

Center for Agricultural Law & Taxation



Land Ownership and Legal Structures

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Center for
Agricultural
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IOWA STATE UNIVERSITY

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Agenda

- Land Ownership Structures
- Why Use Business Entities?
- Legal Business Structures

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Overview: Real Property Ownership

- Ownership of property can be compared to a bundle of sticks.
 - Right to transfer
 - Right to control
 - Right to possess
 - Right to exclude others
 - Right of use and quiet enjoyment
 - Right to profit
 - Right to destroy



Overview: Real Property Ownership

- Many different ways to own land:
 - Individual Ownership
 - Joint Ownership
 - Trust
 - Life Estate or Remainder
 - Through a business entity

Individual Ownership

Fee Simple

- Interests in land for an *indeterminable* amount of time (versus a leasehold interest for a fixed duration).
- Most common type.
- Three types:
 - **Fee simple absolute** (forever) (default).
 - **Fee simple determinable**
 - Continues until automatically terminated by the happening of some event (land then reverts to grantor heirs).
 - **Fee simple subject to a condition subsequent**
 - May be terminated by the happening of a future event.



Co-Ownership

Tenants in Common

- Default form of co-ownership.
- Each owner holds an undivided, separate and distinct share of the property. All owners have **equal rights** to enjoy and possess the property.
- Each owner can convey his interest by will or sale.
- All owners must share taxes equally.

Joint Tenancy

- Another form of co-ownership.
- Each joint tenant owns an undivided equal interest in the property.
- Key difference from tenants in common: When one owner dies, no probate is necessary. The survivor automatically owns the entire property outright (right of survivorship).

Joint Tenants

- Iowa Code § 557.15:
 - Joint tenancy is now presumed IF a deed fits any of the following descriptions:
 - identifies two grantees as married to each other at time of instrument;
 - says "joint tenants" or something similar; or
 - includes language such as "or their survivor."

Joint Tenancy

- If one joint tenant conveys his or her interest, joint tenancy is severed and ownership is then tenants in common.



Limited Forms of Ownership

Life Estates: Where there's a will, there's a way

- A will can create a life estate.
- Duration of life estate is measured by the life of the life tenant.
- The measuring life is usually the holder of the estate, but could also be a third-party.



Rights of the Life Tenant

- Right to possess
- Right to exclusive use (if remainderman accesses property, it is a trespass)
- Right to lease (what she has)
- Right to convey (what she has)
 - Value calculated based upon life expectancy.
- Life tenant also has quasi-fiduciary duties to the remainderman.
 - Avoid waste;
 - Pay taxes;
 - Keep the use of the property the same.



Business Legal Structures

Why form a businesses entity?

- Tax planning
- Limited personal liability
- Develop a workable management structure
- Attracting investors
- Transition planning
- Estate planning

Sole Proprietorship



Sole Proprietorship

- The default entity for a single-owner business.
 - Owner owns all assets.
 - Owner has personal liability for all debts and contracts of the business.
 - Income tax is reported on individual 1040, using a Schedule C (or Schedule F for farming).
 - Owner can represent himself in court *pro se* (although that is usually not advised).

Sole Proprietorship Example

- Jim is a farmer who starts a new side business. To get the business up and running, he incurs a large amount of debt to get his business started. He never acquires liability insurance.
- Due to the negligence of one of his employees, a customer is injured in a slip-and-fall incident. Jim loses a lawsuit in which the plaintiff wins \$1 million dollars against him because of the injuries suffered by the customer.
- What happens next?



Sole Proprietorship Example

- Because this is a sole proprietorship, the plaintiff can seek to collect the judgment by forcing a sale of Jim's farmland.

General Partnership

General Partnership

- A default entity when two or more people come together to conduct a business for profit.
- Partnerships can arise through conduct. If two people do business together and hold themselves out as partners, the law will treat them as a partnership.
 - Oral agreements to form a partnership are valid.

General Partnership Default Set-up

- Iowa has adopted the Uniform Partnership Code, Iowa Code chapter 486A. It has several default provisions:
 - A partnership is an entity distinct from its partners.
 - All partners have equal management authority and an equal obligation to contribute time, energy, and skill without compensation.
 - Can file a statement of authority limiting which partners may engage in which transactions.

General Partnership Default Set-up

- All partners share equally in profits and losses.
- All partners have **unlimited personal liability to the creditors of the partnership.**
 - This liability is only for debts incurred since the partner joined the partnership.
- A partnership is dissolved at the death of the partner or sale of partnership share.

General Partnership Taxation

- All income flows through the partnership and is taxed individually to each partner.
- Partnership files a Form 1065 to report partnership income, along with K-1s which allocate profits and losses among partners.

