



# Risk Concepts

## Corporations

**H**istorically, farms and ranches were operated as sole proprietorships. The land, machinery, livestock, and other assets were owned and used by an individual or couple. Likewise, the individual (or husband and wife) farmer/rancher was personally responsible for all debts and financial obligations owed by the business. The farmer or rancher was the business, and the business was the farmer or rancher.

There are a number of organizational structures that may better meet the needs of today's farm/ranch business. A few of the more common business entities used by farmers and ranchers include sole proprietorship, general partnership, limited partnership, limited liability company (LLC), and corporation. Each U.S. state recognizes most legal entities, while the U.S. Internal Revenue Code recognizes all business forms except LLCs. Each organizational structure has its strengths and weaknesses. Before a decision is made as to the legal entity under which to operate, a person – or person and his or her family and other partners – need to determine the goals of and needs for the business and its assets.

The corporation (C Corporation) is probably the form of business entity which comes most readily to mind for most people. It is formed by filing articles of incorporation with the appropriate state officials. A corporation may also have written bylaws that will govern day-to-day operations.

The equity owners of a corporation are called shareholders who, in their capacity as shareholders, have only very basic voting rights. They elect the managers of the corporation (called directors), are entitled to vote on most decisions that would require an amendment to the articles of incorporation, and must approve certain fundamental transactions involving a change in structure of the corporation. Generally, any legal person (including individuals, associations of persons, and legal entities) can be a corporate shareholder. In most states, investment in a corporation can be in the form of property, cash, or services. A number of states exclude promises to provide property or perform services in the future from the list of permissible contributions.

## Formation

The corporation is a creature of statute. The statutory requirements must be complied with in order for a corporation to come into existence. In most states, a corporation comes into existence when the articles are filed with the Secretary of State or other appropriate state official.

The articles of incorporation, sometimes called the corporate charter, contain basic information about the corporation and are not intended to govern the day-to-day operation of the business. The articles contain information such as the name of the company, the address of the principal office, a registered agent and office in the state for service of process, detailed information about the stock which the corporation is authorized to issue, information about the incorporators, and possibly the purposes for which the corporation is to be formed. The articles may, but generally are not required to, include the names of the initial directors of the corporation.

Once the articles are filed, the organizers will typically meet to select the initial directors unless they were named in the articles. The initial directors authorize the enactment of bylaws that will govern the day-to-day operations of the corporation. They will also authorize the issuance of shares and take whatever actions are necessary to get the corporation started.

Shares may be issued for any consideration determined by the directors to be adequate, provided that such amount may typically not be less than the par value of the shares as specified in the articles of incorporation. "Par value" is merely a floor below which a corporation may not issue its shares. While some states authorize no-par stock, a relatively low par value (such as \$.10 or even a fraction of a cent) is not uncommon. There is no requirement that all shares must be issued for the same consideration or even consideration having the same value as that accepted in exchange for other shares. All of such decisions are within the discretion of the directors.

## Operational Attributes

Under normal circumstances, all management authority is to be exercised by or under the authority of the board of directors. Because this level of complexity and formality may not be desirable or necessary in a small corporation, some state statutes allow smaller corporations to elect to have shareholders retain management authority by including a provision to that effect in the corporation's articles of incorporation. In the case of a small corporation with such an election, the shareholders could have direct management authority. Not all state statutes would permit or recognize such an election.

Generally, directors are required to hold meetings at least annually or more often as the bylaws may require, and all state statutes provide for special meetings. Notice of meetings, quorum, and record-keeping requirements for directors should be carefully observed in order to minimize the risk that the "corporate veil" will be disregarded.



The directors have full authority over the day-to-day operations of the corporation. Directors are typically elected by the shareholders with a plurality of the votes, and in a minority of jurisdictions shareholders are presumed to have cumulative voting privileges proportional to the number of shares they hold. Even in jurisdictions where cumulative voting is not presumed, the articles of incorporation may provide that shareholders will have this right.

The right to share in the corporation's net profits depends on the stock held by each shareholder. Every holder of the same class of stock is entitled to a pro rata proportion of any distribution to the holders of that class of stock, although different classes of stock can have different priorities and claims to distributions. For the most part, the actual distributions depend on the board of directors, who generally have very broad discretion in declaring dividends. Dividends are ordinary income to shareholders.

## Liability

The primary advantage to a corporation is that all shareholders have limited liability for corporate debts. In other words, a shareholder stands to lose his or her investment in the corporation if the corporation acquires debts greater than its assets, but absent highly unusual circumstances, will not be compelled to pay additional sums to make good on those debts. However, if the shareholder has signed a personal guarantee, the shareholder will have personal liability and personal assets might be subject to entity-level debt.

There are some important caveats and limitations that need to be understood, because this limitation on personal liability is not





absolute. First, a shareholder is liable for the agreed-upon value of his or her contributions. If the contribution has not been fully paid in, the corporation or a receiver appointed to run the corporation may recover such amounts. In addition, the agreed-upon contribution must be equal in value to the par value of the shares to be issued in exchange therefor. If it is not, the shareholder faces potential liability for “watered stock.” Similarly, under the law of some states, there are restrictions on the type of consideration that may legally be paid, and failure to comply with these restrictions may result in excess personal liability. Generally speaking, a shareholder will only recover such value if all corporate creditors are paid in full.

