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OWNERSHIP STRUCTURES FOR YOUR FARM OR RANCH: SOME BASIC CONSIDERATIONS

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This article is not intended as a substitute for the advice of experienced counsel. An effort has been made to provide useful information in some detail. Finally, however, this article is general in nature. Much of what is said in this article will apply in all states, but laws governing entities do vary from state to state.

The first important step to take in considering a business structure is to understand what you are trying to accomplish. What is it that you think a structure is going to do for you? Is your goal:

- to reduce taxes,
- to limit liability,
- to expand your operations,
- to raise capital,
- to comply with state or federal laws,
- to bring a family member into the operation,
- to make gifts, or
- to transfer the farm or ranch to an heir?

Business structures are tools. The tool you choose should fit the work you mean to do.

The second step to take in thinking about choosing a farm or ranch business structure is to gain an understanding of the possible structures: what tools exist and how they can be used to accomplish your goals. This article focuses on four basic business structures, or forms of ownership: the sole proprietorship, the general partnership, the corporation (both C and S corporations) and the limited liability company.[1] Some basic questions about the business characteristics of each of these forms are addressed:

- How is it owned?
- How is it formed?
- How is it managed?
- How are profits and losses allocated?
- How are profits and losses distributed?
- How are ownership interests transferred?
- How is it brought to an end?

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[1] There are numerous other possible forms of doing business: limited partnerships, registered limited liability partnerships, joint ventures, business trusts, and others.

It is practically impossible to separate a discussion of a form's *business* characteristics from its *tax* characteristics. The article therefore attempts to describe the basic tax considerations for each of the forms.[2] The article concludes with a discussion of certain business considerations common to each of these forms, such as the use of insurance, buy-sell agreements, and the potential application of what are called securities laws.

SOLE PROPRIETORSHIP

The sole proprietorship is the form you create when you simply go into business for yourself. It is owned by one person.[3] A sole proprietorship is not a separate legal entity; it is one and the same as its owner. The owner may of course hire employees to help in conducting the business.

No Limited Liability
The owner is personally liable for the business obligations – for trade debts, loans or lawsuits. Sole proprietorship provides no limitation on personal liability. For example, let's assume a family who own a farm or ranch. The husband, in the off seasons, puts some of his farm assets to work by hauling grain, cattle or other goods for third parties. No business structure is used for the trucking. If an accident should occur, and a large liability be created against the husband as part of his trucking, all of his assets are at risk for that liability. What insurance does not cover may come out of the farm. Put another way, in a sole proprietorship, non-business assets are not protected from business-related liabilities.

Running the Sole Proprietorship
The individual owner of the sole proprietorship has total control over business operations; he or she calls all management shots. A sole proprietorship, because it is not a separate entity, does not require registration with the state. No papers need to be filed. Licenses or permits may be required, depending on what activities the sole proprietorship will engage in. If employees are hired, general principles of agency and employment law will apply. The owner may typically transfer his or her interest in the business freely, simply by transferring the assets and liabilities of the business. (The existence of liens or other encumbrances on the assets may affect the owner's ability to transfer assets.) The owner decides whether or not the business continues or ends. Business operations generally terminate upon the death of the owner, if no decision to shut down the business was previously made. Termination of the business requires no formal documentation or procedure.

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[2] Tax law, perhaps more than any other area of the law, abounds in detail. The Internal Revenue Code, together with the regulations promulgated by the IRS, supplemented by Revenue Rulings that interpret the rules and regulations, fill a long wall floor to ceiling with thick books of thin paper. In many respects, the Internal Revenue Code is the principal congressional tool for changing policy. It is well beyond the scope of this article to describe any but the most basic tax considerations in choosing a business structure.

[3] It is typical to find that even where spouses in effect run a farm or ranch together, the farm or ranch for tax purposes is considered a sole proprietorship. The farm or ranch has one formal owner for tax purposes; the Schedule F will be filed in the name of one of the spouses. This prevents the need for spouses to form a partnership and file partnership tax returns. This treatment by the IRS ignores the fact that many farms and ranches are in fact jointly owned – if not operated – by both spouses, not to mention the fact that most state laws protect each spouse's interest in marital property. If both spouses want formal ownership of the farm or ranch business, beyond their title ownership, they may set up a partnership, LLC or corporation, as indeed some farm or ranch families do. It is also possible for one spouse to hire another as an independent contractor who would then pay his or her own self-employment taxes.

There is no formal requirement to keep business and personal assets separate – no requirement to maintain separate accounts – though it seems generally accepted that a better record-keeping practice is to keep accurate records for the farm or ranch business that are separate from personal records.

Taxation of Sole Proprietorship
A sole proprietor reports all business income and losses on his or her individual tax return. (There is a separate schedule – Schedule F for farms and ranches – to compute business income and loss, but the result goes into the individual's 1040.) The business itself is not taxed separately. The owner is taxed on *all* the profits of the business – income minus expenses – regardless of whether or not the owner leaves money in the business. In general, farmers and ranchers are allowed to deduct (treat as expenses) any money that is spent in the pursuit of profit. In general, farm or ranch income is subject to self employment tax, as income that is derived from a trade or business. (Self-employment taxes are contributions to the Social Security and Medicare systems; they are the equivalent to payroll taxes for employees.) Special rules exempt certain farmers and ranchers from the obligation to make estimated quarterly income tax payments.[4]

PARTNERSHIP

A partnership is a business with more than one owner that has not filed papers with the state to become a corporation or a limited liability company. In fact, no specific papers are required to establish a partnership; a partnership begins when two or more people start doing business together.[5] The partnership may therefore be the simplest co-owned business structure to create. However, partners are responsible for each other's actions, and a partnership, perhaps more than any other multiple-owner structure, depends on trust. The experience of the law seems to be that partnerships last longer, run into fewer problems, and better resolve the problems that arise if the partners have discussed, negotiated, and prepared a partnership agreement. In the absence of a partnership agreement, there are state statutes that govern partnership relationships – relations between partners, relations between partners and the partnership, and relations with third parties.

