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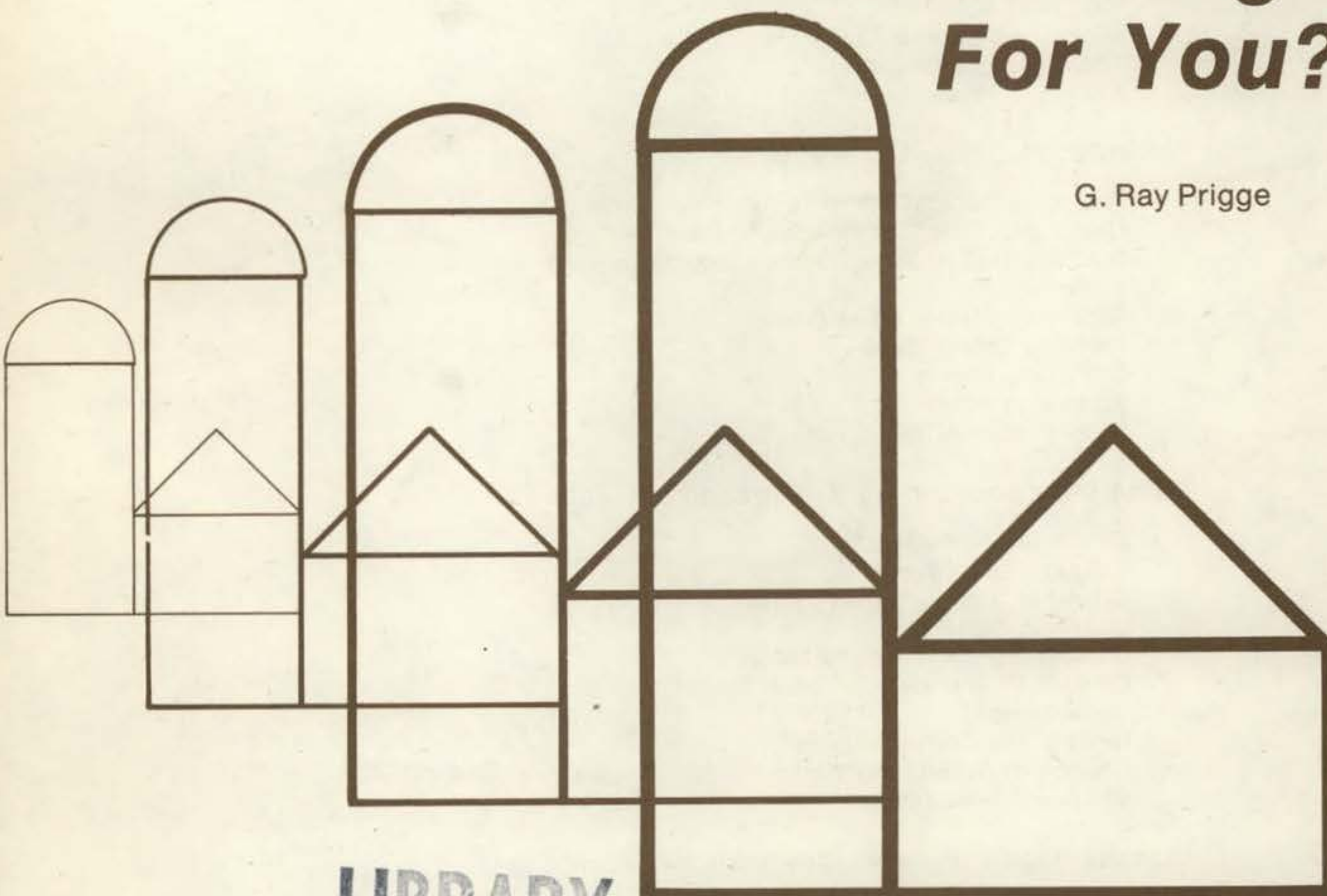
FARM INCORPORATION — An Advantage For You?



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Contents

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Farm Incorporation — An Advantage For You?

Farmers and ranchers are faced with increasingly difficult decisions concerning the organization of their farms and ranches to best accomplish 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 — A Capital Crisis

Farmers tend to concentrate on building a large, well-managed farm business. Their attention is often directed to improving the technical performance of the business to the neglect of long-term financial planning — particularly in the matter of transferring the farm estate. 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 use 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 usually a strong desire to retain ownership of the land for future generations. The average farm and ranch net income-to-asset ratio is about 3 percent nationally. Liquid assets generally total less than 5 percent of a farmer's net worth. As a result, the family wealth is accumulated through accrual of equity in production resources — mainly land, buildings and livestock. Earnings are left in the business to supply the vitally needed working capital, not taken out as current income.

Coupled with these characteristics is the fact that efficiency of labor and capital use often decreases as the operator advances in age. 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. 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. The owner has built an estate which has increased substantially in value, both due to individual efforts and due to inflation. The estate usually has very low liquidity and, as a result, 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 rebuilding capital assets.

