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SHOULD I INCORPORATE MY FARM?

by

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Farmers and ranchers are faced with increasingly difficult decisions concerning the organization of their farms and ranches to best accomplish their operational and inheritance goals. They seek to minimize annual income tax liability, provide for growth of the farming operation, ease the problems of transfer to heirs and minimize estate tax liability.

Most farms and ranches are presently organized as sole proprietorships and the owner-operator bears complete financial and management responsibilities. The current tax structure often works to the disadvantage of the sole proprietorship in relation to income and estate taxes. The increasing size and complexity of farming operations add further complications and uncertainties to the operation and transfer of the farm business.

Incorporation of the farm can often ease the income and estate tax burdens, facilitate transfer from one generation to another, reduce the personal financial liability of the owners, offer favorable employee benefits and retirement programs not otherwise available and improve the credit status of the farm or ranch business.

This bulletin will examine some of the legal and financial problems confronting farmers and ranchers and explore the use of a corporation for solving farm business problems.

SPECIAL PROBLEMS OF SOLE PROPRIETORS

Owner's Death Can Be a Devastating Economic Burden

Many farmers have concentrated on building a large and well managed farm business. The farmer's attention has often been directed to improving the technical performance of the business to the neglect of long-term financial planning -- particularly in the matter of transfer of the farm estate to his children. Farm and ranch estates have certain characteristics which can create a "capital crisis" on the death of the farmer or rancher.

Farm firms have historically attempted to exploit economies of size and new technologies which require large amounts of capital. This is evidenced by continued expansion of farm size, increased complexity and expense of machinery and increased sophistication in the usage of fertilizer, herbicides, seed, irrigation, tillage methods and livestock production systems.

Besides increasing in value, farm capital investments are usually non-liquid and not readily marketable apart from the unit with which they are combined.

The owner operator performs both management and financial functions on farms and ranches organized as proprietorships. Land is an integral part of the family structure and there is a very strong desire to retain ownership of the land for future generations. The average farm and ranch net income to asset ratio is about three percent nationally. Liquid assets generally total less than five percent of a farmer's net worth. As a result, the family wealth is accumulated through the accrual of equity in production resources -- mainly land, buildings, and livestock. Historically, earnings are left in the business rather than taken out as current income and have supplied the vitally needed working capital.

Coupled with these characteristics is the fact that as the operator advances in age, his efficiency of labor and capital usage often decreases. If the farm is not incorporated, but operated as a proprietorship, the succeeding generation and key employees may lack incentive to remain on the farm as they may not have developed a capital participation during the operator's lifetime.

The "capital crisis" occurs once each generation in this context when the owner/operator dies. He has built an estate which has increased substantially in value, both due to his efforts and due to inflation. His estate usually has very low liquidity and as a result, the estate taxes can be devastating. The succeeding generation is usually required to mortgage the land in order to pay the taxes. Each generation must then start the process all over again by re-building capital assets.

Problem of Giving Equal Interests to Family Members With Equal Contributions and Providing Incentives to Non-Family Key Employees

An operator of a large farm or ranch generally has several children, perhaps a son who is interested in staying in the farm business and a daughter (or son) living in a far-off city who has no active interest in the enterprise. He may also have one or two key employees he wishes to retain.

The operator usually wants to gradually turn over equity interests to the son and provide him with incentives. However, he may not be sure of the son's marriage and may be hesitant to give the son an interest in land which could be lost to the wife in a divorce.

He usually wants to treat the daughter equally with the son, but is even more reluctant to give her an interest in the enterprise since her interest could also be lost in a divorce or lost to creditors. In addition, the daughter could be influenced by her husband and try to interfere with the decision-making process of the farm.

The operator usually wants to provide incentive for key employees so he can retain them. However, it may be difficult to give them an equity interest in the business particularly if he wants to keep the business's major asset - the land - in the family. Thus it may be difficult to attract and keep good non-family key employees where the owner's goal is to keep the business in his family.

These problems, coupled with the owner/operator's desire to maintain control over the assets until he has full confidence in his son, usually result in the owner retaining ownership of all of the assets in the face of the pending "capital crisis."

Some Aspects of Farm Business Involve High Risk Which Can Jeopardize Land Holdings

Ownership of land involves a fairly low rate of return and a very low risk. On the other hand, farming and ranching can involve substantial risks. Substantial amounts of money are needed in order to finance expansion and irrigation projects. Substantial losses can occur from adverse weather, diseases, negligence on the part of employees, etc. To the extent that these risks are not covered by insurance, land may have to be mortgaged or sold.

