Family Business Entities

SOLE PROPRIETORSHIP / SOLE OWNERSHIP

A profit-motivated business of one — the owner is the company. This is the most common structure for a small family business.

TAXATION: The income and losses of the business are reported directly on the owner's tax return.

PROS: It is simple to establish, and startup costs are low. Relatively speaking, accounting is easy and taxes are simple to prepare. It is also fairly simple if you decide to sell the business. Only one person makes decisions for the business.

CONS: Personal and business assets are treated the same. This may sound ideal for simplicity, but it means that personal assets are not protected against liability resulting from your business. This results in unlimited personal liability risk. Because one person owns the business, the business typically ends when the owner dies; land passes outright to a successor the owner names on the deed or in the owner's will.

ESTATE AND GIFT ISSUES: The value of the business or land is the fair market value of the assets at the date of death. It is not possible to transfer ownership prior to death because of the one-owner structure; however, the business can always be sold prior to death.

GENERAL PARTNERSHIP (GP) / JOINT OWNERSHIP / TENANTS IN COMMON

Very similar to a sole proprietorship except there is more than one owner conducting business for profit. Under the Uniform Partnership Act that Virginia has adopted, each partner has equal management authority and equal share of the profits and losses. Similarly, each partner is individually financially liable for

the debts of the business. A general partnership may be oral or written; however, having written contracts is typically recommended. Joint tenancy (spouse) or tenancy in common (in land operated as a business) creates a general partnership among the joint tenants.

TAXATION: The partnership pays no tax, but it files a tax return (Form 1065) to report the income or loss of the business. Schedule K-1 is issued by the partnership to each partner indicating the individual partner's share of income. The partners then report their respective share of the partnership income on their individual tax returns. Owners/partners are not considered employees, and thus no payroll tax reporting is required for owner salaries.

PROS: Partners can pool finances and share the creativity and the workload. Taxes and accounting are relatively simple. Partners can organize the affairs and structure of the partnership as they see fit, with few statutory restrictions.

CONS: Similar to a sole proprietorship, each partner has unlimited personal liability risk. Partners share liability and responsibility for one another's actions. Potential for disagreement and conflict is greater than in a sole proprietorship. General partnerships terminate at the death or bankruptcy of any partner. Written buy-sell agreements are important to determine what happens to the business and the land when an owner dies. Individual owners (tenants in common or joint tenants) in the land (and their creditors, including divorcing spouses) can demand their share of the fair market value of the property at any time and force the sale of the property to get their share (a partition action). This creates an unstable and unpredictable situation for the property and the remaining owners.

ESTATE/GIFT ISSUES: In joint tenancy, the ownership passes to the joint tenant(s) automatically at death. Tenancy in common and partnership interests pass to the heirs of the tenant/partner if there is no written buy-sell agreement between the partners. The value is based on the value of the individual's ownership interest, reduced by any transaction costs that may be necessary for the owner to get his/her cash out of the business or file a partition action.

LIMITED PARTNERSHIP (LP)

A partnership where certain partners have limited liability. Per the Uniform Limited Partnership Act adopted by Virginia, an LP must have at least one general partner and one or more limited partners. Typically, the limited partner(s) supply cash or other property, such as forestland. The general partner(s) is the partner who manages the business.

TAXATION: As with a general partnership, taxes are paid at the individual level with a partnership tax return prepared annually.

PROS: The liability of a limited partner is limited to the amount of his/her investment in the business. It is possible to have only one partner, which means, like a sole proprietorship, business decisions may be made by only one person.

CONS: A general partner has unlimited personal liability risk. A limited partner has no control over business decisions. Unlike a GP, an LP must be created by filing with the Secretary of State. In Virginia an LP must file an annual report to be recognized under Virginia law.

ESTATE/GIFT ISSUES: Same as a general partnership.

FAMILY LIMITED PARTNERSHIP (FLP)

A limited partnership made up of family members. Just as with an LP, one or more general partners have unlimited personal liability risk for the business and operate the business for the benefit of the limited partners. The limited partners are investors in the business, are not active in management, and have limited liability for the debts of the partnership up to the amount of their investment.

TAXATION: Same as GP and LP.

PROS: A widely used form of business for family businesses, farms, and forests because it allows the general partners (generally tne parents) to begin sharing ownership of the property with their children while retaining control of the property and to create an ongoing management structure.

