

1975

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Recommended Citation

C. William Eastwood, *The Farm Corporation from an Income Tax Viewpoint: Friend or Foe?*, 54 Neb. L. Rev. 443 (1975)

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The Farm Corporation From an Income Tax Viewpoint: Friend or Foe?

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I. INTRODUCTION

While the number of farmers and ranchers in the post-World War II period has continually declined, the amount of capital required for farm operations has grown at staggering rates. No longer is agricultural production the result of the sweat of the farmer's brow, but is instead the result of efficient employment of capital and the utilization of modern management techniques. Unlike other types of businesses, such as banks, in which the form of organization is dictated, the farming enterprise can theoretically be operated in any known form of organization.

Proprietorships, partnerships, and corporations are the most commonly encountered forms of business organization used in farming operations. Consistent with their independent nature, the vast majority of farms and ranch operators have elected to do business as proprietorships or modified proprietorships—an organizational form associated with the absence of formal organization. Most farming enterprises operated as partnerships, despite their classification as a partnership, are doubtlessly little more than a proprietorship except that there is more than one owner, and the partners operate according to loose-knit arrangements providing capital sharing income expenses and dividing responsibilities. A third frequently utilized form of organization by commercial farmers and ranchers is the corporation. Despite its formal requirements, and the additional state ad valorem tax and expenses involved with organization and operation, an increasing number of farming enterprises are being operated in the corporate form.

A number of reasons may exist for a corporate operation such as control of minority owners, limited liability, continuity of enterprise, ease of transfer, licensing requirements and ownership by a large number of entities. Despite the length of this list, a careful examination of the farming enterprise operated by a single family unit will generally reveal that the so-called advantages of the corporate operation are illusory. Indeed, the failure to adhere to the formal requirements for corporate operation may subject the operators to unforeseen legal snarls.¹

The principal advantages of operating in the corporate form are the tax benefits to be derived from gift and estate planning.² The

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1. An analysis of the problems associated with operation of the family farm in the corporate form appear in a companion article in this symposium. See Comment, *Sole Proprietors' Quandry: Opening the Close Corporation*, 53 NEB. L. REV. 527 (1975).
 2. For a detailed analysis of the estate and gift tax advantages of corporate farming, see Kelley, *The Farm Corporation As an Estate Planning Device*, 53 NEB. L. REV. 217 (1975), in Part I of this symposium.

potential gift and estate tax benefits result from an ability to make gifts of shares of stock thereby creating interests or future interests in property not otherwise readily subject to transfer. Separation of control from ownership, restriction on transfer, and transfer of minority interests enable those interests to be transferred at a lower valuation for the shares of stock than the value of the percentage interest in underlying assets.³ Because historically the increase in the farm operator's net worth has been principally the result of increased land values passed from generation to generation rather than the cash flow from farm operations, minimization of estate taxes through corporate operation can become the principal tax objective. However, the probability of the sale of part or all of the corporation's assets, which involves a major refinancing to provide funds for non-farm activities, the lost investment yield from payment of higher income taxes, and the psychological impact on the farm operator from payment of substantially higher income taxes in some years to minimize taxes after he has departed cannot be measured with a great degree of certainty. Before making the decision to incorporate, however, it is imperative that the income tax consequences of organization, operation and liquidation be compared with those of operation as a proprietorship or partnership.

In general, the major tax advantages of operating a closely held farming organization in the corporate form are: (1) an ability to split income that is not available in a proprietorship or family partnership; (2) a lower maximum income tax rate; (3) an ability to make new elections; (4) the utilization of subchapter S to minimize double taxation; (5) an ordinary loss deduction for bad debts; (6) an opportunity to adopt more favorable incidental fringe benefit and deferred compensation plans; (7) an exclusion from taxation of \$5,000 in death benefits; and (8) estate and gift tax advantages. The major disadvantages are: (1) the lock-in effect on positive cash flow and appreciation in property; (2) the difficulty in offsetting losses against income from other sources; (3) the increased social security taxes; (4) the tax price of distributing borrowings to the stockholders resulting from corporate property appreciation; (5) the inapplicability of the fifty per cent capital gains deduction; (6) the loss of accelerated depreciation methods on incorporation for

3. Although the estate tax consequences have not been fully developed in litigated cases, the author believes that the same estate tax consequences can often be achieved through the use of limited partnerships without incurring the adverse income tax consequences associated with a corporate operation. Other operational problems, however, may make limited partnerships impractical. See Rossbach & Faber, *Tax Shelter Investment and Trusts*, TRUSTS & ESTATES at 70 (Feb. 1975).

existing property; (7) the increased tax record-keeping; and (8) double taxation.

This article focuses on the federal income tax⁴ consequences of farm operation in the corporate form⁵ and is based on the assump-

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4. The subsequent discussion generally excludes consideration of state tax consequences. If the state of incorporation has an income tax similar to that of Nebraska, the state tax is a percentage of the federal income tax and the state tax consequences will parallel the federal tax. See NEB. REV. STAT. § 77-2715 (Reissue 1974). The impact of the state's corporate franchise tax and cost of incorporation can be significant and should be considered in planning the capital structure. See NEB. REV. STAT. § 77-2734 (Reissue 1974). The state occupation tax is often a minimal addition to the administrative costs. See NEB. REV. STAT. § 21-303 (Reissue 1974).
 5. Although farm corporations are governed primarily by the general provisions of the Internal Revenue Code, there are several tax provisions applicable only to farming operations. The basic tax consequences unique to farming operations are: (1) the ability to use the farmer cash method of accounting which ignores inventories, INT. REV. CODE OF 1954, §§ 446, 471 [hereinafter cited as CODE]; Treas. Reg. §§ 1.446-1(c) (1970), 1.471-6 (1960). (2) deduction of certain soil and water conservation and land clearing expenses. CODE § 175. (3) a longer holding period for capital gain treatment on cattle and other livestock. *Id.* § 1231(b)(3)(B). (4) the required maintenance of a so-called excess deduction to account ("EDA") which can result in the treatment at ordinary income rates of gain which would otherwise be treated as capital gain. *Id.* §§ 1251, 1252.

Under existing law, the special tax attributes of farming operations are generally applicable regardless of the form of organization. A significant piece of proposed legislation that would obviate this general rule was introduced in 1974. The House Ways and Means Committee in its tentative draft of tax reform act provisions in 1974 would have required corporate farms, other than subchapter S and "family farm" corporations, to report their income on the accrual method of accounting. For the purposes of the proposed legislation, a "family corporation" was defined as one in which seventy-five per cent (75%) of the voting stock and seventy-five per cent (75%) of the total stock in the corporation are owned either by a family, which includes the taxpayer (presumably any one stockholder), brother, sister, spouse, ancestor, and lineal descendants or the estate of the taxpayer. HOUSE WAYS AND MEANS COMMITTEE, 93d CONG., 2d SESS., TENTATIVE DRAFT OF TITLE 1, CHANGES PRIMARILY AFFECTING INDIVIDUALS § 477(2) (Comm. Print No. 1 1974). This provision was modified to exempt family farm corporations. HOUSE WAYS AND MEANS COMM., 93d CONG., 2d SESS., SUMMARY OF TENTATIVE DECISIONS OF WAYS AND MEANS COMM. ON TAX REFORM BILL § 133, *appearing in* BNA Daily Report for Executives, Nov. 5, 1974, at J-1.

The House Ways and Means Committee's 1975 proposals contain a provision identical with the 1974 bill of the House Ways and Means Committee. See BNA Daily Tax Report, Sept. 9, 1975, at J-1. There were numerous other provisions in the 1974 House Ways and Means Committee bill and tentative proposals at the 1975 House Ways and

tion that an independent decision can be made regarding the best form of organization. Thus, potential difficulties such as obtaining consent of the various owners to the proposed change in organizational form or possible restrictions on form imposed by the government or lenders have been disregarded. Some states prohibit operation of farms in the corporate form and Nebraska requires additional reporting.⁶ Otherwise, there is probably no legal impediment to changing the form of organization to one which the farming enterprise owners prefer, except for possible adverse tax consequences. For purposes of this article, it is assumed that the farming enterprise is currently conducted in the proprietorship or partnership form and a change to the corporate form is being considered. Finally, it is assumed that the farming operation is not subject to attack as a hobby operation, which by definition is not engaged in business for profit.⁷

II. INCORPORATION

A. The Initial Transfer of Assets

The transfer of assets from a proprietorship or partnership to a corporation can be accomplished tax free⁸ if the requirements enumerated below are satisfied. The requirements demanding the most detailed analysis⁹ are that the corporation must not assume liabilities greater than each transferor's aggregate tax basis in transferred assets¹⁰ and the principal purpose of the assumption

Means Committee mark-up session that would substantially reduce the ability of entities with income from sources other than farming or in a different farming operation to utilize so-called "artificial losses" from prepaid feed, seed, fertilizer or similar farm supply expenses and certain preproductive crop expenses to offset such income. See HOUSE WAYS AND MEANS COMM., 93d CONG., 2d SESS., TENTATIVE DRAFT OF TITLE I, CHANGES PRIMARILY AFFECTING INDIVIDUALS (Comm. Print No. 1 1974) and see JOINT COMM. ON INTERNAL REVENUE TAXATION FOR HOUSE WAYS AND MEANS COMM., 93d CONG., 2d SESS., TAX SHELTERS: FARM OPERATIONS, appearing in BNA Daily Tax Report, Sept. 9, 1975, at J-1.

6. KAN. STAT. ANN., § 17-5901 (1974); NEB. REV. STAT. § 76-1503 (Supp. 1975).

7. CODE § 183.

8. *Id.* §§ 351, 368(c).

9. The scope of this article is limited to the transfer of assets being operated as a proprietorship or partnership which are transferred to a controlled corporation. When stock is transferred to a corporation or farm assets are transferred together with stock owned by a third party significantly more complex problems arise. See CODE §§ 368(a)(1)(B)-(D), and § 304; Rev. Rul. 68-349, 1968-2 CUM. BULL. 143; Rev. Rul. 70-140, 1970-1 CUM. BULL. 73.

10. CODE § 357(c); Treas. Reg. § 1.357-2(a) (1961).

of liabilities must not be tax avoidance.¹¹ If there are two or more transferors of property to the corporation, the liability in excess of basis test is applied on a transferor by transferor basis.¹² The transferors must exchange "property"¹³ for "stock" or "securities" in the corporation and immediately after the exchange all transferors, in the aggregate, must be in "control"—control being defined as ownership of at least eighty per cent of all classes of voting stock and eighty per cent of the total number of shares of all other classes of stock of the corporation.¹⁴ If a transferor receives property ("boot") from the corporation other than stock or securities, and if there is unrecognized gain, the boot will be taxed to the extent of the greater of the gain realized or the value of the boot.¹⁵ The corporation succeeds to the shareholders' basis in the transferred assets, increased by any gain recognized by the shareholders on the transfer.¹⁶ The shareholders' basis in the stock of the controlled corporation is equal to the basis in the property transferred decreased by the fair market value of boot received by the stockholder and increased by any gain recognized on the transaction.¹⁷ If the corporation assumes liabilities of the transferor as part of the transfer, the transferor's basis in the newly acquired stock or securities is reduced by the amount of the liabilities assumed.¹⁸ The application of section 351 is automatic and does not depend on election by the taxpayer.

Once the decision to incorporate is made, the farm operator(s) must decide the form of capitalization and what assets to transfer.¹⁹ If transfers of stock or assets, by gift or otherwise, are con-

11. CODE § 357(b).

12. Rev. Rul. 66-142, 1966-2 CUM. BULL. 66.

13. Stock issued for services rendered to the issuing corporation will constitute ordinary income to the shareholder. Section 351(a) specifically provides that stock issued for services shall not be considered as issued in exchange for property. Thus, a recipient of stock for services (whether past or future services) will not be considered as a transferor for purpose of the eighty per cent control test. However, a recipient of stock issued for a significant property transfer and for services will be considered a transferor for the purpose of determining whether the eighty per cent control test has been met. The portion of the stock received for services will produce taxable income to the recipient and should produce a corresponding deduction to the corporation unless the services were in the nature of capital expenditures. See CODE §§ 83, 162, 263; Treas. Reg. § 1.351-1(a)(2) example 3 (1967).

14. CODE § 368(c).

15. *Id.* § 351(b).

16. *Id.* § 362(a).

17. *Id.* § 358(a).

18. *Id.* § 358(d).

19. See Section II, C, *infra*.

templated at the time of incorporation, it is easier, from a mechanical position, to make the gift after completion of the incorporation process. This approach is also desirable as a gift planning device because a lower valuation can generally be supported for a minority interest.²⁰ The effect of the section 351 requirement that the transferors be in control "immediately after the exchange" is unclear regarding simultaneous gifts to parties who transfer no property to the corporation.²¹ Because of this uncertainty, contemplated gifts of stock in excess of twenty per cent of the stock should be delayed for at least twelve months after incorporation and the corporation should issue no stock directly to the donee.

Despite elimination of the statutory requirements for issuance of stock in proportion to the pre-existing interest in transferred property,²² the regulations²³ adopt the principles outlined in the Senate Report²⁴ which indicate that in cases of a disproportionate issuance of stock and securities, the transfer will be treated as if the stock and securities had been issued proportionately, but that the stock and securities representing the disproportionate issuance will be treated as gifts, as compensation²⁵ or as satisfying other obligations of the transferor. If the recipient of the stock does not transfer other property which is substantial in relation to the property transferred by the other transferors, and such recipient(s) receive more than twenty per cent of the stock, the tax free treatment granted by section 351 may be lost.²⁶

Another problem that should be considered in determining the amount of stock to be issued to the transferees is the impact of the difference between the fair market value of the property and the tax basis for property transferred to the corporation. The following example illustrates this problem. Father contributes property valued at \$100,000 without encumbrances and with a tax basis of \$40,000. Son contributes property valued at \$100,000 without encumbrances and with a tax basis of \$80,000. Although the fair market value of the property transferred is the same, the value to the corporation (the basis to the corporation pursuant to section 362(a) is the transferor's basis) for sales and depreciation is substantially less for the property contributed by the father. Unlike section 704

20. Estate of Maxcy, 28 CCH Tax Ct. Mem. 783 (1969); Edwin A. Gallun, 33 CCH Tax Ct. Mem. 1316 (1974).

21. Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir. 1942).

22. The proportionate interest test of § 112(b) (5) of the Internal Revenue Code of 1939 was removed by the 1954 Code.

23. Treas. Reg. § 1.351-1(b) (1) (1967).

24. S. REP. NO. 1622, 83d Cong., 2d Sess. 264 (1954).

25. United States v. Frazell, 335 F.2d 487 (5th Cir. 1964).

26. Treas. Reg. § 1.351-1(a) (ii) (1967); CODE § 368(c).

(c) (3), which permits special allocation of the gain on disposition and depreciation in a partnership to reflect the differing tax basis, there is no mechanism for specially allocating this gain when it is taxed at the corporate level because the corporation is a separate tax paying entity. In the farm context, the impact of the basis problem can be immediate when one party is transferring substantially more zero or low basis assets to the corporation than another. The proper way to account for the basis differential is in the determination of the amount of stock to be issued in the incorporation process.

Section 351 provides that the transferors may receive stock (in any class) or securities without the recognition of income. This provision gives the farm operator considerable latitude in structuring the capitalization to fit his particular circumstance. For example, if a father-son operation is incorporated and the father desires to limit future appreciation of his stock, a disproportionate amount of common stock can be issued to the son and a disproportionate amount of preferred stock or nonvoting common stock can be issued to the father. This structure can also be used to assure that the party contributing a larger share of capital will have a larger share of capital at liquidation while future earnings will be shared according to each person's contribution to the farming operation. Multiple classes of stock (multiple common classes or common and preferred) can vest management control in desired shareholders while giving all parties an equal share of the operation's profits. Two disadvantages of this form of capital structure are that the advantages of subchapter S taxation are lost²⁷ and the preferred stock does not qualify for the benefits of section 1244.²⁸ Also, any dividends paid on the stock will be subject to taxation both at the corporate and shareholder level.

The issuance of debt "securities" is generally a more desirable alternative than preferred stock for distributing cash periodically and for liquidating the interest of parties no longer active in the business. Included in this category are long-term bonds and notes but not short term obligations.²⁹ The principal advantages derived from

27. CODE § 1371(a)(4).

28. *Id.* § 1244(c)(1).

29. Unfortunately, there is no statutory definition of the term "securities." The general rule of thumb followed by practitioners on the basis of case law, see *Camp Wolters Enterprises, Inc.*, 22 T.C. 737, *aff'd*, 230 F.2d 555 (5th Cir. 1956), *cert. denied*, 352 U.S. 826 (1956), is that obligations payable in less than five years are not securities while those payable in more than ten years will be classified as securities. The justification for this construction is that the tax-free incorporation is based on the mere change in form of ownership and that a short-term obligation indicates a sale of property. *Treas. Reg.* § 1.368-1(b) (1960).

the issuance of debt "securities" are the ability of the corporation to deduct interest distributions³⁰ and the ability of the shareholder to be taxed on principal payments at capital gain rates³¹ only to the extent of his gain. The gain would be the difference between the stockholder's basis³² in the debt obligation and the amounts distributed. Dividend distributions would be taxed at ordinary income rates to the extent of the greater of current or accumulated earnings and profits of the corporation.

Case law requires that in any tax free reorganization, every member must have a continuing proprietorship interest in the business.³³ Combining this proprietary interest concept with the section 368(c) requirement that transferors be in "control immediately after" the transfer to the corporation, the Internal Revenue Service (hereinafter "Service") has ruled in Revenue Ruling 73-472³⁴ that when one transferor receives only debt "securities" in a purported section 351 transfer, that section's nonrecognition provision will not apply to that transferor.

For planning purposes, there is no definitive minimal percentage value of stock in relation to securities that a transferor must receive to avoid recognition of gain from securities received in the incorporation process. One approach would be to apply tests for determining whether persons who have contributed both property and services qualify as transferors. The Treasury's regulations seemingly disqualify a person as a transferor only if the property transferred is a relatively small amount of the value in proportion to the securities issued or if the transaction is a sham.³⁵ Although there are no interpretations of what constitutes a relatively small amount, under this approach, if the value received on incorporation by one stockholder was allocated ninety-five per cent securities and five per cent stock, the transferor would seemingly meet the continuity test for purposes of section 351. Because the Service's attack in Revenue Ruling 73-472 is based principally on continuity grounds while the stock for services test is concerned with the transferors of property being in control of the newly formed corporation, this approach would not seem persuasive.

The other approach is to define the limits of the continuity of interest applicable to section 368 reorganizations. To date, the cases

30. For the interest payments to be deductible, the interest must be paid within two and one-half months after the close of the taxable year or otherwise escape the domain of section 267.

31. CODE § 1232.

32. *Id.* § 358; Treas. Reg. § 1.358-2(h) (1960).

33. *LeTulle v. Scofield*, 308 U.S. 418 (1940).

34. Rev. Ruls. 73-472 and 73-473, 1973-2 CUM. BULL. 115.

35. Treas. Reg. § 1.351-1(a)(ii) (1967).

in which continuity was in issue have applied tests interpreting section 368 and its predecessor statutory provision governing reorganization of existing corporations rather than tests interpreting section 351 incorporations. The Service's current position on continuity is to aggregate equity-type securities received by all stockholders for the purposes of determining continuity.³⁶ Because of the application of sections 354(a) (2) and 356, stockholders will recognize gain (if there is realized gain) and/or dividend treatment upon the receipt of "securities" in excess of the principal amount of securities exchanged in the reorganization. As a result, the continuity question at the individual stockholder level in a reorganization becomes less relevant from a tax revenue standpoint than in a section 351 incorporation where no gain is realized on the receipt of securities. To date there are no reported cases denying reorganization treatment to an individual shareholder when the aggregate of equity interests issued in the reorganization satisfied the continuity tests.³⁷ If the Service was successful in imposing the current continuity standards applicable in acquisitive reorganizations (fifty per cent for ruling purposes or forty per cent or lower imposed by case law) on each individual transferor in a section 351 transfer, numerous transferors in purportedly tax free section 351 incorporations would be subject to taxation as a result of a shareholder's failure to satisfy the continuity tests.

There are several factors which together form a solid argument against application of the acquisitive reorganization continuity levels to each transferor shareholder in a section 351 incorporation. The language of section 351 provides for nonrecognition of gain by a transferor upon receipt of stocks or securities, regardless of the ratio between them. Section 368(c) requires that the transferors be in control of the transferee corporation (in essence an eighty per cent control test) while acquisitive reorganizations require the acquiring corporation to gain control of the acquired corporation either by merger or stock acquisition, with the pre-reorganization shareholders of the latter allowed to hold a relatively miniscule degree of ownership in the acquiring corporation. In addition, Revenue Rulings 73-472 and 73-473 failed to consider the value of securities in relation to the outstanding stock. Finally, the thin capitalization rules³⁸ prevent too great a proportion of the aggregate values

36. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232; Rev. Proc. 74-26, 1974-2 CUM. BULL. 478. When the interest of all shareholders of the organization are aggregated, if at least fifty per cent of stock outstanding before reorganization is exchanged for stock ownership in the reorganization, the continuity test is satisfied.

37. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.1 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

38. CODE § 385.

received by the control shareholders to be classified as securities. While all of these factors seem to refute application of acquisitive reorganization continuity levels to section 351 incorporations, they do not provide much comfort to attorneys opining on the minimum level of continuity required at the shareholder level. Until this issue is clarified by statutory amendment or case law, any transferor who receives an insubstantial amount of the total value of the property received in stock is risking the loss of nonrecognition benefits.

Despite their classification, purported corporate debt obligations may be treated as stock for tax purposes.³⁹ Unfortunately proposed regulations governing section 385, which defines thin capitalization, have not been issued though more than five years have elapsed since its enactment. This delay emphasizes the difficult nature of the area and an indepth analysis of it is beyond the scope of this article. Case law and section 385, however, indicate that the following questions are relevant:

1. What is the debt to equity ratio of the corporation?
2. Is the debt issued pro rata to the stock issue?
3. Is there a written obligation to pay at a specified time or on demand, with a fixed rate of interest?
4. Is there a preference to or subordination to other debts?
5. What is the earning capacity of the enterprise?

To assure that the securities are treated as debt:

1. The total debt to equity ratio of the corporation should not exceed three or four to one in the typical capital intensive agricultural enterprise.⁴⁰

39. Burke, *Sec. 351—Problems, Planning and Procedure*, 6 Tax Adv. 103, 108-09 (1975) [hereinafter cited as Burke].

40. Because substantially appreciated property will generally be transferred on incorporation, the important question arises of whether the transferor's tax basis or the actual fair market value of the assets is the value used in determining debt to equity ratios. The weight of authority requires use of the fair market value of the transferred assets and not their tax basis. See *Miller Estate v. Commissioner*, 239 F.2d 729 (9th Cir. 1956); *Maurice H. Brown*, 18 CCH Tax Ct. Mem. 483 (1959); *Haskel Eng'r & Supply Co. v. United States*, 380 F.2d 786 (9th Cir. 1967). There is also the possibility that good will and other intangibles should be treated as items of value. *Murphy Logging Co. v. United States*, 328 F.2d 222 (9th Cir. 1967). Although the corporation's equity in relation to debt may be substantial using the fair market value approach, negative shareholder's equity will appear on the balance sheet if the corporation's assets are recorded at their tax basis.

