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Business planning for farms and ranches

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Introduction

If possible succession and business planning for farmers and ranchers should be done at the same time because of the important relationship that exists between these two objectives. This interrelationship is evidenced by the fact that in most cases the greatest threat to the continuation of the business enterprise is the loss of operating capital to make distributions to off-farm heirs for their share of the family inheritance. That means the parents are caught with having to deal with both creating fairness in the inheritances of the on and off-farm children while preparing a business plan that provides the income that they and their successors need.¹

Selecting a business entity

The cornerstone of simultaneous business and succession planning for farmers and ranchers is the selection which type of entity or entities should be employed for the operation. This is because the type of business entity selected affects matters such as liability protection for personal assets, the ease of transferring fractional interests in the business, managerial control of the operation plus the allocation of earnings and their taxation. In any case, the options are as follows.²

Sole Proprietorship - In the case of a sole proprietorship the owner has ownership and management of the business and assumes all risks of loss as well as being entitled to all profits. To establish such an operation no special legal permission required which reflects its principal advantages of simplicity and freedom of operation from interference by others. On the other hand, the disadvantages are personal liability, typically smaller size and lack of continuity. With regard to taxes they are paid on profits at tax rate of owner.

Operating Agreements - These arrangements involve two or more sole proprietors that carry on some activities jointly while maintaining individual ownership of their resources. Further, operating expenses are usually shared among the parties in some fixed proportion while income is shared in same proportion as fixed assets with expenses being contributed

¹ Planning For Continuation Of The Farm or Ranch Business, Neil E. Harl, Center For International Agricultural Finance, Iowa State University, Ames, Iowa, March 2, 1993.

² Farm Management, 7th Edition, 9780077418977ISBN-13: 0077418972ISBN: [William Edwards](#), [Patricia Duffy](#), [Ronald Kay](#).

Partnerships -These business arrangements are defined as an association of two or more persons who share ownership of a business. In that regard, there are the two types of partners defined as follows:

- General partners contribute to the management of the business and are exposed to unlimited liability.
- Limited partners do not participate in the management and are liable only for what they have contributed to the business.

Additional details about General Partnerships are that they involve the sharing of business profits and losses with shared control of property and shared management of the business. These arrangements also normally involve a written partnership agreement that describes who is responsible for making management decisions along with instructions on how decisions should be made. Further, the partnership agreement lists the property each partner will contribute and how it will be owned. Other details that should be covered include:

- How profits and losses will be divided.
- Who will keep the business records?
- A detailed account of the tax basis of contributed property.
- A termination date for the partnership if one is known. Otherwise, a partnership is terminated upon the incapacitation or death of a partner (the partnership may continue if the written agreement contains provisions for passing on the estate and continuing the partnership), bankruptcy and mutual agreement.
- A method for division of the partnership property in case the firm is dissolved.

The Advantages of a Partnership include that it is easier and cheaper to form than a corporation and that it is a flexible form of business that can accommodate many different situations. On the other hand, the disadvantages include that each general partner has unlimited personal liability and that any general partner can act for the partnership in legal and financial dealings upon which the other partners will also be held responsible.

As to partnership taxation a partnership does not directly pay taxes. Rather, the partnership files an information income tax return that reports income and expenses with each partner's share of income from the partnership being reported on his or her own tax return.

Corporations - As distinguished from the above business arrangements, a corporation is a separate legal entity that is formed and operated in accordance with laws of the state in which it is organized.

Accordingly, to form a corporation the following steps are typically followed:

- An application is filed with the secretary of State for the state of incorporation) reserving a name for the corporation.
- The articles of incorporation are drafted and filed with the Secretary of State.
- Property and/or cash is contributed to the corporation in exchange for shares of stock.
- The shareholders meet to organize and elect the corporation's directors.
- The directors elect officers, adopt bylaws, and start the business.

The advantages of Corporations include limited liability for shareholders as they are liable only to the extent of their investment. (This advantage may, however, be negated if a shareholder is required to personally sign a note to borrow funds.) In addition, a corporation provides business continuity along with the opportunity for several individuals to pool their resources. Conversely, the disadvantages of corporations include that they are costly to form, require legal advice and necessitate that shareholder and directors hold periodic meetings.

The two types of corporations are a C or "regular" corporation and an S or "tax option" corporation. As to a C Corporation, it pays taxes on its earnings before dividends are distributed. The shareholders

then pay taxes on the dividends, at their individual rates. Further, if shareholders are employees, their salary and benefits can be charged as expenses to the corporation, but these expenses must be reasonable.

With respect to S Corporations, they have special features that include:

- Limited to no more than 75 shareholders.
- Shareholders must be U.S. citizens, estates or certain types of trusts.
- There may be only one class of stock.
- All shareholders must agree to form an S corporation

Tax wise an S corporation is taxed like a partnership in that the corporation files an information tax return, but shareholders report their share of income on their own tax returns and are taxed at their own rates.

Limited Liability Companies - These business arrangements or “LLCs” are a form of highbred in that they resemble a partnership but offer members the advantages of a corporation. Specifically, the members’ liability is limited to the assets of the LLC, the LLC can have any number of members that can participate in management, ownership is held according to the fair market value of contributed assets, net farm or ranch income is passed to members, who pay taxes at their individual rates and an LLC does not automatically continue in the event of the death of a member.

