THE CLOSE CORPORATION AS A FORM OF BUSINESS ORGANIZATION FOR MICHIGAN FAMILY FARMS

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J. Paxton Marshall

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ABSTRACT

THE CLOSE CORPORATION AS A FORM OF BUSINESS ORGANIZATION FOR MICHIGAN FAMILY FARMS

by J. Paxton Marshall

Farm families are manifesting an increased interest in the corporation as they seek an improved form of business organization and hope to maintain family ownership of large farm businesses. The passage by the United States Congress of the Technical Amendments Act of 1958 (Title I, Public Law 85-866); the large potential federal estate and state inheritance tax liabilities; and the complexities encountered when several families conduct a single farm business are all reasons that have combined to increase the number of farm families seeking information about the corporate form of business organization.

The corporation is an independent legal entity that can take and own title to any type of farm property; hence, corporations conducting farm businesses may own such farm property as is necessary to own or conduct a farm business as a tenant, part owner, owner, or landlord. These alternative ways of organizing a corporation permit farm families to use the corporation to solve different problems; however, each of these alternatives has unique problems of its

own. In making decisions about incorporation, individual farmers or families must assemble and analyze information with respect to the alternatives available and assess how each will affect their farm business and family members. The farm families who investigate the corporation are seeking to solve a complex, normative, as well as positivistic, micro-dynamic, practical problem in farm management requiring a decision of right action.

This study examined the close corporation organized by family related individuals conducting family farm businesses. A close, or closely held, corporation is one organized by a relatively few shareholders and in which the shares of stock are usually not available to the general public. The objective was to seek answers to these questions: (1) Does the corporation facilitate inter-generation, intra-family farm transfer? (2) Does corporation taxation affect farm earnings? and (3) Does the farm corporation distribute rights and risks equitably among the participating owners and operators?

A survey was made of eighteen close corporations conducting family type farm businesses in Michigan. The study also includes a descriptive analysis of information assembled relating to the taxation of corporations, the problems and benefits incurred with a corporation, and the procedures required during the organization, existence, and

dissolution of a corporation. Case studies of four selected farm business and family situations are presented. Each case study illustrates a different tax situation and problem that farm families may encounter when organizing a corporation.

The conclusion is reached that most Michigan farm families who incorporate would be well advised to organize their corporation initially as a tenant. Such a corporation will normally minimize the federal income tax cost basis problem; the minority shareholder problem; the Michigan annual corporation privilege fee; and federal income taxes as effectively as a corporation organized as a part owner or owner. A few Michigan families may find the corporation organized initially as a part owner an acceptable alternative when the federal estate and state inheritance tax liabilities may be large. Farm families that can advantageously organize a corporation as an owner are rare.

The corporation does facilitate the inter-generation, intra-family farm transfer, but other institutional arrangements such as the land contract will be equally effective in many instances. Corporate taxation does affect farm earnings both positively and negatively. The right of individuals to make decisions concerning the corporation's business is equally distributed when all shareholders are on the board of directors. The individual's right to make decisions and receive returns on the investment may not be equitably distributed for a minority shareholder. Financial risks associated with the corporation are normally limited to the extent of the shareholder's investment in the business.

When the shareholders do not own the real property used in the farm business, the corporation may encounter problems involved in making productive investments required either in or on the land. An implication of this study is that a farm corporation that makes these productive investments on leased land may effectively increase the income of those family members electing to remain on the farm as well as for the family members who retain only the ownership rights to the land.

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CHAPTER I

INTRODUCTION

Traditionally, most Michigan farms have been organized so that ownership and operating control of the property used in the farm business are exercised by a farm family. Most often, farm families have organized their farm businesses as sole proprietorships or partnerships. These are two of three types of institutional arrangements used to organize businesses. The third is the corporation.

This study in farm management examines the corporate, legal-business structure and its use on Michigan family farms. It does not examine all the similarities and differences between the corporation and the sole proprietorship and partnerships. One important and fundamental difference between these forms of business organization is that the corporation is recognized as an independent legal entity. Therefore, the corporation can take and own title to property and conduct business in its own name in a manner similar to an individual.

This study in farm management includes a descriptive analysis of information relating to some problems farm families will encounter during the organization, existence, and dissolution of a corporation.

Since the corporation can take and own title to farm property just as an individual farmer, each corporation organized to conduct a farm business can be classified according to the type of property owned as an owner, a part owner, a tenant, or a landlord. These classes are determined by whether the corporation owns the real property and/or tangible personal property used in the farm business. Thus, a corporation that owns title to both the real property and the tangible personal property required for the farm business is an owner. A corporation that owns title to only part of the real property and all the tangible personal property is a part owner. When a corporation owns title to only the tangible personal property used in the farm business, it is a tenant. If the corporation owns title to only the real property, it is a landlord. This distinction between the type of property owned and the class of farmer a corporation is, is particularly important in determining the purpose for which the corporation may be used and the costs and problems encountered.

Both the real property and the tangible personal property used in a farm business may be separated into different kinds of assets. Thus, real property includes the asset land and the assets included in realty. Realty is the term used throughout this thesis to refer to those assets which are either in or attached to the land and though a part of real property are distinguished from land for tax purposes. For example, realty includes the buildings, the trees of an orchard, tile, and similar assets in or attached to the land. The tangible personal property used in the farm business includes machinery and equipment, dairy cattle, and similar property.

This study is a descriptive analysis of information concerning the corporation. Farmers and farm families will find the results useful in considering questions of organizing and/or reorganizing their farm businesses as a corporation. Such questions increase in frequency as size and value of farms increase and the ownership pattern of farms becomes more complex. In addition to being useful to farmers who are investigating the corporation, it is anticipated that this study will be useful to individuals who advise farmers about the use of a corporation and those who assist farmers in organizing corporations.

Organization of Thesis

The problem area investigated by this study, the purpose and objective of the study, and the procedure and methodology used in the study are described in Chapter II. The criteria required of the close corporation studied in this thesis are stated in Chapter III. These include the requirement that the corporation is organized by family related individuals to conduct the business of the family farm. In Chapter IV, the information obtained in a survey of close corporations organized by Michigan farm families is presented. Before a corporation is organized, it is necessary to determine the impact that it may have on the farm business and the family members. Thus, in Chapter V, information relating to federal taxes on income during the period of the corporation's existence, organization, and dissolution is presented; it also includes information on the federal and state excise taxes applicable to the corporation. The discussion in Chapter VI concerns the problem of limiting liability and the problem of control; in addition, certain fringe benefits and other features sometimes associated with a close corporation are discussed. The procedures required to organize a corporation, conduct business as a corporation, and dissolve the corporation are given in Chapter VII. Chapter VIII includes four case studies of Michigan farms whose owners are investigating the applicability of a corporation to their farm business and family situation. The summary, the conclusions, and the implications of this study are located in Chapter IX.

CHAPTER II

DELINEATING THE STUDY

The purpose of this chapter is to describe the general problem area being investigated, discuss decision-making in relation to the problem, present the purpose and objective, and explain the procedure and methodology to be used in this study.

The Problem Area Being Investigated

Michigan farm families who seek information relating to the corporate legal-business structure are usually seeking an improved form of business organization and a better means of maintaining family ownership and control over large or rather profitable farm businesses. The passage of Public Law 85-866 by the United States Congress on September 2, 1958, is another reason the corporation is receiving increased attention from farm families.[1] Title I of this law is known as the Technical Amendments Act. This act modified the Internal Revenue Code of 1954 to permit certain qualifying corporations to elect, with the consent of shareholders, to have any federal income tax payable on any taxable income of the corporation paid by the shareholders instead of by the corporation. A third reason

[1] U. S. Congress, Title I, Technical Amendments Act; Title II, Small Business Tax Revision Act, Public Law 85-866, 85th Congress, 2nd Session, 1958.

for interest in the corporation is that as the value of farm property has increased, either by inflation[1] or the purchase of more land,[2] the potential federal estate and state inheritance tax liabilities of farm families likewise has increased. The knowledge of the Technical Amendments Act, these individual problems of farm families and the implication that the corporation may ease intra-family farm transfer, lengthen continuity of the business, and increase capital availability have focused increased attention on the corporation as a method of conducting farm businesses.

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[1]The change in value as a result of inflation has been studied by M. E. Wirth and James Neilson. They found that Michigan farmers who had capital investments ranging from \$61,000 to \$163,000 experienced an average inflationary gain of \$27,000 in the five year period ending January 1, 1959 (Resource Ownership and Productivity on Michigan Farms, Special Bulletin 435, East Lansing: Michigan State University, Agricultural Experiment Station, 1961).

[2]The opportunity to purchase more land may be expected to continue for the next one or two decades, with the result that the number of farm families and potential estate and inheritance tax problems will increase. This is indicated in a recent study by J. R. Brake, D. E. McKee, and J. T. Bonnen. They report that the proportion of farm operators 55 years of age and over is higher in Michigan than for the United States. They also report that 129 of 353 farm operators included in their study who were 41 years of age and over said they had no apparent successor, an apparent successor being a male member of the family 14 years of age or over. In the group of 129 were 39 farm operators 55 years of age with no apparent successor. ("The Ages and Future Plans of Michigan Farmers as Related to Agricultural Adjustment," Michigan State University Quarterly Bulletin, XLIII (November, 1960), p. 431 (East Lansing: Michigan State University, Agricultural Experiment Station)). How many farms will be absorbed into larger units is yet to be determined; the number of farms of different sizes that may be absorbed could be substantial.

Consequently, the owner-operators of a number of farms are questioning themselves and others concerning the prudence of continuing to conduct their farm business as a sole proprietorship or as a partnership. These farmers are investigating the corporation as they seek (a) to accomplish an equitable inter-generation, intra-family farm transfer, (b) to determine the way corporate taxation affects net farm earnings, and/or (c) an improved legal-business structure to distribute the rights and risks of the farm business.

A farmer who is investigating the corporation may perceive each of these as an independent problem requiring an independent solution, or he may perceive them as a joint problem requiring a single solution. How they are perceived by a farmer will usually be influenced by his age, the number, ages and sex of children in the family, and his present and expected financial position. Farmers who are investigating the corporate structure realize that their decision to continue conducting the farm business with their present form of business organization or to organize a corporation to conduct the farm business, may affect them personally as well as their family. Thus, farmers who investigate the corporate legal-business structure are seeking to solve a complex, normative as well as positivistic, micro-dynamic, practical problem in farm management.[1] Management presupposes decision-making.

Problems in management involving questions about what to do have two facets -- the positive (including the technical) or factual and the normative. It is apparent that farmers realize this, for those who investigate the corporate form of business organization rarely ask only the question, "How do we incorporate our (family) farm business?" which is a question requiring a technically correct answer[2] and which presupposes that the person questioned knows how to organize and, perhaps, conduct a farm business through a corporation. Yet obtaining technically correct answers to questions concerning the corporate structure is only one aspect of the

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[1]Lawrence Bradford and Glenn Johnson state that "management is an intangible part of production which develops within the lives of men. It is first a mental process, a concentration of desires, a will power . . . . Management can be seen only through observing the decision-making process and its result." Farm Management Analysis (New York: John Wiley and Sons, 1953), p. 3.

[2]Questions of technically correct "constitute a part of the theory of any part or the critique of any professional practice." Such questions may or may not be associated with a question of right doing on the part of the individual undertaking a given technical or professional task. However, when an individual commits to a particular task the "manner in which it is pursued or carried out is subject to criticism as technically correct and justified or technically wrong and contravening the dictates of such practice" (C. I. Lewis, Ground and Nature of the Right (New York: Columbia University Press, 1955), p. 13).

decision to organize a corporation, for this problem has normative aspects as well. This is evident in the other question which the farmers who are investigating the corporate legal-business structure nearly always ask. It is, "What 'good' can we obtain by organizing a corporation, and is it the right thing to do?" This is a question which asks for a prudential judgment based on both normative and positive information.[1] Individuals who ask a question of this type presuppose that the person questioned has the ability "to weigh the interest of others -- their self interest."[2] Those who are investigating the corporation and others who are asked to make a judgment concerning the decision to incorporate a particular farm business realize the latter question is particularly difficult to answer.

The decision is difficult because the problems that impinge upon the decision-maker, who will often be the individual farmer, have no solution that results in making one or more persons better off while making no one worse off;

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[1]"The prudential questions are questions of right conduct." Such questions are concerned with the rational self-government of action -- the determination to do something. The prudential questions are indicative that the questioner recognizes that "there is no decision of action which could reasonably be taken without reference to the external circumstances of it or without foresight of consequences to be expected from adoption of it" (Lewis, op. cit., pp. 12, 19).

[2]Ibid., p. 12.

hence, the decision-maker must reconcile the conflicting values in view of what the facts indicate is possible and select the best alternative -- the right action.[1] Consequently, decisions of this magnitude require the decision-maker to assemble, co-ordinate, interrelate, and analyze information from (the academic disciplines of) sociology, law philosophy (including ethics), economics, business, and the technical agricultural sciences. Normally, a farmer or other individual will not have access to all the normative and positive information required for a decision concerning the applicability of the corporate legal-business structure to his farm business within his own family. Yet after this information is assembled and analyzed, the decision-maker can relate the relevant factual information available within his family to that attained elsewhere and determine how the corporation may affect the farm business and the members of the farm family.

This study assembles and analyzes information concerning the corporate legal-business structure as it affects

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[1] "A right action or goal is an action or goal determined to be the best in view of the factual and normative beliefs involved where 'best' means that which maximizes human interests and purposes as directed by the value concepts involved" (G. L. Johnson and L. K. Zerby, "Values in the Solution of Credit Problems," Capital and Credit Needs in a Changing Agriculture (eds.), E. L. Baum, et al. (Ames: Iowa University Press, 1961), p. 272).

this practical problem which farmers are seeking to solve as they make the decision of right action.[1]

Decisions of Right Action

Decisions of right action concern practical problems which involve people in a dynamic situation. Solutions to such problems require the individual(s) making the decision to use both positivistic and normative information. Pure positivistic information is obtained when problems are studied to determine concepts of what is, what will be regardless,

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[1]Some will argue that normative aspects of problems are not researchable; that the questions to be studied by scientists should be positivistic. This writer believes, however, that problems involving both normative and positive concepts are researchable. Furthermore, that such problems are particularly important within the profession of agricultural economics: the area of farm management is concerned directly with the analysis of the reality that exists for farm families, and analyzing and selecting among the alternative realities that can be for farm families. The alternative realities that can be for farm families must be submitted to the test of workability, which is based on both positive realism and normative realism. Both normative and positive concepts can be required to pass tests of objectivity. Objectivity, but not perfect knowledge, seems attainable whether the problem involves only the positive, or only the normative, or both. The criteria for objectivity include tests of logical consistency with existing concepts and experience. Logic provides the basis for <u>analytic</u> concepts that are positivistic, and for <u>analytic</u> concepts that are normativistic, while <u>both</u> positivistic and normativistic experience provide a basis for <u>synthetic</u> concepts in both instances. When the test of workability is applied to the alternative realities that can be for farm families, the test, which is based on both positivistic and normativistic concepts (either analytic or synthetic), reveals flaws in the alternatives in an objective manner.

and what can be given alternatives including the "if . . . then . . . statements" of science. Pure normative information is obtained when problems are studied to determine beliefs about the "goodness" or "badness" of what is and of what can be.

Individuals who seek solutions to practical problems must assemble, analyze, and reconcile both positive and normative beliefs concerning past, present and future reality in order to select the best among alternative actions available as possible solutions to their problems. This best alternative then becomes the goal which the individuals involved seek to attain.

The decision as to what is right to try to do (a goal) involves the goodness and badness of consequences which follow from action. Since the consequences of decisions affect people and one alternative decision is selected from a group available, it follows that the decision is normally a compromise among the goods and bads in view of what is possible. Therefore, the alternative selected is normally a compromise between the extremes of maximizing the maximum favorable consequences and minimizing the maximum of unfavorable consequences that will follow from a decision. A common procedure is to maximize the average (expected) net goodness of the alternatives. Therefore, the selection of an action as right is made after an evaluation of the alternative actions open to the individual(s) seeking that action which will produce the greatest possible net good within some period.

The period, in the case where the decision is to or not to organize one of several alternative types of corporations to conduct a farm business, may be the current year, the next decade or two, or some intermediate or longer period. Selecting the right action among alternatives involving consequences through time requires that the decision-maker be able to establish the present value of all future consequences. The present value of future gains and losses depends upon the individual circumstances of various decision-makers and upon the interest rate, which, in one sense, reflects the value society places upon future gains and losses.

Decisions as to which is the right action among various alternatives also depend upon the values of the individuals involved in the decision-making process. These values are weighted together by various devices. Though the articles of incorporation, by-laws, and the distribution of shares will determine how the values of individuals will be weighted together once the corporation is formed, very serious problems exist during the process of forming a corporation in weighting the wants and preferences of the individuals to be involved. During this process, the weights to be assigned to the wants and preferences of the individuals will depend upon their economic, moral, and persuasive powers. Both during the process of forming the corporation and in the period during which the corporation exists, the wants and preferences of people not directly involved in the corporation will be reflected in the laws which the incorporators and the corporation are required to obey in order to form a valid, legal corporation and which the shareholders, directors, and officers are required to obey in order to maintain that corporation in existence.

Thus, where decisions of right action are involved, the decision-making process requires (1) problem definition, (2) observation and collection of (a) positive and (b) normative information, (3) analyzing the information, including determination of alternatives and consequences, (4) selecting the action to be taken, (5) taking the action, and (6) bearing the responsibility for the decision made, the action taken, and the consequences that follow from the action.

Purpose and Objective

Our purpose in this study is to examine critically, in relation to our problem area, some economic and other changes which can be expected by Michigan farm owners, or co-owners, who may decide to organize a corporation to conduct their farm business.

Within the broad framework established by the statement of purpose, this study shall seek as its objective to determine answers to the following primary questions.

1. Does the corporation facilitate the inter-generation, intra-family farm transfer?
2. Does corporation taxation affect farm earnings?
3. Does the corporation distribute rights and risks equitably among farm owners and farm operators?

By determining answers to these questions, we can also determine the economic and other changes which Michigan farmers might expect when organizing a corporation. After assessing the impact of these changes upon a particular farm business, one can select the right action to organize a corporation to conduct the business of a particular farm.

Procedure and Methodology

Basically, this study consists of three parts: (a) a survey and description of some corporations presently organized and conducting farm businesses in Michigan; (b) an assembly and analysis of information on the corporation; and (c) some case studies of farm businesses that could conceivably incorporate.

Survey

We knew that corporations organized for the purpose of operating farms in Michigan were scarce. Yet it was decided to locate as many as possible and then conduct a survey of not more than 20 of those located. This number was arbitrarily established as the survey is but one aspect of this study, and the wide dispersion of corporations over the state made it economically unfeasible to include all of them in the survey.

Locating the corporations proved difficult, since there is no source that publishes the names or purpose of corporations organized in Michigan. The Corporation and Securities Commission could provide no help, since they file by name only. After exhausting these potential sources, it was decided to conduct a mail survey of all county extension directors in lower Michigan, except those in Wayne and Macomb counties. These counties were eliminated because of their high urban population.

There were 66 county extension directors included in the survey, of whom 56 returned the questionnaires. In this group there were 27 directors who could furnish no information, while 29 were able to furnish varying amounts. In the latter group, 12 directors listed a total of 20 farmers who had discussed with them during 1960 the problem of organizing a corporation. Also, there were 27 county extension directors who listed 44 farmers whom they knew, or thought, to be incorporated. Using this group of 64 names, it was possible to verify through the Michigan Corporation and Securities Commission records that not less than 25 corporations were organized in Michigan for the purpose of conducting a farm business. The data obtained from 18 farms included in this group of 25 are presented in Chapter IV.

In addition, three county directors named four farmers who they thought had organized corporations to conduct their farm business and who had dissolved the corporations. The dissolutions were verified in three instances, but only one shareholder of one of the dissolved corporations could be interviewed. The sources of investment capital available to this corporation turned out to be primarily non-agricultural. Therefore, there is no discussion of corporations that have been dissolved in this study.

The schedule used in the interview with a shareholder -- usually the president -- of 21 of the 25 corporations was prepared, pre-tested and modified before the final interviews were conducted. Before visiting each corporation, the names of the president and the resident agent were obtained from the Michigan Corporation and Securities Commission.[1]

Assembly and Analysis of Information On Close Corporations

The materials assembled in Chapters V, VI, and VII of this study encompass a variety of specialized subjects. Every effort is made to use qualified, authoritative sources. The sources are documented. Some readers will be familiar with some subjects discussed in these chapters. Others will not be so familiar with these subjects. Since this diversity among readers exists these subjects are treated, in some instances, in detail because it is essential in case studies to provide answers to the many questions possible. The detail is not as extensive in other instances, but the effort is made to present the pertinent information in each instance.

Case Method

Since the differences among farm businesses are so great, no general recommendation for all farms, or for all farms of a given type, can be made from a single study. An individual analysis of each family and farm business situation

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[1]The resident agent is an individual located at the corporation's registered office. Each corporation must name the place at which the office of the corporation is located, that is, the registered office in Article III and the resident agent in Article IV of the Articles of Incorporation (Michigan General Corporation Act, Sec. 450.4).

is required. Hence, the case methodology, where the facts relevant to each situation may be focused on the problems, is appropriate.

The cases included in this study are not abnormal in the sense that they represent peculiar family and business situations. They were selected to give a breadth to the study to show the effect of organizing a corporation on farms with varied family situations, types of assets, and volumes of business. Therefore, it is anticipated that the cases studied will "offer evidence of relationships which have instrumental [and] suggestive usefulness."[1]

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[1] Leonard A. Salter, Jr., A Critical Review of Research in Land Economics (Minneapolis: The University of Minnesota Press, 1948), p. 71.

CHAPTER III

THE CLOSE CORPORATION

The purpose of this chapter is to familiarize the reader with some particular features of the close corporation to be studied. Our study will be restricted to a close corporation organized by family related individuals with the specific purpose of conducting a farm business for the family. It is anticipated that such a corporation may, at least occasionally, have taxable income. Therefore, this chapter also includes the criteria that the corporation must possess if it is to qualify to elect to have its shareholders pay income tax, at their respective income tax rates, on their pro rata share of the corporation's undistributed taxable income.

Orientation to a Particular Type of Close Corporation

A corporation does not exist independently; it must be created by the State, for it is an institutional arrangement administered by the State. In Michigan, the corporation is created when the Articles of Incorporation are filed "in the office of the secretary of state," for then, "the corporate existence shall begin and those persons who subscribed to shares prior to the filing of the articles, whether by signing the articles or otherwise, or their assigns shall be shareholders in the corporation."[1] Although the corporation and its shareholders are created simultaneously by the same act of the State, we know little about a corporation until we determine (1) whether it has "public" or "close" ownership, (2) the business purpose for which the corporation was organized, or (3) how the corporation's income taxes are paid. These considerations orient this study.

"Public" or "Close" Ownership

A public corporation has numerous shareholders, most of whom are unrelated and dispersed over a wide geographic area. In a public corporation, the right of shareholders to make sales or purchases of shares is not restricted by lack of an established market for the shares or by the corporation's articles or by-laws.

A close corporation has a small number of shareholders. Normally, the individual shareholders in a close corporation are family related. However, the shareholders may be unrelated or corporations. The right of shareholders in a close corporation to make sales or purchases of shares is normally restricted by the corporation's articles and/or by by-laws. There is no established market for shares in a close

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[1] Michigan General Corporation Act, Sec. 450.5(2).

corporation. Under certain conditions a close corporation can become public.

We will consider in this study only close corporations with family related shareholders who organize a corporation with the <u>intent</u> of having it remain a close corporation.

Business Purpose

In Michigan a corporation may be organized "for the purpose of carrying on any lawful business,"[1] which, of course, permits a corporation to be organized to conduct a general or specific farming operation, including any and all other activities connected with or incident to the operation of a farm. Yet, the <u>intent</u> of the shareholders is not clarified by the statement of purpose. That is, we cannot determine from a corporation's statement of purpose alone whether the <u>intent</u> of the shareholders is to organize the farm business as a "corporate farm"[2] or as a "family farm."[3] The term "corporate

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[1]Michigan General Corporation Act, Sec. 450.3.

[2]See B. D. Crossman, "Research Into Management Problems of Corporate Farming," <u>Journal of Farm Economics</u>, XXXV (December, 1953), 956, for further discussion of the corporate farm.

[3]C. C. Zimmerman has defined the family farm "as an organization of agriculture in which home, community, business, land and domestic family are institutionalized into a living unit which seeks to perpetuate itself over many generations" ("The Family Farm," <u>Rural Sociology</u>, XV (September 1950), 211). See also family farm defined in <u>Family Farm Policy</u> (ed.), J. Ackerman and M. Harris (Chicago: University of Chicago Press, 1947), pp. 386-90 and dissenting opinions on pp. 402-4.

farm" as used here means the corporation organized to conduct the farm business was organized solely for the purpose of attracting capital, labor, and management from non-family related individuals.

We shall, in this study, discuss only close corporations organized by family related shareholders with the intent of operating a "family farm." Although this term is fraught with many meanings, let us agree that the corporation conducts the business on a "family farm": if (1) all the real property used by the corporation is contributed to it as capital,[1] leased by the corporation from family related individuals, or purchased by the corporation; (2) all the management is furnished by family related individuals; (3) all, or a part, of the labor is furnished by family related individuals, some of whom own shares; and (4) at least one family related shareholding-employee is dependent upon the corporation for his personal income. Thus, the family related shareholders must provide the corporation with land, management and some labor, and at least one related family to support.

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[1]The term contributed means the corporation received the title to the property contributed to it as capital in a tax-free transfer. The individual who contributes the property receives shares of stock issued by the corporation. The corporation owns the property. The corporation may also receive property by purchase, gift, or bequest, which are other forms of transfer.

Payment of Taxes

Every corporation organized for profit is endowed with some of the duties and rights of a taxpayer. Since the passage of the Technical Amendments Act of 1958 (Title I, Public Law 85-866), corporations that qualify may elect to be taxed in one of two ways. If the corporation has taxable income, the income taxes due may be paid in the corporation's name by the corporation, or, if the corporation has taxable income, the income taxes may be paid by the individual shareholders in their name. When the corporation's taxes are paid in its own name, it is referred to as a corporation that pays income taxes in its own name. When the taxes are paid by the individual shareholders, the corporation is referred to as taxed as prescribed in Subchapter S. This Subchapter of the Internal Revenue Code of 1954 includes Sections 1371-1377 of Chapter I and was authorized by the Technical Amendments Act of 1958. Since a corporation that pays income taxes in its own name can elect to have the shareholders pay the income taxes on its taxable income, each is discussed and, when necessary, distinguished from the other throughout this study.

Thus, we find that this study is oriented toward close corporations whose shareholders will be family related individuals who wish to organize a close corporation with the <u>intent</u> of having it conduct the farm business on their family farm. The corporation will be organized in such a manner that it may pay its own income taxes or be qualified to be taxed as prescribed in Subchapter S.

Before proceeding further, we should obtain information for a corporation taxed as prescribed in Subchapter S on (a) the criteria for qualifying, (b) making the election, (c) terminating the election, and (d) reinstating a terminated election.

Criteria That Qualify a Corporation to Elect to Be Taxed as Prescribed in Subchapter S

It is reasonable to expect the close corporation organized to conduct a farm business to usually qualify to be taxed as prescribed in Subchapter S. To do so, the corporation must be a domestic corporation,[1] not be a member of an affiliated group,[2] and must not have (1) more than 10 shareholders,[3] (2) as a shareholder a person (other than an estate)

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[1] A domestic corporation is one "created and organized under the law of the United States . . . or any State" (U.S. Treas. Reg., Sec. 1.1371-1(b)).

[2] An affiliated group results when a common parent corporation owns at least 80 percent of the voting power and at least 80 percent of each class of non-voting stock of at least one other corporation (P. Barnes, et. al. (eds.), Montgomery's Federal Taxes 37th Edition (New York: Ronald Press, 1959), p. 17.41).

[3] Int. Rev. Code of 1954, Sec. 1371(a)(1).

who is not an individual,[1] (3) more than one class of stock,[2] and (4) a non-resident alien as a shareholder.[3]

Counting the Number of Shareholders

Only individuals and estates are counted as shareholders. Shares may not be held by a trust, corporation, or partnership.[4]

Except for a husband and wife as discussed below, each individual who owns shares in the corporation as tenants in common, joint tenants, or tenants by the entirety is considered one shareholder. Each person for whom shares in the corporation are held by a nominee, guardian, agent or custodian, that is not a trust, is considered a shareholder.[5] Thus, minors may own shares in the corporation as well as certain other legally protected individuals such as mentally handicapped persons.

A husband and wife who own shares in the corporation as tenants in common, joint tenants, or tenants by the entirety -- even though they also own shares in the corporation as individuals -- are considered as one shareholder. The husband

[1] Int. Rev. Code of 1954, Sec. 1371(a)(2).

[2] Int. Rev. Code of 1954, Sec. 1371(a)(4).

[3] Int. Rev. Code of 1954, Sec. 1371(a)(3). This restriction will not be discussed further.

[4] U.S. Treas. Reg., Sec. 1.1371(d).

[5] U.S. Treas. Reg., Sec. 1.1371(d).

and the wife who own shares in the corporation as individuals -- and who do not own shares jointly -- are each considered one shareholder.[1]

Each estate is counted as one shareholder.[2]

On most farms, the property contributed to the corporation will be owned by 10 or less qualifying individuals, so this criteria will usually be met. In situations where the real property is held by more than 10 individuals, they may consider leasing it to the corporation as the number of family members owning the tangible personal property required in the farm business in a situation of this type will normally be 10 or less. Although the number of shareholders at a future date may be a problem as estates are created, this should be a rare occurrence.

One Class of Stock

The shares of stock which the corporation issues as payment for property, and which are outstanding, must be

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[1] "If a husband and wife owns stock in a corporation individually and the husband and wife own other stock in the corporation jointly, the husband and wife will be considered one shareholder. However, if the husband and wife each owns stock in the corporation individually, they will be treated as two shareholders" (U.S. Treas. Reg., Sec. 1.1371-1(2)(i)).

[2] While not an individual technically an estate is, at least, a potential taxpayer with property that does not become owned by others until the estate is settled, that is, transfers the property.

identical with respect to the rights and interest conveyed in control, profits, and assets of the corporation.[1]

Except where an individual may wish to separate ownership from control by issuing two classes of stock, this requirement will not ordinarily prevent a close corporation organized to conduct a farm business from meeting the qualifying criteria.[2]

Making A Subchapter S Election

The election of a corporation to be taxed as prescribed in Subchapter S and the consent of the shareholders to the election must be made during (a) the month preceding the first day of the corporation's tax year, or (b) the first month following the first day of the corporation's tax year.[3] The corporation must elect and all its shareholders must unanimously consent to be taxed as prescribed in Subchapter S

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[1] U.S. Treas. Reg., Sec. 1.1371-1(g). A corporation can be authorized to issue two classes of stock, for example, voting and non-voting stock; but so long as one is not issued or, if so, is owned in total by the corporation as treasury stock, the corporation qualifies.

[2] Anonymous, "Incorporating the Farm Business Part II: Tax Considerations," Minnesota Law Review, XLII (March, 1959), 786.

[3] U.S. Treas. Reg., Sec. 1.1372-2(b)(1). If the election is made during period (a), all shareholders at the time the election is made must consent. If made during period (b), all shareholders on the first day of the taxable year must consent.

to obtain a valid election.[1] Both the corporation and the shareholders must meet the qualifying criteria at the time of electing, or if the election is made after the tax year of the corporation begins every day preceding the day of electing for that tax year, before the corporation is eligible to elect.[2] The consent of a shareholder is binding and may not be withdrawn in the first tax year for which a valid election is made by the corporation.[3] A valid election continues from year to year without annual renewal until terminated.[4]

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[1]This consent is given with respect to taxes on the corporation's earnings and profits, the undistributed taxable income and the net operating loss of the corporation. Also, consent must be given to special rules with respect to any distribution of earnings and profits and adjustments to the basis of shareholders stock and debt interest, interests in the corporation (W. A. Patty, "Qualification and Disqualification under Subchapter S," Proceedings of New York University 18th Annual Institute of Federal Taxation 1960 (ed.), H. Sellin (New York: M. Bender and Co., 1960), p. 671).

[2]U.S. Treas. Reg., Sec. 1.1372-1(a).

[3]"The consent of a shareholder shall be in the form of a statement signed by the shareholder in which such shareholder consents to the election of the corporation . . . . The statement shall set forth the name and address of the corporation and of the shareholder, the number of shares of stock owned by him, and the date (or dates) on which such stock was acquired" (U.S. Treas. Reg., Sec. 1.1372-3(a)).

[4]U.S. Treas. Reg., Sec. 1.1372-2(c). However, an annual return of information must be filed (Int. Rev. Code of 1954, Sec. 6037).

Terminating a Subchapter S Election

The corporation may have its election terminated by (a) corporate revocation, (b) failure of a new shareholder, either individual or estate, to file consent, (c) ceasing to qualify as a small business corporation, or (d) becoming a personal holding company.[1]

Corporate Revocation

An election may be revoked by the corporation only for a tax year after the first tax year for which the election is effective;[2] that is, the corporation's tax must be paid as prescribed in Subchapter S at least one year[3] if the election is not invalidated in some other manner. When the corporation wishes to revoke the election, it must file the revocation along with the unanimous consent of all its shareholders at the beginning of the day the revocation is effective.[4] A

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[1] U.S. Treas. Reg., Sec. 1.1372-4(5). An election may also be terminated by the corporation having gross receipts 80 percent of which are from sources outside the United States (U.S. Treas. Reg., Sec. 1.1372-4(b)). The district director of revenue, with whom the election was originally filed, must be notified in the event the election is terminated other than by revocation.

[2] Int. Rev. Code of 1954, Sec. 1372(e)(2).

[3] "A termination by revocation cannot be made effective for the first taxable year of the corporation for which the election is made" (U.S. Treas. Reg., Sec. 1.1372-4(c)).

[4] U.S. Treas. Reg., Sec. 1.1372-4(b)(2). This would be the first day of a tax year.

revocation may be made during (a) the first month of the tax year to be effective for the tax year, or (b) after the first month of a tax year to be effective the following tax year.[1]

Shareholder Fails to Consent

Each individual who becomes a shareholder of the corporation after a valid election is made by the corporation must file a statement of consent within 30 days from the day he becomes a shareholder. In the event the new shareholder is an estate, the consent must be filed by the executor or administrator qualified by local law within 30 days after being qualified but not later than 30 days following the close of the corporation's tax year.[2] When the consent is not filed by the new shareholder within the prescribed period, the election is automatically terminated[3] for all of the corporation's tax year in which the event occurs.

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[1]Int. Rev. Code of 1954, Sec. 1372(e)(2)(A)(B). To effectively revoke an election, the corporation must file a statement indicating the first tax year which it is to be effective. Each shareholder must also file a consent, if the corporation revokes the election.

[2]U.S. Treas. Reg., Sec. 1.1372-3(b).

[3]Unless the shareholders show to the satisfaction of the district director with whom the election was filed that the failure of the new shareholder to file, a timely and proper consent was not due to an intention to terminate the election (U.S. Treas. Reg. Sec. 1.1372-4(b)(iii)). See Shareholder's will, p. 166.

Ceasing to Qualify

The corporation may cease to qualify to elect for a series of reasons.[1] Yet, most close corporations may cease to qualify when a new shareholder fails to file a timely and proper consent.

