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Tax and Estate Planning Consequences of Farm Incorporation

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Tax and Estate Planning Consequences of Farm Incorporation

*By Frederic G. Emry**

THE DECISION whether to incorporate a farm or ranch business or whether to operate it as a sole proprietorship or partnership is one of primary concern to the farmer due to high tax structures under income, gift, and estate taxes. It is a decision which deserves thorough examination before either continuing the present form of business operation or changing it because the effects are likely to be substantial and semi-permanent. Furthermore, the initial form of business of the farm or ranch will most often have a substantial bearing on the outcome of future events, as results may unfortunately prove.

This article is designed to examine the major tax considerations in determining whether to incorporate a farm business. No general rules can be applied to all farmers. It is essential that each individual's farm or ranch business be analyzed separately. Some of the factors which must be considered are the farmer's goals in life, the size of his farm business, and the size of his family. To determine whether there are tax advantages in incorporating, the farmer must actually compute his income for the present year and project income and needs for future years to arrive at a rough estimate of what he will be paying in taxes if he conducts his business as a sole proprietorship or partnership, or as a corporation.[1]

I

FARMER'S OVER-ALL OBJECTIVES

To ascertain whether a farm corporation is advantageous, it is necessary to itemize generally the farmer's over-all objectives. Then, the farm cor-

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[1] It is intended that the term "farmer" and "farm" includes a rancher and his ranch, for the Internal Revenue Code definition of a farmer includes an individual, partnership, or a corporation which operates a farm for profit. Treas. Reg. §1.61–4(d). The term "farm" is further defined as including stock, dairy, poultry, fruit, truck farms, ranches, and all land used for farming operations. Treas. Reg. §1.61–4(d).

poration must be analyzed with these objectives in mind to see if farm incorporation will facilitate attainment of these goals.

In general, there are five basic long-range objectives for the farmer, namely:

1) To provide satisfactory support for his family.

2) To provide adequate retirement income for his wife and himself.

3) To provide opportunities for his children to join him in the farming business.

4) To arrange for an equitable distribution of his estate among his children.

5) To pass the farm business intact to the next generation with a minimum of estate and gift taxes.[2]

II

INCOME TAX LIABILITY CONSIDERATIONS

A. Differences in Tax Structure

Depending upon the farmer's circumstances, there is a possible tax advantage in farm incorporation due to the difference between income tax brackets for individuals and corporations. An individual pays income tax on a graduated scale. Thus, a high income is taxed at a higher rate than lower income. A corporation has an income tax rate of 22 per cent on the first $25,000 taxable income and a rate of 48 per cent on taxable income above $25,000.[3] Thus, a corporation would pay a tax at the rate of 22 per cent on $25,000 income, which is net income after deducting the business expenses of farming including salaries and bonuses to the stockholder-employees. On the other hand, an individual who has taxable income of $25,000 pays over 34 per cent of it to the Internal Revenue; and an individual with taxable income of $12,000 pays over 23 per cent of it to the Government.[4]

This difference in tax rates is important to the farmer for several reasons. First, farm income is often subject to sharp fluctuations so that the farmer will be forced to pay higher taxes in one year and lower taxes in other years if he is in a sole proprietorship or partnership, while under

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[2] Eckhardt, *The Farmer, Like Other Business Owners, Needs Expert Estate Planning Advice,* 15 J. TAXATION 294 (1961).

[3] INT. REV. CODE of 1954 §11.

[4] The current tax on $25,000 for an individual is $8,530 exclusive of any credits, and tax on $12,000 is $2,830. The tax would be slightly lower if joint or head of household returns were filed. INT. REV. CODE of 1954 §§1, 2.

the corporate form the farmer's income can be leveled out through salary, bonuses and other means.[5]

The second reason that a difference in tax rates may be important to the farmer is that he can conserve working capital by paying less tax. Generally, the farming business is one which needs a great deal of capital; and depending upon the farmer, a considerable portion of his earnings are usually plowed back for operating purposes, replacement of buildings and machinery, or for land acquisition. Through the use of the farm corporation, the farmer can retain in the corporation those earnings which he ordinarily uses in his business and which are subject to lower corporate rates. Otherwise, the farmer as a sole proprietor or partner will be paying income tax on all his income at a much higher rate even though he is going to use a considerable portion of it in his business for the following year. The net effect is that the farmer is saving taxes and conserving much needed working capital through the use of a corporation.[6] Unlike the sole proprietorship or the partnership in which the owner or partner pays a tax on all of the earnings, the corporation itself pays a tax on the farm business earnings and the farmer pays a tax on the salary he receives, with the salary deductible by the corporation.[7] It is important that each individual case be analyzed to determine the net tax effect, using as a possible basis income for the last five years and projecting income for the next five years.[8]

B. Double Tax Problem

One of the chief detriments to farm incorporation, as well as incorporation of any medium-sized business, is the higher over-all income tax liability due to so-called double taxation; that is, the corporation pays a tax on its earnings and the stockholder pays another tax on the same earnings when they are received as dividends. This result is based upon a conclusion that

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[5] It should be noted that farmers, like other individuals, can partially mitigate sharp fluctuations in income through use of the income-averaging provisions of Internal Revenue Code of 1954 §§1301–1305.

[6] *See* Jamison, *Tax Planning with Livestock and Farming Operations,* U. So. Cal. 1961 Tax Inst.

[7] Int. Rev. Code of 1954 §11, 162.

[8] It should be noted that there is a potential problem in retaining farm profits in the corporation due to the accumulated earnings penalty tax under Internal Revenue Code §531 et.seq. However, an agricultural corporation has an advantage over some other businesses in that the farm corporations may properly maintain reserves to protect against weather injury and instability of business conditions inherent in farming. Millane Nurseries & Tree Experts, Inc. v. Commissioner, 1 CCH T.C.M. 228 (1942); C. R. Burr & Company v. Commissioner, 9 P-H T.C.M. 54 (1940). Thus, the potential hazard of the accumulated earnings penalty tax is somewhat remote for farm corporations.

dividends will have to be paid by the farm corporation. Whether this is correct depends upon a number of factors and the particular case involved. Should a farmer want earnings out of his corporation, there are numerous ways for him to receive corporate profits without paying a double tax; that is, without having the payment in the form of dividends.

