Chapter 17.

Corporations

Closely held, family-owned tree farm corporations have increased in number during the past several decades in most States that have a substantial commercial timber acreage. Research findings indicate that estate planning considerations are a major rea-son for incorporation of nonindustrial tree farms. The corporate stock is typically owned by persons related by blood or marriage or both. Some non-industrial woodland corporations are also owned by unrelated shareholders, most of these are small and closely held.

CORPORATE FORMATION AND MANAGEMENT

A corporation is a distinct entity, separate from the shareholders who own it or from those who manage or work for it. Thus, a corporation can sue and be sued, enter into contracts, and own property--all in its own name. A corporation has most of the rights of an individual.

A corporation is formed by drafting the necessary documents and filing them with the designated State official, usually the Secretary of State. Generally, these documents consist of the corporate name, the nature of the business, the names and addresses of the incorporating parties, the corporate charter, and the articles of incorporation. State law specifies certain items to be addressed in the charter and articles of incorporation; others can be added by the incorporators. Additional documents may also be required, depending on the State in question. An incorporation fee will have to be paid and reports filed at least annually with the State.

Qualifying as a Foreign Corporation

Because a corporation is formed under the laws of a particular State, it cannot do business in other States without qualifying in them as a foreign cor-poration. This requirement should be considered if the timber land ownership in question lies in more than one State. However, occasional transactions outside the State of incorporation that do not occur on a regular basis generally do not constitute "doing business."

Limited Liability

Probably the most notable feature of a corporation is the limited liability status of its shareholders. Corporate debts and liabilities may be satisfied only from corporate assets. Thus, unlike partnerships, shareholder personal assets--other than investment in the corporate stock--are protected from corporate liability. If the shareholders commit substantial personal assets to the corporation, limited liability obviously has less meaning than if such assets are maintained outside the corporate structure.

Loss of Limited Liability--A corporate shareholder may lose his (her) limited liability in three ways: (1) if the shareholder is personally involved in a tort that gives rise to corporate liability; (2) if the shareholder personally signs a corporate contractual obligation--that is, signs without acting on behalf of the corporation; and (3) if the corporation fails to meet and maintain corporate organization and management requirements on a continuing basis.

Corporate Management

A corporation contains three clearly defined managerial groups: shareholders, board of directors, and officers. In a closely held family corporation, the same individuals often fill all these positions.

Shareholders.--The shareholders are the persons who have contributed money or property to the corporation in return for shares of stock. In some cases, the stock may have been received by gift or inheritance. The shareholders are the basic decision-making group. They approve changes in the corporate charter and articles of incorporation, and also elect the board of directors. Each shareholder has one vote for each share of voting stock. Most States permit nonvoting stock but a few do not.

Generally, a majority vote governs, and the holders of 51 percent or more of the stock have direct control over corporate decisions made at the shareholder level. The shareholders also indirectly control decision making at the other levels because of their power to elect the board of directors. Minority shareholders have little, if any, decision-making power unless permitted by the majority.

It is possible to grant minority shareholders greater participation in decision making. In most States, the vote level required for shareholder action may be increased from a simple majority to some higher level. The majority of States also allow cumulative voting. This procedure permits shareholders to multiply their votes by the number of directors to be elected and cast the entire number for one director. It helps insure that minority shareholders will at least be represented on the board of directors.

Board of Directors.--The board of directors is the policy-making body of the corporation. It develops corporate policy and long-range management strategies. The board also establishes the bylaws, which are written rules and guidelines for corporate structure and day-to-day management. The directors may receive fees for their services but are not salaried. In a family corporation, the fees may be waived. The selection of the officers is another important responsibility of the board.

Officers.--The officers are the day-to-day corporate decision makers. Usually in a small or family corporation these are a president, vice president, secre-tary, and treasurer. The officers often also function as employees and receive salaries. They are charged with executing policy developed by the board of directors. Authority to hire employees, sign negotiable instruments, enter into contracts, and borrow money may be granted to designated officers by the board.

INCOME TAX IMPLICATIONS OF INCORPORATION

Before addressing estate planning considerations related to corporations, a discussion of income tax implications is appropriate. An incorporated family tree farm is treated virtually the same with respect to expenditures as is a noncorporate timber ownership. Certain other aspects of corporate income taxation, however, differ from the rules applicable to individual woodland owners.

