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Whole Farm Planning Model

ANR-52
Agriculture and Natural Resources
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Planning is one of the most important aspects of managing any business. This is especially true for farms and agribusinesses due to their complexity and the inherent uncertainties (i.e., weather, commodity prices) associated with agriculture. It is essential that farm managers take time to adequately plan for all facets of their business. Farm families are encouraged to adopt a whole farm planning approach as they develop strategies for the future success of their business. This approach allows families to examine the internal structure of their business and then develop business, retirement, transition, estate and investment plans.

The Farm Family

At the center of most farms and agricultural businesses is the family unit. Each family, individually and collectively, has its own history, values, and goals. It is valuable for the business to begin the planning process by reflecting on family and farm history. Valuable lessons can be learned by all the generations involved by examining past successes and disappointments. The underlying values and goals of the family unit should also be determined. While these values and goals oftentimes remain unspoken, they have a large impact on how family members treat each other and employees and make business decisions. A critical look should also be given to understanding the effect that family members could have on the farm operation, especially those (spouses, in-laws, cousins, ex-spouses) who are not directly involved in the day-to-day operations.

Individual Assessment

There is no one test that can identify individuals suited for a career in agriculture. Each member of the farm business should conduct a self-assessment of his or her communication, financial, production, marketing and management skills. There are a multitude of skills that each individual can bring to an operation. This is beneficial given the complexity of most farming operations. While some family members may be better with bookkeeping or managing employees, others may be better at managing livestock or fixing equipment.

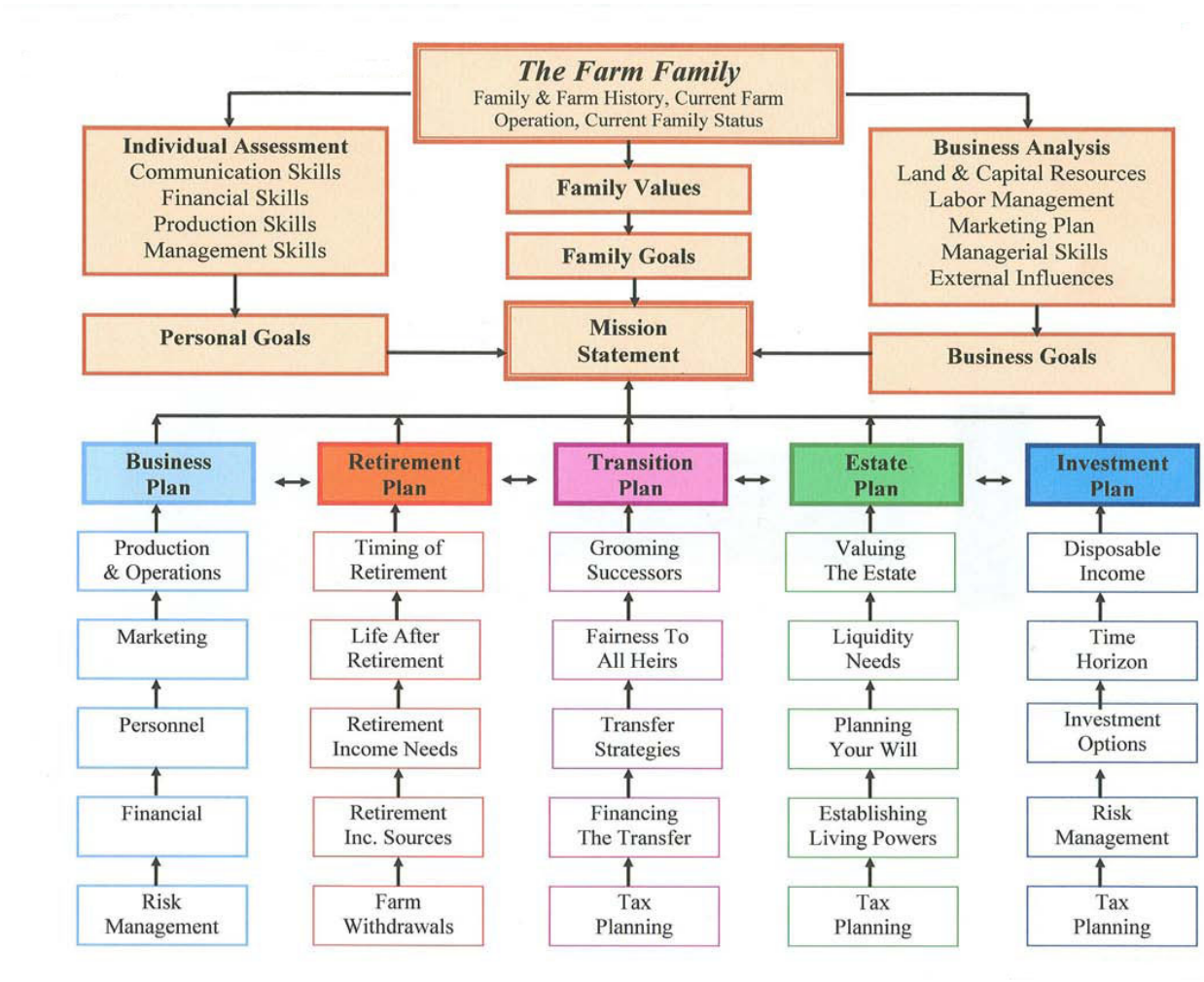
Each family member should take time to analyze his or her own skills to determine how he or she can best fit into the farm operation. Some of the questions that can be asked during individual assessments are:

- Why do I farm?
- What do I value?
- What goals do I have for our farm?

- How do my personal goals and dreams agree with or conflict with the business goals?
- What strengths and weaknesses do I have in regard to managing the enterprises raised or produced by the farm (crops, livestock, manure, agricultural service)?
- How are my decision-making skills?
- What are my budgeting and financial skills?
- What are my marketing skills?
- What is my personality type, and how does it blend with family members or employees?
- What are the financial needs of my family?
- How does my family feel about the business?

There are many individual assessments available for use by farm operations. Contact your local Extension office for examples of these assessments.

OSU Extension Whole Farm Planning Model



Adapted from: Manitoba Agriculture and Food

Business Analysis

An analysis of the current state of the farm should be conducted to determine the available land, labor, capital and management resources. This process looks at the who, what, where, and why of the business. Who works on the farm? What does the farm grow or raise? Where does it produce its commodities? Why

does the farm exist? This analysis should determine the physical, fiscal and personnel status of the business. This analysis should also examine the operation's efficiency and identify any available resources that are not currently being utilized. The farm's profitability, business structure, operating procedures and employee management should also be determined. It is also helpful for the management team to identify the external influences that could impact the business in the future. These influences could include any governmental, political, economical, environmental, social or technological elements.

After taking a snapshot of where the farm business is currently, the family business team should develop key goals for the future. It is important that each individual share his or her individual goals and skill-set assessments with the other members of the business during this process. Members can then work together to determine the responsibilities of each and to develop goals. Successful farm businesses are ones whose goals and objectives are a reflection of all the members involved in the operation.

Mission Statement

Once the family, individual and business analyses have been completed, the management team should develop a mission statement for the farm. A mission statement is a short statement describing the fundamental reason for the business to exist — its critical purpose. This statement aligns what the business says it does, what it actually does, and what others believe it is about. This statement is a reflection of the underlying values, goals, and purposes of the family business.

Here is an example of a mission statement:

"The purpose of the Buxton Fruit Farm is to produce and market high-quality apples and table grapes in sufficient quantity to provide a good standard of living for my family and full-time employees. We believe the farm is a good environment for raising children and desire to have the farm remain economically viable for future generations."

For more information on developing mission statements, refer to the OSU Extension fact sheet *Develop a Useful Mission Statement for Your Agricultural Business.*

Developing the Five Essential Plans

Once a family has completed its internal analysis, family members can continue the planning process by developing business, retirement, transition, estate, and investment plans. A description of each planning area is given in the following paragraphs. It should be noted that each of these planning areas does not stand alone. Like spokes in a wheel, all will need to work in harmony to ensure the long-term viability of the business. Each area can positively or negatively affect the performance of the others. One example of this would be if investment planning has gone well, more assets will be available to help fund business operations or retirement needs. As plans are developed for each of the five areas, it is essential that the management team examine the effects that each has or could potentially have on the other plans.

Business Plan

A business must be profitable in the long run in order to exist. On most farms, the major planning that occurs is for the farm's production practices. An example of this is deciding what variety of corn to plant or deciding what sires to use for breeding cows. However, planning for the success of the farm business should include much more.

A comprehensive business plan should be developed. This plan not only helps the family develop a plan of action for production and operation practices, but also helps develop plans for the financial, marketing, personnel and risk-management sectors of the business. One recommended method of evaluating the

farm business is to conduct a SWOT analysis. This analysis examines the Strengths, Weaknesses, Opportunities and Threats in each of these areas. For information on how to conduct a SWOT analysis, refer to the OSU Extension fact sheet *Conducting a SWOT Analysis of Your Agricultural Business*. In short, the agricultural business plan presents a picture of the agricultural business or farm, where the business is going, and how it will get there.

Retirement Plan

No one expects to work forever. A strategy to help each business member meet his or her expected retirement needs should be developed. The two main retirement questions that should be addressed are how much money does each family member need for retirement and what will the farm's obligation be to retirees? A variety of factors such as age at retirement, retirement housing and other retirement accounts held by the family will affect retirement needs. It is essential that retirement plans are established early for all members of the business. It is also important that the profitability of the farm be such that a family member can retire and not adversely affect the financial position of the business.

Transition Plan

The goal of transition planning is to ensure that the business has the resources to continue for many generations. Transition planning helps the family analyze its current situation, examine the future, and then develop a plan to transfer the business to the next generation. This includes planning not only for the transfer of assets but also managerial control. Members of the primary generation should invest time in transferring their knowledge to the next generation. For more information on transferring the family business to the next generation, refer to the OSU Extension fact sheet *Planning for the Successful Transition of Your Agricultural Business*.

Other discussions should center on when the next generation is authorized to make capital purchases and when that generation will take over control of activities such as paying bills and keeping production or compliance records. The transition plan, coupled with the estate plan, should also address how off-farm heirs will be treated through the transfer process without jeopardizing the future of the farm or the agricultural business.

Estate Plan

Farm estate planning is determining how the farm assets, such as land, buildings, livestock, crops, investments, machinery, feed, savings, life insurance, personal possessions, and debts owed to or by the farm, will be distributed upon the death of the principal operator(s). Due to the potential tax implications of transferring these assets, consultation should be made with an attorney and a tax practitioner, each having experience in transition planning.

Investment Plan

The primary investments made by farm families are usually in land, machinery, and livestock. Farm operations may, however, wish to invest in such off-farm investments as stocks, bonds, mutual funds, real estate, life insurance, retirement homes, precious metals or disability insurance. These investments allow farmers to save for future education or retirement needs and allow for investment diversification. Factors that farmers will need to consider during investment planning include the rate of return, personal risk tolerance levels, tax considerations and the time horizon available for investing.

Summary

Planning for the future is one of the most important functions of management. By implementing a whole farm approach to planning, farm businesses can be ready to face the future with confidence. A multitude

of resources are available through Ohio State University Extension offices to help farm operations plan for the future. Contact your local Extension office for more specifics in any of these planning areas.

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Planning for the Successful Transition of Your Agricultural Business

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As the age of farm operators increases, transferring the ownership and management of the family business to the next generation will become one of the most important issues farm families will face.

While many farmers dream of seeing their legacy passed on to the next generation, many postpone initiating a plan for the transition of their business for a variety of reasons. Many claim that there is not enough time to discuss these matters. Or if planning does occur, it simply involves the senior generation drafting a will describing how the farm assets should be divided among heirs.

The main question that the principal operator of a farm or agribusiness should ask is: "Do I want to pass my farm operation to my heirs as an ongoing business or do I want to pass it on as a group of assets?"

If asset transfer is the goal, then an estate plan can be developed to determine who will get what, when they will get it and how they will receive it. If the goal is to keep the business intact for the next generation, then a transition plan needs to be developed.

Age of Ohio Farm Operators	
Year	Age of Principal Operator
2012	56.8
2007	55.7
2002	53.8
1997	52.5
1992	52.0
Source: Census of Agriculture, NASS	

What Is Farm Estate Planning?

Farm estate planning is determining how farm assets (i.e., land, buildings, livestock, crops, investments, land, machinery, feed, savings, life insurance, personal possessions and debts owed to or by the farm) will be distributed upon the death of the principal operator(s).

What Is Farm Transition Planning?

Farm transition planning is the process by which the ownership and the management of the family business are transferred to the next generation.

The goal of transition planning is to make sure the business has the resources to continue for many generations. Transition planning helps the family analyze its current situation, examine the future, and then develop a plan of action. This includes planning not only for the transfer of assets but also managerial control. It should also include developing a strategy to meet the retirement needs of each generation.

Each farm family is different in regard to its goals for transition planning. Family dynamics, physical resources, financial position and managerial styles vary from operation to operation. As farmers plan to transfer the family business to the next generation, there are a myriad of decisions to be made. One of

the most difficult is determining how to be fair to off-farm heirs without jeopardizing the future of the heirs who have remained with the family business. Other decisions include deciding who will manage the business in the future, how to distribute assets, how and when the senior generation will retire, and how the business will deal with the unexpected.

No two transition plans are alike. Given the complexity of individual farm businesses and the unique personalities and characteristics of family members, a cookie-cutter plan, which families can adopt, does not exist. It is recommended, however, that the family address the issues presented here when developing the transition plan.

Determine If the Business Is Profitable

A business must be profitable in order for future generations to continue the operation. A comprehensive review should be conducted to determine the production, financial, marketing, and personnel management strengths and weaknesses of the business.

An excellent way to accomplish this is by conducting what is called a SWOT analysis. This analysis examines the Strengths, Weaknesses, Opportunities and Threats of the farm operation. This analysis helps the business examine a variety of business performance indicators. Some of these indicators could include commodity productivity, farm efficiencies, debt structure and the financial viability of the business. (For information on how to conduct a SWOT analysis, refer to the OSU Extension fact sheet *Conducting a SWOT Analysis of Your Agricultural Business.)*

After completing a SWOT analysis, it is recommended that a comprehensive business plan be developed. This plan allows the family to develop strategies to meet the production, marketing, financial, risk and personnel management sectors of the business. It can also include strategies for improving the financial position of the business so that multiple generations can be involved in the business. In short, the agricultural business plan presents a picture of the agricultural business or farm, where the business is going, and how it will get there.