The most direct way of minimizing any adverse tax effects is through salary payments. The corporation receives a deduction for the salaries, unlike dividend payments. The amount of salaries that can be deducted by the farm corporation is limited to the extent that total compensation, whether in form of salary, bonus, or otherwise, is reasonable.[9]

A second possible way to receive profits not in the form of dividends is by leasing part of the necessary farm assets to the corporation. A great deal of flexibility can be obtained in leasing situations. Not only is there a choice as to what portion of the farming business may be leased to the corporation, but there also is a choice as to the particular assets that may be leased. If all the machinery and equipment and other farm business assets are transferred to the corporation except the land, the farm corporation would, in effect, be only an operating corporation. The rental payments made by the corporation to the farmer for the use of the land which is leased is a deductible expense.[10] As an alternative, it may be more desirable for a particular farmer to lease farm buildings and machinery to the corporation which holds the land.[11]

A third way for a farmer to obtain earnings from his corporation is

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[9] Treas. Reg. §1.162–9; Botany Worsted Mills v. United States, 278 U.S. 282 (1929). In determining the amount of compensation that is reasonable, form is important. The salary or bonus should not be in proportion to stock holdings. *See* Currier Farms, Inc. v. Commissioner, 7 CCH T.C.M. 677 (1948) and E. H. Meltler & Sons v. Commissioner, 8 CCH T.C.M. 329 (1949) wherein the court disallowed salary paid according to the compensation agreement. In Pacific Grains, Inc. v. Commissioner, T.C.M. 1967–7, a portion of a bonus was disallowed as a wage expense. In holding that part of the bonus was a dividend, the court stressed that there was no proof that the increase in compensation was reasonable.

[10] INT. REV. CODE of 1954 §162. The cases demonstrate the general rule that for a rental deduction there must be a valid rental agreement under which payments are fair and reasonable are actually made. LeMoyne v. Commissioner, 47 F.2d 539 (7th Cir. 1931); Spriesch Tool & Manufacturing Company v. Commissioner, 19 P-H T.C.M. 610 (1950); Limericks, Inc. v. Commissioner, 7 T.C. 1129 (1946) *aff.* 165 F.2d 483 (5th Cir. 1948); McKeever v. Eaton, 6 F.Supp. 697 (D.C. Conn. 1934).

[11] In the first situation where land is leased to the corporation, there is the advantage that the lands will receive a new fair market basis when they pass to the farmer's heirs on his death. Also, payment of any state excise transfer tax upon the transfer of land to the corporation may be avoided. On the other hand, where buildings and farm machinery are retained and leased by the farmer and the land is transferred, the farmer will be able to continue deducting depreciation and other expenses and take advantage of greater estate tax planning techniques. In the latter situation, personal holding company problems may arise.

through loaning money or property to the corporation and receiving back, in addition to principal, interest payments which are deductible by the corporation. Thus, the farmer upon initial incorporation has part stock and part debt obligations of the corporation in receipt for the transfer of property.[12]

A fourth way for an individual farmer to obtain earnings and profits from the corporation is through the use of the election provided in Subchapter S. This method of incorporation provides the advantage of doing business in a corporate form, but the shareholders pay the tax on all farm income as they would in conducting business as an individual or through a partnership.[13]

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[12] Recently the Internal Revenue Service has somewhat sought to reduce litigation on this problem of "thin corporation." Formerly, the Internal Revenue Service would not issue advance rulings on this question. In REV. PROC. 67-29, 1967 INT. REV. BULL. No. 29 at 28, it was announced that advance rulings will not ordinarily be issued on whether advances to thin corporations constitute loans or are equity investments. As indicated, the problem of thin corporation is one in which the loan to the corporation is to be considered as a loan with deductible interest being taken, or as really a contribution of capital with the interest payments thus being dividends. Some of the various factors to consider in this area are: (1) Excessive debt to equity ratio; (2) Unity of interest between the stockholders and creditors. (*See* Gooding Amusement Company, 23 T.C. 408 (1954), *aff.* 236 F.2d 159 (5th Cir. 1956), which held that the debt was actually equity investment where there was complete identity between the three noteholders and their control of the corporation.); (3) A valid business purpose for using debt financing (1432 Broadway Corporation v. Commissioner, 4 T.C. 1158 (1945) *aff.* per curiam 160 F.2d 885 (2d Cir. 1947); (4) A reasonable expectation of repayment regardless of the success of the venture as opposed to being placed at the risk of the business (Gilbert v. Commissioner, 248 F.2d 399 (2nd Cir. 1957)). *See* Hickman, *The Thin Corporation: Another Look at an Old Disease,* 44 Taxes 883 (1966). In this recent excellent article it was observed that two factors, the business purpose test and the debt to equity ratio, have not been too influential in the later cases. The factors of risk of business and funds for a core asset or an asset necessary to the business are very important. As suggested by the writer, the best safeguards against a possible attack by the Internal Revenue Service is to follow the normal formalities in setting up the debt, including a realistic plan for repayment which should be followed.

[13] INT. REV. CODE of 1954 §§1371-78. In electing Subchapter S provisions, the shareholders each year pay tax on all corporate income whether distributed or not and likewise take the annual corporate losses on their own income tax return. In view of the advantages and disadvantages of electing Subchapter S, there may be better ways to avoid the double tax. First, income from the farm operation has to be fairly low before the individual rates are lower than the corporate rate of 22 per cent. Secondly, there are certain disadvantages of electing Subchapter S. For instance, the leveling out of income otherwise provided by the corporate form is forfeited. The corporation also foregoes the advantages of using two or more classes of stock which may inhibit estate planning, income spreading, retention of control and the ability to hold stock in trust. *See* Hall, *Agricultural Corporations: Their Utility & Legality,* 17 OKLA. L. REV. 389 (1964). Apparently stock held for minors by a guardian or custodian does not disqualify the corporation from Subchapter S election on the ground that the shares of stock are now owned by an individual. T.I.R. No. 113 (Nov. 26 1958), 1959 P-H TAX SERVICE 1103.

C. Capitalization of the Farm Corporation

These methods of withdrawing corporate earnings without paying a double tax on dividends touches upon the possible variation of capitalizing a farm corporation. A farmer has the choice of transferring property to a corporation completely tax free, partially tax free or fully taxed.[14] If a transfer to the corporation is not taxed, the corporation takes the property with the same basis for depreciation and other purposes that it had prior to incorporation.[15] There may be more tax advantage by transferring some of the property tax free to the farm corporation and selling the remainder to it. In a sale to the corporation, the farmer pays, to the extent possible, a capital gains tax on the sale, which in turn allows the corporation to take a larger depreciation calculated on a new stepped-up basis for the property equivalent to the fair market value.[16] The farmer may find it advantageous to make a sale of all the farm business to the corporation. Two recent cases lend support to the farmer in being able to plan the best kind of transfer of business assets to the corporation in advance and carry out such transfer with reasonable assurance of its permanency.[17] If a taxable transfer is desired, the effects of Section 1239 of the Internal Revenue Code must be avoided to obtain as much capital gain as possible. (This

However, the use of Subchapter S will still enable the farmer to obtain the distinct advantages of qualified pension planning. If certain conditions do not exist, it also allows corporate capital gains to be passed through intact to the shareholders. The effects of the new 1966 provision, §1378, must be taken into consideration in determining the extent of the capital gain pass-through. Such a capital gains pass-through would be unsuccessful if a Subchapter S election were used to obtain benefits of a corporate loss pass-through. Section 1375(a)(1) cancels out any ordinary loss pass-through to extent of corporate long term capital gains which are included in Subchapter S calculations for taxable income.

It should be noted that a farm corporation which leases its lands will not lose Subchapter S status because of "rents" received under §1372(e)(5) if the corporation participates to a material degree, through agent or otherwise, in the physical work or management decisions, or a combination of both. Rev. Rul. 61-1112, 1961-1 CUM. BULL. 399.

