An Agricultural Law Research Article

The Farm and Ranch Corporation –Business Organizational Form of the Future

by

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THE FARM AND RANCH CORPORATION—BUSINESS ORGANIZATIONAL FORM OF THE FUTURE

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Thank you, Howard. You know, all the talk about my being an economist reminds me of something that comes to mind every time I am so introduced, and that is the two or three or half dozen definitions of an economist. I would like to just share two of those with you this morning by way of introduction.

One that I have always treasured is that an economist is a chap who tells you how to spend the money you wouldn't have had if you had listened to him the last time. Then there is the old saying that if all the economists in the world were laid end to end they still couldn't reach a decision.

Howard's reference to me as a "hybrid" merits comment. We normally think of hybrids as being something eminently desirable. We think readily of hybrid corn; we think also of the hybrid effort between chemistry and physics that produced the atomic bomb and all of the knowledge now associated with nuclear fission. But then there is the other side of the coin, too. I am sure you are all familiar with that institution known, at least down where I came from in southern Iowa, as the Missouri mule. That too is a hybrid, and it is an interesting hybrid in that it has "no pride of ancestry nor hope of posterity." I would hope that our legal-economic hybrid would perhaps not be quite so sterile intellectually as that hybrid has turned out to be.

Some of my colleagues in economics are frankly skeptical about this combination of law and economics. It is becoming more and more popular but still there is skepticism. My economist colleagues tell me that they have yet to see an economical lawyer. Then my friends at the bar say there hasn't been anything legal about economics since Lord Keynes of the 1930s.

At any rate, it is with great pleasure that I do appear before your sixty-fourth meeting of the Nebraska Bar Association and, along with Dean Mason Ladd and President Mayne of our Association, bring you greetings from Iowa.

This subject of farm and ranch incorporation has been kicked around for years. Much of the talk, I am afraid, has stemmed from some misconceptions and perhaps some misunderstandings as to

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just what this corporate animal is that has sneaked into farming and ranching. I am reminded of the story of the old Englishman who was making his first visit to the United States, visiting a dude ranch in one of the western states. He was really one from the old sod. One of the aspects of American life that he simply scorned was the tomboyish ways of American girls. He thought this despicable, and made this fact known at every opportunity.

On his first morning at the dude ranch he walked out of his air-conditioned bunkhouse and the first thing he saw was a raw-boned, teen-age girl leaning against the corral fence. She had on a man's shirt and she was wearing faded Levi's. This set him off on his pet peeve. "Look there!" said the English chap to a bystander, with a great deal of disdain, as only an Englishman could, "you can't tell if that's a boy or a girl!"

"Oh, it's a girl," spoke up the equally raw-boned bystander, "she's my daughter."

This touched the Englishman deeply and he replied, apologetically, "Oh, please forgive me. I didn't realize you were her father."

Whereupon the bystander said, "I'm not. I'm her mother."

As I said, there has been some confusion about the corporate form as applied to farm firms, too. As one examines the literature over the past several years, two distinct eras stand out in bold relief with respect to the corporate form as applied to farm firms. The most recent era, dating from about 1955, is essentially an era of application of the close corporation to farm firms in which ownership is frequently maintained within a family.

The other era, extending through the 1920s and 1930s, was characterized first by an emergence of a few well-publicized farm corporations of substantial size. Some of these behemoths were even publicly held. Later on in the period, more particularly during the 1930s, ownership of farm land by absentee corporations, especially by insurance companies, came to play a very significant role in agriculture. Much of this corporate land ownership actually evolved through mortgage default by farmers during the depression. As an indication of the extent of corporate ownership, nearly 12 per cent of the farm land in Iowa was owned by corporations in 1939. This percentage dropped off rapidly in the 1940s.

Largely in response to the fears that an agricultural economy of a few very large corporate farms might develop, with the concomitant death of the so-called family farm, several states enacted legislation prohibiting or discouraging farm incorporation. Several of these statutes are in effect today. Kansas and North Dakota have perhaps the most complete limitations on farm incorporation.

The North Dakota statute constitutes a flat prohibition; the Kansas statue is only selectively prohibitive. The Oklahoma constitutional provision is of undetermined breadth. The author of an article in the May 1963 issue of the *Oklahoma Law Review* suggests that the provision may not prevent farm corporations from owning land in Oklahoma; the matter is still open to considerable doubt in Oklahoma. The Minnesota acreage limitation, the Texas limitation on what has come to be known as vertical integration, and the West Virginia special tax merit only passing mention.

