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Family Farm and Cooperative Corporation Exceptions of North Dakota Corporate Farming Statute

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FOREWORD

This report is the first of two discussing North Dakota's corporate farming statute. The research was conducted as part of ND 3353--Analysis of Laws Affecting Agriculture with the results initially presented in an unpublished Masters paper prepared by the author. Drs. Donald F. Scott, William C. Nelson, David W. Cobia, and F. Larry Leistritz and Mr. Richard B. Crockett served as committee members, reviewers and helpful sources of information. To them and Ms. Cindy Danielson who typed the manuscripts, the author extends his grateful thanks.

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HIGHLIGHTS

North Dakota's corporate farming statute, after nearly 50 years without changes, was amended by both the 1981 and 1983 sessions of the state legislature. The statute continues to prohibit corporations from owning or operating farmland within the state but includes several exceptions of which two pertain to farm businesses which select a corprate business organization. These two are the domestic family farm corporation and the cooperative corporation exceptions.

As a consequence of the requirements specified in statute, managerial personnel of farm corporations will need to pursue strategies that assure compliance. These strategies will include imposing restrictions on the transfer of shares in order to limit shareholders to fifteen relatives and dividing the family's properties so at least 65 percent of the corporation's income is derived from farming operations but less than 20 percent is received from passive sources.

Several statutory requirements can have more than one interpretation. These ambiguities, once identified, may be corrected during the 1985 legislative session. Points needing clarification include 1) whether beneficiaries of trusts permitted to own shares are required to be related to just one shareholder or to all shareholders and 2) what is meant by "actively engaged in operating the farm," "operating the farm," and "actually engaged in farming."

FAMILY FARM AND COOPERATIVE CORPORATION EXCEPTIONS OF NORTH DAKOTA CORPORATE FARMING STATUTE

by

David M. Saxowsky

North Dakota, since 1932, has prohibited corporations from owning farmland within the state. Not until the 47th session of the North Dakota legislature (1981) was this general prohibition amended to allow family farms to incorporate and own farmland. This exception, however, is available only if the organization meets all the requirements set forth by statute. The 48th session of the legislature (1983) again amended the statute to resolve ambiguities of the 1981 law and allow additional types of corporations to own farmland in North Dakota but under more restrictive circumstances than is required of family farm corporations.

This report presents a brief history of North Dakota's corporate farming statute and explains the law as it exists after the 1981 and 1983 amendments. Ideas for managing a corporation owning farmland in North Dakota to reduce the possibility of violating the statute are discussed. This report is not a discussion of corporate tax law nor of general principles for using the corporate business structure.

There are four sections in this report. The first section presents background information about the corporate farming statute. This information is categorized as pre July 1, 1981; after June 30, 1981; and current statute. The second section is an explanation of the general prohibition against corporations owning farmland or engaging in farming in North Dakota. An exception for cooperative corporations is explained in the third section. The fourth section discusses the seven requirements of the domestic family farm exception including the relationship requirement and strategies to minimize the risk of violation. This section also describes the mandatory reports for domestic family farm corporations and the enforcement procedure.

I. Background

A. Pre July 1, 1981

North Dakota has had a corporate farming law since 1932. That year, during the depth of the great depression, an initiated measure was passed by the voters of the state prohibiting domestic and foreign corporations from "engaging in the business of farming or agriculture."[1] The measure, which resulted in part from a concern over ownership by corporations of farms and farmland acquired primarily through foreclosure,[2] also prohibited all corporations "from acquiring and holding real estate" regardless of its use.

Corporations owning real estate on the day the initiated measure was approved were required to dispose of the property within 10 years but were allowed to farm the land until disposition. If the real estate had not been disposed of within the established period, the state's attorney was empowered to institute an action for the title to escheat to the county in which the real estate was situated. The county had one year to sell the real estate at public auction to the highest bidder and return the proceeds, minus expenses, to the corporation.

Three exceptions were included in the law. The first exception allowed cooperative corporations to own real estate or conduct farming or agricultural business if 75 percent of the members or shareholders were actual farmers, residing on farms or depending principally on farming for their livelihood. The meaning of these requirements has never been expanded.

Second, corporations could own real estate but not "in excess of that necessary for the conduct of their business." This exception, however, did not explicitly allow the landowning corporation to farm the land. Likewise, the general prohibition against corporations engaging in farming or agriculture prevented any argument that the land was necessary to conduct a farm business. It was implicit that corporate ownership of necessary real estate was permitted only for businesses in which corporations could lawfully engage.[3]

The third exception allowed corporations to acquire real estate as long as the acquisition occurred in the course of corporation business and by judicial process or operation of law such as foreclosure. Without this exception, corporations such as insurance companies and banks would have discontinued lending capital to landowning farmers on the basis that mortgages were not security. Real estate acquired under this provision and not necessary to conduct the business of the corporation must have been disposed of within 10 years after acquisition or be subject to escheatage. Corporations could farm and use the real estate for agricultural purposes during the period of ownership.

The 1933 legislature amended the law by deleting the prohibition against acquiring and holding real estate but required all corporations holding rural real estate, used or usable for farming or agriculture, to dispose of it within 10 years.[4] This allowed corporations to retain nonrural real estate as well as rural real estate not usable for farming or agriculture. The legislature also provided that the 10-year limitation was a covenant running with the land against successor corporations which prevented the law from being evaded by simply transferring real estate to another corporation just before the 10-year period had passed.

In 1935, the legislature again amended the statute by expanding the section of the statute which declared title to real estate owned by corporations to be valid and legal regardless how ownership was acquired.[5]

After the 1935 amendments, the corporate farming statute prevented farm operators from incorporating their businesses but allowed nonfarm corporations to own and farm land for 10 years after acquiring the real estate. Similarly, it did not prohibit corporations from re-acquiring their land sold at the county public auction nor effectively penalize the corporation for engaging in farming.

Some farmers avoided the statute by organizing their businesses as joint stock companies. These companies had many of the same features as a corporation but did not violate the letter of the law which only addressed corporations. The 1978 Census of Agriculture indicated 131 corporations operating farms within the state,[6] further evidence that the law did not prevent corporate farming.

Attempts to amend the statute were made both in the legislature and by use of the initiative.[7] Some of the attempts were to prohibit or more severely penalize corporations that engaged in farming. Other attempts to amend the statute would have eased the statute by allowing certain corporations to farm.

Recent legislative sessions during which amendments to the corporate farming statute were introduced include 1959, 1961, 1963, 1967, 1969, 1971, 1979, and 1981. In 1967, the legislature passed a bill allowing certain closely held corporations to farm.[8] The bill was vetoed by the governor but the veto was overridden by the legislature. Sufficient referral petitions were filed to place the question on the 1968 general election ballot and the measure was defeated at that time.[9] In addition, the voters, in 1974, defeated an initiated measure to amend the statute.[10] The statute remained unchanged until 1981 despite the numerous attempts to amend it.

B. After June 30, 1981

The 1981 legislature continued the general prohibition against corporations owning land within the state.[11] Likewise, it continued the exception for cooperative corporations[12] and included, for the first time, an exception allowing family farms to incorporate and own land.[13] The legislature discontinued the "reasonably necessary" exception for businesses and modified the exception for corporations that acquire land through process of law in the collection or enforcement of debts and mortgages.[14] Land acquired under this last exception must be divested within three years of acquisition rather than 10 years as allowed by pre-1981 law.

The 1983 legislature addressed at least six bills that would have amended the corpoate farming statute but only two were signed into law. The first established an exception allowing corporations engaged in surface coal mining activities to own or lease farmland that is reasonably necessary in the conduct of its business. The second bill passed late in the session and clarified ambiguities of the 1981 law. In addition, it included exceptions for 1) tax-exempt nonprofit organizations and 2) corporations involved in development of land for residential or commerical purposes. This last exception as well as some of the requirements imposed on tax-exempt nonprofit organizations will expire on June 30, 1985.

C. Current Statute

The current statute continues the general prohibition that no corporation may own or lease land used for farming or ranching nor may any corporation engage in the business of farming or ranching. Although the statute provides six exceptions to this general rule, this report emphasizes only the two exceptions which apply to current farm operations; that is, domestic family farm corporations and cooperative cooperations. A subsequent department report describes the other exceptions in addition to presenting suggestions for consideration by the upcoming legislature.[15]

II. General Prohibition

The range of activities prohibited by the current law is more encompassing than the 1932 initiated measure as originally passed or amended. Corporations are now prohibited from 1) owning land used for farming (read farming to mean "farming or ranching" and farm as "farms or ranches"), 2) leasing land used for farming, and 3) engaging in the business of farming. Farming is defined by the statute to mean:

> Cultivating land for production of agricultural crops or livestock, or the raising or producing of livestock or livestock products, poultry or poultry products, milk or dairy products, or fruit or horticultural products. It does not include production of timber or forest products, nor does it include a contract whereby the processor or distributor of farm products or supplies provides grain, harvesting, or other farm services (NDCC 10-06-01.1).

The objective of the statute is to prohibit corporations from owning or leasing land used for farming or engaging in the business of farming yet allow North Dakota farm families to incorporate and benefit from the corporate business organization without being in violation of state law.

