Taxes and Farm Business Organizational Form

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The impact of the federal tax law on farm sector participants has received considerable discussion in the literature (Hanson and Bertelsen, 1987; Boehlje and Carman, 1982; Hughes and Adair, 1983). Between 1970 and 1990, for example, self-employment tax increases more than offset reductions in income tax liabilities for low- and middle-income farm families. At the same time high-income farm families enjoyed the same relative tax position that they had in 1970 (Nixon and VanTassell, 1989). Yet, most studies of federal tax incidence in the farm sector have focused primarily on sole proprietors (Rossi and Durst, 1989). Researchers have not adequately discussed the impact of the federal tax law on farm operators using different business organizational forms. For this study, we analyzed three different business forms; sole proprietorships, husband/wife partnerships, and Subchapter C (regular) corporations. We did not examine subchapter S corporations (often referred to as small business corporations) because of their similarity in tax treatment to partnerships (Internal Revenue Code, IRC, Sec. 1366). We used a simulation model to assess which business organization provides the farm operator with the greatest present-value of annual after-tax changes in net worth over a five-year period under alternative operating conditions.

Farm Business Organizational Forms

Each business organizational form provides different benefits and costs to the farm operator. There are several tax and nontax considerations in choosing which business form is most suitable for the farmer. First, is the cost of formation. Sole proprietorships and husband-wife partnerships require no legal documentation, aside from tax returns, thus minimizing both formation costs as well as annual compliance requirements. Non husband-wife partnerships often will incur nominal costs associated with drafting the partnership agreement. Corporations, on the other hand, require a charter from the state in

which incorporation occurs. They are also subject to federal income taxes as well as state income or franchise taxes, where applicable. Yet, corporations, in contrast to sole proprietorships and partnerships, provide for limited liability, ease in transfer of interest and continuity of existence. The focus here, however, is on the tax issues under alternative business organizations.

Sole Proprietorship

Sole proprietors combine the net income earned by the farming operation with income generated from nonfarm activities to determine gross family income (IRC Sec. 61). In general, income earned by the sole proprietor from the sale of crops and livestock is subject to both federal income and self-employment taxes (IRC Sec. 1402). Specifically excluded from self-employment tax consideration are gains or losses from the sale or exchange of certain livestock, depreciation recapture, interest income, dividends, royalties, and rents (IRC Sec. 1402(a)).

Personal expenses of the farmer such as charitable contributions, home mortgage interest and property taxes, state and local income taxes and others are treated as itemized deductions (IRC Sec. 63(d)). These personal itemized deductions are the same regardless of business organizational form. Farmer personal income tax exemptions are likewise similar across organizational forms. These personal deductions reduce the farm operator's taxable income (IRC Sec. 151). The filing status of the farm operator then determines the applicable federal and state tax rate schedule and the resulting income tax liability. Self-employment tax liabilities are determined separately.

Farm operators may also incur the alternative minimum tax (AMT) with high levels of taxable income or significant tax preference items. The law requires the farm operator to pay the greater of his or her regular federal income tax liability and the AMT (IRC Sec. 55(a)). Most farm operators, however, are not subject to the AMT because of a liberal exemption amount (for example, $40,000 for married filing a joint return) and the lack of tax preference items applicable to farming operations (intangible drilling costs, depletion and incentive stock options, among others, IRC Sec. 57). The model used in this analysis does, however, calculate the potential AMT.

Partnerships

A partnership is a form of business organization in which two or more persons agree to conduct a business jointly in an unincorporated form (IRC Sec. 761). Although a partnership does not pay income tax as such, it still must file a

partnership tax return. In addition, partners are liable in their individual capacities to pay tax on their share of the partnership's income (IRC Sec. 701).

The determination of partnership taxable income follows the same rules that govern the computation of the taxable income of any person engaged in business (IRC 703). There are, however, opportunities for tax planning where special allocations of items of income, loss, deductions, credits, etc. may differ from the share of partnership ownership (IRC Sec. 704(b)).

