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Incorporation as a Device for Keeping the Farm Intact and in the Family

Clarence S. Naatjes

INCORPORATION AS A DEVICE FOR KEEPING THE FARM INTACT AND IN THE FAMILY

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CLARENCE S. NAATJES

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This thesis is approved as a creditable, independent investigation by a candidate for the degree, Master of Science, and is acceptable as meeting the thesis requirements for this degree, but without implying that the conclusions reached by the candidate are necessarily the conclusions of the major department.

Thesis Adviser

Head of the Major Department

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INTRODUCTION

Farming in South Dakota is an occupation which is experiencing increased economic difficulty. Much of this difficulty has been attributed to the cost-price squeeze on agriculture. This situation is illustrated by Figure I.

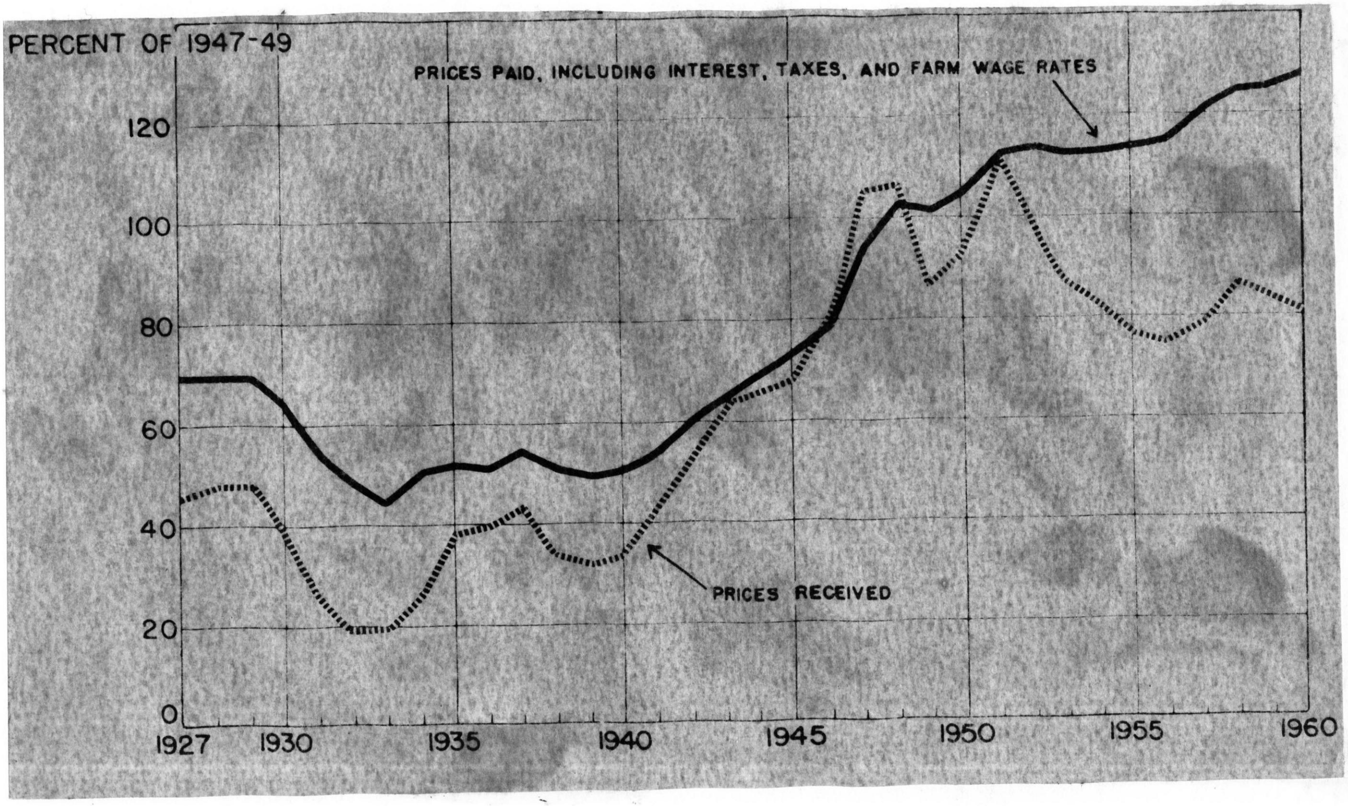

Figure I. Indexes of Prices Paid by Farmers and Prices Received by Farmers: Annual Average South Dakota, 1927-60 (1947-49 = 100)

Source: Crop and Livestock Reporting Service, South Dakota Agriculture, 1960, p. 49.

Although the fact is usually not recognized, figures such as these are not by themselves conclusive. What is really significant is not the relation between prices paid and received but the relation between cost and revenues.

The revenue situation in agriculture has been under downward pressure due to two facts. The farmer as an individual is faced with a very elastic demand for his products. This means that he can see no price decline and certainly no decline in revenue if he individually increases his production, since he is only one of a large number of producers.[1]

Since the individual demand for a farmer is perfectly elastic, it means that his marginal revenue is equal to his demand and the price of the product. In maximizing his profits, the farmer must equate marginal cost with marginal revenue. If profits even then are not sufficient to make a satisfactory living, the farmer must do something to improve his profit situation.

Since the farmer cannot change his demand (marginal revenue), he must try to decrease costs. One of the ways for a farmer to do this is to become more efficient in his operation through the use of capital and new technologies. This may allow the farmer to decrease his marginal costs while marginal revenue remains the same. This means that the farmer can increase profits by expanding his output until the new marginal cost equals marginal revenue.

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[1]Willard W. Cochrane, Farm Prices, University of Minnesota Press, Minneapolis, Minnesota, 1958, p. 95.

This will be fine for the individual farmer as long as only he acts in such a manner. When many or even all farmers can become more efficient, it is evident that the agricultural supply will increase appreciably. Since the aggregate demand for agricultural products is relatively inelastic,[2] prices may decline so much that the increase in the quantity supplied will actually decrease total revenue for the farmer.

An increase in costs of production is suggested by Figure I, since costs of production are made up of the inputs that go into production. The figure shows a price index of these inputs. This increase in costs of production can be explained by the inflationary trend in the general economy.

The adjustments for farmers described above result in a trend toward increased size of farms and capital outlay. The increase in the size of farm solves problems for some individuals, but it means that other people must leave the farm since there is only so much land available. Increasing the capital outlay may well solve both the problem for the individual and the farm population. As a consequence of this increasing size of farms and capital outlay, some old problems are solved, but new problems arise and these problems are the concern of this paper.

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[2]Ibid., pp. 88-89.

Table 1. Number of Farms, Average Size of Farm and Land in Farms, South Dakota, 1930-1960

Year	Number of farms (000)	Average size farm (Acres)	Land in farms (Acres) (000)
1930	83.2	439	36,500
1935	83.4	446	37,200
1940	72.5	545	39,500
1945	68.8	626	43,100
1950	67.1	669	44,900
1955	64.7	703	45,400
1960	59.0	769	45,400

Source: Crop and Livestock Reporting Service, South Dakota Agriculture, 1960, p. 51.

Nature of the Problem

One of the main problems involved with increasing the size of the farm operation is the increased difficulty of making farm transfers from generation to generation.

In many farm families, there is more than one heir. The difficulty involved in this situation is that of awarding each of the heirs a fair share of the estate and still maintaining an efficient operating unit. If the farm is split up among the heirs, the units will be broken up leaving small parts of the whole, none of them efficient. These transfers also tend to break the continuity of planning necessary in the farm business.

This problem is magnified by the fact that insufficient capital of one of the heirs may be a hindrance to his buying out the others. If an estate is to be divided among the heirs at death, there is usually a sale, at which time one of the heirs may buy out the others if he has

a genuine interest in the farm and if he has sufficient capital or can secure adequate credit.

The value of farms in South Dakota has increased from an average of $31.30 per acre in 1950 to $53.05 per acre in 1960.[3] These figures include the average value per acre of farm land and buildings. It should be remembered that these figures are averages and contain many small-size farm units. The figures do not separate the state into economic areas which would show higher land values in some economic areas of the state.

A closer look at this problem can be given by looking at the total investment in the farm business. In this study six personal interviews were conducted with farmers who had incorporated. The approximate average total value of these farms was $390,800. The problem in this study involves the farmers with a high investment in the farm. In the light of the figure just presented and the fact that the use of expensive machinery and equipment has increased considerably in the last 30 years, there are many farms with an investment totaling well over $100,000. A young farmer who is trying to buy out this size farm might find it very difficult to do so in the light of the figures just presented. If credit is unavailable, he may indeed find himself unable to accomplish his goal.