Joint stock companies are explicitly defined as a corporation for purposes of the new corporate farming law.[16] Existing joint stock companies engaged in farming will be forced to adjust their operation to conform with the statute. The Attorney General, in a letter to the Secretary of State dated August 14, 1981,[17] explained that he does not consider joint stock companies as domestic corporations since they have not been issued certificates of incorporation. Furthermore, the Attorney General advised the Secretary of State to reject any purported annual corporate farm reports unless submitted by a business that has been issued a certificate of incorporation. The Attorney General has stated that his office will be gathering information about joint stock companies and prosecuting violators.

III. Cooperative Corporations

The cooperative corporation exception is essentially unchanged since the 1932 initiative. A cooperative corporation, in order to be exempt, must have 75 percent of its members actual farmers residing on farms or depending principally on farming for their livelihood[18]. This appears to require shareholders to be 1) actual farmers residing on the farm, or 2) actual farmers depending principally on farming for their livelihood. However, it could be argued that the law is requiring the shareholders to be either 1) actual farmers residing on the farm, or 2) (persons) depending principally on farming for their livelihood. The second group of the latter interpretation would allow anyone, including absentee landlords, to use a cooperative corporation as long as they depend on the farm as their principal source of livelihood. The first interpretation more closely aligns with the spirit of the statute although it is not clear from the statute that the second interpretation could not be made.

This is a unique exception for two reasons. First, no other state corporate farming statute explicitly exempts cooperatives. Second, the features of a cooperative offer owners of a farm operation a distinctively different alternative form of business organization. These features include one vote per member regardless of the amount of ownership and the requirement that all remaining net proceeds be distributed unless the cooperative's articles of incorporation or bylaws provide differently.

One question remaining after the 1981 legislature session was whether cooperative corporations are subject to the requirements of the family farm exception. Amendments by the 1983 legislature suggest that cooperative corporations are not subject to these additional requirements. The clearest indication was the elimination of all reference to "members" in the requirements of the family farm exception. This indication was implicitly confirmed by the Secretary of State in the explanation why references to "members" were being deleted.[19] In addition, Chapter 10-15 of the North Dakota Century Code addresses cooperative associations, delineating powers and responsibilities as well as requiring an annual report. Little would be gained by requiring cooperative corporations to also meet the requirements of the family farm exception because no additional aspects would be regulated; only different (and perhaps conflicting) criteria would be imposed. Finally, infrequent use of cooperative corporations by farm operators minimizes the practical importance of the question.

IV. Domestic Family Farm Corporation

A second group of corporations exempt from the general prohibition is domestic (incorporated in North Dakota) family farm corporations; that is, all shareholders must be related. A foreign corporation (incorporated somewhere other than North Dakota) will need to establish a corporation within the state with all its stock held by family members if they desire to also operate within North Dakota. Similarly, state law does not prevent a family living outside North Dakota from incorporating in the state as long as the other requirements of the statute are met. Whether the other requirements can be met without living in the state will be addressed later.

As of August 1983, 120 farms have been reorganized as domestic family farm corporations. Eighty operations were incorporated during the first year (July 1, 1981 to June 30, 1982), 39 corporations during the second year, and one from July 1, 1983 to the time of this writing. Generally, the corporations do not own land, choosing instead to rent it. This is expected due to the possible burdensome tax liability of dissolving a corporation which owns appreciated property. In addition, most family farm corporations have fewer than six shareholders.[20]

Domestic family farm corporations must meet the seven requirements of section 10-06-07 (NDCC) as well as file requisite reports in order to be exempt from the general prohibition. These requirements will be discussed in the order they are listed in the statute. The relationship requirement is listed second and accordingly is discussed second. This requirement is more complex than it first appears. Consequently, ownership patterns, transfers likely to result in violations and strategies to minimize the risk of violation are addressed before the other five requirements.

A. Who May be Shareholders

A.1. Number of Shareholders

The corporation must not have more than 15 shareholders [NDCC 10-06-07 (1)].

This is not as simple as counting how many persons own stock. If any shares are held by trusts or estates, the number of beneficiaries plus the number of shareholders can not exceed 15. This is discussed in detail under the third requirement (Page 21). A husband and wife each owning stock most likely will be counted as two shareholders, though the statute does not explicitly address the issue. It also appears that each person having an ownership interest in jointly held stock will be counted as a shareholder.

A.2. Relationship Requirement

> Each shareholder is related to each of the other shareholders within one of the following degrees of kinship: parent, child, grandparent, grandchild, brother, sister, uncle, aunt, nephew, niece, great-grandparent, great-grandchild, first cousin, or is the spouse of a person so related [NDCC 10-06-07 (2)].

This requirement is the family feature of the domestic family farm exception. It was written with the expectation that only individuals would be permitted as shareholders and was not changed when provision was made for including certain trusts and estates (see third requirement, page 21). The effect of the relationship requirement upon trusts and estates is addressed as part of the third requirement. The present discussion addresses only individuals and their required relationships.

All shareholders must be related to all ("each of the") other shareholders. Being related to just one other shareholder is not sufficient to meet this requirement. In practice, this requirement may be the one most likely to be inadvertently violated by domestic farm corporations. Shareholders must consider whether current ownership and transfers as well as future transfers will violate the statute. Unless proper steps are taken, uncontrolled transfers of stock can result in a violation sometime in the future.

Several topics are addressed in explaining this requirement. First, examples of ownership patterns permitted by the statute are presented; second, an ownership pattern that violates the statute is explained; third is a discussion of transfers that are likely to result in a violation; and finally, strategies are suggested for managing stock ownership to minimize the risk of violating the statute.

A.2.a. Permitted Ownership Patterns

Each shareholder must be related to all other shareholders as 1) a lineal descendant or ancestor within four generations, 2) a sibling, 3) a child of a sibling, or 4) a spouse of a person who is related to all other shareholders within one of the other permissible degrees of kinship. The statute is not clear whether adopted persons or half-blood relatives are within the scope of the exception.

A hypothetical farm family is used to illustrate permissible ownership patterns. Figure 1 represents a four generation pattern. The statute allows four generations of shareholders as long as the second oldest generation (Bob and Betty) consists of no more than one shareholder and a spouse. The third and fourth generations can include lineal descendants as shareholders limited only by the requirement that the corporation has no more than 15 shareholders.

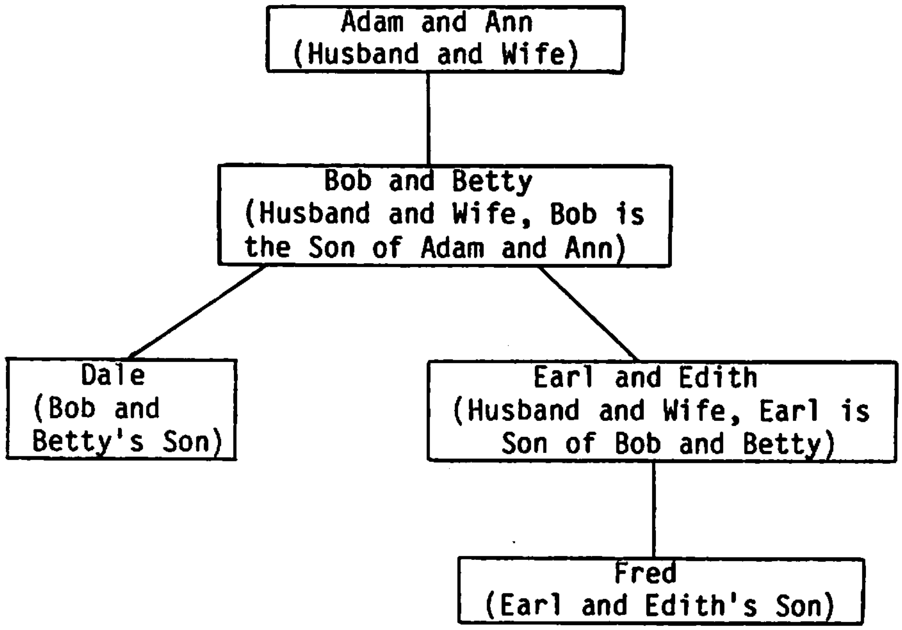

Figure 1. An Example of a Permissible Four-Generation Ownership Pattern

All family members do not have to be shareholders simply because the law allows them to be. For example, members of the third and fourth generations may incorporate and not include either of the two older generations.

Figure 2 illustrates a permissible ownership pattern that includes first cousins. The second oldest generation has two married couples, whereas the fourth generation has been excluded. Similar to the four generation example, all family members do not have to be shareholders simply because the law allows them to be.

Both of these simple examples show patterns of stock ownership by family members that are permissible under the law. However, the result of combining the two would violate the statute.

A.2.b. Volative Ownership Patterns

The statute would be violated if the shareholders allow 1) children of first cousins or 2) grandchildren of their siblings to be shareholders in the same domestic farm corporation. Clearly, shareholders who are more distantly related as well as unrelated persons are not intended to be within the scope of this exception.