Data from several sources indicate that increasing use has been made of the corporate form by farmers in recent years. Much of the evidence shows a substantial increase in farm incorporation since about 1958. This interest and increased use of the corporation probably stem from several independent factors: (1) the passage of Subchapter S of the Internal Revenue Code; (2) the emergence of the small closely held corporation as a relatively mature business organizational structure; and (3) the vast and pervasive effects of technological change that has swept agriculture during the past several years. For example, the changes in investment per farm and per farm worker since 1940 have been substantial. The value of production assets per farm has shot up from $6,094 in 1940 to over $34,000 in 1960. These figures are for the nation as a whole. Looking at another statistic, and this for the State of Nebraska, the average size of farm in Nebraska has increased from 391 to 528 acres during the nineteen-year period from 1940 to 1959. These are indications of the technological transformation that agriculture has been through in recent years. The substitution of capital for labor has had far-reaching effects.

The essential link between technological change in agriculture and greater use of the corporate form has been the economic and legal motivations for incorporation. Under the corporate form of doing business there are certain economic motivations that bear mention here. Resource allocation within the firm may more nearly approach what economists call the theoretic optimum. The decision makers' effective planning horizons—and by that I mean the distance into the future to which the farm planners look in making plans—may be extended, resulting in more nearly optimum production over time. Problems of capital accumulation may be alleviated. And the economic effects of the so-called "family farm cycle" may be ameliorated as well. It might be added, parenthetically, that the family farm cycle is caused by the relative scarcities of labor and capital during the productive life of the farm family. During the first few years that a farmer operates he is usually long on labor, short on capital; in the final years this reverses itself so

that a farmer wishes to contribute less and less labor in his final years and usually has more and more capital with which to work. The family farm cycle frequently involves some economic inefficiencies. In many respects the corporation offers a near perfect form of organization from an economic viewpoint, where there is multiple ownership of resources of production.

Several empirical studies have been conducted in recent years in an effort to determine, among other things, what precise factors have influenced farmers to incorporate. Data from studies in four States—Nebraska, Iowa, Oregon, and South Dakota—indicate that there are four principal reasons why farmers have incorporated in those states. Incorporation has occurred mainly to accomplish objectives of estate planning, business planning over time, limitation of liability, and income tax saving. There have been numerous variations of these answers by specific firms but those categorize, in very general form, the motivating factors for incorporation.

As we turn now to the more technical aspects of the presentation, let me say just a word about the amount of material included in the outline. It will not be possible in the time allotted to discuss every point in detail. Therefore some sections will be submitted "on the brief," as it were.

One of the important considerations in almost every instance wherein the corporation is considered as an alternative business organizational form is that of the income tax effect of incorporation. Income taxes are relevant, indeed, in a discussion of farm and ranch incorporation. It is often the first question or among the first questions asked by people who are interested in incorporation.

In most cases in which agriculture is carved out for special treatment in the tax law, a farm corporation is a farmer for tax purposes. This is true of most of the elections on deductions for expenditures, for example. However, a farm corporation does face some differences in terms of income taxation. For example, a farm corporation is permitted less extra first-year 20 per cent depreciation deductions than is allowed for an unincorporated farm firm. A farm corporation is limited to $2,000 of such depreciation per year. A married farmer filing jointly can claim up to $4,000, as can a married partner filing jointly.

Even more importantly, death of an owner has a much different effect upon the tax basis of property after incorporation. Under present law, property passing through a decedent's estate takes as tax basis the fair market value on the date of death or the alternate valuation date. This wipes out the capital gain in the property at periodic intervals, and, among other things, makes it

possible for depreciable property to be depreciated out in each generation. For example, buildings that are depreciated out can again be placed on the depreciation schedule after death of the owner. After incorporation, the adjustment of basis at death of a shareholder inures to the corporate stock, but not to the underlying corporate assets. Therefore, older farmers in particular may want to consider carefully this aspect of tax treatment under the corporate form of doing business.

