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

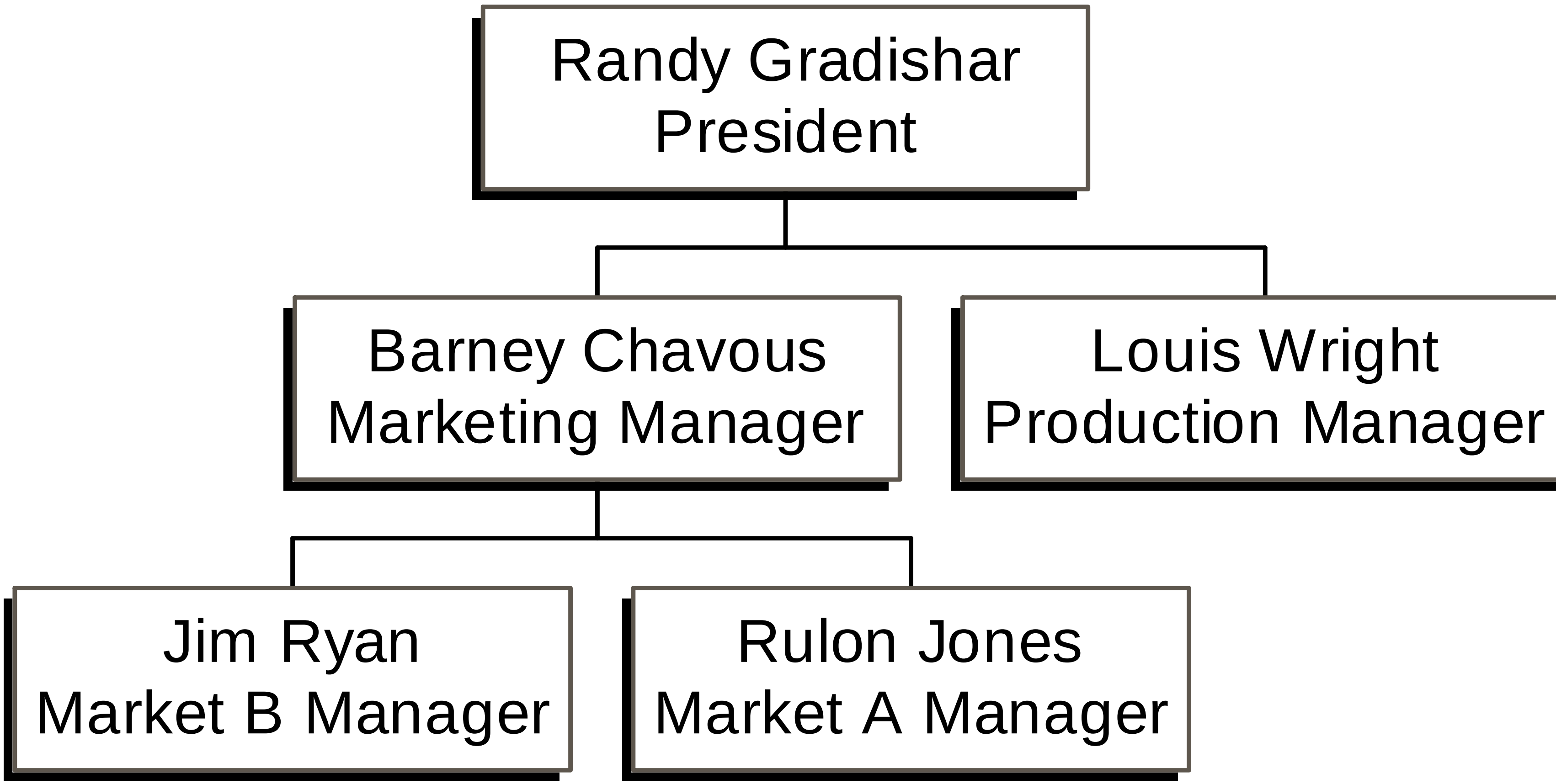
Types Of Business Organizations

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- 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



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

Source: Legal Structures and Considerations for Businesses. 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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

Source: Legal Structures and Considerations for Businesses. 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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

Source: Legal Structures and Considerations for Businesses. 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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

Source: Legal Structures and Considerations for Businesses, 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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

Source: Legal Structures and Considerations for Businesses. 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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

Source: Cori and Dave Singleton. Pros & Cons of Incorporating Your Business.
2003: Legal Ease Library Inc. Online at: http://www.risingwomen.com/arcsingleton2.htm.

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

Source: http://home3.americanexpress.com/smallbusiness/resources/starting/structuring/structure_cc.shtl, 2003; and Cori and Dave Singleton, “Pros & Cons of Incorporating Your Business.” Legal Ease Library Inc., 2003. Online at: http://www.risingwomen.com/arcsingleton2.htm.