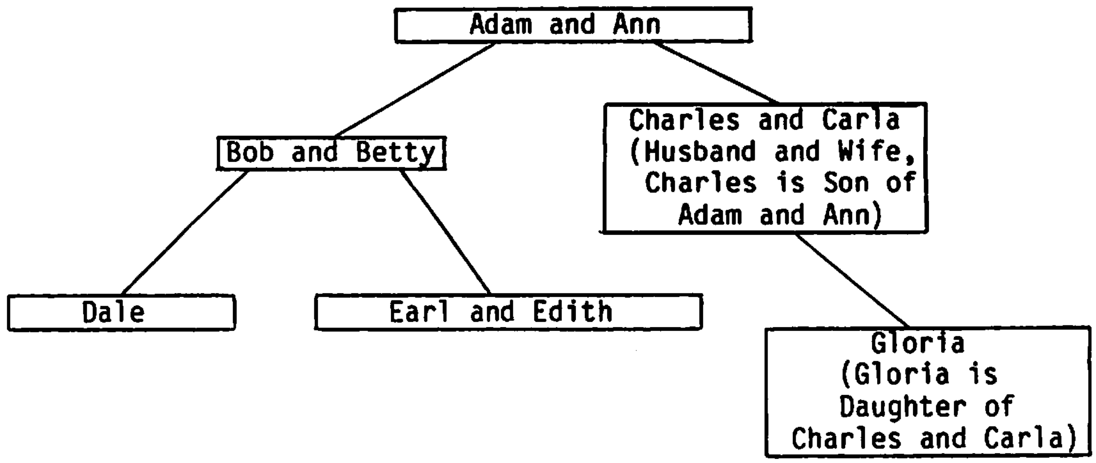

Figure 2. An Example of a Permissible Three-Generation Ownership Pattern

The combined pattern in Figure 3 is the same as the three generation pattern illustrated in Figure 2 except a fourth generation (Earl's and Edith's son, Fred) is included. A corporation with such an ownership pattern would be in conflict with the law because of Fred's relation to his great-uncle Charles, great-aunt Carla and first cousin once removed, Gloria. None of these relationships are listed in the statute as permissible. Likewise, the ownership would be violative even if only members of the two youngest generations are shareholders. Specifically, the relationship between Gloria and Fred would be the culprit.

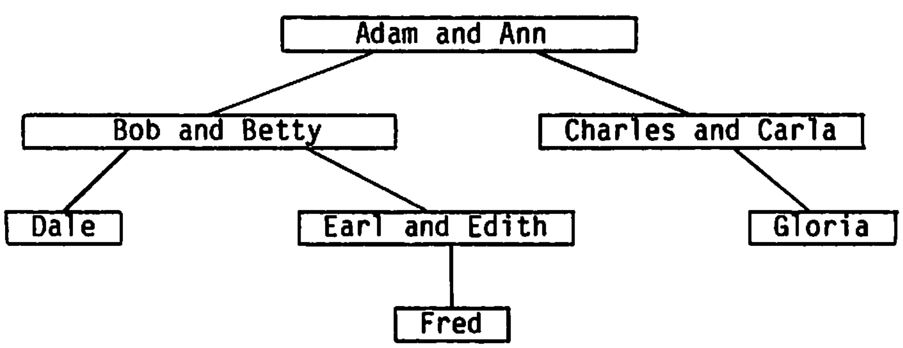

Figure 3. Example of a Violative Four Generation Ownership Pattern

As a general rule, the statute is violated whenever the closest common ancestor of all shareholders is four generations older than the youngest generation of shareholders. This is true irrespective of whether the common ancestor or members of the intervening generations are shareholders. Consequently, if first cousins combine their separate farm businesses into a single corporation, a transfer of stock to any of their children will result in a violation of the relationship requirement.

A.3. Transfers That Could Result in a Violation

Careful planning when incorporating will eliminate any current relationship problem. Future transfers, however, could result in violations if the new shareholder is not related to all the other shareholders within the specified degrees of kinship. The unfortunate aspect is that these transfers can occur almost by accident or as the result of innocent well-intended acts. Shareholders transferring stock as part of their estate planning or in an effort to include their children in the business may not consider the implications the transfer will have upon the relationship requirement. This potential for unexpected violation due to oversignt on the part of shareholders renders management of stock ownership an intergral part of corporate farming in North Dakota.

North Dakota's corporate farming statute does not declare the transfer of stock in a domestic farm corporation to be illegal. Instead, it is the resulting stock ownership pattern that violates the statute. For this reason, the explanation of this requirement is written in terms of resulting in a violation rather than the transfer being illegal.

A.3.a. Transfers of Stock to the Next Generation

Transfer of stock by parents to their children is one type of transfer that could inadvertently result in a violation. Even though the shareholders incorporate with intentions of not transferring stock to someone that would cause a violation, shareholders, over time, will want to pass their property, including their shares of stock, to their children. It would only be a matter of time until the relationship requirement is violated if all shareholders follow this practice. For example, a farm corporation in which members of the youngest generation of shareholders are siblings would violate the statute if this practice is continued for two generations. Only one additional generation needs to be included if any current shareholders are first cousins. Furthermore, inclusion of another generation can occur within a few years if present members of the youngest generation of shareholders already have children to whom they will transfer an ownership interest. Consequently, a corporation that has no current problem with the relation requirement could experience such a problem within a few years as children of present shareholders are transferred shares of stock.

A.3.b. Shareholders Related Only by Marriage

A problem with the relationship requirement also can result from a change in the marital status of shareholders who are not blood relatives of the other shareholders but instead rely on their marriage to meet the statutory requirement. Several questions arise in interpreting the meaning of the statutory language "or the spouse of a person so related." First, will the statute be violated if the spouse of the nonrelated shareholder (that is, the shareholder who is not related by blood but is related only by marriage) is not a shareholder. The language of the statute only requires the spouse upon whom relationship is based to be a "person." The statute does not require the spouse to be a shareholder. Therefore, the statute should be interpreted to mean there is no violation if the spouse of the nonrelated shareholder is not also a shareholder.

A related question is whether two persons, who are each married to a sibling, can form a domestic farm corporation and meet the requirements of the statute even though their spouses (the siblings) are not shareholders? Again the answer appears to be yes because the statute only requires nonrelated shareholders to be married to a person who is related to all other shareholders within the listed degrees of kinship. Each one of the siblings will be the spouse of one shareholder and the sibling of the spouse of the other shareholder and would not violate the words of the statute.

It appears the statute will not allow a nonrelated shareholder to continue as a shareholder after termination of the marriage by either divorce or annulment. At that point, the two persons are no longer spouses and will not be able to rely on their former marriage. A nonrelated shareholder, on the other hand, should be permitted to rely on the marriage even though the couple is separated. In such a circumstance, however, it is probably the related shareholders who are more concerned about violating the statute than the person who will likely no longer be a member of the family.

The next question is whether the nonrelated shareholder can continue to be a shareholder after the death of the spouse. The statute does not explicitly require the person upon whom the relationship is based to be alive. It merely requires the shareholder to be the "spouse of a person so related." The surviving nonrelated shareholder should be able to continue as a shareholder even after the death of the spouse. Any other interpretation would result in undesirable situations.

One such situation would be a farm corporation with four shareholders; a married couple, their son, and a brother of the husband. (An illustration of this situation would be Dale, Earl, Edith, and Fred in Figure 1, Supra.) The wife (nonrelated spouse) and the brother-in-law are related only through the husband; consequently, that is the only basis for allowing both of them to be shareholders. This middle person is removed with the death of the husband. It would seem unfair to force out either the surviving spouse (mother) or brother (uncle) simply because the husband died. Both the wife and the brother may have spent most of their lives working for the business with the hope that someday the son (nephew) will own it. Any other interpretation would force a family to reorganize their farm corporation simply because a married shareholder passes away.

Finally, can the nonrelated surviving spouse continue to be a shareholder after remarriage to a nonfamily member? At this point, the remarried shareholder is no longer the spouse of the relative but is instead the spouse of someone else. The remarried person will most likely be required to relinquish his or her shares of stock. This would be analogous to the estate planning strategy of terminating, upon remarriage, the right of the surviving spouse to property left by the first spouse. In addition, the remarried shareholder would be permitted to sell or give the stock to a related person of his/her choice.

A.3.c. Nonrelated Creditors as Shareholders

The relationship requirement also could be violated as a result of a nonrelated individual or corporate creditor (such as a bank) acquiring ownership of stock that had been pledged by a shareholder as security for a debt. This creditor would not be related to all other shareholders and as a shareholder would result in violation of the statute. Although a third exception allows any corporation to own land acquired as security for indebtedness, that exception does not apply to the acquisition of stock in a domestic farm corporation by a nonrelated entity. The corporation and its shareholders must take steps to resolve this problem.

A.4. Strategies for Managing the Relationship Requirement

Stock transfers can be in the form of a sale, gift, inheritance, or settlement of a legal obligation or property division. Any restrictions placed upon the transfer of stock must take into account all the various forms of transfers as well as the objectives of the family members. The restrictions must be sufficient to assure attaining the goal of not violating the statute and yet provide needed flexibility.

The relationship requirement, as complex as it is, is not insurmountable. Shareholders can and should monitor, as well as anticipate, changes in the ownership pattern. A table is one way to keep track of the shareholders' relationships (Table 1). Each shareholder's name is listed on the vertical axis and corresponds to the same number on the horizontal axis. A key indicates the allowed relationships and those which violate the statute. By maintaining an up-to-date table, the first two requirements (no more than 15 shareholders and each must be related to all other shareholders) should be easier to manage.

Table 1 has been completed using the farm family described in Figure 3 as an example of how the table would be completed. Note that only half of the table needs to be used.