Structuring the farm or ranch business

When setting up the business the farmer or rancher may want to create one or more entities. For example, the farmer or rancher might put the land in one entity with the machinery, livestock, equipment and inventory held in another entity.³ This may provide flexibility in meeting the retirement income objectives of the parents while creating options for achieving fairness in dealing with off-farm children without involving them in the farming operation. It may also reduce the investment required by the on-farm children in gaining control of the operating side of the business. On the other hand, separating the land from the rest of the assets could create some practical problems such as stripping out too much cash from the operating budget to pay a land rental to the parents. Further, the land would not be available as collateral for business loans and using multiple entities would create complexities in accounting and capital transactions.

Developing a business Plan

Once the choice of the operating entity is made the farmer or rancher needs to create a business plan that outlines how they intend to generate a profit and manage business risks. That begins with identifying their specific business/personal goals and objectives and preparing complete inventories of their available resources for accomplishing those goals and objectives.

In terms of identifying specific goals and objectives the areas for consideration may include sales volume, profits, owner compensation, and number of employees. To set these goals and objectives, the farmer or rancher should follow guidelines established by the military for describing each goal or objective in terms of who, what, when, where and why. Then they should set timetables to match the goals and objectives and identify who will be responsible for the tasks.

With regard to identifying resources farmers and ranchers should consider items such as farm/ranch maps by productive capacity, soil analysis, water resources, machinery, crop/livestock production information, and complete financial statements.⁴ As to the later, farmers and ranchers tend to prefer to

³ Supra 1.

⁴ Financial management: The Key to Farm-Firm Business Management, Jose G. Pena and Danny Klinefelter, Agri Life Extension, Texas A & M System.

concentrate on production rather than planning, recordkeeping and marketing but these skills are also very important.

In preparing a business plan there are also certain questions the farmer or rancher must address. They include matters such as determining:

- Is the business large enough to productively employ another person or family?
- Can management responsibilities be shared?
- Whether the operation can produce products lower than the average cost of production?
- What is the breakeven price for each commodity being produced?
- Will the proposed business plan take into consideration economic conditions, and government programs?
- Does the business have sufficient equity and liquidity to handle unexpected emergencies and economic cycles?
- Can the farm or ranch operation provide the required income for the on-farm family members?

Having set their goals and objectives, identified available resources and answered the above questions the farmer or rancher can move on in the planning process by developing production, marketing and financing plans for several years going forward. This will require that they build into the plan the following features:⁵

- A long-term strategy for the future considering historical data and the current outlook with attention paid to information on government farm programs, the general economic outlook and technological developments. Remember that it is much easier to run a business when you have a goal in mind to reach rather than having vague ideas about what you might like to see happen. When creating this strategy farmers and ranchers should keep in mind that it needs to include stating how they plan to deliver value to their customers, how they intend to convince them to obtain that value from themselves and why they can deliver that value better than the competition.
- A crop/livestock rotation plan that involves enough years to cover any changes in production and financing that may cause significant fluctuations in the year-to-year cash flows.
- A three phase capital improvements plan dealing with immediate, intermediate and long term needs.
- Operating capital requirements for the near and long term.
- A month by month and year by year production plan that specifically outlines all of the required production practices and resources, for each commodity and the entire operation as a whole. Here the farmer or rancher must be careful to have a plan that can handle the best with the worst which means not pushing their resources to their limit because if they use all their resources all the time they don't have flexibility.⁶ And they should not forget to maximize every dollar that their farm or ranch can bring in. That includes diversifying activities to include social event gatherings as well as hunting leases.
- Projections of cash flow needs for individual projects and the farm/ranch as a whole on a month by month and year by year basis.
- A product marketing plan reflecting best and worst case scenarios for product pricing.

After the business plan is in place a crucial aspect of ongoing success is the ability of the farmer or rancher to determine the financial position and performance of the business at any time in terms of where the business is, has been, and is going. This is because such information enables the farmer or rancher to control the business operation over time in terms of the ability to recognize developments and make adaptations. In other words, they can compare actual performance to the plan and take action to make changes when and as necessary. To do that, however, they need a farm/ranch recordkeeping

⁵ Supra 4.

⁶ The Ranch Business Plan, Larry Stalcup, The Cattleman, Texas and Southwestern Cattle Raisers Association, 2014.

system that facilitates the preparation of financial statements and the monitoring of the operation's business performance. This includes balance sheets, income statements, and cash flow projections used to keep the business on track and show creditworthiness to lenders. A description of each of these statements is as follows:

- Balance Sheet – The balance sheet is a summary of all assets and liabilities of the farming or ranching operation at a specific point in time.
- Income Statement – An income statement shows the profitability of a farm/ranch business over a period of time such as a one tax or calendar year.
- Cash Flow Statement – A cash flow statement reflects all anticipated cash inflows and outflows for a specific future period. This includes operating expenses and capital outlays, family living expenses, borrowing transactions and tax payments.

In any case, while Farmers and ranchers can use the information provided by these financial statements to keep track of what is going on they need to be cautious to the extent that a farm or ranch business can be failing and still show a positive cash flow for a limited period by deferring expenses, restructuring or refinancing debts, selling off assets, and not replacing capital assets as they wear out. Consequently, the business has to be profitable to survive over the long run and even then the farmer or rancher must be careful to not consume more than the business is earning.⁷

Federal income tax laws are complex and subject to change. The information in this memorandum is based on current interpretations of the law and is not guaranteed. Neither Nationwide, nor its employees, its agents, brokers or registered representatives gives legal or tax advice. You should consult an attorney or competent tax professional for answers to specific tax questions as they apply to your situation.



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⁷ Supra 4.