[14] INT. REV. CODE of 1954 §351.

[15] INT. REV. CODE of 1954 §362. One of the conditions for a tax free transfer of property to the corporation is that the transferor must have 80 per cent control of the corporation immediately after the transfer. §351(a), §368(c). However, the transferor-farmer may then subsequently give away his stock or sell it to others without eliminating the tax free corporate transfer. Ethel Gary v. Commissioner, 18 B.T.A. 1204 (1940); W. M. Smith Electric Company v. Commissioner, 13 CCH T.C.M. 646 (1954).

[16] INT. REV. CODE of 1954 §§1245 and 1250 will prevent capital gains to the extent of depreciation recaptured.

[17] Murphy Logging Company et.al. v. United States, 67-1 U.S.T.C. 9491 (9th Cir. 1967) *rev.* 239 F.Supp. 794 (D.C. Ore. 1965); Wooley Equipment Company v. United States, 67-1 U.S.T.C. 9281 (D.C. Texas 1966).

section treats any capital gain as ordinary income in a sale of property to a corporation if the transferor owns more than 80 per cent of the value of the outstanding stock.[18])

III

ACCOUNTING METHOD CHANGES

Several possible tax advantages may result from accounting procedures possible through farm incorporation. The first of these is a different treatment of paying estimated tax. In addition to paying his tax as any other individual, the farmer has two special elections available to him. First, a farmer need file only one declaration of estimated tax and pay his estimated tax only once on January 15 of the succeeding year instead of quarterly.[19] The farmer has an additional choice of filing no declaration of estimated tax at all, but filing a return and paying his tax in full on or before February 15 of the succeeding year.[20] However, a calendar year corporation does not pay any tax until March 15 of the year following unless the total tax after adjustment for credit exceeds $100,000[21] and a corporation can elect to pay the tax in equal installments on March 15 and June 15.[22] Thus, a corporation can retain its funds longer, thereby obtaining a greater interest return.

A second tax accounting advantage in farm incorporation is that the farmer can select a new fiscal year for the corporation which will be more

[18] Although attribution rules apply to Internal Revenue Code of 1954 §1239(a), they are not as extensive as in other sections of the code. By its own terms, §1239(a) does not attribute ownership to adult children, and the courts have refused to apply it where a trust for minor children owns 20 per cent of the stock. *See* Mitchell v. C.I.R., 300 F.2d 533 (4th Cir. 1961); United States v. Rothenberg, 350 F.2d 319 (10th Cir. 1965). Section 1239 has not been applied where a trustee employee owned 20 per cent of the stock, even though the controlling shareholder had an option to repurchase the stock. Trotz v. Commissioner, 361 F.2d 927 (10th Cir. 1966). However, in United States v. Parker, 67-1 U.S.T.C. 9380 (5th Cir. 1967) *rev.* 65-2 U.S.T.C. 9491 (1965), the Fifth Circuit held that a stockholder who owned exactly 80 per cent in value of the outstanding stock still came within §1239 on the sale of depreciable property to his corporation because he held in value more than 80 per cent of the stock due to the restrictions placed on the minority interests.

[19] INT. REV. CODE of 1954 §§6073(b) and 6153(b) permit the calendar year farmer to file his declaration of estimated tax on January 15 of the succeeding year with payment in full of the estimated tax at that time. A return must be filed by him on or before April 15 of the succeeding year if those provisions are used.

[20] INT. REV. CODE of 1954 §6015(f). These provisions for filing by a farmer on a calendar year apply correspondingly to a fiscal year individual farmer.

[21] INT. REV. CODE of 1954 §6016(a).

[22] INT. REV. CODE of 1954 §§6152(b)(2), 6154(a). A similar method can be used for a fiscal year corporation.

beneficial for his over-all purposes.[23] A certain amount of year-end planning may be possible due to the farm corporation being on a different fiscal year than the farmer's calendar year. For example, an accrual basis corporation with its fiscal year ending November 31 could deduct the salary and bonuses accruing in that year but payable by February 15, which would place such salary and bonuses in the farmer's succeeding calendar year. Similarly, a cash basis corporation with a fiscal year ending February could pay salary and bonuses in January or February to the farmer who would not report such income until the succeeding calendar year.[24] In the former example the corporation takes a deduction when the salary and bonuses accrue, and in the latter situation the corporation takes a deduction when the salary and bonuses are paid.

By changing the accounting method of farming, the farmer may obtain a third major accounting tax benefit depending upon his present method and situation, since a new choice of accounting is available for the farmer without prior approval of the Commissioner of Internal Revenue.[25] Thus, the new corporation has a choice when filing its first return of the cash, accrual or any acceptable method which clearly reflects income.[26] However, if a farm corporation is not being formed and the farmer desires a change of accounting method, he must first obtain the consent of the Commissioner of Internal Revenue.[27]

Unlike many other industries, the farm corporation may select the cash method of accounting even though inventories are an important income-producing factor.[28] Many farmers prefer the cash basis method due to simplified book and record keeping, to partial control over taxable in-

23 INT. REV. CODE of 1954 §441; Treas. Reg. §1.441-1(b)(3) permits a new taxpayer in its return to adopt any taxable year without obtaining prior approval.

24 INT. REV. CODE of 1954 §267 will disallow salary, bonuses and other expenses deducted by an accrual basis corporation which are not paid to certain stockholders within two and one-half months after the close of the corporation's fiscal year.

25 INT. REV. CODE of 1954 §446; Treas. Reg. §1.446-1(e)(1).

26 INT. REV. CODE of 1954 §446(c); Treas. Reg. §1.446-1.

27 INT. REV. CODE of 1954 §446(e). In one instance the procedure to obtain the Commissioner's prior consent to change accounting methods has been somewhat simplified. Recently it was announced in the REV. PROC. 67-10, 1967 INT. REV. BULL. No. 9 at 123, that for purposes only of a change from cash to accrual method, form 3115 may be filed with the District Director within ninety days of the taxable year of change, and unless notification is received from the District Director denying permission, consent may be assumed to have been given.

28 1967 FARMERS' TAX GUIDE 24. Farmers are allowed to use the cash method of accounting even though Treasury Regulation §1.446-1(c)(2)(i) states that in any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales.

come by deferring or accelerating the payment of bills and sales of farm products, or to the assurance of obtaining long term capital gain for the sale of livestock raised for draft, breeding or dairy purposes.[29] Under the cash basis method, livestock held more than twelve months for draft, breeding or dairy purposes is eligible for a capital gain when sold and all expenses of purchasing or raising such animals are deductible yearly as ordinary expenses.[30] The term "livestock" includes cattle, horses, hogs, mules, donkeys, sheep, goats, fur bearing animals and mink. It does not include chickens, turkeys, pigeons, geese, fish, frogs, reptiles and race horses held for racing.[31] Thus, farmers who raise and sell draft, breeding and dairy animals are converting ordinary income into capital gains.