Depreciation

Although depreciation is handled in essentially the same way after incorporation as before, there are a few exceptions. One of these concerns the expense method of depreciation under Section 179 of the Internal Revenue Code (IRC). Section 179 previously permitted most taxpayers in a trade or business to immediately deduct rather than depreciate up to $10,000 of otherwise depreciable costs per tax year. The 1993 Revenue Reconciliation Act raised the maximum Section 179 deduction to $17,500 beginning in 1993. As under prior law, the maximum deduction phases out dollar-for-dollar for that portion of the total cost of qualifying property placed in service during the year that exceeds $200,000. For example, if $210,000 of qualifying property were placed in service during the year, the maximum deduction under Section 179 would be $16,500. With respect to corporations, members of a group of controlled corporations (discussed on page 109) divide the expensed amount. Normally, however, a family tree farm corporation will not be part of a group of controlled corporations. In that case, there is no difference in Section 179 treatment between corporate and noncorporate taxpayers.

Taxation of Corporate Income

Two methods for the taxation of corporate income are available to qualifying corporations. These are the regular method for so-called "C" corporations and the tax-option method for so-called "Subchapter S" corporations. Most closely held family tree farms will qualify for either method.

"C" Corporation.--If no Subchapter S election is made as discussed on page 109, a family woodland corporation will pay income tax under the regular method. Federal corporate tax rates were reduced in 1987 and increased slightly in 1993 by the 1993 Revenue Reconciliation Act. The current corporate rates are as follows:

Corporate taxable income			Marginal rate
0	-	$50,000	15 percent
$50,000	-	$75,000	25 percent
$75,000	-	$10,000,000	34 percent
over	-	$10,000,000	35 percent

An additional 5-percent surtax (for a maximum of $11,750) is imposed on a corporation's taxable income above $100,000. This provision will completely phase out the benefit of the 15- and 25-percent rates for corporations with taxable incomes of more than $325,000. For corporations with taxable incomes between $100,000 and $335,000, the 15- and 25-percent rate benefits will be partially phased out. Corporations with taxable income above $15 million also pay a 3-percent surtax on income above that

amount to a maximum of $100,000 extra tax. This recaptures the benefit of the 34-percent rate.

The attractiveness of the regularly taxed corporation is dependent on the relationship of corpor-ate income tax rates to the rates applicable to individuals. The top individual marginal rate on ordinary income is currently 39.6 percent as compared to the top marginal corporate ordinary rate (including surtax) of 39 percent. Although this represents little difference, the spread between corporate and noncorporate long-term capital gains rates is considerably greater. The maximum long-term capital gain rate for individuals is 28 percent; for corporations it is 39 percent at income levels where the 5-percent surtax applies. This is particularly significant in the case of corporate family tree farms where, presumably, most of the income would be from timber sales and thus capital gain.

In effect, formation of a regularly taxed corporation represents creation of a new taxpayer at the 15-percent rate for the first $50,000 of corporate taxable income and at the 25-percent rate for the next $25,000. This may save on income taxes for those shareholders whose individual rate is 28 or 31 percent, with respect to net income left in the corporation for business purposes or expansion. However, if the net earnings are removed from the corporation and paid to the shareholders as dividends, the shareholders will have to pay tax on the dividends received as ordinary income, resulting in the so-called "double taxation" associated with "C" corporations.

A group of controlled corporations cannot be used to circumvent the graduated corporate rate brackets. In other words, it is not possible to create two or more corporations with common ownership in order to take advantage of the reduced corporate tax rates on the first $75,000 of corporate taxable income. Thus, if two corporations are established with respect to a family tree farm--one to own the land and the other the timber--there will be only one set of graduated rate brackets below 35 percent. With no stipulation for unequal apportionment, each corporation would be taxed at 15 percent on the first $25,000 of taxable income and at 25 percent on the next $12,500.