Another difficulty involved with farm transfers is the interruption in business planning. When an operator realizes that he will be

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[3]Crop and Livestock Reporting Service, South Dakota Agriculture, 1960, p. 50.

selling his business in the near future, or that the farm will be liquidated after his death, there may be a tendency to quit planning for the future. With a son buying the farm, the change in managership is commonly quite abrupt. A smoother method or transition of ownership would result in more continuity of economic planning.

It may be very desirable for the parents to maintain some control in the farm business during their lifetime if they are to be financially secure. Some of the transfer arrangements, such as selling out their entire interest to a son during the parents' lifetime, would not meet this requirement. Here again we find the need for a smooth transition of control from one generation to the next.

In some instances one or more of the heirs may not be interested in the farm business. They may wish to dispose of their share of the estate. If this is true, it is very difficult for the heir interested in the business to buy out the interests of the others, unless there is some plan by which he can do so gradually without the heavy use of credit facilities. It is possible that credit from commercial sources may not even be available.

The problem to be investigated in this study is whether or not the corporate form of business organization holds an answer to these problems of estate planning. It must also be decided if incorporation will create other counterbalancing difficulties.

Objectives of the Study

The objectives of the study included the following:

1. To make an inquiry into the use that can be made of the corporate form of organization by farmers in solving their estate-planning problems.

2. To make a thorough investigation into the advantages of the corporation in the operation of the farm business.

3. To study the mechanics of the corporate form of organization in order to set up a model that might be used by people as a guide in making the decision as to whether to incorporate.

Hypothesis

The hypothesis of this paper is that the corporate form of organization has desirable characteristics which can be of use in keeping the farm intact and in the family. The hypothesis further states that, on balance, these desirable characteristics will make the corporate device a useful organizational tool for farms of certain types and in certain situations.

Procedure

The plan of procedure included the following steps:

1. Obtaining as much information as possible from previously written material.

2. Finding the names of family corporation farms in South Dakota. This was done by two methods:

   a. By searching the articles of incorporation records filed in the Secretary of State's office at Pierre. The filing system at Pierre was such that it was not efficient to search the records except from 1950

until the present.

b. The additional farm corporations in the state were located by means of correspondence with the county agents in the state.

3. Gaining insight into the practical needs and ideas of farmers throughout the state by means of interviews with two attorneys at law and four county agents.

4. Gaining knowledge as to the practical use of the corporation by the farmers in the state by the use of two questionnaires.

Information sought through the questionnaires included the following: (a) size of the farm; (b) how ownership is distributed among members; (c) how the corporation ledns itself to management of the farm; (d) how and why the corporation was set up; (e) how the corporation is taxed; (f) credit aspects; and (g) an evaluation by the owners of the corporate form of organization.

Since funds for the study were limited, most of the information was obtained through the use of a mailed questionnaire. A longer and more detailed questionnaire was used for six personal interviews. Forty-nine corporate farms were located in the state. Questionnaires were mailed to 43 of these farms and 12 questionnaires were returned. If the six personal interviews are included, a response of 35 per cent was received from the corporate farms contacted.

POSSIBLE ARRANGEMENTS FOR MAKING TRANSFERS AND ESTATE PLANNING

Under law, a person involved in planning his estate has available three different means by which he can transfer his property in addition to a sale. These three arrangements provided under law are wills, laws of intestate succession, and intervivos gifts. Property is most commonly transferred by some type of sale, but this type of transfer will not be considered in this study, although transfers of property by sale can play an important role in estate planning.

Transfers by Inheritance

Wills

Estate planning for most farmers should involve a will, sometimes as the sole device and other times in connection with one or more other methods of transfer. A will is simply an instrument by which a person makes a disposition of his property to take effect after his death. This will is revokable at any time during the person's life.

Advantages of a will for transferring title of a farm include the following:

1. It requires the owner of the property to give some thought to the manner of distribution and the needs of those who survive him.

2. A will leaves control of the property with the owner as long as he lives. Other types of transfer such as joint tenancy become final when they are set up and can only be dissolved if all members so desire. If one of the members of a joint tenancy should become incompetent, it

could seriously inhibit the operation of the business.

3. By means of a will, a person can provide for contingent beneficiaries; for example, "to my wife, if she survives me, and if she does not, then in equal shares to my children."

4. A will permits the owner to treat heirs according to the family situation. Unequal shares can be awarded to the various heirs, subject to the homestead right of a surviving spouse.[4] This cannot be done under the laws of intestate succession. Aside from the homestead right, there is no legal requirement in South Dakota that a husband or wife leave the other any specific fraction of his or her estate.

5. If property is transferred by will, the Internal Revenue Bureau considers the appraised value in the inventory as the cost to the heirs. If property is sold, the capital gains tax must be paid on the basis of the selling price.[5]

There is one major disadvantage to a will. That is "a will often fails to provide enough security for the operating son or sons."[6] The reason for this is that a will can be changed at any time during the maker's life. Changes such as this may operate to the disadvantage of the operating heir. Another disadvantage is the fact that the property might not be transferred until the heir is past his most productive years.

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[4]South Dakota Code of 1939, Sec. 56.0202.

[5]Max Myers, Keeping Your Farm in the Family, Agricultural Economics Department, Agricultural Experiment Station, South Dakota State College, Brookings, South Dakota, Bulletin 398, February, 1950, p. 11.

[6]Marshall Harris and Elton B. Hill, Family Farm Transfer Arrangements, North Central Regional Publication No. 18, Cir. 680, University of Illinois, College of Agriculture, Urbana, Illinois, 1951, p. 17.

If an operator has a child when he is 25 years old, his son will be ready to take over the farm when the operator is 50 years old. It is quite possible that the son will not gain title until he is himself 50 years old, or more.

Some of the uncertainties listed above can be reduced by specifying terms of repayment to the other heirs, but these uncertainties cannot be entirely eliminated.

Intestate Succession

When a person dies without making a will, he is considered as having died intestate. If this is the case, the property owned by him at his death will be distributed according to the laws of intestate succession. These laws provide a fixed plan of distribution and vary considerably between states. Briefly, the laws of intestate succession in South Dakota provide:

1. If a father dies and leaves a wife and child, his estate will be divided evenly between them. If a parent dies and leaves a wife and two or more children, two-thirds of the estate is divided between the children and one-third goes to the wife. If any of the children are deceased, and one child is still living, the deceased child's share of the estate is claimed by the lawful heirs of that child. If the father dies and no child is living, the remaining two-thirds of the estate goes to the father's lineal descendants.

2. If a man dies leaving his wife and no children, she has a right to claim the entire estate, if it does not exceed $50,000. If the estate exceeds this amount, the wife can select the first $50,000.

Any property over this amount is divided evenly between his wife and his parents. If one of the man's parents is deceased, that share all goes to the other parent. If a man leaves no wife and no children, the estate goes to his next of kin parents in equal shares.[7]

The laws of intestate succession in South Dakota cite other exceptions and the succession in those cases, but for our purposes the two paragraphs mentioned above shall be sufficient. It is easy to see that these laws may not fulfill the wishes of a property owner in disposing of his estate. If this is the case, it is important that the owner make a will.

Taxes on Succession

Whether a person dies with a will or intestate, there is a state inheritance tax levied on the heirs.

When the property in question exceeds the exemptions and does not exceed $15,000, the primary tax rate is 1 to 5 per cent, depending on the relationship of the heir to the deceased person.[8]

Any inheritance in excess of $15,000 and not exceeding $50,000 shall be taxed at two times the primary rate. An inheritance in excess of $50,000 and not exceeding $100,000 shall be taxed at three times the primary rate and anything above this amount will be taxed at four times the primary rate.[9]

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[7] _South Dakota Code of 1939_, Sec. 56.0104.

[8] _Ibid._, Sec. 57.2402.

[9] _Ibid._, Sec. 57.2403.

When property is inherited by a surviving spouse or by children, an exemption of $10,000 is allowed in computing inheritance tax.[10] For example, if a man dies leaving a $60,000 estate to a wife and two children, each heir will receive $20,000 of which $10,000 is the exemption to which the heirs are entitled. This means the taxable inheritance is less than $15,000 and the heirs are taxed at a primary rate of 1 per cent because of their close relationship to the father. The inheritance tax paid by each of the heirs is then $100.

There is also a federal estate tax on transfers of property at the death of the owner. This is a tax on all real and personal property of the decedent except real property located outside the United States. It is important to note that this is a tax on the total estate, not the inherited share of each heir.

Certain deductions and exemptions are subtracted from the total estate before the tax is computed. They include funeral expenses, administration expenses, executor's commissions, attorney's fees, unpaid property taxes, unpaid mortgages, and certain other claims against the estate.