The accrual method of accounting may be chosen to keep income from fluctuating and to a limited extent to permit expenses to be deducted without paying out cash prior to the deduction.[32] Also, long term capital gains for livestock raised for draft, breeding and dairy purposes can be obtained under the accrual method of accounting if certain inventory methods are chosen and the rules for segregating the inventory herd from the livestock raised for draft, breeding and dairy purposes are strictly kept.

Under the accrual method of accounting the farm corporation has the selection of valuing inventories in one of the following ways:

1) Cost.[33]

2) Lower of cost or market.[34]

3) Farm price method, which values farm products including livestock at market value less direct selling and transportation cost.[35]

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[29] Miller, *Why Farmers Use The Cash Basis,* 12 J. TAXATION 122 (1960); *Tax Planning For Capital Gains in Livestock Operations,* THE MONTHLY DIGEST OF TAX ARTICLES (Jan. 1967, Col. L. Rev.).

[30] INT. REV. CODE of 1954 §1231(b)(3) includes livestock within §1231(b) definition of property used in the trade or business, which makes it eligible for long term capital gains. Section 1245(a)(3) prevents the normal depreciation recapture rules from applying to livestock. The §1245 recapture rules treat gain on the sale of depreciable property as ordinary income to the extent of prior depreciation taken. The combination of these two sections result in almost the full sale price of livestock qualifying for capital gain. Livestock that is raised has no basis, as the cost of raising such livestock is deductible yearly as a current expense. For livestock purchased, there is a basis for depreciation which is deductible down to salvage value. Thus, on livestock raised there is no adjusted basis at time of sale and the adjusted basis for livestock purchased can be quite low. *See* Johnston v. United States, 181 F.Supp. 887 (D.C. Ala. 1960); Koelling v. United States, 171 F.Supp. 214 (D.C. Neb. 1951). The Treasury has issued guidelines for the useful life in depreciating purchased livestock. Rev. Proc. 62-21, 1962, 2 CUM. BULL. 418.

[31] R. I. A., TAX COORDINATOR N-1203.

[32] O'Bryne, FARM INCOME TAX MANUAL 800 (3rd ed. 1964).

[33] Treas. Reg. §1.471-2(c).

[34] *Id.*

[35] Treas. Reg. §§1.471-4(a), 1.471-6(b).

4) Unit-livestock method, which consists of valuing different classes of animals at a constant unit price for each animal within the class. The prices selected theoretically approximate the cost of raising the animal to the class at which it is inventoried.[36]

These various inventory methods have a major importance among farmers in the livestock business.[37]

Gain from the sale of livestock held for breeding, drafting and dairy purposes which are included *in inventory* will generally be only ordinary income.[38]

However, the Internal Revenue Service, with one limitation, has long recognized that an accrual basis farmer at the time he begins operations either for a new farm or as a new corporation may elect whether or not to include draft, breeding and dairy animals in inventory. If the farmer or farm corporation does not so include these animals under a selected inventory method, the draft, breeding and dairy animals would receive the same treatment as held by a cash basis rancher.[39] This means generally that the accrual basis farmer can obtain the same advantages concerning draft, breeding and dairy animals as a cash basis farmer if he so elects at the outset and keeps good records. The one limitation to this is that if the unit-livestock inventory method is used rather than the other inventory methods, such price method must be used on all livestock *raised*, whether for sale or breeding.[40] Thus, under the unit-livestock inventory method, the farmer can elect only to capitalize *purchased* draft, breeding and dairy animals, and will receive capital gains treatment only for such purchased draft, breeding and dairy animals.[41]

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[36] Treas. Reg. §§1.471-6(e), 1.471-3(d).

[37] Farmers growing crops generally do not inventory their crops for the practical reason that it is almost impossible to determine the value and amount of such crops with any degree of accuracy; however, a farmer growing crops can elect with the consent of the Commissioner to use the farm crop method provided for by Treasury Regulation §§1.161-4, 1.162-12. *See* O'Bryne, FARM INCOME TAX MANUAL §114 (3rd ed. 1964).

[38] There is capital gain for livestock held for breeding, drafting and dairy purposes which are included in inventory only to the extent that the sales price exceeds the last inventory valuation which constitutes their basis, and the last inventory valuation will generally approximate their selling price. *See* O'Bryne, *Inventory Methods,* 24 J. TAXATION 376 (1966).

[39] O'Bryne, FARM TAX MANUAL §120 (3rd ed. 1964); O'Bryne, *Inventory Methods,* 24 J. TAXATION 376 (1966); 1967 CCH FEDERAL TAX REPORTER ¶2946.017.

[40] Treas. Reg. §1.471-6(f). Thus, it is mandatory for the accural basis farmer using the unit-livestock method to place in inventory all draft, breeding and dairy animals that are raised.

[41] In United States v. Catto, 86 S.Ct. 1311 (1966), the United States Supreme Court upheld Treasury Regulation §1.471-6(f) regarding unit livestock accounting method and held that if a farmer elected to use the unit livestock price method it applied to all livestock *raised,* whether held for sale or for draft, breeding, or dairy purposes. This ended a conflict

Under the other methods of inventorying, including the farm price method, the accrual basis farmer can elect to treat both purchased and raised draft, breeding and dairy animals in the same manner as a cash basis farmer with the same result. The election upon the part of the accrual basis farmer to capitalize or inventory breeding animals must presumably be made at the time the farmer has a breeding animal that could be included in inventory or excluded therefrom. The election applies to all subsequent animals (at least all animals in a continuing herd) and cannot be changed without permission from the Commissioner of Internal Revenue.[42]

The various types of depreciation methods allowed for all kinds of depreciable property are available to the farmer for depreciating his livestock.[43] Also, the additional first year depreciation provided by Section 179 of the Internal Revenue Code is likewise available to the farmer.

Each accounting method contains advantages and disadvantages for the farmer, depending upon his particular situation. Whichever method is finally chosen, it is important to note that upon incorporation a farmer has this selection of a new or different accounting method. Each method should be explored thoroughly prior to selection, and the one which is finally adopted should be carefully implemented.

IV

POSSIBLE INCOME SHIFTING

There are generally three areas for shifting of income to reduce the overall income tax burden which are possible through farm incorporation. These areas are year-end planning, allocation of income and expenses on incorporation, and the spreading of income among family members.

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among the Circuit Courts. In addition, the Supreme Court questioned generally the capitalizing of breeding animals under any system of accounting because under general accounting principles expenses incurred in raising breeding livestock should be capitalized. Thus, the door is left open for the Treasury. *See* 24 J. TAXATION 376 (1966), *supra* note 39.

[42] 24 J. TAXATION 376 (1966), *supra* note 39. At least for the unit livestock basis farmer this is so, according to Revenue Ruling 60-60, 1960-1 CUM. BULL. 190, wherein it was stated that, under the unit livestock price method of inventory, the farmer elects to capitalize or inventory *purchased* livestock for breeding, draft or dairy purposes, and thereafter his election is binding for all animals and for all subsequent use. In United States v. Wardlaw, 344 F.2d 225 (5th Cir. 1965) it was held that the election to inventory or capitalize draft, breeding or dairy animals applies not to each individual animal but to the herd as a whole.