No Limited Liability
Partners are personally liable for all business debts and obligations, including court judgments. Each partner is liable for *all* of the partnership's obligations.[6] This is called joint and several

[4] For information on the taxation of farm or ranch income, readers may see the IRS's free, useful Publication 225, *Farmer's Tax Guide*, available at www.irs.gov/businesses/small/farmers/index.)

[5] A partnership may file a statement with the secretary of state, signed by at least two partners. The statement, if filed, must state the name of the partnership, its chief operating officer (if there is one), the names and addresses of the partners or the partnership's agent, and must identify that person authorized to execute real estate transfer documents.

[6] There is a structure called a limited partnership, which one person (the "general partner") usually creates and runs. The general partner typically solicits investments from other persons who will have little or no involvement in the day-to-day running of the company and who will not be personally liable for the partnership's debts (the "limited partners"). Limited partnerships tend to be costly and complicated to set up and run and are not typically recommended for use by small business owners. More small business people concerned about limiting liability will choose the limited liability company. Some discussion of limited partnerships takes place in the section on limited liability companies.

liability. So, for example, if one partner in a farming partnership defrauds creditors or misrepresents information to the FSA, each partner will be liable for the consequences. Each partner will be held liable for the wrongful acts of his or her partners, if those acts were committed in the normal course of partnership business.

Partnership Relationships
Any one partner can usually enter into legally binding arrangements on behalf of the partnership itself. This is called joint authority and arises from the fact that each partner is an agent of the partnership. This authority is not unlimited: one partner typically cannot bind the partnership to a sale of all of its assets, nor confess a judgment on behalf of partnership. Nor does this authority extend to acts a partner undertakes outside of the scope of the partnership business.

Partners owe duties of trust to one another under the law. Those duties include the duty of loyalty: an obligation to account for partnership property, not to deal with the partnership as an adverse party, and not to compete with the partnership. A partner also owes to the partnership and the other partners a duty of care: not to engage in grossly negligent or reckless conduct, not to engage in intentional misconduct, and not knowingly to violate the law.

The Partnership Agreement
As stated, a partnership agreement may be important to the continuing success of a partnership. Partnership agreements offer an opportunity for the would-be partners to sit down and address some critical issues in an open and frank way, an effort that might lend to the longevity of the partnership. Such issues typically include the following:

- What to name the partnership and whether or not to register the name.
- A statement of the business purposes of the partnership, should the partners wish to limit the scope of the partnership's potential activities. This might also be a place to define what it would mean to compete against the partnership and a place to set limits on what the partners can do on behalf of the partnership.
- What each partner will contribute to the partnership (money, property, services) and how much of the partnership each partner will own. This is a critical provision that typically sets out the type and amount of each partner's contribution, the timing of contributions, agreed-upon value of the contributions, adjustments to contributions, and consequences of failure to make contributions. It may also include provisions for making loans to the partnership.
- How to divvy up and distribute the money (also called allocating profits, losses, and draws). Will profits and losses be allocated according to ownership interests? In the absence of an agreement, state law says that each partner shares equally in profits and losses. Imagine a situation in which one partner owns a dairy farm and operating assets worth $900,000, but cannot run the operation herself. In order to encourage two other partners to help run the dairy, she contributes that farm and assets to the partnership. The other partners agree to contribute $50,000 each in operating funds. At the end of the year, there are profits – net income – of $100,000. Absent an agreement, the partners will split the profits equally, in spite of the difference in the value of their contributions.
- Will each partner be entitled to a regular draw (a withdrawal of allocated profits from the business), or will profits be distributed only at the end of the year?
- Will the partnership pay compensation and benefits to partners for services? In the absence of an agreement, no partner is entitled to compensation for services rendered to

the partnership. Imagine a partnership in which one party contributes $100,000 in cash and the other contributes services. Assume they have no agreement on salary or what to do should losses occur. Imagine things do not go well. At year end, the assets are sold to pay creditors and no money is left. The partner who contributed the cash now comes to the other partner and demands $50,000 – his share of the losses. It would not be clear at all under state law that the "service" partner could offset the $50,000 demand against the value of his labor.

- How much authority will each partner have? Do certain decisions require the consent of all partners? Should consent be required only for major decisions? If so, what are the major decisions that would require unanimous consent? Without a partnership agreement, the law says that each partner can bind the partnership.
- How to apportion managerial responsibility. Who will keep the books, deal with the bank, supervise employees, negotiate contracts, oversee government relations? Without an agreement, each partner has an equal say in management.
- What about letting in new partners? When, if ever? Under what conditions? In the absence of an agreement, the law says that new partners are allowed in only upon the consent of all the existing partners.
- Can a partner transfer his partnership interest to a third party? Without an agreement, a partnership share may be transferred to a third party, but the transfer conveys only the right to receive profits, not the right to engage in management or to vote in partnership affairs.
- What happens when a partner wants to leave the partnership or when a partner dies? There is typically no ready market for partnership interests. Will there be a buy-out agreement? Should the partners who continue in the partnership be required to buy out the departing partner's share? What price will be paid or how will that price be determined? Who else can buy a departing or deceased partner's share? What events will trigger a buy out: retirement, resignation, an attractive outside offer, divorce settlement, foreclosure, bankruptcy, disability? Without an agreement, the withdrawal or death of a partner may lead to dissolution and termination of the partnership, although in certain circumstances the business may be continued and the departing partner paid off.
- How will the partners resolve disputes in a deadlock? Mediation? Arbitration? Straight to court?
- How long will the partnership continue?