Subchapter S Corporations

Although the double taxation of dividends associated with family owned "C" corporations can sometimes be avoided to a certain extent by making payments in the form of salaries and bonuses, which are deductible by the corporation, this method will never alleviate the problem entirely. Another problem concerns the corporation accumulating funds rather than using them to pay dividends. The so-called "accumulated earnings tax" is designed to discourage the buildup of funds within a corporation in excess of reasonable business needs. A corporation can accumulate up to $250,000 of earnings and profits without imposition of the tax. Beyond that level, accumulations are taxed at rates ranging from 27 1/2 to 38 1/2 percent unless higher accumulations are justified as being retained for the reasonable needs of the business. For those woodland corporations investing in additional timberland, the $250,000 level should pose no problem.

The Subchapter S corporation method of taxation was enacted in 1958 to remove the disadvantages of the regular corporate method of income taxation for small, family-owned corporations. If a corporation that meets the requirements (discussed on page 104) elects Subchapter S status by filing Form 2553 with the Internal Revenue Service (IRS), double taxation is eliminated. There is no taxation of earnings at the corporate level; only the dividends paid to the shareholders are taxed and then on their individual returns. For all other purposes, however, a Subchapter S corporation remains identical to a "C" corporation.

A Subchapter S corporation passes through to its shareholders their pro rata share of capital gains and losses, operating losses, business deductions, depletion allowances, tax exempt interest, and credits. The pass through is on a daily basis. These items are then reported by the shareholders on their individual income tax returns. Gains and earnings are taxed to the shareholders as if actually received, even if held by the corporation for expansion or paid out as dividends at a later time. Generally, dis-tributions from a Subchapter S corporation without earnings and profits are tax free to the extent of a shareholder's adjusted income tax basis in the stock (the amount of original investment in the stock not previously recovered). If a distribution exceeds a shareholder's adjusted basis, the excess is treated as a capital gain.

Distributions from a Subchapter S corporation can thus affect the income tax basis of the corporate stock. Undistributed taxable income on which tax is paid by the shareholders increases the basis of their stock. Losses and tax-free distributions of previously taxed income reduce the basis. To avoid later con-fusion over stock basis, the basis for each share-holder should be computed annually and made a matter of record.

Requirements for Electing and Maintaining Subchapter S Status

A number of requirements must be met in order for a corporation to elect Subchapter S status with the IRS and continue to maintain that status.

Shareholders.--There can be no more than 35 shareholders. Stock owned by both spouses, regardless of how it is held or in whose name, is considered to be owned by only one shareholder. A surviving spouse and the estate of a deceased spouse are also treated as only a single shareholder. Generally, all shareholders must be individuals or the estates of individuals. In certain limited circumstances, however, trusts can be shareholders. Nonresident alien shareholders are not permitted.

Stock.--A Subchapter S corporation can have only one class of stock outstanding. Differences in voting rights are allowed, however, and do not violate the requirement for a single class of stock. This can be an important consideration when minor children are shareholders. Preferred stock is not allowed.

Accumulated Earnings Carryover.--Some "C" corporations have accumulated earnings and profits when the Subchapter S election is made, which are carried over to the Subchapter S corporation. A Subchapter S corporation in this position cannot have passive investment income, such as interest, in excess of 25 percent of gross corporate receipts for more than 2 consecutive years. If it does, its Sub-chapter S status will be terminated. This rule could constitute a trap for the unwary Subchapter S tree farm that maintains an interest-bearing bank account in years in which no timber harvesting is done.

Election.--The election, as noted earlier, is made by filing Form 2553 with the IRS. It may be made at any time during the preceding taxable year, or on or before the 15th day of the 3d month of the taxable year in question. An election too late for 1 year may become effective the following year. All shareholders of record must consent to the election. It can be voluntarily revoked but only if the holders of more than half of the corporate stock consent to the revocation. Thus, a new shareholder by reason of gift or inheritance cannot unilaterally terminate the election, as was once allowed, unless he (she) owns a majority of the voting stock. The election can also be terminated by the IRS for failure to continue to meet the Subchapter S requirements.