Farm operators are taxed on their share of partnership income regardless of the amount of cash or property distributed (IRC Sec. 704(a)). Usually, a written partnership agreement delineates how the partnership will operate as well as the allocation of various items of income, deductions, credits, etc. If both husband and wife are partners in a partnership, each will receive their respective share of the profits or losses of the partnership.

Corporations

Corporations (Subchapter C or S), like partnerships, are legal entities. When a corporation meets the requirements under the Internal Revenue Code, the incorporation of a farm business occurs without the contributing party recognizing gain or loss on the property contributed (IRC Sec. 1032). A gain would occur if the value of property contributed by a sole proprietor to his new farm corporation was greater than its tax basis. A loss would also exist if the value of property at the time of contribution to the new corporation was less than its tax basis in the hands of the sole proprietor. However, such gains or losses are not recognized until later disposition of the property by the newly formed corporation. Similarly, partners in a partnership would not recognize gain or loss if they chose to convert from operating as a partnership to operating as a corporation.

A Subchapter C corporation computes taxable income as the difference between gross receipts and deductible business expenses (IRC Sec. 63(a)).[1] Salaries of shareholders who are employees of their Subchapter C corporation are also deductible as long as they are reasonable in amount (IRC Sec. 162(a)(1)). Shareholders who are also employees, do not have self-employment income from the corporation. Yet, as employees of the corporation, they are subject to income tax withholding and social security.

The corporation does, however, pay federal income taxes based on its taxable income. A non-tax deductible distribution of funds to the shareholders may occur in the form of a cash or stock dividend. Cash dividends are taxable to the shareholders as ordinary income. Yet, rather than issuing cash dividends, most farm corporations pay reasonable salaries to the employee/shareholders. This enables the corporation to claim a deduction for the salary paid, thereby

reducing corporate taxable income. The benefit of this approach is the avoidance of double income taxation.

Another approach is to issue currently nontaxable common stock dividends to the shareholders (IRC Sec. 305(a)). Shareholders merely increase the number of common shares held. The shareholder's tax basis in stock already owned is divided equally among all common shares (IRC Sec. 307(a)). The shareholders receive no gain until the stock is sold.

There are several other options available for reducing corporate taxable income without the shareholder incurring additional taxable income. For example, the corporation can pay the employee's health insurance premiums (IRC Sec. 106). This saves the employee from paying the health insurance premiums with after-tax dollars. The corporation can deduct the cost of these fringe benefits as long as they are offered in a nondiscriminatory manner to employees (IRC Sec. 132).

Tax Law Changes

The Tax Reform Act of 1986 (Government Printing Office, 1986) significantly reduced the marginal tax rates for individuals and corporations. There was, however, a greater percentage decline in the tax rates for individuals versus corporations. The top individual rate fell from 50 to 28 percent and the top corporate rate fell from 46 to 34 percent. The Act also imposed a five percent surtax on higher individual taxable incomes. The marginal tax rates were again modified through the Omnibus Reconciliation Act of 1990 or OBRA'90 (Government Printing Office, 1990). Beginning in 1991, the top individual marginal tax rate increased to 31 percent and the income tax surtax was repealed. The OBRA'90 did not contain an increase in the top marginal tax rate for corporations, however. The result is a narrowing of the top marginal tax rates between corporations and individual taxpayers.

The OBRA'90 also changed many other provisions which directly affect the tax liability of higher income individuals. First, only the individual alternative minimum tax (AMT) rate was increased from 21 to 24 percent (IRC Sec. 55(b)(1)(A)). However, as noted earlier, most farmers are not subject to the AMT because of the nature of their income and deductions. Second, the OBRA'90 increased to $125,000 the wage base subject to the Medicare tax. The Medicare tax rate is 2.9 percent for self-employed individuals. Similarly, the rate is 1.45 percent for both the employee and employer. This represents a maximum tax increase from 1990 to 1991 of $1,069 for corporate employees (and a similar amount for the corporation) with gross wages of $125,000 and $2,137 for an individual with self-employment income arising from either a sole proprietorship or partnership. Self-employed individuals can still deduct 50 percent of this medicare tax in determining adjusted gross income.