These are the kind of questions that a good partnership agreement will address.

Partnership Taxation

In general, a partnership does not itself pay income taxes on profits. It is not a separate tax entity, but is what the IRS calls a "pass-through" or "flow-through" entity. Each item of income or loss from the business "passes through" the partnership to the individual partners, who then report their share of profits (or losses) on their individual tax returns. The partnership does however file each year a Form 1065, which is an informational return. The partnership also provides to each partner and to the IRS a Schedule K-1, which sets out each partner's share of profits and losses. Individual partners, using Schedule E, then report their profit or loss on their own Form 1040.

Each partner has a "distributive share" in the partnership, which is the portion of profit that a partner is entitled to under the partnership agreement or, in the absence of an agreement, under state statute. State law usually allocates profits and losses in proportion to ownership interest: 50

percent ownership equals a 50 percent distributive share. To split up profits and losses in a different manner is called a “special allocation” and requires careful adherence to complex IRS rules. In brief, the IRS requires that a special allocation have a *substantial economic effect*, that is, that it reflect real economic factors and not mere tax planning. For example, A and B own the AB Partnership in equal 50/50 shares. The partnership has $100,000 of net income. IRS rules do not allow A and B to split the $100,000 for economic purposes 50/50 (distributing $50,000 to each partner) while at the same time “allocating” for tax purposes all of the $100,000 to A, simply because A happens to be in a lower tax bracket. A simple example of a special allocation that would have substantial economic effect might be where one partner puts cash into the partnership and the other partner signs a promissory note with the partnership to pay his share in installments over two years. They still decide in their partnership agreement that each partner will have a 50 percent distributive share. However, to reflect the fact that one partner put in cash and the other only a promise of cash, the partnership agreement might provide that the “cash” partner will receive a special allocation of 75 percent of the profits (or losses) for the duration of the installment agreement of the other partner.

A partner is taxed on his distributive share of partnership profit (income less expenses) whether or not he actually got the money. So, if a partnership decides to leave profit in the partnership, say, to meet future expenses, each partner is still liable for the taxes on his share of that profit. Partners who actively participate in running the partnership business are also responsible for paying self-employment taxes in addition to income, taxes on their distributive share.

There may be certain tax consequences in the formation and funding of a partnership. As a general matter, the transfer of property to a partnership in return for a share in the partnership is not considered a taxable transaction: no taxable gain or loss is recognized. However, if a partner transfers property that is subject to a liability into the partnership, and in the transfer the partner is relieved of that liability, then the partner to the extent he is relieved of liability will be deemed to have received a taxable distribution of money from the partnership. If a partner transfers appreciated property into the partnership, the built-in gain in that property cannot be reallocated to other partners but must be taken into account in determining the partner’s distributive share. Distribution of this property within five years of its contribution may result in recognition of taxable gain.

A partner’s basis in his partnership interest is generally equal to the sum of the adjusted basis of property and money that he contributed. A partner may also add to his basis his proportionate share of partnership liabilities. A partner may deduct his distributive share of partnership losses only to the extent of his adjusted basis in the partnership. (Passive loss rules apply to partners: they may offset only passive income with passive losses.) A partner does not recognize gain on a partnership distribution, including a liquidating distribution, except to the extent that the distribution exceeds the adjusted basis of his partnership interest. Partnership interests may be discounted for lack of control or liquidity, and the gifting of discounted shares may form part of a person’s estate plan, subject to the restrictions on assignability of interests imposed by the partnership agreement or by statute.

CORPORATION

A corporation is a legal person, separate from its owners and managers. It is a creature of statute, created by filing articles of incorporation with the secretary of state. It is governed by the laws of the state in which it is incorporated. A corporation may be either a "C" corporation or an "S" corporation. All corporations are C corporations unless they *elect* to be treated as an S corporation. This election is a tax matter; the distinction between C and S makes no difference under state law.

Limited Liability

A corporation offers its owners (shareholders) limited liability. This limited liability is sometimes called the corporate shield or the corporate veil. Doing business in the corporate form limits the owners' personal liability for corporate debts and obligations; it means that the personal assets of the owner of the corporation are protected from creditors of the corporation. Only corporate assets are used to pay corporate debts. An owner of a corporation therefore stands to lose only what he or she invests in the corporation.

The corporate shield can be lost. The owners' (shareholders') limited personal liability for corporate obligations is not absolute. First, a shareholder remains liable for the agreed-upon value of his or her contribution to the corporation – the property they agree to put into the corporation. This is the "investment" which the shareholder stands to lose if the business fails. Second, the shareholder remains liable for anything that he or she personally guarantees; a shareholder who personally guarantees loans made to a corporation will not be protected from that liability by the corporate shield. Third, a shareholder is not protected when he or she personally and directly injures someone, or does something intentionally fraudulent or illegal that harms the corporation or someone else. Fourth, an owner remains liable for failing to deposit taxes withheld from an employee's wages. Fifth, and perhaps most important, a shareholder may lose the limited personal liability of a corporation where he or she treats the corporation as an extension of the owner's personal affairs, rather than as a separate legal entity. In this last exception, it is possible for a court to declare that the corporation does not really exist – that its owners are in fact merely doing business personally.