[43] Treas. Reg. §1.167(b)-2. However, Revenue Ruling 56-256, 1956-1 CUM. BULL. 129 stated that the double declining balance method of depreciating bulls would be taken away upon a nontaxable incorporation situation because the necessary "original use" would not begin with the new corporate taxpayer.

Year-end tax planning is possible on farm incorporation due to the fact that the farm corporation and the individual farmer may have different taxable years.[44]

Secondly, it may be possible to shift income and expenses in the year of incorporation. Income from unharvested crops or livestock may be shifted to the farm corporation by the individual farmer; and, at the same time the individual farmer may retain some expense deductions related to the income which has been shifted.[45]

Lastly, the farm corporation facilitates spreading of income among members of the family, which can be advantageous in reducing income tax payments. As a sole proprietor, the farmer can spread income among his children and other family members only through the payment of wages or actually giving fractional interests in land, buildings or machinery.[46] In a farm partnership, the farmer can spread the income to other members of his family only by payment of reasonable wages or giving a part interest in the partnership.[47] Under the corporate form, however, since members of the family could be given non-voting common or non-voting preferred stock in the farm corporation, the farmer can give over half of the value of the farm corporation to his family without losing control by retaining all the voting stock. No specific farm asset is involved and the farm is kept as a unit with little disruption in the business.

Spreading of farm income among the members of the family can also be accomplished through electing Subchapter S for the farm corporation. The farmer can give stock to the children and elect Subchapter S with the result that the corporation will not be taxed on any farm income and vari-

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[44] *See* text accompanying note 23 *supra* for a discussion of how the farm corporation can shift income to the stockholders in one year or the next depending on the extent of expenditures for that year or the estimated income for the following year.

[45] C.I.R. v. South Lake Farms, 324 F.2d 837 (9th Cir. 1963) wherein the value of an unharvested cotton crop was not included in income of the selling corporation. In Thomas W. Briggs v. Commissioner, 15 CCH T.C.M. 440 (1956) a sole proprietor was not charged with income on a receivables transfer to a corporation. However, in Rooney v. United States, 305 F.2d 681 (9th Cir. 1962) the production costs applicable to an unharvested crop were not deductible by the farmer where the land and unharvested crops were transferred to a controlled corporation in a nontaxable exchange under §351. In the latter case, the Internal Revenue did not try to allocate income to the transferor under §482 which provides the Commissioner with broad authority to reallocate expenses or income among businesses to clearly reflect income.

[46] The wages paid to members of the family must be reasonable, ordinary and necessary to be deductible. Rev. Rul. 59-110, 1959-1 CUM. BULL. 45.

[47] INT. REV. CODE of 1954 §704(e). Under the Uniform Partnership Act a partner has the right to the specific partnership property and on termination of the partnership by death or otherwise may divide up the farm as a unit and possibly disrupt the business.

ous shareholders in the corporation will be taxed on farm income to the extent of their percentage ownership in the farm corporation.[48] The decision to elect Subchapter S provisions should be decided by the farmer prior to incorporation since the farm corporation can have only one class of stock if Subchapter S is used.[49] Again, each farmer's situation must be analyzed separately to determine whether use of one or two classes of stock would be more advantageous for his family and himself.

V

STOCKHOLDER-EMPLOYEE BENEFITS

If the farm business is incorporated, the farmer has a number of new benefits which can save taxes and conserve liquidity which are available because the farmer has cast himself in the role of an employee for his farm corporation, the employer. Generally, the advantages may be classified into three areas: fringe benefits, whereby the employee is never taxed; Section 401 qualified deferred compensation benefits; and nonqualified retirement salary continuation or compensation deferral contracts. The availability of deferred compensation plans is the major tax benefit arising from this shareholder-employee relationship.

A. Non-taxable Fringe Benefits

Among the fringe benefits employees receive tax free are group health and accident insurance, group term life insurance, and meals and lodging.

Under farm corporation-financed accident and health plans, the stockholder-employee is able to receive a number of benefits tax free. He may receive reimbursement for medical care and expenses incurred not only by himself, but also by his spouse or dependents.[50] An employee may also receive payments from the corporation for permanent injury or loss of bodily function free from income tax.[51] The farm corporation may also have a health and accident plan for its employees which include payments

[48] INT. REV. CODE of 1954 §1371–1378. These sections permit a domestic corporation with ten or less individual shareholders to elect with the consent of all its shareholders not to be taxed on its income. Thus, the corporation's income is taxed to the shareholders at the close of the corporation's taxable year whether or not the income has been distributed.

[49] INT. REV. CODE of 1954 §1371(a)(4). *See* note 13 *supra*.

[50] INT. REV. CODE of 1954 §105(a), (b). There is no limitation on the amount of reimbursement that can be deducted and such amounts may be deducted in the year received even though the farmer or his family does not actually pay the medical expenses in that year. Treas. Reg. §1.105-2.

[51] INT. REV. CODE of 1954 §105(c). Like the medical expenses, these payments for permanent injury include injury to wife and family.

for loss of wages or in lieu of wages as a result of injury or sickness.[52] Payments up to $100 a week to the employee while absent from work because of such personal injury or sickness are received tax free.[53] This type of plan is especially important to the farmer due to the hazards of his work and the need to be on the job at various critical times of the year. The corporation's contribution to the health and accident insurance plans is deductible.[54] Thus, the stockholder-employee receives a double benefit in that he is not paying for the plan with his own after-tax dollars and the cost can be less than if he individually purchased the plan.

The farm corporation can also purchase group term life insurance with the cost of such insurance being deductible.[55] The employee need not include in his income the cost of $50,000 of group-term life insurance paid by the farm corporation,[56] and the insurance proceeds received by reason of the death of the employee are excluded from gross income.[57]

A final tax-free fringe benefit available to employees consists of meals and lodging. Such meals and lodging furnished by the corporation on its premises and for its convenience are not income to the farmer-employee and are deductible by the corporation.[58]

B. Qualified Deferred Compensation Plans

Qualified deferred compensation plans under Section 401 include regular pension plans, profit sharing plans, stock bonus plans and annuity plans.[59] Stock bonus plans have almost no practical application to farm corporations since stockholders of a farm corporation are generally closely-held corporations. Annuity plans are similar to regular pension plans and will

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[52] INT. REV. CODE of 1954 §105(d).

[53] *Id.* There is a thirty-day or seven-day waiting period before this exclusion applies depending upon whether or not the employee receives in sick pay more than 75 per cent of his weekly wages. If payments received are 75 per cent or less, the waiting period is seven days.

[54] INT. REV. CODE of 1954 §106, Treas. Reg. §1.162-10.

[55] INT. REV. CODE of 1954 §§162, 264.

[56] INT. REV. CODE of 1954 §79.

