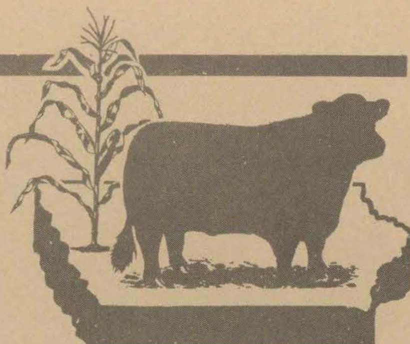
Beef Cattle Feeding In Iowa 1974



ORGANIZATION OF FEEDLOT OPERATIONS

Most cattle feeding in Iowa is currently carried on in conjunction with a sole proprietorship farming operation. However, cattle feeding operations may be established using partnership, limited partnership, corporation, cooperative or trust organizational structures. Each is different and offers a unique set of organizational attributes. The choice depends heavily upon (1) income tax considerations, (2) ownership, management and control features desired, and (3) differences in investor liability.

Methods of Organization

Organizational alternatives, as applied to cattle feeding operations, may involve (1) ownership of the facilities, (2) conduct of the production process, (3) ownership of the animals or (4) all three.

Where multiple ownership of facilities and animals and multiple involvement in decision making are involved, certain key features of organizational structure take on considerable significance: (1) control over decision making, (2) taxation of income and treatment of losses, (3) responsibility for losses in excess of investment, and (4) transferability of interests. The alternatives available differ sharply with respect to these characteristics. The basic alternatives for multiple ownership and decision making include the general partnership, limited partnership, regularly taxed corporation, Subchapter S corporation and the cooperative.

Sole proprietorship

Sole proprietorship implies single party dominance of the organization. The single owner provides equity (ownership) capital, contributes necessary management, assumes the risks of the business, reports income and losses from the firm, and exercises complete control over the operation. A sole proprietor pays income tax at rates ranging from 14 to 50 percent for earned income and 14 to 70 percent for unearned or investment income. For expansion, dollars of net profit are reduced by taxes to 30 to 86 cents. Capital gains may be treated in either of two ways: (1) a 50 percent deduction of capital gains income with the other 50 percent taxed as ordinary income, or (2) a flat rate tax of 25 percent on the first $50,000 of capital gains (for a joint return), 35 percent on amounts above that level.

Any investment credit is claimed on the sole proprietor's Form 1040.

The sole proprietorship is the dominant form of organization in Iowa farming with 105,087 reporting "individual or family" ownership in the 1969 Census of Agriculture. A large proportion of the feedlots in Iowa are operated in conjunction with a farming operation. It follows that sole proprietorship would be the prevailing method of organization for cattle feeding in Iowa.

As indicated in table 1, 72 percent of the cattle shown as fattened on grain and concentrates in the 1969 agriculture census were reported by individual producers. That figure may be contrasted with 6 percent in Arizona and 43 percent for the U.S. The average number fed per "individual or family" feeding unit was 108 in 1969. Of the major feeding states reported in table 1, only Illinois reported a smaller average number for feeding operations organized on an individual or family basis, ostensibly as sole proprietorships. It should be pointed out that the census data reflect numbers of cattle on facilities operated by "individual or family" units and do not necessarily reflect ownership of the animals.

General partnership

The partnership form of organization, defined as "an association of two or more persons to carry on as co-owners a business for profit" accommodates multiple ownership and multiple participation in management for the firm. Since 1971, Iowa has had the Uniform Partnership Act which makes the general partnership a more useful form of organization. For example, a general partnership can now hold title to land. The 1969 Census of Agriculture showed 16,965 farm partnerships in Iowa which reported 23 percent of the fed cattle that year (table 1). The 4,465 partnership feeding operations

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in Iowa averaged 173 head each. Again, only Illinois of the major feeding states showed a smaller average number. It should also be pointed out that the census data portray cattle by operation of facility and do not necessarily reflect ownership of cattle.

There is no limit on the number of partners in a general partnership although most have fewer than a dozen.

Each partner has a right to participate in management. Unless otherwise provided by agreement, each partner has an equal voice in decision making and can bind the partnership as an agent.

One of the key features of general partnerships, and one that often discourages their use, is the unlimited liability of the partners for obligations of the partnership. Partnership debts and other obligations are first paid out of partnership assets. Any remaining obligations may be satisfied from the individually owned assets of the individual partners.