Other exemptions include a basic $60,000 exemption which is not taxed and a 50 per cent deduction of the adjusted estate if property passes without reservation from the decedent to his or her spouse. This will be taxed when the spouse dies.

The federal estate tax also includes any gifts made in contemplation of death and credit is allowed for gift taxes.

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[10] Ibid., Sec. 57.2404.

Table 2. Federal Estate Tax Rates on Value of the Taxable Estate, 1957

Taxable estate above exemptions	Tax and rate
Not over $5,000	3% of the taxable estate
$5,000 to $10,000	$150 plus 7% of excess over $5,000
$10,000 to $20,000	$500 plus 11% of excess over $10,000
$20,000 to $30,000	$1,600 plus 14% of excess over $20,000
$30,000 to $40,000	$3,000 plus 18% of excess over $30,000
$40,000 to $50,000	$4,800 plus 22% of excess over $40,000
$50,000 to $60,000	$7,000 plus 25% of excess over $50,000
$60,000 to $100,000	$9,500 plus 28% of excess over $60,000
$100,000 to $250,000	$20,700 plus 30% of excess over $100,000
$250,000 to $500,000	$65,700 plus 32% of excess over $250,000

Source: United States Internal Revenue Code of 1954, September, 1956, Edition, Ch. 11, Sec. 2001.

Intervivos Gifts

The last arrangement provided by law, to be considered, is transfer by intervivos gifts or transfers. These are transfers of property during the lifetime of the donor.

This type of arrangement does have certain advantages. It saves the expense of probating an estate and it eliminates uncertainties for the young farmer heir who wants to take over the farm.

There are also certain disadvantages to transfer of property during the parent's lifetime.

1. If the parents dispose of their property, it may be difficult for them to make a living.

2. While gifts avoid probate costs, there are gift taxes involved.

3. It is difficult to treat all the children fairly.[11]

[11]Max Myers, op. cit., p. 14.

Another method of transferring property which can be considered in this section of gifts is the joint tenancy arrangement. This occurs when title to the property reads substantially as follows: "John Doe and Anna Doe as joint tenants with rights of survivorship and not as tenants in common." The instrument must clearly state the intention to create a joint tenancy.[12] If this is not stated, the property will be treated as a tenancy in common. Under this type of ownership, when one of the owners dies, the property does not have to be probated but the transfer is subject to inheritance tax in South Dakota. It is not advisable to place all property in joint tenancy for reasons mentioned below. This means that there will be some probate costs anyway. The real advantage of joint tenancy is that it allows the surviving owner to take immediate possession of the property, for instance, a car.

When property is held in joint tenancy of two or more persons other than husband and wife, it shall be taxable as though the whole property belonged to the deceased tenant. The burden of proof falls on the surviving tenant to prove that he paid for part of the property. Where a husband and wife hold property jointly, half of it is taxable under our inheritance laws.

Still another method of transferring property is through a trust. In this arrangement, title to the property is left to an administrator who operates and administrates the property in the best interests of the heirs.[13]

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[12] Max Myers, op. cit., p. 12.

[13] Ibid., p. 16.

This arrangement is very useful when the owner feels that the operation of the estate is so complex that highly trained specialists should be engaged to manage his estate. The costs involved in such an arrangement may, however, be detrimental to the success of such a plan.

There is a gift tax levied on the donor for the transfer of property by gift, but there are certain exemptions. An individual can give away $3,000 per year per person for as long as he likes without being taxed. An individual can also claim a $30,000 lifetime exemption in excess of the $3,000 per year per person. These amounts can be doubled if the gift is to a spouse or is the joint gift of a husband and wife.[14]

Table 3. Federal Gift Tax Rates on Gifts in Excess of Authorized Deductions as of 1961

Net gifts in excess of deductions (a)	Amount of tax and rate on next bracket
$0 to $5,000	2.25% on excess up to $5,000
$5,000 to $10,000	$112.50 plus 5.25% on excess up to $10,000
$10,000 to $20,000	$375.00 plus 8.25% on excess up to $20,000
$20,000 to $30,000	$1,200.00 plus 10.5% on excess up to $30,000
$30,000 to $40,000	$2,250.00 plus 13.5% on excess up to $40,000
$40,000 to $50,000	$3,600.00 plus 16.5% on excess up to $50,000
$50,000 to $60,000	$5,250.00 plus 18.7% on excess up to $60,000
$60,000 to $100,000	$7,125.00 plus 21.0% on excess up to $100,000
$100,000 to $250,000	$15,525.00 plus 22.5% on excess up to $250,000

(a) Gifts from a husband to his wife or vice versa are taxed only half their value. A husband and wife can elect to give a gift made by either to a third person and have it taxed as though each gave half.

Source: United States Internal Revenue Code of 1954, September, 1956, Edition, Ch. 12, Sec. 2501.

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[14]Prentice Hall, Federal Tax Course, Prentice Hall, Inc., Englewood Cliffs, N. J., 1961, Sec. 4015.

Organizational Arrangements for Transfer of Property

Partnerships

The first of these organizational arrangements to be considered is the partnership. "A partnership is an association of two or more persons to carry on as co-owners a business for profit."[15]

This partnership is formed by an oral or written agreement. A written agreement stating the purpose and the organization of the partnership is, however, much better than an oral agreement as it is good insurance against disagreement by partners.

The main advantages of a partnership for farm operators are as follows:

1. It is a means of pooling resources; when a young farmer wants to start in farming, it is sometimes impossible to buy a farm individually. If the young man goes into a partnership with his father or perhaps a brother, it is easier for the young man to get started in the business of farming.

2. It is a democratic system of management. That is, each partner has an equal right in the management of the business regardless of his financial interest. The only way a partner can lose his voice in management is if he gives it up of his own accord.

3. The partnership has a tax advantage over the corporation in that the business itself does not pay taxes. Only the partners do.

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[15] N. G. P. Krausz and F. L. Mann, Partnerships in the Farm Business, Cir. 786, University of Illinois, College of Agriculture, Urbana, Illinois, 1958, p. 3.

4. The partners may change the organization or dissolve the partnership entirely at any time without any notice to a public agency.

5. The farm operator qualifies for social security since he is self-employed and has earned income.

The major disadvantages of a partnership are as follows:

1. There is unlimited personal liability where each partner is personally liable for the debts and obligations of the partnership.

2. There is uncertainty as to the life of the partnership. It is dissolved (a) upon the death, expulsion, bankruptcy, or retirement of a partner, (b) by the option of any partner when no definite term is stated, (c) by agreement of all the partners, or (d) by court decree.

3. The value of each partner's interest is difficult to determine as each partner owns a part of each item in the partnership. A shareholder in a corporation owns stock representing an interest in the entire business. This tends to make partnership interests less marketable than corporation shares and also to make the transfer of a partnership interest more complex.[16]

4. Every partner is an agent of the partnership and any contract is binding when made by one member even though expressly forbidden by the partnership agreement, unless the person with whom he is dealing knows he is acting without proper authority.

The partnership is quite useful in pooling resources in order to get started in the business of farming, but it leaves something to be

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[16] *Ibid.*, pp. 4-8.

desired as far as ease of transfers is concerned. This problem and the problem of unlimited liability seem to be solved by the corporate form of organization.

Cooperatives

The next organizational arrangement for the transfer of property is the cooperative. The arrangement is very similar to a corporation, having shareholders, board of directors, officers and employees. The cooperative must file articles of incorporation just as the corporation.

The big difference between a cooperative and a corporation is that in a cooperative each member has only one vote regardless of financial interest.

Another difference between the two types of organizations is the method of taxation. The cooperative can deduct the following items from its taxable income in computing its tax.[17]

1. Amounts paid in dividends during the taxable year on its capital stock.

2. Amounts allocated during the taxable year to patrons with respect to its income not derived from patronage.

3. Amounts paid out as patronage dividends.

Certain other rules make a cooperative completely exempt from federal income tax if the organization qualifies under the following rules and files a letter of exemption.

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[17] U. S. Internal Revenue Code, 1954, Sec. 521,522.

1. The organization must be for the purposes of marketing farm products and turning the proceeds over to the members,

2. or for buying farm supplies and equipment and turning these over to the farmers at actual cost, plus expenses.

3. Organizations can only maintain a reasonable reserve for a reasonable purpose.

4. Transactions with non-members cannot exceed 15 per cent of business volume.

The basic principles of cooperatives do not lend themselves to the farming business as well as the corporation. First of all, a cooperative rewards its members on the basis of patronage since most cooperatives are service organizations. Secondly, the one vote per member makes it difficult for someone in the organization to maintain control of the business. In family-farm transfers, it may be quite important for the parent to maintain majority control during his life.