Problem of Minimizing Income Taxes

In most, but not all cases, the cash basis method of tax accounting is the most advantageous for the farmer or rancher. In some instances farmers have inadvertently started out on the accrual method of accounting. The change from one method of accounting to another requires the consent of the Internal Revenue Service and is very difficult to get. Incorporation provides the opportunity to select the most advantageous accounting method - regardless of the method being used prior to incorporation.

Most farmers are on a calendar year for tax purposes. Harvest of most crops is usually in late summer or early fall. In some tax situations, a farmer will not sell his crops immediately after harvest even though the price may be good. To limit his current tax liability, he may defer the sale of his crop until the next year. However, unless he can get a forward contract, he is risking a drop in the market price.

Problem of the Family Farm Cycle

Agricultural economists have described the process of the generation, growth, decline, and death of the farm proprietorship and have referred to it as the "family farm cycle". The typical farm business tends to start out with a relative abundance of labor and a severe shortage of capital. Over time, capital is accumulated and substituted for labor until at some point (when the farmer typically reaches 45 to 50 years of age), the farm firm reaches its most rapid rate of growth and earns the highest profit. The farm firm is at the stage where it is making long-term investments that are going to create growth and income opportunities in the future.

Following this period, the amount of labor being provided by the farm family declines rather abruptly. The farmer is increasing in age and is unable, or unwilling, to furnish the quantity of physical labor that he previously did. The children in the family are usually grown and have left the farm, causing the supply of labor to become more scarce relative to capital. The farm proprietor is anticipating retirement and the eventual liquidation of the farm business. He may no longer be planning and investing for long-range growth and return. Thus, the growth rate and efficiency level of the farm firm may tend to decline until the retirement or death of the farm operator.

For each farm or ranch, there is a certain combination of labor and capital that will produce the highest prossible net profit. To deviate from that optimum combination is to reduce the profitability of the enterprise. Typically at the beginning of the farm cycle there is too little capital to go with the labor available; while at the end of the cycle just the reverse is true. Therefore, the optimum combination of labor and capital is reached for only a few years in the middle of the farm cycle. Stated another way, the farm is producing at its most profitable level for only a few years out of the total farm cycle.

Delay in bringing a son into the farm business, assuming that an adequate size of business to support both families exists, may cause additional problems. The son may be interested in joining the farm business when he is 20-25 and his father is 45-50 years of age. However, by the time the father has reached 70 years of age the son may be established in another occupation or in a separate farming operation and be unwilling to return to the family farm. Even when farms are eventually inherited by the son, it may be extremely difficult for an orderly transfer to take place without prior planning

of the estate. The estate is typically inherited at the time the new farmer is about half way through his own farm cycle, or at about that point where he has already generated most of the equity capital that he is going to generate from his own efforts. It would have been far more efficient to have had access to that capital some 20 years earlier when it was most needed and when it could have contributed much more to the productivity and growth of his farm operation.

Problem of Access to Fringe Benefits

Unincorporated farmers and ranchers do not have access to many of the fringe benefits that are available to incorporated businesses. These may include tax sheltered medical, dental, retirement, housing and life insurance programs.

HOW A CORPORATION CAN ALLEVIATE SOME OF THE PROBLEMS OF THE SOLE PROPRIETORSHIP

A Corporation May be Economically More Efficient

A corporation is a separate legal entity, distinct from its shareholders. It usually has an unlimited life and reduces uncertainty over continuity of the farm business and the long-term efficiency of resource allocation. Incorporation is a method of facilitating the holding of undivided fractional interests in the property of a business. The assets are owned not by the shareholders, but by the corporation. The shareholders' "ownership" is a complex bundle of rights and duties between the shareholders themselves and between the shareholders and the corporation. These rights vary depending upon the percentage of the corporate stock owned by the individual shareholder, the types and classes of corporate stock created, and the requirements relating to stockholders' voting power, selection of management, and property disposition.

The existence of a corporation is usually perpetual. It can only be terminated by an act of the shareholders and its existence is not affected by the death of a shareholder. A shareholder's liability is limited to his interest in the corporation. A corporation's articles and by laws and shareholder agreements usually set up a formal framework for controlling internal management and settling disputes.

A Corporation Can Reduce Fluctuations in the Family Farm Cycle

By using the corporate form of business organization, some of the fluctuations in the farm cycle can be reduced. The son can be brought into the farm business at a much earlier age, allowing him to develop an equity or ownership position in the farm firm. Given the unlimited life of the corporate farm firm (does not ease with the death of the present farm owner), it is possible to further reduce the large fluctuations of the family farm cycle by reducing the uncertainties associated with the limited life of the proprietorship. Incorporation can reduce the need for the conservative decision-making and investment strategy that characterizes the declining stage of the farm cycle when the availability of equity capital is probably the highest. Thus some of the uncertainty about the future, resulting in the unwillingness to make long-term investments, may be eliminated.

