Business Arrangements for Dairy Operations : The Pros and Cons of Various Alternatives

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The type of business arrangement that should be adopted by a dairy producer depends largely on a producer s preferences. Almost every producer wants to earn profits and generate wealth but they have different ideas about how they should go about doing this. For example, some producers want to have total control over their operations and make all of the management decisions, even if it prevents them from gaining access to additional labor and capital. Alternatively other dairy producers are quite willing to enter into a shared management arrangement because it can boost the producers earnings. These differences in the producers attitudes about shared management decisions are the major reason that different business arrangements are employed by dairy producers.

In this paper we will consider a variety of business arrangements that can be used by dairy producers. As we analyze the business arrangements we will try to identify the pros and cons of each arrangement so that dairy producers and other farmers can determine if a particular arrangement is compatible with their business objectives and needs. This analysis of business arrangements will start with a discussion of how a dairy business stage of development determines what business arrangements may be appealing to a dairy producer. Next we will consider the spectrum of business arrangements from labor for wages to corporations and cooperatives. We will conclude our analysis of business arrangements by examining some of the key issues that should be considered when choosing a business arrangement.

Stages of Business Development and Business Arrangements.

The type of business arrangement that might be employed by a dairy producer depends, in part, on whether the producer s business is well established or just getting started. In the case where producers are established and well capitalized, producers are most likely to be interested in operating arrangements that bring more labor and management to the business. When start-up businesses are involved, producers are not as concerned about gaining access to more labor and/or management. Instead they want to enter into business arrangements that will give them access to productive assets or the financial capital that is needed to fund farming operations.

There are a four stages of development for all dairy operations and farm businesses. These stages

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of development are: (1) Start-up; (2) Growth; (3) Consolidation; and (4) Termination.The following table summarizes the distinguishing characteristics of businesses that fall into these various stages of development.

Start-up
- Limited productive assets
- Limited equity and credit reserve
- Adequate to surplus labor
- Surplus management capacity

Growth
- Sufficient base of productive assets
- Limited to adequate equity and credit reserve
- Adequate labor
- Surplus management capacity

Consolidation
- Sufficient base of productive assets
- Adequate to high equity and credit reserve
- Adequate to shortage of labor
- Adequate to shortage of management

Termination
- Excess production assets
- Adequate to high equity and credit reserves
- Shortage of labor
- Shortage of management or unwanted management responsibilities.

Dairy operations in the start-up and growth stages are similar in that both types of farms are attempting to gain access to more productive assets like cows, machinery, buildings, and land. Gaining access to these types of assets is a challenge for these operations because they generally lack the equity and credit resources that are needed to finance the purchase of the assets. Given this capital availability problem, it follows that dairy operations in the start-up and growth stages would be interested in business arrangements that could help them gain access to assets and financial capital that can be used to fund operations.

Dairy farmers with operations in the consolidation and termination stages of development have generally acquired all the assets they desire and in many cases retired all or most of the debts that were used to finance the farm business. These dairy farmers have an abundance of capital and a desire to become investors versus business managers. Thus it follows that the dairy producers in the consolidation and termination stages of development are the individuals who are interested in business arrangements that will let them earn returns on their capital while they turn over management responsibilities to other individuals.

Operations in the start-up and growth stages of development can work with the owners of established dairy operations to establish some mutually beneficial business arrangements. The operators of developing businesses can take over the management burdens that the owners of established dairy businesses no longer wish to assume. In return for taking on these additional management responsibilities, the operators of start-up and growth businesses gain access to the farm assets and capital resources they need to generate profits and create wealth. The exchange of management for capital occurs in almost every business arrangement that pairs developing businesses (start-up and growth) with established businesses (consolidation and termination).

Spectrum of Business Arrangements

There is almost no limit to the variety of business arrangements that can be developed by people who want to be involved in business activities. The arrangements can only involve an exchange of labor for wages for a short period of time or they can be quite complex and involve major investments of capital and services over an extended period of time. In this section we will consider the variety of business arrangements that are commonly used in agriculture and discuss some of the advantages and disadvantages of the arrangements that are considered.

Employer - Employee Arrangements

The simplest and most basic business arrangement is one where a producer hires someone to work for wages or a salary. This business arrangement is easy to implement given that it only involves the development of a job description and the specification of a compensation package.

Employer-employee arrangements are ideal for determining whether two parties can work together and possibly enter into other business arrangements over time. If things go as planned the two parties can shift to an alternative business arrangement. Alternatively, the two parties can easily terminate the employee-employer arrangement if either of them determine that they cannot work with the other party.