Involve the Family

Transition planning is a process in which the entire family should have a role. It should not be about secret meetings between parents and the favorite sibling. Many operations utilize family business meetings as a strategy to involve the entire family in the transition process. It should be noted the underlying success of any business depends greatly on healthy family relationships and open communication. Many two-generation family business arrangements fail because of poor family communication and relationships.

Family business meetings can help the entire family communicate about sensitive issues. They can also allow the family to plan for growth so that multiple generations can earn a living from the business. These meetings also allow the family to develop a transition plan that complements the estate, retirement, investment and business operation plans. (For more information on conducting family business meetings, refer to the OSU Extension fact sheet *Conducting Family Business Meetings.)*

Develop a Plan to Transfer Assets

Planning how to transfer the tangible and intangible assets of the farm operation should also be addressed in the farm's transition plan. In most cases, these plans are made and executed through the estate plan, which is initiated upon the death of the principal operator. However, a business can also transfer many of these items to the next generation prior to the death of the principal operator.

Tangible items include things you can touch such as breeding livestock, crop inventories, machinery, equipment, land, and buildings. Rarely does the next generation take over ownership of all the tangible business assets at once. Usually ownership is assumed as their experience and commitment to the business increase. These assets can be transferred through gifts, sales, or through the estate or a trust upon death. Due to the potential tax implications of transferring these assets, consultation should be with an attorney and tax practitioner, each having experience in transition planning.

The intangible items that should be transferred are sometimes less obvious, but they are just as important when developing the transition plan. Intangible items can include verbal agreements, goodwill, authority and location of records. The senior generation should invest the time necessary to transfer their knowledge of these items to the junior generation. For instance, there may be many unwritten arrangements with neighbors or with suppliers of feed, seed, fertilizer or veterinary services. The primary operator also has historical information that should be shared with the next generation. This could include well and tile placement, electrical wiring, and the location of legal documents vital to the operation.

Other discussions should center on when the next generation is or is not authorized to obligate the farm (buying a tractor or other expensive capital items) and when the next generation will take over control of certain activities such as paying bills and keeping production or compliance records.

Develop Future Managers

Transferring assets to the next generation is often easier than transferring management. Many family farms have two to three generations working side by side. Farm families traditionally operate in a hierarchical structure where the older generation holds the purse strings until death. Oftentimes, the junior generation is not given any managerial control until its members are old enough to retire themselves. Farm businesses should develop a plan for sharing managerial responsibilities between generations and anticipate management voids created by people moving up, retiring or leaving the business.

Development of managers is a long-term investment in people and should not be ignored. Many excellent community and Extension management courses exist in which the junior generation can enroll to increase its managerial skills. The senior generation should not wait until death or a few months before retirement before transferring control. The transfer of managerial skills should be treated as a process, not as an event.

Develop Plans for Retirement

No one expects to work forever. Each generation should develop an individual retirement plan, and the business should help family members meet their expected retirement needs. The two main retirement questions that will need to be addressed are how much money does each family member need for retirement and what will the farm obligation be to retirees?

A variety of factors such as age at retirement, retirement housing and other retirement accounts held by the family will affect the amount needed for retirement. It is important that the profitability of the farm be such that a family member can retire and not adversely affect the financial position of the business. In some cases, the farm business has to be sold in order for a senior member to meet retirement needs.

Develop Contingency Plans

Successful businesses also recognize that life is full of twists and turns. Given this, attention should be given to the unexpected. Contingency plans should be made for when key managers leave the business

unexpectedly or when unplanned events such as death, divorce, disability and health problems arise. Each of these unexpected twists could damage the viability of the operation if contingency plans have not been made.

Develop a Timetable for Implementation

It doesn't happen all at once. A timetable should be established for accomplishing each step in the transition process. Without a timetable, you won't know if you are failing or succeeding in hitting your objectives. Many families will utilize a testing or a probationary period for the transfer of ownership, management, income and labor. Given the complexity of most farm operations, the transition process could take years.

Final Thought

Transferring a family farm or farm business to the next generation can be a challenging task. Legal issues, tax laws, and personal differences between family members are some of the issues families must confront when deciding how to transfer the managerial and asset control of a family business. Working together, families can answer the tough questions and develop a transition plan that will provide the opportunity for the agricultural business to be successful for many generations.

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FACT SHEET

Ohio State University Extension, Ashland County, 804 US Hwy 250, Ashland, OH 44805

Develop a Useful Mission Statement for Your Agricultural Business

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Introduction

Farms or agricultural businesses that are able to clearly communicate who they are and what they stand for are often more successful than those that don't have a true understanding of their focus. One way to develop strong communication lines and a clear understanding of what the business does is through the process of writing a mission statement. It does not matter whether the farm business consists of two people or 50, all involved must have a clear understanding of what the business does and why they do it in order to move the business in the desired direction.

A mission statement is a short statement describing the fundamental underlying reason for the business to exist — its critical purpose. This statement aligns what the business says it does, what it actually does, and what others believe it does. It clarifies what the business is not trying to do and not trying to be.

This statement is a reflection of the underlying values, goals, and purposes of the farm and of the management team. The mission statement should be communicated and remembered.

Writing a Mission Statement

The process of developing a mission statement is by nature very abstract, and it can be a challenging and time-consuming process for management to conduct. However, the mission statement development process can be a very rewarding undertaking, if the time and energy are spent to write an honest description of who the business is and what is valued, what the business does and how it is done, and who the customers are. The end result will be a shared understanding of the focus of the business and a strong foundation on which to make business decisions.

A well-written mission statement should describe the farm business accurately and also provide inspiration to those who work to meet the everyday and long-term goals of the business. Since the creation of a mission statement is one of the first steps in the planning process, many of the discussions held during the process can also be used when writing the goals for the business.

Here are some sample mission statements:

Farm Market Mission Statement

Our mission is to produce a healthy and safe food product, maximize profitability, and maintain our rural heritage. It is important for us to provide a quality product and agricultural education for the tri-state farm market consumer. Building on our strong reputation, we will continue to grow our business and our people to ensure long-term success.

ABC Farm Mission Statement

We are a family-owned and -operated grain farm and plan to ensure this opportunity to the next generation. We strive to make efficient use of inputs, maintain excellent land stewardship practices, and produce high-quality commodities for the end user. We value rural life and are committed to keeping our rural community vital.

Landscape Service Mission Statement

Our mission is to enhance the outdoor living environment of our customers by providing quality

landscape services that are environmentally safe and economically sound while allowing our employees to grow as landscape professionals.

When developing a mission statement, give attention to what is important to the business now and in the future. Use the worksheet on the final page of this fact sheet to help you sort out your thoughts first as an individual, then as a group. It is important to have a clear understanding of where you stand as an individual before you think about the farm business. Ask both management and employees to complete the worksheet on their own. You will need to consider questions such as:

- What are my personal values?
- What are my business values?
- Why do we farm?
- What do we really want to do?
- What are the strengths of our business?
- What role does each family member and/or employee fulfill?
- What standard of living does the family want?
- How much family time do I want?
- Are nonfarm and/or community activities an important part of my life?
- When do I want to retire?
- Do we want to transfer the family business to the next generation?

Mission statements have a tendency to quickly get out of control and can become lofty, meaningless statements of grandeur. For example: *Our farm business strives to produce the best quality milk possible and provide customers worldwide with a nutritious supply of milk.* This statement does not tell anything about what the business really stands for or how they produce '"the best quality milk." It doesn't explain what the "best quality milk" is, and "customers worldwide" is a broad explanation of the customer base. This statement is written more like a vision statement, which is the futurist dream of the farm business. The mission statement should be a more specific and focused statement. A good example of a mission statement is the Yoder Farm Mission Statement:

Yoder Farm Mission Statement

The Yoder Farm mission is to produce and market high-quality milk in sufficient quantity to provide a good standard of living for our family. The business should also be profitable enough to provide above-average compensation for employees and long-term security for our family.

Group Process

One person should not take on the job of writing the mission statement. It is essential that everyone directly involved in the operation of the farm business — spouse, parents, siblings, children, non-family employees, etc. — have the opportunity for input. This will provide a more true statement of what the farm business does and what it values. This approach also provides for greater buy-in and acceptance by those involved in the business. Although some business members may grumble about spending time on what may be viewed as an unimportant task, in the end everyone does appreciate being asked his or her opinion. It is hoped that everyone will feel like he or she played an important role in the success of the business.

After answering the questions on the worksheet on the last page of this fact sheet, the next step is to come together to discuss your answers as a group. Remember, it will take some time to work through the development process. Try to spread the group discussion over a set period of time involving more than one family meeting. Try to find times that fit everyone's work schedule and meet in a neutral place. In other words, don't save this discussion for the holiday dinner around mom and dad's table. Family dinners should be reserved for family time, and discussions about the farm business mission statement should be conducted on work time when not in a peak production season.

As a result of the group discussions, a draft form or forms of the statement should be developed. The draft(s) can be two sentences or several paragraphs. Share the draft(s) with family members and employees, asking them to suggest revisions and additional thoughts.

The final form should be a concise statement of what the farm business does, how it is done, who the customers are, and what is valued. It does not matter what form it is written in, paragraph style or bullet points. Choose whatever form is comfortable for you. It is your business mission statement and should be a reflection of your business and its style.

Use of the Mission Statement

The value of a mission statement comes from the active use of it. Review your mission statement often to be sure it still fits with the direction of the business. Use the mission statement to aid in the goal-setting process and when making decisions. Successful businesses are built on strong foun-

dations. Taking the time to develop a meaningful mission statement will provide your business with the foundation it needs to be successful today and into the future.

Finally, once the mission statement has reached its final form, it should be printed and posted in an area such as the farm office, tool shop, milking parlor, or employee break area where it can be viewed on a daily basis. It will be of little use to the business saved in a computer file or in a desk drawer. Be proud of what your farm business does, how it does it, and why!

Summary

There is no perfect mission statement form. Managers should concentrate more on the process of gaining a better understanding of the business, themselves, and employees rather than worrying about the appearance of the mission statement. A useful mission statement will be one that clearly represents the business and its employees and will provide a foundation on which to develop business goals.

For more information on writing business goals, refer to the Ohio State University Extension Fact Sheet *Developing Goals for the Agricultural Business.*

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Mission Statement Worksheet

The following questions should be answered individually and then brought together for those involved in the business to answer collectively. Your answers don't have to be confined to one page. A mission statement can be developed from the group's answers.

1. Why do I farm?

2. What do we do? What is our purpose?

3. Who are our customers? What do they want?

4. How do we accomplish our purpose? What practices do we use and who is responsible for what?

5. What beliefs and values do we hold?

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Developing Goals for the Agricultural Business

Building for the Successful Transition of Your Agricultural Business Series ANR-45
Agriculture and Natural Resources
Date: 04/11/2018

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Goal setting is a critical step in the strategic planning process of any agricultural business. While a mission statement steers the direction of the business, it tends to be rather abstract. Goals are more concrete and are therefore easier to comprehend and to act on. Ultimately, goals will be the standard by which we will measure our progress in the agricultural business, so goal setting deserves the utmost attention.

SMART Goals

An acronym commonly used to describe effective goals is SMART. Goals must be Specific, Measurable, Action-oriented, Realistic, and Timed in order to be useful management tools.

Goals should be:

Specific—Goals should focus on a specific problem or need.

Measurable—There must be some means of tracking achievement of goals.

Action-oriented—Actions will be the pathway to achieving goals.

Realistic—Aim high, but keep goals within the realm of possibility.

Timed—Goals are only useful when they are current. They should include a realistic timeline and a completion date.

Goal setting should include a specific action, an evaluation process, and, if needed, refinement of the goal. In this respect, the goal-setting process closely resembles the scientific method. Goal setting is purely an internal function intended solely to benefit your operation or in some cases, just the manager. Developing and refining goals for any operation may be challenging; however, the process should be enjoyable for those involved. If goal setting becomes tedious or exhausting, take a break from it and come back to it at a latter time. There is no finite time frame for goal setting—it is a fluid process that will evolve as an operation grows and changes. Since goals are intended to guide a specific agricultural business, the manager has great latitude in goal setting and the chosen approach to achieving those goals. From a manager's perspective, there are three types of goals that are crucial to the agricultural business. They are the manager's personal goals, production goals for a specific enterprise, and operational or business goals for the operation as a whole.

Three Types of Management Goals

1. *Personal goals*
2. *Production goals*
3. *Operational or business goals*

Personal Goals

Personal goals involve the ambition and dedication of a single individual. Several people may share the same goal, but it is a goal for them individually. Personal goals often pertain to the advancement of a person's career or to the allocation of scarce resources, particularly time. A manager's personal goal might be to own the operation, which he or she currently manages, within the next five years. Another could be just to attend his daughter's spring concert next Thursday, even if it means finding someone to cover his normal duties. Personal goals will come in all sizes, but the take-home message is that they must be communicated to others within the business because the manager's personal goals can have a profound effect on the outcome of business goals.

Production Goals

Production goals involve improving a process within the operation. Production goals are much narrower in scope than operational goals because they pertain to just one piece of the much larger puzzle that is the agricultural business. Agriculture as an industry embraces production goals but many times at the expense of operational or personal goals that are equally important.

If you are a dairy manager, a good production goal might be to increase the rolling herd average by 10 percent over the next two years. This goal will never be realized if it is not communicated to the right people within your operation. A goal of this scale is likely to require several improvements in the day-to-day operation of the dairy. As the manager, it is your responsibility to educate your employees on specific changes that they can make to help the team achieve this production goal.

Operational or Business Goals

Operational goals are usually grander, both in scope and scale, than production goals. While operational goals are still focused, they pose a good opportunity for the managers of an operation to dream big and challenge themselves in the future. While commonly overlooked, operational goals are essential for long-term growth of any operation. A common operational goal is to accommodate the income needs of the next generation by expanding the operation. Again, the initial step in seeing this goal to fruition requires good communications. Why should the operation expand to support the next generation if the next generation has no plans of ever joining the operation on a full-time basis? A good manager will convey to the other employees of the operation the importance of operational goals and what their role will be in the process of achieving the goals.

