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INCORPORATION - A POTENTIALLY USEFUL TOOL FOR TAX MANAGEMENT

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Corporations and other legal entities (such as partnerships, trusts, wills, etc.) are nothing more than tools which are used to accomplish goals and solve problems. This paper will first examine some of the legal and financial problems confronting farmers and ranchers and then set forth the way in which a corporation can be used to accomplish those goals and help solve those problems.

I. SPECIAL PROBLEMS OF FARMS AND RANCHES.

A. Owner's Death can be a Devastating Economic Burden.

Farms and ranches have certain characteristics which can create a "capital crisis" on the death of the farmer or rancher.

First, farm firms have historically attempted to exploit the economies of size and new technology which require large amounts of capital. This is evidenced by the expanding size of farms, the increased complexity and expense of machinery and the increased sophistication involving the usage of fertilizer, herbicides, seed, irrigation, livestock and tillage methods.

Second, not only are the capital investments increasing, these capital investments are usually non-liquid and not readily marketable apart from the unit with which they are combined.

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Third, farms and ranches are generally organized as proprietorships. As a result, the management function and the financial functions are performed by the owner/operator. In addition, land is an integral part of the family structure and there is a very strong desire to retain ownership of the land for future generations.

The average farm and ranch net income to asset ratio is about 3% nationally. Liquid assets generally total less than 5% of the total net worth. As a result, the family wealth is accumulated through the accrual of equity and production resources, mainly land, buildings and livestock. Historically, earnings are left in the business rather than taken out as current income and have supplied the vitally needed working capital.

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

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

B. <u>Problem of Giving Equal Interests to Family Members With Equal Contributions and Providing Incentive to Non-Family Key Employees</u>.

A large farm or ranch operator generally has one or two key employees, at least one child, usually a son who is interested in staying in the farm business, and one child, usually a daughter, who is living in a far-off city and has no active interest in the enterprise.

The operator usually wants to provide incentive for the key employees so that he can retain them. However, it is difficult to give them an equity interest in the business since he wants to retain the business' major asset - the land - in the family. It is difficult to attract and keep good non-family key employees where the owner's desire is to perpetuate the business in his family.

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

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

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

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

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

D. Problem of Minimizing Income Taxes.

In most, but not all cases, the cash basis method is the most advantageous, tax wise, for the farmer or rancher. In some cases, farmers have been inadvertently started out on the accrual method of accounting. The change from one method of accounting to another requires the consent of the Internal Revenue Service which is very difficult to get.

Most farmers are on a calendar year for tax purposes. Harvest usually occurs in late summer or in the fall. In some situations, a farmer will not sell his crops after harvest during the months of October, November or December even though the price may be good, because of his tax situation. He will defer the sale of his crop until the next year. However, unless he can get a forward contract, he is risking a drop in the market price.

E. Problem of the Family Farm Cycle.

Agricultural economists have described the process of the generation, growth, decline and death of the farm proprietorship and have referred to it as the "family farm cycle". As we look at the typical farm business, we observe that it tends to start out with an abundance of labor and a severe shortage of capital. Over time, capital is accumulated and substituted for labor until at some point, around age 45 or 50, the farm firm reaches its most rapid rate of growth. It is at the stage where it is making long-term investments that are going to create growth and income opportunities in the future. Following this period, the amount of labor being provided by the farm family declines rather abruptly. The farmer is increasing in age and is unable, or unwilling, to furnish the quantity of physical labor that he previously did. The children in the family are usually grown and have left the farm, causing the supply of labor to become scarce, relative to capital. The farm proprietor is anticipating retirement and the eventual liquidation of the farm business. He is no longer planning and investing for long-range growth and return. Thus, the growth rate and efficiency level of the farm firm tends to decline after about age 45 or 50 and continues to decline until the retirement or death of the average farm operator. Economic theory tells us that there is a most efficient usage of capital, labor and all other inputs in the production process. To change the ratio of capital to labor from the optimum is to reduce the efficiency and the profitability of the individual crop and livestock enterprises. Thus, in the initial stages of the life of the farm firm, inefficiencies and higher unit costs are forced upon the farm firm by having too many hours of labor being used in association with too few dollars of capital. Near the end of the farm life, labor usage tends to be too little in relationship to the capital that is available for production and growth of the farm business. At some point in between, perhaps between age 40 to 50, a more efficient capital-labor mix is being used. This contributes to a higher level of profitability by producing the most product from the dollars of inputs, both labor and capital, that are being used.