The son entering into the farm corporation is in a position to provide labor and management to offset the declining labor resources and management interests of the farm owner. The son's labor and management can be complementary to the father's capital allowing the development of a more profitable and larger farm firm. Thus, with additional labor and management inputs coming into the firm on a regular basis, the firm should be able to maintain the traditional peak efficiency of the mid-cycle for an indefinite period.

A Corporation Allows Ownership that Corresponds to Participation

A corporation allows ownership in the business to correspond with the participant's inputs. For example, the farmer may have a daughter (or son) who is not at all interested in the farm business so her participation is limited to that which evolves through right of inheritance as a member of the family. Most farmers would want her to share in the value of the estate but would be reluctant to have her participate in management. In addition, the owner may not want to give her an interest in appreciation since she is not participating in the business and contributing to it.

In this situation, the daughter could be given an interest paying debenture. A debenture is nothing more than a long-term promissory note which could have a value equal to the share of the estate received by other children in the family. However, the note would not appreciate in value and would not give a vote except perhaps in special circumstances. Income would be derived through interest payments which would be tax deductible to the corporation. An additional advantage to non-farm heirs, debentures can be readily redeemed or bought back by the heirs continuing the farm business, either directly or through the corporation.

There may be a key employee in the enterprise (an agronomist, livestock specialist, agricultural economist, etc.) who is very important to the success of the enterprise. His participation is through provisions of management or services, but not through right of inheritance. Therefore, he would usually not be given an interest in the equity of the corporation, but may, in appropriate cases, be given or sold an interest in farm business appreciation so that there will be incentive. The key employee would then have an interest in income and a voice in management - but not a controlling voice. He could be repurchased from him at cost or at some other deflated figure. If he remains with the corporation until retirement, the stock would be repurchased

at its fair market value at that time. The stock would be voting so that he could participate in management. He would not have enough stock, however, to control the corporation.

The farmer may have a son who is living on the farm or ranch and wants to actively participate in the farm business. This participation would be in management and through inheritance. The owner/operator parent could give or sell him stock in the corporation. He could gradually acquire more and more stock until he reached the point where he did control the business of the corporation when the owner/operator parent is ready to retire. There would be no buy back provision in this case since the son would retain an ownership interest in the business which he would pass on to his children.

Incorporation Reduces the Estate Value Even Without Gifting

This concept can be best explained by an example. The farmer holds 65 percent of an unincorporated farm with a million dollar value. The value of his ownership is $650,000 for federal estate tax purposes. However, if the same farm were incorporated, his 65 percent interest would be worth, for federal estate tax purposes, approximately $487,500. This is $162,500 (or 25 percent) less than if the farm were not incorporated.[1] The estate tax savings resulting from the discount would equal approximately $21,800. Even greater savings would be realized when the farm later passed through the wife's estate.

This "discount" in value is allowed because the farmer owns less than liquidation control of the corporation. In most states, a shareholder must own 66 2/3 percent of the stock in order to liquidate the corporation. Since the farmer owns 65 percent he cannot liquidate unless he gets the conset of the minority shareholders. Since he does not have the ability to liquidate

[1]The actual discount allowed may range from 0 to 50 percent depending upon the circumstances pertaining to a particular estate. A 25 percent discount is used here for illustration.

the corporation and get the assets in his hands personally, the Internal Revenue Service allows him to discount the value. There may be an additional discount if the farmer owns less than 50 percent, because 51 percent generally represents the operating control of the corporation.

There is planning flexibility in the above discount procedure inasmuch as the operating control percentage and the liquidation control percentage can be increased to a higher percentage when the farm is incorporated. This would allow the discounts without giving away as much of the stock of the corporation.

The discount referred to above is commonly called the "minority discount." In some cases, it is possible to have an additional discount which is referred to as a discount because of "lack of marketability." This can be described as follows: where all of the assets of a diversified business or more than one business are placed in a corporation, it lacks marketability because there are fewer persons in the market place who would be willing to buy a corporation with that particular mixture of business. On the other hand, if the business were not incorporated, it would be possible to find one buyer for one set of assets and another buyer for the other set of assets. For example, if a farm business was incorporated along with a clothing store, it may be very difficult to find an individual who would be willing to buy a corporation which owns both a farm and a clothing store. However, if the businesses were not incorporated, the clothing store could be sold to one individual and the farm business to another.

Corporate Stock Facilities Gifting

Gifts of minority stock may be a useful way in which to encourage a child to continue in the family business and give him a sense of ownership.