In many cases, one set of goals is directly dependent upon another set of goals first being achieved. For example, an operational goal may be to expand an operation by 50 percent in the next two years. This goal would probably be dependent on achieving reasonable production goals over that period. Likewise, if the manager has personal goals of earning more money, this may hinge on the proposed expansion. Assuring that goals within the operation do not conflict is another responsibility of the manager.

Building a Consensus

Goals that a manager hopes to achieve in his or her farm business need to be communicated directly to those who can help achieve those goals. This communication could take any of several forms, but in most settings, talking directly with key people or meeting with employees in a group setting will help build consensus among the people who will make goals attainable. Without the universal support of your

employees, the chances of accomplishing your goals will be greatly reduced. Striving for universal support of a farm's goals is an ongoing management task and a critical step in seeing goals to fruition.

Good managers surround themselves with intelligent people who have their finger on the pulse of the operation. If key people in the operation do not offer support of established goals of the business, then consider that there may be aspects of those goals that have been overlooked. Ask for their input, but be ready for the possibility that the response does not parallel your viewpoint. Working through this dialog will help to refine the goals for a business and make strides in building consensus among its employees.

In many farm businesses, a consensus would mean getting only two or three people to agree. At times, this can be more difficult than getting support from a room full of people. Even if a manager is only in charge of one other employee, setting goals without seeking that person's input will usually prove ineffective. One very effective approach is to offer a goal as a suggestion, let the idea simmer for a few weeks and then bring it up again. By that time the goal will either have gained momentum or it will just fade away. This is particularly effective in small and/or intergenerational operations.

Goals Reflect Persistence

Let's look at a real-farm example of a practical production goal. A father and his two mature sons operate a successful grain and hog operation with the help of two very dedicated full-time employees. One son provides leadership to the farrow-to-finish operation while the other son manages the grain production. All five people work in both segments of the operation when needed. The son managing the hogs realizes that the operation experiences poor performance in growing pigs following the move from nursery to finishing floor. His hunch is that the growing pigs would make the transition to the finishing floor more efficiently if they were a bit larger, say 37 pounds instead of 34 pounds as they had averaged in the past. The manager makes this a goal of the hog operation for the next few months. He brings up the idea at the morning coffee break which doubles as a morning meeting for the entire operation each day. The group discusses it briefly, and they all go their separate ways. No formal action was taken, but the seed of a production-improvement goal has been planted.

Strong Operations Make Goals Happen

Just one discussion was enough to prompt the people in this operation to spend a few more minutes each day to ensure that the nurseries were as comfortable as possible so that the pigs grew just a little faster. In just two months, the operation increased the nursery weights to 37 pounds and ultimately the operation reduced the days from farrow to market by three days. Six months later, no one in the operation could agree where the suggestion came from, but all agreed that the young pigs were making the transition to the finishing floor more smoothly than ever. In this example, the goal was specific, measurable, realistic, action-oriented, and had a time element. Even more important is that the goal was subtly stated, and as a result, the team accepted the challenge and worked toward attaining the goal without having to commit extraordinary time or resources. As far as no one remembering who should get the credit—that is a great example of a work team achieving a shared goal.

Summary

Goal setting is a management duty, but it should be an enjoyable experience. Goals help challenge those involved in the business, but more importantly, goals can get everyone in the organization working for the betterment of the operation. Many goals will never be realized. Some will spawn new ambitions. Others will be achieved and surpassed, but the process of goal setting should continue for the life of your business.

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Conducting a SWOT Analysis of Your Agricultural Business

Building for the Successful Transition of Your Agricultural Business Series ANR-42
Agriculture and Natural Resources
Date: 04/06/2018

Chris Zoller, Extension Educator, Agriculture and Natural Resources, Tuscarawas County
Chris Bruynis, Extension Educator, Agriculture and Natural Resources, Ross County

Many large businesses conduct an analysis to identify the Strengths, Weaknesses, Opportunities, and Threats (SWOT) of their business in order to keep pace with the competition. You may not consider yourself a large corporation, but completing a regular SWOT analysis of your farm or agricultural business can be beneficial to keep you competitive. It may sound like a difficult task to complete, but it does not have to be. The following paragraphs help explain what a SWOT analysis involves and how to complete this process.

Strengths and Weaknesses

The first two sections of the SWOT analysis usually examine the internal workings of your farm business. These items are usually within the control of the business owners. One example could be future management of the business. Is there a next generation owner/manager who has the interest in the business and the ability to manage the complexities of the business? Another example could be the financial position of the business. Does the farm business have too much debt held as short-term? Here are some sample questions that can be asked to assist in determining your business' strengths and weaknesses.

Strengths

- *What strengths does your business have that make you competitive?* Examples might include family, labor, machinery, farm size, etc.
- *What do you do better than anyone else?* Are you a better marketer? Are you a well-respected employer? Are you able to complete planting and harvesting duties efficiently?
- *What do your customers see as your strengths?* Ask your customers what they think.

Weaknesses

- *What could you improve?* What is holding you back? What little changes might make big impacts?
- *What should you avoid?* Have you completed a financial analysis of your business to evaluate enterprises?
- *What do your competitors do better than you?* You can work to be better than the competition, but in some cases you may be better off to fulfill a need they are not meeting.

Opportunities and Threats

The second part of the SWOT analysis requires you to look outside your business at issues that you cannot control but can manage to enhance or reduce their impact on your business. An example for a livestock producer could be the development of the neighboring farm into single-family housing units. Here are some sample questions that can be asked to assist in determining opportunities and threats to your business.

Opportunities

- *What trends are facing your business?* Will you have to increase in size to remain competitive or can you remain at your present size?
- *What is happening in your community that can be advantageous?* Are new livestock facilities coming to your area that could provide a new market for crops you grow and sell? Is there an opportunity to market directly to local consumers? Is there a niche market?

Threats

- *What obstacles do you face?*
- *What is your competition doing?*
- *Do changes in technology threaten your business?*
- *Does your financial position threaten your business?*
- *Could any particular weakness seriously threaten your farm?*

Who Should You Involve?

Generally speaking, the people most directly involved with the business should participate in a SWOT analysis. This would include family members employed in the business and hired employees. Input from outside advisors, such as your attorney, banker, Extension educator, or accountant, may also be helpful as they may see your farm from a different perspective.

Depending on the type of farm you have, asking customers their opinions can prove useful. Asking spouses, even if they are not employed in the business, for their opinions and perspective is critical. Involving them may provide a different perspective and help the business achieve its goals. Not involving spouses can potentially do more harm to the family and the business.

Next Steps

Completing a SWOT analysis of your farm business is the first step in strategic planning. (A form for doing the SWOT analysis appears on the following page.) The process should help you identify areas where your strengths and opportunities align with a high probability of success. Conversely, you will also identify combinations of weaknesses and threats. Your strategic plan should avoid these areas or at least provide for methods to minimize their effects on your farm business.

The SWOT analysis is not something you do one time and place on a shelf to collect dust. At least once a year, complete a new analysis. You may find little change has occurred, but it is still a good idea to review achievements, measure production efficiencies, and evaluate alternatives.

Acknowledgments

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Clevenger, Extension Educator, Agriculture and Natural Resources/Community Development, Defiance County.

Reviewer of this fact sheet was Bruce Clevenger, Extension Educator, Agriculture and Natural Resources/Community Development, Defiance County.

Completing Your SWOT Analysis

In the space provided, list the strengths, weaknesses, opportunities, and threats for your farm business. Once you have listed all the items you can think of, prioritize each category. Use this information in developing a strategic business plan to help your business remain competitive.

Strengths

Weaknesses

Opportunities

Threats

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Conducting Successful Family Business Transition Meetings

Building for the Successful Transition of Your Agricultural Business Series ANR-43
Agriculture and Natural Resources
Date: 04/09/2018

Chris Zoller, Extension Educator, Agriculture and Natural Resources, Tuscarawas County

"I'm too busy."

"We'll start after the corn is planted and the hay is made."

"We tried them before, and they didn't work."

"We've never needed them before."

"We all get along."

"Why should I care what my son-in-law or daughter-in-law thinks about the farm?"

These are just a few of the excuses people give for not conducting family business meetings. You can probably think of others. However, conducting family business meetings can have a very positive influence on the success of your business. Let's take a look at what a family business meeting is and some reasons to consider holding these meetings.

What Is a Family Business Meeting?

There is no one definition that is applicable to all families, but in its simplest form, a family business meeting is an opportunity for members to come together on a regular basis to discuss issues of interest to those family members involved in or who have an interest in the business. These meetings are not for discussing which field to be planted today or which cows to breed, but rather to determine long-term plans for the operation and management of the business. Some families will hold these meetings as little as once or twice a year, while others choose to meet on a more regular basis.

Preparing for and Conducting a Family Business Meeting

An agenda is one of the most important items to develop as you plan a family meeting. The agenda lets people know the starting and ending time of the meeting, location, and date, and allows members to know what will be discussed. The agenda should be distributed to all family members one week prior to the scheduled meeting. Someone needs to take notes of the discussion, and these meeting minutes need to be distributed to each member.

Questions often arise about where to hold family business meetings. Some families prefer to go to a hotel or a state park lodge for a relaxed atmosphere. This is advantageous because it puts people in a different environment, minimizes distractions, and allows families to spend time at the pool or visiting local attractions. It isn't always practical for family members to get away, but when planning a family business meeting attempt to minimize phone calls and visitors and make the location as comfortable as possible.

Developing a Stronger Family

Family meetings can give individual family members an opportunity to develop their leadership, conflict management, listening, speaking, and management skills. These meetings can help members understand their role in the successful transition of the business and develop strategic, capital, estate, or transition planning knowledge.

Meeting together as a family on a regular basis can help members work together for the success of the business. Throughout the process, members will learn a lot about themselves and the business. Although conflicts will still arise, the purpose of these meetings is not to focus on the conflict, but rather to focus on building a stronger family team through open and honest discussion.

Developing a Stronger Business

Not only can these meetings benefit family members, they can also send a message to employees that the family is committed to the future of the business and helping their employees. This may allow employees to feel comfortable knowing they are valued and the family is interested in helping them be successful.

Planning for Future Ownership

Too often, if at all, family meetings happen because of some abrupt change like the death of the senior manager. Issues faced at this time may not be handled well if family members have not been previously involved in planning the future of the business. Family meetings can help answer questions about the present owners' financial retirement needs and goals along with those of the next generation. Members who have been involved early on and are informed of the discussions are more likely to buy in to the transition plan. Transition can be a difficult process for many families, especially when spouses are involved or children are not actively involved in the business but have their own ideas about the future of the business.

Which family members should be involved? Are in-laws invited and encouraged to be involved in discussions? What if there are conflicting goals among family members? What if a family member doesn't have the ability to successfully manage the business?

The earlier you begin holding effective family meetings, the sooner you can avoid potential conflicts. Allowing young children to be involved in discussions helps them to better understand the business and

decide what future they have in the business. Involving children also helps parents determine the commitment their children have to the business before making plans for expansion or other changes.

Unless it is clearly obvious and communicated openly who the next manager of the business will be, some members may question how and why the decision was made. Family meetings provide a way to communicate how the process was done, and why and how the decisions were made. Explaining that the process was carefully and objectively conducted with a clear plan in place can go a long way in avoiding hard feelings or misunderstandings. Family meetings can also send a message to members that the new successor will be accountable to the family business.

Family meetings may be useful if there is no obvious family successor. In this situation, family meetings can serve to develop alternatives such as naming a non-family successor or liquidating the business.

Recognizing and Resolving Conflict

It is no surprise that conflicts arise in every family business. If disputes over the future of the business—which family members are involved in the process, family members' roles in management, or other issues are allowed to multiply—they can only divide a family and do nothing for the long-term success of the business. The key to resolving conflict is to acknowledge it early on in the process and realize it is normal. If you are dealing with a particular issue that may cause real conflict, the use of an outside, objective facilitator may be helpful.

Summary

The business management process is one that should not happen overnight. The use of family business meetings can be a good way to help members transition smoothly into management roles. In addition, family business meetings can help improve relations, communicate a positive message to employees, and build a stronger business.

Learn More

If you want to learn more about this topic, consider purchasing a copy of the book *Family Meetings: How to Build a Stronger Family and a Stronger Business,* 2nd edition, 2002.

Sample Agenda

A sample agenda for a family meeting is presented on the following page.

Acknowledgements

This fact sheet was developed as a result of a grant received by Ohio State University Extension from the North Central Risk Management Education Center, 2006-2007. Reviewer of this fact sheet was Mark Mechling, Extension Educator, Agriculture and Natural Resources, Muskingum County.

Sample Family Meeting Agenda

Meeting Date: March 15

Starting time: 10:00 a.m.

Ending time: 4:00 p.m.

Location: Spruce Creek Lodge

Discussion items:	**Person responsible:**
Welcome/Purpose for meeting	Sally
Individual goals	All members
Key issues for the future of the business	All members
Mission statement	Tom

Action items for the next meeting:	**Person responsible:**

Next meeting:

Date:

Time:

Location:

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Is a Prenuptial Agreement Right for Your Farm Business?

Building for the Successful Transition of Your Agricultural Business Series ANR-51
Agriculture and Natural Resources
Date: 04/11/2018

Chris Zoller, Extension Educator, Agriculture and Natural Resources/Community Development, Tuscarawas County
David Marrison, Extension Educator, Agriculture and Natural Resources, Ashtabula County

Farm and agricultural businesses often have high capital investments in land, machinery, livestock, and miscellaneous equipment. The typical Ohio farm has over $1 million in capital assets. These assets are usually owned and held by multiple members of a family. With the rising divorce rate (almost 60%), it is in the long term financial interest to protect business assets from a divorce of one of the business partners.

A prenuptial agreement is something many couples do not discuss (or dare to discuss) as they make their wedding plans. However, such an agreement can help minimize the financial stress on a family business in the event of a divorce. This agreement can also help determine the disbursement of assets, responsibilities for liabilities, and care of minor children.

A marriage is intended to be a life-long commitment; however, a significant number of marriages end in divorce. In fact, statistics from the Ohio Department of Health show that in 2011 Ohio had a divorce rate of 58.1 per 100 marriages.