There is one other way not previously mentioned, however, in which the close corporation can cease to qualify without the knowledge of the officers or directors. This is by permitting the corporation to become "thin" as excessive debt obligations issued by the corporation may be designated for tax purposes as a second class of stock.[2]

Becoming a Personal Holding Company

The close corporation would normally conduct the farm business on all its own property and receive little income from rents. But if a corporation receives as gross receipts more than 20 percent from renting property to operating tenants, it becomes a personal holding company.[3] Thus, if a corporation

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[1]Others are (a) a shareholder who is an alien adopts foreign residence, (b) the corporation becomes a member of an affiliated group, and (c) transferring a share to a partnership, trust or corporation.

[2]U.S. Treas. Reg., Sec. 1.1371-1(g), reads "If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock." See "Thin" corporations, p. 57.

[3]Patty, _op. cit._, p. 680.

decided to rent a substantial portion of land owned by it to tenant operators, it could cease to qualify.

Reinstating a Terminated Subchapter S Election

A corporation that terminates a valid election for any reason is not normally eligible to make a new election for any tax year before the fifth tax year after the tax year in which the termination occurs.[1] Thus, if a corporation using the fiscal year ending June 30, 1963, as a tax year obtained a new and non-consenting shareholder on March 1, 1963, the election would be automatically termed effective July 1, 1962. The corporation would not be eligible to make a valid election effective again until the tax year beginning July 1, 1968.

Summarizing then, we find that the close corporation organized to conduct the farm business of its shareholders must exercise every care to continue a valid election in effect. Some procedures which will encourage the continuity of an effective valid election are discussed in subsequent chapters.

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[1] U.S. Treas. Reg., Sec. 1.1372-5(a). There is a possibility of an exception when more than 50 percent of the shares are owned by shareholders who owned no shares during the year in which the termination occurred. See Shareholder's will, p. 166.

CHAPTER IV

THE CORPORATIONS SURVEYED

Eighteen corporations organized to conduct farm businesses in Michigan were studied through a survey. This chapter presents a descriptive analysis of the information obtained.

Seeking Information on Corporations Conducting Farm Businesses

When a farmer seeks information about an institution, such as the corporate legal-business structure, he, like any other person, is restricted to two basic information sources -- non-communicative[1] and communicative.[2] Since the non-communicative sources used by farmers include farm business records, reasoning from information known to be true, observing the experience of others, trial and error, and experience,[3] we should not be surprised to find that farmers turn to

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[1] A non-communicative source provides information in a manner that it may be obtained and used _without_ the written or oral cooperation of another person.

[2] A communicative source provides information in a manner such that it may be obtained _only with_ the written or oral cooperation of another person.

[3] Russell G. Mawby and Cecil B. Haver, "Types and Sources of Information Used by Farmers," _A Study of Managerial Processes of Midwestern Farmers_ (eds.), Glenn L. Johnson, Albert N. Halter, Harald R. Jensen, and D. Wood Thomas (Lafayette, Indiana: Forthcoming Purdue University Publication), p. 39.

communicative sources such as newspapers, friends and relatives, and to the radio when seeking information on institutions. Because the information required to make a decision with regard to the corporation is quite varied and corporations conducting farm businesses are relatively scarce, it seems reasonable to assume that farmers will not find their normal communicative sources very useful when seeking to learn about the corporation, except in the case where a farmer has a friend or relative who is a lawyer or an accountant or who has investigated and organized a corporation to conduct a farm business. Thus, an alternative source is required to obtain information about other farmers who have organized a corporation. The purpose of this chapter is to provide one alternative source. It presents a descriptive analysis of eighteen corporations organized to conduct farm businesses in Michigan.

The Period of Existence

In the studied group are two corporations which were organized before 1950. From 1950 through 1955 four were organized. The remaining 12 were organized after 1955.

Only two farmers studied the corporate legal-business structure for less than one year before deciding to organize a corporation. Nine studied the corporation at least one year before making their decision to organize a corporation. Among the remaining seven, the period of study ranged from two to six years.

During the period when farmers studied the corporation and immediately before organizing a corporation, nine farmers operated their businesses as sole proprietors. Five other farms were operated as a father and son partnership and two operated as a partnership other than father and son. Only two farms were operated by farm managers. Family members replaced the managers on these farms at the time the corporations were organized.

Type and Size of Farm

Specialized farm businesses were conducted by thirteen of the eighteen corporations. A farm business was considered specialized if more than 90 percent of the gross income in 1960 resulted from sales of one product; for example, apples, or one type of product; for example, fruits. Thus the farm might produce corn for grain, corn for silage, barley and oats and be considered specialized, because beef cattle were the only products sold from the farm.

Two farms produced only one product sold by the corporations -- potatoes or onions. Seven produced and sold only one type of product such as fruit or vegetable crops. Four produced more than one type of product such as poultry or livestock. The remaining five farms were considered diversified, since more than 10 percent of their gross income in 1960 came from sales of a second type of product. In this latter group, only one corporation obtained more than 80 percent of its gross income from sales of one type of product.

In 1960, this group of eighteen corporations conducted business on farms averaging 704 acres with the range in size being from 105 to 2100 acres. Nine corporations held title to contributed or purchased farms averaging 746 acres with a range from 265 to 2100 acres. Twelve corporations conducted business on land leased from shareholders in addition to that owned. In this latter group, the average size of farm was 679 acres. No corporation studied conducted business on property owned by a non-shareholding individual.

The attitude of the Board of Directors of eleven corporations was favorable to increasing the facilities within the next five years. The board of five corporations did not expect their farm, or farm business, to expand in the next five years. In two instances, the corporation was reducing the size of its business. In the last seven cases, age, health, and the present size of business in relation to the managerial capacity available were factors mentioned as restraining expansion.

Shareholders

Each corporation studied was a close corporation and the shareholders intended to continue that policy. Statements restricting the transfer of shares were included in the articles of by-laws of several corporations. This form of restraint was not used in all cases, since a close relationship existed between many shareholders. A father and son or husband and wife owned all the shares of ten corporations. Three to five family related individuals owned all the shares in six other corporations. Only two corporations included in the study had shareholders who were unrelated.

The shares were not distributed equally among the shareholders of all the corporations, because they were used, in some instances, as a means of transferring estates.

Reasons for Organizing a Corporation

The reasons given by the individuals interviewed for organizing corporations most often were estate planning, limiting liability, and reduction of income taxes. Eight corporations were organized when estates were planned. In this group, seven received contributions of real property. However, only three of the seven received all the real property owned by the estate planning shareholder(s). Three families organized a corporation to provide limited liability to the

the shareholders. This group included the two corporations with unrelated shareholders. The third family organized to limit liability, because their farm business required trucks and other farm vehicles to be operated regularly over a heavily traveled highway. Two families operated farm businesses producing sufficient taxable income that tax advantages were gained by incorporating.

The remaining five families organized corporations for different reasons. One organized a corporation rather than a five-way partnership to give shareholders "equal rights and equal shares in profits or losses of the business and equal voice in the way the business operated."[1] Another family organized a corporation to purchase the mortgage on the family farm. A third family considered both the separate accounting available to a corporation and its usefulness in planning an estate as the principal reason for organizing their corporation. The remaining two were organized to provide a continuity of title to the farm property, but the persons interviewed did not state that the corporations were organized for estate purposes.

Other Advantages of the Corporation

In addition to the principal reasons for incorporating,

[1] This equality can also occur in a partnership.

the persons interviewed usually said they derived other advantages from the incorporation. The limiting of liability, presumably against torts, was considered the most important secondary advantage by those persons who owned shares in corporations conducting business as part owners or tenants.[1] In six instances, former farm owner-operators considered it an advantage to be a corporation employee, for they were covered by Workmen's Compensation Insurance.[2] Incidentally, these six corporations employed an average of seven full-time employees compared to an average of four full-time employees employed by the remaining corporations. Business continuity in the event of a shareholder's death was mentioned as a potential advantage in four instances. Also mentioned as advantages were flexibility of management, simplification of accounting on a large farm with multiple owners, and the formality of corporate procedure in reducing intra-family friction.[3] One family thought their corporation possessed more market power as a single farm business than if the same type of farm business had been conducted as several smaller family businesses.

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[1] See Limited liability, p. 118.

[2] See Workmen's compensation insurance, p. 145.

[3] This is what the interviewee said. However, there is no reason to believe that the corporation will either increase or decrease intra-family friction.

Disadvantages of the Corporation

Taxes associated with the corporate entity were the principal disadvantages mentioned. Not every person interviewed mentioned taxes, but nearly every applicable tax was mentioned. Included were the state business activities,[1] annual corporation privilege fee, intangible tax, federal income, and social security taxes. The annual privilege fee, a tax, was mentioned most often where real property had been contributed to the corporation. Federal taxes were seen as a disadvantage in only three instances, social security in two instances, and, in the third, the 30 percent tax rate on corporate income was considered a disadvantage.[2]

Opinions varied widely among the three persons who mentioned bookkeeping as a disadvantage. One person said the increase in bookkeeping was minor, another indicated it had increased, and a third said he considered it his principal problem. Only one person said the corporation restricted his position as a manager in any way. He said he could not "trade and swap" machinery as readily as when operating in a

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[1]Every farm business in Michigan is, at least, potentially subject to this tax.

[2]The corporation is taxed at the 30 percent rate on the first $25,000 of taxable income. If the taxable income is not reduced to zero it is possible that an individual shareholder could be in a lower income tax bracket than the corporation.

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partnership.[1] One family that contributed all its property to the corporation in return for shares found it necessary to purchase some property in its own name to be eligible to vote in school board elections.

Organizing the Corporation

Every farmer sought advice before making the decision to organize a corporation. Three consulted with personnel at Michigan State University. All had consulted with a lawyer, or an accountant, or both before making the final decision to organize a corporation. An accountant was consulted first by four farmers with large farm businesses and large taxable incomes. Six farmers conferred with a lawyer and an accountant jointly when making the decision to organize a corporation. The eight remaining farmers discussed their estate and tax problems with a lawyer.

The approximate cost of organizing fourteen corporations averaged \$343 and ranged from \$100 to \$700.[2] The cost includes legal and accountant fees, printing costs, state franchise taxes and federal stamp taxes. Cost varied with the detail required in the articles of incorporation, the property

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[1] This is a misconception. There is no reason for a difference.

[2] All the persons interviewed did not know, or could not estimate, the organization costs.

contributed to the corporation, and the amount of stock authorized by the corporation. Organization problems involving taxes were encountered by two corporations. In each case, the cost basis of purchased inventories contributed to the corporation created an income tax problem.

The property contributed to most corporations as capital was transferred tax-free, that is, the corporation adopted the cost basis of the contributor. The basis of real property contributed to the corporation was determined for federal tax purposes as cost plus improvements minus depreciation.

Every corporation did not receive real property, but all received the machinery and equipment and other tangible personal property used in the farm business. The corporation received this property in a tax-free transfer in nearly every instance by adopting the contributor's cost basis. A few items of property with a zero cost basis were sold at fair market value to corporations. By this process the buyer gained a new cost basis for depreciation and the seller received capital gain income.

The assets owned by individual shareholders varied greatly within corporations and between corporations. Individuals had contributed from five to 100 percent of their assets to the corporation. Most shareholders contributed less than 50 percent of their total assets to the corporation. However, in four instances, the shareholders had contributed more than 90 percent of their assets to the corporation. In this group, three corporations conducted the business of diversified farms and the fourth the business of an orchard. Three other corporations with orchard businesses received less than 10 percent of the assets owned by individual shareholders.

Board Operating Policies

In Michigan each corporation has a three-member board of directors -- not necessarily shareholders -- who hold at least one formal meeting annually. The boards of thirteen corporations held the required number of formal meetings. Five boards held formal meetings from four to twelve times annually. Incidentally, all corporations held one formal shareholder meeting annually. Even though the directors of most corporations were in daily contact they used formal procedures to establish corporate policy.

Only one corporation had elected to be taxed as prescribed in Subchapter S. The other seventeen corporations paid income taxes in their own name.

Nearly all male shareholders were corporation employees. Salaries, set prior to the business year, varied with the type of business with $10,000 being the maximum salary drawn by a shareholding-employee in 1960, although some were authorized by the corporation by-laws to draw higher salaries. No corporation paid salaries to anyone serving in the capacity of a director or an officer. Most shareholders over sixty-five provided services to their corporation to the extent allowable under social security regulations.

Rents were received by many shareholders for land leased by the corporation. Some rents were for cash amounts and others were on a fifty-fifty crop share or profit share basis. Usually rental payments were designed to fluctuate with yields and/or prices.

Day-to-day operating decisions on the farms were made by many of the same individuals who would have made them if the farm business had been conducted as a partnership or sole proprietorship. Some older farmers who organized corporations shifted the major responsibility for operating decisions to their sons, who consulted with them before making major expenditures. The independence of decision and independence of action commonly found in partnerships existed in the corporation. For example, the board policy in all but two corporations permitted all officers to write checks against the corporation's account without having a co-signer. All the officers in the other two could write checks, but board policy required the checks to have the signature of two officers. This was explained as a normal double check on business expenditures. The boards of only two corporations limited the maximum single expenditures that the corporation could make without having board approval.

Every corporation had received board approval to borrow money. Commercial banks were used as a credit source by seventeen corporations. Federal Land Bank loans were also obtained by four corporations. In addition, one corporation obtained a loan from a Production Credit Association, and another corporation obtained a loan from family members. Both the Federal Land Bank and the Production Credit Association required the officers who signed the credit instrument to also endorse it as private individuals. This was also the policy of commercial banks from which nine of the seventeen corporations obtained credit.[1] Thus, not all of the corporations were required to have credit instruments endorsed by shareholders or other individuals. No relation appeared to exist between corporate assets and whether the bank required loans to be endorsed by an officer or officers of the corporation.

Most corporations were restricted by their board, or type of property, to borrowing only with secured notes. Four

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[1]See Limited liability, p. 118.

corporations had mortgaged real property.

Policies for pricing shares transferred between persons who owned shares of the corporation had been formulated by only four boards. This group established the book value of shares, which was determined annually, as the transfer price. One board required the corporation to purchase all shares offered for sale and then offer them to the remaining shareholders. Several persons interviewed recognized that a system of valuing and transferring shares required board action; however, their boards had taken no action.

Some form of buy-sell agreement existed among the shareholders of eight corporations. In three cases, shareholders desiring to sell were required to offer the shares to the other shareholders before offering them to an outsider. The buy-sell agreements of shareholders in five corporations were supported by life insurance. In each case, the corporation was named the beneficiary and was required to use the proceeds of the policy to purchase the share owned by the insured's survivors. This procedure was designed to stabilize the control of the corporation and to prevent the survivors of the insured from unwillingly owning shares in the family corporation.

Some Financial Aspects of the Corporations Surveyed[1]

Each corporation must file its financial statement at the close of its business year with the Annual Report Section of the Corporation and Securities Commission. Seven of the eighteen corporations studied operated on a calendar year; the others operated on a fiscal year.

Thirteen corporations had completed, at least, one business year before January 1, 1960, and paid their annual corporation privilege fee in 1960. The average fee paid by twelve corporations was $261 with a range from $80 to $596. The thirteenth corporation paid $1,394, which raises the average to $348; therefore, it is stated separately.

The annual privilege fee is assessed, at the rate of five mills per dollar, on paid-in capital and surplus, the sum of which represents the equity owned by the shareholders. The thirteen corporations had issued an average of $46,940 worth of shares for paid-in capital. The total par value of shares issued ranged from $1,000 to $146,000, but the sum of

[1]The number of corporations included in this section is less than eighteen because all the corporations had not completed a full business year by May, 1960, or were delinquent. Data are based on the 1960 Annual Reports which report for the business year of 1959. Filing of the 1961 Annual Reports which contain the data for 1960 is not completed by the Corporation and Securities Commission for several months after they are received. Thus these were not available at the time of this study.

the shares issued and the surplus, reported as paid-in and earned averaged $53,452, with a range from $15,950 to $132,435. All the corporations did not report a surplus. Three reported deficits. In two cases, the deficits exceeded 50 percent of the paid-in capital. One of these corporations conducted the farm business as owner. A third corporation reported a deficit of approximately 10 percent of paid-in capital. The annual privilege fee is assessed against the paid-in capital and surplus, and deficits reduce this fee only so long as they reduce surplus.

The financial statement of a corporation balances; therefore, its total assets, including operating cash, accounts receivable, inventories, capital assets less depreciation reserves, and other assets always equal total liabilities, which includes notes, mortgages, paid-in capital, and surplus. The total assets reported by six corporations that owned some or all of the farm land used in the farm business averaged $114,981 and ranged from $49,284 to $187,920. Land, buildings, and other items of real property included in this group had a book value of $66,861 before allowances for depreciation. A seventh corporation which owned only part of the land used in the farm business reported total assets of $611,348.

The total farm income of eleven of the corporations in 1960 averaged $120,822, with a range from $16,000 to approximately $350,000. Total farm expenses averaged $99,239, with a range from $22,000 to approximately $335,000. The maximum net profit after taxes earned by a corporation in this group was $17,548. Two corporations had profits, after taxes, of approximately $10,000. Another two paid federal income tax, but the profits were not disclosed. The remaining corporations restricted profit to the approximate break-even point or suffered a loss in 1960. Since a corporation may reduce taxable income to zero by paying salaries and bonuses to shareholding-employees, it would be in error to conclude that all the corporations in the group that were at the break-even point in 1960 were unprofitable farm businesses from the shareholder's viewpoint.

Summary

Our observations of eighteen corporations conducting farm businesses in Michigan show that farmers normally study the corporate structure for periods exceeding a year before making the decision to organize a corporation. The number organized is small but appears to be increasing. Most corporations conducted the farm business of specialized farms. The average farm size was 704 acres, with a range from 106 to 2,100 acres. Included in the study were corporations organized as owners, part-owners, and tenants.

Estate planning, limiting liability, and income tax advantages were given most often as reasons for incorporating. One corporation was organized in preference to a five-way partnership and another to purchase the mortgage on the family farm. The interviewees said their additional advantages were limited liability, potential continuity of business, and increased market power. Taxes were considered a disadvantage. The annual privilege fee and the associated intangible tax were the tax disadvantages mentioned most often, especially when real property was contributed to the corporation as capital for which the corporation issued shares.

Each corporation was organized with the advice and assistance of a lawyer or an accountant. The average cost of organizing fourteen corporations was $343 and ranged from $100 to $700. Real and tangible personal property contributed to the corporation by shareholders was transferred tax-free, except in one case where a shareholder sold the corporation some property.

Each corporation complied with the law by holding an annual shareholders meeting. Formal meetings of the board of directors ranged from one to twelve per year, with the former figure predominating. Most male shareholders were employees. As employees, their salaries depended upon the

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the services rendered to the corporation and were established prior to the beginning of the business year. In 1960 salaries ranged up to $10,000. Seventeen of the eighteen corporations had obtained credit at a commercial institution. Nine of these required an officer of the corporation to endorse the credit instrument as a private individual. Share transfer plans were formalized in eight corporations where shareholders used buy-sell agreements.

The annual privilege fees cost twelve corporations an average of $261 in 1960. Three corporations had deficits with respect to paid-up capital. The book value of assets owned by six corporations owning real property averaged $114,981, with a range from $49,284 to $187,920, with a seventh having assets of $611,348. Total farm incomes of eleven corporations averaged $120,822 and ranged from $16,000 to $350,000. Four corporations had earnings sufficiently great that they reported taxable income in 1960.

CHAPTER V

FEDERAL INCOME AND FEDERAL AND STATE EXCISE TAXES

In this chapter, information on federal taxes on income and federal and state excise taxes,[1] applicable to close corporations conducting farm businesses, is presented. This tax information is useful in making decisions concerning certain problems encountered when organizing a corporation to conduct a farm business. Hence, it will be used in both informal and formal analysis of farm and family situations by individuals who investigate the corporate legal-business structure.

Need for Additional Information

Only a few farmers will obtain enough information from observing corporations of other farms to reach a decision about organizing a corporation to conduct their farm business. Thus, information gathering will continue for the many who have not reached a decision until the observation and analysis phases of their decision-making process becomes indistinguishable. The information obtained from the communicative sources to which they must turn requires an analysis based on information

[1]The term excise tax is used to designate collectively the taxes imposed on businesses for the privilege of conducting a business.

obtained from some of their own non-communicative sources, namely, (a) written records on their farm businesses, (b) experience, and (c) reasoning from information known to be true. Generally, the first analysis will be conducted informally, that is, by mental budgeting, and simultaneously with the information gathering process, with each farmer selecting those facts relevant to his specific farm situation.

A corporation that conducts a farm business is a farmer for tax purposes.[1] Even though the farm business conducted by a corporation receives any tax payment privileges available to an individual farmer, the business is also subject to the taxes applicable to corporations. The taxes on corporations may influence significantly the way a specific corporation is organized as well as the final decision to organize a corporation. Therefore, how the corporate entity is taxed should be analyzed carefully.

It must also be recognized that the close corporation is a taxpayer which possesses unique characteristics. It is (a) invisible, (b) incapable of oral or written communication, except when assisted by a natural person; and (c) intimately knowledgeful of the tax position of its shareholders. Consequently, the corporation must, in all instances, and especially

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[1]U.S. Treas. Reg., Sec. 1.61-4(d) states, "All individuals, partnerships or corporations that cultivate, operate or manage farms for gain or profit, either as owners or tenants, are designated as farmers."

when conducting transactions with its shareholders, act in a technically correct manner and follow normal business practices. Hence, we shall turn first to the general tax problems sometimes associated with the close corporation, then to the specific federal taxation of corporations, and finally, to state taxation of corporations.

Avoidable Tax Problems of a Close Corporation[1]

One fact should be recognized -- the tax problems associated with (a) the arm's length transactions, (b) the "thin" corporation, and (c) the accumulated earnings tax, can be minimized when the corporation and its shareholders conduct their business in a technically correct manner and follow normal business practices.

Arm's Length Transaction

The principle of the "arm's length" transaction is derived from Section 482 of the Internal Revenue Code and is

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[1] These problems are discussed here, not with the intent of oversimplification, but to familiarize the reader with the concept represented by the terms.

applicable to all forms of business under common control.[1] This standard devised by the U. S. Treasury is used when two taxable entities under common control seek to use their relationship to improperly reduce, avoid, or escape taxes.[2]

When a transaction between entities under common control is subjected to the standard of "arm's length," it is generally, but not always, sufficient to prove that similar transactions were conducted with non-controlled outside parties or were established industry practices.[3]

Many close corporations will conduct one or more transactions which need to be subjected to the standard of "arm's length." One such example would be a rental or lease agreement with its land-owning shareholders.[4] When parties under a common business control enter into a rental agreement with

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[1] "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 or his delegate 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 such organizations, trades, or businesses" (Int. Rev. Code of 1954, Sec. 482).

[2] Robert S. Holzman, Arm's Length Transactions (New York: Ronald Press Co., 1958), pp. 3-6.

[3] Ibid., p. 213. It would seem reasonable that in agriculture the term "community practices" should replace "industry practices."

[4] See Rental payments, p. 65.

themselves, they must be able to show (or prove) that outside parties would have entered into the agreement on the same terms or have a disinterested third party expert set the terms of rent.[1]

In addition, a taxpayer who must show that his transactions are at "arm's length" may need "a reason as to why the dealings with parties under common control took the form that they did. In the case of a corporation, there is no better place than the [corporation's] minutes 'to determine the intent of the corporate officers . . .'"[2]

The shareholders of a close corporation may need to ask, "Is this transaction being conducted at arm's length?" In nearly every case, reasonableness, records, and technical advice will provide the correct answer.

"Thin" Corporation

A corporation is "thin" when it is financed by an excessive amount of debt with little or no equity (or share) financing by its shareholders. Debt used to finance a "thin" corporation is nearly always held by the shareholders who severely aggravate their situation when they own corporate

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[1]Holzman, op. cit., p. 125.

[2]Ibid., p. 128.

debt in proportion to their shareholdings.[1]

Farmers who have funds to lend to their corporation will find that some corporate debt can be advantageous to both the corporation and to its lending shareholders. One advantage for the corporation is that interest paid or accrued on outstanding indebtedness is a deductible expense.[2] The advantage to the shareholder is that the interest received from the corporation is not susceptible to "double taxation."[3] In addition, a shareholder who owns corporate debt is provided a means of regaining a portion of his investment in the corporation.[4] Other advantages may also exist for some corporations and shareholders.[5]

Shareholders who do lend money to their corporation should use the real value of the corporation's assets, not par or book value, when determining its debt-equity ratio.[6] What represents an acceptable debt-equity ratio apparently

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[1]Martin M. Lore, Thin Capitalization (New York: Ronald Press, 1958), p. 3.

[2]Int. Rev. Code of 1954, Sec. 163(a).

[3]See Federal Taxes on Income, p. 62.

[4]M. Caplin, "The Caloric Count of a Thin Corporation," Proceedings of New York University 17th Annual Institute on Federal Taxation 1959 (ed.), H. Sellin (New York: M. Bender and Co., 1959), p. 772.

[5]*Ibid*.

[6]Bardes, *op. cit*., p. 4.3.

varies with the type of business and other surrounding circumstances. However, "the tax advantages of thinning a corporation when the ratio of [debt to equity] exceeds 2:1 are relatively small as compared to the risk of having the debt [converted] into capital contributions."[1] A corporation that borrows from its shareholders must be able to justify its debt-equity ratio, and shareholders who lend to their corporation must be able to justify their loan. The shareholders "can probably justify [the corporation's] debt-equity designation if the amount of the debt issued by the corporation [to its shareholders] is no greater than that which could have been obtained [by the corporation] from outside creditors on the same terms."[2]

Thus, it is again evident that adequate records and acceptable business practices need to be maintained.

Accumulated Earnings Tax

The accumulated earnings tax is assessed against

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[1] Lore, op. cit., p. 200 (Italics added).

[2] "Anon.," ". . . Part II . . . ," Minnesota Law Review, XLIII (March, 1959), 809 (Italics added). This opinion is based on a test found in Gilbert vs. Commissioner, 248 (F.2d) 399 (2d Cir. 1957).

"accumulated taxable income."[1] "Accumulated taxable income" is the undistributed taxed income which could have been distributed as dividends to shareholders which is retained in the corporation's account after adjustment for all tax debits and credits, and a $100,000 accumulated earnings credit. Up to $100,000 of earnings may be retained by the corporation without imposition of the accumulated earnings tax of 27-1/2 percent on that not in excess of $100,000 and 38-1/2 percent on that in excess of $100,000.[2] Accumulated earnings in excess of $100,000 may be retained by the corporation if they can be shown to be "reasonable needs of the business." Generally, the corporation operating a farm business will not be affected by the accumulated earnings tax,[3] because the income from farming is such that "only the very large farm corporation need be concerned" about the accumulated earnings tax,[4] while the "small farmer . . . will be able to manipulate

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[1]Int. Rev. Code of 1954, Sec. 535. Any earnings accumulated are first taxed at the applicable corporate rate. For those interested, the debits and credits allowed are presented in tabular form in Bardes, op. cit., p. 7.14.

[2]Int. Rev. Code of 1954, Secs. 531 and 532(a).

[3]For a supporting view see S. H. Hart, C. M. Maer, Jr., and J. A. Moore, "Some Special Tax Problems of Farm and Ranch Partnerships," Proceedings of New York University 16th Annual Institute of Federal Taxation 1958 (ed.), H. Sellin (New York: M. Bender Co., 1958), p. 169. Also F. L. Mallare, "Tax Considerations of Farm Incorporation," Wisconsin Law Review, CMLX (July, 1960), 578.

[4]"Anon.," ". . . Part II . . .," Minnesota Law Review, XLIII (March, 1959), 795.

his surplus earnings that are retained in the corporation quite satisfactorily."[1]

Nevertheless, in the event of accumulated earnings problems, and especially questions related to "reasonable needs of the business," it is necessary to offer proof in writing as, for example, minutes of the board of directors,[2] why the accumulated earnings are required in the business at that particular time. Substantiating proof often requires that records indicating the corporation's future need for investment funds be maintained not only in the year at issue but prior years as well.[3]

Thus, we find that the arm's length transaction, the "thin" corporation, and the tax on accumulated earnings are situations that sometimes occur in corporations which demonstrate one point: business transactions between a close corporation and its shareholders, as well as outsiders, must be properly conducted and properly recorded so that taxable income is determinable and the tax due paid. However, it is

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[1]Mallare, Wisconsin Law Review, CMLX (July, 1960), 578.

[2]Bardes, op. cit., p. 17.19.

[3]S. S. Weithorn, "What Constitutes a 'Reasonable' Corporate Accumulation?" Proc. of N.Y.U. 17th Ann. Inst. on Fed. Tax. 1959, op. cit., p. 323.

not necessary that the corporate records be written in legal terminology.[1]

Federal Taxes on Income

Four major subsections are included in this section concerning federal taxes on income. These taxes are discussed with reference to the (1) corporation that pays income taxes in its own name, (2) corporation that is taxed as prescribed in Subchapter S, (3) cost basis problem, and (4) corporation at the time of dissolution.

Taxes and the Corporation that Pays Income Taxes in Its Own Name

Every taxpayer is required to pay federal income tax on the adjusted taxable income reported. Since the corporation is a taxpayer and the shareholder is also a taxpayer, income received by the shareholder from the corporation in the form of dividends is taxed twice, that is, subjected to "double taxation." This occurs because (a) the adjusted taxable income of the corporation is first taxed at the applicable rate which is 30 percent on the first $25,000 of adjusted taxable income and 52 percent on all in excess of $25,000

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[1]Holzman, op. cit., p. 87.

adjusted taxable income,[1] and (b) the dividends distributed by the corporation are then taxed as ordinary income at the rate applicable to the receiving shareholder.[2] It follows that "any apparent advantage of the corporate farm on the basis of comparison of tax rates alone vanishes if the income received by the corporation is taxed twice,"[3] that is, as corporate income and again as dividends to the shareholder.

However, a farmer who is consistently in an income tax bracket exceeding that applicable to the first $25,000 of corporate income may find that substantial tax savings result from organizing a corporation. The savings will depend upon the individual's applicable tax rate and must be individually computed.

Any farmer investigating the corporation will find the possibility of "double taxation" an extremely important problem which he will wish to solve. Having the corporation taxed as prescribed in Subchapter S is one acceptable way to reduce "double taxation." This problem may be solved but not

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[1] Int. Rev. Code of 1954, Sec. 11(b)(c).

[2] Int. Rev. Code of 1954, Sec. 61(a)(7). This effect is reduced somewhat by the $50 exclusion granted the individual by Section 116 of the Code and also by the 4 percent credit allowed on the tax imposed on dividends in excess of the exclusion (Int. Rev. Code of 1954, Sec. 34).

[3] "Anon.," ". . . Part II . . .," Minnesota Law Review, XLIII (March, 1959), 784 (Italics in original).

eliminated in the usual corporation by (a) payment of salaries, (b) payment of rent, and (c) retaining earnings.

<u>Payment of salaries</u>.--The corporation as a taxpayer is entitled to deduct all the ordinary and necessary expenses paid or incurred during the tax year, including "a reasonable allowance for salaries or other compensation for personal services actually rendered."[1] Where salaries and bonuses are paid for services actually rendered, the total amount paid as compensation is subject to the test of reasonableness.[2] This test is a question of comparative fact raised almost exclusively in the case of shareholding-employees of close corporations.[3] A U. S. Treasury test rule states, "It is, in general, just to assume that reasonableness and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."[4] Since the conditions vary so from farm to farm and on the same farm from year to year, this test could be a problem to both parties -- the one attempting to show unreasonableness and

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[1]Int. Rev. Code of 1954, Sec. 162(a)(1).

[2]Bardes, <u>op. cit</u>., p. 3.11.

[3]A. J. Dixon, "Planning Reasonable Compensation," <u>Proceedings of New York University 19th Annual Institute on Federal Taxation 1961</u> (ed.), H. Sellin (New York: M. Bender and Co., 1961), p. 182.

[4]U.S. Treas. Reg., Sec. 1.162-7(b)(3).

and the one attempting to show reasonableness. However, if the corporation can show that the compensation arrangement was established before, or early in, the tax year when the services were begun,[1] and before the profits for the year became known or estimable,[2] and that the "sole purpose was to give fair compensation," the arrangement will be upheld.[3] Items paid as compensation which lack the "element of compensation, for example gifts, may not be deducted by the corporation."[4]

Usually the number of shareholding-employees and the income of most corporations conducting a farm business will be such that few questions about salaries will be raised, particularly where the corporation (1) sets forth its compensation arrangements as a part of its regular records, for example, in the minutes of the board of directors, and (2) receives competent advice.[5]

Rental payments.--The corporation may also deduct, as ordinary and necessary expenses, rental and other payments

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[1]Dixon, op. cit., p. 186.

[2]Bardes, op. cit., p. 3.10.

[3]"Anon.,"". . . Part II . . . .," Minnesota Law Review, XLIII (March, 1959), 793. Corporations with farm businesses in Michigan did pay or where authorized to pay salaries of $10,000 to $12,000 to managing shareholding-employees.

[4]U.S. Treas. Reg., Sec. 1-162-9.

[5]Dixon, op. cit., pp. 181, 184.

required to be made as a condition for the continued use,[1] or possession, of property to which it has not taken title, or is not taking title, or in which it has no equity.[2] Rental payments are taxable as ordinary income to the individual who leases property to a close corporation.[3] The rental payments may be paid "in money or property and may be a fixed amount for a given period or a variable amount such as percentage of sales or of production."[4]

Rents paid to shareholders of a close corporation will be scrutinized by the Internal Revenue Service.[5] They must be reasonable and consistent with prevailing rates in the community[6] and established in a transaction conducted at "arm's length."[7] Both under- and over-payments of rent

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[1] See Leasing property to the corporation, p. 89.

[2] Int. Rev. Code of 1958, Sec. 162(a)(3). A corporation cannot deduct payments made on a land contract transaction or payments on a mortgage for such payments represent purchases of equity (Mallare, Wisconsin Law Review, CMLX (July, 1960), 588).

[3] Int. Rev. Code of 1954, Sec. 61(a)(5).

[4] Bardes, op. cit., p. 10.46.

[5] "Anon.," ". . . Part II . . .," Minnesota Law Review, XLIII (March, 1959), 794.

[6] J. C. O'Byrne, et. al., The Farm Corporation, North Central Regional Extension Publication No. 11, Cooperative Extension Services, Pamphlet 273 (Ames: Iowa State University, June, 1960), p. 10.

[7] Bardes, op. cit., p. 10.47.

will be questioned,[1] and if disallowed, "could be treated [for tax purposes] as dividends or gifts, depending on the circumstances."[2] Even so, a "farm owner may be well advised to rent his [real] farm property to the corporation rather than to exchange it for [shares]."[3] This view is supported by Bardes, et. al., who states, "Generally the double taxation or corporate profits makes individual ownership of income producing real property preferable to corporate ownership if the income is needed for living purposes and is not to be reinvested."[4]

Here again, records are important, for it is necessary to be able to prove that a rental agreement exists and that actual payments have been made.

Retained earnings.--"Double taxation" may be postponed by retaining income which could be distributed as dividends, in the corporation rather than paying dividends. The retained earnings will, of course, be taxed at the applicable corporate rate. However, earnings may be retained in succeeding tax years cumulatively up to $100,000 without

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[1]Holzman, op. cit., p. 140.

[2]Bardes, op. cit., p. 10.48.

[3]"Anon.," ". . . Part II . . .," Minnesota Law Review, XLIII (March, 1959), 794.

[4]Bardes, op. cit., p. 10.58.

imposition of the accumulated earnings tax.[1] Corporations conducting large farm businesses that have only one or two shareholding-employees who receive reasonable salaries from the viewpoint of the Internal Revenue Service, may find earnings retained for business purposes an important internal credit source.

