

ENTITY CHOICE FOR AGRICULTURAL, FORESTRY, OR HORTICULTURAL VENTURES

Editor's note: One of the most common questions encountered when engaging farmers on transfer planning is about business entities, and their effectiveness in limiting operating liability (i.e. protecting assets from lawsuits and creditors). Placing land and operating assets into business entities is also an effective tool in transferring income, management and ownership/control of those assets to ensure they remain productive or under ownership of the family. The following narrative is an overview of the different business entity choices, written by Theodore Feitshans and Guido van der Hoeven of North Carolina State University for the *Rural Lands Update* professional credit series, held in North Carolina in 2008. It has been edited to reflect Virginia law and the changes to estate tax law that went into effect in 2011.

Land owners engaged in agriculture, forestry, and horticulture have a wide variety of entities available to them to manage working assets and capital. This wide variety of entities reflects the diversity of interests of those involved in agriculture, forestry, and horticulture. Choosing an entity is an important task that requires research reflection and, typically, expert assistance. Concerns about choice of entity are often prompted by concerns about tax or tort liability. While these issues are important they are generally not the most important issue driving the choice of entity. Issues such as management of the business, whether the activity is even a business (i.e., motivated by a profit motive), business continuity, transfer of land interests, and the need to attract outside capital often override tax and liability issues.

Decisions made solely upon the consideration of tax and tort liability fears often result in a business structure unsuitable to the activity or to succession planning. The failure to make a decision about business structure is indeed a choice. Some of the entities discussed below are created by the operation of law.

ENTITY TYPES

Sole proprietorship

The sole proprietorship is the simplest type of entity. Nothing is needed to create one although there may be a need in some cities and counties to apply for a business license (generally not true for agricultural, forestry, and horticultural operations). The owner of a sole proprietorship has the widest latitude to operate the business possible. Indeed a sole proprietor may do anything that is not prohibited by law. Any business engaged in by an individual without the formalities of creating a separate entity is a sole proprietorship. The sole proprietor retains unlimited personal liability.

Partnership

General partnership

A partnership is an association of two or more persons to conduct a business for profit. The relationship is consensual and usually contractual. A partnership is treated as an entity for litigation, holding title to property, and bankruptcy proceedings. Many states have adopted the Uniform Partnership Act (UPA), which Virginia adopted in 1997. Under the UPA, the partners must have equal management authority and share equally in profits and losses. They have an equal obligation to contribute their time, energy and skill without compensation to the partnership business. Each partner has unlimited personal liability to the creditors of the partnership, and all partners are liable for wrongful acts and breaches of trust by any partner.

A partnership files a federal information tax return (Form 1065) annually. However, all income flows through and is taxed to the individual partners. A partnership interest is personal to the partner. The partnership is dissolved by the death of a partner or by the sale of a partnership share. Most provisions of the UPA can be modified in a written partnership agreement (e.g., capital contributions, management, sharing of profits and losses, rights and obligations, terms of property ownership, termination and dissolution, and buy/sell agreements).

A general partnership agreement may be oral. If there is never any attempt to make an agreement but two or more people begin conducting business together then a partnership agreement is created by

operation of law. Its terms are the default terms in the UPA. Courts (particularly bankruptcy courts) have imposed a partnership relationship upon parties who did not think that they were partners. Examples of relationships that may, in actuality, be partnerships include employer/employee relationships, particularly where the employee has received a share of the crop and has shared in the risk of production; and landlord/tenant relationships, particularly those involving share-lease arrangements. Likewise some poorly constructed partnerships may be recharacterized by the Internal Revenue Service (IRS) employer/employee relationships. In such a situation the relationship could remain a partnership for state law purposes but not for purposes of federal tax law. Farmers are particularly prone to these types of costly mistakes because they often proceed without professional advice. Correcting such a problem is much more difficult than avoiding it in the first place.