In order to guard against this loss of the corporate shield, corporate formalities should be observed. Such formalities include: a) adequately funding the corporation, b) formally issuing stock to the initial shareholders, c) holding regular meetings of shareholders and directors, and d) keeping corporate records and transactions separate from those of the owners. In addition, retaining corporate status means holding annual shareholder and director meetings, keeping minutes of major decisions, making sure that documents are signed by officers and directors in the name of the corporation, maintaining separate bank accounts for the corporation, keeping detailed financial records and filing separate corporate income tax returns. There is more to creating and running a corporation than filing a few papers with the secretary of state's office. Running and maintaining a corporation requires organization.

Forming a Corporation

Legally, a corporation is created by filing articles of incorporation with the secretary of state. However, the typical steps involved in forming a corporation include the following:

- <u>Choosing a corporate name</u>

The name cannot already be registered with the secretary of state and the name must include the term corporation, or company, or incorporated, or limited, or an abbreviation of one of these terms. The name cannot violate another company's trademark.

- <u>Appointing initial directors of the corporation</u>
  Directors make the major policy and financial decisions for the corporation, such as authorizing the issuance of stock, appointing and setting the salaries of officers, approving loans to and from the corporation. Directors are typically elected by shareholders to manage the corporation. Directors are typically appointed by the initial owners of the corporation before the start of business, and often the owners simply appoint themselves as directors.
- <u>Filing the formal paperwork and pay the filing fees</u>
  The articles of incorporation must be prepared and filed with the secretary of state. In single-owner corporations, the owner often prepares, signs, and files the articles; for co-owned corporations, all owners sign or appoint a single person to sign for them. Whoever signs the articles is called the "incorporator." Articles of incorporation contain very basic information, including the name and address of the company, the name and address of its registered agent, information about the stock the corporation is authorized to issue, information about the incorporators. The articles may authorize shares or stock with differing characteristics, such as voting and non-voting stock, which may be useful in planning for shifts in control or ownership of the corporation. (A Subchapter S election is generally not available if the corporation has more than one class of stock.) The articles may describe the purpose of the corporation, but every corporation has the purpose of engaging in *any* lawful business unless the articles limit that purpose.
- <u>Publication of notice</u>
  Notice of incorporation must be published for three successive weeks and proof of notice filed with secretary of state.
- <u>Enacting by-laws of the corporation</u>
  By-laws govern day-to-day operations of a corporation, setting out such matters as when and where to hold director and shareholder meetings; the duties of officers and directors; the procedures for inspection of the corporate books; the provisions for removal of officers and directors; the qualifications, election, and term of directors; the method for filling vacancies on the board; the provisions for indemnification of directors and officers; the voting requirements; the provisions for entering into contracts, incurring loans, and signing checks; and the provisions relating to the sale of shares and to declaration of dividends.
- <u>Holding the first meeting of board of directors</u>
  Until the directors are elected, if they are not named in the articles of incorporation, the incorporator directs the affairs of the corporation. If initial directors are not named in articles, then the incorporators must hold an organizational meeting to elect the board of directors. In the first meeting of a board of directors, the board adopts the by-laws, elects officers, sets salaries of directors and officers, sets bonds for financial officers, opens bank accounts, adopts a seal, adopts a form of stock certificate, authorizes the issuance of shares of stock, schedules regular meetings of the board, sets the corporation's accounting or fiscal year, hires accountants and legal counsel, and authorizes reimbursement of incorporators and payment of attorney fees. If the corporation is to elect Subchapter S status, directors should approve that decision. The directors should consider whether or not the stock needs to be registered under federal and state securities laws.

- Issuing stock
  The issuance of stock formally divides up ownership of the corporation. A corporation should not conduct business until stock has been issued. The directors should receive the consideration for the sale of stock. Consideration may be in cash, promissory notes, any tangible or intangible property, services performed, or contracts for services to be performed. In general, the law is that shares may be issued for any consideration that the directors determine to be adequate, though it cannot be for less than par value. "Par value" does not mean economic value; it is a floor value below which the corporation may not issue its shares. Relatively low ($0.10) par value is common.

Corporate Housekeeping & Management
A corporation is required to hold shareholder and director meetings, maintain corporate records, and document major corporate decisions. Written minutes or resolutions should be prepared for such matters as

- Issuing stock to new or existing shareholders,
- purchasing real property,
- approving long-term leases,
- authorizing significant loan or line-of-credit amounts,
- adopting a stock option or retirement plan,
- making important federal and state tax decisions, and
- recording the proceedings of annual meetings.

A corporation operates under what is called centralized management. It is important to understand what roles the different parties in a corporation play. Shareholders, for example, elect and remove directors; they amend the articles of incorporation and the by-laws; they approve the sale of substantially all of the corporate assets; they approve mergers and acquisitions, and they approve dissolution of the corporation.

Directors, as a general matter, possess authority for management of the corporation. They authorize the issuance of stock; elect officers; set officer and key employee salaries; decide whether to mortgage, sell, or lease real estate; and approve loans. Directors are required to hold meetings at least annually or more often if the by-laws so require. There are notice, quorum, and record-keeping requirements that the director should observe as part of corporate formalities. In small corporations, the directors and shareholders may often be the same people. Still, it is important for retaining corporate status to observe corporate formalities, which may mean wearing different hats at different times.

Officers run the day-to-day affairs of the business. A corporation typically will have at least a president, a secretary, and a treasurer. In small corporations, the employees of a corporation are also usually its owners. Owners of small corporations typically receive most of their financial benefit through salaries and other compensation they receive as corporate employees.

