MANAGEMENT CONSIDERATIONS IN ORGANIZING A FAMILY FARM CORPORATION

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ABSTRACT

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As family farm businesses continue to grow in size and complexity, there has been increased interest in the use of the corporate form of business organization. The purpose of this study is to provide Michigan farmers with information on the potential use of the corporation under Michigan conditions.

The legal features, advantages, and disadvantages of closely-held farm corporations are presented and examined along with related Internal Revenue Code provisions. Representative case studies are used to estimate possible annual tax savings available at different net farm income levels and to analyze the possibilities for estate tax reduction through the use of common corporate estate planning tools.

The results of this research indicate that annual tax savings and estate planning considerations are the two main categories to take into consideration when analyzing the benefits available through incorporation. However, the possibilities for benefits will vary with the particular farm situation.

ACKNOWLEDGMENTS

Several people deserve special recognition for assisting me in completing this study. I would like to express special thanks to Dr. Ralph Hepp who served as my major professor and thesis advisor. His professional guidance throughout my graduate study has been invaluable. I am extremely grateful for the tremendous amount of time he has devoted in assisting me with this research project.

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CHAPTER I

INTRODUCTION

A. Changes in Business Organization Among Farmers

Throughout history, the traditional form of business organization among American farmers, as well as Michigan farmers, has been the sole proprietorship. This sole proprietorship has been characterized by the farmer himself owning the entire farm business and also supplying the capital, labor, and management. In other words, he has been his own employer and boss.[1]

Today, the sole proprietorship is still the dominant form of business organization among American farmers. It will probably continue to be an effective form of business organization for many farmers in the future. However, its use in agriculture may not be as universally widespread among farmers in the 1980s and beyond because of certain trends taking place in agriculture.

Since World War II, there has been a distinct trend toward larger farms and increased mechanization. This has resulted in farmers controlling increasing amounts of capital assets.

Worldwide inflationary pressures in the 1970s have further increased the value of farm assets--especially farmland. In fact, some

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[1]For purposes of simplicity and easier reading, "he" is used throughout this thesis rather than "he and she." "He" is used in its grammatical sense and refers to women as well as men.

areas have seen farmland values increase fourfold in less than five years.

Also in the 1970s, there has been a growing importance of foreign markets to American agriculture. This expanding foreign market has resulted in very dramatic swings in prices paid to farmers for their raw commodities. Such widely fluctuating prices subject farmers to great financial risk.

The net result of these trends has been an increasing importance being placed on the capital aspect of the farm business. Not only have the capital needs grown, but there has been an increasing demand being placed on the financial management of the farm business.

B. Partnerships and Corporations

Since every farm operation has differing characteristics and objectives, there is no one "best" type of business organization for all farms. However, certain attributes of the partnership and corporate form of business organization may make them better suited toward handling the financial management problems encountered in this period of rapidly changing agriculture.

As capital needs for farming have grown, it has made it more difficult for the younger generation to start out farming on their own. As a result, there has been an increased desire by the younger generation to enter into the ownership and management of their parent's business rather than starting their own operation. However, the older generation normally does not desire to sell the farm assets to the younger generation all at once (nor can the younger generation afford to do so)--they would rather transfer them gradually. Therefore, there is a need for a multi-owned form of business organization whereby the younger generation can gradually ease into the ownership and management of the farm business while the older generation gradually withdraws. Both the partnership and corporate form of business organization are ideally suited for this purpose.

As capital becomes more of a limiting factor to the growth of some farm businesses, the use of "outside equity financing" may increase. This is a broad term generally referring to the contribution of risk capital with no obligation upon the operation or its operator to pay a fixed rate of return on that capital during its use nor an obligation to repay it to the contributor during the continuance of the operation.[2] The outside contributor-investor becomes a partial owner of the business assets and thus is entitled to a share of the operating profits of the business as well as sharing in the appreciation of the overall value of the operation. The partnership and corporate form of business organization are the two main business forms used for this purpose. Since a sole proprietorship is, by definition, a one owner business, it can't be used to attract outside equity financing.

1. Types of Corporations

This study will examine the corporate form of business organization. It should be noted that there are a variety of forms of corporations.

There are both "for profit" corporations and "not-for-profit" corporations. The "for profit" corporations are ordinary business enterprices that have incorporated and are operated to make a profit which

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[2]Donald H. Kelley, "The Farm Corporation as an Estate Planning Device," Nebraska Law Review 54(1975):280.

can then be distributed to the owners in several ways such as dividends, interest payments, salaries, bonuses, etc. This is the type of corporation most individuals visualize when they hear the term "corporation."

"Not-for-profit" corporations are incorporated under special corporation statutes that are reserved for charitable, religious, educational, fraternal, and social enterprises. They can be money making operations. However, these profits cannot be distributed to the corporations owners or members. The profits must be devoted to the enterprises' philanthropic causes.[3]

These "not-for-profit" corporations are not important for consideration in this study. Obviously, this study will only be concerned with "for profit" corporations.

2. Public vs. Closely Held Corporations

"For profit" corporations can be "publicly-owned" or "closely-held" corporations. A "publicly-owned" corporation may have thousands of owners, most of whom are usually unrelated and dispersed over a wide geographic area. Normally there is an established market for shares of "publicly-held" corporations where the general public can freely buy or sell as they so desire.

"Closely-held" corporations are owned by a small number of shareholders. Usually they are family enterprises that have been incorporated to enjoy the benefits of corporate organization. However, the shareholders aren't always related. They could be unrelated or even other corporations, partnerships, trusts, etc. Normally there is no

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[3] Frederick J. Naffziger and Arthur D. Wolfe, Legal Perspectives of American Business Associations (Columbus, Ohio: Grid, Inc., 1977), p. 259.

established public market for shares in a "closely-held" corporation. The articles and/or bylaws may have some restrictions on sales or purchases by shareholders or shareholders-to-be to prevent the stock from passing to outsiders. In some cases, "closely-held" corporations may become "publicly-owned" by establishing a market for the stock.

Most farm corporations are "closely-held" family corporations. A family held corporation is one in which at least 50 percent of the voting power and 50 percent of the total number of shares of all other classes of stock are owned by members of the same family. The members of a family include an individual, his brothers and sisters, aunts and uncles, grandparents, and ancestors and lineal descendents of any of the foregoing, the spouse of any of the foregoing, and the estate of any of the foregoing.[4]

This study will be concerned only with "closely-held" family farm corporations. It will also be assumed in this study that those farm families who organize a corporation intend on having it remain "closely-held."

3. Numbers of Corporations Increasing

Both interest in and use of the corporate form of business organization in agriculture have increased in recent years. According to the 1969 and 1974 U.S. Census of Agriculture, the number of Class 1-5 farms (those with gross sales over $2,500) organized as corporations has

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[4]Michael Glenn Barton, "Management Implications of Incorporating the Family Farm," (M.S. thesis, University of Illinois, 1978), p. 10.

increased from 21,513 in 1969 to 28,656 in 1974. Most experts say that corporations have grown even faster since 1974.[5]

Michigan numbers have increased from 277 in 1969 to 420 in 1974. Preliminary data from the 1978 census indicates that corporate numbers have again increased to a total of 728. The 277 farm corporations in 1969 were .7 percent of all class 1-5 farms while the 420 in 1974 were .9 percent. This percentage humped to 1.5 in 1978.

Most of the Michigan farm corporations are "closely-held" family type farm corporations with less than 10 stockholders. Of the 277 farm corporations in 1969, 250 were owned by 10 or fewer shareholders. Only 9 out of the 420 corporations in 1974 were "publicly-held" corporations. In 1978, 636 out of the 728 total farm corporations were classified as being family owned.

4. Use of Corporations Expected to Increase

The number of "closely-held" family type farm corporations in both the U.S. and Michigan is expected to increase in the future for a number of reasons.

Technological changes in agriculture since World War II have resulted in an increasing use of capital as a substitute for labor as an input on farm operations. Increasing mechanization is largely responsible for a striking decrease in the labor input in farming--in 1978 it was only one-third of that in 1950. To put it in another way, fewer

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[5]"The Farm Corporation: Take Stock of Your Future," Successful Farming, March 1977, p. 19.

people on fewer farms containing more acres than in 1950-1954 are producing significantly higher yields and larger crops.[6]

Such changes have resulted in farm operations today that have a sizeable investment in machinery and equipment, livestock and real property such as land, buildings, and improvements. Worldwide inflation is rapidly increasing the value of these assets, especially farmland. The net result is the creation of sizeable estates for many farmers.

These sizeable estates have made the intergenerational transfer of farm assets by gift or inheritance increasingly difficult without significant tax liability. As a result, farmers and estate planners are looking to the corporation for help in the estate planning process. It is believed that certain attributes of the corporate business structure may help facilitate the intergenerational property transfer. In fact, research in several states points to estate planning advantages as a major reason why farmers incorporate.[7]

Along with the sharp increase in world demand for agricultural products since 1973, there has been a general rise in the price level for many of these products. There is reason to believe that prices will keep rising in the 1980s, perhaps even faster than the annual rate of inflation, as the world population grows.

As a result of these increasing prices, the last seven years have seen some farmers with substantially higher taxable incomes. Consequently, farmers and their accountants have looked at incorporation of the

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[6]Leslie McConkey, "Farming Trends for the 1980s," The Farmer's Digest, October 1979, p. 33, (reprinted from the information service of MSU).

[7]Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications, 1979), p. 217.

farm business as a means of annual income tax savings. One of the reasons behind this is that federal income tax rates for a regularly taxed corporation have been altered favorably since 1974.[8]

Michigan tax laws have also been altered favorably toward incorporation. Tax law changes implemented in 1976 eliminated the annual corporate franchise fee and the corporate income tax. These were replaced by a single business tax (SBT). However, in 1977 farm businesses were declared exempt from the SBT.[9] As a result, a regular tax paying farm corporation currently pays no state income tax on its earnings.

The corporate form of business organization has received extensive promotion recently by farm magazines. Consequently, farmers are more familiar with its potential use and are more likely to be willing to incorporate.

Because of these and perhaps other reasons, it is expected the use of corporations among family farmers will be on the increase.

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[8]Through 1974, the first $25,000 of corporate taxable income was taxed at 22 percent and all additional income at 48 percent. For 1975-1978, the rates were reduced to 20 percent on the first $25,000, 22 percent on the next $25,000 and 48 percent on all above $50,000. Starting in 1979, the rates have been reduced further, to 17 percent on the first $25,000 of corporate taxable income, 20 percent on the second $25,000, 30 percent on the third $25,000, 40 percent on the fourth $25,000 and 46 percent on all over $100,000.

[9]This exemption applies only to farm business carried out at the wholesale level. Any farm business carried on at the retail level may be subject to SBT. For more information, see Chapter IV.

C. Need for the Study

1. Potential Use of Corporations under Michigan Conditions

The basic structural characteristics of corporations, how they work and how they are taxed are well known and accepted among attorneys, accountants, and business consultants.

However, some of the advantages of the corporate form have limited applicability when applied to a closely held family farm business. North Central and other extension publications give a general discussion of the potential use of corporations in family farm situations, but there is no evaluation of the relative merits of farm corporations over other business types in Michigan.[10] Marshall's study in 1961 presented an analysis of the close corporation as a form of business organization for Michigan family farms, but is out of date because of numerous federal and Michigan income, estate, inheritance, and gift tax law changes.[11]

Thus, there has been no analysis done recently of the potential applications of family farm corporations for Michigan conditions. This study will attempt to fill that void.

2. Specific Areas of Concern Among Farmers

Michigan farmers are increasingly asking for information on incorporation and guidelines in analyzing their situation with regards to intergenerational farm transfer as well as estate, gift, and inheritance

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[10] Neil E. Harl and John C. O'Byrne, The Farm Corporation, North Central Regional Extension Publication, No. 11, revised April 1978.

[11] James Paxton Marshall, "The Close Corporation as a Form of Business Organization for Michigan Family Farms," (Ph.D. thesis, Michigan State University, 1961).

tax ramifications. In other words, they would like to know the potential role that corporations can play in the estate planning process.

Another area of concern involves the use of the corporate structure as a means for annual income tax savings. Specifically, some farmers are asking for federal and Michigan annual income tax comparisons with other business types for different types of farm operations (swine, cash crop, fruit, dairy, etc.)--i.e., at what level of annual income are savings possible through incorporation of the business.

Farmers that have made the decision to incorporate have slightly different needs. They seek guidelines in areas such as which assets should be contributed to the corporation, whether debt financing should be used in addition to stock, when (time of the year) to form the corporation, what tax year to select, possible lease arrangements for entities separate from the corporation, selecting fringe benefits for employees, and possible estate planning tools to use in formulating an estate plan.

An attempt will be made in this study to answer these questions through a discussion of each of the various areas as well as through the use of several case examples illustrating possible annual income and estate tax effects of incorporating several different types of farm operations.

3. Concern with Oversimplification and Generalization

There is concern that a few professional counselors in the accounting, legal, and insurance areas are proposing the farm corporation as the cure-all for farm business transfer and taxation without a thorough analysis of the fact situation in each case. Also, some farmers have misconceptions about the role of corporations in their business--especially its role in the intra-family farm transfer process.

a. Annual Income Taxes

Problems have developed in the area of annual income taxes. Farmers with two or three years of high incomes have been urged to incorporate to reduce annual taxes. However, after following this advice, a few farmers have found out that they aren't saving as much as originally planned because their professional advisor failed to take into account increased social security payments, increased worker's and unemployment compensation costs, loss of the homestead property tax credit, and other added costs. The net effect of increased taxes paid for these items cancels out some of the savings from a reduction in the federal income tax.

b. Lack of Long Range Planning

In some cases there has been a lack of long range planning on the part of the farmer and his professional advisor to make some estimation as to the probability of high net farm income levels in future years.

If, after incorporation, the net farm level declines--the result is lost tax benefits. In fact, if the income level drops too far, there is the possibility that the incorporated farm business will pay more total taxes than it would if it was organized as a partnership or sole proprietorship.

When this happens, the farmer will most likely want to dissolve the corporation. However, sometimes to their dismay, they find it very costly to do so.

c. Limiting Liability

Some attorneys stress the great importance of limiting liability through incorporation. However, it has little applicability to most closely held farm businesses. There are several reasons for this.

First of all, the majority of financial institutions that lend money to farm corporations require the principal shareholder(s) to personally guarantee the loan. When this is done, the shareholders will face unlimited liability with regards to the corporation's debt obligations.

Also, most farm families have few non-farm assets. Therefore, if the majority of the farm assets are transferred to the corporation, there is often few personal assets left outside that can be protected.

d. Minority Shareholders

Problems have developed with regards to minority stockholder (any shareholder who owns less than 50 percent of the stock in a closely-held corporation) rights. A few farm corporation by-laws and/or buy-sell agreements do not consider the minority stockholder problem of obtaining income from the corporation and establishing a market for the stock. In such cases, the minority shareholders own an essentially worthless piece of paper--since they have no rights to income nor a market for their stock.

e. Estate Planning

The potential estate planning advantages of corporations have been well publicized. However, incorporating the farm business does not in itself form an estate plan--contrary to the belief of some.

Estate planning is often cited by farmers as their main reason for incorporating. However, an analysis of their estate plan will often show that little, if anything, has changed from the plan before incorporation. The concern here is that if estate planning is the main reason for incorporating, the family should take full advantage of as many opportunities in this area as possible. Otherwise, there is little reason to incorporate from an estate planning viewpoint.

f. Differing Situations

Although they will not admit it, too many farmers incorporate because someone they know and respect has done so. The attitude is "if trendsetter Joe First incorporates, it must be the thing to do, as Joe is one of the best farmers in the area." What they fail to realize is that their farm business situation may be entirely different from Joe's. For instance, they may have a lower taxable income than Joe or perhaps they have different long range plans and estate planning objectives. Or maybe Joe has more business expertise which enables him to obtain more benefits from the corporate structure.

D. Purpose of the Study

It can be seen that there are many misconceptions and potential problem areas to be concerned with in the area of farm business planning. Therefore, one of the purposes of this study and any resulting extension publications is to serve an educational role in making Michigan farmers and their professional counselors more aware of these potential problems and also to clear up any misconceptions.

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The evaluation of the relative merits of farm corporations over other business types in Michigan is much too complex to make sweeping generalizations. Henceforth, the other purpose of this study will also be educational. Specifically, the purpose will be to make an impression upon Michigan farmers and their professional advisors of the need for an individual analysis of each family farm situation. The decision to incorporate must be analyzed on a case-by-case basis. This study will provide some guidelines for this analysis.

E. Objectives of Investigation

The overall objective of this study is an analysis of management considerations for Michigan farmers incorporating the family business. Within this broad objective, several specific objectives can be noted. These specific objectives are:

a) To determine the business organization and operating characteristics of Michigan and U.S. farms now incorporated.

b) To ascertain the advantages and disadvantages for farmers to incorporate their business and to evaluate and generalize those factors for various types of Michigan farms.

c) To examine the Michigan and Federal taxation impacts upon farm corporations for annual taxes, incorporation procedures, and ways to dissolve and liquidate corporations.

d) To investigate the appropriate estate planning tools to be used in the intergenerational family farm transfer process.

It is hoped that a study of these objectives will lead to a greater understanding of farm corporations and provide guidelines for helping professionals, farmers, and others to form corporate structures that achieve the goals and objectives for those involved in the farm business.

F. Procedure and Methodology

Basically, this study consists of three parts:

1) Assembly and analysis of information on closely held corporations with respect to legal status, federal annual, gift, and estate taxation, Michigan annual and inheritance taxation, relative advantages and disadvantages, and problems encountered during the organization, existence, dissolution, and liquidation. Also, assembly of descriptive statistical information on Michigan and U.S. farm corporations.

2) Surveys

    a) Survey of several corporations presently conducting farm business in Michigan.

    b) Survey of attorneys who have incorporated farm businesses in Michigan.

    c) Survey of Michigan accountants who currently work with farms that are incorporated and those who advise farmers about incorporation.

3) Hypothetical Case Studies

    a) Several case studies illustrating annual tax comparisons between various business organizational types.

    b) Case examples illustrating possible estate planning tools to be used in the intergenerational family farm transfer process.

1. Sources of Information Assembled and Analyzed

The information presented in Chapter II was obtained from U.S. Census data. However, the majority of information presented in the rest of the thesis--especially Chapters III, IV, V, VI, VII, and IX--comes from either the Internal Revenue Code (and sources explaining it) or else from sources describing various legal features, advantages, disadvantages, etc., of closely-held corporations.

Every effort has been made to use qualified, authoritative sources. The sources of information quoted directly are documented.

Since there will no doubt be diversity among readers' legal and tax understanding, an attempt has been made to explain most concepts in detail in layman's terms so that a person with no prior knowledge could obtain at least some familiarity with the subject matter.

2. Surveys

Twenty-five incorporated farmers were interviewed (they were located over various geographical areas of the southern half of the lower peninsula) as well as six attorneys and one accounting firm. A copy of the questionnaire form used for the incorporated farmers is contained in the appendix.

These surveys were not so much concerned with general descriptive statistics as with obtaining information with regards to annual taxation, leasing arrangements for assets outside of the corporation, employee fringe benefits, dealing with minority stockholders and transfer means to the next generation. In other words, the surveys were used for background information for the author. As such, there is no direct statistical data from the surveys in the thesis. However, some of the information received from the surveys is presented in indirect form in that it was used as a basis for making decisions as to what concepts should be discussed in each chapter and in what detail.

3. Case Studies

Case examples were used in Chapters VII and IX. The purpose of including them in the thesis is to show application of two of the biggest advantages for forming a farm corporation--a reduction of annual taxes and an aid in the estate planning process.

These case examples are not, of course, intended to apply to all farm situations. They are merely examples which should further the reader's understanding in the particular subject area.

CHAPTER II

HISTORICAL USE OF CORPORATE ORGANIZATIONS IN U.S. AND MICHIGAN AGRICULTURE

A. Use of Corporate Form in the United States

The use of corporations in agriculture has been on the increase, especially since World War II. Some reasons for this increase were discussed in the introductory chapter.

The passage of Public Law 85-866 by Congress in 1958 most likely also contributed to an increase in corporate numbers.[12] Title I of this law is known as the Technical Amendments Act. Section 64 of this act modified the Internal Revenue Code of 1954 to permit certain qualifying small businesses to incorporate as Subchapter S corporations. Under this tax option, the corporation pays no tax and the shareholders are taxed directly for corporate income. Although a Subchapter S corporation pays no corporate income tax, it can still make use of the other advantages of incorporation such as limited liability, employee fringe benefits, ease of ownership transfer, and continuity of operation.

U.S. Census of Agriculture data on the magnitude of change in farm corporation numbers is only available for the past decade. Type of organization data for farms with sales of $2,500 or more was collected in

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[12]Public Law 85-866, Title I, Technical Amendments Act, Section 64; 85th U.S. Congress, 2nd Session, 1958.

the U.S. Census of Agriculture for the first time in 1969. Much more detailed data on corporations was collected in 1974.

1. 1969 Census Data

Some information from the 1969 Census is shown in Table 1. Types of organizations were separated into five categories: 1) Individual or family (sole proprietorship); 2) Partnership; 3) Corporation (ten or fewer shareholers); 4) Corporation (more than ten shareholders); and 5) Other (includes those farms operated by estates, trusts, colonies, cooperatives, etc.).

Approximately 85 percent of U.S. Class 1-5 farms in 1969 were operated as sole-proprietorships while only 1.2 percent were operated as corporations. Over 90 percent of these corporations had ten or fewer stockholders. It is believed that a high proportion of these corporations with ten or fewer shareholders are family owned and controlled and thus may not be significantly different from large individually owned farms or partnerships.

This census data tends to confirm the widely held belief that corporations operate significantly larger operations. While the average size of all farm organizations is 529.7 acres, the average size of corporate organizations is 3,757.3 acres. Well over half of the corporations are Class 1 farms ($40,000 and over farm product sales) as compared to 20.8 percent of the partnerships and 10.9 percent of sole proprietorships being Class 1 farms.

Even though partnerships and corporations account for a small percentage of the total number of farms, they both account for a relatively larger percent of farmland and the value of agricultural products sold.

Table 1. Selected U.S. Farm Characteristics by Type of Organization, 1969

				Corporations			
	All Organizations	Individual	Partnership	Total	10 Shareholders or Fewer	More than 10 Shareholders	Other
Class 1-5 Farms (number)	1,733,683	1,480,565	221,535	21,513	19,716	1,797	10,070
Percent of Class 1-5 Farms	100.0	85.4	12.8	1.2	1.1	0.1	0.6
Land in Farms (Acres)	918,312,613	665,692,881	163,387,960	80,831,188	66,471,436	14,359,752	8,400,584
Percent of Land in Farms	100.0	72.5	17.8	8.8	7.2	1.6	0.9
Average Size of Farm (Acres)	529.7	449.6	737.5	3,757.3	3,371.4	7,990.9	834.2
Average Value of Land and Buildings per Farm ($)	103,526	91,131	140,279	N/A	476,211	1,355,079	164,324
Percent Value of Ag. Products Sold	100.0	67.8	17.4	14.1	11.2	2.9	0.6
Percent Distribution by Value of Sales:							
Class 1-40,000 + farm product sales(%)	12.8	10.9	20.8	57.4	57.1	60.7	10.7
Class 2-20,000-39,999 farm product sales(%)	19.1	18.7	22.2	13.2	13.5	10.4	16.6
Class 3-10,000-19,999 farm product sales(%)	22.8	23.0	22.6	10.5	10.6	9.3	21.4
Class 4-5,000-9,999 farm product sales(%)	22.5	23.2	18.9	9.2	9.2	9.7	24.8
Class 5-2,500-4,999 farm product sales(%)	22.8	24.1	15.5	9.6	9.6	10.0	26.4

N/A Not Available

Source: U.S. Census of Agriculture, 1969, Vol. II, Chapter 3, Part 2.

While corporations account for only 1.2 percent of the total farm numbers, they account for 8.8 percent of the land in farms and 14.1 percent of the value of agricultural products sold. In 1969, 12.8 percent of U.S. farms were operated as partnerships. These partnerships account for 17.8 percent of the land in farms and 17.4 percent of the value of agricultural products sold.

2. 1974 Census Data

Table 2 presents some type of organization data from the 1974 U.S. Census of Agriculture. As in the 1969 census, types of organizations were separated into individual or family operations (sole proprietorships), partnerships, corporations, and others.

When comparing 1969 data in Table 1 with 1974 data in Table 2, it is noted that the average size of farms and average investments per farm generally increased from 1969 to 1974. As would be expected, the total number of farms with sales over $2,500 (Class 1-5 farms) decreased from 1969 to 1974 while the total number of corporate organizations increased from 21,513 in 1969 to 28,656 in 1974. Naturally, this increase in the number of corporations resulted in an increase in the percentage of farms organized as corporations from 1.2 percent in 1969 to 1.7 percent in 1974.

Several interesting facts appear in comparisons between Tables 1 and 2. The total number of partnerships declined quite sharply--from 221,535 in 1969 to 144,969 in 1974. The average farmland per corporation also declined quite sharply--from 3.757.3 acres in 1969 to 3.377 acres in 1974. The reason for these sharp drops is not known. However, a possible explanation for this could be that a large number of farms that

Table 2. Selected U.S. Farm Characteristics by Type of Organization, 1974

	All Organizations	Individual	Partnerships	Corporations	Other
Class 1-5 Farms (Number)	1,695,047	1,517,573	144,969	28,656	3,849
Percent of Class 105 Farms	100.0	89.5	8.6	1.7	0.2
Land in Farms (Acres)	905,640,107	678,081,579	124,479,156	96,781,155	6,298,217
Percent of Land in Farms	100.0	74.9	13.7	10.6	.7
Average Size of Farm (Acres)	534	447	859	3,377	1,636
Acreage Value of Land and Buildings Per Farm ($)	182,231	158,962	284,936	856,921	465,311
Percent Value of Ag. Products Sold	100.0	67.4	13.9	18.2	.5

Sources: U.S. Census of Agriculture, 1974, Volume I, Part 51, Chapter 1.
U.S. Census of Agriculture, 1974, Volume IV, Part 5.

incorporated after 1969 were smaller family-owned partnerships. This would reduce the number of partnerships, increase the number of corporations, and decrease the average size of corporations.

In addition to the general type of organizations data collected in the 1974 census, a new survey was conducted that was devoted entirely to the collection of specialized data for corporations with agricultural operations. The U.S. Department of Agriculture in cooperation with the Bureau of the Census separated this data into several categories in order to better describe the role of corporations in today's agriculture.

Corporations were classified as being either a primary farm or a business-associated farm. A primary farm is "a farm operated by a corporation which received 50 percent or more of its gross business income (farm and non-farm) from the sale of agricultural products." A business-associated farm is "a farm operated by a corporation which received less than 50 percent of its gross business income (farm and non-farm) from the sale of agricultural products." A corporation operating one or more primary farms was referred to as a primary farm firm and a corporation operating one or more business-associated farms was called a business-associated firm.[13]

Corporations were also divided according to types of ownership--either privately held or publicly held. Privately held corporations were defined as those that "all or almost all of the corporation stock is owned by the few persons who formed the business firm or by their successors." In a publicly held corporation, "the shares of stock of the business are bought and sold on recognized stock exchanges or over-the-

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[13]U.S. Bureau of the Census, 1974 Census of Agriculture, Volume IV, Special Reports Part 5, Corporations in Agricultural Production, p. 3.

counter markets." Other corporations not classified as privately held were included as publicly held.[14]

Privately held corporations were further classified as to the number of shareholders: 1-5, 6-10, 11-15, 16 or more, or shareholders not reported. The number of shareholders was requested only of privately held corporations. It was assumed that most, if not all, publicly held corporations have more than ten stockholders.

Classifications were used to indicate the kind of corporate control which best described the corporations. These are as follows:[15]

1. Family Corporation--A corporation in which 51 percent of more of the stock is owned by persons related by blood or marriage. It has no interlocking ownership or control by, or of another corporation.
2. Independent Corporation--A corporation which is not a family corporation and which does not own or control another corporation, nor is it owned or controlled by any other corporation.
3. Parent Corporation--A corporation which owns or controls one or more subsidiary corporations. If the farming operation was operated by a subsidiary, corporate data was collected for the parent rather than the subsidiary.

Using these new classifications, Table 3 presents some data from the 1974 special corporate survey.

There has been some concern about large corporate farms owned by people outside of agriculture, particularly large publicly-held corporations. It is believed that further growth of these corporations could

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[14] Ibid.

[15] Ibid.

Table 3. Selected U.S. Farm Corporation Characteristics, 1974

	All Corporate Farms	Kind of Corporation			Type of Corporation Ownership				
					Privately Held				
		Family	Independent	Parent	1 to 5 Shareholders	6 to 10 Shareholders	11 Share-holders or more	Shareholders Not Reported	Publicly Held and Other
Farms (Number)	28,442	21,758	5,115	1,569	21,672	4,005	1,013	805	947
Percent	100.0	76.5	18.0	5.5	76.2	14.1	3.6	2.8	3.3
Average Size of Farm (Acres)	3,380	3,250	2,067	9,460	2,589	4,596	11,527	5,207	6,060
Percent Land in Farms	100.0	73.6	11.0	15.4	58.4	19.1	12.1	4.4	6.0
Average Value of Land and Buildings per Farm ($)	865,836	746,856	855,186	2,550,512	701,278	936,253	2,347,815	1,037,971	2,602,343
Market Value of Agricultural Products Sold--Average Per Farm ($)	515,030	337,425	690,651	2,405,420	359,622	556,598	1,525,563	432,280	2,885,092
Percent Value of Agricultural Products Sold	100.0	50.1	24.1	25.8	53.2	15.2	10.5	2.4	18.7
Farms Operated by Subchapter S Corp. (Number)	8,003	6,716	1,240	47	6,470	1,502	--	31	--
Percent Operated by Subchapter S Corporations	28.1	30.9	24.2	3.0	29.9	37.5	--	3.9	--
Farms by year of incorporation									
Before 1930	772	465	197	110	352	163	221	36	--
1930-1949	1,454	1,026	309	119	917	310	181	46	--
1950-1959	3,059	2,340	591	128	2,310	528	169	52	--
1960-1969	10,594	8,378	1,955	261	8,506	1,646	285	157	--
1970-1974	11,109	9,176	1,785	148	9,474	1,331	147	157	--
Not reported	1,454	373	278	803	113	27	10	357	947
Farming as a % of Total Corporation Receipts: Under 25%	2,749	1,037	655	1,057	1,339	307	251	111	741
+25 to 49 percent	+ 711	+ 439	+ 176	+ 96	+ 451	+ 119	+ 70	+ 27	+ 44
Business-Associated Farms	3,460	1,476	831	1,153	1,790	426	321	138	785
% Business-Associated Farms	12.2	6.8	16.2	73.5	8.3	10.6	31.7	17.1	82.9
Farming as a % of Total Corp. Receipts 50-74 Percent	819	538	162	119	567	112	64	28	48
+75-99 Percent	+ 918	+ 648	+ 149	+ 121	+ 625	+ 138	+ 91	+ 25	+ 39
Farming Only - 100 Percent	23,245	19,096	3,973	176	18,690	3,329	537	614	75
Primary Farms	24,982	20,282	4,284	416	19,882	3,579	692	667	162
% Primary Farms (>50% of Gross Income from the sale of Agricultural Products)	87.8	93.2	83.8	26.5	91.7	89.4	68.3	82.9	17.1

Source: U.S. Census of Agriculture, 1974, Volume IV, Part 5 lead to oligopolistic control of some segments of American agriculture. Such control is seen as a potential threat to family farms and the survival of rural communities. However, there has been considerable disagreement as to the actual extent of involvement of large corporations in agriculture.

This survey showed that family corporations make up more than three-quarters of all corporate farms and account for 50 percent of the agricultural products sold by corporations. Approximately 97 percent of all corporations are privately held. Those with five or fewer shareholders make up over three-quarters of all corporations. Although publicly held corporations make up only 3.3 percent of corporate farm numbers, they account for 18.7 percent of the agricultural products marketed by corporations.

As would be expected, the survey shows that agricultural production by corporations is big business. Family corporations, which have the smallest average investment, have investments in land and buildings averaging approximately three-quarters of a million dollars. Average sales of farm products for family corporations exceeds one-third of a million dollars. By most standards, these are large operations. However, the average sales of agricultural products of publicly held corporations were close to three million dollars.

Over one-quarter of the corporations were operated by Subchapter S corporations. The majority of these are family owned and operated since Subchapter S corporations in 1974 could have no more than ten shareholders.

Included in Table 3 is a classification of corporations by year of incorporation. Some have been in business for quite some time as almost

8 percent incorporated before 1950. However, most of the corporations have been formed in the early seventies. About 40 percent of the corporations were formed between 1970 and 1974. Thus, the use of corporations as a form of business organization among agricultural producers is clearly a relatively new phenomenon.

Almost 90 percent of the corporations were primary farm firms that received 50 percent or more of their total business receipts from the sales of agricultural products. Eighty percent of corporate agricultural sales came from these firms. Approximately 93 percent of these primary farm firms received 100 percent of their income from farming. The majority of family corporations were classified as primary farm firms while the majority of publicly held corporations were classified as business-associated firms.

B. Use of Corporate Form in Michigan

1. 1969 and 1974 Census Data

Some type of organization data for Michigan farms, similar to the U.S. date in Table 1 and 2, is presented in Tables 4 and 5.

When comparing Michigan data from Tables 4 and 5 with U.S. data in Tables 1 and 2, several similar trends can be noted. The number of corporations in the U.S. and Michigan both increased sharply from 1969 to 1974 while the number of partnerships fell. The proportion of total agricultural products sold by corporations also increased from 1969 to 1974 while the proportion from partnerships declined. The number of individual operations rose slightly from 1969 to 1974 in both Michigan and the United States while their percentage of agricultural products marketed remained essentially constant.

Table 4. Selected Michigan Farm Characteristics by Type of Organization, 1969

	All Organizations	Individual	Partnership	Corporations			
				Total	10 Shareholders or Fewer	More than 10 Shareholders	Other
Class 1-5 Farms (number)	44,175	38,519	5,227	277	250	27	152
Percent of Class 1-5 Farms	100.0	87.2	11.8	.7	.6	.1	.3
Land in Farms (Acres)	9,142,760	7,497,635	1,462,469	150,122	134,642	15,480	32,534
Percent of Land in Farms	100.0	82.0	16.0	1.6	1.5	0.2	0.4
Average Size of Farms (Acres)	206.9	194.6	279.7	541.9	538.5	573.3	214.0
Average Value of Land and Buildings per farm($)	67,982	62,695	97,387	241,967	229,174	360,415	79,516
Percent Value of Ag. Products Sold	100.0	75.0	19.0	5.7	5.2	0.5	0.3

Source: U.S. Census of Agriculture, 1969, Volume II, Chapter 3, Part 2.
U.S. Census of Agriculture, 1969, Volume I, Part 13, Section 1.

Table 5. Selected Michigan Farm Characteristics by Type of Organization, 1974

	All Organizations	Individual	Partnerships	Corporations	Other
Class 1-5 Farms (Number)	46,647	42,627	3,552	420	48
Percent of Class 1-5 Farms	100.0	91.4	7.6	0.9	0.1
Land in Farms (Acres)	9,549,692	8,049,388	1,245,008	243,817	11,479
Percent of Land in Farms	100.0	84.3	13.0	2.6	.1
Average Size of Farms (Acres)	205	189	351	581	239
Average Value of Land and Buildings per Farm ($)	112,958	102,776	201,511	391,474	165,288
Percent Value of Ag. Products Sold	100.0	75.0	17.4	7.4	.2

Source: U.S. Census of Agriculture, 1974, Volume I, Part 22, Chapter 1.

Several differences between Michigan and U.S. data can also be noted. Michigan agriculture has a higher percentage of individual operations and a lower percentage of both partnership and corporate organizations.

As would be expected, all types of organizations in Michigan have a much smaller average size than do other farm organizations in the U.S. In fact, the average size of corporate farms in Michigan is approximately equal to the average size of individual operations in the U.S. In general, Michigan agriculture can be described as having a large number of small farm units and a few commercial farms (those grossing over $20,000). In fact, Michigan has had, over the years, a consistently greater percentage of small farms than the national average. Part of this is due to the type of agricultural enterprises in the state. There are no large open ranges such as those in western states. Also, many of the crops grown in Michigan (sugar beets, potatoes, fruits and vegetables, horticulture specialty) are high value specialty crops. Consequently, not as many acres are required to gross a given amount of income as are required on, for example, wheat farms. Also, many farmers in Michigan have jobs off the farm. These are a few of the reasons that Michigan farm operations have a much smaller average size than the national average.

Corporations in Michigan do not account for as high a percentage of total farm products sold in the state as do all corporations in the U.S. In 1974, corporate farms in Michigan accounted for only 7.4 percent of all agricultural products sold in the state while all U.S. corporate farms accounted for 18.2 percent of the total value of agricultural products sold.

However, partnerships in Michigan accounted for a higher percentage of the total agricultural products sold in the state than did all partnerships in the U.S. In 1974, partnerships in Michigan accounted for 17.4 percent of all agricultural products sold in the state while all U.S. partnerships accounted for 13.9 percent of all agricultural products sold in the U.S.

Another interesting fact is that the total amount of land in Michigan farms increased by over 400,000 acres from 1969 to 1974 while the total land in U.S. farms declined. This increase in farmland is contratry to the popular opinion that Michigan is losing farmland at an alarming rate. Perhaps this increase is due to marginal land being brought into production after the profitable years of 1972-1974.

Table 6 presents some Michigan corporate data from the 1974 special corporation survey.

This survey showed that percentage of family corporations in Michigan is about the same as in the U.S. However, family corporations account for over 70 percent of the production of all agricultural products in Michigan as compared to only 50 percent in the U.S.

Approximately 98 percent of all farm corporations in Michigan are privately held. Those with five or fewer shareholders make up over 84 percent of all corporations. Both of these percentages are higher than the U.S. percentages.

Publicly held corporations in Michigan play a much smaller role in the agricultural production by corporations in the state. Publicly held corporations in Michigan make up only 2.2 percent of all corporate farms and account for only 6.6 percent of the agricultural products marketed by corporations. This compares with 3.3 percent of all U.S. corporate

Table 6. Selected Michigan Farm Corporation Characteristics, 1974

	All Corporate Farms	Kind of Corporation			Type of Corporation Ownership				
					Privately Held				
		Family	Independent	Parent	1 to 5 Shareholders	6 to 10 Shareholders	11 Shareholders or more	Shareholders Not Reported	Publicly Held and Other
Farms (Number)	416	324	79	13	352	35	6	14	9
Percent	100.0	77.9	19.0	3.1	84.6	8.4	1.4	3.4	2.2
Average Size of Farm (Acres)	587	561	723	416	508	720	236	1,338	2,225
Percent Land in Farms	100.0	74.4	23.4	2.2	73.2	10.3	.6	7.7	8.2
Average Value of Land and Buildings per Farm ($)	395,663	373,424	452,584	604,029	347,938	520,598	262,100	415,184	1,835,045
Market Value of Agr'l Products Sold-Average per Farm ($)	262,930	237,160	308,025	631,231	239,830	396,629	153,000	208,286	804,889
Percent Value of Agr'l Products Sold	100.0	70.3	22.2	7.5	77.2	12.7	.8	2.7	6.6
Farms Operated by Subchapter S Corp. (Number)	85	74	11	-	78	7	-	-	-
Percent Operated by Subchapter S Corporations	20.4	17.8	2.6	-	18.8	1.7	-	-	-
Farms by year of incorporation:									
Before 1930	9	5	3	1	7	1	-	1	-
1930-1949	23	19	3	1	19	2	-	2	-
1950-1959	37	32	5	-	33	2	-	2	-
1960-1969	180	130	46	4	152	18	5	5	-
1970-1974	154	134	18	2	139	12	1	2	-
Not reported	13	4	4	5	2	-	-	2	9
Framing as a % of total Corporation Receipts:									
Under 25%	59	31	18	10	43	4	2	3	7
+25 to 49 percent	11	9	2	-	9	2	-	-	-
Business Associated Farms	16.8	12.3	25.3	76.9	14.8	17.1	33.3	21.4	77.8
Farming as a % of Total Corporation Receipts:									
50-74 Percent	20	17	3	-	16	3	-	1	-
+75-99 Percent	10	10	-	-	6	4	-	-	-
Farming Only - 100 Percent	316	257	56	3	278	22	4	10	2
Primary Farms	346	284	59	3	300	29	4	11	2
% Primary Farms (50% of Gross Income from the Sale of Agricultural Products)	83.2	87.7	74.7	23.1	85.2	82.9	66.7	78.6	22.2

Source: U.S. Census of Agriculture, 1974, Volume IV, Part 5.

farms being publicly owned and accounting for 18.7 percent of the total agricultural products sold.

Approximately one-fifth of all Michigan corporations are Subchapter S corporations. This is slightly below the U.S. percentage.

As in the U.S. as a whole, the vast majority of Michigan corporations have been formed since 1960. Approximately 37 percent of Michigan corporations in agricultural production were formed between 1970 and 1974.

Primary farm firms made up 83.2 percent of all corporate farms. Approximately 91 percent of these primary farm firms received 100 percent of their income from farming. Both of these percentages are slightly lower than the U.S. percentages. For some reason, Michigan has a higher percentage of business-associcated firms.

Table 7 presents some data on the type and size distributions of Michigan farm corporations.

Over one-quarter of the corporations in the state can be classified as being horticultural specialty farms. Fruit farms are the next most numerous type of corporation with livestock farms being a distant third.

The other three charts in Table 7 give a clue as to the size distribution of Michigan farm corporations. By most standards, over one-quarter of the corporations are quite small. Approximately 27 percent have assets totaling less than $100,000 and have agricultural sales under $40,000. About 30 percent operate less than 100 acres. Perhaps many of these smaller operations are horticultural specialty farms.

On the other end of the scale, only 4.7 percent operate over 2,000 acres. Approximately 12 percent have sales over $500,000 and 21.9 percent have assets worth over $500,000.

Table 7. Michigan Farm Corporations by Standard Industrial Classification (SIC), 1974

SIC	No. of Farms	Percent
Cash Grain Farms	44	10.5
Sugar Crop, Irish Potato, Hay, and Other Field Crop Farms	22	5.2
Vegetable and Melon Farms	19	4.5
Fruit Farms	72	17.2
Horticultural Specialty Farms	122	29.1
General Farm, primarily Crop	9	2.1
Livestock Farms, except dairy, poultry and animal specialty	47	11.2
Dairy Farms	35	8.3
Poultry and Egg Farms	27	6.4
Animal Specialty Farms	18	4.3
Farms not classified by SIC	5	1.2

Michigan Farm Corporations by Value of Farm, 1974

Value of Farm	No. of Farms	Percent
$1 to $39,999	41	9.8
$ 40,000 to $99,999	76	18.1
$100,000 to $199,999	74	17.6
$200,000 to $499,999	137	32.6
$500,000 and Over	92	21.9

Michigan Farm Corporations by Value of Agricultural Products Sold, 1974

Value of Agricultural Products Sold	No. of Farms	Percent
$500,000 and over	50	11.9
$200,000 - $499,999	94	22.4
$100,000 - $199,999	76	18.1
$ 40,000 - $ 99,999	90	21.4
Under $40,000	110	26.2

Michigan Farm Corporations, by Size, 1974

Acres	No. of Farms	Percent
1 to 99	129	30.7
100 to 219	79	18.8
220 to 499	78	18.6
500 to 999	73	17.4
1000 to 1,999	41	9.8
2000 and over	20	4.7

Source: U.S. Census of Agriculture, 1974, Volume I, Part 22, Chapter 1, pp. 1-28, 1-29, and 1-30.

2. Preliminary 1978 Data

Table 8 presents some Michigan preliminary data from the 1978 _U.S. Census of Agriculture._

The total number of Class 1-5 farms continued upward in 1978. In fact, there were over 3,500 more farms in 1978 than there were in 1969 and over 1,000 more farms in 1978 than in 1974.

Along with this increase in total farm numbers, was an increase in land in farms in 1978 over either 1969 or 1974. Again, this increase is contrary to the popular opinion that Michigan is losing farmland.

Also up in 1978 was the average size of farms along with the average value of land and buildings per farm. This could be expected with inflation increasing the value of all farm assets along with a general nationwide increase in the size of farms. However, the number of individually owned farms was down in 1978 as compared to 1974, but still greater than the number of individually owned farms in 1969.

Accompanied by this decline was a sharp upward trend in the number of partnerships and corporations. In fact, the percentage increase in the number of corporations was the greatest--over 70 percent from 1974. These statistics certainly illustrate the fact that the use of farm corporations seems to keep increasing. Only time will tell how much of an increase there will eventually be.

Table 8. Selected Michigan Farm Characteristics by Type of Organization, 1978

	All Organizations	Individual	Partner ships	Corporations		Other
				Family Owned	Other than Family Owned	
Class 1-5 Farms (Number)	47,743	41,853	5,073	636	92	90
Percent of Class 1-5 Farms	100.0	87.7	10.6	1.3	.2	.2
Land in Farms (Acres)	10,219,392	N/A	N/A	N/A	N/A	N/A
Average Size of Farm (Acres)	214	N/A	N/A	N/A	N/A	N/A
Average Value of Land and Buildings per Farm ($)	205,101	N/A	N/A	N/A	N/A	N/A

N/A Not Available
No other data available at the time of writing

Source: U.S. Census of Agriculture, 1978, Preliminary Report, Michigan, Issued July 1980.

CHAPTER III

CHARACTERISTICS OF A CORPORATION--
HOW IT DIFFERS FROM OTHER FORMS OF BUSINESS ORGANIZATIONS

This chapter contains a discussion of some of the characteristics or features of corporations. Along with this discussion on corporations is a short description of sole proprietorships and partnerships. It is believed that a general understanding of these two other forms of business organization will aid in understanding the corporate form.

This belief is reinforced in a paper on the methodological aspects of legal-economic research on farm corporations.[16] Dorner and Eckhardt present a discussion of conditions to be met to carry out effective research on farm corporations. They mention two preconditions that are needed: 1) A basic knowledge of the legal and economic characteristics of the corporate form of business organization, and 2) A knowledge of the legal and economic characteristics of other forms of business organization such as the sole proprietorship and partnership. Meeting these conditions will help a researcher to make comparisons among farm corporations (organized under differing rules and procedures and operating under various types of farming) as well as comparisons between corporations and other forms of farm business organizations.

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[16] Peter Dorner and August Eckhardt, "Methods of Research on Farm Corporations," Family Farm Corporations, Agricultural Law Center, College of Law, State University of Iowa, (monograph), No. 2, May 1963, p. 81.

With this in mind, let's look at the three forms of farm business organizations. This discussion will not examine all the similarities and differences between sole proprietorships, partnerships, and corporations. Rather it will be only a general overview of each organization. Specific discussions on such topics as liability, differences, income tax comparisons, estate planning alternatives, and others will be presented in later chapters.

A. Sole Proprietorship

The sole proprietorship is a form of business organization where the farm is operated for the benefit of one individual. All of the income from the farming operation belongs to this individual. The individual may hire employees to provide labor or other services to the business, but he makes the management decisions and decides the course of action for the business.

There is no separate legal entity in a sole proprietorship as the assets and liabilities of the proprietorship are one and the same as the proprietors personal assets and liabilities. If money is borrowed, it is borrowed in the proprietor's own name. Those who extend credit to the proprietorship rely upon the sole proprietor's personal assets and credit standing. Thus, the sole proprietor assumes personal liability for all debts. This means that if there is any legal judgement against the business for any reason, the proprietor's business property as well as his personal belongings or even his future income could be subject to attachment to meet the legal obligations.

The sole proprietor's business pays no income tax itself. Instead, the taxable income of the business is combined with the sole proprietor's personal income and a tax is paid according to individual tax rates.

Since the sole proprietorship is a one-person business, it follows that the business suffers the same fate as the proprietor. The sole proprietorship comes to an end when and if the sole proprietor decides to transfer his interest in the business by sale or gift. Likewise, if the sole proprietor dies or becomes legally incapacitated, the sole proprietorship legally comes to an end.

This lack of continuity associated with a sole proprietorship farm business can place serious limitations on the intergenerational transfer of the farm business. This is especially true if off-farm heirs inherit an interest in the farm business. Typically, they desire cash for their portion of the business. Thus, upon death of the sole proprietor, if proper plans have not been made to transfer interest in the business to the on-farm heir(s) through either the creation of another sole proprietorship or through some other legal structure, it may be necessary to either liquidate part of the farm business to pay off the off-farm heirs or else place a debt obligation on the on-farm heirs to pay off the other heirs. Either way poses potential difficulties for the on-farm heirs.

However, a properly designed estate plan can usually overcome these potential disadvantages. The problem is that some sole proprietors fail to see such problems and thus may neglect on-farm heirs.

Despite this disadvantage, the sole proprietorship offers numerous advantages to the farm business. Probably the chief advantage is its simplicity. For instance, there are no legal formalities or organizational expenses needed to start such a business. Decisions can be made faster and more easily than in other types of business organizations as there are no articles of incorporation or partnership agreements that must be followed before making business decisions. Management decisions are up to the proprietor's discretion. These and other advantages are probably the underlying factors for the sole proprietorship being the dominant form of business organization in U.S. agriculture today.

B. Partnership

The Uniform Partnerships Act, the act adopted by all the states which govern the rights and duties of the partners, defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit."[17] Individuals forming partnerships contribute assets, capital, labor, time, or skills to the business, then share with each other the management responsibility, profits, and losses of the business. Profits and losses may be divided among the partners in any manner upon which they agree. They don't necessarily have to be divided on the basis of the amount of capital contributed by each, although some partnerships do divide income in this manner.

In some instances, the persons conducting the business may not intend to be partners, but their relationship may have a sufficient number of partnership characteristics that a court may impose the partnership form on the individuals for tax or non-tax (liability) reasons. For example, a father and son that operate a farm together, share profits and losses, and own common assets could be considered partners. However, the owning of property together in itself doesn't necessarily qualify as a partnership. Two or more farmers may be co-owners of property and

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[17]Uniform Partnership Act, Part II, Section 6.1.

still be considered as operating separate businesses. The owner of a farm and his tenant who owns livestock and equipment and who divide the proceeds of the farm are not, as a general rule, partners. No one single factor can conclusively demonstrate the presence of a partnership. Rather, a court of law looks at the particular circumstances surrounding each case and decides accordingly.