Shareholders will find that "double taxation" of income will be rare in corporations that conduct farm businesses and pay income taxes in their own name. However, shareholders will find that such corporations are taxed differently than individuals on income arising from capital gains.

Taxing capital gains.--Every farm business has some property that may be classified as the asset land, capital assets, or as "1231 assets."[2] When such property is sold, traded, or involuntarily converted, the gains and losses that result receive special tax treatment -- that is, treatment

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[1]See Accumulated earnings tax, p. 59.

[2]The term "1231 assets" refers to assets which are included by Section 1231 of the Internal Revenue Code of 1954. Such assets must be used in the trade or business, held for more than six months, not properly includable in inventory, and not held primarily for sale in the ordinary course of business. They must be of a character subject to depreciation. The "1231 assets" are normally considered to be realty, that is, farm buildings, orchards, tile, etc., machinery and equipment, and livestock held for draft, breeding, or dairy purposes for twelve months or more. Land is not a depreciable asset and is not included in the "1231 asset" group, although it is used in the farm business.

as capital gains.[1] Capital gain income is taxed at an over-all rate that is less than the income tax rate on ordinary income. Farm property subject to capital gain treatment includes (a) farm realty and land held more than six months, (b) property used in the farm business that may be depreciated which is held for six months, for example, farm machinery, etc.,[2] (c) livestock, regardless of age, held for draft, breeding, or dairy purposes for twelve months or more from the date of acquisition,[3] and (d) unharvested crops sold in special situations.[4] Except for products inventoried for sale in the normal course of business,[5] substantially all the property on a farm can be classed as the asset land, capital assets, or "1231 assets." Consequently, the gains and losses that are associated with such assets are normally permitted capital gain treatment.

The distinction between the capital gain treatment accorded the asset land, capital assets, and "1231 assets"

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[1] Int. Rev. Code of 1954, Sec. 1222.

[2] Int. Rev. Code of 1954, Sec. 1231(b)(1) and Section 167(a)(1)(2).

[3] Int. Rev. Code of 1954, Sec. 1231(b)(3). Livestock includes cattle, hogs, sheep, etc., and excludes poultry, other fowl, fish, etc.

[4] Int. Rev. Code of 1954, Sec. 1231(b)(4).

[5] Including, for example, livestock being fattened for market, hay, small grains, corn, orchard, and truck crops.

is important when organizing a corporation. This is especially so since the principal asset used by most farmers is land, which is a non-depreciable asset. But farms that produce substantial amounts of income from sales of "1231 assets," for example, dairy and livestock breeding farms, will find the capital gain treatment accorded corporations and individuals particularly important. It is important, but less so, on those farms which receive nearly all their income from products inventoried for sale in the normal course of business. Since the tax treatment accorded the asset land, "1231 assets," and other forms of income producing property differ, these may influence (a) the type of assets which should be contributed to or purchased by a corporation, and (b) the manner in which the corporation income taxes will be paid.

Capital gains are of two types, "net long-term"[1] and "net short-term."[2] Any excess of net long-term capital

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[1]Int. Rev. Code of 1954, Sec. 1222(3)(4)(7). "Net long-term capital gain" is the gain from the sale of capital assets held over six months, less loss from sale by capital assets held over six months. Loss may exceed gain creating net long-term capital loss.

[2]Int. Rev. Code of 1954, Sec. 1222(1)(2)(6). "Net short-term capital gain" is the gain from sales of capital assets held less than six months, less the loss from sales of of assets held less than six months. Loss may exceed gain, creating net short-term capital loss.

gains over net short-term capital losses resulting from the sale of assets subject to capital gain treatment by a corporation that pays its own income taxes receives different tax treatment than that received by an individual farmer.

For a corporation that pays income taxes in its own name, the tax rate on the net long-term capital gain is 25 percent on any gain exceeding ordinary taxable income or that is not used to offset net operating losses.[1] The individual farmer, however, can include one-half of his capital gain to be taxed at his regular income tax rate or include the capital gains to be taxed at the 25 percent rate,[2] whichever results in the smaller tax. As long as the individual farmer is in an income tax bracket where his ordinary income is taxed at a rate less than 50 percent, he has a tax advantage in his treatment of capital gains over the corporation. Consequently, it is not advisable to contribute to a corporation land or other assets that are subject to substantial appreciation in value when it is unnecessary to do so.[3]

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[1] Int. Rev. Code of 1954, Sec. 1201(a).

[2] Int. Rev. Code of 1954, Sec. 1201(b)(1), 1201(b)(2).

[3] "Anon.," ". . . Part II . . .," Minnesota Law Review, XLIII (March, 1959), 805. Circumstances may alter the situation, however. For example, a farmer may own title to so much farmland that his untimely death would result in an extremely large estate tax, or an individual in a partnership who is seriously ill may organize a corporation to provide control to his partner and support for his family in case of his death. These situations have occurred in Michigan.

The treatment of capital losses resulting from the sale of capital assets made by the corporation and the individual farmer is also different. A corporation conducting a farm business can deduct capital losses from the sale of capital assets "only to the extent of gains" in any one year.[1] Yet an individual farmer can deduct capital losses "to the extent of gains from such sales or exchanges plus the taxable income of the taxpayer or $1,000, whichever is smaller."[2] Both the corporation and the individual farmer are permitted to carry over a net capital loss occurring in one tax year as a short-term capital loss for each of the five succeeding tax years.[3] Thus, to the extent that the initial capital loss from the sale of capital assets exceeds the total of any net capital gains made from the sale of capital assets in the five succeeding tax years, the capital loss is recoverable by the corporation. When a series of capital losses occur, the oldest must be exhausted first, and some may remain "locked in" the corporation, that is, unrecoverable to the individuals owning shares of the corporation.[4]

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[1] Int. Rev. Code of 1954, Sec. 1211(a).

[2] Int. Rev. Code of 1954, Sec. 1211(b). In special circumstances, then, an individual could deduct up to $6,000 of capital losses from ordinary income which the corporation cannot do.

[3] Int. Rev. Code of 1954, Sec. 1212.

[4] Bardes, _op. cit_., p. 9.10.

Any capital gains from sales of "1231 assets" are taxed as the capital gains discussed above, but capital losses on the sale of "1231 assets" are taxed to the corporation just as they are to the individual farmer, that is, they are deductible from ordinary income.[1] This may not be a particularly important feature on losses resulting from sale of "1231 assets," as the basis on the majority of "1231 assets" will have been reduced by depreciation.[2] Yet any uninsured "1231 asset" losses are completely deductible.

Thus, we see that losses from sales of capital assets can be "locked in" the corporation and be unrecoverable to the shareholders, while losses from sales and uninsured casualties of "1231 assets" are treated in the same manner for both the corporation and the individual farmer. Therefore, from an income tax standpoint, the farmer will normally find it advantageous to contribute only tangible personal property used in the farm business to the corporation as

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[1] "The gains shall be included only if and to the extent taken into account in computing gross income and the losses . . . shall be included only if and to the extent taken into account in computing taxable income, except Section 1211 shall not apply . . . . In the case of any property used in the trade or business and of any capital asset held for more than six months and held for the production of income, this subsection shall not apply to any loss, in respect of which the taxpayer is not compensated for by insurance in any amount . . . ." (Int. Rev. Code of 1954, Sec. 1231(a), as amended by Sec. 49(a), Public Law 85-866).

[2] "Anon.," ". . . Part II . . .," Minnesota Law Review, XLIII (March, 1959), 798.

capital. This property should be used for income producing purposes and included in the "1231 assets" category.

Taxes and the Corporation that Elects to be Taxed as Prescribed in Subchapter S

A corporation that elects to be taxed as prescribed in Subchapter S pays no federal income tax for the tax years in which a valid election exists.[1] The shareholders of a corporation with a valid election pay taxes on any taxable income that the corporation may have at their respective income tax rates. However, the corporation is required to file, for each tax year the election is valid, a federal income tax return indicating its gross income and deductions, including salaries and rental payments to shareholders and amounts of dividends distributed, as money or property, to each shareholder during the tax year.[2]

The shareholders of a close corporation will require information on how they will be affected if the corporation elects to be taxed as prescribed in Subchapter S, (a) by the undistributed taxable income of the corporation,[3] (b) by a

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[1]The only effect of a valid election is to exempt the corporation from federal income tax (U.S. Treas. Reg., Sec. 1.1372-1(b)).

[2]Patty, op. cit., p. 685.

[3]Int. Rev. Code of 1954, Sec. 1373.

net operating loss of the corporation,[1] (c) by the capital gains and losses of the corporation,[2] (d) by distributing previously taxed income,[3] by changes in the basis of shares,[4] and (f) by other factors.

Undistributed taxable income.--The taxable income of the corporation, minus the amounts of money distributed as dividends out of earnings and profits during the current[5] tax year of the corporation, is the undistributed taxable income.[6] Each shareholder of the corporation on the last day of the tax year includes in his gross income for tax purposes[7] and amount of money equal to that which he would have received if the corporation had distributed all the undistributed

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[1] Int. Rev. Code of 1954, Sec. 1374.

[2] Int. Rev. Code of 1954, Sec. 1375(a).

[3] Int. Rev. Code of 1954, Sec. 1375(d).

[4] Int. Rev. Code of 1954, Sec. 1376.

[5] Int. Rev. Code of 1954, Sec. 1373(d)(1). The corporation with a valid election is not permitted to deduct operating losses carried forward from previous years in which it did not have an election when computing taxable income in the current tax year. Note that no dividends may be distributed if taxable income is reduced to zero by paying salaries and rents.

[6] Int. Rev. Code of 1954, Sec. 1373(c).

[7] Int. Rev. Code of 1954, Sec. 1373(a). This is included in his personal income tax return filed at the close of his tax year which may be different from that of the corporation.

taxable income on a pro rata share basis.[1] Thus, if all the earnings and profits for the tax year were distributed as money dividends, the corporation's undistributed taxable income would be reduced to zero. Such distributions may be made on the last day of the tax year.

Distributions of property are not treated as money distributed as dividends. Property distributions do not reduce earnings and profits or undistributed taxable income. Furthermore, property distributed in place of a dividend declared in money is taxed at its fair market value.[2] Corporations, therefore, "should not distribute dividends in any form other than cash, as a property distribution will not reduce the undistributed taxable income of the shareholders"[3] and simply increases any taxes payable.

Shares of a corporation with a valid election may be

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[1]U.S. Treas. Reg., Sec. 1.1373-1(a)(1). Technically, this undistributed money is taxed as a "constructive dividend." That is, "income which is unqualifiedly subject to the demand of the cash-basis taxpayer, although it has not actually been received in cash or the equivalent . . . income is constructively received if it is credited to the account of the taxpayer . . . ." (Bardes, op. cit., p. 1.30).

[2]U. S. Treas. Reg., Sec. 1.1373-1(d).

[3]Jeremy C. Shea, "Taxing Corporation Income to the Shareholders," Wisconsin Law Review, CMLX (July, 1960), 594 (Italics added). For example, a corporation with two shareholders has taxable income of $2,000 and makes a property distribution of $1,000; the shareholders must pay taxes on $3,000.

transferred at any time, including the last day in the tax year. In the event of such a transfer, the new shareholder is taxed on any undistributed taxable income for that tax year or distributed to him from previous tax years of the corporation[1] but not on any dividends distributed in the tax year in which the shares are transferred prior to the day of transfer.

Net operating loss of the corporation.--The corporation is not allowed a deduction for a net operating loss in the tax year it has a valid election.[2] However, each person who is a shareholder in the corporation during the tax year of the corporation is allowed his pro rata share of the corporation's net operating loss for that year.[3] Thus, a person who owned shares in a corporation with a valid election for only ten days during the tax year of the corporation must include in his tax return his pro rata share of the net operating loss

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[1] U.S. Treas. Reg., Sec. 1.1373-1(a)(2). Such transfers must be bona fide transfers of ownership. The circumstances will be investigated. Transactions between members of a family will be scrutinized.

[2] U.S. Treas. Reg., Sec. 1.1374-1(a). The net operating losses a corporation has in a year the election is not valid may be carried back over an electing year. Thus, to take advantage of any losses occurring before an election year, a corporation would be able to elect for only two consecutive years; otherwise, all possibility of a tax carry-back or carry-over would be lost.

[3] U.S. Treas. Reg., Sec. 1.1374-1(b).

for the year on the number of shares owned.[1] This loss may be offset against other ordinary income.

Shareholders are not permitted to deduct net operating losses incurred by the corporation from ordinary income indefinitely. They may deduct losses only to the extent of their investment in the corporation. For this purpose, each shareholder's investment is the adjusted basis of the shares and any indebtedness of the corporation owned by the shareholder.[2] Thus, the total of net operating loss allowable to individual shareholders can vary in relation to the number of shares and the indebtedness held by each.

Net operating loss carry-over and carry-back restrictions should be considered carefully in relation to the total losses a shareholder is permitted to deduct and to the stability of the market for the product from which the corporation derives its farm income. For example, corporations conducting farm businesses which produce products with an

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[1]U.S. Treas. Reg., Sec. 1.1374-1(b)(3). For example, a person owning 100 shares for 10 days would be entitled to $x/y \times 10 \times 100$ where x is the net operating loss for the tax year of the corporation and y is the number of days in the corporation's tax year.

[2]U.S. Treas. Reg., Sec. 1.1374-1(4). The adjusted basis is the value of each share on the day prior to sale or the last day of the corporation's tax year, whichever is applicable. Any indebtedness is always determined the last day of the corporation's tax year.

unstable price that result in widely fluctuating annual incomes that cannot be reasonably well predicted, for example, orcharding, beef cattle feeding, may not find it an advantage to elect to be taxed as prescribed in Subchapter S because of the risk of losses exceeding the basis of shares. A corporation conducting a farm business which produces products with a stable market and with a highly predictable income, for example, dairying, may find it an advantage to elect to be taxed as prescribed in Subchapter S, since the risk of losses exceeding the basis of shares is low.

Capital gains and losses.--All capital gains and losses, just like all other taxable income, are computed on the tax year of the corporation and not the tax year of the shareholder.[1] Every person owning shares in the corporation during the tax year of the corporation must include in his gross income, as dividends received, his pro rata share of the corporation's net long-term capital gains.[2] In the event shares in the corporation are sold during the tax year of the corporation, after a distribution of dividends in money, the shareholder who sells shares must include in his gross income

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[1]U.S. Treas. Reg., Sec. 1.1373-1(b). Thus, where the corporation and shareholders were on different tax years, the shareholders could conceivably receive dividends in money in one tax year and not pay taxes on them until his next tax year.

[2]U.S. Treas. Reg., Sec. 1.1375-1(a). Corporations could pay capital gains as salaries, then capital gain income loses its character as such.

his pro rata share of the net long-term capital gains.[1] His share is the proportion of his shareholdings times the total of net long-term capital gains available for distribution.[2] However, the total amount of net long-term capital gains allowed to all shareholders in any tax year cannot exceed the total net income of the corporation for that tax year. Thus, ordinary net operating losses of the corporation may offset long-term capital gains.[3] For example, assume that a corporation with three shareholders owning equal shares has $900 of net long-term capital gains in a year when the corporation has undistributed taxable income of $1,000. In this case, each shareholder is permitted to include $300 in his gross income as long-term capital gain. However, if the undistributed taxable income is reduced to $600, each shareholder can include only $200 in his gross income as long-term capital gains from the corporation.

Long-term capital gains from sales of "1231 assets" owned by the corporation may not be offset against long-term capital losses resulting from a transfer or conversion of

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[1]U.S. Treas. Reg., Sec. 1.1375-1(c).

[2]U.S. Treas. Reg., Sec. 1.1375-1(b).

[3]Int. Rev. Code of 1954, Secs. 37 and 116. Richard H. Valentine, "Taxation of Shareholders of Subchapter S Corporations During the Election Period," Proc. of N.Y.U. 18th Ann. Inst. on Fed. Tax. 1960, op. cit., p. 690.

"1231 assets" owned by a shareholder.[1] Capital losses on "1231 assets" sold by the corporation are ordinary losses to it and are not netted against long-term capital gains the shareholders may have from other sources. Consequently, the treatment accorded Section 1231, gains and losses of a shareholder of a corporation taxed as prescribed in Subchapter S, is different from a partnership where the Section 1231 gains and losses retain their character as such to the partners.[2] However, losses from transfer or conversion of capital assets are retained in the corporation. Therefore, net long-term capital losses "[do] not pass through to shareholders, but . . . apparently remain available at the corporate level for five years as a capital loss carry-over."[3] Since capital losses are deductible against the shareholder's ordinary income, this is an important reason why an individual shareholder should not contribute all his "1231 assets" to a corporation that plans to maintain an election continuously.[4] Consequently,

[1] Mortimer M. Caplin, "Subchapter S vs. Partnership: A Proposed Legislative Program," Virginia Law Review, XLVI (January, 1960), 64.

[2] Valentine, op. cit., p. 103. Sec. 702(a)(3) of the Int. Rev. Code of 1954 requires each partner to take into account separately his distributive share of the partnership's gains and losses from sales or exchanges of property prescribed in Section 1231.

[3] Caplin, Virginia Law Review, XLVI (January, 1960), 65.

[4] Since machinery and equipment have high rates of depreciation, likelihood of capital loss is small unless they are involuntarily converted, for example, by fire. If they were insured, this would not be considered a loss and could not have been offset by the corporation anyway.

it would be advisable to contribute as capital to the corporation that tangible personal property required in the farm business that will not normally be subjected to large capital losses, and which ordinarily produces capital gain income such as that received from sales of livestock retained for draft, breeding, or dairy purposes or from sales of machinery and equipment.

Distributing earnings and profits.--Any taxpaid earnings and profits retained in the corporation in a year when the corporation has a valid election may be distributed as money to the shareholders who paid the tax on the retained earnings, tax-free in subsequent years when a valid election has been in effect continuously.[1] Yet when the corporation has retained earnings in one tax year and suffers net operating losses in a succeeding tax year, the undistributed taxpaid income available to the shareholders is reduced pro rata to the extent of the net operating loss incurred.[2] Any earnings and profits retained in the corporation in a year when the corporation did not have a valid election and which are distributed as

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[1] Such a distribution is not considered a dividend (U.S. Treas. Reg., Sec. 1.1375-4(d). The right to tax-free distributions of retained taxed income is a personal right of the shareholder and cannot in any manner be transferred to another shareholder tax-free (U.S. Treas. Reg., Sec. 1.1375-4(e).

[2] Valentine, op. cit., p. 695. Thus, the corporation absorbs the operating loss indirectly for the taxpayer.

as dividends in money in excess of taxable income, in a year when a valid election is in effect, are taxed to the shareholders as ordinary dividends at their applicable tax rate.[1] Furthermore, when a corporation does not have a valid election, it cannot distribute income retained in the corporation during the period of a valid election until all earnings accumulated before and after the period of election have been distributed;[2] in addition, "the regulations [suggest that] no undistributed taxed income could ever be distributed tax-free, even after all other earnings retained are exhausted."[3]

Thus, a farmer planning to organize a corporation that will elect to be taxed as prescribed in Subchapter S should plan to either (a) maintain a valid election in effect from year to year[4] or (b) draw out any undistributed taxable earnings and profits annually, and especially, before terminating the election.[5]

Basis of shares.--Any undistributed taxable income which a shareholder has included in his gross income for

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[1] Shea, Wisconsin Law Review, CMLX (July, 1960), 596.

[2] "Anon.," ". . . Part II . . . ," Minnesota Law Review, XLIII (March, 1959), 789.

[3] Ibid.

[4] See Shareholder's wills, p. 166.

[5] Valentine, op. cit., p. 699.

taxation that is retained in the corporation increases the basis of each outstanding share proportionately.[1] Likewise, net operating losses of the corporation deducted by the shareholder for tax purposes reduce the basis of each share held proportionately.[2] The basis of shares may not be reduced below zero.[3]

When the basis of shares is reduced to zero, a shareholder may use a net operating loss to reduce the basis on any corporation debt he owns.[4] Although the basis of indebtedness may be reduced by the shareholder by carrying out corporation losses, it cannot be increased as is the basis of shares by retaining future undistributed taxable income in the corporation. However, future repayment of the indebtedness by the corporation may result in capital gains. This depends upon the type of debt instrument used.[5]

Other factors.--Shareholders of a corporation with a valid election are not entitled to the $50 exclusion from taxable income on dividends received from the corporation.[6]

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[1] U.S. Treas. Reg., Sec. 1.1376-1.

[2] U.S. Treas. Reg., Sec. 1.1376-2(a).

[3] U.S. Treas. Reg., Sec. 1.1376-2(a)(2). See Net operating loss of the corporation, p. 77.

[4] U.S. Treas. Reg., Sec. 1.1376-2(b).

[5] Valentine, op. cit., p. 694.

[6] Int. Rev. Code of 1954, Sec. 116(a). A farmer who received dividends from another source would be entitled to the $50 exclusion for those dividends.

As might be anticipated, a family may not allocate salaries among its shareholding, or other family, members in such a manner as to minimize taxes, except under circumstances corresponding to the actual value of services rendered by each family member.[1] However, if salaries are reallocated among family members by the Internal Revenue Service, consideration "shall be given to all the facts and circumstances of the business, including the managerial responsibilities of the shareholder, and the amount that would ordinarily be paid to obtain comparable services from a person not having an interest in the corporation."[2] The normal earnings on family farms are such that this should not be a burdensome problem to either party.

Taxes, the Cost Basis of Property, and Contributing Capital

Some property owned by taxpayers has a cost basis for income tax purposes. As taxpayers, farmers own some property that has an unadjusted cost basis such as land which is a non-depreciable asset. The unadjusted cost basis of land may be cost or fair market value, depending upon the manner of acquisition. Many items of property owned by farmers, for

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[1] Int. Rev. Code of 1954, Sec. 1375(d).

[2] U.S. Treas. Reg., Sec. 1.1375-3(a).

example, "1231 assets," will have an adjusted cost basis as they are depreciable. The adjusted cost basis of some items of property may be zero if the cost basis has been completely depreciated or the farmer reports income taxes on the cash basis.

The cost basis of property is an important item because it may be changed when an estate is created. Here a fundamental difference exists between property owned by an individual and that owned by a corporation, even though an individual may own all the shares of the corporation. The difference is that each item of property, including the shares in the corporation owned by the individual farmer, receives a new cost basis at the time of his death; property owned by a corporation never obtains a new cost basis as the result of an estate, for it is a taxpayer that does not die. The new cost basis that may be obtained from an estate is the appraised fair market value of all the property owned by the taxpayer at the time of death.[1] Consequently, the cost basis of property transferred in an estate can have income tax consequences on (a) future sales of property and (b) future depreciation deductions.

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[1]Int. Rev. Code of 1954, Sec. 1014(a). This appraisal may establish the value at the date of death or at an alternate date within one year.

Future sale of property.--When property is sold, taxable income is computed on the difference between the cost basis of that property and its selling price. Therefore, any difference in the cost basis and selling price can affect taxable income. For example, assume a commercial livestock farm reporting income tax on a cash basis which produces all the animals sold, and further, that at the date an estate is created, the farm property includes $8,000 of marketable steers. If either an individual farmer or a corporation sold the steers, the full value could be taxable income, as they will have previously charged the costs to expenses and the asset has a basis of zero. But as property includable in the estate of an individual, the steers will be appraised, that is, obtain a new cost basis, at their fair market value. A subsequent sale at that value by the estate, or heirs, will result in no difference between the sale price and the new cost basis, and hence, in no income that may be taxed. On the other hand, the same property sold by the corporation would result in $8,000 of income that could be taxed, since this is property of the corporation and not of the estate. This difference in income taxes will be of only slight significance if the property owned by the corporation has appreciated but little between the time of acquisition and the time of sale.[1] Although all

[1] "Anon.," ". . . Part II . . .," Minnesota Law Review, XLIII (March, 1959), 800.

property may appreciate under certain circumstances, the problem will arise primarily with property having an adjusted cost basis of zero that taxpayers on the cash basis may not depreciate and with property such as land with a cost basis that is not depreciable. Since land is a property that may appreciate in value, individuals planning to organize a close corporation to conduct a farm business should consider carefully the tax consequence of contributing land and/or real property to the corporation as capital. Land is property that receives a new cost basis each time it is appraised in an estate. Real property also includes realty such as orchards, buildings, and tile. These are, of course, "1231 assets," but it may be desirable for farmers who organize corporations to retain title to some "1231 assets," particularly those that are included in real property and are depreciable.

Future depreciation deductions.--Any property owned by an individual farmer that may be depreciated may also attain a new cost basis when included in the estate of an individual. It, too, receives a cost basis equal to its fair market value. Two classes of property that are "1231 assets" may be affected here. Realty such as farm buildings may have a cost basis of zero to the deceased and receive a new cost basis when appraised for estate purposes. Tangible personal property such as machinery may also be affected.

When estates are appraised, we would not normally expect the appraised fair market value of tangible personal property required in the farm business to be increased above the cost basis of its late owner.

Since realty is an integral part of real property which includes land, the prospect of a change in cost basis may influence the type of property which should be leased to the corporation.

Leasing property to the corporation.--Farm families may find that substantial income tax advantages are attained by leasing property to a corporation. Rental payments[1] are not payments made to acquire equity in property.[2] The individual who leases property retains the title to that property. Thus, real property leased to a corporation by an individual may acquire a new cost basis at the individual's death. The realty such as farm buildings may attain a new cost basis. Land (a non-depreciable asset) may also attain a new basis. The result may be income tax advantages for the owner or his heirs. Lease agreements must be conducted at arm's length.[3]

Farm owners who contribute tangible personal property

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[1]See Rental payments, p. 65.

[2]Bardes, *op. cit.*, p. 1046.

[3]See Arm's length transaction, p. 55.

to the corporation and lease their real property to it become landlords with a corporation for tenant. The corporate tenant can be required to pay for the landlord such things as taxes,[1] insurance premiums on the property, repairs to the leased property and other items, all of which are deductible expenses to the tenant but included when computing the landlord's rent.[2] The cost basis of improvements made upon leased property that may be depreciated may belong either to the shareholders owning the property or the corporation. The corporation retains the cost basis for all depreciable improvements it makes on the property.[3] Such improvements, however, have no basis to the owner of the property when the lease is terminated.

Any improvements made by the corporation will normally be depreciated over a period not less than the remaining useful life of the improvements.[4] Hence, if a corporation made an improvement upon leased property and the lease was terminated, the basis that remained would not be available to the corporation

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[1]"Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord the amount of the tax being deductible by the latter" (U.S Treas. Reg., Sec. 1.162-11).

[2]U.S. Treas. Reg. 1.16-8(a).

[3]Int. Rev. Code of 1954, Secs. 109 and 1019.

[4]Int. Rev. Code of 1954, Sec. 178(b) as amended by Sec. 15(a) of the Technical Amendments Act of 1958.

for depreciation. For example, if a corporation with a five year lease constructed a building, say a milking parlor, on the property leased from a family member and the building had a useful life span of ten years, the corporation would receive only five years depreciation if the lease were not renewed. Consequently, when real property is leased by a close corporation, the lease should normally require the family member leasing the property to make, on written request of the corporation, all improvements on the property that will be depreciable. In some instances, it may be preferable for the family members who lease the property to make particular non-depreciable repairs and maintenance, thus avoiding situations where the corporation is required to maintain realty at an unnecessarily high cost.[1]

Leasing real property to a close corporation will not completely solve the inter-generation, intra-family farm transfer problem of some farmers who organize a corporation for that purpose. Yet where the value of real property is large and the value of the tangible personal property required in the farm business (such as a dairy or commercial livestock breeding farm) is also large, a farmer can substantially reduce the total value of his estate by contributing the

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[1]For example, some family member may wish to maintain the property in a higher state of repair than would be required to satisfactorily conduct the farm business.

tangible personal property to a corporation where there is a succession in management if he can make gifts of shares. Where proper provision for maintaining control of the corporation is made, continuity in the farm business may be encouraged at the time the estate is created. The farmer could dispose of the real property through various other institutional arrangements.

When the value of the real property is large and the value of the tangible personal property used in the farm business is small as, for example, on a cash crop or grain farm, there will be instances when at least some real property may be transferred to a corporation to reduce the total value of an estate. The quantity of property to contribute to a corporation as capital must then be determined.

Type of property to contribute to the corporation.--From a tax standpoint,[1] the corporation and the shareholders will usually be served best if only the tangible personal property used in the farm business is contributed to the corporation as capital. The shareholders should also avoid purchasing property such as fertilizer in their own name and having it delivered to the corporation. Any initial operating capital required should normally be obtained from an institutional source, or the corporation should give a note for the

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[1]Capital gains and annual corporation privilege fee.

amount contributed. Although small amounts of operating capital will normally be required, any question of paying taxes on contributed cash in the event the corporation is dissolved will be removed.

In some cases, where the corporation is used to transfer an estate, it will be advisable to contribute real property to the corporation. However, there will be but few cases in which farmers will find it advisable to contribute or sell the family home(s) to the corporation. The home should be retained if for no other reason than a homestead because some farm property is exempted from court judgments by the State of Michigan Constitution.[1] The land and homes owned by a corporation would not be exempted as a homestead if the corporation encountered financial troubles.

Valuing property contributed to the corporation as capital.--Property can be contributed to a corporation tax-free by adhering strictly to Section 351 of the Internal Revenue Code of 1954,[2] which requires the corporation to

[1] Michigan Constitution of 1908, Article XIV, Sec. 73, states, "A homestead of not exceeding 40 acres of land, and the dwelling house thereon and the appurtenances, to be selected by the owner thereof . . ., owned and occupied by any resident of this state, not exceeding the value $2,500,00 shall be exempt from forced sale on execution or any other final process from a court."

[2] "Anon.," ". . . Part II . . .," Minnesota Law Review, XLIII (March, 1958), 820. "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation" (Int. Rev. Code of 1954, Sec. 315(a)).

adopt the contributor's cost basis.[1] In return, the contributor must receive in exchange for the contributed property shares issued by the corporation. Such an exchange will also be tax-free for the corporation.[2] However, property cannot be contributed to the corporation tax-free when "the incorporating farmer . . . brings other members of his family into substantial ownership at the time of the incorporation."[3]

Most farmers who investigate the corporation will have adequate records from which they can readily establish the cost basis on each item of their property. Hence, a problem that will arise is whether to have a completely tax-free transfer or not, since property may be sold to the corporation.

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[1]"If property was acquired by a corporation

(1) In connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) As paid-in surplus or as a contribution to capital then the basis shall be the same as it would be in the hands of the contributor, increased in the amount of gain recognized to the contributor on such transfer" (Int. Rev. Code of 1954, Sec. 362(a)).

[2]"No gain or loss shall be recognized to a corporation on the receipt of property or money in exchange for its stock, including treasury stock" (Int. Rev. Code of 1954, Sec. 1032). "Treasury stock" is shares issued by the corporation but which are not outstanding as they are held by the corporation.

[3]"Anon.," ". . . Part II . . .," Minnesota Law Review, XLIII (March, 1959), 802. It is necessary for the contributors to have "ownership of shares 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 shares of the corporation" (Int. Rev. Code of 1954, Sec. 368(c)).

When such a sale is made, the property sold will normally receive a higher cost basis. Thus, capital gains from the sale that the seller receives will be taxed at the applicable capital gain rate. The corporation can deduct depreciation against ordinary income from the new cost basis.[1] However, taxable income from such sales will be taxed as ordinary income if the sale occurs between a corporation and an individual where more than 80 percent in value of the outstanding shares is owned by the contributing individual, his spouse, and his minor children and grandchildren.[2] An individual farmer would not normally find this restriction important on sales of tangible personal property used in the farm business. The capital gains obtained will vary from case to case and normally will be relatively small.

Individuals endeavoring to obtain a higher cost basis on real property may find the 80 percent share ownership restriction effective and the taxes resulting from a paper transfer an excess expense. Even when the 80 percent share-ownership restriction is unimportant, any effort to increase the cost basis on real property would result in excess expense. Simultaneously, failure to increase the cost basis

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[1]Bardes, op. cit., p. 15.

[2]Int. Rev. Code of 1954, Sec. 1239. Note the term minor children is used.

on real property which has appreciated in value may result in excess taxes on future sales by the corporation on the individual owner who receives the property in a tax-free dissolution.[1]

Taxes at the Time of Dissolution

The process of selling or distributing property by a corporation that plans to dissolve is termed liquidation.[2] Whether the corporate liquidation is partial or complete, by distributing property in kind or by sale, the corporation must redeem shares in proportion to the assets distributed. A corporation that has paid, or is paying, income taxes in its own name may, if it qualifies, elect to be taxed as prescribed in Subchapter S during the period of liquidation.[3]

The corporation may plan to distribute some assets to shareholders in kind in a partial liquidation. Any gain recognized in the value of assets distributed in partial liquidation may be taxed at the capital gain rate. However, the gain may be treated as dividends and taxed at ordinary income rates, particularly if the property is distributed by a

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[1] See Case A, p. 184.

[2] See Dissolving the corporation, p. 177, for procedures required when a corporation is dissolved.

[3] U.S. Treas. Reg., Sec. 1.1372-2(b)(2).

corporation taxed as prescribed in Subchapter S.[1] To qualify for a partial liquidation in which the assets are distributed tax-free is difficult and "is seldom attempted."[2]

A close corporation which plans to dissolve will normally plan to completely liquidate, either by (a) distributing assets in kind or (b) by selling the assets and distributing cash.

Distributing assets in kind.--If the shareholders plan to continue the farm business, liquidating the corporation at the minimum tax cost is important. The gain in value of property owned by a corporation that completely liquidates is normally taxed as capital gain. However, shareholders who wish to continue the farm business can (1) postpone the recognition of gain on certain property that has appreciated in value by planning to dissolve the corporation and have it completely liquidated within a one-month period, or (2) recognize the gain on certain property and liquidate within a twelve month period.

1) One-month liquidation: A corporation may prepare

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[1] See Undistributed taxable income, p. 75.

[2] Mallare, Wisconsin Law Review, CMLX (July, 1960), 583. Although this is clearly a complex process, one corporation conducting a farm business in Michigan did partially liquidate by transferring the real property contributed to it as capital back to the shareholders. The corporation redeemed shares of equal value and is still in business.

a plan to liquidate and distribute the assets in kind within a selected one-month period. The plan to liquidate the assets must be approved by the Internal Revenue Service and 80 percent of the "qualified electing shareholders" must file a written consent to the plan.[1] This consent, once given, is irrevocable. The plan adopted must provide for the distribution of the corporation's property, except that needed to settle claims, within a one-month period, during which the corporation redeems all its shares.[2] Only real property or tangible personal property can be distributed without recognizing gain. Intangible property such as cash, stocks, or securities which are distributed pro rata to the shares will be taxed

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[1]The term "'qualified electing shareholder' means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election . . . has been made . . . but . . . in the case of a shareholder other than a corporation, only if written elections have been filed by shareholders . . . who at the time of the adoption of such plan of liquidation are owners of stock possessing at least 80 percent of the total combined voting power . . . of all classes of stock entitled to vote on the adoption of such plan of liquidation" (Int. Rev. Code of 1954, Sec. 333(c)(1)).

[2]"In the case of property distributed in complete liquidation of a domestic corporation . . . if (1) the liquidation is made in pursuance of a plan of liquidation adopted on or after June 22, 1954, and (2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month . . . then in the case of each qualified electing shareholder . . . gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f)" (Int. Rev. Code of 1954, Sec. 333(a)(1)(2)).

at the applicable capital gain rate, if there is gain.[1] Any real property or tangible personal property transferred by the corporation to the shareholders can be transferred tax-free if the shareholders accept as the cost basis of the property received the same cost basis as their shares.[2] The cost basis of the shares and, therefore, the property received is decreased by the amount of money received and increased by the amount of gain recognized.