There are a variety of compensation packages that can be used in employee-employer arrangements. The simplest package is one where the employee is paid an hourly wage or a set salary. An alternative compensation plan would be one where the employee is paid a performance bonus on top of regular wages or salary. Paying employees performance bonuses is a way that employers can share profits with employees who may want to start their own business or buy an interest in their employer's operation.

Custom Services and Production Contracts

It is not always possible for agricultural producers to own all of the machinery, equipment, facilities, etc. that are needed to raise crops and livestock. Sometimes this occurs because producers do not have the financial resources needed to purchase expensive machinery or equipment. More often producers are unable to justify owning machinery and equipment because they cannot fully utilize the assets. For example, it makes little sense for a dairy producer raising 200 acres of corn to own a $150,00 combine that is designed to harvest 1000-2000 acres of corn annually. Few producers can afford to bear this cost of under-utilizing capital investments.

Dairy producers can also be faced with the problem of having to try to manage more activities than they are capable of managing effectively. For example, it can be quite difficult to manage corn and hay crops, a milking herd, replacement stock, dry cows, and other enterprises that are typically found on a conventional midwestern dairy operation. Dairy producers are starting to understand that it can be costly for them to stretch their management abilities to the point that enterprises are not run efficiently.

Custom services and production contracts are business arrangements that some dairy producers are using to solve the problems that arise when capital investments are under-utilized or management is stretched across numerous enterprises. Planting, cultivating, and harvesting are the most common custom services that are used by producers. Contracting for feed or replacement stock is a way some producers have eliminated enterprises on their dairy operation and still gained access to the feed and replacement stock needed to operate a dairy farm.

The payoff from using custom services or entering into production contracts is that it helps a producer keep capital costs to a minimum. Furthermore, it lets a producer focus on fewer activities so that it is possible to capture all the profits that come from gains in efficiency.

There are some potential problems with using custom services and production contracts. One problem is valuing, or pricing, the services. Another is setting performance standards and then establishing penalties for not meeting the standards. A final problem with custom services and production contracts is locating individuals and businesses that are willing to perform the desired services.

Leasing

Leasing is another business arrangement that dairy producers can use to gain access to capital assets, like land and buildings, at affordable rates. This arrangement is attractive to any dairy producer or farm operator who is unable or unwilling to borrow large sums of money and purchase farm real estate or other expensive capital assets. Leasing is a very flexible business arrangement that gives lessees and lessors considerable latitude in setting payment terms, the time horizon for the lease, and the rights and responsibilities of all parties involved in the lease.

There are generally two types of leases that are used in agriculture: cash leases and share leases. Cash leases, as the name suggests, are those lease arrangements where all payments are made in cash. These lease arrangements are relatively easy to initiate because they are straight forward - the lessee pays an agreed upon dollar amount to the lessor who gives the lessee control of the asset for a specified period of time. Share leases are not as "cut and dried" as cash leases. With share leases, the lessor receives a share, or percentage, of production as compensation for giving the lessee use of the leased asset. The share of production set aside for the lessor typically has a value that is comparable to the cash rental value of an asset. Thus a share rent arrangement will generally give a lessor a return that is equal to a cash rent.

Share lease arrangements are a little more difficult to initiate because the lessors and the lessees have to decide what share of production should go to the lessor. In order to make this decision, the lessors and lessees have to value all of the inputs, labor, and assets they are committing to productive activities. Once these contributions are valued the lessors and lessees share in production based on the value of their respective contributions. Thus a lessor would receive 40 percent of production if the value of his contributions was 40 percent of the total contributions.

Share lease arrangements do not give lessors a guaranteed return. Lessors are given a percentage of the production. The value of this production will vary depending on market prices. Also production can vary from year to year depending on weather or other acts of nature. This uncertainty in returns is a disadvantage to lessors but it is a plus for lessees because their risks fall as lessors assume a portion of price and production risks.

Shared Ownership and Management Arrangements

The most complex and sophisticated business arrangements that dairy producers can enter into are those where ownership and management responsibilities are shared with other individuals. The primary advantage of these shared ownership arrangements is that they let individuals pool their financial resources and form a business that is large enough to achieve scale efficiencies. The major disadvantage of these types of business arrangements is losing control of the capital resources that are invested in these businesses.

There are generally five types of business arrangements where ownership and management are shared. These business arrangements are partnerships; limited liability companies; C corporations; S corporations; and cooperative corporations. Each of these arrangements has advantages and disadvantages depending on the needs and wants of the dairy producers who may want to enter into these arrangements.

Partnerships are associations of two or more parties who operate as co-owners of a for-profit business. Partners share in assets, debts, and profits depending on the "contributions" of the partners. These contributions are generally financial capital but partners can make contributions in other forms.