A second strategy for domestic farm corporations to use in managing the relationship requirement is to impose restrictions on the transfer of stock. These corporations will be closely held due to the statutory limitations of no more than 15 related shareholders and will

TABLE 1. RELATIONSHIPS AMONG SHAREHOLDERS OF A HYPOTHETICAL FARM FAMILY CORPORATION

	Name	1	2	3	4	5	6	7	8	9	10	11
1	Adam	-										
2	Ann	2	-									
3	Bob	1	1	-								
4	Betty	1*	1*	2	-							
5	Charles	1*	1	3	3*	-						
6	Carla	1*	1*	3*	3*	2	-					
7	Dale	5	5	1	1	4	4	-				
8	Earl	5*	5	1	1	4	4	3	-			
9	Edith	5*	5*	1*	1*	4*	4*	3*	2	-		
10	Fred	6	6	5	5	8	8	4	1	1	-	
11	Gloria	5	5	4	4	1	1	7	7	7*	8	-

Key:
1 Parent/Child
2 Spouse
3 Sibling
4 Uncle-Aunt/Nephew-Niece
5 Grandparent/Grandchild
6 Great-Grandparent/Great-Grandchild
7 First Cousin
* Spouse of Person so Related
8 All Others and Violates the Statute

use the same types of restrictions imposed by other closely held corporations. Frequently used restrictions include first options to buy for either the corporation or the shareholders, buy-sell arrangements, consent prior to transfer, redemption, and specifying a class of permissible transferees.

All stock transfer restrictions imply a sequence of who will have first opportunity to acquire the stock. First options will grant the holder of the option first opportunity to acquire the stock. Buy-sell arrangements obligate the corporation or other shareholders to acquire the stock. Consent restrictions require approval from the directors or other shareholders prior to consummation of the transfer. Redemption arrangements imply the corporation will acquire the stock whereas specification of a class of transferees limits who may become shareholders in the future.

A closely held corporation generally imposes restrictions to preserve its closely held status and protect itself and shareholders from competitors and other undesired outside influences.[21] North Dakota domestic farm corporations have two additional reasons for restricting the transfer of their stock. First, North Dakota farm corporations are required to own and operate the business as closely held, that is, no more than 15 related shareholders. A second reason to impose stock transfer restrictions is to render inapplicable the statutory sequencing of who will have first opportunity to acquire stock of a selling shareholder.[22] This statutory scheme, intended to protect minority shareholders, is inapplicable if the shareholders have already provided a scheme for the transfer of stock. Statutory protection of minority shareholders will be addressed next followed by a discussion of stock transfer restrictions and how they can be applied to minimize the likelihood of violating the relationship requirement.

A.4.a. Protection of Minority Shareholders

The legislature included in the 1981 law a unique provision to protect minority shareholders from being unable to sell their stock in the family corporation.[23] Minority shareholder is defined by the statute as any shareholder owning less than 50 percent of the corporation's stock. Consequently, nearly all shareholders of domestic farm corporations are minority shareholders and within the scope of this provision if the "terms and conditions for the repurchase of that stock by the corporation or by the other shareholders are not set forth" in 1) the corporate's by-laws, 2) the instrument that conveyed the stock to the shareholder, 3) a shareholders' agreement, or 4) an agreement between the shareholder and the corporation.

The language of the statute would seem to indicate that this provision applies only to shareholders who are attempting to dispose of all their ownership in the corporation; that is, the language of the statute addresses the "withdrawing" shareholder. It would be inconsistent with the purpose of this provision, however, to narrow its application. Shareholders selling less than all their shares in a family farm corporation may encounter the same difficulty of consummating a sale as shareholders who are attempting to dispose of all their interest. Therefore, it would seem appropriate to apply this statutory scheme to all sales of stock by minority shareholders.

If no terms for the repurchase of stock have been established, shareholders desiring to sell their stock must take the following steps in sequence:

1) Offer the stock to the remaining shareholders in proportion to the number of shares owned by them

2) Offer any unpurchased stock to any of the remaining shareholders

3) Offer any unpurchased stock to the corporation

4) Sell any unpurchased stock to any person eligible to be a shareholder. The statute is not clear, but in order to be "eligible," the person must be able to meet the relationship and not cause the corporation to exceed 15 shareholders.

The first three steps are a succession of first options with the fourth step granting the shareholder the right to sell to any person who, as a shareholder, will not cause a violation of the statute.

Selling shareholders are empowered by the statute to bring an action in district court if they had not sold all their shares at a fair price after completing the four sequential steps. The court will direct the corporation or the remaining shareholders to purchase all the unpurchased stock within 12 months of the date of the order. The court also will order that the purchase price be "a fair price" which the statute defines as the value of the stock for federal gift tax purposes. If the purchase is not completed at the end of the 12-month period, the corporation shall be dissolved with the assets first used to pay all liabilities and any remaining assets distributed to the shareholders in proportion to their stock ownership.

Value for federal gift tax purposes is fair market value, which is the price at which property would change hands between a willing buyer and a willing seller with neither under the compulsion to buy or sell, both having reasonable knowledge of relevant facts, both able and willing to trade, and both well-informed about the property and the market for such property. The following factors should be considered in valuating the stock of a closely held corporation:

1) The nature of the business and history of the enterprise since its inception

2) The economic outlook in general and condition and outlook for the industry in particular

3) Book value of the stock and financial condition of the business

4) Earning capacity of the company

5) Dividend-paying capacity

6) Goodwill or other intangible value

7) Sales of stock and size of block of stock to be valued

8) Market price of stocks of corporations engaged in similar line of business having their stocks actively traded in a free and open market (Revenue Ruling 59-60, 1959-1 CB 237).

There are two disadvantages of relying on the statutory scheme. First, if the remaining shareholders do not want to purchase the stock but will do so only to prevent dissolution of the corporation, the most the purchase price will be is the "fair price," or restated, the purchase price will be no greater than the value of the stock for federal gift tax purposes. This conclusion is based on the assumption that the remaining shareholders will not exercise their option thus causing the selling shareholder to initiate a court action. The court will order the remaining shareholders to pay a fair price if it is found that the selling shareholder is not able to sell for such a price.

The remaining shareholders, realizing that they will be forced to pay that price and desiring to save time, may want to complete the purchase when they are first given the opportunity to do so according to the statute. However, they know they will not be forced to pay more than the amount and will refuse to do so. The selling shareholder may be pressured, as a result, to accept a discounted fair price knowing that it will take time, possibly several years, until the scheme of the statute has been followed and that even after the delay, no more than the stated price will be paid.

A second and primary disadvantage of relying on the statutory scheme is that selling shareholders are not able to sell to an eligible person, perhaps their children, without first allowing current shareholders an opportunity to buy the stock. The statute requires that a divesting (selling) shareholder shall first offer the stock to the remaining shareholders. Although this provision assures a sale for minority shareholders, the disadvantages of relying on it may outweigh its benefits.

A.4.b. Imposing Restrictions

As an alternative to relying on the statutory scheme, most domestic farm corporations (like many closely held corporations) will impose restrictions on the transfer of its stock. The most common restrictions imposed on stock are first option, buy-sell arrangements, consent, redemption, and specifying a class of transferees. Courts, however, will enforce only reasonable restrictions; that is, the restriction must serve the best interest of the overall corporation and be reasonable in duration, price, and similar terms. Absolute prohibitions of transfer are never enforced.[24]

Even though restrictions on the free transfer of stock are looked upon by North Dakota courts with disfavor,[25] restrictions are more vital for a farm corporation than other business corporations of the state. Shareholders of a nonfarm business corporation may be disappointed if an outsider acquires stock but the legal status of the corporation is not altered. Farm corporations, on the other hand, will violate state law if an outsider acquires stock in a North Dakota farm corporation and continued violation will result in dissolution of the corporation. It becomes a necessity for domestic farm corporations to restrict their stock.

The North Dakota Supreme Court suggested that the purpose of restricting stock be specifically stated.[26] It may be helpful, in light of this ruling, to state explicitly when drafting restrictions that they are imposed in an effort to minimize the possibility of a statutory violation. Other ideas for the practitioner that can be discerned from recent North Dakota Supreme Court decisions include:

1) Eliminating ambiquity; recent cases have arisen almost entirely due to unclear language of the restriction

2) Addressing all types of transfers that are to be restricted, not just sales; otherwise the restrictions will be enforced only for the specified transfers

3) Explaining the purpose of the restriction

4) Stating that failure to exercise an option or other authority is not a waiver of that authority for later transfers. The language of the restriction should clarify that each waiver applies only to the transfer for which the authority was not exercised

5) Noting restrictions on stock so that later shareholders or transferees have notice that the stock is restricted. Likewise, state law requires restrictions to be noted on the certificate in order to be binding on persons not having actual knowledge of the restriction[27]

6) Keeping restrictions reasonable; assure that there is some arrangement for the stock to be transferred at a fair price even if the transferee is not the person the selling shareholder desires to acquire the stock

Restrictions can be imposed by either the incorporators during formation of the corporation or the shareholders after incorporation. They can be included in the articles of incorporation, by-laws, an agreement between the corporation and shareholders, an agreement among the shareholders, or by the instrument that transferred the stock. Ease of amending the restriction and whether it will render inapplicable the protection of minority shareholders are two considerations in deciding in which document to include the restrictions. It is recommended that restrictions be included in both the articles of incorporation and a shareholders' agreement in order to maximize their effectiveness.[28] The protection of minority shareholders provision, moreover, is not rendered inapplicable if the restrictions are included only in the articles of incorporation (see page 14).

