Chapter 16

Corporations

Closely held family forest corporations exist in substantial numbers in most States with large commercial timber acreage. Fewer have been formed in recent years, however, with the move to limited liability companies and family limited partnerships. In the past, estate planning considerations were a major reason for incorporation of nonindustrial forest land. The corporate stock typically is owned by persons related by blood or marriage or both. Some nonindustrial forest land corporations also are owned by unrelated shareholders; most of these are small and closely held.

Corporate Formation and Management

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

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. Additional documents may be required as well, 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 corporation. This requirement should be considered if the forest 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

Perhaps 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 general partnerships, shareholder personal assets—other than their 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 any of 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; or (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 voting 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 allows shareholders to multiply their votes by the number of directors to be elected and cast the entire number for one director; it helps ensure that minority shareholders will 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 decisionmakers. Usually in a small or family corporation these are a president, vice president, secretary, 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 forest is treated virtually the same with respect to expenditures as is a noncorporate forest ownership. Certain other aspects of corporate income taxation, however, differ from the rules applicable to individual forest landowners.

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 permits most taxpayers in a trade or business to immediately deduct, rather than depreciate over a period of years, up to $128,000 of otherwise depreciable costs per tax year [2008, as set by the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28)]. 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 $500,000. For example, if $547,000 of qualifying property were placed in service during the year, the maximum deduction under section 179 would be $81,000 [$128,000 – ($547,000 – $500,000)]. With respect to corporations, members of a group of controlled corporations (discussed below) divide the expensed amount. Normally, however, a family forest 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 corporations will qualify for either method.

"C" Corporation

If no Subchapter S election is made as discussed below, a family forest land corporation will pay income tax under the regular method. The current corporate marginal tax rates are as follows:

Corporate taxable income over	But not over	Marginal tax rate
$0	$50,000	15 percent
$50,000	$75,000	25 percent
$75,000	$100,000	34 percent
$100,000	$335,000	39 percent
$335,000	$10,000,000	34 percent
$10,000,000	$15,000,000	35 percent
$15,000,000	$18,333,333	38 percent
$18,333,333	–	35 percent

The chart reflects a 5-percent surtax, to a maximum of $11,750 in additional tax, imposed on corporate taxable income above $100,000 and a 3-percent surtax on taxable income above $15 million, to a maximum of $100,000 in additional tax. The 5-percent surtax entirely eliminates the benefits of the 15- and 25-percent brackets for corporations with taxable income over $335,000, and partially eliminates the benefits of the 15- and 25-percent tax brackets for corporations with taxable income between $100,000 and $335,000. The 3-percent surtax recaptures the benefit of the 34-percent tax bracket for corporations with taxable income over $15 million.

The attractiveness of the regularly taxed corporation depends on the relationship of corporate income tax rates to the rates applicable to individuals. For individuals, the top marginal tax rate for ordinary income currently is 35 percent, compared to 39 percent (including surtax) for corporations, as shown above. While this may be considered a small difference, the spread between corporate and noncorporate long-term capital gain rates is considerably greater. For individuals, capital gains are taxed according to a different rate schedule from ordinary income, with a maximum tax rate of 15 percent for most long-term capital gains. However, for corporations, capital gains are taxed according to the same rate schedule as ordinary income, with a minimum rate of 15 percent and a maximum rate of 39 percent (including surtax). This is particularly significant in the case of corporate family forest lands where, presumably, most of the income would be from timber sales and thus a 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 represent a tax saving for shareholders whose individual rates are higher than 25 percent with respect to ordinary income left in the corporation for business purposes or expansion. If, however, the net earnings are then removed from the corporation and paid to the shareholders as dividends, the shareholders will have to pay an additional tax on the dividends, 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 forest land—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 a 15-percent rate unless higher accumulations are justified as retained for the reasonable needs of the business. For those family forest land corporations investing in additional forest holdings, the $250,000 level should pose no problem—particularly in light of the fact that amounts in excess of that level can be justified for business purposes.

Method of taxation—The Subchapter S corporation method of taxation was enacted in 1958 to remove the disadvantages of the regular corporate method of income taxation, as outlined above, for small, family-owned corporations. If a corporation that meets the requirements (discussed below) elects Subchapter S status by filing Form 2553, Election by a Small Business Corporation, 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 shareholders are taxed—on their individual returns at their individual rates. For all other purposes, however, a Subchapter S corporation remains identical to a "C" corporation.

Distributions—A Subchapter S corporation passes through to its shareholders their pro rata share of capital gains and losses, ordinary income or losses, business deductions, depletion allowances, tax exempt interest, and credits, on a daily basis. The shareholders then report these items 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 to be paid out as dividends at a later time. Generally, distributions 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.

Effect on basis—Distributions from a Subchapter S corporation thus can 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, while losses and tax-free distributions of previously taxed income reduce the basis. To avoid later confusion over stock basis, the basis for each shareholder 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.

There can be no more than 100 shareholders, although multiple members of a family may elect to be treated as one shareholder. A family member is defined as a common ancestor, the lineal descendant of the common ancestor, and the spouses (or former spouses) of the ancestor and the descendants. A surviving spouse and the estate of a deceased spouse also are treated as one 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 two consecutive years. If this occurs, its Subchapter S status will be terminated. This rule could constitute a trap for the unwary Subchapter S forest land that maintains an interest-bearing bank account in years in which no timber harvesting is done.