Dairy producers who want to limit their liabilities may want to consider a business arrangement known as a limited liability company. This business arrangement is essentially a partnership except for one important difference. The difference is a liability limitation that is extended to each member of the limited liability company. This limitation in liabilities is quite appealing to individuals who want to control risks.

Both partnerships and limited liabilities have lives that correspond directly with the lives of partners or members. Thus these business arrangements must be terminated or restructured upon the death of partners and members. Some investors do not want to be a party to business arrangements, such as partnerships or limited liabilities, that have finite lives. The business structure preferred by investors who want businesses to have infinite lives is a corporation.

By definition, a corporation is a distinct entity that is separate from individuals who own it, mange it, and work for it. A corporation's life is not tied to any one individual. Hence a corporation will continue to exist as long as the investors, also known as shareholders or stockholders, continue to keep the business in operation.

Corporations are by far the most complex business structures. There are three decision-making groups for all corporations. These groups are shareholders, board of directors, and officers. The shareholders have invested capital in the business and they decide whether they are willing to keep the capital at risk with the corporation. The board of directors is a group of shareholders and other individuals who make policy decisions about the corporation and select the officers who will manage the corporation. The officers of the corporation are the individuals who make decisions about the day to day operations of the corporation. The duties and responsibilities of these three decision-making groups are spelled out in the articles of incorporation that have to be drawn up for every corporation.

Because a corporation is a separate entity, its shareholders are not liable for all of the corporation's obligations. Instead the shareholders' liabilities are limited to the equity capital of the corporation, which is the shareholders' investment in the corporation. This liability limitation is one of the benefits of a corporate business structure.

There are different types of corporation. The most common type of corporation is known as a "C" corporation. This is the standard corporate structure that has the problem of double taxation that is generally identified as a drawback to forming a corporation. A C corporation pays income taxes on any profits it earns and the shareholders pay income taxes on any of the profits the corporation passes on to them as dividends. This heavy burden makes C corporations unattractive and encourages small business operators, like dairy producers, to form "S" corporations.

S corporations are special business arrangements that essentially allow businesses to adopt a corporate structure and still be taxed as a partnership. The advantage to this arrangement is that it eliminates the double taxation problem. The disadvantage of an S corporation is that there is a limit on the number of shareholders for this type of corporation. This limitation on the stockholders makes it difficult for the corporation to issue stock and raise capital.

Another corporate structure that enjoys some tax advantages is a cooperative corporation. In the case of cooperatives, the owners of the business are also the primary patrons of the business. Given this arrangement, the owners of the business essentially create "profits" for themselves as they patronize the cooperative they own. The taxing authorities account for this special arrangement by exempting cooperatives from paying income taxes on any profits they distribute back to their owner/patrons on the basis of patronage. This preferential tax treatment on "patronage refunds" is how the taxing authorities have reduced the double taxation problems of cooperatives. It is still possible for cooperatives to face the problem of double taxation when they distribute profits to investors on the basis of how much capital they have invested in the cooperatives.

In order to adopt a cooperative structure, a business must comply with regulations that pertain to returns on investor capital. These regulations generally limit the rate of return cooperatives can pay on investors' capital. The limit on returns to capital is usually eight percent. This return on capital restriction can make it difficult for cooperatives to attract investor capital because higher returns can generally be earned on alternative investments.

Choosing a Business Arrangement

It is safe to assume that almost everyone would prefer a business arrangement where they have access to unlimited resources and are accountable to no one. Few, if any, people can put together this type of arrangement. Thus it follows that individuals are going to have to develop some alternative business arrangements that give them access to necessary resources and still allow them to have some ability to manage and make decisions.

Earning and accumulating capital is a prerequisite for owning some or all of a dairy operation or any other business. Without this capital a person cannot purchase an interest in a business and have the right to share in ownership and management decisions. Thus individuals interested in becoming the owners of a business should be willing to become engaged in arrangements that let them earn and accumulate financial capital.

Employee-employer arrangements are an excellent way for a young individual to gain expertise about dairy operations and earn capital that can be used to purchase a farm or an interest in a dairy farm business. These types of arrangements are a stepping stone to arrangements where the employee can eventually own or manage farm assets.

Leasing is another business arrangement that individuals will need to consider when they cannot afford to own all the assets they need to run a dairy operation. Leasing puts some restrictions on the persons who are using the assets but it is generally a cost-effective way for dairy producers and other farmers to gain access to the real estate assets they need to operate. One advantage of leasing is that it lets a younger producer earn profits that the producer ultimately uses to purchase the farm that was going leased.