The farmer and his wife may each gift up to $3,000 per donee each year tax free. It is easier to use the annual gift exclusion with corporate stock than with parcels of land or head of livestock. In addition, the transferability of stock may be more readily restricted than other types of property.

Gifts of stock, unlike gifts of real estate, are private transactions that are not recorded with the county - thus assuring a greater degree of privacy of personal and family business matters.

Retaining Control While Gifting

Operating control of an incorporated business can be retained by the parents, even though a substantial portion of the family wealth may be given or sold to the children. One method of accomplishing this would be to sell and/or gift 49 percent of the stock while retaining 51 percent for the remainder of the farmer's lifetime. Fifty-one percent of the stock usually represents operating control of the corporation.

Control may also be accomplished by using several classes of stock. For example, a corporation could have three classes of stock: voting preferred stock (representing all of the vote), non-voting common stock (representing future growth), and non-voting preferred stock (equivalent to the full value of the retained earnings). A farmer can give away the future growth of the company (non-voting common) by selling/or gifting the non-voting preferred stock while retaining the voting preferred stock. This allows him to indefinitely control the farm business. Preferred stock is generally fixed in value so all of the growth would be represented outside of the parents' estates.

Incorporation Allows Freezing of the Value of the Estate

The value of a farm estate, in the hands of an owner/operator, can be frozen through the use of preferred stock.

Preferred stock is like common stock except that upon liquidation of the corporation, the preferred shareholders will be paid a fixed amount before payment of the common shareholders. If there are not enough assets to go around, preferred shareholders would be paid while the common shareholders would get nothing. On the other hand, if the assets have appreciated in value, the preferred shareholders will still get only the fixed amount while all of the appreciation will go to the common shareholders. Preferred shareholders may also receive dividends before common shareholders.

If the owner/operator of a farm owns only preferred stock, the value of his interest in the corporation will not increase even though the value of the underlying assets may be increasing dramatically. All of the increase in value will be reflected in the common shares which would usually be gifted or sold to an operating son or daughter or sold to key employees. The preferred stock could be voting stock so that the owner/operator would still retain operating control of the corporation.

A Corporation Can Shelter Assets From Liabilities

A corporate shareholder's liabilities for corporate debts and corporate obligations is limited to his interest in the corporation.* If land is not placed in a farming or ranching corporation or is placed in a different corporation, the land may be sheltered from the liabilities, debts, and risks of the farming and ranching business. This can be a very important consideration in some farm and ranch businesses.

*A shareholder of a small family corporation is often required to personally sign notes, thereby losing his limited liability status.

A Corporation Can Protect Assets From Creditors, In-Laws, and Other "Outside Owners

Restrictions can be placed upon the transferability of stock. It is difficult to place restrictions on other assets such as land, equipment and cattle after they have been transferred to someone else. If a daughter's husband goes bankrupt, the creditors will be able to acquire assets owned by the daughter. If those assets include stock in a family corporation, there can be a provision in a shareholders' agreement or in the bylaws that the corporation will have a right to buy that stock back at a fixed price which could be less than fair market value. The same could apply in the event of a divorce or attempted sale of stock to outsiders.

It is also difficult to create a life estate in equipment, cattle, sheep, and other assets that do not have a long existence. By putting those assets in a corporation in exchange for stock, a life interest can easily be created in the stock.

A Corporation Can Save Income Taxes

Advantage of Corporate Flat Rates: It may be possible to save income taxes through taking advantage of the corporation's flat income tax rate. At present, the first $50,000 of taxable income of a corporation is taxed at an average rate of 21 percent. Everything over $50,000 is presently taxed at a 48 percent rate. Individual tax rates, however, are graduated and can go as high as 70 percent. Due to the fact that the maximum tax rate of the corporation is 48 percent, there can be a substantial income tax savings by incorporating the business and keeping most of the income below the 48 percent tax bracket. This can be accomplished by splitting the income between the corporation and the farmer as an individual.

Maximum Tax on Earned Income: The Internal Revenue Code provides that the maximum tax on earned income be 50 percent. However, IRS contends the farmer can only treat 30 percent of the net profits of an unincorporated farm as "earned income" for the purpose of the 50 percent maximum rate. If a farmer incorporates, he may be able to avoid this rule by transferring all of his farm assets to the corporation and paying himself a salary which in effect would exceed 30 percent of the total net profits of the incorporated farm business.