[57] INT. REV. CODE of 1954 §101(a). Similarly, a death benefit up to $5,000 paid by the farm corporation to a beneficiary or the estate of any employee is excluded from income. INT. REV. CODE of 1954 §101(b). However, the Internal Revenue Service might raise the issue that such a payment to beneficiaries on the life of a stockholder employee constitutes a dividend distribution. Ducros v. Commissioner, 272 F.2d 49 (6th Cir. 1959); Rev. Rul. 61-134, 1961-2 CUM. BULL. 250.

[58] INT. REV. CODE of 1954 §§119, 162. Section 119 also requires the furnishing of lodging to be a condition of employment. A recent District Court decision has held that the meals and lodging furnished by the farm corporation to its two controlling stockholders were deductible expenses even though the corporation elected Subchapter S provisions. Wilhelm v. United States, 66-2 U.S.T.C. 9637 (D.C. Wyo. 1966).

[59] INT. REV. CODE of 1954 §401(a).

be discussed under that heading. Thus, only regular pension plans and profit sharing plans under Section 401 will be discussed below.

Basically, a qualified pension plan provides for definitely determinable or fixed benefits upon retirement for the employees participating in the pension plan. Each year the corporation contributes an amount actuarially necessary to provide for these benefits upon retirement. The amounts contributed by the corporation are not geared to profits of the corporation. The pension plan may provide for a certain amount of preretirement death benefits to be funded through the purchase of life insurance or otherwise. In addition, payment of a pension due to disability may be provided. A pension plan may also provide for a certain amount of sickness, accident, hospitalization and medical benefits to retired employees and their dependents.[60]

On the other hand, a profit sharing plan is based upon profits of the farm corporation in that contributions by the farm corporation to the trust are dependent on yearly profits. Contributions do not have to be made each year, but must be recurring and substantial and cannot be single or occasional.[61] In addition, varying amounts of profits may be contributed to the trust up to fifteen per cent of the total compensation paid in a year[62] and no fixed formula for contributions is required.[63] A profit sharing plan may provide for distribution of the funds after a stated number of years, at a certain age, upon retirement, death, or disability.[64] In addition, a profit sharing plan may provide for the same incidental benefits as a pension plan, such as pre-retirement death benefits, disability payments, sickness, accident, and health plans.[65]

All qualified pension plans, whether regular pension plans, annuity plans, profit sharing plans or stock bonus plans, have certain general characteristics and tax advantages.[66] The farm corporation contributes amounts, generally in annual payments, to a trust for future benefit of its employees, including stockholder-employees, for which it obtains an immediate deduction for income tax purposes.[67] The employee does not include

[60] Rev. Rul. 65-178, 1965-2 CUM. BULL. 94 at 105-7.

[61] *Id.* at 101.

[62] INT. REV. CODE of 1954 §404(a)(3). If there are excess contributions made to a trust in a year, §404(a)(3) provides that the excess may be deducted in the succeeding years.

[63] Rev. Rul. 65-178, 1965-2 CUM. BULL. 94 at 101.

[64] *Id.* at 99.

[65] *Id.* at 105.

[66] One main characteristic of all qualified plans is that the contributions or benefits must not discriminate in favor of employees who are officers, shareholders, supervisors or highly compensated employees. INT. REV. CODE of 1954 §401(a)(4).

[67] INT. REV. CODE of 1954 §§401(a), 404(a).

the amounts set aside for him in the trust in his income.[68] The trust is not taxed on the income earned during the years it invests the contribution.[69] Thus, future benefits for the employee increase faster than if he were to invest the same amount. When the employee dies or separates from the employer's service, the benefits from the qualified pension plans contributed by the employer are taxed at capital gains rates if paid within one year in a lump sum.[70] If paid out in monthly income, the benefits are taxed to the employee at ordinary rates but at a time when his income is generally lower due to retirement and at a time he is eligible for more $600 tax exemptions and retirement income credit.[71] In either event, the earnings of the farm have been converted from ordinary income into capital gains, or, will be taxed to the employee at lower rates. In addition, amounts paid from a qualified pension or profit sharing plan to designated beneficiaries other than decedent's estate escape estate tax since they are not included in decedent's gross estate to the extent they are attributable to employer's contributions and have not been made available to decedent employee during his lifetime.[72]

As can be seen, great flexibility is created by the use of qualified pension plans or profit sharing. Depending on the circumstances of the farmer, he can retire and in one year obtain long term capital gains accumulated out of ordinary income, or he can receive a monthly income for the rest of his life or his wife's life. Finally, he can choose to continue working, if in good health, and substantially reduce his estate tax.[73] Long term capital gains and lump sum distribution might be desirable if the farmer has other income sufficient to live on. In any event, liquidity is provided for the farmer through the use of a qualified pension plan as well as the ability to withdraw substantial sums from the corporation without paying a double tax in the form of dividends.[74]

Also of importance is the fact that funds contributed to the trust can be at the disposal of the corporation, since the corporation can use the

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68 INT. REV. CODE of 1954 §402(a).

69 INT. REV. CODE of 1954 §501(a).

70 INT. REV. CODE of 1954 §402(a)(2).

71 INT. REV. CODE of 1954 §§151(c), 37.

72 INT. REV. CODE of 1954 §2039(c).

73 A qualified pension plan can provide that an employee does not have the right to receive funds until retirement. In such a case, if the employee chooses to work until death §2039(c) applies to exempt from estate tax the amounts paid from a qualified pension or profit sharing plan.

74 Since the corporation is able to deduct under §404 the contributions made to the qualified plan, the corporate earnings paid into the plan are never taxed at the corporate level.

funds in the trust through borrowing, if the loan has a reasonable rate of interest and is backed by adequate security.[75]

It should be noted that a corporation which elects Subchapter S provisions can use the qualified pension or profit sharing plans that are available to ordinary corporations.[76]

The decision to adopt a pension plan or profit sharing plan should be made only after careful consideration of the circumstances of the particular farm and with a thorough understanding of the differences between the two plans,[77] for once adopted the plan cannot be terminated except in certain limited situations.[78]

The extent of income-tax saving through the use of a qualified pension or profit sharing plan depends upon the particular plan and the circumstances of the farmer. As an example of the savings possible through a qualified profit sharing plan, assume there are two controlling stockholders in a farm corporation, a father and adult son.[79] Assume further than they draw salaries of $30,000 each and eight other employees on the farm are paid $5,000 a year. With these assumptions, the farm corporation could deduct up to $15,000 each year and contribute that amount to the trust. Of this $15,000, $9,000 could be allocated in the trust for the benefit of the two stockholder-employees. Because of taxes, the net cost of the plan would be approximately $7,500 yearly, and yet the farmer and his son are receiving $9,000 a year allocated specifically to them in the trust. If these contributions were made annually over twenty years and invested at a return of five per cent, the father and the son would each have on hand $150,000 which they could use as monthly retirement income, turn into capital gains, or use for estate planning without estate tax liability. On

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[75] INT. REV. CODE of 1954 §503(c)(1).

[76] Rev. Rul. 66–218, 1966 Int. Rev. Bull. No. 32 at 23.