Partnerships, limited liabilities, and corporations are business arrangements that can be considered when all of the parties are able to make "contributions" to the business. These contributions are generally financial capital or assets with a determinable value. In some cases persons contribute labor and/or professional services to gain ownership in the business.

Choosing between partnerships, limited liability companies, S corporations, C corporations, and cooperative corporations is a decision one should make after considering a variety of issues. Some of the more important issues to be considered are: 1) ownership; 2) getting started; 3) decision-making and management; 4) flexibility in distributions; 5) taxes; and 6) adjusting to change. Table 1 lists each of these issues and presents some of the key topics of concern for each issue.

There are advantages and disadvantages for each of the business arrangements where ownership is shared. Some of the major advantages and disadvantages are summarized in Table 2. A dairy producer trying to choose between various business arrangements would be wise to prepare an evaluation similar to the one presented in Table 2. By performing this evaluation a producer can better determine which business arrangement is most advantageous.

Concluding Remarks

In this paper we have only brushed on some of the issues that diary producers and farm operators should consider when they are trying to select a business arrangement that is appropriate for them. Entering into a business arrangement is a big step that should only be taken after a producer has carefully considered all of the ramifications of the decision. Dairy producers should make an effort to learn all that they can about the consequences of entering into a business arrangement before they take any actions. Furthermore they should probably consult with their lawyers to see if a business arrangement is in their interest and in compliance with the law.

Business arrangements can help dairy producers construct and organize a profitable and successful business. Hopefully the comments abut business arrangements that are presented in this paper will help producers get an idea of what business arrangements could be useful to them.

Table 1: SIX ISSUES TO BE CONSIDERED WHEN CHOOSING A BUSINESS ARRANGEMENT.

OWNERSHIP

a) Limitations on Owners
b) Liability Limitations

GETTING STARTED

a) Legal and Administrative Costs
b) Familiarity

DECISION-MAKING AND MANAGEMENT

a) Distribution of Voting Power
b) Decision-Making body
c) Majority rule or Consensus

FLEXIBILITY IN DISTRIBUTIONS

a) Distribution to Employee-Owners
b) Distribution to Investors

TAXATION

a) Pass through Income Taxation Versus Double Taxation

ADJUSTING TO CHANGE

a) Withdrawal and Transfer of Ownership Interest

Table 2: Some Advantages (A) and Disadvantages (D) of Shared- Ownership Business Arrangements

Partnership

Ownership
- Partners must receive unanimous approval (D)
- Partners have unlimited liability (D)

Getting Started
- Limited Legal and Administrative Costs (A)
- Common (A)

Decision-Making and Management
- One vote per partner
- Decisions made by partners as a whole
- Unanimous consent on decisions

Flexibility in Distributions
- Cannot deduct benefits of employee-owners (D)
- Can make special distributions to investors (A)

Taxation
- Income taxed at partner level (A)

Adjusting to Change
- Owners may withdraw at their will
  (Advantages to partner but disadvantages to partnership)

Limited Liability Company

Same as partnership except for the following differences

Ownership
- Members have limited liability (A)

Getting Started
- Relatively new option so financial consultation could be costly (D)

Decision-Making and Management
- Voting in proportion to investment
- Majority of ownership interest generally rules

S Corporation

Ownership
- Limited to 35 owners (D)
- Shareholders have limited liability (A)

Getting Started
- Legal and administrative costs rise in relation to number of shareholders (D)
- Not as common as C corporations (D)

Decision-Making and Management
- One vote per share of stock
- Decisions made by board of directors
- Majority of ownership interest elects board and majority rules on board

Flexibility in Distributions
- Can deduct benefits of employee-owners (A)
- Single class of stock limits special allocations to investors (D)

Taxation
- Income taxed at shareholder level (A)

Adjusting to Change
- Majority interest may prohibit withdrawal of minority interest capital (Advantage to corporation, disadvantage to shareholder)

Table 2: Some Advantages (A) and Disadvantages (D) of Shared- Ownership Business Arrangements -- Continued

C Corporation

Same as S corporation except for the following differences

Ownership

Few, if any limitations (A)

Getting Started

Quite common (A)

Flexibility in Distributions

Multiple classes of stock allows for special allocations to investors (A)

Taxation

Income taxed at both corporate level and shareholder level (D)

Cooperative Corporation

Same as S corporation except for the following differences

Ownership

Limited to users of the business goods and services (D)

Getting Started

Unusual farm ownership method (D)

Decision-Making and Management

One vote per member

Flexibility in Distribution

Distributions based on patronage

8% limit on return on equity (D)

Taxation

Income taxed at shareholder level only if income distributed as refund (A)