CONS: General partners have unlimited liability. Limited partners risk losing their liability protection when they get involved in management. FLPs may be required to terminate at the death of a general partner, and/or within 50 years of formation, so they lack unlimited life. Often the complexity of an FLP is greater than that of an otherwise similar GP or LP.

ESTATE/GIFT ISSUES: Both the general and limited partnership interests are easily transferred. Buy-sell provisions written into the general agreement control how these transfers are made and what restrictions exist on transfer, including how interests are to be valued. The value of a partner's interest is based on the assets and cash flow of the business, reduced by any restrictive provisions in the agreement. Ownership transfer typically happens within the FLP by transferring ownership in annual incremental amounts under the annual gift tax exemption to maintain the full estate exclusion amount.

LIMITED LIABILITY COMPANY (LLC)

A business structure combining some of the best features of corporations and partnerships. Owners are called members; those with decision-making authority are called managers.

TAXATION: Same as a GP.

PROS: All members of an LLC have the liability protection of a corporation but are taxed as a partnership (or a sole proprietorship if only one member). The agreements have wide flexibility in how they are drafted, giving families the ability to craft the special provisions that will protect the property and create an intergenerational management structure. The managing member of the LLC functions in the same role as the general partner of an FLP or LP, but enjoys limited liability protection. Non-managing members do not lose their liability protection when they get more involved in the business. Profit distribution is flexible, and there's no legal requirement to keep meeting minutes (though it is highly recommended). Like corporations, LLCs can be drafted to have unlimited life. This form of ownership is becoming the preferred method for ownership and transfer of land between generations because of its flexibility and liability protection.

CONS: If the business has debt, many lending institutions won't lend to it unless all the members sign personal guarantees. In such a case, an FLP or LP, in which only the general partner has to guarantee the debt, may be the better choice.

ESTATE/GIFT ISSUES: Same as FLP.

S CORPORATION

An IRS designation for corporations that allows taxation similar to that of a partnership or sole proprietorship, but provides corporate liability protection to all shareholders.

TAXATION: Special rules give shareholders tax treatment similar to that of partnerships, with exceptions. Shareholder employees are considered to be employees, and payroll reporting is required for the shareholder salaries. Reasonable salaries are required to be paid to all shareholders working in the business.

PROS: An S Corporation avoids the double tax burden placed on corporate profits. All shareholders have protection from liability. Self-employment tax may be less than under a partnership.

CONS: Only one class of stock is permitted. The form, language, and structure of the corporation is defined by state law, giving owners little flexibility in drafting agreements. Distributions to owners are required to be exactly equal. An S corporation requires annual corporate meetings with minutes. All appreciation in the value of assets, including land, is taxed if land is transferred out of the corporation or if the corporation is dissolved. This makes S corporations (and C corporations) unsuitable for owning and holding real estate.

ESTATE/GIFT ISSUES: Transfers of stock are controlled by corporate statute and limited by any buy-sell agreements that may exist between the shareholders. There are limitations on transfers of interests to charities. No transfers are allowed to corporate shareholders.

C CORPORATION

A legal entity formed by one or more shareholders under state laws. It offers both liability protection for owners and favorable tax treatment for the accumulation of capital inside the corporation.

TAXATION: Corporations pay taxes on their income at corporate tax rates. Distributions (dividends) from corporations are not deductible to the corporation but are taxable to the shareholder (the double tax burden).

PROS: Corporate tax levels, while variable, may be lower than those for sole proprietorships or partnerships. A corporation can issue common and preferred shares with different rights for each shareholder class. Shareholders are protected from liability. Corporations easily allow unrelated individuals to pool capital and resources to conduct business.

CONS: Corporations are creatures of statute and thus offer limited flexibility for drafting special provisions required for intergenerational planning. The only way to get money out of a C Corporation is through salaries or dividends, creating a double tax burden for family ownerships. Appreciation on property is taxed the same as in an S Corporation when property is transferred out of the corporation or when the corporation dissolves. Corporations do not have the benefit of reduced capital gains tax rates, making them unattractive tax-wise for timber-owning businesses.

ESTATE/GIFT ISSUES: Transfer of stock is controlled by corporate statute, limited by any buy-sell agreements that many exist between the shareholders.