It is perhaps noteworthy to point out that the matter of filing income tax estimates changes after incorporation. A corporation has its own rules on estimates. There is no need for an estimate by a corporation unless income tax is expected to exceed $100,000. Of course, a Subchapter S corporation need not file a declaration of estimated tax in any event. The special provision available to "farmers," of filing tax by February 15 and avoiding estimates, is not extended to farm corporation employees. Thus, after incorporation a farmer as an employee is an ordinary taxpayer and may be required to file a declaration of estimated tax.

It is worth noting that individuals need not withhold income tax on wages paid to agricultural labor. This provision is extended to a farm corporation as well as to individual farmers.

Until recent years the greatest disadvantage to farm and ranch incorporation in most instances was said to be the basic corporate income tax treatment of ordinary income and capital gains. Until 1958 this apparently discouraged many firms from incorporating. The corporation, in a great majority of the cases, suffered from five disadvantageous tax aspects:

(1) Corporate income was taxed at only two rates, 30 per cent on the first $25,000 and 52 per cent on the remainder.

(2) Corporate income was taxed twice if paid out as dividends before it was in spendable form in the hands of the shareholders, with only a limited exclusion and credit.

(3) Corporate long term capital gains were taxed at a flat 25 per cent.

(4) Corporate capital gains and tax exempt interest lost their tax-privileged identity when passed to the shareholders as dividends.

(5) Excess capital losses could be used only to offset capital gains and could not be used to offset up to $1,000 of ordinary income as in the case of individual taxpayers.

It is easy to see, then, why farm corporations, before 1958, generally paid very little income tax. Operations were carefully calculated to keep corporate taxable income low and this was gen-

erally accomplished by paying out corporate income in the form of tax deductible salaries, interest, or rent.

Since 1958 it appears that many farm corporations have utilized Subchapter S of the Internal Revenue Code despite its numerous shortcomings. Without going into great detail, let me say that many of the disadvantages of the regular corporate method of taxation are alleviated inasmuch as the Subchapter S corporation pays no tax. The corporation passes through to the shareholders, to be included in their individual income tax returns, their pro rata share of undistributed taxable income, long term capital gains (but not capital losses) and operating losses. In addition, each shareholder also reports, as usual, any salary, interest, or rent that he might receive from his corporation.

The requirements for Subchapter S election are undoubtedly quite familiar to you. One requirement for continued eligibility has caused some difficulty for some of the farm "landlord" corporations. By landlord corporation is meant a corporation that owns land and rents it out to tenants under a conventional leasehold arrangement. The law specifies that the election under Subchapter S terminates if more than 20 per cent of the corporation's gross receipts come from investment type income—rents, royalties, dividends, interest, and so forth. The question has arisen over the definition of "rent" in the statute. Does it capture landlord corporations that merely own land and rent it out under a lease? The Treasury has taken the position that income of farm corporations owning and leasing farms to tenants is not "rental" income *if* the corporate officers or agents participate to a material degree in production through physical work, management decisions, or both. The rule seems to have been picked up from social security law.

Every practitioner engaged in the preparation of farmers' tax returns fights the battle of household-firm transactions. The problem may take the form of deductibility of automobile expenses, the tax aspects of home-raised products that are consumed at home, or it may take the form of deductibility of expenses for the personal residence of the taxpayer. These problems are not really avoided if a farmer incorporates; they are often cast in a slightly different and more formal context. If the residence is conveyed to the corporation, all costs in connection therewith are deductible. This includes some expenses that may not have been deductible before. But the tax man's *quid pro quo* is a reasonable rental picked up by the occupants on their personal income tax return.

Some taxpayers have raised this question: Can you deduct meals and lodging furnished to employees residing on the farm ostensibly to take care of baby pigs, baby chickens, etc., that

demand the almost constant attention of the farmer? This question has apparently not been settled. The *Schwartz* case cited in the outline made it work with six employee-shareholders of a corporate undertaker whose religious practices required that bodies be processed immediately after death.

The problem of the tax aspects of automobile expense and the question of which farm vehicles to convey to the farm corporation have many angles. Individual ownership of automobiles presents the problem of expenditure deduction in its usual form—claiming as great a proportion of expenses as possible on the corporate return. If the corporation owns the automobiles, then personal use of the automobiles may be taxable income to the user.