Giving Interests to Family, Incentives to Key Employees

An operator of a large farm or ranch may have a son or daughter who is interested in staying in the farm business and other children living in a far-off city who have no active interest in the enterprise. The operator may also want to retain one or two key employees.

The operator usually wants to gradually turn over equity interests to and provide incentives for the son or daughter on the farm. However, the operator may not be sure of the son's or daughter's marriage and may be hesitant to give an interest in land which could be lost to the spouse in a divorce.

The operator usually wants to treat the children off the farm equally with the one on the farm, but is even more reluctant to give them an interest in the enterprise since their interest could also be lost in a divorce or lost to creditors. In addition, the son or daughter away from the farm could be influenced by the spouse to try to interfere with the decision-making process of the farm.

The operator may also want to provide incentive for key employees to retain them on the farm. However, it may be difficult to give them an equity interest in the business, particularly if the operator 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 the family.

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

High Risk Activities

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 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.

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 before incorporation.

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

The Family Farm Cycle

Agricultural economists have described the process of the generation, growth, decline and death of the farm proprietorship 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-parents are increasing in age and are unable, or unwilling, to furnish the same quantity of physical labor as in earlier years. 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 proprietors, anticipating retirement and the eventual liquidation of the farm business, 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 operators.

For each farm or ranch, a certain combination of labor and capital will produce the highest possible 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; 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 of the total farm cycle.

Delay in bringing a son into the farm business, assuming that the business is large enough to support both families, may cause additional problems. The son may be interested in joining the farm business when he is 20 to 25 and his parents are 45 to 50 years of age. However, by the time the parents have 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 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.

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.

Advantages of the Corporation

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 bylaws and shareholder agreements usually set up a formal framework for controlling internal management and settling disputes.

Reducing Fluctuations in Family Farm Cycle

The corporate form of business organization can reduce some of the fluctuations in the farm cycle. 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 cease with the death of the present farm owner), the large fluctuations of the family farm cycle can be further reduced 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 or daughter 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 younger person's labor and management can be complementary to the parents' 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.

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 daughters or sons who are not at all interested in the farm business so their participation is limited to that which evolves through right of inheritance as a member of the family. Most farmers would want them to share in the value of the estate but would be reluctant to have them participate in management. In addition, the owner may not want to give them an interest in appreciation since they are not participating in the business and not contributing to it.

In this situation, these sons or daughters 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 key employees in the enterprise (an agronomist, livestock specialist, agricultural economist, etc.) who are very important to the success of the enterprise and whose participation is through provision of management or services, but not through right of inheritance. Therefore, they 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 to provide incentive. The key employees would then have an interest in income and a voice in management — but not a controlling voice. They could be given a right to purchase common voting stock of the corporation to retain as long as they are employed by the corporation. The stock could be repurchased at cost or at some other deflated figure from a key employee who is discharged for cause. If the key employees remain with the corporation until retirement, the stock would be repurchased at its fair market value at that time. The stock would be voting so the employees could participate in management. They would not have enough stock, however, to control the corporation.

The farmer may have a son or daughter who is living on the farm or ranch and wants to participate actively in the farm business. This participation would be in management and through inheritance. The owner/operator parent could give or sell stock in the corporation. The son or daughter could gradually acquire stock to the point of controlling 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 or daughter would retain an ownership interest in the business.

Incorporation Reduces Estate Value

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 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 consent of the minority shareholders. Since he does not have the ability to liquidate 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 this 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 here 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.

Easier 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 livestock or parcels of land. 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 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

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[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.

stock (equivalent to the full value of the retained earnings). The farmer-parents 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 them to control the farm business indefinitely. Preferred stock is generally fixed in value so all of the growth would be represented outside of the parents' estates.

Freezing Estate Value

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 that 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.

Sheltering Assets

A corporate shareholder's liabilities for corporate debts and corporate obligations is limited to his or her interest in the corporation.[2] 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.

Protecting Assets

The transferability of stock can be restricted. 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, for example, 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.

Saving Income Taxes

Advantage of corporate flat rates: Taking advantage of the corporations' flat income tax rate may save income taxes. At present, the first $50,000 of a corporations' taxable income 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. Since the maximum tax rate of the corporation is 48 percent, substantial income tax savings are possible by incorporating the business and keeping 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. The farmer who incorporates may be able to avoid this rule by transferring all farm assets to the corporation and receiving 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 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 the 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 allows 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-

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

sheltered, qualified pension or profit-sharing plan than if the money were invested for retirement by a farmer outside of such a plan.

Table 1. Comparison of corporate and non-corporate pension plans.

	Sole[1] 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 5 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

[1]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 3 percent of 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 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 inexpensive way to purchase life insurance is not available to the unincorporated farmer.

Housing: In some farm and ranch situations, the corporation can 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 commodities in November or December to avoid having to pay the income taxes for 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 until August 31 of the following year without having any impact on total tax liability.