Corporations

The third and fourth organizational arrangements are the corporation and the pseudo-corporation. These business arrangements will form the body of this thesis and only brief mention of them will be made at this time. The difference between the two arrangements is that the pseudo-corporation is taxed just as a partnership while the regular corporation has the double taxation feature. Chapter III will outline the difference more fully.

The organization of the corporation is illustrated by the following table. It should be remembered, however, that an incorporated farm

is operated rather informally and the duties of each echelon are merged together in a few people.

Table 4. Organization of a Corporation

Duties of the various positions	Positions	
1. Vote for members of the Board of Directors on the basis of the number of shares of stock.	Stockholders	
2. Determines main policies of the corporation.	Board of Directors	These positions are probably held simultaneously by a few people in the case of a small farm corporation.
3. Operate the corporation from day to day.	Officers	
4. Perform duties assigned by the officers.	Employees	

Sole Proprietorship

The final organizational arrangement is the sole proprietorship. Since it is not a method of transferring ownership, the sole proprietorship will not be discussed in this study in spite of its many advantages.

ECONOMIC AND LEGAL ASPECTS OF FARM INCORPORATION

Advantages of Incorporation

Some of the possible legal devices for estate planning such as wills, intervivos gifts, partnerships, and cooperatives have already been considered. A brief preview of the corporation, including corporate organization, was also given. A more intensive look should now be taken at the corporate form of organization--its advantages, disadvantages, and how the farm corporation operates in practice. What then are the desirable aspects of the corporation for farming? The following advantages are listed by Deon Hubbard and Grant E. Blanch of Oregon State University: (1) Limited personal and corporate liability, (2) ease in transfer and distribution of ownership, (3) continuity of operation, (4) possible tax advantages, (5) possible means of improving credit status and pooling capital, and (6) possible fringe benefits, such as social security and retirement plans.[18]

More advantages may be added to this list. They are (1) control by the parents for as long as they desire, (2) rewards to heirs for contributions made to the farm during their life. Finally, all of these advantages relate to estate planning which will be considered the basic advantage of the corporate form of organization.

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[18]Deon Hubbard and Grant E. Blanch, The Farm-Ranch Corporation, Station Bulletin 576, Agricultural Experiment Station, Oregon State University, Corvallis, Oregon, 1961, p. 3.

An explanation of each of these advantages may be helpful in understanding the corporation as an estate-planning device.

Limited liability means that, unlike the member of a partnership, the shareholder is only responsible for corporate debts up to the limit of his investment. Likewise, the corporation is not liable for personal claims against the shareholder.

Ease in transfer and distribution of ownership is accomplished because the farm property itself is not divided up. Rather, each person owns a share of the whole. This concept of partial ownership in the entire business rather than distinct ownership of cattle, machinery, or land is foreign to the thinking of many farmers. Once accepted, however, it permits easy transfer or distribution of shares by sale or gift without changing the physical operation of the farm.

When the life of a business does not depend upon the life of a single individual, business planning can always be looked at with an eye to the future. The corporation is a legal person with the possibility of perpetual life. Even though one of the owners may die, operation of the business continues since no material difference is made in the farm except that the voice in management shifts somewhat with the transfer of shares of stock.

Tax implications will be treated at greater length in a separate section below.

The credit rating of a business may be improved by incorporation. Because of the necessity of keeping corporate records and of planning and improving the future of the farm through estate planning, commercial credit sources may look with more favor on the particular business. It

is possible that commercial credit sources might require the principal shareholders in the corporation to co-sign any loan made because of the limited liability feature described above. Capital accumulation can also be accomplished by the issuance of stocks or bonds. The success of these ventures, however, depends upon the reputation and condition of the individual business as an investment risk by other people. Incorporation cannot, of itself, make a good credit risk out of a poor credit risk.

The next advantage commonly listed is that certain fringe benefits such as social security, retirement plans, and pensions can be set up under the corporate device. These fringe benefits are available because the corporation is a legal person and anyone working in the business is considered an employee of the corporation. These various fringe benefits will be considered further in Chapter V.

The next advantage to be considered is control of the farm by parents as long as they desire. In transferring the farm from one generation to the next, the parents may not wish to relinquish control of the farm until they die. This is especially true if the farm is their only means of support. Through the corporate device, the parents could transfer 49 per cent of the stock in the farm to their children and still maintain their security as they would own the majority of the stock.

Rewards can be made very easily through the corporate device to members of the family for contributions they have made to the farm. Gifts of shares of stock can be made to the contributors much more easily than a part of the farm property could be transferred. When a farmer gives a part of the farm to a contributor, he runs the risk of splitting up the farm and making it less efficient. If the gift is personal property, he

confuses ownership and complicates management.

The final advantage is estate planning; that is, planning the use of a person's property during his lifetime and its disposition after his death. The advantage of estate planning, through the corporate device, is made possible because of the other advantages listed above.

Tax Implications

There are two methods of applying the income tax to a farm corporation. It may be taxed as a partnership (pseudo-corporation) or taxed the same as a regular corporation.

The regular corporation must report and pay tax on its taxable income much the same as an individual. The corporation has about the same kinds of deductions as the individual except that it has no personal or non-business deductions. The corporation deductions include salaries, rent, and interest.[19] After the corporation pays its tax, the corporate income distributed to the shareholders as dividends are also included on the individual's tax return. This is the unpopular double tax feature of the corporation. There are, however, methods of reducing this effect. The first of these is not to declare any dividends. This can be accomplished by paying earnings out in salaries or leaving the money in the business for expansion and paying a capital gains tax later if the corporation is dissolved. Secondly, under current regulations, an individual may exclude from his gross income the first $50 of income he receives as

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[19] John C. O'Byrne, N. G. P. Krausz, Neile Harl, and Jurgenson Hein, The Farm Corporation, North Central Farm Management Extension Committee, April, 1960, p. 10.

dividends. Thirdly, an individual is allowed a credit against his tax in an amount equal to 4 per cent of the dividends received during the taxable year and included in the gross taxable income.[20]

The income tax rate for a corporation is 30 per cent of all taxable income up to $25,000. The rate is 52 per cent for all taxable income exceeding $25,000.[21]

The individual tax rate exceeds 30 per cent for any taxable income over $8,000. The rate exceeds 52 per cent for any taxable income over $18,000.[22]

When corporate income is high enough to justify salaries of $8,000 or more, careful consideration should be given to the computation of income tax. The individual should set his salary at a level high enough to satisfy the standard of living he wishes to maintain and yet justifiable with regard to services rendered to the corporation. (If wages are not justifiable, the income tax authorities may disallow them as expenses to the corporation.) Any taxable income over this amount may to advantage be left in the corporation for reasonable reserve or expansion, as the corporate tax rates are lower than the individual's rate when taxable income exceeds $8,000.

In the Technical Amendments Act of 1958, Sub-chapter S provides certain tax advantages to small corporations. The act allows the

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[20]Prentice Hall, *op. cit.*, pp. 1704-1705.

[21]*Federal Tax Guide*, Commerce Clearing House, Inc., N. Y., 1961, Vol. 1, Sec. 1225.

[22]Prentice Hall, *op. cit.*, p. 1109.

corporation to transfer its earnings to the shareholders just as a partnership would. The individuals then include the income in their individual tax returns, thus escaping double taxation. A pseudo-corporation must meet the following qualifications:

1. It must be a domestic corporation, not a member of an affiliated group eligible to file a consolidated return with any other corporation.

2. The corporation must not have more than 10 shareholders.

3. All shareholders must be individuals (including estates).

4. No non-resident alien may be a shareholder.

5. The corporation may not have more than one class of stock.

6. The corporation may not get more than 80 per cent of its gross receipts from sources outside the United States.

7. The corporation may not get more than 20 per cent of its gross receipts from interest, dividends, rents, royalties, annuities, and gains from sales or exchanges or securities.[23]

Table 5 illustrates the tax implications of three different types of organization--partnership, regular corporation, and pseudo-corporation. It is assumed that the business includes a father and a son, both are married, have no dependents, and are less than 65 years of age. Both the father and the son take optional standard deductions.

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[23] United States Internal Revenue Code, 1954, as amended to August 1, 1959, Sub-chapter S, "Election of Certain Small Business Corporations as to Taxable Status," Commerce Clearing House, Inc., Chicago, Illinois, 1959, p. 4415-4422.