Partnerships don't necessarily have to be created by the drafting of a written legal document. Although this is the suggested and usual method of creation, a partnership can be created without a written contract. The agreement may be oral or expressed verbally between partners. In some instances, the agreement may be implied, that is a partnership may be created by observing how the individuals actually run their business on a day-to-day basis.

For some purposes, a partnership is a separate legal entity from its owners. It conducts business in its own name and contracts in its own name. A partnership may hold title to assets in its own name and be sued in its own name. It is treated as a separate entity by bankruptcy statutes.

In other instances, a partnership is not a separate legal entity. Each partner is liable for partnership obligations for the settlement of debts or judgments against the business. In other words, if the partnership doesn't have enough assets to discharge its legal obligations, its creditors can bring legal proceedings against any or all of the partners to collect any remaining debts. Thus, a partner can't separate his own individual assets from those of the partnership.

However, an individual partner can't be forced to pay the personal debts and obligations of other partners. If any partner can't pay his personal debts, his partnership interest may be attached to settle his debts. This procedure essentially tells the partnership to pay the debtor-partner's share of the partnership income to his creditor until the debt is discharged. This allows the partnership to be able to continue to operate without being hindered by the personal financial problems of an individual partner.

There are two different kinds of partnerships, general and limited. A general partnership consists of general partners who have unlimited personal liability whereas a limited partner has liability limited to his amount of investment in the partnership. A limited partner is essentially only an investor and may not participate in the business management or operation of the partnership as a general partner can. If a limited partner participates in management he will be treated as a general partner and become liable for all partnership obligations.

Management decisions in a partnership are made by an agreement of the parties. The agreement may be part of the written partnership agreement or the partners may simply have an oral agreement that dictates how the business will be operated on a day-to-day basis. The Uniform Partnership Act provides that each partner has an equal voice in management decisions unless the partners agree otherwise.

Capital for the business can come from the partner's personal funds or funds may be borrowed by the partnership itself. Capital can also be raised through the addition of a limited partner. Remember, however, that a limited partner will also share in any profits.

A partnership continues at the will of the partner or until it is terminated by the agreement. Even though a term of existence is specified in a partnership agreement, courts of law do not generally force partnership continuation if a partner desires to withdraw. Dissolution of a partnership normally occurs whenever a partner ceases to be associated with the business. Anytime a partner dies, is incapacitated, or voluntarily leaves the partnership, the partnership is legally dissolved. Even if a partnership operation continues after the death of a partner, it is a new partnership entity. Also, if a new partner joins, the old partnership is dissolved and a new partnership is created.

Since partnerships are so easily dissolved and for so many reasons, they can be quite unstable unless proper provisions are made in the partnership agreement to continue the business. For example, a partnership agreement may be worded so as to permit remaining partners to purchase the partnership interest or assets of a deceased partner as well as one who voluntarily withdraws from the partnership. Such provision can help a partnership achieve a fairly high degree of continuity of both management and ownership, thus helping to prevent a total liquidation and dissolution of the business.

A partnership does not pay any federal income tax. However, it must file an information return showing the income and expenses of the business, the names of the partners, and how the partnership returns will be divided among the partners. The profits, losses, and capital gains are allocated to the partners according to the terms of the agreement. The partners then pay tax as individuals on their respective share of partnership income.

A partnership is usually relatively easy and inexpensive to form as compared to corporations. Partnerships are also probably more informal and flexible to operate than corporations. They may be more easily transferred than sole proprietorships as it may be easier to transfer a share of a partnership rather than individual assets owned by a sole proprietorship.

The pooling of resources in a partnership can be especially attractive to fathers and sons who desire to own and operate a farm business together, but not form a corporation. The father usually has a substantial amount of assets and know-how to contribute to a partnership, but may desire to slow down his business activity and take life easier. On the other hand, the son may be short on available assets and experience, but long on desire and be willing to contribute more time in operating the business. Combining these assets and talents into one operation and sharing the management and profits can be very advantageous to both parties.

C. Joint Venture

Although joint ventures will not be discussed further in this study, their existence should be noted. A joint venture is another variation of the partnership form which is more narrow in function than a partnership. It normally involves a single business operation of short duration such as buying a single group of feeder cattle and feeding them to market weight. The primary purpose for this form of organization is for two or more people to share the risks and profits of a short term specific business undertaking. Persons engaged in a joint venture are subject to the same legal rights and restrictions which exist with a partnership.

D. Corporations

The corporate form of business association has several fundamental characteristics which distinguish it from sole proprietorships and partnerships. One of the more important characteristics is that a corporation is considered a distinct legal entity, separate and apart from the individuals who own it (shareholders), manage it, and work for it. A corporation is essentially an artificial legal person created according to state law. It has many of the rights of an individual. A corporation can own and transfer real and personal property, sue and be sued, contract to buy and sell--all in its own name.

Most important, however, is the characteristic of limited liability for the shareholders. Corporate legal obligations arising either from tort liability (such as negligence) or contractual commitments may be satisfied only out of corporate assets, not out of shareholder's individual assets. Thus, the liability of shareholders is limited to the amount of money they have paid or promised to pay into the corporation.

A corporation does not necessarily enjoy all the same legal rights of an individual. The U.S. Constitution speaks in terms of "citizens" or "persons". In some cases, these references include corporations. The Fourteenth Amendment says that no "person" shall be deprived of due process nor denied equal protection of the law. Within this context, "person" does include corporations. The Fourteenth Amendment also prohibits states from enforcing laws that abridge the privileges or impunities of citizens of the U.S. Within this context, corporations are not considered "citizens". A corporation incorporated in one state is not free to go into a neighboring state and do business. It must qualify as a foreign corporation. The Fifth Amendment protects a "person" from being compelled to be a witness against himself. This self incrimination provision is not available to a corporation. It can be forced to produce documents and records that are incriminating to it and its employees. As one can see, it is impossible to provide generalizations as to when a corporation qualifies as a person or a citizen.[18]

1. Perpetual Life Characteristic of Corporations

Another distinguishing characteristic of the corporate form is that it can have perpetual life. In other words, a corporation could conceivably go on forever--it is not dissolved upon the death of its owners as are the sole proprietorship and partnership. Upon the death of a shareholder in a farm corporation, only the corporate stock owned by the decedent is subject to probate--not the corporate assets. Since title of land and other farm property owned by the corporation are not affected by the death of a shareholder, the operation of the farm business may continue without interruption if ownership and management succession have been planned. This continuity of existence of a corporation results in an estate planning advantage over sole proprietorships and partnerships.

All corporations do not necessarily have to continue forever. The shareholders could fix its life for a certain period of years by stating such in the articles of incorporation.

2. Ownership and Management of Corporations

A corporation has a measure of flexibility in the transfer of ownership not available in other forms of business associations. Stockholders may sell or transfer their ownership shares in the corporation without altering the corporate farm. For instance, if a large block of

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[18]Arthur D. Wolfe and Frederich J. Naffzinger, Legal Perspectives of American Business Associations (Columbus, Ohio: Grid, Inc., 1977), p. 260.

corporate stock was to be transferred, it could change the management control of the corporation. But such a transfer would not affect in any way the assets within the corporation, only the stock ownership of the corporation would be affected. Thus, the corporation could continue to operate as a separate legal entity without interruption. This is in direct contrast to a partnership where the partnership automatically dissolves whenever a partner ceases to be associated with the business.

Another unique characteristic of the corporate form is the way in which it is owned and managed. The owners are called shareholders because they hold shares of interests in the corporation. Corporations issue these ownership shares in the form of stock. There are several types or forms of stock with the most widely used being common stock.

At the time of incorporation, stock is received in exchange for the assets which are transferred to the corporation. Thus, shares of stock represent the specific amount of interest each owner holds in the corporate assets. However, these shares of stock do not represent an interest in individual assets. The corporation owns the assets and shareholders do not have a right to any specific assets owned by the corporation.

Decision-making powers in a corporation are allocated to the stockholders, the directors, and the officers. The owners of stock vote individually or combine in numerous ways to elect a board of directors who manage the corporation for the stockholders. The board of directors in turn elect officers who are the day-to-day decision makers of the corporation. These officers may in turn hire the managers and/or laborers to help operate the corporation.

Thus, there could theoretically be five groups of persons involved in a corporation: 1) the Incorporators, 2) the Stockholders, 3) Board of Directors, 4) Officers, 5) Salaried Employees and Hourly Wage Earners.

1) Incorporators--These are the persons who sign the articles of incorporation and see to it that they are filed in the state of incorporation. In Michigan, there can be one or more incorporators.

2) Stockholders--Owners of the corporation. Legally it is the stockholders that exercise ultimate control of the corporation. This control is exercised through voting their shares of stock. Stockholders hold annual meetings (and sometimes special meetings) to transact such business as electing directors, approving changes in the corporate charter and articles of incorporation, acting on financial reports, and providing general overall guidance to the operation. Any transaction that would alter the corporation in a fundamental manner requires shareholder approval. Examples of such fundamental changes include mergers, consolidation, sale or lease of all the assets, dissolution, and alteration of the stock structure.

3) Board of Directors--Usually the directors are given broad authority in the bylaws to manage the business for the benefit of the stockholders. Directors are responsible for making operating policy decisions, keeping the corporation in a sound financial condition, recording their business decisions, and selecting the officers. They exercise authority as a group; acting separately as individuals has no legal effect. Decisions are made by majority vote with each director having one vote regardless of stock ownership. Directors typically receive fees for their service, but are not salaried. In Michigan, the board shall consist of one or more members. Also, in Michigan, a director need not be

a shareholder of the corporation unless the articles or bylaws so require.

4) Officer--The officers execute the corporate policy on a day-to-day basis, hence the term executives. Officers often function as full- or part-time employees and receive salaries. Officers are the agents of the corporation who are authorized and directed to perform regular business duties of the farm operation such as making contracts, hiring and firing employees, receiving and paying out money, maintaining adequate records of business transactions, etc. Officers may be removed whenever the board feels that it would be in the best interest of the corporation.

5) Salaried Employees and Wage Earners--Salaried employees may or may not be officers. Wage earners are all the other non-salaried employees hired by the corporation to help in the operation of the business.

In large publicly-held corporations, these above groups are separate and distinct from one another. Thus, there is a separation of ownership and management. Practical control of the corporation is removed from the owners by the board of directors. This separation of ownership and management is another unique characteristic of the corporate form.

In most closely-held family farm corporations, the same individuals hold membership in each of the groups. Frequently an individual will wear three hats, that of a stockholder, director, and officer. Under these circumstances, ownership and management may be merged in the same persons. However, if a stockholder is also a director or an officer or both and he handles corporate business, he is technically acting as a manager and not as an owner. The reason for this is that stockholders completely lack any right to establish management policy by direct action. They can only influence management of the corporation indirectly through their election of the directors. There is one exception to this. A few states, Delaware is one, have included special provisions for close corporations in their business corporation statutes. Delaware has a provision that allows the stockholders of a closely-held corporation to manage the corporation rather than a board of directors. However, this is an unusual exception. The general rule is that the separation of ownership and management always exists legally in a corporation, even though an owner is also a manager. Thus, it is important to know the separate functions of each group as the law judges the authority and obligations of such an individual according to the specific capacity within which he or she is operating.

3. States Regulate Corporations

As was stated earlier in this chapter, corporations are creatures of state laws. Corporate law is state law. That is not to say that federal laws can be ignored in corporate matters. Federal securities laws, federal income tax law, and the federal labor law are examples of federal laws which have an impact on corporate affairs. However, the federal government does not grant corporate charters; the individual states possess that power.

The state of incorporation determines the general purposes for which a corporation may be formed and the procedures which must be followed. After the formal requirements have been met, the state recognizes the existence of the corporation and permits it to engage in the activities provided in its charter or articles of incorporation. The articles of incorporation set forth the general purposes and powers of the corporation. The state must approve any amendments to it.

In addition, the stockholders or directors of the corporation enact their "own" set of laws which provide governing rules for the corporation. These laws are known as the corporate bylaws. The bylaws are rather detailed and contain the specifics for regulating the internal affairs of the corporation. This is in direct comparison with the articles of incorporation which are very general in nature. Also, no state approval is required for enactment or amendment of the bylaws.

Because a corporation is a creature of state statutes, somewhat greater formality is required of a corporation than of other forms of business organization. The corporation must keep separate books and records. These records are used in filing reports with a number of governmental agencies. Usually a corporation is required to file license, franchise, or other tax returns, an annual report to the state, and possible special reports for issuance of shares of stock, amendment of articles, and change of address. In a few states, Michigan excluded, corporations are required to file annual reports showing the amount of agricultural land owned and leased in the state. Some states even prohibit or severely limit the size and/or activities of corporations engaged in agriculture.

Corporations must also have an annual meeting of stockholders. Minutes of this meeting and any board of director meetings must be kept.

A corporation operating within the state of its incorporation is called a domestic corporation. In other states and countries it is called a foreign corporation. Each state has the power to regulate foreign corporations that are doing business within its borders.[19]

A corporation does not have the right to do business in other states without first qualifying to do business as a foreign corporation. Monetary penalties and/or criminal misdemeanor charges may be imposed on those corporations and possibly their directors or officers who do not properly qualify.

4. How a Corporation Is Financed

There are two basic sources for financing a farm corporation: 1) the issuance and sale of bonds, debentures, notes, etc., called debt financing, and 2) the issuance of stock called equity financing.

A bond is a written promise by the corporation to pay a stated sum of money at a specific date accompanied by a stated interest rate. Bonds are normally secured by a lien or a mortgage. Thus, a bond holder is a secured creditor of the corporation. Some bonds are designed so that it is possible to convert them into shares of stock of the corporation. A debenture is a debt instrument similar to a bond except that it is unsecured.

Remember that a stockholder is an owner of the corporation and not a creditor. As noted earlier, there can be several different classes or types of stock. A stockholder's ownership of the corporation is represented by a stock certificate.

The ability to issue various classes of stock and debt instruments provides a corporation greater flexibility in arranging the capital structure than possible with a sole proprietorship or partnership.

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[19] _Ibid._, p. 282.

Through the use of debt instruments in addition to stock, investments can be made in corporations without changing the control of stock ownership.

Corporations can also borrow money, just as a sole proprietorship or partnership would. One would thank that the incorporation of a farm business would increase its attractiveness to lending associations because a corporation is of greater permanence (it can have perpetual life) than the other forms of business organization. However, this is not usually the case as the management of the farm corporation is usually of greater concern to lenders than is perpetual life. Thus, the ability to obtain credit from a bank is usually not affected by incorporation.

5. Types of Corporations

As was discussed in the previous two chapters, the two common types of corporations are regular corporations (also referred to as Subchapter C corporations) and tax-option corporations (also referred to as Subchapter S corporations). Both types are separate legal entities. Their difference lies in the method of federal income tax payment.

a. Regular Corporations

A corporation taxed under the regular method of income taxation is considered a separate taxable entity--it becomes a legal, tax-paying "person" itself. It pays its own income taxes at tax rates established for a regular corporation. Amounts paid by the corporation as salaries, wages, rents, and interest are deductible by the corporation as expenses when figuring taxable income. Every person--stockholder or not--who works for the corporation becomes an employee. Being an employee, they must pay personal income taxes on their wages--just as all employees are required to. Stockholders must also pay personal income tax on any other income received from the farm corporation such as land rental payments or interest received on corporate debentures.

A disadvantage of Subchapter C corporations is that double taxation is possible. It occurs when corporations pay dividends to their shareholders. The reason for this is that dividends are distributed from the corporation's after-tax income. They are not a deductible corporate operating expense. And shareholders must include dividends in their taxable income. Thus, shareholders are in effect paying taxes a second time on the same profits. However, this double taxation on dividend income is partly offset by the $100 dividend exclusion.[20]

Most closely-held farm corporations avoid paying dividends because of the double taxation. Many corporations strive to pay out all "profits" as salaries, bonuses, rent, interest on debentures, or wages to stockholders, thus avoiding double taxation.

b. Subchapter S Corporations

If a farm corporation elects to be taxed under the special tax option or Subchapter S method, it is normally not a taxpayer. That is, the corporation itself is not taxed on any income. The income of the corporation "flows through" to the shareholders and each shareholder pays a tax on his or her prorated share of the corporation's earnings when he or she files his or her individual income tax return. All income is taxed the year it is earned whether or not it is retained or

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[20]Section 116(a) of the Internal Revenue Code states that "gross income does not include amounts received by an individual as dividends from domestic corporations, to the extent that the dividends do not exceed $100."

distributed. Subchapter S rules are similar to partnership rules in that an information return is filed annually on behalf of the corporation.

Thus, corporate earnings in a Subchapter S corporation are only taxed once--to the shareholder. This avoids the double taxation possibility present with Subchapter C corporations.

However, only certain types of small business corporations may elect to use the Subchapter S option. Several requirements must be met initially and on a continuing basis to be eligible. These requirements will be discussed in detail in later chapters.

A Subchapter S corporation does not lose its other corporate characteristics. It is a corporation for every other purpose. It hires employees and pays salaries and bonuses in the usual fashion and may declare dividends (without the dividend exclusion) to shareholders. Limited liability, transferring shares, employee fringe benefits, stock purchase agreements, and the like are all similar.

Table 9 provides a quick synopsis of this chapter. It illustrates some of the differing characteristics of sole proprietorships, partnerships, and corporations.

Table 9. Comparison of Farm Business Organizations

	Sole Proprietor	Partnership	Corporation
Nature of entity	Single individual	Aggregate of two or more individuals	Legal person separate from shareholder-owners
Life of business	Terminates on death	Agreed term; terminates at death of a partner	Perpetual or fixed term of years
Liability	Personally liable	Each partner liable for all partnership obligations	Shareholers not liable for corporate obligations
Source of capital	Personal investment; loans	Partners' contributions; loans	Contributions of shareholders for stock; sale of stock; bonds and other loans
Management decisions	Proprietor	Agreement of partners	Shareholers elect directors who manage business through officers elected by directors
Limits on business activity	Proprietor's discretion	Partnership agreement	Articles of incorporation and state corporation law
Transfer of interest	Terminates proprietorship	Dissolves partnership; new partnership may be formed if all agree	Transfer of stock does not affect continuity of business--may be transferred to outsiders if no restrictions
Effect of death	Liquidation	Lidquidation or sale to surviving partners	No effect on corporation. Stock passes by will or inheritance
Income taxes	Income taxed to individual; 60% deduction for long-term capital gains	Partnership files an information return but pays no tax. Each partner reports share of income or loss, capital gains and losses as an individual	<u>Regular Corporation</u> *Corporation files a tax return and pays tax on income; salaries to shareholder-employees deductible *Capital gains offset by capital losses; no 60% deduction for capital gains *Commencing in 1979, 17% on first $25,000, 20% on second $25,000, 30% on third $25,000, 40% on fourth $25,000 and 46% on all over $100,000 or corporate taxable income (federal rates). *Shareholders taxed on dividends paid <u>Tax-Option Corporation</u> *Corporation files an information return but pays no tax. Each shareholder reports share of income, operating loss, and long-term capital gain.

Source: Neil E. Harl and John C. O'Byrne, The Farm Corporation, North Central Regional Extension Publication No. 11, revised April 1979, p. 3.

CHAPTER IV

WHAT TAXES APPLY TO A CORPORATION?

Since a corporation is a separate legal entity, it is also a separate taxpayer for most purposes. This chapter will discuss some of the general tax aspects relating to farm corporations.

A. Methods of Federal Income Tax Payment

The general characteristics of the two methods of federal income tax payment available to corporations--regular or Subchapter C and tax-option or Subchapter S--have been discussed in previous chapters. Remember that corporations are taxed according to the regular method unless the shareholders choose the tax-option method to have corporate income taxed to them. However, for a corporation to qualify for the special status as a Subchapter S corporation, it must meet several requirements to be eligible. Let's take a look at these qualifying conditions.

B. Subchapter S Election Requirements

A corporation must meet the following requirements before it may elect the Subchapter S tax option:[21]

1) Starting in 1979, the corporation can have no more than 15 shareholders. This limitation is the limit at any time during the

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[21]The requirements for Subchapter S election are contained in Sections 1371 and 1372 of the Internal Revenue Code of 1954.

taxable year even though the total number of shareholders for the entire taxable year may exceed the limit. The limit was ten or fewer shareholders with some exceptions for taxable years beginning prior to December 31, 1978.[22]

2) Generally, only individuals or estates of individuals may be shareholders. Partnerships and corporations cannot be shareholders. Before 1977, all trusts were not eligible as shareholders. However, starting in 1977, certain grantor and voting trusts are now eligible shareholders.[23]

3) The corporation must be a domestic corporation (organized under the laws of one of the states or territories of the United States or under federal law) with no non-resident alien shareholders.

4) The corporation may have only one class of stock outstanding.[24]

5) No more than 20 percent of the corporate gross receipts can be from passive sources. Passive sources are defined as royalties, rents, dividends, interest, annuities, or the sale and exchange of stocks and securities. However, there is an exception for farm corporations. The IRS has ruled that for a farm corporation renting land, income received under the lease arrangement is not "rent" if the corporation through its officers and agents participates materially in the production of income.[25]

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[22]For further information on this matter see Chapter VI, Sections C. Estate Planning Disadvantages--Federal and 4. Subchapter S Disadvantages.

[23]Ibid.

[24]Ibid.

[25]See Rev. Rul. 112, 1961-1 Cum. Bull. 399.

6) The corporation cannot be a member of an affiliated group as defined in Section 1504 of the Internal Revenue Code.[26]

7) All of the shareholders of the corporation must consent to the election initially. Prior to 1976, all new shareholders were also required to consent to the election. However, the Tax Reform Act of 1976 modified the requirement for consent by a new shareholder. After 1976, the new shareholder must take action himself and file the affirmative refusal to consent to the Subchapter S election within 60 days of acquiring the stock. Thus, new shareholders are assumed to consent to the election unless they make this written refusal.

C. How the Subchapter S Election Is Made

To elect the Subchapter S method of taxation, the corporation must file IRS Form 2553 with the district director of the IRS. The consent of each shareholder must be attached to this form.

For taxable years beginning after December 31, 1978, an election may be made at any time during the preceding taxable year or during the first 75 days of the taxable year in question. For taxable years prior to 1979, the election had to be filed during the month preceding or following the beginning of the corporation's tax year for which the

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[26]As defined in Section 1504, the term "affiliated group" means "one or more chains of includable corporations connected through stock ownership with a common parent corporation which is an includable corporation if 1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includable corporations (except the common parent corporation) is owned directly by one or more of the other includable corporations, and 2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock of at least one of the other includable corporations."

election was to be effective. The change was made by the Revenue Act of 1978. An election that is too late for one year may become effective the following year.

Once an election is made, it need not be renewed annually. In fact, it remains in effect for all subsequent taxable years until it is voluntarily or automatically revoked.

D. Termination of the Election

A Subchapter S election can be terminated voluntarily or involuntarily.

Voluntary termination occurs when the corporation and its shareholders file a revocation with the district director of the IRS. There is no specific form for revocation. However, the consent of all shareholders on the books on the date of revocation must accompany the revocation statement.

A Subchapter S election can be voluntarily revoked at any time after the first year the election becomes effective. An attempt to revoke the election during the first tax year will not be effective until the following year. After the first year, if the revocation is made during the first month of the tax year, it will be effective for that year and subsequent years. Revocations filed after the first month of the tax year are effective at the beginning of the following year.

Involuntary or "automatic" termination occurs whenever the corporation fails to meet any of the Subchapter S election requirements discussed earlier in this chapter. In this case, termination is retroactive to the <u>first</u> day of the taxable year in which the disqualification occurs.

1. Effect of Terminating the Election and Possibility for Re-election

After termination, whether voluntarily or involuntarily, the corporation will be taxed as a regular or Subchapter C corporation. Furthermore the corporation is prohibited from re-electing Subchapter S treatment for a five year period, unless the commissioner of the IRS (not the District Director) consents to an earlier election.

The burden is on the corporation to establish that the commissioner should consent to a new election. The fact that more than half of the stock in the corporation is owned by persons who did not own any stock in the corporation in the year of termination of the previous election will tend to establish that consent should be granted.

An IRS regulation prohibits the same shareholders from creating a new or "successor corporation" to avoid or shorten the five-year ban if the corporation is formed solely for the purpose of avoiding the ban.[27]

E. How a Subchapter S Corporation Works Taxwise

Remember that a Subchapter S corporation has all the characteristics of a regular corporation. The only difference is in the method of income taxation. Although the amount of taxable income for a Subchapter S corporation is determined in a manner similar to a Subchapter C corporation, the difference comes in the distribution of taxable income.

A regular corporation reports its own gains and losses. If there is taxable income, the corporation itself pays the taxes according to

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[27] A "successor corporation" is one a) Which acquires a substantial portion of the assets of the former corporation or which acquires a like quantity of what were the assets of the corporation, b) In which the owners of 50 percent or more of its stock were the owners of 50 percent or more of the stock of the former corporation at the time the election was terminated. U.S. Treas. Reg. Section 1.1372-5(b) (1959).

the tax rates for Subchapter C corporations.[28] If the corporation desires to pay dividends to its shareholders, these will be distributed out of after-tax earnings. Of course, the shareholders are taxed on any dividend income.

A Subchapter S corporation itself pays no income tax. Rather, the taxability of income and expenses of an "S" corporation is passed directly to the shareholders. Specifically, each shareholder will report these items of income from the corporation on his individual tax return: 1) Any salary received from the corporation along with rental payments received from the corporation such as those for land, machinery, etc. 2) The portion of income actually dispensed to the shareholder in cash as a dividend during the year, and 3) The shareholder's pro rata share (based on the percentage of stock ownership on the last day of the corporation's taxable year) of income earned by the corporation but not distributed to shareholders (referred to as undistributed taxable income UTI). 4) If part of the corporate income is long term capital gain, each shareholder will receive his pro rata share (again based on the percentage of stock ownership on the last day of the corporation's taxable year) if the corporation's net long-term capital gains exceed net short-term capital losses. Capital losses do not pass through to shareholders. 5) Investment tax credit passes to the shareholders on a pro rata basis. 6) Net operating losses are also passed to shareholders. But the method in which they are passed is slightly different. Instead

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[28]Starting in 1979, the federal tax rates for regular corporations are 17 percent on the first $25,000 of corporate taxable income, 20 percent on the second $25,000, 30 percent on the third $25,000, 40 percent on the fourth $25,000, and 46 percent on all corporate taxable income over $100,000.

of passing the loss to shareholders on the last day of the corporation's taxable year, operating losses pass to shareholders on a daily basis. This means that a shareholder holding a share of stock for three days during the year would be entitled to claim 3/365 of the annual net operating loss attributable to that share of stock.

One item that cannot be claimed by the individual stockholder is the credit for federal excise tax on gasoline and lubricating oil. These amounts may be claimed only by a refund form filed by the corporation.

F. Subchapter S Tax Advantages

Besides avoiding the double taxation possibility of Subchapter C corporations, Subchapter S corporations have a number of tax advantages.

The "flow through" characteristic of income tax credits (investment credit, long-term capital gains, net operating losses, etc.) can prove to be very advantageous to shareholders with substantial outside income. These tax credits may put the shareholder in a lower personal income tax bracket and thus result in overall income tax savings.

Frequently for the first year or two, a corporation sustains a net operating loss because of the startup costs and other large expenses incurred in the incorporation process. Therefore, it may be advisable to use the Subchapter S election for those first several years to enable the shareholders to use these operating losses to offset any personal income from the corporation or otherwise. When the corporation begins to make a profit, the Subchapter S election can be terminated and the profits of the corporation would then become subject to the lower tax rates of a regular or Subchapter C corporation.

As is discussed in Chapter VI, Subchapter S corporations are not subject to the accumulated earnings tax nor the personal holding company tax.

The advantage of deferring payment of income taxes through the use of different taxable years for the corporation and the stockholder employee is discussed in Chapter V.

G. State Income Tax

Even though the details vary from state to state, state income tax laws generally treat a regular corporation as a separate taxpayer. However, state treatment of Subchapter S corporations vary. Some states recognize the tax option status of Subchapter S corporations for state income tax purposes while others do not. In the North Central region of the U.S., Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and North Dakota recognize the Subchapter S corporation.[29]

1. Michigan Income Tax

Michigan tax law relating to corporate taxes has changed dramatically in the last few years. Currently, the tax laws are quite favorable toward farm incorporation. However, this wasn't the case before 1977.

Up to 1976, the state franchise fee was an extreme disadvantage to incorporating a farm operation in Michigan. The actual costs involved with this tax are discussed in Chapter VI.

In 1976, this annual corporate franchise fee and the state corporate income tax were eliminated and replaced by a single business tax

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[29] Neil E. Harl and John C. O'Byrne, The Farm Corporation, North Central Regional Extension Publication, No. 11, revised April 1979, p. 11.

(SBT). The SBT is a value added tax levied on all entities doing business in Michigan--this means sole proprietorships and partnerships along with corporations. It is levied at a rate of 2.35 percent and is a tax " . . . upon the privilege of doing business and not upon income." It is not a tax on gross receipts, although gross receipts is used as a measure for certain special benefits. Most firms calculate their tax by adding compensation paid, depreciation, royalties paid and interest paid to their federal taxable income and subtracting interest received, royalties received and investments made during the tax year. Even though the expressed tax rate is 2.35 percent, the act limits the tax base to 50 percent of gross receipts, which effectively limits the actual rate to no more than 1.175 percent of gross receipts. Furthermore, corporations may deduct the SBT from their federal tax base, making the effective rate to them a maximum of 0.6 percent of gross receipts. Individuals also receive a tax credit against their state tax, effectively lowering their rate.[30]

Michigan agriculture was hit particularly hard by this tax. Even though individuals received a tax credit against their state tax, a sole proprietor or partner had to pay two state taxes--the SBT for his farm business and then his personal state income tax. A farm corporation also had to pay the SBT and the stockholder-employees, of course, had to pay their state individual income tax.

Michigan agriculture made it known to the state legislature that this double form of taxation put it at a comparative disadvantage to

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[30] A Guide to Michigan's . . . Single Business Tax Act of 1975, Office of Economic Expansion, Michigan Department of Commerce, November 1975.

agriculture in other states. As a result of this lobbying, in 1977 farm businesses were declared exempt from the SBT.

However, this exemption applies only to farm business carried on at the wholesale level. This would seem to indicate that, for example, a farmer that packed apples for neighboring farmers, along with his own apples, would have to pay the SBT on that portion of income received from doing business for others. Farms that have processing facilities and/or operate part of their business at the retail level may be subject to the SBT.

Thus, unless part of the farm business falls into the above category, a farm business itself--be it a sole proprietorship, partnership, Subchapter C or S corporation--currently pays no state income tax. Of course, a sole proprietor, partner, or shareholder of a Subchapter S corporation must still pay individual state income tax on any net farm earnings. The only income subject to state tax for a stockholder-employee of a Subchapter C corporation is the employee's salary along with any other income received from the corporation such as land rental payments, dividends, etc.

H. Property Taxes

Corporate real and personal property is subject to regular state and local property taxes, just as individually and jointly owned (partnership) real and personal property are. In most states, shares of stock in the hands of the shareholder are also personal property subject to tax. State law may provide some form of offset so that the property tax does not fall on the property owned by the corporation and also on the share of stock which represents an interest in corporate property.

However, it may happen that the total tax on the corporation and the shareholders is greater than the tax would have been on an individual alone.[31]

1. Michigan Property Taxes

In Michigan, there is a tax on some items of personal property. This tax is known as the Michigan Intangibles Tax and it is a tax on income producing intengibles. This includes stocks, bonds, notes, accounts receivable, annuities, and any other form of income producing intangibles. Thus, corporate stock of a farm corporation would be subject to the tax.

The rate of this tax is 3.5 percent of income but not less than one-tenth of 1 percent of the face value of the intangible. There is a $350 deduction for a husband and wife filing a joint return.

A farm corporation in Michigan must, of course, pay property taxes on any real property owned, just as an individual or partnership must. However, farm corporations may not always qualify for the two forms of property tax relief available to Michigan farm owners--the Homestead Property Tax Credit and the Farmland and Open Space Preservation Act (P.A. 116). The potential problems with each of these are discussed thoroughly in Chapter VI under the heading of Michigan Income Tax Disadvantages.

I. Social Security Tax, Worker's Compensation Tax, Unemployment Compensation Tax

Since a farm corporation is an employer, it must pay all the associated payroll taxes such as social security, worker's compensation, and

[31]Harl and O'Byrne, *loc. cit.*

unemployment compensation on each of its employees, including stockholder-employees, if the corporation meets the qualifying criteria. Incorporation of a farm business usually results in increased payroll taxes being paid by the farm business. The actual extent of these taxes and the qualifying criteria for each is discussed in Chapter VI.

J. Inheritance, Estate, and Gift Taxes

A common misconception held by some farmers is that by forming a corporation, estate planning problems will be solved because corporate stock is not subject to the federal estate and state inheritance tax. However, such a belief could not be farther from the actual truth.

The truth is that corporate stock, like any other real and personal property interests, is subject to the federal estate tax and state inheritance tax on the death of the owner. Also, gifts of corporate stock may be subject to federal and state gift tax (Michigan has no gift tax), just as gifts of any other property are. Thus, neither the corporate structure nor ownership of corporate shares of stock offer any special exemption from paying federal estate tax, state inheritance tax, and federal and state gift taxes.

1. Methods of Stock Valuation

Upon the death of a shareholder in a closely held farm corporation, the shares of stock will be valued for federal estate and state inheritance tax purposes according to their "fair market value." Treasury Regulation 20.2031-1(6) defines "fair market value" as "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

However, there is no exact formula that is used for the determination of the "fair market value" of shares in all closely held corporations. The best guide available is Revenue Ruling 59-60 which outlines methods and factors to be used in a valuation. Some of the factors listed in the Revenue Ruling (Cumulative Bulletin 237) are: a) The nature of the business and the history of the enterprise from its inception; b) The economic outlook in general and the condition and outcome of the specific industry in particular; c) The book value of the stock and the financial condition of the business; d) The earning capacity of the company; e) The dividend-paying capacity; f) Goodwill or other intangible value of the company; g) Sales of the stock and the size of the block to be valued; h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

Several of these factors do not apply to most closely held family farm corporations. For instance, most family farm corporations do not have any goodwill or other intangible value associated with the business (factor f) nor is there an exchange or over the counter market that trades shares of family farm corporations (factor h). Also, most family farm corporations operated as regular tax paying corporations do not pay dividends (factor e) since doing so involves double taxation.

Probably the three most commonly used factors are c, d, and g. However, the book value aspect of factor c is hardly every used since it is a historical cost rather than actual market value. Instead, the financial condition of the business is usually determined by an appraisal of the actual fair market value of the assets in the farm corporation.

The fair market value of the assets is then reduced by the total liabilities of the corporation to arrive at a net asset value of the assets. A value per share can then be determined by dividing the total net asset value by the total number of shares issued.

Factor d, the earning capacity, requires the multiplication of the normal earnings of the corporation by a capitalization rate. The most common areas to consider when determining the capitalization rate are 1) the nature of the business, 2) the risk involved, and 3) the stability of earnings.[32]

Since there are few sales of stock in family farm corporations (even if there are sales, the sales value may not be a true market value), the size of the block to be offered is the most commonly used aspect of factor g. The appraised value of the corporate stock may be adjusted upward or downward depending whether the block of stock involved is a controlling (greater than 50 percent of the stock issued by the corporation) or minority interest (50 percent or less of the stock issued by the corporation). The logic behind an adjustment is that a willing buyer, being under no compulsion to buy, would not pay full value for a minority stock interest in a family corporation because the buyer knows that other shareholders (family members) will still control the management of the corporation. Similarly, a willing buyer, being under no compulsion to buy, might possibly pay a greater price for a controlling interest in a family corporation because the buyer can control the management of the corporation as he sees fit.

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[32]Michael Glenn Barton, "Management Implications of Incorporating the Family Farm," (M.S. thesis, University of Illinois, 1977), p. 36.

In cases involving minority interests in closely held family corporations where the IRS has followed the above line of reasoning, the result has been that the stock has been valued from 5 to 66 percent below the actual appraised value of the underlying assets.[33]

It should not be implied that the above factors are the only elements used to determine the value of stock shares in a family corporation for federal estate and state inheritance tax purposes. Another element available that may limit or remove the weight to be given to the above factors is a binding buy-sell agreement. A binding buy-sell agreement is an agreement whereby a corporation or individual (usually a co-stockholder) promises to buy stock, and the stockholder promises to sell, upon the happening of a certain contingency, usually the stockholder's death. Since this agreement involves a binding mutual promise, courts--in some cases--have adopted the specified price of the buy-sell agreement in determining the valuation of the stock for federal estate tax purposes.[34]

In addition, there is a possibility of using the alternative valuation (IRS Code Section 2032A) procedure to lower the valuation of the stock. Under this election, if certain conditions are met, the executor of estates of decedents dying after December 31, 1976, may elect to value real property which is devoted to farming on the basis of the property's value as a farm, rather than its fair market value determined on the basis of its highest and best use. Corporate stock qualifies

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[33]For more information on the "discounting" of minority stock interests in closely held corporations, see Chapter IX.

[34]Federal Estate and Gift Taxes Explained (Chicago: Commerce Clearing House, 1979), p. 68.

for this election if the corporation has 15 or fewer shareholders or 20 percent or more of the voting stock is included in the deceased's estate. However, this special valuation procedure can only reduce the gross estate by a maximum of $500,000.[35] Also, it can be used for valuing the estate for federal estate tax purposes only. It cannot be used when valuing the heir's share of an inheritance for Michigan inheritance tax purposes.

Valuing gifts of corporate stock for gift tax purposes is done in pretty much the same manner as it is done for federal estate and state inheritance tax purposes. Of course, the alternative valuation procedure cannot be used.

The point of this discussion is that some method must be used to arrive at a "fair market value" of the stock shares for federal estate, state inheritance, and gift tax purposes. The ownership of stock shares does not offer any special freedom from paying these taxes.

K. Taxes on Dissolution and Liquidation

The process of dissolving a corporation and distributing the assets (liquidation) to the shareholders and creditors has annual tax implications--both for the corporation itself and for the shareholders. Some liquidations will involve taxation of both the corporation itself and also the shareholders. Other liquidations may only result in taxation at either the corporate level or the shareholder level. Seldom will there be a situation where there will be no additional income taxes payable upon a corporate liquidation. The amount of the tax may not

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[35]For a more detailed discussion of this matter, see Chapter VI, Sections C. Estate Planning Disadvantages--Federal, 1. Special Use Valuation.

always be very significant, but there will usually be tax consequences.

Chapter VII contains a detailed discussion of the tax implications of corporate liquidation.

L. "Arm's Length" Transactions

The principle behind "arm's length" transactions is Section 482 of the Internal Revenue Code. It states "in any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

If Section 482 is applied to closely held family farm corporations, the two organizations which are controlled and owned by the same interests are the corporation itself and the shareholders (they are probably all related). Thus, any transaction between the corporation and a shareholder is subjected to the standard of "arm's length."

To decide whether the related taxpayers involved in a particular transaction acted in an "arm's length" manner, this question is normally asked: Would unrelated parties have handled the transaction in the same way? (compensation, terms, etc.) If not, the parties may be guilty of income tax evasion.

Therefore, for any transaction between the shareholders of a close corporation and the corporation itself, the shareholder should ask themselves "Is this transaction being conducted at "arm's length?"

An example of transaction in a family farm corporation which must be conducted at "arm's length" is the land rental or lease agreement between the corporation and the land-owning shareholders. The two parties of the agreement must be able to show that unrelated or third parties would have entered into a similar agreement with the same terms (length of lease, compensation amount, time period for compensation, etc.).

CHAPTER V

ADVANTAGES OF INCORPORATING A FAMILY FARM BUSINESS

This chapter consists of a listing of the normal textbook advantages (disadvantages are discussed in Chapter VI) for incorporating a business along with a thorough discussion of their potential application to closely-held family farm businesses. It will become apparent in this discussion that some attributes of the corporate form are less important to farm businesses than to non-farm businesses. In fact, some characteristics of the corporate form that are highly advantageious to most non-farm businesses, present virtually no advantages to farm businesses. This is because of the unique business characteristics of agriculture.

Also, potential advantages and disadvantages can even vary among farms themselves. What may be a plus to one farm business could well be a disadvantage to another. Farm families face different circumstances and have different goals and objectives. Thus, it becomes difficult to generalize. In determining whether a farm business should use the corporate form or some other form of business it is extremely important to evaluate the potential advantages and disadvantages in terms of the specific farm situation. In other words, each farm situation must be evaluated separately.

Keeping the limitations of generalizations in mind and recognizing that circumstances differ widely among farm families, some of the more common advantages of incorporating a business will be summarized in this chapter.

A. Limited Liability

The characteristic of limited liability of stockholders in a corporation was discussed in Chapter III. Remember that the general rule is that a shareholder's risk is usually limited to the amount of his investment in the corporation. However, there are several ways in which a shareholder may lose limited liability.

An employee, officer, or director may be personally liable for his negligent actions even though the ocrporation is also liable. For example, a shareholder who is also a corporate employee might become involved in an accident while driving a corporate vehicle such as a combine. In this instance, the shareholder could be held personally liable, not as a shareholder-owner, but in his capacity as a corporate employee. A person is always responsible for his own shortcomings, no matter what his title or status in a business may be. A corporation is usually not a substitute for proper liability insurance coverage.

Once a corporation has been formed, it must continue to comply with the statutory requirements set forth in the state of incorporation in order for shareholders to continue to have limited liability. This includes such corporate formalities as filing the required reports to the state, paying the annual filing fees, holding required meetings and keeping minutes of these meetings, and maintaining separate book-keeping and accounting records for the corporation. In some states, if a corporation does not comply with some of these requirements, the state attorney general can force its involuntary dissolution and shareholders may lose their limited liability.[36]

Under certain circumstances a court will disregard the corporate entity or "pierce the corporate veil" and hold the owner liable for the actions of his corporation. Sometimes a court will speak of disregarding the corporate entity when the owner is the "alter ego" of the corporation. This means that the corporation is simply a shell intended to insulate the owners from personal liability. The following are examples of the abuse of the corporate privilege leading to the disregard of the corporate entity. 1) Where the owners of the corporation add or withdraw capital from the corporation at will, thereby treating the corporate assets as their own. 2) Where the owner almost predestines the corporation to financial failure by inadquately capitalizing the venture. 3) Where the owner has previously held himself out to be liable for the corporate debts. These examples could all possibly result in holding the shareholder-owner personally liable for the actions of his corporation.[37]

A shareholder will also lose limited liability if he signs personally on corporate contractual obligations. For example, it has become common practice for credit agencies lending money to farm corporations to require that the principal stockholder and/or president of the corporation co-sign the note.

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[36]Section 922 of the Michigan General Corporation Act states "if a domestic corporation neglects or refuses for 2 consecutive years to file the annual reports or pay the annual filing fee or a penalty added to the fee required by law, the corporation shall be automatically dissolved."

[37]Arthur D. Wolfe and Frederick J. Naffziger, Legal Perspectives of American Business Associations (Columbus, Ohio: Grid, Inc., 1977), p. 272.

If an individual transfers property to the corporation, the major advantages of limited liability is that a deficiency judgement against the corporation cannot be satisfied from other property owned by the shareholder. However, if a shareholder places all his assets in the corporation and owns little or nothing in his personal capacity (a common situation in some farm corporations), limited liability has little meaning as there are few other assets to protect.

Also, in a suit against a corporation, a plaintiff is quite likely to name not only the corporation, but also the individuals who are involved such as an officer or director. As stated in Chapter III, the shareholders, officer, and directors in a small closely-held corporation may be the same persons. Thus, in such a case, it becomes likely that the shareholders will lose limited liability.

In summary, the value and importance of the limited liability feature will vary from one farm situation to another. It probably is most advantageous to shareholders not directly involved in the management and operation of the farm since these individuals normally have extensive assets in other areas (that is, outside of the business) which they want to protect. This is in direct comparison to most farmers whose vast majority of assets are invested in the farm business.

For these and possibly other reasons, it appears that limited liability is not as great an advantage for incorporating farm businesses as it is in many non-farm businesses. Each farm situation should be analyzed separately to see if this is the case.

B. Continuity of Operation

As discussed in Chapter III, a corporation may have perpetual life. It can exist as long as the shareholders desire and as long as it continues to fulfill the requirements of corporate law. The death of a stockholder has no effect upon the life of the corporation. It is not dissolved upon the death of an owner as are the sole proprietorship and partnership.

The perpetual life characteristic would not present any advantages to a farmer who does not want the farming operation to continue and only plans on the farm being sold at his death with the proceeds distributed among family members. If, however, the farmer wants the operation to continue, or if he wants his family members to be able to make their own decisions after his death, this characteristic of incorporation may have some advantages.

The fact that specific farm assets do not have to go through probate permits the board of directors of the corporation to make farm management decisions without being limited by the legal constraints of probate. This results in a greater continuity of management and may result in a smoother transition of ownership of the farm business from one generation to the next. It also permits longer range planning which is necessary to keep up with the technological changes of farming today. Thus, the corporate form of business may help to maintain the farm at a point of peak operating efficiency by avoiding the problems of business interruptions that result from the death of a sole proprietor or partner.

However, considerable advanced planning is required in a closely-held family farm corporation to accomplish this continuity of ownership. For example, consider the case of a farmer who is the majority stockholder, owning 70 percent of the stock (his wife owns the remainder), of a closely-held farm corporation and he is the sole employee and manager of the business. If there are no plans for management succession by a son or some other party, this corporation most likely has no practical permanence--it will dissolve upon the death of the majority shareholder. Thus, in reality, a corporation does not necessarily have perpetual life unless proper advanced planning has been completed.

C. Credit Status

Given the perpetual life characteristic of a corporation, it can be argued that incorporating a farm business will increase its attractiveness to lending agencies. If the corporation appears to a lender to be a permanent form of business organization, there is less fear that a death or withdrawal of a member of the business might cause a termination of the farm business. Another advantage to lending agencies is that corporations, by law, must keep accurate records of all business activities. This helps a lender keep better track of the financial status of the business.

However, a contrary viewpoint can be taken with regards to the credit availability of farm corporations. Some argue that the prospective quality of corporate management is of greater concern to lenders than is perpetual life. A lender might be inclined to extend credit more liberally if assured of continued management responsibility and capability. Thus, according to this viewpoint, incorporation may have little effect upon credit availability.

Credit availability may also very well depend upon the relative amount of assets in the corporation. Some individuals leave substantial assets, such as all the farmland and machinery, outside the corporation at the time of formation. In such cases, a checkbook corporation is essentially formed. This type of corporation may have adverse effects on credit availability as the land and machinery would normally represent the majority of available collateral for operating loans. This may lead to requests by lenders for the stockholders to personally guarantee any corporate operating loans. Thus, limited liability for the stockholders would be lost.

Corporations may have more ready access to capital than other forms of business organization because they aren't subject to state usury laws. However, they will probably have to pay the price in the form of higher interest rates. For this reason, several farm corporations were formed in Michigan in the late sixties. However, this need not be a reason for incorporating a farm business in Michigan today. Any loan for business purposes in Michigan is not subject to the state usury laws. Also, Production Credit Association (PCA) and Federal Land Banks (FLB) may not be subject to usury laws in some states since these lending institutions are federally chartered.

Farm corporations face limitations on loans from some governmental agencies. Some Production Credit Associations (PCA) and Federal Land Banks (FLB) may require principal shareholders to personally sign corporate notes. FLB and PCA loans may be made to "bona fide farmers and ranchers." A corporation may be a qualified borrower if it meets at least one of the following three requirements: 1) More than 50 percent of the value or number of shares of its outstanding voting stock or equity is owned by the individuals conducting the farming or livestock operation. 2) More than 50 percent of the value of its assets consists of assets related to the production of agricultural products. 3) More than 50 percent of its income originates from production of agricultural products. If at least 50 percent of ownership or control is vested in another legal entity that does not meet at least one of the criteria, loan approval must be obtained from the Farm Credit Administration. A legal entity engaged in agriculture for the primary purpose of conducting its operations at a loss to absorb taxable income from nonagricultural sources is not eligible.[38]

In past years, a farm corporation has not been eligible for Farmers Home Administration (FHA) real estate or operating loans. However, a corporation could borrow under the emergency loan and soil and water loan programs. Currently, under 1978 legislation, "family size" corporations, partnerships, and cooperatives are now eligible borrowers for FHA operating and real estate loans.

Since 1976, the Small Business Administration (SBA) has been authorized to make loans to farm businesses including farm corporations. However, SBA loans may not be made available unless the financial assistance applied for is not available from non-federal sources.

In summary, incorporation of the farm business may present some credit advantages. However, as pointed out in the above discussion, there may be some limitations on loans to corporate borrowers. Therefore, before incorporating, each farm business should analyze and investigate how incorporation would affect its ability to obtain both operating and real estate credit.

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[38]Harl and O'Byrne, op. cit., p. 7.

D. Employee Fringe Benefits

Since a corporation is an "artificial person" it can only do business through its employees. If a sole proprietor incorporates his farm business his status is changed from employer to employee since a sole proprietor cannot be an employee of himself. The same is true of a partnership. However, by being an employee of the farm corporation, the owner-operator is eligible for a number of employee fringe benefits not available to a sole proprietor or partner.

There is no formal definition of the term "fringe benefits." However fringe benefits generally refer to any benefit provided to employees above and beyond wages or salaries paid for work actually performed. They are normally available only to employees of the corporation. Being a shareholder or director alone does not qualify one to receive fringe benefits.

The main reason for providing fringe benefits to corporate employees instead of giving them extra wages or a higher salary is because of the more favorable tax treatment available for fringe benefits. Most fringe benefits provide double tax advantages as they are deductible to the corporation as an ordinary business expense, but are not included in the employee's taxable income. Thus, they boost the corporate employees real income since they are tax exempt and their net cost to the employer-corporation can be less than the boost in salary or wages that would be required to cover them.

1. Life Insurance

Group term life insurance policies up to $50,000 (face amount of coverage) per employee may be paid by the corporation without the premiums being treated as taxable income to the corporate employee. The cost of any group insurance coverage exceeding $50,000 is taxable to the employee. Also, for the premiums to be deductible, the corporation cannot be a beneficiary or receive any benefits at the person's death.

There is no tax advantage in having a corporation pay the premiums on ordinary life insurance policies for its employees. The corporate employer can deduct the premiums as a business expense, but the corporate employee is taxed on the amount of the premiums.