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)

Source: Legal Structures and Considerations for Businesses. 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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

Source: Legal Structures and Considerations for Businesses. 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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

Source: Legal Structures and Considerations for Businesses. 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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

Source: Legal Structures and Considerations for Businesses. 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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

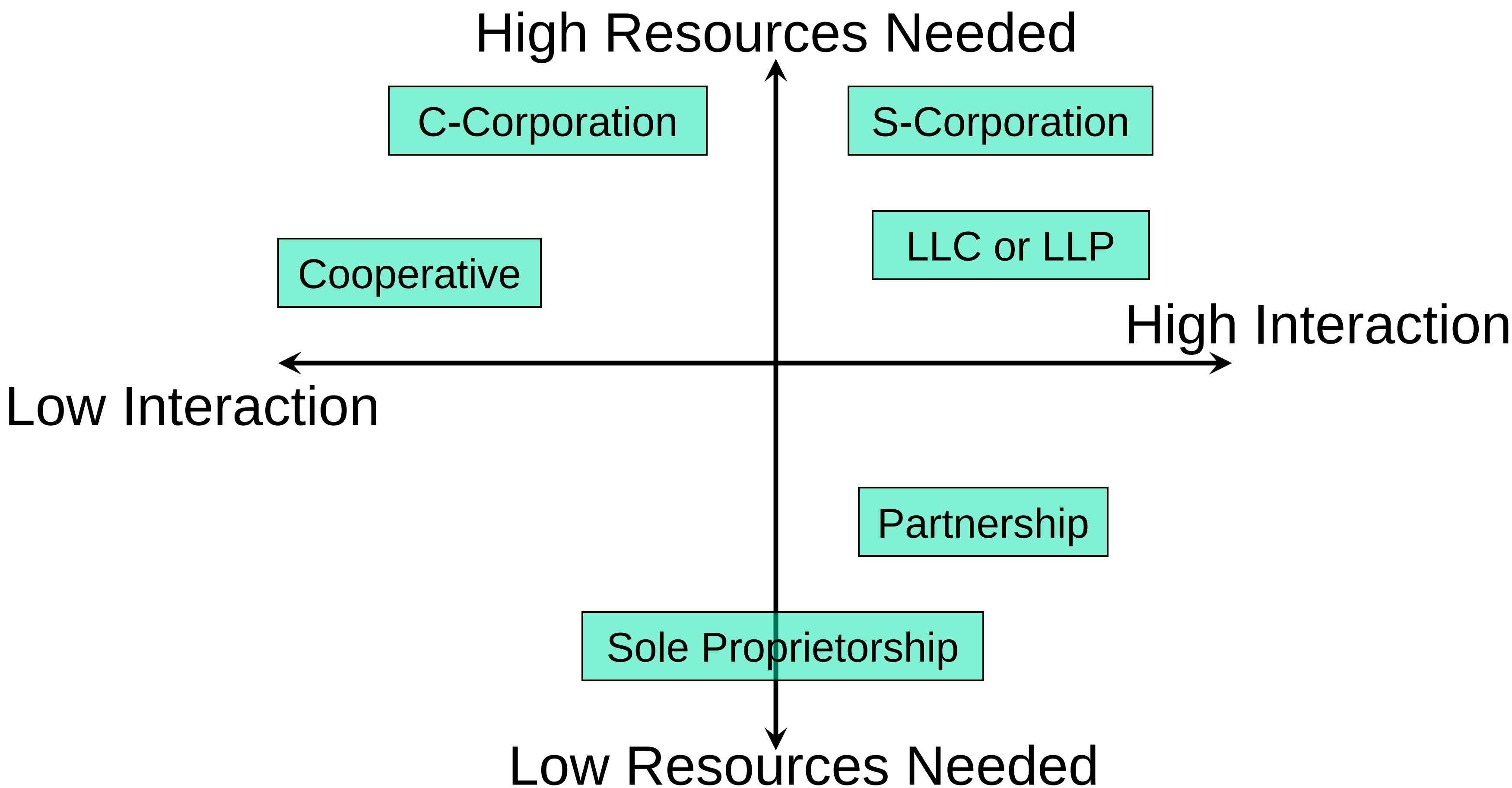
- Tax-exempt cooperatives may be established

Source: Legal Structures and Considerations for Businesses. 2003. Online at http://www.ciras.iastate.edu/beefmanual/index.html.

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



References & Additional Resources

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- http://www.businesstown.com/gettingstarted/structure-procon.asp
- http://www.businesstown.com/gettingstarted/structure-partnershipprocon.asp
- Legal Structures & Considerations for Businesses. Online at http://www.ciras.iastate.edu/beefmanual/index.html

References & Additional Resources

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