The wage base for social security likewise increased in 1991. The 1991 maximum wage base is $53,400. The employee tax rate is 6.2 percent (matched by an employer contribution) and the self-employment tax rate is 12.4 percent. The self-employed individual is again able to treat one-half of the social security portion of the self-employment tax as a deduction when calculating adjusted gross income (IRC Sec. 164(f)). The wage base for social security and medicare are upwardly adjusted annually to reflect changes in inflation.

Simulation Model

The simulation model developed in this study calculates the after-tax returns to farm operators under three distinct business operating forms; sole proprietorship, husband/wife partnership and regular or Subchapter C corporation. We assume that all nonpecuniary issues associated with the alternative business forms have no differential impact on the farmer. For example, there is no premium provided in the model because a corporation has limited liability versus a partnership or sole proprietorship having unlimited liability. We also assume management decision-making is constant across the alternative business forms. In addition, we assume the farmer receives the same personal satisfaction from one form of business versus another.

We assume all revenues from dispositions of crops and livestock as well as associated expenses are the same regardless of business form. Stochastic prices and yields provide robustness to the model and take account of the impact of varying levels of taxable income across time. The model also includes a full machinery complement for the farming operation examined.

We incorporated the 1991 federal income and employment tax schedules, as amended by the OBRA'90, in the model.[2] In addition, we have updated the personal exemption and standard deduction values and annually adjusted them for inflation. The model further maximizes the farm operator's personal deductions by reducing taxable income by the greater of the standard deduction or total itemized deductions. We determined the annual depreciation of farm machinery and buildings using the modified accelerated cost recovery system, as enacted under the Technical and Miscellaneous Revenue Act of 1988 (Government Printing Office, 1988). This included the extension of class lives for selected farm assets and cost recovery using the 150 percent declining balance method. The annual depreciation deduction is the same regardless of business organizational form.

We included the calculation of the alternative minimum tax (AMT) for both the individual and the corporation in the model. We then compared the AMT to the regular tax liability. If the AMT exceeds the regular tax liability, addi-

tional taxes are owed. Otherwise, the AMT is not a factor in determining the farm operator's tax liability.

We assumed the sole proprietor married, filing a joint return. All farm income is attributable to the farm operator. On the other hand, we assumed the partnership to consist of the farm operator and his spouse. Both share equally in the profits and losses of the farming operation. Each spouse then files either a separate or joint tax return including their individual sources of income (both farm and nonfarm). The model calculates the tax liability under partnership organization using both married filing jointly and separately. The most beneficial filing status for a husband and wife under a partnership arrangement depends, in part, on state income tax provisions and the couple's level of taxable income. We treated distributions from the farm corporation as wages solely to the farm operator. This approach minimizes employment taxes for the farm operator. Total taxes paid under the corporate form is the combination of corporate taxes and individual taxes for the farm operator and his spouse. The individual tax component represents the tax on the farm operator's salary and other off-farm income generated by the farm operator and his spouse. There are other taxes that farm operations with employees may also incur. These include worker's compensation and unemployment insurance. Although the specific requirements of worker's compensation coverage and unemployment insurance vary among states, we considered both of these additional charges in the model.

A fee is charged the farm operator when choosing the corporate form of business. Varying by state, it is based on the cost of filing a charter and articles of incorporation with the state as well as attorney fees for drafting corporate documents. The partnership is not charged an organizational fee because a formal partnership agreement is considered unnecessary between spouses. If, however, a partnership consists of other than husband and wife, $500 is charged as an organizational expense. The partnership fee is less than the corporate fee as no state charter is needed for general partnerships.