The partnership is a relatively unstable form of organization from a legal point of view. A partnership is technically dissolved upon death or departure of a partner, admission of a new partner to the partnership, or by incapacity or bankruptcy of a partner. Hence, the partnership is generally viewed as providing less stability than a corporation as the other primary form of business organization permitting multiple participation in ownership and management.

From an income tax standpoint, the partnership is ordinarily not a taxpayer. Rather, ordinary income, capital gains, losses and investment credit pass through to the partners as taxpayers, who report the amounts on their own individual returns. The partners are ordinarily considered as self-employed persons for purposes of social security and income tax payment. So, again, dollars of net profit for expansion are reduced to 30 to 86 cents.

Limited partnership

A limited partnership is similar to a general partnership in many respects. The same income tax rules apply, for example:

The major distinguishing feature is that a limited partnership has one or more general partners and one or more limited partners. Limited partners may not participate in control of the business and are accorded limited liability from partnership obligations. The extent of a limited partner's liability is that person's investment in the partnership. Individually owned assets cannot be reached to satisfy partnership obligations. Typically, limited partners are investors of equity capital who assume risks of ownership but without rights to participate in managing the firm.

In limited partnerships engaged in cattle feeding, the general partner (often a corporation) has management control and responsibility for purchasing, feeding, and marketing the cattle. The general partner also sometimes guarantees debt financing obtained by the limited partners. For those services, the general partner may receive a management fee and a small percentage of the profits. The Internal Revenue Service imposes requirements on general partners in terms of net worth relative to the limited partnership.

Unlike a general partnership, which need file no documents publicly, a limited partnership is required to file with the county recorder of the county in which the principal place of business is located (1) the name of the partnership, (2) the character of the business, (3) the location of the principal place of business, (4) the name and place of residence of each general partner and of each limited partner, (5) the term for which the partnership is to exist, (6) the amount of cash and other property contributed by each limited partner, and (7) various other information about the partnership and rights of the partners.

Regularly taxed corporation

As a creature of state law, a corporation is formally organized and chartered to carry on business operations as a separate and distinct entity from those who own it, manage it or work for it. A corporation can sue and be sued, own real and personal property, have perpetual life and hire employees (including shareholder-employees) to carry on its operations. A corporation affords limited liability to its shareholders in that corporate obligations may be satisfied only out of corporate assets and cannot be satisfied from the individually owned assets of the individual shareholders.

Management responsibility and authority are divided among three decision making groups: (1) shareholders elect the directors and make fundamental decisions on corporate operations on the basis of one vote per share of voting stock; (2) the board of directors is charged with developing corporate policy, making long-term decisions and selecting officers, with one vote per director; and (3) the officers as day-to-day decision makers are charged with executing board policy.

Upon incorporation, each corporation is required to list the names of the incorporators and names of the members of the first board of directors. An annual report is required showing, among other things, the names of the officers and directors. Thus, greater public disclosure is required.

A regularly taxed corporation is subject to both federal and state income taxes. At the federal level ordinary income is taxed at two rates—22 percent on the first $25,000 of corporate taxable income and 48 percent on all above that amount. Dollars of net income held for expansion are reduced to 52 to 78 cents. Capital gains are taxable either as ordinary income at the 22 percent rate or a maximum flat rate of 30 percent. The 50 percent deduction for capital gains available to individual taxpayers may not be claimed by regularly taxed corporations. Expenses of corporate operation, including salaries, bonuses, interest and rents are tax deductible, but dividends are not. Hence, dividends are taxed twice—once when earned, at the corporate level, and again when received by the shareholders (except for the $100 dividend exclusion). Corporate operating losses may not be used by individual shareholders to offset their other income, but are "locked in" the corporation and may be used to offset corporate income in other years.

Investment credit is claimed by the corporation, not by the individual shareholders.

In Iowa, regularly taxed corporations pay Iowa income tax at a rate of 6 percent on the first $25,000 of corporate taxable income, 8 percent on income between $25,000 and $100,000, and 10 percent on income above $100,000. State corporation income tax rules otherwise tend to parallel the federal rules.

Normally, failure of a corporation produces a capital loss for the shareholder. A more favorable ordinary loss treatment may be obtained up to $50,000 for joint returns if the stock issued qualifies as "Section 1244 stock." The stock must be issued under a plan adopted by the corporation.