2. The interest rate on the debt obligations should be comparable to an arm's length market rate at the time of issuance.
3. The debt should not be subordinated to the claims of general creditors.
4. All interest and principal payments must be made according to their terms.

Strict adherence to these desirable criteria is not always feasible. The third and fourth criteria in particular may restrict the ability of the corporation to obtain adequate financing for its activities. If the fourth requirement is satisfied, however, and a reasonable degree of compliance is achieved on the other three, the corporation has a reasonable chance of sustaining the debt allocation.

Debt obligations which are determined to be stock will result in the disallowance of the interest deduction to the corporation. The interest payments to the holder of the debt obligations will be classified as dividends to the extent of the greater of corporation's current or accumulated earnings and profits.⁴¹ Unless the debt obligations are issued pro rata to the stock ownership interests, the reclassification also might result in a loss of subchapter S status. This risk, however, would seem to be slight.⁴² Principal payments on the debt obligations will also be reclassified as dividends to the extent of earnings and profits unless there is simultaneous redemption of voting stock sufficient to meet the requirements of sections 302(b) (1), 302(b) (2) or 302(b) (3). The amount of the distribution in excess of the greater of current or accumulated earnings and profits will first reduce the shareholder's stock basis to zero and the remaining distribution will be taxed as gain from the sale of stock.⁴³

Because of prepaid items, inventory holdovers and depreciation on the straight line basis, the earnings and profits of livestock breeding and feeding operations at a constant or expanding level of operation will typically be very low. Consequently, the risks from reclassification by the Service of debt as equity will not be great. The following example demonstrates this result. XYZ Farm Corporation (which does not elect under subchapter S) has shareholders A, B and C whose adjusted bases for both their stock and securi-

Because of the negative equity presentation that will appear on the balance sheet, an appraisal is desirable to support the debt-equity ratio and the issuance of stock for valid consideration.

41. CODE § 316(a) (1) and (2).

42. See Section III, B, *infra*.

43. CODE § 301(c).

ties under section 358 are \$100,000, \$200,000 and \$300,000 respectively. On the date of incorporation the fair market value of XYZ Corporation's net assets (assets less liabilities) transferred by A, B and C is \$1,500,000 (A—\$333,333; B—\$533,333; and C—\$633,334). A, B and C each receive 100 shares of common stock. B receives a ten year note bearing interest at the rate of eight percent in the principal amount of \$200,000 and C receives an identical note bearing interest in the principal amount of \$300,000. Pursuant to section 358 and the Treasury's regulations thereunder,⁴⁴ B's basis in his debt obligations would be approximately \$75,000 and C's basis would be approximately \$142,000, assuming the fair market value of the securities equaled their principal amount on the date of issuance. If the obligations were redeemed at or after ten years and the obligations were classified as debt for federal income tax purposes, B would have approximately \$125,000 (\$200,000 principal on obligation less \$75,000 basis) of long-term gain and C would have approximately \$158,000 (\$300,000 principal on obligation less \$142,000 basis) of long-term capital gain. If the purported debt obligations were classified as equity and XYZ had \$20,000 of accumulated earnings and profits on the date of redemption, the aggregate effect on distribution would be to convert \$20,000 of capital gains to ordinary income. The interest deduction would be disallowed to XYZ for those payments on which the statute of limitations has not run. The earnings and profits would also be increased by the amount of the after tax profits resulting from the interest disallowance.

Treatment of debt obligations as equity could result in drastically more adverse tax consequences for grain and other non-live-stock farming operations. The earnings and profits during a successful period of operation would be substantially higher assuming annual distributions resulting in double taxation were not made, subjecting a greater amount of gain to treatment as distribution of dividend rather than more favorable capital gain treatment. Because the issuance of debt securities enables the shareholder to remove cash flow from the corporation at capital gains rates, they should be evaluated carefully in determining the capital structure.

Numerous other possibilities are available for formulation of the capital structure within the basic tax framework previously analyzed. The exact combination of common, preferred, and debt securities that should be issued can only be determined by the practitioner in light of present farming operations and the objectives of his client. Despite the complexity of the favorable pay out devices, the practitioner should never forget that the client could

44. CODE § 358(b); Treas. Reg. § 1.358-2(b)(2) (1960).

probably receive these amounts tax free if operations had been continued in a proprietorship or partnership form.

An exception to the general nonrecognition rule of section 351 is that property other than stock or securities is recognized to the extent of gain realized or the fair market value of the boot, whichever is greater.⁴⁵ In the farm operation context, complicated questions arise concerning the character of the gain. The sale of depreciable property (otherwise qualifying for capital gain treatment under section 1231) to an eighty per cent "controlled" corporation is treated as ordinary income.⁴⁶ Depreciation and investment credit recapture may also apply.⁴⁷ The exact application of these statutory provisions to section 351(b) when a series of assets are transferred is unclear. In other areas of the tax law an asset by asset approach has been used.⁴⁸ By adopting this approach, it is conceivable that all boot could be taxed as ordinary income. Because the incorporation of a closely held farm operation seldom involves an infusion of cash by one transferor which could be withdrawn by another, there is generally no "boot" problem unless liabilities assumed result in gain under section 357. Another disadvantage to the transfer to the corporate form is the loss of the double declining balance and sum of the years digits methods of depreciation upon transfer to the corporation. In the case of a farming operation with a substantial amount of depreciable real property, the availability of less rapid methods of depreciation can result in substantially higher taxable income for identical opera-

45. CODE § 351(b).

46. *Id.* § 1239. For the purpose of section 1239, control is defined as the ownership by the transferee, his spouse, children and grandchildren.

47. *Id.* §§ 1245, 1250, 1251, 47(a). If there is no boot under section 351(b), the depreciation recapture rules of section 1245 and section 1250 do not apply. See §§ 1245(b)(3) and 1250(d)(3). The farm recapture rules of section 1251 require nonfarm adjusted gross income in excess of \$50,000 and would not generally be applicable in closely held farm situations. If the farm recapture rules apply, section 1251(d)(3) provides for nonrecognition on section 351 incorporation. However, stock or securities of the corporation received in exchange for farm recapture property becomes farm recapture property. CODE § 1231(d)(6). Investment credit will not be recaptured if there is a mere change in the form of doing business and the transferor retains a "substantial" interest in the business transferred. CODE § 47(b); Treas. Reg. § 1.47-3(a) (1967). Investment credit may be recaptured even if there is no boot. See J. Soares, 50 T.C. 909 (1968).

48. Treas. Reg. § 1.357-2(b) (1955); BITTKER & EUSTICE ¶¶ 3-28, 3-29 and Rev. Rul. 68-55, 1968-1 CUM. BULL. 140.

tions.⁴⁹ The other substantial disadvantages (which can often be a deterrent to incorporation) result from the possible unfavorable allocation of expenses by an operation which has continually made large prepayments to defer income.^{49a}

B. Establishment of a Section 1244 Plan

At the time of incorporation, the farm operator does not anticipate any loss on his investment. However, because section 1244 bestows significant benefits in the event of subsequent loss, without any adverse consequences, qualifying stock should be issued under a section 1244 plan. For stock other than that issued under this special provision, losses recognized on disposition will be capital losses (long-term or short-term depending upon the holding period).⁵⁰ Because of the limitation on deduction of capital losses, many losses on investments in corporations are not used currently and in many cases are never utilized.⁵¹ Section 1244, however, allows an ordinary loss deduction in any one year for up to \$25,000 on an individual return and \$50,000 on a joint return for losses recognized on the sale or exchange of section 1244 stock. Losses on section 1244 stock exceeding the statutory limitations are capital in nature. By carefully planning the disposition of section 1244 stock (which is not worthless) on which losses will be recognized, a substantial deduction from ordinary income can be obtained. In view of the large number of farm incorporations capable of qualifying for section 1244 treatment, the practitioner should adopt a section 1244 plan as part of the incorporation process unless the corporation clearly fails to meet the statutory requirements.⁵²

Section 1244 requires that common stock be issued pursuant to a written plan of a qualifying domestic "small business corporation" to individual shareholders⁵³ in exchange for property or cash within two years after the adoption of the plan. If the corporation is not a new corporation, no portion of any prior offering of stock

49. Rev. Rul. 67-28, 1967-2 CUM. BULL. 101. The transferee corporation is not considered to be the original user of depreciable assets which it receives in a section 351 transaction. Treas. Reg. § 1.167 (1956).

49a. See Section II.C, *infra*.

50. CODE §§ 1201, 1202, 1221.

51. *Id.* § 1211. Long-term capital losses will first be offset against long-term capital gains or fifty per cent of such losses up to \$1,000 can be offset against ordinary income.

52. An excellent guide for the form to be utilized in adopting section 1244 is located in NEBRASKA BAR ASSOCIATION, NEBRASKA CORPORATION SYSTEMS FOR LEGAL ASSISTANTS (1973).

53. CODE § 1244(d) explicitly disqualifies trusts and estates.

can be outstanding at the time the plan is adopted.⁵⁴ To qualify as a "small business corporation," the aggregate amount of common stock issued pursuant to the plan, plus the net basis of other property and the amount of money received as contributions to capital and as paid-in surplus subsequent to June 30, 1958 must not exceed \$500,000, and the net equity of the corporation must not exceed \$1,000,000. For purposes of determining the \$500,000 value of the stock issued pursuant to section 1244 plans, the basis of the property in the hands of the transferee corporation, rather than the fair market value of the property, is considered.⁵⁵ As a result of the application of sections 351 and 362(a), the corporation can receive equity contributions with a fair market value substantially in excess of \$500,000.

If the stock qualifies under section 1244 at the time it is issued, subsequent issuance of other stock will not change its character. The only events that can prevent section 1244 treatment for a previously qualified issue in the event of a loss are (1) the transfer of the stock, or (2) if 50 per cent of the gross receipts of the corporation during the previous five years of operation (or such shorter period in which the corporation has been in existence) are derived from passive income sources such as rents, dividends, interest and gain on the exchange of sale or securities.⁵⁶ The only penalty in the event of failure to qualify for section 1244 treatment is that the general capital gain and loss rules will apply. Thus, the corporation would be in the same position as it would have been had it not attempted to qualify. Because debt securities are governed by the general capital loss provisions and do not qualify for section 1244 treatment, section 1244 should also be considered in formulating the capital structure of corporations whose operation is subject to high risk.

C. Selection of Assets and Liabilities for Transfer and Allocation of Income and Expenses

One of the most important decisions in the incorporation process involves the assets to be transferred to the farm corporation. Five basic questions should be asked by the practitioner in making this decision:

1. What assets are exclusively for the personal use of the stockholders?

54. *Id.* § 1244(c) (1) (C); Treas. Reg. § 1.1244(c)-1 (c) (1965).

55. Treas. Reg. § 1.1244(c)-(2) (b) (1) (1960).

56. For an in-depth analysis of section 1244, see, BITTKER & EUSTICE, *supra* note 48, at ¶ 4.11 and Taylor & Tripp, *Section 1244, Avoiding Its Problem*, N.Y.U. 29th INST. ON FED. TAX. 201 (1971).

2. What assets does the farm operator intend to sell in the near future?
3. Does the farm operator have cash needs outside the farm operation which may have to be satisfied out of farm borrowings?
4. What assets will be needed by the corporate farm for its normal operations?
5. What are the tax consequences of the transfer of assets deemed desirable from answering questions 1 through 4?

Personal family living expenses are not deductible⁵⁷ and the use of corporate property by the shareholders should be treated as constructive dividends⁵⁸ or additional compensation.⁵⁹ Therefore, assets which are principally personal should not be transferred to the corporation. The principal farm property subject to the personal use of the shareholders is the farm house. While providing lodging facilities to shareholders would appear to be within the provisions of this general rule, an employee may exclude from income the value of lodging furnished on the business premises if the arrangement is for the convenience of the employer, if the use of this lodging is a condition of employment.⁶⁰ *Wilhelm v. United States*,⁶¹ and *F. R. McDowell*⁶² have held that an officer-stockholder who is the manager of a ranch can be an employee required to live on the ranch for the convenience of the employer. Despite the *Wilhelm* and *McDowell* decisions, however, the practitioner should not automatically assume that the farm operator may exclude the value of furnished lodging from his income while the farm corporation deducts depreciation and other expenses related to the maintenance of the farm house. The Treasury's regulations require that the lodging must be furnished to enable the employee properly to perform his duties. One such case is the manager who is required to be available to perform his duties at all times.⁶³ This requirement would seem to be satisfied in a livestock operation

57. CODE § 262. Specific statutory deductions are allowed for nonbusiness expenses, e.g., interest, CODE § 163; taxes, *id.* § 164; and theft and casualty, *id.* § 165(c)(3).

58. *International Artists*, 55 T.C. 94 (1970).

59. *Max P. Lash*, 15 CCH Tax Ct. Mem. 453 (1956), *aff'd per curiam*, *Lash v. Commissioner*, 245 F.2d 20 (1st Cir. 1957).

60. CODE § 119. *See also* *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968).

61. *Wilhelm v. United States*, 257 F. Supp. 16 (D. Wyo. 1966).

62. *F.R. McDowell*, 33 CCH Tax Ct. Mem. 372 (1974).

63. *Treas. Reg. § 1.119-1(b)* (1964).

where the duties of the stockholder-employee include care for or supervision of the livestock. However, in situations involving a pure farming operation, a shareholder not involved in management, or the widowed mother occupying the "home place," the shareholder will encounter substantial difficulty in excluding the value of the lodging from income. The tax risks in the transfer of the farm house can only be determined after an extensive investigation of the client's activities. If the decision is made to transfer the farm house can only be determined after an extensive investigation executed between the corporation and the occupant, requiring him to live in the farm house as a condition of employment and requiring him, as manager, to be available to perform duties at all times. Property such as automobiles (trucks should be transferred to the corporate farm), snowmobiles, boats, furniture (other than office furniture, although furniture could be a part of the residence), and other items not used almost exclusively in the farm operation involve lesser economic decisions and generally should not be transferred.

There are both business and non-business elements in addition to tax factors which should be considered in the transfer of the farm house. The home has traditionally been a personal asset built or prepared to satisfy individual tastes, and the thought of corporate ownership is repugnant to those personal factors. Unless the occupants control the corporation's stock, corporate ownership may also affect the maintenance of the facility. In addition, the home represents security to the family. Parent occupants may not wish to subject it to the business risks of the farm operation managed by the children. It is also possible that the present occupants may wish to transfer the house (by death or otherwise) to persons other than the owners of the farm land. Another consideration that is becoming less important in our inflationary economy is the homestead exemption of \$4,000⁶⁴ for dwelling houses in the event of execution or judgment liens. Corporate property would not seem to qualify for this homestead exemption.

If an immediate sale of appreciated real property (or any other significant corporate assets) is contemplated, these assets should generally not be transferred to the farm corporation. An exception would be a situation in which the benefits of splitting the income result in a lower rate of taxation such as when shareholders have substantial income from other sources and do not wish to distribute the sales proceeds. The corporation does not receive the section 1202 fifty per cent long-term capital gain deduction or the maxi-

64. NEB. REV. STAT. § 40-101 (Reissue 1974).

imum effective tax rate of twenty-five per cent on the first \$50,000 of long-term capital gain available to individuals. Instead, except for taxable years ending in 1975, the corporation pays a flat rate of twenty-two per cent on the recognized gain if income including capital gains does not exceed \$25,000.⁶⁵ If taxable income including capital gains exceeds \$25,000, the corporation is taxed at the rate of twenty-two per cent on the first \$25,000 and forty-eight per cent on the excess. Alternatively, it can pay the section 11 rates on ordinary income and a thirty per cent rate on long-term capital gains⁶⁶ plus the minimum tax.⁶⁷ Any corporate distribution of the sales proceeds then subjects the shareholders to dividend income to the extent of the corporation's earnings and profits—in effect double taxation.

Unless the farm operator has substantial taxable income at the individual level and capital gains substantially in excess of \$50,000, the rates from the sale of the appreciated real estate will generally be much higher than they would be for one doing business as a proprietorship, even if the proceeds are not distributed to the shareholder. This difference in tax rates and the double taxation problem can generally be reduced by electing subchapter S taxation. Two situations often occur, however, in which the sale of farm property by subchapter S farm corporations results in higher taxation than the sale by a proprietorship or partnership. First, since capital gains flow-through to the shareholder is limited to taxable income of the corporation, and since the cash basis farm corporation often has a taxable loss in the initial year of operation, part of the capital gains benefit can be lost.⁶⁸ Second, if the net tax basis of the shareholders in the corporation's stock (after deducting the amount of liabilities assumed by the transferee corporation) is less than the selling entity's cost basis in the property sold, the shareholders who receive the proceeds in distribution will be required to recognize gain under section 301(c)(3) in addition to the gain attributable to him from the subchapter S corporation's gain on the sale. For example, sole shareholder A transfers property with an adjusted basis of \$80,000 and subject to liabilities of \$70,000 to a newly formed, wholly-owned corporation. The subchapter S cor-

65. CODE § 11(b). For corporations whose taxable year ends in 1975, the tax rate is 20 per cent on the first \$25,000 of taxable income and 22 per cent on the first \$25,000 of taxable income exceeding \$25,000. See § 303, Pub. L. 94-12 (Feb. 18, 1975). There have been recommendations by President Ford and various congressmen to extend the so-called tax reductions or to further reduce income taxes.

66. CODE § 1201(a).

67. *Id.* § 56.

68. See Section III, B, *infra*.

poration immediately sells property with a basis of \$20,000 (not encumbered by any mortgage) for \$30,000 in cash and distributes the entire proceeds to shareholder A. Assuming the subchapter S corporation has no gains or losses except from the sale of property, shareholder A's income attributable to the subchapter S corporation's income is \$10,000. Pursuant to section 358, shareholder A's basis in his stock prior to the sale is \$10,000 (\$80,000—\$70,000 assumed liabilities). If the entire \$30,000 of sales proceeds is distributed, shareholder A will recognize \$20,000 of gain from the sale (\$10,000 attributable to the pass through of subchapter S gain and \$10,000 from the section 301(c)(3) distributions),⁶⁹ assuming there are no earnings and profits, and his basis in the stock will be reduced to zero. If A had sold the property as a sole proprietor, only \$10,000 of gain would be recognized.

The foregoing impediments to distribution of the proceeds of a sale of property by a corporation at the same tax price which would have been imposed had the sale been completed in the hands of the proprietor or partnership necessitate withholding appreciated property from the corporation which the shareholders intend to sell in the foreseeable future unless there is a desire to retain the proceeds in corporate solution. As a general rule, it is recommended that any real property which at the time of incorporation has a fair market value significantly in excess of the value of such property if it was used exclusively for agricultural purposes, should not be transferred to the corporation, even if there is no immediate intent to sell.

One of the least considered but most important decisions in the incorporation process concerns receivables, inventory and payables to be transferred to the farm corporation. Because the "farmer cash method" of accounting is used so extensively, these assets will generally have a "zero basis" to the transferor. The failure to examine thoroughly the effects of the transfer of zero basis assets and assumption of liabilities may result in totally unexpected and unfortunate tax results. Section 357(a) excludes from taxable income liabilities assumed by the corporation unless (1) the liabilities were incurred for a tax avoidance purpose (in which case all liabilities assumed are taxed)⁷⁰ or (2) the liabilities transferred exceed the aggregate tax basis of the transferor. Consequently, all financing statements, chattel mortgages, real estate mortgages, ac-

69. CODE § 301(a)-(c). The distribution would be taxed at ordinary income rates to the extent of earnings and profits. See CODE § 312. The excess would first be used to reduce the shareholders' basis and the remainder, if any, would be taxed as the sale of stock.

70. *Id.* § 357(b).

counts payable, milk base contracts, futures contracts, fertilizer delivery contracts, seed contracts and any other type of liability must be examined.

The starting point is always the major asset—the real property. Because middle age farmers whose memories extend to the depression of the 1930s are generally conservative and do not use the high degree of leverage exercised in other businesses, it is unusual to find a fact pattern in which the real estate is highly leveraged. However, recent financial losses by cattle feeders and ranchers, as well as the differing attitudes of newcomers to the farm industry dictated by high capital requirements, may result in a highly leveraged operation. If real estate with a low tax basis has been encumbered by a mortgage substantially in excess of the transferor's basis,⁷¹ it is probably impractical to incorporate the farming operation (unless the land is excluded). If the real property's basis significantly exceeds the encumbrances against it, there are probably no section 357 problems that cannot be overcome by careful planning.

After preparation of a complete list of all assets and liabilities, regardless of whether they are recorded on the cash basis books of the corporation, a decision should be made with respect to each asset and liability. Unless the farm operator wants to transfer income (zero basis assets) or deductions (zero basis payables) to the corporation, it is generally advisable to incorporate in January or February or any other time during the calendar year when the farm operation's inventory, supplies, payables and receivables are the lowest. The reason for this timing is the impact of a literal reading of section 357 on zero basis assets and receivables. On the transfer of zero basis assets and payables, the Service and the Tax Court have taken the position that zero basis assets transferred are immaterial for purposes of section 357(c). At the same time, unbooked accounts payable are considered liabilities for the purposes of section 357(c).⁷² In most farm incorporations, the tax basis of the real property and machinery transferred will substantially exceed related liabilities, allowing the operator to escape the jaws of 357(c) even if unbooked accounts payable are considerable. It is nevertheless advisable to withhold all accounts payable and inventory that will not be used in the newly formed corporation be-

71. An example would be mortgaging the real property and retaining the proceeds immediately prior to the incorporation.

72. Peter Raich, 46 T.C. 604 (1966); Wilford Thatcher, 61 T.C. 28 (1973); *Wiebusch v. Commissioner*, 487 F.2d 515 (8th Cir. 1973), *aff'g* 59 T.C. 777 (1973). *But cf.* Bongiovanni, 30 CCH Tax Ct. Mem. 1124 (1971), *aff'd*, *Bongiovanni v. Commissioner*, 470 F.2d 921 (2d Cir. 1972).

cause the cases considering assumption of liabilities have determined that the accounts payable assumed by the corporation will reduce the taxpayer's basis in his stock under section 358(d)⁷³ and no credit for basis is obtained for zero basis assets. This reduction in basis could make otherwise nontaxable distributions from a return of capital taxable under section 301(c)(3), or it could result in a disallowance of losses to the shareholder in a subchapter S corporation.⁷⁴

In addition to the reduction in basis and impact on section 357 (c), there is also a possibility that when the liabilities are paid the cash basis corporation will not receive a deduction. The tax theory underlying the cash method is based on matching revenues and expenses, and transferred liabilities represent expense incurred by the prior entity. Since the prior entity was a cash basis taxpayer which did not make the payments, it is not entitled to a deduction.⁷⁵ In 1946 the Eighth Circuit in *Holcroft Transportation Co. v. Commissioner*,⁷⁶ concluded that the corporation was not entitled to a deduction. In *Wilford Thatcher*⁷⁷ the corporation reported income from zero basis receivables and claimed a deduction for the zero basis payables transferred from a noncorporate entity. This treatment was apparently not in issue and was not discussed in the Tax Court's majority opinion. Dissenting Judges Quealy and Goffee would have required the transferee corporation to report income from the receivables and would have allowed a deduction for the payables.⁷⁸ Judge Hall, joined by Judges Featherstone and Forrester, would have allowed the prior entity a deduction for accounts payable and would have required recognition of an equal amount of income from receivables.⁷⁹ Presumably, income from the remainder of the receivables would be recognized by the transferee corporation. It is my understanding that the Service will issue rulings that the transferee corporation will be allowed the deductions, provided there was a transfer of a going concern "which is not carried out in such a way as to cause a distortion of income" and provided the transfer is accompanied by a closing agreement that the

73. *Id.*

74. Section 1374(b) limits the net operating losses of a subchapter S corporation that may be used by a taxpayer to affect income from other sources to his adjusted basis in his subchapter S stock.