In addition to the escalating divorce rate, family businesses should also discuss the impact of a second marriage. When a farm widow or widower remarries, the assets may be at risk if they pre-decease their new spouse.

As farms increase in size and new family members become a part of the business, either directly or indirectly, there becomes a real need to discuss how assets and liabilities will be divided in the event of a divorce, dissolution, or death.

An example of how one farm was affected by not having a prenuptial agreement:

John and his parents, Ida and Levi, were partners in the family's dairy business. Together they milked 100 cows and farmed 500 acres. This little farm's assets were worth $2.5 million at this time. John was in partnership for five years with his parents prior to marrying Elizabeth. John and Elizabeth were married 11 years. They had an okay marriage, but life on the farm wore on Elizabeth. As a result of the divorce, Elizabeth was awarded one-quarter of the net worth of the farm at settlement. During the time they were married, the business's assets grew by $1 million. Elizabeth was awarded $875,000. In order to pay, John and his parents sold 50 acres of their prime farmland and took out a second mortgage. This hampered the financial stability of this operation for many years following the divorce.

What is a prenuptial agreement?

A prenuptial agreement (prenup) in its simplest form is a written contract between two people before they are married. This agreement typically lists all of the property each person owns along with all debts and specifies the rights each will have if the marriage ends in divorce, dissolution, or death of a spouse.

Marriage without a prenuptial agreement

In the event of a divorce, dissolution, or death, and without a prenuptial agreement, state law will determine who owns property acquired during marriage (known as marital or community property) and what happens to the property. Marriage is viewed by the court as a contractual relationship and with it comes certain rights for each spouse. In the absence of a prenuptial agreement, a spouse usually has the right to:

- Share ownership of property accumulated during the marriage with the expectation that such property will be divided between the spouses in the event of a death, dissolution, or divorce.
- Incur debts during marriage the other spouse may have to pay.
- Share in management and control of any marital or community property.

Preparing a prenuptial agreement

A prenuptial agreement should be discussed and completed well before the wedding day. This will require the couple to fully discuss their present finances and future goals. In order for the agreement to be enforced, each party must completely and accurately disclose all assets and liabilities assumed prior to the marriage. Once the agreement is written, copies of tax returns and balance sheets should be attached to the agreement as an appendix. The completed agreement should be reviewed by separate attorneys to add validity and because one attorney cannot represent both parties in the event of a divorce or dissolution of marriage. Ohio law also requires two witnesses to be present for the signing of the prenuptial agreement.

Enforcement of the agreement

Only in cases of divorce or dissolution will the court enforce a premarital agreement. In these instances, either party can ask the domestic relations division of the common pleas court to enforce the agreement. Factors that may impact enforcement include: if either party failed to fully disclose information prior to the signing of the agreement or where there is fraud or the terms of the agreement are contrary to law or against public policy. Interestingly, the court is not likely to enforce agreements presented and signed the eve of the marriage.

Examples of prenuptial agreements

Sample prenuptial agreement forms are available online. Simply type “prenuptial agreements” into any search engine and you will locate several resources. Once the agreement is written, it should be reviewed by an attorney. It is important that each party understands the agreement prior to signing. No one should sign an agreement unless she or he understands the terms.

Summary

A prenuptial agreement can help farm and agricultural businesses protect their business assets from a costly divorce. Many businesses are including a clause in their organization agreements that states a prenuptial agreement is required for any married partner before entering the family business. This allows the partners to be assured that a separation or death does not interfere with the future success of the business. It is crucial this planning is done in consultation with an attorney. Writing a prenuptial agreement does not mean a couple believes their marriage will fail but rather they are planning for the continued success of their agricultural business.

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FACT SHEET

Ohio State University Extension, 2120 Fyffe Road, Columbus, OH 43210

A Comparison of Business Entities Available to Ohio Farmers

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Ohio farmers have many choices when selecting a business entity for their farm operations. The choice of business entity affects liability, taxation, management, and succession planning. Therefore, selecting a business entity should be given a great deal of thought and attention. A brief overview of the various factors to consider when deciding on a business entity is presented here. The reader is encouraged to use this publication as a means to identify the many issues involved with selecting a business entity but is strongly encouraged to seek professional advice.

Formation

A Limited Partnership (LP), Limited Liability Corporation (LLC), and Corporation (Corp.) must file registration documents with the Ohio Secretary of State. Upon approval of the application, the Ohio Secretary of State issues a certificate to the entity acknowledging its legal status.

A Sole Proprietorship (SP) and General Partnership (GP) do not require any registration with the Secretary of State. Simply conducting business establishes the SP or GP.

Governing Documents

While governing documents are not required by Ohio state law, they are highly recommended for any business entity, other than an SP. The documents declare how the business is to be managed and operated, establish the initial owners, control how ownership transfer may occur, control how termination and liquidation of the company are handled, and deteremine how disputes are resolved. If an entity does not have a governing document, the Ohio Revised Code controls.

Cost of Creation

A Sole Proprietorship has no cost of creation. A General Partnership may have a low cost of creation if a partnership agreement is drafted. A Limited Partnership and a Limited Liability Corporation will have medium to high start-up costs due to registering with the Secretary of State and drafting of governing documents. A Corporation will have the highest costs of creation because it must register with the Secretary of State; it should have governing documents; and it must also distribute stock to the shareholders.

Owners

An SP is owned by its sole proprietor; a GP is owned by its partners; an LP is owned by its general partner(s) and limited partner(s); an LLC is owned by its member(s); and a Corp. is owned by its shareholder(s).

Number of Owners

An SP is limited to one owner. A GP and LP must have at least two partners. An LLC and Corp. must have at least one owner but thereafter can have an unlimited number of owners. However, if a Corporation is taxed as an S-Corporation, the Corporation may not have more than 75 owners and only one class of stock.

Personal Liability of Owners

The owners of an SP and GP are personally liable for the actions of the entities. Personal liability means that the owners' personal assets may be used to pay any obligation, debt, or judgment of the partnership. The owners of an LLC and Corporation are not personally liable for the actions of the entities and their personal assets are not at risk. The general partner(s) of an LP is(are) personally liable for the LP while the limited partner(s) is(are) not.

Taxation

Taxation of business entities is a very important and complicated matter when comparing entities. Generally, the profits or losses from an SP, GP, and LP flow through to the owners. A Corporation taxed as a C-Corporation will be taxed at the entity level (corporate tax), and the shareholders will be taxed on their dividends. A Corporation taxed as a S-Corporation allows profits and losses to flow through to the shareholders in a similar manner as a partnership. An LLC can elect to be taxed as an SP (if only one member), a partnership (if at least two members), a C-Corporation, or an S-Corporation The taxation election is one reason the LLC has become the entity of choice for many business owners. If no election is made, a single-member LLC is taxed as an SP and a multi-member LLC is taxed as a partnership.

Applicable Tax Rates

Owners of an SP, GP, LP, or S-Corporation will pay taxes on any profits at their personal income tax rate. A C-Corporation will pay corporate taxes on any profits, and the shareholders will pay either 5 percent or 15 percent taxes on dividends based on their income level. The applicable tax rates for LLC members depends on which tax structure is elected for the LLC.

Tax Treatment of Liquidation

Generally, an SP, GP, LP, and LLC taxed as a partnership will have no tax on the liquidation of assets. A Corporation will treat a liquidation as a sale and cause taxes to be paid at both the corporate and shareholder level.

Management

Management varies widely among the different types of entities and the entities themselves. However, generally, an SP is managed by the sole proprietor; a GP is managed by all of its partners; an LP is managed by its general partner(s); an LLC is managed by its members or managing member(s); and a Corporation is managed by a board of directors elected by its shareholders. There is a great deal of variation to the previous general statements, particularly for an LLC, which has the ability to structure itself in nearly any manner.

Raising Capital

Other than a Corporation, the entities will typically raise capital by additional owner contributions. A Corporation will typically sell stock to raise capital. The other entities may sell ownership interest to raise capital but rarely do so.

Transfer of Ownership

An SP may transfer ownership freely as he/she is the only owner. A GP, LP, LLC, and Corporation will often have restrictions on transfer of ownership. Typically, the company itself and the other owners have a right to buy any ownership interest before it is transferred to a non-owner. Furthermore, many farm and family businesses make it very difficult if not impossible to transfer any interest outside the family. The restriction on transfer of ownership is either controlled by the company's governing document or a separately executed document often called a buy-sell agreement or a stock purchase agreement.

Dissolution and Liquidation Costs

Most of the costs of dissolution and liquidation are the taxes incurred due to the liquidation. Therefore, the SP, GP, LP, and LLC taxed as a partnership will tend to have lower dissolution and liquidation costs. The LP and LLC must file a notice of dissolution with the Secretary of State for a small fee. A Corporation will have the highest costs as the liquidation will create tax liability at the corporate and shareholder level. The Corporation will also need to file a dissolution notice with the state.

Acknowledgements

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BUSINESS ENTITY COMPARISON CHART

	Sole Proprietorship (SP)	General Partnership (GP)	Limited Partnership (LP)	Limited Liability Company (LLC)	Corporation (Corp.)
Definition	One person owns all the assets, owes all the liabilities, and operates in his or her personal capacity.	A voluntary association of two or more persons who jointly own and carry on a business for profit.	A partnership with one or more general partners and one or more limited partners	Statutorily authorized company that is characterized by limited liability and management by members or managers.	Having lawful authority to act as a single person distinct from the shareholders who own it.
Formation	No formal requirements.	No formal requirements.	Filing with the state.	Filing with the state.	Filing with the state.
Governing Documents	None	Partnership agreement.	Partnership agreement.	Articles of organization and operating agreement.	Articles of incorporation and bylaws.
Cost of Creation	None	None or Low	Medium	Medium to High	High
Owners	Sole proprietor	General partners	General/ Limited partners	Members	Shareholders
Number of Owners	One	Unlimited	Unlimited	Unlimited	Unlimited, except 75 shareholders for S-Corp.
Personal liabilities of owners	Unlimited liability for the obligations of the company.	Unlimited liability for partners for obligations of the company.	Unlimited liability for general partner(s); generally no liability for limited partners.	Generally no liability for members for obligations of company.	Generally no liability for shareholders for obligations of company.
Taxation	Pass-through	Pass-through	Pass-through	Typically pass-through but may elect taxation as a corporation.	Entity taxation unless electing subchapter S.
Applicable Tax Rates	Individual tax rates.	Tax rate of partner.	Tax rate of partner.	Tax rate of partner if taxed as partnership; otherwise corporation tax rates.	Corporate tax rates for C-Corporation; tax rates of shareholders for S-Corporation.
Tax treatment of liquidation	No tax.	Generally no tax.	Generally no tax.	Generally no tax if taxed as partnership; generally will be corporate and shareholder level taxes if taxed as corporation.	Generally will be corporate and shareholder level taxes.

BUSINESS ENTITY COMPARISON CHART (continued)					
	Sole Proprietorship (SP)	**General Partnership (GP)**	**Limited Partnership (LP)**	**Limited Liability Company (LLC)**	**Corporation (Corp.)**
Management	Sole proprietor has full control.	Typically each partner has an equal voice.	General partners manage; limited partners have limited management authority.	Either member-manager or manager-managed (controlled by operating agreement).	Board of directors elected by shareholders.
Raising Capital	Proprietor's own funds.	Contributions from partners or adding partners.	Contributions from partners or adding partners.	Contributions, add members, or sell interest; controlled by operating agreement.	Sell stock.
Transfer of ownership	Freely transferable.	May be limitations.	May be limitations.	May be limitations; controlled by operating agreement.	May be limitations; controlled by bylaws or stock purchase agreement.
Dissolution and liquidation costs	Low	Medium	Medium	Medium, if taxed as partnership, and high, if taxed as corporation.	High

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THE OHIO STATE UNIVERSITY EXTENSION

FACT SHEET

Agriculture and Natural Resources

"Building for the Successful Transition of Your Agricultural Business" Fact Sheet Series

Using Liability Limiting Entities to Manage Liability Exposure for Ohio Farms

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Today's farms are more susceptible to liability claims than ever before. This liability exposure comes in many different forms such as moving large machinery over roadways, inviting customers and vendors onto the business property, and environmental issues. While liability exposure cannot be eliminated, it can be managed. Liability limiting entities, such as corporations and limited liability companies (LLCs) can be valuable tools in managing liability. This fact sheet will address the liability protection attributes of these entities and how to design a comprehensive business plan for liability protection.

Corporations and LLCs

A corporation provides liability protection to its shareholders in a nearly identical manner as LLCs provide liability protection to it members. For simplicity of discussion, only LLCs will be referred to hereafter. However, throughout this fact sheet, a corporation can be substituted for an LLC and shareholders can be substituted for LLC members interchangeably.

What is Limited Liability?

An LLC provides limited liability for its members (owners). The concept of limited liability means that a person is not liable for the actions of a business just by being a member or owner of that business. Conversely, having full liability, such as being a partner in a general partnership, does mean that the partner has full liability for the actions of the partnership merely by being a partner. Consider the following examples:

Example 1. Partner 1 and Partner 2 decide to combine their farming operations into a general partnership called Ohio Farms Partnership. While Partner 1 is driving to the local implement dealer to pick up a part for the partnership's tractor, he negligently runs a stop sign and collides with another vehicle. The driver of the vehicle is seriously injured and is awarded $1 million by a court for injuries resulting from the accident. (Assume the $1 million in damages is above and beyond the liability insurance the Partnership or Partner 1 may have.) Who is liable and for how much?

Because Partner 1 was acting on behalf of the partnership at the time of the accident, all of the assets in the partnership are at risk. Any and all of the partnership assets may be liquidated to pay the damages.

Partner 1 is personally liable. The person who causes the accident is always liable, regardless of the business structure. Here, Partner 1 caused the accident and he is

therefore liable. All of his assets, including personal residences, bank accounts, and investments can be liquidated in order to pay the damages.

Partner 2 is personally liable. Because Partner 1 was acting on behalf of the partnership at the time of the accident, Partner 2 is fully liable for his actions. Therefore, the damaged party could go after Partner 2 for the damages. All of Partner 2's assets, including all personal assets are at risk of being liquidated to pay the injured party. Even though Partner 2 did not cause the accident, he is still liable for the actions of Partner 1.

