

**2010 TENNESSEE AGRITOURISM  
CULTIVATING FARM REVENUE  
CONFERENCE**



**CHOICE OF ENTITY**

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# Selection of Business Entities

- Each type of business entity has advantages and disadvantages
- The choice of a particular entity depends on how the entity performs on a number of factors such as:
  - Management and Control
  - Owner Liability
  - Taxation
  - Transferability of Ownership Interest
  - Start-up Costs
  - Administrative Costs
  - Continuity of the Business Entity

# Management and Control

- Some entities allow the business to be run by a single individual
- Other entities allow or require other owners to have a say in the management and control of the business

# Owner Liability

- Some entities such as sole proprietorships or general partnerships do not protect the owner from business debts and other obligations
- Other entities such as corporations and LLCs do protect the owner from these types of liabilities

# Taxation

- Some entities such as corporations are “double taxed”
  - Both the corporation itself and the owners must pay taxes on profits
- Most entities are “pass through entities”
  - These entities do not pay taxes themselves
  - Instead the tax obligation for profits “passes through” to the owners

# Transferability of Ownership Interest

- Easy transferability makes the entity more attractive to outside investors and makes it easier to raise additional capital
- Stricter transferability give the present owners control over who may become an owner and how those ownership interests are transferred

# Start-Up Costs

- Some entities such as a sole proprietorship or partnership have little or no start-up costs
- Others such as corporations and LLCs require the entity to be registered with the Secretary of State, along with paying annual filing fees

# Administrative Costs

- Some entities require annual meetings in order for the business to continue to qualify as those particular entities
- Failure to comply with these requirements can lead to the dissolution of the legal entity

# What are the Legal Entities?

- Sole Proprietorships
- Partnerships
  - General Partnerships
  - Limited Partnerships
  - Limited Liability Partnerships
- Corporations
  - S Corporations
  - C Corporations
- Limited Liability Companies

# Sole Proprietorships

- Organization
  - Simplest legal entity
  - There is no distinction between the business and the individual owner
  - Owned by a single individual who is personally responsible for all the debts and obligations of the business
- Formation
  - No agreements or filings with the State are necessary to operate as a sole proprietor
    - Exception: Licenses or permits may be required for certain businesses such as salons, restaurants, etc.
- Taxation
  - Any income or profit earned by the business is treated as income earned by the owner
    - All profits (or losses) are reported on the individual's own tax return
    - Sole proprietorships are subject to self-employment taxes (contributions to Social Security and Medicare)

# Sole Proprietorships

- Transferability
  - Transfer of sole proprietorships is accomplished by transferring the individual assets and/or liabilities associated with the business
- Termination
  - No formal procedure is required
  - Stop doing business
  - Death of the owner

# Sole Proprietorships

- Advantages
  - Exclusive ownership
  - Taxed at personal income tax rate
  - Little to no start up costs or fees
- Disadvantages
  - Personal liability for all profits, debts, and other obligations of the business
  - Difficult to transfer the business to another owner

# General Partnerships

- Organization
  - General association of two or more individuals, partnerships, corporations, or other entities for the purpose of carrying on, as co-owners, a business for profit
  - Any partner may legally bind the partnership to any deals/ contracts
    - However, the capacity to bind the partnership may be limited by a written partnership agreement
  - Unless otherwise specified, partners share profits and losses equally
    - Can have different ownership and distribution rights if spelled out in written agreement
  - Unless otherwise specified, each partner has equal rights in the management of the partnership business
  - All partners are liable for the debts of the partnership

# General Partnerships

- Formation

- No filing requirements
- Formed by oral or written agreement
  - Can also be implied by the conduct of the partners
- Written partnerships are recommended

- Transferability

- A partner can assign his rights to a third party who gets the right to share in the profits and losses of the business, but not the right to participate in the management
- Can gift/transfer partnership interests if addressed and approved in written agreement
- Buy-Sell provisions should be addressed in written partnership agreement