A.4.c. Selecting Type of Restriction Based on Objectives

Incorporators or shareholders, when selecting restrictions, should consider how each implicit scheme of transfer affects the objectives they wish to accomplish. One type of restriction and its implicit transfer scheme may be more appropriate than another type in reaching a desired objective. The primary objectives of imposing restrictions on the transfer of stock, as already discussed, may be to assure that the number of shareholders and relationship requirements are met as well as render inapplicable the provision for protecting minority shareholders. Additional specific objectives for restricting the transfer of stock will vary with each family corporation, but whichever restriction is imposed, it should provide sufficient flexibility for handling unexpected situations that will almost certainly arise in the future. Other objectives of restrictions may be to answer questions such as which family members should be shareholders in the future or who must sell if there are more than 15 shareholders or the relationship requirement is violated. Furthermore, restrictions should not impede estate planning, treat family members inequitably, discourage business growth, nor hinder involving the younger generation in the farm business.

A second consideration when imposing restrictions should be the type of transfer. Incorporators may want to impose one restriction on transfers of stock by sale, gift, or inheritance, and another type of restriction upon transfers arising from pledge, bankruptcy, or divorce. Shareholders of other closely held corporations address the disposition of stock when a shareholder retires. This transfer may not need to be addressed as the retirement of a shareholder probably will not be different than when an unincorporated farmer retires. They usually sell or give their farming assets to their heirs or whomever is assuming their farming operation. Therefore, restrictions on transfers of stock by sale, gift, or inheritance should be sufficient.

A.4.d. Type of Transfer

The first option is one of the more common restrictions imposed by closely held corporations. It, however, may not be the most appropriate restriction for family farm corporations for two reasons. First, holders of the option have no control over who will be offered the stock after they decide not to exercise their options. Consequently, the remaining shareholders will feel forced to buy because they cannot, without risking statutory violation and possible dissolution of the corporation, implicitly grant the selling shareholder unlimited discretion in transferring the stock by deciding not to exercise their options. Nonfarm corporations are not subject to the same statutory requirements, and therefore do not feel pressured to exercise first options simply to avoid violation. Second, first options never allow the selling shareholder to transfer the stock to an eligible person without first granting the remaining shareholders an opportunity to purchase. It would be impossible to transfer stock to a desired transferee if the remaining shareholders exercise their options.

Requiring consent of shareholders or the board of directors may be a more appropriate type of restriction for transfers by sale, gift, or inheritance. Disposing shareholders have an opportunity to select or name in their wills who should have first chance to acquire the stock yet reserve for the corporation some control over the transfer. If the transfer would result in a statutory violation, consent would not be granted and the intended transfer never completed. Shareholders should refer to the transfer restriction in their wills as well as provide for an alternative scheme of disposition, if the first scheme, upon fulfillment, results in a violation.

Consent arrangements can be problematic for two reasons. First, the shareholders or directors may not consent to a proposed transfer simply because they do not want the proposed transferee to become a shareholder even though the resulting ownership pattern would not be violative of the statute. Second, consent arrangements do not obligate the corporation nor remaining shareholders to purchase. The withdrawing shareholder may have little possibility of disposing of the stock if consent is withheld and neither the remaining shareholders nor the corporation agree to purchase the stock.

The first problem is remedied by the legal principal that power of consent must be exercised reasonably and in good faith, not arbitrarily.[29] It may also be helpful to include in the restriction a description of when consent must be given, such as when the transfer is to a child of the shareholder and will not result in a statutory violation. Likewise, enumerate when consent cannot be given, for example, the transfer will produce an ownership pattern that violates the statute. In all other cases, consent is at the discretion of shareholders or directors. This type of guidance should help clarify the purpose of the restriction and reduce future problems. Limitations on consent should be individualized to meet the needs of each farm corporation.

One solution to the second problem would be to couple the consent arrangement with a mandatory buy-sell agreement which would be triggered if the disposing shareholder is not able to identify an acceptable transferee after several attempts within a given time period. This way the withdrawing shareholder always has a buyer. The buy-sell arrangement could permit the buyers to suggest acceptable transferees and, like most buy-sell arrangements, should describe a formula for establishing the price of the stock.

A first option may be the best arrangement in case of a divorce where both spouses were shareholders or the nonrelated spouse acquired stock as part of the divorce settlement. The former spouse could hold the first option with a successive option to remaining shareholders as well as the corporation. A mandatory buy-sell agreement also may be included even though it is unnecessary since the remaining shareholders know that if they do not exercise their options, the corporation will be violating the statute and risking dissolution.

A restriction also should address transfer of stock to a nonrelated creditor whether it be an individual or an entity. Shareholders as well as corporations may pledge stock as collateral but it is more likely that a corporation would pledge its assets rather than stock. The actual pledge will not be a problem since the creditor is not considered a shareholder for simply holding pledged stock. The problem arises when the creditor becomes owner of the pledged stock. Similarly, bankruptcy of a shareholder may cause stock to be transferred to a nonrelative. One approach to resolving this potential problem is to include a mandatory buy-sell arrangement that is triggered if the stock is acquired by a nonrelated creditor. Such a restriction should be supported by a statement that its purpose is to provide an opportunity for the creditor to be compensated, as well as allow the corporation to remove a violation. The buy-sell arrangement could be obligatory upon remaining shareholders or the corporation, whichever is deemed more desirable, and should include a formula for establishing a purchase price.

A.4.e. Alternatives to Restrictions

There are alternatives for managing the relation requirement other than restricting the transfer of stock, although some alternatives are impractical or do not reach desired objectives. One impractical alternative is to involve only one family member per generation. This eliminates all possibilities of violative ownership patterns. Identification of which family member should be the shareholder, however, would have to be delayed until the members of the generations are old enough to formulate or determine interests and career plans. Delaying inclusion of family members as shareholders, in turn, may frustrate estate planning and the equitable treatment of family members.

A second alternative is to issue debt securities rather than ownership (stock) as a means of holding interest in a closely held corporation. Debt, however, does not have an infinite life such as stock. Debt, by its nature, must mature, and as it does, the holders of debt will lose their interest in the corporation. Likewise, due to favorable tax consequences of using debt, the Internal Revenue Service more closely reviews closely held corporations that use debt rather than stock. Families should consider using debt as they structure their farming businesses; however, they should use it for a business reason other than attempting to avoid violating the relationship requirement of state law.

Preferred stock is a third alternative to imposing restrictions to prevent violative ownerhship patterns. Preferred stock could be callable and therefore allow the directors to purchase it from shareholders whose ownership results in a violation of the statute. Callable preferred stock, like debt, would eventually be unavailable as the call privilege is exercised. In addition, it is not clear until a later time who should receive preferred stock or debt and who should receive common stock. This is similar to the problem mentioned as part of the discussion of the first alternative of including only one member per generation. A second class of stock also would prevent the corporation from being able to elect subchapter S status - an election for tax purposes that some farm corporations may consider desirable. Finally, preferred stock, like debt, should be used only if there is a business reason to do so other than to avoid violating the relationship requirement.

A final alternative is for the corporation to split into two separate entities so neither ownership pattern would violate the statute. Shareholders would form a subsidiary once a corporation is in violation of the statute followed by a transfer of stock to separate the organizations.[30] Unfortunately, the resulting corporations may not be viable economic units after a division of the farming assets. Corporation split is an alternative for shareholders to be aware of but it should not be used if there is a better way to eliminate or prevent a violative ownership pattern.

A.5. Individuals and Certain Trusts and Estates

> Each shareholder is an individual, except that any of the following may also be shareholders:
>
> A. A trust for the benefit of an individual or a class of individuals who are related to a shareholder of the corporation within the degrees of kinship specified in this section.
>
> B. An estate of a decedent who was related to a shareholder of the corporation within the degrees of kinship specified in this section.
>
> Neither a trust nor an estate may be a shareholder if the beneficiaries of the trust or the estate together with the other shareholders are more than 15 in number [NDCC 10-06-07 (3)].

This limitation prohibits artificial entities such as corporations or partnerships from owning stock in a family farm corporation. Only individuals and certain estates and trusts are allowed to be shareholders. The exception for trusts was included so that estate planning would not be unduly complicated or restricted. Likewise, the exception for estates prevents family farm corporations from violating the statute every time a person dies owning some stock in the corporation.

Both the number and relationship requirement must be met when a trust or estate owns stock. The number of shareholders is the number of beneficiaries plus all other shareholders, but a person who is both a beneficiary and directly owns stock should be counted as one.

The statute requires beneficiaries of a trust which owns stock to be related to "a shareholder." This implies that the beneficiaries do not need to be related to all shareholders. If that is the case, establishment of a trust is a way to circumvent the relationship requirement. Such a narrow reading, however, is not the spirit of the statute nor the purported intent of the legislature. Most likely the language will be amended or interpreted to require beneficiaries to be related to "all shareholders."

The statute does not specify if the trustee must be a related individual or whether a corporate trustee would be acceptable. Arguably, any type of trustee is permissible as long as the requirements are met by the beneficiaries of the trust. A different interpretation could complicate estate planning for families that have incorporated their farm business.

The definition of a qualifying estate is also ambiguous. The determining factor for the relationship requirement for estates is the decedent and not the beneficiaries as is the case for trusts. The statute requires that the decedent had been related to "a shareholder;" not all shareholders. If the statute is strictly read, more estates would qualify to be shareholders than would living persons; that is, a living person needs to be related to all shareholders but an estate qualifies if the decedent was related to only one shareholder. This, again, does not align with the apparent spirit of the statute.