Therefore, if property with a low cost basis which has already appreciated in value were contributed to a corporation with no gain recognized, the shares would have a low cost basis. If these shares were transferred as gifts and were not sold or given a new value by passing through an estate, they would retain their original cost basis which would be the cost basis at the time of liquidation.

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[1]"In the case of a qualified electing shareholder other than a corporation . . . there shall be recognized . . ." and "(2) treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits" (Int. Rev. Code of 1954, Sec. 333(e)(2)).

[2]"Property received in liquidation under section 333 -- This basis of assets (other than money) acquired by stockholders in a liquidation upon which the amount of gain recognized was limited under section 333 shall be the same as the basis of shares redeemed or cancelled, decreased in the amount of money received and increased in the amount of gain recognized and the amount of the unsecured liabilities assumed by the stockholders" (U.S. Treas. Reg., Sec. 1.334-2).

Thus, if real property with a high value was contributed as capital to a corporation with the purpose of reducing the potential tax liability of an estate and the shares were distributed as gifts, the cost basis of those shares would not change. If the corporation is dissolved at a later date and distributes its assets in kind, the cost basis of the property received is the same as that contributed to the corporation. The total number of individuals owning the property will normally increase, and the total tax liability will normally be reduced. If the number of individuals owning the property is not increased, the potential tax liability is simply shifted. On the other hand, when shares are sold or inherited, we would expect the cost basis of shares to more nearly approximate the value of the property distributed in kind. Consequently, capital gains taxes and liability for taxes in a subsequent estate may not be reduced by successive gifts if the number of shareholders does not increase. However, the responsibility for the taxes can be shifted.

If the tangible personal property required in the farm business was contributed to the corporation, the cost basis of shares representing it would immediately be the same as the cost basis of that property. The effect of an appreciation in value on the cost basis would not normally be the same as the effect on real property, but the impact would depend more upon the difference in the cost basis of the "1231 assets" owned by the corporation and the basis of the shares at the time of liquidation. The value of the tangible personal property distributed in kind would be important.

If the value of assets distributed is less than the cost basis attained at the time of distribution, any proceeds received from a subsequent sale at less than the cost basis would be tax-free and a capital loss would result. If the value of assets distributed is greater than the cost basis of shares, the proceeds in excess of the value would be capital gain and taxed as such. Since "1231 asset" losses are ordinary losses, excess tax may be paid only if the basis of shares is less than the value of the assets distributed. This would be capital gain income. Therefore, machinery and equipment could normally be liquidated with relatively little extra tax cost, because proceeds in excess of cost basis are normally capital gains. Many corporations can be organized to conduct business as tenants owning only machinery and equipment; therefore, this method of liquidating is favorable.

Corporations owning property with a large appreciated value and small cash assets, including a small amount of retained earnings, should consider a one-month liquidation. If the corporation does not purchase property that is not used in the farm business, the tax cost of dissolution could be minimized. However, "a valid election under section 333 is irrevocable and should be made only after due consideration and analysis of the potential effects."[1] Since the one-month plan of liquidation requires considerable planning, one would expect a liquidation that minimized tax costs to require at least a year.

2) Twelve month liquidation: If a corporation conducting a farm business has a large surplus of earnings and property with low appreciated value, it may plan a twelve month liquidation. The benefits of this plan of liquidating a corporation will be rather limited, since farms usually do not have large surplus earnings, and it would not be a normal practice to retain them in the corporation.

In a twelve month liquidation, "the entire gain . . . which the shareholder receives will be subject to tax."[2] Since this tax may be at the full 25 percent rate on capital gain rather than at ordinary income tax rate which farmers normally pay, the possibility of having to pay a higher than normal tax on such distributions exists. In addition, any small gain recognized on appreciated value of property would be either an excess expense and/or a prepayment of taxes.

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[1] Bardes, op. cit., p. 14.33.

[2] Mallare, Wisconsin Law Review, CMLX (July, 1960), 584.

Since the shareholders will normally plan to continue the farm business, the increase in value that is taxed will increase their cost basis but will be an unnecessary expense, particularly where real property is concerned. Where tangible personal property such as "1231 assets" is concerned the basis will be increased, but this is simply a prepayment of taxes subject to recovery as cost basis, since a high proportion of such property is normally disposed of within a decade. The twelve month liquidation will obviously require a considerably longer period to accomplish than a one-month liquidation.

Distribution in cash.--Corporations may plan to dissolve and completely liquidate by selling all the property used in the farm business. Any proceeds that remain after the debts and obligations of the corporation are paid must be distributed pro rata by the corporation in complete redemption of its shares. Since the shares are capital assets of the shareholders, the cash distributed may be taxable. It is taxable at the capital gain rate if the distribution exceeds the cost basis of the individual shares. Individual shares may have a different cost basis, depending upon the manner of acquisition. Thus, a shareholder may own shares at the time the corporation is liquidated that have capital gains and shares that have capital losses, which will be long-term or short-term depending upon the period held.

When a corporation that pays its own income taxes liquidates, any net operating loss that is carried forward remains with the corporate entity. Net operating losses for corporations which have maintained a continuous valid Subchapter S election are deductible to shareholders and would not be lost to individual shareholders. Any capital losses would, however, remain with the corporate entity in either case and be lost to the shareholders.

Certainly, the liquidation of a corporation is something to be considered seriously before organizing the corporation, not after.[1]

Federal Excise and Social Security Taxes

Other federal taxes to be considered when organizing a close corporation are (a) the federal stamp taxes and (b) the social security tax.

Federal Stamp Taxes

Shares issued by a corporation are subject to a federal tax of $0.11 per $100 of actual value.[2] Shares transferred between shareholders are subject to a federal tax

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[1]See Dissolving the corporation, p. 177.

[2]Int. Rev. Code of 1954, Sec. 4301.

of $0.04 per $100 of actual value.[1]

Certificates of indebtedness issued by the corporation, for example, bonds, are subject to a federal tax of $0.11 per $100 of face value.[2]

Social Security Taxes

A close corporation is an employer. As such, it must pay social security tax on all its employees. This is different from individual farmers who need not pay social security on members of family working on the farm or children who work for their father under age 21. Since the employees will usually be shareholders also, this means they will pay social security taxes both as employer and employee on the wages and salaries received by the family related employees from the corporation. During the period 1960-1961, this tax is three percent for the employer and three percent for the employee, for a total of six percent.[3] Thus, the social

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[1]Int. Rev. Code of 1954, Sec. 4321.

[2]Int. Rev. Code of 1954, Sec. 4311.

[3]The following social security tax rates are effective January 1, 1962.

Year	Employee	Employer	Self-Employment Tax
1962 only	3 1/8%	3 1/8%	4.7%
1963-1965	3 5/8%	3 5/8%	5.4%
1966-1967	4 1/8%	4 1/8%	6.2%
1968 and after	4 5/8%	4 5/8%	6.9%

Old Age and Survivors Insurance, Pamphlet 35 (Washington: U.S. Government Printing Office, 1961), p. 16.

security tax paid by the corporation is one and one-half percent more than that paid by self-employed individuals, whether a partner or sole proprietor.

The corporation, as the employer, pays the social security tax, deducting it as business expense. Individual farmers cannot deduct social security as a business expense.

Michigan Excise Taxes

Each corporation organized for profit and doing business in Michigan must pay an annual privilege fee, a tax, on the franchise to do business in Michigan. This fee is assessed at the rate of five ($0.005) mills per dollar of the corporation's paid-in capital and surplus but is not to be less than $10 and must be paid each year at the time the corporation files the Annual Report.[1] Thus, there is a minimum annual tax of $500 on each $100,000 of property contributed to the corporation as capital and/or surplus owned by the corporation.

There is another tax which is not imposed on the corporation directly which must be considered when organizing a corporation. This is the intangible tax on shares of a corporation. It is assessed at the rate of 3-1/2 percent of the income but not less than one ($0.001) mill on the par

[1] Michigan General Corporation Act, Sec. 450.301.

value of the shares issued and outstanding.[1] Shares subject to this tax are, however, exempted from personal property tax.[2]

When the annual privilege fee and the intangible tax are combined, we find that the paid-in capital represented by shares is taxed at an actual rate of six ($0.006) mills. This arises from the sum of the annual privilege fee of five ($0.005) mills and the intangible tax of one ($0.001) mill. However, surplus is taxed at only five ($0.005) mills. These taxes are sufficiently high that individuals planning to organize a corporation in Michigan should consider carefully the quantity and value of property to be contributed as capital to their corporation.

The amount of capital contributed which is credited to paid-in capital is especially important, since the annual privilege fee is always assessed against this even though the corporation has a deficit.[3]

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[1]Michigan, Act 301, P. A. of 1939, Sec. 205.132(a). "The tax on income producing intangible personal property shall be 3 1/2 percent of the income but in no event less than 1/10 of 1 percent of the face or par value of each item."

[2]Michigan, Act 301, P. A. of 1939, Sec. 205.132(e). "Intangible personal property subject to tax under this act or expressly exempt from the tax hereunder shall be exempt from all property taxes under the laws of this state."

[3]Michigan General Corporation Act, Sec. 450.304.

Summary

We may summarize this chapter on taxes most conveniently by itemizing our findings.

1. Arm's length transactions are relatively less important when the corporation conducts the farm business as an owner than when it conducts the business as a tenant or part owner. Care should be exercised, however, to avoid this problem in all cases where shareholders transact business with the corporation.
2. The "thin" corporation problem is important when families or family members, especially those who are shareholders, have enough funds to make loans to the corporation. We may expect these to be relatively few.
3. The accumulated earnings tax will rarely be a problem to corporations conducting a farm business, since earnings are relatively low and retained earnings will normally accumulate slowly and be reinvested in the business before the tax is applicable.
4. Corporations that pay income taxes in their own name can reduce the problems of "double taxation" by paying salaries and rents. However, any taxpaid earnings retained in the corporations that are later paid out

to shareholding-employees as salaries are taxed as ordinary income, and hence, are taxed twice from the shareholding-employee's point of view. When such a corporation pays out capital gain as salaries, shareholders are subject to tax on all, not just half, of capital gain income paid as salaries or rent. This is important to taxpayers below the 50 percent bracket and normally represents an increased expense.

5. A corporation that is taxed as prescribed in Subchapter S can completely avoid "double taxation" of income, and the shareholders are taxed on capital gains at their individual rates. This institutional change is certainly desirable to the extent that more farm businesses at least have an opportunity to adopt the corporate legal-business structure.

6. Corporations that pay income taxes in their own names can carry over net operating losses without limit. These may not be recoverable, but a corporation taxed in this manner is preferred for high risk businesses subject to large profits and large losses from one year to the next.

7. Corporations that are taxed as prescribed in Subchapter S transfer any net operating loss to shareholders. The losses are available to shareholders for tax

purposes only to the extent of the basis of shares and debt obligation to shareholders. Consequently, corporations taxed in this manner should conduct a business that would not normally be subject to large operating losses within one year or a series of small operating losses over a period of years.

8. Net long-term capital losses remain with the corporation regardless of how federal taxes on income are paid. Long-term capital losses must be reduced by net long-term capital gain. Individuals who suffer net long-term capital losses receive somewhat more favorable tax treatment than corporations; hence, it is preferable not to transfer property subject to large capital loss to the corporation. Losses on "1231 assets" are treated as ordinary losses. Consequently, transfer of property receiving tax treatment as "1231 assets" is not restricted by capital loss considerations. This tax feature is favorable to the corporation organized as a tenant.

9. Cost basis of property is important, particularly the cost basis of real property which may receive a new cost basis for depreciation purposes when appraised in an estate. Real property held by a corporation organized as an owner would not be subject to a change

of basis. The income tax savings resulting from a change in the cost basis of property in an estate and subject to sale in the near future is relatively unimportant. This income tax cost will be incurred only at the death of an individual and will tend to be relatively small.

10. Leasing real property to the corporation is an effective solution to the cost basis problem encountered with land and realty such as buildings. Depreciable improvements to realty may be made by the corporation or the shareholder, or other family members who lease real property to the corporation.

11. Property contributed as capital may be transferred to the corporation tax-free if the corporation adopts the cost basis of the contributor and no gain or loss is recognized. When property is contributed to a corporation, the individual and the corporation should adhere strictly to the provisions of Section 351(a) of the Internal Revenue Code of 1954.

12. Corporations can dissolve and liquidate by distributing their property in kind as prescribed by Section 333 of the Internal Revenue Code of 1954. Normally, some tax will be payable, because the corporation will own some property such as cash that will be taxed when it

distributes the property in kind. A properly planned dissolution can minimize the tax paid at the time of liquidation.

13. The federal excise tax on shares is relatively insignificant, especially after the corporation is organized.

14. Social security taxes paid on qualified earning received by shareholding-employees are increased but become a deductible business expense.

15. The annual privilege fee and intangible tax will increase with the value of property contributed to the corporation; therefore, the tax position of the corporation as an owner and a tenant must be contrasted. The annual privilege fee will increase as the corporation reduces any indebtedness and increases surplus.

16. Corporations whose directors and officers maintain adequate records, compute taxable income accurately, and manage the corporation's business affairs in a technically correct manner and follow normal business practices will suffer few adverse tax consequences. However, the Michigan excise tax costs may be a substantial problem for corporations whose shareholders cannot gain tax benefits by dividing taxable income with the corporation.

CHAPTER VI

THE PROBLEMS, BENEFITS, AND FEATURES OF A CORPORATION

Farmers who are investigating the corporate legal-business structure will find the information presented in this chapter on limited liability, control, fringe benefits, and some additional aspects of the corporation useful. The close corporation is never freed from the duties and privileges imposed upon it as a taxpayer; therefore, it is necessary to discuss taxes from time to time in some sections in this chapter.

Limited Liability--A Concept

Shareholders in a close corporation are normally liable for corporate debts and acts only to the extent of their investment in the corporation. The original investment may be in the form of cash, property, or services actually contributed in return for shares issued, and any shares subscribed for which cash or property would be contributed.[1]

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[1]"Shares of capital stock shall be issued only for money, or other property real or personal, tangible or intangible, actually conveyed or transferred to the corporation for its use . . . or for labor or services actually rendered . . ."

"Every person who subscribes for par value shares or to whom such shares are issued . . ., shall be obligated to pay . . . in money or other property or labor or services, not less than the par value . . ." (Michigan General Corporation Act, Sec. 450.21).

Regardless of the way the investment is made, the corporation must achieve limited liability by conforming to the legal requirements designed to prevent (a) overvaluing shares and (b) piercing of the "corporate veil." The courts will hold the shareholders of a close corporation responsible if they do not conform to legal requirements designed to prevent these problems from arising, thus causing the corporation to act deliberately to create inequity or injustice.

Over-Valued Stock

Any corporation that issues shares with a total par value in excess of the actual value of cash, property, or service received over-values (or "waters") its stock. For example, if a corporation issues $5,000 par value in shares for each $1,000 of actual value received, this makes the shareholders personally liable for the difference of $4,000 should the corporation become insolvent.[1] Although Michigan corporate law clearly forbids shareholders to pay less than par value for shares issued, a problem may arise when shares are issued for any consideration other than cash. Thus, this could be a problem for farmers, for they will normally contribute property to the corporation. In this connection, the

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[1]Anonymous, "Incorporating the Farm Business: Part I," Minnesota Law Review, XLIII (December, 1958), 310.

law specifically states that the judgment of the board of directors as to the value of the shares shall be conclusive except where bad faith or lack of care in determining the value of shares can be shown.[1]

Surely, a farmer organizing a corporation has no incentive to over-value shares, particularly since he must pay the annual privilege fee on the paid-in capital and surplus contributed to the corporation.[2] Since all that is required by statute is that the money or other property or services received by the corporation for which it issues shares shall be not less than the par value, over-valuing shares may be protected against in two ways. First, this can be done by issuing shares with low par value (for example, $10 per share as opposed to $1,000) and second, by an accounting procedure whereby a relatively few shares are issued (the remainder is credited to paid-in surplus). Thus, the "total par value of the corporation's stock . . . need not equal the actual value of the shareholders contribution; it need only satisfy the minimum stated capital required by state statute."[3] Hence, no reason exists for a farmer to find

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[1]Michigan General Corporation Act, Sec. 450.21.

[2]See Michigan excise taxes, p. 106.

[3]"Anon.," ". . . Part I," Minnesota Law Review, XLIII (December, 1958), 310. "In Michigan any profit corporation shall have a minimum paid-in capital of not less than $1,000" (Michigan General Corporation Act, Sec. 450.5). Payments received by the corporation in excess of this can be credited to paid-in surplus which is subject to the five ($0.005) mill annual privilege fee.

over-valued shares a problem.

"Corporate Veil"

The corporation and each shareholder is normally considered a separate business entity. Though the "corporate veil," at least figuratively, limits the shareholders from liability for corporate debts and acts, and, vice versa; there is an exception where the problems of (1) "alter ego," or (2) inadequate capitalization, exist.

"Alter Ego".--This is a problem that has importance in the close corporation from an internal business standpoint as well as an external legal standpoint. This is clear when one understands that:

> where the corporation is not actually conducting business as a separate entity it may be considered the "alter ego" of the owner, and disregarded for purposes of limited liability. To [achieve] limited liability, there must be "not only initial corporate organization, but, also, actual conduct of the business in corporate form by the corporation." In determining whether or not the corporation is a separate entity
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> 'proof of co-mingling of personal and corporate funds, payment of personal expenses from corporate funds, disregard of the corporation as a separate entity in transactions and bookkeeping, and conformity to corporation laws requiring the holding of stock-holder's and director's meetings will all be of significance.'
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> The moral of this principle is: when organizing a farm corporation the attorney [and the farmer] must make certain that it will comply with the state corporation laws and operate in all respects as an entity distinct from its shareholders. Since farm

> corporations frequently have only a few shareholders, the "alter ego" problem should be carefully considered. However, the mere fact that only one or two shareholders have complete control over the corporation "is not sufficient ground for disregarding the corporate personality."[1]

Certainly where the shareholders do not act to recognize the corporate entity they should not expect others to do so. The "alter ego" problem simply reinforces the necessity for the shareholders to recognize their close corporation as a distinct business entity that must conduct business in a technically correct manner and use normal business practices.

Inadequate capitalization.--The "corporate veil" may also be pierced if an obvious inadequacy of capital exists in relation to the volume of business and indebtedness. Capital is used here as corporate net worth, that is, as corporate assets minus liabilities. Generally in cases where corporations have been deemed inadequately capitalized, the amount of capital contributed has been less than the statutory minimum or shareholders have contributed no capital. It has been suggested, therefore, that attorneys -- and it should apply equally to farmers -- be hesitant in approving plans where a corporation operating a farm business leases "most of its property from the shareholders."[2] Certainly a

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[1]"Anon.," ". . . Part I," Minnesota Law Review, XLIII (December, 1958), 310.

[2]Ibid., p. 311.

corporation which holds title to the tangible personal property required to conduct a farm business would not normally have the "corporate veil" pierced because of an obvious inadequacy of capital, for it is customary for tenant farmers to conduct business with this amount of capital.

We find, therefore, that limited liability is achieved by having the corporation conduct business as a separate entity and by the incorporators contributing sufficient property as capital to enable it to meet its normal business obligations.

Limited Liability

When limited liability is achieved, the shareholders and the corporation are recognized as independent legal entities. Hence, the individual shareholder is liable for torts[1] committed or contracts[2] entered into by the corporation only to the extent of his investment.[3] This is the essence

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[1]A tort is an act or omission giving rise, in virtue of the commonlaw jurisdiction of the court, to a civil remedy which is not an action of contract; a private or civil wrong, as by assault, trepass or libel (Funk and Wagnalls, New "Standard" Dictionary, 1960).

[2]A contract is an oral or written agreement recognized by law as consisting of an obligation to do or not to do a particular thing. The obligation of a contract is an obligation created and determined by will of the parties (Funk and Wagnalls, New "Standard" Dictionary, 1960).

[3]N.G.P. Krausz and Fred L. Mann, Corporation in the Farm Business, Extension Service Circular 797 (revised) (Urbana: University of Illinois, 1960), p. 5.

of limited liability which has varying degrees of importance depending upon whether corporate liability arises from a tort or contract and how the property used in the farm business is owned.

Risks arising from torts are insurable and, of course, both individuals and corporations can insure these risks. Yet whether a single shareholder and a corporation actually have limited liability against torts depends upon the property relationship existing between the shareholder and the corporation. If the shareholder's only property is shares in a corporation to which he has contributed all his property, limited liability loses its meaning.[1] This occurs even though the property of the shareholder, which is now shares issued by the corporation, is technically independent of the actual property owned by the corporation because the shares represent all the property the shareholder owns. Consequently, while the shareholder is not liable technically, if the corporation commits a tort, the assets of the corporation may be reached to satisfy a judgment in excess of insurance coverage. Any reduction in the net worth of the corporation arising from this source or any other is tantamount to reducing the shareholder's net worth.

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[1]Joseph Shoemaker, "Incorporation of the Family Agricultural Business," Taxes, XXXVI (July, 1958), 517.

If there were several shareholders, for example two or more persons, of a close corporation all of whom had contributed all of their assets to the corporation as capital, limited liability for any particular shareholder would not exist. But this situation is fundamentally different from the preceding one, for here if one shareholder committed an uninsured tort or one not adequately covered by insurance, the property owned by the corporation and the property (or shares) owned by all the other shareholders would be protected in the event of a judgment against that shareholder. Certainly this is a desirable feature of the close corporation. Should this occur, the other shareholders might find it necessary to purchase the shares held by the shareholder against whom the judgment is obtained to retain control of their farm business in the family. However, their shares and the property of the corporation could not be reached to satisfy the judgment. Again, however, if the tort is committed by the corporation and the judgment is obtained against it, the net worth of all shareholders will be reduced in proportion to the number of the shares owned. Individuals who have no other source of income should not contribute all their property to the corporation if they wish to take advantage of the limited liability against torts.[1]

Limiting liability from torts may be of real importance,[2] particularly where there are multiple owner-operators of a farm business, for the individuals can never be certain that they have complete insurance coverage against tort liability.[3]

Risks arising from contracts are at least impractical, if not impossible, to insure; therefore, limiting liability for contractual obligations is applicable only when a shareholder is not required to endorse contracts made by the corporation. The officers of a close corporation that obtains credit on notes and/or mortgages are usually required to endorse these credit obligations as guarantors. If all shareholders are officers and all must endorse the credit obligation, then clearly the liability of no shareholder is limited. Limited liability is lost by the shareholder who endorses corporate contractual obligations. But if the members of the family own all the shares of the corporation and they all

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[1] There are other examples of limiting liability generally used. First, where an outsider furnishes money to a family farm business, and second, where the farm family operates an independent business such as an implement dealership or an artificial insemination business. We have limited our discussion to the close corporation conducting a farm business; hence, these examples are not discussed.

[2] E. B. Hill, Should We Incorporate the Farm Business, Extension Bulletin 371 (East Lansing: Michigan State University, 1959), p. 8.

[3] "Anon.," ". . . Part I," Minnesota Law Review, XLIII (December, 1958), 312.

endorse the credit instrument, they simply endorse their own indebtedness and no increase in liability has occurred. Yet it is possible that individuals approaching retirement or who have retired can shift the liability for the corporation's indebtedness to younger shareholders who may expect to receive the maximum benefits from any investment made in the farm business. When the corporation conducts the farm business as a tenant, those individuals who wish to retire and simultaneously reduce their liability could sell or give their share to younger members of the family and continue to rent real property owned to the corporation. To the extent that family members can limit liability among themselves and increase productive investment and, thereby, farm profits, the corporation is a useful institutional arrangement.

Control

Normally we would expect that the control of a close corporation would be explicitly and/or implicitly ascribed by being based not solely on the number of shares owned by each shareholder but rationed within the family group according to the ability and status of individual family members. Yet we must recognize that control of a corporation can always be explicitly achieved by one or more shareholders who choose to recognize only that control represented by the ownership of shares. Since one of the risks in close corporations is that the ascribed control may deteriorate, it is necessary to provide shareholders who may become dissatisfied an alternative to share ownership. Hence, farmers organizing a corporation must consider control with respect to (a) minority shareholders and (b) transfer of shares in the corporation.

Share Distribution and Control

Technically, the control of the corporation is three tiered, with the shareholders having the right to elect the directors.[1] The directors in turn have the right to select the officers and delegate to them the authority to conduct the corporate affairs.[2] Although most shareholders in close corporations will also be directors and officers and employees, it does not follow that a particular shareholder will own a sufficient number of shares to always be elected a director and/or officer. Actually, in the normal case a given shareholder may not own an absolute majority (that is, more than 50 percent) of the shares. Thus, the problem of minority shareholders is divisible into situations where: (1) the shareholders own an equal number of shares with no shareholders

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[1] Michigan General Corporation Act, Sec. 450.32.

[2] Michigan General Corporation Act, Sec. 450.15.

owning an absolute majority; or (2) the shareholders do not own an equal number of shares and one shareholder may or may not own an absolute majority.

Minority shareholders with equal shares.--When the number of directors to be elected equals the number of shareholders and cumulative voting is permitted by statute, as in Michigan,[1] each shareholder is assured that he may be a director -- for he can elect himself.[2] As each director is permitted only one vote on each item of corporate business, each shareholder will have as a director an equal voice in managing the corporation.[3] Moreover, since the board must be composed of at least three directors[4] and the majority vote

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[1]Michigan General Corporation Act, Sec. 450.32. Under the present Michigan Law the method of cumulative voting is made mandatory, that is, it is granted to shareholders irrespective of authorization in the charter or by-laws (H. L. Wilgus and B. Hamilton, Michigan Corporation Law, 2nd ed., by M. S. Wolf (Chicago: Callaghan and Co., 1950), Sec. 32, note 2.

[2]"Every stockholder entitled to vote shall have the right to vote in person or by proxy the number of shares of stock owned by him for as many persons as there may be directors to be elected, or to cumulate said shares and give 1 candidate as many votes as will equal the number of directors multiplied by the number of shares of his stock, or to distribute them on the same principle among as many candidates as he shall think fit" (Michigan General Corporation Act, Sec. 450.32).

[3]The separation of ownership and management always exists legally, even though the owners elect themselves managers (O'Byrne, et. al., op. cit., p. 7.

[4]Michigan General Corporation Act, Sec. 450.13(1).

rules,[1] a particular shareholder cannot achieve more than his pro rata share of control over the corporation whether measured as ownership of shares or voting rights as a director. To protect the voting right of each shareholder in this case, it would seem reasonable to stipulate in the articles or by-laws that the presence of all the directors is required to constitute a quorum to conduct business. However, there can be no by-law requiring the unanimous vote of all the directors before business may be transacted.[2] Thus, it is possible to organize a corporation in a manner that permits each shareholder to achieve his pro rata share of control.

We must recognize, however, that nothing will necessarily prevent a shareholding-director from voting consistently in the minority. Consequently, his position on the board may become valueless from a managerial standpoint. Yet he cannot be removed from the board even by a concerted action of the shareholders, since he will have the necessary

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[1]Wilgus and Hamilton, op. cit., Sec. 13, note 1.

[2]"Such a by-law . . ., is, almost as a matter of law, unworkable and unenforceable for the reason given by the Court of King's Bench in Hascard V. Somany, 1 Freeman 504, in 1693: 'prima facie in and acts done by a corporation, the major number must bind the lessor, or else differences could never be determined'" (Norman D. Lattin and Richard W. Jennings, Cases and Materials on Corporations, 3rd ed. (Chicago: Callaghan and Co., 1959), p. 641).

votes to continue to elect himself a director.[1] In such a situation, however, a shareholder may find that his position is similar to that which threatens a second class of minority shareholders -- those with unequal shares.

Minority shareholders with unequal shares.--In this situation, one shareholder may own an absolute majority of shares (that is, over 50 percent) or a simple majority (that is, more than any other shareholder, but not more than 50 percent of the total shares). Absolute control requires ownership of 51 percent of the outstanding shares, if the corporation issues only one class of shares.

Farmers who wish to dispose of more than 50 percent of their property by organizing a corporation, yet retain control of the corporation and hence the property, may have the corporation issue voting and non-voting shares. Control may be retained by holding the voting shares while reducing property ownership by distributing the non-voting shares to other individuals. This could be an acceptable procedure for

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[1] "At any meeting of the shareholders of any corporation called for the purpose of removing any director, such director may, by a vote of a majority of all the shares of stock outstanding and entitled to vote . . . be removed from office for cause and another be elected in the place of the person: Provided, That the shareholders shall have the right to vote cumulatively on such removal and no director shall be removed against whose removal sufficient votes shall be recorded to have elected a director on the election of a full board or a division thereof, if the board should be classified" (Michigan General Corporation Act, Sec. 450.13(3)).

the farmer with a large estate who desires to retain absolute control over the farm business. When the individuals receiving the shares are corporation employees or have alternative sources of income, this method of reducing an estate and retaining control over the business could prove useful.

Corporations where control is achieved in this manner normally will be organized as owners or part owners. This alternative may not be applicable if there are individuals who are dependent on the farm business for their income and who are not able to be employed by the corporation, since it may be necessary to declare dividends to provide these individuals income. Furthermore, the corporation may find it advantageous to elect to be taxed as prescribed in Subchapter S but find that two classes of shares outstanding prevent this.

The control of a close corporation, whether achieved or ascribed, will normally deteriorate only when the family members reach an impasse. The way the corporation is organized may increase the problems of minority shareholders in the event such a situation occurs.

Minority Shareholders and Organization

The minority shareholders of a close corporation conducting a farm business are sometimes in a disadvantageous position. We will, therefore, examine their position when the corporation is organized to conduct the farm business as (a) an owner, (b) a part owner, and (c) a tenant.

Owner.--The corporation organized to conduct the farm business as an owner owns title to both the real and tangible personal property required in the farm business. Shares issued by the corporation in exchange for any property contributed as capital are intangible property. This exchange of property, at least technically, removes the shareholder from all rights of ownership associated with the real and tangible personal property used by the corporation in the farm business. These rights become corporation property and are controlled by the board of directors.

Whether minority shareholders hold equal or unequal numbers of shares, there is always the possibility that because of age, sex or place of residence, some cannot be shareholding-employees and, of course, it is always possible that some may not even be directors. Shareholders in such a situation must receive any returns on their investment as dividends. It need not be the case that what follows requires a family disagreement though it may well lead to one.

Normally the earnings and profits of farm businesses are small. Consequently, the directors can pay the shareholding-employees a moderate salary and usually make a substantial case for reinvesting the remaining profits in the business.

The result is that no residual remains for dividends. If the amount reinvested is sufficiently large that all the shares may increase in an amount equal to a satisfactory return on the investment, this lack of money income distribution may make little difference so long as the minority shareholders have adequate money income from other sources. When this is not the case, the minority shareholders may wish to sell their shares. They will, however, find no, or at least a meager, market for an equity that yields no return. Consequently, the minority shareholders are either "locked in" or placed in a position that they may be required to sell their shares at less than actual value. When a shareholder is placed in this position, he can only conclude that the corporation organized as an owner is a poor means of conducting a farm business.

This facet of the minority shareholder problem has received much attention. One solution is for the corporation to issue some preferred shares. This may increase costs and/or prevent it from being able to be taxed as prescribed in Subchapter S. Another way is for the corporation to issue interest bearing certificates of indebtedness such as bonds. Either solution tends to establish a fixed level of income for the owner and costs for the corporation and, hence, may not be satisfactory to either party.

Recently it has been suggested that an institutional arrangement be designed to purchase shares offered by minority shareholders of close corporations conducting farm businesses.[1] Underlying this suggestion is the recognition that owning property in a close corporation organized as an owner (and, perhaps, as a part owner) is different from owning a similar minority interest in property as tenants in common and/or a partnership. The essential difference is that in the corporation the group of minority shareholders we are discussing here has neither freedom nor security and cannot effectively exercise the rights of ownership. As tenants in common and partners these values and rights are not violated even though they may be constrained, for as a last resort the property required in the farm business can always be divided, and the individual may take sole possession of his portion regardless of size. Minority shareholders of a close corporation organized as an owner are unable to exercise this option prior to dissolution. Therefore, to the extent this problem is encountered, the corporation conducting a farm business as an owner is inconsistent with the values of freedom, security, equitable treatment of heirs, and the

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[1] Peter Dorner, "The Farm Problem: A Challenge to Social Innovation," Journal of Farm Economics, XLII (November, 1960), pp. 811-826.

right of access to land and, hence, is normally viewed by farm families unfavorably.

Consider now the unique position of a minority shareholder who is the only shareholding-employee of a corporation organized by a family to conduct their farm business as an owner. If such a shareholder owns less than one-third of the shares in the corporation, he cannot prevent the other shareholders from dissolving and liquidating the corporation for cash in the event the other shareholders decide to do so.[1] Yet if he owns more than one-fifth of the shares, he can prevent the corporation from being dissolved and liquidating its assets in kind.[2] Any family of shareholders that reached this impasse would, at least, be able to remove the minority shareholder as an employee. Furthermore, they could sell the corporation and its assets without the consent of the minority shareholder. Although such actions within families should be extremely rare, we can only conclude that a corporation is undesirable for any minority shareholder who objects when it does occur, for the values of freedom and security, as represented by the land such a shareholder may have otherwise owned, are violated.

Part owner.--Families owning large farms may organize

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[1] See Dissolving the corporation, p. 177.

[2] See Taxes at the time of dissolution, p. 96.

corporations with the specific purpose of transferring the farm to, at least one, and perhaps, several individuals who will be minority shareholders in relation to the original incorporators. Minority shareholders of a corporation organized as a part owner should normally have an alternative source of farm income either from property leased to the corporation, to other farmers, or operated individually. Thus, while the minority shareholder problem exists in identically the same way when the corporation is a part owner as when it is an owner, the alternatives available to minority shareholders should normally be greater. Consequently, any restraints imposed by the corporation should not impinge upon the minority shareholder to the same extent.

Corporations specifically organized as part owners for the purpose of transferring large farm estates may be but a passing phenomena in our society, a phenomena resulting from an unparallelled agricultural depression, followed by an extended period of inflation and accompanied by a migration from farms which permitted large farms to be accumulated within the life span of one generation. A few of these large farms will be owned by families where there is a single heir, but with many farm families the number of heirs will exceed one. Consequently, the tendency for a total farm property to divide into smaller individual holdings may increase over time. The minority shareholder may, therefore, have a totally different problem in the part owner corporation. This will be one of cost basis, particularly where shares are transferred as gifts. As the equity in the farm business becomes smaller the inheritance tax problem may tend to decrease in importance, and the maximum cost basis obtainable may tend to increase in importance. Consequently, the transfer of shares by sale or through an estate may be more beneficial to prospective heirs. Hence, the need for corporations organized as part owners and used for the specific purpose of reducing the potential estate and inheritance tax liabilities of an individual estate may exist for only a relatively short period. However, some families who organize corporations as tenants to minimize income taxes or for other reasons may direct the corporation to purchase some real property.

<u>Tenant</u>.--The minority shareholder of a corporation organized as a tenant will, in nearly every case, be an employee. Family members who become shareholding-employees may own all, part, or none of the real property used in the farm business. This may be owned by other shareholders and/or other family members. But as the real property is owned separately, the value problems concerning land itself are not encountered within the corporation. Although the minority shareholder in a close corporation organized as a tenant may encounter the same

problems as a corporation organized as an owner, the probability of not doing so is certainly greater. Transfer of shares in such a corporation would normally not begin until both the shareholder(s) and any prospective new shareholder had decided definitely that such a step would benefit the family. Thus, the number of shareholders will usually be restricted to the number of individuals who would conduct the business as a partnership. The transfer of ownership will usually occur gradually, with the younger shareholder eventually becoming an equal, if not a majority, shareholder and then reducing his shares as he retires. The outstanding technical difference is that the shareholders do not have direct ownership rights in the corporate property. Consequently, both the major, if any, and minority shareholder(s) are assured that, in the event of any disagreement, the property used in the farm business will remain intact. Thus, even when the corporation is organized as a tenant provisions for transferring shares are necessary.