[77] *See* Ridley, *Employee Benefit Plans for Close Corporations,* 45 TAXES 188 (March, 1967). A qualified pension plan is generally not suitable for a small farm business because the required yearly contributions are fixed in amount or at least capable of actuarial calculation. The corporate contributions under a qualified pension plan are in essence an obligation that must be met each year regardless of profits. Larger farms may have a sufficiently established cash flow in reserve to meet the funding requirements.

[78] One of the requirements to qualify for the special tax treatment of pension and profit sharing plans is that they be established with the intent of being a permanent program. Rev. Rul. 65–178, 1965–2 CUM. BULL. 94 at 101. An employer may reserve the right to discontinue contributions or terminate the plan, and in fact do so when there exists valid business reasons such as insolvency or a sale of the business. *See* speech by Isidore Goodman, *Permanency as a Requisite of Tax Qualified Pension and Profit Sharing Plans,* Nov. 15, 1960, reported in 2 CCH PENSION PLAN GUIDE §26901.

[79] This example is from Homer *Profit Sharing Plans,* 45 ILL. B.J. 884 (1966) as reported in THE MONTHLY DIGEST OF TAX ARTICLES (Jan. 1967) at 58.

the other hand, if the father and son stockholders each received a bonus of $4,500 each year, at the end of twenty years' investment at a five per cent return each would have $37,500 less than the $150,000 possible through the qualified profit sharing trust on the same terms. The reason for this is that each stockholder receiving a $4,500 yearly bonus would have only approximately $2,800 to invest after paying income tax, assuming he has a wife, two children, files a joint return and takes the standard deduction. Thus, a savings of $75,000 is possible for the two stockholders through the use of a qualified profit sharing plan.

Many variations are possible to tailor the qualified pension or profit sharing plan to the particular farm corporation and stockholder's family. For example, provisions can be made for voluntary contributions by the participants to the plan,[80] or the qualified pension or profit sharing plan may exclude all employees who earn less than $6,600 annually.[81] In the second instance, the maximum amount that can be contributed by the farm corporation for a participant in any one year is 9⅜ per cent of compensation rather than 15 per cent.[82] A qualified pension plan may provide for incidental life insurance protection for each participant, which can be particularly important due to the general liquidity shortage and cash needs of most farm estates.[83] A qualified pension or profit sharing trust can purchase life insurance on the lives of the corporation's key employees. More insurance can be purchased by the trust for less cost due to purchasing with non-tax dollars,[84] and, when the shareholder-employee or other key employees die, the trust will receive the insurance proceeds free from income tax and distribute the allocated portion to the beneficiaries in accordance with the trust provisions.[85] Thus, large amounts of necessary cash can be provided at a reduced cost.

A qualified pension or profit sharing plan can provide greater tax sav-

[80] Rev. Rul. 65-178, 1965-2 CUM. BULL. 94 at 114. The shareholder-employees may place into trust each year up to 10 per cent of their compensation and they are not taxed each year on the income earned on their contribution while it is in the trust. INT. REV. CODE of 1954 §501(a).

[81] Goodman, *Integration with Social Security*, CCH PENSION & PROFIT SHARING SERVICE ¶1081 (1960).

[82] *Id.*

[83] Rev. Rul. 65-178, 1965-2 CUM. BULL. 94 at 106. Life insurance is considered incidental if there is no more than $1,000 worth of life insurance for each $10 monthly retirement payment. For a qualified profit sharing plan, life insurance protection is incidental if the life insurance premium paid for each participant is less than one-half of the contribution made by the corporation to the trust for a participant. *Id.* at 10.

[84] Laurence, *Pensions to Solve Business Problems*, J. AMERICAN SOCIETY OF CHARTERED LIFE UNDERWRITERS (Jan. 1967).

[85] *Id.* at 57.

ings and more advantages to the farmer and his family than an individual self-employed retirement plan, commonly known as H.R. 10 (The Keough Act).[86]

C. Nonqualified Deferred Compensation Plans

The last general classification of fringe benefits available to the farm corporation stockholder employee is the nonqualified deferred compensation, retirement or salary continuation plans. So much has been said and written about the tax advantages of qualified pension and profit sharing plans that the nonqualified plans and deferred compensation agreements are often overlooked. While a qualified pension or profit sharing plan may benefit younger stockholder-employees, the older farmer who is approaching retirement age may not have enough years of service ahead to benefit substantially from such a plan and his years of service as a sole proprietor or partner prior to incorporation cannot be used to meet the minimum service requirement.[87] A nonqualified or deferred compensation contract may better meet his needs. In a nonqualified pension plan or a deferred compensation contract there are no requirements against discrimination and no requisites for coverage.[88] Thus, the agreement may benefit only one employee in any amount of coverage if the ordinary and necessary business expense rules are met.[89]

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[86] Effective for the taxable years beginning in January, 1968, the provisions of the self employed retirement plan (INT. REV. CODE of 1954 §§401(a)(9), 401(c), (d) & (e)) have been liberalized to permit a reduction for contribution to the trust for each owner-employee up to 10 per cent of earned income or $3,500, whichever is less, and in addition, earned income will be taken into account in full even when capital and personal services are material income-producing factors. P.L. 89–809, 3 CCH 1967 FEDERAL TAX REPORTER ¶2613. However, there are still many serious drawbacks; first, penalties are imposed upon excess contributions for owner-employees instead of the carry-over provisions of the corporate qualified pension and profit sharing plans discussed above. §401(e). Secondly, distributions are not to be made to owner-employee before age sixty except in case of prior disabilities, or penalties will attach. §401(d)(4). Third, distributions to owner-employees must begin at age seventy which in many cases prevents the escape of estate tax now possible under corporate plans. §401(a)(9). Fourth, lower benefits to owner-employees are required to be used if the plan is integrated with Social Security. Fifth, a qualified profit sharing plan must contain a predetermined formula for contributions on behalf of owner-employees. §401(d)(2). Sixth, no loans may be made by the trust to the owner-employee or any property sold to the trust by the owner-employee. §503(j). Seventh, no long-term capital gain is available to the self employed upon distribution from the plan. §402(a)(2). Furthermore, the self employed is denied the gift tax exclusion, the sick pay provisions of §105, and the $5,000 death benefit exclusion permitted by §101(b). *See* Graych, *Tax Qualified Retirement Plans for Professional Practitioners: A Comparison of the Self-Employed Individuals Tax Retirement Act of 1962 and the Professional Association,* 63 COL. L. REV. 415 (1963).

[87] Eckhardt, *Family Farm Corporation,* 1960 WIS. L. REV. 649 (1960).

[88] Goodman, *Nonqualified Plans of Deferred Compensation,* 45 TAXES 48 (Jan. 1967).

[89] *Id.* at 50.

Non qualified deferred compensation plans are either nonforfeitable plans or deferred compensation agreements. A nonforfeitable plan is one under which contributions are made by the corporation to an irrevocable trust and stockholder-employee's rights to the funds become nonforfeitable at the time of corporate contribution, or, one under which a deferred annuity contract is purchased for the shareholder-employee.[90] Under both nonforfeitable plans, the corporation receives a deduction for the contribution at the time it is made regardless of the corporation's cash or accrual method of accounting and the employee is taxed on the contribution in the year it is made to the non-exempt trust or the nonqualified annuity plan.[91] This immediate taxation of the employee limits the usefulness of this type of nonqualified pension plan.