We also assumed that the farmer will not divest from his farming interest soon. Should the farmer sell the farmland and close the corporation, there would be important tax consequences to the farmer based on the undistributed earnings of the corporation. In addition, under all three business organizations, increases in farm asset values would generate taxable income in the year of liquidation.

The model uses a schedule of farming operations, together with an equipment complement, to estimate monthly cash needs for operational purposes. Debt servicing, tax payments, and equipment purchases also compete for cash. We assumed the farmer to have a line of credit. We also calculated monthly interest expenses (or revenues). We then used ending income statement values to

estimate net farm income, before and after tax. Finally, we determined the annual change in net worth for the farm operator's household. The present value of these annual changes in net worth (positive or negative) are then comparable across alternative farm business organizational forms.

Data

We developed data for the simulation runs from a small grains-fallow farming operation located in Eastern Oregon. We incorporated the actual farm asset base (including land, buildings and equipment) in the data set. We also estimated costs of production and yield data based on the farmer's records. We randomly selected annual prices of inputs and durable assets based on historical price changes during the 1965-1989 period. We assumed the annual rate of inflation (three percent to seven percent) for 1991-1995 varied depending on historical changes in these price indices. We calculated commodity and land prices using a long period lag of price as the independent variable, with a randomly generated error term. All prices were randomized using multivariate normal distributions. White wheat prices in this region varied by $1.25 per bushel depending on which price was randomly drawn from the historical price data above. Barley prices varied by $.85 per bushel again depending on which price was randomly drawn. Similar variability occurred in wheat and barley yields.

The Eastern Oregon farm contains 1,883 acres of tillable land. Some 335 acres are in the Conservation Reserve Program, which generates an income of $50 per acre per year (U.S. Congress, OTA). Although white wheat is the principal crop and is grown in a grain fallow rotation, there is also some barley raised. Both the farmer and his wife are employed full-time off the farm. Their combined annual income from off-farm sources is $47,000. Because of the time demands imposed by his off-farm business, the farmer hires a full-time employee (at $24,000 per year) to do much of the farm labor. Family living expenses are about $37,000 per year. The value of all farm assets at the beginning of 1991 was $950,000. Total debt at the beginning of 1991 was $280,000. The typical yields in this area are 40 bushels per acre for wheat and 62 bushels per acre for barley. We used a ten percent after-tax discount rate in the present value calculations. The ten percent discount rate is consistent with the farmer's cost of borrowing which has averaged 13 percent over the past 5 years.

Under the circumstances where the farmer has a full-time off-farm job and hires a full-time worker on the farm (base scenario), we limited corporate salary payments to the farm owner to $2,000 annually. The limited corporate salary payments are the result of the off-farm income generated by both spouses. The farmer would prefer to keep the income in the corporation rather than be paid a

salary. Lower salary payments reduce the employment tax obligation. The base scenario is representative of those farmers who have off-farm employment and yet are integrally involved in a farming operation.

An alternative owner/operator scenario (no farm employees and only farm operator spouse has off-farm income), assumes that corporate salary payments to the farm operator equal his total family living expenses. This includes personal federal and state tax payments less his spouses' off-farm salary. Earnings, if any, more than those distributed in the form of farm operator salary, are reinvested in the corporation (placed in an interest bearing financial asset account which is tied to current money market rates). The farm operator and his spouse file joint federal tax returns under the sole proprietorship and corporate business organizations. However, we assumed separate returns filed under the partnership arrangement.

Results

The choice of business organization had a significant impact on the farm operator's present value of after-tax changes in annual net worth over the five-year period. Table 1 represents the base scenario where the farm operator had off-farm employment. Here, the corporate form of business yielded the highest increase in the net present value of annual changes in net worth during this period. The increasing tax liabilities are a function of an upward trend in product prices over the planning horizon. The results presume that the farm operator will not divest of his farming operation soon. Additional tax consequences would be incurred for divestiture.