Group term life insurance does not have to be provided to all employees of a closely-held corporation is there are at least ten members in the group who are receiving this insurance coverage. The covered employees must constitute a "group" whose members are selected solely on the basis of age, marital status, or "factors related to employment." Membership in the group cannot be based on the employee's status as a stockholder. However, the group could be limited to stockholder employees provided the criteria for their membership in the group is not their stock ownership but some employment-related factor such as duties performed or wages or salary received.[39]

Although most states require a minimum of ten employees for a group plan, "baby group" plans covering several groups of fewer than ten employees qualify for tax deductibility of contributions if certain requirements are met. One of these requirements is that a group of less than ten members for which term life insurance protection is to be provided must cover all employees except the following: a) Employees who have been employed full-time less than six months; b) Employees whose

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[39] Special Report, Guide to Retirement Plans and Fringe Benefits (New York: The Research Institute of America, October 1979), pp. 107-108.

customary employment is 20 hours or less in one week and no more than five months in any calendar year; c) Employees who elect not to be covered by group term life insuranace; d) Employees over age 65. Evidence of insurability may be required from an employee to determine whether he is eligible for insurance. However, it is limited to a medical questionnaire to be completed by the employee. If additional evidence of insurability beyond a medical questionnaire is involved, such as a medical examination, the plan may not qualify. The amount of term life insurance to be provided to a member of a group of less than ten full-time employees must be computed either 1) on a uniform percentage of salary or 2) on the basis of coverage brackets established by the insurance company, under which no bracket exceeds 2½ times the next lower bracker, and the lowest bracket is at least 10 percent of the highest bracket.[40]

Farm corporations may encounter difficulties in obtaining group policies as some insurers place restrictions on sales of group life insurance to agricultural groups and may charge a higher premium for group term coverage of farm employees, particularly if disability benefits are included. Moreover, some insurers may not insure groups involving employees who are all members of a family.[41]

2. Tax-Free Death Benefits

Besides furnishing life insurance coverage to its employees, a closely-held corporation can pay tax-free death benefits up to $5,000 to

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[40] Ibid.

[41] Neil E. Harl, Farm Estate and Business Planning (annotated materials) (Des Moines: R.E. Hays and Associates, Revised to April 5, 1980), p. 11-5.

a deceased employee's surviving spouse, children, or estate at the death of the employee. If these death benefits are paid for past services of the deceased employee, they will be both deductible as compensation by the corporation and tax-free to the recipients. Self-employed individuals and their beneficiaries are not eligible for this income tax exclusion.

3. Medical Benefits

Corporate paid medical benefits are another type of fringe benefit for stockholder-employees and other employees of a closely-held corporation. In order for these benefits to be tax-free, they must be paid under a health and accident "plan." Tax-favored medical benefit "plans" are those which provide any or all of the following: 1) accident or health insurance; 2) direct payment or reimbursement of medical or dental expenses; 3) medical examination. A "plan" means that there is a predetermined course of action. No plan exists if the employer makes a separate decision of whether and how much to pay as each case arises.[42]

A closely-held corporation can set up an accident and health insurance plan that pays for all of the medical and dental care expenses for not only stockholder-employees and other employees, but also for their spouses and dependents. The payment of the premiums is fully tax-exempt to these employees and also deductible to the corporation. An insured medical accident and health plan can cover a few selected employees or only one employee of a closely-held corporation.

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[42]Special Report, Guide to Retirement plans and Fringe Benefits (New York: The Research Institute of America, October 1979), p. 110.

Disability insurance premiums are also deductible by the corporation and not taxable to the insured employee. Such insurance provides for payment of a specified amount if the employee is unable to work due to illness or temporary or permanent disability. However, these payments to the insured employee would be taxable. This insurance coverage can be limited to selected employees.

Rather than using an insurance arrangement to cover an employee's medical and dental bills, a closely-held corporation can set up a plan whereby it directly reimburses the employee for medical expenses of himself, his spouse, and his dependents. New rules, effective in 1980, alter the tax treatment of medical reimbusement plans if the plan is "self-insured" (any plan whose reimbursement is not provided under a policy of accident and health insurance) and disciminates in favor of certain employees. These rules are designed to prevent discrimination in favor of officers (the five highest paid), shareholders (owning more than 10 percent of the employer's stock) or those among the highest paid 25 percent of all employees. Also, a plan must benefit at least 70 percent of all employees or at least 80 percent of employees eligible to participate. Employees who can be excluded include those who have not completed three year's service, those under age 25, part-time and seasonal employees, those covered by a labor union's medical plan and nonresident alien employees.[43]

If a plan fails to meet these rules, part of the reimbursement to highly compensated employees (based on a formula) is taxable. If a

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[43] Neil Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications, 1979), p. 262.

highly compensated individual receives a reimbursement not available to other employees, the full amount is taxable.

Except in the case of self-insured medical reimbursement plans after 1979, all forms of medical benefit coverage can be limited to selected employees and their families while still being tax deductible to the corporation and tax-free to the employees. However, all plans must be for employees. A plan that is limited to stockholder-employees will not qualify if it intends to cover them as stockholders rather than as employees. Payments under plans limited to stockholder-employees may be treated as taxable dividends.

4. Worker's Compensation

Worker's compensation insurance might also be classified as an accident and health fringe benefit for stockholder-employees and other employees of a farm corporation.

Traditionally, agricultural labor has been exempt from worker's compensation coverage. Recently, agricultural employees have been brought under worker's compensation coverage by several states, including Michigan.

Under worker's compensation, an employee suffering an injury or illness need only prove: 1) the injury or illness occurred, 2) the injury or illness was causally related to the employment, and 3) the injury or illness occurred or was suffered while the employee was acting within the scope and course of employment. Fault of the employer is not a factor in recovery. The employer's responsibility to pay benefits to insured or ill employees is typically discharged through worker's compensation insurance.[44]

In Michigan, worker's compensation insurance must be provided for all employees who come under the Act. This Act states that these employers must comply: a) All employers who regularly employ three or more employees at one time, or b) All employers who regularly employ less than three employees if at least one of them has been regularly employed by that same employer for 35 or more hours per week for 13 weeks or longer during the preceding 52 weeks.[45]

Any Michigan farm corporation that meets the above compliance standards has to provide coverage for all of its employees. Thus, stockholder employees would be covered whereas they couldn't be if they were sole proprietors or in a partnership. Also, other employees that weren't covered before incorporation may be covered after incorporation is the addition of stockholder-employees creates a sufficient number of workers to force compliance with the Act.

This additional coverage can be viewed as a fringe benefit available upon incorporation. However, the benefit is not free. Premiums must be paid for such insurance. These premiums are relatively expensive, especially in Michigan, and may amount to over 15 percent of payroll. These costs will be examined in Chapter VI when the disadvantages of incorporation are examined.

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[44] Ibid., p. 256.

[45] Allen E. Shapley, 1979 Revision: The Law and Michigan Agricultural Labor, Michigan State University Cooperative Extension Bulletin E-831, revised January 1979, p. 2.

5. Employee Meals

Under certain circumstances, employees, including stockholder-employees, can receive tax-free meals from the corporation. In general, the IRS states that the meals will be deductible to the corporation and tax-free to the employees if the meals are a) furnished on the employer's "business premises" and b) for the "convenience" of the employer. The corporation does not have to maintain a formal dining room to qualify. For example, a corporation engaged in farming could send meals out to employees scattered over different areas of the farm. There is no requirement that this type of fringe benefit be provided to all employees.[46]

6. Employee Lodging

Some corporations may be able to provide tax-free lodging for their employees. Lodgings are exempt from taxation if they are a) furnished on the employer's "business premises" (generally means the place of employment of an employee); b) for the employer's convenience; and c) the employee must be required to live in the housing provided as a condition of his employment.[46] If these conditions are met, then the interest, depreciation, property taxes, maintenance, repairs and other deductions relative to the upkeep of the house become deductible to the corporation and the employee doesn't have to count the value of this benefit as income.

If these conditions aren't met, the employee will either have to pay a reasonable rental on the home or else the value of the personal use of the home will be taxed as additional compensation or as a dividend to the occupant employee.

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[46] Ibid.

Several farm cases concerning this issue have been taken to court. Farm taxpayers have won some and lost some. Results of the cases suggest that farm taxpayers are likely to be more successful if they are expected to be on the premises at all hours of the day throughout the year. Generally, livestock operations stand the best chance of succeeding in winning their case.[47]

7. Group Legal Insurance

A prepaid group legal insurance plan can be another tax-saving employee fringe benefit. Such a plan requires the employer-corporation to make payments to a qualified group legal service plan for the exclusive benefit of employees (or their spouses or dependents). A qualified plan is one that meets IRS regulations. If the plan qualifies, both the employer contributions to the plan and any benefits received by an employee will be excluded from the employees income (or his spouse or dependents). Also, the payments are deductible by the employer-corporation.

However, the exclusion does not apply to direct reimbursements made by the employer to the employee. For example, payment by the corporation of a stockholder-employee's legal expenses would be taxed to him as additional compensation or as a dividend.

To avoid taxation to employees, employer's contributions must be made to qualified group legal service plans. Such plans must be: a) written, for the exclusive benefit of employees, etc. and communicated to them so that they understand what personal (i.e., non-business) legal

[47]Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications, 1979), p. 262.

services are covered; b) nondiscriminatory in favor of employees who are officers, shareholders, self-employed, or highly compensated with respect to enrollment and benefits; c) organized through tax-exempt organizations or trusts, or through insurance companies; d) limited as to amounts which can be contributed to provide benefits to employee-shareholders or owners. The contribution for the class of such persons (or their spouses or dependents), which consists only of those each of whom on any day of the year owns more than 5 percent of the stock or of the capital or profits interest in the employer, cannot exceed 25 percent of total contributions.[48]

8. Low-Interest Loans

Another fringe benefit available to corporate employees is low interest loans. The employer-corporation can make low interest or even interest free loans to shareholder-employees and other employees. These loans can be granted for a number of purposes such as the purchase of a residence, a car, life insurance or even for the payment of major personal expenses such as medical bills or taxes. There are no federal tax rules on the persons to whom low-interest loans may be made, i.e., there are no nondiscriminatory requirements. The IRS has not established a formal position as to whether or not the corporate employee is taxed on the interest not charged. In some cases, concerning stockholder employees, the IRS has treated the difference between the prevailing rate of interest and the actual interest charged as either additional taxable

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[48] Special Report, Guide to Retirement Plans and Fringe Benefits (New York: The Research Institute of America, October 1979), p. 116.

income to the borrower or else it is treated as a dividend because the borrower is a stockholder.[49]

9. Social Security

For farmers especially concerned about retirement planning and social security benefits, incorporation of the business may offer some potential advantages. Incorporation may produce greater social security benefits for stockholder-employees than they would normally receive as self-employed farmers. The reason for this is that the self-employment income of farmers often fluctuates greatly from year to year. If earnings fall below the maximum covered amount ($29,700 for 1981) for more than the permissible drop-out period for computing social security benefits, the retirement benefits are reduced. Also, income above the maximum covered amount doesn't increase benefits. Thus, even though the average annual income of a farmer may be the same over a period of years whether he incorporates the business or not, the fixed salary of a corporate employee may lead to higher benefits.

However, these benefits are not without costs. For 1981, a self-employed farmer must pay social security at a rate of 9.37 percent on the first $29,700 of income from self-employment. This results in a maximum tax of $2,762.10 per year. By contrast, a farm corporation employee pays 6.65 percent on the first $29,700 of income at 1981 rates and the corporation pays another 6.65 percent. For a farmer who is the sole shareholder of a corporation and an employee of that same corporation, this means that he would pay an effective social security rate of

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[49] Ibid., p. 117, 118.

13.3 percent in 1981. This amounts to $3,950.10 per year if an employee's salary is $29,700 or more. The tax difference of $1,188.00 at 1981 rates is a disadvantage of employee status in the form of an added annual cost.

However, as an offset to this added cost, the corporation's share of the tax (6.65 percent) is deductible for income tax purposes while no part of the social security tax paid by a self-employed person is income tax deductible. The corporation also has the option of paying the employee's share as a fringe benefit in addition to the employer's share. If this is done, the corporation would claim a tax deduction for the entire social security tax, but the employer's share of the tax then becomes additional income to the employee.

10. Retirement Plans

There are various types of retirement plans available to employees of closely-held corporations. Generally, retirement plans are classified as being either qualified plans (those approved by the IRS) and non-qualified plans.

In general, there are four tax advantages offered by qualified retirement plans: 1) Contributions by the employer corporation to a qualified plan are immediately deductible to the corporation as they are paid, even though the employee doesn't receive his plan benefits until a future time; 2) After the employer corporation makes contributions to the plan, they are held under the plan until distributed at some future time to the employees. All interest, dividends, capital gains or other income earned by the funds during the period before distribution are tax exempt; 3) The employee is not taxed on his share of plan funds until he receives distributions or they are "made available" (when it is unconditionally credited to or set apart for him and made subject to his withdrawal or other disposition) to him at retirement or some other future time. This can result in considerable tax savings, particularly for high income employees, as taxable income can be deferred to a future date, normally retirement, when the employee's income is usually lower and he is thus usually in a lower marginal tax bracket; 4) Distributions from a qualified plan may be tax-favored: a) A lump sum distribution from a qualified plan gets special tax breaks. The taxable portion of the distribution allocable to the employee's active participation in the plan before 1974 may be taxed as a long-term capital gain. The remaining portion is taxed as ordinary income but may qualify for a favorable ten-year forward averaging computation; b) If qualifying distributions are made in the form of stock or securities of the employer corporation, tax on the unrealized appreciation in value of the stock or securities is deferred beyond the time of distribution until the stock is sold or otherwise transferred in a taxable transaction.[50]

Types of qualified plans include pension plans, profit-sharing plans, stock bonus plans (which are a special form of profit-sharing plan), and employee stock ownership plans (ESOP). Qualified plans are also classified as defined benefit and defined contribution plans. Many variations in plans of these basic types are permitted.

a. Pension Plans

Pension plans are a form of defined benefit plans. Under a pension plan, the employer-corporation is required to make a fixed annual payment

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[50] *Ibid.*, p. 2.

to the plan (usually based upon a percentage of the employee's compensation) regardless of the corporation's profits or economic circumstances. This provides for the payment of definitely determinable benefits to an employee over a period of years, usually for life, after retirement. In other words, this type of plan states the retirement benefit the employee will receive and the employer-corporation contributions are designed to produce that amount.[51]

b. Profit Sharing Plans

Profit sharing plans are a form of defined contribution plans. A qualified porfit-sharing plan is one established and maintained by an employer to provide for participation in profits by employees and their beneficiaries. The plan must have a definite, predetermined formula for allocating contributions made under the plan among the participants and for distributing the funds accumulated under the plan. Such a plan may, but is not required to, have a definite, predetermined formula for determining the amount of contributions to be made from profits. A plan cannot qualify as a profit-sharing plan unless the employer's contributions are contingent upon the existence of the necessary profits. Since the employer-corporation makes contributions only if it has profits, retirement benefits are less predictable than the pension plans.[52]

c. Stock Bonus Plans

Stock bonus plans are another form of defined contribution plans. However, the employer corporation's contributions are not dependent upon profits. The employer corporation makes contributions either in cash or

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[51] Ibid., p. 3.

[52] Ibid., p. 4.

in stock to a trust. If in cash, the trustee invests the funds in the corporation's own stock. Such a plan allows the corporation a substantial tax deduction without depleting the corporation's assets.[53]

d. ESOP

An employee stock ownership plan (ESOP) is also a defined contribution plan. The official definition of an ESOP is found in Section 4975 (e)(7) of the Internal Revenue Code. Such a plan must contain the following four elements: 1) The plan must be a stock bonus plan or a stock bonus plan coupled with a money purchase plan; 2) It must be qualified under Section 401 of the Internal Revenue Code; 3) The plan must be designed to invest primarily in qualifying employer securities. These securities are defined by Section 4975 (e)(8) of the Code as being either stock of certain limited debt securities. Stock includes any equity securities, including non-voting common and preferred stock. Debt securities include certain bonds and notes subject to restrictions in Section 503 (e) of the Code; 4) It must meet such other requirements as the Secretary of the Treasury may prescribe by regulation.

An ESOP is different from profit-sharing and pension plans in that the ESOP may invest up to 100 percent of its assets in stock of the corporation. Annual contributions to the ESOP in the form of stock are tax deductible to the corporation up to 15 percent of the employee's salary. Thus a tax deduction is obtained without the expenditure of cash. The assets are held in trust for employees and then are distributed later as retirement benefits. An ESOP pays no tax on earnings. Taxes are paid only on the distribution of benefits. An ESOP may only put out benefits in the form of qualifying employer securities, except for fractional

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[53] Ibid.

shares (which may be distributed in cash) and some insurance proceeds (which may be paid in cash to the deceased participant's beneficiary). It is this dealing in employer stock without limits that distinguishes the ESOP from other qualified retirement plans.[54]

An ESOP may also be a useful tool in the estate planning process of stockholder employees. It can help reduce estate taxes and help provide liquidity to the estate of a stockholder employee.

In fact, reports indicate that it is possible to use an ESOP in a farm operation to transfer the farm assets from generation to generation--without paying any federal estate tax. However, such a plan does have some disadvantages. All the farm business assets, including farmland, would have to be "in" the corporation and the ESOP would have to own 100 percent of the corporation's outstanding stock. Furthermore, all employees, with limited esceptions, must participate in the plan. Therefore, if the farm corporation had a substantial number of non-family employees, the plan probably would not work for them. Finally, the administrative chores with an ESOP require heavy use of professional advisors (accountants, attorneys) which can become quite expensive.[55]

e. Requirements for Qualified Retirement Plans

All of the qualified plans discussed above and any others must meet certain criteria. A qualified plan must be a definite, written program

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[54]Gerald S. Susman and Charles L. Borgman, "ESOP's Can Be a Useful Tool for Both Financial and Estate Planning," Estate Planning, July 1978, p. 224.

[55]For more information on this, see "No Reason to Pay Estate Taxes on Farmland," by Loren Kruse, in Successful Farming, (September 1978), pp. 23 and 34.

and it must be communicated to employees such as by giving them a copy of the plan or a summary of its essential provisions. The plan must be permanent, not a temporary program, and it must be for the exclusive benefit of the employees.[56]

A qualified plan doesn't have to cover all employees, but it must cover at least enough to meet one of these two tests: 1) a nondiscriminatory classification--this test compares the composition of the class or classes of covered employees to the composition of excluded employees to determine whether the covered class or classes discriminate in favor of officers, shareholders, or highly compensated employees. Generally, all active employees are taken into account with a major exception being the exclusion of union employees. A reasonable difference in the percentage of employees in each group is allowed. This allowable difference will vary depending on the facts and circumstances of each case; 2) a percentage test--a plan meets this test if it "benefits": a) 70 percent or more of all employees; or b) 80 percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all employees are eligible to benefit under the plan.[57]

Qualified plans must also be concerned with vesting and participation. Vesting refers to the entitlement to the amounts contributed by the employer on an employee's behalf and is associated with a point in time. When an employee is participating, amounts are being contributed on his behalf. A participating employee who leaves the corporate

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[56] Special Report, Guide to Retirement Plans and Fringe Benefits (New York: The Research Institute of America, October 1979), p. 4-5.

[57] Ibid.

employer before any vesting has occurred will forfeit his or her contributions and accrued earnings to the benefit of the other remaining employees.[58]

There are limits on the amount of contributions that are income tax deductible to the employer corporation and are not part of an employee's taxable income. The limit on contributions for corporate defined contribution plans is the lesser of 25 percent of $25,000 of employee compensation. Defined benefit plans are limited in terms of benefits. The initial limitation is the lesser of $75,000 or 100 percent of the average of the participant's highest consecutive three years of salary. Both the $25,000 and $75,000 limits increase with a cost of living index (base period fourth quarter of 1974) so that for 1979, the actual limits were $32,700 and $98,100. There also are limits on contribution deductions when pension and profit-sharing plans (defined contribution and defined benefit plans) are combined.[59]

With regards to defined contribution plans, the shareholder employees of a Subchapter S corporation holding more than a 5 percent stock ownership interest in the corporation are subject to special limitations. To the extent contributions exceed 15 percent of an employee's compensation or $7,500, whichever is less, the amount is includable in the employee's gross income. Somewhat larger contributions are allowed for Subchapter S defined benefit plans.

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[58] Darrel L. Acker, Paul L. Wright, and Gerry A. Harrison, Tax Sheltered Retirement Plans or Farm Investments, North Central Regional Extension Publication No. 55, 1978, p. 7.

[59] Ibid.

f. IRAs

Until recently, tax-deferred retirement programs were restricted to the corporate form of business. However, under the Employment Retirement Income Security Act of 1974 (now known as the Pension Reform Act) provisions were made for "Individual Retirement Accounts and Annuities" (IRAs). Through this Act, any individual who is not participating in a retirement plan operated by his employer may establish a retirement plan of his own, making contributions to it and be granted tax deductions for the contributions. Thus, a corporate employee can set up his own IRA as long as he is not covered by a retirement plan from another source.

For a farmer considering a retirement plan, an IRA offers an advantage that qualified corporate retirement plans can't offer. An IRA doesn't have to meet the nondiscriminatory classification test required of corporate plans. This test was described earlier in the chapter. Under the Pension Reform Act, individual retirement funds can be established for any one individual without regard to whether other farm employees are receiving this benefit. This could be an advantage to stockholder-employees who desire a retirement plan, but don't wish to cover other farm employees.

However, a disadvantage of an IRA is the limited amount of tax-deductible contributions that can be made. The maximum tax-deductible contribution is $1,500 or 15 percent of "earned income" whichever is less.

g. Keogh Plans

Besides IRA's, self-employed farmers (owner-operators or tenants) are also eligible to establish an H.R. 10 or Keogh Retirement Plan. A farmer who incorporates his entire farm business as a Subchapter C corporation would not generally be eligible, unless he had other self-employment earnings. A stockholder-employee of a Subchapter S corporation is not strictly "self employed," but may be covered in the plan of the Subchapter S corporation as an employee, subject to the limitations of Keogh plans.

Employees of self-employed farmers are also eligible. In fact, full-time employees who have worked for the business for thirty-six months (if the farmer has been in business that long) must be covered if the farmer wants to participate himself. These employees may not be discriminated against (by contributing at a lower rate, for example) in favor of owner-employees or other employees. The amount set aside for employees must be "fully vested", i.e., it is their or their beneficiaries' even if they quit, become disabled, die or otherwise withdraw from the plan.[60]

The distinction between what can be achieved with corporate plans as opposed to an IRA or Keogh plan comes about because of the substantial flexibility and leeway in the federal tax law. One of the major advantages available to the corporate plans in the higher limit placed on tax-deductible contributions. The annual deductible contribution to Keogh plans is limited to a maximum of 15 percent earned income or $7,500, whichever is less. IRAs are limited to $1,500 or 15 percent of earned income, whichever is less. Both of these are substantially lower than the $25,00 and $75,000 limits for corporate defined contribution and benefit plans. Remember, however, that Subchapter S corporations

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[60] *Ibid.*, p. 4.

are limited to the same maximum levels of contributions in a defined contribution plan as the Keogh plan.

For a further comparison of Keogh, IRA, and corporate retirement plans, see Table 10.

h. "Nonqualified" Retirement Plans

In addition to all the qualified retirement plans discussed above, "nonqualified" retirement plans are also available to a farm corporation's employees. Deferred compensation is a term applied to arrangements which postpone part of an employee's compensation to a future period. Frequently the term is used in a more narrow sense referring only to these "nonqualified" arrangements. A "nonqualified" deferred compensation arrangement does not have to meet the strict Internal Revenue requirements for qualified plans that were discussed earlier in the chapter (such as nondiscrimination, funding limits, etc.). However, there are certain guidelines which must be followed to prevent the income taxation of nonqualified deferred compensation prior to its receipt by the employee. Also, in such arrangements, deferral of payment of compensation results in a corresponding deferral of the employer's deduction for such compensation.

There are two basic types of deferred compensation--funded and unfunded. An unfunded deferred compensation contract involves only the employer's bare promise to pay an amount in the future. No funds are set aside to meet the obligation, although book entries may be made and reserves recorded. Under this type of arrangement, the employee will generally not be taxed until he receives payment from the employer if the deferral meets these IRS guidelines: a) the deferral is agreed to

Table 10. Comparison of Corporate and Non-Corporate Retirement Plans

Points of Comparison	Self-Employed Plans (Keogh)*	Individual Plans (IRA)	Corporate Plans
A. Participation:			
1. Who may participate	Self-employed persons and their employees. Must have income from "personal services."	Persons not covered by a qualified corporate, self-employed or governmental plan. Must receive compensation, except in special case of spouse.	Employees.
2. Coverage for Employees	Required for full-time employees.	Not applicable (Contribution is really by the employee).	Required for certain "classes" of employees.
3. Maximum waiting period	36 months for employees (Less if employer has not been in business for 3 years).	Not applicable.	1 year, or 3 years, if 100% immediate vesting is provided.
4. Minimum Age for	Not applicable.	Not applicable.	25 years.
5. Vesting of Benefits from employee contributions	100% immediately when eligible to participate.	100% immediately upon establishing account.	100% immediately when eligible to participate.
6. Vesting of Benefits from employer contributions	100% immediately when eligible to participate.	Not applicable. Is really employee contribution.	Graded over 5 to 15 years, or 100% after 10 years, or "rule of 45."
B. Contributions			
1. Limits on Deductible Contributions	Lesser of $7500 or 15% of self-employed person's earned income. $750 regardless, if AGI is less than $15,000. Higher limit may apply under "defined benefit" plan.	Lesser of $1500 or 15% of compensation or earned income. In special case of employed person and unemployed spouse, limit is $1750 for both, or $875 for each beginning in 1977.	a) Lesser of $25,000 or** 25% of employee's compensation. b) 15% of aggregate compensation paid (25% for carryover year). c) Funding needs.
2. Final date for Deductible Contribution	Final date for filing tax for year, including extensions.	45 days after end of tax year, beginning in 1977.	Final date for filing for year, including extensions. Liability for the contribution must arise before the end of the tax year.
3. Penalties for Excess Contribution	6% cumulative, each year, on excessive contribution left in account.	6% cumulative, each year, on excess contribution left in account.	Loss of tax deduction in current year.
4. Transfers of Funds Permitted			
Into Plan	No.	Yes.	Yes, if Plan allows.
Out of Plan	Yes. Within 60 days of distribution.	Yes. Within 60 days of distribution, no more often than once in three years.	Yes.
C. Distributions			
1. Age of Distribution	Not before 59½, nor after 70½.	Not before 59½, nor after 70½.	Determined by plan requirements (not later than 65, usually).
2. Limits on Benefits	Lesser of $75,000 or 100% of average of high three years' earnings (for defined benefit plans).	Not applicable.	Lesser of $75,000** or 500% of average high three years' pay.
3. Penalties Premature Distribution	10% of funds withdrawn (or pledged) plus income taxes on amount withdrawn in year of withdrawal (voluntary contributions excepted).	10% of funds in the account plus income taxes in year distributed or pledged.	Doesn't apply.
Insufficient Distribution	Plan is terminated.	50% of difference between what should have been withdrawn that year and what actually was.	Doesn't apply.
4. Taxing of Benefits			
Lump Sum	In year received. Special 10-year averaging formula available. That portion attributable to years of participation before 1974 may be treated as capital gain.	As ordinary income. Can use standard 5-year income averaging.	In year received. Special 10-year averaging formula available. That portion attributable to years of participation before 1974 may be treated as capital gain.
Annuity	As ordinary income in years received. Standard (5-year) income averaging applicable.	As ordinary income in years received. Standard (5-year) income averaging applicable.	As ordinary income in years received. Standard (5-year) income averaging applicable.
5. Inclusion of Balance of Account in Gross Estate of Decedent	Excluded to extent of income tax-deductible contributions, if balance is not distributed as lump sum (within one year).	Excluded to extent of income tax-deductible contributions, if balance is distributed as an annuity of at least 36 months.	Excluded to the extent attributable to employer contributions (i.e., tax deductible) and if balance is not payable to estate of distributed in lump sum (within one year).
D. Funding			
1. Alternatives	IRS-approved; Trust with bank, trust company, building and loan. Custodial account with bank or building and loan. Mutual funds, life insurance contracts, annuities, endowment. Special U.S. "retirement" bond. Can design own plan.	IRS-approved: Account-bank, savings and loan, credit union, others approved by IRS. Annuity-insurance company annuity or endowment contract. Special U.S. "retirement" bond. Can design own plan.	IRS-approved trusts are the usual method, but also certain annuities or face amount certificates or custodial accounts may be used.

*Applies to plans which cover at least one "owner-employee" (one who is a self-employed sole proprietor or who owns more than 10% of the capital interest or profit in a partnership).

**Modified by cost of living index.

Source: Darrel A Acker, Paul L. Wright, and Gerry A. Harrison, Tax Sheltered Retirement Plans or Farm Investments, North Central Regional Extension Publication No. 55-1978, pp. 9-10.

before the compensation is earned; b) the deferred amount is not unconditionally placed in trust or in escrow for the benefit of the employee or independent contractor; and c) the promise to pay the deferred compensation is merely a contractual obligation not evidenced by notes or secured in any way.[61]

Under a funded deferred compensation set-up, the employer does set aside funds to meet his future ogligations, usually by contributions to a trust or custodial account or to an escrow fund or by the payment of premiums for the purchase of annuity contracts. When a non-qualified arrangement is funded the employer's contribution to the trust or other funding arrangement must be included as compensation in the gross income of the employee for his taxable year during which the contribution is made, but only to the extent that the employee's interest in such contribution is "substantially vested" at the time the contribution is made. If the employee is not taxed on the employer's contribution in the year that it is made because his interest in the contribution is not substantially vested, he will be taxed when his rights to the assets in the trust change from nonvested to vested.[62]

Since "nonqualified" plans need not be concerned with nondiscrimination rules (applicable to qualified plans), they offer the advantage of allowing the establishment of favorable deferred compensation agreements with key stockholder employees only. These agreements are typically used when a high salaried employee is willing to receive less money in his or her most productive years in return for a substantial

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[61] Special Report, Guide to Retirement Plans and Fringe Benefits (New York: The Research Institute of America, October 1979), p. 8.

[62] Ibid., p. 10.

retirement income and/or payment to his or her spouse or estate. Often these arrangements are used as a means of supplementing the benefits provided under qualified employee benefit plans.

i. Applicability of Tax-Sheltered Retirement Plans to a Farm Business

Retirement plans may not be nearly as advantageous to farmers as might appear. For stockholders of family farm corporations, investing after-tax dollars in land and other farm investments may yield a higher return than deferring taxable income to the retirement period. In a study comparing tax-sheltered retirement benefits versus non-tax sheltered investments in non-real estate farm assets and farmland, the result was that farmland appreciating an average of 7 percent per year yielded higher benefits than any plan at any tax rate.[63]

Also, according to IRS rules, a tax-sheltered retirement plan may not be pledged as security on a financial statement. Thus, such plans may compete directly for capital for farm investments. This may be one of the reasons behind the lack of any widespread use of retirement plans among farmers.

E. Estate Planning

All estate plans must be developed so that they satisfy the goals and objectives of the farm family. These goals and objectives will vary among farm families and even among the various members of each family. However, many families share similar estate planning goals and objectives. Some of the more common ones are:

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[63] Darrel L. Acker, Paul L. Wright, and Gerry A. Harrison, Tax Sheltered Retirement Plans or Farm Investments, North Central Regional Extension Publication No. 55-1978.

1. Most parents want to assure themselves an adequate amount of income and security during retirement.

2. Keep the farm in the family, if so desired, by helping one or more children to get started in farming. Also, enable the wife and/or family to continue the operation as a going concern in the event of an untimely death of the owner-operator, i.e., minimize federal estate taxes at death in order to prevent a forced sale of farm property to meet tax and administrative costs.

3. Distribute property according to the parents' wishes, providing equitable treatment of the children.

4. Minimize expenses associated with intergeneration property transfers, including state inheritance taxes, federal estate taxes, state and federal gift taxes, and probate expenses.

5. Minimize income taxation and expenses in order to maximize earnings.

Regardless of how a farm business is organized--as a sole proprietorship, partnership, or a corporation--it is possible to develop a sound estate plan. However, studies made in several states indicate that the number one reason farmers incorporate is to accomplish estate planning objectives.[64] It is not that the corporation has a monopoly over estate planning as incorporating a farm business does not in and of itself solve the estate planning problem. The reason for the corporation's popularity is that it offers a collection of attributes that may make the accomplishment of estate planning objectives somewhat easier.

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[64] Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications, 1979), p. 265.

These characteristics are particularly advantageous if the farm family has decided to continue the farm business beyond the death of the parents who are either majority or sole owners of the business. Normally, in such a situation, the parents will desire to make lifetime transfers of farm property to the children. However, the increasing size of farm businesses along with double-digit inflation poses significant problems in transferring property to the next generation. Although it is theoretically possible to transfer small, undivided interests in the assets of a farm business regardless of the form of business organization, shares of stock of a corporation make the transfer easier. Stock certificates provide a clear cut manner for determing partial ownership in a business. A share of stock may be sold, given away, or transferred by will or under state inheritance laws at death.

As was discussed in Chapter III, transfer of shares of stock results in the shift of ownership interests in the farm corporation without necessarily disrupting the continuity of the business. This is an important factor that allows the farm business to make a smooth transition through a change of ownership by avoiding business interruptions that might result from the death of a sole proprietor or partner.

1. Use of Gifts

Of all the costs associated with the transfer of farm property from one generation to the next, federal estate and gift taxes usually have the greatest impact on large estates. Transfer of shares by gift is one way of minimizing these federal estate and gift taxes. The Tax Reform Act of 1976 "unified" the estate and gift tax systems by making estate and gift tax rates the same and by making gift transfers interrelated with estate tax calculations. Even though federal estate and gift tax rates are now the same (after 1976) there are still several tax advantages to making lifetime gifts. Federal gift tax laws allow a person to make $3,000 of outright gifts to each beneficiary each year without paying gift taxes, so long as they involve a present interest (e.g., cash, outright ownership or a life estate would be a present interest; a remainder would be a future interest). This gift tax annual exclusion can be doubled to $6,000 if the gifts are made by a husband and wife to third persons, even though only one owned the property given.

Corporate stock in a farm corporation can be issued in convenient denominations ($1 or $10 per share for example) to take advantage of this annual exclusion from the gift tax. Thus, incorporation may allow a major shareholder (parents) to transfer $3,000 of shares ($6,000 for husband and wife) in the incorporated farming operation each year by gift without paying any gift taxes. Usually these gifts of stock are made to the shareholder's children in order to reduce the value of the estate subject to tax at the shareholder's death.

Another advantage of making lifetime gifts is that they are valued at the time they are made. If appreciating assets (such as land) are held until death, the value of the asset may have increased, causing an increased estate tax liability. Thus, in an inflationary economy, it is likely that the taxable values of most farm assets may be lower today than in the future.

Lifetime transfers of corporate stock often is more consistent with the retirement security estate planning objective than are direct gifts of assets used in the farm business. Parents who are sole or co-owners of property may be reluctant to make gifts of land, livestock, or machinery to children in order to achieve death tax savings of business contribution. It is believed that the potential loss of control is the single most important factor contributing to this reluctance. Normally, once gifts are made, the children are free to retransfer the property to others. Restrictions on the transfer of such property are often unenforceable. Thus, if the children were successful in transferring some prime property outside of the family business, it could result in economic hardship for the parents.

Also, the available collateral for farm loans is reduced when property is given away. If the parents give away a percentage interest in the farm to the children, it is necessary for the children to sign loan documents when using that property as collateral.

However, lifetime gifts of corporate stock do not result in a loss of control over assets essential to the economics of the farm business. Instead of specific assets being transferred, a portion of the entire farm business can be transferred. So long as the parents retain voting control (normally 51 percent of the voting stock) they can be assured of continued employment as officers of the corporation and of control over corporate management. Possibly even more stock could be given away if part of the stock were nonvoting. In addition, reasonable restrictions, such as a first option to buy or a buy-sell agreement, can be placed on the retransfer of stock by individuals receiving stock by gift. Also, the right of "partition and sale" which may generally be used to terminate co-ownership arrangements is not available to individual shareholders.

All these factors help to ease any concerns the parents may have over retirement security. The farm can continue to be operated as a unit and the parents can gradually retire from the farm by gradually transferring ownership to the children as they become old enough to share in the management and responsibility of the business. Since the opportunity to decrease estate taxes while retaining control is more difficult to achieve with other forms of business organization, this is a major reason why some farmers are now incorporating.

Another advantage associated with gifts of corporate stock is that stock in a farm corporation is eligible for transfer to minors under the Uniform Gifts to Minors Act or Uniform Gifts of Securities to Minors Act (each U.S. state has one of these laws). These acts provide basically for a simple trust or custodianship by which a bank or an adult holds and manages the property for the minor (since minors are not considered legally competent to manage their property). Besides stock, securities or money are eligible for transfer under these acts. Gifts of land, livestock, machinery and equipment do not qualify.[65]

Thus, by being able to transfer farm assets to minor children (in the form of stock), it is possible to further reduce the parent's estate value through gift programs.

Gifts of stock in a farm corporation aren't always the perfect estate planning tool. They sometimes have disadvantages, as well. Some recent cases have treated gifts of stock in corporations with a history of no dividend declaration and highly restrictive stock transfer provisions to be gifts of future interests and hence not eligible for the federal gift tax annual exclusion ($3,000 per recipient per year, $6,000 per recipient per year for husband and wife as donors even though only

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[65]Ibid., p. 231.

one owned the gift property). For that reason, it would seem wise to maintain a record of some dividend declarations and to examine carefully stock transfer provisions that purport to bar stock transfer under specified circumstances.[66]

This discussion on the use of gifts of corporate stock is by no means complete. There are other advantages and disadvantages. For a further discussion, see Chapter IX.

2. Simplification of the Estate Settlement Process

The fact that the probate process is simplified when a decedent's estate consists only of corporate stock rather than ownership interests in land, livestock, machinery and equipment, and other items was discussed earlier in this chapter and also in Chapter III. This simplification of the estate settlement process is another advantage of incorporation. If ownership and management succession have been planned, death should not jeopardize continuation of the family business as it may in a sole proprietorship or a partnership.

3. Two Classes of Stock

Another estate planning advantage is that the corporate form of business may be used to essentially fix current values as fair market value on all shares owned by the older generation, even though their death may come years later. This is especially attractive to farmers with a large net worth consisting mainly of appreciating property (i.e., farmland) and/or substantial annual corporate earnings.

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[66]Neil E. Harl and John C. O'Byrne, The Farm Corporation, North Central Regional Extension Publication No. 11, revised April 1979, p. 7.

Such a plan involves the use of the two basic types of stock--common and preferred.[67] The main difference between them is that preferred shareholders are entitled to certain preferences over the common shareholders. Generally, they enjoy the right to receive dividends at a specified rate before any dividends can be distributed to the common shareholders. This will sometimes mean that the preferred shareholders will receive dividends and the common shareholders will not. The preferred shareholders are also given a preference over the holders of common stock to assets of the corporation upon liquidation. The common shareholders share in any assets that remain after payment of the creditors.

Basically, the plan requires the donor parents to make gifts of the common stock while retaining the preferred shares. The preferred stock should include a dividend preference, a liquidation preference, and be subject to redemption at a fixed price. This freezes the maximum value of the preferred stock at its redemption price and liquidation preference, and all corporate asset growth is channeled to the common stock.[68]

If all common stock is owned by the younger generation, all preferred stock is owned by the older generation, and the normal order of death occurs, the result is that the older generation will have a smaller

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[67]Since Subchapter S corporations are restricted by law to using only one class of stock, only regular or Subchapter C corporations can take advantage of such a plan.

[68]Donald H. Kelley, "The Farm Corporation as an Estate Planning Device," Nebraska Law Review 54(1975):247.

estate tax liability than if they shared in or realized all of the increase in asset value.[69]

However, even though this technique provides some real opportunities for estate tax savings, it should be noted that it involves a complex area of tax law that is open to varying interpretations. Whether or not the plan actually limits the capital appreciation of preferred stock will probably not be known until the IRS values the stock at death for estate tax purposes.

F. Annual Tax Savings

Certain federal income tax savings possibilities may occur if a farm business incorporates and becomes subject to federal income taxation under Subchapter C of the Internal Revenue Code. Being a separate taxpayer, a Subchapter C corporation can be used as a tax shelter to split taxable income between the corporation and the individual shareholders.[70] This can be done because there are separate tax rates for individuals and corporations.[71]

When the farm corporation is owned primarily by the family, the tax objective is to minimize the family's total annual income taxes payable.

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[69] Donald R. Levi, Agricultural Law, 4th ed. (Columbia, Mo: Lucas Brothers, 1978), p. 308.

[70] This cannot be done with a Subchapter S corporation since the corporation itself is not taxed on any income. All income is passed on to the shareholders who, in turn, are taxed.

[71] For 1979, the tax rate for an individual ranges from a low of 14 percent to a high of 70 percent. For 1979, the tax rates for Subchapter C corporations are 17 percent on the first $25,000 or corporate taxable income, 20 percent on the second $25,000, 30 percent on the third $25,000, 40 percent on the fourth $25,000, and 46 percent on all taxable income over $100,000. This makes the average tax bracket 26.75 percent for the first $100,000 of income for regular corporations.

This means that the total taxes paid by the corporation plus the personal income taxes paid on the stockholder-employee's salary plus any other personal income taxes paid by the stockholder-employee on any other income received from the corporation should be less than the total personal income taxes paid by the owners before incorporation.

This tax reduction can be accomplished by equalizing the rates at which income is taxed in the "hands" of the corporation versus those at which it is taxed in the "hands" of the individual stockholder-employees. Normally this is done by adjusting the salary of major employees and/or adjusting lease or rental rates of assets (primarily land) owned by stockholders.

However, this can't be done arbitrarily. Salaries must be established at the beginning of each corporate fiscal year. They can't be increased or decreased with year-to-year changes in the financial success of the business. However, considerable flexibility can be obtained by establishing a bonus or profit-sharing agreement based on either the farm's production or the farm's income.

The IRS states that all salaries must be "reasonable" and paid only for work actually performed on behalf of the corporation. Among the factors considered by the IRS in determining the reasonableness of a salary are the time and effort spent by the employee, the rates of pay by similar business organizations in the community for the same work, and the experience, age, and other abilities of the employee. If the salary is held to be unreasonable, the excess over that which is reasonable will be taxed as a dividend--which is unearned income. Also, the corporation will not be able to deduct the attempted salary as a business expense.

Leasing or rental rates must also be "reasonable." They must be similar to the rates of comparable property leased or rented in the community under similar circumstances (i.e., they must meet the standards of an "arm's length" transaction).[72]

Since corporate tax rates of a regular corporation are substantially lower at higher income brackets, there can be considerable tax savings at high income levels. The income level at which tax savings will result will depend upon many things--number of personal exemptions, filing status (single or joint), amount of personal itemized deductions, income from other sources--to name a few. However, it is generally agreed that there is little or no reason, taxwise, for a sole proprietor (with no outside income) to incorporate the family farm business until his net farm income (Schedule F) exceeds $30,000. At $30,000-$50,000 net farm income (Schedule F), the possible tax savings will depend upon what assets are contributed to the corporation, the amount of salary and lease payments, and the amount of capital gain income. Over $50,000 net farm income (Schedule F) it is clear that incorporation can result in annual tax savings. If the farm business is a partnership and has two or more owners, the above values should be multiplied by the number of owners to arrive at the potential income level where tax savings will result. There are several case examples in Chapter VII illustrating these concepts.

1. <u>Different Taxable Years</u>

Another method of shifting income is to have a different taxable year for the corporation and the stockholder-employee's personal taxable

[72] The concept of "arm's length" transactions was discussed in Chapter IV.

year. This is often used with Subchapter S corporations. Normally the stockholder-employee will have a calendar year (Starting January 1--Ending December 31). The corporation will then have a fiscal year that ends on January 31. The result is that taxes due on the stockholder's share of income from the corporation (not his salary) can be delayed for a full year. For example, a stockholder of a Subchapter S corporation with a fiscal year ending January 31, 1979, would not have to pay his share of the corporate taxes when he files his personal income tax return for 1978 due on April 15, 1979. Instead he would declare the taxable income from the corporation on his personal income tax return for 1979, due on April 15, 1980, thus delaying payment of tax for over a year. This lets the corporate officers and board of directors make management decisions with less concern about the income tax consequences.

2. Increased Business Deductions

Another tax advantage of incorporation is that there are increased business deductions available. Most of these are created by the fact that the sole proprietor or partner becomes an employee of the corporation. The corporation can take a deduction for a number of fringe benefits. These include group life insurance plans, medical and hospital plans, pension and profit sharing plans, and others. Each was discussed in detail earlier in the chapter.

With a corporation, some of the owner's family-living expenses may be classified as business deductions. Under some circumstances, the corporation can provide meals for the employees, including stockholder employees, and deduct the cost of these meals. In addition to meals, some corporations may be able to provide tax-free lodging to stockholder-employees. Both of these deductions were discussed in detail earlier in this chapter.

The advantage of these increased business deductions is that it permits the corporation to use pre-tax dollars to pay for benefits received by a stockholder which the same individual not in a corporation would acquire by using after-tax dollars. This results in more after-tax total income available to the stockholder-employees.

However, just because federal income taxes may be reduced by incorporation doesn't necessarily mean that all taxes and costs will be reduced. Rather, there are a number of increased costs and taxes present with corporations. All of these must be examined in arriving at the total savings possible by incorporation. These other costs and taxes will be examined in later chapters.

G. Single Entity Advantage

Many father-son or brother-brother farm businesses operate under an informal partnership agreement. Unfortunately, some of these do not operate very smoothly. Property ownership usually becomes so complex that everyone begins to wonder what ownership rights they do actually have. Determining who owns what can completely divide the family if one of the partners dies or decides to withdraw.

Consider this example of a "typical" informal father and two-son partnership in which property ownership has become extremely complex. The parents own all but 50 acres of the farmland in joint tenancy. Thirty acres are owned by the father alone and the other 20 acres are owned by the oldest son. Livestock is owned on a 1/3 - 2/3 basis. Part of the equipment is owned on a 1/4 - 1/4 - 1/2 basis. Some equipment is owned entirely by the father and some by the youngest son. Other pieces are owned jointly--some by the father and the oldest son while still other pieces are owned jointly by the two sons. Each of the two sons rent some land on their own and use the "partnership" equipment to run it. The father doesn't rent any land; however, he leases a hog confinement facility to his brother.

Every year, at tax time, there is considerable disagreement in dividing up the annual income. Each partner has his idea of the most equitable method. Generally, the sons feel that their father is getting too much income for doing so little work (he's semi-retired). Not only is there trouble splitting up income, but splitting the depreciation, investment tax credit, recapture of investment credit, capital gains, capital losses, and other expenses according to ownership of the assets is an enormously complex job. Even worse is figuring the income tax basis, depreciation, investment tax credit, and recapture of investment credit for machinery trades.

To top it off, the oldest son is considering leaving the partnership and farming on his own as he "has worked on the farm for 20 years and doesn't have much of anything to show for it."

If such an operation were to incorporate and include all of the assets of the farm business (land and improvements, livestock, machinery and equipment) in the corporation, family tension levels could very well be reduced. There would be less uncertainty over property ownership rights. The values placed on each person's assets transferred into the corporation (in exchange for stock) would determine the various shares each owned in the business. A buy-sell agreement would establish the ownership rights of the stockholders. These rights would include such items as minority stockholder rights, terms of payment if shares are sold, method of determining price, and rights to sell to outsiders.

Internal accounting would be greatly simplified. No longer would the persons involved have to keep track of the ownership of one-third of the livestock and one-fourth of the machinery or some share of other assets. Details of income sharing and machinery trades would be less complex. Most likely there would be a reduction of squabbles over dividing up the annual income. Each stockholder-employee would receive a salary plus perhaps a bonus to compensate for his labor and management contributed to the corporation.

Incorporation of a farm business is in no way a "cure-all." However, incorporation in cases such as this may help reduce family tensions. This may contribute to the operation of a more efficient and profitable family business.

H. Pride of Status of Owning a Farm Corporation

Having discussed several business advantages, let's look at a personal or psychological advantage of incorporating. Incorporating a family farm business may lead to a "pride of ownership" similar to that apparent when a young person purchases his or her first automobile. The "Inc." notation behind John Doe Farms can give an owner a feeling of status similar to the feeling when one puts up a new milking parlor (the most advanced model) or when one owns certain resources such as pure-bred cattle (with the National Grand Champion Bull in the herd). This feeling can lead to a new challenge in the mind of the owner-managers. They may strive to operate a better, more efficient and profitable business to keep up the "corporate image."

Even if incorporating doesn't present a new challenge to the owners, it can be helpful to the mental well-being of its stockholder-employees and other employees if they are proud to be connected with such an organization. Psychologically speaking, all individuals have a need to be proud of something--be it owning the best producing dairy herd, achieving the highest corn yield, owning the largest farm in the county, or owning shares in your "own" farm corporation.

I. Employee Participation

Employees can be encouraged in their performance by awards of stock in the farm corporation. Then the benefit of the corporation becomes identified with their own personal benefit. In other words, they feel they are helping to advance the interests of "their" corporation--not just putting in their time to make more money for the owner. They own a piece of the business.

However, since these employees would be minority stockholders, such a program would require a carefully designed buy-sell program to protect their stock ownership rights. Without proper planning, minority shareholders can easily become "locked-in" shareholders with no management rights, no income on the stock, and essentially no outside market for the stock if there are stock transfer restrictions. This can, in effect, result in employees holding virtually worthless stock certificates. These minority stockholder problems will be discussed in detail in the next chapter.

J. Increased Business Efficiency

Some farmers who have incorporated believe that the increased formality and red tape required of a corporation has resulted in a more efficient and profitable business. In other words, they believe that corporate laws relating to accounting procedures, annual business meetings, and other required records and business procedures have forced them into being better managers. They feel that they have a better handle on where the business has been, its current position, and where it is going.

Even though incorporation has, in the minds of some farmers, made them more efficient, it is probably a poor excuse to incorporate. Good accounting records and other business records plus sufficient forward planning are a necessity for any good manager--no matter what type of business organization they operate from.

CHAPTER VI

DISADVANTAGES OF FORMING A FARM CORPORATION

This chapter consists of a listing of disadvantages associated with incorporating a family farm business. The format will be similar to Chapter V.