Transfer of Corporate Shares
Traditionally, corporate shares are freely transferable. In other words, a shareholder may sell his shares to any other person, and that person becomes a full shareholder, without restrictions. However, in many small corporations, shareholders enter into agreements voluntarily restricting the free transferability of shares. (See BUY-SELL AGREEMENTS)

Termination of Corporation
Dissolution must be approved by the shareholders. Typically, the directors recommend dissolution to the shareholders. The corporation then files articles of dissolution, gives notice to known claimants/creditors, and publishes notice to unknown creditors or claimants. The business continues until operations can be wound up, assets liquidated, and all debts paid off.

A shareholder can petition for judicial dissolution, i.e. ask a court to dissolve the corporation, by showing to the court that the corporation is being irreparably harmed by director or shareholder deadlock or that the people in control of the corporation are acting illegally, oppressively, or fraudulently, or that corporate assets are being misapplied or wasted. Special rules allow creditors in certain circumstances to ask courts to dissolve corporations.

Corporate Taxation
A corporation is the only type of business that must pay its own income taxes on profits. The profits do not "pass through" as they do in sole proprietorships, partnerships, and limited liability companies.[7] A corporation must pay taxes on all the profits which it cannot deduct as business expenses. In essence, all money the corporation spends in the legitimate pursuit of profit may be deducted. The net income is taxable to the corporation, whether that income is kept in the company as "retained earnings" or is distributed to shareholders as dividends. If the net income is distributed to shareholders as dividends, that income is in effect subject to double taxation: it is taxed once at the corporate level and again at the shareholder level – the dividends become ordinary income to the shareholders and are subject to their personal income tax. In order to prevent corporations from endlessly retaining earnings and thereby avoiding double-taxation, the Internal Revenue Code imposes a special tax on excess retained earnings. (In general, up to $250,000 may be retained without question.)

There are planning mechanisms both to avoid double taxation and to take advantage of the fact that a corporation pays tax on its income. First, if the shareholders are also employees, the corporation, rather than paying out net income as taxable dividends, may pay higher salaries and bonuses to the employees. Salaries and bonuses are deductible to the corporation. Similarly, shareholders may loan money to a corporation; interest payments by the corporation are deductible to the corporation, and so the only tax imposed is at the shareholder level. In addition, rental payments to shareholders may be deducted as operating expenses under certain circumstances. (For example, if a corporation rents farm ground from its owners, that rental payment would be a deduction to the corporation.) This method of reducing double-taxation is known as "income splitting."

The fact that a corporation pays taxes on its income may be an advantage to the owners. Corporations pay tax at a rate of 15 percent on the first $50,000 of income, and at the rate of 25 percent on income from $50,000 to $75,000. These initial rates may be lower than the rate at which the owners are taxed. It may therefore be a tax advantage for the owners of profitable corporations to keep some income in the corporation as retained earnings (profits that are not paid out to the owners as salary and bonuses). (Corporate shareholders do not pay taxes on

[7] As mentioned, a corporation can elect to be treated as a Subchapter S corporation, if it is eligible, which election has the effect of turning the corporation for tax purposes into a pass through entity. See discussion of S Corporations.

earnings retained in a corporation, in contrast to sole proprietorships, partnerships, and limited liability companies.)

Another advantage to C corporations arises from the company's deduction for fringe benefits provided to employees, such as health insurance, medical expenses, and retirement plans. In general, the costs of such benefits are allowed as business deductions to the corporate employer and are not included in the income of shareholder employees. This assumes that the benefits are extended to all employees and not just shareholder employees. In addition, the costs of annual director and shareholder meetings may be deducted.

A disadvantage to corporate taxation is that corporate losses may not be taken as deductions by the shareholders, in contrast to the flow-through forms. A corporation may carry forward its losses to offset future income, and in some circumstances a shareholder may be able to declare a loss on the value of his or her shares if the corporation is liquidated at a loss.

In general, no gain or loss is recognized for tax purposes when property is transferred into a corporation in exchange for stock. (There are complicated exceptions to this general rule.)

Troublesome tax issues arise when the owners of a corporation, who at one time transferred land into the corporation, now seek to get that land out of the corporation. The gain on the land will be taxed twice, first to the corporation and then to the shareholder, either as a dividend distribution or as a liquidating distribution. In addition, corporations do not receive favorable capital gain tax rates. Finally, the step-up in basis that may benefit heirs in a time-of-death transfer is unavailable to corporations. One solution to this problem may be for the C corporation to make the Subchapter S election.

THE "S" ELECTION

As stated, all corporations are C corporations unless the owners elect to be treated as an S corporation for tax purposes. In an S corporation, with few exceptions, the business profits, losses, credits, and deductions pass through the corporation to the owners who report them on their personal tax returns. There is no entity-level tax. The S corporation is therefore a hybrid entity, combining the legal characteristics of a corporation with the tax characteristics of a partnership. An S corporation that is owned by more than one person must file an informational tax return and must issue Schedule K-1 to its shareholders.

S corporation shareholders are <u>not</u> subject to self-employment taxes on income received from the S corporation, a significant difference from partnership and sole proprietorship taxation. Profits and losses may be allocated only in proportion to ownership interests; no special allocations are permitted. Items of income and loss pass through to the shareholder regardless of whether or not a distribution is made to the shareholder. A shareholder would therefore be subject to tax on corporate income even if no dividends were distributed.

An S corporation may not deduct the cost of fringe benefits provided to employee-shareholders who own more than 2 percent of the corporation, a potentially significant negative difference from C corporations. In addition, employees of S corporations who own more than 2 percent of the stock of the corporation must include the value of fringe benefits they receive from the corporation, such as health insurance premiums, as taxable individual income.