There are other considerations, too, in deciding which vehicles should be conveyed to the corporation and which vehicles should be kept out. It is well to consider any differential in insurance costs and differences in insurance coverage under corporate ownership versus ownership by the individuals. It is well also to consider the matter of liability for claims arising out of personal use in the case of corporate ownership and liability for claims out of business use in the event of individual ownership.

Undoubtedly one of the most crucial stipulations laid down by incorporating farmers is that incorporation must proceed without recognition of the potential gain wrapped up in the farm property to be conveyed to the new corporation. Farm property in particular often has a fair market value substantially in excess of tax basis. Land, for example, has appreciated in value in recent years. Land worth $100 an acre twenty years ago may be selling for $300 or $400 an acre today. Many farmers have used rapid depreciation methods which may have driven tax basis well below fair market value. And, of course, much of the farm inventory may consist of animals and crops with zero basis because costs of production have been deducted. In almost every case the tax basis is substantially below the fair market value of the property at the time it is conveyed to the corporation. Thus, for the vast majority of farmers, a so-called "tax-free" incorporation is essential.

The two basic requirements of a tax-free incorporation, wherein the parties do not recognize the capital gain in the property, are: (1) the transfer of property must be solely in exchange for stock or securities in the corporation; and (2) the transferors of property must end up "in control" of the corporation after the transfer. This requires that 80 per cent or more of the stock go to the transferors. Gifts at the time of incorporation in excess of 20 per cent of the stock may preclude a tax-free incorporation. With a tax-free

exchange there is simply an exchange of basis and holding periods between the corporation and the individuals who form the corporation and contribute property to it. The stock received in exchange for the property takes its basis from the transferred property. Mortgages or other obligations simply reduce the basis of stock or securities received by the transferor.

In a few cases a "taxable" incorporation may appear to be advantageous for some farmers. They may find it desirable to trade capital gains recognition for deductions from ordinary income, or to spread the recognition of income over a period of years. There is no election between a "taxable" or a "tax-free" incorporation. The result depends precisely on how the transaction is handled. For most farm corporations a "taxable" incorporation loses its luster because of the restraints placed upon a taxable incorporation in which the gain is recognized on all of the property conveyed to the corporation. First, transfers of property to a "controlled" corporation are not eligible for capital gains treatment. Secondly, it has been held that the gain on growing crops is taxable as ordinary income and not as capital gain. Thirdly, losses incurred in a transfer to a controlled corporation are not deductible. These features remove much of the glamour of a taxable incorporation for most family farm situations.

In financing a farm corporation a farmer faces several new decisions after he incorporates. The basic decision of whether and to what extent to use debt capital as well as equity capital takes on new significance. A shareholder can be a creditor as well as a contributor of equity securities. With debt capital, income tax savings accrue in a regularly taxed corporation because of the deductibility of interest. Moreover, a shareholder may have greater investment security as to the debt portion of his contribution. Also, repayment of principal on a debt may avoid the dividend consequences of repayment of equity capital. And imposition of the accumulated earnings tax is less likely in the case of accumulations to pay off debt obligations. The controversy over the deductibility of bad debts arising from a transaction between a shareholder as a debtor and his corporation was virtually settled in a recent United States Supreme Court case. Tax-wise, it has been advantageous to get some of the investment into the corporation as debt and then, if the business fails, to claim a bad debt deduction. Under the *Whipple* case, however, such bad debts are treated as non-business bad debts, receiving only capital loss treatment and not business bad debts which merit ordinary loss deductibility.

It should be noted that debt capital cannot be substituted for

equity capital throughout the entire range of capitalization with impunity. The advantages of debt capital may be lost if debt is pushed too far. The guidelines as to what constitutes excessive debt to equity in farm or ranch firms are not abundantly clear.

In addition to facing the debt-equity capital decision, incorporating farmers face also the question of fashioning the equity capital structure. The precise use made of equity capital in a farm corporation is heavily dependent upon the latitude accorded the incorporators under state law in setting up the capitalization pattern. Normally classes of equity securities are differentiated on the basis of dividend priorities, voting rights, and liquidation preferences.

In Nebraska, as in many states, some restraints are imposed upon the differentiation of equity securities on these bases. The articles of incorporation may provide for non-voting stock; otherwise, every share is entitled to vote. Again, with respect to voting, the Nebraska Constitution makes cumulative voting mandatory for elections to boards of directors. And all shares must have par value.