Table 1.
Results of Farm Financial Simulations Under Different Business Arrangements—Base Scenario

	Sole Proprietorship		Partnership with wife		Subchapter C Corp.	
	Year 1 1991	All Years 1991 - 1995	Year 1 1991	All Years 1991 - 1995	Year 1 1991	All Years 1991 - 1995
				$		
Net cash farm income	42,887		42,763		43,151	
Taxes						
Federal income	11,980	99,102	12,395	98,619	4,505	26,801
Social security	6,077	37,539	7,343	50,228	3,392	18,422
State income	4,585	30,457	4,461	29,657	2,649	15,402
Federal corporate	0	0	0	0	4,573	40,965
State corporate	0	0	0	0	1,670	14,476
Total taxes paid	22,642	167,098	24,199	178,504	16,709	117,066
NPV of change in net worth		143,453		133,177		187,367

The corporation could minimize the self-employment tax liability through nominal distributions to the farmer. In the base scenario, off-farm income met most of the farmer's personal living expenses. All corporate distributions to the farmer were treated as wages. If all of the net farm income had been distributed to the farmer, then the results from the sole proprietorship and corporation would be much closer. In such a case, the corporation would pay its share of the employment taxes and the employee (farmer) would pay his share. The total employment taxes would match the amount that the sole proprietorship farm operator would pay in self-employment taxes. However, where the corporation does not distribute all the earnings to the farmer, employment tax savings accrue. The corporation would only pay employment taxes on actual salaries paid to the farm operator. Undistributed income is not subject to employment taxes.[3] Clearly, a sizable portion of the benefit to the farm operator under the corporate organizational form is the net employment tax savings available.

The corporate form of business also allows the farmer to take advantage of the progressive tax rate schedules for both corporations and individual taxpayers. The farm corporation qualifies as a regular corporation rather than a personal service corporation, thereby enabling utilization of the corporate progressive tax rate schedule.[4] The first $50,000 of corporation earnings are taxed 15 percent, the next $25,000 at 25 percent, and above $75,000 at 34 percent. A surtax is imposed on regular corporations whose taxable income exceeds $100,000. The surtax is 5 percent of taxable income in excess of $100,000 but less than $335,000. The effect of the surtax is to eliminate the benefit of the progressive tax rate schedule for high income corporations. Since the farm corporation's annual taxable income was considerably below $50,000, the farmer could use the corporate 15 percent tax rate. In contrast, when in the base scenario all of the farm income comes from the sole proprietorship, it is combined with other nonfarm income and taxed at a 28 percent rate.

In all three scenarios, the impact of farm expenses including depreciation was the same. There were, however, a few expenses which provided benefit under the corporate form which were unavailable under either the partnership or sole proprietorship. For example, the corporation paid medical expenses as a fringe benefit to the farm operator and his family. This nontaxable benefit enabled the corporation to claim a deduction without corresponding income to the farm operator. In the sole proprietorship and partnership, medical expenses were only partially deductible.[5]

The partnership, on the other hand, is the least favorable from a tax standpoint because both the farmer and his spouse must pay self-employment taxes on their individual shares of net farm income. The higher federal income tax in the partnership compared to the sole proprietorship is partially a result of the farmer and his spouse filing separate individual tax returns. If the couple had

filed a joint tax return instead of separate returns, their federal income liability would have decreased by about two percent. However, their state income tax would have increased by one percent. Overall, the married filing jointly status compared to filing separately would have benefitted this farm operator and his spouse. Nonetheless, we presented the filing separately information under the partnership organization to show the effect on the farmer's total tax liability of combining these two less than optimal business decisions.

