Evaluating Your Estate Plan: Business Entities

The state of Iowa allows for several different forms of business. The choice of a business entity affects liability, taxation, capitalization, decision making, agricultural government payments, gifting, or transfer options. Such a decision requires much thought and advice from professionals such as attorneys and accountants when deciding on which business structure is appropriate. This publication is not intended to provide legal advice but to familiarize you with some of the terms and concepts. A table is provided at the end of this publication to compare the various options available.

The business structures allowed in Iowa include:

- Sole Proprietorship
- General Partnership (Iowa Code chapter 486A)
- Limited Partnership [Domestic or Foreign] (Iowa Code chapter 488)
- Limited Liability Partnership [Domestic or Foreign] (Iowa Code chapter 486A)
- For Profit Corporation [Domestic or Foreign] (Iowa Code chapter 490)
- Nonprofit Corporation [Domestic or Foreign] (Iowa Code chapter 504)
- Professional Corporation [Domestic or Foreign] (Iowa Code chapter 496C)
- Limited Liability Company [Domestic or Foreign]

“For Profit Corporations” are further divided into C corporations and S corporations. In addition, there are provisions for different types of cooperatives.

Liability

Individual liability for debts and torts varies based on the business structure. Often preference will be given to a business structure that limits the individual’s financial liability to the equity contributed and shields the other personal assets from possible business exposure.

Taxes

Another factor is the way that the business will be taxed. Some entities allow for the pass through of tax liability. Others may be subject to double taxation but will have more favorable tax rates, tax deductions, fringe benefits, or possible “minority shareholder discounts” for estate planning. Advice from a tax attorney is critical to understanding the implications.

Capitalization

Equity in a business can be raised from personal contributions, borrowing, or including other investors. Each business structure has unique issues relating to how this can be done. Keep in mind that a lender may still want personal guarantees on loans to provide additional collateral on borrowed capital.

Decision Making

The business structure can also impact the amount of decision making and control that other investors have. Certain classes of shareholders may or may not have voting rights. Some may have buy-sell agreements or other restrictions on transfer of shares or units. The structure also impacts the complexity of the organization, record keeping, tax reporting, and related costs.

Ag Program Payments

In the past, USDA farm program payments have been a substantial part of farm profits. Eligibility and payment limits can be impacted by the type of business structure. The USDA rules

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have changed over time and continue to be a moving target. Currently the programs look at payments at the business level and at the individual level.

**Gifting or Transferring Ownership**

Often we want to transfer wealth to the next generation by gifting, commonly using the annual gift tax exclusion. We may or may not want to give the income from assets that are transferred or control of the business. For estate tax planning, we may also want to qualify for “minority shareholder discounts” on the shares of assets given away as well as those that are retained in the estate.

**Business Name**

After a decision is made as to the type of business entity the next step may be to select a name. The Iowa secretary of state maintains a database of names that have been used by Iowa-based companies. You can search the list online to see if your proposed name is already taken or is so similar to others that it might cause confusion. Search the database at http://sos.iowa.gov/.

Also, make sure you don’t infringe on someone else’s trademark by checking http://www.uspto.gov/trademarks/index.jsp.

**Business Entities**

**Sole Proprietor (SP)**

The simplest and most common form of business entity is the sole proprietorship. This provides you with a great deal of control. All you need to do is start doing business. A business license, sales tax permit, purchase insurance, or registered name may be useful, but is not required in this situation. Record-keeping requirements may be less. The assets may be transferred easier and financing may be simpler.

A major disadvantage is that personal assets are not protected from creditors of the business. These businesses tend to have limited life if the owner dies. All income is taxable and subject to self-employment taxes subject to limits.

**General Partnership (GP)**

A partnership is a legal entity created by two or more people wanting to operate a business together. Partners transfer money or property to the entity in exchange for a partnership interest. They are very easy to set up. They can be set up formally (written operating agreement) or informally. The name of the partnership should be registered. One caution is that people may unintentionally set up a partnership by holding themselves out to the public as a partnership; for example, by selling grain in the names of two people. A crop-share landlord is not in a partnership necessarily but you may want to reinforce that by stating it in the lease.

One limitation of the partnership is that all partners are able to conduct business in the name of the partnership thus binding them to contracts and financial obligations. One option to limit a partner’s exposure is to become a “limited partner,” which would limit your financial exposure to the amount invested. This requires a written agreement and filing with the secretary of state.

If all of the partners agree, an incoming partner may purchase or be given a partnership interest. A person or entity could also be given interests as compensation for labor or management given to the partnership.