Limited partnership

A limited partnership has the characteristics of both a partnership and a corporation. It is used when some partners want neither management responsibility nor unlimited liability for the business venture. Most states (including Virginia) have adopted the Revised Uniform Limited Partnership Act (RULPA). Under statutes modeled on RULPA, a limited partnership is formed by at least one general partner and one or more limited partners. A general partner manages the partnership and has full personal liability for the debts of the partnership. A limited partner contributes cash or other property. His liability for partnership debts is limited to the amount of his investment in the partnership. Limited partners do not participate in the management of the partnership. A limited partnership also files an information tax return, but income is taxed to the individual partners. Limited partnerships are required to file with the department of the secretary of state and pay the required filing fee. An annual report and fee are often required.

A family limited partnership is a special type of limited partnership that is used to promote efficient management of family businesses, business succession, and avoidance of estate taxes, as well as other purposes. Family limited partnerships are created under RULPA and have the same filing requirements as any other limited partnership.

Limited liability partnerships

A limited liability partnership (LLP) is a general

partnership used by professionals such as attorneys and is not an appropriate entity for an agricultural, forestry, and horticultural operation.

Limited Liability Company (LLC)

The LLC is a distinct entity that is a hybrid of a partnership and a corporation. All states have authorized this type of business entity. It can be treated like a partnership, an S corporation or a C corporation for tax purposes. Like a corporation, the members have limited liability for debts of the LLC. This business entity offers more flexibility because of its hybrid nature. The LLC is technically not allowed to have an unlimited life, as a corporation is, but it may have orderly transfer provisions. Membership interests are not freely transferable without consent of all other members according to the operating agreement, but a member may assign his economic rights, but not his voting rights. Many state LLC statutes require only one member to create the entity. This business entity is often used in estate planning because it can be an efficient way to manage and transfer assets over time to the next generation as a valued percentage of the entity as opposed to retitling of individual assets.

Corporations

A corporation is a legal entity, created under state law, that has rights and liabilities separate from its shareholders. A shareholder of a corporation is only liable for the debts of the corporation to the extent of his investment in the corporation. Shareholders elect a board of directors who set policy and appoint officers to manage the company on a daily basis. Shareholders do not participate directly in management decisions (unless they are also directors or officers). A corporation has a potentially unlimited life, and it is not dissolved by the death of a shareholder, director or officer.

Generally, shares of stock are freely transferable by the stockholder. However, state law permits the creation of restrictions on stock transfers under the articles of incorporation, bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation. Such restrictions must be authorized by statute and not unconscionable under the circumstances, and there must be a conspicuous notice of the restriction on the certificate or in the information statement required by the statute. One type of restriction would be a buy-sell agreement between a stockholder and the corporation or other

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stockholders requiring the selling stockholder to offer his stock first to the other party to the agreement. The agreement would set a price to be paid for the shares, which would be particularly useful if the shares were not publicly traded. (see *What is a Buy Sell Agreement?* following this article)

Shares in a corporation can be defined as common or preferred, based on the rights and privileges that belong to the owner. Common stock represents a fractional proprietary interest in the property and assets of a corporation. Therefore, the common shareholder participates on a pro rata basis in the distribution of corporate assets upon dissolution, participation in corporate profits (dividends) and management of corporate activities (right to vote). Traditionally, holders of preferred stock are not creditors of the corporation and therefore do not share in corporate assets upon dissolution. Instead, they have a right to a fixed dividend, due and payable before any dividends to common shareholders. However, the articles of incorporation can grant rights to preferred shareholders to receive preference over common shareholders with regard to distributions of dividends and corporate dissolution proceeds.

The shareholders are the actual owners of the corporation, and ultimately they choose the people who will manage the company. The shareholders must elect a board of directors to whom they delegate the power of management. The board is responsible for all of the business affairs of the corporation, such as issuing shares of stock and the rights of the shares issued, the sale of corporate assets, mortgaging corporate assets, declaring dividends, and the election of corporate officers. The senior management of the company, represented by the Chief Executive Officer (CEO) and the senior management team, are responsible for the day-to-day operations of the corporation. Their authority and duties are prescribed by the bylaws and the directors.