75. Treas. Reg. § 1.461-1(a)(1) (1967).

76. *Holcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946). See also Arthur L. Kniffen, 39 T.C. 553 (1962).

77. 61 T.C. 28 (1973).

78. *Id.* at 39-42.

79. *Id.* at 42-44.

transferee will recognize income upon collection of the receivables.⁸⁰ Because of the uncertainty in this area, the safest course in the absence of a ruling is to withhold from incorporation receivables and liabilities in an equal amount.⁸¹ If additional cash is desired by the transferors, all receivables should be retained.

There are a number of other cases where assignment of income principles and tax benefit issues have been raised regarding inventories, expenses attributable to growing crops, receivables and the payment of expenditures applicable to the assets and liabilities transferred to or from a corporation.

A major problem faces proprietorships or partnerships which have continually prepaid substantial expenses at the end of their taxable year to defer income and do not elect subchapter S following incorporation. The same problem arises with crop cycles such as winter wheat which require substantial cash expenditures in a taxable year other than the one in which the crop is harvested. The Service's position is that the expenses paid or prepaid by the proprietorship or partnership prior to incorporation must be allocated to the corporation which recognizes the income.⁸²

80. Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 32 J. TAX. 88, 90 (1970); Burke, *supra* note 39, at 111.

81. Lipoff, *Organizing a Professional Service Corporation*, N.Y.U. 28TH INST. FED. TAX. 1223 (1970).

82. The basic statutory authority for the position of the Service lies in re-allocation of income from receivables and inventory or deductions attributable to accounts payable in sections 446(b) and 482. Because no clear conclusions can be drawn from these decisions, they are summarized. *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962) (deductions due to expenses for growing crops incurred prior to incorporation were reallocated to the transferee corporation which recognized the income; *Adolph Weinberg*, 44 T.C. 233 (1965), *aff'd per curiam*, 386 F.2d 836 (9th Cir. 1967) (income from crop inventory reported by corporate transferees was allocated back to the transferors). Using the terms "sham," "tax avoidance," and "assignment of income," the Tax Court relied heavily on the fact that only growing crops and no land or leaseholds were transferred to the corporation. In *Hempt Bros. Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974), a cash basis partnership transferred accounts receivable to a corporation in a section 351 incorporation. The Service forced the corporation (a non-farm operation—concrete mix and stone gravel) to adopt the accrual method. The taxpayer corporation was required to report the income on the receivables and was not allowed to include the value of materials received from the predecessor partnership in its opening inventory. Because most farm corporations would adopt cash basis accounting, the problem in *Hempt Brothers* should not exist. However, if legislation requiring farm corporations to adopt the accrual basis is enacted, and the corporations did not qualify for the family exception, (see Note 5 *supra*), an added impetus would be present for withholding all receivables, inventories and payables. For an in-depth analysis

For example, ABC Partnership has annual prepaid expenses in December attributable to the subsequent year's crop in amounts which will substantially reduce the taxable income of the partnership. In 1975 such expenses were \$80,000 and such amounts are deducted on the partner's income tax returns for 1975. In February, 1976, the partners decide to incorporate and not elect subchapter S. All income attributable to the 1975 prepayments is reported by the corporation. There is a substantial risk that the Service will allocate the expenses to the corporation and require the partners to recognize additional income of \$80,000 for 1975 resulting from the disallowance of expenses. The author recommends election of subchapter S for the first taxable year (even if a section 368 (a) (1) (E) recapitalization is required at a later date to issue desired preferred stock). Within the required period, the subchapter S election could then be terminated for the second year's operations. In ABC partnership's case, the subchapter S election would remain in effect until after the 1976 prepayment had been made. Even if the 1975 prepayment were allocated to the corporation, the former partners should receive the deduction in 1976 plus the 1976 prepayment by the corporation to offset 1975 and 1976 income assuming each shareholder has sufficient basis to utilize the subchapter S losses. The only tax loss except for the timing difference under this approach would be the itemized or standard deduction and exemption if the 1976 deduction could only be utilized by a net operating loss carryback at the shareholder level. The Service's ability to add an additional tax on to the incorporation process would then be limited to its ability to deny the 1976 prepayment deduction attributable to the 1977 crop. Despite the weakness of the Service's position on prepayment (particularly in the Eighth Circuit), the more conservative taxpayer could delay sale of the 1976 crop until 1977 and avoid the year end prepayment.⁸³

of this area, see White, *Sleepers that Travel with Section 351 Transfers*, 56 VA. L. REV. 37 (1970); Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations*, 40 TAXES 995 (1962); BITTKER & EUSTICE, ¶ 3.17.

83. Rev. Rul. 75-152, 1975 INT. REV. BULL. No. 17, at 11, imposed a stringent three part test for prepaid feed deduction. The third or "material distortion" test would appear to be an inappropriate criterion not supported by any direct authority since cash basis accounting by its nature will often materially distort income, under traditional financial accounting concepts. In view of this ruling, the area of prepaid deduction is hardly free from doubt, but the full-time farmer is certainly treading in much safer waters than those created by the issue of allocation of expenses between entities. This area is even more certain in the Eighth Circuit. See *Mann v. Commissioner*, 483 F.2d 673 (8th Cir. 1973). See also Schapiro, *Prepayments and Distortion of In-*

Where the transferor wishes to retain as many assets as possible outside the corporation, retention of all receivables, inventory that will not be utilized in the ongoing business enterprise, and payables is desirable. If the cash basis farm corporation does not sell its production in its initial tax year and has production expenditures, it will generally realize a loss while the predecessor entity will report income from disposition of the prior year's crops. In the absence of other factors, the minimum overall tax rate for the first year's operation could then be obtained by transferring to the corporation all receivables and inventory in excess of payables if the transferors do not wish to receive the proceeds at the shareholder level.

Another impetus to transferring inventory and receivables may be the conditions of existing bank loans. If the tax rate and credit factors dictate transfer of receivables and inventory to the corporation, it is recommended that zero basis assets equal to zero basis liabilities be retained and any excess be transferred for recognition by the corporation.⁸⁴ If there are substantial dollar amounts involved in the transaction, the practitioner should keep in mind the possibility of applying for a ruling under Revenue Procedure 73-16.⁸⁵ Because time is rarely of the essence in the incorporation process, issues on which there is flexibility and for which the tax results are uncertain make the ruling process desirable, provided the amount of money involved justifies the expense. Because of the factual nature of each case and the opportunity for tax avoidance, each ruling is based on its facts.

D. The Use of Multiple Entities

From the previous discussion it can be inferred that all property required for farm operation should be transferred to a single corpo-

come Under Cash Basis Tax Accounting, 30 TAX L. REV. 117 (1975); Willingham & Kasmir, *Prepaid Feed Deduction: How to Cope with IRS' Restrictive New Ruling*, 43 J. TAX 230 (1975).

84. The author is aware of private rulings in which the Service has ruled favorably on transactions in which receivables equal to payables have been withheld and the remainder of the receivables have been transferred to the corporation and the income from them recognized by the corporation. Lipoff, *supra* note 81, at 28; Burke, *supra* note 39, at 111. The only other possible adverse tax impact from retaining zero basis assets would be that the incorporation would not comply with the mere change in form requirement of Treas. Reg. § 1.47-3(a) (19) (1967). From a cost standpoint, retaining receivables and payables would necessitate maintaining two sets of books. While the temptation might be present to allow the corporation to become the agent for the predecessor's organization, such an approach is not advised.
85. Rev. Proc. 73-16, 1973-2 CUM. BULL. 464.

ration except certain zero basis items, personal items, and highly appreciated real property or other property which will probably be sold in the near future. This recommendation is based on the assumption that the family farm operation is a basically unitary business enterprise (although the enterprise may be integrated) owned by one investor group. Where this fact pattern is not present, the farming operation may be advantageously operated as more than one entity.

Several tax problems arise that are present in all transactions between related entities: (1) for taxable years beginning after December 31, 1974, section 1561 limits all members of a controlled group of corporations to one \$25,000 surtax exemption, which is subject to taxation at a rate of twenty-two per cent (except for taxable years ending in 1975 in which the first \$50,000 of income is subject to a maximum tax rate of twenty-one per cent)⁸⁶ and one \$150,000 accumulated earnings tax credit;⁸⁷ (2) the application of the provisions of sections 269 and 1551, disallowing certain deductions, credits and exemptions in certain multiple corporate organizational structures; (3) the inability to offset profits against losses between related entities (except through consolidated income tax returns) or income from sources outside farming in the case of noncorporate entities; (4) increased social security taxes when the same employee works for more than one corporate employer and the employee's aggregate salary exceeds the maximum social security limitation; (5) constructive dividends if intercompany transactions are consummated other than on a fair market value basis; and (6) reallocation of expenses and income between related entities under section 482.

Before listing fact patterns under which the multiple entities are desirable, analysis of some of the common types of multiple farm entities is helpful. Because the principal asset likely to appreciate substantially in value is real estate, some practitioners, for estate planning purposes and also to minimize the total effective tax rate by splitting income, recommend transferring only the real estate to the farm corporation. The operating partnership or proprietorship then rents the real estate used in the farming operation from the corporation.

To avoid reallocation of income under section 482 and/or constructive dividends, the operating entity is required to pay rent at fair market value. Even under a "crop-share" arrangement, the corporation will be paid rental income that will not be sheltered

86. CODE § 11.

87. *Id.* § 535(c)(2).

except to the extent of interest or depreciation although the operating entity experiences a loss. If it can be assumed that the operating entity will not have losses, and the splitting of income results in a lower effective tax rate, this benefit is generally lost when the income is taxed upon distribution to the shareholders. This double taxation problem cannot generally be solved by electing under subchapter S since rental income constitutes passive income.⁸⁸ In addition, substantial passive income may be received from investment of the rental income unless such income is used to reduce existing debt or is invested in additional or capital improvements.

The transfer of only real estate to the farm corporation also has the effect of locking into corporate solution the assets of the farm operation which are the most likely to appreciate in value. A corporate distribution of proceeds from the sale of land or of a mortgage by the land corporation to the operating entity which may be required to finance the operating entity after substantial losses from cattle feeding, drought, etc. generally results in additional taxes that would not have been incurred had the entire operation been one entity. If such events occur after formation of a "land" corporation, it will probably be desirable to contribute the remainder of the farming operation to the corporation or to liquidate the corporation pursuant to section 333.⁸⁹ The operator should also be able to withstand the adverse cash flow resulting from payment of rent to the farm corporation unless the double tax resulting from dividends is not too great. The factual circumstances that warrant establishing a "land" corporation may appear in an estate plan for persons of a very advanced age.

The reverse approach of transferring only equipment and other operating assets to the corporation and allowing it to rent the real property from the proprietorship or partnership seems equally undesirable. The basic estate tax advantages of transferring appreciated land would also be lost. As will be seen later the tax results from corporate operation, even with the election of subchapter S, are generally less desirable than operation in the proprietorship form unless the parties wish to accumulate substantial earnings in the corporate entity or set aside substantial amounts in pension and profit-sharing plans. In addition to the tax issues associated with multiple corporations, the added expense of multiple incorporations, accounting and tax returns must also be considered.

88. *Id.* § 1372(e)(5)(C). For possible qualification for subchapter S treatment under crop-share arrangements, see note 134, *infra*. Segregation of management functions with related entities is more difficult.

89. In such event a liquidation of the corporation under section 333 or 337 may be possible without significant additional tax costs. See Section IV, C, 2 and 3, *infra*.

Despite the conclusion that multiple corporate entities generally should not be utilized in the family farm operations, there are circumstances in which multiple entities are desirable. Where the investors are different, where there is a desire to limit liability (as in a commercial feedlot), where the businesses are separate (grain operating and cattle feeding partnership with outside investors), and where the income splitting benefits are substantial and the owners can afford to leave earnings in the corporation, the circumstances should be examined closely for possible multiple entity operation.

III. OPERATION

A. General Considerations

Despite the significant pitfalls involved with midstream incorporation of an existing farm operation, careful selection of the assets to be transferred to the farm corporation usually eliminates the income tax cost in the incorporation process. If such tax costs cannot be eliminated because of excessive liabilities or assignment of income problems, incorporation will generally not be advisable. As a result, the primary analysis in making the incorporation decision should be devoted to the assessment of the significant differences in tax treatment between operation in the corporate form and operation in the proprietorship or partnership form. The basic difference results from two factors: the rate of taxation and the fact that the corporation is taxed as a separate taxpaying entity.⁹⁰

The tax rates for individuals begin lower and run higher than the rates for a corporation.⁹¹ There are also significant personal exemptions, exclusions and allowances available to an individual which are not available to the corporation. A married person filing a joint return is taxed at graduated income tax rates from a low of fourteen per cent on the first \$1,000 of taxable income to a maximum of seventy per cent on the taxable income in excess of \$200,000.⁹² Corporate tax rates are graduated only to the extent that

90. For purposes of this comparison, the partnership and proprietorship are generally discussed as one form and the corporation as the other, although there are in fact significant differences between the taxation of a partnership and a proprietorship. Although the partnership is a separate entity for tax purposes, the partnership itself is not taxed. The partnership is merely a tax computation entity which files an information return listing the names of the partners and their distributive share of income. The taxable income or loss from the partnership flows through to the individual partners for filing on their individual return, as is the case in a proprietorship.

91. CODE §§ 1, 11.

92. The Tax Reduction Act, Pub. L. No. 94-12 (Feb. 18, 1975) ("TRA of 1975") slightly alters these computations for taxable years ending in

they contain two brackets: the first \$25,000 of taxable income being taxed at twenty-two per cent with the remaining taxable income above \$25,000 taxed at forty-eight per cent.⁹³ A corporation's net long-term capital gains are taxed at the regular corporate income tax rates or a rate of thirty per cent plus the minimum tax.⁹⁴ At the individual level there is a fifty per cent capital gains deduction resulting in only one-half of the individual's net long term capital gain income in excess of short term capital losses and capital loss carryover being reported at the regular graduated income rates.⁹⁵ There is also a maximum tax rate for individuals on the first \$50,000 of capital gains of twenty-five per cent plus the minimum tax.⁹⁶

Before making the decision to incorporate, a projection of income from the farming operations and the non-farm income of the farm operators is essential. The point at which the corporate taxation of farming income results in a lower effective rate of taxation than the individual rate depends on the number of persons comprising the farm operation, their incomes, and their deductions from other sources. Although projections of income in any type of business enterprise are illusive, the projection of income in the farming enterprise is extremely difficult because of price changes, weather, and other variables over which the farm operator has no control and weighs in favor of retaining the flexibility available in a proprietorship or partnership.

Another factor to consider in the comparisons between tax rates at the individual and corporate level is the maximum tax on "earned income." Income from services rendered by an individual taxpayer is subject to a maximum effective tax rate on earned income of fifty per cent.⁹⁷ Where both capital and services are material income-producing factors in an unincorporated business (as in a farming operation), a proposed regulation provides that not more than thirty per cent of an individual's share of the net profits of a trade or business shall constitute "earned income."⁹⁸ The Service

1975. See note 65 *supra*. See also CODE § 1348 for individuals and corporations.

93. CODE § 11. See also note 65 *supra* for tax rates for years ending in 1975.

94. CODE §§ 56, 1201(a).

95. *Id.* § 1202.

96. *Id.* §§ 56, 1201(b), (d).

97. *Id.* § 1348. Certain income paid under deferred compensation plans does not qualify. Certain tax preference items as defined in section 57 in excess of \$30,000 reduce the amount of income qualifying for the maximum tax. See CODE § 1348(b); Proposed Treas. Reg. § 1.1348-2(d)(3), 36 Fed. Reg. 23815 (1971).

98. Proposed Treas. Reg. § 1.1348-3(a)(3), 36 Fed. Reg. 23817 (1971). See

has ruled that the proposed regulation applies to an unincorporated farmer. Despite the position of the proposed regulation and Revenue Ruling 74-597, there would be no precedent or logic for limiting the reasonable compensation of the corporate employee to thirty per cent of the farm corporation's profit.⁹⁹ As a result, substantial benefits might be derived from a corporate farming operation which has taxable income in excess of approximately \$44,000 per family member (the approximate cutoff point for benefit from maximum tax rates ignoring the temporary lower rate imposed by the Tax Reform Act of 1975). The "constructive dividend" double taxation of compensation exceeding a reasonable amount can make the tax risks in the corporate farm great. Subchapter S taxation, however, may offer the opportunity for payment of salaries subject to the fifty per cent maximum tax rate without risk of double taxation should part of the established level of compensation be disallowed.¹⁰⁰

The application of the foregoing analysis to the desirability of corporate operations can be explained by the following analysis. A proprietor or a partner operating a farming enterprise combines his farming income or loss with income or loss from other sources. On the other hand, a corporation (other than the special rules applied to subchapter S corporations)¹⁰¹ is a taxable entity apart from its shareholders. The corporation pays taxes on its income and the owners are not affected for tax purposes by the income of the corporation so long as it remains in corporate solution. If the farm operators would never need to withdraw funds or property from the farm corporation in excess of reasonable compensation, the tax analysis could be made purely on an income rate determination (assuming the accumulated earnings tax of section 531 and personal holding company taxes of section 543 could be avoided). Generally the farm operator will need earnings for his individual expenses, the acquisition of personal items such as essentials, automobiles, boats, vacations, home improvements (unless the home is corporate property), and furniture. Further, wealth accumulated from farming operations may be used to purchase second homes, make other investments, or establish a retirement fund. The fractional share of the farming income or cash flow required to satisfy these needs will vary from family to family. In the absence of liquidation, the only way to distribute money from the corporation to the stock-

also CODE § 911(b). The Service has ruled that this proposed regulation applies to an unincorporated farmer. Rev. Rul. 74-597, CUM. BULL.

99. Treas. Reg. § 1.162-7 (1958).

100. See note 122 and accompanying text *infra*.

101. See Section III, B, *infra*.

holder employee is through salaries, dividends or interest on loans from stockholders, and loans to the stockholders.

Distributions by a corporation not electing subchapter S will be taxed as dividends to the stockholders to the extent of the corporation's accumulated or current earnings and profits,¹⁰² even though the corporation has already been taxed on this income. This so-called double taxation is the principal disadvantage of a corporate operation. Part of the double taxation problem can be eliminated through payment of reasonable compensation to the stockholder employees. Except in the event of a very low level of compensation, however, it seems likely that part of distributions from the corporation to shareholder-employees will constitute dividends.¹⁰³ Payment of dividends in profitable years and a base salary with a designated percentage of current operating profits is the recommended method of sustaining reasonable compensation. If the base salary is subject to yearly changes both upward and downward, the taxpayer would seem to be in a much worse position and the Service would likely claim that the changes were only arbitrary.

Because of the significant fluctuations in farming income, establishing a high base salary can result in substantial payments subject to taxation at the individual level even though the farming operation may have incurred a substantial loss. In the industrial or professional corporation there are significant swings in profits, but these changes are generally not as large nor as cyclical as those which frequently occur in farming operations. Also unlike the "professional corporation" and other service-type corporate businesses formerly operated as proprietorships or partnerships, the capital intensive nature of the farming operation makes payment of large percentages of the profits as reasonable compensation more difficult. Any standard which required the typical farm corporation's profits before compensation of the shareholder employees to be allocated on the basis of service and a reasonable return on shareholder's invested capital, would doubtlessly require distribution of a substantial percentage of the average amount of profits as dividends. If an ongoing profitable farming enterprise is incorporated, allocating a higher percentage of profits to compensation is even more difficult. In the early stages of any business enterprise, the profits would be expected to be small and the corporation could pay out substantially all the profits as reasonable salaries to the owner resulting in a minimal corporate taxation.¹⁰⁴

102. CODE §§ 301, 317(a).

103. Charles McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct. Cl. 1970).

104. The issue of reasonable compensation is a factual one determined on

The lock-in effect and double taxation problems resulting from the sale or refinancing of appreciated real property operating assets

a case by case method. *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929). This analysis has resulted in the "reasonable compensation" question becoming the most litigated of the tax laws. One traditional test is the comparison with salaries of executives in similar positions in the industry. This comparison of trade industry data is generally not available in the corporate farm context. The fact that the farm operator does not generally have a prior "salary" history is also detrimental. The amount of time devoted to the farming operation, the impact of the economic decisions made by the farm operator and the salary and share of the profits that the farm operator would have been required to pay to a farm operator had he chosen to remain an absentee landlord are factors that may support the corporation's contention that compensation paid to the shareholder employee is reasonable.

A more troublesome theory that has arisen in recent years is the so-called automatic dividend rule. In *Charles McCandless Tile Serv. v. United States*, 422 F.2d 1336 (Ct. Cl. 1970), although there was no question about the reasonableness of the compensation paid to employee shareholders, the Court of Claims held that in the absence of dividends to the shareholder employee, a corporation which had distributed approximately 50 per cent of the pre-tax profits to the shareholder employees as compensation had given a portion of the "compensation" as a return on invested capital. Although the Tax Court has not yet adopted the *McCandless* rule, it has clearly been influenced by its compelling logic. See *Shiocton Lumber Co.*, 33 CCH Tax Ct. Mem. 599 (1974); *Carole Accessories, Inc.*, 32 CCH Tax Ct. Mem. 1285 (1973). *But cf. Edwin's Inc. v. United States*, 501 F.2d 675 (7th Cir. 1974).