Partnerships have specific rules about how they are dissolved, but usually can easily be dissolved. They automatically dissolve if one of the general partners dies, withdraws, goes bankrupt, or has legal disability, often resulting
in unintended tax consequences for the other partners. Buy-sell agreements can provide requirements for the dissolving of a partnership.

Partnerships are taxed as “pass through entities.” The partnership gets its own tax identification number and files tax returns. The partnership’s earnings, capital gains, or losses flow through to the individual and are taxed at the individual’s rate. Individuals are responsible for self-employment taxes. Your basis in the partnership totals the amount of money you brought in plus the basis in property that you transferred in plus the share of the partnership liabilities you assumed.

The advantages of a partnership are that they are easy to set up and the income is taxed the same as a sole proprietor. The disadvantages are your assets are subject to creditors, partners can bind you to contracts, and they may have to be dissolved to separate interests.

**Limited Liability Partnership (LLP)**

Another way to limit liability is to become designated as a limited liability partnership. A limited partnership has one or more general partners and one or more limited partners. A person becomes a limited partner either by the consent of all the partners, as a result of a conversion or merger, or as provided in the partnership agreement. Limited partners don’t participate in management. If you do, you may be considered a general partner with the associated liability issues.

A limited partner cannot bind the partnership. An obligation of the limited partnership is not an obligation of the limited partner, even if the limited partner is involved in management or control. A limited partner doesn’t have a fiduciary responsibility to the partnership. All general partners are liable jointly and severally for all obligations of the limited partnership unless otherwise agreed to by the claimant or provided by law.

Limited partnerships are taxed the same way as general partnerships.

**Family Limited Partnerships (FLP)**

Family limited partnerships are restricted to family members. The parents generally set up the partnership. Then, over time, they transfer shares of the partnership to the children or grandchildren. Often parents are using the annual gift exclusion ($14,000 in 2014) to make these tax-free transfers. The management may be kept with the general partners so a large percentage of the partnership could be gifted away with the parents still maintaining control. The income tax liability for profits goes with the ownership interest so you want to watch the income tax liability and the income distribution together.

The restrictions on the ownership of the FLP may make it difficult for someone wanting to sell out since family members are the only ones eligible to buy. If the partnership has to be dissolved, there will probably be some significant income tax issues to deal with. One of the reasons for using a FLP is to reduce the value of the assets for estate tax purposes. This may result in the partnership’s assets being reduced by 25 percent or more for valuations.

**“C” Corporation**

The traditional corporation is the C corporation. It has investors called stockholders and they are only at risk for the amount they have invested in the company. The stockholders elect a board of directors that hires the management. In small family corporations, stockholders, board members, and officers are often the same people. Minority shareholders may have very little decision making in the operation of the corporation. The stockholders have one vote for every share of stock they own.
The corporation can generally continue indefinitely. Small, closely held corporations need to maintain records of annual meetings and elections and file annual or biannual reports as required if they want to maintain their status. The corporation, at start-up, files “Articles of Incorporation.” Corporations require more recordkeeping than other types of business entities.

The corporation is taxed as a separate entity. The corporation pays taxes on its profits and then, when it pays out profits to the shareholders in the form of dividends, the shareholders may pay taxes on the profits again. In the past, corporations had lower tax brackets and greater deductibility of fringe benefits. C corps may have a fiscal tax year different than the calendar year.

Traditionally, C corps were viewed as a way to pass ownership onto the next generation by gifting, selling, transferring for compensation, or by inheriting shares of stock. That is why you may find land owned by the corporation. At death the shares of stock get an adjustment in basis, but the underlying assets don’t, which can result in significant tax liability issues if the corporation is liquidated. It is possible to convert a C corp to an S corp.

“S” Corporation

The “S corp,” which is a special form of the C corp, is also referred to as “Subchapter S,” referring back to provisions in the federal tax code. The S corp has limited liability like the C corp, but it is taxed like a partnership. The income and the deductions flow through to the individual tax payers, who may be able to utilize potential tax losses in the start-up phase. S corps must use a calendar year for tax purposes.

Some restrictions on the S corp are that it is limited to 100 shareholders, may not have a corporate shareholder, and may not have more than one type of stock. There are filing requirements as well.

Many of today’s S corps started out as C corps, but were converted to S corps. The IRS states that if more than 25 percent of a S corporation’s gross receipts consists of passive income for three consecutive years when the corporation has accumulated earnings and profits, the S corporation will automatically lose its subchapter S status. Cash rent from farmland would be “passive income.”

Limited Liability Company (LLC)

The most recent form of business is the limited liability company. It is a simpler form of business than a corporation, retains the limitation of liability, while still providing the option of having pass through taxation by making an “election.”