An additional problem is the high start-up costs of a new farming venture. Even when farms are eventually inherited by the son at the death of the farmer, it is extremely difficult for an orderly transfer to occur without a great deal of proper planning far into the future. This inherited income is typically received at the time the new farmer is about half way through his own farm cycle, or at about that point where he has already generated most of the equity capital that he is going to generate from his own efforts. It would have been far more efficient to have had access to that capital some 20 years earlier when it was most needed and when it could have contributed much more to the productivity and growth of his farm operation.

By using the corporate form of business organization, some of the fluctuations in this farm cycle can be reduced. The son can be brought into the farm business at a much earlier age, allowing him to develop an equity or ownership position in the farm firm. Furthermore, given the unlimited life of the corporate farm firm (does not cease with the death of the present farm owner), it is possible to reduce the large fluctuations of the family farm cycle. Incorporation can reduce the need for the conservative decision-making and investment strategy that characterizes the declining stage of the farm cycle when the availablity of equity capital is probably the highest. In other words, some of the uncertainty about the future, resulting in the unwillingness to make long-term investments, has been eliminated. The son entering into the farm corporation is in a position to provide more labor and management to offset the declining labor resources and management interests of the farm owner. The son's labor and management can be complementary to the father's capital allowing the development of a more profitable and larger farm firm. Thus with additional labor and management inputs coming into the firm on a regular basis, the firm should be able to surpass the traditional peak efficiency of the mid-cycle of 45-50 years of age.

F. Problem of Access to Fringe Benefits.

Unincorporated farmers and ranchers do not have available to them all of the fringe benefits that are available to incorporated businesses as will be discussed below.

II. HOW A CORPORATION CAN ALLEVIATE SOME OF THESE PROBLEMS.

A. A Corporation is Economically More Efficient.

A corporation is a separate legal entity, distinct from its shareholders. Incorporation is a method of facilitating the holding of undivided fractional interests in the property of a business. The assets are owned not by the shareholders, but by the corporation. The shareholders's "ownership" is a complex bundle of rights and duties between the shareholders themselves and between the shareholders and the corporation. These rights vary depending upon the aggregate fraction of the corporate stock owned by the individual shareholder, the types and classes of corporate stock created and the requirements relating to stockholders' voting power, selection of management and property disposition.

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

These corporate characteristics have several effects. One is that they reduce uncertainty since the resources are allocated more efficiently. Where there is uncertainty, the decision makers are more conservative in making economic decisions. By reducing uncertainty, resources are allocated more efficiently with the result that more goods and services are produced with the same imput, or the same output can be produced at a lower cost.

B. The Corporation Allows Ownership That Corresponds to Participation.

A corporation allows participation in the business to correspond with the participant's inputs. For example, the farmer may have a daughter who is not at all interested in the farm business so her participation is limited to that which evolves through her right of inheritance as a member of the family. She should be entitled to an equity interest in the enterprise and an income interest, but should not participate in management. In addition, the owner may not want to give her an interest in appreciation since she is not partaking in the business and contributing to it. In this situation the daughter could be given a debenture paying interest. A debenture is nothing more than a long-term promissory note which could have a value equal to the share of the estate received by other children in the family. However, the note would not depreciate in value and would not give a vote except maybe in special circumstances. Income would be derived through interest payments which would be tax deductible to the corporation.

There may be a key employee in the enterprise (for example, an agronomist) who is very important to the success of the enterprise. His participation is through services management, but not through right of inheritance. Therefore, he should probably not be given an interest in the equity of the corporation, but he should, in most cases, have an interest in farm business appreciation so that there will be incentive - an interest in income and a voice in management - but not a controlling voice. He could be given a right to purchase common voting stock of the corporation. He would be able to retain the stock as long as he was an employee of the corporation. If he were discharged for cause, the stock would be repurchased from him at cost or at some other deflated figure. If he remains with the corporation until retirement, the stock would be repurchased at its fair market value at that time. The stock would be voting so that he could participate in management, but since he would not have enough stock he could not control the corporation.

