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Creating a New Business From a Family Business

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Partners in Tax Education

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About the Instructor

Poppy Davis is a business and policy adviser to agricultural enterprises, nonprofits, and local governments. She works through programs around the country to deliver trainings on topics including agricultural taxation, accounting, credit, and cash-flow.

She began her career as a California CPA, and later worked for the USDA.

She holds a Juris Doctor with a certificate in Food and Agricultural Law from Drake University Law School, and a BS in Agricultural Economics from the University of California at Davis.



Overview

This session is for people who are considering creating a new business inside or alongside or apart from an existing family business.

We will cover:

1. Defining Business Ownership
2. Assets and Labor Drive Profitability
3. Cash or Credit?

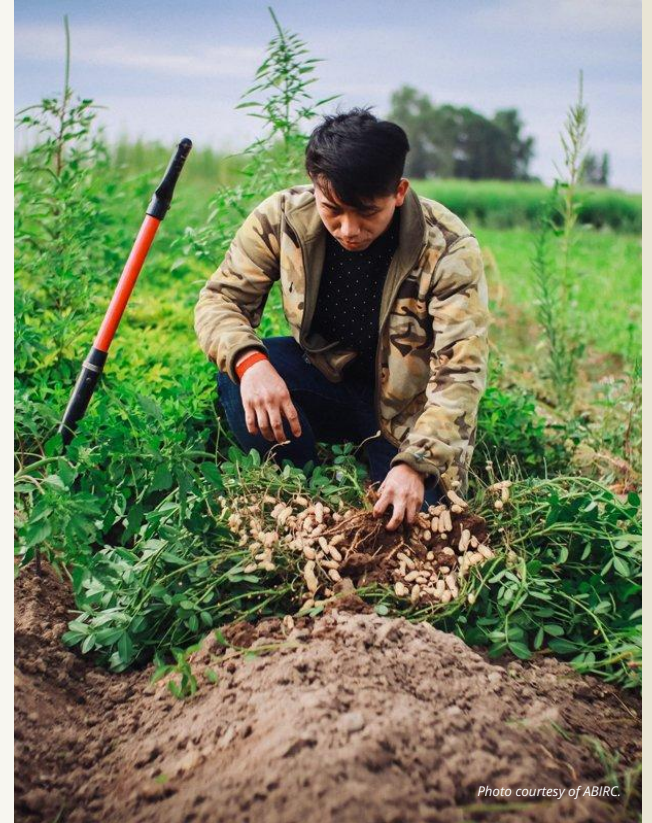


Photo courtesy of ABIRC.

Defining Business Ownership



Photo Courtesy of ABIRC.

Legal Forms of Business Ownership

- **Sole Proprietorship** is the default legal ownership for a single owner.
- **General Partnership** is the default legal ownership for more than one owner.
- **Limited Partnership, Limited Liability Company, and Corporation** are forms of legal ownership that must be deliberately created under state law.
 - They are **designed to protect the owners from some of the risks of being in business.**



Photo courtesy of ABIRC.

Business Entities

- Informally, the legal form of a business is its **entity type**.
- **Formally, a business is a separate legal entity if it can sue and be sued separately from its owners.** Formal business entities include:
 - Limited Partnerships
 - Limited Liability Companies
 - Corporations
- Sole proprietorship and general partnership are informal entities - they **can not sue or be sued separately from the owners** - the owners are the same legally as the business.