Transfer of Shares

Establishing a procedure for transferring shares in the close corporation is important to all shareholders, because the ownership of shares could be transferred beyond the family without their desire or consent, if a shareholder is not restricted to some extent in the transfer of shares. Therefore, it may be desirable to provide some means of (1) restricting the transfer of shares and (2) placing a value on shares.

Restricting share transfer.--Shares in a corporation are personal property of the shareholder. Therefore, no corporation has the right to prohibit or absolutely restrict the transfer of shares as this is an alienation of property rights and such restrictions are void as against public policy.[1] Partial restrictions are not void, however, if they are justifiable in "that the interest protected is significant, and the best method of protecting that interest is by the share transfer restriction."[2] To have a valid partial restriction on share transfers, the restriction must establish an equitable price, or a method of establishing an equitable price, and a reasonable time period, after which the shareholder desiring to transfer shares is released from the restriction.[3]

Restrictions on the transfer of shares that are within the "proper limits, may be imposed by charter or by-law

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[1]William J. Sullivan, "Stock Transfer Restrictions in the Family Farm Corporation," Wisconsin Law Review, CMLX (July, 1960), 621.

[2]Ibid., p. 626.

[3]Sullivan states that ". . . an option which would run in excess of 90 days would be unreasonable . . ." (Ibid., p. 626, n. 25).

provision (that is, by the corporation), or by some agreement among the shareholders or between the shareholders and the corporation."[1] Regardless of who the parties to an agreement are, or the restrictions of the agreement, if the agreement is to be valid and a valid transfer made, the restrictions must be stated upon the share certificates as required by Section 15 of the Uniform Stock Transfer Act.[2]

Restrictive agreements among the shareholders of a corporation are called cross purchase agreements, while those between shareholders and the corporation are called entity agreements. It is considered advisable to have the corporation a party to any restrictive agreement, particularly when the agreement requires the corporation to act to fulfill the agreement.[3]

Regardless of the parties involved, restrictive agreements are of two types (1) the first option, and (2) the

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[1]Wilgus and Hamilton, <u>op. cit</u>., Sec. 17, note 3.

[2]Michigan has adopted the Uniform Stock Transfer Act which reads in part that "There shall be no lien in favor of such corporation upon the shares represented by a certificate issued by such corporation and there shall be no restriction upon the transfer of shares so represented by virtue of any by-law of such corporation, or otherwise, unless the right of the corporation to such lien or the restriction is stated upon the certificate." (Mich. Stat. Ann., Sec. 19.345; C.L. 1948, Sec. 441.15).

[3]Richard E. Petrie, "Considerations When Incorporating the Family Farm," <u>Nebraska Law Review</u>, XXXIX (May, 1960), 557.

buy-sell agreement. Both are methods of providing a means of settling ownership and control problems, if specific events occur, such as the retirement of a shareholder, a shareholder selling shares for personal reasons, or the death of a shareholder.

1) First option: This simply requires that the shares offered for sale be offered first to the parties to the restrictive agreement. Although it has the form of a contract, no obligation to buy is imposed upon those who are parties to a first option agreement. Therefore, a shareholder can never be certain that a market actually exists for any shares that he might offer. The first option is an integral part of every buy-sell agreement. Thus, we may discuss them jointly.

2) Buy-sell agreements: A buy-sell agreement is a contract that requires shareholders offering shares for sale to offer those shares only to the parties to the agreement who are in turn obligated to buy the shares when offered. Buy-sell agreements must, from both a practical and legal standpoint, include a method of pricing the shares that will permit the shares offered for sale to be priced "as close as possible to the anticipated [or actual] 'fair' value."[1] It is essential

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[1] David Keith Page, "Setting the Price in a Close Corporation Buy-Sell Agreement," Michigan Law Review, LVII (March, 1959), 657.

that the agreement avoid vague and ambiguous terminology and methods of establishing price which can be manipulated by those in control of the corporation.[1] Furthermore, each party to the buy-sell agreement must recognize that the provision for determining the price of shares must not improperly under-value or over-value the shares. For instance the consequence of a method of pricing shares designed to reduce estate taxes could result in a gift by the decedent to the surviving shareholders.[2] Any gift tax payable would be paid by the beneficiary. Since farmers are often interested in providing for their survivors, they may want to avoid this situation.

Many methods of establishing the value of shares are available and accepted. Among these are book value, par value, or some other definitely established and unchanging price.[3] Each method of valuing shares may be advantageous in certain situations and each could actually be the fair value when the buy-sell agreement became effective. However, each is subject to severe criticism because it may not determine the fair value of shares in all instances. Therefore, it appears that the most satisfactory method of pricing shares for a buy-sell

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[1]Page, op. cit., p. 658. For example, permitting the board of directors to establish the price of shares.

[2]Milton H. Stern, "Buy-Sell Agreements," Proc. of N.Y.U. 19th Ann. Inst. on Fed. Tax. 1961, op. cit., p. 666.

[3]Page, op. cit., p. 682.

agreement is that of <u>agreed value</u>, with the shareholders periodically establishing the value of their corporation. <u>Agreed value</u> has the advantage of definiteness in that questions surrounding other methods of valuing shares and outside appraisal and arbitration are removed. In addition to establishing the exact amount to be paid in case of, and prior to, the occurrence of an event covered by the restrictive agreement, the method of <u>agreed value</u> when properly recognized will force the shareholders to review their agreement and business situation at definite intervals.[1]

Farmers investigating the corporation will realize that any buy-sell agreement presupposes a method of financing the agreement at any time. Also, that the type and amount of property contributed to the corporation will influence the size of fund required for financing the agreement, and further, that a buy-sell agreement may cover (a) uninsurable and (b) insurable events.

<u>a) Uninsurable events</u>: Certain events are uninsurable. For example, a shareholder may decide that he wants to sell his shares at retirement or for a number of other personal

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[1]Stern, <u>op. cit</u>., 671. This form of agreement should not be permitted to become "stale" by the failure of parties to determine the agreed value. Since this may occur for some reason and the price become the equivalent of definitely established price a method of adjusting the agreed value should be included in the agreement.

reasons. Shareholders who use a buy-sell agreement to cover these contingencies will find a cross purchase agreement most satisfactory. A cross purchase agreement is one to which only shareholders are parties and each agrees to buy the other shares for specific reasons. Normally, this form of agreement can be financed by shareholders more readily if the corporation is a tenant and if the agreement does not require the real property of a shareholder to be purchased at the same time. When a corporation owns title to substantially all the real property used in the farm business, the amount of money required to purchase the shares offered for sale may be relatively large in relation to the total assets owned by the shareholder(s) who must fulfill the agreement. The problem of transferring shares will vary in magnitude in relation to the number and value of shares offered and the number and value of shares owned by the remaining shareholder(s).

Although cross purchase agreements seem most useful for uninsurable events, the entity purchase agreement may be most useful for an insurable event such as the death of a shareholder.

b) Insurable events: When entity purchase agreements are designed to assure that control of the corporation remains in the hands of the surviving shareholder(s), the funds required to fulfill the agreement must, in most instances, be made available from surplus funds owned by the corporation.[1] There is no assurance that the corporation will have a surplus; therefore, life insurance is often used to alleviate or eliminate the problem of creating surplus in the corporation. It is necessary to exercise care when using life insurance to create all or part of the surplus necessary to fund entity purchase agreements.

Any life insurance policy purchased by a corporation to fund a buy-sell agreement must be owned by and payable to the corporation. Premiums paid by the corporation on life insurance policies are not deductible from gross income as ordinary and necessary expense "when the taxpayer is directly or indirectly a beneficiary under such policy."[2] However, the proceeds from the policy received by the corporation are not considered taxable income to the shareholders when the agreement requires the transfer of the decedent's shares to the corporation, even if the shareholder had the right to designate the beneficiary.[3]

Proceeds a corporation receives from life insurance policies purchased to fund entity agreements which it owns are

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[1] Ibid., p. 658.

[2] Int. Rev. Code of 1954, Sec. 264(a)(1).

[3] U.S. Treas., Cum. Bul. 1959 - 1, Rev. Rul. 59-184, 65.

tax exempt,[1] even though this surplus is considered as earnings and profits. When the proceeds are paid by the corporation to the decedent's estate, some tax may be payable, if the value paid is less than, or greater than, the fair market value of shares involved in the transaction.[2] If there are insurance proceeds in excess of the agreed value which will normally be accepted as the fair market value, and it is desired that these proceeds be paid to the decedent's estate, this should be included in the agreement.[3] If the proceeds exceeding the fair market value of the shares purchased remain in the corporation that pays its own income taxes, they are taxable income when paid out to the surviving shareholders. However, if the proceeds exceeding the fair market value of the shares purchased are owned by a corporation that is taxed as prescribed in Subchapter S, they are tax exempt income to the remaining shareholders, but they may be withdrawn from the corporation only after all of the current year's earnings and all of the accumulated earnings and profits are distributed.[4]

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[1]Int. Rev. Code of 1954, Sec. 101(a)(1).

[2]U.S. Treas., Cum. Bul. 1958 - 2, Rev. Rul. 58-614, 920.

[3]Joel Irving Friedman and Henry L. Wheeler, Jr., "Stock Redemption Agreements Funded by Life Insurance," Taxes, XXXVII (October, 1959), p. 923, n. 46.

[4]George Byron, "Buying Out the Deceased Co-Adventurers: The Use of Insurance," Proc. of N.Y.U. 1954 Ann. Inst. on Fed. Tax. 1960, op. cit., p. 687.

Generally we would expect life insurance on shareholders in a close corporation to provide only a portion of the necessary funds required by an entity agreement, with the result that excess proceeds will be unimportant.

The least expensive form of insurance that will qualify to fulfill the entity agreement should be purchased. Term insurance, convertible term insurance, or ordinary life insurance may each be satisfactory depending on the situation.[1] Group life insurance should be avoided when funding entity agreements, because the shareholder normally has some rights of ownership in such policies,[2] and the corporation must have the sole ownership rights in all policies used to fund entity agreements.

Shareholders who are parties to an entity purchase agreement and who survive will have their equity increased without an increase in the number of shares owned. To the extent this reduces the minority shareholder problem and encourages (management) continuity in the business, this is a favorable arrangement.

Fringe Benefits

A fringe benefit is generally considered to be an

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[1]Friedman and Wheeler, *op. cit*., p. 925.

[2]Gordon, *op. cit*., p. 677.

economic benefit that an employee receives free from taxes or at the preferred capital gain rate. It is also assumed that the employer may take a tax deduction for the cost of the benefit.[1] Farmers who organize a corporation and who are shareholding-employees may receive certain fringe benefits due to the technical change in their legal status from employer to employee. Still, because they must bear the total cost less tax savings fringe benefits may be unimportant to many. Fringe benefits may be classed as (a) insurance benefits and (b) tax benefits.

Insurance Benefits

Accident and health plans.--These are insurance plans that cover both occupational and non-occupational medical expenses. Any such plan provided employees by the employer must qualify as accident and health insurance.[2] Under approved plans, the employer reimburses the employee for his medical expenses and those of his spouse and dependents, if they are covered by the plan. If an accident and health plan also provides for income replacement the income would not be

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[1] Irving Schreiber, "Employee Fringe Benefits; Cash and Noncash," Proc. of N.Y.U. 17th Ann. Inst. on Fed. Tax. 1959, op. cit., p. 607.

[2] Int. Rev. Code of 1954, Sec. 105(e)(1).

tax-free except for portions that qualified under a wage continuation plan.[1] Many farmers now own the same type of accident and health plans which a corporation could provide. The essential difference between the individual farmer's and the corporation's accident and health insurance plan is that the individual farmer cannot deduct the cost of the policy as a business expense and the corporation can.[2]

Permanent injury.--Any payment for a permanent injury must be made through an accident or health insurance plan. Payments received by an employee who has a permanent injury or loss of bodily function are excluded from gross income. In addition to these payments, he may also claim deduction from medical expenses. The amounts paid by such a plan must not be computed with reference to the period of absence from work.

Workmen's Compensation.--Individual farmers are employers; they are not covered by the Michigan Workmen's Compensation Act. However, the shareholding-employee of a close corporation will have the technical legal status of an employee. Although farm laborers as employees are specifically

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[1] Schreiber, "Employee Fringe Benefits: Cash and Non-cash," Proc. of N.Y.U. 17th Ann. Inst. on Fed. Tax. 1959, op. cit., p. 611.

[2] This applies to both individual and group accident and health insurance policies (Bardes, op. cit., p. 3.4).

exempted from coverage by the Act, an employer of farm labor may voluntarily elect to insure his employee as provided in the Act.[1]

If the corporation does not elect to come under the Act, any income received by the employees from Workmen's Compensation insurance will be tax-free.[2]

The shareholding-employees of corporations conducting a farm business will usually consider the cost of workmen's compensation policies carefully before having the corporation elect to provide workmen's compensation insurance covering only its shareholding-employees. The policy cost is determined by the premium rate, which is $5.35 per $100 of payroll, times the employer's payroll divided by 100, with a minimum premium of $90. Corporate officers may not exclude themselves from coverage. When determining premium costs, their earnings are

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[1]Michigan Workmen's Compensation Act, Sec. 2a, reads, "This act excepting Section 1 hereof, shall not apply to private employers who regularly employ less than 3 employees at any one time nor to domestic servants or farm laborers; Provided, that a private employer who employs less than 3 employees, or an employer of farm laborers or domestics, may assume the liability for compensation and benefits imposed by this act upon employers and the purchasing and accepting by such employer of a valid compensation insurance policy which, in the case of farm laborers and domestics, shall include in its coverage a classification of farm laborers and domestics . . . in which case the employer shall be subject to no liability other than workmen's compensation as provided for in this act."

[2]Int. Rev. Code of 1954, Sec. 104(a)(1).

computed at a minimum of $50 and a maximum of $300 per week.[1]

Tax Benefits

<u>Wage continuation plans</u>.--[2]Payments, not to exceed $100 per week, made under these plans are deductible to the employer as ordinary business expense and tax-free to the employee. The payments may be provided through insurance or otherwise. However, if they are not provided through insurance, the arrangements must qualify as an accident and

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[1]Letter from Mr. W. D. Morgan, Secretary, Michigan Workmen's Compensation Rating Bureau, Detroit, Michigan, July 18, 1961. See other advantages of the corporation, p. 39.

[2]"'Wage continuation plan' means a health and accident plan as defined in [U.S. Treas.] Reg., Sec. 1.105-5 . . . [which] . . . includes plans which limit the period for which benefits will be paid, plans under which benefits are continued until the employee is able to work or reaches retirement age, and plans under which wages or payments in lieu of wages are paid to a sick or injured absent employee . . . . In order to qualify for exclusion . . . the more important . . . requirements are: (a) the employee must perform no substantial services for the employer during the period of disability; (b) the weekly rate of amounts received may not be greater than $100, and (c) the payment must actually be for an absence due to sickness or accident . . . . There is no exclusion granted to amounts paid which are attributable to the first seven calendar days of an absence due to sickness (but not accident) unless the employee is hospitalized on account of sickness for at least one day during such period" (Don V. Harris, Jr., "Deductibility of Employees Medical and Sickness, Accident and Health Plans," <u>Proc. of N.Y.U. 17th Ann. Inst. on Fed. Tax. 1959</u>, <u>op. cit</u>., p. 223, n. 55).

health "plan"; but it is not necessary that it be in writing[1] -- though it may be preferable. Payments made under wage continuation plans when the illness or injury does not require hospitalization are excludable from income only to the extent they cover a period after the first seven days. Clearly the shareholding-employees of a close corporation can benefit from wage continuation plans as the wages are deductible at both the corporate and shareholder levels.[2] Although wage continuation plans may be burdensome, under some circumstances, "it is a method by which the owners of the family corporation can care for an incapacitated member of the family for less money than if each shareholder had to contribute to such support individually."[3]

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[1]"It is not necessary, however, that the plan be in writing, or that the employees have legally enforceable rights to benefits. In the case of wage continuation payments, for example, an employer's established policy or practice of continuing wages during temporary periods of disability will qualify as a plan if such policy or custom is known to the employees, or knowledge of it is reasonably available to them, although as is frequently the case, the plan has not been formalized in writing and the employees do not have enforceable rights to receive payments" (Bardes, op. cit., p. 3.4).

[2]"As to [share]holder-employees of a corporation electing under Subchapter S, the wage continuation payments they receive are not only tax free distributions of the corporation's earnings, but actually reduce the [share]holder-employee's taxable income (since the corporate deduction for these payments reduces the taxable income allocable to the [share]holders) (Schrieber, op. cit., p. 612).

[3]David M. Hecht, "Retirement and the Farm Corporation," Wisconsin Law Review, CMLX (July, 1960), 633.

Death benefits of $5,000.--A corporation as an employer is permitted to deduct not in excess of $5,000 paid to the beneficiary or estate of a deceased employee. The payments, whether made voluntarily or by contract, in lump-sum or installments over a period of three years, are income tax-free to the beneficiary or estate.[1]

Qualified pension, stock bonus, and profit sharing plans.--Every pension, stock bonus, or profit-sharing plan established by a corporation must qualify under Section 401 of the Internal Revenue Code of 1954 before it may be implemented. Each type of plan requires that a trust be established to control the funds that are contributed to the plan. Financing the establishment of, and the contributions to, any of these plans will be an important problem on all farms; hence, their use will be limited to special situations. They do have tax advantages, however.

> For example: An employer [the corporation] can deduct . . . contributions to a qualified plan immediately for income tax purposes; the trust fund of a qualified plan is exempt from income tax; employees are not taxed on distributions from the fund until actually received or made available; and in some cases, the long-term capital gain rate applies.[2]

A plan may be approved for only one employee.[3]

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[1] Bardes, op. cit., p. 3.5.

[2] Hecht, Wisconsin Law Review, CMLX (July, 1960), 633.

[3] U.S. Treas., Cum. Bul. 1955 - 1, Rev. Rul. 55-81, 392.

Pension plans are based on profits, and regular contributions must be fixed amounts or capable of actuarial computation. Hence, pension plans are not suitable for a farm business.[1]

Stock bonus plans may be geared to profits and must be paid in stock. This has "no practical application in a closely held corporation."[2]

Profit-sharing plans must be permanent to qualify. Even though the employer need not contribute every year, the contributions "must be substantial and recurring, not merely occasional."[3] Furthermore, the plan may not discriminate for any reason against any employee who qualifies. This in itself would prohibit most close corporations conducting a farm business from establishing a profit-sharing plan. Alternative methods of counting employees exist, however, so that it is not essential that every employee be covered, but the alternatives will normally be of "little or no value to a corporation that has only a few employees."[4]

These problems, plus the cost of qualifying a plan, the uncertainty of farm income, and alternative uses for that

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[1] Hecht, Wisconsin Law Review, CMLX (July, 1960), 635.

[2] Ibid., p. 636.

[3] Ibid., p. 637.

[4] Ibid., p. 639.

income by the farm family and farm business, are sufficient to eliminate the use of these plans, except in extremely rare circumstances.

Automobiles.--Included among the items of tangible personal property required to conduct a farm business are automobiles. A shareholding-employee of a close corporation may use automobiles owned by the corporation for his own personal use; however, he must pay tax on that portion of costs of automobile use allocated to him. This may be taxed as constructive dividends or compensation. So long as the total compensation is reasonable this will be taxed as a part of gross income from compensation.[1] The amount of taxable compensation from using "a company car [for personal use] has been limited to an allocation to the user of depreciation and actual operating costs."[2] Thus, a shareholding-employee who used a corporation car 3/4 time for his personal use would be taxed on 3/4 of that year's depreciation and 3/4 of that year's actual operating costs, and vice versa. The corporation could deduct the remainder as ordinary business expense in the same manner as an individual farmer.

The purchase price of automobiles owned by the

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[1] See Payment of salaries, p. 64.

[2] Mathew F. Blake, "Non-Cash Fringe Benefits," Proc. of N.Y.U. 18th Ann. Inst. on Fed. Tax. 1960, op. cit., p. 890.

corporation is not taxable income to the shareholders, however, because the automobiles are a capital investment made by the corporation.[1]

Travel and lodging.--The shareholding-employee of a corporation is entitled to deduct from his own personal gross income "expenses for travel, meals and lodging while _away_ from home (overnight)" if the expenses are borne by the shareholding-employee "in connection with employment services performed for the employer [the corporation]."[2] This will be unimportant to most shareholding-employees of close corporations conducting farm businesses.

Convenience of the employer.--The corporation as an employer and a farmer for tax purposes may find, in special circumstances, that the cost of fuel for lighting, heating, or cooking furnished its employees is a customary expense of farmers and an item deductible as a business expense. This expense may be deducted as expense by individual farmers when incurred for hired help or other business use.[3]

Taxpayers who lease their property are permitted to depreciate the leased property.[4] Thus, there may be

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[1] _Ibid_.

[2] Bardes, _op. cit_., p. 19.5.

[3] John C. O'Byrne, _Farm Income Tax Manual_ (Indianapolis: Allen Smith Co., 1958), Sec. 412.

[4] _Ibid_., Sec. 812.

circumstances in which some farm property that was not previously depreciable property for individual farmers may become so when the corporation leases real property. Conceivably, a share-holding-employee could be required to occupy such property for the convenience of his employer.

Additional Features

Continuity of business and ease of transfer of ownership are inherent characteristics of the corporation. In addition, some farm businesses may, under some conditions, attain an improved credit status when a corporation is organized.

Continuity of Business

The corporate entity is not viable; consequently, it is a legal entity that is not subject to death. This characteristic permits the corporation to have continuity in business without respect to the death of shareholders, directors, or officers. In this respect, the corporation is different from the partnership which terminates upon the death of a partner. However, where continuity in management is provided, this termination is often only a legal technicality. Yet the continuity of business of a family farm is not solely dependent upon the form of business organization adopted by the family. Continuity in family businesses, and farm businesses are not excepted, depends, first, upon continuity in the family itself, and second, upon a succession of family members who have an interest in owning and/or managing the business. Given the final condition, the corporation may encourage the second. This encouragement will exist to the extent that uncertainties sometimes associated with other forms of business organization are reduced. Uncertainty is sometimes created in family business when it cannot be predicted with reasonable confidence that the action of potential heirs will be favorable towards continuing the farm business. To the extent this uncertainty exists there exists a lack of control -- exemplified by the lack of freedom to have power in action -- by the individual family member(s) who are, and who may reasonably expect to be, associated with the farm business management. To the extent a corporation reduces these uncertainties more effectively than other forms of business organization and institutional arrangements, continuity in the farm business may be increased.

Transfer of Ownership

The land and realty, such as orchards and buildings, that farm families own is often difficult to divide equitably and/or transfer in sufficiently small tracts that gift taxes are not payable. Furthermore, the actual physical division of farm property is often an unacceptable alternative.

When the corporation owns title to the farm property, shares issued by the corporation represent ownership of a specific portion of that property. Shares in a corporation can be transferred without physical division of the farm property. Normally, the actual value of shares of a corporation is such that one or more shares may be transferred as a gift without the gift tax being applicable. Transferring ownership of a large farm business and/or a large estate by making gifts of shares of a corporation is an effective means of minimizing estate and inheritance tax liability. Although transferring shares by gift will often minimize tax liability, it is not necessary that all transfers be gifts. Shares of a corporation may also be transferred by sale or bequest.

Improved Credit Status

An improved credit status implies that increased credit is available to a farm business conducted by a corporation. There are three reasons why this may occur. One is closely associated with an encouraged continuity of business, another with tax advantages to shareholders of corporations taxed as prescribed in Subchapter S, and the third with limited liability.

Institutional credit sources may, under conditions where the corporation reduces uncertainty and enables the family to provide management continuity, increase the credit available to a family farm business. However, there is no reason to believe that more credit will be available to family farm businesses conducted by a corporation than institutional lendor's would make available to an equally stable sole proprietorship or family partnership offering equal collateral, expected return on investment, and family integrity as security for the loan. A corporation can change none of these substantially, if at all, but where certainty of business continuity can be introduced by a corporation the maximum loan, whether long-term or short-term, may be more readily available.

An institutional lendor may find it more convenient to transact business with a corporation where there are many owners of the real property used in the farm business. However, before a farmer or a farm family organizes a corporation solely for the purpose of attaining a final increment of credit or for the convenience of the lendor, they should consider carefully the increased tax costs and any tax advantages in relation to the expected returns on the final increment of credit obtainable.

Some farm businesses may obtain credit and/or investment capital from family members by organizing a close corporation that elects to be taxed as prescribed in Subchapter S. If such a corporation has a series of net operating losses, the lendor and/or investor can recover the loan and/or investment as a tax deduction to the extent of the basis of the debt instrument and/or the shares issued.[1] Farm families who have individual members capable of lending and/or investing in the farm business in this manner will be few in number.

Some farm families may have individual members who are financially able to extend credit or invest directly in the farm business, yet hesitate to do so when they cannot limit their liability. When this condition exists, organizing a corporation so the liability of the prospective family creditor or investor is limited could be very profitable. As farms continue to increase in size, farm families may find the corporation can be used to obtain additional credit and/or investment capital from family members who are not living on the farm.

Summary

We have examined in this chapter the problems, benefits, and some additional features of a close corporation organized to conduct a farm business. We may classify the principal problems as achieving limited liability, property transfer, and control.

Achieving limited liability is a problem of accounting

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[1] See Basis of shares, p. 83.

which may be resolved by crediting to the paid-in capital account of the corporation the acceptable statutory minimum, thus eliminating the problem of over-valuation of shares. Shares have the value credited to capital and surplus. The problem of "alter ego" is solved by following proper business management and accounting practices. Though limited liability can be achieved, it may not exist for purposes of contractual obligations of the close corporation. This is primarily associated with the fact that the shareholder who is also an officer of a close corporation is often required to endorse its debt obligations. Limited liability against torts will not exist if the shareholders contribute all, or substantially all, of their property to the corporation and have no alternative source of income.

Control of a close corporation conducting a farm business is a critical problem. The problems of control are usually resolvable so long as the directors and shareholders are the same persons owning equal shares. Where the shares are not held equally, control becomes a more serious problem and one which may ultimately be resolved only by dissolving and liquidating the corporation. However, minority shareholders may be numerous and no problems exist. We may reasonably expect the problems of control and minority shareholders to be most serious when the corporation conducts business as an owner, less serious when the corporation is a part owner, and least serious where business is conducted as a tenant. The problems of control and minority shareholders should be considered before, not after, the corporation is organized.

We also examined some of the fringe benefits shareholders may receive from their corporation. The benefits are classed as insurance and tax. Insurance benefits can be obtained only by purchase of the particular policy. Since this requires an expenditure on the part of the family, they cannot benefit directly unless they have previously purchased such insurance and can transfer the costs to the corporation. Conceivably, when certain types of insurance become tax deductible, the cost may be decreased sufficiently that the directors will direct the corporation to provide that type of insurance for its employees. The tax benefits shareholding-employees receive from the corporation can be substantial or meager, depending upon the business arrangement and size of each corporation.

Also, the closely related additional benefits of continuity of business, transfer of ownership, and improved credit status were examined. To the extent the ease of transfer of ownership reduces estate transfer problems, the corporation is certainly acceptable. However, the maximum benefits may be attained when management continuity and the transfer of the control of the farm business operation reduces uncertainties sufficiently to permit increased productive investment in the farm business.

CHAPTER VII

THE PROCEDURES OF THE CORPORATION

In this chapter, the information presented relates to planning and organizing a corporation, conducting business as a corporation, and dissolving the corporation. Many procedures used in each phase of the corporations contemplated and actual existence have been at least partially formalized. Many others have not been formalized successfully for the circumstances of the particular family and farm business situation but will influence the detail necessary in the papers that must be prepared. It is essential that farm families who do organize corporations to conduct their farm business obtain the professional services of a reputable accountant and a reputable lawyer even though they may make the decision to incorporate independently. Such advice can be invaluable particularly if the accountant and lawyer are familiar with the family and farm business situation and with corporations organized to conduct farm businesses.

Planning the Organization

Farm families who plan to organize a corporation must determine exactly what they want their corporation to do for them. That is, do they want the corporation to (a) facilitate the inter-generation intra-family farm transfer, (b) minimize tax cost, (c) encourage (management) continuity in the business, and/or (d) redistribute some of the rights and risks of the family business. Certainly the family should first consider the alternatives to incorporation; if none are acceptable, the procedures required when organizing a corporation may be undertaken.

Families that plan to organize a corporation should give particular attention to determining how any tax payable on the corporation's taxable income shall be paid. This will be influenced by the income tax bracket of the prospective shareholders and their ability, as determined by age, sex, or location of residence, to be employees of the corporation. The tax plan will also be influenced by the degree to which the farm business is specialized and the type(s) of assets and/or property from which the income of the farm business is derived. Thus, as we have seen, the tax plan may be substantially different if the income of the farm business is derived from (a) property inventoried for sale to customers in the normal course of business; for example, purchased feeder cattle, poultry, etc., or such products produced from the asset land; for example, vegetable crops; (b) "1231 assets" that are an integral part of real property; for example, orchards, which produce products inventoried for sale to customers in the normal course of business; for example, apples, nuts, etc.; (c) "1231 assets" that are tangible personal property; for example, dairy cows raised on the farm which produce products that may be inventoried for sale to customers in the normal course of business; or (d) some combinations of these types of assets and/or property.

After the family has considered the situation of prospective shareholders and the type(s) of assets and/or property that produce the income of the farm business, they can determine the type of farmer their corporation should be, that is, whether the corporation should conduct the farm business as (a) an owner, (b) a part-owner, or (c) a tenant. The total value of the farm property owned by the planners will influence this decision substantially.

After considering the above aspects of the family and farm business situation, the preliminary written plans can be formalized more readily by their lawyer with the advice of an accountant. These plans would normally include (a) preincorporation agreements, (b) plans for corporate accounting, and (c) the shareholder's wills (page 166).

Preincorporation Agreements[1]

The preincorporation agreement is a formal written plan that specifies how the corporation is to be organized. It is recommended that a preincorporation agreement be used by farm families.[2] The preincorporation agreement has the advantage of permitting each prospective shareholder to determine his position in, or relative to, the corporation with clarity prior to organization. If the prospective shareholders 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. However, if the persons who sign the preincorporation agreement do conduct business or act in the name of the corporation before it is legally created, the corporation is required to

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[1]See University of Illinois Circular 797 (revised), Corporations in the Farm Business, by N. G. P. Krausz and Fred L. Mann (Urbana, 1960), for an example preincorporation agreement.

[2]Hill, Should We Incorporate the Farm Business, op. cit., p. 10; D. W. Hubbard and Grant E. Blanch, The Farm-Ranch Corporation: A Tool for Financial Planning and Management (Oregon State University, Agricultural Experiment Station, Corvallis, 1961), Station Bulletin 576, p. 23; O'Byrne, et. al, op. cit., p. 14; Krausz and Mann, op. cit., p. 13.

recognize such action.[1] This fact alone should not preclude the use of the preincorporation agreement, for shareholders who are properly advised will not encounter this problem.

Accounting Problems

Families planning the organization of a corporation must determine the corporation's tax year. If the corporation does not elect to be taxed under Subchapter S, the tax year is assumed to start the day the corporation is organized.[2] However, the tax year of a new corporation that elects to be taxed as prescribed in Subchapter S begins when the corporation acquires assets, or shareholders, or begins doing business.[3]

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[1] Michigan General Corporation Act, Sec. 450.8, "Preincorporation contracts. No contract made by the incorporators for or on behalf of any corporation to be formed be preliminary to the filing of the articles shall be deemed to be invalid or ineffectual because it is made prior to such filing, and all property held by such incorporators for the benefit of the proposed corporation shall be deemed to be the property of such corporation."

Wilgus and Hamilton, op. cit., in Sec. 8 note 1, make this comment about Sec. 450.8: "Under this section, the incorporators, that is, the signers of the articles of incorporation, are made statutory agents of the corporations preliminary to the filing of the articles and contracts made by them for and on behalf of the corporation are valid and effectual to bind it . . . . Its purposes seems merely to be to permit the making of contracts by the incorporators in the brief interim between the signing of the articles of incorporation and the completing of formation of the corporation by filing the articles."

[2] U.S. Treas. Reg., Sec. 1.443-1(a)(2).

[3] U.S. Treas. Reg., Sec. 1.1372-2(b)(1).

Thus, signing the preincorporation agreement would not start the tax year, but conducting business in the corporation's name would. If a corporation starts business with an effective Subchapter S election on a tax year different from the shareholders, income tax payment may be a problem. The shareholders pay income tax on dividends on their tax year; but, the corporation must close its tax year before it is known whether the dividends are taxable as long-term capital gain or ordinary dividends.[1]

The planners must also decide how the corporation shall keep accounts for income tax purposes. This will be influenced by the type of assets and/or property from which the farm income is derived. The cash method of accounting is as advantageous for the corporation as for individual farmers. A plan of organization that requires the corporation to report federal income tax on the cash basis when the individuals who are to contribute property as capital report income tax on the accrual basis should be reviewed carefully, for it will normally result in income tax at the time of organization.

Shareholder's Will

Every shareholder of a close corporation that may have a valid election to be taxed as prescribed in Subchapter S at the time of death should make a will, or insert a clause in

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[1]Valentine, op. cit., p. 700.

his will, directing the administrator of his estate to file the estate's consent to the election.[1] This is essential since neither the time of death nor the length of time required to settle the estate is controllable. This will prevent the administrator from making a decision not to consent, refusing to consent, or failing to consent because of inadequate information. Any failure to consent could cause the election to be terminated at an inopportune time.

Organizing the Corporation

Persons who act as the formal organizers of a corporation are called incorporators. Normally when a close corporation is organized all the prospective shareholders act as the incorporators. The incorporators are required to complete two formal procedures to completely organize their corporation. They must (a) prepare and submit the Articles of Incorporation and (b) hold the first meeting.

Articles of Incorporation[2]

Every corporation organized for profit in Michigan must have its Articles of Incorporation prepared in triplicate

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[1]Valentine, op. cit., p. 706.

[2]Krausz and Mann, op. cit., p. 38.

and submitted to the Corporation and Securities Commission for approval. A series of eight Articles must be completed.

Article I requires that the corporation be given a name approved by the Commission, which includes the word "company" or "incorporated."[1] In Article II the purpose or purposes of the corporation are given. The corporation must conduct the business stated in the purpose, but usually this is sufficiently broad that no problem exists unless the corporation actually changes industries. If so, Article II may, like any other, be amended. The address of the corporation's first registered office is given in Article III. Usually the address of an incorporator is given. Shareholders must hold their annual meeting at this office except when the by-laws provide otherwise.[2] Article IV states the name of the resident agent. This is normally the person living at the address given in Article III. There are two principal parts to Article V. First, total authorized capital stock must be stated.[3] Normally, only par value common stock is

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[1]Michigan General Corporation Act, Sec. 450.6.

[2]Michigan General Corporation Act, Sec. 450.38.