In general, a new election cannot be made within 5 years of a revoked election without IRS consent. This provision was recently utilized by a Subchapter S corporation formed to hold and manage timber properties (Letter Ruling 9111036). The corporation obtained a new treasurer in 1986 who was unaware of the Subchapter S election and, thus, began filing conventional "C" corporation tax returns. In addition, the corporation, through the treasurer, had violated the 25-percent passive income rule because no timber sales had been made for a number of years due to depressed prices, but yet interest was earned on the accumulated earnings realized from the "C" corporation years. For these reasons, the IRS revoked the Subchapter S status in 1990. At the corporation's request, however, the IRS determined that the election had been inadvertently terminated because of the treasurer's lack of knowledge. It permitted the corporation to return to Subchapter S status in 1991 after filing amended tax returns for the tax years after 1987, paying additional taxes due, and eliminating the interest-bearing account until such time as timber sales were resumed.

ESTATE PLANNING CONSIDERATIONS

Certain characteristics of corporate ownership may enable it to more completely accomplish a forest landowner's estate planning objectives than will other forms of ownership. This is particularly true if the tree farm is to continue as an economic unit beyond the death of the parents as majority or sole owners.

Lifetime Transfer of Stock

When planning for continuation of the family tree farm, particular attention should be given to transfers of ownership and management from one generation to the next. This process is simplified with a corporation, in which ownership and control is facilitated by merely transferring shares of stock.

Parents who are sole owners or co-owners of forest property may be reluctant, for reasons of personal security, to make gifts of the property to the children in order to achieve death tax savings or business continuation. Their fear may be compounded by the fact that the donees are free to retransfer the property to others once the gifts are made. Restrictions on retransfers are often unenforceable. Even if gifts are otherwise acceptable, however, donations of forest land are not easily made--either in terms of undivided interests or as separate parcels (see chapter 8).

On the other hand, transfer of corporate stock

does not involve these disadvantages. Tree farm ownership can be divided into easily transferred shares of stock so that the gift or sale of stock translates into a proportionate share of the tree farm. Majority owners can dispose of some stock without losing control over decision making. They can be assured of continued employment as cor-porate officers and of control over corporate dividend policy. This eases the income security problem. Restrictions can also be placed on the retransfer of stock by those receiving it through gift or sale. Stock can additionally be used to channel tree farm income to low tax bracket taxpayers so as to mini-mize overall income tax liability.

Transfers to Minors

It may be desirable to transfer interests in the timberland to minors in order to reduce the family income tax burden or to encourage the minors to develop a greater involvement and interest in the tree farm. Minors, however, are not considered legally competent to manage their property. The transfers of property interests to minors have long created problems. Such gifts are usually made easier if the transfer is in the form of shares of corporate stock.

Uniform Gifts to Minors Acts.--Stock in a family corporation is eligible for transfer to minors under the Uniform Gifts to Minors Acts now available in every State. These statutes are relatively easy to use, inexpensive, and involve little red tape. They basically provide for a simple custodianship by which a bank or an adult holds and manages the property for the minor. Only gifts of stock, securities, or money are eligible for transfer in most States. Gifts of land and timber, by contrast, are generally not eligible. An important consider-ation is that, if the donor is also the custodian and dies before the child reaches majority, the amount of the property held would very likely be included in the donor's estate for death tax purposes. Therefore, the custodian should probably be someone other than the donor.

Unearned Income.--Unearned income of a child under age 14 who has at least one living parent will be taxed at the parent's marginal income tax rate if the child's investment income is more than $1,100 for the year. This rule may lessen the advantage of making transfers to young children.

Estate Settlement

A corporation is an entity that does not terminate when one of the owners (a shareholder) dies. On the other hand, at the death of an individual owner with fee title, all of his (her) property is normally subject to probate--a process during which all assets are usually administered by the estate representative. Upon the death of a corporate shareholder, in con-trast, only the corporate stock owned by the is sub-ject to probate and transfer--not the underlying assets. The stock, of course, must be valued for Federal estate and State death tax purposes, but operation of the tree farm may be continued without interruption.

Ancillary Probate.--If an individual owns real property in two or more States, a probate proceeding is normally required in each State. A probate court proceeding in one State cannot pass title to real property, including land and timber, in another State. Thus, the original probate proceeding is held in the State of residence and ancillary pro-bate in the other State(s). In the event that real property is owned in two State(s) by a corporation, however, ancillary proceedings are not required because corporate stock is personal property--not real property--and generally is subject to the law of the decedent's State of domicile at death.