Table 5. A Comparison of Federal Income Tax for the Partnership, Regular Corporation, and Pseudo-Corporation, 1961

Type of organization	Recipients' income	Taxable business income $10,000		$30,000	
		Income	Computed tax	Income	Computed tax
Partnership	Father	$ 5,000	$ 660	$15,000	$2,960
	Son	5,000	660	15,000	2,960
Total		$10,000	$1,320	$30,000	$5,920
Pseudo-corporation	Father	$ 5,000	$ 660	$15,000	$2,960
	Son	5,000	660	15,000	2,960
	Corporation	none	none	none	none
Total		$10,000	$1,320	$30,000	$5,920
Regular corporation	Father	$ 5,000	$ 660	$10,000	$1,636
	Son	5,000	660	10,000	1,636
	Corporation	none*	none*	10,000	2,500
Total		$10,000	$1,320	$30,000	$5,772

*The corporation has not paid any tax in this case since all corporate income was paid out as salaries. In practice, this is difficult to do.

From the table above, it is clear that the partnership has no advantages over the pseudo-corporation with regard to taxes, as they are identical. The main problem to be answered for the corporate farmer is whether to elect to be taxed as a partnership or as a regular corporation. The answer lies in the amount of taxable earnings of the business. When individual tax rates exceed the corporate tax rate, it may be to the advantage of the owners to operate as a regular corporation. When the taxable income is low enough so that corporate tax rates exceed individual rates, it is usually advantageous to be taxed as a partnership. It is possible to be taxed as a corporation and still keep taxes at a minimum if all earnings can be paid out as salaries as in the illustration. This, of course, is very difficult when the earnings of a business fluctuate

as much as earnings do in the farm business, as the internal revenue department might well question the legality of a plan to vary wages with corporate income.

SURVEY RESPONSES FROM INCORPORATED FARMS

Financial Aspects of Corporate Farms

It is thought that incorporating the farm gives the business a better credit rating. This is made possible because of the additional planning and effort given to keeping records and to planning the future operation and continuity of the farm. The financial aspect of corporate farms was studied primarily in the more detailed questionnaire because it is a subject thought to be too personal to be handled by a mailed questionnaire.

The first question asked of these farmers about this subject was, "Does the corporate device facilitate securing credit from commercial sources?" Five of the corporations said yes and one said no. The farmer who gave the no answer did not think securing credit was improved since his bank would only loan so much money to a farmer as a matter of policy and he could borrow this maximum amount even before he incorporated.

It was thought that banks sometimes required one or more of the principal stockholders to sign as personal surety on corporate loans. Such a requirement would, of course, eliminate the limited liability advantage of the corporation. When asked whether they signed as personal surety on corporate loans, five farmers replied that they never did and one farmer occasionally had to co-sign the note.

Four farmers reported that the corporation borrows money from its shareholders and two farmers replied that in their corporation they never loaned money to the business. One of the reasons for this practice is that when a corporation is taxed as a partnership, all earnings are

transferred to the shareholders, at least on paper, for taxation purposes. This means that the corporation does not accumulate any operating capital from earnings unless they are only transferred on paper; therefore, such a corporation may need to borrow money from some source in order to operate. The source of credit could be from shareholders or commercial credit facilities.

It is interesting to note that, of the four corporations which are taxed as partnerships, three borrowed funds from the shareholders regularly.

Only one farmer replied that the corporation declared dividends. The other five corporations never declared a dividend. This seems to indicate that double taxation was not a particular problem with the corporations that chose to be taxed as such, as they either paid out all earnings in salaries or else retained the excess of earnings in the corporation for expansion purposes.

On the shorter questionnaire the question was asked, "Would the owners have incorporated if they were not permitted to be taxed as a partnership?" Seven of the farmers answered yes and five answered no, they would not. Four of the seven who answered yes said they kept taxes at a minimum by distributing earnings as salaries. On the more detailed questionnaire, four corporations reported being taxed as partnerships and two as regular corporations. Here again salaries were used to minimize regular corporation taxes.

Costs Involved in Forming and Operating a Corporation

The cost of incorporating a business is often listed as a disadvantage to the corporate form of organization. These costs include (1) a fee for examining, filing, and recording the articles of incorporation with the Secretary of State (a schedule of fees is given in Table 6), (2) a federal stamp tax levied on the original issue of stock at the rate of 10 cents on $100 of value,[24] and (3) attorney's fees for drafting the articles, publication costs, and office supplies of approximately $215 minimum.[25]

Table 6. Schedule for Filing Articles of Incorporation, South Dakota, 1960

Corporations without capital stock	$10
Capital stock of $25,000 or less	$25
Over $25,000 to $100,000	$35
Over $100,000 to $500,000	$40
Over $500,000 to $1,000,000	$60

Source: Session Laws of South Dakota, 1959, Sec. 55.1208.

Table 7 gives an estimate of the costs involved in incorporating a farm. This is a minimum cost estimate and a farmer's incorporation costs may be higher than this amount, depending on the amount of work the attorney must do.

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[24] U. S. Internal Revenue Code of 1954, as amended through April 9, 1960, Chapter 34, 4301-4305.

[25] Estimate based on personal interviews with three lawyers.

Table 7. An Estimate of the Cost of Incorporating a Farm with Capital Stock Valuing $100,000, South Dakota, 1960

Filing articles	$ 35
Federal stamp tax	$100
Minimum legal fee	$185
Publication costs	$ 10
Minute book and seal	$ 20
Total cost of incorporation	$350

Note: These costs are figured on the basis of the minimum legal fee.

There does not seem to be any significant legal cost once the farm is incorporated. In both questionnaires the question was asked, "Has the business encountered any legal difficulties after the corporation was formed?" Every farmer who answered the question (16 farmers) replied that no serious difficulties had been encountered. The only permanent expense to the corporation would then seem to be record keeping since this is required. This practice may, however, do the farmers more good than harm and would be the rule for most farmers, regardless of the type of business organization.

When Should a Farm Incorporate

This is a question to be answered individually by each farm owner. It is possible, however, to furnish some basic framework within which to make the decision. The first question a farmer should ask himself is whether the advantages of incorporation will make a contribution to his estate-planning problems and to the operation of the business. If there are contributions to be made by these corporate advantages, then it must be decided if they offset the incorporation costs and other expenses that

may be incurred by incorporating the farm business.

In the questionnaire, the question was asked of the incorporated farms, "What type of farm do you operate?" The replies to this question are summarized in Table 8.

Table 8. Relative Economic Importance of Farm Enterprises as Ranked by Corporate Farmers, South Dakota, 1960

Type of farm enterprise	Order of economic importance 1	2	3	4
Cash crop	1	7	1	
Beef cattle	9	1		
Hogs		1	3	
Dairy	1			
Poultry	1	1		
Sheep		3		

It appears that the beef cattle enterprise is more closely associated with the corporate form of organization than any other enterprise. In fact, no other enterprise was mentioned more than once by the respondents as their most important activity. Cash crops were the most important supplemental enterprise.

It is difficult to infer from this that beef cattle is the most suitable enterprise for a corporate farm. The answer may lie deeper than this. It is highly possible that the high incidence of corporations in the beef cattle business arises because of the greater investment necessary in this enterprise. If this is true, then size may be the better indicator of when to incorporate the farm.

In the mailed questionnaire, the question was asked, "Could you make an estimate as to the minimum capital assets required to make a

family farm corporation pay?" The information is not tabulated here because of the problem of identification. No farm with assets less than $50,000 had chosen to incorporate. The median investment for the sample was $150,000. In the six personal interviews, the farmers were asked to give an estimate of the net worth of their business. The average value of these estimates was $390,000. These six farmers were also asked to give an approximation of their corporation's gross income. Half of the corporations had gross incomes under $50,000, and one grossed less than $15,000 in 1959.

In order to get an estimate of the amount of land involved, the following information was assembled. The average amount of land owned by all corporations in the sample was 6,675 acres. The average amount of land rented was 2,327 acres. Only two corporations rented out corporate land to other people, so an average of this amount is not meaningful. The average size of the operating unit reported by these corporations was 8,779 acres.

These figures do not attempt to establish the minimum size farm which should incorporate, but they may furnish a guide for farmers thinking of incorporating.

Transfers Made Through Incorporation

Perhaps the biggest advantage of the corporation for farmers involves the ease of transferring stock to the next generation and the control of the farm by the parents as long as they desire to control it. This phase of incorporation was investigated further in order to determine how real these advantages really are.

Most of the corporations investigated were closed corporations. That is, stock could not be sold to anyone outside of the corporation without first offering sale of the stock to the present members.

