Ag Decision Maker

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Corporation

The corporation is a separate legal entity, making it a more complex form of business organization. Below is a summary of the major provisions of the corporation.
A corporation is a separate business entity created under state law. It is separate from its owners (shareholders). A major characteristic of the corporation is this distinction between the business and its owners.

Corporations can be publicly owned or closely held. Major U.S. corporations are publicly owned. Their stock is widely owned and traded. Closely held corporations are owned by a small group of shareholders. Outsiders cannot generally buy into these corporations. Farm corporations are usually closely held corporations.

Corporation Taxation

The regular C corporation creates a separate taxing unit. This permits a splitting of income between the corporation (retained earnings) and the individuals (salaries, rents, interest).

To take advantage of this feature, the after-tax earnings of the corporation must be retained in the corporation and reinvested. Otherwise, the earnings will be subject to double taxation (corporate and individual levels) if distributed as dividends, or to an accumulated earnings tax if retained within the corporation beyond the reasonable needs of the business. Thus, the corporation is often recommended where there is a growing business in which retained earnings can be reinvested for an acceptable business purpose.

A tax option or S corporation is similar to a regular C corporation except that it pays no income tax. Net income, capital gains, and other items pass through to the individual stockholders and are taxed at the personal level.

Employee Benefits for Owners

Since the corporation is a separate legal entity, the owners/operators of the corporation can become employees of the corporation. They become eligible for a wider range of fringe benefits than under self-employed status. Employee retirement plans may be established by the corporation. Employees can receive tax-free medical benefits from the corporation. Employees may receive tax-free meals and lodging if required to live and eat meals on the premises as a condition of employment. Also, the corporation may provide group term life insurance. The cost of these benefits is a tax deductible expense for the corporation.

Estate Planning

A desirable estate planning feature of the corporation is the ease of property transfer while maintaining control of the business. With a corporation, transferring property involves transferring shares of stock rather than property items. As little as one share of stock can be sold or given away at a time, making an interest in the business easily transferrable.

Often parents want to transfer part of their property to the farming children or other heirs without giving up control over the business. With a corporation, parents can transfer a substantial amount of the business ownership in the form of corporate stock. As long as they retain 51 percent or more of the common stock, they retain control of the business.

Financial Structure

An important decision at formation is how to financially structure the corporation. In addition to common stock, the corporation may issue nonvoting stock or preferred stock (some

Iowa State University
Extension and Outreach

Don Hofstrand
retired extension value-added
agriculture specialist

restrictions exist for tax-option corporations). These stocks may be used to give special or preferential dividend rights to shareholders. A person could be issued bonds or notes to make them a creditor rather than an owner of the corporation although the issuance of debt securities as part of a tax-free exchange is discouraged. For example, if the corporation is also capitalized with preferred stock or bonds, and these go to the parents or off-farm heirs, the amount of common stock the farming children need to gain control of the business is reduced.

Business Continuity

A key feature of the corporation is business continuity. A corporation can be established to continue forever or until it is dissolved by the owners or by operation of law. So the life of the corporation may transcend the life of individual members and is not disrupted by the death or withdrawal of a family member. This aspect of the corporation allows for a smoother transfer of the business from one generation to the next. However, this is no guarantee of success. The remaining corporate members must have the managerial skills to operate the business.

Limited Liability

As a general rule, the liability of the shareholders is limited to their investment in the corporation. Limited liability becomes an important issue when the owner-operators have personal investments outside the business. However, there is no absolute guarantee of limited liability. Even the corporate shareholder may be subject to liability greater than his/her investment (or commitment to invest) if the shareholder assumes personal liability for debt obligations. This frequently occurs in farming when shareholders are asked to co-sign the corporation's loan agreements. Adequate liability and property insurance should be carried to protect the business capital. The liability issue should be checked carefully with your attorney.

Minority Stockholders

The interests of majority stockholders may be different from those of minority stockholders. For example, the majority stockholders also may be employees of the corporation. They may want to distribute the corporate income as salaries rather than dividends. The majority stockholders may vote against the interests of minority stockholders leaving them with little or no cash return on their investments. In addition, there may be little or no market for the stock of a closely-held corporation. Minority stockholders may be locked in unless their rights are specified in the articles of incorporation and by-laws, and buy-and-sell agreements are used to protect their investment.

Corporation Control

Two key issues that arise at corporate formation are:

- What property should be put into the corporation?
- What type of capital structure should be used?

If all the farm property is put into the corporation and the owners all receive common stock in return, the farming child must gain control of 51 percent of the total business assets to control the business.

An alternative would be to keep certain property out of the corporation. For example, the production side of the business could be incorporated with the land not included. This would reduce the amount of common stock the farming child would need to gain control. However, leaving the land out may not meet the estate planning objectives. So, holding the land in a limited partnership or trust may be used. Also, the production side of the business tends to be a heavy user of capital. Leaving the land out eliminates a very important source of collateral for borrowing.

Another alternative would be to place all the assets into the corporation, but use a capital structure that also includes preferred stock or debentures or both. This would reduce the amount of common stock needed to gain control of the business, while guaranteeing returns to minority stockholders.

Disadvantages

Generally, it costs more to set up and maintain a corporation. There also are some possible adverse tax consequences in the formation, operation, and dissolution of the corporation. At formation, a tax free exchange is usually possible. Since the exchange of assets is normally tax free at formation, termination holds the potential for a large capital gains tax. Also, more formal record keeping is required of a corporation.