Election—The election, as noted above, is made by filing IRS Form 2553, Election by a Small Business Corporation. It may be made at any time during the preceding taxable year, or, on or before the 15th day of the third month of the taxable year in question. An election made too late for one year becomes effective for the following year. All shareholders of record must consent to the election. The election can be voluntarily revoked, but only if the holders of more than 50 percent of the outstanding shares of stock (voting and nonvoting) consent to the revocation. Thus, a new shareholder by reason of gift or inheritance cannot unilaterally terminate the election, as once was allowed, unless he (she) owns a majority of the stock. The election also can 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 forest properties (Private Letter Ruling 9111036, December 17, 1991). In 1986, the corporation obtained a new treasurer who was unaware of the Subchapter S election and thus began filing conventional "C" corporation tax returns. In addition, the corporation—through the treasurer—violated the 25-percent passive income rule because no timber sales were made for a number of years due to depressed prices, but 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 terminated inadvertently 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 timber sales were resumed.

Estate Planning Considerations

Certain characteristics of corporate ownership may enable a more complete accomplishment of a forest owner's estate planning objectives, depending on personal goals and the particular facts of the situation, than might other forms of ownership. This particularly is true if the forest land 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 forest enterprise, 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 merely by transferring shares of stock.

Parents who are sole owners or co-owners of a forest property may be reluctant, for reasons of personal security, to make gifts of the property to their children in order to achieve estate 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 often are unenforceable. Even if gifts are acceptable, donations of forest land are not easily made—either in terms of undivided interests or as separate parcels (see chapter 8).

In contrast, transfer of corporate stock does not involve these disadvantages. Forest land ownership can be divided into easily transferred shares of stock so that their gift or sale translates into a proportionate share of the forest. Majority owners can dispose of some stock without losing control over decision making. They can be assured of continued employment as corporate officers and of control over corporate dividend policy, which eases the income security problem. They also can place restrictions on the retransfer of stock by those receiving it through gift or sale. Additionally, they can use stock to channel forest land income to low tax bracket taxpayers so as to minimize overall income tax liability.

Transfers to Minors

It may be desirable to transfer interests in the forest land 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 forest operation. Minors, however, generally are not considered legally competent to manage their property. The transfers of property interests to minors have long created problems. Such gifts usually are 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. Basically, they 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 generally are not eligible. An important consideration is that, if the donor also is 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 probably should be someone other than the donor.

Unearned income—Unearned (investment) income of a dependent child under age 19 at the close of the tax year—or under age 24 if the child is a full-time student and has at least one living parent—generally will be taxed at the parent's top marginal income tax rate if the child's investment income exceeds the sum of the standard deduction for dependents ($900 in 2008) and the greater of $900 or the itemized deductions directly connected to the production of that investment income. This rule may lessen the advantage of making transfers to children.

There are two exceptions to the general rule. The first is if the child files a joint return with his (her) spouse for the tax year; the second is for funds distributed from a qualified disability trust as defined under IRC section 642. These distributions are treated as earned income.

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 normally is subject to probate—a process during which all assets usually are administered by the estate representative. Upon the death of a corporate shareholder, only the corporate stock owned by the decedent is subject to probate and transfer, not the underlying assets. The stock, of course, must be valued for Federal estate and State death tax purposes, but the forest enterprise may be continued without interruption.

Ancillary probate—If an individual owns real property in two or more States, a probate proceeding normally is 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 probate in the other State(s). In the event that a corporation owns real property in two or more States, however, ancillary probate 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 14), which generally is available to joint tenants or tenants in common for terminating co-ownership arrangements, is not available to corporate shareholders. While shareholders who are not active participants in the operation of a corporate forest enterprise may have sufficient votes to dissolve the corporation, they do not have the option of receiving their portions through division or forced sale of the property. This particular corporate feature may cause disputes. Restrictions often are 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 forest enterprise to gradually purchase the stock held by the other shareholders. A buy-sell or first option agreement could specify that the purchase 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 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, while others cannot.

Subchapter S corporations—As discussed above, a Subchapter S corporation can have no more than 100 shareholders. If death and inheritance increase the number of shareholders to more than 100, 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 a key estate planning device (see chapter 9). 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 permitted for stock in a Subchapter S corporation to be held by a marital deduction trust (see chapter 9).

Complexities and expenses—Incorporation is a more formal and complex method of organization than a sole proprietorship or partnership, and a corporation is more expensive to establish 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 usually are deductible annually.

Liquidation—A corporation generally can 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, but it can be difficult to liquidate a corporation without adverse income tax consequences. 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.

Death of a shareholder—Upon the death of a shareholder, the shares of stock owned by the decedent will (under current law) receive a "stepped-up" basis to market value as of the date of death (or alternate valuation date if elected). The underlying assets—such as forest land owned by the corporation—are a determinant in the value of the stock, but do not themselves receive a stepped-up basis.

Revised Estate Plans

When a corporation is formed, 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 ensure that the stock does not pass into a testamentary trust. If it does, the Subchapter S election will be lost after 2 years and the corporation will revert to "C" corporation status.