Another plan in use for keeping the number of shareholders limited was life insurance stock funding. There are two different ways of handling this plan. One way is for the corporation to take out a policy on each stockholder equal to his investment in the business. The corporation is then the beneficiary and agrees to use the proceeds to buy the stock from the estate of the deceased stockholder. This plan has certain drawbacks in a closely held family corporation involving something other than brothers. If the proceeds from the stock bought out go to someone like the mother or a son of the deceased, these proceeds might be considered as dividends for income tax purposes. In cases where parents and children are participating in a closely held corporation, a better plan is for each stockholder to hold a life insurance policy on the other stockholders so they can buy out the stock from the deceased stockholder's estate. This plan does not have the income tax implications present in the first arrangement. Under both arrangements, it is essential that the stockholders have a buy-sell agreement which requires the purchase of stock from any deceased stockholder's estate.

In this way it is possible to limit ownership to the immediate family and maintain the closed-corporation status. Only one corporation in this study used life insurance as a method to maintain the closed corporation. Seventeen corporations reported they did not use this device.

The fact that the closed corporation is a very common device is evidenced in part by the fact that of the six farmers interviewed personally five indicated that there was a written agreement concerning transfer of stock. The other farmer had an oral agreement as to transfer of stock. All six of these farms were closed corporations.

Distribution of ownership in these corporations tends to indicate that most of the incorporated farms are family-type farms, as indicated by the following tabulation from the questionnaire.

Table 9. Persons Having an Economic Interest in the 17 Reporting Corporations, South Dakota, 1960

Type of owner	Number of persons holding an interest
Husbands	16
Wives	10
Sons	14
Daughters	5
Other relatives	5
Non-relatives	4

One corporation was entirely composed of non-relatives, and the other 16 were composed of family members, with the exception of one corporation which had one non-relative as a shareholder.

This stock could be transferred in two different ways--by purchase and gift. A possible combination of these two is a reward to the children for contributions to the business. Of the corporations answering the question, "How did the children acquire ownership in the corporation?" one acquired ownership by purchase, seven by gift, and three as rewards for their contributions to the farm.

Ten of the major stockholders had wills made out disposing of the balance of their estate on death, and five did not. Of these five, two had some other plan for disposing of their estate, such as trusts or purchase agreements. This seems to indicate that among these people there was an awareness of the need for estate planning.

When asked if there is a plan for one of the children to acquire controlling interest in the corporation, only four replied that there was such a plan. Seven said there was no plan and the remaining people did not answer the question. It may well be that these remaining people did not wish to name the person who eventually gained control of the farm. Much thought should be given to this part of the estate plan in order to avoid confusion and resentment among the future heirs.

Reasons for Incorporating

Perhaps the most basic question to be answered by this study is, "Why do farmers incorporate?" The hypothesized answer to this question is that the corporate form of organization has desirable characteristics which can be of use in keeping the farm intact and in the family.

In order to find out the reasons why farmers incorporate, the following question was asked: "Why did you incorporate your farm?" The results of this question are summarized in Table 10.

Table 10. Reported Reasons for Incorporating the Farm, South Dakota, 1960

Reasons for incorporating	Order of preference			
	1	2	3	4
1. Estate planning	5	2		
2. Continuity of business planning	3	2	2	1
3. Control of ownership by parents as long as they desire		4	2	1
4. Limited liability	3	3		
5. The ability to raise capital	1			
6. Social security, insurance, and other fringe benefits			2	
7. Rewards to members of the family for contributions made		1	1	
8. Others	1			

Note: Not all of the farmers answered all questions; therefore, the totals will not be the same for all columns.

It should be noted that estate planning, as a reason for incorporating, received the highest number of first-choice responses. This gives some indication as to the usefulness of the corporate device in estate planning.

Continuity of business planning and limited liability each received three first choice responses indicating that they are important reasons for incorporating. Both of these advantages lend considerable stability to the farm business, especially where more than one person is involved in the business.

Control of ownership by parents as long as they desire received the highest number of second-choice responses. This is an important aspect to consider in passing the farm from one generation to the next, as the parent's security is an important consideration in any estate plan.

The favorable response to the first four reasons for incorporating gives a definite indication of the fact that incorporation is very useful in planning the future operation of the family farm.

AN EXAMPLE SOLUTION TO THE ESTATE-PLANNING PROBLEM OF A HYPOTHETICAL FARM

One way to illustrate the advantages and disadvantages of incorporating a farm is to work through the decision-making process and the actual incorporation of a hypothetical model. The information furnished and the methods used in this model may help farmers make the right decision with regard to their own farm.

It should be remembered that no form of business organization will work if the people involved in the business do not get along. When making the decision as to whether to incorporate, the family situation and the wishes of the family must be very carefully considered. The human factor has been treated rather lightly in this model since human reactions and emotions are so variable that it would be impossible to build a model which would take into account all family situations. Instead of dwelling on problems such as this, the model covers the economic and legal aspects of incorporating much more extensively.

The Situation

The family consists of a father and mother, both aged 59. The father is still very active in the business. There are two children--a son and a daughter, aged 32 and 28 respectively. Both children are married. The son has two children and the daughter has one child.

The father and the son operate the business as a partnership. The daughter is not living at home and has no particular desire to take part in the operation of the farm.

The value of the farm is $120,000, with ownership by the father and son being in an 80 : 20 ratio. The son's ownership is made up of an interest in the livestock and machinery. This 20 per cent ownership by the son was acquired as a reward for his special contributions to the farm and through purchases which he has made through the years. Profits are distributed in this same ratio.

The basic problem is that upon their death the father and mother desire to treat both children equally. The son has put considerable effort into the business and the parents feel that some day he should own the property. At the same time, they realize that the daughter must also be awarded her share of the estate. The parents' estate is almost entirely made up of the father's $96,000 interest in the farm. Since the parents desire that each child fall heir to half the estate, the son will have to buy out a $48,000 interest from his sister if he eventually wants to gain control of the farm. This transfer should take place with little break in the continuity of the business. The problem may well be magnified if the son finds that he cannot acquire sufficient credit from commercial sources to both operate the farm and buy out his sister's interest at the same time.

In addition to this problem, the father wishes to retire at the age of 65 with a sufficiently high income to maintain his standard of living. He is worried that he cannot accumulate enough money under the present form of business organization to do so.

If the farm were to incorporate, the son could make an agreement with his sister whereby he could buy a few shares of stock from her every year. This plan would result in a smooth transition of ownership with

little hardship for the son or daughter. Incorporation might also help the father to achieve his goal of retirement by age 65.

How the Corporation Would Be Set Up

The beginning corporation will be formed with three shareholders--the father, the mother, and the son. Shares of stock will be issued on the basis of financial interest in the existing farm. The father will set up a joint tenancy with his wife so that 80 per cent of the stock is jointly held by the father and mother. This gives the parents control of the farm for as long as they desire.

The plan for future ownership of the farm is that when one of the parents dies, the other will succeed to the parents' property. Upon the death of both parents, the estate is to be divided equally between the son and the daughter. The father also desires that as much as possible of the daughter's share in the estate should come from sources other than corporate stock. This desire coincides with the wish that the son eventually gain control and ownership of the farm. It is also a possibility that when the father reaches age 65, he may wish to supplement his retirement income by selling some of his stock in the corporation to the son. Since these are the wishes of the parties, the corporate documents should be drawn up with these wishes in mind. It is important for the incorporators to have a basic idea as to what they want the business arrangement to do before they enlist the aid of an attorney.

In talking about the corporate documents, it is important to realize that the attorney will do most of the work concerning the legal matters of setting up a corporation. Only a general knowledge of this

area is necessary for the farmer thinking of incorporating. The first step is usually to enter into some type of pre-incorporation agreement. This practice insures that there will be no misunderstandings and that the expense incurred in organization will not be wasted. This agreement would set forth the amount of stock to be issued and the principal rights and duties of the parties. The distribution of ownership will also be included in this document.

The next step to be made is drawing up the articles of incorporation. Three or more incorporators are required to sign the articles.[26] In general, the articles include the name of the corporation, the purpose, the place of business, the term for which the corporation is to exist, the number of directors, the names and addresses of directors who will serve until an election can be held, and finally, information about the capital stock.[27] It is important to note that, in specifying the purposes of the corporation, they be set down in broad enough terms so as not to hamper the activities of the corporation in carrying on the farm business. The term for which the corporation is to exist is usually stated as perpetual so that the corporation will not dissolve until its members so desire.

After the articles of incorporation are filed with the Secretary of State, he will issue to the corporation a certificate of incorporation. At this time stock will be issued in exchange for property, cash, or other value. The stockholders then hold an organization meeting, elect

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[26] South Dakota Code of 1939, Sec. 11.0202 (2).