Tax Sheltered Retirement Plan: A corporation can set up a qualified pension and/or profit-sharing plan which generally is less expensive and more flexible than a retirement plan that can be utilized outside of a corporation. Larger amounts of tax sheltered income can be placed into the qualified pension or profit-sharing plan than can be placed with a Keough Plan (a tax sheltered retirement plan for the self employed), and fewer employees may have to be included in a corporate plan. A qualified pension and profit-sharing plan has the advantage of allowing an individual to put aside before-tax dollars in a trust and invest those dollars in tax sheltered investments until retirement. Taxes are deferred until funds are received at retirement. The following table provides an example of how much faster a "nest egg" would build up in a tax sheltered, qualified pension or profit-sharing plan than if the money was invested for retirement by a farmer outside of such a plan.

Table 1. Comparison of Corporate and Non-Corporate Pension Plans

	SOLE* PROPRIETOR OR PARTNER RETIREMENT PLAN	PARTICIPATE IN CORPORATE QUALIFIED RETIREMENT PLAN
Top Segment of Earnings	$ 15,000	$ 15,000
Tax at 50 Percent	7,500	0
Net for Investment	7,500	15,000
Assume Five Percent Net Yield	375	750
Less Tax at 50 Percent	188	0
Net After-Tax Annual Yield	188	750
Accumulations at end of:		
10 years	79,025	188,668
20 years	190,085	495,668
30 years	256,183	715,906

*Several more restrictive tax-deferred retirement plans are available to the sole proprietor or partner.

Medical-Dental Plan: An unincorporated farmer or rancher can deduct health expenses only to the extent they exceed three percent of his adjusted gross income. A corporation may pay all of the farmers' medical and dental bills. The corporation, if certain requirements are met, can take the deductions and the farmer does not have to include the amount in his personal income. These expenses include premiums on insurance and expenditures for dental bills, eyeglasses, chiropractors, nursing services, crutches, etc.

Deductible Life Insurance: If certain requirements are met, a corporation can purchase group term life insurance for the benefit of the owner of a farm or ranch. The premium for group term life insurance, up to $50,000 is deductible and the amount is not includable in the income of the employee. This is a very inexpensive manner in which to purchase life insurance and is not available to the unincorporated farmer.

Housing: In some farm and ranch situations, it is possible to have the corporation furnish housing for the owner. Such expenditures are deductible to the corporation and are not included in the taxable income of the farmer or rancher.

Tax Year: A corporation can choose its fiscal year increasing opportunities for effective tax planning. For example, farmers who are on the cash basis will often not sell their commodity in the months of November or December in order to avoid having to pay the income taxes in that year. The price of the commodity may have decreased by the time an actual sale is made in January. If a corporation had a fiscal year ending on August 31, the sale could be made in the fall or up until August 31 of the following year without having any impact on total tax liabilities.

Change of Accounting Method: The corporation can choose an accounting method that is different than that of a farmer as an individual.[1/] A farmer who is on the accrual basis of accounting can switch to a cash basis or from a cash to an accrual basis upon incorporating. A change in accounting method, particularly from accraul to cash, can freqently reduce the farmers tax liability and increase net farm profits.

AN EXAMPLE OF THE USE OF INCORPORATION AS A FARM AND RANCH MANAGEMENT TOOL

The following example is intended to illustrate the potential benefits to be derived from utilizing the corporate form of business organization to reduce or eliminate several of the problems which have been mentioned above.[2/]

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[1] If the farm corporation has annual sales greater than $1,000,000 and is not closely held, the accrual method must be used.

[2] The specific examples presented in this paper are for purposes of illustration. All may not apply to any one farm or ranch situation. A competent attorney can provide assistance in determining which legal techniques to employ in planning and establishing an actual specific farm corporation.

The farm owner is 55 years of age and his wife is 52. He has a 28 year old son who is married, with two children, and an active participant in the farm business. His second child is a 26 year old daughter, also married and with two children. Her husband is a businessman and they are living in Los Angeles. The farmer also has a key employee he wants to retain. He wishes to provide the key employee with not only an adequate level of salary, but with incentives to participate in the increased growth and thus the value of the farm business.

The composition and market value of the farmer's pre-incorporation estate are as listed in Table 2.

Estate Tax Considerations

If the farmer wills his entire estate to his wife, she will owe (if his death occurs after 1980) $297,800 in federal estate taxes. At her death, the estate will owe an additional $733,800 (Table 3). Total federal estate

Table 2. Value of the Hypothetical Farm Estate

	Fair Market Value
Land	$1,500,000
Farm House	60,000
Farm Buildings	150,000
Machinery and Equipment	250,000
Other Assets	40,000
Total Assets	$2,000,000

taxes of $1,031.600 or roughly one half of the market value of the farm estate, must be paid in order to transfer the farm estate to the heirs. The above figure does not include state inheritance taxes, legal fees, probate fees, executor's fees, etc. Future farm growth and/or inflation would increase both the percentage and the dollar amount of estate taxes owed.