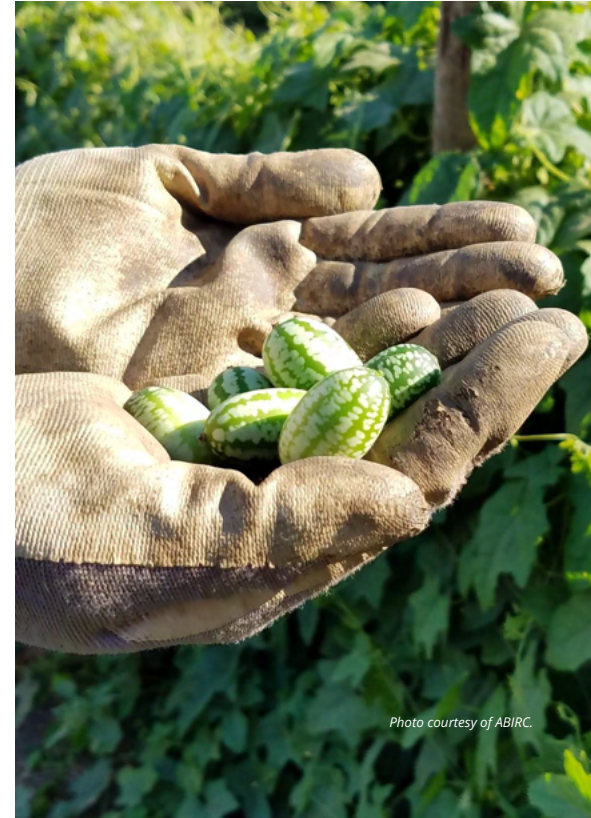


Photo courtesy of ABIRC.

Ownership Defined

A business owner:

- Has invested cash or equipment into the business.
- Is entitled to direct the business.
- Is entitled to their share of profits.
- Is responsible for following all applicable laws and regulations, and may be sued or fined for harms caused or rules broken.
- Is required to report the income and expenses of the business on annual income tax returns, and to pay tax if owed.

A non-owner who is **perceived** as a decision-maker:

- Has no legal rights to assets or profits.
- May not have directed the business or received payment.
- **But may be held responsible as a general partner and become legally and financially liable for debts or fines.**

Becoming a Business Owner

Any person may **become an owner** of a business by:

- **Contributing** cash or assets to create a new business
- **Purchasing** all or part of a business
- **Receiving** all or part of a business as a gift or inheritance

But a sole proprietorship can not be partially transferred through sale, gift, or inheritance.

- If you inherit a sole proprietorship you really just inherit the equipment. You then must create your own business if you want to continue in business.
- If someone who is a sole proprietor wants you to become a partial owner, you and they must create a new business entity because there is no such thing as a sole proprietorship with more than one owner.

Buying in or Buying Out

You buy in to a business by purchasing a portion of it.

- This will make you a partial owner, so the business must become a partnership or an LLC.
- You can determine a purchase price by looking at the total value of all the assets less all the liabilities and then dividing that value by the desired ownership percentage.
- The former owner must report the purchase as taxable income.

You buy out a business by purchasing all of it.

- If you buy out a sole proprietorship you buy the assets only.
- The former owner must report the purchase as taxable income.

Sale of used farm equipment is subject to California sales tax, but there is a 5% reduction on the tax rate for *qualified farm equipment*. The seller is responsible for reporting and paying.

Gift or Inheritance

If you receive some or all of the business through gift or inheritance:

- If sole proprietorship, you have only received some or all of the assets.
- If partnership or LLC, the value of what you have received is the value of all the assets less all the liabilities divided by your ownership percentage.

You may choose to end the business you have received:

- Take the assets out of old business/end old business
- Contribute those assets to create a new business



At-Risk Capital

Once an owner invests in a business, the investment is **at risk** - because **it may be lost**. It may be used to:

- Fund unprofitable activities
- Repay debts that can't be paid from profits
- Settle legal claims against the business

At-risk capital is also called **invested capital**, because one of the key qualities that makes something an investment is the **risk of loss**.

Your investment in a business is:

- The financial value of cash or equipment you contribute
- Cash or a note payable used to purchase some or all of the business
- The financial value of a gift or inheritance you received

Unlimited Personal Liability

In addition to invested capital, business owners also have unlimited personal liability for debts, fines, penalties and legal judgments against the business.