Regularly taxed corporations may be subject to the accumulated earnings tax if the corporation accumulates earnings and profits beyond the reasonable need of the business. A corporation may accumulate earnings and profits of $100,000 without imposition of the tax. Beyond that level, the tax rate is 27½ percent on accumulated taxable income up to $100,000 and 38½ percent above that amount unless justified by the reasonable needs of the business.

A personal holding company tax (70 percent) is imposed if 60 percent or more of "adjusted ordinary gross income" comes from passive investment sources (such as dividends) and if five or fewer people own half or more of the stock.

The 1969 Census of Agriculture reported 621 farm corporations in Iowa, 553 with 10 or fewer shareholders. The 1969 Census of Agriculture reports corporate cattle feeding on the basis of number of shareholders rather than by method of corporate income taxation. Iowa corporations with 10 or fewer shareholders reported 7 percent of the total which is a lower percentage even than in North Dakota where farm corporations are legally prohibited. Those with more than 10 shareholders were responsible for 2 percent of the total. Among the major cattle feeding states, Arizona, California, and Colorado show the greatest incidence of corporate activity with more than 65 percent of the cattle in each state reported by corporate feeders.

The average number fed per corporate unit varies substantially by state. The 1969 Iowa corporations with 10 or fewer shareholders averaged 724 animals which compares with 15,771 each in Texas. The 17 Iowa corporations with more than 10 shareholders averaged 3,071 head while the 18 Texas corporations in the same classification averaged 34,406 head.

For the U.S. as a whole, about one-third of the cattle are fed in corporate operations.

As noted earlier, these data represent not ownership of cattle but operation of facilities. Also, in many areas of substantial activity by commercial feedlots, corporations often serve as the general partner in a limited partnership. The cattle may be owned by the limited partnership.

Subchapter S corporations

A tax-option or Subchapter S corporation (so named for the portion of the Internal Revenue Code containing the relevant rules) is a corporation for every purpose except one. Ordinarily, a Subchapter S corporation does not pay income tax. Rather, its ordinary income, capital gains and operating losses (but not capital losses) pass through to the shareholders, who report the amounts on their own individual income tax returns. Investment credit passes to the shareholders also. Subchapter S status may be elected for state income tax purposes in Iowa as well as for federal income tax purposes.

Among the requirements for a Subchapter S corporation is that the number of shareholders not exceed 10. This limitation prevents the Subchapter S corporation from being an acceptable (and sometimes desirable) substitute for the limited partnership for operations with more than 10 owners. Yet, as indicated in table 1, some states report substantial feeding activity by corporations with 10 or fewer shareholders. Subchapter S is also limited to corporations with one class of stock issued and outstanding, only individuals or estates of individuals as shareholders, and no more than 20 percent of gross receipts from passive investment income—rents, royalties, dividends, interest, and sale or exchange of property. Moreover, all shareholders must consent to the Subchapter S election.

Cooperative

As a variant of the corporation, a cooperative may be organized in corporate-like form to carry on a business venture. Cooperatives are more common in input-supplying and output-purchasing than in actual production. However, the Iowa cooperative statute, chapter 499 of the Iowa Code (1973), specifically recognizes production of agricultural products as a legitimate object of a cooperative.

Like corporations organized for profit, cooperatives may be organized to have perpetual life.

A cooperative may be organized by five or more individuals or two or more cooperatives. All individual incorporators of agricultural cooperatives must be engaged in producing agricultural products. Limited liability is afforded the members. Membership in the cooperative is evidenced by stock or certificates of membership. Nonstock membership is not transferable and stock is not transferable unless the articles of incorporation so provide. If a stockholder or member dies, becomes ineligible for membership or is expelled, his or her stock or membership is canceled. The member or the member's representative is entitled to receive the "value as shown by the books. . .but not more than its original issuing price." Each voting member is entitled to one vote, and no member may own more than one share of common stock or membership. Nonvoting stock may be issued to nonagricultural producers. Voting stock shall be issued to all agricultural producers.