An S corporation may pass business losses through to the shareholders who may then offset those losses against personal income. This ability is subject to the passive loss rules: passive losses may only be offset against passive income. A shareholder may not deduct corporate losses in excess of his or her basis in the corporate stock. A shareholder's basis in S stock is equal to the cost of the shares if the stock was purchased. If property was exchanged for the stock, the basis is equal to the basis in the transferred property. The initial basis is adjusted from year to year to reflect the income and loss of the corporation.

An S corporation is subject to the built-in gains tax if it disposes of an appreciated asset within the first 10 years after the election of S status; the S corporation would have to pay a corporate level tax at the highest corporate rate on the net recognized built-in gain. Within the restrictions of this 10 year limitation, a Subchapter S election may provide a solution to the problem of farmland trapped in a C corporation; careful tax planning is required.

An S corporation shareholder must be a US citizen or resident. There may be no more than 75 shareholders. There may be only one class of stock, though there may be differences in voting rights between shares. Neither partnerships nor corporations may be S corporation shareholders. Certain types of trusts may qualify for shareholder status in an S corporation.

Both a representative of the corporation and each shareholder must sign the S election. Once elected, the S status continues until terminated. A corporation may terminate its election. In general, the IRS will not allow a corporation that has revoked its S status to reelect S status for a period of five years. Status may also terminate should the corporation fail to qualify as a small business corporation: for example, should its shareholders exceed 75 in number or should an ineligible person become a shareholder. Conflicts could arise between shareholders where a minority shareholder, for example, refused to sign the S election, or where an S shareholder terminated the S status by selling shares to an ineligible person. Such possibilities to some extent may be guarded against in a buy-sell agreement. (See BUY-SELL AGREEMENTS)

The popularity of the S corporation has plummeted in recent years with the rising popularity of the limited liability company, or LLC.

LIMITED LIABILITY COMPANY ("LLC")

In many respects the LLC has replaced the S corporation and the limited partnership. The LLC is a hybrid form: it combines the limited liability of a corporation with the managerial and decision-making informality of a general partnership. In an LLC, members can retain their limited personal liability while still engaging in the management of the company, something that is not possible, for example, for limited partners in a limited partnership. They can do this and still have the company treated like a partnership for tax purposes. It is also possible in an LLC, unlike an S corporation, to allocate profits and losses on a basis other than ownership percentages. However, because an LLC is taxed like a partnership, owners of an LLC who are active in running the business must pay self-employment taxes on profits they received from the LLC. It is more difficult to set up an LLC than a partnership, but running an LLC is simpler than running a corporation. Owners of an LLC can manage the company themselves or they can elect managers who function like a board of directors. An LLC owned by a single individual can be treated for tax purposes like a sole proprietorship, simplifying even further the recordkeeping requirements of the form.

Limited Liability

As with a corporation, an LLC shields its members from personal liability for the acts, errors, omissions, debts, contracts, and obligations of the company. The assets of the LLC alone stand at risk to the claims and obligations of the company. The owners stand to lose only what the owners have invested in the company. However, as with a corporation, the owner of an LLC may forfeit the limited liability through certain actions or inactions. This loss of limited liability may occur when an owner personally and directly injures someone; or personally guarantees an LLC loan or debt; or fails to deposit taxes withheld from an employee's wages; or intentionally does something fraudulent, illegal, or clearly wrong-headed that harms the company or someone else. The owner may also lose the liability shield by treating the LLC as an extension of his or her personal affairs, rather than as a separate legal entity. In order to guard against the loss of limited liability an owner should act fairly and legally (do not conceal or misrepresent financial facts), adequately fund the LLC (invest enough cash in the LLC to enable it to operate), keep the LLC business separate from personal affairs (obtain an employer ID, use a separate bank account), and create an operating agreement (a formal written operating agreement, similar to corporate by-laws).

Formation and Management

An LLC is formed by filing articles of organization with the secretary of state and paying the filing fee. Standard articles of organization, as well as other LLC forms, are available online from the secretary of state (http://www.sos.state.ne.us/business/corp_serv/corp_form.html).

Articles of organization include information on:

- the name of the LLC (members' names may be used in the name of an LLC, even though they possess limited personal liability; this is not the case in a limited partnership, where use of a limited partner's name in the naming of the partnership itself would forfeit the limited liability of that partner);
- the duration of its existence (which may be perpetual);
- the company's purposes;
- its address;
- its registered agent, with address;
- the amount and value of cash and other property contributed to the LLC's stated capital, and a statement of any additional contributions to be made, together with the time and circumstances in which those additional contributions will be made (stated capital is the sum of capital contributed to the company whether in cash or other tangible or intangible property or benefit. Contributions may be in the form of cash, property, services rendered or to be rendered, promissory note, or other obligation to contribute in the future. A record should be maintained of members' contributions. Members remain liable for unpaid or unfulfilled contributions in spite of limited liability.);
- a statement of whether or not, and under what terms, the members will have the right to admit additional members;

- the names and addresses of the managers of the LLC (will the LLC be managed by the members or will a manager be named to run the company?);
- any other provisions not inconsistent with law.

The articles need not be signed by more than a single person. The secretary of state will then issue a certificate of organization. Issuance of the certificate creates the company. Business should not be conducted until the certificate is issued. A notice of organization must be published in a newspaper of general circulation for three consecutive weeks in the county where the principal office is located. An LLC must maintain a registered office in the state.