Within the framework of these rather broad restraints, incorporators in Nebraska have a great amount of latitude in fashioning the equity capital structure best suited for their needs, differentiating on the basis of voting rights, dividend priorities, and liquidation preferences.

Very little need be said about sources of equity capital for farm corporations. Although arguments can be made for the beneficent effects to agriculture of tapping the equity securities markets, there are several reasons why this does not loom large in importance today, nor is it likely to in the future. Given present earnings in agriculture (which are relatively low), present sizes of firms in a relative sense (again quite low), present costs of obtaining outside equity capital (which may be quite large), and present attitudes relative to diffusion of ownership and control rights among outsiders, it is unlikely that outside equity capital will play a very important role in farming at least in the near future.

The notable exception to the statement that outside equity capital is not likely to play a very important role in farming in the near future seems to be equity capital supplied by non-farmers wherein the equity capital devolved upon the non-farmer by gift or by testate or intestate succession. This situation often involves brothers, sisters, and other relatives of those remaining on the farm. Non-farm heirs may have received equity securities during the lives of the parents or at their deaths and thus become outside equity shareholders. This type of involuntary investment by related

non-farmers is often a necessary by-product of use of the farm corporation to accomplish estate planning objectives, at least for an interim period. Professor O'Neal will cover some of the problems involved in such situations at a later point in the program.

Turning now to sources of debt capital, it can, as suggested earlier, be obtained from shareholders at least up to some maximum level. It should be pointed out, however, that the fiduciary duty requires that loans from officers or directors be free from fraud or impropriety and that the lender act in good faith and be able to show the inherent fairness of the transaction.

A farm corporation does face certain restrictions on the availability of debt capital from some of the usual sources. Federal Land Bank loans may be made to a farm corporation, provided holders of 75 per cent or more of the stock assume personal liability for the loan. Similarly, Production Credit Association loans may be made to farm corporations if the holders of a majority of the shares sacrifice limited liability for that particular obligation. Farmers Home Administration real estate and operating loans and FHA farm housing loans and grants are simply not available to farm corporations. Small Business Administration loans are available to farm corporations only if the corporation engages in a non-farm business activity accounting for more than 50 per cent of the corporation's income.

In obtaining loans from private credit agencies, a 1959 Iowa study revealed that in many cases shareholders are required to guarantee personally loans to the corporation. The question of whether farm or ranch incorporation improves or inhibits credit availability is still an open question. We have no good quantitative data on the precise effect of incorporation upon credit availability. There are both pluses and minuses to consider. Some of them have been indicated in the outline.

One of the most dramatic and perhaps far-reaching effects of farm and ranch incorporation is the transformation of self-employed farmers into employees. This new employee status is accompanied by both advantageous and disadvantageous consequences.

Looking first at social security, there are several social security implications to consider before incorporation. The social security tax is levied at a greater rate after incorporation, which results in substantially greater total social security tax. Using 1963 rates, the tax is computed at the rate of 5.4 per cent for a self-employed farmer on the first $4,800 of self-employment income. The tax is imposed at a 3⅝ per cent rate on employees and a like rate is

imposed upon the corporation, making a total of 7.25 per cent for the combined employee and employer shares. This results in a maximum of $88.80 per year per employee more in social security tax *after* incorporation than before at 1963 rates.

However, it might be pointed out that if the entire tax, both the employee's share and the employer's share, is paid by the corporation, the corporation can deduct the entire amount. Of course, if the corporation pays the employee's share, that amount is taxable to the employee as additional compensation.

It is worth noting also that wages earned by children under 21 years of age are not subject to social security tax if the child is working for a parent. However, if the child is working for the parent's farm corporation, the wages would be subject to social security tax.

One offsetting factor to these social security tax disadvantages is the fixed nature of employee compensation. This feature may result in greater social security benefits for owner-employees after retirement compared with the fluctuating income of a self-employed person. Farm income frequently fluctuates widely, sometimes above and sometimes below $4,800 per year. If an employee of a farm corporation receives a salary of $4,800 per year, assuming that is the maximum base for social security benefits, then upon retirement that person would be entitled to maximum social security benefits. But if he is a self-employed person, and his income drops below $4,800, this will reduce his benefits after retirement except for the drop-out years. This aspect of "evening out" income over time may partially offset the increased social security tax cost.