Distributions to members are limited by rules unique to the cooperative. After creating a reserve for "depreciation, obsolescence, bad debts, or contingent losses or expenses," at least 10 percent of the remaining earnings "must be added to surplus until surplus equals either 30 percent of the total of all capital paid in for stock or memberships, plus all unpaid patronage dividends, plus certificates of indebtedness payable upon liquidation, or one thousand dollars, whichever is greater." In addition, "not less than one percent nor more than five percent of such earnings in excess of reserves may be placed in an educational fund, to be used as the directors deem suitable for teaching or promoting cooperation." After these amounts are set aside, dividends may be declared on common and preferred stock up to 8 percent per year. Remaining amounts of earnings are allocated to members' accounts "in proportion to the business he had done with the association" during that year. The directors determine the part to be paid in cash and the part to be placed in a revolving fund.

Upon liquidation, assets remaining after paying all dividends due and paying stockholders and members for their original investments, are distributed among the members in proportion to their deferred patronage dividends.

A cooperative's affairs are managed by a board

Table 1. Cattle Sold Fattened on Grain and Concentrates, Reported by Method of Organization, 1969.

State	Individual/Family			Partnership			Corporations						Other		
							Ten or fewer SH			More than 10 SH					
	No. units	Average no. per unit	Percent of total	No. units	Average no. per unit	Percent of total	No. units	Average no. per unit	Percent of total	No. units	Average no. per unit	Percent of total	No. units	Average no. per unit	Percent of total
Iowa	22,190	108	72	4,465	173	23	169	724	4	17	3,071	2	125	67	0.25
Nebraska	10,462	149	56	1,785	318	20	188	a	a	2	a	a	37	91	0.12
Texas	1,428	286	15	286	1,270	13	84	15,771	49	18	34,406	23	19	78	0.05
California	730	340	12	161	2,829	21	95	12,014	54	13	22,180	14	17	69	0.05
Kansas	4,140	155	37	871	309	16	67	8,135	32	10	26,779	16	13	56	0.04
Oklahoma	861	154	24	138	536	13	19	11,764	40	4	30,385	22	7	156	0.20
Colorado	1,139	310	21	293	693	12	90	10,884	59	7	16,971	7	2	60	0.01
Illinois	11,667	74	67	2,883	114	25	113	691	6	14	717	1	87	105	0.71
Arizona	89	549	6	35	2,618	11	42	15,191	76	3	--	--	1	--	--
U.S.			43			19			30			8			--

a Because of the small number of respondents, data were not released. For Nebraska, the average number fed for all corporate feedlots was 3,572.

Source: 1969 Census of Agriculture.

of not less than five directors who must be members. The directors select the officers from among their own members.

For income tax purposes, cooperatives are subject to regular corporate taxes. For qualified purchasing and marketing cooperatives, Subchapter T of the Internal Revenue Code provides a set of rules for reducing the amount of the income to which the corporate tax applies.

Trust

The various types of trusts are generally viewed as alternatives for property ownership and management but not for carrying on a business. For example, land is often held in trust with a lease to a tenant who carries on a business with the land as an input. Trust operation of a business is relatively rare.

With a trust, a trustee manages the trust operation for a fee. The trustee may be a bank or an adult person or persons. The beneficiaries designated in the trust instrument or document receive the income during operation of the trust and share the principal upon its termination.

Responsibility for income tax payment usually rests with those receiving distributions from the trust. Under certain circumstances the trust may be a taxpayer on income not distributed.

Multiple Unit Facilities

Various financing and organizational techniques have been developed to permit unit ownership of animals with the advantages of scale from locating units under single management, feed delivery and marketing. In some instances, such as condominium ownership, investors may acquire a purchase or leasehold interest in the facilities as well as control over the animals. Under custom feeding arrangements, investors typically own the cattle and acquire the necessary support services from a firm owning and operating the feedlot or feedyard.

Condominium ownership

As a relatively recent development, the condominium concept relates to a method of property ownership and not necessarily to business organization. Thus, a condominium could be owned by a general or limited partnership, regular or Subchapter S corporation, trust, or a sole proprietor.

- Legally, the term "condominium" is often viewed as involving a specific state statute such as the Iowa Horizontal Property Act. ch. 499B of the Iowa Code. This act was designed primarily for residential housing but it seems to be applicable to other situations.

  A key definition is that of "apartment" which means "one or more rooms occupying all or a part of a floor or floors in a building of one or or more floors or stories and notwithstanding whether the apartment be intended for use or used as a residence, office, for the operation **of any industry or business or for any other use not prohibited by law**" (emphasis added).
- Some other operations have come to be referred to as condominiums although not organized

under ch. 499B. One of the best known of these is in northwest Iowa and involves individual ownership of feedlot units on leased land. That installation is operated under a management agreement.