The results presented in Table 2 show the impact of the farm operator devoting all of his time to the farming operation, thereby, eliminating all off-farm income and hired farm labor. The net present value of all three farm business organizational forms significantly declined. This is largely due to annually eliminating $33,000 of off-farm income, while saving $24,000 in farm labor costs. The percentage decline in the net present value for all years was nearly the same. The federal employment tax liabilities incurred by operating as a corporation increased over the base scenario. The corporation had to increase the farm operator's wage to cover family living expenses previously covered from non-farm income sources. There was, of course, a corresponding decline in the federal and state corporate income taxes. Individual federal and state income taxes also declined over the five-year period as the farm operator's total gross income decreased.

The increase in the social security tax liability under both the sole proprietorship and partnership is a result of higher farm income subject to self-employment taxes. The decline in federal and state income taxes reflects a drop in the farm operator's gross income. The lower federal and state income taxes for the

Table 2.
Results of Farm Financial Simulations Under Different Business Arrangements—Full-Time Employment on Farm

	Sole Proprietorship		Partnership with wife		Subchapter C Corp.	
	Year 1 1991	All Years 1991 - 1995	Year 1 1991	All Years 1991 - 1995	Year 1 1991	All Years 1991 - 1995
				$		
Net cash farm income	67,506		67,607		67,775	
Taxes						
Federal income	8,836	75,644	8,942	73,829	4,523	24,823
Social security	7,625	48,261	8,463	57,749	6,106	32,545
State income	3,718	25,969	3,676	25,593	2,658	14,430
Federal corporate	0	0	0	0	2,309	26,020
State corporate	0	0	0	0	867	9,693
Total taxes paid	20,179	149,863	21,080	157,171	16,283	107,511
NPV of change in net worth		93,906		87,861		129,811

partnership versus the sole proprietorship is tied to the deductibility of one-half of the social security taxes incurred.

In Table 3, the farm operator chooses to sell his farm equipment, pay off his operating loan and rent the farmland to another farmer on a one-third crop share basis. The one-third crop share arrangement is common to this area. The farm operator also returns to his off-farm employment. The results show that the farm operator continues to be better off operating as a corporation, but the net present value of change in net worth narrows. The percentage decline from the base scenario, in net present value, is comparable under all three types of organization. Thus, organization as a corporation provides the greatest benefit because of the income splitting opportunity between the corporation and the individual.

Summary and Conclusion

The increased sophistication of today's farm operators has introduced the use of alternative business organizations in production agriculture. While the predominant form of farm business organization remains the sole proprietorship, an increasing number of farm operations are being organized as either partnerships or corporations (Barry, et al). As farm operations increase in size, both capital and management constraints encourage the use of corporations. Federal income and employment tax considerations may also encourage farmers to consider the benefits of forming regular corporations. However, for less profitable farming units, the lower compliance costs of sole proprietorships will likely encourage their continued use.

Table 3.
Results of Farm Financial Simulations Under Different Business Arrangements—Farm Acreage Rented to Neighbor

	Sole Proprietorship		Partnership with wife		Subchapter C Corp.	
	Year 1 1991	All Years 1991 - 1995	Year 1 1991	All Years 1991 - 1995	Year 1 1991	All Years 1991 - 1995
				$		
Net cash farm income	18,115		18,084		18,122	
Taxes						
Federal income	5,664	40,255	7,671	48,506	4,505	26,800
Social security	4,114	27,843	4,110	28,229	3,392	19,422
State income	3,012	18,369	2,752	17,443	2,649	15,400
Federal corporate	0	0	0	0	864	9,886
State corporate	0	0	0	0	324	3,863
Total taxes paid	12,790	86,467	14,533	94,178	11,734	75,371
NPV of change in net worth		76,598		69,423		85,632