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

C. <u>Incorporation Reduces the Estate Value Even Without Gifting</u>.

This concept can be best explained by an example. The farmer holds 65% of an unincorporated farm with a million dollar value. The value of his ownership is $650,000.00 for federal estate tax purposes. However, if the same farm were incorporated, his 65% interest would be worth, for federal estate tax purposes, approximately $487,500.00. That is, $162,500.00 (or 25%) less than if the farm were not incorporated. If the farmer had a total estate of $1,500,000.00, the estate tax savings on incorporating would equal $56,875.00.

The reason for this "discount" in value is because he owns less than liquidation control of the corporation. In corporations in the State of Washington, a shareholder must own 66 2/3% of the stock in order to liquidate the corporation. Since the farmer in our example owns 65% he can not liquidate the corporation unless he gets the consent of the minority shareholders. Since he does not have the ability to liquidate the corporation and get the assets in his hands personally, the Internal Revenue Service allows him to discount the value by approximately 25% once the stock ownership drops below that liquidation value. There would be an additional discount if the parent farmer owns less than 50% of the corporation, because 51% is generally the operating control of the corporation.

There is planning flexibility in the example set forth above due to the fact that the operating control percentage and the liquidation control percentage can be increased to a higher percentage when the farm is incorporated. This would allow the discounts without giving away as much of the stock of the corporation.

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

D. Corporate Stock Facilitates Gifting.

Gifts of minority stock may be a useful way in which to encourage a child to continue in the family business and give him a sense of ownership. A prolonged pattern of substantial gifts may be readily engaged in at a minimum gift tax cost. It is easier to use the annual exclusion and lifetime exemption with corporate stock. In addition, the transferability of stock may be more readily restricted than other types of property.

A regular gift program of minority stock will establish a pattern that can help in arguing contemplation of death questions.

Gifts of stock are private transactions that are not recorded with the county such as gifts of real estate.

E. Retaining Control While Gifting.

Operating control of an incorporated business can be retained by the parents, even though a substantial portion of the family wealth may be given to the children. One method of accomplishing this would be by making an outright gift of 49% of the stock, while retaining 51% for the remainder of the farmer's lifetime. 51% of the stock usually represents operating control of the corporation.

This may also be accomplished by using several classes of stock. For example, a corporation could have three classes of stock: voting preferred stock (representing all of the vote), non-voting common stock (representing future growth) and non-voting preferred stock (equivalent to the full value of the retained earnings). If a farmer could give away the future growth of the company (non-voting common) and parcel out the non-voting preferred stock in an amount within the annual gift tax exclusions, he would retain the voting preferred stock so that he controls the company's destiny for future years. Preferred stock is generally fixed in value so all of the growth would be represented outside of the parents' estates.

F. Incorporation Allows Freezing of Value of Estate.

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

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

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

G. A Corporation Can Shelter Assets From Liabilities.

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

H. Corporations Protect Assets From Creditors, In-Laws and Other "Outside" Owners.

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

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

I. <u>A Corporation Can Save Income Taxes</u>.

1. Advantage of Corporate Flat Rates.

It may be possible to save income taxes through taking advantage of the corporation's flat income tax rate. Generally, the first $50,000.00 of taxable income of a corporation is taxed at a rate of approximately 22%. Everything over $50,000.00 is taxed at a 48% rate. However, it appears as though the tax reduction act will not be extended by Congress and if this is not the case, the ceiling on the 22% rate will be back to $25,000.00. Therefore, everything over $25,000.00 will be taxed at a 48% rate. Individual tax rates are graduated and can go as high as 70%. Due to the fact that the maximum tax rate of the corporation is 50%, there can be a substantial income tax savings by incorporating the business and keeping most of the income in the 50% bracket by splitting the income between the corporation and the farmer as an individual.