So it's partly a matter of the definition of condominium. Let's return again to the ch. 499B version of a condominium.

Essentially, this type of condominium permits separate ownership and management of "slices" of a building. To commit a structure to condominium ownership, Iowa law requires that a declaration be filed with the county recorder of the county where the property is located describing the land and building or buildings involved, location and description of the units or "apartments," a description of the "general common elements and facilities" (parts of the premises intended for common or general use), a description of "limited common elements and facilities" (parts of the premises intended for use by some units or apartments) and information as to decision making in the event of damage or destruction of part or all of the property. Property taxes are levied on the individual units or apartments.

Bylaws are required in which administration and maintenance procedures are specified.

The decision to establish a condominium operation, regardless of specific type, rather than separate feeding units, is a matter of economics. What cost advantages accompany a condominium? Are there significant economies of scale in this type of confinement unit? Does the sharing of some facilities reduce the cost of production? Or does the presence of units in close proximity increase the cost per 100 pounds of beef? Or is it a mixed bag? More research is needed before much can be said about the competitive position of condominium units. One factor will likely be the waste disposal problem, including the impact of recent federal legislation.

Buildings (except for storage structures) normally are not eligible for investment tax credit. But a structure so closely integrated into production that it can be expected to be replaced when the property it houses is replaced is generally believed to be eligible for the credit. In effect, there is no other practical use for the structure. An example cited by the Senate Finance Committee when the investment tax credit was reinstated in 1971 was a unitary system for raising hogs in confinement.

Thus far, there's no reason to suspect that a condominium confinement facility would be treated differently.

Custom feeding

Many of the larger feedlots custom-feed cattle belonging to investors. The investors are charged for the feed consumed as well as a pen charge. Some lots charge a markup on feed sold to investors which, in recent years, has ranged from $10 to $15 or more per ton. Medication and veterinary services, at least in some instances, are charged at cost. For lots charging a "head-day" fee of 4 or 5 cents per day, a lesser feed markup may be levied.

Investors typically bear all risks of cattle ownership, death and disease included.

Frequently, investors are highly leveraged with less than $100 invested in each animal placed on feed. Those high tax bracket investors seeking maximum tax advantages look for actual and prepaid expenses approaching the amount of their equity investment.

Cattle funds

The various types of available cattle funds offer a wide assortment of investment alternatives. In each fund, a management company oversees the cattle investments made. The funds are organized often as limited partnerships, or a contractual relationship of some other type exists between the investor and the management company. Investors need have no prior experience in cattle feeding and many have not had such experience. Some observers have reported that after gaining cattle investment experience in a cattle fund, many investors turn to custom feeding investments.

Fixed cost contracts

Some feedlots charge the investor a specified amount per pound of gain on the cattle. In one variation, the feedlot and the investor agree to a maximum cost per pound of gain. It is generally conceded that such arrangements are not typical among the more successful, better managed feedlots.

Profit/loss contracts

Another arrangement for cattle feeding features an agreement for the feedlot to absorb losses in excess of a stated amount per animal. And in exchange the feedlot receives profits in excess of a specified amount per head. This type of arrangement represents a different type of risk and uncertainty sharing.

Compliance With State and Federal Securities Laws

Most cattle feeding ventures organized in Iowa would likely be exempt from state and federal securities regulation. State law exempts securities of agricultural cooperatives and initial stock subscriptions of corporations if no commission is involved, the number of subscribers is 10 or fewer, and the securities issue was not advertised. Securities not exempt or transferred in exempt transactions must be registered. And remember, there is no exemption from regulation. Any fund-raising should involve full disclosure and avoid misrepresentation.

Federal securities law exempts from registration intrastate offerings (offered and sold only to persons resident within the same state where the issuer is doing business) and transactions not involving a public offering. Again, for securities transactions that are not exempt, registration is required.

In conclusion. . .

Numerous choices are available for organization of feedlot operations. Even though it's not possible to construct a totally unique organizational structure, the choices are numerous and the permissible variations are many.

The actual choice is likely to depend upon (1) the tax brackets of the individuals involved, (2) the numbers and types of investors, (3) the anticipated profitability of the venture, and (4) the preferences of the individuals. A key point: What's best for one operation is not necessarily the best for another.

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