A. Income Tax Disadvantages--Federal

The problem of double taxation of dividends in regular or Subchapter C corporations was discussed in Chapter III. This disadvantage provides a strong incentive for providing the shareholders with economic benefits that are not characterized as dividends. A simple example would involve a corporation which pays its sole shareholder a salary of $60,000 for services worth only $10,000. The extra $50,000 is not taxed at the corporate level and thus, the shareholder-employer has substantially more funds at his disposal than if the corporation had been taxed on the $50,000 and distributed the remainder as a dividend.

However, in striving to pay out "profits" in the form of salaries, bonuses, interest and rent, corporations are sometimes taxed as though they had paid dividends anyway because the IRS found the amounts to be unreasonable. Such unreasonable compensation to stockholders in closely-held corporations is often referred to as a constructive distribution or constructive dividend. In the example above, the $50,000 excess salary would be classified as a constructive dividend and therefore taxed as a dividend. Thus, a danger of double taxation exists in closely-held farm corporations even though dividends are not actually paid.

1. Capital Gains Treatment

There are noticeable differences in the way Subchapter C corporations treat capital gains and losses when compared to an individual farmer. Regularly taxed corporations often pay a higher tax on long-term capital gains than would an individual farmer. For an individual farmer, a long-term capital gain is 60 percent deductible and the other 40 percent is subject to tax at the individual's ordinary income tax rates.

However, this 60 percent long-term capital gain deduction used by individuals is not available to Subchapter C corporations. Instead, a regularly taxed farm corporation has the option of including the full long-term capital gain with ordinary income (no 60 percent deduction allowed) or else adding the alternative tax on capital gains to the tax liability on ordinary income. Thus, capital gains are either taxed at the corporation's ordinary tax rate or else at the alternative tax rate which is a flat rate of 28 percent.

Unlike individuals, corporations are not permitted to claim any net capital loss as a deduction against their ordinary income. Capital losses can be used only as an offset against net capital gains and any loss not absorbed in the year substained may be carried back three years and forward up to five succeeding years. However, the amount that can be carried back is limited to an amount which does not cause or increase a net operating loss in the carryback year. The carryback and carryover are treated as short-term capital losses for the year to which they are carried. As such, they are grouped with any other capital losses for the year to which carried and are used to offset any capital gains. Any undeducted loss remaining after the three-year carryback and the five-year carryover is lost as a deduction.

Similarly, corporate operating losses do not benefit shareholders directly since the losses cannot be used by shareholders to offset their personal income. As a general rule, business or operating losses may be carried backward three years and forward to as many as seven years (five years for net operating losses incurred in tax years ending before 1976) to offset corporate income in such years. New corporations, of course, get no benefit from the three-year carryback provisions because they were not operating during this time period. Additionally, where the Subchapter C corporation has been operating less than three years, it cannot pass through such operating losses for use by shareholders on their personal returns, even though such shareholders operated the same business prior to incorporation. These operating losses are "locked in" the corporation. This restriction on passing through losses may be unattractive to some corporations, particularly those which anticipate little or no profit during the first few years of operation.

Another difference in capital gains taxation is in the minimum tax. For individuals, the 1978 tax act removed the excluded portion of capital gains and excess itemized deductions from the list of tax preference items for the add-on minimum tax calculation (15 percent of tax preference items with a $10,000 exemption) and instituted a new alternate minimum tax on these items. The alternate minimum tax is the difference between the individual's regular tax plus minimum tax and the alternate minimum tax computation. In effect, this means the individual's tax will be the greater of the regular tax or the alternate minimum tax computation.

Thus, individuals could be subject to two minimum taxes--the "add-on minimum tax" and the "alternative minimum tax"--on certain tax preference items. However, as a practical matter, the new alternative minimum tax is rarely invoked. The result of this is that capital gains income for individuals has been removed from the add-on minimum tax without being subjected, in most instances, to the new alternative minimum tax.[73]

However, regular corporations are not subject to the alternative minimum tax. They are subject only to the add-on minimum tax. For corporations, the rules on minimum tax on preference income were not changed in 1978. When determining the minimum tax, a Subchapter C corporation's tax is 15 percent of the tax preference items (that includes long-term capital gains income) reduced by the greater of $10,000 or the regular income tax. A controlled group of corporations must divide the $10,000 exemption figure equally unless the members consent to a different division. This difference in treatment of preference income between individuals and corporations can be a big item for those with large amounts of capital gains income such as dairy, cow-calf, and swine breeding farms.

Another tax disadvantage is that both regular and Subchapter S corporations are limited to $2,000 of extra first-year 20 percent depreciation, whereas a joint individual return may claim $4,000 annually.

2. Penalty Taxes

A regular corporation may encounter two "penalty" taxes--the accumulated earnings tax and the personal holding company tax. These

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[73]Neil E. Harl, Farm Estate and Business Planning, 1975, 5th ed. (Skokie, Illinois: Century Communications Inc., 1979), p. 239.

taxes don't apply to Subchapter S corporations.

a. Accumulated Earnings Tax

The accumulated earnings tax is a penalty tax applied on accumulated corporate earnings or profits when such profits are accumulated at the corporate level with no bona fide plans for reinvesting them in the business.

One incentive for accumulating profits is that it avoids the double taxation that results when a dividend is declared and paid. Since accumulating profits increases the value of one's stock in the corporation, and since the sale of stock will yield a long-term capital gain (if held longer than six months), one also can turn what would have been ordinary income (a dividend) into a long-term capital gain (by later selling his stock). Thus, the accumulated earnings tax is designed to prevent taxpayers from avoiding the payment of tax on dividends and turning ordinary income into long-term capital gains.[74]

A corporation can accumulate up to $150,000 of earnings and profits (earnings and profits in a technical accounting sense, not necessarily in terms of liquidity) without imposition of the tax. Beyond that level the tax rate ranges from 27½ percent on amounts up to $100,000 to 38½ percent on amounts in excess of $100,000.

However, a corporation can accumulate over the $150,000 level if the accumulation is justified as a reasonable need of the business. A corporation may accumulate, in the year of the death of a stockholder or

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[74]Donald R. Levi and James B. Grover, Federal Income Tax Savings Possibilities by Incorporation, Southern Extension Farm Management Committee Publication 16, Texas Agricultural Extension Service, 1975, p. 5.

a later year, amounts reasonably needed for redemption to pay death taxes and estate settlement costs. Profits can also be accumulated in anticipation of reasonable business needs such as to buy machinery and equipment, another farm, or to provide necessary working capital for the business. As a practical matter, most farm corporations will not be subject to the accumulated earnings tax because they continually reinvest corporate profits in more land, livestock, machinery, and equipment. However, a checkbook corporation (operating corporation with no land, livestock, or machinery and equipment in the corporation) with no plans for further expansion may find it necessary to take preventative measures to avoid being subject to this additional tax.

b. Personal Holding Company Tax

The personal holding company tax is intended to discourage use of the corporation as one's personal investor. Individuals are tempted to use the corporation as their "stand-in" for investments any time the corporate tax rate on ordinary income is less than the individual shareholder's marginal tax bracket (i.e., the tax rate applicable to the last dollar of income). In addition, it has available an 85 percent dividend received credit. So if a corporation received $1,000 in dividends from another corporation only $150 would be taxable. To limit this tax break, Section 541 of the Internal Revenue Code imposes a 70 percent tax on all undistributed personal holding company income of a personal holding company.

The tests for personal holding company status have numerous exceptions and qualifications, but two basic rules are that a corporation is a personal holding company if 1) five or fewer people own more than 50 percent of the stock during the last half of the taxable year, and 2) 60 percent or more of "adjusted ordinary gross income" comes from passive investment income such as dividends, interest, royalties, (other than copyright royalties and mineral, oil, and gas royalties), annuities, rents, compensation for use of corporation property (if the person entitled to its use owns 25 percent or more of the corporation's stock), and amounts received under personal service contracts in certain cases.

There is a special exception for income from rents. If the corporation has only rental income, there is no personal holding tax problem. Even if the corporation, in addition to substantial rental income, has some investment income other than rent, it may be possible to avoid the personal holding company tax. If rents are 50 percent or more of gross income, and dividends declared for the year by the corporation equal or exceed the amount (if any) by which investment income (other than rent) exceeds 10 percent of gross income, there will be no personal holding company tax.[75]

Rarely is this tax a problem where the farm business is structured as a single entity. The tax problem is most likely to arise when multiple entities are created--specifically in cases where a corporation is created to own only farmland and another entity rents the farmland from that land-owning corporation. The reason for this is that most likely a large portion of the income of the land-owning corporation will consist of rental and interest income. Such a mixture of rental and other

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[75]Neil E. Harl, "Taxes Strangle a Personal Holding Company," Monthly Management, November 1979, pp. 10-11.

passive income (interest, etc.) may trigger the personal holding company tax.[76]

However, few farm corporations are created to own only farmland. Therefore, farm corporations are seldom subject to the personal holding company tax. The existence is noted simply as a caution to the unwary.

3. Problems with Multiple Corporations

What about forming two corporations and holding $100,000 of earnings each year in each corporation to avoid the accumulated earnings tax? Or what about creating several corporations with common ownership among each to take advantage of the reduced corporate tax rates? If the corporate stock of these corporations is held in the same hands, both of these situations should be avoided. The reason is that if two or more corporations are owned and/or controlled by essentially the same persons, those corporations may be combined by the IRS for tax purposes.

The only exception allowed is if there is a business reason to form more than one corporation. It is difficult to say exactly what the IRS would consider as being a business reason for a farm operation. For example, if there is business reason to keep an operating corporation in the hands of as few persons as possible (those who are doing the actual work and making the business go) and if there is reason to disperse the stock in a land corporation (getting the ownership into as many hands as possible--children and grandchildren--for purposes of reducing the estate and inheritance taxes) then two corporations may be feasible.

There are two types of controlled corporation groups--a brother-sister controlled group and a parent-subsidiary controlled group. In

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[76] Ibid.

general, a brother-sister controlled group exists if five or fewer individuals, estates, or trusts own at least 80 percent of the stock of two or more corporations and the five or fewer persons own more than 50 percent of the stock. A parent-subsidary controlled group exists if one or more group of corporations are connected through stock ownership with a common corporate parent, 80 percent or more of the stock of each corporation in the group (other than the parent) is owned by one or more corporations in the group and the common parent owns at least 80 percent of the stock of one of the other corporations in the group.[77]

A group of controlled corporations is limited to one set of graduate tax rate brackets below 46 percent (after 1978) or one surtax exemption (before 1979).[78] For example, this means that if there are three members of a controlled group of corporations and no plan for unequal apportionment is adopted, each member of the group is taxed at a rate of 17 percent on the first $8,333.33 of corporate taxable income, 20 percent on the second $8,333.33, 30 percent on the third $8,333.33, 40 percent on the fourth $8,333.33 and 46 percent on taxable income in excess of $33,333.33. For a farm business, it means one set of graduate rate brackets below 46 percent if two corporations are established--one to own the land and another to carry on the farming operation as an

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[77]Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications Inc., 1979), p. 238.

[78]Remember that commencing in 1979, the federal corporate income tax rate for regularly taxed corporations is 17 percent on the first $25,000 of corporate taxable income, 20 percent on the next $25,000, 30 percent on the third $25,000, 40 percent on the fourth $25,000, and 46 percent on all taxable income over $100,000.

operating corporation. That's if the requirements are met for either type of controlled group.[79]

4. Investment Tax Credit Problems

Incorporation of the farm business can cause several investment tax credit problems. The most common possibility is the unintentional recapture of investment tax credit. It can happen in several instances.

One way it can happen is when a regularly taxed corporation elects the Subchapter S option of taxation. Unless the shareholders sign a statement agreeing to be responsible for recaptured investment tax credit and file it with the District Director of Internal Revenue within 2½ months after the close of the last taxable year as a regularly taxed corporation, all investment tax credit on corporate property is recaptured.[80]

A second possibility for investment tax credit recapture occurs at the time a corporation is formed. The problem is the same whether the corporation elects to be taxed as a regular corporation or else adopts the Subchapter S option.

Contributions of property to a corporation (or a partnership) will trigger a recapture of investment tax credit, unless the contribution is considered a "mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as

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[79]Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications Inc., 1979), p. 238.

[80]Ibid., p. 247.

Section 38 property (property qualified for investment credit) and the taxpayer retains a substantial interest in such trade or business."[81] Associated regulations specify that "substantially all the assets (whether or not Section 38 property) necessary to operate such trade or business" must be transferred to the new form of business.[82] A "substantial interest" is defined as "substantial in relation to the total interest of all persons, or . . . is equal to or greater than his interest prior to the change in form."[83]

The biggest uncertainty with the above regulations is defining what is exactly meant by the retention of a substantial interest in the business. The regulation in point does not offer much guidance when it suggests that the exchange of a 5 percent interest in a partnership for a 5 percent interest in a corporation constitutes the retention of a substantial interest.[84] The question is how far one can depart from an identical interest without triggering a recapture. For example, what about exchanging 50 percent interest in a partnership for a 20 percent interest in a corporation?

In a 1968 case, a 48 percent partnership interest was exchanged for a 7.22 percent interest in a newly formed corporation.[85] The court ruled that it wasn't a "mere change in the form of doing business" and investment tax credit was recaptured.

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[81]Internal Revenue Code Section 47 (6).

[82]Treasury Regulation Section 1.47-3(f)(1)(ii)(c)

[83]Treasury Regulation Section 1.47-3(f)(2)

[84]<u>Ibid</u>.

[85]<u>James Soares</u>, 50 T.C. 909 (1968).

The ruling that has created the greatest concern is Revenue Ruling 514 at the end of 1976.[86] The case involved a dentist who incorporated his dental practice. All assets used in the dental practice were transferred to the corporation except for the building housing the practice. The building represented about 30 percent of the value of all assets used in the dental practice. The ruling held that it was not a "mere change in the form of doing business" and investment credit was recaptured as to all assets transferred.

This ruling, if taken literally, suggests that investment tax credit recapture is a distinct possibility whenever a farm corporation is formed and the land or other assets of substantial interest (machinery and equipment, livestock) are not transferred. Courts will have to eventually define what is exactly meant by the retention of a substantial interest. Until this is done, the only way to be assured there will be no recapture will be to transfer all farm assets to the corporation.

a. Eligibility of Improvements for Investment Tax Credit

If a farm business consists of multiple entities with land separated from the production side of the business, there exists a good potential for problems involving the eligibility of improvements for investment tax credit. There could be a problem, for example, if the land is held in individual ownership and the individual builds an improvement on the land which is rented to others (i.e., to a corporation). The individual as a

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[86]Revenue Ruling 514, 1976-2 Cum. Bull. 11.

"noncorporate lessor" may not be able to claim investment tax on the improvement.[87] However, even though the individual lessor is denied the credit, he or she may elect to pass it through to the lessee. Therefore, in this situation, the credit is not denied to the acquisition itself, but simply to the lessor. This pass-through option is only available for new property. Also, according to the regulations, the noncorporate lessor rules do not apply to "property used by the taxpayer in his trade or business (other than the leasing of property) for a period of at least 24 months preceding the day on which any lease of such property is entered into."[88]

Apparently if a farmer wishing to incorporate refrains from purchasing new equipment for two years before incorporating and retains his old equipment during this time, he can retain the property and lease it to the corporation without losing his investment credit. However, this may create a problem as to whether or not substantially all the assets necessary to conduct the business are transferred (Revenue Ruling 514, 1976, discussed earlier).[89]

5. Method of Accounting

Another tax disadvantage facing some farm corporations is that they may be forced into the use of the accrual method of accounting rather

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[87]The "noncorporate lessor" rules apply to individual owners and to Subchapter S corporations and partnerships as lessors but not to regularly taxed corporations. See Chapter VII for further information.

[88]Treasury Regulation Section 1.46-4(d)(1)1972.

[89]C. Allen Bock, "Forming the Farm Corporation," (mimeograph), University of Illinois, Urbana, Illinois, pp. 8-11.

than the cash method. Generally, a newly formed farm corporation may elect the cash or accrual method of accounting if the corporation books are so kept and the method clearly reflects income. The corporation is not necessarily bound by the method of accounting used prior to incorporation.

However, a farm corporation with gross annual receipts of more than $1 million must use accrual accounting and capitalize pre-production period expenses. There are several exceptions to this rule: 1) Subchapter S corporations, 2) Family corporations if at least 50 percent of the stock is owned, directly or indirectly, by members of the same family, 3) Members of two families own, directly or indirectly, at least 65 percent of the stock, 4) Three families own at least 50 percent of the stock and substantially all of the rest of the stock is owned by employees, their families, or a tax-exempt employees retirement trust. If a corporation with gross receipts of more than $1 million meets any one of the above four exceptions, it is free to choose its method of accounting. Also, these rules do not apply to nursery operations or sod farms or to the raising or harvesting of trees other than fruit or nut trees.[90]

Once a corporation is forced to use accrual accounting, it can't shift back to cash accounting later merely because gross receipts fall below $1 million. Accounting adjustments caused by the shift in accounting method may be spread over ten years.[91]

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[90]Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications Inc., 1979), p. 249.

[91]Ibid.

B. Income Tax Disadvantages--Michigan

1. Homestead Property Tax Credit

The Michigan Homestead Property Tax Credit is available to homeowners and renters whose homestead property taxes, or 17 percent of rent paid, is more than 3.5 percent of their household income in 1979. The term "homestead" means a person's dwelling whether owned or rented. Household income is the total income of a husband and wife or of a single person maintaining a household. It includes income from all sources. Household income is defined by law as all income subject to Federal income tax, plus all income excluded or exempted from the Federal income tax.

Farmers (sole proprietors) owning farmland are entitled to a homestead property tax credit on farmland taxes under certain conditions. If gross receipts from farm operations are greater than household income, a homestead property tax credit can be claimed on all the farmland property taxes. If, however, the farmer has lived on the farm ten years or more, he or she may claim a property tax credit on all his or her land adjacent and contiguous to his or her home, regardless of his or her gross receipts from farm operations. If the farmer has lived on the land for less than ten years and gross farm receipts are less than household income, only the property taxes on the farmer's home and five acres of land may be claimed for credit.

The tax credit is calculated as follows. Household income is multiplied by 3.5 percent (.035) to arrive at the amount of property taxes not refundable. The amount by which total property taxes available for credit exceed this unrefundable amount is then multiplied by .6 to arrive at the total homestead property tax credit. The tax credit is limited to $1,200.

Rules pertaining to the availability of a homestead property tax credit on farmland owned by farm corporations aren't exactly spelled out in the provisions of the law. Therefore, the availability of this tax credit to farm corporations is somewhat in question. There have been some rulings by the state in this area, but one can't be certain if or how long they will hold.

What is currently known about the availability of this tax credit to Michigan farm corporations is presented below.

For a Subchapter C corporation with the farmhouse and all the farmland "in" the corporation--only the property taxes paid on the home and five acres of farmland may be claimed for the tax credit. Of course, a "C" corporation with all of the farmland "out" of the corporation will not receive a homestead property tax credit because the corporation itself does not pay any property taxes.

However, a farmer who leases all his farmland to a Subchapter C corporation of which he is a shareholder may be eligible for a homestead property tax credit on the farmland taxes. In such a case, the rules of eligibility are basically the same as for a sole proprietor owning farmland except for one difference. For a sole proprietor, a tax credit can be claimed on all farmland property taxes if the gross receipts from farm operations are greater than household income. However, for a farmer leasing his farmland to his own Subchapter C corporation the amount of rental income received from the corporation must be greater than household income. Thus, the only difference is that the rental income from the corporation is compared to household income rather than comparing the gross receipts from farm operations with household income. If the rental income received from the corporation is less than household income, then the same rule as used for sole proprietorships in this situation takes hold--namely the length of time lived on the farm. If the farmer has lived on the farm for ten years or more, he can claim a property tax on all land adjacent and contiguous to his home, regardless of the rental income received from the corporation. If however, the farmer has lived on the land for less than ten years and the rental income received from the corporation is less than household income, only the property taxes on the home and five acres of land may be claimed for credit.

The rules described in the paragraph above also hold for a farmer who leases all his farmland to his own Subchapter S corporation.

Farmers who are shareholders in a Subchapter S corporation with all the farmland "in" the corporation may be eligible for a homestead property tax credit on their share (the percentage of stock the individual owns) of farmland taxes paid by the "S" corporation. The qualifying rules in this case are the same as for a sole proprietorship except for this difference--the individual's share of corporate net income, as shown on Schedule E of his individual tax return, must be greater than household income. This turns out to be quite a stiff requirement because it says that the corporate profits for each shareholder must be greater than his household income which normally consists of the shareholder-employee's salary from the corporation along with nonfarm income. In reality it is believed that this will rarely happen unless the farm corporation had a very profitable year.

Thus, for all practical purposes, the shareholders of Subchapter C and S farm corporations with all farmland "in" the corporation will receive little, if any, benefits from the homestead property tax credit. Also, the amount of homestead property tax credit available when all the farmland is "out" of a "C" or "S" corporation is uncertain. Therefore, incorporation of the farm business could result in a loss of a tax credit of up to $1,200--which isn't exactly small change!

2. P.A. 116

The Michigan "Farmland and Open Space Preservation Act" (Public Act 116) is separate legislation from the homestead property tax credit. Corporate farmland owners (both Regular and Subchapter S corporations) are eligible for a farmland development rights agreement and a property tax credit against state tax liability. The development rights agreement is a restrictive covenant upon the land. The landowner and the state, for a term of years, agree to jointly hold the right for land development. The agreement lasts for a term of not less than ten years and can be renewed again for ten years or longer periods. The agreement stays with the land and will affect subsequent owners with no penalty as long as they comply with the provision of the agreement.[92]

The owner of the farmland continues to pay property taxes as before, but any amount by which the tax on the farmland under agreement exceeds 7 percent of the owner's household income becomes a tax credit applied to the state income tax. If the credit is larger than income tax owed,

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[92]Ralph E. Hepp, Farmland and Open Space Preservation Act, Public Act 116, Michigan State University Extension Bulletin E-792A, Department of Agricultural Economics, January 1980, p. 1.

the excess is refunded to the owner by direct payment. Household income is the same as computed for homestead property tax relief.

For a Subchapter S corporation owning farmland, the property taxes are allocated to the owners in the same proportion as net income from the entity. Each stockholder's share of property taxes would then be applied to his or her household income to determine any possible tax credits.

Because a regular taxpaying farm corporation does not have household income as defined for an individual family unit, an alternative definition of corporation income is used. Adjusted business income is defined as the federal taxable income for the farm corporation plus compensation to stockholders. When calculating adjusted business income, federal taxable income must not be less than zero. Federal taxable income excludes any deductions for depletion allowance taken during the current taxable year. Since a farm corporation is exempt from the single business tax, a regular taxpaying farm corporation will receive a refund of property taxes greater than 7 percent of adjusted business income. The refund cannot exceed the total property tax due and payable by the claimant in that year.[93]

A regular taxpaying corporation executing a farmland development rights agreement since January 1, 1978, has an additional eligibility requirement in order to claim a property tax credit or refund. A farm corporation must demonstrate that its agricultural gross receipts from farming exceed five times the property taxes on the land for each of three out of five tax years immediately preceding the year in which the

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[93] Ibid.

credit is claimed. A property tax credit or refund for a regular tax-paying farm corporation is not allowed unless the gross receipts qualification is met.[94]

The farm corporation may also meet the gross receipts qualification by comparing the average of the most recent three years of agricultural gross receipts to property taxes in the first year that the corporation entered the program under the present contract. Once an election is made by the participant to compute the gross receipts qualification in the alternative manner, all future calculation must be made in the same manner.[95]

These additional eligibility requirements should present no problems for the majority of farm corporations. However, some may have a difficult time qualifying. For example, a farm corporation whose sole source of income is from the rental of farmland might not qualify. Assuming a cash rent lease and a property tax of $25 per acre (not uncommon in the "Thumb" area of Michigan), the corporation would have to receive a rental of over $125 per acre to qualify. This is at or above any current rental rates (in the "Thumb" area). Or assuming a typical 1/3-2/3 crop share lease and $25 per acre property tax, the crop would have to have a gross value per acre over $375 to qualify. Most crops grown in the "Thumb" area would have a hard time meeting this figure (i.e., 120 bu. corn @ $3.00/bu. = $360, 14 cwt. navies @ $25 = $350, 60 bu. wheat @ $4 = $240. Sugar beets may qualify).

If part of the farm business is incorporated, such as the operating side, while land ownership remains the same (owned by individuals or a

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[94] _Ibid._

[95] _Ibid._

partnership), the P.A. 116 tax credit as well as the homestead property tax credit will most likely change. Each could increase or decrease depending upon the amount of compensation the stockholders (who also own farmland) receive from the corporation. This includes amounts received for land rental, salaries, dividends, or any other compensation.

For example, a farmer who had little taxable income before incorporation may find both his P.A. 116 and homestead property tax credit decreased. This is because it is likely that rental income received (for his land leased to the corporation) plus his salary received from the corporation will increase his household income and therefore reduce the P.A. 116 tax credit as well as the homestead property tax credit.

Thus, it becomes extremely important to analyze P.A. 116 and homestead property tax credit ramifications before incorporation. If this is not done, there is a good possibility of a substantial loss of state income tax credits.

C. Estate Planning Disadvantages--Federal

The Tax Reform Act of 1976 contains several provisions that provide possible estate tax relief for farmers. This special tax treatment reflects the Congressional philosophy that family farms are worth preserving.

Because Congress was concerned that nonfarm investors might take advantage of these special provisions, each of them have complex qualifying conditions. Incorporation of the farm business may, in some cases, cause problems in meeting the qualifying conditions. This is especially true where multiple entities are created such as one type of business structure for the operating side of the business (perhaps a corporation) and another for the land (individual ownership). Let's take a look at these special estate tax relief provisions and examine how incorporation could cause problems in qualifying for each.

1. Special Use Valuation

Prior to 1976, farm property and other real estate was valued for estate purposes at the property's fair market value determined on the basis of highest or best use. The Tax Reform Act of 1976 provides that, if certain conditions are met, the executor of estates of decedents dying after December 31, 1976, may elect to value real property which is devoted to farming on the basis of the property's value as a farm, rather than its fair market value determined on the basis of its highest and best use. In no case may this special use valuation process reduce a gross estate by more than $500,000.

Section 2032A of the Internal Revenue Code contains numerous provisions that must be met in order to qualify for the special use valuation. This discussion will, however, only be connected with those provisions that relate in some way to farm corporations.

a. "Qualified Use" Requirement

Real property may qualify for special use valuation if it is located in the United States, belongs to a citizen or resident of the United States, and it is devoted to a "qualified use." A "qualified use" means the property is devoted to either 1) use as a farm for farming purposes or 2) use in a trade or business other than farming. In either case, there must be a trade or business use.

Real property which qualifies for special use valuation includes residences and related improvements located on the qualifying real property and occupied on a regular basis by the owner, his lessee or employees for operational and maintenance purposes. However, property or property rights which are not related to farm or business use (such as mineral rights) are not eligible for special use valuation.

Mere passive rental of property generally is not considered to be a "qualified use." Recent IRS regulations (specifically Reg. Section 20.2032A-3(c)(1)) made it clear that the landowner must have a non-passive leasing arrangement to satisfy the "qualified use" requirement. Furthermore, the regulations state that a passive rental arrangement such as a cash lease is normally not an at risk arrangement since it does not make the landowners return directly dependent upon production of the land owned and rented. A typical crop share rent arrangement would be considered as dependent upon production.[96]

Of course, it is possible that this regulation will be challenged and changed in the future. However, it is probably best to be safe by avoiding the use of cash leases.

The decedent must also have personally satisifed the "qualified use" requirement for five out of the eight years immediately preceding his death. This requirement cannot be fulfilled by a family member arrangement or activity. If, at the point of the decedent's death, the "qualified use" requirements have not been met, the otherwise eligible farm real property is disqualified from consideration for use valuation according to IRS regulations and subsequent IRS personnel comment.[97]

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[96]Gerald A. Harrison, "Material Participation: Social Security, Retirement and Federal Estate Tax Planning," (mimeograph), Purdue University, December 1980, p. 14.

[97]Ibid., p. 15.

To illustrate, if a sole proprietor retired after operating his own farm business by cash renting to his son (even for only one year) and the death of the sole proprietor occurred during this cash rental arrangement, the farm real property would not be qualified for use valuation (because the cash lease is a passive rental arrangement). However, if the decedent is not organized in a proprietorship but has stock in a corporation the "qualified use" requirement is viewed differently. In this case, a decedent can cash rent land to a corporation and have the land meet the "qualified use" test if the decedent owns an equity interest in the corporation and this corporate interest meets the test in Section 6166(b)(1) of the Internal Revenue Code for a closely-held business interest.[98]

Section 6166(b)(1) states that stock in a corporation is a trade or business if "a) 20 percent or more of the value of the voting stock of such corporation is included in determining the gross estate of the decedent or b) such corporation has 15 or fewer shareholders."

A long term danger associated with this test is that the stock ownership in the farm corporation may become so diluted for the farm operating members in the second or third generation (depending upon the original number of stockholders and the size of the family) that each stockholder's estate may not contain 20 percent of the voting stock of the corporation. Henceforth, if less than 20 percent of the voting stock of the corporation is included in the decedent's estate or the number of shareholders in the corporation grows to more than 15 the result will be that real property interests will not be eligible for special use valuation.

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[98] Ibid.

b. Material Participation Requirement

Another qualifying condition for the special use valuation is that there must have been material participation in the operation of the farm by the decedent or a member of his family in five out of the eight years immediately preceding the decedent's death. Members of a decedent's family include his ancestors or lineal descendants, lineal descendants of his grandparents, his spouse, or spouses of any such descendants.

Tax benefits realized by the estate under the special use valuation procedure must be recaptured if the qualified real property passes out of the family or ceases to be used as a farm within 15 years of the decedent's death and the qualified heir still lives. Full recapture occurs within the first 10 years with a partial recapture between 10 and 15 years. The recapture rules are also activated on a "cessation of qualified use." A "cessation" occurs if, during any eight-year period ending after the decedent's death and before the qualified heir's death, there have been periods aggregating three years or more during which there has been no "material particiation" by the decedent or by a family member or, after the property was held by a qualified heir, by the qualified heir or by a family member. Hence, if the decedent was not participating materially in the production of income in the year immediately prior to death, two more years of nonmaterial participation immediately after death could place the qualified heir on the verge of recapture of benefits.

Thus, it can be seen that there is a concern with material participating both before and after the decedent's death. Whether there has been material participation by an individual or closely-held business is determined in a manner similar to that set forth in the income tax provisions relating to whether income is subject to self-employment taxes.

However, the material participation requirements for farm corporations have not yet been finalized by the IRS. One of the concerns is whether the members of the board of directors and officers must meet the material participation test. A proposed regulation states . . . "with corporations and partnerships, activities in the management and operation of the real estate component of the business as a whole are central. Merely holding corporate officers or being a partner in name and financial risk only are not sufficient participation."[99] In light of this proposed regulation, it would seem wise for all members of the board of directors and all officers to be material participators until definitive guidance is received from the IRS.

c. Recapture of Benefits Upon Incorporation

There has also been some concern as to whether tax benefits realized by an estate under the special use valuation procedure would be recaptured if the qualified real property is transferred to a corporation. Apparently, there will be no recapture upon tax-free transfer of the real property to a corporation if a) the qualified heir retains the same interest in the corporate stock as the individual held in the property given up, 2) the firm is a closely-held business (at least 20 percent of the corporate stock is included in the decedent's estate or the firm has 15 or less shareholders), 3) the corporation consents to personal liability for the recaptured tax if it disposes of the real property or ceases to

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[99] Federal Estate and Gift Tax Reports, Commerce Clearing House September 17, 1979, Proposed Amendments of Regulations, 15356.

use the property for qualified purposes during the period in which recapture could occur.[100]

2. Installment Payment Plans for Federal Estate Taxes

Since 1958, the executor or administrator of an estate has been allowed to pay estate taxes over a ten-year period on the portion of an estate associated with a closely-held business interest, such as a farm, if certain qualifying conditions could be met. Also, a discretionary extension of up to ten years was allowed occasionally if immediate payment caused an "undue hardship."

The Tax Reform Act of 1976 still allows an executor to elect the ten-year extension for qualified business interests and for "reasonable cause." In addition, the Act created a new 15-year extension for qualified business interests. Under this new extension, the executor can defer the payment of any tax for a period of five years, then pay the tax due in equal installments over the next ten years.

Provisions of the two elections differ sharply so each must be examined separately.

a. 10-Year Installment

Under the 10-year installment payment election, which has been available since 1958, the portion of the federal estate tax attributable to a closely-held business may be paid in two or more (but not exceeding 10) equal annual installments.[101] The installment payments are subject

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[100]Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications Inc., 1979), p. 47.

[101]Provisions of this election are found in Section 6166A of the Internal Revenue Code.

to interest on the unpaid balance. The rate is tied to the prime rate and adjusted periodically. The interest rate was 6 percent from February 1, 1978 to February 1, 1980.

For this election a "closely-held business" includes a proprietorship. It also includes a partnership or a corporation, which has no more than ten partners or stockholders, or in which the decedent owned a 20 percent or more interest. Also, to be eligible, the interest in the proprietorship, partnership, or corporation must exceed 35 percent of the value of the gross estate or 50 percent of the value of the taxable estate.

The installment privilege terminates when there has been a withdrawal from the business of 50 percent of its value or where 50 percent of the value of the decedent's interest is distributed, sold, or otherwise disposed of. The installment privilege does not necessarily terminate where transfers are made to the heirs or devisees of the decedent.

b. <u>15-Year Installment</u>

The 15-year installment payment election differs sharply from the 10-year election. The 15-year election is more restrictive on eligibility, but the economic advantages are much greater.

If more than 65 percent of a decedent's adjusted gross estate (gross estate less debts, expenses, claims, and losses) is an interest in a farm or other closely-held business, an executor may elect to defer all payments of tax attributable to the closely-held business part of the estate for five years (paying interest only) and thereafter pay the tax in equal installments over the next ten years.[102] Interest is payable on

[102]Provisions of this election are found in Section 6166 of the Internal Revenue Code.

the unpaid balance. The rate is 4 percent on the estate tax attributable to the first $1 million of the farm or other closely-held business. Amounts of tax beyond this level are subject to interest at the same rates as for the 10-year installment election.

For purposes of the 65 percent rule, an "interest in a closely-held business" is defined as: 1) any interest as a proprietor in a business carried on as a proprietorship, 2) any partnership in a trade or business with no more than 15 partners or where 20 percent or more of its assets help determine the decedent's gross estate; or 3) (a) stock in a corporation with no more than 15 stockholders or (b) where 20 percent of its voting stock is included in determining the decedent's gross estate. Interests held in two or more businesses can be counted toward the 65 percent requirement if more than 20 percent of each is included in the deceased's estate.

Under amendments made by the Revenue Act of 1978, for deaths after November 8, 1978, all stock and partnership interests of a decedent and his family will be considered owned by the decedent for the purpose of meeting the requirments of 3(a) above.[103] Family members whose interests will be considered held by the decedent are a spouse, brothers, sisters, ancestors, and lineal descendants. Also, for deaths after November 8, 1978, an election may be made to treat interests in non-readily-tradable stock in a corporation that is held by family members as though owned by the decedent for purposes of the 20 percent requirement in 3(b) above. Non-readily-tradable stock is stock for which no market on a stock exchange or in over-the-counter trade existed at the

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[103]Internal Revenue Code Section 6166(b)(2)(D).

time of the decedent's death. This election is designed to help family operations where ownership of the business is spread over more than 15 owners. However, the 4 percent interest rate is not available if such an election is made to meet the 20 percent requirement 3(b) by counting family ownership interests. Under such circumstances, the deferral period is limited to ten years at the regular rate of interest.

The installment privilege terminates when there is a disposition of one-third of the value of the decedent's interest in a qualifying business or trade or aggregate withdrawals of one-third of the decedent's interest in money or other property.

c. Potential Problems Associated with Corporations

As was the concern with the special use valuation, there is a danger that stock ownership in the farm corporation may become so diluted for the farm operating members in the second or third generation (depending upon the original number of stockholders and the size of the family) that each stockholder's estate may not be able to meet the qualifying conditions. However, this danger has been lessened by the amendments made by the Revenue Act of 1978 (discussed above) -- although there still is a disadvantage in that the special 4 percent interest rate is not available if family ownership interests are combined to meet the 20 percent requirement 3(b).

Probably the biggest potential problem area concerns qualifying for either of the two installment payment elections if the farm business is organized into multiple entities--i.e., a corporation for the operating business and the land owned individually or in a partnership.

Specifically, the question is whether farmland leased to tenants will qualify as a "business" for purposes of the installment payment elections.

There has been a ruling with regards to what constitutes a "business" for purposes of the 10-year installment plan. A Revenue Ruling in 1975 indicated that crop share lease arrangements would satisfy the "business" requirement for a decedent.[104] However, the ruling intimated that a cash rental arrangement would not qualify as a "business." In this ruling, farmland was leased to a tenant under a crop share lease with the landlord receiving 40 percent of the crops and paying 40 percent of the expenses. The landlord participated in important management decisions and made almost daily visits to inspect the farm and discuss operations although the landlord lived several miles from the farm.

It is not known whether this ruling will apply to the 15-year installment payment election. However, it seems reasonable that it may very well do so. Therefore, in farm businesses where the land is owned individually and leased to a corporation (or a partnership), it would probably be wise to design a crop share lease arrangement that specifically involves the landowner in management decisions, physical work, etc. Cash rental arrangements should be avoided. This is especially true if the landlord plans on using the installment payment election as a part of the liquidity plan for his estate.

3. Alternative Election for Spouses

The Revenue Act of 1978 provides owners of farms and other closely-held businesses with an optional procedure whereby an estate may elect

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[104] Revenue Rul. 366, 1975-2 Cum. Bull. 472.

to credit the surviving spouse with part of the value of the property based on the surviving spouse's number of years of service to the business.[105] This procedure has no one particular name--some call it a "joint interest exclusion" while others refer to it as a "credit for services rule." It will be referred to as an alternative election in this discussion.

This election applies to estates of decedent's dying after December 31, 1978, and is elected at the time a federal estate tax return is filed. It applies to property in an estate held by the decedent and the decedent's spouse as joint tenants or as tenants by the entirety, but only if the joint interest was created by the decedent, the decedent's spouse or both; and in the case of a joint tenancy, only the decedent and the decedent's spouse are joint tenants. Property refers to any interest in real or tangible personal property which is devoted to use as a farm or used for farming purposes or is used in any trade or business.

Since the election is made at the point of filing a federal estate tax return for the decedent, there is little advance planning required to take advantage of the provisions. The most important requirement is that the surviving spouse must have materially participated in the management and operation of the business. Material participation is to be determined in a manner similar to that for self-employment tax purposes. Regulations have not yet been issued by the IRS on what constitutes material participation for this rule. However, it seems reasonable

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[105]Internal Revenue Code Section 2040(c).

that some significant involvement in the day-to-day operation and/or management of the business will be required.

To figure the amount of the exclusion under the election, one follows this procedure. 1) Calculate the adjusted consideration furnished by the joint tenants. To do this (a) take the original consideration furnished by the decedent when the property was purchased and expand this amount by a 6 percent simple interest rate per year for the number of years since the property was purchased, (b) follow the same procedure as in (a) except do the calculations for the surviving spouse, (c) add (a) and (b). 2) The amount of adjusted consideration (a) + (b) is subtracted from the current market value of the jointly held property. 3) Determine the percentage rate. Under this rule, a percentage rate of 2 percent is allowed for each year the surviving spouse had materially participated in the business. However, the total percentage is limited to 50 percent or 25 years of material participation. 4) Apply the percentage rate (computed in step 3) to the amount computed in step 2 (the excess of the value of the joint interest over the adjusted consideration). 5) To the amount arrived at in step 4, add the adjusted consideration furnished by the surviving spouse (from step 1-b). 6) The result arrived at in step 5 is the amount excluded from the value of the jointly held interest otherwise includible in the decedent's gross estate. However, the total amount of decrease in the value of the decedent's gross estate resulting from the exclusion may not exceed $500,000.

a. Potential Problems Associated with Corporations

As with the other tax code provisions that provide estate tax relief for farm property, incorporation of the farm business could possibly cause problems in meeting the material participation requirements. No treasury regulations or rulings have been issued yet, so one can only speculate as to potential problems.

Since a farm corporation is a formal business organization with directors, officers, and employees, one wonders what role a spouse would have to play to have jointly owned corporate stock meet the material participation requirements. Would it be necessary to be a full-time paid employee? Or, would engaging in physical work and management decisions in the operation without receiving compensation from the corporation be sufficient? Would merely holding a corporate office be sufficient participation?

Problems may also develop with multiple entities. For example, would jointly owned farmland that is cash rented to another entity (owned by other family members) qualify as a business? If so, how could there be material participation?

Answers to these and other questions will give an indication of the usefulness of this tax provision. Only time will tell.

4. Subchapter S Disadvantages

If a farm corporation elects to be taxed under Subchapter S rules, several estate planning problems may be created.

As was discussed in Chapter IV, a Subchapter S corporation can have no more than 15 shareholders. For purposes of this limitation, stock owned by a husband and wife, regardless of how held (in sole ownership, or community property, tenancy in common, joint tenancy, or tenancy by the entirety), is considered held by only one shareholder. This is the rule starting in 1979. Before 1979, if some stock was held by the spouses individually, they counted as two shareholders. This 15 shareholder limitation and its associated regulations may cause problems in family farm corporations where the parents desire to center their estate planning program around annual gifts of corporate stock. It is very possible, especially in large families, that a 15 person limit may be insufficient to include the children and their spouses and perhaps the grandchildren. Even if this limitation poses no problems to the original incorporators, the situation will get worse as the members of each successive generation desire to become shareholders. It's very important to keep this limitation in mind because if it is violated, tax-option status is lost.

a. Limitation on Trusts as Shareholders

Another requirement for Subchapter S status is that generally, only individuals or estates of deceased individuals may be shareholders. Neither a corporation nor a partnership may be shareholders.

Grantor trusts, under which the income is taxed to the grantor, and voting trusts (each beneficiary is treated as a shareholder) were added as eligible stockholders by the Tax Reform Act of 1976. Under a grantor trust, the grantor rather than the grantor trust is considered to be the shareholder and the grantor must be a citizen or resident of the United States. This precludes an alien, partnership, another corporation or trust from being the grantor for a grantor trust and qualifying as a shareholder.

Starting in 1977, any other trust receiving stock by will is an eligible shareholder for a 60-day period after the transfer to it. This 60-day period becomes two years if the entire amount of trust property is included in the deceased shareholder's estate.

No other trust can be a shareholder in a Subchapter S corporation.

Since trusts are key estate planning devices, the limitation on trust ownership of stock has been a major estate planning problem for shareholders of Subchapter S corporations. For example, it isn't possible to set up a testamentary trust for minor children to hold stock of a Subchapter S corporation (if the parents should die) until they reach the "legal" age.

Nor can stock in a Subchapter S corporation pass into a martial deduction trust. Usually, such a trust is set up to take maximum advantage of the marital deduction (for federal estate tax purposes). One method to accomplish this is to give the trustee the power to split the trust into a marital deduction portion and a residuary portion. The marital deduction portion is often used to hold and manage property for the benefit of the surviving spouse. The residuary portion would have the children or someone other than the surviving spouse as residuary beneficiary.

Marital deduction trusts are an integral part of the estate plans of many farmers today. Even though there are a few acceptable alternatives to them, the fact that they can't be used to hold Subchapter S stock presents a major disadvantage to forming a Subchapter S corporation.

b. <u>One Class of Stock</u>

A Subchapter S corporation may have only one class of stock. This restriction applies only to outstanding shares of stock. A Subchapter S corporation may have more than one class of stock as long as only one class is issued. However, it does mean essentially that no preferred or nonvoting stock is allowed. Thus, a Subchapter S corproation cannot take advantage of the use of two classes of stock to limit capital appreciation in the estate of the older generation. This estate planning alternative was discussed in Chapter V.

D. Estate Planning Disadvantages--Michigan

Upon death, Michigan imposes a transfer tax upon the fair market value of the heirs' share of an inheritance. This tax is in addition to any Federal Estate tax that the estate may be subject to. All real and personal property owned by a Michigan resident decedent and all real property located in Michigan but owned by a non-resident is subject to the tax.

The Michigan Inheritance Tax law was amended in 1978 with the new provisions becoming effective on January 1, 1979. The amendments increase the tax rates and exemptions and allow an optional deferment and partial forgiveness of the inheritance taxes on farm real property. Those provisions relating to farm real property are the ones that we will be concerned with in this analysis.

The transfer of farm real property is eligible for two optional tax saving provisions under the amended Michigan Inheritance Tax law if the estate meets the qualifying conditions. The two provisions are 1) a 50 percent farm exemption for the market value of farm real property, and

2) a deferment of the inheritance taxes on the remaining half of the farm real property.[106]

The farm exemption and deferred inheritance taxes are recaptured if the heir sells the farm or ceases to use the property for farming within a ten-year period. If the law's provisions are met for a ten-year period, the farm exemption becomes permanent and the deferred inheritance taxes become a lien against the property and are due at that time.[107]

The qualifying conditions for the Michigan Inheritance Tax farm real property provisions are similar to the qualifying conditions under the Federal Estate tax to value farm real property based on use value rather than fair market value. However, the amended Michigan Inheritance Tax law does not mention whether farm real property interests held in a corporation are eligible for the two optional tax saving provisions, just as there is a question whether farm real property interests held in a corporation are eligible under the special use valuation provision of the Federal Estate tax (discussed earlier in this chapter).

Early indications are that the qualifying conditions for the farm exemption and deferment of inheritance taxes on farm real property are being interpreted in quite a broad manner.

Two cases have come before the Inheritance Tax Division where the farmer's real property was put into a marital deduction trust for the wife at his death. Initial reaction by the department was that a trust

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[106]Ralph E. Hepp and Myron Kelsey, Michigan Inheritance Tax, Michigan State Extension Bulletin E-1348, November 1979, Michigan State University, p. 3.

[107]*Ibid.*

was not a "qualified heir" as specified under the qualifying conditions of the amendment. However, it was later ruled to be a qualified heir and the farm real property in each of the farmers' estates was ruled to be eligible for the farm exemption and deferment.[108] As of yet, there have been no cases involving farm real property interests held in a corporation. Since the law is apparently being interpreted quite liberally, it is possible that such interests would be eligible. Some reports indicate that this was the intention of the legislature.[109] However, it is also possible that such interests would not be eligible. Some have taken this position.[110] It will probably take several years of rulings and possibly more legislation before the issue is clarified.

Since there is so much uncertainty involving farm real property interests held in a corporation, it would probably be wise to write a letter of clarification to the Michigan Inheritance Tax Division before incorporating a farm and completing the associated estate planning. Loss of the optional tax saving provisions could prove to be very costly.

E. Minority Shareholder Problems

A minority shareholder is any shareholder who owns less than 50 percent of the stock of a closely-held corporation. Minority shareholders

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[108] Telephone conversation (August 1980) between Mr. Jim Hoeflinger of the Michigan Department of Treasury, Inheritance Tax Division and Dr. Mike Kelsey, Department of Agricultural Economics, Michigan State University.

[109] Ibid.

[110] Conversation with Dr. Ralph Hepp, Department of Agricultural Economics, Michigan State University, November 1980.

are subject to the rule of the majority. The reason behind this is that majority shareholders can elect more than half of the board of directors who in turn are entrusted with the overall management of the business. As was discussed in Chapter III, shareholders completely lack any right to establish management policy by direct action.

Let's examine some of the common characteristics of family farm corporations which can create problems for minority shareholders. Since most farm corporations are closely-held, restrictions are usually placed on the sale of shares to outsiders. This is done to insure that non-family members are kept out of the family business. Many farm corporations also lack a binding "buy-sell" agreement which makes arrangements for requiring or permitting the purchase of stock by the corporation or the remaining stockholders if one shareholder dies or wishes to sell his stock. It also should establish a procedure for setting a fair market price for the stock.

Such characteristics may present a danger to a minority shareholder. While a partner or a co-owner in joint tenancy or tenancy in common can take action and have the co-ownership relationship severed, a minority shareholder may be unable to withdraw from the business and take his share of equity out of the enterprise because he will most likely have no ready market for his stock. Since there are normally stock transfer restrictions, he can only sell to other shareholders at a price they offer him. Obviously, this probably is not a "fair" market price. Even if there are no transfer restrictions limiting sales of stock to outsiders, there may be few willing buyers. In other words, who would want to buy minority shares of stock in a small family farm corporation in which they will have no effective voice in management. Therefore, many minority shareholders may find that they have no ready market for their stock and are "locked-in" the corporation, subject to the majority.

Minority shareholders may also find that they have little, if any, income on their stock. Even if the corporation is making a profit, the double taxation of dividends (in a regularly taxed corporation) and the desire to accumulate capital for expansion may discourage dividend payments. Since a minority stockholder has no control over the board of directors, he can't force them to pay dividends on his stock.

Thus, it can be seen that a minority stockholder can easily be a dissatisfied, "locked-in" shareholder subject to the rule of the majority. In fact, such a shareholder really becomes an involuntary contributor of capital for use by the corporation. The stock may be increasing in value but it is meaningless if there is little possibility of sale of the stock.[111]

The dissatisfied minority shareholder could be anyone in a family farm corporation. It could be an off-farm heir such as a daughter. She may have been given some shares of stock as part of the estate plan of the parents. Or it could even be the parents themselves. If more than 50 percent of the stock had been sold or given to an on-farm heir, such as a son, the parents may be left with considerable property but little, if any, income.

Even though each minority shareholder may have different interests and objectives, most of their problems can be avoided by proper advance planning. Most importantly, a binding "buy-sell" agreement should be part of the bylaws of all family farm corporations. It should establish

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[111]Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications Inc., 1979), p. 267.

arrangements for creating a market for the stock, at a fair market value if, at any time, a shareholder desires to sell.

A possible plan to keep both on- and off-farm heirs happy would be for the parents to formulate an estate plan whereby all corporate shares are left to the on-farm heirs and the corporate debt securities plus non-farm assets could be left to the off-farm heirs. Often it is desirable to keep ownership of the farm business out of the hands of off-farm heirs. Doing so usually works to the advantage of all parties and keeps family squabbles to a minimum.