The corporate form may facilitate retirement planning for senior owner-employees. Neither dividends nor undistributed taxable income of a Subchapter S corporation is subject to the social security tax and they do not produce social security benefits. Likewise, such income does not reduce social security benefits after retirement and before age 72.

Thus, a retired corporate employee could receive a part-time salary of $1,200 per year, assuming that is reasonable compensation for services rendered. The $1,200 salary is in keeping with receipt of the maximum social security benefits to which the individual is entitled. And additional income could be received in the form of dividends or distributions out of previously taxed income in the case of Subchapter S corporations. Such retirement arrangements must be reasonable in terms of contribution of effort and allocation of income. It can be said that the corporation offers

substantial flexibility in planning for retirement of employees with the possibility of at least limited participation by the retiring employee in the affairs and activities of the firm. It may be easier to work out an arrangement for a retiring farmer on the basis of his being a part-time corporate employee than trying to use the traditional lease arrangement or a partnership.

In passing, some additional aspects of employee status might be mentioned. A corporation may elect to come under workmen's compensation. And a corporation may choose to take advantage of certain tax privileged fringe benefits for its employees, including owner-employees. The possibilities include group term life insurance, which is perhaps an ideal fringe benefit. Premiums are deductible by the corporation, and neither premiums nor proceeds is taxable to the beneficiary in certain instances. Nebraska law, however, requires a minimum of five employees for a group plan. This requirement might render group term life insurance of very little usefulness for many farm corporations inasmuch as few have as many as five employees. Some insurers do have "baby group" plans, or plans that are set up to handle less than five employees per firm. A word of caution is in order since these special groups may require medical examinations; the Internal Revenue Service has indicated that a plan may not qualify for the group insurance deduction if a medical examination is required.

Time does not permit discussion of some of the interesting possibilities and problems posed by some of the other tax privileged fringe benefits. For example, a farm corporation may set up for its employees health and accident plans and various types of deferred compensation plans. Some of our Iowa farm corporations are taking advantage of the deferred compensation plan provisions for retirement planning and receiving a current tax benefit as well. It was thought for a time that perhaps the Self-Employment Retirement Act of 1962 might substitute for employee status granted by incorporation for purposes of tax-privileged retirement planning. However, the 1962 Act is of very little interest to most farm people because of the relatively small contribution and deductions that can be made under it.

One result of farm or ranch incorporation is a restructuring of member liabilities for firm obligations. In this regard, and before moving into a brief examination of limited shareholder liability in a farm corporation, two aspects of liability that are particularly affected by incorporation might be mentioned. One is the matter of bankruptcy. Federal law has long provided that an individual farmer may file a petition as a voluntary bankrupt but cannot be declared a bankrupt involuntarily. But a farm corpora-

tion enjoys no such exemption from involuntary bankruptcy. A farm corporation can be an involuntary bankrupt, given the necessary set of facts with respect to debts owed and acts of bankruptcy committed.

Another result of incorporation is the loss by farmers of exemptions from execution by creditors. An individual farmer who is head of a family in Nebraska may be able to claim a substantial amount of property exempt from creditors: a homestead not exceeding $2,000 in value or 160 acres in area, and considerable personal property, for example, all pigs under six months. These exemptions are lost if the exempt property is conveyed to a corporation.

Shareholder limited liability is, of course, a concomitant of a legally organized corporation. Limited liability is generally not denied merely because the stock is held by members of a family or even by one shareholder. Of interest to farm corporations is the requirement that the parties must comply with certain corporate formalities in order for the shareholders to be assured of continued limited liability. A seemingly inexorable tendency exists in many closely held farm corporations for the usual corporate formalities to be ignored or at least slighted after incorporation. During the first year or so after incorporation, the parties generally follow the corporate formalities fairly well. The shareholders hold an annual meeting and they keep minutes; and the board of directors meets and votes on certain matters. Even though in most cases the same people occupy all three groups, the parties are relatively careful about which hat they have on when they make decisions, whether it is the shareholder's hat, the board of director's hat or the officer's hat. But as time goes on there seems to be less and less attention given to the matter of maintaining corporate formalities. An effort should be made by counsel at every opportunity to stress the importance of corporate formalities.