Change of accounting method: The corporation can choose an accounting method that is different from that of a farmer as an individual.[3] 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 accrual to cash, can frequently reduce the farmer's tax liability and increase net farm profits.

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

Using Incorporation as a Management Tool

The following example illustrates the potential benefits to be derived from using the corporate form of business organization to reduce or eliminate several of the problems which have been previously mentioned:[4]

The farmer is 55 years of age and his wife is 52. They have a 28-year-old son who is married, has two children and is an active participant in the farm business. Their 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) $298,800 in federal estate taxes. At her death, the estate will owe an additional $733,800 (Table 3). Total federal estate taxes of $1,032,600, 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. This 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.

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, 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

[4] 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.

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

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
Taxable estate	$1,000,000	$2,000,000
Estate tax	$ 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 non-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.

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: 900 shares of stock, worth $2,000 per share (for a total of $1,800,000), and $200,000 of 8 percent debentures. 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 8 of the 10 shares of common stock to his son and sells the remaining 2 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. Over time 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.[1]

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
Total stock	$2,000,000		

[1]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 educational purposes.

Common Stock

By gifting or selling the common stock the farmer has provided an incentive to his son and his key employee since increases 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. 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 8 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 earnings are subject to the federal income tax rate of 70 percent. If, however, the farm business were 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 computed. Table 6 provides an illustration of the additional tax savings available from a farm corporation.

Table 5. Example — income tax savings of corporation vs. 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 dividends 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 an 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 products without incurring additional tax liabilities by choosing a fiscal year to minimize marketing problems. Many farmers have been delaying sale of their product 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, the farmer 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 farm in this example is a wheat operation with harvest normally in August, the farmer may wish to select a corporate fiscal year of August 1 to July 31. With this fiscal year, wheat can be sold anytime after harvest until the following July 31 without affecting 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 vs. the calendar year of the sole proprietor is explored in Table 7. The farmer who has been delaying sales into the next year is able, after incorporation of the farm business, to sell in the year of harvest without any 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 taxes due on the sale of 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 and his wife have been able to provide for an equitable distribution of the estate between their children and have been able to do so while maintaining operating control of the farm firm. At the same time, they have been able to provide very strong incentives for the key employee and for their son to remain in the farming operation. They have provided for their own retirement with the option for more liberal retirement programs through the corporation. Finally, they have the opportunity to reduce their income tax. The farmer 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 the farmer 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, the farmer can provide funds for farm expansion and operating expenditures while significantly reducing income tax liability. During retirement, the farmer and his wife may also sell some of their remaining stock to their son to provide additional funds for retirement and to reduce the taxable estate still more. Proceeds from the sale of additional stock to the son can be used as a source of cash to pay any estate taxes owed upon the eventual death of the farmer.

Table 7: Reduction of income tax by change of tax year.

Year product produced	Year product sold and taxes owed	Taxable income on 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[1]

[1]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.

Disadvantages of Farm Incorporation

Disadvantages of farm incorporation can offset many or all of the advantages of incorporating a farm. Some of these disadvantages include loss of the protection of the federal bankruptcy 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 exemption 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 continuing costs of establishing and maintaining the corporate form. Filing fees and legal fees must 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 to farm corporations. Federal Land Bank and Production Credit Association loans may only 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, including the "locking in" of capital and unfavorable tax treatment of ordinary income losses, capital gains and capital losses. There are also 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, obtain competent legal and accounting assistance to evaluate the advantages and disadvantages of a corporation for your particular farm and personal situation.

The State is truly our campus. We desire to work for all citizens of the State striving to provide the best possible educational and research information and its application through Cooperative Extension in order to provide a high quality food supply, a strong economy for the State and a quality of life desired by all.

Auttis M. Mullins
Dean, College of Agriculture
University of Idaho

SERVING THE STATE

This is the three-fold charge of the College of Agriculture at your state Land-Grant institution, the University of Idaho. To fulfill this charge, the College extends its faculty and resources to all parts of the state.

Service ... The Cooperative Extension Service has active programs in 42 of Idaho's 44 counties. Current organization places major emphasis on county office contact and multi-county specialists to better serve all the people. These College of Agriculture faculty members are supported cooperatively by federal, state and county funding to work with agriculture, home economics, youth and community development.

Research ... Agricultural Research scientists are located at the campus in Moscow, at Research and Extension Centers near Aberdeen, Caldwell, Parma, Sandpoint, Tetonia, Twin Falls and at the U.S. Sheep Experiment Station, Dubois and the USDA/ARS Soil and Water Laboratory at Kimberly. Their work includes research on every major agricultural program in Idaho and on economic and community development activities that apply to the state as a whole.

Teaching ... Centers of College of Agriculture teaching are the University classrooms and laboratories where agriculture students can earn bachelor of science degrees in any of 20 major fields, or work for master's and Ph.D. degrees in their specialties. And beyond these are the variety of workshops and training sessions developed throughout the state for adults and youth by College of Agriculture faculty.