The partners are also subject to a concept known as joint and several liability. This allows for the injured party to receive the entire damages from both or either of the partners. For example, if there were no assets in the partnership, the damaged party could collect all $1 million from either Partner 1 or Partner 2. This means that the injured party could potentially collect all $1 million from only Partner 2. This is often referred to as going after the "deep pockets."

Assume the above scenario is changed to where Partner 1 was driving to the grocery store on his own time and was not acting on behalf of the company. Driver would still be able to collect damages from Partner 1's personal assets. However, neither the Partnership nor Partner 2 would likely be liable in this situation since Partner 1 was driving for a personal reason and not a business reason.

The above example shows the risk of organizing the farm business as a partnership. When one partner acts on behalf of the partnership, all other partners are completely and fully liable for his actions.

Example 2. In this scenario, the farm business is organized as a LLC, Ohio Farms LLC, with Member 1 and Member 2 as the owners. Using the same scenario as Example 1, Member 1 is involved in a vehicle accident.

Just like Example 1, the LLC and Member 1 are fully liable for the damages to Driver. The LLC is liable because Member 1 was acting on its behalf and Member 1 is liable because he caused the accident.

The difference between the examples is the liability exposure of Member 2. All of Member 2's ownership interest in the LLC is subject to the damages. Therefore, Member 2 could potentially lose all his ownership interest in the LLC. However, his liability likely stops there as Member 2's personal assets are likely not at risk. The damaged driver cannot go after Member 2 personally for any of the damages. This is the concept of limited liability. Member 2, as a member of an LLC, has limited liability for the acts of his fellow members. Member 2 is not liable for Member 1's action simply by being a fellow member of the LLC. In effect, the LLC shields Member 2's personal assets from the actions of Member 1.

Employees and Agents

Generally, an employer is responsible for the actions of an employee while that employee is performing his work related duties. Therefore, if an employee triggers some type of liability event, the employer will often be liable as well. Since many Ohio farms have employees, the employer–employee relationship is a significant source of liability exposure for Ohio farms.

Example 3. Ohio Farms Partnership hires Employee to assist with its grain operation. While moving large tillage equipment on the roadway, Employee negligently injures the driver of a passenger vehicle. Who is liable?

Employee is liable because he caused the accident. The Partnership is liable because it is the employer of Employee. Partner 1 is liable because he is fully liable for the actions of the partnership. All of Partner 1's assets, including personal assets, are exposed to damage claims. Partner 2 has full liability, the same as Partner 1.

An LLC provides liability protection to Employers. If we assume the same facts as Example 3 above except that Ohio Farms is organized as an LLC instead of a partnership, how does the use of an LLC affect the liability of the parties involved?

Employee is still fully liable for the accident he caused. The person causing the accident will be fully liable regardless of the business structure. Ohio Farms LLC will be fully liable. As discussed before, Ohio Farms LLC is the actual employer of the Employee. Therefore, due to an employer being liable for an employee's actions, the LLC is likely liable for the driver's damages and all its assets will be fully exposed. Member 1's ownership interest in Ohio Farms LLC is at risk. However, Member 1's personal assets are not at risk. The LLC shields Member 1 from personal liability. Member 2's liability issues are the same as Member 1's.

Financial Liability of an LLC

An LLC is considered to be separate and apart from its members. That is, an LLC is considered by the law to be a "person." The LLC as a person is responsible for its actions.

Example 4. Ohio Farms LLC purchases a tractor from the local tractor dealer. John Doe, managing member of the LLC, signs the loan papers on behalf of the LLC allowing Ohio Farms LLC to purchase the tractor on credit.

(Note: the same scenario for a corporation could involve the President of the corporation signing on behalf of the corporation.) Ohio Farms LLC later defaults on its payments. Who can the tractor dealer go after to collect the debt?

The Tractor dealer can only go after the LLC. The LLC is the "person" that bought the tractor and signed the loan documents. John Doe signed the documents on behalf of the LLC, not as John Doe individually.

Therefore, if the LLC is unable to pay the note, the Tractor Dealer cannot seek payment from any of the LLC members. It is the LLC that is liable for the debt, not the LLC members. If the LLC has no money or no assets to liquidate or attach to, the tractor dealer will not be able to collect the debt.

The above scenario illustrates how the members of an LLC can make business decisions for the LLC, yet not be held personally responsible for their actions. Persons and businesses dealing with LLCs are usually aware of this dilemma and deal with it by making one or more LLC members sign the loan documents personally.

Using the previous example, Tractor Dealer would almost assuredly require John Doe to sign the note twice: once as managing member of the LLC, and once as John Doe, the individual. Now if the LLC cannot pay the loan, the tractor dealer can collect the debt from John Doe personally.

Another potential source of financial liability is one owner/partner acting on behalf of the business without the other owner/partner's knowledge.

Example 5. Partner A in Ohio Farms Partnership, unbeknownst to the other partners, commits a large amount of money to a risky business venture on behalf of the partnership. The business venture fails and Ohio Farms Partnership now has substantial debt due to Partner A's activities. Who is liable?

Even though the other partners did not know about Partner's A activities, the partnership may be liable for the debt. If so, the partnership is liable for the debt and if the partnership cannot pay the debt, all partners are personally liable.

Using the above example with an LLC instead of a partnership, the LLC and Member A may still be liable for the debt. However, the other members of the LLC will not be personally liable for the debt and thus have limited liability for the actions of the other member's actions.

A Comprehensive Business Plan

Managing liability exposure for a farm business can best be accomplished with a comprehensive business plan. Using multiple entities to separate and divide liability exposure can be the most effective strategy.

Single Entity Plan

In Diagram 1, the owners of Ohio Farms have organized into an LLC. All of the farm assets have been put into the LLC including checking accounts, grain, machinery, and real estate. The owners' personal assets are outside of the LLC.

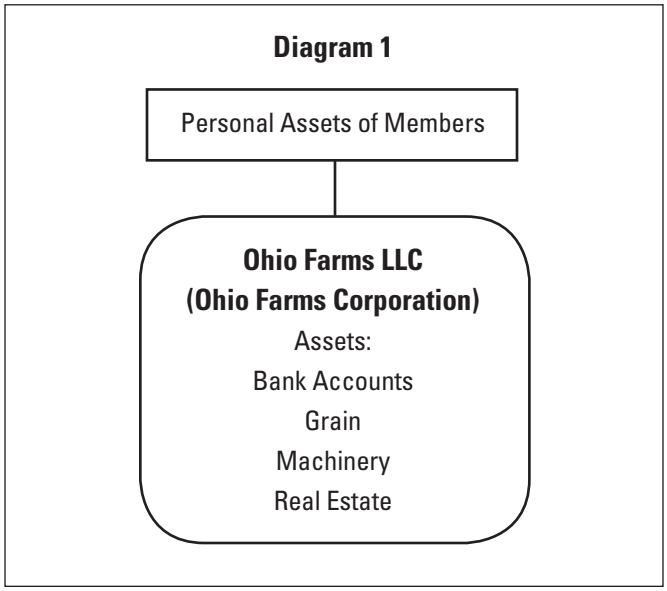
Using the similar scenarios as above, assume an employee of Ohio Farms LLC causes an accident while operating machinery over the road. Ohio Farms LLC, as the employer of the employee, will likely be liable for the accident. Thus, all of Ohio Farms' assets are subject to be liquidated to pay damages to the injured party. The personal assets of the owners are not at risk.

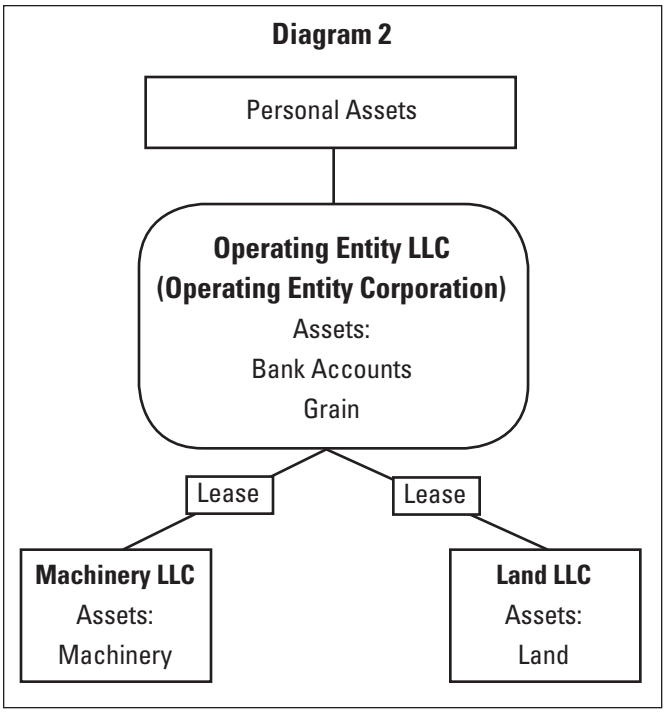
The problem with this situation is that most farmers' assets are in their land. In the above scenario, while the owner's personal assets are not at risk, their land is. So while the farmer's house and other personal assets are safe, the majority of his wealth is still at risk because it is in the LLC. A single entity plan is better than no plan at all but still may put much of a farmer's wealth at risk.

Multiple Entity Plan

Diagram 2 shows Ohio Farms organized using multiple entities. The first entity is the Operating Entity LLC. This entity buys the inputs, sells the grain, and maintains the checking accounts. Other than grain and cash, this entity holds no other assets.

The second entity is the Machinery LLC. This entity owns all the machinery required by the farming operation.





The Operating Entity LLC and the Machinery LLC have a lease agreement wherein the Operating Entity LLC leases the machinery from the Machinery LLC.

The third entity is the Land LLC and owns all the real estate. The Operating Entity LLC leases the land from the Land LLC. (It is important to note that corporations are usually not ideal entities to hold real estate for tax planning purposes. LLCs taxed as partnerships allows a step up in tax basis of the land upon a member's death and has fewer tax implications for future land distributions out of the LLC. Corporations do not allow a step up in basis of the land, only the stock, and distributions of the land out of the corporation usually create higher tax liability.)

Using the same scenario, assume an employee working for the Machinery LLC injures someone while operating machinery. The Machinery LLC will be liable because it was the employer. The Operating Entity LLC may also be liable because it had a contractual relationship with the Machinery LLC via the machinery lease. The owners could possibly lose all the machinery and all assets in the Operating Entity LLC.

However, the land is not subject to the liability. The Land LLC had no contractual relationship with the Machinery LLC and its contractual relationship with the Operating Entity LLC had nothing to do with the accident. Therefore, while the owners may lose machinery, grain, and cash, the majority of their wealth is likely protected by the Land LLC.

The multiple entity plan has its limitations. If the same person owns all the entities or a majority of the entities, the plan has limited effectiveness. The reason being that if the owner causes a liability accident, all his ownership in all the entities are at risk anyway. The multiple entity plan is most effective when the various entities have multiple or varied ownership and employees are involved in the operation. In some situations, the farmer is better off foregoing multiple entities and increasing his liability insurance instead.

Liability Protection of Other Business Entities

Ohio farmers have many business entities from which to choose from. These various entities have different degrees of limited liability protection. The following is a brief description of the liability characteristics of these entities.

Sole Proprietorship. A sole proprietorship enjoys no limited liability protection. The owner of the business is fully liable for any actions of the business.

General Partnership. A general partnership offers no liability protection to its partners. The partners in a general partnership are fully liable for the actions of the business and the other partners.

Limited Partnership. A limited partnership is made up of at least one general partner and at least one limited partner. A limited partnership provides no liability protection for the general partner. A general partner of a limited partnership has the same liability exposure as a partner in a general partnership. A limited partnership offers liability protection to the limited partners. That is, a limited partner is not liable for the actions of the limited partnership or the other partners.

Other Factors to Consider

While liability protection is an important factor in selecting a business entity for a farm operation, it is only one of many. Other factors include taxation, management, ownership, transfer restriction, start-up costs, liquidation costs, and Farm Service Agency requirements. Of special note, operations that are eligible for more than one direct payment from the Farm Service Agency should not use a limited liability entity for its operating entity. Any entity that has limited liability protection may only receive one direct payment regardless of the number of owners.

Liability Insurance

Every business should have liability insurance as it is a relatively inexpensive means of managing liability exposure for injuries and physical damages. Liability insurance does

not make the business less exposed to liability but rather gives the business a means of paying damages in the event a liability incident occurs. The question becomes, "how much liability insurance should a farm operation have?" This question must be answered on a case by case basis by analyzing the potential liability exposure of an operation and the cost of the insurance premiums. In the event that the damages from a liability incident exceed the liability insurance, limited liability entities are the next line of defense to manage liability exposure.

Liability insurance offers no protection for financial liability created by the business or its owners. Therefore, while liability insurance should be a key component of every business plan, it does not protect the business from all liability.

The above discussion is based on generalities of business and liability law. Both areas of the law are fraught with exceptions, and determinations of liability are always very specific to the particular incident. Readers should not rely on this publication for legal advice but merely as a presentation of some of the legal issues related to farm liability. Professional counsel should be sought before implementing any liability management plan or assessing liability.

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Starting, Organizing, and Managing an LLC for a Farm Business

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The Limited Liability Company (LLC) has become the entity of choice for many new businesses in Ohio. The LLC provides the flexibility and ease of startup of a partnership while providing the liability protection of a corporation. By combining the best attributes of a corporation and partnership, the LLC provides an attractive business entity for Ohio farms and farm businesses.

What is a Limited Liability Company (LLC)?

An LLC is a legal entity created by Ohio statute. An LLC is considered to be a "person," separate and distinct from its owner(s). The LLC owners, called members, can range in number from a single owner to unlimited owners. The LLC can be established to engage in any lawful activity under Ohio state laws.

Why Form an LLC?

An LLC can provide the following to farm businesses in Ohio:

- An operating entity from which to run the farm business
- Liability protection for the LLC owners
- An estate planning tool to manage estate taxes and estate distributions
- A real estate holding entity
- A business succession planning tool
- Conforming to and managing Farm Service Agency program payments

History

In relation to other business entities, the LLC is relatively new. The first LLC statutes were enacted in Wyoming in 1977 but initial use of LLCs was minimal. However, in 1988 the IRS allowed LLCs to be taxed as partnerships. This ruling made LLCs a very attractive business entity and opened the floodgates for LLC statutes in all 50 states. By 1996, every state and the District of Columbia had enacted legislation permitting LLC formation.