In amending the statute, it may be appropriate to allow the estate of a deceased shareholder to own stock as long as the number of beneficiaries does not cause the total number of shareholders to exceed 15. This change would not cause any hardship because the decedent, in order to have been a shareholder before death, would have been related to all other shareholders--not just one other shareholder. In addition, few estates will own stock unless the decedent had been a shareholder. This is somewhat stricter than the present statute but does not alter the rule that the beneficiaries do not have to meet the relationship requirement while the stock is owned by the estate. Likewise, it continues to limit the corporation to 15 shareholders and beneficiaries.

A.6. Citizens or Permanent Resident Aliens

> Each individual who is a shareholder is a citizen of the United States or a permanent resident alien of the United State [NDCC 10-06-07 (4)].

Requiring all shareholders to be citizens or permanent resident aliens of the United States should pose no problem for most families. This requirement needs to be addressed, however, if there is a possibility that stock will be owned by relatives who are neither citizens nor permanent resident aliens of the United States. Two possible restrictions to manage the citizenship requirement are 1) a mandatory buy-sell agreement triggered if stock is ever acquired by a person not meeting this requirement, or 2) expansion of when consent to transfer will not be given. This requirement, however, does not prevent citizens living abroad from being shareholders in the family farm corporation.

The statute is not clear whether indirect shareholders, especially beneficiaries of a trust, must be citizens. A trust could be established to involve noncitizen relatives in the North Dakota farm corporation if the statute is interpreted to require only direct shareholders to be citizens. On the other hand, any stock restriction should be broad enough to assure compliance with this requirement if the statute is interpreted to mean that beneficiaries must be citizens or permanent resident aliens.

B. Officers and Directors

> The officers and directors of the corporation must be shareholders who are actively engaged in operating the farm or ranch and at least one of its shareholders shall be an individual residing on or operating the farm or ranch [NDCC 10-06-07 (5)].

There are three requirements in this statement. First, officers must be shareholders who are actively engaged in operating the farm. Second, directors must be shareholders who are actively engaged in operating the farm. Third, one shareholder must be an individual residing on or operating the farm.

This requirement initially posed a problem for persons wishing to incorporate with less than three shareholders. The business corporation statute requires that North Dakota corporations have at least two officers[31] and three directors.[32] The 1981 legislation was not clear whether the business corporation act applied to farm corporations, but if it did (and it certainly would), farm corporations would have to have at least three shareholders who would function as directors and fill the two offices.

The Attorney General issued an opinion stating that corporations with less than three shareholders could have less than three directors;[33] this, however, did not resolve the implicit requirement of needing two shareholders to fill the two offices.

The 1983 legislature resolved these questions. First, it clarified that the business corporation act applies to farm corporations, but in case of conflict, the farm corporation act prevails.[34] An additional amendment now permits a farm corporation with one shareholder to have only one director with the shareholder serving as the director, president, and treasurer. Other offices can be filled by persons who are not shareholders. In the case of a corporation with two shareholders, only two directors are required but both directorships and all general corporate offices must be filled by the two shareholders.[35]

Directors and officers are required to be actively engaged in operating the farm. Unfortunately, neither the 1981 nor the 1983 legislatures defined "actively engaged in operating the farm." The only indication of the meaning of this phrase is found in legislative history from the 1981 session. The sponsors of the law did not intend "actively engaged in operating the farm" to mean material participation as defined by federal tax law.[36]

This lack of definition raises three problems. First, officers and directors of farm corporations have no indication what level of activity is required. Will they be considered actively engaged if other shareholders or employees perform the actual farming operations, or must the directors and officers feed the livestock and drive the machinery? Second, enforcement will be difficult, if not impossible, without a definition. The intent of the legislature may have been to require directors and officers to be more involved in the farming operation than an absentee landlord; but without a definition, the agencies responsible for enforcing the corporation farming law have no guidance. Finally, the vagueness of the statute leaves it open to constitutional challenge.[37]

The third part requires the corporation to have at least one shareholder who is an individual residing on or operating the farm. Several statements can be made about the definitions of various terms assuming the third part of this requirement is more stringent than the first two parts. (The third part of this requirement has no purpose if this assumption is not accepted.)

First, directors and officers do not have to be individuals, and trusts and estates are the only artifical entities permitted to be shareholders; therefore, trusts and estates must be capable of being directors and officers. Consequently, active engagement in operating the farm is possible through agents since estates and trusts only function through their agents.

Second, operating the farm, by the inevitable assumption, is a higher level of activity than actively engaged in operating the farm. As a consequence, directors and officers are not required to operate the farm; and these operations, if not performed by the directors and officers, most likely would be performed by other shareholders or employees of the corporation. Unfortunately, neither the level nor type of activity that constitutes operating the farm have been delineated in the law.

A related question is whether directors and officers can be actively engaged in operating the farm if the operation is performed by a tenant. A cash or nonparticipating share crop lease will not meet the statutory requirement because neither the landlord corporation nor its agents are involved in operating the farm business. Furthermore, income received by the corporation from the operation would be considered rent which is restricted by the statute to be less than 20 percent of the corporation's gross receipts. The limitation on the amount of passive income a farm corporation can receive is discussed in more detail beginning on page 28.

The statute gives no indication whether a participating crop-share lease sufficiently involves directors and officers to regard them as actively engaged in operating the farm. There are actually two concerns in this statement. First, is the corporation "engaging in the business of farming,"[38] or is it simply leasing farmland? The most generally accepted legal test is whether the land owning entity is materially participating in the operation of the business. This test is applied in several different settings throughout federal tax law for resolving whether the arrangement is a lease or a business; e.g. Sections 2032A, 1402, 543, 6166, I.R.C. State courts, however, may decide to apply a different test.

The second concern is, if a corporation is engaging in farming, are the officers and directors sufficiently involved to be considered actively engaged in operating the farm? Again, the answer depends on the definition of this key phrase--actively engaged in operating the farm.

Even if the corporation cannot lease its land, there are alternative arrangements which facilitate the corporation taking a less active role in the farm operation. These arrangements include 1) the corporation being in partnership with an actual operator (who would not have to be a family member) or 2) paying employees of the corporation a portion of production or basing wages on the level of production.

Third, the more stringent requirement includes the alternative that an individual shareholder reside on the farm. Directors and officers, by implication, are not required to reside on the farm because this part would not be requiring anything additional if the directors and officers are expected to reside on the farm.

Fourth, the shareholder who resides on or operates the farm can be a token shareholder, that is, owns as little as one share of stock.

Fifth, a trust or an estate cannot be the sole shareholder of a family farm corporation. There must be at least one shareholder who is a natural person (i.e., an individual), even if the interest is only token. This statement is made assuming that having an indirect interest in the corporation (i.e., being a beneficiary of a shareholding trust or estate) is not sufficient to meet this requirement. If this assumption is not made, a farm corporation does not need an individual direct shareholder as long as one beneficiary resides on or operates the farm.

Sixth, a token individual shareholder who resides on the farm does not need to operate it since the requirement is in the alternative.

Seventh, the definition of residing on the farm is not clear. Does a shareholder have to live on the farm or will a person be considered residing on the farm by living in a nearby town? Shareholder/ employees who commute to the farm will most likely be considered operating the farm and thus meet this requirement because of their involvement in the operation rather than due to their residence. Therefore, the primary question is whether the requirement can be met by an individual shareholder who lives nearby but does not work on the farm? If the answer is no, then, paradoxically, the individual shareholder who works on the farm can live off the farm, whereas a farm corporation which relies on one of its individual shareholders to reside on the farm even though not working on it, must have the shareholder living on the farm. The geographic limitation is not clear and interpretations will vary depending on the perceived purpose of this alternative.

There is some concern that the death of the individual shareholder who is either residing on or operating the farm will leave the corporation in violation of the statute and subject to potential dissolution.[39] This concern can probably be overcome by ensuring that a surviving family member who resides on the farm owns some stock and thus meets the requirement even though this individual is not operating the farm.

A synthesis of these statements demonstrates that this requirement does not prevent farm corporations from functioning as absentee landlords. All requirements are met if the corporation has 1) an individual shareholder residing on the farm even if he or she is not involved in its operation; and 2) directors and officers actively engaged in operating the farm even though they do not operate or reside on the farm. The corporation could be in a partnership with the actual farm operator, or the corporate employees' pay could be based on production. The corporation, in such arrangements, could have a minor role in the actual farm operation as long as the directors and officers are considered actively engaged in operating the farm.

The 1985 legislature should define "actively engaged in operating the farm" and "operating the farm" in an effort to resolve some of these problems. Operating the farm could mean performing day-to-day activities of farming including both physical efforts and daily low-level management decisions. The legislature should also eliminate residency by an individual shareholder as a means of complying with the statute. These changes would assure that each corporation has at least one shareholder who is a natural person actually operating the farm.

The definition of actively engaged in operating the farm should emphasize management since that is the responsibility of directors and officers, but their involvement in management should be more than establishing general corporate policy. Perhaps directors and officers should be required to be involved on a regular basis (weekly or biweekly) to review current corporate activities and make management decisions about important farm activities such as planting, harvesting, and marketing.

These definitions will not adversely affect farm families because the shareholders/directors will often be the persons actually operating the farm. Problems will arise primarily when the owners and managers are not the persons actually performing the farming activities; that is, those situations in which the individuals were never intended to be allowed to incorporate.

C. Income Limitations

C.1. Income Derived from Farming Operations

> An annual average of at least 65 percent of the corporation's gross income over the previous five years, or for each year of its existence, if less than five years, shall have been derived from farming or ranching operations [NDCC 10-06-07 (6)].