Loss of Capital

The right of partition and sale (see chapter 15), which is generally available to joint tenants or tenants in common for terminating co-ownership arrange-ments, is not available to corporate shareholders. While those shareholders not actively participating in operation of the tree farm may have sufficient votes to dissolve the corporation, they do not have the option of receiving their portions through divi-sion or forced sale of the property. This corporate feature may cause disputes, however. Restrictions are often placed on retransfer of inherited or gifted stock, and minority shareholders have relatively few management rights.

Stock Purchase Options.--To avoid this problem, it may be advisable for those most concerned with continuity of the tree farm to gradually purchase the stock held by the other shareholders. A buy-sell or first option agreement could specify that the pur-chase price is to be paid either in cash or by installments over a period of time with interest.

As an alternative, stock could be permitted to pass to minority heirs with specific rights granted in regard to management, a minimum dividend level in conjunction with timber sales, and a ready market for their stock in the event they may wish to sell. This would balance corporate stability against minority shareholder rights.

Corporate Disadvantages

A corporation has estate planning disadvantages as well as advantages. Some can be resolved with proper planning, others cannot.

Subchapter S Corporations.--As discussed earlier, a Subchapter S corporation can have no more than 35 shareholders. If death and inheritance result in more than 35, Subchapter S status is lost. Another disadvantage is that a Subchapter S corporation's stock cannot be held by a trust except in certain limited instances, even though trusts are key estate planning devices (see chapter 10). It is not possible to establish a testamentary trust for minors, with the trust holding Subchapter S stock, and have the trust continue as a shareholder for more than a short period of time after the death of the grantor. Nor is it possible for stock in a Subchapter S corporation to be held by a marital deduction trust (see page 68).

Adjustment of Basis

One corporate attribute that may prove to be a decided disadvantage with respect to tree farms concerns the basis of the land and timber. Assets held until death receive a new income tax basis, which is generally equal to the fair market value of the assets on the date of the decedent's death or 6 months after. This adjustment in basis cancels out any unrecognized gain or loss on the property and the new basis provides values (depletion values in the case of timber) for computing future gains or losses upon sale.

Thus, when a shareholder dies, the shares of stock owned at death receive a new income tax basis equal to their value as determined for death tax purposes. But the basis of the underlying property, such as land and timber, in the hands of the corporation remains unchanged. Therefore, the sale of timber by a corporation after the death of a shareholder creates the same amount of taxable gain or loss as if the timber had been sold before the shareholder died. Also, depreciable property already fully depreciated by the corporation may not be placed on a new depreciation schedule with a new income tax basis after a shareholder dies. These features of the corporation may discourage incorporation by those older family members holding valuable timber assets that have a low basis.

Complexities and Expenses.--Incorporation is a more formal and complex method of organization than a partnership or sole proprietorship, and a corporation is more expensive to form and maintain. In addition to the legal cost of incorporation, most States impose an annual fee and require the filing of an annual report. The initial costs are deductible over the first 5 years, however, and subsequent costs are usually deductible annually.

Liquidation.--A corporation may usually be dissolved under State law either by written consent of all shareholders or by approval of the board of directors followed by a simple majority or higher vote of the shareholders. This process usually poses few problems. The greatest concern is the income tax consequences of liquidation as the corporate assets are distributed to the shareholders in exchange for their stock. A corporation can be formed rather easily without paying income tax on the gain in property transferred to the corporation. Liquidating a corporation, however, without adverse income tax consequences is more difficult. Basically, a liquidating corporation, including a closely held family corporation, recognizes gain or loss on the distribution of property that takes place in a complete liquidation as if the property had been sold at its fair market value.

Revised Estate Plans

Upon formation of a corporation, the wills and estate plans of each shareholder should be reviewed. Corporate stock is personal property and will pass as such at the death of the shareholder. If a will was drafted to pass real property, it may have become outdated by incorporation. If Subchapter S status has been elected, wills should be checked and revised, if necessary, to insure that the stock does not pass into a testamentary trust. If it does, the Sub-chapter S election will be lost after 60 days, and the corporation will revert to "C" corporation status and the double taxation rules.