Member-managers of the LLC are liable for any unpaid taxes imposed on the LLC. If management of the LLC rests in one or more managers, those individual managers will be liable for the taxes.

An LLC's articles of organization are like a corporation's articles of incorporation. The heart of an LLC is in its "operating agreement" which, like the by-laws in a corporation, generally governs the conduct of the business and the affairs of the LLC. An operating agreement, though not legally required, helps to preserve the limited liability of the entity; it also helps to head-off misunderstandings between members and to establish individualized profit-sharing and decision-making rules. In the absence of an operating agreement, the rules of the state statute will govern.

Some common issues addressed in operating agreements include:

- determining what percentage of the LLC each member owns;
- determining a member's distributive share, either according to ownership interest or by special allocation;
- determining the amount of LLC profit that will be distributed each year: Will there always at the least be a distribution to cover the income tax each member will have to pay on his or her annual allocation of LLC profits?
- determining how and when profits will be distributed – regular distributions or at-will draws;
- determining voting power of members either according to percentage interest in the company or per capita (one vote per member);
- determining which actions, if any, will require unanimity, such as amending the articles or the operating agreement, admitting new members, voluntary dissolution, liquidation of assets;
- determining the authority of the manager(s) to borrow money: How many member/managers must approve loans? Do certain loan amounts require approval of all members?
- Determining the conditions for transfer of interests: Unless provided for in the agreement, a majority in interest of the owners must approve the transfer; if a transfer occurs without majority approval, the new owner is entitled only to receive his share of profits, but not to participate in management or voting. The operating agreement could provide for an option or right of first refusal in the existing members, which, if not exercised, would then entitle the buyer of the shares to full membership.

Dissolution and Termination

An LLC dissolves upon the expiry of its term as fixed in the articles of organization or upon the unanimous consent of the members. It will also dissolve upon the death, retirement, resignation, expulsion, bankruptcy or dissolution of a member, unless a majority in interest of the members approves the continuation of the business. A member may also petition a court to dissolve an LLC. An LLC that is being dissolved is required to file a statement of intent to dissolve with the secretary of state. In dissolution, assets are distributed first to meet liabilities to creditors, second to members to the extent of their distributive share, and third to the members as return of capital contribution.

LLC Taxation

An LLC is taxed like a partnership and not like a corporation. It is a pass-through entity, which means that the business income passes through the company to the owners who then report their share of profits or losses on their individual tax returns. Single-owner LLCs, treated as sole proprietorships by the IRS, not only pay no taxes but are not required to file a return. The owner must report all income and losses on Schedule C, attached to the 1040. A co-owned LLC is required to file an informational tax return (Form 1065) and to provide each member with a Schedule K-1, which breaks down the member's share of profits and losses.

The IRS treats multiple-owner LLCs as partnerships. The company itself does not pay taxes on business income, but each member/owner of the LLC pays taxes on his or her share of the profits. A member's share of the profits or losses of the LLC is called his distributive share. Each member's share is stated in the LLC operating agreement. Most operating agreements provide that a member's distributive share is equal to his or her ownership interest in the company. However, in an LLC, it is possible to undertake "special allocations." In a special allocation, profit and loss is split up in a way other than according to ownership interest. This can be a useful planning tool for businesses. However, care must be taken to follow the IRS rules in making special allocations. (See discussion under PARTNERSHIP; note that the IRS regulations on special allocations go on for 80 pages.)

As in partnerships and S corporations, LLC members must pay taxes even on funds left in the company (for example, to meet future expenses or for business expansion). The IRS treats each member as having received his or her rightful distributive share, regardless of whether or not a distribution was actually made.

Owners of LLCs are not considered employees; they are self-employed business owners who must therefore estimate and make quarterly payments and pay self-employment taxes. However, if an owner is not actively involved in running the business but merely a passive investor, he or she may not have to pay self-employment taxes on the distributive share.

In general, an owner may deduct losses of the LLC on his or her personal tax return only to the extent that he or she is "at risk." A member is at risk to the extent of his or her contributions to the company and to the extent that the member has personally guaranteed obligations of the company. In effect, losses are useable by the member only to the extent of the adjusted basis of the owner's interest in the company. A member's ability to use company losses is also subject to the passive loss rules: a member may use "passive losses" only to offset passive income and may not use passive losses to offset other income. If the member materially participates in the affairs and management of the company, he or she in general may make use of company losses in his or her personal tax return.

An LLC may elect to be taxed like a corporation. This election may make good tax sense where the LLC regularly has to keep significant amounts of profit in the company. Recall that owners of corporations do not pay personal income tax on profits left in the corporation as retained earnings; the corporation pays tax on those profits. If the corporate tax rate is lower than the personal tax rate of the owners, a tax savings could be realized by the corporate election. Once a corporate election is made, it cannot be reversed for five years.

COMPARING THE LLC AND THE CORPORATION

Once a decision is made to operate through a limited liability entity, what factors should a person consider in trying to choose between a corporation and an LLC? In general, for small businesses, the simplicity and flexibility of the LLC makes it the better choice. In particular, if your entity will own real estate such as farmland that is likely to increase in value, a corporation will be subject to double taxation on the gain in the land, should a time come to sell. In an LLC, the gain is passed through to the owners.