- May have to use personal savings
- May have future wages garnished
- Liability may extend to a spouse's savings and future earnings

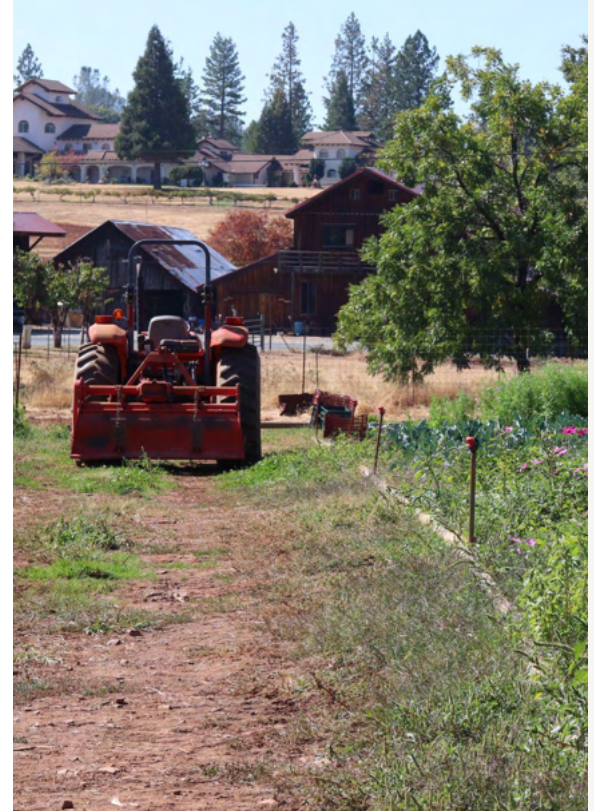
In a partnership each partner (and their spouse) is liable for all of the obligations of the business. If other partners cannot pay, the partners who can must - and then it is up to them to collect from the other partners if they can.

Limited Liability

Business owners may limit their liability to their at-risk capital contributions by forming a business entity that is intended to protect the owners from unlimited personal liability:

- A limited partnership
- A limited liability company
- A corporation

These entities are formed under state law and may provide liability protection across state lines and under federal law.



Ownership Rights and Obligations

A business plan discusses the owners rights and obligations including the legal structure and key terms in the operating agreement covering:

- The amount of cash each owner will initially contribute
- The owners' rights to direct and manage the business, and decision-making authority if there is more than one owner
- Circumstances under which an owner may be required to contribute additional cash
- Limitations on how much owners may withdraw
- Circumstances under which an owner may withdraw capital from the business
- Restrictions on the sale or transfer of ownership interests
- How profit and loss will be shared

Developing a Business Model for Profit and Security



IRS Requires a Business To Show a Profit Motive

A business may lose money. When that happens the loss is reported on the owner's tax return and it reduced other taxable income, creating a tax savings. For this reason the IRS limits when you can report a business loss.

1. The business must have started (can't still be in the planning stages, needs to have made substantial actions **directly related** to generating income)
2. The business must be able to demonstrate it has a **profit motive**.

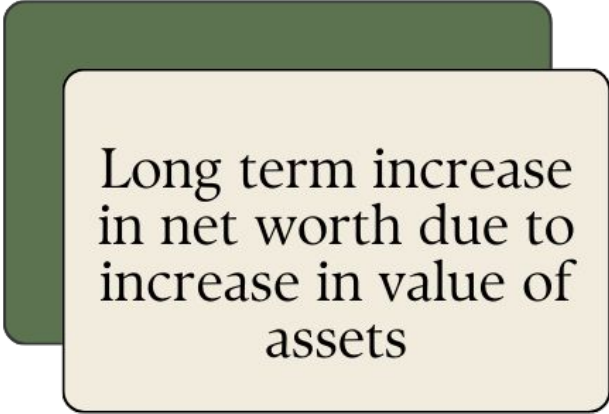


What is a profit motive?