2. Maximum Tax on Earned Income.

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

3. Tax Sheltered Retirement Plan.

A corporation can set up a qualified pension and/or profit-sharing plan which generally is less expensive and more flexible than a retirement plan that can be utilized outside of a corporation. Larger amounts of money can be placed into the qualified pension or profit-sharing plan and can be done with a Keough Plan and not as many employees have to be included in a corporate plan. A qualified pension and profit-sharing plan has the advantage of allowing an individual to put aside before tax dollars in a trust and invest those dollars in tax sheltered investments until retirement. First taxes are paid when the funds are doled out at retirement. The following is a chart setting forth an example of how much faster a "nest egg" would build up in a tax sheltered, qualified pension or profit-sharing plan than if the money was invested for retirement by a farmer outside of such a plan.

	SOLE PROPRIETOR OR PARTNER	PARTICIPATE IN CORPORATE QUALIFIED RETIREMENT PLAN
Top Segment of Earnings	$ 15,000	$ 15,000
Tax at 50%	7,500	0
Net for Investment	7,500	15,000
Assume 5% Net Yield	375	750
Less tax at 50%	188	0
Net after-tax yield	188	750
Accumulations at end of:		
10 years	$ 79,025	$188,668
20 years	190,085	495,668
30 years	256,183	715,906

4. Medical-Dental Plan.

An unincorporated farmer or rancher can deduct health expenses only to the extent they exceed 3% of his adjusted gross income. A corporation allows a farmer to deduct all of his medical and dental expenditures by having the corporation pay for them. The corporation gets the deduction and the farmer does not have to include the amount in his personal income. These expenses include premiums on insurance and expenditures for dental bills, eyeglasses, chiropractors, nursing services, crutches, etc.

5. Deductible Life Insurance.

A corporation can purchase group term life insurance for the benefit of the owner of a farm or ranch. The premium for group term life insurance, up to $50,000.00, is deductible and the amount is not includable in the income of the employee. This is a very inexpensive manner in which to purchase life insurance and is not available to the unincorporated farmer.

6. Housing.

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

7. Tax Year.

A corporation can choose its own fiscal year end. This increases the amount of year-end type tax planning that is available. For example, farmers who are on the cash basis will often not sell their commodity in the months of November or December in order to avoid having to pay the income taxes for that year. The price of the commodity may have decreased by the time an actual sale is made in January. If a corporation had a year-end ending on September 30 or August 31, the sale could be made in the fall and the income would not have to be reported until the end of the corporation's tax year.

8. Change Accounting Method.

The corporation can choose an accounting method that is different than that of a farmer as an individual. In other words, a farmer who is on the accrual basis of accounting could switch to a cash basis by incorporating or vice versa.

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

The following example is intended to illustrate the potential benefits to be derived from utilizing the corporate form of business organization to reduce or eliminate several of the problems which have been mentioned above. We will assume the existance of a typical farm which would be somewhat representative of the people attending this meeting. We will assume that the farm owner is 55 years of age, he has a wife who is 52 years of age and has two children. He has a 28 year old son who is married, with two children, and an active participant in the farm business. His second child is a 26 year old daughter, also married and with two children. Her husband is a lawyer and they are living in Los Angeles. The farmer also has a key employee who is 45 years of age. He wishes to provide the key employee with not only an adequate level of salary, but with the opportunity to participate in the increased growth and thus the value of the farm business, in order to be able to retain his services.

	The Estate Adjusted Basis	Fair Market Value
Land	$200,000	$1,500,000
Farm House	60,000	60,000
Farm Buildings	75,000	150,000
Machinery & Equipment	250,000	250,000
Other Assets	——	40,000

A. Income Tax Considerations.

If the farmer has an annual net taxable income of $200,000.00, federal income taxes would be $110,980.00. (State income tax will be ignored here.) The last $100,000.00 of his earnings is subject to the federal income tax rate of 70%. If the farm was incorporated the maximum tax rate would be 50%. If the corporation paid him no salary, the total corporate income tax would be $82,500.00 versus the $110,980.00 he would pay as a sole proprietorship. In practice, the corporation would pay the farmer a salary which would be taxed at a much lower rate than the 70% bracket he was formerly in. This would further reduce the net taxes paid.