The Eighth Circuit has indicated that bonus arrangements which distribute the majority of net profits and necessarily leave little or nothing to be paid as dividends are a vehicle for distributing profits to shareholders. *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148 (8th Cir. 1974). The Tax Court has also determined bonuses based on profits for shareholder employees will not be upheld. *Universal Chevrolet Co. v. Commissioner*, 16 T.C. 1452 (1951), *aff'd*, 199 F.2d 629 (5th Cir. 1952); *Paul E. Kummer Realty Co. v. Commissioner*, 511 F.2d 313 (8th Cir. 1975). In the author's opinion existing case law, when combined with investment required on the modern family farm and its traditionally low return on invested capital, make payment of a large percentage of the corporation's profits as reasonable compensation most difficult. Unless there are other factors which override the negative impact of partial double taxation, or unless the farm operators are willing to allow a substantial amount of the profits from the farm to be reinvested in the farm operation, the corporate farm is advantageous only if subchapter S operation is desirable. If the non-subchapter S form is elected, payment of annual dividends of not less than 5 per cent of the after-tax profits is a desirable policy. See generally O'Neill, *Reasonable, But Nondeductible, "Compensation"?*, 57 A.B.A.J. 82 (1971); Holden, *Has Court of Claims Adopted an "Automatic Dividend" Rule in Compensation Cases?*, 32 J. TAX. 331 (1970); Jones, *Is There a Dividend Requirement for Professional Corporations?*, 34 J. TAX. 139 (1971).

in the corporation are even greater than those connected with the distribution of earnings. In a partnership or proprietorship, income from the sale of property other than agricultural production retains its character as long-term capital gain (except for investment credit and depreciation recapture) in the hands of the proprietor or partners. Unfortunately, the distribution of all income from the corporation to the shareholder is taxed as a dividend at ordinary income rates.¹⁰⁵ An even more difficult situation is created if the corporation mortgages highly appreciated real property. Even though there is no tax at the corporate level, the distribution of the mortgage proceeds to the shareholder would be taxed first as dividends to the extent of the greater of accumulated or current earnings and profits. After elimination of earnings and profits and the stockholder's basis in the stock, the remainder would be taxed at capital gains rates.¹⁰⁶ When measuring the tax effect of such a distribution, great care should be taken in measuring earnings and profits. Even though the corporation has paid only minimal income taxes, substantial earnings and profits may have been generated by the difference between straight line and accelerated depreciation for tax years commencing after June 30, 1972 or other sources.¹⁰⁷

The principal federal income tax advantage unique to farming operations is the availability of the "farmer cash method" of tax accounting.¹⁰⁸ Through cash payments for fertilizer, supplies, crops in the ground and by withholding harvested crops from sale, or selling the crops without the constructive receipt of cash, the farm operator is able to defer recognition of taxable income to a much greater extent than comparable businesses with similar inventory levels. The rancher who does not have to account for the inventory of growing calves is also able to defer his taxable income through feed prepayments and delaying the sale of his calf crop until January. In cases where progeny are placed in the breeding herd, this deferred income can be converted into capital gains.¹⁰⁹ The feedlot operator, by acquiring significant quantities of feed and withholding fat cattle from the market, is also able to defer his taxable income.

Under present law, no distinction is made between the corporate farm and the proprietorship and the partnership on utilization of

105. Subchapter S taxation will eliminate part of their undesirable result but the shareholder's basis in his stock would be reduced unnecessarily by the loss attributable to the salary.

106. CODE § 301(c).

107. *Id.* § 312(m).

108. Treas. Reg. § 1.471-6 (1958).

109. CODE § 1231(b)(3).

the farmer cash method of accounting. Under tentative proposals of the House Ways and Means Committee in 1974 and 1975, all corporate farms except subchapter S corporations and family controlled corporations would be required to adopt the accrual method of accounting.¹¹⁰ If similar legislation is enacted, most nonfamily corporate farms would be required to account for their inventory and to report their income on the accrual method. The necessity of accounting for inventory and receivables, when added to the complicated and burdensome corporate record-keeping requirements, would eliminate the flexibility currently available in agricultural operations and would in almost all instances result in higher annual taxable income. Consequently, practitioners recommending incorporation of farm operations which do not qualify for the exemption from the accrual method as presently proposed, could be subject to attack by their farm clients if this type of legislation is enacted.¹¹¹

Other tax concepts unique to farming operations, such as the crop method of accounting, hybrid method of accounting, deduction of pre-productive stage expenses, the farmer price method, the unit livestock method, deduction of soil and water conservation expenses, required amortization of citrus groves, treatment of land, sales with growing crops, land clearing expenses, and holding periods for long-term capital gain treatment on the sale of livestock are applicable without regard to whether the farm operation is conducted in the corporate, partnership or proprietorship form of organization.

A new provision, added by the Tax Reform Act of 1969¹¹² converts into ordinary income the gain from the disposition of farm property that would otherwise be taxed as capital gains by requiring the recapture of certain farm losses as ordinary income for farming operations not accounting for inventories in computing taxable income.¹¹³ The statutory scheme of section 1251 provides for maintenance of an excess deduction account ("EDA") on an on-

110. See note 6 *supra*.

111. Due to the present membership of the Ways and Means Committee and Congress in general, it is impossible to estimate the chances of passage of this legislation. However, due to the weakening position of farm-oriented legislators, the recent changes in the committee's structure, and the increasing focus on large farm corporations, the possibility of passage cannot be dismissed. It should be noted that the proposed legislation would also force farm partnerships to adopt the accrual method if a corporation had more than a five per cent interest in the profits and losses of the partnership.

112. Proposal to Abolish E.D.A. See HOUSE WAYS AND MEANS COMMITTEE PRINT, *supra* note 5.

113. CODE § 1251; Proposed Treas. Reg. § 1.1251-2, 36 Fed. Reg. 25019 (1971).

going basis. Each year in which the farming operation not accounting for inventories has a net taxable loss this balance is added to the EDA account. Subsequent taxable income is subtracted from the EDA account. Section 1251 does not provide for a negative balance in the EDA account, and as a result a single loss year subsequent to highly profitable years can create a balance in the EDA subjecting later sales of property to recapture. There is a provision for adjustment if there was no tax benefit from the losses.¹¹⁴ If the losses are subsequent to profits by the corporate farm, tax benefits would be derived as a result of the net operating loss carryback under section 1721 from the EDA and this exemption would not be applicable. The property which is subject to EDA recapture upon disposition is: (1) depreciable personal property (other than livestock) held for six months and used in the farming business; (2) real property other than section 1250 property, used in the farming business and held for more than six months; (3) cattle and horses held for breeding and sporting purposes and held for 24 months or more; (4) livestock (other than horses or cattle) held for draft, breeding, various sporting purposes and held for 12 months or more; and (5) growing crops sold with the land and qualifying for section 1231 treatment.¹¹⁵ An asset can be treated as farm recapture property although it has not been used in farming business if the property was received by the transferee from a transferor who did use it on the property in the farming business and the taxpayer acquired the property in certain tax free or gift transactions.¹¹⁶

Although land used in the farm operation is farm recapture property (if held for more than six months), the recapture of ordinary income is limited by the amount of soil and water conservation and land clearing expenses deducted in respect to the land and sold during the year of disposition and four preceding taxable years.¹¹⁷ In addition to the recapture of soil and water conservation and land clearing expenses required by section 1251, further recapture of the expenses may be required by section 1252. Section 1252 requires the recapture of all soil and water conservation expenses and land clearing expenses previously deducted upon disposition of the land if the land was disposed of within the five years after its acquisition. Between six and nine years after acquisition the amount of these expenditures that must be recaptured decreases until ten years or more after acquisition, after which no recapture is required under

114. CODE § 1251(b) (3) (A).

115. *Id.* § 1251(e).

116. Proposed Treas. Reg. § 1.1251, 36 Fed. Reg. 25019 (1971).

117. CODE § 1251(e) (5).

section 1252. If both sections 1251 and 1252 apply to the disposition of a piece of real property, section 1252 applies only to the extent that recapture under that section exceeds recapture under section 1251.¹¹⁸

There is a significant distinction between EDA computations for corporate farms and proprietorships, partnerships or corporate farms electing subchapter S. This distinction lies in the fact that no addition to the EDA is required for proprietorships, partnerships or subchapter S corporations unless the non-farm adjusted gross income of the individual taxpayer in the year in question exceeds \$50,000 and the farm loss exceeds \$25,000.¹¹⁹ Corporations not electing under subchapter S do not have any exemption under EDA and all losses are added to the EDA account regardless of the non-farm adjusted gross income.¹²⁰ As a result of this distinction, there is a much greater risk that disposition of farm property will be subject to recapture under the EDA provisions if operations are conducted in the corporate form without a subchapter S election.¹²¹

B. Subchapter S Taxation

The principle mechanism to avoid the undesirable double taxation aspects of the corporate form of operation is the so-called subchapter S corporation.¹²² Subchapter S was enacted in 1958 to give small businesses more flexibility in choosing a form of business organization by allowing corporate income to "pass through" to the shareholders for taxation. Despite their theoretical similarities, it is erroneous to refer to subchapter S corporations as incorporated partnerships. The subchapter S provisions are extremely complex and technical, and contain many pitfalls that can only be avoided by constantly monitoring corporate operations and distributions. The following discussion will summarize the application of subchapter S to farm corporations, designate the steps that must be followed to qualify for subchapter S treatment, discuss the most advantageous procedure for making distributions to the shareholders,

118. *Id.* § 1252(a).

119. *Id.* § 1251(b) (2) (B).

120. *Id.* § 1251(b) (2) (A).

121. Although previous discussion (see Section II, C, *supra*) described the undesirability of transferring property which would be sold by the corporate farm in the near future, there are a number of instances in which farm recapture property, particularly livestock, will be sold and would be taxed as ordinary income if there was an outstanding balance in the EDA account. For an excellent analysis, see Bravenec, *The Farm Recapture Provisions and Tax Planning for Corporations*, 1 J. CORP. TAX. 391 (1975).

122. CODE §§ 1371-79.

and analyze the effect of subchapter S status on the income tax price of operation in the corporate form.

The election of subchapter S taxation eliminates most taxable income at the corporate level by passing through the corporation's taxable income to the shareholders as taxable dividends.¹²³ The election under subchapter S is not available to all corporations. Only a domestic corporation which is not a member of an affiliated group,¹²⁴ having ten or fewer shareholders,¹²⁵ all of whom are individuals or estates and residents or citizens of the United States may elect subchapter S treatment.¹²⁶ The corporation must have only one class of stock.¹²⁷ Because most closely held farm corporations not having a second class of stock are eligible for subchapter S tax treatment, it is generally advantageous for the farm corporation to make the election. This is not the case if taxation of all income at the shareholder level results in a higher effective tax rate than the taxation of income to the corporation and the taxation of "reasonable compensation" and distributions of desired dividends to the stockholders.

If the corporation qualifies for subchapter S treatment, there are certain technical requirements that must be satisfied to effect the election. Existing corporations must exercise the option in the first month of the taxable year for which the election is made, or during the preceeding month by filing Form 2553. Newly organized corporations must elect within the first month after commencing operations, acquiring assets or having shareholders. All shareholders must consent to the election and the election may be revoked (but not for the first taxable year following the election) if all stockholders consent to the revocation. The revocation must be made before the close of the first month of the taxable year to be effective for that tax year. Otherwise, it will be effective for the following taxable year. If a new shareholder acquires stock in a subchapter S corporation and does not consent to continuation of the election within thirty days,¹²⁸ the election terminates

123. Distribution of previously taxed but undistributed taxable income is subject to significant pitfalls discussed below. See notes 141-43 and accompanying text *infra*.

124. Affiliated group is defined in CODE § 1504(a).

125. Spouses are counted as one shareholder if the stock is owned as joint tenants, tenants in common or community property. See Treas. Reg. § 1.1371-1(d)(2)(i) (1959); Hicks Nurseries, Inc. v. Commissioner, 517 F.2d 437 (2d Cir. 1975), *rev'g* 62 T.C. 136 (1974).

126. Treas. Reg. § 1.1371-1(a) (1959).

127. *Id.*

128. The 30-day period for filing a statement with the District Director begins on the date the person becomes a shareholder. CODE § 1372(e)(1); Treas. Reg. § 1.1372-2(b) (1969).

for the taxable year in which the non-assenting shareholder became a shareholder.¹²⁹ Because of the transfer of stock by bequest, gift or otherwise, it is important to include a restriction on all stock issued that transfer is conditional on the filing of the required forms by the new stockholders.¹³⁰ If the subchapter S election is revoked, or if it is terminated for failure to meet the statutory requirements, the corporation or any successor is ineligible to make the subchapter S election prior to the fifth taxable year for which the termination or revocation is effective, unless the consent of the Commissioner is obtained.

There are certain income tests which must be met by the electing corporation. It must not derive more than 80 per cent of its gross receipts outside of the United States¹³¹ nor have more than 20 per cent of its gross receipts from passive income sources, such as rents, royalties, dividends, interest and annuities, and gains on the sale or exchange of securities or stock.¹³² The first and second taxable years of the corporation are exempted from the passive income test if the corporation is engaged in an active trade or business and the amount of passive income is less than \$3,000.¹³³ Generally, the farm corporation will have minimal passive income. An exception is the case in which only land is transferred to the farm corporation and is rented to controlled entities. Another exception would be the rental of an acreage and/or equipment to a third party. These types of rental arrangements will either constitute "passive" rental income which cannot exceed 20 per cent of the qualifying corporation's gross receipts or constitute farming income.¹³⁴ If the lessor merely provides land and/or equipment for cash rental without providing substantial services, the income will constitute passive income. In a so-called "material participation lease" in which the lessor participates in the management decisions

129. Treas. Reg. § 1.1372-2(b) (1969). When the corporation's taxable year does not begin on the first day of the calendar year, a month is computed from the commencement to the numerical date in the next month immediately preceding the date of the beginning of the taxable year.

130. There may be some question about the enforceability of such a restriction in certain jurisdictions.

131. CODE § 1372(e) (4).

132. *Id.* § 1372(e) (5) (C).

133. *Id.* § 1372(e) (5) (B).

134. If the crop share constitutes rental income, it is taxed upon receipt. If it constitutes farming income, a cash basis taxpayer can defer income until he is in constructive receipt of the proceeds. See Treas. Reg. §§ 1.61-4, 1.451-1 (1957). Another area in which the character of farming income is important is that involving gifts. Rev. Rul. 63-66, 1963-1 CUM. BULL. 13.

(such as the designation of crops) or if he participates in planting crops acquiring fertilizer, and harvesting and receives a portion of the crops, the income should constitute farming income rather than passive "rental income."¹³⁵ Other factors favorable to classification as farm income are actual disbursements by the lessor for seed, fertilizer, machinery, etc. and participation in the physical labor.

Another potential source of passive income would be interest income resulting from the installment sale of farm property. When evaluating the decision to incorporate and in determining the assets to be transferred, the operation should be planned to eliminate substantially all passive income if subchapter S status is desired.¹³⁶ The farm corporation which must plan to absorb a certain amount of passive income annually will often be forced to make business decisions regarding expenditures or marketing that are not economically desirable. These decisions can also increase the amount of taxable income recognized by the shareholders.

Section 1373 provides the statutory mechanism for the "pass through" of a qualifying subchapter S corporation's taxable income to its shareholders as dividends. In determining the corporation's taxable income, such income is generally computed in the same manner as that of a non-electing corporation except that neither the net operating loss carryover of section 172 nor the corporate dividends received exclusion of sections 243-246 are allowed.¹³⁷ Distributions during the current taxable year and within two and one-half months thereafter are classified as dividends to the shareholders.¹³⁸ Any remaining undistributed taxable income of the corporation is taxed as a constructive dividend to the shareholders pro rata on the basis of stockholdings¹³⁹ on the last day of the corporation's taxable year.¹⁴⁰ The shareholder's basis in the cor-

135. In Rev. Rul. 61-112, 1961-1 CUM. BULL. 399, participation in the management decisions, such as determining the time and amounts of crops to be planted, the time for harvesting, and records to be maintained were deemed significant enough to classify the income as farming income. Rev. Rul. 61-112 was approved in Rev. Rul. 67-423, 1967-2 CUM. BULL. 221. In *Gladys M. Kennedy*, 33 CCH Tax Ct. Mem. 655 (1974), crop shares were deemed to be rents and subchapter S status was terminated. The Tax Court found that even though the contract provided for management decisions, such decisions were in fact made by an officer-tenant.

136. CODE § 1372(e)(5).

137. *Id.* § 1373(d).

138. *Id.* § 1375(f).

139. The Commissioner, however, may reallocate income in family groups to reflect the value of services actually rendered. CODE § 1375(c).

140. *Id.* § 1373(b).

poration's stock is increased by the amount of undistributed taxable income.¹⁴¹

The previously taxed but undistributed income is maintained in a previously taxed income ("PTI") account. Cash (but not property) distributions of PTI are not treated as dividends to the shareholders, but a tax free distribution of PTI can be made only after actual distribution of current earnings and profits.¹⁴² Because earnings and profits in a year could be greater than the income on which the shareholders are actually taxed under section 1373 (e.g., the use of accelerated depreciation tax for taxable years beginning subsequent to June 30, 1972)¹⁴³ additional cash taxable to the stockholders might be required to be distributed to the shareholders prior to distribution of the PTI. When the PTI is distributed, the shareholder's basis is reduced by the amount of the distribution.¹⁴⁴

Another so-called advantage of subchapter S taxation is the ability of shareholders to offset the losses of the corporation against income from other sources.¹⁴⁵ Although the loss pass-through may be advantageous to tax shelter-oriented investors with income from non-farm sources, the primary advantages to the farm operator who devotes his full time to the business are an offset of the losses against his corporate salary and the net operating loss carryback and carryforward of section 172. The use of the net operating losses may eliminate any benefit from the personal exemption and standard or itemized deductions. While the constructive dividends are allocated to the shareholder on the basis of ownership on the last day of the taxable year under section 1373(b), section 1374(c) requires allocation of net operating losses on the basis of *daily* ownership of the shares. This allocation is required to prevent sale of stock with operating loss benefits at the end of the taxable year.

The shareholder's basis in a subchapter S corporation is reduced by any net operating losses which are allocated to him through an electing corporation. One of the pitfalls in subchapter S election is that in a loss year the stockholder may not have sufficient stock basis to take full advantage of the loss.¹⁴⁶ Since the net op-

141. *Id.* § 1376 (a).

142. *Id.* § 1375 (d); Treas. Reg. § 1.1375-4 (1959).

143. *Id.* § 312 (m).

144. Note, 67 COLUM. L. REV. 495 (1967).

145. CODE § 1374.

146. An example of a tremendous tax blunder is George W. Wiebusch, 59 T.C. 777 (1973), *aff'd*, 487 F.2d 515 (8th Cir. 1973). The Wiebuschs (Nebraska taxpayers) transferred liabilities in excess of the "tax basis in the assets" upon incorporation and elected subchapter S. Not only

erating losses cannot be carried forward from any taxable year in which the corporation's losses for the taxable year will exceed the shareholder's tax basis in the corporation, the shareholders, either by loan or capital contribution, should make a direct investment in the corporation to increase their basis to equal their share of projected loss prior to the last day of the taxable year. Even if the shareholders do not have sufficient compensation or other taxable income in the current year or the preceding three years to utilize the net operating loss of the subchapter S corporation, obtaining sufficient basis in the stock to "pass through" the entire loss to the shareholders will give the shareholders five years to utilize the net operating loss carryover. Because both loans and equity investments increase a shareholder's basis,¹⁴⁷ a loan (assuming thin capitalization tests are satisfied) repayable in the subsequent taxable year will enable the shareholder to increase his basis sufficiently to pass through the net operating loss. The loan repayment, however, may result in taxable income under section 301 (c) (3) if the shareholder's basis in his stock has not been increased by subsequent undistributed earnings or additional capital contributions or losses. It may be advisable to classify the injection of cash into the subchapter S corporation as equity rather than as a loan. Distributions in excess of earnings and profits to a stockholder will be taxed as capital gains under section 301(c) (3) only after the stockholder's entire basis in his stock has been eliminated. Repayment of part but not all of the loan may result in taxation prior to elimination of the stockholder's basis in loans and stock in the corporation.¹⁴⁸ For example, stockholder A's basis in his stock on January 1, 1975 is \$5,000. The corporation has no accumulated earnings and profits. His pro rata share of losses in a subchapter S corporation for 1975 is \$20,000. On December 1, 1975 he contributes \$20,000 in cash to the corporation. In 1976, the corporation has no taxable income or loss or earnings and profits and repays \$16,000 to stockholder A on December 1, 1976. If the \$20,000 had been classified as a loan, A would have to report \$12,000 as capital gain.¹⁴⁹ If the contribution had been classified as stock, A would have reported only \$11,000 of gain under section 301(c).

were the taxpayers subject to recognized gain on the incorporation process under section 357(c), all operating losses of the corporation were disallowed because of insufficient basis in the stock.

147. CODE § 1374(c) (2).

148. CODE §§ 1001, 1376; Rev. Rul. 64-162, 1964-1 CUM. BULL. 304.

149. If contributions are to be classified as indebtedness, a note must be issued designating the time for prepayment and interest. Indebtedness on open account has been classified as ordinary income gain or loss. Rev. Rul. 68-537, 1968-2 CUM. BULL. 372 demonstrates the results of repayment.

The shareholder's proportionate share of the corporation's net long-term capital gains in excess of capital losses retains its capital gain character when passed through to the stockholder.¹⁵⁰ Under section 1378, added in 1966 to penalize certain large one-time capital gains, an electing subchapter S corporation may also be subject to capital gains taxation. If the farm operation is incorporated and the subchapter S election is made immediately, the pass-through capital gains benefits can be obtained as long as subchapter S qualification is maintained. However, if the election was not made at the formation of the corporation and the election has not been made for three years prior to the capital gains transaction, the gain can be subject to taxation at both the corporate and shareholder level. The capital gains tax at the corporate level applies if, for the taxable year, the corporation's net long-term capital gain (the excess of long-term capital gain over its short-term capital loss) exceeds \$25,000 and fifty per cent of the corporation's taxable income for the year. If these conditions are satisfied, the net long-term capital gain (the excess of net long-term capital gain over net short-term capital loss) in excess of \$25,000 is taxed at the lesser of the rate of thirty per cent or the amount computed as if a section 11 tax had been imposed on the corporation's taxable income. The amount of capital gain income passed through to the shareholders under section 1375 is reduced by the taxes paid by the corporation.¹⁵¹

If the farm corporation has been in existence and has not elected under subchapter S for the entire period of its existence, or three years prior to the capital gain transaction, the recognized capital gains should be kept below \$25,000 or fifty per cent of its taxable income, whichever is greater. Election of the installment method should allow the corporation to make a desired sale and keep the recognized gains below the limits imposed by section 1378. When the decision to incorporate is made, the probability of the sale of appreciated property in the near future (which for other reasons must be transferred to the corporation) and the impact of section 1378 on that sale should be considered when deciding whether to make the subchapter S election upon incorporation.

Even the pass through of capital gains to the shareholder in subchapter S taxation does not eliminate the tax advantage of operation as a proprietorship or partnership if the farming operation has a taxable loss in the year in which a capital gain is recognized. Pursuant to the provisions of section 1375(a)(1), the amount of capital gains which can be passed through to shareholders is limited

150. CODE § 1375.

151. *Id.* § 1375(a)(3).

to the taxable income of the corporation for that year. This would have the effect of taxing capital gains equal to the corporation's losses at ordinary income rates. On the other hand, if the farming operation had been kept in a proprietorship or partnership form, the entire capital gain would be reduced by the section 1202 deduction. The losses from the farming operation in the proprietorship or partnership form could be offset against the capital gain after the section 1202 deduction in determining the net taxable income of the farm operator for the year.

There are other undesirable characteristics of subchapter S operations when compared with partnerships or proprietorships. Similar to the tax consequences of a regular corporation is the inability to deduct capital losses. The subchapter S election does not allow capital losses to be passed through to the shareholder. They are carried forward to offset against future capital gains at the corporate level.¹⁵² If the election is made for an existing farm corporation, prior operating losses of the corporation may not be carried forward as an offset against shareholder income. A corporation, as a separate taxable entity, can carry forward the loss from the non-election years to a subsequent non-election year but intervening election years are counted in computing the five-year carry-over period.

A disadvantage of the subchapter S corporation relative to taxation of a non-electing corporation is the limitation on contributions to a qualified pension and profit-sharing plan pursuant to section 401. Section 1379, added by the Tax Reform Act of 1969, limits contributions on behalf of shareholder employees of subchapter S corporations to those imposed under Keogh plans for self-employed persons. This disadvantage is not as great as in the past because of the 1974 increase in the annual limitation on contribution to Keogh plans to \$7,500 (or greater after 1975 in the case of certain defined benefit plans¹⁵³).