[27] Ibid., Sec. 11.0202 (1), (2).

directors, and adopt by-laws. By-laws are adopted by the consent of a majority of all the subscribed capital stock. The by-laws are simply the rules which govern the internal operation of the corporation, including the election of officers, duties of the officers, meeting dates, etc.

As indicated by the questionnaire, most farm corporations are closely held and contain a small number of members. This means that there is little distinction between ownership and management. This also means that, while an annual meeting will be held as provided by law, most of the management will be handled on an informal day-to-day basis, much as a partnership. The major management difference between the two forms of organization is that in a corporation the stockholder with the most shares of stock will be the most powerful voice in management decisions.

At this time other documents might well be drawn up. If a will has not been made, it would be good practice to do so at this time, especially for the father and mother. It was the wish of these people that the son become the eventual owner of the corporation and that corporation membership be limited to the members of the family. Since these are the wishes of the family, a very important document for them will be a stock buy-sell agreement. The agreement should set forth provisions for a closed corporation. This is usually done by requiring that any person desiring to sell corporate stock must first offer it to members of the corporation or the corporation itself. The other portion of this agreement concerns the method by which the son will eventually buy out the sister's interest in the farm. This agreement provides that the son will buy a few shares each year so that hardship will not be worked on him. At the same time, it allows the sister to take part in the corporation as long as she

has an investment in it. It is not anticipated that troubles or disputes will arise between the brother and sister over this point, but the possibility should not be overlooked. The stock will be valued by common agreement. If this is not possible, the help of an appraiser will be enlisted. Since the son will be the majority stockholder, it is possible that he could neglect the better interests of his sister regarding her ownership in the corporation. In order to avoid this possibility, some safeguard must be given to the sister. If a dispute arises as to the sister's investment, the son must buy all of her shares at a fair price at the time of the dispute.[28] This price will be set by an appraiser. The purchase of this stock will then be conducted on the basis of a loan from the sister to the brother. He must pay her the going rate of interest on the unpaid balance of the loan. It should be remembered that such difficulties are not anticipated, but the precaution should be made. It is also thought to be equitable treatment for the sister since she will lose nothing on her investment in the corporation and she has no particular interest in owning the farm.

Finally, the help of a competent attorney should be enlisted in drawing up the corporation documents. Time and effort can be saved, however, if the incorporators understand what must be done, can give the attorney all the information needed, can explain to the attorney their desires, and the goals to be achieved by incorporation.

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[28]August G. Eckhardt, Family Farm Corporations, "Wisconsin Law Review," University of Wisconsin, July, 1960, p. 616.

Income Tax Implications

The father's income tax rate has seldom exceeded 22 per cent annually. If they incorporated, it would be disadvantageous to be taxed as a regular corporation. The corporate tax rate on the first $25,000 of taxable income is presently 30 per cent.[29] In this case if the corporation could not pay out all of its earnings as salaries, its income would be taxed at a higher rate than the individual tax since the father's tax rate has seldom exceeded 22 per cent. The question of double taxation also enters in if corporate income is ever distributed as dividends.

If the business is taxed as a corporation, there is also a disadvantage with respect to the capital gains tax. Suppose the farmer realizes a capital gain of $2,700. An individual would pay tax on 50 per cent of this amount at his regular income tax rate but not to exceed 25 per cent.[30] In this case his tax on a $2,700 capital gain is $297, assuming a tax rate of 22 per cent. As a corporation, the tax would be $675 since they are taxed at the rate of 25 per cent on the whole amount of the capital gain.[31]

It is apparent that this corporation should elect to come under Sub-chapter S and be taxed as a partnership, as this would serve to reduce income taxes and capital gains taxes.

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[29] _Federal Tax Guide_, Commerce Clearing House, Inc., N. Y., 1961, Sec. 1225.

[30] Prentice Hall, _op. cit._, Sec. 1600 (1), (2).

[31] _Ibid._, Sec. 3206 (2) (b).

A small disadvantage tends to deter the use of the pseudo-corporation. The cost basis of assets of the corporation is not re-established periodically upon the death of an owner.[32] This means that the depreciation deductions of an asset may run out while there is still value in the asset. This could affect the income tax paid on the sale of capital assets. If this problem must eventually be faced, a solution can be worked out in order to nullify this disadvantage. It may be possible to transfer the critical asset to the estate of a deceased stockholder in exchange for stock, passing the specific asset through the estate to the heirs.

Retirement Plans

When the father reaches age 65, he plans on retiring. There are many aspects of incorporation which the father should consider regarding his retirement. The first of these is social security.

One advantage of incorporation is that the farmer can set a salary for himself which will result in maximum retirement payments under social security. When operating as a sole proprietorship, income is variable and it is difficult to get maximum payments. In years when income is below $4,800, contributions will be reduced; however, if income exceeds $4,800, contributions do not similarly increase. Benefits are based on contributions or payments made into the social security account.

If a farm is incorporated and the farmer is an employee of the corporation, his salary can be set at $4,800 or more each year, depending

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[32] August G. Echhardt, *op. cit.*, p. 659.

on his contributions to the farm, and social security benefits will be at a maximum.[33] A person can earn up to $1,200 per year and still draw his full social security benefits. Such things as real estate rentals and interest are not counted in this $1,200.[34]

The corporate form of organization has a drawback when considering social security payments. There is a difference in rates between self-employed and employees. If a person is self-employed, his social security tax rate will be 4½ per cent for the period 1960-1962. This is scheduled to be raised to 5¼ per cent in 1963, to 6 per cent in 1966, and to 6 3/4 per cent in 1969.[35]

When the self-employed father and son incorporate the farm, they become employees of the corporation. Under this system, both the employee-operator and the corporation must pay matching taxes for social security. These social security tax rates are 3 per cent for the period 1960-1962. This is scheduled to be raised to 3½ per cent in 1963, to 4 per cent in 1966, and to 4½ per cent in 1969.[36] Here, of course, the corporation must match the individual payment, in effect doubling these rates.

If the increase in benefits due to uniform maximum salary exceeds the additional tax rates, then social security will not work to disadvantage. Assuming that this farmer's income for two years prior to

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[33] U. S. Internal Revenue Code of 1954, 1402 (b) (1) (c).

[34] Social Security Handbook, Department of Health, Education, and Welfare, 1960, Sec. 1701, 1708.

[35] Ibid., 1401 (2).

[36] Ibid., 3101 (2).

incorporation was also at least $4,800 a year, his benefits would be $190.50 per month upon reaching age 65.[37]

The shareholders would probably not desire to set up a pension plan in a small corporation. The pension plan is a method of providing a definite income to retired employees. If a corporation were to do this, they would almost have to contract with an insurance company to figure out the contributions to be made to each employee. The cost to the corporation of such a plan is a fixed amount each year. Contributions to the fund would not be on the basis of profit making.[38] This plan is not ordinarily suitable for a small farm corporation because of the uncertain and fluctuating farm income.

A stock-bonus plan where rewards are made by giving stocks to employees is geared to the profits of the business. This type of plan would result in something other than a closed corporation if the business has other employees, unless the plan was limited to the key personnel in the corporation.[39] Since most of the farm corporations studied are closely held, the stock-bonus plan is unsuitable as a means of retirement planning for its employees.

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[37]U. S. Department of Health, Education, and Welfare, Social Security Administration, "Your Social Security," U. S. Government Printing Office, April, 1959, p. 13.

[38]August G. Eckhardt, Law Review Seminar, Family Farm Corporations, reprinted from Wisconsin Law Review, published by the Law School of the University of Wisconsin, Waterloo, Wisconsin, July, 1960, Volume I, No. 4, p. 635.

[39]*Ibid.*, p. 636.

A profit-sharing plan does seem to hold potential as a retirement plan for a small farm corporation. In this type of plan, contributions by the employer are paid into a trust where they must be allocated to the participant's accounts by means of some fixed formula. The profits are then distributed to the participants after a certain number of years or after some event, such as layoff, illness disability, retirement, death, or severance.[40]

If such a plan is qualified under Section 401 of the Internal Revenue Code of 1954, the employer can deduct his contributions to the plan for income tax purposes.[41] When the profits are distributed to the employees, they are taxed as part of his income.[42]

In order for such a plan to be qualified, it must meet the following requirements:

1. The plan must be for the purpose of distributing to the employees or their beneficiaries the income accumulated in the fund.

2. The plan must be for the exclusive benefit of the employees or their beneficiaries.

3. The plan must benefit 70 per cent of all the employees or at least 80 per cent of the employees who are eligible if at least 70 per cent are eligible. Employees who do not work more than 20 hours a week or more than five months in a year or a minimum of five years may be

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[40] Ibid., p. 636.