# General Partnerships

- Termination of the partnership
  - Bankruptcy, withdrawal, or death of any partner

# Limited Partnerships

- Two types of partners: general and limited
  - General Partners
    - Same rights as in a general partnership
    - Must have at least one general partner in a limited partnership
  - Limited Partners
    - Invests capital in the partnership but does not the right to participate in the management of the partnership business
    - Liability limited to the amount of his capital investment
    - If limited partner participates in the management of the partnership, then he can lose his limited status and become personally liable for all debts and obligations

# Limited Partnerships

- In Tennessee, a limited partnership must file a Certificate of Limited Partnership with the Tennessee Secretary of State
  - Filing fee is \$100
  - Any changes made to the limited partnership require the filing of an amendment with the Tennessee Secretary of State
  - Partners must draft a Limited Partnership Agreement that specifically states how the partnership is to be structured and operated
- Tennessee Limited Partnerships are required to pay franchise and excise taxes to the Tennessee Department of Revenue

# Limited Liability Partnerships

- All partners enjoy a reduced form of limited liability in that they are not normally personally liable for the negligence of another partner
  - However, partners are still liable for their own negligence
- Usually limited liability partnerships benefits associations of professionals such as doctors, lawyers, or accountants to protect against the malpractice claims against a partner
- Subject to Tennessee Franchise and Excise Taxes

# Partnerships

- **Advantages**

- Depending on type of partnership and written agreement, management authority may be equal or delegated
- Taxed at personal income tax rate
- Little to no start-up costs or administrative fees
  - Limited Partnerships and Limited Liability Partnerships have filing fees, renewal fees, and franchise and excise taxes

- **Disadvantages**

- Depending of the type of partnership, personal liability for all profits, debts, and other obligations of the business
- Without written agreements, cannot transfer interest in right to manage the business

# Corporations

- A corporation is a legal entity separate and distinct from its owners
  - Corporations can sue or be sued, enter into contracts, hold title to property, and transfer property
  - Tennessee recognizes two types of corporations: C Corporations and S Corporations
- The formation, operation, and dissolution of a corporation are heavily governed by the laws of the state in which the corporation was incorporated
- A corporation incorporated in one state can do business in another but it must qualify as a foreign corporation by filing with those states to do so

# Corporations

- Formation
  - A Tennessee corporation is formed by filing a charter/ article of incorporation with the Tennessee Secretary of State and by paying a \$100 filing fee
  - A name for the corporation must be chosen
    - Name must be distinct from existing corporation
  - Stock must be issued to the owners or shareholders
  - By-laws must be drafted and approved
  - Initial board members and officers must be chosen
- Structure
  - Board of Directors
    - Shareholders elect the board
    - Responsible for making policy decisions concerning the operation of the corporation

# Corporations

## – Officers

- The board of directors elect officers who oversee the day-to-day activities of the corporation
- Typically include a Chief Executive Officer, Secretary, and Treasurer

## – Shareholders

- Elect board of directors
- Vote to amend corporate charter and by-laws, and approve major decisions
- Often in closely held corporations, shareholders are often involved in the management of the business as officers and/or board members

# Corporations

- Stock
  - Common Stock
    - Represents ownership of the residual value of the corporation, or the difference between the corporation's assets and liabilities
    - Each share gives its holder the right to one vote in shareholder elections
  - Preferred Stock
    - Given certain rights over common stock
      - Examples: fixed dividend, or greater right to corporate assets upon the liquidation of the corporation
    - Often has either reduced or no voting rights

# Corporations

- Liability
  - Corporations are liable for their own debts and obligations
  - Shareholders are not personally liable for the corporation's debts and obligations
    - Note: The limited liability of shareholders can be set aside if shareholders fail to observe the legal requirements for properly organizing and operating a corporation