The articles of incorporation must be filed with the secretary of state, and depending on state law must contain the following information: (1) a corporate name, (2) the number of shares that may be issued, (3) the street address and mailing address, including county, of the initial registered office and the name of the initial registered agent, and (4) the name and address of each incorporator. This document may also provide: (1) the names and addresses of the

initial board of directors, (2) provisions regarding the business purpose and par value of shares, etc., and (3) limitations on personal liability of directors. At the organizational meeting of the corporation, bylaws should be adopted. This document may contain any provisions for managing the company and regulating the affairs of the company that are legal and consistent with the articles of incorporation. The bylaws are the continuing set of governing rules under which the corporation, its officers, directors and shareholders exercise management powers, transfer shares, hold meetings and all other activities related to the corporate objective.

There are two ways to dissolve and terminate a corporation: voluntary dissolution and involuntary dissolution. The directors and shareholders may voluntarily dissolve a corporation by passage of a resolution of dissolution and filing of articles of dissolution with the Secretary of State. In addition, a corporation may be dissolved without its consent by court action or administrative action of the Secretary of State. If the directors are not acting in the best interest of the company, any shareholder may obtain judicial dissolution. If the corporation fails to file annual reports or pay the franchise tax, for example, the Secretary of State may administratively dissolve the corporation.

Subchapter C corporations

A corporation formed under Subchapter C of the Internal Revenue Code is an ordinary corporation subject to double taxation, which means that profits are taxed as they are earned by the corporation and then when those profits are distributed to the shareholders as dividends, they are taxed again to the individual.

Subchapter S corporations

A corporation formed under Subchapter S is a close corporation that has elected to be taxed like a partnership. Instead of being taxed at the corporation level, the income is deemed to flow through to the shareholders and is only taxed once, at the individual level (whether the profits are distributed or not).

Professional corporations

Professional corporations are another type of corporation used by professionals such as attorneys for their practice. Such an entity is not appropriate for agricultural, forestry, and horticultural operations.

Nonprofit corporations

These entities are corporations organized for charitable purposes including education. These entities are expected to fulfill a charitable purpose and are not designed to make a profit. These entities include family foundations that are often used by wealth families to carry forward the family's charitable activities.

Family foundations have only rarely been employed by landowners who are engaged in agricultural, forestry, and horticultural operations. However, such an entity might be appropriate for a family's charitable activities. An example would include land that is used by local educational institutions in their educational programs. Property donated to such a family foundation would be excluded from the estates of family members but family members could be appointed to the board of directors to ensure that the family's charitable goals are realized.

Cooperatives

Cooperatives are another type of entity that may be used both by groups of farmers and for individual farm businesses. Most cooperatives are organized as corporations; however, ownership of shares is restricted to the customers of the business. Profits of a cooperative are all eventually distributed to the members, as a cooperative is not designed to make a profit. The U.S. Department of Agriculture provides both technical and financial assistance to farmers who wish to form cooperatives.

Trusts

Agricultural, forestry, and horticultural operations may also be operated through trusts. The most common type of trust employed for this purpose is a revocable living trust that also functions as a will substitute.

Estates

Estates may be created either as the result of the death of the owner or the bankruptcy of the owner. Although the former is under the jurisdiction of the state probate court and the latter is under the jurisdiction of a federal bankruptcy court there are similarities. Both involve a great deal of judicial control over the business, and both are generally in existence for a limited period of time.

TAXATION OF ENTITIES

Business entities become subject to various taxes over the course of entity existence. The sole proprietorship is subject to several taxing authorities during the life of the proprietor, but upon death, the proprietorship terminates, an estate is created and the estate of the decedent proprietor may be subject to estate taxes. In contrast, unless specified in the articles of incorporation a corporation does not "die" and can continue into perpetuity.

It is important for business operators to not let the "tax tail wag the business dog". Fundamentally, sound business decisions made using good business principles should be the focus of the business's management team. Once a business decision is made and the course of action implemented use of appropriate tax rules to optimally minimize the tax burden naturally follows.