It has frequently been asserted that shareholder limited liability has little meaning if shareholders own no non-exempt assets other than stock in the corporation. In many cases farmers own no property, or virtually no property, other than what they have invested in or conveyed to their farm corporation. However, in the case of an unsatisfied judgment, corporate limited liability may be of value even though the shareholders own no non-exempt property individually, other than stock in the corporation.

Let's examine for a moment problems arising when a farm corporation does business in two or more states. In this peripatetic age, it is unlikely that a farm corporation will long function without

some out-of-state contacts. Even the most provincial farm corporation may purchase feeder cattle from out-of-state vendors; sell livestock or crops at terminal markets out of the state; or its vehicles may travel out of the state. These are a few of the possible contacts that a farm corporation may have with states other than the state of incorporation or principal operation. If corporate operations extend across state lines, three different types of legal problems may arise: (1) A corporation may be subjected to the judicial jurisdiction of the foreign state. This requires very little contact, at least in states having modern "single act" jurisdictional statutes; (2) the corporation's income or property may be subjected to taxation in the foreign state; this normally requires substantially greater contact than for jurisdiction to be taken; (3) or the corporation may be subjected to the regulatory or qualification statutes of the foreign state. Inasmuch as qualification requires paper work and expense, most farm corporations are reluctant to qualify to do business in other states. To encourage qualification, some states impose sanctions for non-qualification. Farm corporations doing business outside the state of incorporation should be cognizant of these provisions and take appropriate steps to insure protection of their interests. Some non-qualification statutes deny use of the courts and some involve a penalty which may be substantial in amount.

The last major point in this presentation is a brief discussion of the estate planning aspects of farm or ranch incorporation. It can be said that certain attributes of the corporate form may facilitate the accomplishment of specific estate planning objectives. But it should not be supposed that a satisfactory estate plan involving a farm or ranch cannot be developed without the corporate form. The corporation simply offers a tool for estate planning. The point is that the flexibility of the corporation may make the estate planning task somewhat easier in some essential respects.

Some of the corporate attributes that commend the corporation as an estate planning device might be mentioned briefly. The 1959 Iowa study revealed that the estate planning aspects were one of the major reasons why farmers incorporated their farms. Many of the farm corporations in Iowa involve parents and children, both on-farm heirs and off-farm heirs. Parents having most of their assets tied up in the farm business are in a quandary as to how to be equitable and fair to the children, both those on the farm and those off the farm, and still maintain the farm as a going operation from one generation to the next. This has posed problems, and some farmers have turned to the corporation as a possible solution.

(1) First of all, in looking at estate planning attributes of the corporation, a majority shareholder can accomplish something that is virtually impossible elsewhere in the tax law. Unqualified gifts of stock can be made that remove the stock from the estate of the transferor yet control over the corporation, and thus indirectly over the gift property, may be maintained so long as the transferor retains 51 per cent of the voting stock in the corporation, or whatever is required under state law and the articles of incorporation to give control. In a corporation operating under simple majority rule the holder of all of the stock could give away 49 per cent of it without loss of corporate control. He is still in a position of dominance with respect to the board of directors.

(2) The transfer of corporate stock represents the transfer of a portion of the total farm business, not just a transfer of specific assets.

(3) The transfer of stock may be restricted. In the case of property other than stock, it is difficult to impose a restriction on transfer that would be upheld. Yet it is frequently desirable from the standpoint of the firm to prevent the recipients of a gift from later transferring the interest to a third party, as might be done to gain ready capital to undertake some venture other than continued affiliation with the farm business. This attribute promotes the continuation of the firm over time as an organizational unit. Again, Professor O'Neal will be discussing this point with you from the standpoint of problems involved therein.

(4) Minority shareholders do not have the right of partition and sale that tenants in common and joint tenants or lessees have. This, too, promotes continuation of the farm business, but it also raises problems as well. Intra-firm disputes may arise because of the locked-in characteristic of investments in a small closely held corporation where the stock is virtually unmarketable because of restrictions placed on stock transfer, the difficulty in valuing the stock, and the relatively small potential market for the stock of a farm corporation.