F. Increased Formality and Red Tape

Because a corporation is a creature of state law, somewhat greater formality is required of a corporation than of other forms of business organization. Many farm families do not find the additional formalities very appealing. They are not insurmountable, but rather they are additional procedures that are not required under the other business organizational types.

In fact, this disadvantage can actually be an advantage if it encourages a more business-like approach to the farm business and results in smoother relationships between shareholders.

Some of the additional procedures and related documents required of a corporation are listed below:[112]

1) Preincorporation Subscription Agreement to be executed by the subscribers of the corporation's stock.

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[112] Illinois Institute for Continuing Legal Education, Closely-Held Corporations, Illinois Practice Handbook No. 18, Illinois Bar Center, Springfield, Illinois.

2) Reservation of the Corporate Name by application to Secretary of State.
3) Articles of Incorporation to be executed by the incorporators.
4) Filing of Articles with Secretary of State.
5) Issuance (by Secretary of State) of Certificate of Incorporation.
6) Recording of Certificate by County Clerk or Recorder.
7) Periodic meetings of shareholders to elect directors or to approve major corporate transactions such as sale of substantially all corporate assets or a major financing merger or dissolution.
8) Periodic meetings of directors to approve and amend by-laws, to elect officers and to approve transactions other than those taken by the officers in the ordinary course of business.
9) Filing of Annual Reports with the Secretary of State.
10) Filing in states foreign to the state of incorporation if business is to be conducted in more than one state.

Most of these documents to be filed or recorded are frequently prepared by the corporation's attorney and/or accountant and require only the signatures of the officers, board of directors, or in a few cases, the stockholders of the corporation. However, since the documents are sometimes quite complex, it does require a reliance on professionals, namely an accountant and an attorney.

Some farmers are unwilling to let such professionals become that involved in the operation of their business. If this is the case, a farmer should think twice before incorporating.

Doing business as a corporation also requires a more comprehensive set of records than a proprietorship calls for. However, it is the author's opinion that these bookkeeping requirements are probably not any more detailed or troublesome than the bookkeeping systems of a well-run partnership or proprietorship. Good bookkeeping systems and other business records are a necessity for any profitable and successful business, even though they may not necessarily be legally required for all types of business organizations.

G. Additional Costs

1. Initial or Formation Costs

The principal costs of forming a farm corporation are usually the fees for the professional services of a lawyer and accountant. This expense will vary with the size and complexity of the farm business.

In addition to fees for professional services, there are also other expenses incurred at the time of incorporation such as state filing fees, the cost of printing stock certificates and for purchasing the corporate seal plus the expense of a minutes book to record the business conducted at board of director meetings, etc. However, these costs are minimal in comparison to the professional fees.

The attorneys who were interviewed by the author were asked what the total costs for incorporating a typical family farm would be. Their answers ranged from $600 to $1,000. This amount included their services along with most of the miscellaneous expenses mentioned above. However, there would be additional fees if a will, trust, profit sharing or pension plan was drawn up. There may also be additional accountant's fees to determine the possible tax benefits obtainable through incorporating and possibly helping oversee some of the other financial matters when forming the corporation (i.e., the initial balance sheet for the new corporation along with possible tax consequences when transferring property to the corporation in exchange for stock).

Most of these initial costs for incorporating a farm are deductible over the first five years of corporate life.

2. Maintenance Costs

In addition to the initial fees paid for professional services, there will be annual fees paid to an accountant and/or attorney for assistance with corporate bookkeeping and the filing of annual income tax returns. Assistance may also be required in filing the annual report to the state. In addition, farm corporations in a few states, Michigan excluded, are required to file annual reports describing their agricultural activities in the state (i.e., amount of farmland owned and leased, number of shareholders and whether or not any of them are related, number of shareholders residing on the farm or actively engaged in farming, commodities produced, etc.).

There may also be some additional annual costs. All corporations chartered in some states, Michigan excluded, are subject to an annual license or franchise fee. This fee is quite substantial in some states.

Up until 1976, a corporation organized and doing business under the laws of the state of Michigan was subject to an annual fee of 5 mills on each dollar of its paid up capital and surplus. This is the same as the book value net worth of the corporation. For example, a corporation with a $200,000 net worth was taxed $1,000 annually for the privilege of operating in Michigan. A partnership or sole proprietorship was not subject to this tax.[113]

Therefore before 1976, this franchise fee was an extreme disadvantage to incorporating a farm operation in Michigan. However, if a farmer desired to incorporate, he would generally put as few assets as possible in the corporation to keep the franchise fee as small as possible.

Even though some of these annual costs of maintaining a corporation are quite substantial, most of them are deductible as expenses for annual income tax purposes.

3. Complexity Costs

All of the extra costs associated with incorporating a farm that have been mentioned so far have been cash or "out of pocket" costs. However, there are also noncash costs associated with incorporating a farm. These costs could be referred to as the intangible costs of learning to work with a corporate entity and understand its operation.

It is sometimes difficult for a farmer to accept the notion that a corporation is a separate business entity. For example, he can't draw money out of corporate funds to surprise his wife with a weekend trip to a resort. Instead, the farmer who becomes a stockholder-employee after incorporation finds himself in the same situation as all other employees--merely that he must use his own salary or personal savings to finance personal expenditures. This is not true for sole proprietorships as a

[113]Ralph Hepp, Mike Kelsey, and Dayton Matlick, "Michigan Farm Estate Planning," Michigan Farmer, p. 67.

farmer can dip into business funds to finance personal expenses. Of course, these personal expenditures are not tax deductible.

Other farmers may not be used to the idea of a separate checking account for the farm business corporation and another for personal affairs. What's even worse is the situation where there are multiple entities--such as an operating corporation along with machinery owned jointly in a partnership and land owned individually. With so many separate business entities, it is easy to pay the bills with the wrong checkbook and thus foul up the bookkeeping. This can cause tension in the business relationship and perhaps reduce overall business efficiency.

A corporation also has an accompanying set of tax laws and procedures, just as sole proprietorships and partnerships do. The more that is known about these tax laws, the more one can use a corporation to work to one's advantage taxwise (legally, of course). If one isn't aware of all the tax options, it could cost him potential tax savings, thus making the corporate entity a tax disadvantage.

4. Payroll Tax Costs

After incorporation, the sole proprietor or partner finds his status changed from employer to employee. Therefore, after incorporation, the farm business will have at least one additional employee, if not more. This results in increased payroll taxes being paid by the farm business.

Social security taxes are one of these additional payroll taxes. As was discussed in detail in Chapter V, the total amount of social security tax that must be paid under the corporate structure is higher than for self-employed farmers (partners or sole proprietors).

Another social security tax disadvantage involves wages paid to a farm owner-operator's children under 21 years of age. Wages earned by a child under 21 are not subject to social security tax if the child works for his or her parent. However, if the owner-operator incorporates his business, all wages paid to his children are subject to social security tax.

Stockholder-employees of Michigan farm corporations are also subject to Worker's Compensation charges on their salary and are entitled to benefits under the act. This is not true of sole proprietors or partners in a partnership.

The main problem with Worker's Compensation in Michigan is that it is extremely costly. In fact, Michigan has some of the highest, if not the higest, rates in the nation. Several states have Worker's Compensation rates that are less than half the amount of those in Michigan.

The rates for Michigan farm businesses are listed in Table 11. One of the more expensive rates is for dairy or livestock operations. Note that the rate of 1980 is 15.54 percent. If a stockholder-employee had a $15,000 salary, for example, the added payroll cost per year after incorporation is $2,331. Of course, the employee is entitled to benefits under the act, but it is possible to purchase an individual insurance policy with similar coverage and comparable benefits for a fraction of the cost.

Because of this tremendous added cost, along with the prospect of no immediate relief in sight, many believe that Worker's Compensation costs are one of the biggest disadvantages of incorporating a farm operation in Michigan.

Table 11. 1980 Worker's Compensation Premium Rates and Minimum Premiums

Farm Classification	Rate 8/1/79	Rate 1/1/80	Min. Premium 1/1/80
Dairy or Livestock[1]	$13.15	$15.54	20 percent of payroll if total annual payroll is less than $2500 but never less than $60.
Farm Machinery Operation	15.16	13.07	
Farm--Market or Truck[2]	6.73	6.70	
Farm--No other category[3]	12.56	13.71	
Florists	5.57	4.92	
Fruit Packing & Handling	5.96	6.66	
Nurserymen	6.73	6.70	
Orchards	13.38	15.51	
Poultry	8.49	9.87	
Tree Pruning, etc.	15.79	16.26	
Veg. Packing & Handling	7.79	5.74	

[1]Applies to all acreage devoted to producing milk or cream and shall also include the raising of cattle, hogs, cattle feeders, hog feeders, and sheep and goats.

[2]Applies to all garden vegetable crops and shall also include acreage devoted to potatoes, dry peas, dry beans, sugar beets, berries, flower and vegetable seed, cucumbers and all grapes (table, wine or raisin).

[3]Applies to all acreage devoted to raising hay, alfalfa, all the cereal grains such as wheat, barley, rice, corn and oats, all sorghums, flax and maize.

Source: Allen E. Shapley, "Clarification of Workmen's Conpensation Insurance," 1980 Update of CRMPA Special Paper #16, Department of Agricultural Economics, Michigan State University, October 1973.

A stockholder-employee's salary may also be subject to the unemployment compensation tax. Starting in 1978, agricultural employers are subject to the tax if they either a) paid wages of $20,000 or more for agricultural labor during any calendar quarter in the current or proceding calendar year <u>or</u> b) employed ten or more individuals in agricultural labor for some part of the day on each of 20 days during the current or preceding calendar year with each day being in a different calendar week.

For Michigan employers, taxes for the first two years of an employer's participation is 3.4 percent (2.7 percent state plus 0.7 percent federal) of the first $6,000 in annual wages for each employee. This results in a maximum of $204 per employee. After the first two years of participation, the amount of tax is dependent, in part, on the benefit claims made by unemployed workers against the employer's account. If a liable employer had no claims against his account, his rate would fall slightly below 3 percent after the second year. If he had many large claims against his account, the rate could rise to almost 7 percent after the second year and almost 10 percent by the seventh year.[114]

The disadvantage of incorporation is when the addition of the stockholder employee's salary to the farm business payroll is enough to cause the employer corporation to be liable for this tax.

Of course, it is possible for the corporation to lay off the stockholder-employees during a slack period and then they could possibly collect benefits. Currently, some Michigan cash crop farmers who have incorporated their farm business are collecting benefits during the winter months. As officers of their own corporation, they lay themselves off as an employee.

Another disadvantage to owner-operators after incorporation is that personal income taxes (Federal and Michigan) must be paid through

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[114] Allen E. Shapley, Unemployment Insurance on Michigan Farms: Questions and Answers, Department of Agricultural Economics, Michigan State University, Extension Bulletin E-1198, revised January 1979, p. 3.

quarterly estimates or withholding, rather than as a lump sum on March 1 as permitted by sole proprietors.

Specifically, the law states that if a person's tax year starts January 1 and either 1) at least two-thirds of his estimated gross income for the tax year is from farming, or 2) at least two-thirds of the gross income shown on his return for last year is from farming, he has two choices. He may either 1) File an estimate of his tax and pay this amount on or before January 15, then file his yearly return and pay any balance by April 15; or 2) In lieu of an estimate, he can file his yearly return and pay the tax on or before March 1.

There is some authority that a farm corporation employee is not a "farmer" for this purpose. In a 1965 ruling, the Internal Revenue Service said that a farm employee (a farm corporation stockholder-employee would most likely be one) was not a farmer and therefore must file a declaration of estimated tax and make quarterly payments.[115]

H. Increasing Government Scrutiny

Another disadvantage of farm corporations is the political climate. Even though big corporations have never been very successful in agriculture, there is still widespread concern about them taking over agriculture.

This has led to restrictive legislation in several states that limits the formation of farm corporations. Even though most of these restrictions are aimed at large scale corporate farming by nonfarm investors, a few of the restrictions have affected large family farm operations.

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[115] Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications Inc., 1979), p. 256.

For example, North Dakota prohibits corporations from engaging in farming in that state, period. Although it has numerous exemptions, a Wisconsin law passed in 1974 limits growth to 20 percent in acres in any five-year period by existing farm corporations which have more than 15 shareholders.

Recently, it has been popular public opinion that tax laws in prior years have encouraged tax sheltered farm investments by nonfarm investors. As a result, in recent years corporate farms and cash basis accounting have been the target of most of Congress's tax reform proposals. For example, much of the 1976 Tax Reform Act was aimed at clamping down on farm syndicates and "tax loss" farming. Some of these restrictions have penalized larger family farm corporations.

Some farmers also believe that being incorporated subjects their operations to closer scrutiny by government regulatory agencies such as the Federal and State Departments of Labor (especially the OSHA division), State Employment Security Commission, State Departments of Public Health, etc. The farmers feel that these agencies are more likely to visit or inspect their operations for rule violations because the agencies believe that most incorporated farms are very large operations with many employees. This can't be proven, but the farmers' concern probably does have some truth to it.

I. Problems with Dissolution and Liquidation

State statutes generally set forth the procedures for voluntarily dissolving a corporation. These procedures generally pose few problems, although an attorney will be required to do the legal work.

However, the problems develop during liquidation. Many times there are adverse income tax consequences for both the corporation itself and for the shareholders. Although the income tax consequences will differ somewhat depending upon the Internal Revenue Code liquidation procedure selected, generally, if the corporation has operated profitably and/or its assets have appreciated in value, taxable gain will be generated upon liquidation.

This topic is discussed in detail in Chapter VII.

CHAPTER VII

FORMING AND DISSOLVING A CORPORATION

The information presented in this chapter relates to forming and dissolving a corporation--the two extreme phases in the life cycle of a corporation.

A corporation doesn't simply blossom into existence itself nor can an operating corporation simply sell its assets and go out of business. Since a corporation is a separate legal entity formed under state law, there are certain legal procedures and formalities that must be followed when forming or dissolving a corporation.

Some of these procedures are quite complex. Therefore, it becomes imperative when forming a farm corporation to have good professional help with the absolute minimum being a reputable attorney and accountant. Other professional help from such individuals as extension agents, life insurance agents, bank trust officers, and other estate planning experts might be desirable. This is especially true if the attorney and/or accountant is unfamiliar with farm corporations or the taxation of farms in general and/or is unfamiliar with the family and farm business situation.

A. Deciding Whether or Not to Incorporate

This is perhaps the most difficult and probably the most important question to be answered by a farm family considering incorporation. A wrong decision either way might be regretted for years afterward. Therefore, much time and thought should go into making this decision.

Probably the best way to start analyzing the matter is for the farm family to list exactly why they want to form a corporation. In other words, what objectives do they want to accomplish by incorporating. The advantages listed in Chapter V could be used as a guide.

For instance, does the farm family want the corporation to a) facilitate in the inter-generation intra-family farm transfer process and encourage management and ownership continuity of the farm entity, b) achieve annual income tax savings, c) limit liability because the family has extensive non-farm assets, d) obtain tax deductible fringe benefits for the owner operator, e) increase the pride of ownership of the family farm, f) any combination of these reasons or any other reason.

After the objectives have been defined, the family should examine the other two alternative forms of business organizations to see if they might meet some or all of the objectives. For example, a partnership will probably not reduce annual income taxes if the farm family is in a high income bracket nor can liability be limited in a general partnership. However, a family partnership can be set up so that it facilitates the inter-generation intra-family farm transfer process.

If, after this process, the family still desires to incorporate as it feels that the other business organizations will not meet its objectives, then the potential disadvantages of incorporation should be examined. Chapter VI can serve as a guide for this. Along with listing the disadvantages, an attempt should be made to arrive at their potential cost--not only in monetary terms, but also in other more intangible terms such as legal formalities, hassles involved with more paperwork, requirement of depending upon professional help, etc.

After completing the above process, tradeoffs can be examined. For example, if a farm family's main objective for forming a corporation involves estate planning, but the family has little taxable income, they should ask themselves whether their main objectives outweighs the disadvantage of added annual income taxes and greater business formality. Or a farm family with a high taxable income might ask themselves if the annual tax savings possible now through incorporation is worth the risk of paying more taxes (as compared to a sole proprietorship or partnership) in later years if the net farm income level declines. If, after completing this entire process, the family still feels that there are no acceptable alternatives to incorporation, the actual incorporation process itself can be undertaken.

B. Where to Incorporate

A farmer is free to incorporate his farm business in the geographical location of his choice. It is not necessary to incorporate in the state where farm property is located. However, unless the farm business intends to carry on extensive business outside the state where most of the farm property is located or certain features of the corporate law in the farmer's home state are particularly disadvantageous, there is little reason for incorporating in another state. Probably the main reason against incorporating in another state involves the disadvantages associated with being a foreign corporation.[116]

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[116]Remember that any corporation doing business outside the state of incorporation is called a foreign corporation. States have the power to regulate foreign corporations that are doing business within its borders.

C. Some General Statutory Requirements by State

Business corporation statutes in each state set forth the general requirements for incorporating a business. Table 12 lists some of the major provisions of the corporate law in 13 North Central states. As shown by the table, the corporate statutes can vary in important respects from state to state.

In fact, certain features of the law in some states could be disadvantageous for farm incorporation. For instance, Illinois has a prohibition against nonvoting stock. This might pose problems in farm corporations where it is desired to have two types of stock--common with voting privileges and preferred without voting privileges. However, the state with the biggest disadvantage is North Dakota. North Dakota law prohibits corporations from engaging in farming, period--no exceptions!

D. Common Procedural Steps in Incorporating

Generally, the incorporation procedure is about the same in all states and it applies to businesses of all sizes considering incorporation. However, a few states have separate and less complex rules for closely-held corporations. Kansas is one of these states.

The successive steps to be taken in most states (we will ignore the few states with separate rules for closely-held corporations) are as follows: 1) The prospective incorporators may make a preincorporation agreement.[117] This agreement is not legally necessary but may be desirable. A preincorporation agreement is a formal written plan that

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[117]Persons who act as the formal organizers of a corporation are usually called incorporators, although they may be also referred to as promoters.

Table 12. Statutory Provisions in the 13 North Central States

	Illinois	Indiana	Iowa	Kansas	Kentucky	Michigan	Minnesota	Missouri	Nebraska	North Dakota***	Ohio	South Dakota	Wisconsin
Minimum number of incorporators	1	1	1	1	1	1	1	1	1	3	1	1	1
Minimum number of directors	1*	1*	1	1	1	1**	1*	1***	1*	3	1*	1	1
Must directors be residents of state?	No	No	No	No	No	No	No	No	No	No	No	One must be resident	No
Must directors be shareholders?	No	No	No	No	No	No	No	No	No	No	No	No	No
Cumulative voting permitted?	Yes	Yes, if provided by articles	Yes, if provided by articles	Yes	Yes	Yes, if provided by articles	Yes, unless denied by articles	Yes	Yes	Yes	Yes	Yes	No
Minimum paid in capital	$1000	$1000	None	None	None	None	$1000	None	None	$1000	$500	$1000	None
Perpetual life permitted?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Nonvoting stock permitted?	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

*If the corporation has only one shareholder

**A provision in the articles of incorporation may provide that there shall be no board of directors if authority to manage is delegated to another group or individual

***A corporation may have one or two directors if so stated in the articles of incorporation, otherwise it must have three or more.

****North Dakota law prohibits corporations from engaging in farming.

Source: Neil E. Harl and John C. O'Byrne, The Farm Corporation. North Central Regional Extension Publication No. 11, revised April 1979.

outlines the major rights and duties of all parties once the corporation has come into legal existence. In other words, it serves as a guide for the incorporators in the initial formative stages of the corporation. If the prospective incorporators sign the preincorporation agreement and do not conduct any business or perform any act in the name of the corporation and then decide not to organize the corporation, the preincorporation agreement can be declared null and void.

A preincorporation agreement for a farm corporation usually includes:[118] a) the agreement to incorporate and the kind and number of shares each shareholder agrees to acquire; b) restrictions on transfer of stock; c) the prospective directors and officers, their duties, and perhaps their salaries; d) other important items such as decisions that will require unanimous approval, voting rules, quorums, etc. Many of the items in a preincorporation agreement will later be included in the articles of incorporation or bylaws.

2) The "articles of incorporation" are drafted, signed by the incorporators, and then filed with some state official, usually the Secretary of State. This document is also sometimes referred to as the "certificate of incorporation" or the "corporate charter."

The articles of incorporation is the basic charter or governing instrument of the corporation. It contains the powers and limitations of the corporation and its shareholders.

The information required by most states in the articles of incorporation is pretty much standardized. In fact, many states provide forms for the articles.

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[118]Neil E. Harl and John C. O'Byrne, The Farm Corporation, North Central Regional Extension Publication No. 11, revised April 1979, p. 14.

In Michigan, the articles of incorporation shall contain these items:[119] a) the name of the corporation; b) the purposes for which the corporation is organized; c) the aggregate number of shares which the corporation has authority to issue; the number and par value of any shares having a par value; and the number of any shares without par value together with a statement that such shares are without par value; d) if the shares are, or are to be, divided into classes or into classes and series, the designation of each class and series, the number of shares in each class and series, and a statement of the relative rights, preferences and limitations of the shares of each class and series, to the extent that the designations, numbers, relative rights, preferences and limitations have been determined; e) if any class of shares is to be divided into series, a statement of any authority vested in the board to divide the class of shares into series, and to determine or change for any series its designation, numbers of shares, relative fights, preferences and limitations; f) the street address, and the mailing address if different from the street address, of the corporation's initial registered office and the name of the corporation's initial resident agent at that address; g) the names and addresses of the incorporators; h) the duration of the corporation if other than perpetual.

3) If the state official finds that the articles of incorporation conform to the state's statutory requirements, upon payment of various fees and taxes, a certificate of incorporation will be issued under the seal of the state. This signifies the creation of a legally valid

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[119] State of Michigan Business Corporation Act, Act 284 of 1972, Chapter 2, 450.1202 Articles of Incorporation; Contents. Section 202.

business corporation. Some states will also require that a copy of the articles of incorporation be filed in the county of the corporation's principal place of business.

4) Capital is turned over to the corporation in exchange for stock and, in some cases, debt securities. Once a specified minimum amount of capital has been paid into the corporation, it is generally permitted to legally commence business (own property, hire employees, etc.).

5) The shareholders hold an organizational meeting to elect directors. In some states the meeting may not be necessary as the initial directors are named in the articles of incorporation.

6) The directors meet to elect officers, adopt the bylaws, select a depository bank, accept capital transferred into the corporation, and begin business in the name of the corporation.

The corporate bylaws set out the basic rules which, in addition to state law, govern the internal conduct of the corporation. The bylaws are <u>not</u> filed publicly as the articles of incorporation are. Included in most corporate bylaws are these items: time and place for shareholders' and directors' meetings, quorum requirements for shareholders' and directors' meetings, a listing of officers' duties as well as special limitations on their authority in such matters as borrowing money and entering into contracts, the corporation's tax year, and kinds of insurance to be carried. Many other items may be contained in the bylaws. In fact, Chapter 2 of the Michigan Business Corporation Act states that "the bylaws may contain any provision for the regulation and management of the affairs of the corporation not inconsistent with law or the articles of incorporation."[120]

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[120]State of Michigan Business Corporation Act, Act 284 of 1972, Chapter 2, 450.1231, Contents of Bylaws, Section 231.

E. Accounting and Tax Management Concerns During Incorporation

These six procedural steps for forming a corporation are quite straight-forward. In fact, the attorney selected by the incorporators will probably take care of most of the paperwork and legal formalities. However, one of the steps involves important decision making on the part of the incorporators. This step is number 4)--the step involving the transfer of capital into the corporation. This step involves making decisions that can have dramatic tax ramifications (annual income, gift, and estate tax)--both at the time of incorporation and later on during the remaining life of the corporation.

The process of transferring capital assets owned by various members of the farm family into the corporation raises a number of tax related questions. First of all, the decision must be made as to which assets should be contributed to the corporation. The answer to this question will determine whether or not there is a possibility of a recapture of investment tax credit (annual tax problem), whether problems develop in claiming investment tax credit on real property improvements if the land is owned by a noncorporate lessor (individuals, partnership, and Sub-chapter S corporations) and leased to the corporation (annual tax problem), how easy it will be for the second generation to obtain control of the corporation, and it may also influence eligibility for installment payment of federal estate tax (estate tax problem).

Once it has been decided as to which assets to contribute to the corporation, the best method for transferring them into the corporation must be decided upon. In other words, will the assets be transferred into the corporation solely in exchange for stock or will a combination of stock and debt securities be used? If a combination is to be used, exactly what ratio of debt to equity should be used? In addition, what type of debt securities will be used and what will be the terms (years to maturity, interest rate, etc.)?

Another major decision that must be made is whether the property exchange should be a tax-free or else a taxable exchange.

Let's take a look at each of these questions.

F. Which Assets to Contribute to the Corporation

There are several different combinations of farm assets that can be transferred to the corporation. The combinations range from incorporating only the production side of the business (referred to in other chapters as a checkbook corporation) to transferring all assets to a corporation. In fact, several corporations could be formed. There is no limitation on the number of business entities that can be formed as long as the parties involved can demonstrate to the satisfaction of the IRS that there is a legitimate business purpose for the existence of each.

Probably the best way to begin the analysis is to examine the reasons for incorporating. If the farm family has taken the author's advice given earlier in the chapter, they already have a list of objectives to be accomplished through incorporation.

1. Reasons for Putting All Assets in the Corporation

If the main reason for forming the corporation involves estate planning with the chief area of concern being the minimization of federal estate taxes, state inheritance taxes, and other estate settlement costs--it may be a good idea to have all the farm assets in a corporation. There are several reasons for this.

First of all, remember that shares of stock are the simplest and most convenient method available for making use of the annual gift tax exclusion ($3,000 per recipient, $6,000 per recipient for husband and wife as donors, even though only one owns the property given), especially when compared to gifts of farmland. Therefore, if the parents are willing to undertake a yearly gift giving program to transfer the farm business through the use of the annual exclusion--much more of the farm business can be given away if all the assets are in the form of stock. If the parents are hesitant about giving up control over the business, they can still give away up to 49 percent of the stock of the corporation (which is 49 percent of the business if all assets are in the corporation) and still retain voting control of the corporation. Also, there is a possibility that gifts of a minority stock interest in a corporation could be "discounted" for gift valuation purposes. This idea was discussed in Chapter IV and will be discussed further in Chapter IX. Such a discounting would result in the parents being able to transfer a larger portion of the farm business through the annual exclusion than if the farm business assets themselves had been given away.

Another possible estate planning advantage of putting all the farm assets in a corporation is that it will be easier for the farmer's estate to meet the qualifying provisions for the 10- and 15-year installment payments of federal estate tax. As was thoroughly discussed in Chapter VI, the use of multiple entities can create problems in qualifying for either of the elections. However, if the farm business consists of a single entity, these potential problems are eliminated.

2. Reasons for Keeping Some Assets Out of the Corporation

Another possible estate planning reason for forming the corporation might be to provide the children with an opportunity to gain control of the production or operating part of the farm business. If this is the case, the fewer the assets that are transferred into the corporation will mean the less the investment (or a fewer number of gifts given under the annual exclusion) that will be required for the children to gain operating control. Thus, control can be gained in a shorter period of time.

Leaving the farmland out of the corporation and renting it to the operating unit offers estate planning advantages--especially to the older generation. Since most of the farmland is usually owned by the parents and also is probably the most valuable portion of their estate, it is more likely that they will be willing to give up control of the operating corporation when they still have the farmland as security. The rental payment can provide a steady source of retirement income while the land itself is an excellent hedge against inflation.

Estate planning advantages are not the sole reason for leaving farmland or other assets out of the corporation. A farm family with a high annual taxable income may form a corporation (of course it would be a "C" or regular corporation) solely for the reason of annual tax savings. Leaving the farmland out of the corporation will allow more flexibility in managing the income level of both entities (the corporation and the landowning entity) since the rent can be raised or lowered (not indefinitely, but within a reasonable range) depending upon the income of the corporation. In addition, the results of the four case examples

presented in Chapter VIII seem to indicate that the greater the deductions available on the farmland (interest, property tax, etc.), the more advantageous it is--annual tax wise--to leave the farmland out of the corporation.

Michigan annual taxes may also be reduced if the farmland is left out of the corporation. The reason for this is that the farm business receives a higher homestead property tax credit since present interpretation of the law dictates that a "C" corporation with the farmhouse and all the farmland in the corporation can only claim for the credit the property taxes paid on the home and five acres of land. For more information on this, see the discussion in Chapter VI.

Annual state franchise fees paid on the book value net worth of a corporation also provide a strong incentive for leaving land, and possibly machinery, out of the corporation. However, this only applies to those states with a franchise tax (Michigan no longer has one).

3. <u>Long-Run Annual Tax Concerns</u>

Whether or not a particular asset is transferred to the corporation can have a bearing on the amount of annual taxes that will be paid in years after the corporation is formed.

a. <u>Capital Gains</u>

The difference in treatment of capital gains between a "C" corporation and an individual (remember that a "C" corporation pays a higher rate on long-term capital gains) can result in extra taxes being paid when a "C" corporation sells farmland. Therefore, if there is any chance that a particular piece of farmland may be sold during the owner's lifetime, it is probably wise not to transfer that acreage into the corporation. This especially applies to those farmers who do not have any children with a desire to continue farming as they may very well sell the farmland to provide for retirement.

b. Depreciation Concerns

If an individual farmer dies while holding farm assets, his beneficiaries will receive a stepped-up cost basis equal to the value used for federal estate tax purposes. This new basis provides values for a new depreciation schedule for depreciable items. Thus, it is very possible that the younger generation can depreciate some of the same assets depreciated by the preceding generation.

When a farm corporation shareholder dies, the shares of stock held at death will receive a new income tax basis equal to the value determined for federal estate tax purposes. However, the underlying property held by the corporation itself is not affected and the basis remains unchanged. Thus, the corporation can't redepreciate items after a shareholder dies.

Because of this feature, it may be desirable for farmers holding large amounts of property that have appreciated heavily in value (farmland, also possibly machinery and improvements) to form only a checkbook corporation and keep these highly appreciated assets out of the corporation.

c. Investment Tax Credit

Leaving farmland and/or machinery out of the corporation can cause investment tax credit problems. As was discussed in Chapter VI, unless the contribution of property to the corporation is considered a "mere change in the form of conducting a trade or business," there may be a recapture of investment tax credit in the year of incorporation for the assets transferred to the corporation. The only way to be absolutely sure that there will be no recapture of investment tax credit is to transfer all the farm assets into the corporation.

Another area of concern involves the eligibility of real property improvements (fences, tile lines, etc.) for investment tax credit when the real property is left out of the corporation. If the land is owned by a "noncorporate lessor" (individuals, partnerships, and Subchapter S corporations) and leased to the family farm corporation (or even an unrelated tenant), the noncorporate lessor may claim investment tax credit on the leased property only if 1) the property subject to the lease was manufactured or produced by the lessor "in the ordinary course of business" or 2) the term of the lease is less than 50 percent of the estimated useful life of the property and for the first 12 months of the lease, the lessor's deductions (depreciation, taxes, interest and depletion can't be counted) exceed 15 percent of the rental income.[121] It is very unlikely that condition 1) will be met in a farm situation and condition 2) is especially hard to meet because depreciation, interest, taxes, and depletion can't be counted toward the 15 percent. Therefore, the only way to be assured of obtaining investment credit on real property improvements is to put all the farm assets into the corporation.

d. Management Concerns

When land and/or machinery is left out of the corporation and put into other business entities, several management problems may be created.

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[121]This rule comes from the Internal Revenue Code Section 46(e)(3). For a detailed discussion on this matter, see Chapter VI.

As the number of business entities increase, so does the complexity in managing the accounting details and cash flow aspects of the business. A good accountant may help reduce some of this complexity, but there may be some practical problems over which he or she has little control.

If the farmland is left out of the operating business, there may be a shortage of collateral for production credit since land is often used for security for production loans. This may make it necessary for the landowners to personally guarantee production loans of the operating business. If so, the advantage of limited liability for the shareholders is lost.

The payment of a reasonable rent to landowners from an operating corporation can result in cash flow difficulties for the landowners. The exact nature of the cash flow problem will depend on the circumstances. Actually, there are two extremes. One extreme involves a landowner who is rapidly expanding the farm business by buying lots of high-priced land. In doing so, the landowner may find that a reasonable rent along with his salary from the corporation will not cover his debt obligations (interest, principal) on the land. If this happens, the landowner will either have to up his salary (which must, of course, be reasonable) or else transfer some farmland (probably the parcels with the highest debt payments) into the corporation. Either option can result in higher annual taxes. A higher salary will increase the personal income tax payable for the individual while a later sale of corporate held land can result in higher capital gains taxes than if the land was sold by an individual.

The other extreme concerns a landowner with few debt obligations on a large amount of holdings. The payment of a reasonable rent may lead to a buildup of excessive amounts of capital to the landowner and a shortage of capital in the operating corporation. Also, since the landowner receives rent plus his salary and probably has few deductions, it is likely that he may end up in a higher tax bracket than the corporation,which is probably the exact opposite of what it should be.

G. Methods for Transferring Farm Assets to the Corporation

Chapter III discussed the two methods for transferring assets into a corporation--stock and debt securities. Probably the most difficult decision that must be made involves selecting the one method or combination of methods that will result in the best tax consequences both for the immediate transfer and for the future life of the corporation.

1. Tax-Free Exchange

Unless Section 351 of the Internal Revenue Code is followed, a transfer of property to a corporation in exchange for stock is considered a sale or exchange of property and thus constitutes a taxable transaction. The gain or loss is measured by the difference between the tax basis of the property transferred and the value of the stock received. Therefore, failure to qualify under Section 351 could be very costly taxwise for farmers who have a relatively low tax basis in their real and/or personal property.

Section 351(a) of the Internal Revenue Code states that "no gain or loss shall be recognized if property is transferred to a corporation by one or more persons 1) solely in exchange for stock or securities in such corporations <u>and</u> 2) immediately after the exchange such person or persons are in control of the corporation as defined in Section 368(c)" which means "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." The latter condition is really stating that a large amount of gifts can't be made at the time of incorporation.

A tax-free exchange under Section 351 generally results in the corporation assuming the same basis that the transferors had in the property transferred, i.e., the basis is simply carried forward. For example, if a farmer contributed raised livestock which had a zero tax basis, the corporation's tax basis for the livestock would also be zero. If the corporation sold the livestock at any time after the exchange, the entire amount of the sale would be taxed.

Section 358(a)(1) of the Internal Revenue Code states that under a 351 exchange, the transferror's stock basis ". . . shall be the same as that of the property exchanged, decreased by a) the fair market value of any other property (except money) received by the taxpayer, b) the amount of money received by the taxpayer, and c) the amount of loss to the taxpayer which was recognized on such exchange, and increased by a) the amount which was treated as a dividend and b) the amount of gain to the taxpayer which was recognized on such exchange." Section 358(d)(1) states that if the corporation assumes a liability of the transferor or takes property subject to a liability, the amount of the liability is treated ". . . as money received by the taxpayer on the exchange." Thus, if an individual farmer transferred property to the corporation with a \$100,000 tax basis plus a \$30,000 mortgage and received no money or property in the exchange other than stock, the stock would have a \$70,000 income tax basis. Any sale of the stock in the future for more than $70,000 would produce a taxable gain.

A problem associated with the transferring of liabilities into a corporation should be noted. Section 357(c)(1)(b) of the Internal Revenue Code states that "if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be." Therefore, farmers should make sure that the amount of liabilities to be taken over by the corporation does not exceed the income tax basis of the property transferred. Otherwise, there will be a taxable gain on the excess.

Table 13 illustrates a tax-free incorporation of a farm business involving four individuals.

a. Problems with Defining Debt Securities

The definition of securities in Section 351 has required clarification. The main issue has been over the length of time to maturity of the debt obligation. Courts have required that the definition of "security" be limited to long-term obligations while excluding short-term notes. However, there is no definite length of time to maturity that separates long-term from short-term notes. Some courts will require a 10-year note while others find a 5-year note sufficient. Generally, a maturity length of at least ten years seems to be the safest.

The big disadvantage associated with a security being declared a short-term note is that courts have held short-term notes to be the

Table 13. Tax-Free Incorporation Process

Assume four individuals, A, B, C and D, wish to form a farm corporation with the following property. Assuming a tax-free exchange, the incorporation process would produce the following results:

(1) Indi-vidual	(2) Property con-tributed	(3) Tax basis	(4) Fair market value	(5) Indebt-edness	(6) Net contri-bution (4)-(5)	(7) Shares of stock received ($100 per share)	(8) Tax basis of stock received (3)-(5)	(9) Corpora-tion's basis for property (from (3))	(10) Indebtedness assumed by corporation (from (5))
A	Land	$120,000	$180,000	$ 40,000	$140,000	1,400	$ 80,000	$120,000	$ 40,000
B	Machinery	36,000	40,000	10,000	30,000	300	26,000	36,000	10,000
C	Livestock	5,000	10,000	0	10,000	100	5,000	5,000	0
D	Cash	5,000	5,000	0	5,000	50	5,000	5,000	0
	TOTAL	$166,000	$235,000	$ 50,000	$185,000	1,850	$116,000	$166,000	$ 50,000

Note: 1. The amount of stock issued to each shareholder depends only on that person's net contribution to the corporation (fair market value of property minue indebtedness). Tax basis does not affect stock issuance.

2. The corporation's basis for the property is the same as the basis in the hands of the shareholder who contributed the property.

3. A shareholder's basis for stock is the same as the basis of the property contributed minus any indebtedness assumed by the corporation.

Source: Neil E. Harl and John C. O'Byrne, The Farm Corporation. North Central Regional Extension Publication No. 11, revised April 1979.

equivalent of cash. This means that the transfer of assets to the corporation is considered to be a sale of property and would thus constitute a taxable transaction.

2. Ratio of Stock to Debt Securities

The decision as to whether farm assets transferred to the corporation should be exchanged solely for stock or else a combination of stock and debt securities will primarily depend upon the retirement and estate planning objectives of the parents. Chapter IX contains a detailed discussion of this topic.

However, it should be noted that the amount of debt securities that can be issued is limited. The ratio of debt to equity of the corporation is the factor most often used as a guideline. If the debt to equity ratio is too high, it denotes "thin capitalization" of the corporation and the IRS will treat the debt instrument as a form of stock. The result of this is that principal and interest payments will be considered dividends.

In the past, a debt to equity ratio of 4:1 has been about the maximum that might be allowed. Anything in excess of 4:1 is generally considered to be very risky. A ratio of 3:1 or 2:1 is more conservative and considered to be quite safe.

H. Dissolving a Corporation

Dissolving a corporation is the term used when a corporation's existence is terminated according to the technical requirements of the law in the state of incorporation. Corporate dissolutions are either voluntary or involuntary.

Voluntary dissolution involves exactly what the term implies--the corporation is voluntarily dissolved by a vote of shareholders, incorporators, or directors (the details vary from state to state). A corporation could also be dissolved voluntarily by the expiration of a definite period of existence to which the corporation is limited by its articles of incorporation.

Involuntary dissolution involves legal action against a corporation by the state of incorporation. Usually the attorney general of the state is the one who starts the legal action. The reasons behind involuntary dissolution vary from state to state. Some common reasons are failure to file an annual report and pay the franchise tax or other fees, fraudulent procurement of the certificate of incorporation, abuse or misuse of its corporate powers, or other violations of state law. In any case, the state can dissolve the corporation against the wishes of the stockholders or directors.

Section 801 of the Michigan Business Corporation Act lists the following ways in which a corporation can be dissolved in Michigan.[122] Each is labeled as to whether it is voluntary (V) or involuntary (I) dissolution.

V a) Automatically by expiration of a period of duration to which the corporation is limited by its articles of incorporation.

V b) By action of the incorporators or directors pursuant to Section 803.

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[122]State of Michigan Business General Corporation Act, Act 284 of 1972, Chapter 8, 450.1801, Methods of Dissolution, Section 801--References are also made to Sections 803, 804, 805; and 922 of the same Act.

V c) By action of the board and the shareholders pursuant to Section 804.

V d) By action of a shareholder pursuant to Section 805.

I or V e) By a judgment of the circuit court in an action pursuant to this act or otherwise.

I f) Automatically, pursuant to Section 922, for failure to file an annual report or pay the privilege fee.

Also, in Michigan, a corporation whose assets have been wholly disposed of under court order in receivership or bankruptcy proceedings may be summarily dissolved by order of the court having jurisdiction of the proceedings.

I. Liquidation of a Corporation

Once the dissolution procedure is completed and the proper report is filed with the state, the corporation doesn't just disappear. Although it can't undertake any new business activities, the corporation must still legally wind up its business affairs.

During this wind up period, a process of liquidation occurs. Liquidation involves the disposition or sale of corporate assets under conditions of the federal tax laws and the settlement of debt obligations. Notice of the intended dissolution is given to each creditor of the corporation since they have first rights to the assets of the corporation at liquidation. After the obligations with the creditors are settled, the shareholders divide the rest. If there isn't a liquidation preference for some shareholders, all shareholders will share in the distribution of assets of the corporation in proportion to their shareholdings.

1. Tax Implications of Liquidations

The liquidation process has annual tax implications--both for the corporation itself and for the shareholders. Although the income tax consequences will vary depending upon the Internal Revenue Code liquidation procedure selected; in general, it is not as easy to liquidate a corporation without paying income taxes as it is to form one.

The actual tax effect on either the shareholder or the corporation not only varies with the Internal Revenue Code liquidation procedure selected but also according to the type of liquidation desired as well as the particular characteristics of the corporation.

Reference to the type of liquidation desired involves these alternatives: 1) whether the liquidation will be partial or complete; 2) whether the liquidation will involve a) a distribution of the corporate assets "in kind" to the shareholders in exchange for their stock or b) the corporation sells the assets and inventory and then distributes the cash to the shareholders in exchange for their stock. If this is done, will the assets and inventory be sold to more than one person? or c) sell the stock itself to liquidate the shareholder's interest in the corporation; 3) the time period over which the distribution will take place.

Some of the characteristics of a corporation that influence the tax effects on either the shareholder or the corporation include: 1) the amount of earnings in the corporation, either a) a substantial amount of retained earnings or b) no earnings or c) corporate loss; 2) whether the corporation has more than one type of stock outstanding; 3) whether the

IRS finds that the corporation is collapsible.[123]

Another important consideration when liquidating a farm corporation is whether or not the farm operation will be continued or discontinued after the liquidation of the corporation.

Thus, there are many variables that will determine the tax effect of a corporate liquidation. Keeping this in mind, some of the Internal Revenue Code provisions involving liquidations will be discussed.

a. Section 331

This is probably the simplest and most fundamental method available as there are no special qualifying provisions. The only requirement is that the corporation actually liquidate (it can be partial or complete) by distributing its assets to the shareholders.

Taxwise, the liquidation is treated in the same manner as a sale of stock by the shareholders. Each shareholder's gain or loss is the difference between the income tax basis on his or her stock and the fair market value of the assets received from the corporation. This gain or loss can be treated as a capital gain or loss if the stock is a capital asset in the hands of the shareholder. Since income tax is paid on the gain (or a loss is taken as a deduction), the income tax basis for the assets received in the distribution is the fair market value at the time of dissolution.

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[123] A corporation may be collapsible if more than half of its assets consist of inventory which has been held less than three years. If the corporation sells the assets, both the corporation itself and the shareholders must recognize the gain as ordinary income if the intent of the sale was to convert ordinary income into capital gains income.

b. Section 333

This provision is an exception to the general rule of Section 331 that a shareholder has a gain or loss upon a corporate liquidation. If the shareholders elect to have the liquidation come under 333 and all the assets are distributed by the corporation within one calendar month, a "qualified electing shareholder" does not recognize gain on the stock if a) the corporation has no earnings and profits accumulated after February 28, 1913, and b) the shareholder receives no money, stock, or securities acquired after December 31, 1953.[124] However, a "qualified electing shareholder" does recognize gain to the extent of the greater of a) the stockholder's share of earnings and profits accumulated after February 28, 1913, or b) amounts received by the shareholder consisting of money and/or stock and securities acquired by the corporation after December 31, 1953.

If a gain is not recognized, a shareholder does not get to use the fair market value as the income tax basis of the assets received from the corporation. Instead, the income tax basis of the assets received equals the basis of the stock given up, decreased by the amount of money received, and increased by any gain recognized and unsecured liabilities assumed by the shareholders. This amount is allocated among the various assets received on the basis of their net fair market values.

Even though a part of the gain is not recognized at the time of liquidation under Section 333, it does not mean that the gain will never be recognized. When the assets are sold, the remainder of the gain will be taxable. Thus, the gain is really only deferred until a later date.

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[124]For a definition of a "qualified electing shareholder," see Section 333(c)(1)(2) of the Internal Revenue Code.

Since Section 333 provides a specified tax result for an electing shareholder, it does not carry any direct tax consequences to the corporation being liquidated. However, there is an indirect effect on the corporation. When Section 333 is utilized by any shareholder, Section 337 becomes unavailable to the corporation.[125] Section 337 will be discussed later in this chapter.

Section 333 is often used in farm situations where the farmer wants to dissolve the corporation, but still keep farming with the same farm assets under some different form of business organization. It is also often used by Subchapter S corporations since they often have little or no earnings and profits (usually have been distributed to shareholders).

Sections 331 and 333 described above are both provisions relating to the tax treatment of a shareholder receiving a distribution upon the liquidation of a corporation. However, remember that there can also be taxation at the corporate level during a liquidation.

Two major tax code provisions relating to the tax consequences to the corporation itself will be discussed next. These two code provisions can, and frequently do, apply to the same corporate liquidation.

c. Section 336

This section provides a general rule that no gain or loss will be recognized to a corporation that distributes its assets directly to its shareholders in return for their stock (referred to as an

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[125] William H. Hoffman, ed., West's Federal Taxation: Corporations Partnerships, Estates, and Trusts (New York: West Publishing Company, 1980), p. 203.

"in-kind" distribution).[126] This distribution can be a partial or a complete liquidation.

As is common with most of the Internal Revenue Code, there are numerous exceptions to the general rule. Some common exceptions, which are of concern to farmers, are that the corporation may have to recognize gain if the assets distributed consist of installment notes receivable or assets subject to the recapture of investment credit or depreciation.

d. Section 337

This section states that "if, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period." This section does not apply to partial liquidations.

The provision does not apply to these items of property: a) inventory or property held by the corporation primarily for sale to customers in the ordinary course of its trade or business, b) installment obligations acquired upon the sale of inventory items, and c) installment obligations acquired with respect to property sold or exchanged before the date of the adoption of the plan of liquidation. There is one exception relating to the sale of inventory. Inventory can be included as property under the provision if substantially all of it is sold in bulk to one person in one transaction.

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[126] An "in-kind" distribution means that the property is distributed "as is" rather than the situation where the corporation sells the assets and then distributes the sale proceeds to its shareholders.

A sale of any of these items which aren't considered qualifying property will require recognition of a gain or loss at the corporate level. This is also the case if the liquidation procedure is not completed within the 12-month period.

Therefore, the advantage of Section 337 is that it prevents having to pay two taxes at the time of a corporate liquidation--one on the sale of assets at the corporate level and another at the time of distribution to the shareholders. As a result, the tax treatment for a corporation which sells its assets and then distributes the sale proceeds to the shareholders is no different from that of a corporation which distributes its assets "in-kind" to the shareholders who later sell them.

This section will probably only be used by those farmers who wish to liquidate their corporation (through a sale of the corporate assets) and quit their farming operation.

J. Summary of Dissolutions and Liquidations

As has been demonstrated in this chapter, the dissolution and liquidation of a corporation involves a set of very complex tax laws which dictate the need for professional tax advice to minimize any possible tax burden.

However, it would probably be wise to analyze the tax effects of liquidating a farm corporation even before it is formed. Hopefully, an analysis would at least give the incorporators a general idea of what they might face if they ever desired to dissolve their corporation--thereby eliminating any "unpleasant," costly surprises.

One possible method for this analysis might involve assuming several alternative combinations of assets that could be transferred to the corporation and then analyze the liquidation tax treatment for each alternative using various Internal Revenue Code provisions. The probability of continuing the farm operation after liquidation should also enter into the analysis.

CHAPTER VIII

CASE STUDIES--ANNUAL TAXATION

This chapter consists of annual tax comparisons between various business organizational types (proprietorship, Subchapter S corporation, and regular or "C" corporation) for four different types of farms. These four types of farms include dairy, fruit, swine, and cash crop.

Most of the statistical data for each of these types of farms was obtained from the 1978 Telfarm Business Analysis Summaries. However, some statistics were adjusted if it was felt that they were not representative of a normal or average year.

The mathematical calculations for the income tax analysis were done by using a Texas Instruments 59 programmable calculator. The program used was developed by Dr. Ralph E. Hepp of the Department of Agricultural Economics, Michigan State University.[127] Basically, this program estimates the annual Michigan and federal income, worker's compensation, and social security taxes for a farm business and its owner(s) (proprietor, partners, employee-stockholders). Unemployment compensation tax was not considered.

A user's manual for this program is contained in the appendix. It contains a complete input/output description as well as a discussion

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[127] Ralph E. Hepp, "Annual Tax Comparison for Alternative Business Organizations," User's Manual, Agricultural Economics Staff Paper 80-6, Programmable Calculator TI/59, TELCAL 38, Department of Agricultural Economics, Michigan State University, January 1980.

of objectives, assumptions, definitions and limitations of the program.

A. Assumptions Made for the Analysis

Let's take a look at the assumptions made for all four case examples.

1. One Owner-Operator

Each example assumed the farm operation consisted of one owner-operator who owned 100 percent of the business.

Although the programmable calculator routine is designed to accommodate up to four partners, it was felt that one operator was sufficient for these cases. The reason for this is that if other assumptions remain unchanged, adding partners or stockholders generally does not change the annual tax consequences per person that much.

For example, for the assumptions made in the fruit farm case example the result was that beyond $34,000 net farm income, a sole proprietorship could achieve annual tax savings by forming a "C" corporation. Now if one made all the same assumptions, except assumed two owner-operators instead of one, the "break-even" amount would be approximately double that for one owner.[128] That is, beyond $68,000 net farm income, two owners operating in a partnership could achieve annual tax savings by forming a "C" corporation. Of course, any such example should be calculated to find the actual "break-even" point.

2. Four Exemptions

Along with assuming one owner, each example also assumed four exemptions for both Michigan and Federal income tax purposes.