One or both:



Annual
Profits

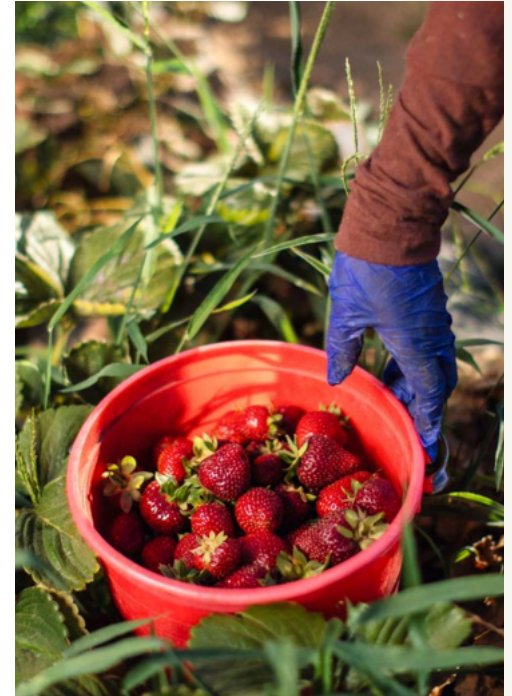


Long term increase
in net worth due to
increase in value of
assets

Your Theory of Profit or Basic Business Model

There are several tests to determine if you have a genuine profit motive - but first you need to be able to make a simple statement about how you plan to make a profit.

- Your theory of profit or business model is your idea about how to have revenue in excess of expenses, or how to create a business asset with long-term value in excess of total costs to create.
- A theory is an unproven idea. It has to be reasonable; it does not have to be correct.



What is a business model?

Your theory about how you will use intellectual capital (knowledge), physical capital (land, facility, equipment), and labor (yours, that of employees) to create current or long-term income, or both.

- Your theory about **extracting profits** from the business as take-home income to you and **investing profits** back into the business to make the business more profitable or valuable.
- Your plan to **change the mix** of how you use **knowledge, assets and labor** to increase profits and assets.



Photo courtesy of the Hmong American Farmers Association

Demonstrating a Profit Motive

A business plan demonstrates a profit motive by summarizing the business model:

- The goods or services that will be offered
- The markets or customers who will purchase the goods or services, and expected prices or fees
- The cost of offering the goods or services
- When revenue is expected to exceed cost and generate profit (If the business will not be profitable within the year the plan must show how the business will be financed before becoming profitable.)



Statements That Describe A Business Model

- *Most years I will be able to sell strawberries to a wholesaler/coolers for more than the cost of production.*
- *If I sell mixed vegetables at the farmers market for 2-3 years I will break even and develop a more profitable customer base in restaurants and for a CSA. By then my fruit trees will also be in production and I will be able to sell fruit and mixed vegetables at a price greater than the cost of production.*



No Business Model = No Business

- *I want my family and community to have healthy and culturally appropriate food to eat.*
- *I want my parents to feel useful and get exercise.*
- *I want my kids to learn the value of hard work.*
- *I will host community events.*

These statements do not say how money will come in to the business, so they do not describe a business model.

These are personal values or goals. They are so important - **to you** - but not at all important to the IRS!



Assets and Labor Drive Profitability



Managing for Profit and Increased Assets

A **business model** is how you use your assets, or capital, to create income, or revenue. Here are formulas for different business models:

Capital = Cash + Natural Resources + Equipment + Buildings

Example: Assets = Cash + leased land + 0. Asset value is cash only.

Land + Labor -> Current Income

Example: Leased land + Labor -> Current Income

Land + Equipment + Labor -> Current Income & New Assets

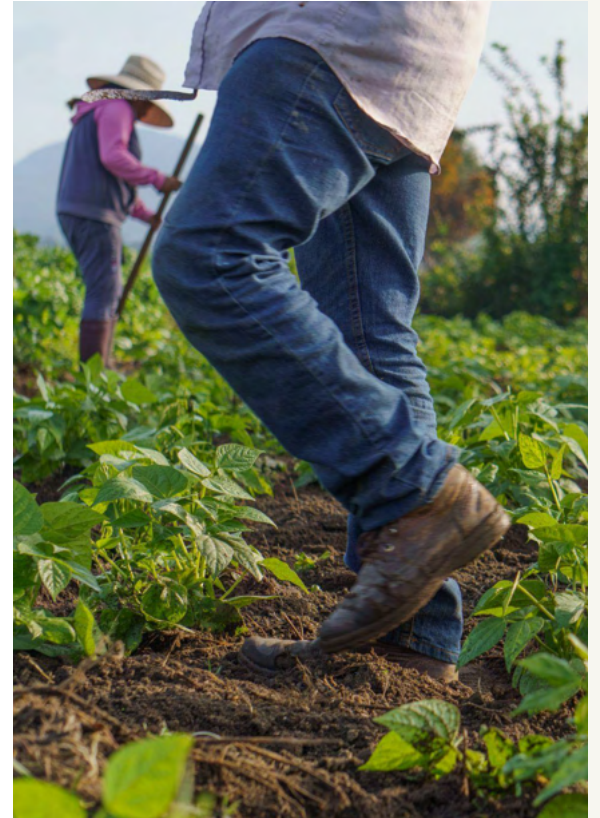
Example: Leased land + Tractor + Labor -> Current Income & Tractor