In this regard it should be recognized that the present rate of out-migration from farming is such that each generation carries off the farm rights to a very substantial proportion of agriculture's net worth. A high proportion of the young people reared in agriculture are leaving agriculture for non-farm pursuits. In many cases they take with them rights to property received or to be received from their parents at death, either by testate or intestate succession. This assumes, of course, some basic notion of equitable treatment of heirs by farm parents.

Without some limitation on partition and sale, death of the parents may be an occasion for either splitting up the farm business or forcing the heirs remaining on the farm to purchase the interests of those off the farm. As capitalization per farm increases in the future, and there is every indication that it will continue to increase, the buy-out problem of the heir who remains on the farm becomes more and more severe. Some type of interim or permanent ownership of farm corporation securities by off-farm heirs may help to bridge the gap that arises in the transition of ownership between generations.

(5) Corporate stock can, to some degree, be used as an income channeling device for minimizing over-all income tax liability.

(6) Corporate stock may be issued in convenient denominations of $1.00 or $10.00 or $100 per share. This makes it easy to take advantage of the federal gift tax exclusions and exemptions.

(7) Finally, corporate stock is eligible for transfer to minors under the Nebraska Uniform Gifts to Minors Act. Gifts of farm personalty or farm realty are not eligible for transfer to a minor under the statutory custodianship.

It perhaps should be emphasized that many models of intra-generation stock transfer, using the corporate form as an estate planning device, do not provide adequate protection to certain groups. Unity of objective is not a common element of all groups interested in the farm business. The father may have one set of objectives; his wife may have another. Those children remaining on the farm may have yet another set of objectives; those children off the farm may have still different ideas as to how and when property shall pass. It is quite important as a matter of planning and drafting to consider with care the rights and protection accorded the spouse. And it is well to consider the situation of the non-farm heirs as minority shareholders. They might well become a vocal and bitter locked-in minority.

In conclusion, it is perhaps safe to say that the corporation is not the most suitable form of organization for every farm firm. The farm corporation is not like much of the technology that farmers have become used to accepting. The farm corporation is not like fertilizer, for example; it doesn't apply the same to everyone up and down the road, but in different amounts.

For many farmers the disadvantages of farm incorporation far outweigh the advantages. In general, however, as farms grow larger and as continuation of the business from one generation to the next becomes more important, the advantages will carry greater and greater weight. There seems to be no reason why farm and

ranch incorporation should not increase unless other states follow the lead of Kansas and North Dakota in either limiting or prohibiting, by the enactment of appropriate legislation, the incorporation of farm firms.

CHAIRMAN MOLDENHAUER: Thank you, Neil.

I think you will find there is a wealth of material in his outline, which he didn't have time to cover, which should supplement that very excellent speech.

Now rather than have questions I think we will take a ten-minute break, but Mr. Harl will be up here. I know several of you have written him letters with personal questions. I think he would be very happy to meet you and talk with you about them.

[Recess.]

CHAIRMAN MOLDENHAUER: Gentlemen, we have a lot of material to cover before noon. It is almost impossible for anyone who has dealt with corporate problems at all and done any research in the field to do so without coming across the name of Professor F. Hodge O'Neal from Duke University. He is one of the leading writers on the closely held corporation and has devoted his life to the subject.

Professor O'Neal is a professor of law at Duke University in Durham, North Carolina. He received his A.B. degree and LL.B. degree from Louisiana State University. He has received a J.S.D. from Yale Law School and an S.J.D. from Harvard Law School. I asked him what that meant and he wasn't quite sure. He thinks one of them is Doctor of Science of Jurisprudence and one a Doctor of Juridical Science, but he isn't sure which belongs to which school.

He is the author of the two-volume set on *Close Corporations: Law and Practice.* He was co-author of that little pamphlet which so many of you have utilized entitled "The Drafting of Corporate Charters and Bylaws." He was also co-author of a book—and I admire his courage for entitling it this—*Expulsion or Oppression of Business Associates: "Squeeze-Outs" in Small Enterprises.* Very few authors are that frank.

He is editor of the *Corporate Practice Commentator.* He is one of the leading authorities in the field of the closely held corporation. We are very privileged to have him give us two presentations, one this morning and one this afternoon. I think that he may speak a little more slowly than some of our previous speakers because of the fine Southern gentleman that he is, and we thought we would give our convention reporter a little break on that.