Additional tax advantages result from being able to deduct all health expenses, the premium for $50,000.00 in term life insurance, housing expenses (usually), retirement programs, etc. from corporate income before the taxable income is computed.

B. Estate Tax Considerations.

If this farmer wills his entire estate to his wife, he will owe (at his death) $356,650.00 in federal estate taxes. At her death, she will owe an additional $642,520.00. Total estate taxes of $999,171.00, or roughly one-half of the market value of the farm estate, must be paid.

If 80% of all classes of stock are owned by the farmer at the time of incorporation (a controlled corporation), the value of the stock and securities have the same basis as that of the property exchanged or placed in the corporation. In this example, the stock and securities would be valued at $585,000.00 rather than 2 million dollars. This keeps the value of future gifts to the heirs quite low for tax purposes. No gain will be recognized until the stocks and securities are sold or pass through an estate.

By gifting, the estate value can be reduced to a minimum. The owner and his wife each has a $30,000.00 lifetime exemption and each has a $3,000.00 yearly exclusion per donee from gift taxes. If donated, these exemptions and exclusions apply to the donors basis, rather than the market value. By incorporating, the donor's basis has been reduced from $2,000,000.00 to $585,000.00. Up to $90,000.00 ($60,000.00 combined exemption to one child and $30,000.00 exclusion consisting of a $3,000.00 gift from the farmer and from his wife to the second child and to each of the four grandchildren) the first year, and up to $36,000.00 exclusion each year thereafter can be gifted without paying any gift tax. In a few years, the entire estate may be reduced to the point where little or no taxes are owed. Thus, the farmer of this example may save nearly $1 million by establishing the proper gift program! Shares of stock are quite useful and convenient for such a gifting program.

C. Farmer's Objectives.

At this point, let us assume that the farmer has the following objectives:

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

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

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

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

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

(6) He wants to provide an incentive in order to insure the retention of his key employee; but he does not want the key employee to obtain any long-term title to the land.

In this example, the farmer incorporates his farm, including the land, buildings, machinery and equipment. Both stocks and debentures will be issued in exchange for the property incorporated. Three classes of corporate stock will be issued to the farmer. Nine hundred shares of stock, worth $2,000.00 per share (for a total of $1,800,000.00), and $200,000.00 of 8% debentures will be issued by the new corporation. The stock will be divided into three classes. There will be 50 shares of class A preferred voting stock, worth $100,000.00; 840 shares of class B preferred non-voting stock, worth $1,680,000.00 and 10 shares of non-voting stock, worth $20,000.00 (see table 1).

D. Gifting of Stock.

The farmer gives 8 of the 10 shares of common stock to his son and the remaining 2 shares to his key employee. He gives 20 shares of

TABLE 1: BASIS OF STOCKS AND SECURITIES

Basis of Property Incorporated	585,000
Total Market Value of Corporation	2,000,000

Make-up of Corporation:

Type	Amount	% of Total
Debentures	200,000	10%
Class A	100,000	5%
Class B	1,680,000	84%
Common	20,000	1%

Basis of Stocks and Securities if Corporation is controlled:

Type	% of Total	Total Adjusted Basis	Allocated Basis
Debentures	10%	$585,000	$ 58,500
Class A	5%	585,000	29,250
Class B	84%	585,000	491,400
Common	1%	585,000	5,850
			$585,000

	Controlled		Regular	
	Total	Per Unit	Total	Per Unit
Debentures (100)	$ 58,500	$585	$ 200,000	$2,000
Class A (50)	29,250	585	100,000	2,000
Class B (840)	491,400	585	1,680,000	2,000
Common (10)	5,850	585	20,000	2,000
	$585,000		$2,000,000	

the class A voting preferred stock to his son and retains 30 shares for himself. (The 20 shares given to his son are worth $40,000.00 at market [$11,700.00 adjusted basis] value.) He gives in whatever ratio he wishes, the class B non-voting preferred stock to his daughter and son.