There are other pitfalls which the practitioner should be aware of in the formation and operation of a subchapter S farm corporation. The right to withdraw PTI is a personal right and does not extend to any transferee.¹⁵⁴ If the taxpayer dies or transfers his stock, the transferee is denied the benefit of the tax-free distribution of PTI which would have been available had the distribution been made to the shareholder. If the subchapter S election is revoked or is terminated for failure to qualify, the shareholder loses

152. *Id.* § 1212(a) (3).

153. See Section III, D, *infra*.

154. Treas. Reg. § 1.1375-4(e) (1959).

the benefit of the taxes which he had previously paid on the income of a subchapter S corporation and will be taxed a second time at normal dividend rates on a later distribution, provided there are sufficient other earnings and profits in the corporation.¹⁵⁵ Subsequent operating losses will also reduce previously taxed earnings. To avoid these undesirable consequences, a dividend in cash should actually be distributed to each shareholder during the taxable year or within two and one-half months after the close of the taxable year. Distribution of cash by the corporation and an immediate loan back to the corporation by the shareholder is not a desirable alternative.¹⁵⁶

As indicated previously,¹⁵⁷ estate planning advantages are often the principal reason for incorporating a farm operation. Many recommended estate plans separate management control from ownership or lock in the value of the stock owned by one group of stockholders. In most cases, the use of preferred stock is a desirable method of accomplishing this objective. However, an electing subchapter S corporation can have only one class of stock. What constitutes a second class of stock is not always clear.¹⁵⁸ In the sixteen-year history of subchapter S, there has been extensive litigation regarding this issue. At this date, there are still no definite criteria for determining what constitutes a second class of stock. Where stock is issued that has different voting rights and different income and liquidation rights, there is clear precedent that the one class of stock requirement is violated.¹⁵⁹ It also appears well settled that options, warrants and convertible debentures are not a second class prior to their conversion.¹⁶⁰ The principal remaining areas of uncertainty regarding the status as a second class are (1) where unequal voting rights are created by using a voting trust arrangement or by the corporate charter and (2) where debt obligations actually constitute contributions to capital (as a result of their terms and the thin capitalization of the corporation).

The Treasury's existing regulations provide that if two or more groups of shares are identical in every respect except that one group

155. Undistributed taxable income of subchapter S corporations does not increase earnings and profits. CODE § 1377(a).

156. See Grant, Alden, Kaufman & Lee, *The Relative Tax Advantages of Partnership and Subchapter S Corporations*, 21 SO. CAL. TAX. INST. 409 (1969).

157. See note 2 and accompanying text *supra*.

158. CODE § 1371(a)(4); Treas. Reg. § 1.1371-1(g) (1959).

159. *Pollock v. Commissioner*, 392 F.2d 509 (5th Cir. 1968); Treas. Reg. § 1.1371-1(g) (1959).

160. Rev. Rul. 67-269, 1967-2 CUM. BULL. 298.

of shares has the right to elect directors in a number disproportionate to the number of shares in the group, both groups will constitute a single class of stock.¹⁶¹ To date there have been no interpretations of what is "disproportionate." Based on a literal reading, "Group A" could elect five or more directors as long as "Group B" could elect at least one director. Such an interpretation would be ill-advised for planning purposes. In view of the Service's current position on voting trusts, there is a better alternative. After its recent loss in *Parker Oil Company*,¹⁶² the Service agreed to accept form over substance when different voting rights are involved. The currently accepted position is that where disproportionate voting rights in stock of a subchapter S corporation arise out of the corporation's charter or articles of incorporation, the corporation has more than one class of stock. However, if different voting rights arise out of agreements between shareholders, or shareholders and third parties, the disproportionate voting rights do not constitute a second class of stock.¹⁶³ When, for estate planning purposes or business reasons, it is desirable to place voting control with one group and equal equity position with another group, the recommended procedure is to create an irrevocable voting trust in favor of the group to which management responsibilities are to be assigned. Nebraska law explicitly authorizes such a trust.¹⁶⁴

The issue of debt securities as part of the incorporation process presents the possibility that the purported debt instruments will be classified as equity and thus constitute a second class of stock. The regulations provide that purported debt instruments which for tax purposes are equity will constitute a second class of stock unless they are issued proportionately to the other equity interests outstanding.¹⁶⁵ In view of numerous decisions holding this segment of the regulations invalid, the Service has announced that it will propose regulations amending Treasury Regulation section 1.1371-1(g), though none have appeared as of the time of this writing.¹⁶⁶ Pending the revision, the Service will not litigate cases factually similar to the facts in these cases.¹⁶⁷ Until new regulations are

161. Treas. Reg. § 1.1371-1(g) (1968).

162. *Parker Oil Co.*, 58 T.C. 985 (1972).

163. Rev. Rul. 73-511, 1973-52 CUM. BULL. 402.

164. NEB. REV. STAT. § 21-2034 (Reissue 1974).

165. Treas. Reg. § 1.1371-1(g) (1959).

166. See TIR-1248, 7 CCH 1973 STAND. FED. TAX REP. ¶ 6754. The Service's most notable defeats were in *Amory Cotton Oil Co. v. United States*, 468 F.2d 1046 (5th Cir. 1972); *Shores Realty Co. v. United States*, 468 F.2d 572 (5th Cir. 1972); *Portage Plastics Co. v. United States*, 470 F.2d 308 (7th Cir. 1972); *James L. Stinnett, Jr.*, 54 T.C. 221 (1970).

167. Perhaps the worst possible fact pattern from the taxpayer's viewpoint

promulgated, it appears that, in the absence of a flagrant attempt to disguise preferred stock as debt, purported debt obligations issued disproportionately either on incorporation or subsequently will not result in disqualification under subchapter S for violation of the second class of stock requirement. However, continued caution is dictated because the severe penalties for disqualification, including taxation at the corporate level, the prohibition against election of subchapter S for five years without the consent of the Commissioner, and possible costs in defending the practice from challenge at the lower levels of the Service.

C. Corporate Tax Elections

When a new corporation is formed, certain corporate elections in addition to the subchapter S decision must be made. These elections should be carefully considered by the taxpayer, since most elections once made cannot be changed without the consent of the Commissioner. One of the most important considerations is the choice of a fiscal year. The annual accounting period is that on which the taxpayer's records are kept. A newly formed corporation may adopt a fiscal year on or before the time for filing their initial return without obtaining the Commissioner's approval.¹⁶⁸ Because the farm operation's inventory, receivables, and payables are generally low in February and March (as opposed to a cattle feeding operation where inventory, receivables and payables fluctuate with market conditions), these months are generally the ideal time to incorporate the farm operation in the absence of timing factors previously discussed.¹⁶⁹

The choice of fiscal year may depend upon whether the corporation intends to adopt subchapter S. If subchapter S is elected, the profitable farm corporation's fiscal year should generally end on January 31. The undistributed taxable income of the cash basis

was that presented in the *Portage Plastics* case. A shareholder's aunt received subordinated debentures with interest payable as a percentage of the corporation's profits in exchange for cash. The corporation had a high debt to equity ratio. The court concluded that the purported debt instruments were clearly a contribution to capital, but that the traditional thin incorporation tests were not adequate for determining whether a purported loan constituted a second class of stock within the meaning of CODE § 1371(a)(4). The other cases lost by the Service involve fact patterns ranging from interest bearing obligations issued for cash to noninterest bearing notes issued upon incorporation of a partnership. *Portage Plastics Co. v. United States*, 470 F.2d 308 (7th Cir. 1972).

168. Treas. Reg. § 1.441-1(b) (1957).

169. See Section II, C, *supra*.

farm corporation (assuming there are no distributions) can theoretically be deferred for up to two years following incorporation. For example, the 1975 crop of the farm corporation is sold in February of 1976. The subchapter S corporation will not report the income until its taxable year ending on January 31, 1977. By delaying distribution of the proceeds to the shareholders until January of 1977, the taxpayer will not be required to report taxable income from the 1975 crop until the taxable year ending in 1977. If market conditions dictate, the corporation will also be able to sell its crops before the end of the calendar year 1975 while the shareholders can avoid income recognition until the following calendar year by delaying distribution of the proceeds to the shareholder operator until after December 31.

Since the taxable income or loss of the farm corporation not electing subchapter S is not "passed through" to the shareholders, the considerations in the choice of fiscal year involve both deferral of the corporation's taxable income and the payment of compensation to the shareholder operator. If the incorporation process is completed in January or February, the election of an October 31 fiscal year (or the month which is immediately prior to the general month of sale of the farm operation's principal crop) will defer recognition of income by the corporation until the following taxable year. If the doctrine of constructive receipt can be avoided, the portion of the employee shareholder's salary which is dependent upon profits can be deferred until after December 31.¹⁷⁰ The corporation will also have the flexibility to sell its crops according to the dictates of market conditions following harvest rather than selling after December 31 for tax reasons as would be desirable had it adopted a calendar fiscal year.

If flexibility for the crop sale is not desired, the fiscal year could end on the last day of December, January or February. Generally, the same considerations in choice of fiscal year would apply to livestock breeding or combination breeding and farming operations. Because the level of activity of feedlot operations generally depends on market conditions, the choice of fiscal year for a feeding corporation not electing subchapter S is less definite although weather conditions in Nebraska generally result in a lower number of cattle on feed in the winter months. Despite these general guidelines, the practitioner should carefully examine each client's particular fac-

170. If the farm corporation were on the accrual basis, a deduction would be allowed only if payment was made prior to January 15, pursuant to CODE § 267. Care should also be taken to avoid constructive receipt to the shareholder employee. Treas. Reg. § 1.451-2 (1957); Rev. Rul. 72-317, 1972-1 CUM. BULL. 128.

tual situation to determine the appropriate fiscal year. Numerous factual situations, such as expiration of an individual net operating loss or significant income from outside sources, could make other fiscal years more desirable.

Directly related to the issue of choice of fiscal year by the corporation is the payment of estimated taxes. Farmers, defined as persons at least two-thirds of whose estimated gross income will be derived from farming, are exempt from paying estimated taxes prior to January 15.¹⁷¹ In addition, if the farmer on the cash basis files his tax return on or before March 1, he need not file the required declaration on January 15, and there is no penalty for underpayment unless the tax is underpaid by more than one-third.¹⁷²

An agricultural corporation does not receive the special benefit for estimated taxes available to farmers who operate in the proprietorship or partnership form. The corporation will be subject to quarterly payments on the fifteenth day of the third, sixth, ninth and twelfth months of its fiscal years.¹⁷³ The requirement of the farm corporation to pay estimated taxes quarterly could adversely affect the cash flow and increase the borrowing requirements of the farm operation. Since the subchapter S corporation pays no taxes, it is exempt from estimated payments. For the farmer-stockholder, the issue is whether the income from subchapter S farm corporations is "farming income" for purposes of section 6073(b). The statutory purpose of subchapter S is to provide flow-through treatment to a small number of shareholders. Unfortunately, the statutory scheme of 1373(b) treats taxable income as a dividend to the subchapter S stockholder and the subchapter S stockholder whose sole source of income is from the farm corporation would be required to make quarterly payments. It is also clear that reasonable compensation to the farmer-shareholder is not "farm" income and the corporation will be required to withhold.¹⁷⁴

The other significant election that the corporation is required to make is its accounting method. The corporation's taxable income is computed on the same basis which the corporation uses in keep-

171. CODE §§ 6015, 6073, 6153 generally require individuals to pay quarterly estimated income tax payments. CODE §§ 6073(b) and 6153(b) provide a special rule exempting farmers from filing estimated returns and making quarterly payments if the estimate and required tax payment are made on or before January 15 of the succeeding taxable year.

172. CODE §§ 6015(f), 6153(b).

173. *Id.* § 6154. The rules for commencing payment of estimated taxes are found in CODE § 6154(b).

174. Rev. Rul. 74-44, 1974-4 CUM. BULL. 287.

ing its books.¹⁷⁵ If the farm operation was on the "farmer cash method" of accounting prior to incorporation, the corporation should probably elect the "farmer cash method." If the prior operation used the accrual method or hybrid method, or maintains inventories under the "unit livestock method," the "farm price method" or some other method, the farm corporation should carefully evaluate the prior accounting procedures. Except in exceptional circumstances, the farm corporation should always elect the "farmer cash" method of accounting. A conceivable factual pattern in which the accrual method would be desirable is a period of extensive losses in which the operator wants to reduce the tax losses to increase the time period for using the loss carryover or to prevent a loss carryback that would be effectively lost (in a subchapter S corporation) when passed through to the shareholder because personal exemptions and non-business deductions would be eliminated.

D. Fringe Benefits

There is a substantial opportunity for bona fide employees who are also shareholders of the farm corporation to receive tax free medical and term life insurance benefits. The expense of these payments is generally deductible by the farm corporation and the benefits are not taxable to the employee. The sole proprietor or partner cannot deduct a large part of these expenses paid in his own behalf.¹⁷⁶ The tests for deduction by the employer corporation are whether the fringe benefits combined with all other compensation are reasonable¹⁷⁷ and are paid in return for services rendered by the employee. Premiums paid on "group" life insurance up to \$50,000 in coverage per employee (the employee is the beneficiary)

175. CODE § 446(a); Treas. Reg. § 1.446-1 (1957).

176. Medical expenses are deductible only to the extent that they exceed 3 per cent of the taxpayer's adjusted gross income. CODE § 213(a)(1); Treas. Reg. § 1.213-1 (1974). One-half of the medical insurance payments not to exceed \$150 for the taxpayer and his spouse are deductible without regard to the three per cent limitation. CODE § 213(a). Medicine and drugs are included as medical expenses only to the extent they exceed one per cent of the taxpayer's adjusted gross income. *Id.* § 213(b). Life insurance premiums are not deductible. Despite the general rule of nondeductibility of medical payments as business expenses in the noncorporate organization, there are limited circumstances under which the deduction can be obtained. In Rev. Rul. 71-588, 1971-2 CUM. BULL. 91, a sole proprietor adopted a medical reimbursement plan that covered all employees, their spouses and families. One of the proprietor's employees was his spouse. Under the facts of the ruling, a deduction was allowed to the proprietor when there were medical reimbursements for *all* employees and their spouses.

177. CODE § 162; Treas. Reg. § 1.162-10 (1958).

are deductible by the corporation and not included in the income of the employee.¹⁷⁸ To constitute group coverage where there are less than ten full time employees, the regulations under section 79 have stringent requirements including coverage of all full time employees with the amount of coverage dependant on the compensation of the employee or on the basis of employee classes.¹⁷⁹ Consequently, unless all full time employees are members of the family group, coverage of other employees will be necessary to obtain the maximum tax advantage from term life insurance in which the employees are the beneficiaries.

Sickness and accident benefits received by an employee and attributable to employer payments (insurance or direct) are taxable income to the employee unless one of four important exceptions are satisfied. The four exceptions which allow the exclusion of the employer's payments from the employee's taxable income are: (1) amounts received for accident and health plans for the employee, his spouse, and dependents (through insurance or otherwise);¹⁸⁰ (2) insurance proceeds to reimburse the employee for medical expenses of the employee, his spouse or dependents;¹⁸¹ (3) payments for loss of limb, disfigurement, etc.;¹⁸² and (4) qualified wage continuation payments.¹⁸³

Neither the statutes nor the regulations prohibit discrimination in favor of stockholder-employees in medical reimbursement plans. There have been, however, a number of cases in which the Service has attacked payments made solely on behalf of stockholder-employees and favorable rulings will not be issued on these payments.¹⁸⁴ The Service's position, which has been unsuccessful in a majority of the litigated cases,¹⁸⁵ has been that such payments

178. CODE § 79. Some states have statutory limitations on the maximum amount of life insurance that may be issued to an individual under employer group insurance. These limitations apply for purposes of section 79. See Treas. Reg. § 1.79-(b) (1) (i) (1966).

179. Treas. Reg. § 1.79-1(b) (1) (iii) (d) (1966). An exception is made for health reasons either as to amount or coverage for health reasons of certain employees.

180. CODE § 106; Treas. Reg. § 1.106-1 (1956). The definition of dependents is contained in CODE § 152.

181. CODE § 105(b).

182. *Id.* § 105(c).

183. *Id.* § 105(d).

184. T.I.R. 313, 1961 INT. REV. BULL. No. 15, 52.

185. *Bogene, Inc.*, 27 CCH Tax Ct. Mem. 730 (1968); *E.B. Smith*, 29 CCH Tax Ct. Mem. 1065 (1970); *Nathan Epstein*, 31 CCH Tax Ct. Mem. 217 (1972). The Service also conceded the issue before trial in two docketed cases—*Peterson Co.*, Tax Court Doc. No. 865-65, and *Noemen*, Tax Court Doc. No. 3457-65. *But cf. Larken v. Commissioner*,

constitute dividends to the stockholder. Assuming the reasonable compensation test is satisfied and that a plan has been adopted, the Service's only litigation success has been attained when the plan was for the benefit of "stockholders" rather than employees. In *Larkin v. Commissioner*¹⁸⁶ dividend treatment was accorded where the father of the principal officer and stockholder of the corporation, who was not a full-time employee, received medical reimbursement benefits equal to those of executive officers who received much higher compensation. Consequently, extreme care should be taken to establish a plan covering stockholders in their capacity as employees rather than as stockholders. Meshing benefits to length of service, salary, etc., as opposed to stock ownership ratios would provide a favorable indicator. Where feasible, the plan should also cover employees other than stockholders. When the plan consists solely of insurance payments, key employees who are not stockholders can be included at a defined cost. Where the corporation has adopted an uninsured plan, a ceiling on benefits may result in an undesired limitation on benefits that a stockholder might receive. Yet, a plan without limitation could result in substantial liability for payment by the corporation to non-stockholders. One method of limiting this exposure is to vary maximum benefits according to compensation. For example, maximum benefits on the first \$10,000 of salary could be limited to one-half of one per cent of compensation; from \$10,000 to \$20,000, one per cent; and in excess of \$40,000, five per cent; etc.

Another ground for dividend treatment by the Service has been that the payments were not made pursuant to a plan.¹⁸⁷ Although a written plan is not required by statute, and systematic payments in the absence of a written plan have been upheld,¹⁸⁸ a farm corporation's medical reimbursement plan should be adopted in writing by the board of directors specifying the employees covered and the benefits to be provided under the plan.

A fringe benefit that is becoming less important because of inflation is the five thousand dollar death benefit that the farm corporation can pay to beneficiaries in the event of the death of an employee. Such payments are excluded from the income of the employee's estate and from the income of his beneficiaries.¹⁸⁹

394 F.2d 494 (1st Cir. 1968), *aff'g* 48 T.C. 629 (1967); Smithback, 28 CCH Tax Ct. Mem. 709 (1969).

186. 394 F.2d 494 (1st Cir. 1968), *aff'g* 48 T.C. 629 (1967).

187. *Id.*

188. John C. Lang, 41 T.C. 352 (1963).

189. Code § 101(b).

1. *Individual Qualified Deferred Compensation*

The principal reason for the wave of incorporation of professional service organizations in the last two decades has been the deferred compensation advantages available through operation in the corporate form. Income that would be taxed at a high effective tax rate is placed in tax-exempt plans¹⁹⁰ which earn income for distribution and taxation at a later date when the taxpayer is in a lower income tax bracket. The contributions to the qualifying plan are deductible by the employer if they do not exceed specified limits.¹⁹¹ The income earned on contributions to the plans is generally tax-free prior to distribution.¹⁹² The taxable income picture of a farm operation is generally quite different from the operation of a successful professional service organization. The professional organization earns income which is immediately subject to taxation without a ready means of deferral. Because of the extensive educational requirements of many professions, the lifetime income of the professional is grouped into a relatively short period of time. Before passage of the Tax Reform Act of 1969, which placed a fifty per cent limit on earned income from services, some of the professional's income was subjected to the maximum tax rates in excess of seventy per cent.¹⁹³ As an alternative to or in combination with the speculative tax shelters, placement of funds in managed trust funds was considered a desirable method of deferring current taxable income and reducing the effective tax rate. The price of this deferral and accumulation of income was placing the plan's funds beyond the control of the individual.

The inflexibility of tax planning and bunching of income problems plaguing a professional service organization are not prevalent in most farming operations. Due to the ability to amortize rapidly the very large capital expenditures (except for land) required for the operation of the modern farm, to defer income, to accelerate deductions by using the "farmer cash method," to reduce taxes by investment credits, and certain other tax benefits previously described¹⁹⁴ which are unique to farming operations, the modern farm operation can shelter substantial amounts of income without resorting to qualified pension and profit sharing plans. Consequently, the primary benefit to the farm operator is generally the establishment of a retirement fund apart from the farming operation to provide security unrelated to the operation's financial fu-

190. *Id.* § 401.

191. *Id.* § 404.

192. *Id.* § 501(a).

193. Act of Feb. 26, 1964, Pub. L. No. 88-272, § 111, 78 Stat. 19.

194. See note 5 *supra*.

ture. The multiplier effect from accumulating tax free income can be very significant over the productive life cycle of a farm operator. Since the passage of the Employee Retirement Income Security Act of 1974 ("ERISA"),¹⁹⁵ the disparity between benefits available under corporate and non-corporate forms of ownership has been reduced substantially. A proper analysis of the ERISA and the current law on deferred benefit plans would require a detailed study far beyond the scope of this article. However, a brief summary of the basic differences in qualified deferred compensation plans under the corporate and non-corporate forms of ownership, highlighting the advantages still available from corporate operation, will be undertaken.

Before 1974, proprietorship and partnership contributions were limited to the lesser of ten per cent of earned income or \$2,500. Since enactment of the ERISA, proprietorships and partnerships can make annual deductible contributions to qualified plans of up to fifteen per cent of "earned income" not to exceed \$7,500.¹⁹⁶ Although capital is a material income-producing factor in a farm operation, as long as services rendered by the shareholder-employees also constitute a material income-producing factor, all self-employment income from the trade or business of farming in proprietorship or partnership form can qualify as earned income for purposes of contributions to qualified plans although all of the income does not qualify as earned income for purposes of computation of the maximum tax on earned income.¹⁹⁷ If the self-employed individual devotes substantially all his time to the farm operation, his personal services are treated as a material income-producing factor in that business. In determining whether personal services are a material income-producing factor where less than full-time effort is devoted, the Treasury will take into account the respective contribution made in the forms of personal services and capital.¹⁹⁸

For the contributions to a non-corporate plan to be deductible, they must be made pursuant to a qualified plan ("Keogh plan"). The Keogh plans for self-employed persons offer a choice of four basic types of investments: (1) trusts, (2) custodial accounts, (3) annuity plans, and (4) qualified bond purchase plans.¹⁹⁹ If the

195. Act of Sept. 2, 1974, Pub. L. No. 93-406, 88 Stat. 829 [hereinafter cited as "ERISA"].

196. CODE § 404(e). After 1975, the \$7,500 limitation may be exceeded in the case of certain Defined Benefit Plans.

197. *Id.* § 401(c)(2).

198. IRS Document No. 5592, October, 1967.

199. CODE §§ 401(a), (f), (g), § 405.

owner-employee is covered by the qualified trust, a bank or person meeting similar requirements must be the trustee.²⁰⁰ Even though the contributions to the plan are placed with a trustee, the owner-shareholder can direct the investment of the proceeds. Many Keogh plans are master or prototype plans. A master or prototype plan is a standard plan approved in advance by the Service for dealer mass-marketing by banks, insurance companies, or securities firms to a number of unrelated business organizations.²⁰¹ Although bank trustees are utilized, the investment decisions for many other Keogh plans are made by the participants.