[41] Internal Revenue Code of 1954, p. 404.

[42] Ibid., p. 402.

excluded in figuring these percentages.

4. The plan cannot discriminate in favor of officers, shareholders, persons whose duties are of a supervisory nature, or highly compensated employees.

5. The plan is not discriminatory if benefits bear a uniform relationship to regular compensation.[43]

A plan such as this would not be of great benefit for the father because he only has six years in which to accumulate his share of the fund. The plan does represent a very good method in planning for the son's retirement, and for that reason it will be included in this model. It does seem realistic, however, that the father's share in the fund could amount to $3,000 at the end of six years. With this sum the father could purchase an annuity which would pay him $18 per month as long as he lives.[44]

Another way in which the farmer could boost his retirement income would be to hold some land out of the corporation and rent it to the corporation. He could also receive dividends from the corporation to supplement his income. These earnings must clearly be in the form of dividends, however, and not represent another name for wages. The reason for this is that under social security laws a person under 72 years of age can earn no more than $1,200 per year and still receive maximum

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[43] Ibid., p. 401.

[44] Information gained from a local insurance agent.

benefits. Rents, interest, and dividends are not included in this figure.[45]

Finally, the retired father could sell stock to his son if he did not have enough income on which to live. Since the father owns $96,000 worth of stock, he could sell his stock to the son as he needed income. Even if he sold $3,000 worth of stock a year, it would take him 32 years to completely divest himself of his interest in the farm. If the value of the father's interest changes in future years, the 32-year period may have to be lengthened or shortened.

The father in this corporate model has eight alternatives for retirement income. They are social security, profit-sharing plan, stock-bonus plan, pension plan, sale of stock, rent, interest, and dividends. Personal savings might also be a factor in retirement income. In our model the father ruled out the stock-bonus plan, the pension plan, rent, and interest, as indicated above.

This model may serve as a guide to anyone contemplating incorporation of a farm. Considerations such as retirement plans, method of taxation, distribution of ownership, and transfer plans are very important in deciding whether to incorporate.

Transfer plans are especially important and should be given much consideration in planning a farm corporation. In many cases the father may have enough financial security or large enough ownings in the corporation so that intervivos gifts can be utilized to good advantage in making

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[45]Prentice Hall, <u>Federal Tax Course, 1959</u>, Prentice-Hall, Inc., Englewood Cliffs, N. J., 1959, 3819 (2).

disposition of the estate. As mentioned earlier in Chapter II, a married couple can give away $6,000 in value per year per person without any gift taxes being levied. The couple would also have a $60,000 lifetime exemption in addition to the yearly exemption. Through the use of shares of stock as gifts, the father and mother could transfer a sizeable portion of their estate without having any taxes levied.

The sale of stock to children or other members of the family, as illustrated in the model, is a good method of receiving an adequate retirement income and at the same time accomplishes the transfer of property to the next generation without federal estate, inheritance, and gift taxes being levied on the transfer.

Each farmer should consider his situation carefully in order to decide the best method of transferring his property, whether it be by sale, intervivos gifts, or by inheritance at the owner's death.

SUMMARY AND CONCLUSIONS

The basic problem of this thesis was whether or not estate planning on the farm was facilitated by the corporate form of business organization. The difficulty in estate planning arises because of the problem in transferring the large farm of today from one generation to the next.

The first step in solving this problem was to consider types of transfer by law and other business arrangements. Transfer arrangements by law, such as wills, gifts, sales, and trusts, can, of course, be employed in any estate plan regardless of whether the farm is incorporated. These devices must be considered in any estate-planning problem.

The sole proprietorship is the most commonly used business organization. The problem of passing large farms from one generation to the next is not satisfied by the sole proprietorship in many cases because of the difficulty for one of the heirs to gain control of the farm. If one heir cannot gain control of the farm because of lack of capital, the farm would have to be split up or else sold to some person not a member of the family.

The partnership makes it possible for an heir to gain an equity in the business and perhaps to own it completely in the future. This type of business organization does have some difficulties. The members of a partnership do not have limited liability. Each partner has an equal voice in management regardless of financial interest. When one of the partners dies, the business organization is automatically dissolved. This means that business planning may suffer from a break in continuity. The partnership may well result in the fragmentation of ownership which would

make transfer of property difficult and could conceivably handicap the operation and management of the business. This form of organization does hold many good advantages for a farm business, however, and should be considered in planning the future of the farm.

Cooperatives were also discussed in Chapter II. The major drawback here is that each member has only one vote regardless of extent of ownership and it is difficult for the parents to maintain the control necessary for their security. It has also been questioned whether or not the laws would permit a family to operate as a cooperative, especially for tax purposes. In other words, the business organization might well be taxed twice on any earnings distributed as dividends.

In Chapter III, the advantages mentioned most as reasons for incorporating were estate planning, continuity of business planning, and control of ownership by the parents as long as they desire. The response to limited liability as a reason for incorporating from persons who have incorporated was also very high on the list of reasons for incorporating. The ability to raise capital, social security, and other fringe benefits, rewards to members of the family for contributions made, and other miscellaneous advantages did not appear to be too important.

Taxes did not appear to be a disadvantage to farm incorporation. Farms which were taxed as a regular corporation eliminated double taxation by the use of salaries equal to earnings to the extent that this was possible. The pseudo-corporations are taxed just as a partnership, and therefore, are not taxed any more than any other business.

The ability to raise capital did not seem to be enhanced by the corporate form of organization because of the ability to issue stocks or

bonds. This was not a motivating reason for incorporation by those contacted in the sample. The reason for not being able to raise capital through the corporate device is that most of the farms desire to operate as a closed corporation. The corporations did seem to enjoy a higher credit rating, probably because their businesses were well organized and efficiently operated.

Costs of incorporating may very well represent a disadvantage or at least a deterring influence in adopting the corporate form of business organization. A minimum estimate of the cost of incorporation is about $350.

Conclusions

1. The results from the questionnaire used in this study and the information found from other sources such as the Wisconsin, Iowa, and Oregon studies give definite indications that the corporate form of organization is a useful device in estate planning and the future operation of the farm.

2. The fact that only ten of the interviewees out of 19 questioned answered that they had a drafted will seems to indicate that these farmers had not completed their estate planning. Two other farmers had some other plan for disposition of their property at death, such as trusts, but in general, it appears there is a need for more counseling to farmers in completing an estate plan. It would be well if attorneys would acquaint farmers with the possibilities for estate planning when they assist farmers in incorporation. Farmers who do incorporate, or who adopt any form of business organization, should realize that such a step is merely one

aspect in the total complicated process of estate planning.

3. Agreements whereby one heir could eventually own the farm were also lacking. Only two of the interviewees indicated that the children had stock purchase agreements for gaining control of the farm from the other heirs. Only four persons indicated that there was any plan for one of the children to acquire controlling interest in the farm. It may well be that such a plan is not desired, but where the people concerned desire that one heir gain control of the farm, a written agreement should be made which will accomplish this objective.

4. Chapter V is essentially a model which may be helpful in making the decision as to whether to incorporate. It is important to remember, however, that this is only a guide which may help some farmers in making a future business plan. The help of an attorney should be enlisted after the farmer has some idea about what he wants to accomplish. The problem and possible solutions to it should be discussed among the family or by the possible incorporators, whoever they may be, until goals are agreed upon. An attorney is then in a position to give counsel as to how the mutual desires can be achieved. The family will require several discussions among themselves and with their attorney and only by patient and thoughtful consideration can a sound estate plan be achieved. Another important thing to remember is that the initial plan may be good today and need revision in the future as conditions change. Estate planning requires periodic review and to some extent is a constant process.

5. In the interviews with farmers who have incorporated, only one farm was owned by non-relatives. This indicated that most of the corporations were closely held corporations. In the six personal interviews, one

thing seemed to be common with all the corporations. They were definitely family owned. The family had a great deal of pride and sentiment for the farm. None of these people wanted to see the farm split up after they had worked hard to build it into the operating unit. Perhaps pride and sentiment in the farm business and family loyalty are the most basic ingredients in making a success of the family farm. It can be stated with considerable confidence that this pride and loyalty must be present in a family farm corporation in order to insure smooth working relations among the shareholders in the corporation. This is essential to good management in any business.

6. The incorporation of a business should be looked upon as nothing more than a means to some end. The emotional overtones given to corporate farms do not seem valid in the light of this study. This device should be compared with other methods of accomplishing the end goal and then a proper decision should be reached. The corporation has many estate-planning advantages and will be a very suitable method for many people in accomplishing their objectives.

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