Why is an LLC Unique?

Simply put, the LLC combines the best attributes of a corporation and a partnership. Prior to LLCs, new business were generally limited to a sole proprietor, corporation, or some type of partnership. Some business owners would opt for a sole proprietorship for simplicity and taxing structure, others would opt for a corporation and its liability protection and centralized management, while others would chose a partnership for its pass-through taxation and more informal structure.

Primary Attributes of an LLC

Informal Organization Possible

Ohio law allows the LLC members to determine the management structure of the company. The LLC members can choose between centralized management (corporation) or management by the members (partnership). Most

LLCs choose a partnership-like management structure as it tends to be easier to establish and manage, provides more flexibility, and allows for management by committee, management by a sole member, or management by a non-member manager.

Flexible Tax Structure

LLCs are subject to check-the-box tax regulations allowing the business owners to elect the desired status for federal tax classification. If no election is made, a single member LLC is taxed as a sole proprietorship and a multi-member LLC is taxed as a partnership. However, circumstances may be such that a corporate tax classification would be advantageous for the LLC. In that case, the owners merely "check the box" and elect a corporate tax classification. The "check-the-box regulations" make tax classification a very simple matter. This check-the-box election is made on IRS form 8832.

No Restriction on Ownership

Individuals, corporations, other LLCs, trusts, and estates may be members in an LLC. There must be at least one member of the LLC but there is no limit on the maximum number of members.

Allocations and Distributions of Earnings may be in Different Proportion than Capital Contribution

Allocations are the proportions of any item of gain, loss, deduction, or income that is attributed to each member. The allocation does not have to be in proportion to the members' contributions. Allocations can be based upon per capita, ownership interest, or any other means of distributing allocations that the members agree to. Each year, an LLC taxed as a partnership will file an informational return (IRS Form 1065) with the IRS to show how the LLC's income or losses have been allocated among the members.

Disadvantages of an LLC

Relatively New Entity

As discussed previously, the LLC is a relatively new entity. Therefore, legal issues affecting LLCs have not had time to work their way through the judicial system. The issue that has the most potential of being interpreted by the courts is limited liability. It is widely believed that LLCs have the same liability protection for its members that corporations have for its shareholders. However, until an Ohio court rules on that very issue, it will only be speculation.

Liability Veil Piercing

Corporations are subject to a concept called veil piercing where the limited liability of the shareholder is challenged. A person or person(s) cannot use a corporation to commit fraud on others, have such complete control over the corporation that the corporation has no separate existence of its own, or cause injury or unjust loss from the shareholder's wrong. If one of these conditions exists or occurs, the court may declare that the corporation and shareholder(s) are one and the same, or otherwise pierce the liability protection of the corporation. If this occurs, the shareholder(s) will have full liability for the debt and acts of the corporation.

LLC liability protection is based on corporate liability protection. Therefore, the concept of veil piercing would almost certainly apply to LLCs as well. However, no known Ohio cases have addressed this issue. Thus, some uncertainty remains with the extent of liability protection that an LLC provides it members. However, a properly formed and managed LLC will have very little chance of having its limited liability shield pierced. The most likely scenario where an LLC may have its limited liability veil pierced is where it is grossly undercapitalized from the outset and the members do not treat it as a separate entity by commingling funds and not documenting loans to the LLC.

Additional Costs

Forming an LLC costs money. The costs of setting up an LLC will include a registration fee with the Ohio Secretary of State ($125) and may include attorney fees, accountant, and deed preparation. The total cost of establishing an LLC is totally dependent upon each situation and the professionals that are involved. However, larger, more complex LLCs can easily cost several thousand dollars in set-up fees. Before starting an LLC, always ask the attorney and/or accountant assisting with the project for an estimation of costs. It is important that the LLC be cost effective.

In addition to start-up costs, each LLC, other than a single member LLC, will need its own accounting system and tax return. Again, the costs of the accounting and tax returns depends on each situation but at minimum will likely be a few hundred dollars annually. Additional costs may also include setting up new bank accounts and the time needed to change account names with vendors.

Legal Requirements for an Ohio LLC

A business entity does not become a valid LLC until certain requirements are met under Ohio's LLC statute. The primary requirement is that the LLC must be registered with the Ohio Secretary of State. The application for

registration with the Secretary of State is an easy process that involves declaring a valid name and a statutory agent for the LLC.

Name

Each business entity in Ohio must have its own unique name.* Therefore, a new LLC must use a name that is different enough from any other Ohio business so that the names would not be confused. For example, if a business entity already exists by the name of Ohio Farms Inc., a new LLC could not be formed with the name of Ohio Farms LLC, as the names are too similar.* However, a slight modification of the name, such as Ohio Dairy Farms LLC, would likely be approved by the Secretary of State. A business organized as an LLC must include "LLC", "Ltd", or "Limited Liability Company" in its name.

Statutory Agent

The Secretary of State also requires the name and address of a statutory agent. The statutory agent is a person who is a resident of the state where the LLC is being organized and is authorized to accept service of process for the LLC. Any legal process or notice required by law may be served on the statutory agent. Essentially, the statutory agent is the contact person for the LLC. The statutory agent takes on no liability of the LLC for merely being the statutory agent. For example, if an LLC were to be sued, the court documents would be served on the statutory agent who would then be responsible for passing them on to the company. The statutory agent may be a member of the LLC but is not required to be a member. Often a non-member, particularly the LLC's attorney, will serve as statutory agent. The statutory agent must sign the Articles declaring that he/she has accepted appointment as statutory agent.

Filing

The application for formation must be filed with the Secretary of State along with a filing fee, currently $125. The Secretary of State will review the application, and if there are no problems, declare the entity to be a valid LLC and issue Articles of Organization. The Articles of Organization is essentially a certificate declaring the entity to be in good standing with the state. The most common reasons applications are rejected by the Secretary of State are using a name already in use, attempting to use an out of state statutory agent, or not getting proper signatures.

*A new business entity may get permission from an existing business entity to use the same name. A signed permission form must be filed with the Secretary of State. For example, Ohio Farms Inc. could grant Ohio Farms LLC permission to use the "Ohio Farms" name.

Employer Identification Number (EIN)

The EIN is to a business what a Social Security Number is to an individual. Every new LLC will need to file for and receive an EIN from the IRS. The only exception is an LLC with only one owner who will report the LLC's income or loss on his or her own 1040 using Schedule C or Schedule F. Obtaining an EIN is a very easy process that can be done via telephone, fax, or on-line through the IRS.

The Operating Agreement

The operating agreement is the equivalent of bylaws for a corporation or a partnership agreement for a partnership. It is an agreement among the members that governs the operating and management aspects of the LLC. Ohio law does not require an operating agreement but it is highly recommended that each and every LLC have one. If there is no operating agreement or the operating agreement is silent on a certain point, the Ohio Revised Code provides the default provisions.

The more thorough and robust an operating agreement is, the better. However, the following are certain minimum provisions that should be addressed in every operating agreement.

Management Structure

As discussed briefly above, one of the primary advantages of an LLC over other business entities is the flexibility of the management structure. The LLC can be managed on a very formal basis like a corporation or managed on a more informal basis like a partnership. If there is no operating agreement or the operating agreement is silent on management structure, the default provision in the Ohio Revised Code provides that all members of the LLC will have management authority in proportion to their ownership.

A. Centralized Management

Centralized management is the management system used by most corporations. Shareholders or owners elect directors who in turn appoint a president, treasurer, and secretary of the company. This system takes management decisions and "centralizes" them to a few individuals to make decisions for the entire company. This is especially true for large corporations with many shareholders. While this management system is not typical for LLCs, an LLC may incorporate this system by requiring it in the operating agreement. The primary challenge with centralized management is the formal requirements of setting up the structure of the corporation, having shareholder and director meetings, and maintaining minutes from those meetings.

B. Member Managed

The member managed system is the more common system when farm businesses choose to organize as an LLC. In this system, all the members of an LLC have a say in the management of the company. All critical business decisions require a member vote. Some decisions such as ordinary business transactions may only require a majority vote. Other decisions, such as the addition of additional members, may require a unanimous vote. It is very important to declare in the operating agreement which decisions require a vote and what portion of the members must affirm the vote. The majority of LLCs incorporate this management system as it provides each member with at least some say in management. This system can be burdensome in that many votes may need to be taken as management decisions are made.

C. Managing Member

The managing member system allows the members of an LLC to appoint one or more members to act as manager for the LLC. The managing member will typically be responsible for the day-to-day operations of the LLC. Only the managing members have the authority to enter into contracts and other business arrangements on behalf of the company. However, the managing members typically do not have unlimited authority. Critical decisions such as dissolving the company, selling key assets, or adding additional members can still require an affirmative vote by all members. For example, a managing member may have the authority to purchase the production inputs for the upcoming crop year. However, the managing member would be required to receive permission from a member-wide vote if he/she wished to sell the company's real estate.

The managing member system has several advantages over the member managed system. First, it puts management into the hands of the member(s) who have the talent, skills, and desire to manage the company. Second, it allows those members to be inactive who do not want a managing role and thus benefit by not being subject to self-employment (FICA) taxes. Lastly, only a limited number of members have the authority to bind the company.

Procedure for Liquidation and Dissolution

The operating agreement should have a contingency plan if or when the LLC is dissolved. The LLC may be dissolved voluntarily by member agreement, upon the expiration of a specified length of time or upon a triggering event. Typically, the plan will call for outside creditors to be paid first followed by member creditors. After all debt is paid, capital contributions are returned to members and any remaining capital is distributed to the members in proportion to their ownership.

Arbitration and Mediation

There will be times when members cannot resolve a conflict among themselves. In such an event, the operating agreement can force the parties to arbitration and/or mediate before resolving the conflict in the judicial system. Mediation and arbitration are often less costly and move more quickly than a lawsuit. The members can either agree to be absolutely bound by the mediation/arbitration or merely use it as a means of attempting to resolve a dispute before going to court. Arbitration and mediation clauses are designed to save both the members and the LLC time and money in the process of resolving disputes.

Death of a Member

In the event of a death of an LLC member, the operating agreement will determine where their interest is allowed to go. The operating agreement will often allow for the deceased lineal descendants to inherit their ownership without approval from other members. Spouses may be allowed to inherit the deceased ownership but there are risks with spouses being owners. The spouse may remarry and then divorce or predecease the second spouse. Now, the second spouse may receive the ownership in the LLC and what once was a family owned LLC now has a third party stranger involved in ownership. Other options for dealing with the deceased member's ownership is allowing the company to buy the interest from the estate, allow the other members to buy from the estate, or place the interest in trust.

If there is no operating agreement or the operating agreement does not address deceased members' interest, the Ohio Revised Code controls the disposition of interest. In that situation, the ownership interest may be transferred to anyone. However, if the person receiving the interest is not already a member of the LLC, they only become a full, voting member with the approval of the other members. Otherwise, the new owner is entitled to profit and losses from the LLC but has no say in management.

Transferability of Ownership Interests

Transferability of ownership interests refers to how ownership interests may be transferred and who may own interest in the LLC. State default rules allow LLC ownership interest to be transferred to any party, but unless they are admitted to the LLC as a member by unanimous consent of the other members, they are only entitled to an economic interest in the LLC. Someone having only an economic interest in an LLC, called an assignee, will

be entitled to any profits and distributions made by the LLC, but is not entitled to participate in management and may not vote in company matters.

Like other aspects of the LLC, the default rules regarding ownership interest may be overridden by an agreement among the LLC members. The agreement controlling transferability of ownership interest is typically called a buy-sell agreement and may be integrated into the operating agreement or may be a separately executed document. There are several key concepts that every operating agreement should address.

Who May Become a Member

The first and most important issue to address is eligibility for membership in the LLC. In some situations, the buy-sell agreement will have a very liberal policy of allowing new members so as to attract more investors and capital. In other situations, a very strict policy may be implemented to limit or even restrict entirely the admission of new members into the LLC. A typical LLC will fall somewhere in between. That is, having some restriction on additional members so that not just anyone can join the LLC but also not so restrictive that new members are essentially prevented all together.

Generally, closely held LLCs will tend to have more restrictive buy-sell agreements. There are several reasons for this. First, a closely held company will typically have a small number of members that have a great deal of control over the LLC. The control may be in the form of management rights and/or voting rights. Each time a new member is added to the LLC, the existing members' management and or voting power is diluted. The existing LLC members may restrict new members to protect their control over the company.

Second, closely held companies are often family businesses. The family/LLC members may go to great lengths to keep the company in the family, particularly if the underlying business and assets are tied to the family heritage. For example, a farm family that establishes an LLC to hold farmland that has been in the family for generations will likely make it very difficult, if not impossible, for anyone other than family members to have an ownership interest in the LLC.

Options to Purchase

Most buy-sell agreements will provide the members of the LLC and perhaps the company itself with an option to purchase another member's interest before it can be transferred to a non-member. This is yet another technique for limiting the ability of non-members to be admitted to the LLC. For example, Member A dies and leaves all of his ownership interest in the LLC to his wife. The buy-sell provision provides that before the wife can take ownership as either a member or assignee, Members B and C as well as the company has an opportunity to buy Member A's membership units from his estate. If Member B, Member C, or the LLC buys Member A's interest, the estate will receive all the proceeds from the purchase.

The same process could be used if Member A received an offer from a non-member to buy his LLC interest, if Member A went bankrupt and creditors attempted to attach his interest, or if Member A divorced and his LLC interest was given or awarded to his wife. The concept of purchase options give the company and the other members first chance at purchasing other members' interest before being transferred to a non-member.

Discounting

Another aspect of the transfer of ownership interest is discounting. In closely held LLCs, discounting is often used to account for the lack of marketability, lack of control, minority holdings, or other factors that would affect the value of any member's holdings. The members may agree to a predetermined discount value that is included in the operating agreement. Discount values can be as high or low as the members wish but typically discount rates will be 10–30%. Sometimes the operating agreement allows for the discount to be determined by an appraiser at the time of a triggering event rather than having a preset discount in place.

To illustrate how discounting works, consider an LLC formed to hold real estate that restricts transfer of ownership interests to family members only. The real estate within the LLC has a fair market value of $1,000,000. The five members, having equal ownership, have agreed to a 20% discount. If Member A wishes to sell his entire interest to Member B, B will pay A $160,000 ($200,000 ownership interest @ 20% discount = $160,000).