Under the ERISA, there is some question as to whether the owner-employee can continue to exercise control over Keogh plan investments. Section 404(c) refers only to a participant or beneficiary exercising control. Sections 3, 7, and 8 of the ERISA defining participants and beneficiaries may exclude self-employed persons. This result does not appear to have been intended, but until clarifying regulations or rulings are issued, the practitioner should seek a Service determination letter on the proposed plan. The author would warn any owner-employee who directs investment of contributions allocated to his employees into any assets except mutual funds, insurance contracts, etc. against possible action under the stringent fiduciary standards of the ERISA. The recommended solution is to allow the employee to designate his qualified investment.

Keogh plans must cover and provide vested ("irrevocable") funding pursuant to the plan for all employees with service of three or more years.²⁰² The requirement that the Keogh plan not discriminate against other employees also requires the owner-employee to cover all employees of businesses which he controls if he participates in the plan of any business.²⁰³ Control means complete ownership of an unincorporated business or ownership of more than fifty per cent of the capital or profits interest by one or more owner-employees.²⁰⁴ A year of service means the twelve-month

200. CODE § 401(d)(1); ERISA §§ 1017, 1022-23.

201. A master plan is a standard form of plan with a related form of trust or custodial agreement which is administered by a bank or individual company as the funding medium to provide standardized benefits. A prototype plan is also a standard form of plan. It differs from the master plan in that it is not administered by the organization which sponsors it.

202. CODE § 401(d)(2)-(3).

203. *Id.* § 401(d)(9)(A).

204. *Id.* § 401(d)(9)(B). Because of the previously discussed definitions of earned income, the participation by the owner-employee in another business operation (since he would necessarily devote less than full time to one business) may result in a substantial reduction of the total earned income qualifying for contribution to the Keogh plan as well

period in which an employee completes not less than one thousand hours of service computed from the date employment commences (the commencement date for certain seasonal businesses may be determined under regulations implemented by the Secretary of Labor).²⁰⁵

Before adopting a Keogh plan, the farm "owner-employee" should carefully evaluate the payments that will be required on behalf of persons who are not employees. Because the old definition of a full-time employee in section 401(d)(3) was deleted and the ERISA was substituted for section 410(a)(3), the farm operator may be required to cover seasonal employees who work for one thousand hours in four months or less during peak periods for three consecutive years. The farm employees who are not "owner-employees" may be so numerous that the tax and security benefits to the "owner-employee" will not outweigh the additional required payments for non "owner-employees." Generally farm employees place no value on the employer's contribution to Keogh plans and do not consider this contribution to be additional compensation. If the cost of covering persons who are not owner-employees is substantial, the farm operator would be well-advised to evaluate funding his security program with after-tax dollars or using the new Individual Retirement Account plans which permit annual deductions from gross income of up to \$1,500.²⁰⁶

Under the Keogh plans, an employer may elect one of two methods of funding—a pension plan or a profit-sharing type plan.²⁰⁷ The pension plan requires the employer to contribute either an amount necessary for a fixed benefit at retirement ("defined benefit") or a money purchase contribution based on annual compensation, years of service, etc. Profit-sharing type plans are based on a contribution of an established percentage of the operation's profits. Despite required contributions based on a percentage of compensation on behalf of common law employees, the contributions on behalf of the owner-employee are still subject to the \$7,500 and fifteen per cent of income limitation (except for a *de minimis* provision

as requiring contributions on behalf of employees of the other unincorporated businesses.

205. CODE § 410(a)(3).

206. *Id.* §§ 219, 408; Rev. Proc. 75-6, 1975 INT. REV. BULL. No. 5, at 26; Rev. Proc. 75-31, 1975 INT. REV. BULL. No. 27, at 40.

207. The ERISA provides for only two types of plans—Defined Benefit and Defined Contribution Plans. For purposes of illustration, the old terms "pension" and "profit-sharing plans" will be used. The correct terminology is "defined contribution money purchase plan," "profit sharing defined contribution plan" and "defined benefit pension plan." Prop. Treas. Reg. 1.401(e)(5) Fed. Reg. 412117.

for the lesser of earned income of the owner-employee or \$750).²⁰⁸ Because of fluctuations in farm income, pension type Keogh plans may result in substantial contributions for persons who are not owner-employees and a very low contribution on behalf of the owner-employee in years in which his earned income and cash flow are low. Consequently, a farm operator should adopt a profit-sharing type of Keogh plan in which all contributions depend on the farm operator's earned income, even though such a plan may result in contributions of less than the maximum amount which might have been contributed on behalf of the owner-employee under a pension type plan. This occurs because a profit-sharing plan would provide a fixed formula for contributions to be made by the owner-employee on behalf of his employees. Under this approach, the contribution of a fixed percentage of earned income (regardless of cash available) allocated on the basis of relative income will not discriminate in favor of owner-employees.²⁰⁹ A profit-sharing Keogh plan in which contributions made on behalf of eligible employees equal the same percentage of their compensation as the percentage of earned income contributed on behalf of owner-employees (with a \$100,000 limit on earned income of the farm operator), and the amount of contributions on behalf of the owner-employee equal fifteen per cent of earned income not to exceed \$7,500,²¹⁰ the farm operator can limit the contributions on behalf of employees to the same percentage of earned income that is contributed on his behalf. For example, if the earned income of a sole proprietor is \$100,000, he could contribute \$7,500 on his own behalf and would be required to contribute seven and one-half per cent of the compensation of his employees. Under the recommended formula, the farm operator would limit aggregate contributions in low income years by placing a ceiling on aggregate contributions based on a designated percentage of earned income. Such aggregate compensation would be allocated on the basis of compensation and earned income. In such years a disproportionately higher share of the contributions would still be paid to the employees if their aggregate compensation was greater than the earned income of the self-employed farm operator. If the de minimis \$750 or earned income provisions are added to the

208. CODE § 405(b) and (d). The ERISA amendments for taxable years beginning after December 31, 1975 provide for contributions in excess of \$7,500 on certain defined benefit plans. In applying the percentage limitation, only one \$100,000 base may be used regardless of the number of Keogh plans attributable to separate entities to which the farm operator participates.

209. CODE § 401(d)(2)(B); Treas. Reg. § 1.401-12(d) (1963).

210. CODE § 401(d)(10).

plan, the required contributions on behalf of the employees is uncertain.²¹¹

Other important considerations when deciding to establish a Keogh plan are the time of distribution, the excess amounts that can be contributed and the penalty for premature distributions. Distributions to owner-employees must be made not later than age 70½ and not earlier than 59½ except in the event of disability.²¹² Premature distributions are subject to a penalty tax of ten per cent of the amount of the distribution in addition to the tax on the distribution.²¹³ These distributions do not affect the qualifications of the Keogh plan, but the owner-employee is prohibited from participating in the plan on his own behalf for five years following the date on which the distribution is made.²¹⁴ Excess nondeductible contributions of up to ten per cent of earned income or \$2,500,²¹⁵ whichever is greater, may be made on his own behalf by the owner-employee. The amounts attributable to voluntary contribution can be withdrawn at any time. There is a potential problem resulting from constructive receipt in such case and the author generally recommends a prohibition on the withdrawal of income earned on such contribution. An excise tax of six per cent is imposed on contributions in excess of these limitations to plans for taxable years beginning after 1975.²¹⁶

Distributions attributable to contributions to a Keogh plan (and investments for years subsequent to 1973) are taxed at ordinary income rates upon receipt.²¹⁷ "Lump sum distributions" are subject to a special ten year averaging²¹⁸ which allows the recipient, for tax rate purposes, to treat the income as if it had been received over a ten-year period. Contributions for taxable years beginning after 1975 may be made at any time up to the due date of the employer's tax return (including extensions) even if the employer is on

211. Irish, *Impact of the New Pension Law on H.R. 10 and Subchapter S Retirement Plans*, 42 J. TAX. 144, 145 (1975).

212. Treas. Reg. § 1.401-11(e) (1963); Treas. Reg. § 1.401-12(m) (1968); T.D. 6985, 1969-1 CUM. BULL. 66.

213. CODE § 72(m) (5).

214. *Id.* § 401(d) (5) (c). If the excess contributions are not made willfully, disqualification will not result if distribution of the excess contribution is made within six months following notification from the Commissioner. *Id.* § 401(e) (2) (c).

215. *Id.* § 4972. For taxable years beginning after 1975, an additional limitation is placed equal to the rate at which employees other than owners-employees can contribute to the plan. Prior to such time, the CODE § 401(e) (1) (B) limitation of 10% or \$2,500 applies.

216. *Id.* § 4972.

217. *Id.* § 402(a).

218. *Id.* § 402(e).

the cash method of accounting.²¹⁹ Fiduciary responsibilities, required publication of information concerning the Keogh plan, obtaining consent to be covered by the Keogh plan, and prohibited transactions such as contributions of property or self-dealing with the owner-employee are some of the additional qualification requirements which the practitioner must review carefully to ensure maintenance of a qualified plan.

2. Corporate Qualified Deferred Compensation Plans

Substantial additional tax benefits are still available through operation in the corporate form (other than as a subchapter S corporation)²²⁰ despite the increase in the level of deductible contributions to Keogh plans of \$7,500 (and higher in the case of certain Defined Benefit Plans). The benefits available through operation in corporate form are higher annual contributions for corporations not electing subchapter S, a greater ability to avoid contributions on behalf of employees who are not equity owners, vesting requirements that may result in forfeiture of benefits for employees who terminate, and the ability to exclude certain death benefits from the taxable estate.

The farming business by its nature is subject to significant fluctuation in profits and losses. As previously discussed,²²¹ one disadvantage of pension type Keogh plans is that in low taxable income years fixed contributions must be made on behalf of some employees while contributions on behalf of owner-employees are subject to the earned income limitations. Because the stockholder-employee will be paid a salary or other reasonable compensation that in loss or low income years would be larger than a proprietor's "earned income," the limitation on behalf of owner-employees will be much greater in the corporate form of operation. Even with the ability to make greater contributions on behalf of owner-employees, it is unwise to obligate the farm corporation to substantial contributions under any type of qualified deferred contribution plan when the corporation's low income or loss position is due to economic conditions rather than tax planning. Because the ERISA imposes required minimum funding, corporate liability for vested

219. *Id.* § 404(a) (6). For plans adopted subsequent to January 1, 1974, the delayed contribution provisions should be effective immediately. Until clarifications or regulations are issued, the result is not entirely clear.

220. See Irish, *supra* note 211 at 147. Subchapter S contributions on behalf of shareholder-employees are subject to the same monetary restrictions on annual deductible contributions as proprietorships and partnerships under Keogh plans. CODE § 1379.

221. See note 209 *supra*.

benefits upon termination of the plan, costly actuarial computations, and stringent fiduciary standards, the corporation should elect a defined benefit plan only in unusual circumstances. Therefore, the following analysis will be limited to defined contribution plans based on profit sharing.

In contrast to the Keogh plan limitations of fifteen per cent of earned income and \$7,500, the lesser of twenty-five per cent of compensation or \$25,000 (profit sharing plans are limited to fifteen per cent of compensation) may be contributed on behalf of employees of corporations not electing subchapter S.²²² Unlike the fixed \$7,500 in Keogh plans, the \$25,000 limitation is subject to automatic upward adjustment for cost of living increases.²²³

One method of reducing plan contributions allocated to lower paid employees is to "integrate" the contribution benefits with those received under the Federal Insurance Contributions Act ("FICA").²²⁴ The underlying theory is that integration permits an employer to receive credit for FICA contributions as part of the deferred benefits established for employees. As a result, more of the employer's contributions to the deferred compensation plan can be allocated to highly paid employees without violating the discrimination rule. Due to the increasing FICA taxation, integration can offer a significant opportunity to reduce plan contributions allocated to employees who are not shareholders. Keogh plan contributions can be integrated with FICA only if contributions on behalf of owner-employees to the qualified plan are less than one-third of the annual contributions to the Keogh plan.²²⁵ Since the employer is not likely to adopt a Keogh plan if more than two-thirds of the contributions are not for the benefit of owner-employees, there is generally no practical benefit from integration in the non-corporate form of ownership.

The rules for integration with corporate plans are quite complex. In 1971 the Service issued guidelines for integration of FICA payments with profit-sharing type plans.²²⁶ The maximum discrimination in favor of employer contributions and forfeitures for any year may not exceed seven per cent of actual compensation in excess of covered compensation. Covered compensation is the maxi-

222. CODE § 415(c). A corporation's deduction for contributions to profit-sharing-type plans is limited to fifteen per cent of compensation, if maximum contributions have been made. CODE § 404(a)(3).

223. *Id.* § 415(d)(1).

224. *Id.* §§ 3101-26.

225. *Id.* § 401(d)(6).

226. Rev. Rul. 446, 1971-2 CUM. BULL. 187, *as amended*, Rev. Rul. 276, 1972-1 CUM. BULL. 111; Rev. Rul. 492, 1972-2 CUM. BULL. 222.

imum amount which may be used to compute FICA benefits, and its level rises with each increase in the level of compensation subject to FICA taxation. For employees retiring after the year 2004, the covered compensation level is \$9,000. The following example will illustrate the level of contributions on behalf of various employees when integration is utilized in a corporate defined contribution profit-sharing plan. The level of covered compensation is deemed to be \$9,000. Total contributions based on profits and forfeitures (previous contributions on behalf of employees which were not vested and are forfeited by virtue of termination, etc.) to the plan are \$14,250. Shareholder-employee A's compensation is \$80,000. Employee B's compensation is \$10,000 and Employee C's compensation is \$5,000. The maximum differential between contributions and forfeitures for any year may not exceed seven per cent of actual compensation in excess of covered compensation. The compensation in excess of covered compensation for Owner A is \$71,000 (\$80,000—\$9,000), Employee B, \$1,000 (\$10,000—\$9,000), and Employee C, 0 (\$5,000—\$9,000). Seven per cent of total compensation in excess of covered compensation (\$72,000) is \$5,040. The \$9,210 (\$14,250—\$5,040) is allocated to all employees in proportion to their individual compensation as a percentage of total compensation, as follows: A—\$7,756 plus seven per cent of A's compensation in excess of the \$9,000 covered compensation would result in total contributions for the benefit of A of \$12,726; B—\$969 plus seven per cent of B's \$1,000 compensation in excess of covered compensation would result in contributions attributable to B of \$1,039; C—\$485 would be the contribution attributable to C, since his compensation did not exceed covered compensation. The contributions attributable to each employee using integration is contrasted with contributions attributable to each employee with the same total contribution to the plan of \$14,250 on the basis of fifteen per cent of compensation: A—\$12,000; B—\$1,500; and C—\$750. Computing a hypothetical investment yield and contemplated years of operation of the plan, substantial additional lifetime benefits are allocated to the Shareholder-employee A that would otherwise be allocated to employees who are not shareholders. The limitation on integration in Keogh plans is not imposed on shareholder-employees in a subchapter S corporation, regardless of the size of the shareholder-employee's stock ownership.²²⁷ Consequently, only the subchapter S limitation on contributions would impede favorable integration.

Another advantage of corporate qualified deferred compensation

227. In CODE §§ 401(d)(6), 401(j)(4), and 1379, there is no statutory reference to subchapter S corporations and the integration rules are applicable to corporations not electing subchapter S.

plans is the point at which employees obtain irrevocable rights to receive the benefits attributable to employer contributions. Under Keogh plans, immediate vesting is required for all covered employees.²²⁸ Although the ERISA significantly increased the vesting benefits to employees covered by corporate plans, it is still possible under qualified deferred compensation plans to delay any vesting of an employee's rights to contribution for ten years. By adopting the ten year vesting alternative of section 411(a)(2), it is possible to transfer all benefits for employees who terminate before the expiration of ten years (as is typical for many farm employees) to other employees, including the shareholder-employee. The attribution of benefits from forfeitures is included in the permitted integration formula and can have the effect of reducing the shareholder-employee's benefits from integration if total contributions under the plan are not required to be reduced. If the effect of the vesting requirements is to exclude all employees except shareholder-employees (i.e., only shareholder-employees work for ten years), there is authority that the plan will be disqualified because it discriminates in favor of highly paid employees.²²⁹ Also, the benefits of forfeiture may not inure to the benefit of shareholder-employees in a subchapter S corporation.²³⁰ Somewhat mitigating the benefits of the longer vesting period is the requirement that all employees who have completed at least one year of service be covered by the plan if they are at least twenty-five years old unless the plan provides for vesting after three years of service for all employees who have attained the age of twenty-five.

There are other complex compliance requirements that must be followed by a corporation to maintain qualification of its plan. Included among these requirements are reports which must be filed with the Labor and Treasury Departments, fiduciary requirements and accounting and actuarial reports. The operational requirements, in addition to the costs of implementing a qualified plan, will in most cases substantially exceed the costs under a master or prototype Keogh plan.

In summary, the ERISA has increased the opportunities for tax deferral through self-employed qualified plans, thereby reducing the advantages of incorporation for the purpose of utilizing qualified corporate plans. There are, however, continuing advantages to corporate qualified plans. An example of a situation where incorporation would be desirable would be a farm operation which continually has a large taxable income (\$100,000 plus for each major

228. CODE § 401(d)(2)(A).

229. *Id.* § 401(a)(4); Treas. Reg. § 1.404(a)-4 (1961).

230. CODE § 1379(a).

stockholder) and cannot shelter the income through other tax deferrals generally available to farm operations or other investments of the farm operator.²³¹ However, there are few situations which justify adoption of the corporate form of farm operation primarily for obtaining the benefits of a qualified plan, and annual cash disbursements required in such plans should always be kept in the forefront.

IV. SALE AND LIQUIDATION

One of the primary disadvantages of the corporate farm is the "lock-in" effect on earnings and appreciation in the farm property. The farm operator who becomes disenchanted with corporate ownership usually cannot reverse the tax-free incorporation process and return the property to the proprietorship or partnership form or liquidate the corporation and sell its assets without incurring greater taxes than if the operation had operated as a proprietorship or a partnership from the beginning.

Many circumstances unforeseen on the date of incorporation may arise in which distribution of all or a substantial amount of the corporation's assets to its shareholders will be desirable.²³² If the complete termination of the corporate farming operation is desired, there are three basic methods of accomplishing this objective: (1) sale of corporate stock; (2) liquidation of the corporation and sale of the assets; and (3) sale of the assets by the corporation and distribution of the proceeds to the shareholders. These methods may be employed in many conceivable combinations, all of which contemplate total disposition of the farming operation. From the subsequent discussion of the alternative forms of liquidation, the practitioner should attempt to adopt the alternative which will accomplish the economic objectives of the parties at the lowest possible tax cost.

231. For a detailed comparison of corporate and Keogh plans, see Thies, *Keogh Plan v. Qualified Corporate Plan: An Analysis of the Respective Advantages*, 42 J. TAX. 9 (1975), Irish, *supra* note 211, and Wanguard, *Selecting a Qualified Plan After ERISA: The Alternatives, Problems and Costs*, 43 J. TAX. 145 (1975).

232. For example, after the father's death the son, who had always intended to run the farm operation, may decide to sell the farm and invest in another business. Or unforeseen financial difficulties outside the farming operation may require mortgaging of the corporate farm and distribution of the proceeds to the shareholders. Industrial development and a new highway may increase the value of the farm property so that it is triple the value of comparable land utilized exclusively for agricultural purposes.

A. Sale of Stock

From a tax and liability position, sale of stock (or pledging stock if there is unrealized gain at the shareholder level) is generally desirable for the seller or mortgagor. If the corporation is not collapsible²³³ and the shareholders have held the stock for more than six months, the gain on the sale of stock will be accorded long-term capital gain treatment; an individual loan secured by stock will not be taxable; liabilities of the corporation will remain at the corporate level, except for personal guarantees by the shareholder; and the selling shareholder will be liable only for warranties made to the purchaser. From the purchaser's viewpoint, acquisition of stock is generally the least desirable method of buying the farm operation's assets. A real estate operator will not be interested in acquiring a large inventory of crops, machinery and livestock; the lenders would prefer a first mortgage against the corporation's land rather than attempting to acquire nearly equal security through a pledge of stock; a neighboring farmer who wants to acquire the farm ground might not be interested in acquiring additional machinery; prospective purchasers are always concerned with hidden liabilities of the corporation; and a purchaser is buying the corporation's elections and tax attributes.

Even if the non-tax factors make acquisition of stock as favorable as the purchase of assets, the tax ramifications of the acquisition of stock will, except in unusual situations, make the acquisition

233. CODE § 341. Very generally, the disposition of stock on liquidation or sale by a five per cent or greater stockholder will be treated as a transaction not involving the sale or exchange of a capital asset if the corporation was utilized to dispose of property which it produced or acquired, and any gain would be subject to taxation as ordinary income. An example would be the sale of stock of a corporation whose only asset consisted of fat cattle whose market value is substantially in excess of the corporation's tax basis. The sale of the cattle would be taxed at ordinary income tax rates. Except for section 341, the sale of the stock for a slight discount from the fair market value of the fat cattle would result in the gain to the shareholder being a capital gain. The foregoing explanation is a vast oversimplification of the operation of the collapsible corporation provisions which are among the most complex in the Internal Revenue Code. As a general rule, a farm corporation which has been in operation for a substantial period of time will not be subject to collapsible corporation problems. In a case in which more than seventy per cent of the gain is attributable to inventory of grains, livestock whose sale would not result in capital gain income, etc. held for less than three years (as might be the case if the corporate farm leased land and machinery from another entity), the practitioner should examine in depth the possible application of section 341. The collapsible corporation provisions are also applicable to sections 337 and 333 liquidations, as well as to the sale of stock. See CODE §§ 337(c)(1), 333(a), 341(e)(3)-(4).

of assets preferable.²³⁴ Because of the number of zero basis assets in the corporation (such as grain, livestock and receivables) and the inflationary trend in land and equipment values, the fair market value of the corporation's assets will almost always exceed its tax basis in its assets. If the purchaser operated the farm as a continuation of the existing corporation, disposition of the assets at a fair market value equal to the value on the acquisition date could result in a substantial tax liability for the corporation and a resulting diminution in its value to the purchaser. A significant exception to this general rule would be a corporation which had a substantial net operating loss carryover that could be utilized without being trapped by sections 382(a) and 269, or a corporation which had a tax basis in a feedlot that was higher than the fair market value.

B. Purchase of Stock and Subsequent Liquidation

If the corporation was liquidated immediately, some but not all, of the tax disadvantages of acquiring stock would be eliminated. If the purchaser²³⁵ is a corporation, it can liquidate pursuant to a plan adopted not more than two years after the date of purchase and receive a basis in the assets equal to the purchase price of the stock, increased by liabilities assumed and post-acquisition earnings and profits and decreased by distributions prior to liquidation.²³⁶ Under section 332, the corporate transferee is exempt from taxation on the liquidation. If an individual or partnership acquires a corporation's stock and the value of the underlying assets is equal to the value of the stock, an immediate liquidation would also result in the purchaser obtaining a basis in the assets equal to the acquisition price of the stock.²³⁷ Even if the liquidation does not result

234. An exception would be the availability in the corporate form of a large net operating loss deduction under section 172 which outweighed the basis differential. Utilization of the loss would be subject to the perils of CODE §§ 382(a) and 269.