Table 3. Federal Estate Taxes - Estate Willed to Wife[1/]

	At Farmer's Death	At Wife's Death
Gross Estate	$2,000,000	$2,000,000 · [2/]
less marital deduction	1,000,000	0
	$1,000,000	$2,000,000
Taxable Estate	$ 345,800	$ 780,800
less unified credit (after 1980)	47,000	47,000
Estate Tax Payable	$ 298.800	$ 733,800
Total Transfer Tax	$1,032,600	

1/ Assuming no gifts or debts and ignoring state inheritance taxes and administrative expenses, assumes no community property.

2/ Gross estate value at wife's death is here assumed to be $2,000,000. It may be larger or smaller, but probably larger.

Farmer's Objectives

The farmer has the following specific objectives he wishes to accomplish:

1. He wants his son to inherit the farm business.

2. He wants his daughter to share equally in the value of the estate, but does not want her to control the farm business. He is worried about potential divorce or bankruptcy resulting in dissolution of the estate and wishes to prevent any attempt to transfer farm assets to non-family recipients.

3. He wants to minimize his income taxes, estate taxes, and probate fees.

4. He wants to keep the farm intact as one economic unit; not subdivided into separate parcels among the various heirs.

5. He wants to work 10 more years and then semi-retire and live elsewhere during the winter months.

6. He wants to provide an incentive designed to assure the retention of his key employee; but he does not want the key employee to obtain any long-term title to the land.

After investigating the various tools available for helping to obtain these goals, the farmer, in this example, selects the farm corporation as the most usable tool for his purposes. Thus the farmer incorporates his farm, including the land, buildings, machinery, and equipment. Both stocks and debentures (bonds) are issued in exchange for the property incorporated. Three classes of corporate stock are issued to the farmer. Nine hundred shares of stock,worth $2,000 per share(for a total of $1,800,000) and $200,000 of eight percent debentures are issued by the new corporation. The stock is divided into three classes. There are 50 shares of Class A Preferred Voting Stock, worth $100,000; 840 shares of Class B Preferred Non-Voting Stock, worth $1,680,000; and 10 shares of Non-Voting Common Stock, worth $20,000 (see Table 4).

Gifting of Stock

The farmer gives eight of the 10 shares of commong stock to his son and sells the remaining two shares to his key employee. He gives 20 shares of the Class A voting Preferred Stock to his son and retains 30 shares for himself. Everytime he gifts, or eventually wills in whatever ratio he wishes, the Class B Non-Voting Preferred Stock to his daughter and son and their children. In this example, he gifts one half of the Class B Non-Voting Preferred stock to the daughter and one half to the son.

Table 4: Example - Incorporation of the Farm Estate and Distribution of Shares of Ownership[3]

Type	Amount	Number of Units	Distribution
Debentures	$ 200,000	100	Retained for income
Class A Preferred, Voting	100,000	50	20 shares to son 30 shares retained
Class B Preferred, Non-Voting	1,680.000	840	420 shares to daughter and family 420 shares to son and family
Common, Non-Voting	20,000	10	8 shares to son 2 shares to key employee

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[3]Law in this area must be carefully followed or the tax savings illustrated by this example will not be realized. This is an over-simplification of tax law for education purposes.

Common Stock

By gifting or selling the commong stock the farmer has provided an incentive to his son and his key employee inasmuch as the increase in the value of the farm (machinery, equipment, and land) will accrue to the son and to the key employee according to the ratio of the shares of common stock which each owns. The farmer has also insured that his own estate will not increase in size in the future, as all increase in the value of the estate will

be divided 80 percent to his son and 20 percent to the key employee. (Common stock represents the "ownership" of future growth and increase in value.) This should encourage the son and the employee to remain a part of the farm business and work to increase its size and profitability as each will be rewarded for his contribution to increased growth and profitability. In order to prevent the permanent transfer of ownership of the farm assets to the employee, the agreement could stipulate that the stock would be repurchased at market value by the corporation at the time of the employee's retirement and in the event that he quit before retirement, it would be repurchased at a price below market value.

Class A Preferred Voting Stock

The farmer gains an additional advantage by gifting or selling 20 shares of the Class A Preferred Voting Stock to his son because he has legally given away 40 percent control of the farm. Transfer of 40 percent of the Class A will effectively reduce his remaining taxable estate by a discounted amount (25 percent in this example) because the ownership of less than two-thirds of a corporation generally means that a stockholder has lost the ability to legally liquidate the company.