Income Tax

Individuals and business entities generate income tax liabilities when business activities create a profit. Individuals acting as sole proprietors calculate and pay taxes on personal income tax returns using Schedule F (for farming activities) and Form 1040 to report all sources of income. Partnerships (general and limited), Sub-S corporations, LLCs, Estates and simple Trusts are "flow-through" business entities; meaning that business profits (or losses) are passed through on a pro rata basis to owners or beneficiaries of these entities. The individual recognizes the tax consequence on his or her own personal tax return (Form 1040).

C corporations are taxpaying entities and use Form 1120 to report gains and losses from business activities. Likewise, a complex trust operating a business will pay income taxes; the trust uses Form 1041. Furthermore, if a business is held, temporarily, in a bankruptcy estate positive income can be created and income taxes are due by the bankruptcy estate. Cooperatives and non-profit organizations are generally exempt from paying income taxes. However, circumstances may arise where income tax is paid by these entities. One such example is non-related business income in the case of a non-profit organization.

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Gift Tax

Gift taxes federal and state, are imposed on natural person donors. However, some states (including Virginia) do not have a gift tax. Generally business entities do not make gifts. However, under certain circumstances a closely held corporation may transfer property without consideration to an individual donee (natural person) where the shareholders are deemed to make the gift [Treas. Reg. 25.2511-1(h)(1)]. The federal annual gift tax exclusion amount is currently \$13,000 per donee and the lifetime gift exclusion amount is \$5,000,000 until the end of 2012. Generally the donor is responsible for payment of gift taxes. However, if the donor does not make payment, the obligation falls to the recipient of the gift.

For donors of closely held business interests (corporate stock, LLC membership or partnership interests) a discount may be used to reduce the value of the gift. The IRS has allowed a 20 percent discount for lack of control (minority interest) and a second 20 percent discount for lack of marketability, though care should be given not to become too greedy with the use of discounts.

Estate Tax

A natural person's (decedent) estate may become subject to estate tax. This is dependent upon the size of the taxable estate. On December 17, 2010, Congress enacted a \$5,000,000 estate tax exemption effective from January 1, 2011 to December 31, 2012. This means that a person's estate below this amount is free from estate tax.

The sole proprietor estate will have the business assets included in his/her estate. By definition the business ceases as the proprietor is deceased. Other business entities may be indirectly affected by the death of a shareholder, member or partner. Corporations, LLCs, partnerships and other formal business structures are not subject to estate taxes in a direct fashion since upon dissolution an estate is not created. It is the ownership interests of these entities that belong to the decedent that are included in the decedent's estate. Therefore, depending upon the size and liquidity (cash available) estate taxes may become indirectly important to the continuing success of the business. Without continuity plans for these entities a forced or fire sale of the business assets may occur to provide the funds needed to pay the estate taxes of the decedent.

Practical tips

It is quite common for a family to prepare documents, file papers and then never fund the entities created. Surveys show that very few attorneys follow up with their clients to ensure that plans are properly executed. More follow up would likely result in a greater degree of service and client satisfaction. Transferring property to the entities created must be done with care to ensure that the transfers are effective and that only the assets intended to be transferred are actually transferred. Married couples who own property as tenants by the entirety should understand that they give up the protections afforded by that form of ownership when property is transferred to an entity. In general the landowners' residences should not be transferred to the entity for this reason and for other business and tax reasons. Entities should be created in conjunction with the estate plans of the owners to avoid foreclosing estate planning opportunities. For example, it may be desirable, in restricting the transfer of ownership interests, to permit transfer to a living trust.

Observation of formalities such as holding necessary meetings and keeping minutes of those meetings must be strictly followed if the benefits of forming the entity that were hoped for are to be actually achieved. All required filings must be made and fees and taxes paid to avoid involuntary dissolution of the entity. The consequences of involuntary dissolution are often disastrous.

Although most landowners will want to create their entity under laws of their respective states, there may be valid reasons to create the entity under the law of another state. If that is done the foreign entity must be domesticated by filing with the secretary of state. It is also possible to make certain determinations about how disputes among the owners will be resolved. Among the issues that may be resolved in advance are valuation of assets upon dissolution, choice of the state law applicable to the dispute, the forum for resolving the dispute, the admission and rights of successor owners, and whether to employ alternative dispute resolution tools such as arbitration or mediation.