[3]Section 450.303 of the Michigan General Corporation Act tends to establish the total authorized capital stock at a minimum of $50,000 by providing that: "Every domestic corporation . . . organized for profit . . . shall at the time of filing its articles . . . pay to the Michigan Corporation and Securities Commission, as an organization fee and for the privilege of exercising its franchise within this state, a sum equal to 1/2 mill upon the dollar of authorized capital stock of such corporation; and . . . in no case . . . shall the organization fee be less than $25."

authorized but par value preferred, or no par value preferred or common stock, may be authorized. Second, any and all restrictions, qualifications and limitations on any class of stock authorized must be stated in Article V. Shareholders who restrict the transfer of shares by requiring new shareholders to agree to consent to an election of the corporation that is in effect at the time of transfer should include a statement in this Article.[1] Article VI requires the incorporator's names, addresses, and the number of shares of stock subscribed by each to be stated. In Article VII the names and addresses of the first board of directors must be given. These persons may not be the same as the incorporators, but usually in a close corporation if the number of incorporators is three or more they are the same. Article IX, which is optional, is printed in the Articles of Incorporation, and specifies how creditors and/or shareholders may have their claims settled by a court of equity if the corporation becomes insolvent or is declared bankrupt.[2]

The incorporators sign the Articles of Incorporation before a notary public. When the necessary franchise and filing fees are paid and the Articles approved by the Corporation

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[1] G. Stinson, "Terminating the Election under Subchapter S," Proc. of 18th Ann. Inst. on Fed. Tax. 1960, op. cit., p. 717.

[2] Wilgus and Hamilton, op. cit., Sec. 4, notes 23 and 24.

and Securities Commission the corporation is legally created. The incorporators and shareholders must then hold a first meeting.

First Meeting

The organization of the corporation is completed at the first meeting. This meeting may be held only after the incorporators have given written notice to the shareholders stating the time and place in which the meeting is to be held two days in advance or the requirement for such notice has been waived in writing.[1] When the incorporators and the shareholders are the same persons, or the shareholders are present either actually, or by proxy, the shareholders may complete the organization by adopting the by-laws and electing the directors.

The by-laws contain general guides as to how the corporation shall conduct its business. They may contain any special provisions to which the shareholders agree. If the special provisions are reasonable and do not deprive shareholders of their constitutional rights and are not in conflict with statutes or state policy they will be binding on all parties.[2] Shareholders should include a statement in the

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[1]Michigan General Corporation Act., Sec. 450.7.

[2]Wilgus and Hamilton, op. cit., Sec. 16, note 2.

by-laws about how shares are to be transferred in the corporation, especially if it is to have a valid election as prescribed by Subchapter S and for purposes of control.[1]

The Michigan General Corporation Act makes it mandatory for the by-laws to state (a) that the minimum number of directors of the corporation shall be three, and (b) when the meetings of shareholders and directors shall be held and the time and matter of giving notice of meetings. The Act also requires that the Articles, or by-laws, or both, contain provisions specifying: (a) the number of shares entitled to vote that shall constitute a quorum at a shareholders' meeting, subject to the provision that the vote shall be at least a majority; (b) how vacancies on the board of directors shall be filled, the place of holding directors' meeting, the quorum required for directors' meeting, and number of the quorum required to act in order to constitute an act of the board of directors and provide for the creation of an executive committee composed of directors; and (c) the number of directors, their qualifications, classification, term of office, manner of election, time and place directors shall be elected, and the powers and duties of the directors.[2] Since the shareholders have "the sole power to fix the qualification, classification and terms

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[1]Stinson, op. cit., p. 717.

[2]Wilgus and Hamilton, op. cit., Sec. 4., note 3.

of directors" they must adopt the by-laws.[1] When this is accomplished, the shareholders may elect the directors who will, at least in most instances, be themselves. The directors can then proceed to manage the corporation's business affairs.

Conducting Business as a Corporation

The directors of a close corporation conducting a farm business are responsible for managing that business. As shareholding-employees they are also responsible for carrying out their decisions as managers. When the assets used in the farm business are not increased and no major reorganization of the farm business occurs at the time the corporation is organized, the responsibility for carrying out the farm operating decisions of management will not change to any extent. However, the business management required by the corporation will be, at least slightly, and in certain instances substantially, more complex, for the corporation must (a) maintain the corporate entity and (b) keep adequate records for tax purposes.

Maintaining the Corporate Entity

To maintain the corporate entity specific acts required by the Michigan General Corporation Act must be performed.

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[1] *Ibid.*, Sec. 7, note 1.

Some acts are required annually and others periodically. An annual meeting of shareholders must be held by the corporation and its minutes recorded.[1] A complete detailed statement of assets and liabilities on the last day of the business year must be submitted to shareholders within four months after the close of the business year. This detailed statement must be contained in the Annual Report which the Corporation submits to the Corporation and Securities Commission on or before May 15 each year. The Annual Report also requires additional information, principally of a routine nature. For example, the name of the corporation and its officers and directors and their respective addresses, total authorized capital stock and amount issued, and the type of business conducted must also be given in their Report. The Commission may obtain additional information from the corporation if necessary.[2] When the corporation conducts business outside Michigan, the Annual Report is more complex.

Periodically, certain events will occur which require the corporation to perform specific acts to maintain the corporate entity. Thus, when the corporation obtains a new shareholder to which it issues shares or a new shareholder as a result of a transfer of shares, the owner's name and number

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[1]Michigan General Corporation Act, Sec. 450.38.

[2]Michigan General Corporation Act, Sec. 450.82(p).

of shares owned must be recorded in the stock ledger of the corporation. The stock ledger is a special book maintained for the purpose of recording the shareholders' names, and the value paid for their shares if they are original issues. The corporation may also have occasion periodically to change the name of its registered agent, the address of its registered office, its own name, or to amend its Articles for a number of reasons. Special forms are obtainable when these acts are necessary.

The corporation has costs. In addition to any privilege fee payable when filing the Annual Report, there are filing fees for the Annual Report and other papers that may be filed periodically to maintain the corporate entity. The schedule of forms and fees required when the forms are filed with Michigan Corporation and Securities Commission contains the following list.

	Franchise Fee	Filing Fee
ARTICLES OF INCORPORATION		
Profit Corporations. . . . (Minimum)	$25.00	$10.00
CERTIFICATES OF AMENDMENTS AND CHANGES		
Certified Resolution of Change of Resident Agent	--	2.00
Certified Resolution of Change of Registered Office and Resident Agent	--	5.00
Certified Resolution of Change of Registered Office	--	5.00

	Franchise Fee	Filing Fee
CERTIFICATES OF DISSOLUTION		
Certificate of Termination and Affadavit	--	$ 5.00
Dissolution by Three-Fourths Consent of Outstanding Capital Stock . .	--	5.00
Dissolution by Two-Thirds Consent of Outstanding Capital Stock . .	--	5.00

Keeping Adequate Tax Records

The corporation, as every taxpayer, must maintain an adequate set of records which present all receipts and expenses in a manner that shows profit and taxable income clearly. Since the close corporation and its shareholders will each have an intimate knowledge of the others business, the records should be maintained accurately and correctly to permit both the corporation's and the shareholder's profit and taxable income to be determined. If the corporation conducts business as an owner, record keeping will not change substantially and may be lessened in some special circumstances. If the corporation conducts business as a tenant, we can expect record keeping to increase in complexity. However, the total records should be no more complex than the records maintained by separate individuals who are conducting a farm business as landlord and tenant. If the corporation conducts the farm business as a part owner, the keeping of records for tax purposes may be exceedingly complex. The corporation will have business conducted as an owner and as a tenant, and in addition, the family shareholders will have business conducted as landlord and shareholders, all with the same property normally used in a single farm business conducted by a sole proprietorship or partnership.

Certainly the services of an accountant will be useful to many corporations in preparing their annual financial statement. Although the record books of a corporation conducting business as an owner and tenant should normally be maintained without difficulty by the corporation officers, a corporation organized to conduct a farm business as a part-owner will require, at least, the services of an individual who is well trained in accounting.

Since the close corporation will have many records that will have tax implications such as leases, directors' resolutions, and in some rare instances, special plans for fringe benefits, it seems reasonable to suggest that all such records should be notarized to establish their date without question.

When the corporation is complete, and the new business procedures established, the family will not find the corporate-legal business structure particularly different from that of a well-organized partnership. This is particularly so, since the directors may consent to corporate action individually or collectively in writing without holding a formal directors' meeting.[1] For numerous reasons, the family may find that the corporation has either accomplished what they desire or that the original problem no longer exists. They may then wish to dissolve the corporation.

Dissolving the Corporation

Regardless of how or for what reason a corporation is dissolved, the corporation continues to exist as an entity for at least three years. During this period, the directors may not conduct new business in the corporation's name, except that which may arise from suits against it and which is necessary in settling its affairs.[2] The corporation records and books must be deposited with a bank or trust company in Michigan for a period of 10 years during which time they may be inspected but not destroyed.[3] All known creditors of a corporation that plans to dissolve must be notified by registered mail or personally and a notice of the proposed dissolution be inserted for three consecutive weeks in a

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[1]Michigan General Corporation Act, Sec. 450.13(c).

[2]Michigan General Corporation Act, Sec. 450.75.

[3]Michigan General Corporation Act, Sec. 450.77.

newspaper published in the county or local area.[1] These procedures will be necessary whether the dissolution is (a) voluntary or (b) involuntary.

Voluntary Dissolution

If the corporation is solvent, dissolution may require selling property or distributing it in kind. The procedures are different in each case. When the corporation plans to dissolve and sell its property, it must call and hold a meeting of its shareholders. The owners of at least two-thirds of each class of shares outstanding must consent to the dissolution. If so, the shareholders appoint at least three directors to audit the books, inventory the property, settle the outstanding debts of the corporation, and reduce all corporate property to cash. After this is accomplished, the shareholders receive the remaining cash assets on a pro rata basis. These final payments may occur over a period of several years, since the corporation may be required to hold some funds for the three year period beyond the immediate period of dissolution.[2]

The property owned by a close corporation conducting

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[1] Michigan General Corporation Act, Sec. 450.74.

[2] Michigan General Corporation Act, Sec. 450.67.

farm businesses will normally be such that shareholders may wish to dissolve the corporation and distribute the property in kind. Such a dissolution may occur if the owners of at least three-fourths of each class of shares outstanding give their consent in writing or vote to do so. The corporation must pay its debts and liabilities or make provisions for doing so, when property is distributed in kind. All property distributed in kind is distributed pro rata to the shareholders who must submit within thirty days of dissolution a certificate signed by at least three-fourths of them stating the corporation has paid, or made provision to pay, all debts and liabilities.[1] Property transferred from the corporation to the shareholders "usually results in taxable income to the shareholders."[2] When a family of shareholders decides to dissolve their solvent corporation voluntarily, they should plan the dissolution carefully, with the advice of a reputable accountant and lawyer.

Involuntary Dissolution

If the corporation is involuntarily dissolved, the proceeding must be supervised by a court. In Michigan, the proceedings of the court "shall be under the judicature act

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[1] Michigan General Corporation Act, Sec. 450.73.

[2] Mallare, Wisconsin Law Review, CMLX (July, 1960), 582. See Taxes at the time of dissolution, p. 96.

of 1915."[1] Corporations may be involuntarily dissolved for a number of reasons. The principal ones are failure to maintain the corporate entity in the manner described above, insolvency or bankruptcy. The cost of an involuntary dissolution may be substantial.

Summary

In this chapter, we have examined the planning, organizing, operation, and dissolving of a corporation.

We find that planning the organization should be done carefully with considerable attention paid to (1) the family situation and (2) preparing to maintain the corporation in a workable state for a long period of time. It is obvious that organizing the corporation is one of its most simple aspects and that conducting or operating the business of a corporation may be quite complex. However, maintaining the corporate entity and conducting business as required on an annual basis may improve business practices for some farm families. Yet it is unreasonable to suggest that any farm family that does not already maintain a satisfactory set of farm business records accurately and clearly should organize a corporation. It cannot be determined what the costs of dissolution will be. However, if the corporation does not

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[1]Michigan General Corporation Act, Sec. 450.65.

conduct business or own property other than that needed in a normal farm business, the dissolution should be fairly inexpensive and relatively tax free.[1] Yet if the corporation is managed poorly and the directors do not realize that their farm business has not changed but only its legal-business structure, both dissolution costs and the process of dissolution could be extremely painful.

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[1]See Taxes at the time of dissolution, p. 96.

CHAPTER VIII

THE CASE STUDIES

The purpose of this chapter is to study the corporation in relation to four family and farm business situations that are located in different areas of lower Michigan. Each family situation is different. Each farm business situation is different. The two are closely related on any family farm; this complexity precludes examining every alternative way in which a corporation could be organized to conduct each farm business. Therefore, only the problem posed by the family owning the farm is examined, with the corporation examined in relation to that problem in the way the writer believes is appropriate.

The four families here presented were investigating the corporate form of business organization at the time this study was made; therefore, all the examples presented in this chapter are of proposed corporations and not of corporations actually in existence. Each of the four farm businesses is examined separately. Each illustrates a different problem that may be encountered by a farmer who is considering incorporating his farm business. Some farmers who are investigating the corporation may be confronted with one or more of these problems simultaneously and, therefore, may find more than one case applicable to their situation. One farm has real property with a high value for residential or public use. The second farm had its major income from sources of farm products produced by "1231 assets" that are tangible personal property such as dairy cattle. A third farm received its major income from products produced by a "1231 asset" that is realty[1] -- an orchard. The fourth farm derived the major source of its farm income from products that are cash crops produced directly from the asset land.

Analysis by Budgeting

The quantity and the type of information which farmers who investigate the corporation legal-business structure will assemble and analyze will vary with the complexity of the particular problem each is seeking to solve. Also, with the type of error,[2] and the probability of making that error, each

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[1]The term "1231 assets" refers to assets which are included by Section 1231 of the Internal Revenue Code of 1954. Such assets must be used in the trade or business held for more than six months, not properly includable in inventory, and not held primarily for sale in the ordinary course of business. They must be of a character subject to depreciation. The "1231 assets" are normally considered to be realty, that is, farm buildings, orchards, tile, etc., machinery and equipment, and livestock used for draft, breeding or dairy purposes. Land is not a depreciable asset, and is not included in the "1231 asset" group although it is used in the farm business.

[2]Farmers investigating the corporation may make the error of not organizing a corporation when they should, a type 1 error, or of organizing a corporation when they should not, a type 2 error. Since there are costs associated with organizing and dissolving a corporation, farmers may be expected to minimize the

will accept when deciding if, and how, to organize a corporation to conduct the business of a particular farm. Informal analysis of information gathered will cease at some point, however, and formal analysis or budgeting will begin. Farmers will usually be interested in the impact the corporation will have on their family and farm as the farm is presently organized; thus, they normally will find partial budgeting adequate. Since each farm business will be different, each farmer will need to select from the array of information assembled those facts relevant to his farm business and peculiar to his family situation when determining how the corporate legal-business structure may affect his business and family.

Case A

In Case A, a widow who owns the major portion, 360 acres of an exceptionally well-located 476 acre cash grain farm is investigating a corporation as a method of transferring the title of her portion to her children. The potential federal and state inheritance tax liability of this estate can be large in the family situation.

Land is the important asset to consider in this case. The land in this farm has a higher value than for use in

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probability of making a type 2 error and maximize the probability of not making a type 1 error.

agriculture either as residential or public property. One tract is included in a proposed community development plan. Since the land has a value substantially in excess of the adjusted cost basis (federal income tax cost basis) and the land is destined for use other than agricultural within a decade or two, this case involves what a corporation may do more successfully than other means of business organization in this family situation in transferring some or all of the mother's real property to her children. The following section briefly outlines the farm and family situation.

The Farm and the Family, Case A

Background.--The tracts in this farm have remained in the same family from 80 to 100 years. The mother and the children desire to see the farm continue in the family for two reasons: first, the family members have a strong sentimental attachment to the farm; and second, the farm is located so that the next generation of owners or their heirs can reasonably expect to sell the property for non-agricultural use. The farm has always been operated by family members, and until recently, Sons C and D operated the farm in partnership with their mother. The sons were not compatible, however, and the partnership was dissolved.

Farm location.--The farm is located on the edge of an expanding urban community. One tract actually lies within the proposed plan of development for the community. Consequently, the farm has value for short-run agricultural use, perhaps 20 years, and long-run residential or public use.

Type of farm.--Cash grain -- changing from grain and livestock feeding.

Table 1.--Description of tracts in farm, 1961, Case A

Tract[1]	Acres	Title owned by	Title in
X	130	Mother	Fee simple
Y	185	Mother	Fee simple
Z	45	Mother	Fee simple
Z'	33-1/3	Son C	Fee simple
Z"	82-2/3	Sons C & D	Tenants in common
Total	476		

Table 2.--Description of family, 1961, Case A.

Members	Age	Marital Status	Residence
Mother	72	Widow	Tract Y
Daughter A	42	Married	Outside Michigan
Daughter B	40	Widow	Outside Michigan
Son C	37	Married	Outside Michigan
Son D	33	Married	Tract X

[1]Tracts Z, Z', and Z" lie in a single tract which is divided only by title within the family.

Present business arrangement.--Son D, who lives on the farm and owns as tenants-in-common with Son C an 82-2/3 acre tract, conducts the farm business. All the machinery and equipment is owned by Son _D_, who conducts the business in partnership with his mother. Son _D_ pays cash rent to Son _C_ for the use of his share of their tract.

The problem.--To examine the use of the close corporation as a means of arranging an inter-generation, intra-family transfer of the tracts owned by the mother that will:

1. Provide an annual income satisfactory to the mother.
2. Transfer the mother's portion of the farm in the most economical manner for both present and future family owners.

Discussion

Before we begin our analysis of the problem, we shall, first, estimate the total value of the 360 acres in the three tracts which are presently included in the mother's estate, and second, estimate the future estate and inheritance tax liability for her estate. We shall assume that the mother owns other property equal in value to any deductions such as funeral expenses, debts and so forth to which her estate would be entitled in estate and inheritance tax computations.

In estimating the total value of the tracts owned by the mother, we shall accept the estimates of value made by the family members. They estimate the tracts belonging to the mother to have a value of $200 or $250 per acre for agricultural use. The family also thinks that if the tracts belonging to the mother were sold in 1961 they would sell as an investment for future non-agricultural use, and that tract Z would sell for $400 per acre and tracts X and Y would sell for $500 per acre. (For convenience, we shall refer to the tracts as having an agricultural value and an investment value.)

Using the prices estimated by the family, the tracts owned by the mother have an agricultural value of either $72,000 or $90,000 when valued at $200 or $250 respectively, and the tracts have an investment value of $175,000 which is an average value of $487.50 per acre. The estimated estate and inheritance tax liability of the mother's estate is, therefore, $1830 or $4,650 when valued for agricultural purposes at $200 or $250 per acre respectively, and the total estate and inheritance tax liability is $28,757 at the investment value of $487.50 per acre, Table 3, page 189. The family agrees that the estimated estate and inheritance tax liability is not overly serious if the mother's estate is to be appraised at the agricultural value. However, they consider the estimated estate and inheritance tax liability a serious problem should the tracts be valued at their investment value.

The family does not know what the fair market value of the tracts will be when the mother's estate is created and the tracts appraised for estate purposes. However, they do

Table 3.--Estimates of estate value and tax liability, 1961, Case A[1]

	Tract	Acres	Cost Basis: Land only	Cost Basis: Realty only	Cost Basis: Total[2]	Value of tracts, agricultural: @ 200 acres	Value of tracts, agricultural: @ 250 acres	Value of tracts, investment: @[3] acres
	X	--	$ 6,600	$ 6,130	$12,730	$26,000	$32,500	$ 65,000
	Y	--	7,500	15,165	22,665	37,000	46,250	92,500
	Z	--	2,250	. . .	2,250	9,000	11,250	18,000
Total acres and cost basis	-	360	16,350	21,295	37,645	--	--	--
Total estate value	-	--	--	--	--	72,000	90,000	175,500
Contemplating transfer at death federal estate tax[4]	-	--	--	--	--	720	3,000	24,542
Michigan inheritance tax[5]	-	--	--	--	--	1,110	1,650	4,215
Total tax liability of estate	-	--	--	--	--	1,830	4,650	28,757
Contemplating transfer by sale capital gain tax @ 20 percent[6]	-	--	--	--	--	3,435	5,235	13,735
Capital gain tax @ 25 percent[7]	-	--	--	--	--	8,588	13,086	34,463

[1] Estate and inheritance tax computations are based on tables contained in Special Bulletin 424, Impact of Taxes and Legal Costs on Farm Transfers and Estate Settlements, by E. B. Hill (Michigan State University, Agricultural Experiment Stateion, East Lansing, 1959), pp. 17 and 21.

[2] Value of mother's residence not included.

[3] Tracts X and Y @ $500 per acre. Tract Z @ $400 per acre.

[4] Estate tax after $60,000 exemption from adjusted gross estate.

[5] Inheritance tax after the $5,000 exemption permitted for each of four beneficiaries.

[6] Taxpayers use option to pay tax on one-half of gain. Twenty percent income tax bracket assumed.

[7] Taxpayers pay a straight 25 percent on total value.

have an interest in minimizing the total estate and inheritance tax liability. They also know that it is important to transfer the title to the tracts before the mother's death in order to reduce the tax liability involved at the investment value of the farm. Since none of the children think they can afford to purchase all the tracts at their investment value and they do not desire to see the mother transfer the property at its agricultural value to just one of the children, they have considered organizing a corporation as a method of transferring this estate.

To begin our analysis, assume that a corporation is organized by the mother for the purpose of transferring the three tracts of real property she owns to her children. We shall assume that only the real property is contributed as capital to this proposed corporation and that the real property is transferred to the corporation tax-free. Thus, the corporation adopts the adjusted cost basis of the real property owned by the mother who receives shares having an identical basis of $37,645, Table 3, page 189. The cost of organizing the corporation will not be considered.

This proposed corporation will own only real property. Thus, it is organized to conduct business as a landlord and may not elect to be taxed as prescribed in Subchapter S.[1]

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[1]See Becoming a personal holding company, p. 32.

We shall assume the proposed corporation rents the 360 acres to which it holds title to Son D. This permits Son D to continue operating the farm, but we permit his business relationship to change from that of a partner to a tenant.

We shall examine the effect of transferring shares in this proposed corporation by (a) gifts or shares and (b) sale of shares.

Gifts of corporate shares as a means of transferring farm property.--We shall set aside for a moment the problem of providing the mother a satisfactory annual income and first discuss the possible effects when the mother gives all the shares of the corporation to her children. Assume that two years after the corporation is organized the mother uses her single lifetime federal gift tax exemption of $30,000 plus the $3,000 annual gift exclusion for each child and makes equal gifts of shares to the children. Shares transferred as gifts in this one year would have an actual value of $42,000. There would be no federal gift tax payable on these amounts of gifts.

If only the agricultural values ($72,000 or $90,000) of the mother's estate are considered, these gifts would reduce the federal estate to zero on the remainder of her estate, since the value of the remaining shares owned by the mother would be less than the $60,000 federal estate tax exemption to which her estate is entitled. The state inheritance tax on the shares remaining in the estate would also be reduced but not to zero.

The gift of shares valued at $42,000 would reduce the total estate from the investment value of $175,500 to $133,500. Yet a substantial federal estate and state inheritance tax liability would remain on the value of the remaining shares owned by the mother. With an estate of $133,500, now assume that the mother continues to make annual gifts of shares having a value of $3,000 to each of her four children for a period of eleven years and in the twelfth year makes gifts of the remaining shares. She will then be age 86. We shall assume the mother dies at age 90 having lived for eighteen years following the organization of the corporation. She has been successful in reducing the taxable value of her estate to zero, simultaneously reducing the estate and inheritance tax liability to zero.

<u>1) Liquidate the corporation</u>: Now assume that after their mother's death, the four children who are the only shareholders decide to dissolve and liquidate the corporation, either by distributing the property in kind or selling the property and distributing the proceeds in cash.[1] Son *D*, who

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[1]See Dissolving the corporation, p. 177.

lives on Tract X, may agree to a distribution in kind, since he could conceivably continue the farm business without a major distribution. Son D may not approve if the corporation sells its property and distributes the proceeds in cash. As a shareholder with only a one-fourth interest, however, he could not prevent a dissolution that required the corporation to liquidate the 360 acres of real property for cash.[1]

Suppose, for example, that the shareholders did dissolve and liquidate the corporation's property within some one-month period,[2] distributing the property in kind, taking title to the three tracts as tenants in common. Since the shareholders received the shares as gifts, the adjusted cost basis would be $37,645 or the same as the adjusted cost basis of the real property contributed to the corporation.[3]

a) Selling the assets received from the corporation: The four children now own title to the real property and not to shares in the corporation. Assume that four years after

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[1] Son D could prevent a dissolution and liquidation in kind, because "qualified electing shareholders" owning shares possessing 80 percent of the voting power must consent to the plan to liquidate in kind (see One-month liquidation, p. 97). Son D may not be able to prevent a dissolution and liquidation for cash since only the shareholders owning at least two-thirds of the shares must consent (see Voluntary dissolutions, p.178).

[2] See One-month liquidation, p. 97.

[3] This assumes that depreciable investment equals depreciation for the 18 year period.

the corporation is dissolved and liquidated they have an opportunity to sell the entire 360 acres to which they own title as tenants in common. If the four children are able to receive payment for the tracts over a sufficiently long period, the income tax on one-half of their taxable gain may be only 20 percent. When the taxable gains are taxed at this minimum rate, the total tax on capital gain exceeds the total estate and inheritance tax liability when the property is sold at the agricultural values and less than the potential estate and inheritance tax by $1,605 at $200 per acre and $585 at the value of $250 per acre. At the investment value of $487.50 per acre the tax on the capital gain is greater than the potential estate and inheritance tax liability by $15,022, Table 3, page 189.

Now assume the taxable gain when the 360 acres is sold is taxed at a straight 25 percent. When income from the sale is taxed at this rate, the total income tax paid on the capital gain exceeds the total estate and inheritance tax liability in each instance. Thus, the total tax paid as capital gain is greater by $6,758 at $200 per acre, $8,436 at the value of $250 per acre, and $5,706 at the investment value of $487.50 per acre (Table 3).

In this example, the assumption as to total gifts of the estate is extreme. By means of gifts we have reduced the mother's total taxable estate to zero. This extreme assumption of the total gift was made to indicate that total tax costs may not always be minimized by transferring title to property by making gifts of all the shares of a corporation. The family must determine the alternative use of the real property which they intend to transfer. In this situation, the real property has a higher value in a use other than agriculture. Consequently, minimizing the potential federal estate and state inheritance tax liability is not the only consideration; there is also the tax on capital gain payable when the property is sold without passing through another estate.

By reducing the mother's estate to zero through successive gifts, the $60,000 exemption permitted the estate before the federal estate tax is applicable is foregone. Since property obtains a new cost basis when appraised in an estate, income from future sales is not taxed as capital gain until the proceeds from the sale exceed the applicable cost basis. Thus, the $60,000 which is exempted from federal estate tax is cost basis that is not subject to tax as capital gain. The total tax payable by this family can be minimized by increasing the cost basis on the property in the mother's estate and minimizing the total tax paid to obtain that cost basis.

Some farm families such as this one must consider both the total federal estate and state inheritance tax and the federal income tax on capital gain and seek to minimize the two simultaneously.

Many farm families will be primarily concerned with the estate and inheritance tax liability, for they expect their real property to remain in agriculture. In such circumstances, the costs of maintaining the corporate entity while transferring the total farm property to heirs could be substantially less than the potential federal estate and state inheritance tax confronted by the family.

Sale of corporate shares as a means of transferring farm property.--We shall now turn to the problem of providing the mother a satisfactory income if the proposed corporation is organized. If the mother organizes this proposed corporation, she has the same potential sources of income from the farm as at present. She can receive income from the corporation which it receives in rent from Son D. She can also sell shares of the corporation to family members; Son C and Son D are willing to purchase an interest in the farm. Shares sold would provide the mother additional income. The capital gains on proceeds received in excess of the cost basis of the shares sold would be taxed at the applicable income tax rate. Furthermore, only the shares sold would receive a new cost basis. At the mother's death, the property owned by the corporation would be appraised. This value is distributed pro rata over all the shares in the corporation. The value of the mother's estate is determined by multiplying the number of shares owned by the pro rata appraised value per share. The estate and inheritance tax liability would, of course, not apply to the shares previously sold to the sons, but a substantial estate and inheritance tax could remain, depending upon the number of shares owned by the mother at the time of her death.

We cannot expect that all the children are financially able to participate equally in the purchase of shares, particularly as one is a widow. Consequently, the minority shareholder problem would be encountered if the mother sold a part of her shares disposing of the remainder by will. Although this may not develop into a problem, the potential problem exists.

The minority shareholder problem could be eliminated if the mother sold the corporation to some family member, expecting to receive an adequate income from that sale for the remainder of her life. Yet such a sale is possible without organizing a corporation and such a situation would not involve the costs of maintaining the corporate entity. A sale by land contract may be used to provide the mother an adequate income.[1]

We must conclude, therefore, that the corporation is not applicable to Case A. There will be cases, however, where the corporation can assist in making an effective farm transfer.

Summary, Case A

The family farm in Case A contains a total of 476 acres. A widow who is the mother of four children owns title to 360 acres of the farm. The real property of this farm has a value for residential or public use that is approximately twice its agricultural value. Consequently, the family is attempting to minimize the potential federal estate and state inheritance tax of the mother's estate. It is also necessary to provide the mother an adequate income.

We examined the use of a corporation in solving this inter-generation, intra-family farm problem. The assumption used in the discussion of gifts of shares may be extreme. It was made, however, to illustrate the fact that minimizing the estate and inheritance tax by making gifts of shares of a corporation may not always minimize the total tax paid by a family over a period of years. This is true when the family

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[1]It is, of course, necessary for the contract to be with a family member if the tract or tracts sold are to remain in the family. Although the land contract requires the tracts to be purchased within the family, when the income from the business is inadequate, it does provide income security over a period of years.

members who receive title to the shares and/or the farm property may expect to sell that property within their lifetime. As we were also required to provide the mother a satisfactory income, it was necessary to sell shares in the corporation. The land contract can be used to provide an income for the mother without the cost of maintaining the corporate entity. Therefore, under the given relevant facts and values for this farm and family situation, we conclude that the corporation cannot solve the problem more effectively than other institutional arrangements.

Case B

In Case B, four related families owning a four-tract, 734 acre dairy and swine farm are investigating the tax advantages they may attain by organizing as a corporation. This farm business is now operated as a partnership by three brothers who own the farm property as tenants in common equally with their mother. The income of this farm business is derived from products produced by "1231 assets" -- dairy cattle and swine breeding herds.

Five illustrative examples show the change in federal income tax, social security tax, and the annual privilege fee when the proposed corporation is organized as an owner and as a tenant. The examples also illustrate the change in tax costs arising from alternative income distributions and alternative methods of paying federal income tax. The possible saving in taxes is discussed in relation to two of the five illustrative examples. The following section briefly outlines the farm and family situation.

The Farm and the Family, Case B

Background.--The farm in Case B had been purchased over a period of forty years by the family which operates the farm at present. The parents purchased the first tract in the 1930's, the second and third tracts in the 1940's, and the parents and their sons purchased the fourth tract in the 1950's. The father of the three brothers died recently but their mother is living.

Farm location.--Though each tract in this farm is located several miles from any other tract, it is not necessary to travel along either state or federal highways to reach one tract from another.

Type of farm.--Commercial dairy and swine. (All animals raised on farm.)

Title to tracts in farm.--The mother owns an undivided one-fourth interest in each tract with her three sons who own the remaining undivided three-fourths interest as tenants in common.

Table 4.--Description of tracts in farm, 1961, Case B

Tract	Acres	Cost basis of tracts	Estimated present market value
W	---	---	---
X	---	---	---
Y	---	---	---
Z	---	---	---
Total	734	$120,000	$168,000

Table 5.--Description of family members, 1961, Case B

Members	Age	Marital status	Age and sex of children		Residence
			Sons	Daughters	
Mother	62	Widow	A, B, C		[1]
Son A	42	Married	16, 14	11	Tract W
Son B	37	Married	10	8, 4	Tract X
Son C	33	Married	10, 9, 2	6	Tract W

[1]House and lot adjoining farm.

Present business arrangement.--The mother and her sons own the assets and the liabilities of the farm business equally. The three brothers conduct the farm business as partners. Each participates actively in operating and managing the farm and in conducting its business transactions. Decisions concerning major problems relating to the farm business are made jointly by the family members. A division of responsibilities does exist, however. Son A, who lives on tract W, where the dairy is located, maintains the farm business accounts and coordinates the total farm operation. Son B, who lives on tract X, is responsible for the swine enterprise located there. Son C, who also lives on tract W, is responsible for the dairy enterprise. No evidence exists that this arrangement is unsatisfactory or that the farm business will be dissolved.

Table 6.--Farm business financial statement, December 31, 1960

Type of property	Assets	Liabilities - net worth	
Cash	$ 5,010	Notes and other	
Real property[1]	168,000	short term . .	$ 36,000
Dairy cattle and swine		Mortgages . . .	34,000
breeding herds[2]	25,320		$ 70,000
Machinery and equipment[3] .	26,646	Net worth . . .	$170,000
Feed and other inventory .	15,024		
Total	$240,000	Total	$240,000

[1]Includes houses, $24,000.

[2]All animals raised on farm.

[3]Excludes automobiles, $9,000.

The problem.--What tax advantage can this family obtain by organizing a corporation?

Discussion, Case B, Part I, Tax Costs

A review of this farm and family business situation shows that the four related families have property valued at $240,000 and a net worth of $170,000. The review also indicates that this farm business derives its income from products produced by a commercial dairy herd and a commercial swine breeding herd and that all the animals in these herds were raised on the farms. The income received from sales of animals held for dairy and breeding purposes for more than twelve months is subject to the capital gain tax treatment afforded "1231 assets."

It is necessary to determine a taxable income for each family to use in the examples below. The partners report the federal income tax on the cash basis. In 1960, the farm business had gross profits of $71,257 and deductible farm expenses (including $1,200 rent paid to the mother for the use of her share of the property, and depreciation) totaling $60,797. The net farm profit was $10,460. There were net long-term capital gains of $3,080. The taxable profits and gains were distributed equally among the three brothers as partners.

Each partner filed a joint income tax return with his wife. Each taxpayer used the short form to determine the income tax due. That is, they did not itemize deductions. No family member received income from a non-farm source.

Given this information and our knowledge of this farm and family situation, we can determine that the four taxpayers in this family under the partnership arrangement paid a total of $353 federal income tax and $468 social security tax, for total income and social security tax payments from the family business in 1960 of $821, Table 10, page 226. (Table 10 is placed at the end of Case B for the convenience of the reader who may wish to refer to it from time to time throughout the remainder of the discussion.)

We shall compare the $821 tax cost of the partnership with the tax cost of a corporation organized as an owner and as a tenant in the following five examples. In each of these five examples, we assume that the proposed corporation conducted the farm business in 1960, and also, that it had the same gross profits, farm expenses and depreciation, and the same sources of income as the partnership. We also assume that each taxpayer in the family files income tax in the same manner as in 1960.

In this first section, two examples are presented when the corporation is organized as an owner that pays income taxes in its own name.

In the second section, three examples are presented when the corporation is organized as a tenant. The first example in this section is when the corporation pays income tax in its own name. In the second and third examples, the corporation elects to be taxed as prescribed in Subchapter S. In any event, the decisions made when a corporation is organized will determine, at least in part, the tax costs associated with the corporate entity.

Organizing the proposed corporation as an owner.--We shall assume the family contributes all the real property (except the residence occupied by each family), the tangible personal property and $5,010 cash to the corporation as capital. The family also transfers the liabilities, that is, the notes and mortgages, to the corporation. After crediting $1,000 to paid-in capital and $75,050 to paid-in surplus, the corporation issues shares with a total par value of $1,000 to the mother and her three sons equally. The shares have equal voting rights and privileges. A corporation is required to file an annual report. The annual report is similar to that shown in Table 7, page 206. (See footnote below and compare Table 7 with Table 8, page 207.)[1]

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[1] A question arises as to what value to place on the property at the time it is contributed to the corporation. We have determined that the law states "where shares are issued for any consideration other than cash, the judgment of the Board of Directors as to the value thereof shall be conclusive unless it shall be shown that the directors acted in bad faith or failed to exercise reasonable care in determining value" (Michigan General Corporation Act, Sec. 450.21). If we used only the property values given in Table 6, page 202, then Table 7, page 206, would be similar to Table 8, page 207.