General Partnership

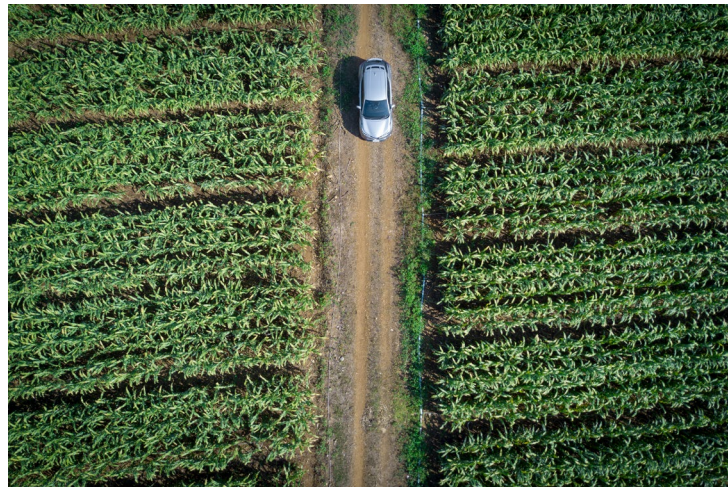
- Partners can enter into a written partnership agreement. Most of the default provisions can be altered by such an agreement:
 - Capital contributions;
 - Management;
 - Sharing of profits and losses;
 - Rights and obligations;
 - Terms of property ownership;
 - Termination and dissolution; and
 - Buy/sell agreements.

General Partnership

- But! Some provisions cannot be waived including:
 - Right of each partner to have access to books and records;
 - Fiduciary duties to partnership:
 - Each partner has a duty of loyalty and a duty of care.

General Partnership Example

- Sarah and Sam are siblings who farm together. They share their equipment and cash rent most of the ground. A passenger is severely injured when Sarah's grain truck (hauling the siblings' corn) strikes a car.
- Sam's personal assets (those outside of the partnership), such as the stock he inherited, can be at risk if a judgment is entered against the partnership.



Limited Partnership

Limited Partnership

- Iowa adopted the Uniform Limited Partnership Act, Iowa Code chapter 488.
- LPs must have one or more general partners and one or more limited partners.
 - General partners have the same obligations and liabilities as those of partners in a general partnership.
 - Limited partners contribute money or property to the partnership and are liable to the partnership **only up to the amount of their contribution.**
- Limited partners do not participate in the management of the partnership.
- Limited partnerships are pass-through entities for taxation purposes.

Example

- Grandpa owns 800 acres of farmland and rents it to his granddaughter.
- Granddaughter can't afford to farm on her own so Grandpa agrees to enter into a limited partnership agreement where he contributes the machinery and costs of inputs in exchange for a share of the profits.
- Grandpa provides no management or oversight.
 - If granddaughter is in an accident while driving her grain truck, Grandpa will only be liable up to the value of the machinery and inputs.
 - His farmland not at risk.

Example Two

- Lola “retires” from farming and creates a limited partnership with her son, Guido.
- Guido is the general partner and Lola is the limited partner.
- Every day, Lola gives Guido a “to-do” list.
- Lola maintains sole control of the partnership’s bank account.
- Would Lola be considered a limited partner for liability purposes?
 - Courts are going to look at the reality of the situation, not just paperwork.

Family Limited Partnership


- Family limited partnerships were once very commonly used as an estate planning tool.
 - Older generation that wants to retire and get out of management can still contribute assets to business, but is only liable up to the amount of the contribution (doesn't put other assets at risk).
- Another reason to have a limited partnerships is to reduce value of assets for estate valuation purposes.
 - Sale restriction means assets have lower value (marketability discount).
 - Minority owner's assets will be discounted using a minority interest discount.
 - These two together can mean assets valued at 40% less than market value.

FLP Example

- Parents own real estate worth \$5 million.
- They form a Family Limited Partnership, naming themselves as 10% general partners and 90% limited partners.
- They then begin gifting interests in the partnership to their children. They gift half of the limited partnership interests to children (45% of total).
 - These interests are valued with 30% or more lack of marketability/lack of control discount.
 - These limited partners can't make decisions.
 - Value \$2.25 million at \$1.575 million.

Limited Partnership

- Parties wishing to establish a limited partnership must **file a certificate** with the Iowa Secretary of State.

	PAUL D. PATE <i>Secretary of State</i> <i>State of Iowa</i>	APPLICATION FOR CERTIFICATE OF AUTHORITY (LIMITED PARTNERSHIP - Iowa Code chap 488)
<p>TO THE SECRETARY OF STATE OF THE STATE OF IOWA: Pursuant to section 902 of the Iowa Uniform Partnership Act, the undersigned limited partnership applies for a certificate of authority to transact business in Iowa, and states:</p>		
1. The name of the limited partnership is: _____		
1A. [See note 6] The name the limited partnership will use in Iowa, if different than the legal name of the limited partnership is: _____		
2. Is the foreign limited partnership a foreign limited liability limited partnership? <input type="checkbox"/> Yes <input type="checkbox"/> No		
3. The limited partnership is organized under the laws of the state [or foreign country] of: _____		
4. The date of organization of the limited partnership was: _____		
5. The duration of the limited partnership: _____		
6. The street and mailing address of its principal office is:		
Address _____		
City, State, Zip _____		

Corporation

Corporation

- A legal entity with rights and liabilities separate from shareholders.
- Shareholders are **only liable for the debts of the corporation to the extent of their investment in the corporation.**
- Shareholders elect a board of directors, which appoints officers to manage the corporation.
- Corporation is formed by filing articles of incorporation with the Secretary of State.