The formation of an LLC is similar to a corporation but the owners are called “members.” The ownership is in units instead of shares, and the directors are called managers. Iowa does allow a single-member LLCs, but LLCs are not recognized everywhere. If it is a single-member LLC, it is a disregarded member for income tax purposes.

Management of an LLC can be very flexible depending upon what the Certificate of Organization and the Operating Agreement require. Distribution of profits is also flexible. The IRS may not allow as great a discount for minority shareholder interests due to the flexibility in transferring business interests.
Other Considerations
The type of business structure may impact USDA Farm Service Agency (FSA) programs as well as other government programs. Rules change over time; to find out the current implications, visit the local FSA office to understand liability issues beyond what the entity may provide and reasons that you may still have liability issues.

When putting together a business structure think about how the business will deal with gifts, transfers, sales, buy-sell agreements, financial stress, death, termination, or transfer to the next generation.

There are other business arrangements such as labor sharing agreements, machinery sharing agreements, livestock production contracts, and strategic alliances that may be useful.

Seek competent professional advice before forming an entity.

Additional Resources
Center for Ag Law and Taxation - http://www.calt.iastate.edu

Iowa State Bar Association - http://iowabar.org/displaycommon.cfm?an=1&subarticlenbr=159

Ag Decision Maker
  Farm Business Choices - http://www.extension.iastate.edu/agdm/wholefarm/html/c4-41.html
  Partnerships - http://www.extension.iastate.edu/agdm/wholefarm/html/c4-46.html
  Corporations - http://www.extension.iastate.edu/agdm/wholefarm/html/c4-47.html

Iowa Code:
  Ch. 486A Uniform Partnership Act
  Ch. 488 Uniform Limited Partnership Act
  Ch. 489 Revised Uniform Limited Liability Company Act
  Ch. 490 Business Corporations
  Ch. 497 Cooperative Association
  Ch. 498 Nonprofit Cooperative Association
  Ch. 499 Cooperative Association
  http://search.legis.state.ia.us/NXT/gateway.dll/ic/1/13/18058/18247/18365?f=templates$fn=default.htm$Q=[field 490]$x=Advanced#LPHit1

Iowa Secretary of State
  Statehouse, Des Moines, IA 50319
  (515) 281-5204
  http://www.sos.state.ia.us/

IRS Taxpayer Assistance Center
  210 Walnut St., Des Moines, IA 50309
  (515) 284-4240

Taxpayer Services
  Iowa Department of Revenue and Finance
  P.O. Box 10457, Des Moines, IA 50306-0457
  (515) 281-3114 or (800) 367-3388
### Relative Advantages and Disadvantages of Various Business Forms

<table>
<thead>
<tr>
<th>Issue</th>
<th>Sole Proprietorship</th>
<th>C Corp.</th>
<th>General / Limited Liability Partnership</th>
<th>Limited Partnership</th>
<th>Limited Liability Company</th>
<th>S Corp.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nature of Entity</strong></td>
<td>Legal person same as the owner</td>
<td>Legal person separate from shareholder-owners</td>
<td>Aggregate of two or more persons</td>
<td>Aggregate of two or more persons</td>
<td>Aggregate of two or more persons</td>
<td>Legal person separate from shareholder-owners</td>
</tr>
<tr>
<td><strong>Life of Business</strong></td>
<td>Fixed term; ends when owner dies</td>
<td>Perpetual or fixed term of years</td>
<td>Agreed term; terminates at death of partner; LLP must register annually</td>
<td>Agreed term; terminates at death of partner</td>
<td>Agreed term; terminates at death of partner</td>
<td>Perpetual or fixed term or years</td>
</tr>
<tr>
<td><strong>Management Decision</strong></td>
<td>Sole proprietor</td>
<td>Elected directors and officers selected by directors</td>
<td>Usually agreement of partners</td>
<td>Usually general partner</td>
<td>Usually manager is elected</td>
<td>Elected directors and officers selected by directors</td>
</tr>
<tr>
<td><strong>Formation of Entity</strong></td>
<td>Very simple</td>
<td>Relatively simple</td>
<td>Relatively complex; LLP must register</td>
<td>Relatively complex</td>
<td>Relatively simple</td>
<td>Relatively simple</td>
</tr>
<tr>
<td><strong>Flexibility in Capitalization</strong></td>
<td>N/A</td>
<td>Very flexible</td>
<td>Very flexible</td>
<td>Very flexible</td>
<td>Very flexible</td>
<td>Somewhat inflexible</td>
</tr>
<tr>
<td><strong>Limited Liability</strong></td>
<td>None</td>
<td>Yes</td>
<td>No; LLP partner exempt from co-partner's torts</td>
<td>No for G.P./Yes for L.P.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Flexibility in Conducting Business Affairs</strong></td>
<td>Inflexible</td>
<td>Flexible</td>
<td>Flexible</td>
<td>Relatively flexible</td>
<td>Relatively flexible</td>
<td>Somewhat inflexible</td>
</tr>
<tr>
<td><strong>Flexibility in Taxable Year</strong></td>
<td>None</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Little</td>
</tr>
<tr>
<td><strong>Allocation of Income, Losses, Deductions, and Credits</strong></td>
<td>N/A</td>
<td>Somewhat inflexible</td>
<td>Very flexible</td>
<td>Very flexible</td>
<td>Very flexible</td>
<td>Generally inflexible</td>
</tr>
<tr>
<td><strong>Tax Effects Upon Liquidation</strong></td>
<td>No double tax</td>
<td>Difficult to avoid double tax</td>
<td>No double tax</td>
<td>No double tax</td>
<td>No double tax</td>
<td>Generally no double tax (Section 1374)</td>
</tr>
<tr>
<td><strong>Convertibility to Another Entity Tax-Free</strong></td>
<td>Yes</td>
<td>Some restrictions</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Some restrictions</td>
</tr>
<tr>
<td><strong>Line of Business</strong></td>
<td>Very flexible</td>
<td>Few restrictions</td>
<td>Flexible; LLP some restrictions</td>
<td>Very flexible</td>
<td>Few restrictions</td>
<td>Few restrictions</td>
</tr>
</tbody>
</table>
### Relative Advantages and Disadvantages of Various Business Forms, cont.

