveraged real-estate investments

• Simpler entity to maintain than a corporation
Disadvantages Of LLCs

• Need written operating agreement on how business will be run (similar to partnership agreement)

• Articles of organization must state that entity will terminate in not more than 30 years

• Must have more than one owner in some states
Disadvantages Of LLCs

• No payment by an LLC to buy out one of its members can qualify as deductible (i.e., goodwill or unrealized receivables)

• All earnings of professional LLC are generally subject to self-employment tax
Tax Considerations For LLCs

- Federal income taxation similar to a partnership
- Share of LLCs income must be reported on the member’s personal income tax form
- Business losses may offset a member’s personal income

Cooperatives

• Integral to agriculture for many years; presently used by many beef producers

• Belong to the people who use them

• Operate for the benefit of their members

• May be producer- or worker-owned

Principles of Cooperatives

• Democratic control: one member = one vote

• Subordination of capital: profit paid back based on patronage of business done, not based on amount of investment in business

• Liquidation preferences based on patronage rather than investment

New Generation Cooperatives (NGCs)

• Date to 1970s with sugar beet growers in North Dakota & Minnesota

• Currently explored for several agricultural practices, including:
  ‣ Hog production
  ‣ Beef processing
  ‣ Egg production
  ‣ Pasta production
  ‣ Wet corn milling
NGC Features

- Producer-owned cooperative
- Link product equity contribution & product delivery rights
- Tradable equity shares & delivery rights
- One member = one vote
- Member earnings distributed on patronage basis
NGC Features

- Value-added processing of member commodities
- Require significant equity investment
- Rely on strict delivery contracts
- Closed membership – membership limited to a certain number of producers
NGC Advantages

- Producers part of integrated food system (receive share of cooperative earnings)
- Mechanism to integrate business around large processors (easier to develop contracts and relationships)
- Free rider problem reduced (delivery rights tied to equity contribution)
- Shares of the cooperative are tradable
NGC Disadvantages

• Inadequate capital:
  ‣ Producer commits 40-50% of retained earnings as equity in cooperative
  ‣ Not enough members to support investment

• Inadequate research and development funding
  ‣ In early years, need additional capital beyond member investment for research and development of markets
NGC Disadvantages

• New members may pay more as cooperative share values increase

• Financial risk:
  ‣ Significant up-front investment
  ‣ May increase debt leverage- ratio of total assets to their equity

• Difficult working with a group of producers toward a common goal
Pitfalls To Avoid With NGCs

• Lack of clearly identified mission
• Inadequate business planning
• Failure to use advisors and consultants
• Lack of membership leadership
• Lack of member commitment
Pitfalls To Avoid With NGCs

- Inadequate management
- Inadequate capital for start-up & operation
- Market not in place when production begins
- May become dependent on grant funding – difficult to wean from grant support
Pitfalls To Avoid With NGCs

- Failure to identify and minimize risk
- Overly optimistic assumptions
- Inadequate communication
- Problems with the physical plant
- Noncompetitive business location
External Support System
For NGCs Important

Organizational catalysts:

• Communication between members important
• Agreement on goals
• Must plan timing of development phases
External Support System For NGCs Important

Financial grants to support organizational phase very beneficial:

- Conduct feasibility study to determine if cooperative will succeed
- Create business plan
- Conduct research and development
- May require matching funds from potential members
Characteristics Of NGC Investors/Members

- Tend to farm more land or farm on a larger scale
- Less farming experience
- Younger, better educated
- Members are often involved in other cooperatives unlike non-investors
- Net worth tends to be nearly double that of non-investors
Characteristics Of
NGC Investors/Members

• View themselves in the food processing business not just food production

• Feel that NGC will:
  ‣ Increase income
  ‣ Reduce market risks
  ‣ Help gain market access
NGC Nonfarm Capital
(Off-farm Investor/Member)

- As farm corporations and agribusinesses grow, off-farm investors more important

- Used to be a tax shelter (before 1986 Tax Reform), but now a potential diversification tool

- Some external investment in agriculture is prohibited by law, too much investment from external sources may remove cooperative status
NGCs Nonfarm Capital (Off-farm Investor/Member)

- Initial Public Offerings (IPOs) very expensive; few firms go after this money
- Very complicated being publicly held corporation, with a loss of control most owners do not want
Tax Considerations For Cooperatives

- Single level of taxation, similar to partnerships, because income distributed to partners on patronage basis rather than investment

- Tax-exempt cooperatives may be established

Choosing The Right Organizational Structure

• Meet with legal consultant to discuss which business organization is best for your situation

• Remember tax considerations

• Following chart describes organizational structures by:
  ‣ Resources needed (labor and capital)
  ‣ Level of interaction by owners

• Each business is unique, may fit in different quadrants of chart than shown (chart shows typical location)
Choosing The Right Organizational Structure

High Resources Needed

C-Corporation
S-Corporation
Cooperative
LLC or LLP

Low Resources Needed

Sole Proprietorship
Partnership

Low Interaction

High Interaction
References & Additional Resources

• http://extension.usu.edu/aitc/resources/tlc_pdf/busines4.pdf
• http://home3.americanexpress.com/smallbusiness/resources/starting/structuring/structure_cc.shtml