When the land is assigned the value shown in Table 8, page 207, the annual privilege fee increases from $380 to $730, an increase of $350. This problem in valuing property was discussed by Richard W. Lindholm (Michigan Tax Study Staff Papers, 1958, p. 250). Lindholm said, "The Michigan General Corporation [Act] does not specify the manner in which property is to be valued, so the definition of surplus, in practice, is not very meaningful . . . . Perhaps no satisfactory standard that would avoid requiring many corporations to keep one set of books for stockholders and federal income tax purposes and another in order to meet the requirements of the Corporation and Securities Commission is conceivable."

This problem is particularly relevant to Michigan farms with livestock held for dairy, breeding or draft purposes that report their income tax on a cash basis. For example, if we use the cost basis in the federal income tax return, the livestock in the Annual Reports would be valued at $0, because this farm reports income tax on a cash basis. This would reduce the annual privilege fee by an additional $126. This would certainly not be assigning a value to this particular property; consequently, a compromise is used here. It is to use the adjusted cost basis from the federal income tax return where one is available on machinery and equipment and other items and to value livestock which has a cost basis of zero at the appraised value as assigned by the family in their financial statement of December 31, 1960. In this instance, the land has been appraised recently for the father's estate.

Table 7.--Annual report,[1] Case B. Financial statement of the farm business of a proposed corporation organized as an owner: land and machinery valued at cost basis: cattle and swine breeding herds are appraised at present market value

Type of asset	Value of depreciable assets	Value of all assets	Type of liability	Value of each liability	Value of all liabilities
1. Cash	$ --	$ 5,010	7. Notes and accounts		
2. Inventories: (to			payable	$ 36,000	$ --
include raw materials,			8. Accrued expenses	--	--
work in process,			9. Other liabilities		
finished goods,			(describe fully) ..		
supplies	--	15,024	Mortgages	34,000	--
3. Deferred charges:			10. Total of items 7, 8		70,000
Prepaid insurance,			and 9		
taxes, etc.	--	--	11. Capital stock:		
4. Capital assets:			Common stock	1,000	--
Land		38,100	12. Schedule of surplus		
Buildings	47,604	--	and undivided		
Machinery	22,962	--	profits		
Dairy cattle and			(Enter deficit in		
swine breeding			red)	--	--
herds	25,300	--	Earned	--	--
Total	$ 95,886		Paid-in arising		
Less reserve for			from property ...	75,050	--
depreciation	8,370	$ 87,516	13. Total capital and		
5. Other assets (describe			surplus		76,050
fully)	--	--			
Organization expense[2]	400	400			
6. Total assets		$ 146,050	14. Total liabilities ...		$ 146,050

[1]Modified version, page two, Annual Report, Form 1. Mich. Corp. and Sec. Commission.

[2]Organization expense is an asset that is amortized. This is shown for expository purposes only.

Table 8.--Annual report,[1] Case B. Financial statement of the farm business of a proposed corporation organized as an owner: land is appraised at the present market value instead of cast basis: machinery value at cost basis: cattle and swine breeding herds are appraised at current market value

Type of asset	Value of depreciable assets	Value of all assets	Type of liability	Value of each liability	Value of all liabilities
1. Cash	$ --	$ 5,010	7. Notes and accounts		
2. Inventories: (to			payable	$ 36,000	$ --
include raw materials,			8. Accrued expenses	--	--
work in process,			9. Other liabilities		
finished goods,			(describe fully) ..		
supplies	--	15,024	Mortgages	34,000	
3. Deferred charges:			10. Total of items 7, 8		
Prepaid insurance,			and 9		70,000
taxes, etc.	--	--	11. Capital stock:		
4. Capital assets:			Common stock	1,000	
Land	--	73,616	12. Schedule of surplus		
Buildings	78,354	--	and undivided		
Machinery	26,646	--	profits		
Dairy cattle and			(Enter deficit in		
swine breeding			red)	--	--
herds	25,320	--	Earned	--	--
Total	$ 130,320		Paid-in arising		
Less reserve for			from property ...	145,000	--
depreciation	8,370	$ 121,950	13. Total capital and		
5. Other assets (describe			surplus		146,000
fully)	--	--			
Organization expense[2]	400	400			
6. Total assets	--	$ 216,000	14. Total liabilities ...		$ 216,000

[1]Modified version, page two, Annual Report, Form 1, Mich. Corp. and Sec. Commission.

[2]Organization expense is an asset that is amortized. This is shown for expository purposes only.

The corporation organized as an owner, as shown in Table 7, must pay a $380 annual privilege fee on paid-in capital and surplus of $76,050.

When the proposed corporation is an owner, its income subject to tax is $14,740. This is an increase of $2,740 over the $12,000 total adjusted gross income (the net farm profits of $10,460 plus one-half of the $3,080 capital gain income) received by the three sons from the partnership, Table 10, page 226, and results from (a) $1,200 normally paid to the mother as rent that is not a deductible expense, and (b) $1,540 of net long-term gain which the partners as individuals could exclude from adjusted gross income but which the corporation must include in taxable income or pay as salaries or dividends if taxable income is to be reduced to zero. The two examples given in this section when the corporation is organized as an owner show the change in tax costs that result when the corporation pays contributed cash as a bonus, and when a dividend is declared by the corporation.

<u>1) Example A - corporation is owner, no Subchapter S election, pays salaries and bonuses</u>: In this example, the corporation pays the $14,740 income from the farm business that is subject to income tax to the three shareholding-employees equally as salaries of $4,913 each. This is a portion of the

allowable salary and reduces taxable income to zero.[1] In addition, we assume that the corporation also distributes a $1,187 bonus to each shareholding-employee. The total bonus is $3,561. To obtain funds for the bonus, the corporation creates a net operating loss by paying the bonus from contributed cash.

Given this situation, the family taxpayers and the corporation pay a total of $2,687 in income tax, social security tax, annual privilege fee, and intangible tax. The result is a tax increase of $1,866 over the partnership,[2] Table 10, page 226.

By paying the $3,561 bonus, the corporation incurs a net operating loss of an equal amount. This loss may be recovered by the corporation by carrying it forward to a succeeding business year. However, when the corporation created the net operating loss by paying the shareholding-employees a bonus, that income is taxable income when received

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[1]It is assumed in each example that the total salary that the corporation is authorized to pay exceeds the total income which the corporation receives that is subject to tax (See Payment of salaries, p. 64).

[2]This $1,866 tax increase is from (a) income tax increase $1,087, (b) social security tax increase $393, of which $156 is due to the one and one-half percent increase in social security tax on the first $10,460 paid in salaries and $230 is due to six percent social security tax paid on an additional $3,940 subject to social security, (c) annual privilege fee of $382, and (d) intangible tax $1.

by them.[1]

It is necessary to recognize that the shareholding-employees and the corporation are distinct entities for tax purposes. In Example A, we have permitted the corporation not to recognize this distinction by (1) paying bonuses that created a net operating loss and (2) paying these bonuses from contributed cash. Therefore, the income received in this instance as a bonus had been previously taxed to the family. When contributed to the corporation as cash and later returned to the shareholding-employees as a bonus, they paid income tax on the cash contributed to the corporation a second time. This would not occur if (1) the corporation obtained the cash necessary for initial expenses from an institutional source or (2) the shareholding-employees used the proper credit instruments, paid interest, and obtained a loan from the corporation.

In addition to increasing the income tax unnecessarily, in this example, we have organized the corporation as an owner. Consequently, the mother cannot receive any income as rent. Since she is not a shareholding-employee her income

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[1]When the income of a farm business fluctuates from year to year, the corporation can be used to level out the income of a farm family. The total income tax paid may be reduced if income received in a year of high profits can offset a large net operating loss carried over. A corporation that elects to be taxed as prescribed in Subchapter S will not have this advantage.

from the farm business is reduced to zero. Consequently, we shall determine the tax cost when the corporation pays dividends.

2) Example B - corporation is owner, no Subchapter S election, pays salaries and dividends: In this example, the corporation pays only the $14,740 of income from the farm business that is subject to income tax. To provide the mother a $1,200 income, the corporation declares a $4,800 dividend and distributes the remaining income subject to income tax as a portion of the allowable salaries.

The corporation must declare the dividend from profits or earned surplus[1] and distribute the dividends pro rata to the shares. Therefore, the corporation pays income tax at the applicable 30 percent rate on $6,586 of profits before declaring the $4,800 dividend. The income tax paid is $2,059, Table 10, page 226. Each shareholder receives $1,200 in dividends which are subject to the three and one-half percent intangible tax.[2] The corporation also distributes the remaining $7,884 of income from the farm business subject to income tax to the shareholding-employees equally as a portion of allowable salaries.

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[1]Dividends, if paid, must be paid from earned surplus (Michigan General Corporation Act, Sec. 450.22).

[2]See Michigan excise taxes, p. 106.

Given this situation, the four family taxpayers and the corporation pay a total of $3,352 in income tax, social security tax, annual privilege fee, and intangible tax. This is an increase of $2,531 over the tax paid by the partnership.[1]

Thus, we learn why corporations conducting farm businesses seldom declare dividends. Example B, in combination with Example A, shows the importance of considering all the family members who are, and perhaps who may be, receiving income from the farm business when the corporation is organized. Furthermore, when dividends are declared, both the income and the intangible tax increase. When dividends are distributed, there is a simultaneous decrease in earnings that qualify for social security tax which, if continued over a period of years, would result in a decrease in social security tax benefits available at retirement. This decrease in earnings qualified for social security results from distributing dividends which are returns to investment and, hence, not subject to the social security tax.

Since a corporation organized as an owner has an

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[1]This $2,531 tax increase is from (a) income tax increase over the partnership of $1,979, (b) social security tax increase of $2 which is a result of declaring dividends and reducing income subject to social security from the partnership by $2,575, (c) annual privilege fee $382, and (d) intangible tax $168 or 3.5 percent of $4,800 income on shares.

annual privilege fee which is greater than for the same corporation organized as a tenant, we shall now determine the change in tax costs when the proposed corporation is a tenant.

Organizing the proposed corporation as a tenant.--We shall assume that the family contributes the tangible personal property required in the farm business to the corporation as capital. The family also transfers their farm liabilities such as notes and accounts payable to the corporation. After crediting $1,000 to paid-in capital and $21,810 to paid-in surplus, the corporation issues shares with a total par value of $1,000 equally to the mother and her three sons. The shares have equal voting rights and privileges.

The corporation borrows $6,000 from an institutional source and thereby increases the notes payable from $36,000 (Table 7, page 206) to $42,000 (Table 9, page 214). The proposed corporation organized as a tenant pays an annual privilege fee of $114 on paid-in capital and surplus of $22,810 (Table 9, page 214). Thus, when this proposed corporation is organized as a tenant, it pays an annual privilege fee which is $164 less than when it is organized as an owner.

The corporation leases the real property, including the residence occupied by the sons and their families, from the mother and her three sons on a fifty-fifty profit share basis.

Table 9.--Annual report: Case B. Financial statement of farm business of proposed corporation

Table 9.--Annual report,[1] Case B. Financial statement of farm business of proposed corporation organized as a tenant: machinery valued at cost basis: cattle and swine breeding herds appraised at present market value

Type of asset	Value of depreciable assets	Value of all assets	Type of liability	Value of each liability	Value of all liabilities
1. Cash	$ --	$ 6,000	7. Notes and accounts payable	$ 42,000	$ --
2. Inventories: (to include raw materials, work in process, finished goods, supplies	--	15,024	8. Accrued expenses	--	--
			9. Other liabilities (describe fully) .. Mortgages	--	--
3. Deferred charges: Prepaid insurance, taxes, etc.	--	--	10. Total of items 7, 8 and 9		42,000
4. Capital assets:			11. Capital stock: Common stock	1,000	--
Land	--	--	12. Schedule of surplus and undivided profits (Enter deficit in red)	--	--
Buildings	--	--	Earned	--	--
Machinery	22,962	--	Paid-in arising from property ...	21,810	--
Dairy cattle and swine breeding herds	25,320	--	13. Total capital and surplus		22,810
Total	$ 48,282				
Less reserve for depreciation	4,896	$ 43,386			
5. Other assets (describe fully)	--	--			
Organization expense[2]	400	400			
6. Total assets		$ 64,810	14. Total liabilities ...		$ 64,810

[1]Modified version, page two, Annual Report, Form 1, Mich. Corp. and Sec. Commission.

[2]Organization expense is an asset that is amortized. This is shown for expository purposes only.

<u>1) Example C - corporation organized as a tenant, no Subchapter S election, pays profits, bonuses, and rents</u>: The corporation has $14,740 income from the farm business subject to income tax, of which $11,660 is in profits ($10,460 plus $1,200 rents normally paid to the mother) and $3,080 is capital gain. We shall assume the corporation pays as a portion of allowable salaries $5,140, which limits profits to $9,600. As it has a fifty-fifty profit share lease, the corporation pays $4,800 as rents to the four shareholders, as landlords. It pays the other $4,800 of profits to the three shareholding-employees as a bonus. Each receives a $1,600 bonus. Thus, the corporation reduces its taxable income to zero.

Given this situation, the four family taxpayers and the corporation pay a total of $1,335 in income tax, social security tax, annual franchise fee, and intangible tax. This is an increase of $513 over the tax paid by the partnership,[1] Table 10, page 226.

In this situation, the mother receives $1,200 income as rents. Rents can, of course, be increased and the mother's income increased accordingly; however, if there is any increase in profits distributed as rent, it will have the

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[1]This $513 tax increase is from (a) income tax increase over the partnership of $270 or 20 percent of $1,540 capital gains, (b) social security tax increase of $126, (c) annual privilege fee $116, and (d) intangible tax of $1.

effect of reducing the earnings received by the shareholding-employees that qualify for social security tax.

Total taxes will not be minimized until the shareholders cease distributing capital gain as a salary and/or rent and minimize the income tax paid on capital gains. This we do in the following example.

2) Example D - corporation organized as a tenant, with Subchapter S election, pays rents, salary, retains capital gains: In this example, the corporation reduces its $11,660 of profits subject to income tax to zero by paying rents and salary. The $3,080 of income which is capital gain is retained by the corporation.

To fulfill the fifty-fifty profit share rental agreement, the corporation distributes one-half of the profits to the mother and her three sons as rent. Each receives a rental payment of $1,457. The corporation pays the remaining one-half of profits to the three shareholding-employees as a portion of allowable salary. Each receives a salary of $1,943.

The $3,080 of capital gains remains with the corporation and is treated as undistributed taxable income. This undistributed taxable income is distributed pro rata to the shares for income tax purposes. Thus, each shareholder must show $770 as capital gain income on his income tax return.

Each shareholder includes one-half the capital gain in his adjusted gross income to be taxed at the applicable income tax rate. Thus, each son has a total adjusted gross income of $3,785, and the mother has a total adjusted gross income of $1,842 for tax purposes. Given this situation, the family taxpayer and the corporation pay a total of $836 in income tax, social security tax, annual privilege fee, and intangible tax. The result is a tax increase of $15 over the partnership,[1] Table 10, page 226.

When this proposed corporation as a tenant is taxed as prescribed in Subchapter S, the money income of the mother increases from $1,200 to $1,457. The mother and her sons each pay income tax on $770 capital gain. This tax-paid income is the property of the taxpayer and as such it may be withdrawn by a shareholder as money at a future date.[2]

When minimizing tax costs, we have also minimized earnings qualified for the social security tax. This is a result of redistributing income within the family as rent and as capital gain, both of which are returns to investment. It does not follow, however, that a corporation taxed as prescribed in Subchapter S must or even will reduce the earnings

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[1]This $15 tax increase is from (a) income tax increase $18, (b) social security tax decrease $120, (c) annual privilege fee $116, and (d) intangible tax $1.

[2]See Distributing earnings and profits, p. 82.

qualified for social security.

3) Example E - corporation organized as tenant, with Subchapter S election, pays salaries: In this example, the corporation pays the $14,740 income from the farm business ($11,660 profits plus $3,080 capital gain) that is subject to income tax to the three shareholding-employees as a portion of allowable salary. The corporation's profits are reduced to zero, and taxable income is also reduced to zero. Thus, there is no payment of rents, bonuses, or undistributed taxable income.

Each shareholding-employee receives a salary of $4,913.

Given this situation, the family taxpayer and the corporation pay a total of $1,722 in income tax, social security tax, annual privilege fee, and intangible tax. The result is a tax increase of $901 over the partnership,[1] Table 10, page 226.

When the corporation pays the total income subject to tax to the shareholding-employees as salary, earnings qualified for social security tax are maximized. The mother's income is simultaneously reduced to zero because the corporation has no profit to pay as rent or capital gain income.

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[1]This $901 tax increase is from (a) income tax increase over the partnership of $388, (b) social security tax increase of $396, (c) annual privilege fee $116, and (d) intangible tax $1.

However, if only the three sons owned the corporation, maximizing earnings which qualify for social security by this procedure would be acceptable within the limitation of reasonableness.[1]

If the objective is to maximize earnings that qualify for social security tax, services of an equal value must be rendered by the shareholding-employee. To attain this objective, however, increases the total of income and social security tax paid by the family and the corporation $784 annually. Consequently, if the corporation distributes its income from the farm business as in Example E, tax costs increase but so do the earnings that qualify for social security which is the point at issue here. This point is important because the social security tax purchases an annuity which is low in cost and can be a valuable asset to one or more family members.

Certainly, it is not necessary for the corporation to elect to be taxed as prescribed in Subchapter S if the objective is to maximize earnings qualified for social security. But if the objective is to minimize the total tax paid on capital gain on farms reporting federal income tax on a cash basis where a substantial portion of the farm income is derived from products produced by "1231 assets" that are

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[1]See Payment of salaries, p. 64, and Rental payments, p. 65.

tangible personal property such as in the case of a dairy cattle and swine breeding herd, then Subchapter S can be advantageous, because such farms normally have some income from the sale of animals that are held for dairy and breeding purposes for more than twelve months that is subject to the capital gain tax treatment afforded "1231 assets."

The five examples presented in this part of the discussion indicate how the income of a family may be affected by organizing a corporation as an owner and a tenant and how income distribution within the family may be changed by the way the corporation is organized and the way the income tax of a corporation is paid. Before any tax savings can occur, it is necessary that tax savings exceed tax costs of the corporation. In addition, if the corporation is to have tax advantages over the partnership, the total tax costs must be less than the tax cost of the partnership. We discuss this in the following section.

Discussion, Case B, Part II, Tax Savings

The tax savings that result when the proposed corporation conducts this farm business must come (1) from changing the tax designation of income which the family members receive from the corporation, (2) from those expenses that are not tax deductible to the individual taxpayers and which are acceptable tax deductible expenses when paid by the corporation to the corporation, or (3) from depreciation on property that was not previously depreciable. The tax costs will be affected by the distribution of income within the family.

Exactly how this family will decide to distribute the income of the proposed corporation cannot be determined. However, if we determine the tax savings that result when the income is distributed so tax costs are minimized as in Example D, we will observe only one aspect of this problem. However, if we consider only the tax savings in relation to the tax costs when the earnings that qualify for social security are maximized as in Example E, we will observe only another aspect. Yet between the minimum tax costs of Example D and the maximum tax costs which we shall accept as being Example E, there is, perhaps, an actual distribution of income received from the corporation that is acceptable to this family. Consequently, we shall compare the possible tax savings for this family if they organize a corporation that distributes income from the farm business as in Example D and Example E with the tax cost of the partnership.

Each taxpayer in this family is in the 20 percent income tax bracket when income is distributed as in Examples D and E. Consequently, to offset one dollar of tax costs, tax deductible expense or depreciation must increase five dollars. Thus, before tax savings can occur, tax deductible expense must increase by $75 to offset the $15 increase in tax cost of Example D, and by $4,505 to offset the $901 increase in tax cost of Example E.

Social security tax is an expense that is tax deductible to a corporation; this is $348 for Example D and $864 for Example E. Each son has a health insurance policy that costs $23 per month. This insurance may be provided by the proposed corporation. This is a tax deductible expense for the corporation of $828.

The corporation is an employer of farm labor. If the employees live on the farm for the convenience of the employer, a corporation may, following custom, furnish its employees fuel. The family estimates their fuel for light and cooking is $20 per month per residence and for heating is $200 annually per residence. Fuel expense for three employees for this corporation would be approximately $1,320.

Individuals who lease property are permitted to depreciate items of realty such as houses and other farm buildings that have a cost basis. The houses leased to the corporation by the family would, therefore, be subject to depreciation. The total value assigned to the houses by the family is $24,000 (Table 6, page 202). We shall assign the three houses leased to the corporation a value of $18,000. When depreciated at two percent, there is $360 depreciation available to the family members.

Certainly a shareholder can have the relationship of landlord to the corporation and depreciate the leased property. Furthermore, he can have the relationship to the corporation of an employee. Yet, it seems that he would act inconsistently to occupy the house for the convenience of his employer as both landlord to the corporation and as an employee of the corporation. Hence, we shall not include this item of depreciation among our tax deductions.

If the corporation is organized, distributes income, and is taxed as in Example D, page 216, there is $348 social security, $828 health insurance, and $1,320 fuel expense for total deductible expenses of $2,496 to offset the tax costs of Example D. Given this situation, the family has a tax saving of $485. Thus, the corporation has a $485 tax advantage over the partnership. If the corporation does not deduct fuel as an expense, tax saving, and likewise the tax advantage, is $220.

If the corporation is organized and distributes income as in Example E, page 218, there is $864 social security, $828 health insurance, and $1,320 fuel expense for total deductible expense of $3,032. This is $1,473 less than required to offset the tax costs of Example E. Given this situation, the family has an unrecovered tax cost from the corporation that is $294 greater than the partnership.

Certainly this family can distribute the income received from this farm business in many patterns that are not considered here. Likewise, they may also have an increase in tax deductible expense in any one year that is not foreseen. However, given the present situation, the tax costs of a corporation that maximizes social security benefits will have tax costs that exceed tax savings.

The tax saving possible in this case is not the only advantage that this family may receive from the corporation. There is also limited liability. If this is an important consideration to the family, certainly the corporation should be organized as a tenant. Then the family members would own the real property independently of the corporation, and the corporation would own the family business. Although there may be no limitation of liability against contractual obligations, limited liability for torts in excess of insurance coverage can reduce the total risk each family has in the partnership.

Furthermore, there is the problem of providing for continuity in the farm business. The three brothers have four sons, ten years of age and over, and a total of ten children. Within the next decade, the brothers will be planning to bring one or more of their children into the farm business. The ownership pattern of this farm business could become very complex in the future even though some of the children do buy out others. A corporation may be very effective in assisting this farm business to continue as an efficient, going concern as the number of owners increases. This family may find a corporation useful in solving some of these problems even though the cost of the corporation is greater than the tax savings it creates.

Summary, Case B

In Case B, we have compared the changes in tax costs that result when a mother and her three sons change their form of business organization from a partnership to a corporation. The changes in tax costs were compared when the corporation was organized as (1) an owner and (2) a tenant. Annual privilege fees were minimized when the corporation was a tenant. Tax costs were also compared when the corporation organized as a tenant (1) did not, and (2) did, elect to be taxed as prescribed in Subchapter S. Tax costs exceeded those of the partnership in each instance; however, they were minimized when the corporation organized as a tenant elected to be taxed as prescribed in Subchapter S.

When tax costs were minimized, the earnings received by the shareholding-employees that qualified for social security were minimized. The tax savings which were associated with Example D resulted from minimizing the social security

Table 10.--Partnership income distribution and tax cost compared to alternative income distribution of a corporation organized as owner and tenant, and tax cost from alternative methods of tax payment, Case B[1]

		Partnership[2]		Corporation									
				Owner				Tenant					
				No Subchapter S election				No Subchapter S		Subchapter S election			
Taxpayer	Income and tax designation	Profits gains	Tax cost	Salary[3] bonus	Tax cost	Salary[4] div'd	Tax cost	Profits[5] bonus rent	Tax cost	Profits[6] rent gain	Tax cost	Salary[7]	Tax cost
Son A W/5 ex[8]	Salary or Profits . .	$ 3,486	--	$ 4,913	--	$ 2,628	--	$ 1,713	--	$ 1,943	--	$ 4,913	--
	Bonus	0	--	1,187	--	0	--	1,600	--	0	--	0	--
	Rent	0	--	0	--	0	--	1,200	--	1,457	--	0	--
	Div. or Cap. Gain . .	1,026	--	0	--	1,200	--	0	--	770	--	0	--
	Adj. Gross Income . .	4,000	--	6,000	--	3,828	--	4,513	--	3,445	--	4,913	--
	Fed. Income Tax . . .	--	125	--	520	--	89	--	215	--	80	--	287
	Soc. Sec. Tax	--	156	--	144	--	78	--	99	--	58	--	144
Son B W/5 ex.	Salary or Profits . .	3,486	--	4,913	--	2,628	--	1,713	--	1,943	--	4,913	--
	Bonus	0	--	1,187	--	0	--	1,600	--	0	--	0	--
	Rent	0	--	0	--	0	--	0	--	1,457	--	0	--
	Div. or Cap. Gain . .	1,026	--	0	--	1,200	--	1,200	--	770	--	0	--
	Adj. Gross Income . .	4,000	--	6,000	--	3,828	--	4,513	--	3,495	--	4,913	--
	Fed. Income Tax . . .	--	125	--	520	--	89	--	215	--	80	--	287
	Soc. Sec. Tax	--	156	--	144	--	78	--	99	--	58	--	144
Son C W/6 ex.	Salary or Profits . .	3,486	--	4,913	--	2,628	--	1,713	--	1,943	--	4,913	--
	Bonus	0	--	1,187	--	0	--	1,600	--	0	--	0	--
	Rents	0	--	0	--	0	--	1,200	--	1,457	--	0	--
	Div. or Cap. Gain . .	1,026	--	0	--	1,200	--	0	--	770	--	0	--
	Adj. Gross Income . .	4,000	--	6,000	--	3,828	--	4,513	--	3,785	--	4,913	--
	Fed. Income Tax . . .	--	5	--	400	--	--	--	95	--	--	--	167
	Soc. Sec. Tax	--	156	--	144	--	78	--	99	--	58	--	144
Mother W/1 ex.	Rents	1,200	--	0	--	1,200	--	1,200	--	1,457	--	0	--
	Div. or Cap. Gains .	0	--	0	--	1,200	--	0	--	770	--	0	--
	Adj. Gross Income . .	1,200	--	0	--	1,200	--	1,200	--	1,842	--	0	--
	Tax on Income	--	98	--	--	--	98	--	98	--	211	--	--
Family	Intangible Tax . . .	--	--	--	1	--	168	--	1	--	1	--	1
Corp.	Corp. Income Tax . .	--	--	--	--	--	2,056	--	--	--	--	--	--
Corp.	Corp. Soc. Sec. Tax .	--	--	--	432	--	236	--	297	--	174	--	432
Corp.	Annual Privilege Fee[9]	--	--	--	382	--	382	--	116	--	116	--	116
	Total Tax	--	821	--	2,687	--	3,352	--	1,334	--	836	--	1,722
	Change from P'rt'ship	--	--	--	1,866	--	2,531	--	+ 513	--	+ 15	--	+ 901

Table 10 - Continued.

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[1]Income tax is from 1960 Federal Income Tax short form.

[2]Partnership income includes taxable profit and gains income of mother is rent.

[3]Income distributed equals partnership, plus rent paid and $3,561 in contributed cash.

[4]Income distributed equals partnership, plus rent paid.

[5]*Ibid*.

[6]*Ibid*.

[7]*Ibid*.

[8]W/ex. indicates the number of $600 tax exemptions allowed each taxpayer.

[9]Includes the $2.00 filing fee.

tax and redistributing income within the family which also miminized the income tax. The maximum tax saving over the partnership was $485. Earnings qualified for social security were maximized when the corporation distributed capital gain income as salary. This resulted in tax costs of $294 more than the partnership. A decision to increase present savings must reconcile the value of those savings with the value of an increased income available to the family members at a later date -- presumably age sixty-five.

Case C

Case C involves the parents, principally the father, of three married sons, all of whom live on a 400 acre farm. This farm business derives its income principally from products produced by a "1231 asset" -- an orchard. The sons have always lived and worked on the farm. The father is investigating the corporation as a means of transferring an equity in the real property to his sons. The farm and family situation is outlined briefly in the following section.

The Farm and the Family, Case C

Background.--The father of the present farm owner purchased the first tract in this farm in 1900 and three additional tracts before 1930. Soon after World War II, the father sold to his only heir, a son, who is the present farm owner, his remaining interest in the farm. The present farm owner purchased an additional 100 acres in two tracts in the 1950's. The farm now contains 400 acres, of which approximately 150 acres is not suitable as an orchard site or for cropland. The sons own no equity in the real property of the farm. The present owner and his three sons would like to purchase two eighty-acre tracts that adjoin the farm. These tracts are valued at $60 per acre with no improvement or orchard on either tract. The family estimates the two eighty-acre tracts have eighty acres suitable as orchard sites. The father, however, is reluctant to take title to additional property.

Farm location.--All the tracts in this farm adjoin. No evidence existed in the spring of 1961 that the tracts had a value in a higher use than agriculture.

Type of farm.--Orchard and cash crop.

Table 11.--Description of tracts in farm, 1961, Case C

Tract	Acres	Title	Title owned by
U	60	Joint tenancy	Father and mother
V	120	Fee simple	Father
W	80	Fee simple	Father
X	40	Fee simple	Father
Y	60	Fee simple	Father
Z	40	Fee simple	Father
Total	400		

Table 12.--Description of family members, 1961, Case C

Members	Age	Age and sex of children: Sons	Age and sex of children: Daughters	Residence[1]
Father	63	A, B, C	.....	Farm
Mother	60	.....	.....	Farm
Son A	40	.....	15, 11, 7	Farm
Son B	35	.....	12, 10	Farm
Son C	30	2	12, 8, 4	Farm

[1]Each family has a separate residence on the farm.

Present business arrangement.--The father and sons have a formal partnership agreement. The machinery and equipment is owned by the partners equally. The farm profits are divided equally. No evidence exists that anyone is dissatisfied with the present arrangement.

Table 13.--Farm values, adjusted cost basis, 1961, Case C

Farm property	Adjusted cost basis
Real[1]	
Land	$ 16,551
Orchard	4,823
Improvements	8,585
Tangible personal	
Machinery and equipment	$ 9,334

[1]Residences not included.

The problems.--(1) To recognize and assure the sons credit for any equity which they contribute to the farm owned by the parents. (2) To determine if organizing a close corporation will ease the process of transferring this farm to the sons and help maintain continuity of the farm business.

Discussion, Case C

This father is confronted with a problem not infrequently encountered on farms. The farm has a relatively high value. In this case, the father estimated the farm property has a present market value of $115,000 and believes that at least a part of this value is the result of labor investments made in the farm by the three sons. The income received by each family from the farm business has been relatively low. For example, during the three year period 1958-1960, the annual net profits from farming averaged $11,047. When divided equally among the four partners, the income per family is relatively low. None of the families receive income from a non-farm source.

Farm income is expected to increase over time, given a stable price for tree fruit. This increase in income will occur gradually as the eighty-five acres of orchard (which has been set during the period the father has owned the farm) matures and attains full production. The four families financed this expansion from farm earnings and the labor of the partners.

Although the cash returns to labor have been low, the orchard -- realty -- has increased in value, and this value is on land owned by the father. The father believes the sons should own the title to that part of the equity represented by this increase in value, for this is a return to labor that partially compensates for low cash incomes.

The father does not want to make gifts to the sons in fee simple, since this will fragment the farm. To divide the orchard equitably among the sons through gifts in fee simple appears to be impracticable. In addition to the equity problem of the sons, the father notes that he has only one grandson and seven granddaughters; hence, another problem exists, namely that of the continuity of business at a future date when the farm property is transferred to the grandchildren. Therefore, this father is investigating the corporation to determine its usefulness in (1) attaining an equitable transfer of the real property that recognizes the sons' equity without dividing the farm, (2) permitting him to retain some ownership control over the farm, and (3) encouraging continuity in the farm business. Certainly the corporation is useful as a means of accomplishing the first two of these objectives if it is organized as an owner, and the father retains ownership of more than fifty percent of the shares.

<u>A corporation organized as an owner</u>.--Assume, therefore, that the proposed corporation is organized as an owner. Assume also that the father contributes all the real property (except

the family residences) and the partners contribute the tangible personal property used in the farm business to the corporation as capital. This transfer of property is accomplished tax-free, with the corporation accepting the adjusted cost basis of the property for federal income tax purposes. The family encounters the problem of valuing the orchard for the purpose of determining the total value of property contributed to the corporation and, in turn, the state annual privilege fee.[1]

We shall assume that the family has the orchard appraised by competent individuals who value the orchard at $457.50 per acre. Given this information, the corporation credits $1,000 to paid-in capital and $85,626 to surplus and issues shares with a total par value of $1,000 having equal voting rights and privileges. The family members receive shares pro rata to their contribution of property. The corporation pays income taxes in its own name.

If the corporation has no deficit to reduce surplus, the annual privilege fee on the $86,626 value of property contributed to the corporation will be $433. Social security tax on the three-year average net profits from farming of

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[1]The orchard has a cost basis of $4,823 (Table 13, page 230). This is not the present market value of the orchard. It is the investment in planted trees which must be capitalized by farmers who file federal income tax on the cash basis. The problem here is similar to the one discussed in Case B. See footnote 1, page 205.

$11,047 increases by one and one-half percent of $165. Thus, the total tax cost is $599, including a $1 intangible tax. Since the residences are not owned by the corporation or leased to it, and the family does not have insurance which may be transferred to the corporation, social security is the only tax deductible expense that the family has to transfer to the corporation. The total social security tax based on these assumptions would be $662. Each shareholder is in the 20 percent income tax bracket, so the tax saving is $134 which reduces the total tax cost of the corporation to approximately $465 annually. The tax costs of a corporation organized as an owner for this family represent approximately four percent of the average profits from farming for the past three years.

The father can act to recognize the equity that the sons have contributed to the farm when the corporation owns title to the real property, for he can make gifts of shares to the sons. When the father makes gifts of shares, he simultaneously transfers title to a portion of the farm property to his sons and reduces his estate. Since the corporation would not ordinarily declare dividends, the income received by the father will not be reduced when he transfers shares in the corporation to his sons. Each shareholder may be a corporation employee and receive a salary for services actually rendered. Therefore, the family may encounter two problems when the corporation is an owner.

One problem is providing the father an income at retirement. If he retires and renders no service to the corporation, he will not be entitled to receive a salary. Consequently, the corporation would need to declare dividends to provide the father an income. Certainly the corporation will require services that the father can perform, if he continues actively in the business after age 65; however, if he should retire, his sole source of income may also cease, because the corporation as an owner cannot pay rent.

A second problem the family may encounter is the minority shareholder problem. The number of shares the father distributes as gifts will determine whether the sons are minority shareholders with respect to him or vice versa. Although the minority shareholder problem may exist, it may not develop during the period the father and sons own the corporation. Yet unless the shareholders protect each other with a cross purchase agreement or enter into an entity agreement with the corporation, the minority shareholder problem may become serious, especially if one of the sons decides to withdraw from the business or dies and transfers his shares to his spouse and/or heirs.

Consequently, if the father decides to organize a corporation as an owner, he must not only consider the annual tax costs of maintaining the corporate-entity, he must also consider his income position at retirement with relation to the corporation and the minority shareholder problem.