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[128] "Break-even" terminology will be used throughout this chapter. It refers to the net farm income level where the total taxes paid by a sole proprietorship (partnership) equal those paid by a "C" corporation.

3. Salary, Fringe Benefits

The salary for the owner-operator in each example was assumed to be $15,000 along with $1,500 in fringe benefits. In each of the cases, except dairy, the salary was raised to $30,000 and then to $45,000 to demonstrate the tax effects of higher salaries. However, the amount of fringe benefits remained at $1,500 for all three salary level comparisons.

4. Worker's Compensation Premium Rates

The worker's compensation premium rates for each case example were assumed to be the 1979 percentage rate appropriate for the farm type. Two of the case examples, Fruit and Saginaw Valley Cash Crop, could be classified into more than one category. For these cases, an average of the appropriate percentage rate for each classification was used.

5. Investment Tax Credit, Property Taxes

The amount of investment tax credit and property taxes were different in each of the case examples. If it was felt that the Telfarm average was too high or low for an average year, an attempt was made to make these amounts more realistic for each farm type.

6. Michigan Homestead Property Tax Credit

It was assumed that all property taxes paid by the proprietorship and the Subchapter S corporation were eligible for the homestead property tax credit. This was also the case when all the farmland was assumed to be left "out" of a "C" corporation. Here it was assumed that the property taxes paid by the stockholder who leased farmland to his "C" corporation were available for the credit.

However, for cases where all farmland was considered as being "in" the "C" corporation, it was assumed that none of the property taxes paid on the farmland by the "C" corporation were eligible for the credit.

The above homestead property tax credit assumptions may or may not hold true for an actual farm business situation.

Remember the eligibility rules for the homestead property tax credit set forth in Chapter VI. All property taxes paid by a proprietorship will almost always be eligible for the credit--unless the farmer has lived on the farmland for less than ten years and gross farm receipts are less than household income, then only the property taxes on the farmer's home and five acres of land may be claimed for credit. In all farm corporation situations, the property tax may or may not be eligible for the credit depending upon the circumstances surrounding the operation (whether a "C" or "S" corporation and whether the farmland is "in" or "out" of the corporation, number of years lived on the farm, amount of property taxes, gross farm income, etc.).

7. Rental Payments

All of the case examples, except fruit, examined the difference in annual taxes paid for a "C" corporation with farmland "in" the corporation vs. farmland "out" of the corporation. When farmland was considered being left "out" of the "C" corporation, two extreme rental rates were considered.

At one extreme, the net taxable rental income received by the stockholder leasing farmland to the "C" corporation was considered to be zero. This doesn't mean that the stockholder did not receive any income from the lease. Instead, it means that all the tax deductions on the land (primarily property taxes and interest payments) equalled the income received from the lease, thus generating no taxable income.

At the other extreme, the highest possible reasonable rent per acre was assumed. It was further assumed that there was no debt on the land. Therefore, only property taxes were subtracted from the rental figure to arrive at the amount of taxable rental income.

Most actual farm situations would fall in between these two extremes. The amount of interest and property taxes paid on the land, along with other tax deductions would determine the general proximity to each extreme.

In all the cases where the farmland was assumed to be left out of the "C" corporation, the rental payments were subtracted as a corporate expense. It made no difference as to the portion of the rental amount that was taxable income to the stockholder-farmland owner. In order to achieve similar tax comparisons between a "C" corporation with the farmland left "out" and the other types of business organizations at each income level, the rental amount paid to the stockholder-farmland owner was subtracted from each level of net farm income considered.

For example, in the dairy case example with the farmland "out" of the "C" corporation, the $20,000 farmland rental was subtracted from each level of net farm income considered. Thus, for the lowest level, the net farm income keyed into the program was $0 ($20,000 net farm income - $20,000 farmland rental). At the next income level ($30,000), $10,000 was keyed in ($30,000 - $20,000) and so on for each income level.

a. Subchapter S Corporations

The annual tax effects of leaving farmland "out" of a Subchapter S corporation were not considered in any of the case examples. The reason for this is that such an example would most likely produce results similar to those when all land is in the "S" corporation.

To demonstrate how this happens, let's look at a simple example considering land "in" and "out" of a "S" corporation with one stockholder owning 100 percent of the stock. It is assumed that the corporate taxable earnings as well as the salaries are the same in each case.

Farmland "in" the "S" Corp.		Farmland "Out" of the "S" Corp.	
Corporate Taxable Income	$20,000	Corporate Taxable Income (Excluding Rental Expense)	$20,000
		Land Rental	15,000
		Corporate Taxable Income (After Rent is Expensed)	$ 5,000

Shareholder's Total Taxable Income		Shareholder's Total Taxable Income	
Corporate Taxable Income	$20,000	Corporate Taxable Income	$ 5,000
Salary	15,000	Salary	15,000
Shareholder's Total Taxable Income	$35,000	Land Rental Payments	15,000
		Shareholder's Total Taxable Income	$35,000

The above example shows that the total taxable income to the sole shareholder of this "S" corporation is the same ($35,000) whether or not the farmland is "in" the corporation. The only difference is that the composition of the shareholder's income is different.

When the farmland is "in" the "S" corporation, the sole shareholder's taxable income consists of his salary from the corporation (in this case,

$15,000) along with his share (here it is 100 percent because of one stockholder) of corporate taxable income ($20,000).

The above income mix can be contrasted to the situation when all the farmland is left "out" of the "S" corporation and the shareholder in turn rents it to his operating "S" corporation. Here the sole shareholder's income consists of his salary from the corporation ($15,000) along with his share (100 percent) of corporate taxable income which is reduced to $5,000 ($20,000 - $15,000 rent) because the land rental is an expense to the corporation. However, the $15,000 land rental payment is taxable income for the operator. Thus, his total taxable income is the same as when all farmland was "in" the "S" corporation.

It should also be noted that the amount of the rental doesn't influence the shareholder's net taxable income either. Even though the rental was assumed to be $15,000 in this example, a rental of $5,000, $25,000 or even $40,000 would produce the same results. The reason for this is that the rental amount is an expense to the corporation which in turn reduces the stockholder's share of corporate taxable income. However, this rental amount is taxable income to the stockholder thereby cancelling out the reduced corporate taxable income.

Of course, this example assumes that all farmland rental transactions between the corporation and its sole stockholder are "arm's length" transactions. If not, there could be other tax implications. Such consequences were discussed in earlier chapters.

This example also assumes that the transfer of land to the corporation was done in a "tax-free" manner. Otherwise, there might be additional taxes when the land was considered as being "in" the corporation.

8. Capital Gains

Two of the case examples--dairy and swine--assumed that the operation had capital gains income. In order that the tax comparisons for each net farm income level would be similar between these farm types and the other two farm types with no capital gains income, the amount of capital gains income was subtracted from each level of net farm income.

For example, in the swine case example, $10,000 of capital gains income was subtracted from each level of net farm income. Thus, for the first level of net farm income considered, $10,000 ($20,000 Net Farm Income - $10,000 Capital Gains Income) was keyed into the program, instead of $20,000. At the next level, $20,000 ($30,000 - $10,000) was keyed in and so on for each net farm income level.

B. Analysis of Results

The results of this chapter should be interpreted in light of what they really are--merely examples. It is hoped that these examples will give a general idea of the key consequences of various farm business organizational types. However, the results are not intended to be representative of all dairy, fruit, swine, or cash crop farms. Because farm characteristics vary tremendously, it is difficult to get very explicit about the tax consequences for the various types of farm business organizations by type of farm. Thus, these examples should demonstrate the need for a complete tax analysis of each individual farm situation when deciding whether the farm business should be organized as a proprietorship, partnership, Subchapter C or Subchapter S corporation.

Keeping these limitations of the case examples in mind, let's look at the results of the four cases.

1. Fruit

The assumptions made for the fruit farm case example are as follows:

Farm Situation:

*Northwestern Michigan Tree Fruit Production Farms, 1978 Crop Year, Telfarm Business Analysis Summary[129]

*185 tillable acres owned

*16 tillable acres rented

*1 owner-operator

Tax Information:

*$15,000 salary

*$1,500 fringe benefits

*$2,500 investment tax credit

*4 exemptions

*$3,800 property taxes

*10% Worker's Compensation Premium Rate

The results of the fruit farm case example are shown in Figures 1 and 2.

Let's take a look at Figure 1. The graph depicts the total annual taxes paid for net farm income levels ranging from $20,000-80,000 for a sole proprietorship, "C" corporation and "S" corporation. It shows that by operating the farm business as a "C" corporation results in the lowest tax bill at income levels above $34,000 (breakeven point). In fact, at

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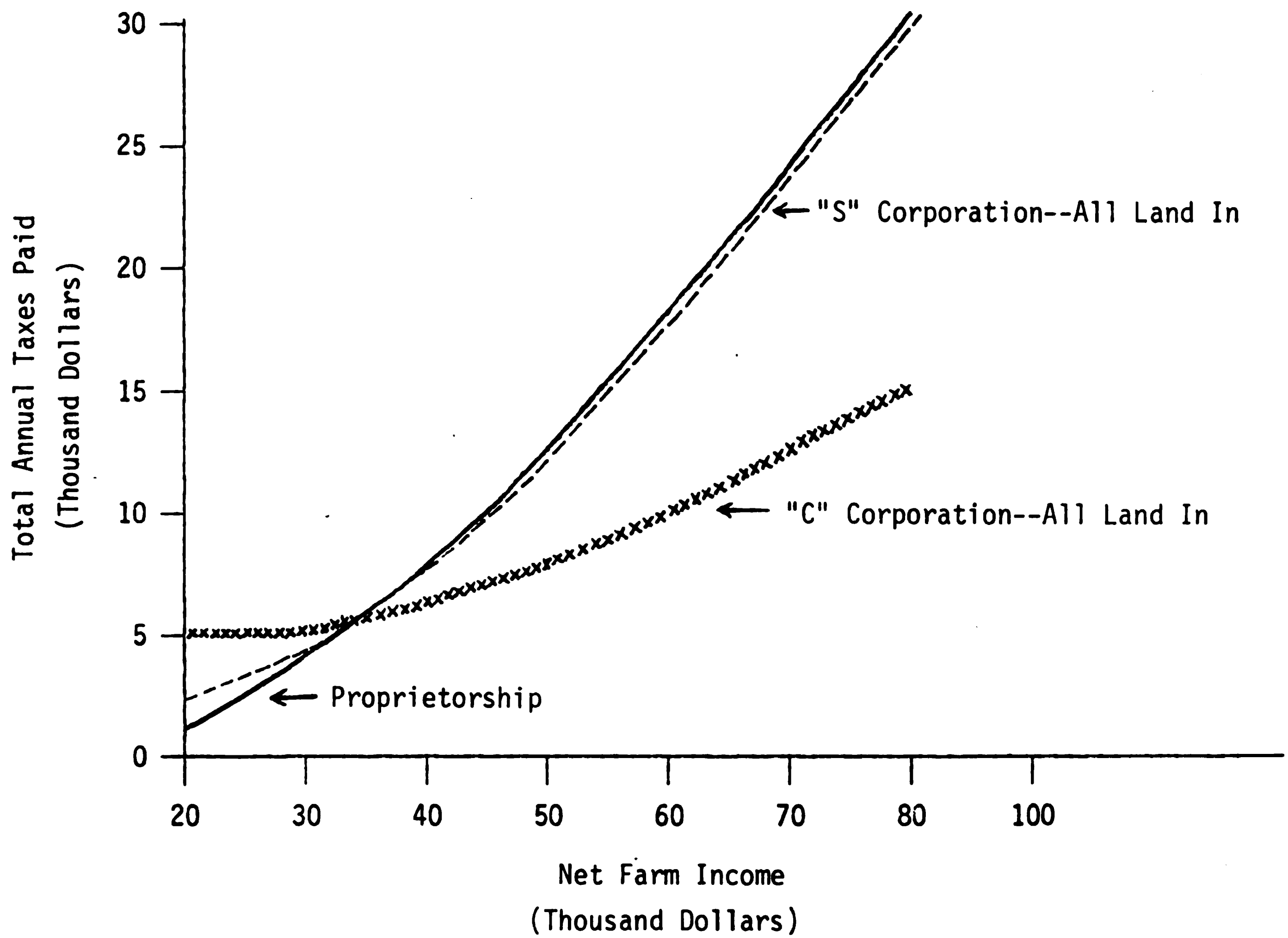
[129] M. P. Kelsey, Telfarm Business Analysis Summary for Fruit Farms, 1979, Agricultural Economics Report Number 355, Department of Agricultural Economics, Michigan State University, July 1979.

Figure 1--FRUIT
Annual Tax Comparison by Business Organization



$80,000 net farm income, the "C" corporation results in a total tax savings of approximately $15,000 over a sole proprietorship or "S" corporation!

However, at lower levels of net farm income, a "C" corporation results in the farm business paying more total taxes than a proprietorship or "S" corporation. For example at the $20,000 net farm income level the farm business would pay almost $4,000 more in total taxes if it is organized as a "C" corporation rather than as a proprietorship.

These results prove the point made in earlier chapters about the tax savings advantages of "C" corporations over proprietorships at high income levels along with increased taxes at lower income levels.

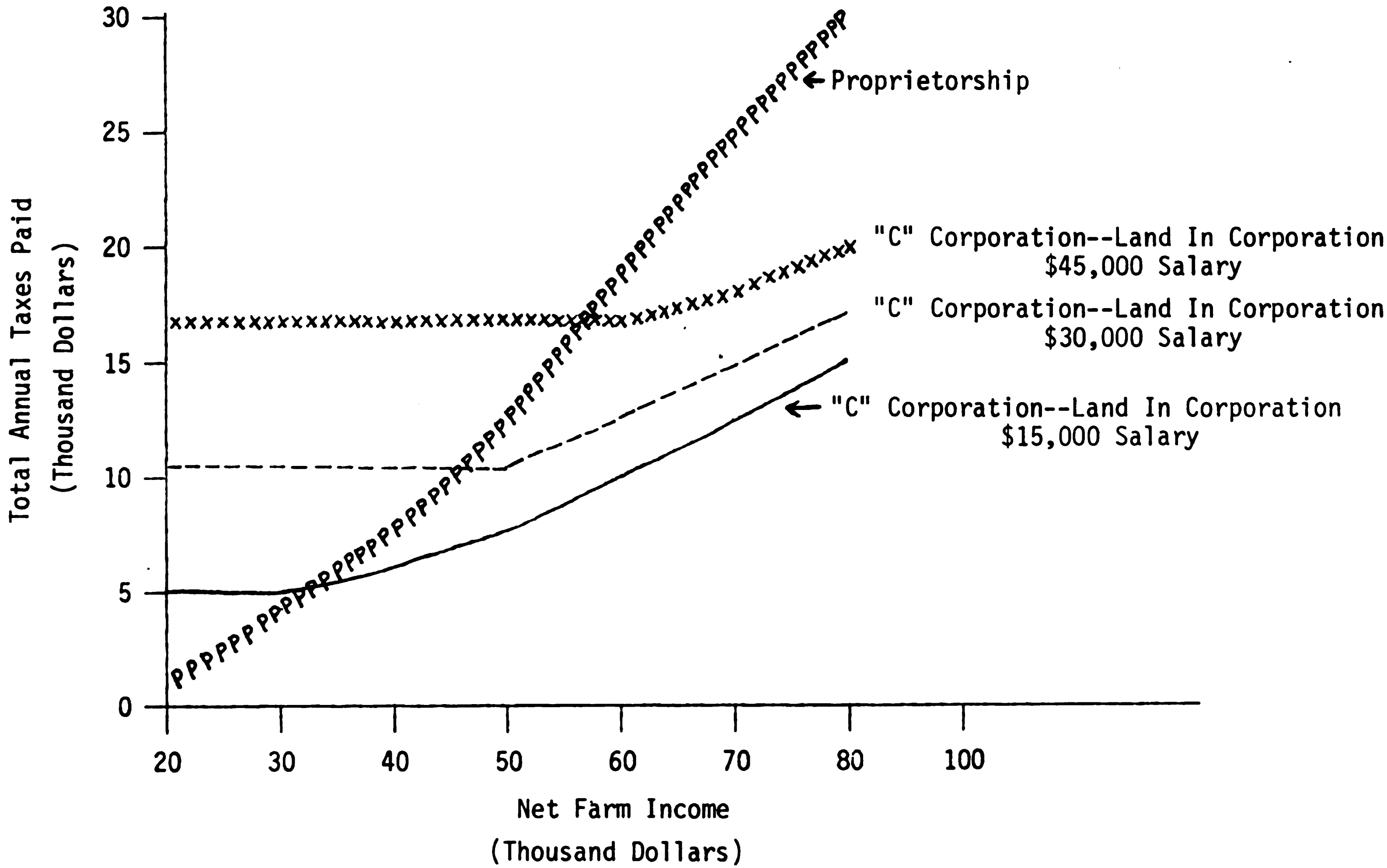
Note also that the total taxes paid by a farm business organized as a "S" corporation are almost the same as for a sole proprietorship. Of course, the reason for this is that a "S" corporation pays no income taxes itself. Instead, it allocates all taxable income to its stockholders.

The reason for the slight difference in total annual taxes paid between a proprietorship and "S" corporation is that the "S" corporation must pay worker's compensation on the stockholder-employee's salary along with paying half of the social security tax on the salary. These extra costs in turn affect the total amount of Michigan and Federal income tax paid.

Figure 2 shows the tax effects of increasing the salary level for the one stockholder-employee in a "C" corporation in $15,000 increments. The proprietorship line gives us an idea of the "breakeven" points.

The "C" corporation was chosen for this example because it clearly had the greatest tax benefits at higher net farm income levels. It was

Figure 2--FRUIT
"C" Corporation Annual Taxes--Varying Salaries



desired to see how much of these tax benefits disappeared at higher salary levels.

As would be expected, the graph shows that the total amount of taxes paid increase when salary levels increase. However, even a $45,000 salary results in tax savings over a proprietorship at net farm income levels above $60,000.

The next three case examples all include a graph depicting the annual taxes paid by a "C" corporation with all the farmland "in" the corporation along with the annual taxes paid by a "C" corporation with all the farmland "out" of the corporation. This was not done for the fruit example because a realistic cash rental figure for the farmland left "out" of the corporation was not available.

Currently, the lease arrangement in most Michigan fruit operations consists of a complex share rental lease. Because income varies so greatly from one year to the next in a fruit operation, it is almost impossible to translate this share rental figure into a cash figure. In fact, it is not known whether any fruit operations lease farmland on a cash rental basis. It is probably done in some instances, but the author is not aware of any in Michigan.

2. <u>Dairy</u>

The assumptions made for the dairy farm case example are as follows:

Farm Situation:

*Michigan Dairy Farms with over 100 cows, 1978 Telfarm Business Analysis Summary[130]

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[130] Myron P. Kelsey and Archie Johnson, <u>Telfarm Business Analysis Summary for Specialized Michigan Dairy Farms</u>, 1979, Agricultural Economics Report Number 359, Department of Agricultural Economics, Michigan State University, July 1979.

*149 milk cows

*386 tillable acres owned

*225 tillable acres rented

*1 owner-operator

Tax Information:

*$15,000 salary

*$1,500 fringe benefits

*$3,000 investment tax credit

*4 exemptions

*$6,000 property taxes

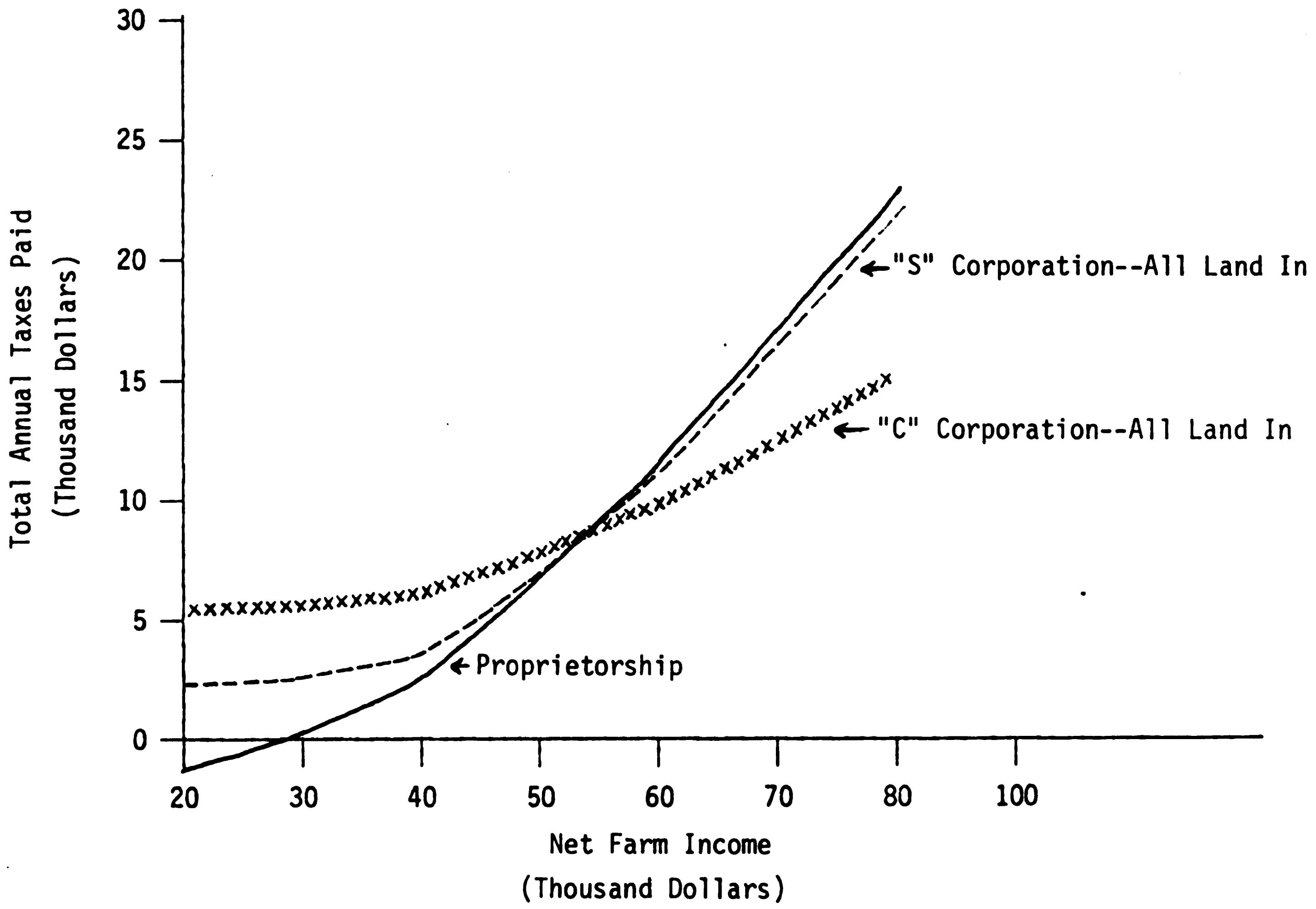
*13% Worker's Compensation Premium Rate

*$20,000 of net farm income is capital gains income

The graph in Figure 3 depicts the total annual taxes paid for net farm income levels ranging from $20,000-80,000 for a sole proprietorship, "C" corporation, and "S" corporation.

The significant point brought out by this graph is that the "break-even" point (approximately $55,000 net farm income), where tax savings are achieved by forming a "C" corporation, is over $20,000 higher than for the fruit farm case example. In fact, the "C" corporation turns out to be extremely costly annual tax-wise at the lower income levels. For instance, at $20,000 net farm income, a dairy farm organized as a "C" corporation would pay over $6,500 more annual taxes than a sole proprietorship and over $2,800 more taxes than a "S" corporation. Even at $40,000 net farm income, the difference in total taxes paid by a "C" corporation and a proprietorship is over $3,000.

Figure 3--DAIRY
Annual Tax Comparison by Business Organization



The reason that the net farm income level where the total annual taxes paid by a proprietorship equals those paid by a "C" corporation is so high is because of the long-term capital gains income incurred by the dairy farm. Remember that for a sole proprietorship, partnership, and "S" corporation, 40 percent of the gain is allocated to the individual taxpayer and then it is taxed according to the individual's marginal tax rate. This can be contrasted to a "C" corporation where the capital gain is taxed at the lesser of ordinary income tax rates where the capital gain is combined with ordinary income or a 28 percent tax rate. Therefore, since a "C" corporation does not get a 60 percent reduction of the capital gain and its income tax rates are higher at lower income levels than those of an individual, it follows that higher taxes are paid by a "C" corporation at lower income levels, when a part of the net farm income is capital gains income.

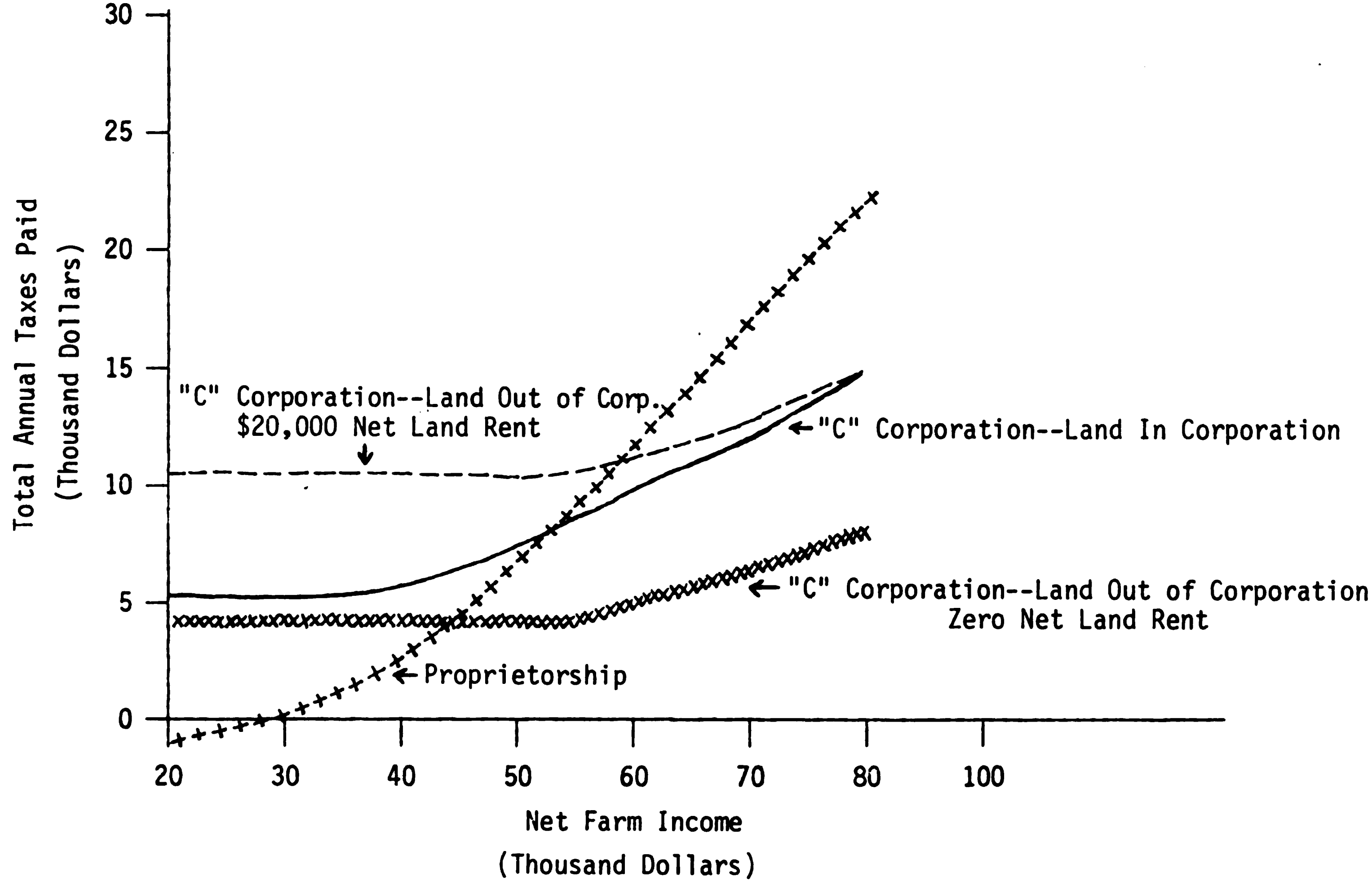
Since the net farm income "break-even" level was relatively high for a "C" corporation there was no need to include an analysis of higher salary levels as was done in the fruit case example because the "break-even" level would just be greater.

However, there was a need to examine whether the net farm income "break-even" level for a "C" corporation would decline if the farmland was left "out" of the corporation. Figure 4 depicts the results of such an analysis.

The graph shows that by keeping the land "out" of a "C" corporation and having a zero net land rent (tax deductions to the individual equal the rental income), taxes are indeed reduced in comparison to having all the land "in" a "C" corporation. However, the net farm income

Figure 4--DAIRY

"C" Corporation Annual Taxes--Land In and Out of Corporation



"break-even" point for a "C" corporation with farmland "out" and zero net land rent is still quite high--almost $45,000 net farm income.

When the net land rental figure for a "C" corporation with land "out" was raised to $20,000,[131] the total taxes paid increased quite dramatically. In fact, the total taxes paid when a net land rental of $20,000 was assumed were approximately $6,000 greater, at every net farm income level, than those paid when a zero net land rental figure was assumed.

At approximately $80,000 net farm income, the total annual taxes paid by a "C" corporation with farmland "out" and a $20,000 net land rental were equal to those paid by a "C" corporation with land "in" the corporation.

The net farm income "break-even" point for a "C" corporation with land "out" and $20,000 net land rent is about $4,000 higher than the "break-even" point for a "C" corporation with all the land "in" the corporation.

The results of this dairy farm case example seem to indicate that for many dairy farms there is little or no reason to form a "C" corporation to save annual taxes. The main reason for this is that the high amount of capital gains income results in a high net farm income "break-even" point. If for some reason a dairy farm had a lower amount of capital gains income than was assumed in this case example, it would lower this net farm income "break-even" point (assuming all other

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[131]The $20,000 figure was arrived at by assuming a $68 land rental per tillable acre and then the property taxes were subtracted from this amount, i.e., ($68 per tillable acre x 386 tillable acres) - $6,000 property taxes $\approx$ $20,000.

assumptions remain the same) and thus make a "C" corporation more attractive annual tax-wise.

Of course, dairy farms with net farm incomes above $55,000 would receive some annual tax benefits by forming a "C" corporation (assuming all farmland is put "in" the corporation) as well as those with high land debts and net farm incomes above $45,000 (here assuming that the farmland is left "out" of the corporation). However, there probably aren't many dairy farms in Michigan that consistently have net farm income levels that fall within this range.

3. Swine

The assumptions made for the swine farm case example are as follows:

Farm Situation:

*Michigan Swine Production Farms with more than 200 litters farrowed in 1978, Telfarm Business Analysis Summary[132]

*365 tillable acres owned

*204 tillable acres rented

*1 owner-operator

Tax Information:

*$15,000 salary

*$1,500 fringe benefits

*$5,000 investment tax credit

*4 exemptions

*$7,000 property taxes

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[132] Gerald D. Schwab, Telfarm Business Analysis Summary for Swine Farms, 1978, Agricultural Economics Report Number 363, Department of Agricultural Economics, Michigan State University, September 1979.

*13% Worker's Compensation Premium Rate

*$10,000 of net farm income is capital gain income

The graph in Figure 5 depicts the total annual taxes paid for net farm income levels ranging from $20,000-80,000 for a proprietorship, "C" corporation, and "S" corporation.

Because some of the net farm income is capital gains income, as it was in the dairy farm case example, the net farm income "break-even" amount is quite high--$45,000. However, it is not as high as for the dairy case example because the amount of capital gains income is lower. Also, the tax difference between the "C" corporation and a proprietorship is not as great at the lower levels of net farm income as it is in the dairy example.

Figure 6 shows the results of an anlysis which calculated annual taxes for a "C" corporation with all farmland "in" the corporation along with those for a "C" corporation with all farmland left "out" of the corporation. As in the dairy case example, two different amounts of net land rents were used in the analysis. For the low amount, a zero net land rental figure was used. A $15,000 net land rental figure was used for the high amount.[133]

The general ordering of the tax payments for each of the types of farm business organizations shown in Figure 6 is about the same as it was for the dairy farm example in Figure 4. However, the "break-even"

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[133]The $15,000 figure was arrived by assuming a $61 land rental per tillable acre and then the property taxes were subtracted from this amount, i.e., ($61 per tillable acre x 365 tillable acres) - $7,000 property taxes $\approx$ $15,000.

Figure 5--SWINE

Annaul Tax Comparison by Business Organization

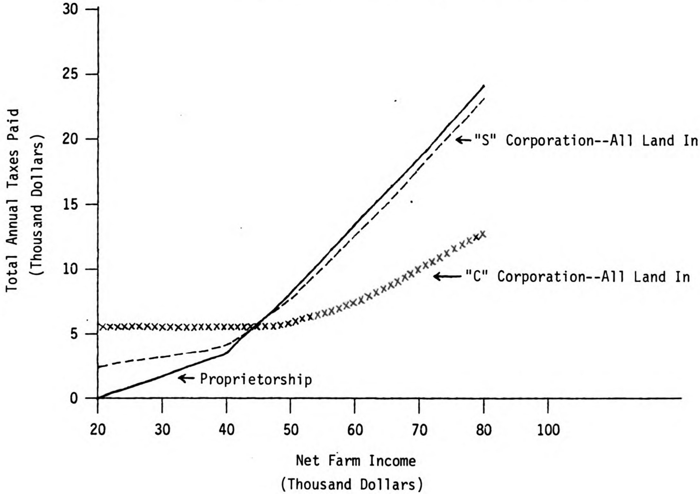
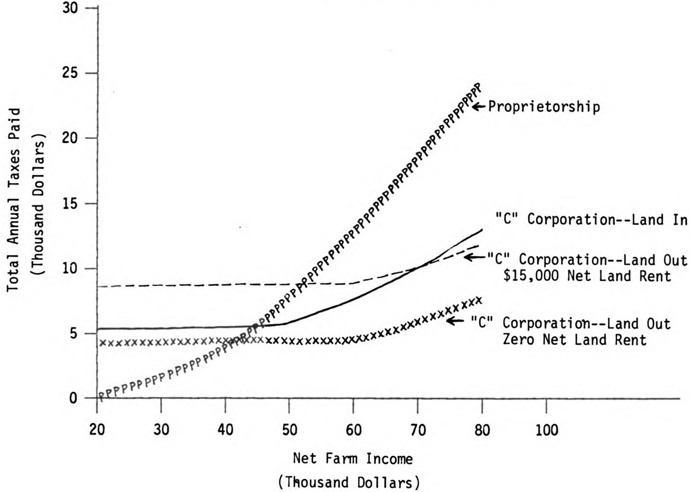


Figure 6--SWINE

"C" Corporation Annual Taxes--Land In and Out of Corporation



amounts where tax savings are achieved by incorporating are slightly lower than the dairy example--again because of the reduced capital gains.

Figure 7 shows the tax effects of increasing the salary levels for the one stockholder-employee of the "C" corporation, with all land in the corporation, by $15,000 increments. As in the fruit farm case example, the graph shows that the total amount of annual taxes paid increases when salary levels increase. According to the graph, a $45,000 salary results in tax savings over a sole proprietorship at net farm income levels above $70,000.

The results of the swine farm case example seem to indicate, as the dairy example did, that somewhat higher net farm income levels are needed for a sole proprietor to justify forming a "C" corporation to achieve annual tax savings. Again, the main reason for this is the large portion of capital gains income.

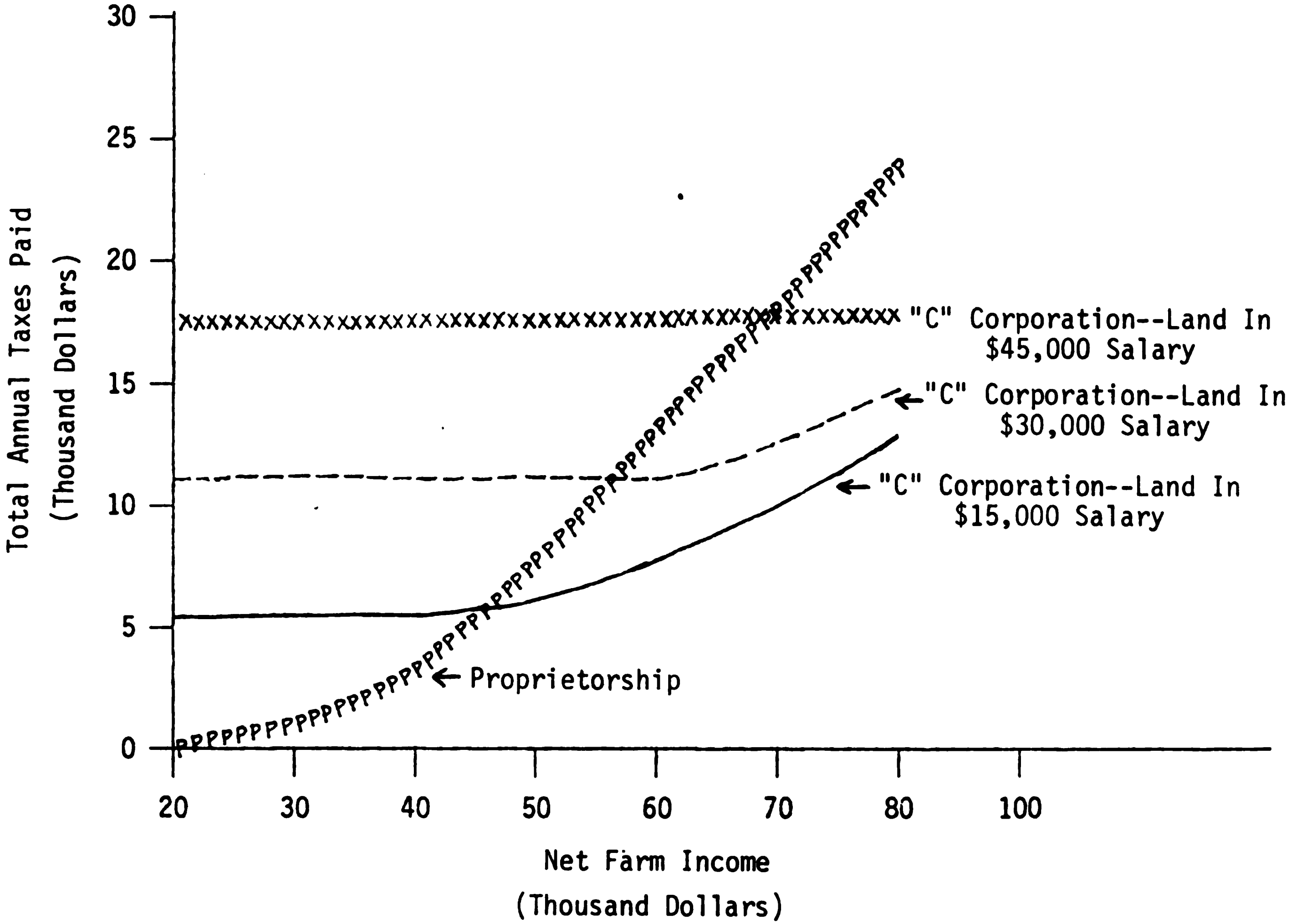
However, the amount of capital gains income may differ more among swine farms than dairy farms. Therefore, it is extremely important to analyze each situation individually to determine whether the farm business should be organized as a proprietorship (partnership), "C", or "S" corporation.

4. Saginaw Valley Cash Crop

The assumptions made for the Saginaw Valley case examples are as follows:

Figure 7--SWINE

"C" Corporation Annual Taxes--Varying Salaries



Farm Situation:

*Saginaw Valley Cash Crop Farms with over 800 tillable acres, 1978 Telfarm Business Analysis Summary[134]

*427 tillable acres owned

*701 tillable acres rented

*1 owner-operator

Tax Information:

*$15,000 salary

*$1,500 fringe benefits

*$3,000 investment tax credit

*4 exemptions

*$7,000 property taxes

*10% Worker's Compensation Premium Rate

For the Saginaw Valley cash crop case example, the annual tax comparison by farm business organization was split up into two analyses--one assumed that all the farmland was "in" Michigan Public Act 116 (P.A. 116) and the other one assumed there was not any farmland in P.A. 116. All the other case examples in this chapter assumed that none of the farmland was in P.A. 116.

Remember that P.A. 116 is known as the "Farmland and Open Space Preservation Act." Basically, its purpose is to preserve farmlands and wildlife areas of Michigan from nonfarm uses through property tax relief. P.A. 116 was discussed in detail in Chapter VI.

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[134] M. P. Kelsey and Archie Johnson, Telfarm Business Analysis Summary for Saginaw Valley Cash Crop Farms, 1978, Agricultural Economics Report Number 358, Department of Agricultural Economics, Michigan State University, July 1979.

Since the Saginaw Valley or "Thumb" area of Michigan can be characterized as having quite high property taxes, it was desired to ascertain the extent of the tax benefits available from enrolling in P.A. 116. Figures 8 and 9 depict the results of this analysis for each farm business organization at net farm income levels of \$20,000-80,000.

The results shown in the graph in Figure 8 are much the same as the results shown for the fruit farm case example in Figure 1. The "break-even" point where tax savings are achieved by forming a "C" corporation is about the same for both. This could be expected as much of the tax information was similar for each.

The graph in Figure 9 is almost identical to the graph in Figure 8 except that each of the "tax lines" for all three business organizations are lower in Figure 9--meaning that less tax is paid at each level of net farm income. This tax savings is entirely due to enrollment in P.A. 116 as it is the only change made in assumptions between the two analyses.

As can be seen in the graph in Figure 9, the savings are quite substantial--especially at the lower net farm income levels. In fact, when all of the farmland is "in" P.A. 116, none of the business organizations incur any net tax liability until the net farm income rises above \$30,000.

The general results of the graphs in Figures 10 and 11 are much the same as similar analyses for the other case farms. No new conclusions can be drawn for these graphs.

The results of these four analyses for the Saginaw Valley case example seem to indicate that at least \$30,000 net farm income is needed for a sole-proprietor to justify forming a "C" corporation to achieve

Figure 8--SAGINAW VALLEY CASH CROP

Annual Tax Comparison by Business Organization--No Land in P.A. 116

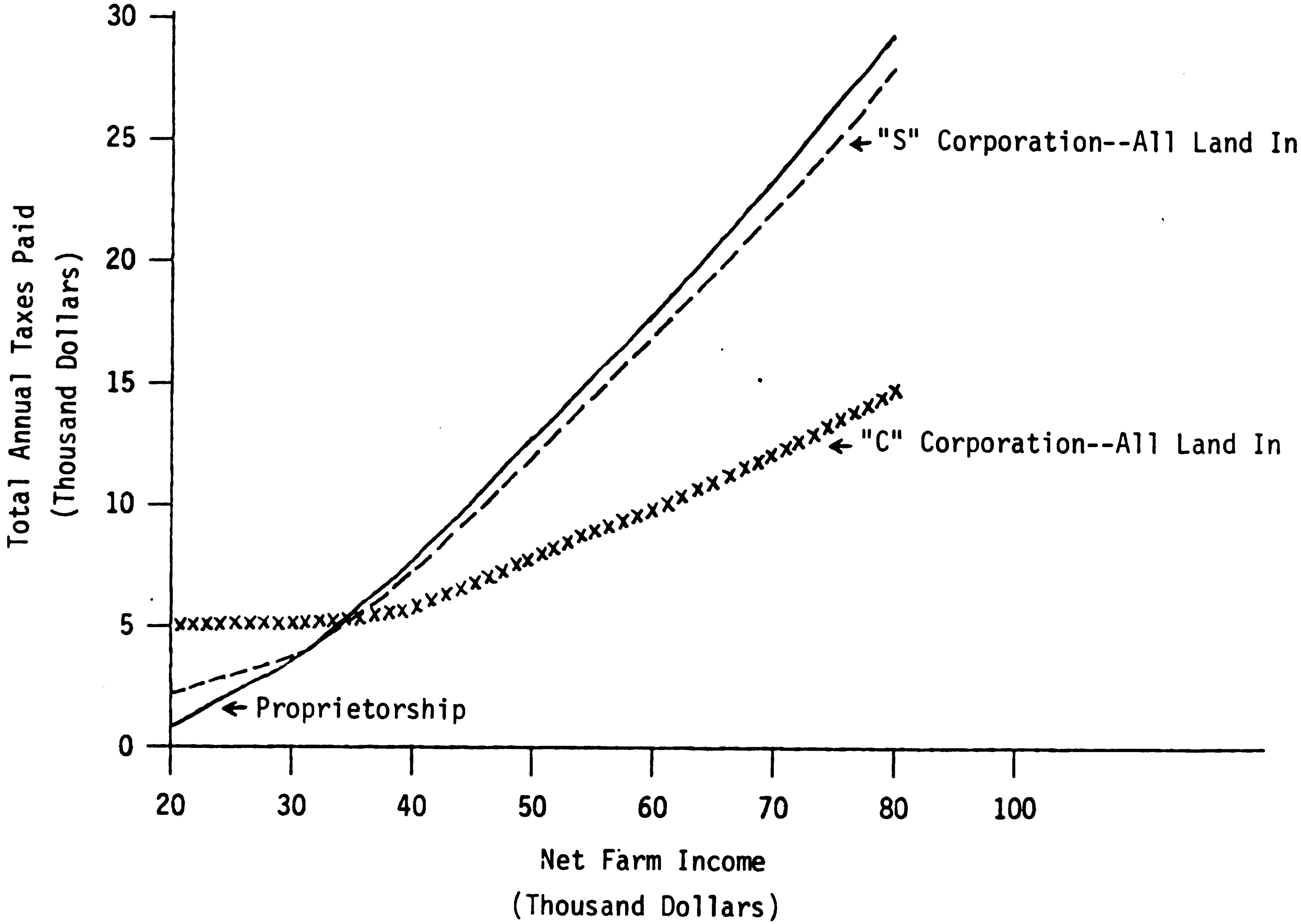


Figure 9--SAGINAW VALLEY CASH CROP

Annual Tax Comparison by Business Organization--Land in P.A. 116

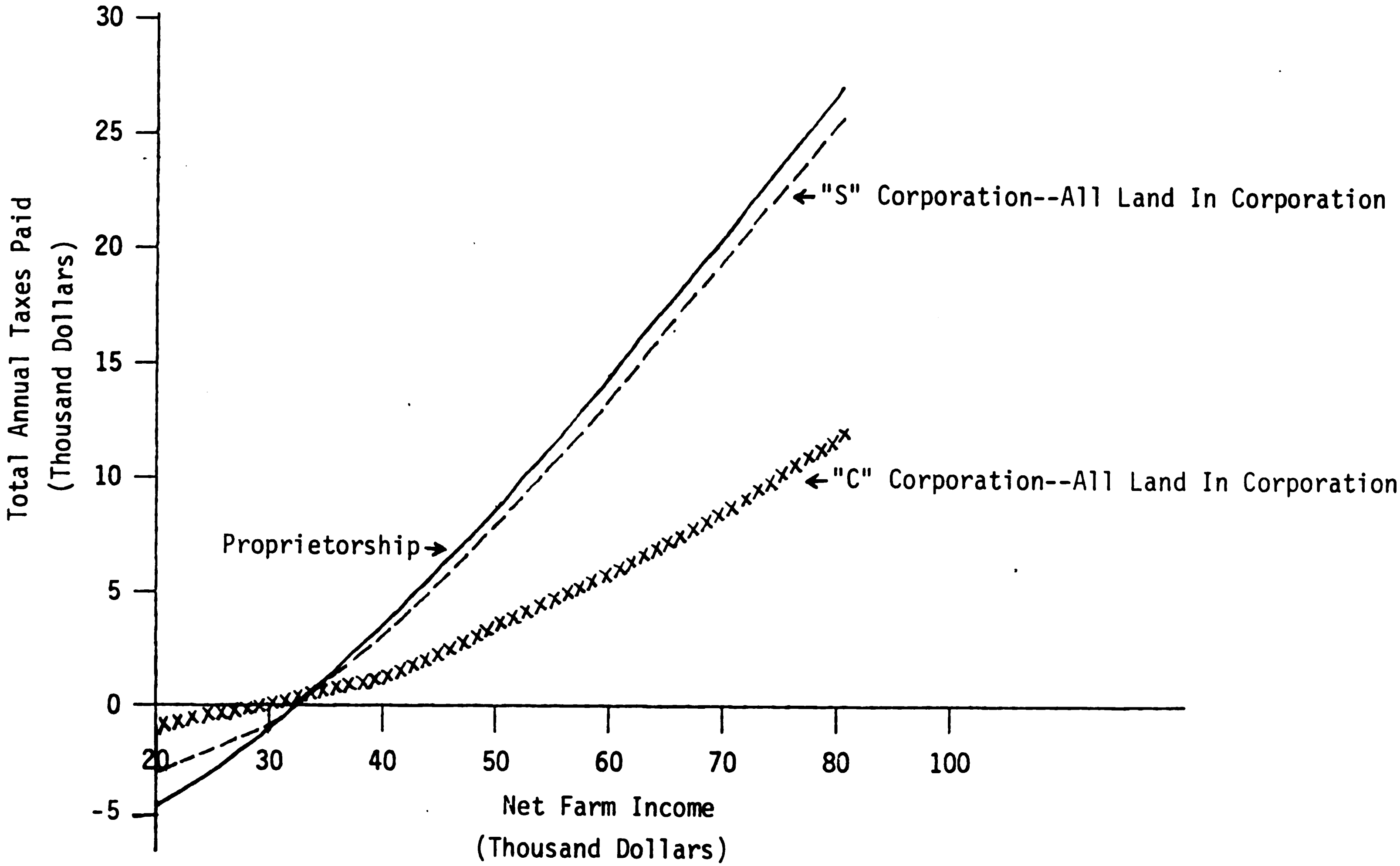


Figure 10--SAGINAW VALLEY CASH CROP

"C" Corporation Annual Taxes--Land In and Out of Corporation--No Land in P.A. 116

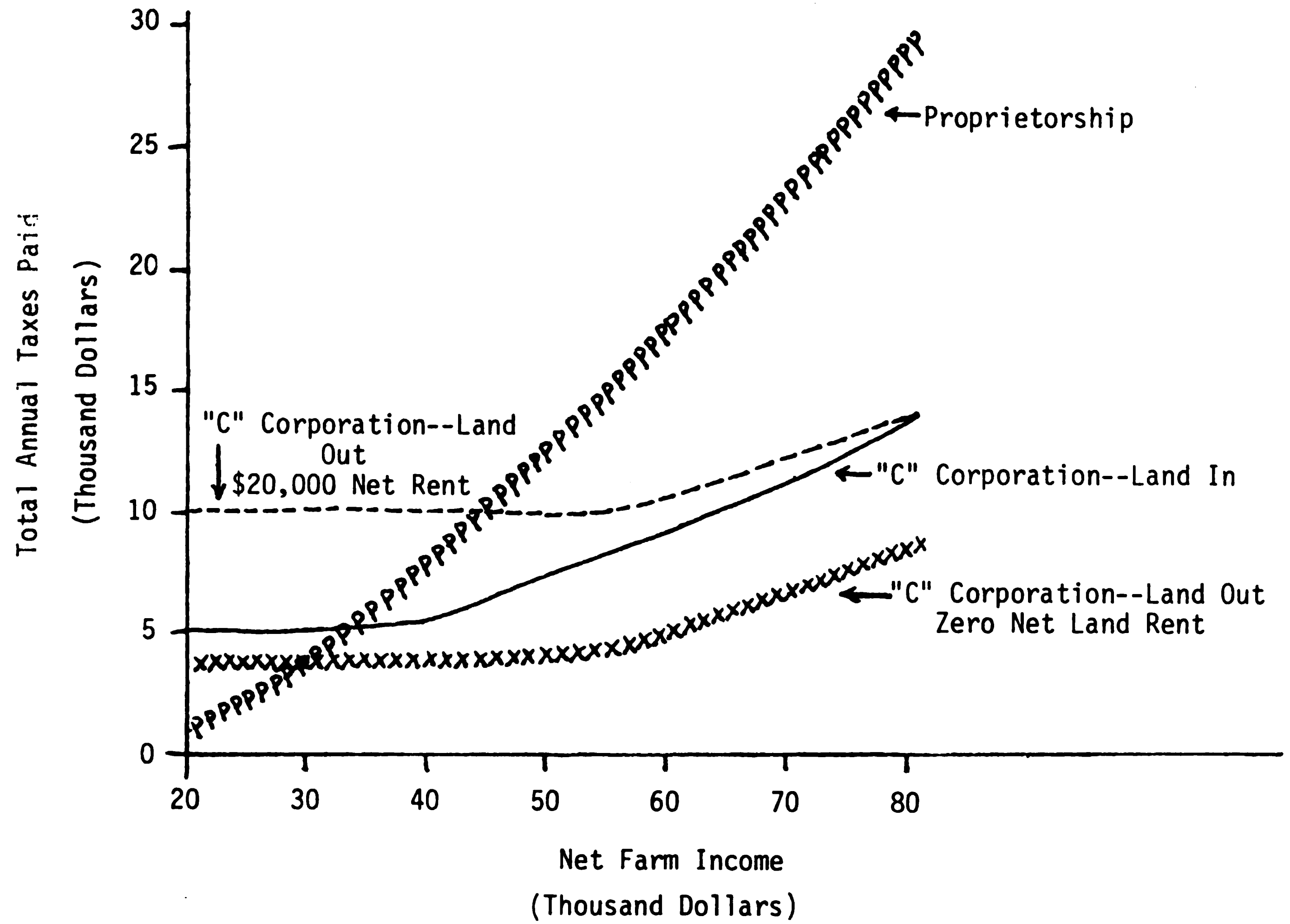
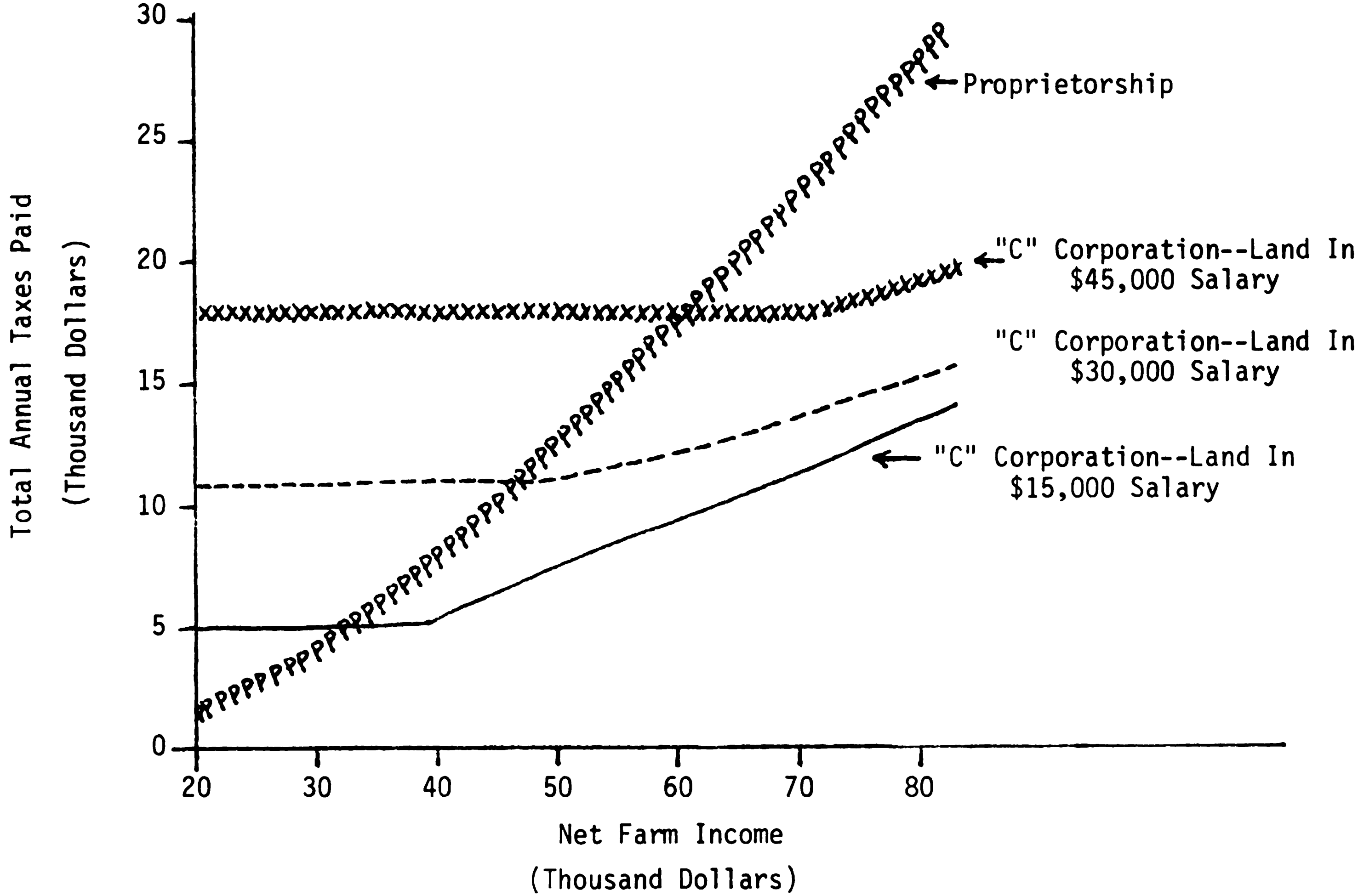


Figure 11--SAGINAW VALLEY CASH CROP

"C" Corporation Annual Taxes--Varying Salaries--No Land in P.A. 116



annual tax savings. However, this "break-even" level could change for a farm with different characteristics, so it becomes imperative that an analysis is done for each farm situation.