# Corporations

- Transferability
  - Shares of stock are freely transferable
  - Subsequent owners of the stock have the same rights prior shareholders had
  - Easy transferability gives corporations an advantage in raising capital
  - Transferability can be restricted with a Stock Restriction Agreement for control and continuity of business

# Corporations

- Taxation
  - C Corporations are subject to double taxation
    - The corporation itself must pay taxes on its profits
    - Shareholders are taxed on any dividends issued by the corporation
    - Note: Many closely held corporations avoid double taxation by paying salaries to shareholders who serve as officers or employees

# Corporations

- S Corporations – Not directly taxed
  - The corporation itself does NOT pay taxes on its profits
  - Profits and losses of the corporation pass through to the shareholders and they pay the taxes
- All corporations are subject to Tennessee Franchise and Excise Taxes

# Corporations

- Advantages of Corporations
  - Limited liability for all owners
  - Perpetual existence
  - Easy to transfer ownership
  - Also easy to restrict ownership as desired with written agreement
- Disadvantages
  - Costly to form and operate (filing and annual fees)
  - Higher tax burden for C Corporations

# Limited Liability Companies

- Organization
  - Combines favorable aspects of partnerships and corporations into a single entity
    - Can elect to be taxed as a partnership
    - LLCs are distinct and separate entities from their owners
    - All owners have limited liability and can still participate in the management of the business

# Limited Liability Companies

- Structure

- Member-managed

- Each member has equal rights in the management and conduct of the LLC's business
    - Any matter related to the business is decided by a majority vote of the members
    - Voting rights can be addressed in Operating Agreement

- Manager-managed

- Each manager has equal rights in the management and conduct of the LLC's business
    - Any matter related to the business is decided by a majority vote of the managers
    - Managers are appointed or elected by majority vote of members and need not be members themselves

# Limited Liability Companies

- Structure

- Director-managed

- All LLC powers are exercised under the authority of its board of directors
    - Any matter relating to the business of the LLC is decided by the board of directors
    - Directors are appointed or elected by the members of the LLC but they do not have to be members themselves
    - A president must be appointed or elected by the board of directors and he acts as the agent for the LLC

# Limited Liability Companies

- Taxation
  - Can elect to be taxed in two ways
    - Taxes pass through the LLC and fall directly on the members, or
    - The LLC itself pays taxes and its members pay taxes on any distributed profits
  - Subject to Tennessee Franchise and Excise Taxes

# Limited Liability Companies

- Formation
  - File Articles of Organization with the Tennessee Department of State
  - Written Operating Agreement
  - Required to file annual reports with the State and pay annual fees

# Limited Liability Companies

- Advantages
  - Variety of ways to structure management of the company
  - Limited liability for all members
  - Ability to be taxed at personal income tax rate
- Disadvantages
  - Costly to form and operate (filing and annual fees)

# Franchise and Excise Taxes

- Any limited liability entity (LP, LLP, LLC, Corp.) in Tennessee is subject to franchise and excise taxes
  - Excise tax is 6.5% of the net earnings in Tennessee for that year
  - Franchise tax is equal to .25% of the greater net worth or the book value of real or personal tangible personal property owned or used, with a minimum tax of \$100 a year

# Franchise and Excise Tax

- Family Owned Non-Corporate Entities
  - Passive income was previously exempt from Tennessee franchise and excise taxes, but the law has recently changed
  - Effective July 1, 2009, industrial and commercial rent is no longer exempt and is now subject to franchise and excise taxes
  - Farm income and residential income (fourplex or less) is still exempt
  - Annual exemption form must be filed along with a Disclosure of Activity Form
  - Option: Become obligated member entity to avoid tax, but this causes loss of limited liability

# Conclusion

- Each business entity has its advantages and disadvantages
- One entity may suit your needs much better than another
- Key is to communicate accurate facts and goals to professional advisors – attorneys, CPAs, financial planners - and make good informed planning decisions AND follow through