<u>A corporation organized as a tenant</u>.--The partners are also investigating a corporation organized as a tenant. Assume they contribute only machinery and equipment to the corporation as capital. This tangible personal property has a value of $9,334. The corporation credits $1,000 to paid-in capital and $8,335 to surplus, issuing shares having a total par value of $1,000 with equal voting rights and privileges equally to the partners. The corporation pays income taxes in its own name.

If no deficit is incurred to reduce surplus, the annual privilege fee is $46 and intangible tax $1 for a total of $47. Social security tax costs are increased by $165 to a total of $662 which is a business expense for the corporation and creates a tax saving of $134. Thus, tax increases are $47 plus $165 less $134, for an increase in total tax costs of approximately $78 annually when this corporation is organized as a tenant. This is a decrease of $387 annually from the tax cost when this corporation is organized as an owner. Thus, if this family contributes the orchard to the corporation, the result is a substantial increase in tax costs.

Since the corporation as a tenant will lease the real property from the father, the income problem at retirement will be solved because the corporation can now pay rents. Furthermore, the minority shareholder problem, when the corporation is a tenant, is negligible. Even though these problems are solved, the original problem of recognizing the sons' equity continues to exist unsolved.

The problem of continuity of business.--Consider now, the problem of continuity of business in the family. We assume the sons will continue this farm business during their lifetimes and also expect them to transfer the farm to their children. When or at what rate this transfer to the sons and/or the grandchildren will occur is unpredictable. The number of family members who will own an equity in this family business during the next two decades can vary widely. When one or two encounter the problem of purchasing the others' share of the farm, assuming they inherit or purchase it equally, the problems in continuing the business may be substantial, particularly if a number of heirs wish to continue the business as a partnership. In such a case, a corporation organized as a tenant can assist in retaining effective control over the farm business. The same end may be accomplished with a well planned partnership agreement, yet the complexity of ownership may increase to the point where a corporation is preferable even when there is a cost of maintaining the corporate entity that cannot be recovered.

Given the present family situation, it is doubtful that this family can solve their present problem effectively by using a corporation.

As this writer sees it, the title transfer problem which the father confronts has four alternative solutions. One is maintaining the status quo, continuing the farm business as at present and letting the sons eventually inherit the farm. A second is to sell the sons the farm using a land contract. The third is for the father to sign as guarantor for the purchase of one or both of the eighty acre tracts that adjoin the farm, thus creating credit for farm expansion. The fourth is for the sons to purchase one or both tracts adjoining the farm using a land contract.

The third alternative appears as the most acceptable, because it will result in no direct income reduction for the father, attain additional productive property for the family, and create prospective increases in income for the sons from property to which they will have title. There is, of course, the risk inherent in signing as guarantor for credit extended to the sons. However, this risk has been compensated for by the sons' labor investments.

The problem of continuity of business is a problem still one generation removed; it involves the ability of a single heir to gain eventual ownership control over the business. Careful planning among the family members may result in continuity of the business; however, this cannot be assured. The family may decide a corporation is a useful institutional arrangement at some stage in this phase of the farm transfer process.

Summary, Case C

Case C discusses the problem of transferring an earned equity that has been contributed by three sons to a family farm.

Their father owns title to the real property upon which this equity exists as an orchard -- realty. A corporation organized as an owner would solve this problem but encounters the problem of income for the father at retirement and the minority shareholder problem. Costs were compared for the corporation organized as an owner and as a tenant. The corporation as a tenant would not solve the problem of transferring the equity to the sons. However, such a corporation might assist this family in solving the problem of continuity in business as the farm is transferred to the grandchildren.

Case D

The farm in Case D is a profitable, specialized, cash crop farm. It derives most of its income from products produced directly by the asset land. The acreage owned has increased rapidly, and the family expects it to continue to do so. Consequently, the family is investigating a corporation to determine its usefulness in reducing their income, estate and inheritance taxes. The following section briefly outlines the farm and family situation.

The Farm and the Family, Case D

Background.--The husband and wife who own this farm have purchased and paid for it since the late 1930's, when they purchased the first and largest tract. They purchased four more tracts during the 1950's.

Farm location.--The farm is located in a commercial agricultural area. In the spring of 1961, there was no evidence to indicate that this farm had value in a higher use than agriculture.

Type of farm.--Specialized cash crop.

Table 14.--Description of tracts owned by family, 1961, Case D

Tract[1]	Acres	Estimated present market value[2]
V	--	--
S	--	--
X	--	--
Y	--	--
Z	--	--
Total	284	$63,900

[1]Husband and wife own title to all tracts in joint tenancy.

[2]Family estimate, $225 per acre.

Table 15.--Description of rented tracts, 1961, Case D

Tract[1]	Acres	Estimated purchase price per acre	Estimated total cost
L	--	--	--
M	--	--	--
N	--	--	--
Total	202		$56,600

[1]Title to each tract is owned by persons over 65 years of age.

Table 16.--Description of family members, 1961, Case D

Members	Age	Residence
Father	50	Farm
Mother	--	Farm
Daughter A	22	Out of state
Daughter B	18	In Michigan
Son	15	Farm
Daughter C	9	Farm

Table 17.--Farm business summary, 1960, Case D

Cash income		Cash expenses and depreciation	
Crop sales	$74,700	Hired labor (1 man full time)	$ 4,200
	---	Hired labor (seasonal)	4,022
	---	Crop expense	5,743
	---	Rent	12,714
	---	Custom hire	138
	---	Fuel for farm power	2,231
	---	Machinery: cash expense	2,517
	---	Depreciation	2,847
	---	Improvements	---
	---	Depreciation	794
	---	Supplies	9,118
	---	Taxes	1,741
	---	Insurance and utilities	1,676
Other sources	-0-	Other	387
	$74,700		$48,128

Machinery and equipment adjusted cost basis.--$27,046.

Present business arrangement.--This farmer conducts business as a part owner. The owned portion is conducted as a sole proprietorship, and the rented portion is conducted as a tenant with fifty-fifty crop share rental agreements. The tenant purchases the landlords' share of the crop each year for cash.

The problem.--If increase in size of farm and farm income continues as expected, then can a corporation

1. Minimize federal income taxes, or

2. Be useful in the inter-generation, intra-family farm transfer period to prevent breaking up the farm as an operating unit?

Discussion, Case D

This family expects the owned acreage in this farm and the taxable income to increase. If the owned acreage does expand, there will also be an increase in the potential federal estate and inheritance tax liability; consequently, this husband and wife are investigating the corporation as an institutional arrangement to determine its usefulness in solving a problem that may develop -- not a problem that actually exists.

This farm business derives its income from products produced directly from the asset land. Such products, when sold, produce ordinary income. Hence, this family will normally have only the income from machinery and equipment sales that is in excess of the adjusted cost basis as capital gain income. When capital gain income is a minor part of total taxable income, the corporation will obtain relatively small income tax savings on capital gain if it elects to be taxed as provided in Subchapter S. Furthermore, if the objective is to minimize income taxes by dividing taxable income with a corporation, while retaining full ownership of all the shares of the corporation, the corporation must pay income tax in its own name. We shall first discuss the problem of minimizing income tax by dividing income with a corporation.

The 1960 farm business summary shows this farm business had total cash income of $74,700 and cash expense and depreciation of $48,128, including $12,714 charged to rent. The federal income tax returns prepared by this farmer showed that he filed a joint return, itemized deductions, received income only from the farm business, had no capital gain and had a taxable income of $14,780. Thus, the applicable income tax rate was 30 percent. The total income tax paid was $3,581 and social security tax was $216 on the $4,800 maximum earnings permitted to qualify for social security, for a total income and social security tax of $3,797.

To determine if and when a corporation could begin to reduce income taxes, assume no corporation formed but all the rented tracts were owned by the husband and wife at the beginning of the 1960 business year. Also, assume that the cash expenses and depreciation incurred by the previous landlords represented one-third the total rent paid. Assume, also, that the taxable income of this family is now increased to $23,256. Thus, the applicable income tax rate is 38 percent. At this rate, the income tax paid is $6,287 and social security tax is $216, for a total of $6,503 and a tax increase over the actual 1960 business year of $2,706.

<u>Proposed corporation to minimize income tax</u>.--A corporation organized as a tenant will minimize income taxes as effectively as one organized as an owner; hence, we shall discuss only a corporation as tenant in this case.

Assume a situation in which this farmer organized the proposed corporation as a tenant by contributing only the machinery and equipment used in the farm business as capital. The corporation adopts the farmer's cost basis of $27,046 for a tax-free transfer, and credits $1,000 to paid-in capital and the remaining $26,046 to surplus. The corporation issues shares having equal voting rights and privileges and a total par value of $1,000 in exchange for the property received as capital to the farmer who owns all the shares and is the only shareholding-employee.

Assume the corporation pays no dividends, but the farmer receives rent as landlord and an allowable salary as the only shareholding-employee such that after itemizing deductions the joint income tax return filed by the husband and wife for 1960 shows taxable income of $16,000. Consequently, the corporation has taxable income of $7,256, for a total of $23,256 presented previously. Given these assumptions, the farm family will pay $3,920 income tax and $144 social security tax, for a total tax of $4,064 on the $16,000 taxable income. The corporation will pay $2,176 income tax and $144 social security tax, for a total tax of $2,320 on the $7,256 of taxable income. The two taxpayers -- the farm family and the corporation -- pay a total tax of $6,240 which is a decrease of $263 from the $6,503 total tax paid by the farm family on $23,256 of taxable income. We must consider, however, the tax cost of maintaining the corporation.

If there is no deficit to reduce surplus, the corporation will pay an annual privilege fee of $135 on the $27,046 of paid-in capital and surplus and an intangible tax of $1 for a total of $136. The $288 social security tax which the corporation pays on $4,800 of salary received by the shareholding-employee is a tax deductible expense.

In the 30 percent income tax bracket, the social security tax offsets $86 of tax costs. Thus, when the taxable income is divided with the corporation, the $263 income tax saving is increased by an $86 tax saving from deductible expense, and the total is decreased by increased tax costs of $136, for a net tax decrease of $213 from the $6,503 paid by the husband and wife on $23,756 of taxable income. Consequently, given these circumtances, this farm business will require approximately $23,000 of taxable income before the tax savings that result from dividing income with the corporation offset the tax costs.

To minimize the income tax payable in this illustration, the corporation retains earnings that are taxpaid. These may remain in the corporation in cash, to be used to pay indebtedness or purchase property. However, if the retained earnings are subsequently reduced by paying the shareholding-employee an allowable salary equal to the normal allowable salary received in a year when income subject to tax is less than the salary paid, the portion paid from retained earnings included in the shareholding-employee's taxable income is taxed at his applicable income tax rate. The corporation may reduce the total income tax paid if the variation in taxable income from the farm business fluctuates widely from year to year.

Some other alternatives that will minimize income tax are available to this family. One, of course, is to encourage the son to continue in the farm business. When the income is divided between the father and son, the income tax problem will be alleviated. Since the son may not enter the farm business for several years, a corporation may be a very effective institutional arrangement to minimize income tax in the intervening years.

Farm transfer.--This husband and wife are also concerned about the potential estate and inheritance tax liability of estates. The family estimates the tracts owned at present have a market value of $225 an acre. At this value per acre, the real property in the estate has a total value at present of $63,900, Table 14, page 241. Assuming the tangible personal property used in the farm business is valued at the cost basis of $27,046, the estate has a present market value of $90,946.

Assume all the tangible personal property is left by will to the surviving spouse. Since the real property is held in joint tenancy, the title passes outright to the surviving spouse. Thus, upon the death of one spouse there will be federal estate tax on $3,900 (that is the $63,900 real property less $60,000) liability on this estate.

If we assume that the tracts L, M and N are now purchased by the husband and wife and are included in their estate at cost, the total estate now has a present value of $147,446, assuming no indebtedness or deductions. If all the real property is held in joint tenancy, the estate passes to the surviving spouse. The potential federal estate and inheritance tax liability on this estate could be a serious problem for the surviving spouse and heirs. However, in this case, the husband and wife are studying a situation that can occur and not an actual situation.

If this family organized a corporation as a tenant for the purpose of minimizing income taxes, they may find it advantageous to have the corporation purchase one or more tracts with retained earnings and/or farm profits from the farm business. Shares in the corporation could then be transferred to the children equally as gifts. One result of this would be to place the son in the position of an operating heir with a minority of shares. Since the corporation would own title to only a portion of the farm, the minority shareholder problem would be less serious than in situations where the corporation owned all the real property. An alternative to giving these shares to the children equally is to give shares to the son only and other gifts of equal value to the daughters. The corporation could then continue to lease the property from the daughters or other family owners.

However, if a corporation is organized and purchases property, the husband and wife could by-pass the minority shareholder problem by dissolving the corporation and taking title to the property the corporation owned. This alternative would not solve the problem of tax liability on their estate.

Since death taxes on the present value of the estate are not a burdensome problem, the husband and wife can take advantage of all or part of their single lifetime gift tax exemption of $30,000 each to assist in reducing their estate. Since they may transfer the estate to their children in connection with the use of a land contract sale or by outright gift, it would not appear necessary to organize a corporation.

The farm transfer problem may be further reduced if the son returns to the farm business and takes title to one or more of the tracts that this farm may have an opportunity to purchase. Such a procedure would assist in minimizing the income, estate and inheritance tax problems simultaneously.

Summary, Case D

Case D examines two problems of a successful farm business. One is minimizing income tax, the other is minimizing the estate and inheritance taxes. A corporation organized as a tenant will minimize the income tax but income tax savings will not equal added tax costs of a corporation in the situation projected until the family has taxable income of approximately $23,000.

The present estate of this husband and wife is not of sufficient value to be a serious problem. However, if the husband and wife continue to take title to additional property, it could become a serious problem upon the death of one spouse. As this family is planning its estate it has several alternatives to minimize the potential tax without using a corporation. Thus, it can exercise its single lifetime gift exemptions, sell a part of the real property to the children using a land contract, then make gifts of payments to the children, and encourage the son to remain in the farm business.

Summary, Case Studies

The use of a corporation in four different farm and family situations was examined in this chapter. Case study farms were selected to illustrate particular tax problems that will be encountered by families who investigate the corporate legal-business structure.

Thus, Case A illustrates the need to consider both the potential federal estate and inheritance tax and the potential income tax on capital gains when transferring farms, and especially those which may be sold before passing through another estate. It is also evident in Case A that farm families who have high value estates and are primarily concerned with the estate and inheritance tax and who have heirs that do not expect to sell the farm property may reduce the potential tax liability of their estate under certain conditions by transferring the farm property via shares in a corporation.

Case B discusses the tax problems encountered when the farm business derives its income from products produced by "1231 assets" that are tangible personal property, such as dairy cattle. Corporations that derive their income from such property and report federal income tax on the cash basis will normally receive substantial capital gain income; hence, they may find it advantageous to elect to be taxed as prescribed in Subchapter S.

The farm business in Case C derives its income from a "1231 asset" that is realty -- an orchard. Since an orchard normally has a high value and is part of real property, the total annual privilege fee when real property, including an orchard, is contributed to a corporation as capital will be large. Corporations that conduct the business of an orchard will not receive capital gain income from the sale of orchard products; consequently, the tax savings obtained when capital gain income is taxed as prescribed in Subchapter S will be relatively small except in situations where the corporation sells the farm property.

The Case D farm income is derived from products produced directly from the asset land. Farms that are in this category will have tax problems that parallel those of the previous case, namely, high annual privilege fees if the real property is contributed to the corporation and small amounts of capital gain income.

The family in each case study is investigating a corporation when seeking an answer to a different problem. Thus, the family in Case A is investigating a corporation as an institutional arrangement to minimize potential estate and inheritance tax liability in a situation where it is also necessary to provide the mother an adequate income. A land contract is equally effective in the situation.

The family in Case B is investigating the corporation to determine the tax advantage available to their family business. Five examples of tax costs of a corporation are presented. Tax costs are minimized and tax savings maximized when the corporation has a fifty-fifty profit share lease and elects to be taxed as prescribed in Subchapter S. When tax costs are minimized, earnings that qualified for social security purposes are also minimized. Social security earnings are also maximized when the capital gain income is paid by the corporation as salary and no profits are permitted. Both income and social security taxes increase in this latter situation, and increased tax costs are greater than tax savings.

In Case C, the father of three sons investigated the use of a corporation to transfer an equity in real property to his sons and to maintain continuity in the farm business. When the corporation is organized as an owner, the equity can be readily transferred. However, the problem of providing an income for the father at retirement and the minority shareholder problem are encountered. Hence, when costs are also considered, this alternative may be unsatisfactory. A corporation organized as a tenant may assist this family in maintaining continuity in the family business at a future date; however, this does not appear necessary at the present time. In Case D, the family is investigating a corporation to minimize income tax. The example shown indicates that taxable income must be several thousand, in this case seven thousand, dollars, in excess of sixteen thousand before the saving in income tax is equal to the cost of maintaining the corporate entity. The estate in Case D can be transferred if properly planned without the use of a corporation.

The case studies presented in this chapter illustrate numerous problems that farmers who investigate the corporate legal-business structure may encounter, but due to the complexity of individual family situations, all problems are not discussed.

CHAPTER IX

SUMMARY, CONCLUSIONS, AND IMPLICATIONS

The family is, perhaps, the most dynamic institution within a society. Since the family possesses this characteristic, farmers who investigate the corporate legal-business structure will find it necessary to consider many characteristics of that family when making the decisions about organizing a corporation. Generally, there are many different situations, goals, and problems within a family; individuals who are not actually members of the specific family can seldom successfully interrelate these factors. Thus, the decision or conclusion -- in any case a judgment -- which the writer reaches with regard to the organization and potential use of the corporate legal-business structure by farm families in Michigan is made with reference to farm families generally.

It is the decision, a judgment of the writer, that most farm families in Michigan who decide to organize a close[1] corporation will be well advised to consider organizing their corporation as a tenant, at least initially. A few farm families may decide to organize their close corporation initially as a part owner. The number of farm families in Michigan who decide to organize their close corporation as an

[1]See p. 20.

owner will be relatively few. This judgment is based on concepts the writer has established concerning selected aspects of the corporate legal-business structure as it would relate to any particular farm. These are summarized in the following section.

Summary of Selected Aspects of the Close Corporation

Farmers and farm families who investigate the corporate legal-business structure will be seeking solutions to different problems. The corporation organized as a tenant, a part owner, or an owner will solve different problems and has different problems of its own from the time of organization to dissolution.

Organization

Every corporation organized by a farmer or a farm family should be organized by a reputable lawyer with the advice of a reputable accountant. The cost of organizing the corporation as a tenant, a part owner, or an owner should not be substantially different. Property contributed to the corporation as capital may be transferred tax-free if the corporation adopts the contributor's cost basis. If the corporation receives the property as a tenant or part owner, written leases must be prepared for the real property leased by the corporation. Preincorporation agreements, shareholders' wills, articles of incorporation, by-laws, and shares should cost essentially the same. Total organization costs may approximate \$350, with a range of \$100 to \$700. This was the average cost and range for the eighteen corporations studied in Michigan.

Excise and Social Security Taxes

The federal stamp tax of \$0.11 per \$100 actual value on shares issued by the corporation and of \$0.04 per \$100 of actual value on shares transferred between shareholders will normally be a nominal cost for a corporation. The Michigan annual privilege fee of five (\$0.005) mills per dollar of paid-in capital and surplus will be largest if the corporation is an owner without a deficit. The intangible tax of one (\$0.001) mill per dollar on the par value of corporation shares will increase to 3.5 percent of income if the corporation distributes dividends.

Increased social security tax is a result of the corporation being an employer, not of the way it is organized.

Federal Taxes on Income

Whether a corporation is a tenant, part owner, or owner is determined by the type of property owned. Each corporation conducting a farm business will normally own some property subject to the tax treatment afforded "1231 assets."[1] If this property is sold or converted involuntarily and a capital loss occurs, that loss becomes a net operating loss that reduces profits in that tax year. Any capital gain income received from sales of property subject to the tax treatment afforded "1231 assets" is treated as net long-term capital gain. Corporations and individuals receive similar tax treatment on capital gains and losses from transfers of "1231 assets."

Corporations which are part owners or owners will own land and/or real property. If this property is sold, a capital loss may occur. If capital losses are incurred by a corporation, the loss must be offset by capital gain income before it is recoverable. Individuals may offset a part of any capital loss of this type against ordinary income. Although capital losses of this type may be infrequent, they can be locked in the corporation. If the capital loss is sufficiently great, neither the corporation nor the individual may be able to offset all the capital loss against income, but the individual may be able to offset more of it than the corporation.

If the corporation pays income tax in its own name, the income tax rate is 30 percent on the first $25,000 of

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[1]See footnote 1, p. 183.

taxable ordinary income and 52 percent thereafter. Capital gains of such corporations are taxed at the 25 percent rate. If a corporation qualifies and elects to be taxed as prescribed in Subchapter S,[1] the shareholders pay income tax in place of the corporation on the taxable income. The undistributed taxable income is distributed pro rata to the shareholders for the purpose of computing and paying the income tax due. Income tax is paid by the individual shareholders at their respective income tax rates. Whether the corporation with a Subchapter S election has an income tax advantage is determined by the total taxable ordinary income, capital gain income, and the age, sex, and place of residence of the family members who are shareholders. Corporations organized to conduct a farm business as tenants, part owners and owners will normally qualify to make an effective Subchapter S election.

Cost Basis Problem

Corporations do not have estates. Thus, property owned by a corporation does not gain a new cost basis for income tax purposes by being appraised in an estate. This may result in increased income tax on future sales of property

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[1]See Taxes and the corporation that elects to be taxed as prescribed in Subchapter S, p. 74.

held by the corporation at the time an estate is created, and also, in the loss of a new cost basis on property that may be depreciated. Since the corporation as a tenant, a part owner, or an owner could normally own title to the same tangible personal property used in the farm business the loss of cost basis for future sale or depreciation will be the same for each. The corporation as part owner or owner will own title to some real property. When the cost basis on the land or the realty included in such property is not changed, some increase in income tax costs may result, either on future sales or from the loss of a new cost basis for depreciation. Individuals who own title to the real property leased to a corporation may attain a new cost basis on property that passes through an estate. The corporation, as a tenant, will own less property subject to this cost basis problem.

Limited Liability

Shareholders who do not own property other than that required in the farm business and have no other source of income will not have their financial liability limited for torts committed by the corporation. If the corporation is a tenant, or a part owner, the title to the property used in the farm business is held by two legal entities and liability against torts is more limited. Any limitation on liability against torts that is achieved by shareholders when a corporation is organized should be that in excess of normally adequate insurance coverage. Limited liability for contractual obligations of close corporations exists only for shareholders or officers who are not required by lending institutions to endorse the corporation's credit instruments as guarantors. This is not determined by how the corporation is organized.

Control

Problems arising from shareholders attempting to gain control of a close corporation conducting a farm business should be relatively few. This problem should be reduced as the total number of shareholders is reduced and/or effective provisions are made among the shareholders to purchase the shares owned by those shareholders who wish to sell. Since the corporation that is a tenant can be expected to have the same number of, or fewer, shareholders than the part owner or owner, the control problem should be, but will not necessarily be, minimized when the corporation is a tenant.

Minority Shareholders

Many close corporations conducting farm businesses will have minority shareholders. Where the minority shareholders are corporation employees or receive a return to investment that is considered satisfactory, the way the corporation is organized should make little difference. However, the corporation that is a tenant will have more alternatives to pay family members for their capital and/or labor contributions than if it is an owner. The problem of minority shareholders who are "locked in" should be alleviated, if not eliminated, by such corporations.

Fringe Benefits

Fringe benefits available to shareholding-employees will seldom be influenced by the way the corporation is organized. In general, tax savings resulting from fringe benefits _per se_ will not be equal to, but will partly offset, the increase in excise and social security taxes that are associated with the corporation. There may be instances, however, when fringe benefits do equal or exceed the added tax costs.

Transfer of Ownership

A corporation that is an owner or part owner will clearly facilitate the transfer of title to real property when shares are transferred as gifts. A corporation which is a tenant cannot do this. When the estate is so large that the potential tax liability of that estate is a serious problem, organizing a corporation for the purpose of transferring the property may be the most acceptable of alternative institutional arrangements. However, alternative institutional arrangements will transfer more normal amounts of real property as effectively as a corporation.

Dissolution

Corporations that dissolve must follow specific procedures. Whether the corporation dissolves and liquidates the assets for cash or in kind, the procedure followed must be carefully planned to minimize all tax costs. If a corporation conducting a farm business owns only real or tangible property and liquidates its assets in kind in a one-month liquidation, tax costs would be minimized. The corporation that is a tenant will normally own fewer assets and have fewer shareholders; consequently, it should normally be dissolved and liquidated with more ease than the owner or part owner. The shareholders of every corporation conducting a farm business that is dissolved should have the advice of a reputable lawyer during the period of dissolution.

Conclusions with Respect to Primary Questions

The objective of this study was to seek answers to three primary questions. The questions and the conclusions reached with respect to each are presented below. We shall consider the questions in their original order.

The _first question is_: Does the corporation facilitate the inter-generation, intra-family farm transfer? Any answer to this question must, of course, be qualified, but certainly the conclusion is affirmative if we consider only the transfer of ownership _per se_. However, we cannot limit ourselves to this single aspect of the situation for the decision to use the corporate entity in the farm transfer process should be made only after the problems of cost, including tax costs of maintaining the corporate entity and federal and estate and state inheritance tax costs, control, and minority shareholders are carefully considered. Since other institutional arrangements will normally transfer the real property owned by a farm family as effectively as the corporation, we can expect the close corporation to be used directly by relatively few farm families to transfer real property. Yet there are cases when a corporation as an owner or part owner may be used successfully to reduce the federal estate and state inheritance tax liabilities on farm estates when alternative institutional arrangements are unacceptable. It is conceivable that the number of these cases will increase if farms continue to increase in size and value.

A corporation organized as a tenant may facilitate the farm transfer when either the farm business is large or it is considered essential to maintain family ownership and control of a farm business through a separate legal entity. The ease of transferring shares and, hence, control of the farm business may facilitate the transfer of farm property owned by the corporation and indirectly the real property that is leased to the corporation and owned by one or more family members.

Whether the corporation used in the transfer process is an owner or a tenant, the problem which the individual family member who remains on the farm has of accumulating the capital and/or credit necessary to attain full ownership will not normally be solved more readily by a corporation than other farm transfer arrangements.

The second question included in the objective was: Does corporation taxation affect farm earnings? The answer to this question is both positive and negative. When the farm family is consistently in an income tax bracket above 30 percent, they may minimize the income tax paid by dividing the taxable income with a corporation. If the corporation pays income taxes in its own name, the taxpaid earnings retained by the corporation are the corporation's property. However, if the corporation is taxed as prescribed in Subchapter S, the undistributed taxable income retained in the corporation is the property of the individual who paid the income tax as a shareholder. Tax savings may result in the latter case from increasing the number of taxpayers who pay taxes on the corporation's undistributed taxable income or from taxing capital gains in the manner applicable to individuals rather than corporations.

The number of farmers who have sufficient taxable income for tax savings to result when their taxable income is divided with a corporation for income tax purposes may not be large. Normally, tax savings from fringe benefits alone will not offset the tax costs of maintaining the corporate entity. Yet an increase in tax cost for the present may be offset by increased returns through increased social security benefits received by some family members at a future period; hence, any statement that increased tax cost would decrease the returns from a farm business would require substantial qualification.

If a corporation is improperly organized, or its business improperly managed, or income tax is paid by the corporation on its taxable income when the income tax could be reduced if shareholders paid the income tax instead of the corporation, then the tax costs can be such that current farm earnings are decreased. However, the corporation that conducts a farm business is but slightly different, in this respect, from the individual farmer who mismanages his own business. Yet when the corporation is properly organized and its business properly managed, the increase in tax cost of a corporation should normally be relatively small. Some farm families may be willing to pay the additional cost for the non-tax benefits the corporation can provide.

The objective included a third question: Does the corporation distribute rights and risks equitably among farm owners and farm operators? When the farm owners and farm operators are the same persons and on the board of directors, the corporation distributes the right to make decisions concerning the farm business in a manner almost identical to the partnership. Few individuals who are both farm owners and farm operators will not be on the board of directors and shareholding-employees of a corporation newly organized to conduct the business of a family farm. Hence, the corporation will change the distribution of the right of such individuals to make decisions concerning the farm business slightly, if at all.

The limited liability that is achieved when a corporation is properly organized distributes risks of individuals so that they carry their own risks and their share of the corporate risks, but not the risk of torts committed by other family members. In this respect, the corporation distributes the risks among the individual family members in proportion to their investment in the farm business.

The question of rights and risks concerning the corporation, particularly when the corporation is organized as an owner, involves individuals who are minority shareholders who are not on the board of directors or who are not shareholding-employees. For such individuals, the corporation may distribute the rights inherent in ownership in an inequitable manner. In this respect, the close corporation is different from other forms of business organization, for a minority shareholder may have his right to access to his invested capital or the property representing it severely curtailed and be simultaneously unable to receive a return on the investment and prevent reinvestment in the business of what may have been received as return to the investment.

In the partnership, liquidating an investment that does not yield a satisfactory return may be as difficult as liquidating an investment in a corporation. However, the right to do so exists simultaneously with the right to refuse to make additional investments in the farm business and accept the risk of receiving a reduced income as a result of this decision.

The shareholders of a corporation organized as a tenant that leases land from family members who are unwilling to make productive investments in real property may find the right to make those investments and accept the risk associated with that decision still distributed between the farm owners and the farm family managing the farm business in a way that restricts productive investment. Hence, unless the corporation shareholders also own the real property leased to the corporation, the right of the corporation to make productive investments may be divided in a way which is not more, or at least not any more, equitable than that attainable with the traditional forms of business organization.

Implications

The principal implication of this study is the potential effect that a corporation may have in increasing productive investments on certain family farms. If the trend of increasing size and value of farms continues, the problems of capital transfer and accumulation on family farms may increase in severity in the future with the result that the problems of family ownership and control will increase. Individual farm families may find that it is extremely difficult to obtain full ownership of such farms; hence, the problem of the distribution of the right to make productive investments in real property and to accept the risks associated with that investment may increase rather than decrease in complexity.

The problem of accumulating capital on farms, as well as the problem of inter-generation farm transfer, is a problem

of attaining and/or retaining control over capital. This control is inherent in the ownership of capital that individual farm families seek to attain or are required to attain, if other heirs decide to liquidate their portion of the farm property. Thus, the family member who remains on the farm is often required to reaccumulate all of the capital required each generation to retain ownership control of the farm business. This becomes more difficult as farms increase in value.
Even though control is inherent in ownership, farmers (and others) have long since discovered that increased incomes and economies to scale do not come from the ownership of all the types of assets used in the farm business. This is demonstrated by farmers who rent land and/or real property and own the tangible personal property required to conduct a farm business as a tenant.

Whether a farm is operated by an individual who is a tenant or a part owner, productive investments may often be required either in or on the land in the form of realty, such as buildings, tile drains, etc., to maximize returns to the farm business. These investments are rarely made by the individual family conducting a farm business on rented land, because the ownership rights to the investment belong to the individual who owns title to the land and/or real property. Often uncertainty as to present or future ownership rights stifles continued productive investment before the farm transfer occurs. In such a situation, the family members planning to continue on the farm may cease making productive investments, if there exists reasons to believe that at the completion of the inter-generation, intra-family transfer period the land or real property may be owned by individuals who for numerous reasons are not in a financial position, or who are unwilling, to make investments in the farm property. However, these same individuals may find it necessary to continue to own the land or real property, as it is, (1) for the income they receive, (2) because of the inherent security afforded by land, (3) for the potential capital gain involved, and/or (4) the status often associated with the ownership rights in a family farm. The individual family with operating control of land or real property may have low incomes because the necessary productive investments are not made in realty by those who own the land. New investments in realty such as farm buildings cannot be made by those who do not have full ownership rights in the land with any degree of certainty that the rights of ownership and, hence, control of the actual property or the investment will accrue to the investor(s). Yet many individual families living on farms owned by family members or others would be interested in making productive investments in realty that they consider necessary if they could control the rights to the productive investments made.

Judiciously used, the corporate legal-business structure may assist in solving the problems (1) of maintaining family ownership and control of family farm businesses and (2) of insufficient productive investment. If the corporate legal-business structure is properly used (and/or modified), it can result in control over productive investments in realty by the individual living on and investing in the family farm. If a corporation can be used in this way by farm families, it can assist in maintaining family ownership and business control of family farms and, at the same time, assist in solving the problems of capital transfer and accumulation.

The corporation may also assist in solving this problem by more effectively distributing the rights and risks associated with the productive investments between (1) the family members who own rights to the land or real property and (2) the individual family member who has operating control of the farm. The corporation is slightly different from an individual who leases land and makes such investments. The difference is that the ownership of investments made by a corporation remain with the corporation and are not redistributed among a number of new individuals when one of several shareholders dies; instead, the ownership remains with the corporation. Shares in the corporation can be transferred but the corporation remains a single entity with a single controlling group, the board of directors. Hence, the ownership of land may be fragmented but the ownership control of the farm business is not.

The question of who owns title to investments in realty made by a corporation on a family farm when the land is leased needs to be clarified. The corporation would be entitled to depreciate its investment in realty but a new cost basis would not be attained on this property at the death of a shareholder. Even though these two problems are present, institutional arrangements to clarify title to corporate investments in realty may circumvent them. The result could very well be a separation of the real property of a farm into two salable properties -- the land owned by family members and the realty, such as buildings, orchards, etc., owned by the corporation. The number of related families who own the land and the corporation could vary over time. Thus, the individual family member who remains on the farm could attain full ownership of the farm over a period of time if he desired. If the corporation can be adapted to family farms in this way, the problem of accumulating and transferring capital that confronts our family farms today may be alleviated.

Is a farm any less a family farm because the number of related families that have ownership rights in, and receive income from the property required in the farm business exceeds one? No; in fact, it is certainly clear that farm families have already determined that it pays to cooperate by owning land in joint tenancy and conducting business as a partnership. Clearly, the partnership is a means by which people cooperate, but it does not follow that all the people in a parntership can cooperate to the same extent that they are willing to exercise all the rights and can assume all the risks other partners are willing to assume. The close corporation used in this way may effectually bring those family members who can cooperate to the extent that they can exercise the same rights and assume the risks for their decision together and, at the same time, have the cooperation and the use of capital owned by those who cannot exercise the rights or assume the risks for one reason or another.

This does not mean that the family farm gives way to the corporate farm. The number of family members having rights or ownership in the farm may increase rather than decrease, since the problems on farms seldom arise over who owns the farm property but the continuous increase in investments necessary to provide an acceptable income for families living on these farms.

If the corporation is used in this way, family members and farm families who voluntarily leave agriculture may be encouraged to retain ownership rights in the land and lease the land to close corporations organized for the purpose of making the investments in realty; consequently, the risks associated with farm business can be spread among more members of society. Rental obligations normally are closely associated with yield and price. However, credit obligations incurred to obtain all the ownership rights in the farm business are contractual, with fixed payments which must be made regardless of yield and price. Thus, a form of farm business organization that can change the payment made to capital used in the business from fixed to variable should reduce the risks associated with the farm business.

If the returns to investments in land *per se* and realty *per se* can be determined and the title, rights, and risks associated with the different investments clarified, the problems involved in maintaining family ownership and control of family farm business may be, at least partly, solved. The family members can own the land directly or indirectly through some other institutional arrangement.

Consequently, the number of families that actually have direct rights of ownership in land might be substantially increased within the next three or four decades by using the corporate structure more extensively on family farms.

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