C. Summary

Even though it is very difficult to draw specific conclusions about the tax consequences for each of the three farm business organizational types, several general guidelines can be drawn from the results of this chapter.

First of all, there seems to be little need for any type of farm operation to form a "C" corporation to save annual taxes unless the net farm income is above $30,000 per proprietor or partner. The case examples demonstrated that this "break-even" figure is higher for farms with high amounts of capital gain income--such as swine farms (especially farrow operations) and dairy farms. Beef cow-calf operations would also fall into this category.

This net farm income "break-even" level should be reached for a number of years after incorporation to save taxes over the long run. One "boom" year with extremely high net farm income may not justify incorporating to save annual taxes, unless there is a good probability that the net farm income will stay at a high level. The reason for this being that the extra tax costs associated with a couple of unprofitable (low net farm income) years after incorporation could completely wipe out any tax savings made during the "boom" year. This is the scenario that many cash crop farmers faced after the "boom" year of 1973 and 1974 and the relatively unprofitable years of 1977, 1978 and 1979. Now it looks as if 1980 and possibly 1981 will again be "boom" years for Michigan cash crop farmers.

Therefore, rather than incorporating, it may be wiser to spend more time using other tax saving devices to level out the income from year to year, thus reducing the probability of falling into a high marginal tax bracket for only one year. For instance, simple year end tax planning can alleviate potential tax problems in many years.

The cases also demonstrated that there is no significant difference in the annual tax liability incurred by a proprietorship and a "S" corporation. Thus, there is little or no reason, annual tax wise, for a sole proprietor or a partnership to incorporate the business as a "S" corporation. However, there may be other benefits attainable by forming a "S" corporation such as employee fringe benefits, limited liability, estate planning benefits, etc.

If, however, the decision has been made to incorporate the farm business, one should pay careful attention when deciding upon the salary levels as well as whether or not to incorporate the farmland along with the rest of the business. The cases in this chapter demonstrated the general tax consequences of these decisions. Remember that generally, the greater the deductions available on the farmland (interest, property tax, etc.), the more advantageous it is--annual tax wise--to leave the farm "out" of the corporation. The cases also demonstrated that the higher the annual salary level, the greater the amount of annual tax liability.

Finally, the Saginaw Valley case demonstrated the tremendous tax benefits available to those who put their farmland in P.A. 116. These benefits are especially high at lower levels of net farm income. If one can live with the limitation on the nonfarm uses of the farmland, it seems to be desirable to enter into an agreement--no matter which type of business organization one is.

However, there is a note of caution for operations considering incorporating as a "C" corporation and leaving all farmland "out" of the corporation. The additional eligibility requirements discussed in Chapter VI may pose some problems in qualifying for this Michigan annual tax credit. Thus, any such operation should carefully analyze the implications of P.A. 116 before incorporating.

CHAPTER IX

CORPORATE ESTATE PLANNING

Studies made in several states indicate that the number one reason farmers turn to the corporation is to accomplish estate planning objectives.[135]

A section in Chapter V discussed some of the commonly shared estate planning goals and objectives of farm families. Also included was a discussion of the corporate characteristics that aid the accomplishment of these objectives.

This chapter will delve further into the corporate estate planning arena. It will begin with a discussion of some of the most common estate planning tools used to carry out the goals and objectives of farm families. The second part of the chapter will examine some hypothetical cases where some of these tools can be applied in conjunction with the corporate structure to formulate a sound estate plan.

Before we begin the discussion, a note of clarification is in order. The estate planning process can be divided into two time periods--planning during the individual's lifetime and planning during the post-mortem period (also referred to as post-mortem planning).

This chapter will only concern itself with estate planning during the individual's lifetime.

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[135]Neil E. Harl, Farm Estate and Business Planning, 5th ed. (Skokie, Illinois: Century Communications Inc., 1979), p. 265.

This is not to infer that post-mortem planning is not an important part of the entire estate planning process. Some of the post-mortem planning tools available to farm families such as the alternative use valuation, alternative valuation date, joint interest exclusion, marital deduction, and installment payments of federal estate tax aid significantly in decreasing federal estate taxes and increasing liquidity in the estate.

These tools are especially useful in the estate planning process between husband and wife. A married couple can transfer a fairly large estate between them without a federal estate tax. But the federal estate tax on the surviving spouse's estate may be substantial.[136] Estate planning to reduce the surviving spouse's federal estate tax obligation may be critical to minimizing death taxes for the family.

A. Co-Ownership

Some farmers believe that co-ownership of farm property constitutes an estate plan. They believe that it substitutes for a will and reduces estate taxes and other estate settlement costs. Whether this is true or not will depend on the particular situation.

Tenancy in common and joint tenancy with rights of survivorship are the two most common forms of co-ownership. Tenancy in common exists when two or more persons each own an undivided portion of the property. Each tenant is free to dispose of his portion as he sees fit. In other words, each has the right to sell, mortgage, assign, or give away his

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[136]For an illustration of this point, see the first case example in this chapter. It involves the disadvantages of holding property in joint tenancy.

undivided portion. At death, only the portion owned by the deceased tenant in common is taxed in his estate. For example, if two farmers own an equal portion of a particular parcel of farmland, only one-half the value of the property is included in the deceased tenant's gross estate.

Joint tenancy with rights of survivorship is similar to tenancy in common in that two or more persons each own an undivided portion of the property. However, this type of co-ownership cannot be broken without the consent of all concerned parties. Jointly, the tenants have the right to sell, mortgage, assign, or give away their ownership rights. Section 2042 of the Internal Revenue Code states that the full value of jointly held property is includible in the estate of the first joint tenant to die unless it can be proven that some part of the property belonged to the survivor before the joint tenancy was created or that the survivor contributed to the acquisition or improvement of the property. If this is the case, then a portion of the property value may be removed from the decedent's estate.

Tenancy by the entirety is a special type of joint tenancy with rights of survivorship between husband and wife. This type of tenancy can exist only between husband and wife and cannot be broken by either spouse without the other's consent.

Besides the difference in treatment for estate tax purposes, joint tenancies and tenancies in common differ greatly in the disposition of the interest of a deceased co-owner. At the death of a tenant in common, that individual's undivided interest is passed on to his heirs according to his will or under provisions of state law if there is no will.

In comparison, joint tenancies and tenancies by the entirety are characterized by a right of survivorship. This right of survivorship could be simply described as a "built-in" will. This "built-in" will stipulates that title of property held by two or more persons in this manner passes directly to the surviving tenant(s) upon the death of a joint owner. In other words, the surviving joint tenant(s) rather than the heirs will receive the interest of a deceased joint tenant. Thus, in general, a joint tenant cannot transfer his interest in joint tenancy property to other heirs by so providing in his will. Of course, the last surviving joint tenant can transfer the property by will as he sees fit.

This characteristic of joint tenancies has led to the belief that it substitutes for a will. However, this usually isn't entirely true--especially for farm families. It would be rare for a farmer or his wife to have all of his or her property in joint tenancy. For example, are crop proceeds from land held in joint tenancy also in joint tenancy? Or, even more complex, is the offspring from breeding livestock held in joint tenancy also in joint tenancy? Also, there is always a possibility that either spouse may receive a last-minute inheritance, settlement, or bonus. So no one can be certain that all his or her property will be in joint ownership.

Probably the main advantage of joint tenancy is that ownership of the property passes immediately to the other tenant(s) upon the death of a joint tenant. This avoids the costs and time consuming delays associated with probating an estate.

This advantage has led to the belief that joint tenancy reduces the costs of settling an estate. However, again this belief may not always hold true. It depends on the situation.

In general, as estates grow larger, joint tenancy becomes less advisable. A case later on in this chapter will illustrate this further.

B. Gifts

Several advantages of making use of lifetime gift plans to transfer farm property from one generation to the next were discussed in Chapter V. It was noted that corporate stock is probably the simplest and most convenient vehicle available for making use of the $3,000 federal gift tax annual exclusion per recipient per year ($6,000 per recipient per year for husband and wife as donors, even though only one owns the property given).

This is especially true when compared to gifts of real estate. All that is required is the endorsement of the stock certificate by the donor, the issuance of the gift certificate to the donee, and the issuance of the certificate for the residue to the donor. Further, the transfer may be made privately and need not be publicly recorded.[137]

1. "Discounting" of Minority Stock

Another potential advantage of making gifts of corporate stock involves the possibility of a "discounting" of minority holding of

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[137] Donald H. Kelley, "The Farm Corporation as an Estate Planning Device," Nebraska Law Review, Vol. 54, No. 2, (1975), p. 234.

corporate stock for gift valuation purposes.[138] Such a "discounting" means that a minority stock interest is valued at a lower figure than the average value per share based upon the value of the underlying corporate assets. This would allow a larger portion of the donor's estate to be transferred within the gift tax exemption than if the corporate assets themselves had been given away.

There are several cases involving the "discounting" of minority holdings of corporate stock. In fact, a recent case involved the estate tax valuation of shares of stock in an agricultural corporation.

The case of Estate of Ethel C. Dooly, (31 TCM 814 (1972)) involved the valuation of two separate blocks of stock, one involving 50.01 percent of the stock and the other being 9.19 percent of the stock. The Tax Court adopted the valuations proposed by the witness for the taxpayer, which amounted to about 37 percent of the underlying asset value per share for the smaller block of stock and about 55 percent of the underlying asset value per share for the large block. It applied Treas. Reg. 20.2031-2(F)(2), which lists "the degree of control of the business represented by the block of stock to be valued" as a relevant factor in determining the value of stock for estate tax purposes.[139]

In Estate of Greg Maxey 28 TCM (1969) minority stock holding in a close corporation was discounted 25 percent below the pro-rated value

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[138]Remember that a minority stock holding is any holding of corporate stock that consists of less than 50 percent of the total outstanding shares of the corporation.

[139]Donald H. Kelley, "Estate Planning for Farmers and Ranchers," The Practical Lawyer, Vol. 20, No. 2, February 1974; in Personal and Business Estate Planning, ed. Gary K. Stone and Jerry S. Rosenbloom (East Lansing: MSU Business Studies, 1976), pp. 183-185.

of the underlying assets, and a majority holding in excess of 70 percent of all stock suffered a discount of 15 percent.[140]

These and other stock valuation cases suggest the possibility that not only may estate taxes be saved by transferring ownership of a donor's stock, but what the donor continues to own may, in effect, have its value for estate tax purposes deliberately reduced. Thus, if stock in a family farm corporation is given away to the point where the donor (one of the parents) no longer retains operating control (less than 50 percent of stock owned), the stock that remains in the donor's hands may very well be discounted in value in relationship to the market value of the underlying assets, for estate tax purposes in his or her estate.

However, minority holdings of corporate stock in closely-held family corporations may not always be discounted for gift and estate tax purposes. The IRS has, on occasion, advanced the argument that the stock holding of the donor-testator should be valued upward not only by reason of his own control but because of family group control of other stock in the corporation. This argument appears to have been accepted only in a few unusual fact situations.[141]

C. Two Classes of Stock

The use of two classes of stock to stabilize or "freeze" the estate value of the older generation was discussed in Chapter V.

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[140] Ibid.

[141] Donald H. Kelley, "The Farm Corporation as an Estate Planning Devide," Nebraska Law Review, Vol. 54, No. 2, (1975), p. 240.

However, remember that the use of such multi-class stock arrangements will disqualify a corporation from the Subchapter S election, since Subchapter S corporations are allowed only one class of stock.

D. Combinations of Common Stock and Debt Securities

At the time of incorporation, it is possible to issue both common stock and debt securities (notes, bonds, or debentures) in exchange for the property that is transferred to the corporation in a tax free manner. The use of debt securities can help accomplish some common estate planning objectives of farm families. These include: 1) Provides an assured retirement income for the parents in the form of investment income rather than earned income. For persons over 65 years of age, investment income is very advantageous because a) it is not subject to the self employment tax and b) it does not affect social security benefits.

2) Since debt securities do not carry voting rights, the use of them in addition to common stock rather than issuing all stock will reduce the investment on-farm heirs need to gain voting control over the corporation. Consequently, they can probably gain majority control over the corporation in a shorter time period.

3) Provides a tax deductible means (interest is a deductible business expense to the corporation while dividends are not) for removal of earnings from the corporation. Further, the shareholders are not taxed on loan repayments unless they exceed basis.

4) Part of the estate value of the parents is fixed (that part which consists of debt securities). This is especially helpful if farmland or other appreciating assets are in the corporation.

5) Creates another estate planning alternative for parents--they can give off-farm heirs debt securities rather than shares of stock in the corporation. This not only should please off-farm heirs who normally prefer the certainty of income associated with debt securities over the risks of stock ownership, but it should also please on-farm heirs who usually have a desire to keep stock ownership entirely in their hands rather than letting it go to outside (off-the-farm) interests.

6) Achieves the objectives of multi-class stock arrangements while still preserving Subchapter S election eligibility.

There may be somewhat of a danger in using combinations of common stock and debt securities in Subchapter S corporations. Until recently, the IRS took the position that if an instrument purporting to be a debt obligation had many of the characteristics of equity capital, it might be considered a second class of stock--thus disqualifying the corporation for the Subchapter S election. Currently, however, the IRS has announced that amendments to the regulations will be proposed and until these are complete, they will not litigate cases in this area.[142]

Also there is a danger in using combinations of common stock and debt securities in regular corporations. It is possible that the IRS will contend that a debt obligation is really an equity interest if it has too many features of stock. If the debt instrument is treated as a form of stock, principal and interest payments will be considered dividends--which, of course, will result in double taxation.

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[142]Neil E. Harl, Farm Estate and Business Planning, (Annotated Materials) (Des Moines: R.E. Hays and Associates, April 1980), pp. 10-21.

The Tax Reform Act of 1969 added Section 385 to the Internal Revenue Code. Section 385 gives the Secretary authority to issue regulations providing rules for distinguishing debt from equity. Also, the statute lists the following factors to be used in the regulations:[143] 1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, 2) whether there is subordination to or preference over any indebtedness of the corporation, 3) the ratio of debt to equity of the corporation, 4) whether there is convertibility into the stock of the corporation, and 5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

Until the regulations, which are forthcoming for Section 385, are presented, it would seem wise for any farm corporation issuing debt securities to take into consideration the above factors.

E. Corporate Buy-Sell Agreements

Corporate buy-sell agreements are often used to help transfer ownership of the farm corporation from one generation to the next. Such an agreement can also establish a market for the stock if a shareholder ever desires to withdraw from the corporation during his lifetime. This is accomplished by requiring the shareholder to offer his stock to the remaining shareholders or to the corporation itself at some stipulated price. This insures that nonfamily members are kept out of the family business.

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[143]Internal Revenue Code Section 385(b).

Since this chapter involves estate planning, the concern here will mainly be with the role of the buy-sell agreement in the intergenerational transfer of the farm corporate business.

1. <u>Definition</u>

A corporate buy-sell agreement is a contract whereby the corporation and/or an individual (usually remaining shareholder(s)) promises to buy the stock, and the shareholder promises to sell, upon the happening of a specified event. Usually, this event is the shareholder's death. However, there might also be provisions for sale upon the disability or retirement of one of the shareholders. Or the event may be simply a shareholder's desire to withdraw from the corporation. It is also possible that the buy-sell agreement may be merely an option to purchase upon the happening of some specified event.

In addition, the contract-agreement normally specifies either an actual purchase price or else a procedure or formula that must be followed in determining the price. One commonly used procedure is to require either the Board of Directors or else all the shareholders to get together each year to set a price at which all parties would be willing to buy or sell their stock during the subsequent 12-month period. Also the terms under which payment will be made may be specified. For example, the purchase price could be paid in cash or else in installments over a period of several months or years at a specified rate of interest.

2. <u>Advantages</u>

A corporate buy-sell agreement offers several estate planning advantages. First of all, potential problems with heirs becoming stockholders in the business are avoided. This is especially advantageous to farm corporations as it avoids problems associated with off-farm heirs becoming stockholders. The remaining stockholders can continue to operate the business as they see fit. Thus, it protects the business by keeping it intact.

The agreement can offer an immediate market for the shares of stock in a stockholder's estate. Also, if the agreement calls for an immediate cash payment in exchange for the stock upon the death of a stockholder, it can be an important source of liquid funds (to pay estate taxes and other estate settlement costs) for the decedent's estate. If the price in the agreement has been updated yearly, there is a chance that this price will be adopted for estate tax valuation purposes.

Finally, an agreement eliminates the risk of the corporation being barred from a Subchapter S election because either a nonqualified trust or else a nonconsenting stockholder became a stockholder in the corporation.

3. Types of Buy-Sell Agreements

There are three different types of buy-sell agreements.

a. Cross Purchase Plan

This is an agreement by two or more stockholders that if one of them either dies or desires to withdraw, the other stockholder(s) will purchase his stock. For example, assume a farm corporation has two stockholders, Joe and Pete (they are also brothers). Joe and Pete each agrees that, upon his death, his estate must sell his stock holdings and the survivor must purchase the stock from the decedent's estate.

This type of agreement is relatively simple and quite useful when the number of stockholders is small. However, it can become quite complicated when there are many stockholders.

b. Stock Redemption Agreement

Under this agreement the corporation itself agrees to buy (redeem) all of the decedent's stock rather than having each of the remaining stockholders purchase a portion of the decedent's stock as is done in cross purchase agreements. For example, assume Pine Valley Farms Inc. has two stockholders, Joe and Pete. Pine Valley Farms Inc. agrees to buy the shares of the first stockholder to die. In turn, Joe and Pete each agree that his estate will sell or tender for redemption the shares he owns.

When the corporation consists of several stockholders, this method has the advantage of simplicity over cross purchase agreements. However, there are dangers associated with stock redemption plans. The biggest danger is that the stock redemption may be treated as a dividend. Section 301 of the Internal Revenue Code creates a presumption that any corporate distribution of property out of the corporation's earnings and profits in exchange for its own stock will result in a dividend distribution to the individual receiving the distribution.

In recognition of this disadvantage, the code includes two sections (302 and 303) which allow relief from 301. Generally, the relief available under these two code provisions is that the redemption is treated as a sale or exchange of stock, thus allowing the distribution to be taxed as a capital gain instead of being treated as a dividend.

Section 303 involves partial redemptions. The death of the stockholder whose shares are to be redeemed is a requirement for its use--i.e., it can't be used during the lifetime of the redeeming stockholder. The amount that can be distributed under 303 without being taxed as a dividend is limited by the amount of estate and death taxes, estate administration expenses, and funeral costs allowable as deductions for federal estate tax purposes. Although they are too numerous and detailed to mention here, there are also several other requirements which must be met in order to qualify for this tax provision. The main point to be made is that it takes careful planning for stock to be eligible for 303 redemptions.

The main advantage of a 303 redemption is that it can help satisfy the liquidity needs of an estate. Another related estate planning advantage is that redemptions can take place over the 15-year period of installment payment of federal estate tax if the estate adopts that option of payment.

Section 302 will allow redemption of unlimited amounts of stock--even a complete redemption of all of a stockholder's interest in the corporation. Also, redemptions can be made during the stockholder's lifetime or after his death (303 redemptions can only take place after death). However, the availability of the provision is severely limited by a set of qualifying conditions, with the most complex and limiting being attribution rules. These qualifying provisions are far too detailed and complex to be discussed here. They are merely mentioned so that the reader is aware of their existence.

c. Combination or hybrid agreement

This type of agreement combines the advantages and disadvantages of both a cross purchase agreement and a redemption agreement when the situation necessitates such an arrangement. As an example, assume Pine Valley Farms has two shareholders, Joe and Pete, each owning 1,000 shares of stock. There could be a cross purchase agreement for 550 shares of stock and a stock redemption agreement for the remaining 450.

4. Funding the Arrangement

A key to any type of buy-sell agreement is the method of funding. If proper plans haven't been made to obtain funds to pay for the stock, the buy-sell agreement is practically worthless. The method and cost of funding each of the arrangements will, of course, be different. However, there are several common methods that should be mentioned:

a. Life Insurance

In cross purchase plans, each stockholder owns an insurance policy on the life of each of the other stockholders. Upon the death of a stockholder, the surviving stockholder(s) collects the insurance proceeds and uses them to purchase the decedent's stock. However, the insurance premiums paid by the stockholders are not tax deductible. Also, if there are several stockholders, the total number of insurance policies required is quite high--therefore the premiums can be quite costly. A formula for determining the number of insurance policies is as follows:

$n(n-1)$, where n is the number of stockholders (assuming all are insurable)

If the agreement involves a corporate redemption, the corporation itself carries a life insurance policy on each stockholder whose stock is to be purchased. Upon the death of a stockholder, the corporation collects the insurance proceeds and uses them to purchase the decedent's stock. However, insurance premiums paid by the corporation to fund the redemption of shares are not tax deductible.

b. Debt Instruments

Another possible method for funding involves the use of a debt instrument which allows the purchase price to be paid over an extended period of time. The corporation or shareholders may desire to obtain some form of collateral for the payment of the purchase price. Such security may include a first mortgage on real estate, a lien on machinery, or it may simply involve the shares of stock being sold. If the security available isn't adequate, the seller may wish to impose some restrictions on the business such as limits on expansion or capital expenditures, the maintenance of a minimum ratio of assets to liabilities, limits on the salary of key employees, etc.

c. Contributions to a Sinking Fund or from Accumulated Earnings

In some cases, the purchase price may come from accumulated earnings in the business or else through periodic contributions to a sinking fund. Such arrangements may be particularly useful where one of the shareholders is uninsurable.

However, these two methods may not be very practical for farm corporations since most farm businesses do not have the necessary cash flow to contribute to a sinking fund nor do they normally accumulate a sufficient amount of earnings to provide for a buy-out of all a stockholder's shares.

F. Trusts

Although a trust instrument is a very complex legal set-up with complicated legal language, the basic concept of a trust is quite simple. The person making the trust transfers property to someone else who, in turn, manages the property for the benefit of a third party. Thus, a trust consists of four essential elements: 1) the person who causes the trust to come into existence is known as the trustor, grantor, or settlor. Or, if the trust is created in a will, a testator. 2) The property held by the trust is often referred to as "corpus." Trust property may be any recognized property interest in personal or real property or an enforceable contract right. 3) The one who owns the property for the benefit of another is known as the trustee. The trustee may be an individual or a corporation (bank, trust company, etc.) or both jointly. The trustee has legal title to the trust property. 4) The third party receiving the benefits from the trust is known as a beneficiary. Final ownership or rights to the trust property are eventually transferred to the beneficiary, according to directions and conditions spelled out in the trust agreement.

Even though there are normally at least three parties to a trust, they do not necessarily have to be different legal entities. For example, the grantor of the trust might also be a trustee or a beneficiary may be one of the trustees. However, at least two different legal entities are normally required for a legally valid trust.

Trusts are very flexible estate planning tools. They can be made to do almost anything the grantor might do for himself and also some things that he might not be able to do because of a lack of skill, disability, sickness, or death. The ability of a trust to function after the death of its grantor makes it a useful estate planning tool. In fact, a trust can continue as long as any living individuals the grantor names remain alive plus 21 years after the last of those designated dies.

Because of the wide variety of ways a trust can be designed to apply to a particular situation, there are an infinite number of possibilities for uses of a trust. There are several different types of trusts. However, space does not permit a discussion of all their potential uses, nor can all of the various types of trusts be described. This discussion will, instead, only be concerned with the two main types of trusts--testamentary trusts and living trusts.

1. Living Trusts

Living trusts are also referred to as "intervivos" trusts meaning "between lives." These trusts take effect during the lifetime of the grantor. Living trusts may, and often do, continue on after death. They may be either revocable or irrevocable.

Under a revocable living trust, the grantor retains the power or right to amend, alter, or completely revoke the trust. Property can be put in or taken out at any time to best suit the estate planning needs of the grantor.

Revocable living trusts generally do not, in themselves, result in estate tax savings in the grantor's estate. This is because the grantor's right to amend, alter, or revoke the trust causes the value of the property in the trust to be included in the grantor's gross estate for estate tax purposes. However, revocable living trusts may result in a savings of estate settlement costs for the grantor. The reason for this is that property put in the trust before the grantor's death does not pass through probate. Therefore, some of the expenses associated with probate are reduced. In addition, there are non-monetary advantages available by avoiding probate. The time delays associated with probating an estate are eliminated. Also, privacy is another advantage. The terms of the trust (amount of assets, beneficiaries, etc.) are not a matter of public record as a probated will would be.

Revocable living trusts often appeal to older individuals as they pass into the stage of being unable or unwilling to properly manage their property interests. One of the main reasons for this is that the trust can provide the needed property management, thereby relieving the grantor of the burdens of investment management.

Revocable living trusts are often used in farm situations to allow use of the maximum marital deduction for federal estate tax purposes. The basic idea behind such a trust is as follows. The trust is established before the death of the farmer. During the grantor-farmer's lifetime, the trust property could be managed and operated by the owner the same as it was before being transferred. In other words, the trust is inactive and thus there probably would not be any fees as the grantor usually serves as trustee. The trust contains a provision that it will be activated upon the death of the grantor-farmer (assuming his wife survives him) and the trustee will divide the trust estate (which may also include property added from the grantor's estate) into two trusts. These two trusts are commonly referred to as the "Marital Trust" or "Trust A" and the "Family Trust" or "Trust B." The "Marital Trust" is intended to pass assets to the surviving spouse having a value equal to the maximum marital deduction. This trust is thus intended for the benefit of the surviving spouse. The rest of the estate is passed on to the "Family Trust." This trust is intended for the benefit of the children or someone other than the surviving spouse, but provisions can be made for the income to be paid to the spouse. In addition, provisions can also be made for the spouse to invade the principal of the family trust under specified circumstances such as a need to maintain the standard of living that the spouse and children enjoyed when the husband was alive.

Instead of splitting the trust into two trusts upon the death of the husband, some estate planners set up two living trusts for the husband's and wife's estate. The basic results are, however, the same as in the above example.

2. Irrevocable Living Trusts

An irrevocable living trust involves making an irrevocable transfer of property to a trust. In other words, it really is a gift into a trust.

Such a trust can result in federal estate tax savings. The trust property is normally not taxable in the grantor's estate if the grantor did not retain the right to enjoyment of the property (receive income) nor retain any decision making powers over the trust. Thus, the potential estate tax savings for the grantor comes about because the transfer of property to the trust reduces his taxable estate--not because of the trust itself. However, there might be gift tax consequences when the property is transferred to the trust. Thus, the amount of actual tax savings depends on whether the reduction in estate taxes was greater than the increase in gift taxes.

An irrevocable living trust can result in estate settlement cost savings, just as a revocable living trust can, because the trust property is not subject to probate. In addition, the time delays and publicity of probate are avoided.

Irrevocable living trusts were very popular before the Tax Reform Act of 1976 because, at that time, the gift tax rates were lower than the estate tax rates. In fact, the gift tax rates were approximately three-fourths of the estate tax rates. However, the '76 Tax Reform Act unified these rates, thus reducing the tax advantages of making gifts during a person's lifetime.

The biggest disadvantage of irrevocable living trusts is that many people are afraid to give up control of the asset forever. However, the loss of control is really no more than is given up when a gift is given.

One possible use for an irrevocable living trust in a farm situation is to keep the parent's estate from growing by giving some of their property (usually farmland) to their children in trust.

3. Testamentary Trusts

Testamentary trusts are not in existence during the lifetime of the grantor, so therefore the grantor retains the complete right to the property till death. These trusts are incorporated as part of the grantor's will and become effective at death. In fact, the trust provisions are incorporated into the will document itself. Thus, the trust is really the beneficiary of the estate.

A testamentary trust itself saves neither federal estate taxes nor estate settlement costs. The reason for this is simple. Because the property goes into trust after the death of the grantor, the property must pass through probate. Thus, there are no chances for a savings of any estate settlement costs associated with probate proceeding. And because the grantor still retains all rights to the property till death, all the property will be included in his gross estate, thus resulting in no reduction of federal estate taxes.

The biggest use of a testamentary trust is to hold and provide management of property for minor children if the parents should die before the children reach legal age. Usually, the trust will provide directions for the trustee to pay out money as needed for the care, support, and education of the children. Then when the children reach legal age (or a specified age when the children are old enough to assume management responsibility), they may receive their share of the trust property.

The same two trust plans described earlier, utilizing a "Marital Trust" and a "Family Trust," can be accomplished with a testamentary trust. However, it is not used as often because there are no probate savings.

4. Summary of Trusts

Even though trusts are very versatile estate planning tools, they are not estate planning cure-alls. They should not be used in an estate plan unless there is an estate planning objective that can be satisfied only through the use of one.

One must also remember that there are costs associated with trusts. Legal fees must be paid to an accountant to take care of filing annual tax forms. In addition, a trustee fee must usually be paid with a possible exception being trustees who are family members. The fees charged by bank trust departments for handling a trust vary, depending on the amount of assets in the trust and the types of services required. A typical range of annual fees for the management of a stock portfolio runs between four-tenths and three-quarters of 1 percent of the property in the trust. The more detailed the management required, the higher the fees will be. In the case of farms, it is common for a trustee to charge a farm manager's fee.

G. Case Examples

1. Disadvantages of Holding Property in Joint Tenancy

In the discussion on joint tenancies earlier in the chapter, it was noted that, as estates grow larger, joint tenancy becomes less desirable as a form of property ownership. It is generally believed that joint tenancy between husband and wife becomes an estate planning disadvantage (increases estate taxes) for estates larger than \$200,000-\$300,000, depending upon the particular circumstances. For estates below \$200,000, and not expected to increase much in value, joint tenancy between husband and wife is probably an acceptable method of co-ownership.

One of the main objectives in estate planning for farm couples, especially those with large estates, is to even out the ownership of property so that it all doesn't end up in the hands of the surviving spouse. Unfortunately, holding all property in joint tenancy between husband and wife creates the very situation you are trying to avoid. When property is owned jointly, the taxes are relatively low upon the death of the first spouse, due mainly to the marital deduction. Remember that upon the death of the first spouse, all the jointly-held property passes to the surviving spouse--no matter what the will states. Therefore, when the surviving spouse dies, the federal estate tax bill really escalates due to the graduated nature of the tax and because the marital deduction can't be used. Thus, in many cases, the result is that the same estate is taxed twice (usually in a period of a few years as husband and wife normally die within a few years of each other)--once at the death of the first joint tenant and again at the survivor's death.

Let's look at a case example involving a farm corporation to illustrate this point. The assumptions to be made are as follows:

*$700,000 gross estate consiting of stock in a farm corporation owned in joint tenancy between husband and wife.

*All farm assets (machinery and equipment, livestock and farmland) in the corporation.

*Estate Administration Expenses 5 percent of Gross Estate
Husband dies first (1981) and all stock is transferred to the wife.

*Wife lives on income from property without touching the principal. Amount of principal remains fixed from husband's death to wife's death--no inflation or deflation in this time period.

*Property passes to two children after death of both parents.

*No farm exemption and no deferrment of inheritance taxes for Michigan Inheritance Tax Purposes.

The total taxes and expenses due at the time of the husband's death would be as follows:

A

	Gross Estate	$700,000
Minus:	Administration Expenses	0
	Adjusted Gross Estate	700,000
Minus:	Marital Deduction	350,000
	Taxable Estate	350,000
	Tentative Tax	104,800
Minus:	Unified Credit	47,000
	State Death Tax Credit	0
	Federal Estate Tax Due	$ 57,800

B

	Gross Estate	$350,000
Minus:	Administration Expenses	0
	Adjusted Gross Estate	350,000
Minus:	Marital Deduction	250,000
	Taxable Estate	100,000
	Tentative Tax	23,800
Minus:	Unified Credit	47,000
	State Death Tax Credit	0
	Federal Estate Tax Due	$ 0

Since the stock was owned jointly, there are no administration expenses or Michigan inheritance taxes. The only expense due on the husband's estate would be the federal estate tax.

The reason for the two examples is that the amount of federal estate tax due depends upon how much the wife contributed toward the estate's creation. Example A assumes that the contribution was all by the husband. Example B assumes that each spouse contributed equally toward the estate buildup; thus, only one-half of the estate is included. It is believed that these would be the two extremes--most farm situations would fall somewhere between them. In either case, the amount to be included in the wife's estate is $700,000.

The total taxes and expenses due on the wife's estate are as follows:

	Gross Estate	$700,000
Minus:	Administration Expenses	35,000
	Adjusted Gross Estate	665,000
Minus:	Marital Deduction	0
	Taxable Estate	665,000
	Tentative Tax	216,850
Minus:	Unified Credit	47,000
	State Death Tax Credit	16,600
	Federal Estate Tax Due	$153,250

Michigan Inheritance Tax for Each Child:

Amount	Rate	Tax
$ 10,000	Exempt	$ 0
40,000	2%	800
200,000	4%	8,000
82,500	7%	5,775
		$14,575

$14,575
X 2 children
$29,150

The above example shows that the total taxes and expenses due on the wife's estate are $217,400. This means a total cost on the estates of both husband and wife would be $275,200 if it is assumed that the original estate had all been contributed by the husband. Or the total cost on both estates would be $217,400 if it is assumed that both had contributed towards the buildup of the estate. Most farm families would find that their costs would most likely fall somewhere in between these two amounts.

There are several different estate planning tools available that could reduce the transfer costs of this $700,000 estate, consisting of corporate stock, and still protect the surviving spouse until her death. Space does not permit going into all the alternatives. Instead, this discussion will concentrate on what is probably the most commonly used tool in this situation--the revocable living trust. So let's look at the potential savings available through the use of this type of trust.

2. Estate Tax Savings Through Use of a Revocable Living Trust

The same assumptions that were made for the joint tenancy example will apply, except that the ownership and distribution of the corporate stock will be somewhat different. Example A will assume that the original contribution was entirely by the husband. Before his death, it will be assumed that all the corporate stock will be transferred to a revocable living trust. Upon the husband's death, the trust will be activated with trustee management. The trustee will divide the trust estate into a "Marital Trust" and a "Family Trust." Thus, all the property will not pass to the wife upon the husband's death--only an amount equal to the marital deduction.

Example B will assume a somewhat different pattern of stock ownership and distribution. It will assume that each spouse contributed equally toward the estate buildup. Before the death of either spouse, it will be assumed that two revocable living trusts will be set up for each of the husband's and wife's estate. Upon the grantor's death, the trust will be activated with trustee management.

These two examples attempt to represent similar assumptions made for the joint tenancy example.

Let's first look at the total taxes and expenses due on the husband's estate for example A.

	Gross Estate	$700,000
Minus:	Administration Expenses	0
	Adjusted Gross Estate	700,000
Minus:	Marital Deduction	350,000
	Taxable Estate	350,000
	Tentative Tax	104,800
Minus:	Unified Credit	47,000
	State Death Tax Credit	5,200
	Federal Estate Tax Due	$ 52,600

Michigan Inheritance Tax:
Wife, $350,000 - $65,000
Exemption = $285,000

Amount	Rate	Tax
$ 10,000	Exempt	$ 0
40,000	2%	800
200,000	4%	8,000
35,000	7%	2,450
		$11,250

These calculations show that the total taxes and expenses due on the husband's estate are $75,450

2 Children, $175,000 Each

Amount	Rate	Tax
$ 10,000	Exempt	$ 0
40,000	2%	800
125,000	4%	5,000
		$5,800

$5,800 x 2 children = $11,600

The calculations for the taxes due on the wife's estate for example A will not be shown because similar calculations have been shown earlier. The total amount of federal estate tax due is $52,600 and the Michigan inheritance tax is $11,600 ($5,800 for each child) making a total of $64,200 due on the wife's estate.

For example A, this means a total cost on the estates of both husband and wife would be $139,650. When the same assumptions were made for the joint tenancy example, the total cost was $275,200. Thus, the difference between the two would be $135,550. The amount that would actually go to the children would be a few thousand less if the total costs for drawing up the trust agreement and other expenses were included. However, well over $100,000 would go to the couple's children instead of the government!

Let's look at example B. No calculations will be shown because similar calculations have been shown earlier. Since $350,000 is the taxable estate for both husband and wife (the marital deduction is not used for either estate), the federal estate tax due on each estate is the same--$52,600. The Michigan inheritance tax is also the same since each trust eventually goes to the two children. This amounts to $11,600. This means a total cost for each estate would be $64,200 or $128,400 total for both estates if it is assumed that each spouse contributed equally toward the estate buildup. When the same assumptions were made for the joint tenancy example the total cost for the estate transfer to the children was $217,400. The amount that would go to the couple's children instead of the government would be $89,000 minus legal and accounting fees for the trust.

These savings in estate transfer costs due to use of a revocable living trust are accomplished by means of by-passing the surviving spouse with property ownership and control. This avoids the doubling up disadvantage associated with joint tenancies. However, the surviving spouse gives up some property rights in order to achieve tax savings for the children. The wife can't invade the principal of the family trust (except in a few emergency situations) and she can't influence who will receive the family trust property at her death.

Even though this example assumed a $700,000 estate, the general results for other estate sizes can be predicted. For estates larger than $700,000, the savings achieved through the use of a revocable living trust would most likely be greater while the savings would not be as great for smaller estates. Of course, there probably would be little, if any, savings for estate sizes between $200,000 and $300,000. Below $200,000, trusts may be more expensive than jointly-held property between a husband and wife.

This case example assumed that all the jointly-held property was stock in a farm corporation. However, the general results would be the same if the property consisted entirely of farmland or a combination of farmland and corporate stock or any other type of real or personal property. No matter what type of property is jointly-held between husband and wife, the results will be the same. Therefore, if a family farm incorporates only the operating side of the business and continues to hold the farmland in joint ownership, they face the same disadvantages.

3. Gifts of Stock Under the Federal Gift Tax Annual Exclusion

The advantages of making annual gifts of corporate stock has been discussed several times in this thesis. The possibility of a discounting of these gifts makes them sound even more advantageous. However, in these inflationary times, gift programs involving transfers of stock under the $3,000 federal gift tax annual exclusion (per recipient per year) may not be able to play as large a role in the intergenerational transfer of a farm corporation as one might think.

Let's take our $700,000 estate as an example. If it is again assumed that all assets are in the corporation, it is likely that the value of the corporate assets will increase 8 to 10 percent per year from inflation alone. This increase in the value of stock would most likely stem from an increase in land values. Thus, the value of the corporation could increase $56,000-$70,000 per year from inflation alone, It is also possible that there will be a yearly increase in the value of the corporate stock from annual corporate earnings. That is, all the earnings would not be paid out in the form of dividends, bonuses, salaries, interest payments and other business expenses. Therefore, the annaul increase in the value of stock would likely be even greater than $56,000-$70,000.

However, let's assume that our $700,000 corporation increases in value 8 percent per year from inflation only and that all corporate earnings are paid out of the corporation, i.e., no annual net earnings. It will also be assumed that the annual gifts of corporate stock given by the parents to their children will be discounted 25 percent for estate tax purposes. Consequently, a husband and wife could jointly give away $8,000 worth of stock per year ($8,000 x 75% = $6,000) to each child under the annual exclusion.

How many children will it take to give away the $56,000 increase each year from inflation alone? If none of the children are married, it would be necessary to have seven children in the family to give away the $56,000 increase in the value of the stock. Or, if some of the children were married and a gift was also given to each child's spouse, the $56,000 increase could be given away to three couples and a single child.

Thus, it takes a big family just to give away (tax-free) the annual increase in value from inflation for a $700,000 estate. If the stock wasn't discounted, it becomes even harder. In addition, there is also the danger that the gifts will be declared a future interest and hence not be eligible for the federal gift tax annual exclusion.

The problem becomes even more severe in larger estates. Of course, it is likely that Congress will increase this annual exemption, but when this is done, the inflation rate may be increasing at an even faster rate.

The main point of this discussion is that it's very difficult in medium- to large-size farm estates to make much headway in reducing the parent's estate by transferring part of the business tax-free to the next generation. It's not uncommon to find $750,000-$1,000,000 farm estates today, so this is not just a problem with large operators only. If farmland keeps increasing in value in the 1980's and beyond, as it did in the 1970's, about all that can be accomplished through a tax-free gift program is to give away part of the yearly increase in value of the corporation from inflation. If these rates of inflation slow down or the country enters a period of deflation, then, of course, these conclusions would not hold.

This discussion does not mean to infer that parents should not make use of a yearly gift program as part of their estate plan. It is still a useful estate planning tool that should be used. However, one should recognize that other tools must also be used if there is a desire to either reduce or stabilize the value of the parent's estate.

4. Use of Debt Securities in Addition to Common Stock

Let's look at the use of debt securities in addition to yearly gifts as a possible way to "cap" the value of the parent's estate at its current value.

Again, we will use our $700,000 estate. Let's assume that the parents own all the farm property and incorporate the farm business, taking in exchange $300,000 worth of debentures with an 8 percent rate of interest and 20 year maturity plus $400,000 worth of common stock. Further, a 8 percent yearly increase in the value of the corporate assets from inflation will be assumed. There will be no increase in the value of the stock shares from annual earnings. Also, it will be assumed that the parent's give away $32,000 of stock shares tax-free each year--$16,000 each to two married sons and their wives.

Does this plan stabilize the estate value for the parents? Yes, it does if one assumes that the parents spend the $24,000 yearly interest payment so that it doesn't further increase their $700,000 estate.

The reason behind this is that the $24,000 needed to pay yearly interest on the debentures would leave a $32,000 yearly increase ($56,000 - $24,000) in value for the $400,000 of common stock--since all appreciation goes to the common stock. Since it is assumed that the common stock appreciates $32,000 yearly and the parents give away that $32,000--their estate should remain fixed at $700,000.

However, in order to "cap" the parent's estate under this plan there was a $24,000 withdrawal (in interest payments) from the corporation. This $24,000 ended up in the parent's hands and it was assumed that they spent it. In other words, the corporation itself sacrificed $24,000 to go to the parents that instead could have been used for some other purpose such as further investment or an increase in stockholder-employee salaries. If the assumptions were changed and the parents didn't spend the $24,000 and they died that year--their estate would have increased in value by $24,000 ($700,000 stock, $24,000 cash).

Thus, there's really no magic involved. In fact, this plan is similar to an actual sale. Assume that at the time of incorporation the parents left out a $300,000 parcel of farmland and sold it on a land contract to the children for 8 percent interest and a balloon payment in 20 years. Under such a plan, there still must be a yearly withdrawal of $24,000 from the business and it goes to the parents. The increase in value of the $300,000 parcel of land goes to the children.

5. <u>Two Classes of Stock</u>

This is another method sometimes used to stabilize or freeze the value of the parent's estate. The basic idea is that common stock is given away to the children while the parents retain the preferred stock.

The common stock can fluctuate in value so, assuming inflation, the increase in value goes to the children. The preferred stock retains a fixed value. Since the parents retain this, their estate value is fixed. The idea sounds great in theory, but there's a catch.

In order to satisfy the IRS, dividends will probably have to be paid on the preferred stock. Of course, dividends are paid out of corporate after-tax earnings and are subject to taxation when received by the stockholders (in this case, the parents).

Thus, the corporation faces somewhat the same situation as it did when debt securities were used. There is a yearly withdrawal from the business (dividends) and it goes to the parents. If the parents don't spend the dividend money, their estate value will increase.