Corporation

- A corporation is managed in accordance with its bylaws.
- A corporation has a potentially unlimited duration.
- It does not dissolve upon the death of a shareholder, director, or officer.
 - Buy-Sell agreements often govern dispensation of the shares at death.
- Corporations must observe strict formalities or shareholders will lose liability protection.
 - Meetings
 - Records

Corporation

- Ordinary corporation income is double taxed.
 - First, corporation is taxed on the profits.
 - Shareholders are also taxed on the income they receive through dividends
- Corporations electing Subchapter S status are pass-through entities for taxation purposes (like a partnership).
 - Can only have 100 shareholders.
 - Often used to reduce Self-Employment tax.

Limited Liability Company (LLC)

LLC

- Emerged in 1977.
- Hybrid business entity considered to have the attributes of a partnership for federal income tax purposes and the limited liability protections of a corporation.
- **By far the most popular business entity.**
- Operational advantages of a partnership by allowing the owners (members) to participate in the management of the business.
- Members and managers are protected from liability in the same manner shareholders, officers, and directors of a corporation are protected.

LLC Options

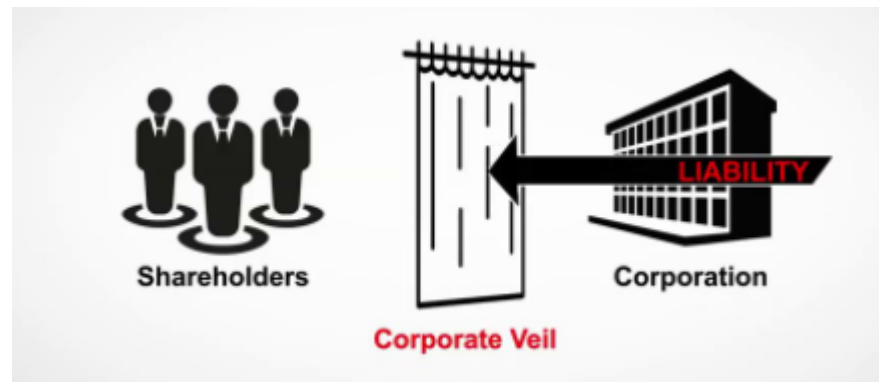
- Single Member.
- Multi-member.
- Professional LLC (Iowa Code 1102).
- Family Farm LLC (Iowa Code § 9H.9).
- Authorized LLC (Iowa Code § 9H.4).

LLC

- Personal liability and asset protection for members and managers (in the same manner as corporations).
 - Only liable up to the amount of the investment (in the absence of a piercing of the veil).
- Similar flexibility of a partnership or sole proprietorship.
 - Fewer formalities than a corporation.
- Choice of taxation structure:
 - Taxed like a partnership, C corporation, or S corporation.
 - Single member taxed like a sole proprietorship (disregarded entity).

LLC Danger

- Must keep finances separate and treat it as if separate entity or you will have “a piercing of the veil.”
 - Courts will set aside the benefit of limited liability and hold members personally responsible for the debts and actions of the LLC if there is serious misconduct such as fraud, intermingling of personal and business assets, or having under-capitalization at formation.



Statutory Law

- Iowa has adopted the Revised Uniform Limited Liability Company Act, Iowa Code ch. 489
 - Current version enacted in 2008, went into effect January 1, 2009.
 - LLCs began in Iowa in 1992.
 - Every state allows the LLC.

Formation

- One or more organizers may act to form an LLC by signing and delivering to the Secretary of State a Certificate of Organization.
- Iowa Code § 489.201.

LLC

- LLCs are managed according to an Operating Agreement.
- An LLC is an LLC *even if no formal operating agreement is adopted*. However, the best practice is creating a written operating agreement. This will be enforced like a contract.
 - Provides foresight for members.
 - Provides legitimacy.
- A LLC can be member-managed or manager-managed.

Iowa Secretary of State

- <https://sos.iowa.gov/search/business/search.aspx>

Additional Resources

- <https://www.extension.iastate.edu/agdm/wholefarm/html/c4-52.html>

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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 485A)
- 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 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.

File C4-52
Updated February, 2019
pdf format

Relative Advantages and Disadvantages of Various Business Forms

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

Questions?

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