The purpose of this requirement is to assure that the major activity of the corporation is its farming operation but still allow some minor nonfarm activities. A family with a substantial nonfarm business will want to exclude it from the farm corporation and perhaps form an additional business corporation, if necessary.

The legislature included a five-year time period for computing whether 65 percent of the corporation's gross income is from farming operations. Unfortunately, the statute is not that clear. The legislature most likely meant to require that

> at least 65 percent of the corporation's gross income over the previous five years (or for its existence, if less than five years) shall have been derived from farming or ranching operations.

Legislative history suggests that this interpretation was intended to reduce the possibility of a statutory violation in years of poor production, low prices, high rate of storage, or low farm income.[40]

Information necessary to determine whether the test is met is the corporation's total gross income and gross farm income since the corpora-tion's inception or for the five most recent years, whichever is shorter. Gross income is not defined by the statute and one possible meaning is total cash received by the corporation. A second meaning would be to include changes in inventory and accounts receivable as well as cash.

The statute does not specify how to compute the percentage. One method (call it Method A) is to total both the corporation's gross income and gross income derived from farming activities for the past five years. The percentage would be computed from these two totals. A second method (Method B) is to compute a percentage for each year and average the five percentages. These two methods produce different numeric results and, in some cases, different legal results (Table 2). The difference is due to the weights the methods placed on the data. The first method appears more logical because dollar amounts rather than percentages are emphasized.

The 1985 legislature should amend this requirement to clarify its meaning, define gross income, and designate a method of computing the percent of gross income derived from farming.

TABLE 2. METHODS OF COMPUTING THE PERCENT OF THE CORPORATION'S GROSS INCOME DERIVED FROM FARMING

	Example 1			Example 2		
Year	Total Gross Income	Farm Gross Income	Annual %	Total Gross Income	Farm Gross Income	Annual %
1	$ 34,000	$ -0-	-0-	$ 60,000	$ 60,000	100
2	160,000	126,000	78.75	90,000	60,000	66.7
3	102,000	68,000	66.7	90,000	60,000	66.7
4	102,000	68,000	66.7	130,000	60,000	46.1
5	102,000	68,000	66.7	130,000	60,000	46.1
Total	$500,000	$330,000		$500,000	$300,000	
Average*						
Method A	66%			60%		
Method B			55.75%			65.1%

*Method A: Farm gross income/total gross income.
Method B: Simple average of the annual percentages.

C.2. Income Derived from Passive Sources

> The corporation's income from rent, royalties, dividends, interest, and annuities does not exceed 20 percent of the corporation's gross receipts [NDCC 10-06-07 (7)].

This requirement assures the corporation does not function primarily as a holding company deriving income from passive sources. If there is a possibility of substantial passive income, its source should not be included in the farm corporation. An example would be mineral interests. This requirement also prevents a family from incorporating just to own land for leasing to actual farmers. The intent is to prevent corporations from leasing out land rather than farming it. If the test of federal tax law is adopted, the corporation will need to materially participate in the farm business in order to assure the income is derived from farming rather than being classified as rent.

Passive income must not exceed 20 percent of the corporation's gross receipts whereas the previous requirement was that at least 65 percent of the corporation's gross income must be derived from farming. Whether gross receipts has the same meaning as gross income is not clear from the statute but the use of different terms suggests a difference in meaning. Gross receipts, however, should mean cash received by the corporation regardless of the meaning of gross income.

Furthermore, this requirement must be met each year (there is no provision for a five-year average). Consequently, it could easily, yet inadvertantly, be violated. A decrease in income from active sources could result in a violation even though the amount of income from passive sources remains constant. This is especially a problem if income from active sources drops due to low prices, poor production, high rate of storage, or overall low farm income.

D. Reports

D.1. Initial Reports

North Dakota farm corporations must file an initial report before they may commence farming or ranching[41] and annual reports each year after incorporating[42]. The initial report, to accompany filing the articles of incorporation, was included in the 1983 amendments to clarify that existing corporations and joint stock companies cannot begin to treat themselves as farm corporations without creating a new entity. The Secretary of State will publish, upon receipt of an initial report, a notice in a newspaper of general circulation in each county in which the new firm owns or leases any land. This notice will include the names of the corporation and each shareholder, a statement that the corporation has reported it owns or leases land used for farming within the county and that a description of the land is available for inspection at the Secretary of State's office.

The number of counties in which the notice must be published is broader than the prescribed statement. The notice must be published in all counties in which the corporation owns or leases any land regardless of its use. The statement in the notice, nevertheless, is that the corporation owns or leases land used for farming. It is possible a corporation owns or leases land in a county that is not used for farming, but the required notice will lead readers to believe the firm controls farmland within the county.

Six specific pieces of information to be included in the initial report are:

1) Name of the corporation.

2) Name and address of each shareholder.

3) "Each shareholder must be related to each of the other shareholders within one of the following degrees of kinship."

4) A statement that the shareholders are citizens or permanent resident aliens of the United States.

5) A statement that at least one shareholder is actively engaged in operating the farm.

6) The description and acreage of all land in the state owned or leased by the corporation.

The third item reads more like an overall requirement for farm corporations rather than specifying what information must be included in the initial report. The legislature could have meant that the incorporators were to simply include a statement that all shareholders are related to one another within the degrees of kinships allowed by law or the language could mean the incorporators are to specify the relationships among all shareholders.

The Secretary of State has taken the position that the legislature intended the second interpretation;[43] that is, the interpretation which best facilitates early detection of whether the relationship requirement is being violated. The initial report form, however, does not allow adequate space for this information. A better format would be to have the incorporators complete a table which clearly indicates the relationships among all shareholders. This table could be similar to the one presented in the discussion of managing the relationship requirement (see Page 13).

Assume a corporation with five shareholders: 1) Dad; 2) his spouse, Mom; 3) Dad's first cousin, Fred; 4) Dad and Mom's son, Joe; and 5) Dad and Mom's grandson, Jack. If the present question on the initial report form is answered with this information, it may look like this:

Name	Address	Kinship
Dad	Hometown, ND	
Mom	Hometown, ND	Spouse
Fred	Hometown, ND	First Cousin
Joe	Hometown, ND	Son
Jack	Hometown, ND	Grandson

This only indicates each shareholder's relation with dad but not with any other shareholder. This corporation may appear legal but it is not. Joe is Fred's first cousin once removed--a relation not permitted by the statue--but this is not obvious from the reported information.

The suggested format (Table 3) would indicate all relationships and, as shown, only half of the table needs to be completed.

The fifth item does not request that all directors and officers are actively engaged. It appears that the corporation has until the due date of the first annual report to be sure that all directors and officers are actively engaged in operating the farm. This statement must also include that at least one shareholder is an individual residing on or operating the farm. The second part of this reporting requirement may need to be amended to maintain consistency if the corresponding requirement is changed; that is, to require the individual shareholder to operate the farm, not just reside on it.

TABLE 3. SUGGESTED FORMAT FOR A TABLE IN THE CORPORATE FARM REPORT FOR INDICATING THE RELATIONSHIPS AMONG ALL SHAREHOLDERS

	Dad	Mom	Fred	Joe	Jack
Dad	-				
Mom	2	-			
Fred	7	7*	-		
Joe	1	1	8	-	
Jack	5	5	8	1	-

Key: 1 Parent/Child
2 Spouse
3 Sibling
4 Uncle-Aunt/Nephew-Niece
5 Grandparent/Grandchild
6 Great Grandparent/Great Grandchild
7 First Cousin
* Spouse of Person so Related
8 All Others and Violates the Statute

The land description must contain the section, township, range, and county in which it is located. These parcels must be listed regardless of their use.

D.2. Annual Report

The second report farm corporations are required to file is the annual report.[44] This report is different than the annual report for business corporations[45] and is generally considered to substitute for the business corporation report rather than require an additional report. The statute does not explicitly state this, but this is how it is being applied.[46] An argument in support of this interpretation would be as follows: the farm corporation law and business corporation law are in conflict in that each requires an annual report; and since the statute explicitly states that the farm corporation law takes precedence on conflicting points,[47] farm corporations need to file only the annual report for corporate farming.

The farm corporation annual report requests information primarily to aid government agencies determine whether the corporation is in compliance with the statute even though it does require some information desired by persons contemplating doing business with the corporation.[48] The annual reports are to be filed with the Secretary of State prior to April 15 for the year ending the preceding December 31. The specific requirements of the report are easy to understand except two--subsections 5 and 6.[49] These two subsections are incomprehensible at best.

The requested information could be better understood if the numerated subsections of Section 10-06-08 NDCC were rewritten as follows:

1) Name and address of registered office of the corporation.

2) Name and address of the registered agent.

3) Name and address of officers and directors and whether each is actively engaged in operating the farm.

4) A. Name and address of each direct shareholder, the number of shares owned by each and whether they are individuals, trusts, or estates.

   B. Name and address of beneficiaries of shareholding trusts and estates, which beneficiaries are also direct shareholders, and percent of the trust or estate each beneficiary is entitled to.

   C. Names of all individuals currently with either direct or indirect ownership interest in the corporation, whether each is a citizen or permanent resident alien of the United States, and who are operating (or residing on) the farm.

   D. The relationships among all direct shareholders, beneficiaries of trusts, and decedent of stock-owning estates.

   E. Names and addresses of all persons who owned stock during the past year but were no longer a shareholder on December 31.