By giving the common stock the farmer has provided an incentive to his son and his key employee inasmuch as the increase in the value of the farm (machinery, equipment and land) will accrue to the son and to the key employee according to the ratio of the shares of common stock which each owns. The farmer has also insured that his own estate will not increase in size in the future as all increase in the value of the estate will be divided 80% to his son and 20% to the key employee. This should encourage the son and the employee to remain a part of the farm business and work to increase its size and profitability as each will be rewarded for his contribution to increased growth and profitability. In order to prevent the permanent transfer of ownership of the farm assets to the employee, the agreement could stipulate that the stock would be repurchased by the corporation at the time of the employee's retirement and in the event that he quit before retirement, it would be repurchased at a price below market value.

The farmer gains an additional advantage by gifting 20 shares of the class A preferred voting stock to his son because he has legally given away 40% control of the farm. Gifting of 40% of the class A will effectively reduce his remaining taxable estate by an additional 25% because the ownership of less than 2/3 of a corporation generally means that a stockholder has lost the ability to legally liquidate the company.

The class B stock, which will be used as a vehicle for gifting, will not increase in value. It is fixed in value, is not-voting and under the proper gifting program may be transferred tax free. The stock can be distributed between the son and the daughter or among the grandchildren and in any quantity that the farmer may desire.

E. Debentures.

The $200,000.00 of 8% debentures could be retained by the farmer for retirement income, used for the daughter's income or for any other purpose which the farmer may desire. (If the farmer's estate, after gifting, includes only $120,000.00 of the debentures, then the estate taxes will be zero at his death. If willed to his wife, his estate is subject to a 50% marital deduction. The remaining $60,000.00 in the estate is excluded from taxes. These debentures would provide $9,600.00 per year to supplement other retirement income. In addition, the corporation could continue to pay a salary to the farmer.) If debentures are given to the daughter, a buy-back agreement at a value considerably lower than the current market value may be included to prevent the assets of the farm from being transferred to non-family investors as a result of the daughter's divorce or her husband's bankruptcy. Such a provision could also prevent the daughter from transferring farm assets to non-farm family shareholders.

In this example, we have seen that the farmer has been able to provide for an equitable distribution of his estate between his children and has been able to do so while maintaining operating control of the farm firm. At the same time, he has been able to provide very strong incentives for his key employee and for his son to remain in the farming operation. He has provided for his own retirement. (He also has the option for far more liberal retirement programs as part of the corporation than he would have had otherwise.) Finally, he has the opportunity to reduce his income tax. He can pay himself a salary, leaving the remainder of the net income in the farm corporation. The corporation is subject to a maximum of 50% in taxes, while he as an individual is subject to a maximum tax rate of 70%. Thus by leaving a portion of the earnings in the corporation, he can save money on his tax bill ($82,500.00 versus $110,500.00 in the previously cited example). During retirement, the farmer may also be in the position to sell some of the remaining stock which he owns to his son in order to provide additional funds for his retirement and in order to further reduce his taxable estate. Proceeds from the sale of additional stock to his son can be used as a source of cash to pay any estate taxes owed upon the evenutal death of the farmer.

F. Disadvantages of Farm Incorporation.

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

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

Perhaps the most important disadvantage of incorporation is the initial expense and the continuing costs of establishing and maintaining the corporate form. There are filing fees and legal fees to be paid. Additional and more complex bookkeeping is required. Annual fees must be paid to the state for the privilege of doing business as a corporation in that state. Several types of loans that are normally made available to farmers from government sponsored credit agencies are frequently limited or denied to farm corporations. Federal land-bank loans may be made to a corporation, only if more than half of its income is derived from farming, and if a substantial portion of the corporate stock is owned by the individuals engaged in the operation of the farm to be mortgaged. Production Credit Association loans are also only available to farm corporations that are engaged in actual farming operations or livestock production and only provided that 75% of the stock is owned by individuals who are actually engaged in such farming operations of the corporation; or that the major portion of corporate assets consist of property actually devoted to farming or livestock production and that at least half of the gross income is derived from these operations. Neither Farmer's Home Administration real estate or operating loans are available to farm corporations. Small Business Administration financing is also unavailable to most farm corporations.

IV. SHOULD YOU INCORPORATE YOUR FAMILY FARM?

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