Income is limited by capital. You can't increase income unless you increase capital. If the only capital you can increase is your own labor...your income is a function of your continued good health.

Assets and Labor

Many assets are substitutes for labor.

- Labor is an expense - you pay as you go.
- Assets are an investment, you pay up front, they save you expenses month to month, and then eventually they need to be replaced.
- *But if you finance asset purchase or acquisition, you pay month to month - so it may be just as affordable as labor if you qualify for fairly priced credit.*



Managing for Profit and Increased Assets

Capital = Cash + Natural Resources + Equipment + Buildings

Example: Assets = Cash + leased land + Tractor. Asset value is cash + tractor

Land + Borrowed Cash + Equipment + Labor ->

-> Current Income + New Assets - (Debt)

Example: Leased land + Tractor + More Labor

-> Increased Current Income + Tractor - Less Debt Payments

Land + Cooler + Credit + (Less) Labor ->

-> Current Income & New Assets - (Debt)

Example: Purchased land + Cooler + (Less) Labor

-> Increased Current Income + Land and Cooler - Less Debt Payments

Assets and Labor

Assets versus labor is one of the most important decisions you will make as a farm owner, and you will make it over and over again.

- Your own labor or hired labor?
- Your own labor or equipment?
- Hired labor + more labor or + more equipment?
- Cheaper land & more drive time or more expensive land and less drive time?



Photo courtesy of the Hmong American Farmers Association.

Evaluating the role of assets in your business

- What are the assets you will need to manifest your vision for your business?
- Is the lack of a key asset holding you back from significant opportunities?
- How does an asset contribute directly to your plan?
- If an asset does not contribute directly, how is it still necessary?



Photo courtesy of the Hmong American Farmers Association.

Evaluating the role of hired labor

- How much hired labor will you need to manifest your vision for your business?
- Is the lack of hired labor holding you back from significant opportunities?
- Could a piece of equipment change the amount of hired labor you need?
- If hired labor is not currently paid on payroll with all required taxes and benefits - is your business model sustainable? What happens if:
 - Someone is injured?
 - You are fined for wage and hour violations?



Cash or Credit?



Credit Flexes the Formula

Capital = Cash + Natural Resources + Equipment + Buildings

Capital = Cash (from owners + from borrowing) + Natural Resources + Equipment + Buildings

Leases also flex the formula:

Capital = Cash + Natural Resources (land you own or land you rent) + Equipment + Buildings

Capital = Cash + Natural Resources + Equipment (owned or leased) + Buildings (owned or leased)

Cash or Credit?

- It is relatively easy to get a loan for an asset because the loan is secured by the asset.
- It is relatively difficult to get an operating loan because even though the lender takes a lien on the crop - the lender does not want the crop.
- One of the biggest mistakes beginning farmers make is using cash on assets and then coming up short on operating cash



Plan ahead!

If you are short on operating cash and have to get a loan, it may be too late in the season to get a loan from a lender focused on agriculture, and loans from other lenders offer fewer protections, less expert guidance, and may have higher rates.

- Some people end up using credit cards with 20% interest rates - it's an expensive mistake!



Cash or Credit?

Advantages of Cash	Advantages of Credit
Fast	Leaves working cash for operations
No interest	Requires insurance
Disadvantages of Cash	Shares risk with lender
Uses cash you need for operations	
You bear all risk	



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Questions?





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Thank you!