5) Description and acreage of all land owned or leased by the corporation and used for farming or ranching listed by section, township, range, and county.

6) Percent of gross receipts derived the past year from passive income sources.

7) Percent of gross income derived from farming for the last five years or since incorporation, whichever is shorter.

E. Enforcement

The Attorney General, Secretary of State, and Tax Commissioner are charged with enforcing the statute. The Secretary of State is to review annual reports, whereas the Tax Commissioner is to select at least 5 percent of the income tax returns of corporations reporting income from farming and compare these with the annual report filed with the Secretary of State. Both the Secretary of State and Tax Commissioner are to report apparent violations to the Governor and Attorney General.[50] The Attorney General is to select at least 5 percent of the corporations authorized to farm and request further information to determine whether corporations are in compliance with the statute.[51]

Two types of violations are delineated in the statute. First, failure to file a report or willfully filing false information is punishable by up to one year in prison, a $1,000 fine or both.[52] The second possible violation is broadly defined to include holding land or conducting the business of farming in violation of the corporate farming law.[53] The Attorney General is directed to bring suit in the district court of the county in which a substantial portion of the farm in violation of this law is located. Likewise, notice of the pending action must be filed with the register of deeds in each county in which any portion of the land is located. This could mean any land the corporation controls but more likely is intended to mean any land that is purportedly in violation of the corporate farm statute.

The district court, if it finds the land is held or the corporation is conducting the business of farming in violation of the statute, shall enter an order so declaring and set a time period in which the corporation must divest itself of all land owned or leased in violation of the statute and cease all farming operations. Maximum time period for divestiture is one year from the date of the order. The Attorney General is required to have the order recorded with the register of deeds in each county in which any portion of the land is located. Again, there is the problem of not knowing with certainty what land is intended to be encompassed by the statutory language.

Corporations failing to comply with the divestiture order shall be dissolved by the Secretary of State with the land sold by public sale. The order to divest will be binding on successor corporations not authorized to conduct farming operations. The Attorney General also is empowered to bring suit to have prospective violations enjoined, and to dissolve the corporation, according to law, if there are continued violations of the statute.

Any authorized farm corporation or resident of legal age in the county in which land is located may bring an action in district court seeking a declaration that land is held or a corporation is conducting the business of farming in violation of the law.[54] If the court finds the statute violated, all costs, including attorney fees, will be assessed to the violating corporation and it will be ordered to divest the land held in violation and cease all farming operations. However, all costs, including attorney fees, will be assessed against the person who brought the action if it is found that the corporate farming statute was not being violated.

Dissolution of the corporation can be a large price to pay for violating the statute. In addition to having to dispose of the land and cease farming operations, the tax consequences of dissolving a corporation can be burdensome. Families intending to incorporate their farming business must take care that the statute is not inadvertantly violated - something that, as discussed earlier, is easily possible. This is especially important since the statute requires divestiture and does not explicitly permit the violating corporation to continue farming after correcting the situation, such as, buying out the 16th shareholder.

V. Summary

North Dakota statutory law for half a century explicitly prohibited corporations from engaging in the business of farming and implicitly prohibited them from owning farmland. The 1981 and 1983 legislative sessions amended the statute to allow families to incorporate their farm businesses. Complexities and emotions surrounding this topic, however, will cause it to be reviewed again by the 1985 legislature. This report presented ideas for managing an incorporated farm operation to reduce the risk of violating state statute whereas a subsequent departmental report will present suggestions for consideration by the upcoming legislature.

North Dakota's corporate farming statute continues to prohibit corporations from owning land used for farming and from engaging in the business of farming. Although there are six exemptions to this general rule, this report addresses only two--cooperative corporations and domestic family farms.

Managerial personnel of a family farm corporation will need to assure that the corporation is complying with the statutory requirements that: 1) there are no more than 15 shareholders, 2) all shareholders are individuals or certain trusts or estates, 3) individual shareholders are citizens or permanent resident aliens of the United States, 4) the officers and directors are actively engaged in operating the farm, and 5) the level of passive income does not exceed 20 percent and that the level of income derived from farming operations exceeds 65 percent.

Directors, officers, and major shareholders of family farm corporations, through management, must reduce the risk of inadvertently violating the requirement that all shareholders of a family farm corporation be related to all other shareholders within certain degrees of kinship. This statute will be inevitably violated if the shareholders transfer shares to their children. It is only a matter of time--one generation, perhaps two.

Imposition of restrictions on the transfer of shares will have two effects. First, it will negate a unique statutory section which details a procedure for the sale of shares by a minority shareholder. This provision is inapplicable if the shareholders or incorporators have delineated an alternative scheme of disposition.

The second effect is a reservation by the corporation, shareholders, or officers and directors of some control over stock transfers. This control offers an opportunity to prevent transfers of stock that will result in a violative ownership pattern. The type of transfer (gift, inheritance, sale, settlement of a legal obligation) is one factor in selection of the type of restriction. Requiring consent prior to transfer of stock by means of inheritance, sale, or gift is one alternative.

FOOTNOTES

1. 1933 North Dakota Session Laws p. 494.

2. McElroy, T.P. "North Dakota's Anti-Corporate Farming Act," North Dakota Law Review, 36:2, 96-103, 1960.

3. Coal Harbor Stock Farm v. Meier, 191 NW2d 583 (1971).

4. 1933 North Dakota Session Laws ch. 89.

5. 1935 North Dakota Session Laws ch. 111.

6. Bureau of the Census, 1978 Census of Agriculture, United States Department of Commerce, Vol. 1, Part 34, p. 31.

7. McElroy, note 2 supra; Harl, Neil E. Agricultural Law, Matthew Bender, New York, NY, 1983, §51.04 (2).

8. 1967 North Dakota Session Laws ch. 97.

9. 1969 North Dakota Session Laws ch. 580.

10. 1975 North Dakota Session Laws ch. 601.

11. North Dakota Century Code (NDCC) § 10-06-01.

12. NDCC § 10-06-04.

13. NDCC § 10-06-07.

14. NDCC § 10-06-13.

15. Review of North Dakota Corporate Farming Statute In Anticipation of the 1985 Legislative Session. Agricultural Economics Miscellaneous Report No. 72, North Dakota State University, Fargo, February, 1984.

16. NDCC § 10-06-01.

17. Copy of letter on file in Agricultural Economics Department, North Dakota State University.

18. NDCC § 10-06-04.

19. Secretary of State, testimony before House Agriculture Committee, March 3, 1983.

20. Office of Secretary of State, personal communication, August 23, 1983.

21. *Remillong v. Schneider*, 185 NW2d 493 (1971); *Sorlie v. Ness*, 323 NW2d 841 (1982).

22. NDCC § 10-06-15.

23. Ibid.

24. Johnston, Allan R. "Shareholders Agreements in Closely Held Corporations," *Illinois Bar Journal*, vol. 47, December 1958, p. 380.

25. *Remillong*, note 21 supra; *Sorlie*, note 21 supra; *Stenehjem v. Sette*, 240 NW2d, 596 (1976).

26. *Remillong*, ibid.

27. NDCC § 41-08-12.

28. Johnston, note 24 supra.

29. Harl, note 7 supra, § 52.02(4).

30. Ibid., at § 59.07(2).

31. NDCC § 10-19-49 "Officers. . . Any two or more offices may be held by the same person, except the offices of president and secretary. . ."

32. NDCC § 10-19-37.

33. Office of Attorney General, State of North Dakota, opinion 81-135, December 23, 1981.

34. NDCC § 10-06-07.1.

35. NDCC § 10-06-07.2.

36. Committee Hearing, January 23, 1981; Eugene Nicholas, Chairman, House Committee on Agriculture, personal communication, March 26, 1981, copy of letter on file in Agricultural Economics Department, North Dakota State University.

37. *United States v. National Dairy Products*, 372 US 29, 32 (1963).

38. NDCC § 10-06-07.

39. North Dakota Stockmen's Association, resolution, 1983 annual meeting.

40. North Dakota Legislature, Senate Agriculture Committee, 1981.

41. NDCC § 10-06-07.3.

42. NDCC § 10-06-08.

43. Question 2 of the initial report requires the name, address and kinship of shareholders as well as whether they are U. S. citizens, permanent resident aliens and living on or operating the farm.

44. NDCC § 10-06-08.

45. NDCC § 10-23-01.

46. Office of Attorney General, personal communication.

47. NDCC § 10-06-07.1.

48. NDCC § 10-06-08.

49. NDCC § 10-06-08 (5) The number of shares of stock or the percentage of interest in the acreage (hectarage) the corporation used for farming or ranching owned or leased by persons residing on the farm or ranch and actively engaged in farming or ranching and the number of shares of stock or the percentage of interest in the acreage (hectarage) the corporation used for farming or ranching owned or leased by relatives within the degree of kinship listed in subsection 2 of section 10-06-07.

    NDCC § 10-06-08 (6) The name, address, and number of shares of stock or the percentage of interest in the acreage (hectarage) the corporation used for farming or ranching owned or leased by each shareholder and the relationship of each shareholder to the other shareholders. The names and addresses and relationships of beneficiaries of trusts and estates must also be included in the report.

50. NDCC §§ 10-06-10 and 10-06-11.

51. NDCC § 10-06-12.

52. NDCC §§ 10-06-09 and 12.1-32-01.

53. NDCC § 10-06-13.

54. NDCC § 10-06-14.

LIST OF TABLES

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