The discounting is appropriate because even though the FMV of the assets are $1,000,000, the ownership interest of the LLC is not available to the open market. Only a very few buyers exist, usually the current LLC members and their families. Therefore, with such a limited pool of potential buyers, the value of any member's interest in the LLC is something less than fair market value.

It is important to note that while the discounting is binding upon the LLC members, the discounting is not binding upon the IRS. It is always possible that the IRS will use a different discount rate when calculating estate or gift tax liability.

Discounting can be used in closely held LLCs as a deterrent to transfer ownership interest to other parties. For example, a two member LLC holds land valued at $1,000,000 with a 20% discount and purchase options for the members. If Member A attempts to sell his interest to another party, Member B can exercise her option and buy Member A's interest for $400,000 ($500,000 at 20% discount). Member A has essentially sold $500,000 worth of land for $400,000 to Member B.

Financing

There may be times when an LLC member may wish to buy another member's ownership interest but does not have the money to pay the selling member. To prevent such a situation, the buy-sell agreement may contain a financing mechanism to make a purchase more feasible for the buyer. Example financing terms would be for the purchasing member to pay 10 percent down with the balance amortized over 10 years documented by a promissory note which may or may not be secured. An interest rate usually accompanies such purchase agreements. Often agreements state that the interest rate on the unpaid balance will be at the lowest applicable federal rate as published by the IRS. The financing mechanism is another means of keeping the LLC membership in the family or closely held group of persons by making it easier for the Buyer to finance the purchase. Additionally, the financing may deter a member from "cashing out" because of the less than advantageous financing terms for the Seller.

Using the above example in the discounting discussion, Member B exercises her option to purchase Member A's ownership interest for $400,000. Member B also chooses to use the financing mechanism which is 10 percent down and the balance paid over 10 years. Now, Member B would pay $40,000 in cash at the time of the sale and can pay the remaining $360,000 over the next ten years with interest being paid on the unpaid balance.

Farm Service Agency (FSA) Programs

Some FSA program payments are affected by the type of business entity that the producer is operating under. Addressing this matter is far more involved than the scope of this publication will allow. It is critical that producers, particularly grain producers, seek legal advice regarding the impact of the chosen business entity on FSA payments. For example, organizing a grain operation as an LLC or corporation will limit FSA direct payments to only one payment limitation.

Seek Professional Advice

The LLC provides an alternative and possibly attractive business entity for many Ohio farm businesses, in part because of its relative ease of establishing and managing. However, it is highly recommended to seek professional advice when setting up an LLC. A well-thought-out and drafted operating agreement can save a great deal of stress, frustration, and money by addressing at start-up, how future issues will be dealt with. Furthermore, the business structure of the farm business should be compatible with the producers' estate plans and business succession plans. Seeking advice from an attorney familiar with business issues, particularly farm business issues, is a good investment of resources.

Another professional that should be consulted is an accountant. The tax structure and financial management of the LLC is also a critical issue best addressed at business start-up. Taxation of businesses can be very complex and errors in taxation or financial management can be very detrimental to the business.

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THE OHIO STATE UNIVERSITY EXTENSION

FACT SHEET

Agriculture and Natural Resources

"Building for the Successful Transition of Your Agricultural Business" Fact Sheet Series

Tax Characteristics of Business Entities Available to Ohio Farmers

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Ohio farmers have a number of options when determining how to structure their farm businesses. The most common business entities are sole proprietorships, C-Corporations, S-Corporations, Partnerships, and Limited Liability Companies (LLCs). One of the primary factors to consider when determining which business structure to use is tax structure. The purpose of this publication is to provide a brief overview of the tax characteristics of the aforementioned business entities. The reader is encouraged to get professional tax advice before making a final determination on the tax structure that is best for their business.

Sole Proprietorship (SP)

A sole proprietorship is a business owned and operated by an individual. Essentially, the owner and the business are one and the same.

Profits

Any profits made by the business are taxed to the SP owner. This is true even if the profits are not taken out of the business by the owner. For example, a SP makes $10,000 in profit but leaves the profit in its checking account as operating money for next year. The owner will pay taxes on the $10,000 profit even though it stayed in the company.

Tax reporting

A SP reports its net income on a Schedule F or a Schedule C for non-farm businesses. The Schedule F (or Schedule C) is a separate schedule attached to the owner's 1040. The Schedule F (or C) requires the owner to list all sources of income and all expenses from which the profit (or loss) is calculated. A Schedule SE is required to be filed if net income from the business (F or C) exceeds $400.

Losses

If a SP loses money, the owner can claim that loss to offset other income. If the owner does not have enough other income to offset the SP loss, the loss may be carried over to future years.

Income and Self-Employment Taxes

SP owners pay two types of taxes, income and self-employment (SE). The income taxes are determined by multiplying the profits from the SP by the owner's personal income tax rate.

The SE taxes are Social Security and Medicaid. SP owners pay 15.3% on the first $97,500 (maximum amount for 2007) of their SE income and 2.9% on everything over $97,500. One half of the SE taxes paid are deductible as an adjustment to income on the owner's personal tax return.

Estimated Tax Payments

SPs with non-farm businesses must make estimated tax payments four times a year. These payments cover self employment taxes and income taxes. The owner must predict how much he/she will earn ahead of time and make payments accordingly. An easy way to make the estimated tax payments is to make payments equal to the owner's tax liability from the previous year. Some SP owners may not have to make estimated tax payments if his/her tax liability will be small or if the owner is having adequate income being withheld at a regular job.

SPs with farming businesses may not have to pay estimated taxes if they meet certain qualifications. Farmers are not required to make estimated tax payments if two-thirds of their gross income is from the trade or business of farming and they file their tax return and pay any income tax and self employment tax due by March 1.

C-Corporation

Corporations are business entities that have shareholders as owners and are managed by a board of directors and operated on a day-to-day basis by the officers of the company. A corporation is considered to be a separate person (different from its owners) that may own property, enter into business contracts, and borrow money. Corporations can be taxed as C or S Corporations. The C and S refer to the applicable subchapters in the Internal Revenue Code. S-Corporations will be addressed in the next section.

Double Taxation

Before a C-Corporation can pay out any of its profits as dividends to its shareholders, it must first pay tax on the profits at the corporate rate. Any dividends paid out to shareholders are then taxed again at the shareholder level. Taxation at both the corporate level and the shareholder level is the concept known as double taxation. For small businesses such as farms, double taxation is obviously not desirable but can usually be easily avoided.

Avoiding Double Taxation

C-Corporations can avoid double taxation by paying out any profits to the shareholders in the form of wages, bonuses, or consulting fees. Consider the following example:

Ohio Farms Inc. is a C-Corporation that after paying all expenses has a profit of $50,000. If Ohio Farms pays out the remaining after-tax profit of $37,500 ($50,000 minus $12,500 corporate income tax) to the shareholder owners as qualified dividends the following taxes will be paid:

Corporate income taxes ($50,000 @ 25%)	$12,500
Shareholder taxes on qualified dividends ($37,500 @ 15%)	$5,625
TOTAL TAXES PAID	$18,125

Because of the double taxation the corporation and its shareholders will pay a total of $18,125 on the $50,000 or 36.25%.

Now consider the same scenario, but with the corporation paying out the $50,000 as a year-end bonus. The year-end bonus is ordinary income to the shareholder-employee(s) and an expense to the corporation, therefore making the corporation's profits $0 for the year. Assume a 28% tax bracket for the shareholders.

Corporate income taxes ($0 profit)	$0
Shareholder taxes on bonus ($50,000 @ 28%)	$14,000
TOTAL TAXES PAID	$14,000

Even though Ohio Farms Inc. is a C-Corporation, by paying out any profits as bonuses or wages, the corporation reduces any corporation profits to zero, therefore eliminating the double taxation problem. By paying out profits as bonuses or wages, the corporation saved $4,125 in income taxes versus paying out profits as dividends.

Corporate Losses

If a corporation incurs losses, the losses must stay within the corporation. Corporate losses cannot be passed along to the shareholders. However, corporate losses in one year can be offset against profits in future years.

Tax Reporting

C-Corporations file annual tax returns on IRS form 1120 regardless of whether the corporation has corporate income to report or not. The due date for the tax return is the 15th day of the third month after the close of the corporation's tax year. If the corporation expects to owe taxes, it must make periodic estimated tax payments.

Retained Earnings

Retained earnings are profits kept in the business to finance the future purchase of inputs or capital assets. Retained earnings are typically most important to small growing businesses that retain much of their earnings to finance the growth of the company. Corporate tax rates for the first $75,000 of profit in a corporation are usually

taxed at a lower income tax rate than an individual's tax rate. See the corporate tax rates in Table A.

Table A. Corporate Income Tax Rates

Over	But not over	Tax is	Of the amount over
$0	$50,000	15%	$0
50,000	75,000	$7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	—	35%	0

Consider the following example:

Ohio Farms Inc. is a C-Corporation that made $50,000 in profits. The company wishes to retain the $50,000 instead of distributing it to the shareholders as wages or dividends in order to finance an upcoming capital purchase. The tax liability for the retained earnings is as follows:

$50,000 @ 15% corporate tax rate = $7,500

The corporation will pay $7,500 in taxes on the $50,000 retained earnings.

If Ohio Farms were a sole proprietorship rather than a C-Corporation, the retained earnings would be taxed at the owner's individual income tax rates. If the owner is in the 28% individual tax bracket the tax liability for the retained earnings would be:

$50,000 @ 28% = $14,000

The total tax liability for the retained earnings for the sole proprietorship is $14,000. The same tax liability would be incurred by partners in a partnership, shareholders in a S-Corporation, or an LLC taxed as a partnership or an S-Corporation.

Tax Benefits of C-Corporations

1. Income Splitting

Income splitting is splitting corporation profits between the corporation and the shareholders to lower overall taxes. Some profit may be retained by the corporation at the lower corporate rates so as to not push the shareholders into a higher individual tax bracket. Conversely, when a corporation has high profits (over $100,000 net income), the corporation may choose to pass on the profits to the shareholders who may have a lower individual tax rate than the higher corporate rates. See the tax rates in Table B.

Table B. Married Individuals Filing Joint and Surviving Spouses—2007

Over	But not over	Tax is	Of the amount over
$0	$15,650	0 + 10%	$0
15,650	63,700	1,565 + 15%	15,650
63,700	128,500	8,772.50 + 25%	63,700
128,500	195,850	24,972.50 + 28%	128,500
195,850	349,700	43,830.50 + 33%	195,850
349,700	—	94,601.00 + 35%	349,700

2. Fringe Benefits

A C-Corporation has the ability to use more fringe benefits than any other business entity. A fringe benefit is any thing of value with a tax advantage given to an employee or owner of the business. Typical fringe benefits for farm businesses include health insurance, medical reimbursements, and retirement benefits.

While all businesses can provide retirement benefits to employees and owners, C-Corporations allow the biggest contribution limits and flexibility. Medical reimbursements allow the corporation to reimburse employees for any out of pocket medical costs. The corporation can in turn deduct these payments as an expense of the corporation. Fringe benefits must be offered to all employees of the company, and cannot be selectively offered to only certain employees.

Disadvantages of C-Corporations

1. Accumulated Earnings Tax

As discussed above, C-Corporations are ideal businesses for retaining earnings. However, there is a limit to how much earnings can be retained. Typically, retained earnings of over $250,000 incur an additional accumulated earnings tax of 15%.

2. Transferring Assets out of Corporation

Transferring assets out of C-Corporation can cause significant tax liability for the corporation and its shareholders. Transfer of assets can occur upon the sale of assets, distribution of assets to shareholders or the dissolution of the corporation. When an asset is transferred out of the corporation, the corporation owes taxes on any gain of the sale and the shareholders owe taxes on the money received. Additionally, any depreciation claimed by the corporation may be recaptured upon the transfer of assets. It is not uncommon for C-Corporations to incur large tax liability when assets are transferred out of the company, even for minimal amounts.

S-Corporation

S-Corporation Election

All corporations start out as C-Corporations. A corporation choosing to be an S-Corporation must elect S-Corporation status by filing Form 2553 with the IRS within specified time frames.

Pass Through Taxation

An S-Corporation allows for pass through taxation. Any profits or losses made by the S-Corporation are passed through to its shareholders. The corporation itself does not pay taxes. Therefore, an S-Corporation eliminates the double taxation dilemma of a C-Corporation. For example, an S-Corporation that makes $50,000 in profits may distribute the $50,000 to its shareholders if desired. However, the shareholders will pay income taxes on their share of the $50,000 profit on their personal 1040 tax returns. The corporation itself will have no tax liability for the $50,000. Corporate losses are also passed through to the shareholders subject to certain restrictions instead of being held within the corporation.

Limitations on S-Corporations

S-Corporations have unique eligibility requirements. If the corporation does not meet the following requirements, it cannot elect to be an S-Corporation and must remain a C-Corporation:

- No more than 100 shareholders
- All shareholders are U.S. citizens, resident aliens, other S-Corporations, or an electing small business trust
- The corporation has only one class of stock
- All shareholders consent in writing to the S-Corporation status

Tax Reporting for S-Corporations

An S-Corporation must file a form 1120S with the IRS regardless of whether or not it has any income. Any profit or loss attributable to the shareholder (owner) is reported on a K-1 which the corporation sends to each shareholder. The shareholder then reports the K-1 on his/her individual tax return.

Employment/ Self-Employment Taxes

An S-Corporation pays employment taxes on any wages paid by corporation, including wages paid to shareholder owners. However, any distributions paid out to the shareholders are not subject to self-employment tax. Therefore, S-Corporation owners may find it beneficial to transfer some corporate profits out as shareholder distributions. CAUTION: the IRS carefully scrutinizes the owner's salary for reasonableness to determine if any distributions paid to the shareholder owner should be reclassified as owner's wages with additional payroll taxes due.

Disadvantages of S-Corporations

1. Limited Fringe Benefits

An S-Corporation cannot offer the full scope of fringe benefits that a C-Corporation can. Particularly, retirement benefits are more limited in both amount and flexibility.

2. Retained Earnings Immediately Taxed

As discussed above, any earnings retained by the corporation is immediately taxable to the shareholders.