Class B Preferred Non-Voting Stock

The Class B Stock will be used as a vehicle for gifting. It is fixed in value, non-voting, and under the proper gifting program, part may be transferred tax free. The stock can be distributed between the son and daughter or among the grandchildren and in any quantity that the farmer may desire.

By gifting, the estate value can be significantly reduced. The owner and his wife each has a $3,000 yearly exclusion per donee from gift taxes. Thus, $36,000 per year consisting of a $3,000 gift from the farmer and from his wife to each of their children and to each of the four grandchildren can be gifted without paying any gift tax. Shares of stock are quite useful and convenient for such a gifting program.

Debentures

The $200,000 of eight percent debentures could be retained by the farmer for retirement income, used for the daughter's income, or for any other purpose which the farmer may desire.

Income Tax Considerations

If the unincorporated farmer has an annual net taxable income of $200,000, federal taxes are $110,980. (State income tax will be ignored here.) The last $100,000 of his earnings are subject to the federal income tax rate of 70 percent. If, however, the farm business was incorporated, the maximum tax rate would be 48 percent. If the corporation paid the farmer a salary of $44,000 and retained the remaining $156,000 of net earnings, the farmer would owe $14,060 in federal income taxes and the corporation would owe $61,380 for a total tax of $75,440 (Table 5.) Thus, the splitting of income between the farmer and the corporation can result in a tax savings of $35,540.

Additional tax savings may result from being able to deduct all health expenses, the premium for $50,000 in term life insurance, housing expenses (under some limited circumstances), retirement programs, etc., from corporate income before the taxable income is computer. Table 6 provides an illustration of the additional tax savings available from a farm corporation.

Table 5: Example - Income Tax Savings of a Corporation Versus a Proprietorship

Proprietor = with $200,000 net taxable income		Tax Bracket
Net taxable income	$200,000	
Federal income taxes	110,980	70 percent
Corporation - with $200,000 pre-tax income, paying $44,000 salary to owner		
Federal tax on salary 1/	14,060	48 percent
Corporate income tax (on remaining $156,000)	61,380	48 percent
TOTAL INCOME TAX	$75,440	
Annual Income Tax Savings of Corporation	$35,540 2/	

[1]Ignoring deductions and exemptions

[2]Additional taxes on dividends to the stockholders must be paid if and when such dividents are disbursed.

Table 6: Additional Income Tax Savings Available From a Farm Corporation

		Annual Income 1/ Tax Savings (70 percent tax bracket)
Retirement Plan	$15,000 annual contribution	$10,500
Medical-Dental Plan	1,000 annual expenses	700
Deductible Life Insurance	500 annual premium	350
Housing	3,000 annual expense	2,100

[1]A change to cash basis accounting and a change in tax year (Table 7) may provide significant additional tax savings.

Change in Accounting Method

At the time of incorporation, the farmer has the option to choose his accounting method. If he had been previously using the accrual method, he now has the opportunity to switch to the generally more tax advantageous cash method.

Change in Fiscal Year

An incorporated farmer has more flexibility in timing the sale of his products without incurring additional tax liabilities. He can do this by choosing his fiscal year to minimize marketing problems. Many farmers have been delaying the sale of their products until after January 1 in order to reduce the present year's income tax. At some point in time, the farmer may be faced with the probability of declining prices after the beginning of the next year. At such a time, he may face the unpleasant decision of selling during the year of harvest at a satisfactory price - with large tax liabilities - or waiting until the new calendar year and selling at an expected lower price. Incorporation of the farm and selection of a fiscal year which corresponds to the harvest date of the major product can add significant flexibility to the marketing program. For instance, if the farmer in this example is a wheat producer and normally harvests his drop during August, he may wish to select a corporate fiscal year of August 1 to July 31. With this selection of a fiscal year, wheat can be sold anytime after harvest until the following July 31, without affecting his income tax liability.

Ignoring the previously discussed advantage of income splitting between a corporation and its employee, the potential for tax reduction by use of the corporate fiscal year versus the calendar year of the sole proprietor is explored in Table 7. The farmer who has been delaying his sales into the next year is able, after incorporation of his farm business, to sell in the year of harvest without additional tax liability for the year. This is because the net income is to the corporation and its fiscal year continues into and ends in 1977. Thus the corporation can be effectively used to delay the taxes due on the sale of the 1976 crop sales until 1977, the 1977 taxes until 1978, etc.