We showed, for the case example base scenario, that the corporate form of farm business operations generated the highest present value of after-tax changes in net worth over a five year planning horizon. The after-tax net present value of the farm organized as a corporation was $187,367. This compared to $143,453 for the sole proprietorship and $133,177 for the partnership. In percentage terms, the corporation outperformed the sole proprietorship and partnership by nearly 25 and 30 percent, respectively. Similarly, total taxes paid as a corporate business organization ($117,066) over the same five year period were 30 and 35 percent lower than for the sole proprietorship ($167,098) and partnership ($178,504), respectively. We modified the base scenario to include two additional scenarios: (1) full-time activity on the farm with no off-farm employment for the farm operator and (2) off-farm employment, as under the base scenario, but leasing the land to another farmer and receiving a crop share in return. In all of the scenarios, the corporate business organization generated the best after-tax returns for the farmer. The differences in the present value of the after-tax changes in net worth changed dramatically among the scenarios, however. In general, as gross income increased, the regular corporation became increasingly favorable. Reduced employment tax liabilities generated the key savings for the corporation. In addition, the farmer could take advantage of the regular corporation's progressive tax rates, thereby minimizing his overall tax liability. A potential drawback to the regular corporation form of business is that at high levels of farm income ($75,000), the tax rate of corporations increases to 34 percent. At this point, the regular corporate tax rate exceeds the maximum individual rate by three percent. In addition, if the regular corporation's farm incurs a loss during the year, there is no way to pass that loss through to the shareholder. Instead, the loss must be claimed in another year.[6]

There are additional factors that should be considered in determining the optimal business organizational form. Corporations usually incur more tax compliance costs than either sole proprietorships or partnerships. Although both partnerships and corporations must file federal income tax returns, typically only corporations must file state income or franchise tax returns. There are also nonpecuniary issues we should consider such as flexibility of management, transferability of interests and liability risks, before determining the optimal organizational structure for the farm business. We did not quantify them for the purposes of this study. There is, however, a need to examine the role that these other factors, combined with the financial considerations, might play in determining which organizational form best suits the individual farm operator.

We did accomplish a discussion of the impact of federal and state tax policy on the choice of business form for a case farm operator. Farm operators under different operating conditions, tenure arrangements, farm sizes and debt levels

might find the corporation form of business more or less favorable. Extensions of this research, using additional case farm examples under alternative state tax schemes, will be an important source of guidance to farm operators trying to determine the most viable farm organization for their farm businesses.

Notes

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1. The focus of this presentation deals with regular (Subchapter C) corporations in contrast to Subchapter S corporations. Subchapter S corporations have tax treatment similar to that of a partnership. That is, taxable income is passed through to the shareholders and not taxed at the entity (corporate) level. For Subchapter S corporation shareholders, the amount of income, deductions, credits and others is allocated based on their share of stock ownership. Partnerships, on the other hand, have more flexibility in allocating items of income and deductions. There are also significant restrictions applicable to Subchapter S corporations including limitations on the number of shareholders and types of corporate stock.
2. We also included the state income and employment tax provisions of Oregon in the model since the case farm is in that state. We can integrate other state tax law provisions in the model as needed.
3. In addition, the OBRA'90 change in the federal employment tax law did not directly affect the farmer in the base scenario. The farmer did not have sufficiently high income in 1991 to incur the extra 2.9 percent Medicare tax on earnings exceeding $53,400.
4. A personal service corporation must have as its principal purpose the performance of services in specific fields such as law, health, consulting, etc. (IRC Sec. 448(d)(2)(A)). Farming is not one of those areas. A personal service corporation can not use the progressive tax rate schedules and instead will be taxed a flat 34 percent rate on all taxable income (IRC Sec. 11(b)(2)).
5. Sole proprietors and partners in a partnership are allowed to deduct 25 percent of medical insurance premiums from gross income (IRC Sec. 162(l)). This provision was to expire after 1989, but was extended through 1991 by the OBRA'90. The remaining 75 percent of the premiums plus all other unreimbursed medical expenses are treated as a personal itemized deduction subject to the adjusted gross income limitation.
6. Farm operators are allowed a three year carryback of net operating losses before applying any excess to carryforwards. There is a provision, however, under IRC Sec. 172 which allows taxpayers to forego the carryback and instead use the carryforward.

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