Factors to consider:

- In LLC, no limit on number of shareholders, as there is in an S corporation;
- No restriction on type of shareholders (Recall that S corporations may not have nonresident aliens, corporations, partnerships or pensions as shareholders);
- LLC is taxed as a partnership without the need for filing an S election;
- Special allocations are permitted in an LLC, whereas the use of special allocations in an S corporation would violate the one class of stock rule;
- Members who are active in running the LLC will pay self-employment tax on their share of the profits, unlike shareholders in an S corporation, who pay self-employment tax only on wages paid[8] ;
- LLC tax rules are less complicated than S corporation rules;
- No double taxation with an LLC;
- Members may share in losses of the LLC;
- LLC has more flexible management options;
- LLC, unlike a partnership, offers limited liability to its members;
- In LLC, continuation of business upon withdrawal of member is easier than in partnership;
- Easier to limit agency power of LLC member than of general partner in partnership; and
- Members can participate in management without loss of limited liability, and also thereby meet the material participation test for use of company losses.

If you expect to have multiple investors and to raise significant amounts of investor capital, a corporation may make more sense. An LLC works fine with just a few investors, in particular if those investors will be active in the day-to-day running of the company. If your goal is to provide extensive fringe benefits to owners who also expect to be employees, then a corporation may be best: the corporation can deduct the cost of fringe benefits such as health insurance premiums and direct reimbursement of medical expenses, and the benefits are not treated as taxable income

[8] It may be worth recalling that the payment of self-employment taxes creates a presumptive entitlement to social security and Medicare benefits.

to the shareholder/employee. In an LLC, only a portion of such payments are deductible for the company.

Buyout Agreements

A buy-out agreement, also called a buy-sell agreement, is recommended for every type of co-owned business. This agreement is a binding contract among the owners that determines when an owner may sell his or her interests, who may buy that interest, and what price should be paid. Such agreements typically come into play when an owner wishes to depart the company, becomes disabled, dies, goes through a divorce, or files a bankruptcy. It may also come into play when an owner receives an attractive offer to buy his interests from a third party. It may be useful to think of a buy-sell agreement as a type of pre-nuptial agreement between the owners. A buy-sell agreement provides for inevitable change and may serve to prevent the dissolution of a profitable business. It may also prevent large attorney fees from being racked up when an owner wants out of the business.

A good buy-sell will require the former spouse of any divorced owner to sell any interest received in a divorce settlement back to the company or the other owners. It will provide a means of valuing the ownership interests. The agreement typically gives the co-owners a right of first refusal or option to purchase the interests of any departing owner. It may limit the rights that a newcomer receives upon the purchase of an interest that occurs without the full consent of the members. It helps if the owners in their agreement can decide on a method of valuing interests in the business; a sound method, agreed to in advance, can prevent expensive trouble down the road. Some agreements may give the company or the other owners the right to purchase the departing owner's interests over time, in installment payments, so as not to burden the owners with a lump-sum payment. In addition, buy-sell agreement can be used to reduce estate taxes in intergenerational businesses, where discounted values may be accepted.

Insurance

Incorporation or use of a limited liability entity should not take the place of sensible business insurance. Insurance may not only protect the business assets, but may also protect the owner personally in circumstances not covered by the shield of limited liability. It is not uncommon for operating agreements and by-laws to provide that the company will indemnify directors or officers for liabilities they incur in conducting the company's business. Companies will often purchase liability insurance to protect the directors and officers in their work on behalf of the company. Insurance may also be purchased that would enable the company or other owners to buy a retiring owner's interest in the company.

Securities Registration

Issuing stock can be complicated and may trigger the application of federal or state securities laws. In general this means that large corporations must register their stock issuance with the federal Securities Exchange Commission and the state securities agency. Registration involves time and additional legal and accounting costs. Most small companies qualify for exemptions from securities registration. For example the SEC does not require a corporation to register a "private offering" – a non-advertised sale to a limited number of people (generally 35 or fewer) or a sale to people who can be expected to look after themselves in such circumstances. In general, if shares are being issued to a small number of people who will actively participate in running the business, the issuance of the shares will qualify for exemption from securities registration. If shares will be sold to passive investors, it may be necessary to seek the advice of an experienced securities lawyer.

TERMINATION OF BUSINESS: GENERAL CONCERNS

In general, in order to protect the owners, a business that is ending should do the following:

<u>Vote to close the business.</u>
In a sole proprietorship, the owner simply makes the decision on his or her own or in conjunction with a spouse. In a partnership, corporation, or LLC, the rules or the organizational documents usually require either a majority or a two-thirds vote to end the business. It is a good idea to review business documents and state statutes to make sure proper termination procedures are followed. Make a record in the minutes of the decision to terminate operations.

<u>Dissolve the business with the secretary of state.</u>
This is an official step for corporations or LLCs. It puts creditors on notice of the intent to dissolve the company. Rules and forms are available with the secretary of state. In the case of a partnership, it is a good idea to file a notice of dissolution in order to put the world on notice that the partnership has been dissolved and to prevent individual partners from binding the partnership to an obligation for which each partner will be held responsible.

<u>Cancel permits, licenses or fictitious names, if any are in place.</u>

<u>Pay off taxes and debts, if possible.</u>
First and most important is to make the final payroll tax deposits. These taxes are considered trust taxes and cannot be discharged, for example, in a bankruptcy or by a statute of limitations. Tax forms have boxes to check to indicate that no future returns will be filed. Forms will need to be filed with the IRS for sale of business property. A final tax return will need to be filed. If sales taxes were collected, then final forms and funds need to be sent to the state agency. Employment matters need to be finished, such as final paychecks and accounting for accrued benefits. As, and if, you pay off creditors, obtain a letter indicating that bills have been paid in full.

<u>Notify creditors, employees and customers.</u>
Notify suppliers and service providers, both of whom may put you on a cash-only basis through the wind-down period. Get back deposits. Close bank accounts and credit cards. Satisfy lenders.

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