3. Converting C-Corporation to S-Corporation

It is possible to convert a C-Corporation to an S-Corporation. Business owners may most often attempt this when they are transferring assets out of the corporation in an effort to avoid double taxation on gain of the transferred assets. The conversion is a very complicated process that can create unforeseen tax consequences and liability. Converting a C-Corporation to an S-Corporation is a complex activity that should not be done without the assistance of a qualified tax professional.

Partnerships

A partnership is two or more individuals engaged in a business endeavor. Partnership taxation is generally considered to be the most complicated of all the various business entities. Therefore, it is even more important to seek tax advice when considering partnership taxation.

Tax Structure

A partnership has pass through taxation similar to an S-Corporation. The partnership itself does not pay taxes but instead passes on profits (losses) to its partners who then pay taxes based on their individual tax rates.

Tax Reporting

A partnership must file a form 1065 tax return annually with the IRS. This return is an informational return only showing the profits or losses of the partnership. The partnership must issue form K-1 to all partners. The K-1s show each partner's share of the income or loss. The K-1 also goes to the IRS to cross-check with the partners' individual tax returns.

Self-Employment Taxes

A partner's share of the partnership profits is subject to self-employment taxes. However, an exception to this

rule is a partner that is not active in the management of the partnership (a silent or investment partner) may not have to pay self-employment tax. This is most common for a limited partner in a limited partnership or a non-managing member in an LLC. IRS regulations provide a number of criteria that must be met before a partner is exempt from self-employment taxes.

Estimated Income Taxes

Partners must make estimated income tax payments periodically on their share of the partnership profits. If the partnership loses money, no periodic payments are due. As discussed in previous sections, the periodic payments cover self-employment taxes. Partners involved in a partnership farming business are subject to the same estimated tax payment rules as a farming sole proprietorship discussed earlier.

Calculating a Partner's Income

A partner is taxed on his/her distributive share of the net income from the partnership. Typically, a partner's share is proportional to the partner's ownership in the partnership. If there is no written agreement, the IRS will assume that all partners are equal owners.

A partner may receive a distributive share different from his/her ownership percentage if such provisions are made in the partnership's agreement. For example, Partner A and Partner B may be equal owners in the partnership but they have agreed to distribute 75% of the partnership profits to Partner A because Partner A puts more labor into the partnership. As long as the partnership agreement authorized this distribution, Partner A may receive a distributive share different from his ownership share. This is known as a special allocation distribution.

Special allocations are sometimes used for partners who are in different tax brackets. A partnership may make special allocations so that a partner in a lower tax bracket receives more of the profit distributions so that the total tax liability for the partnership profits is lower. However, any special allocations among partners should have an economic justification and not be done solely for income tax purposes.

Retained Earnings

Partners are taxed on partnership profits regardless of whether the profits are distributed or not. For example, if a partnership makes $100,000 in profits but keeps $50,000 to invest in a capital asset, the partners are still taxed as if they had received the entire $100,000.

Partnership Losses

Partnership losses are treated in the same manner as profits. Losses are distributed in the same proportion to ownership unless special allocation provisions are made.

Partner Contributions

A partner must make a contribution to a partnership in order to receive profit (or loss) distribution from the partnership. Usually, a partner contributes cash, assets, or both to the partnership. Each partner's contribution is divided by the total contributions of the partnership to determine each partner's ownership in the partnership. It is possible for a partner to have ownership in a partnership without contributing cash or a physical asset. Some partners contribute labor, management, and/or other expertise to the partnership. His/her ownership in the partnership is based on the value of his/her labor, management, and/or expertise. The partnership agreement should establish the ownership of the partnership when the partnership is formed, especially when a partner's ownership share is based on contribution of services and not assets. This avoids any confusion or disputes later as to the ownership percentage of the partnership.

Transferring Assets out of the Partnership

A partnership may transfer assets out to the partners without incurring tax liability as long as the partners do not receive assets greater than their share of ownership in the partnership. For example, if a partnership is worth $500,000 and Partner A is a 50% owner, the partnership can distribute $250,000 of assets to Partner A without causing a taxable event. There are additional rules regarding the timing of distributing the assets and the tax basis of the assets that are beyond the scope of this discussion.

Limited Liability Companies (LLC)

LLCs have become the entity of choice for many new business owners. One reason for the popularity of the LLC is that an LLC can elect several different tax structures. A single member LLC can elect to be taxed as a sole proprietorship, C-Corporation, or S-Corporation. A multi-member LLC can elect to be taxed as a C-Corporation, S-Corporation, or partnership. For example, a multi-member LLC can elect C-Corporation tax status to take advantage of fringe benefits and retained earnings tax savings or the same LLC can elect partnership tax status to take advantage of pass through taxation. The LLC elects its tax structure by filing the appropriate form with the IRS.

Seek Professional Advice

The previous discussion is a very basic and general overview of the tax characteristics of the business entities available to Ohio farmers. The tax code and regulations are very technical and are filled with exceptions and ambiguities. Therefore, it is highly recommended to seek professional tax advice when deciding which tax structure to put in place for one's business. A poor initial decision concerning tax structure can have long term effects on the financial performance of the business over many years.

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OSU Extension Agricultural & Resource Law Program--Ohio Agricultural Law Attorneys

Below is a listing of Ohio attorneys who practice in agricultural law, presented alphabetically and not in any order of preference. Provision of this list does not constitute an endorsement or promise of assistance, nor does it represent a complete listing of all law firms that may provide legal services for agricultural clients.

Law Firm and Website	*Attorney(s)*	*Location*	*Phone #*
Barrett, Easterday, Cunningham & Eselgroth, LLP http://ohiocounsel.com/	David Barrett, Jeff Easterday, Russell Cunningham, Carolyn Eselgroth, Troy Callicoat, Larry Gearhardt (of counsel)	Dublin, OH	(614) 210-1840
Buckley Miller & Wright	Jeffrey L. Wright	Wilmington, OH	(937) 382-0946
Detling, Baker & Fliehman, Ltd. http://www.dbf-law.com/	Jim Detling Travis L. Fliehman	Greenville, OH	(937) 316-4800 (937) 548-6888
Emens & Wolper Law Firm http://www.emenswolperlaw.com/	Dick Emens Beatrice Wolper	Columbus, OH	(614) 414-0888
Eric B. Fenstermaker, Attorney at Law	Eric Fenstermaker	Athens, OH	(740) 594-3401
Law Office of Ted Finnarn http://www.tedfinnarnlawoffices.com/	Ted Finnarn	Greenville, OH	(937) 548-3240
Gallagher, Gams, Pryor, Tallan & Littrell http://www.ggptl.com/	David W. Pryor	Columbus, OH	(866) 378-1624
Gottlieb, Johnston, Beam & Dal Ponte http://www.zanesvillelaw.com/	Susan J. McDonald	Zanesville, OH	(740) 452-7555
Gudorf Law Group LLC http://www.daytonestateplanninglaw.com/	Ted Gudorf	Dayton, OH	(937) 898-5583
Leisa Boley Hellwarth, Esq.	Leisa Boley Hellwarth	Celina, OH	(419) 586-1072
Hisrich Law Office	Tom Hisrich	Dover, OH	(330) 343-8834
Keating Muething & Klekamp PLL http://www.kmklaw.com/	Brian M. Babb	Cincinnati, OH	(513) 579-6963
Kennedy Purdy Hoeffel & Gernert LLC http://www.gernertlaw.com/	Terry L. Gernert	Bucyrus, OH	(419) 562-4075
Logee, Hostetler, Stutzman & Lehman http://www.lhslaw.com/	Christopher N. Finney	Wooster, OH	(330) 264-6115
Martin Browne Hull & Harper PLL http://martinbrowne.com/	Gregory R. Flax	Springfield, OH	(937) 398-0821
Kevin O'Reilly Co., LPA	Kevin O'Reilly	Chardon, OH	(440) 286-9405
Lawrence T. Piergallini, Esq.	Larry Piergallini	Tiltonsville, OH	(740) 859-2178
Robison Curphey & O'Connell http://www.rcolaw.com/	Kathryn Mohr	Monroe, MI	(517) 423-5404 (419) 418-6460
Schaller, Campbell and Untied http://scu-law.com/	Wes Untied	Newark, OH	(740) 349-8505
Schroeder Law, LLC http://www.leeschroeder.com	Lee R. Schroeder	Columbus Grove, OH	(419) 659-2058
Shumaker, Loop & Kendrick, LLP http://www.slk-law.com/	Kevin P. Braig	Columbus, OH	(614) 628-4433
Sitterly & Vandervoort Ltd. http://sitvanlaw.com/	Craig Vandervoort	Lancaster, OH	(740) 653-0461
Van Kley & Walker, LLC http://www.vankleywalker.com/	Jack A. Van Kley Christopher A. Walker	Columbus, OH Dayton, OH	(614) 431-8900 (937) 226-9000
Wright & Moore Co. LPA http://www.ohiofarmlaw.com/	Robert Moore Ryan Conklin Evin Bachelor	Delaware, OH	(740) 990-0750

Transferring the Farm Series #11 5/2014

Putting a Value on Sweat Equity

Agricultural Business Management

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For some farm/ranch families, deciding what to do with the family business can be very troublesome. How can we pass the farming business to the next generation while at the same time not create animosity or envy between the heirs? If we divide it equally between all the children, will it create such small pieces that the successor child cannot make a living operating the family farm? If one child is required to buy out his/her siblings will the business generate enough income to make this a feasible option? Most parents would say "We want to treat our children fairly." Is dividing the farm equally between all the children always a fair solution?

Last week I found myself thinking about a family farming operation struggling with the dilemma of planning their estate. Let's call this family the Smiths. Like many families, Dad and Mom Smith would like to keep the "farm in the family." Fortunately for them, son Jimmy, the youngest of three children, decided to return to the business in 1990. But unfortunately, if the farm business were divided into three equal pieces, the resulting slice would not be of adequate size to create a viable operation.

When Jimmy came back into the family business in 1990, the fair market value net worth of the business was $600,000. Dad and Mom discussed the contribution that each child had made over their "growing up" years and decided that each child had contributed more or less about equally to the business during those years. So $600,000 divided equally between the three children is $200,000 each. Today's net worth of the business has grown to $1,500,000. If divided equally between the three children $500,000 would be left to each. The contributions from the three children toward the success of the farm business have very definitely not been equal since Jimmy's return, however.

There were no promises made to Jimmy when he returned to the farm, but many decisions were made differently because he was part of the business. When the neighbor's land came up for sale, Dad and Mom would not have been interested in purchasing that land if Jimmy had not been involved. It was Jimmy's idea to increase the rented land and add a cow/calf enterprise to the business. It was also the labor and new energy provided by Jimmy that allowed the business to profit, expand and grow. Jimmy has been paid a modest wage and allowed the use of machinery as he has developed his own farming business. But Dad, Mom and Jimmy all know that his contribution to the family farm has resulted in Jimmy developing a sizable investment of "sweat equity" into the farm business.

There are two dilemmas present in this example. The first arises because most of us want to treat our children fairly. Many of us think that the only way to treat each child fairly is to treat them equally. Maybe that's the way it was always done in our family. We certainly don't want to be the cause of any hard feelings. We don't want our non-farm kids to feel that they have been mistreated or slighted, but if you were to divide the farm business into equal pieces would that equal slice be of adequate size to create a viable business? What about the contribution of the farming child to the success and growth of the business? The second dilemma occurs because farm asset values have increased so dramatically. Earning adequate income to pay for the increased value of the assets may be difficult, if not impossible for a successor to accomplish. If the Smiths want their son Jimmy to be successful, they need to consider the income the operation will generate as well as the market value of the farm assets.

Let's look at how the Smith family valued the contribution of their son Jimmy by putting a value on his "sweat equity." Once completed, they used this to explain to the non-farming kids how they reached their estate planning decisions.

Today the farm's net worth is $1,500,000. If the Smiths were to divide the assets equally, they would leave $500,000 to each child. But as they considered the contributions made by each child and the impact in the business growth because of Jimmy's return, they thought of it this way. There has been $900,000 of increase since 1990. The business has grown and diversified. Profits have been reinvested into the farm, and farm assets have appreciated in value. Jimmy has contributed a substantial amount of "sweat equity." Both parents feel that they may have actually retired several years ago and sold some of the original land (prior to the recent jump in land values) had Jimmy not decided

to return to the farm. After much evaluation and discussion Dad and Mom decided that they would equally divide the 1990 value of the farm between their three children, but they decided that Jimmy was responsible for 50 percent of the business growth since 1990. They therefore decided to allocate their assets as follows:

1990 Jimmy Returns to the Family Business:

-1990 Net Worth of the family business = $600,000

-1990 Net Worth divided equally between 3 heirs = $200,000

Business Growth, Appreciation, Inflation and Diversification:

-2009 Net Worth has increased to = $1,500,000

-1990 Net Worth of family business = $ 600,000

Net Worth Growth is = $ 900,000

Parents Attribute 50% of Growth in Net Worth to Jimmy:

-50% of $900,000 = $450,000 attributed to Jimmy's contribution

-50% of $900,000 = $450,000 attributed to parent's contribution

-$450,000 parent's portion divided by three equals $150,000 each child

Asset Distribution in Estate Plan:

-Jimmy receives $800,000 total:
$200,000 (1/3 of 1990 net worth) plus
$450,000 (50 percent of growth contribution)
plus $150,000 (1/3 of parent's contribution).

-Non-Farm Siblings receive $350,000 each:
$200,000 (1/3 of 1990 net worth) plus
$150,000 (1/3 of parent's contribution).

Jimmy's contribution of 50 percent is simply an example. Every operation will have different factors and likely arrive at a different percentage for the value of the successor's contribution. In the Smith's case, Jimmy will receive more than twice as much as his brother and sister. However, they all understand the basic process. Contributions equal compensation. The family business looks much different today because Jimmy came back to become part of that business.

Each family situation will be different. The next family may have decided that their successor had contributed to only ten percent or maybe 80 or 90 percent of the growth. The question is how much has the "sweat equity" contributed to the growth of the farm? It is the business owners that are in the best position to evaluate the contribution and adjust the compensation accordingly. The Smith children understand how the estate is to be distributed, and hopefully, they will all be eating Christmas dinner together for years to come.

Treating unequal's equally, may be the most unfair thing you can do!

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