6. Summary

The point to be made in this discussion on gifts, debt securities, and two classes of stock is that these estate planning tools alone can't transfer the estate to the children tax-free--if one assumes an estate size above $700,000 and perpetual inflation.

At some point in the life cycle of the business, there must be a withdrawal from the business to transfer the estate. This withdrawal can be gradual or it can be in one lump sum at the death of the parents. Only time will tell which method is best.

CHAPTER X

SUMMARY, CONCLUSIONS, AND NEED FOR FURTHER RESEARCH

A. Summary

This research project has explored and analyzed the potential use of the corporation as a form of business organization in Michigan agriculture. An attempt has been made to present the analysis in a simplified and systematic manner so that farmers, as well as their professional counselors, could expand their knowledge in the particular area desired.

Chapter I noted some of the tends taking place in the U.S. and Michigan agriculture that may lead to an increase in the use of the corporate form of business organization in the future. These trends include a continual growth of the average size of farm operations along with the increasing use of mechanization and capital. Inflationary pressures have greatly increased the value of farm assets--especially farmland--which has made it more difficult for an individual to begin farming on his own as well as making it increasingly difficult to transfer the farm operation to the next generation without significant tax liability. In addition, the increasing worldwide demand for food has raised the price levels for many commodities which, in turn, has increased farmers' incomes.

In the second chapter, the use of corporations in U.S. and Michigan agriculture during the past decade was summarized. Although corporations still account for a small percentage of farm numbers, their use seems to be increasing with each passing year. Contrary to popular opinion, large publicly-held corporations do not constitute a majority of farm corporate numbers, nor do they produce a majority of our agricultural products. Compared to the role of corporations in U.S. agriculture, farm corporations in Michigan play a smaller role in the state's agriculture. Also, Michigan farm corporations are much smaller in size than the U.S. average.

Chapter III examined the legal and structural characteristics of corporations. In addition, the similarities and differences that exist between sole proprietorships, partnerships, and corporations were explored. A corporation is a separate legal entity created according to state law. As a legal person, the corporation can do some things which a sole proprietorship and partnership cannot. It continues when owners change and is not dissolved upon the death of its owners as are the sole proprietorship and partnership. A corporation can hire its owners as employees and give them special employee fringe benefits. The liability of all the owners of a corporation can be limited to the amount of money they have paid or promised to pay into the corporation.

The fourth chapter identified the federal and Michigan taxes that apply to both regular and Subchapter S corporations. When a regular corporation is formed, it results in the creation of a new taxpayer as the corporation itself is taxed on income. For federal income tax purposes, there are special rates that apply only to corporations. A corporation is taxed according to the regular methods unless the shareholders choose the tax-option or Subchapter S status. Subchapter S corporations are normally not taxed on any income as the income is passed through to the shareholders who, in turn, pay tax on their respective share of income. A corporation must, however, meet the qualifying criteria before it can elect Subchapter S status. Both regular and Subchapter S corporations must pay employee payroll taxes (social security, worker's compensation, unemployment compensation) as well as property taxes on corporate real and personal property. Neither a Subchapter S or regular farm corporation in Michigan currently has to pay any state income tax on earnings. The shareholder-employees must, however, pay individual state income taxes on any earnings.

The advantages and disadvantages of incorporating a farm business were examined in Chapters V and VI respectively. Where appropriate, the pros and cons for the Michigan situation were discussed. Although there are numerous advantages and disadvantages for incorporating, there seems to be no one overriding factor which dictates whether or not to form a corporation. Each farm operation must analyze its own situation to see whether the plusses outweigh the minuses. In Michigan, there are several disadvantages which may be quite costly. First of all, Michigan has some of the highest, if not the highest, worker's compensation rates in the nation. Second, incorporating may result in the loss of the Homestead Property Tax Credit, depending upon whether the corporation is a regular or Subchapter S corporation as well as whether the farmland is transferred into the corporation. Third, there is a chance that farm real property interests held in a corporation may not be eligible for the optional deferrment and partial exemption allowed on farm real property for purposes of the Michigan Inheritance Tax.

Chapter VII explained the entire incorporation process from the planning stages to the transferring of assets into the corporation. In addition, the dissolution and liquidation process was examined. Both incorporating and dissolving a corporation involves dealing with complex legal and tax matters which will require the services of an attorney and accountant. Since it is probably easier to transfer assets into a corporation than it is to get them out, it would be wise to look at the possible tax ramifications of dissolving a corporation--before it is formed.

Chapter VIII, utilizing case examples, compared the amount of annual taxes which must be paid at various net farm income levels for a sole proprietorship, regular corporation, and Subchapter S corporation. The results indicate that there are no annual tax benefits available through forming a regular corporation for any type of farm operation, unless the net farm income level is above $30,000 per proprietor or partner. For farm operations with high amounts of capital gain income (swine, dairy, beef cow-calf), the net farm income level must be slightly higher (from $40,000-55,000) in order to achieve tax savings. As expected, the cases indicated that there is no significant difference in the annual taxes incurred by a proprietorship and Subchapter S corporation.

Chapter IX discussed some estate planning tools which can be used in conjunction with the corporate structure to aid in the intergenerational farm transfer process. Even though the use of a particular tool will vary according to the particular farm circumstances, some tools are more suited to larger estates, while others are more advantageous in smaller estates. For example, while joint ownership of corporate stock or any other farm property between husband and wife is useful for smaller estates, it should be avoided in estates larger than $300,000.

In contrast, the use of revocable living trusts can result in estate tax savings in larger estates while offering little, if any, savings in smaller estates. One tool, however, should be used no matter what the estate size may be. A buy-sell agreement should be a part of every farm corporation. It can prevent many future problems associated with heirs, minority shareholders, and even majority shareholders. Oftentimes these problems can divide a family and cause everyone undue hardship and frustration.

B. Conclusions

While the corporation is not a cure-all business organization for today's farm businesses, it can be an advantageous form in several situations.

Current tax laws and regulations make the regular corporation the preferred business organization for operations with high annual net farm incomes. This is especially true for expanding farm operations as these tax savings can be used for further growth and investment. The corporation may also permit longer range planning since it can have a perpetual life.

For those individuals with substantial non-farm assets, the corporation offers a means to limit one's liability to the amount of investment in the corporation.

The estate planning advantages of corporations can be particularly attractive to those farm businesses which have decided to continue as an operating unit beyond the death of the parents. The relative case of transferring shares of stock and the minimal effect (assuming proper advance planning) of the death of a shareholder on the business organization can help assure the management and ownership continuity necessary for keeping the farm operating at peak efficiency from generation to generation.

The corporation may also offer advantages in attracting outside equity financing. Although the use of this form of capital in agriculture has been somewhat limited in the past, there is a good chance that this could change. If land prices double and maybe triple in the 1980's, as many experts predict, capital could well become a limiting factor to the growth of some farm businesses. If, and when this happens, farm businesses may incorporate for this reason.

The corporation can also have its drawbacks. It is a complex and formal legal organization which requires a certain dependency upon professionals. In fact, it is virtually required to meet with an accountant and attorney at least once a year. Some farmers may be unwilling to let these advisors play such a role in their business. Also, the shareholders themselves must have some knowledge and understanding about corporate procedures and regulations so that they can properly manage the corporation and use it to their advantage. Otherwise, they may find themselves worse off than they were before they incorporated.

A corporation cannot be dissolved and liquidated as easily as it can be formed. Often there are substantial tax consequences when assets are removed.

Unfortunately, many people don't discover these drawbacks until after incorporation. As is often the case, experience is the best teacher.

1. Need for Individual Analysis

It can be seen that there is no easy, set answer to the question of whether to incorporate a particular farm operation. Selecting the "best" form of business organization involves an in-depth analysis of the circumstances surrounding the farm operation as well as a consideration of the goals, objectives, and capabilities of current and future business associates. This idea has been mentioned over and over again in almost every chapter of the thesis. It is perhaps the most important conclusion of this study.

Recognizing the importance of a thorough analysis of the fact situation before incorporating, some of the more important factors that enter into this analysis will be summarized below. This discussion will be separated into two categories: 1) Important considerations when deciding whether or not to incorporate, and 2) Areas to pay careful attention to once the decision to incorporate has been made.

2. Deciding Whether or Not to Incorporate

The reasons behind a desire to incorporate a farm business can be as diverse as the individual(s) behind the decision. However, in the author's opinion, these reasons can be reduced to two major categories a) annual tax savings and b) achieve estate planning objectives. Before these two categories are discussed, let's look at some other commonly listed advantages for incorporating and the reasons why they may not offer much help to the average family farm business.

a. Limited Liability

Limiting liability is very advantageous to many non-farm businesses.

In fact, it is often listed as the number one advantage. However, it probably doesn't offer any advantages to a typical family farm business.

First of all, the majority of financial institutions that lend money to a farm corporation will require the principal shareholder(s) to personally guarantee the loan. If this is done, limited liability is lost as the shareholder(s) has agreed to pay the creditor if the corporation itself runs out of money. Most farm families have an insignificant amount of non-farm assets. Therefore, there really isn't many outside assets that need to be protected.

In a lawsuit against a corporation, a plaintiff will most likely name officers and directors as well as the corporation itself. Since most shareholders in a closely-held family farm corporation are also officers and directors, it may be difficult to limit their liability.

b. Employee Fringe Benefits

Even though there are a substantial number of fringe benefits available to stockholder-employees, the tax savings resulting from their use will be partially, if not completely, offset by increased social security taxes and the necessity of paying worker's compensation taxes.

For 1981, the extra social security costs for a stockholder-employee drawing an $18,000 salary would be $720 over that paid for a self-employed farmer.

Worker's compensation costs will vary by state with most states having lower rates than those in Michigan. For 1980, the costs for an employee drawing an $18,000 salary on a dairy or livestock farm in Michigan would be $2,797.20.

Thus, the extra costs for these two items for a stockholder-employee of a Michigan farm corporation drawing an $18,000 salary would be over $3,500. For three employees, the cost would be over $10,000--which is quite a substantial extra cost associated with incorporating.

Retirement plans are often mentioned as being one of the more important fringe benefits available to stockholder-employees. However, retirement plans may not be nearly as advantageous to farm corporation stockholder-employees. There are several reasons for this.

First of all, most farm corporations do not have the necessary cash flow to make periodic contributions to a retirement plan. There is a tendency to invest any extra earnings in more farmland, equipment and machinery, or livestock. Second, there is a good possibility that investments in farmland may yield higher benefits than tax-sheltered retirement plans. Of course, farmland is not as "liquid" as a Keogh, IRS, or corporate plan which can be cashed in rather quickly if the need arises. Third, according to IRS rules, a tax-sheltered retirement plan may not be pledged as security on a financial statement. Therefore, these plans may compete directly for funds for farm investments.

c. Annual Tax Savings

The amount of annual tax savings available at various farm income levels is relatively straight forward. The higher the annual net farm income level, the greater the possibility for savings. In fact, the savings at high income levels (above $60,000) can be quite substantial.

This can create problems. After a year or two of high income, many farmers see the possibilities for tax savings and run out and incorporate. A few years later, two problems often emerge: a) Net farm income

declines for any number of reasons and the result is lost tax benefits. In fact, if the net farm income level falls much below $30,000, the annual tax bill will be higher than it would have been if the business had not incorporated. b) The shareholders are unhappy with the corporate form of business. This dissatisfaction may stem from any number of reasons. Sometimes the shareholders find the corporation too complicated and they don't know how to properly manage it. Other shareholders can't get used to the idea of living on a salary and being an employee. Often there is dissatisfaction with the assets in the corporation, i.e., they wish they had left the farmland and/or machinery out of the corporation.

Problem (a) may emerge because, at the time of incorporation, there was little or no consideration given to the probability of obtaining a high income level in future years. Of course, no one can predict the future with certainty. Even so, one can at least make an attempt by examining the future business plans of the owners. If a major expansion is planned in the future, this may increase tax deductions and thus may reduce taxable income. Or the expansion might also involve bringing others (many times it is a son or sons) into the business. If this is the case, the greater the number of owners, the less will be the net taxable income per owner.

It is also a good idea to examine the variability of net income for the particular type of farm operation. Some types of operations are noted for extremely fluctuating incomes (potato, cash crop, fruit) while others have more stable incomes (dairy, swine) from year to year.

Problem (b) often develops in situations where the corporation was hastily drafted, just before the end of a tax year, to avoid paying a large income tax bill. Again, in such cases, there usually was a failure to properly consider future business plans, goals and preferences of the business owners, capabilities of the owners, etc. Even though it can be mighty tempting to reduce the tax bill, this savings can be dwarfed by the emergence of other, more complex problems related to the corporation.

In summary, incorporating a highly profitable farm business can make good business sense. However, it's probably not wise to do so just because income taxes can be reduced during a year or two of high net farm income. Nor is it desirable to do so if the corporate form of business will cause serious problems for the owners.

d. Achieve Estate Planning Objectives

In some farm situations, the corporation is the best form of business organization to carry out the estate planning objectives of the farm family. However, this doesn't necessarily mean that it is always the best form. It is important to analyze the characteristics of all forms of business organizations to see which is best for the particular situation.

Oftentimes, a partnership may be suitable. For instance, it is possible to give away a share of a partnership under the annual gift tax exclusion, just as shares of a corporation can be given away. And it may be possible to "discount" the value of a share of a partnership, just as shares of stock can be "discounted" for gift tax purposes. Also, a partnership can be used to bring a son into the business, just as a corporation can. The son can gradually buy a larger share of the partnership, just as he can do in a corporation.

Usually, there will be no one best organization. Each may have its drawbacks. For example, the corporation may be the best organization to carry out the estate planning objectives of a particular farm business, but incorporating would result in a larger annual tax bill because the business normally has a yearly net farm income below $25,000. Or, estate planning wise, the partnership may be the best business organization, but the farm family has non-farm business interests and is thus concerned with the unlimited liability aspect of partnerships.

In these situations, the farm family must examine the tradeoffs. They must decide which is more important--keeping the annual tax liability to a minimum or transferring the farm business according to their desires. Or in the second case, limiting liability or achieving estate planning objectives.

No matter what form of business organization a farm family eventually decides upon to carry out its estate planning objectives, it is important that the proper plans are carried out. For instance, if one of the main reasons for incorporating is to make annual gifts of stock to the children under the annual gift tax exclusion; then it is imperative that gifts are given every year. Otherwise, there may be no reason for having the corporation.

3. Forming the Farm Corporation

Let's look at some of the areas where the author believes the most critical errors can be made at the time of incorporation.

a. Assets to Transfer into the Corporation

This is listed first because a mistake here could very well result in major problems (usually tax related) for the business a few years after the corporation has been formed.

Before deciding upon which assets to transfer into the corporation, the long-range plans for the business must be examined. Some of the more important areas to examine are: the chances of bringing others (sons, daughters, son-in-laws, etc.) into the business; the probability of selling any farmland during the parent's lifetime; probability of future expansion and if expansion is planned, the time period it will be carried out along with the eventual goal; the desirability of keeping the farmland ownership in the hands of the parents for their financial and retirement security; whether the parents plan on using the special use valuation, joint interest exclusion, or installment payment election (for federal estate tax purposes) as a part of their estate plan; and whether there is a desire to make any estate transfers of farm real property eligible for the 50 percent farm exemption and deferment of Michigan Inheritance Tax.

The type of farm operation may influence the decision. For example, it may be desirable in fruit operations to keep the farmland out of the corporation so that the next generation can redepreciate the trees. If the land is transferred into the corporation, the corporation normally assumes the depreciation schedule of the property owner making the transfer and there is no chance to redepreciate the trees as the corporation passes to the younger generation.

Another consideration might be the pride associated with owning land outright. Some farmers would rather own their land individually than own shares in a corporation which contains farmland.

Possible investment credit recapture should also be considered. The amount which may be subject to recapture should be calculated. If this amount is substantial, it may be desirable to not transfer those items which may be subject to recapture or else put all the assets in the corporation, thus making the transfer a "mere change in the form of doing business."

If there is any question as to whether or not to transfer an asset, it is probably best to leave the asset out. The reason for this is that it is probably easier to transfer an asset later on that it would be to take it out if it should not have been transferred in the first place.

b. Assets to be Leased by the Corporation

If any farm assets are not transferred to the corporation, but will be leased to it, a written "arm's length" lease agreement is mandatory. This agreement should spell out all terms of the lease such as the rental to be charged, time of payment, years during which the lease will be in force, and the parties involved. Such a lease will normally satisfy the IRS and prevent any later disputes.

A special note must be made with regards to the leasing of farmland. If the landlord(s) plans on making the real property eligible for either the special use valuation or the installment payment election (for federal estate tax purposes), it would be wise to design a crop share lease agreement that specifically involves the landowner in management decisions, physical work, etc. Cash rental arrangements should not be used.

c. Protect Minority Shareholders

A buy-sell agreement or a similar type arrangement which protects the interests of minority shareholders should be a part of every farm corporation. With regards to a buy-sell agreement, it should specify the conditions under which a sale can take place (death, disability, retirement, or simply a shareholder's desire to withdraw) as well as the method of stock valuation (appraisal, annual negotiated price). In addition, the terms under which the purchaser will make payment for the stock should be included.

d. Stock and Debt Capital

At the time of incorporation, it is probably wise to issue enough shares of stock so that the fair market value (at the time of issuance) is relatively low (below $100). Assuming future inflation, this will assure that any future gifts of stock will be valued under the amount of the annual gift tax exclusion.

If debt securities are to be used in addition to stock, it is wise to be sure that any note, bond, or debenture adheres to the normal characteristics of a debt instrument. This includes being in proper legal form, bearing a legal rate of interest and having a definite maturity date that is at least five years (ten is safer). Also, payments should not be contingent upon earnings. Further, the debt to equity ratio of the corporation should be considered. A ratio no higher than 2:1 is the safest.

e. Taxable Year

This area is probably the domain of an accountant, but there are a few considerations the farmer himself should be aware of.

First of all, it's not a good idea to set the taxable year to coincide with the date of incorporation, merely because it is convenient for the first year. If there is a sound tax-related reason for this, this is fine.

Second, the taxable year will vary by type of operation. It's hard to regulate sales of some perishable products (apples, potatoes, etc.). Those corporations which handle these commodities and are on cash basis accounting should keep this in mind when setting either a calendar or fiscal year. Sometimes it may be desirable to set the taxable year midway through the normal marketing season.

Third, a Subchapter S corporation should probably consider using a fiscal year rather than a calendar year. This will allow an income tax deferral as well as providing flexibility in allocating income between the shareholders' calendar taxable years.

C. Need for Further Research

Several of the areas discussed in this study lend themselves to further research.

One area to explore further is to analyze the tax ramifications of both partial and complete liquidations of farm corporations. Such an analysis could examine the tax implications under each applicable Internal Revenue Code provision for a variety of situations (different mix of corporate assets, market value of assets, etc.). Hopefully, such an analysis would provide answers to the following questions. Would it make any difference if the corporation was regular or Subchapter S? How do various levels of income affect the results? Do estate planning objectives affect the choice of liquidation alternatives? Does it make any difference if debt securities or two classes of stock are part of the capitalization structure? What are the implications for corporate formation, i.e., what assets should or should not be transferred?

Furthermore, the results generated by a liquidation within the original incorporator's lifetime could be compared with those which would be generated by not incorporating. In addition, it would be useful to make comparisons with partnership liquidations. Specifically, is it less costly (taxwise) to liquidate a partnership? If so, under what circumstances? Would it make a difference if it was a complete or partial liquidation?

A second area to examine further involves selecting the best method for capitalizing the corporation. It seems that there is a wide range of alternatives available. Combinations of stock and debt securities can be used. Each of these offers several variations. Stock can be differentiated with regards to voting rights, dividend rights, conversion rights, pre-emptive rights, as well as liquidation rights. Debt instruments can take the form of bonds, debentures, or notes. Each of these will likely vary with regards to length of maturity and the interest rate. Also, they can be designed so that they are convertible into shares of stock.

However, there is a question as to which of these is best suited for farm corporations. No doubt the answer will depend upon the particular circumstances that surround the farm business. Therefore, pertinent guidelines need to be developed.

A third area for future research is to evaluate the estate planning differences between corporations (both regular and Subchapter S) and partnerships. While this is perhaps the most important research area, it is also likely the most difficult. However, somehow it must be determined under what circumstances each organization would be the most effective over time in transferring the farm business to the next generation at the lowest possible cost while still meeting the other estate planning objectives of the farm family.

A final area would be to study the corporation after the second generation had taken over. How effective was it in transferring the farm business and meeting the estate planning objectives of the original incorporators? Did any unforeseen problems emerge? If so, what were they? What are the implications for other farmers considering incorporation?

APPENDIX A

QUESTIONNAIRE FOR INCORPORATED FARMS

APPENDIX A

QUESTIONNAIRE FOR INCORPORATED FARMS

1. Classify your corporation as to type of operation and also by units of size:

   A. Cash crop — Tillable acres ________

   B. Fruit — Acres of Bearing Fruit ________

   C. Dairy — No. of cows ________
   Tillable acres (including pasture) ______

   D. Beef — No. of cows ________
   Feeders fed per year ________
   Tillable acres (including pasture) ______

   E. Swine — No. of sows ________
   Feeders fed per year ________
   Tillable acres ________

   F. Poultry — No. of laying hens ________
   Broilers fed per year ________
   Tillable acres ________

   G. Other (Sheep)

2. What year did you incorporate? ________

3. How long was the unit in farming prior to incorporation? Number of years: ________

4. What form of business organization was the operation prior to incorporation?

   A. Partnership

   B. Sole proprietorship

Appendix A (Continued)

5. Which of the following gross sales categories does your corporation fall into?

   A. Under $40,000

   B. $40,000-$99,999

   C. $100,000-$199,999

   D. $200,000-$499,999

   E. Over $500,000

6. Does this include any off the farm or non-farm income (trucking, machinery dealership, seed corn dealership, packing fruit or vegetables for neighbors, etc.)?

   A. Yes--If so, approximately how much is non-farm and what is its major source? ______________________________
   ____

   B. No

7. Who assisted you in the incorporation procedure and what is their name?

   A. Attorney--Name ____________ Address ____________

   B. Accountant--Name ____________ Address ____________

   C. Insurance agent

   D. Extension personnel

   E. Banker or trust officer

   F. Other

8. What assets were transferred to the corporation?

   A. Land and Improvements (fences, tile lines)--All or part? ______
   ____

   B. Buildings (storage, livestock housing, home) ____________
   ____

Appendix A (Continued)

C. Livestock--All or part? ____________________
____

D. Machinery--All or part? ____________________
____

E. Inventories (crops, feed, supplies) ____________________
____

F. Other ____________________

9. What assets weren't transferred to the corporation?

10. How were these assets transferred to the corporation?

A. In exchange for stock ____________________
____

B. In exchange for debt securities in the corp. (bonds, debentures)
____

C. Cash purchase ____________________

D. Assets sold to corp. under long-term sales contract __________
____

E. Short-term notes ____________________

F. Other ____________________

11. How were the assets valued that were transferred to the corporation?

A. Book (depreciated value) ____________________
____

B. Market value ____________________
____

C. Appraisal ____________________

D. Other ____________________

Appendix A (Continued)

12. Why did you transfer the assets as you did? (Estate planning, reasons, saved taxes, etc.)

13. Which of the following categories best describe the total current market value of assets in the corporation?

A. Under $50,000

B. $50,000-$99,999

C. $100,000-$299,999

D. $300,000-$499,999

E. $500,000-$999,999

F. Over $1,000,000

14. What was the total number of shares issued by the corporation at the time of incorporation? _______ How was this arrived at?

15. What class(es) of stock were issued?

A. Common

B. Preferred

16. Who owns each class of stock and how much of each do they own?

17. What rights does each class have with regards to?

A. Voting rights (voting, non-voting, proxy voting, cumulative voting) ____________________

____

B. Dividends ____________________

C. Conversion rights, if any ____________________

D. Preemptive rights, if any ____________________

Appendix A (Continued)

E. Any preference on liquidation ______________________________

F. Other rights ______________________________

18. What was/were the main reason(s) for incorporating your farm operation? Why was it seen to be an advantage?

A. Limited liability. Why? ______________________________
____

B. Improved credit stutus. Why? ______________________________
____

C. Continuity of operation. Why? ______________________________
____

D. Employee fringe benefits. Why? ______________________________
____

E. Helped in estate planning. Why? ______________________________
____

F. Tax advantages. Why? ______________________________
____

G. Other ______________________________
____

19. Did these advantages hold true after incorporation? Why?

20. Do you feel that given the fact you are a corporation, does this make it easier to obtain credit?

A. Yes, it is easier because ______________________________
____

B. No, it is harder because ______________________________
____

C. Hasn't changed the availability of credit

Appendix A (Continued)

21. Do you have to sign credit notes as being personally liable for the debt, even though you are incorporated?

    A. Yes

    B. No

    C. Dont' know--haven't borrowed any money since incorporation

22. Has your corporation elected the tax-option or Subchapter S status?

    A. Yes

    B. No

23. What do you consider to be the greatest disadvantage of incorporation? Why?

    A. Taxes. (income, accumulated earnings, other) Why? ____________
    ____

    B. Transfer of stock. Why? ______________________________________
    ____

    C. Additional costs. Why? ______________________________________

    D. Increased formality and red tape. Why? ____________________
    ____

    E. Other. Why? ____
    ____

24. Workers Compensation Insurance for stockholder-employees of the corporation can be both an advantage and a disadvantage. Do you feel that its advantages outweigh the disadvantages?

25. Approximately how much is the annual accounting fee for your corporation?

    A. Under $100

    B. $100-$199

    C. $200-$299

    C. $300-$399

    E. Over $400

Appendix A (Continued)

26. Do you think that the increased formality and red tape required of a corporation has resulted in a more efficient and profitable business? Why?

    A. Yes, it has helped because ______________________________
    ____

    B. No, it has made us less efficient because ______________________
    ____

    C. Hasn't affected business performance ______________________
    ____

27. How is it determined who will conduct and manage the affairs of the corporation? Is there provisions in the corporate bylaws regarding this or is it determined informally as you go along? Is management control of the corporation distributed according to stock ownership?

28. Are there regulations in your corporate bylaws with respect to these items pertaining to officers and directors of the corporation? Or are such items determined informally as you go along?

    A. Selection and removal ______________________________
    ____

    B. Compensation ______________________________________
    ____

    C. Duties ____
    ____

    D. Filling of vacancies in the event of death, resignation or removal ______________________________________

29. How many employees does your corporation have?

    A. Full-time __________

    B. Part-time __________

Appendix A (Continued)

30. What types of fringe benefits does your corporation provide for its employees and give a short description of each? (Both part-time and full-time)

    A. Retirement Plan ____________________

    B. Group Health Insurance. Cost? Level? Benefits? ____________________

    C. Unemployment Insurance. If covered, has anyone ever drawn? ____________________

    D. Disability Insurance ____________________

    E. Life Insurance. Cost? Level? ____________________

    F. Housing, food, How justified? ____________________

    G. Other ____________________

31. How is income obtained from the corporation and how is it divided among stockholders? (wages or salaries, dividends, interest on bonds, retirement plans, lease payments, Subchapter S--goes back to stockholders)

32. What method of accounting does your corporation have?

    A. Cash

    B. Accrual

33. What is your corporation's fiscal year and why did you choose it as such?

Appendix A (Continued)

34. Has your corporation ever paid dividends on any class of stock?

    A. No

    B. Yes. If so, what class of stock received dividends, when was the dividend paid, and what were the reasons behind issuing a dividend?

35. In your opinion, has the fact that your business is now operating as a corporation increased or decreased federal and state income taxes?

    A. Increased

    B. Decreased

    C. Stayed the same

36. Was your corporation audited by the IRS for the year of incorporation?

    A. Yes

    B. No

    C. Haven't been incorporated long enough to find out

37. If you have land in your corporation, is it enrolled in P.A. 116 (Farmland Preservation Act)?

    A. Yes

    B. No

    C. Plan to in the future

38. How does your corporation adjust the level of corporate income so as to minimize income taxes in more profitable years?

    A. Adjust salaries. (arbitrarily or formal plan in bylaws) ______
    ____

    B. Adjust the leasing rates of assets to corporation. (arbitrarily or formal plan) ____
    ____

Appendix A (Continued)

C. Other ____

____

D. No plan to adjust levels of income.

39. If you could go through the incorporation procedure again, what changes would you make that might help to further reduce taxes?

40. How is management control passed on to the younger generation while still assuming adequate financial security for the parents? Specifically, in case of an untimely death or disability of a major stockholder (most likely the father or mother), how would management control be passed onto the other stockholders in case they desire to continue the operation? Is there some formal plan in the bylaws regarding this or would it be determined informally when something happened?

41. What process or plan does your corporation have to transfer stock ownership to the younger generation?

A. Gift Programs. Describe ______________________________

____

B. Trusts. Describe ______________________________

____

C. Buy-Sell Agreement. Describe ______________________________

____

D. Life Insurance Program. Describe ______________________________

____

E. Other. Describe ______________________________

____

F. No plan. If none, how would you want to do it? ______________

____

Appendix A (Continued)

42. Specifically, what would happen with regard to the transfer of stock ownership in these cases?

    A. Untimely death of major stockholder

    B. Voluntary retirement of major stockholder

    C. Disability of major stockholder

    D. Voluntary withdrawal of a stockholder from the corporation

43. How is the transfer price of the shares set?

    A. Pre-arranged method set forth in bylaws:

        1. Fixed price set in bylaws
        2. Appraisal at time of transfer
        3. Book value of shares
        4. Market or best offer at time of transfer
        5. Other

    B. No pre-arranged method set forth in bylaws

44. Has any stock been transferred among stockholders since incorporation?

    A. No

    B. Yes. If so, when, why, and how was it transferred?

45. In case of an untimely death of a major stockholder (most likely the mother or father), what plan does the corporation have to generate enough cash resources to meet tax and administrative costs without a forced sale of farm assets to cover these costs? Or similarly, how can the property be disposed of if a sale is necessary? Do you have a formal plan for this or would it be determined when something happened?

Appendix A (Continued)

46. Do you have a formal estate plan? If so, how does the estate plan recognize the labor and capital contributions of family members who have stayed on the farm? How are family members who move off the farm treated?

47. Related to the above question, what rights do those family members who move off the farm and are minority stockholders have with regards to:

    A. Management rights ______________________________
    ____

    B. Rights to income ______________________________
    ____
    ____

    C. Market for stock ______________________________
    ____
    ____

48. Is stock permitted to pass to off-farm shareholders? Does your corporation have any stock transfer restrictions? If a shareholder a) dies, b) becomes incapacitated, c) resigns from employment with the corporation, can other shareholders buy back that person's shares or is consent from the corporation required first? Who has first option? What if none of the other stockholders want to buy the stock?

Appendix A (Continued)

49. If you could go through the incorporation procedure again, would you change anything relating to the estate plan or intra-family transfer process?

50. What estate plan do you have for transferring assets outside of the corporation? How is this transfer set up? When will it take place? To whom will the assets be transferred?

APPENDIX B

ANNUAL TAX COMPARISON FOR ALTERNATIVE BUSINESS ORGANIZATIONS

APPENDIX B

Agricultural Economics
Staff Paper 80-6

Programmable Calculator TI/59
TELCAL 38

ANNUAL TAX COMPARISON FOR ALTERNATIVE BUSINESS ORGANIZATIONS*

User's Manual

Objective

The programmable calculator routine estimates the annual Michigan and federal income, workers' compensation and social security taxes for a farm business and the partners/employee-stockholders. A tax comparison for various farm business organizations should aid the manager in deciding whether the business should be organized as a partnership (proprietorship), Subchapter "S" corporation or a Subchapter "C" corporation.

Business Organizations Considered

1. A partnership (proprietorship) owns property and operates the business. The partnership allocates all net farm income to the partners and self employment taxes, Michigan income taxes less homestead property tax credits and federal income taxes less federal tax credits are calculated for the partners.

2. A Subchapter "S" corporation owns property and operates the business. The corporation pays the employee-strocker's salary, the corporation's share of social security tax on the employee-stockholder's salary and workers' compensation on the employee-stockholder's slary. Taxable income for the corporation is allocated to the employee-stocholders for inclusion on their personal income tax returns. The employee-stockholder's share of social security taxes, Michigan income taxes less homestead property tax credits and federal income taxes less federal tax credits are calculated for the employee-stockholders.

3. A Subchapter "C" corporation owns property and operates the business. The corporation pays the employee-stockholder's salary, the corporation's share of social security taxes on the employee-stockholder's salary, workers' compensation on the employee-stockholder's salary and federal corporate income tax less federal tax credits on the corporation's taxable income. The employee-stockholder's share of social security taxes, Michigan income taxes less homestead property tax credits and federal income taxes on the salary from the corporation are calculated.

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*The program was developed by Ralph E. Hepp, Department of Agricultural Economics, Michigan State University, January 1980.

Appendix B (Continued)

References

The Farm Corporation, North Central Regional Extension Publication No. 11 and General Partnership for Agricultural Producers, Extension Bulletin E-731, Cooperative Extension Service, Michigan State University.

Limitations

1. The program contains the income and social security tax rates and exemptions applicable in 1980. If the tax rates or exemptions have changed, the estimated tax may be slightly different.

2. The federal income tax rate schedule for a married individual filing a joint tax return is used. The federal tax rate schedules for a single taxpayer's return, married individuals filing a separate return, head of household, estate and trust result in slightly different tax obligations.

3. The income tax calculations for Michigan and federal income taxation are simplified versions of the tax code. The program does not consider the minimum or maximum federal income tax or the addition and subtraction for Michigan income taxes.

Program Cards

1. Card side 1, 1a and 2 -- Tax rate schedule and the tax calculation equations for a partnership.

2. Card side 1b, 1a, and 2a -- Tax rate schedule and the tax calculation equations for a Subchapter "S" corporation.

3. Card side 1c, 1a and 2c -- Tax rate schedule and the tax calculation equations for a Subchapter "C" corporation.

Input Description

1. Farm business income and expenses

   a. Long-term capital gain (before the 60% reduction) -- The program includes 40% of the long-term gain in adjusted gross income where appropriate for business taxation.

   b. Net business income -- Enter the net business income determined after direct and overhead business expenses are subtracted from sales. It should correspond to the net farm profit as calculated on a schedule F.

Appendix B (Continued)

2. Business federal tax credits (investment, jobs, and fuel tax credit)-- If the business had returnable or carry forward investment tax credits, make the appropriate adjustments before entering the value. The program reduces federal income tax due by the amount of federal tax credits entered.

3. Michigan workers' compensation insurance rate for employee-stockholders -- Enter the percentage rate appropriate for the farm type. Use Table 1 rates if the farm business has not established a workers' compensation rate.

Table 1. 1979 Workers' Compensation Premium Rates

Farm Classification	Rate 8/1/79
Dairy or Livestock[a]	13.15%
Farm Machinery Operation	15.16%
Farm--Market or Truck[b]	6.73%
Farm--No other category[c]	12.56%
Florists	5.57%
Fruit Packing & Handling	5.96%
Nurserymen	6.73%
Orchards	13.38%
Poultry	8.49%
Tree Pruning, etc.	15.79%
Vegetable Packing & Handling	7.79%

[a]Applies to all acreage devoted to producing milk or cream and shall also include the raising of cattle, hogs, cattle feeders, hog feeders, sheep and goats.

[b]Applies to all garden vegetable crops and shall also include acreage devoted to potatoes, dry peas, dry beans, sugar beets, berries, flower and vegetable seed, cucumbers and all grapes (table, wine or raisin).

[c]Applies to all acreage devoted to raising hay, alfalfa, all the cereal grains such as wheat, barley, rice, corn and oats, all sorghums, flax and maize.

Appendix B (Continued)

4. Number of partners/employee-stockholders (the number must be less than 5)--If a family member is a business employee, rather than an owner-operator, enter the salary as a business expense in the net business income calculation. Partners/employee-stockholders are family members who have an ownership/management responsibility in the business and share in business earnings/losses.

5. Input data for partner/employee-stockholder--The program can handle up to 4 partner/employee-stockholders in the business on input lines 5, 6, 7 and 8. Use one line for each owner-operator and enter all input data on the annual basis.

   a. Cash wage paid by the business--The salary before income taxes and social security which will be paid if a corporation or partnership is organized.

   b. Tax deductible employee-stockholder fringe benefits paid if a corporation is organized (do not include workers' compensation and social security)--Include only fringe benefits for employee-stockholder where a corporation can deduct them as a business expense, and are not allowed for a partnership. Examples include life insurance and health insurance.

   c. Other family income for the taxpayer which is subject to income taxation (i.e., land rent, wages, interest and dividends)--If land is not contributed to the corporation or partnership, the land rent paid is reflected in a lower net business income on input line 1b(4) and a higher other family income to the individual partner/employee-stockholder. Subtract any expenses from the land rent before entering the taxable portion.

   d. Michigan property tax eligible for the homestead property tax credit--Property taxes paid on the real estate for the land owned by the partner/employee-stockholders. If the farmland is owned by the corporation and the "C" corporation tax analysis is being undertaken, the value entered in this line must be eliminated for output line 3. Employee-stockholders may not assume the homestead property tax credit on farmland owned by the "C" corporation.

   e. Number of exemptions for income tax purposes--Personal exemptions for the family.

   f. Percent of the partnership/stock owned by the partner/employee-stockholder--The percent for all the partner/employee-stockholder must equal 100.

Appendix B (Continued)

Output Description

1. Partnership business organization

   a. Partnership earnings after salary, but including 40 percent of the long-term capital gain income--The net business income which is passed to the partners according to their share of ownership in the partnership.

   b. Self employment tax for partners--Total for all partners.

   c. Michigan income tax for partners less the homestead property tax credit--Total for all partners.

   d. Federal income tax for partners less tax credits--Total for all partners.

   e. Total listed taxes--Total of 1b, c, and d above.

2. Subchapter "S" corporation business organization

   a. Corporation earnings and 40 percent of long-term capital gain income assumed by the stockholders for income taxation--The net business income which is passed to the employee-stockholders according to their share of ownership in the corporation.

   b. Social security tax for the corporation and the employee-stockholders--The corporation share and all the employee-stockholder's share of the social security tax.

   c. Michigan workers' compensation for wages paid employee-stockholders.

   d. Michigan income tax for employee-stockholders less the homestead property tax credit--Total for all employee-stockholders.

   e. Federal income tax for employee-stockholders less tax credits--Total for all employee-stockholders.

   f. Total listed taxes--Total of 2b, c, d and e above.

3. Subchapter "C" corporation business organization

   a. Corporation earnings and capital gains income--Taxable income for the corporation.

   b. Social security tax for the corporation and the employee-stockholders--The corporation's share and the employee-stockholder's share of the social security tax.

Appendix B (Continued)

c. Michigan workers' compensation for the corporation on the employee-stockholder's wages.

d. Corporation federal income tax less tax credits.

e. Michigan income tax for employee-stockholders less the homestead property tax credit--Total for all employee-stockholders.

f. Federal income tax for employee-stockholders--Total for all employee-stockholders.

g. Total listed taxes--Total of 3b, c, d, e, and f above.

Methods Used

1. Social security--The self-employement tax rate is 8.1% on the first $25,900 of self-employment income. The corporation and employee social security tax rate is 12.26% (6.13% for the employer and 6.13% for the employee) on the first $25,900 of salary.

2. Michigan owrkers' compensation--The rate entered in input line 3 times the salary paid by the corporation.

3. Corporation federal income tax--The ordinary corporation income is taxed at 17% on the first $25,000, 20% on the second $25,000, 30% on the third $25,000 and 40% on the fourth $25,000 of taxable income and 46% on taxable income above $100,000. Capital gain income is taxed at the lesser of ordinary income tax rates where capital gain is combined with ordinary income or a 28% tax rate.

4. Michigan income tax--Taxpayer's income less $1,500 times the number of exemptions times the 4.6% tax rate.

5. Homestead property tax credit--The property tax less the household income times 3.5% and the result times 60% up to a maximum of $1,200.

6. Federal taxable income--Taxpayer's income less $1,000 times the number of exemptions.

7. Federal tax rate schedule for married individuals filing a joint income tax return.

Appendix B (Continued)

Taxable Income Over	Taxable Income Not Over	Pay	+	Tax Rate	On Excess Over
.....	$ 3,400	....		...	.....
$ 3,400	5,500	....		14%	$ 3,400
5,500	7,600	$ 294		16%	5,500
7,600	11,900	630		18%	7,600
11,900	16,000	1,404		21%	11,900
16,000	20,200	2,265		24%	16,000
20,200	24,600	3,273		28%	20,200
24,600	29,900	4,505		32%	24,600
29,900	35,200	6,201		37%	29,900
35,200	45,800	8,162		43%	35,200
45,800	60,000	12,720		49%	45,800
60,000	85,600	19,678		54%	60,000
85,600	109,400	33,502		59%	85,600
109,400	162,400	47,544		64%	109,400
162,400	215,400	81,464		68%	162,400
215,400		117,504		70%	215,400

Adjusted Analysis

If an adjusted analysis is desired, change the value, enter card side 1 and press B. Continue through the output analysis. If a new example is considered, enter card side 1, press A (all data registers are cleared), enter the new case examples data and press B. Continue through the output analysis.

Example--The following example can be used for checking the correct operation of your calculator.

ENTER	PRESS	DISPLAY	COMMENTS
10000	STO 10		Long term capital gain (before the 60% reduction)
50000	STO 11		Business income
3000	STO 12		Business federal tax credits
13.5	STO 13		Michigan owrkers' compensation insurance rate for employee-stockholders
2	STO 14		Number of partners/employee stockholders (the number must be less than 5)
15000	STO 15		Cash wage paid by the business
1500	STO 16		Tax deductible employee-stockholder fringe benefits paid if a corporation is organized

Appendix B (Continued)

ENTER	PRESS	DISPLAY	COMMENTS
2000	STO 17		Other family income for the taxpayer which is subject to income taxation
2500	STO 18		Michigan property tax eligible for the homestead property tax credit
2	STO 19		Number of exemptions for income tax purposes
50	STO 20		Percent of the partnership/stock owned by the partner/employee-stockholder
15000	STO 21		Cash wage paid by the business
1500	STO 22		Tax deductible fringe benefits paid if a corporation is organized
300	STO 23		Other family income for the taxpayer which is subject to income taxation
500	STO 24		Michigan property tax eligible for the homestead property tax credit
4	STO 25		Number of exemptions for income tax purposes
50	STO 26		Percent of the partnership/stock owned by the partner/employee-stockholder

ENTER	PRESS	DISPLAY	COMMENTS
Partnership			
	CLR		
Card side 1	B	24000	Partnership earnings after salary, but including 40% of the long-term capital gain income
	R/S	4050	Self employment tax for partners
	CLR		
Card side 1a	CLR		
Card side 2	C	1347	Michigan income tax for partners less the homestead property tax credit
	R/S	6414	Federal income tax for partners less tax credits
	R/S	11811	Total listed taxes
"S" Corporation			
	CLR		
Card side 1b	B	15111	Corporation earnings and 40% of long-term capital gain income assumed by the stockholders for income taxation
	R/S	3678	Social security tax for the corporation and the employee-stockholders
	R/S	4050	Michigan workers' compensation for the corporation on the employee-stockholder's wages
	CLR		
Card side 1a	CLR		
Card side 2a	C	1062	Michigan income tax for employee-stockholders less the homestead property tax credit

Appendix B (Continued)

ENTER	PRESS	DISPLAY	COMMENTS
	R/S	5151	Federal income tax for employee-stockholders less tax credits
	R/S	13942	Total listed taxes
"C" Corporation			
0	STO 18 STO 24		The farmland is owned by the corporation and the employee-stockholders are not allowed to claim the property taxes from the corporation for their homestead property tax credit
	CLR		
Card side 1c	CLR		
Card side 2b	B	21111	Corporation earnings and capital gain income
	R/S	3678	Social security tax for the corporation and the employee-stockholders
	R/S	4050	Michigan workers' compensation for the corporation on the employee-stockholder's wages
	R/S	2472	Corporation federal income tax less tax credits
	CLR		
Card side 1a	CLR		
Card side 2c	C	1071	Michigan income tax for employee-stockholders less the homestead property tax credit
	R/S	3351	Federal income tax for employee-stockholders
	R/S	14623	Total listed taxes

Appendix B (Continued)

Programmable Calculator TI/59
TELCAL 38

ANNUAL TAX COMPARISON FOR ALTERNATIVE BUSINESS ORGANIZATIONS*

Input/Output Form

Objective: Estimate the annual Michigan and federal income, workers' compensation and social security taxes for a farm business and the partners/employee-stockholders. A tax comparison for various farm business organizations should aid the manager in deciding whether the business should be organized as a partnership, subchapter "S" corporation or a subchapter "C" corporation.

STEP	INPUT DESCRIPTION	VALUE	PRESS
1.	Farm business income and expenses		
	a. Long term capital gain (before the 60% reduction)	$_____	STO 10
	b. Business income		
	(1) Sales	$_____	
	(2) Direct expenses	$_____	
	(3) Overhead expenses (except partner/employee-stockholder wages and fringe benefits)	$_____	
	(4) Net business income (1)-(2)-(3)	$_____	STO 11
2.	Business federal tax credits (investment, jobs and fuel tax credits)	$_____	STO 12
3.	Michigan workers' compensation insurance rate for employee-stockholders	_____%	STO 13
4.	Number of partners/employee-stockholders (the number must be less than 5)	_____	STO 14
5.	Input data for partner/employee stockholder No. 1		
	a. Cash wage paid by the business	$_____	STO 15
	b. Tax deductible employee-stockholder fringe benefits paid if a corporation is organized (do not include workers' compensation and social security)	$_____	STO 16
	c. Other family income for the taxpayer which is subject to income taxation (i.e., land rent, wages, interest and dividends)	$_____	STO 17
	d. Michigan property tax eligible for the homestead property tax credit	$_____	STO 18

*The program was developed by Ralph E. Hepp, Department of Agricultural Economics, Michigan State University, January, 1980.

Appendix B (Continued)

	e. Number of exemptions for income tax purposes	_____	STO 19
	f. Percent of the partnership/stock owned by the partner/employee-stockholder	____%	STO 20
6.	<u>Input data for partner/employee-stockholder No. 2</u>		
	a. Cash wage paid by the business	$_____	STO 21
	b. Tax deductible fringe benefits paid if a corporation is organized (do not include workers' compensation and social security)	$_____	STO 22
	c. Other family income for the taxpayer which is subject to income taxation (i.e., land rent, wages, interest and dividents)	$_____	STO 23
	d. Michigan property tax eligible for the homestead property tax credit	$_____	STO 24
	e. Number of exemptions for income tax purposes	_____	STO 25
	f. Percent of the partnership/stock owned by the partner/employee-stockholder	____%	STO 26
7.	<u>Input data for partner/employee-stockholder No. 3</u>		
	a. Cash wage paid by the business	$_____	STO 27
	b. Tax deductible fringe benefits paid if a corporation is organized (do not include worker's compensation and social security)	$_____	STO 28
	c. Other family income for the taxpayer which is subject to income taxation (i.e., land rent, wages, interest and dividends)	$_____	STO 29
	d. Michigan property tax eligible for the homestead property tax credit	$_____	STO 30
	e. Number of exemptions for income tax purposes	_____	STO 31
	f. Percent of the partnership/stock owned by the partner/employee-stockholder	____%	STO 32
8.	<u>Input data for partner/employee-stockholder No. 4</u>		
	a. Cash wage paid by the business	$_____	STO 33
	b. Tax deductible fringe benefits paid if a corporation is organized (do not include workers' compensation and social security)	$_____	STO 34
	c. Other family income for the taxpayer which is subject to income taxation (i.e., land rent, wages, interest and dividends)	$_____	STO 35

Appendix B (Continued)

d. Michigan property tax eligible for the homestead property tax credit	$_____	STO 36
e. Number of exemptions for income tax purposes	_____	STO 37
f. Percent of the partnership/stock owned by the partner/employee-stockholder	____%	STO 38

Enter the tax calculation equations for a partnership--Press CLR, enter card side 1 and continue.

STEP	OUTPUT DESCRIPTION	PRESS	VALUE
1.	Partnership business organization		
	a. Partnership earnings after salary, but including 40 percent of the long-term capital gain income	B	$_____
	b. Self employment tax for partners	R/S	$_____

Enter the remaining tax calculation equations for a partnership--Press CLR, enter card side 1a, press CLR, enter card side 2 and continue.

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	c. Michigan income tax for partners less the homestead property tax credit	C	$_____
	d. Federal income tax for partners less tax credits	R/S	$_____
	e. Total listed taxes	R/S	$_____

Enter the tax calculation equations for a "S" corporation--Press CLR, enter card side 1b and continue.

2.	Subchapter "S" corporation business organization		
	a. Corporation earnings and 40 percent of long term capital gain income assumed by the stockholders for income taxation	B	$_____
	b. Social security tax for the corporation and the employee-stockholders	R/S	$_____
	c. Michigan workers' compensation for the corporation on the employee-stockholder's wages	R/S	$_____

Appendix B (Continued)

Enter the remaining tax calculation equations for a "S" corporation--Press CLR, enter card side 1a, press CLR, enter card side 2a and continue.

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d. Michigan income tax for employee-stockholders less the homestead property tax credit	C	$_____
e. Federal income tax for employee-stockholders less tax credits	R/S	$_____
f. Total listed taxes	R/S	$_____

Enter the tax calculation equations for a "C" corporation--Press CLR, enter card side 1c, press CLR, enter card side 2b and continue.

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3. Subchapter "C" corporation business organizations (if farmland is owned by the corporation, the Michigan property tax for each employee-stockholder must be changed)

a. Corporation earnings and capital gain income	B	$_____
b. Social security tax for the corporation and the employee-stockholders	R/S	$_____
c. Michigan workers' compensation for the corporation on the employee-stockholder's wages	R/S	$_____
d. Corporation federal income tax less tax credits	R/S	$_____

Enter the remaining tax calculation equations for a "C" corporation--Press CLR, enter card side 1a, press CLR, enter card side 2c, and continue.

---

e. Michigan income tax for employee-stockholders less the homestead property tax credit	C	$_____
f. Federal income tax for employee-stockholders	R/S	$_____
g. Total listed taxes	R/S	$_____

If an adjusted analysis is desired, change the value, enter card side 1 and press B. Continue through the output analysis. If a new example is considered, enter card side 1, press A (all data registers are cleared), enter the new case examples data and press B. Continue through the output analysis.

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