235. CODE § 334(b) (3) defines a purchase as an acquisition to which the purchaser's tax basis is not determined with reference to the basis of the stock in the hands of the transferor, thus excluding tax-free reorganizations under CODE § 368. Also excluded from the definition of "purchase" is stock acquired in a section 351 transaction, or from a related party. For purposes of this analysis, it is also assumed that one hundred per cent of the stock of the corporation is acquired in one transaction for case of property not qualifying for section 334(b) (2) (B) requires acquisition of eighty per cent of the stock (except certain preferred stock) during a twelve-month period, dating generally from the first acquisition.

236. CODE § 334(b) (2); Treas. Reg. § 1.334-1(c) (4) (i)-(viii) (1955).

237. The statutory mechanism for this result is found in the interaction of sections 331 and 334(a). Section 331 provides that amounts received in

in taxable income to either the corporate or noncorporate purchaser, substantial taxable income may be recognized by the liquidating corporation. The income taxes on this income would reduce the assets available for distribution to the purchaser-shareholder. Although section 336 provides the general rule of nonrecognition of gain or loss to the corporation on liquidation, recapture pursuant to sections 1245, 1250, 1251, 1252 and 47²³⁸ and assignment of income principles (zero basis receivables, harvested crops, and livestock) may result in substantial taxation on the liquidation of the typical farm corporation. Establishing a value for such assets can be a problem.

Section 1245 requires the corporation on liquidation to recognize income equal to all depreciation on tangible personal property, such

complete liquidation will be treated as full payment in exchange for the stock. If the basis of the stock purchased is equal to the fair market value of the corporation's assets, no gain or loss would be recognized by the shareholder on liquidation. Section 334(a) provides that if property is received in liquidation and is subject to recognition of gain or loss, the basis of the property received is equal to its fair market value. These same principles also apply to partial liquidation pursuant to section 346.

There may be cases in which the purchase price for the stock is greater or less than the value which can be established for the assets on liquidation. The literal application of sections 331 and 334 would require the shareholder upon liquidation to recognize gain or loss, even though in substance the transaction was a purchase of assets. The courts have tended to recognize substance in making an exception to section 331. In both *H.B. Snively*, 19 T.C. 850 (1953) and *Ruth M. Cullen*, 14 T.C. 368 (1950), the Tax Court did not allow gain or loss on liquidation. If the "intent" to liquidate the corporation is "clear" at the time of the acquisition, the Tax Court will seemingly allocate to the noncorporate shareholder a basis in the assets equal to the purchase price of the stock. Because the tax concept of intention is subject to question, a noncorporate shareholder, as soon as possible after the date of acquisition, should complete liquidation. The author also cautions the practitioner that another forum deciding the case *de novo* might not reach the same conclusion. If the "substance test" is to apply, logically it should apply to both the seller and purchaser. In such a case the seller, instead of being assured of treatment as a sale of capital assets, would be forced to allocate the sales price among the underlying assets of the corporation. The *Snively* and *Cullen* cases were decided prior to the enactment of sections 1245, 1250-52 and 47 and would not override these provisions.

238. Because the transferee does receive the carryover basis in the corporation's assets, sections 1245 and 1250-52 override section 336. See generally Gardner, *The Impact of Section 1245 and 1250 on Corporate Liquidations*, 17 U. FLA. L. REV. 58 (1964); Schapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code*, 72 YALE L.J. 1483 (1963); and Bravenec, *supra* note 121. Recapture would not apply in a section 334(b) (1) liquidation since a corporate shareholder succeeded to the liquidated corporation's basis under section 334 (b) (1).

as machinery and livestock, not exceeding the difference between the fair market value and the adjusted tax basis of the property on the date of liquidation. Section 1250 requires recognition of income equal to the excess of accelerated depreciation on farm real property over the amount that would have been taken had depreciation been computed on a straight line basis.²³⁹ The amount of recapture must not be greater than the excess of the fair market value of the section 1250 property over the sum of its adjusted tax basis and the amount of depreciation that would have been taken on a straight line basis.²⁴⁰ The favorable section 1250 recapture rules applicable to residential real property would not seem to apply to farm houses occupied by shareholder-employees and other employees.²⁴¹ Sections 1251 and 1252, attributable to farm losses, would also be recaptured on liquidation. Investment credit on property for which the credit is claimed and which is not held for the required length of time is also recaptured on liquidation.²⁴² Because of the large capital investment in equipment, livestock and depreciable real property that typify most farm operations, the corporation would generally be subject to significant recapture income under sections 1245, 1250, 1251 and 47.

On liquidation, the corporation will also be liable for payment of taxes on income earned after the close of the previous taxable year. The potential for shifting income and deductions through the use of the "farmer cash method" of accounting and zero basis assets

239. All accelerated depreciation on section 1250 property is recaptured for periods subsequent to December 31, 1969. Other more favorable section 1250 depreciation recapture rules apply for periods subsequent to December 31, 1963.

240. CODE § 1250(a) (2).

241. The section 1250 recapture on "residential real property" is reduced one per cent for each full month section 1250 property is held in excess of one hundred months. Thus, section 1250 recapture would not be applicable for "residential real property" held in excess of sixteen years and eight months. "Residential real property" is defined in section 167 (j). If more than eighty per cent of the gross income is rental income from dwelling units (within the meaning of section 167(k) (3) (C)), the real property qualifies as "residential real property." Although no rental income is received by the farm corporation, section 167(j) (2) (B) includes in gross rental the rent value of dwellings occupied by the "taxpayer." Logically, the utilization by the taxpayer would include utilization by its employees. However, Treas. Reg. § 1.167(j) (3) (b) (4) (iv) (1972) provides that the value of space occupied by the resident manager or maintenance personnel is not occupied by the "taxpayer." The issue of whether farm houses qualify as residential real property also determines the rate of depreciation so a position on this issue will likely have been taken long before liquidation. CODE § 167(j).

242. CODE § 47.

has already been discussed.²⁴³ The same potential is available on midstream liquidation of the corporation. In liquidation, the stakes are much greater because of the opportunity to convert ordinary income subject to double taxation into capital gain taxed only once.

Harvested or unharvested crops, zero basis breeding cattle (held for less than two years), and feeder cattle on which the corporation has taken significant deductions under the "farmer cash method" using the cash basis of accounting, could theoretically be distributed without recognition of income or disallowance of previous deductions to the corporation. The shareholder's gain on liquidation is measured by the difference between his basis in the stock and the fair market value of the stocks. Because theoretically the new shareholder's basis in the stock would be equal to the value of the assets, no gain would be recognized, and since the fair market value of the low or zero basis assets was reflected in the stock price to the selling stockholder, he would recognize income at capital gains rates on the increase in value. The entire stock sale or liquidation before sale may be attacked by the Service as the sale of stock of a collapsible corporation, or as a transaction within the purview of the *Corn Products* doctrine.²⁴⁴ It is more likely, however, that the liquidating corporation or recipient stockholder will be required to change its accounting method so that it clearly reflects income. In addition, cash basis deductions attributable to assets distributed on liquidation may be disallowed or recognition of income may be required.

The only benefit to the shareholder from the judicious selection of assets in the incorporation process is the splitting of income and deductions between the farm operator and the newly formed corporation. In the liquidation process, the taxpayers are faced with payment of the taxes resulting from recognition at the corporate level of income on zero basis assets (which would result in fewer assets available for distribution in liquidation) or the possibility of

243. See pages 490-91.

244. *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955). The *Corn Products* doctrine provides that when the assets sold are an integral part of the transferor's trade or business, ordinary rather than capital gain or loss will apply. The *Corn Products* decision resulted in ordinary treatment rather than the statutory capital gain or loss treatment on disposition of futures contracts. Where the sole assets of the corporate farm are fat cattle and the stockholder's principal business was feeding, buying, and selling fat cattle, the *Corn Products* doctrine might apply if the shareholders were not otherwise entangled in the collapsible corporation web of section 341. See BITTKER & EUSTICE, *supra* note 37 at 11-13.

converting ordinary income to capital gains income by deferring the sale of assets until after liquidation.

The application of the aforementioned doctrines to prevent the favorable tax treatment in litigated liquidation cases is uncertain. The Service's positions are based on sections 446(b) and 482. Taxable income is generally computed under the accounting method in which the taxpayer keeps his books. If this method does not clearly reflect income, the Commissioner may compel the taxpayer to adopt another. It is arguable, however, that the "farmer cash method" is specifically authorized for farm corporations and that there is no statutory authority for requiring a different method in the year of liquidation. This issue has been addressed a number of times by the Ninth Circuit, which accepted this view in the *Commissioner v. South Lake Farms, Inc.*²⁴⁵ The court allowed the liquidated corporation to deduct expenses attributable to growing crops when the corporation's stock was sold and the corporate transferee liquidated the corporation, receiving a section 334(b)(2) basis. The Tenth Circuit followed somewhat similar principles in *Diamond A. Cattle Co. v. Commissioner*²⁴⁶ where midstream liquidation losses incurred by a corporation under its accounting method were allowed.

Other corporate farm taxpayers have not been as successful. In *Beauchamp & Brown Groves Co. v. Commissioner*²⁴⁷ involving a section 337 liquidation, the Ninth Circuit disallowed the deduction for expenses paid attributable to an unharvested orange crop. The court's rationale was that permitting the deduction of these expenses from ordinary income, while the shareholders realized capital gain on liquidation, would frustrate the purposes of section 268 (which disallows deductions attributable to growing crops sold with the farm land) and section 337 (one year liquidation on which the corporation recognizes no gain or loss on the sale of "property"). Following the *Beauchamp* decision, the Ninth Circuit in *Spitalny v. United States*²⁴⁸ determined that the taxpayer was not allowed to deduct the expense of an inventory of cattle feed owned by the corporation at the time it adopted a section 337 plan of liquidation. The court, however, did not require recognition of gain on the sale of the feed due to appreciation. Basically, the opinion required the farm corporation to account for inventories during the period of liquidation, even though it had used the "farmer cash method" of accounting.

245. *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963).

246. *Diamond A Cattle Co. v. Commissioner*, 233 F.2d 739 (10th Cir. 1956).

247. *Beauchamp & Brown Groves Co. v. Commissioner*, 371 F.2d 942 (9th Cir. 1967).

248. *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970).

The Ninth Circuit has also applied the tax benefit and clear reflection of income rules in liquidation cases outside of the farm corporation sphere.²⁴⁹ The only meaningful distinction between *South Lake Farms* and other decisions of the Ninth Circuit seems to be in the nature of the entity receiving the liquidation proceeds. In *South Lake Farms* the transferee was a corporation which had acquired the stock in a taxable purchase just prior to the liquidation. In the other assignment of income cases, the transferees were stockholders with a significant holding period. If this is a correct assessment of the court's rationale for the different results, the distinction, though illogical as a matter of statutory construction, would place an additional premium on selling stock as opposed to assets.

Decisions in other forums have not resolved the issue. Two United States Supreme Court decisions give strong support to the position that items of income and deduction are to be computed on the method of accounting employed by the taxpayer. In *Nash v. United States*²⁵⁰ the Court held that bad debt reserve accounts need not be restored to income upon a transfer of receivables in a section 351 incorporation. *Nash* substantially undermined the application in similar circumstances of the recognition of income and tax benefit rules in liquidation decisions, since courts requiring recognition of income from receivables upon liquidation have frequently relied on section 351 decisions.²⁵¹ Despite *Nash*, the Third Circuit ruled that the corporation was taxable on bad debt reserves on liquidation under tax benefit principles.²⁵² In *Fribourg Navigation Co. v. Commissioner*²⁵³ the Court allowed depreciation to be deducted on property in the year of its sale by applying a literal interpretation of the Code. Though its benefit has been partially eliminated by enactment of the depreciation recapture provisions of sections 1245 and 1250, the *Fribourg* decision indicates that the Court will interpret the statutes literally, rather than rely on administrative disallowances under tax benefit or clear reflec-

249. *Commissioner v. Kuckenber*, 309 F.2d 202 (9th Cir. 1962) (sales proceeds taxable to a corporation in a section 337 liquidation on sale of accrued rights to compensation income by the cash basis corporation); *Hollywood Baseball Ass'n v. Commissioner*, 423 F.2d 494 (9th Cir. 1970) (Corn Products doctrine applied to tax a corporation on income in a section 337 liquidation from sale of "business related" minor league baseball contracts.) See also *Idaho First Nat'l Bank v. United States*, 265 F.2d 6 (9th Cir. 1959).

250. 398 U.S. 1 (1970).

251. See BITTKER & EUSTICE, *supra* note 37, at 11-70.

252. *Citizens' Acceptance Corp. v. United States*, 462 F.2d 751 (3d Cir. 1972).

253. 383 U.S. 272 (1966).

tion of income rules. There are numerous other cases involving tax benefit principles on liquidation,²⁵⁴ and it is fair to conclude that the majority of these decisions ruled against literal statutory interpretation, and instead applied assignment of income or tax benefit principles.

To date there have been no decisions directly addressing the assignment of income issue on liquidation in the Eighth Circuit.²⁵⁵ In view of the Supreme Court's position in *Nash* and *Fribourg* and the statutory authority for taking a position favorable to the taxpayer in assignment of income and deduction cases, this area will undoubtedly continue to be litigated, despite the weight of au-

254. Two of the most famous cases involve construction companies—*Jud Plumbing & Heating Co. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946), and *Standard Paving Co. v. Commissioner*, 190 F.2d 330 (10th Cir. 1951), *cert. denied*, 342 U.S. 860 (construction companies on the completed contract method and thus not requiring recognition of income until the contract is completed, on liquidation were required to report income on the percentage of completion method). See also *Midland-Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973). See Rev. Rul. 61-214, 1961-2 CUM. BULL. 60; Rev. Rul. 68-104, 1968-1 CUM. BULL. 361; Rev. Rul. 74-396, 1974 INT. REV. BULL. No. 33, at 10. Distribution of accounts receivable by a cash basis taxpayer is taxable to the corporation, see *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961). The Tax Court rejected the tax benefit rule in *Anders v. Commissioner*, 48 T.C. 815 (1967), *rev'd*, 414 F.2d 1283 (10th Cir. 1969), *cert. denied*, 396 U.S. 958 (1969), *rehearing denied*, 396 U.S. 1031 (1970). However, it has recently announced that it will abandon the position taken in the *Anders* decision and will apply tax benefit principles to require "recapture" of previously expensed items which are sold by the corporation in a transaction otherwise tax exempt under section 337. *Munter v. Commissioner*, 63 T.C. No. 64 (March 19, 1975). For a general analysis of this area see O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX. L. REV. 215 (1972), and BIRTKER & EUSTICE, *supra* note 37, at 11-47 through 11-52 and 11-69 through 11-73. In *United States v. Morton*, 387 F.2d 441 (8th Cir. 1968), a case involving the date of adoption of section 337 plan of liquidation which has probably been overruled by *Central Tablet Mfg. Co. v. United States*, 417 U.S. 673 (1974), and *Helgerson v. United States*, 426 F.2d 1293 (8th Cir. 1970), the Eighth Circuit disallowed selling expenses on liquidation. This position should not be considered a ruling on assignment of income principles. There has also been a paucity of cases on assignment of income in the Eighth Circuit. See generally *Central Life Assurance Soc'y Mut. v. Commissioner*, 51 F.2d 939 (8th Cir. 1931); *Power v. Commissioner*, 61 F.2d 625 (8th Cir. 1932); *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972).

255. Where land that will be sold on a "land sales contract" qualifying for installment sales treatment under section 453 is the principal asset of the corporation, operation in subchapter S may be the most desirable alternative if section 1378 can be avoided and the interest income does not terminate subchapter S status. See Section III, B, *supra*.

thority against the taxpayer, until the Supreme Court directly addresses the issue. In view of dim prospects for favorable resolution, it is unlikely that a prospective purchaser of stock will be willing to undertake any risks of additional taxable income to the corporation without a substantial reduction in purchase price. Due to the seasonal nature of some farm operations it may be possible to reduce the importance of these issues by a sale in January or February, when income from the previous year has been recognized and expenditures attributable to the current crop are minimal. This timing would leave open only the section 1245, 1250, 1251, 1252 and 47 recapture issues. However, a seller rarely has the time luxury available to the incorporator of the farm enterprise.

C. Liquidation and Distribution

If a termination of the farm corporation's activities is desired, and the shareholders intend to sell assets to a prospective purchaser or to transfer the corporation's assets to various family members for operation in a different form, there are three basic liquidation alternatives available: (1) a section 331 liquidation, (2) a section 333 liquidation, or (3) a section 337 liquidation combined with section 331.²⁵⁶

1. Section 331 Liquidation

The basic operation of sections 331, 334(a) and 336 was discussed in conjunction with the immediate liquidation of the corporation by a purchaser of stock.²⁵⁷ The principles discussed in that connection also apply when a stockholder has held his stock for a significant period of time. The general fact pattern will find that the farm property has appreciated substantially over the shareholder's basis in his stock, determined under sections 358 (in a section 351 incorporation), 1011 and 1012 (stock purchased), 1014 (stock acquired from a decedent) or 1015 (stock acquired by gift). In this situation, the gain from the assets will generally be realized by the shareholders upon receipt of property in liquidation, and taxed immediately at capital gains rates (assuming collapsible corporation status is avoided) regardless of whether the property acquired in liquidation is sold after distribution or is retained by the shareholder for operation in another form.

256. Although the issues will not be discussed further unless there is an application unique to a particular form of liquidation, in all the alternative forms of taxable liquidation the issues discussed previously or the assignment of income and clear reflection of income will be applicable.

257. See note 237 *supra*. These same principles would apply to partial liquidations under section 346.

A section 331 liquidation may impose a severe tax on liquidation without cash income to pay the liquidation taxes if the assets will not be sold. The corporation, in addition to its pre-liquidation income, is taxed under the recapture rules of sections 1245, 1250, 1251, 1252 and 47 which override the general section 336 exemption from taxation for liquidating corporations. The shareholder receives a basis in the property under 334(a) (assuming the shareholder is not a corporation owning eighty per cent of the stock) equal to the fair market value of the property received in complete liquidation. Because the distributee is not the original user of the property, some or all of the benefits of accelerated depreciation utilized by the liquidating corporation will be lost.²⁵⁸ There are no statutory time limits on complete liquidation pursuant to sections 331 and 336. Despite the lack of formal requirements, it is wise to adopt formal resolutions evidencing a plan of liquidation and thereafter the plan established should be followed before any liquidating distributions are made.

If the purpose of the liquidation is to prepare for sale of the distributed property by the shareholders, the shareholder should be careful to avoid another potential assignment of income trap. If the income on the sale of the property is attributed to the corporation under assignment of income principles, a tax could be imposed at the corporate level on the sale and at the individual level on the shareholder's receipt of the distribution.²⁵⁹ The enactment of section 337 has, in many situations, eliminated questions of the identity of the seller, i.e., shareholder or corporation. When feasible, the practitioner should structure a section 331 liquidation in which a post-liquidation sale of assets is contemplated so that it

258. See generally CODE § 167(c); Treas. Reg. § 1.167(a)-1 (1956).

259. In *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), negotiations had been conducted resulting in an oral agreement for sale with the corporation and a down payment of \$1,000. The corporation was taxed on income from the sale of its asset although the written contract was made with shareholders who received the property on liquidation after consultation with their tax adviser. In *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950), the Supreme Court upheld the Court of Claims finding that the assets were sold by the stockholders. In *Cumberland*, the shareholders first attempted to sell stock. When the buyer refused, the shareholders offered to acquire the assets of the corporation in liquidation and then sell them to the purchaser. Despite its recognition that the difference between *Cumberland* and *Court Holding* was "shadowy and artificial," the Court determined that Congress had chosen to recognize the form distinction for tax purposes. In 1954, Congress enacted section 337 in an attempt to eliminate the distinction between the *Court Holding* and *Cumberland* cases.

also complies with the requirements of section 337.²⁶⁰ This would counter the Service's contention that the sale was completed by the corporation. When the client does not seek advice until after the sale of the assets has been negotiated, this approach is imperative.

Because distributions are taxed at fair market value and an immediate sale of property after liquidation is most indicative of the fair market value, a section 331 liquidation has little practical utility except where it is preceded by a section 337 non-recognition sale. In the case of an installment sale, such as those used in many "land contracts" for the sale of agricultural real estate, it may be possible to sustain a lower value for the land than the purchase contract. However, such a differential would hardly compensate for the recognition of gain on the entire fair market value of the land when only a fraction of the purchase price was received upon sale. If for some reason a section 331 liquidation followed by a contemplated sale is desirable and if negotiations for the sale are discontinued after liquidation, there is a possibility of avoiding recognition of gain by transferring the assets received on liquidation to a new corporation, and disregarding the liquidation under the liquidation reincorporation doctrine.²⁶¹ This doctrine, however, has generally been applied only to prevent the taxpayer from obtaining a tax benefit (*i.e.*, a dividend distribution receiving capital gain treatment or the taxpayer receiving a step-up in basis) and not to avoid recognition of gain by the shareholder who, with the use of hindsight, has decided that the corporation should not have been liquidated.

2. Section 333 Liquidation

If the shareholder does not intend to sell the property received on liquidation, a section 333 liquidation will often be the least expensive form of liquidating the farm corporation with appreciated property. A section 333 liquidation may also be utilized to obtain installment sale treatment on "land contracts" if the pitfalls of *Court Holding Co.*²⁶² can be avoided. Unlike section 331, which taxes the gain to the shareholder on liquidation regardless of subsequent sale, section 333 permits the liquidation of the corporation holding appreciated property, but holding no cash and securities and without earnings and profits, to proceed without recognition

260. An informal plan of liquidation will generally qualify under section 337. See note 288 *infra*.

261. See *James Armour, Inc.*, 43 T.C. 295 (1964); *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966); *Reef v. Commissioner*, 368 F.2d 125 (5th Cir. 1966).

262. See note 259 *supra*.

of gain or loss by the shareholders. The corporation is subject to taxation in the same manner as described for section 331 liquidations.²⁶³ Property distributed in a section 333 liquidation is taxed to the noncorporate shareholder as dividend income to the extent of his pro rata share of the corporation's accumulated earnings and profits or the unrecognized gain, whichever is less. Accumulated earnings and profits are taxed as dividends pro rata to the noncorporate shareholders.²⁶⁴ If the corporation distributes cash or securities on liquidation in excess of the accumulated earnings and profits, the excess is treated as capital gain, not to exceed the noncorporate shareholder's unrealized gain on liquidation which was not taxed as a dividend distribution.²⁶⁵ The corporate shareholder's gain is limited to the greater of cash and securities, or earnings and profits and is taxed as gain from the exchange of stock.²⁶⁶ In return for nonrecognition of gain on liquidation, the shareholder's basis to be allocated between the assets received is limited to his basis in the stock, increased for gain recognized and liabilities assumed and decreased for cash distributions.²⁶⁷

Before the section 333 election is made, an accurate computation of the accumulated earnings and profits of the corporation must be made.²⁶⁸ Following the inaccurate bromide that earnings and profits equal the retained earnings shown on the corporation's balance sheet can result in substantial ordinary income, much to the chagrin of the shareholder.²⁶⁹

If the farm corporation has not undergone recapitalization or reorganization, the primary factor resulting in earnings and profits

263. Rev. Rul. 73-515, 1973-2 CUM. BULL. 7. Investment credit is recaptured in a section 333 liquidation despite the carryover basis attributed. See note 238 concerning other taxable income.