A shareholder may wind up with personal liability in the event that a court elects to “pierce the corporate veil” or, in other words, to disregard the existence of the corporation in order to impose such liability. The courts generally agree that they should pierce the corporate veil if there is sufficient proof that the corporation has been used in the furtherance of crime, to facilitate fraud, or to justify a similar wrong. Additionally, courts may pierce the veil when shareholder(s) have themselves failed to recognize the separate existence of the corporation. Once the corporate veil is pierced, the corporation is no longer viewed as a legal entity. Instead, the corporation is viewed as an association of persons, exposing the personal assets of the stockholders, and often the personnel connected with the wrongful activity such as corporate directors, to claims by creditors seeking compensation.

## **Tax Attributes**

There are two basic types of corporations for taxing purposes: S Corporation and C Corporation. The only differences between S and other corporations come from rules and restrictions imposed by subchapter S of the Internal Revenue Code.

The net income at the corporate level (not an S corporation) is subject to an entity level tax. When the corporate income is distributed to shareholders in the form of dividends, the dividends become ordinary income to the shareholder and are subject to personal income tax. This is referred to “double taxation”. To prevent the corporation from retaining earnings endlessly and thereby deferring the second level of tax indefinitely, the Internal Revenue Code imposes a special tax on excess retained earnings.

If a shareholder is also a primary employee of the corporation, the shareholder/employee may be paid larger salaries or bonuses in lieu of dividends. Although the salaries are still taxable at the shareholder level, employee compensation is an expense for the corporation and is paid out of pre-tax dollars. Similarly, shareholders may lend money to the corporation. Interest payments by the corporation are deductible to the corporation, and so the only tax imposed is at the shareholder level. If the shareholder rents property to the corporation, rental payments are also subject only to tax at the shareholder level.

Corporate losses are not deductible at the shareholder level. Although the corporation can carry forward losses to offset future income, and under certain 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. It is not generally possible for a shareholder in a C corporation to utilize corporate losses to offset personal income on a yearly basis.

The right of the corporation to deduct wages and interest is not unlimited. Only reasonable business expenses may be deducted by the corporation. This means that there may be disagreements between taxpayers and the I.R.S. as to what constitutes a reasonable business expense.

## Transfers of Ownership (Succession and Estate Planning)

Absent agreement to the contrary, a shareholder may sell or otherwise convey shares at any time to any other legal person. The buyer or transferee becomes a shareholder, with all the rights such a position entails. While a shareholder who has control over the corporation cannot knowingly sell the control shares to someone who intends to come in and “loot” the corporation, there are very few limits on a shareholder’s right and power to transfer shares.

However, in many close corporations, free transferability may not be completely desirable. For example, a corporation may be concerned that such sales might violate the federal or state securities laws and compromise the corporation’s own sales of its shares. Even if the sale does not involve tax or securities law problems, the promoters or primary shareholders may worry about control getting away from those who have an immediate connection with the business. They may want to limit share ownership to employees of the company or family members or to prohibit the sale to those with a significant ownership interest in or management responsibilities to competing enterprises. Any limitations or restrictions should be included in the corporate charter or by-laws.

## Dissolution

The process of terminating a corporation is spelled out in the corporate statutes. Most of these rules are mandatory and cannot be circumvented by agreement of the parties. However, the death, purported withdrawal or resignation, incapacity, etc. of a shareholder will not affect the viability of the corporation as an independent entity, so there is less reason to try and circumvent the usual process of dissolution.

Dissolution of the corporation does not mean the withdrawal of shareholders or directors from the enterprise. It is just the first step in the winding up and termination process. Even after a corporation is dissolved, it continues in existence for the purpose of conducting the winding up.

The usual process requires the corporate directors to recommend dissolution to the shareholders. This must then be approved by the appropriate shareholder vote. Following this vote, the corporation is entitled to file articles of dissolution, give notice to known claimants, and publish notice to unknown or contingent creditors. The business continues until operations can be wound up, assets liquidated, and all debts paid off.

Although there is a five-year statute of limitations for contingent claims in most state corporate statutes, this does not mean that the corporation must continue the winding up process for this entire period of time. Rather, the corporation typically distributes to the shareholders whatever is left after paying all creditors. If a subsequent claim is made, and it succeeds, shareholders who have received a liquidating distribution may be compelled to turn it over to the creditor, but they cannot be compelled to pay more than they received. If the normal process is not possible, as for example would be the case where a majority of the directors refuse to refer the matter to a shareholder vote, or a majority of the shareholders oppose dissolution, the statutes also provide for judicial intervention.

## Summary

The corporation is probably the form of business entity which comes most readily to mind for most people. It is formed by filing articles of incorporation with the appropriate state officials. A corporation may also have written bylaws that will govern how the corporation is run on a day-to-day basis. Any legal person, association of persons, or legal entity can own shares in a corporation. It is the shareholders, as owners of the company, who elect a board of directors which in turn manages the company.

A person wanting to start a business should first determine his or her risk preferences and both short and long term goals; second, seek appropriate professional counsel from an attorney, accountant, and others; and finally, establish the business.

## Resources

Part I: An Overview of Organizational and Ownership Options Available to Agricultural Enterprises. Goforth, Carol R. An Agricultural Law Research Article. National Agricultural Law Center. July 2002.

Part II: An Overview of Organizational and Ownership Options Available to Agricultural Enterprises. Goforth, Carol R. An Agricultural Law Research Article. National Agricultural Law Center. July 2002.

Fact Sheets from the Internal Revenue Service and Secretary of State office in various states.

*The information presented in this document is intended for educational purposes only. It should not be construed as providing legal, accounting, or other professional advice. People considering the establishment of a business enterprise should seek appropriate professional assistance.*

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