<table>
<thead>
<tr>
<th>Issue</th>
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<th>Limited Partnership</th>
<th>Limited Liability Company</th>
<th>S Corp.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-employment Income from Entity</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes - GP No - LP</td>
<td>Usually; See Proposed Regs§1.140-2(a)-18</td>
<td>To extent of salary and bonus</td>
</tr>
<tr>
<td>Effect of Passive Loss Limitation Rules</td>
<td>N/A</td>
<td>Applies at corp. level/generally avoidable for larger corps.</td>
<td>Partners may or may not materially participate</td>
<td>Ltd. partners deemed not to materially participate</td>
<td>Members may or may not materially participate</td>
<td>Shareholders may or may not materially participate</td>
</tr>
<tr>
<td>Availability of Entity Losses to Owners</td>
<td>N/A</td>
<td>No</td>
<td>Flow through of losses to owners</td>
<td>Flow through of losses to owners</td>
<td>Flow through of losses to owners</td>
<td>Flow through of losses to owners</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>Limited compared to C Corp</td>
<td>Widest available</td>
<td>Limited compared to C Corp</td>
<td>Limited compared to C Corp</td>
<td>Limited compared to C Corp</td>
<td>Limited compared to C Corp</td>
</tr>
<tr>
<td>Estate Planning Opportunities</td>
<td>Fair</td>
<td>Very good</td>
<td>Good</td>
<td>Very good</td>
<td>Very good</td>
<td>Fair</td>
</tr>
<tr>
<td>Accumulated Earnings and PHC Tax</td>
<td>N/A</td>
<td>Section 531 and Section 541 applicable</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>State Taxes</td>
<td>Same as individual</td>
<td>Generally uniform and deductible</td>
<td>Generally uniform</td>
<td>Generally uniform</td>
<td>States vary</td>
<td>States vary</td>
</tr>
<tr>
<td>Dividend Received Deduction</td>
<td>N/A</td>
<td>Allowed</td>
<td>Not allowed</td>
<td>Not allowed</td>
<td>Not allowed</td>
<td>Not allowed</td>
</tr>
<tr>
<td>Effect of Bus. Liabilities on Owner's Basis</td>
<td>Full effect</td>
<td>No effect</td>
<td>Proportionate share</td>
<td>Limited partners share in nonrecourse</td>
<td>Proportionate share</td>
<td>Only shareholder's own loans</td>
</tr>
<tr>
<td>Alternative Minimum Tax</td>
<td>Subject to AMT</td>
<td>Subject to corporate AMT</td>
<td>Preference items flow to each partner</td>
<td>Preference items flow to each member</td>
<td>Preference items flow to each member</td>
<td>Preference items flow to each shareholder</td>
</tr>
<tr>
<td>Method of Accounting</td>
<td>Cash method</td>
<td>Depends on size and ownership</td>
<td>Generally may use cash method</td>
<td>Generally may use cash method</td>
<td>Generally may use cash method unless farming syndicate</td>
<td>Generally may use cash method</td>
</tr>
</tbody>
</table>

Source: Principles of Ag Law, Roger A. McEowen, Neil E. Harl
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