Summary of Advantages of Incorporation

In this example, we have seen that the farmer has been able to provide for an equitable distribution of his estate between his children and has been able to do so while maintaining operating control of the farm firm. At the same time, he has been able to provide every strong incentives for his key employee and for his son to remain in the farming operation. He has provided for his own retirement with the option for more liberal retirement programs through the corporation. Finally, he has the opportunity to reduce his income tax. He can pay himself a salary, leaving the remainder of the net income in the farm corporation. The corporation is subject to a maximum of 48 percent in taxes, while he as an individual is subject to a maximum tax rate of 70 percent. Thus, by leaving a portion of the earnings in the farm corporation, he can provide funds for farm expansion and operating expenditures while significantly reducing his income tax liability. During retirement, the farmer mayalso sell some of the remaining stock which he owns to his son in

Table 7: Reduction of Income Tax by Change of Tax Year

Year Product Produced	Year Product Sold and Taxes	Taxable Income or Product	Total Federal Income Taxes Owed: As a Sole Proprietor	Total Federal Income Taxes Owed: As a Corporation
1975	1976	190,000	104,080	
1976	1976	200,000	104,080+140,000 = $244,080	$104,080*

*The $140,000 in income taxes owed on the net income from the 1976 wheat crop have been delayed until the 1977 tax year.

Procedure

1. Incorporate farm business
2. Set fiscal year August 1 - July 31

Results from Incorporation and Use of Fiscal Year Ending July 31

1. Realized 1976 taxable income from combined sales = $390,000 (200,000 + 190,000)

   1976 net farm income reportable on 1976 tax return = $190,000

   1976 net farm income reportable on 1977 tax return = $200,000
2. 1976 tax savings of $140,000 (On $200,000 of additional income), the payment of which is effectively delayed indefinitely as the 1977 crop will be sold during the 1978 fiscal year (after August 1, 1977), the 1978 crop during the 1979 fiscal year, etc.
3. In 1977 and thereafter, wheat can be sold during the autumn or spring without affecting levels of income tax paid.

order to provide additional funds for his retirement and in order to further reduce his taxable estate. Proceeds from the sale of additional stock to his son can be used a a source of cash to pay any estate taxes owed upon the eventual death of the farmer. This bulletin has stressed the advantage of the corporate form of business organization. There are numerous disadvantages, only a few of which will be explored here.

DISADVANTAGES OF FARM INCORPORATION

Disadvantages of farm incorporation can off-set many or all of the advantages of incorporating a farm. Some of these disadvantages include loss of the protection of the federal bunkruptcy law which provides that individual farmers and farm partnerships cannot be placed in bankruptcy involuntarily by their creditors. (The farmer is, however, given the right to be a voluntary bankruptcy). A corporation can be subjected to involuntary bankruptcy and the above protection has been lost.

Most states have statutory provisions which exempt certain property from execution by a creditor. The western states generally provide the most generous allowances to debtors. These exemptions statutes have been designed to protect farmers as debtors from deprivation at the hands of creditors. In almost all cases, the protection of exemption statutes pertains only to a natural person or to the head of a family, and not to corporations. Therefore, a debtor - as a corporation - will lose this protection.

Perhaps the most important disadvantage of incorporation is the initial expense and the continuing costs of establishing and maintaining the corporate form. There are filing fees and legal fees to be paid. Additional and more complex bookkeeping is required. Annual fees must be paid to the state for the privilege of doing business as a corporation in that state. Several types of loans that are normally made available to farmers from government sponsored

credit agencies are limited or denied tc farm corporations. Federal Land Bank and Production Credit Association loans may be made to corporations heavily involved in farming. Neither Farmer's Home Administration real estate nor operating loans are available to farm corporations. Small Business Administration financing is also unavailable to most farm corporations.

Other potentially serious problems of farm incorporations exist and include the "locking in" of capital, unfavorable tax treatment of ordinary losser, capital gains and capital losses. There are potentially serious problems relating to the minority shareholder and to the difficulty of dissolving the corporation.

Should You Incorporate Your Family Farm?

The decision to incorporate is a personal one based upon the relative advantages and disadvantages of farm size, type, and complexity, the number of family members involved in ownership and operation, estate planning considerations, and other general objectives and preferences of the owners. Incorporation of the family farm or ranch business can, in appropriate cases, reduce the personal financial liability of the owners, provide significant tax advantages, offer favorable employee benefit and retirement programs not otherwise available, improve the credit status of the business and simplify and lower the cost of the transferral of assets to heirs. Against the advantages must be weighed the initial costs of incorporating, the annual license fee, the extra time involved in keeping the necessary additional records, possible tax complications and the loss of some legal protection provided for individual proprietors as debtors.

If after reviewing this bulletin you are interested in incorporating your family farm or ranch, you should obtain competent legal and accounting assistance in evaluating the advantages and disadvantages of a corpoation for your particular farm and personal situation.