264. CODE § 333(e)(1); Treas. Reg. § 1.333-4 (1955).

265. See also Battaglia, *Section 333 Liquidation Benefits: Insuring Success in Light of Recent Developments*, 43 J. TAX. 34 (1975).

266. CODE § 333(f)(2).

267. CODE § 334(c); Treas. Reg. § 1.334-2 (1955).

268. The Internal Revenue Code, which is generally precise in its definition of terms, does not define earnings and profits. Sections 316 and 312 and the regulations thereunder provide the method for computation of earnings and profits. Section 1377 provides special rules for certain transactions in a subchapter S corporation. Section 312(m) provides that for purposes of computation of earnings and profits, depreciation in taxable years beginning after June 30, 1972, cannot be computed on the declining balance or sum of the years digits method.

269. Treas. Reg. § 1.333-2(b)(1) (1955) provides that the section 333 election once made is irrevocable. See *Raymond v. United States*, 269 F.2d 181 (6th Cir. 1959). But cf. *Meyer's Estate v. Commissioner*, 200 F.2d 592 (5th Cir. 1962) (shareholders were allowed to withdraw their elections after discovering that earnings and profits were \$900,000 rather than \$80,000).

larger than retained earnings would generally be accelerated depreciation in excess of the straight line amount taken on real property, machinery and livestock for taxable years beginning after June 30, 1972. Because previously taxed but undistributed earnings reduce earnings and profits,²⁷⁰ the farm corporation which has made a subchapter S election from its inception is likely to have insignificant earnings and profits other than from accelerated depreciation. The benefits of previously taxed income will be lost on liquidation (except for the "increase" in basis pursuant to section 1376(a)), so cash available without incurring additional indebtedness should generally be distributed along with dividends attributable to taxable earnings in the taxable year prior to liquidation.

Another factor to be considered in comparing the section 333 liquidation with the section 331 liquidation is the effect on taxation of zero basis receivables and inventory items. Under a section 331 liquidation, the shareholder receives a fair market value basis in the assets pursuant to section 334(a). Assuming these ordinary income items were sold at a price equal to their fair market value on liquidation and tax benefits principles at the corporate level are avoided, the entire gain attributable to these items would have been taxed at capital gains rates. In a section 333 liquidation, the shareholder receives an adjusted carryover basis allocated among the assets received in liquidation according to fair market value of those assets.²⁷¹ The portion of the basis in the shareholder's stock allocated to the inventory is likely to be much less than its fair market value, so significant ordinary income taxation will probably result upon disposition of the receivables and inventory after liquidation. If the sale of substantially all of the corporation's assets is deferred for a substantial period of time, the deferral of gain on appreciated real property, machinery and livestock until the sale date generously compensates for any unfavorable treatment on inventory and receivables.

Because installment sale treatment is not available in section 331 and 337 liquidations, a technique that has often been recommended is the distribution of the assets essentially tax free because of the de minimis amount of earnings and profits, cash, and securities in the corporation to stockholders who can receive the benefits of installment sale treatment by a sale of assets. Despite the substantial benefits that may be derived from installment sale treatment of the corporation's assets following a section 333 liquidation, practitioners should not recommend this procedure when there is more than a remote possibility that the sale of all the assets can

270. CODE § 1377 (a).

271. See note 267 *supra*.

be attributed to the corporation under the *Court Holding* doctrine.²⁷² Unlike the section 331 liquidation in which attribution of the sale to the corporation can be "backstopped" against double taxation by also qualifying for section 337 treatment, this option is not available in liquidations qualifying under section 333.²⁷³ Consequently, sales proceeds following a section 333 liquidation which are attributed to the corporation can result in capital gain taxation at the corporate level and substantial ordinary income treatment at the shareholder level.²⁷⁴ As previously indicated, many farm land sales are structured in a "land contract" generally qualifying for installment sales treatment. Because sections 337 and 331 eliminate substantially all of the benefits of installment sale treatment, there have been many cases in which the benefits of installment sale treatment have been attempted by a section 333 liquidation followed by an installment sale. The previous discussion warns of the possible adverse consequences of such a course. When all phases of negotiation of the sale by the shareholders in their capacity as shareholders can be sustained and a small interval of time expires between the liquidation and sale, the validity of such a plan seems sustainable. Despite the correctness of the taxpayer's position, however, the uncertainty surrounding the area makes such transactions advisable only for taxpayers willing to undertake substantial risk.

Unlike the section 331 liquidation, strict statutory requirements must be satisfied in order to obtain the benefits of section 333.²⁷⁵ The corporation must adopt a plan of liquidation and file a Form 966 with the Service within thirty days of the date of the adoption of the plan of liquidation. Section 333 applies to qualifying electing shareholders.²⁷⁶ To qualify as an electing shareholder the following requirements must be met: (1) written elections must be filed with the Service on Form 964 within thirty days of the date the plan of liquidation is adopted by the shareholders; (2) elections must be filed by shareholders in the same class (noncorporate or corporate) who hold at least eighty per cent of the shares entitled to vote in that class;²⁷⁷ and (3) the liquidation must occur within

272. See note 259 *supra*.

273. CODE § 337(c)(1)(B).

274. For an example of the disastrous results that can occur, see Aaror. Cohen, 63 T.C. No. 49 (Feb. 3, 1975) and Hutton, *The Unforgiving Statute*, Section 333, 2 J. CORP. TAX. 125, 126 (1975).

275. CODE § 333(d); Treas. Reg. § 1.333-3 (1955).

276. CODE § 334(c); Treas. Reg. § 1.333-2 (1955).

277. CODE § 333(b). A corporation which at any time between January 1, 1954 and the date of adoption of the plan of liquidation was the owner of stock shall have fifty per cent or more of the total combined voting power of all classes of stock entitled to vote or the adoption of the

one calendar month and be in complete redemption of the shareholders' stock.²⁷⁸

The previous discussion²⁷⁹ of capitalization of the corporation concluded that it was generally advisable to issue debt securities as part of the capital structure. Section 333 gives nonrecognition treatment solely on the redemption of stock. Therefore, gain would be recognized on the difference between the value of the property received attributable to discharge of the debt securities on the basis in the debt securities held by the stockholders in a section 333 liquidation.

3. Section 337 Liquidation

Section 337 was adopted to eliminate the form distinction between the *Court Holding Co.* and *Cumberland Public Service* cases.²⁸⁰ It provides that a corporation which adopts a plan of complete liquidation, distributes all its net assets according to that plan and accomplishes the liquidation within a twelve month period beginning on the date of the plan, will not recognize gain or loss on the sale of "property" as defined in section 337(b). Because the corporation is not taxed on the income from the sale of "property" during the twelve month liquidation period, and because the shareholder's gain or loss is the difference between the value of the assets received in liquidation and the stockholder's tax basis, the result would theoretically be the same regardless of whether the assets were sold by the corporation prior to liquidation or by the shareholders after liquidation. Section 337 is inapplicable to collapsible corporations, section 333 liquidations and section 332 liquidations in which the distributee computes its basis under section 334(b)(1),²⁸¹ and also precludes the shareholder from receiving installment sales treatment. Although installment sales of non-inventory property and inventory property sold in bulk are not subject to taxation at the corporate level (other than under sections 1245, 1250 or 47), the shareholders will be required to recognize gain or loss on liquidation based on the fair market value of the installment obligations.²⁸²

plan of liquidation is excluded for computation of the eighty per cent shareholder.

278. The distribution of livestock and inventory in the last week of one month and the conveyance of real estate in the first week of the following month would not qualify.

279. See note 259, *supra*.

280. *Id.*

281. CODE § 337(c).

282. *Id.* §§ 337(b), 453(d)(4)(B), 311. For a possible method of obtaining installment sale treatment at the shareholder level, see Rush-

Other tax distinctions between liquidating the corporation and selling the assets result from the sale of inventory. If the corporation in a section 337 liquidation sells inventory in the normal course of business rather than in one bulk transaction, the corporation is not exempt from taxation on the gain from those sales.²⁸³ If the inventory is transferred to the shareholder for sale in a series of transactions in the ordinary course of business, capital gain treatment would result if assignment of income principles are not applicable. This result is obtained because the gain is recognized by the shareholder upon receipt in liquidation in exchange for his stock. Because of the distinction in tax treatment, the *Court Holding Co.* decision can have vitality even in a section 337 liquidation. If the *Cumberland Public Service Co.* form is followed, the *Court Holding Co.* doctrine might be applied more liberally to the sale of inventory.²⁸⁴ Unlike the sale of basically non-liquid real property, it may be possible to refrain from negotiating the sale of readily marketable fat cattle or grain until after liquidation, unless the sale of the underlying real property leaves the stockholder without facilities to maintain the livestock or store the grain. Under either of these approaches the Service is likely to challenge cash basis deductions attributable to the unrealized inventory by applying the failure to reflect income clearly or tax benefit doctrines. The increment attributable to the excess, if any, of value of inventory over the expenses may be subject to unfavorable treatment.²⁸⁵

Section 337, unlike section 333, is not elective and applies automatically if its conditions are met. Section 337 exempts the corporation from taxation only on sales of "property" occurring after the adoption of the plan of liquidation. Extensive negotiations may

ing v. Commissioner, 441 F.2d 593 (5th Cir. 1971). *But cf.* Kinsey v. Commissioner, 477 F.2d 1058 (2d Cir. 1973); Rev. Rul. 73-536, 1973-2 CUM. BULL. 158. See note 254 and Section IV, B, *supra*.

283. CODE § 337(b)(1)-(2). The issue of a bulk sale of inventory in a diversified farming enterprise is not clear. Section 337(b)(2) permits a bulk sale of inventory attributable to a business of the corporation. If the crop and livestock operations are separate businesses, livestock and the separate sale of the livestock and grain would be much less difficult than the sale of all grain and livestock in one transaction. See Treas. Reg. § 1.337-3(d) example (1955); CODE § 355(b)(1)(A); Treas. Reg. § 1.355-1(c) (1955).
284. In *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 455 (1950), the Court said that, "the corporate tax is aimed primarily at the profits of a going concern," indicating that it might look favorably on an inventory sale as opposed to a sale of real property.
285. Sale of inventory by the shareholders in *United States v. Lynch*, 192 F.2d 718 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952), was required to be recognized as income to the corporation. See note 254 and Section IV, B, *supra*.

have been completed and an oral agreement reached prior to consultation with counsel. If that is the situation, the Service could logically contend that, in view of *Court Holding Co.* the sale was consummated prior to the adoption of the plan of liquidation and not protected by the umbrella of section 337. Fortunately, the regulations are very liberal in this regard. They provide that sales may be made on the same day the plan is adopted and that the corporation may negotiate the sale prior to the adoption of the plan.²⁸⁶ The interpretations of the "date of the adoption of the plan of liquidation" has also been liberal. The regulations provide that the date of the adoption of the plan of liquidation is ordinarily the date on which the corporation, by vote of the requisite number of shareholders, adopts a resolution authorizing a distribution of the corporation's assets.²⁸⁷ The Service has ruled that, where an informal agreement was reached by shareholders owning seventy-five per cent of the stock in a closely-held corporation (where state law required a two-thirds vote for liquidation) for the sale of the corporation's assets and distribution of the proceeds, the circumstances constituted a plan of liquidation.²⁸⁸ The Service has also ruled that the failure to file the Form 966 within thirty days after adoption of the plan, or the failure to file the information required on liquidation pursuant to Treasury Regulation section 1.337-6, is not alone fatal.²⁸⁹ Despite these liberal interpretations, the corporation should adopt a formal resolution for liquidation and file the requisite documents, including the Form 966, within thirty days of the adoption of the plan to avoid any subsequent issue of the applicability of section 337.

Where the corporation has "property" which has depreciated in value, the loss on the sale of the assets is also not recognized after the adoption of the plan of liquidation. Where it is feasible from a timing standpoint, the depreciated assets should be sold and the loss recognized before the adoption of a liquidation plan allowing sale of the appreciated property without taxation. The success of this "straddle" is by no means certain, but the taxpayer has nothing to lose by structuring the order of sale in the suggested manner.

Once the plan of liquidation is adopted, the practitioner should monitor the liquidation to ensure that all assets of the corporation, except for a reasonable amount to meet contingent claims, are distributed to the shareholders within the twelve month period re-

286. Treas. Reg. §§ 1.337-1 and -2 (1955).

287. *Id.* §§ 1.337-2(b), 1.337-6(a) (1955).

288. Rev. Rul. 65-235, 1965-2 CUM. BULL. 88.

289. Rev. Rul. 65-80, 1965-1 CUM. BULL. 154; Rev. Rul. 65-30, 1965-1 CUM. BULL. 155.

ardless of whether the assets have been sold. If substantially all of the assets have not been sold because of a breakdown in negotiations, the corporation may be required to abandon the plan of liquidation and allow the corporation to be taxed on any assets sold. This will not be necessary if the shareholders are willing to liquidate and recognize gain on the unsold property, thus assuming the risk that the remainder of the property will be sold within a relatively short period²⁹⁰ or are willing to pay the income taxes from sources other than the proceeds from the sale of assets.

Where feasible, the distribution should not be delayed until the last moment. However, there may be tax deferral available to shareholders by some delay. For example, all of the corporate assets are sold in November and December pursuant to a plan of liquidation adopted in October. If in the case of a calendar year taxpayer the distribution of assets prior to January 1 is limited to an amount equal to the basis in the stock, recognition of gain will be deferred until the following year.²⁹¹

D. Redemption

Frequently one or more but not all of the corporation's shareholders will desire to liquidate part or all of their stock interest. Because the closely-held corporation generally will not want the stock to be transferred to third parties, two alternatives are available to continuing operators. They may acquire the shareholder's shares or have the corporation redeem the stock. The acquisition by the shareholders would normally be accomplished with doubly taxed dollars, obtained from funds distributed by the corporation (except in the case of a subchapter S corporation). As a result, redemption of the selling stockholder's shares by the corporation is generally more desirable for the acquiring stockholders (a cross purchase insurance agreement would be an exception). However, the redemption may not be the most desirable from the viewpoint of the selling shareholder.

A gain from the sale of stock to other stockholders or third parties will be treated as gain or loss from the sale of a capital asset. Redemption of stock by the corporation will qualify for treatment as gain or loss from the sale or exchange of a capital asset only if (1) the redemption is not essentially equivalent to a dividend;

290. Rev. Rul. 67-273, 1967-2 CUM. BULL. 137. Great care should be taken to ensure that the new plan of liquidation is not a continuation of the old plan. See Malcolm C. Howell, 40 T.C. 940 (1963).

291. Rev. Rul. 68-348, 1968-2 CUM. BULL. 141. There are no known cases where the Service has implemented the doctrine of constructive receipt.

(2) the redemption is substantially disproportionate; or (3) the shareholder's interest in the corporation is terminated (assuming the redemption is not pursuant to a plan of partial liquidation under section 346).²⁹² If these tests are not met the distribution is treated as a dividend to the extent of the corporation's earnings and profits.²⁹³ The Supreme Court's interpretation of section 302(b)(1) (not equivalent to a dividend) has made it unlikely that a redemption will qualify for capital gain treatment.²⁹⁴ A redemption is substantially disproportionate only if the shareholder's interest in the voting power of the corporation is less than eighty per cent of his interest before the redemption, and after the redemption the shareholder owns less than fifty per cent of the voting power of all stock. Because the section 318 attribution rules (treating stock owned by some family members as owned by other family members) apply for purposes of the substantially disproportionate test, the redemption will rarely qualify in the family farm corporation. Consequently, the shareholder in a farm corporation which has significant earnings and profits can only receive capital gains treatment by a complete redemption of the shareholder's stock. In a complete redemption, the section 318 family attribution rules are waived only if the shareholder retains no interest in the corporation after the redemption (including an interest as officer, director or employee) other than as a creditor, and agrees not to acquire, other than by bequest or inheritance, a disqualifying interest for ten years.²⁹⁵ Because the redeemed shareholder might retain his residence adjacent to or on the corporation premises (e.g., the retired farmer who sells to his children), care must be taken that he does not perform any services for the corporation.

Another possibility for capital gains consequences upon redemption is section 303. A redemption of the stock of a deceased shareholder is treated as an exchange of stock qualifying for capital gains treatment provided that the distribution does not exceed the sum of estate and inheritance taxes and the administration and funeral expenses of the estate.²⁹⁶ To qualify for section 303 treatment, the value of the stock included in the gross estate must exceed

292. CODE § 302(b)(1)-(3).

293. *Id.* § 301. The advisor should keep in mind that many farm corporations will have a very low level of earnings and profits.

294. *United States v. Davis*, 397 U.S. 301 (1970).

295. CODE § 302(c). The agreement not to acquire the interest within ten years is to be filed with a timely tax return for the year of redemption. *Treas. Reg. § 1.302-4* (1968). The courts have divided on the failure to comply with the requirements for a timely filed agreement, see e.g., *Van Keppel v. United States*, 323 F.2d 717 (10th Cir. 1963); *Archibald v. United States*, 311 F.2d 228 (3d Cir. 1963).

296. CODE § 303(a).

thirty-five per cent of the gross estate, or fifty per cent of the value of the taxable estate. Where multiple corporate entities are utilized, such ownership shall be combined and treated as the ownership of a single corporation only if the decedent owned more than seventy-five per cent in value of the outstanding stock.²⁹⁷

The farm corporation typically operates with a low level of cash and liquid assets. As a result, the redeemed shareholders may desire or be required to take part of the non-liquid assets of the corporation in redemption of stock. Generally, in a complete redemption of the shareholder's interest (which is determined without the ten year carryforward rules of section 302(c) (2) (A) (ii) relating to the waiver of family attribution), the corporation will recognize gain equal to the excess of the value of the distributed property over the corporation's adjusted basis in the property. The gain must be recognized at the corporate level regardless of whether the distribution is taxed as a dividend to the shareholder.²⁹⁸ This general rule does not apply if the shareholders owned at all times during the year of redemption at least ten per cent in value of the outstanding stock of the corporation.²⁹⁹ Substantially appreciated real property should not be used to redeem a shareholder's stock unless one of the exceptions to gain recognition in section 311(d) (2) is satisfied.

E. Partnership Liquidation and Redemption Compared

The tax costs of any method of sale or liquidation of substantially all of the farm operation's assets are generally more expensive in the corporate form. The partnership can generally be liquidated tax-free, regardless of whether the farm operation intends to sell its assets immediately. Only when cash is received in excess of the taxpayer's basis in his partnership interest, or when "unrealized receivables" and "inventory" as defined in section 751 are received in disproportionate amounts, will the partner or partnership recognize gain on liquidation³⁰⁰ (gain will be recognized by the partnership and partners upon sales, etc. of partnership property). Even

297. *Id.* § 303(b).

298. *Id.* § 311(d) (1).

299. For other exceptions, see CODE § 311(d) (2) (B)-(G).

300. CODE § 731. The basic rules of sections 732 and 733 and the "collapsible partnership" provisions of section 751 are quite complex and beyond the scope of this article. On termination, liabilities from which the partner is relieved are treated as a distribution of cash by section 752(b). Unless the assets are sold, the partners will generally assume (or take property subject to) indebtedness equal to a pro rata share of the indebtedness at the partnership level negating the cash distribution.

if the noncorporate farm operation sells all its assets and distributes the proceeds to the owners, the double taxation attributable to recapture provisions of sections 1247, 1250, 1251 and 47 make the tax cost of complete sale and liquidation of the farm corporation higher than those for the farm partnership. This additional cost is generally significant, since farm operations often have substantial recapture items.

On redemption of stock, the minimum price at which a shareholder can be redeemed is capital gain treatment, even if he receives land or other corporate property. In contrast, a partnership interest can generally be terminated without recognition of income to the partnership or to the redeemed partner, unless the partner received cash in excess of his basis in the partnership interest or a disproportionate amount of section 751(b) assets.³⁰¹

V. CONCLUSION

The imposition of an artificial taxpaying entity to own one or more facets of an agricultural enterprise can become a substantial income tax saving or deferral device. The lower maximum income tax rates, the ability to segregate income into two or more taxpaying entities, the ability to reverse old tax elections through formulation of a new entity, and the substantial estate and gift tax advantages make the theoretical tax operation of the farm corporation inviting. Non-tax advantages such as providing a simple mechanism for transferring fractional interests in a necessarily large group of assets, the ability to perpetuate the life of the enterprise and the theoretical limitation of liabilities of the participants seem appealing to the client or attorney who has been involved in an estate in which ownership in the agricultural enterprise has been divided into sixteen different pieces. The tax free nature of the transfer of most agricultural enterprises to corporate form makes the transfer seem like a noble experiment in modern business practice.

Like many experiments, however, the results of corporate farming can be substantially different from the projected results. Rather than being able to abandon the experiment immediately once the fallacy of the theoretical results have been discovered, the farm operator quite often finds that the tax price of terminating the experiment is many times greater than the entry price. Most of the tax disadvantages to corporate farm operators can be summarized by the phrases "double taxation" and "lack of flexibility." Despite many mitigating factors such as subchapter S taxation, the

301. *Id.* § 731. An important exception with respect to a retiring or deceased partner is found in section 736.

tax aspects of operating the corporate farm will generally be less advantageous to the farm operators who want to withdraw all or substantially all of the agricultural enterprise earnings. Because of the special tax accounting rules which apply to businesses such as agriculture and rental of commercial and residential real estate, taxable earnings generally lag substantially behind the cash flow available for distribution to its members. In many instances the effect of corporate farming is to lock this tax free cash flow into corporate solution and prevents distribution without a tax price either in the form of income or a less favorable basis adjustment than would be available in the proprietorship or partnership farm. Similar problems also arise when the farm operators desire to sell part but not all of the agricultural enterprise, to divide the enterprise among the various participants or to revert to another form of ownership.

The general tax disadvantages from operation and liquidation of the corporate farm dictate that the practitioner and his client weigh in minute detail the advantages and disadvantages of corporate farming. In the case of maximum income tax bracket farming operations, operations in which the operators can leave substantial profits in the corporate farm and in cases of necessary estate planning for an elderly owner, the corporate farm can be a desirable form of ownership.

Despite the increasing number of agricultural enterprises opting for corporate ownership, corporate farming will not become a universal practice. Even if all the operational personality and estate planning objectives of the farm family dictate corporate ownership, the offsetting tax price for operation and potential tax price of liquidation must be deducted before eliminating the flexibility so typifying the spirit of most farm families.*

* As this article was set in type, the introduction of the House Ways and Means Committee tax reform bill was imminent. It was expected that the proposed bill would make several changes in existing law which would affect the farm corporation, the most important being the requirement of accrual basis accounting for certain farm corporations. See note 5 *supra*. Diluting the limitations on artificial losses ("LAL") already discussed, (see notes 5 and 83 *supra*), the bill would exempt pre-productive expenses of livestock producers as well as wheat, barley and oat farmers from LAL provisions. See BNA Daily Tax Report, October 20, 1975, at G-3. The committee would also make permanent the 1975 Tax Reduction Act changes in the individual income tax rates, *id.*, October 23, 1975, at G-6, and the corporate rates, *id.*, October 29, 1975, at G-9. See note 91 *supra*. In addition to these lowered rates, the committee would extend the 10% investment credit to 1980. See *id.* October 28, 1975, at G-7.