Under a deferred compensation agreement, the farm corporation promises to pay a stockholder-employee a stipulated sum after retirement for a specified period or for life, or to pay his widow in the event of death prior to or during retirement.[92] Funds are neither paid into a trust nor set aside,[93] although life insurance may be used to fund the obligation.[94] The corporation deducts the deferred compensation payments in the year actually paid to the stockholder-employee, and the employee includes them in his income at that time.[95]

VI

LIFETIME AND ESTATE PLANNING

The importance of proper estate planning for the farmer cannot be overemphasized. Every one of the farmer's five basic lifetime objectives out-

[90] *Id.* 51.

[91] INT. REV. CODE of 1954 §404(a)(5). If the contribution is made to a trust or an annuity plan in a year in which an employee does not have a nonforfeitable right to payment, then no deduction is ever allowed to the corporation for such contribution. Treas. Reg. §1.404(a)-12. This regulation was recently held invalid by the Court of Claims in Buttrey Stores, Inc. v. Commissioner, 67-1 U.S.T.C. 9371 (1967). The Court of Claims held in that case that an employer's contribution to a forceable, nonqualified, deferred compensation plan would be deductible when an employee actually receives payment under the plan, if the employee had nonforfeitable rights at the time of payment.

[92] INT. REV. CODE of 1954 §§402(b), 403(c).

[93] TAXES (Jan. 1967), *supra* note 88 at 58.

[94] Simmons, *Federal Taxation of Life Insurance*, 139 (1966). Life insurance policies will provide funds to pay the promised additional compensation in case of death prior to retirement, and also conversion, surrender, or settlement options will provide funds to meet the retirement benefits.

[95] Rev. Rul. 60-31, 1960-1 CUM. BULL. 174. This ruling sets forth guidelines in establishing deferred compensation agreements. Two main types of deferred compensation agreements are the use of bookkeeping reserves and a conditional promised participation to the stockholder-employee in the corporation's annual net earnings. The employee has no vested interest or rights to immediate payments under a deferred compensation agreement.

lined above is aligned to a material degree with estate planning. To summarize, the farmer places upon himself the obligation to adequately support his family. This includes proper planning in case of untimely death prior to retirement and providing adequate retirement income for his wife with or without his presence. Historically, farms have been handed down and enlarged (if possible) from one generation to the next. The very nature of the business lends itself to such transfers, and these transfers provide satisfying rewards for the farmer. An estate tax taking 20 to 30 per cent or more of the farm assets as the land and property are transferred on each death will soon leave the family without a farm of any appreciable size. Not only is the farmer faced with the problem of passing the farm to his children without sizeable shrinkage due to estate taxes, but also passing it with minimum disruption in the farming enterprise while keeping it intact in one farming unit. In addition, most farmers desire to distribute the farm as evenly as possible among their children considering the different abilities and vocations of the children. To do all of this successfully is at best a difficult task; but the chances of success are far better if a farm corporation is used, since incorporation of the farm business provides the necessary framework for proper estate planning.

The capital structure of the corporation will have its effect upon the kind of eventual estate plan for the particular farmer.[96] The use of pension or profit sharing plans, unfunded or funded with life insurance, together with sickness, accident and health insurance plans discussed above play a formative part in providing liquidity and obtaining other farm objectives.

Developing an estate plan for a corporate farmer will be discussed in relation to (a) the problem of passing the farm land and business to the next generation; (b) minimizing the estate tax; (c) providing for farm liquidity, and (d) the effect of the corporate entity on Social Security benefits.

A. Passing Farm Land to Succeeding Generations

The farm corporation greatly facilitates conveyance of farm land to succeeding generations. With the farm corporation owning the land, equipment and livestock, and with stock now representing the value of the corporation, a number of possibilities arise if there are voting and non-voting classes of stock. The farmer may attract his sons to the business without losing control or endangering the efficiency of the farming unit. If voting

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[96] For instance, whether one class of stock is to be used with Subchapter S election, or two classes of stock, plays a determinate role.

and non-voting stock are of equal value, the farmer may give in excess of 50 per cent of the equity in the corporation to his sons without losing control or breaking up the integrity of the operating unit.[97] There will be no allocation of expenses as would result when varying amounts of livestock and realty are owned by different persons (as in a partnership). And the sons will be owners, not merely employees as they would be under a sole proprietorship, which concerns the farmer today because of the number of young people leaving the farm.

The farmer may transfer stock in the farm corporation to equalize amounts given to his children. For example, if one son decides to go to college and another seeks employment, the latter can receive additional shares to compensate for the expenses of the college education given to the other child.[98] Likewise, in the event children decide not to remain in the farm business, stock can be repurchased by the corporation or sold to other members of the family. This can be accomplished without dissolution of the farm enterprise as might occur in a partnership or sole proprietorship arrangement.

The farm corporation and its stockholders should have a restrictive buy-sell agreement.[99] This will give the farmer a maximum of flexibility with a minimum of risk, because control of the corporation through voting stock can be given to those children best qualified to manage the farm with the other children, especially daughters, still able to share in farm ownership.

The advantage of spreading income and reducing the farmer's eventual estate can be accomplished in whole or in part while the children are minors. Gifts of stock to children can be accomplished by creating an irrevocable trust for the benefit of the children or by transferring stock to

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[97] This same division of stock facilitates growth of the corporation, for outside investment can be attracted to the corporation without losing control. For example, the farm as a single business unit could operate three separate businesses; for example, dairy, poultry and beef. Each business could be run by one individual, a father, and his two sons. The total farm would still be one unit and yet the dairy enterprise (for example) could be expanded by further contributions of cash upon issuance of stock. There is less bookkeeping involved and the various businesses would tend to operate more smoothly than under a sole proprietorship or partnership. *See,* Eckhardt, ***The Farmer, Like Other Business Owners, Needs Expert Estate Planning Advice,*** 15 J. TAXATION 294 (1961).

[98] *Id.* at 297.

[99] A restrictive buy-sell agreement places limitations upon the disposal of corporate stock in certain events such as death or sale of stock. Under such an agreement, it is usually mandatory or optional for the corporation or remaining stockholders to purchase the shares of stock being disposed of at the price and upon the terms specified in the agreement. By such an agreement, the shares of stock are kept in the family.

children under the Uniform Gift to Minor's Act.[100] A Clifford trust for a specified number of years (but not less than ten) can be established for the children which will result in income from the stock being taxed to them.[101]

If a trust is used, the corporation cannot elect Subchapter S provisions.[102] Therefore, the above devices for giving stock to the children are not available if the corporation elects Subchapter S provisions.[103]

The advantages discussed above of transferring stock in a corporation instead of land, machinery and livestock during a person's lifetime, also apply to transfers occurring at death.

B. Minimizing Estate Taxes

The farm corporation, by facilitating the transfer of farm property from one generation to the next, provides the possibility of substantial estate tax savings. Death taxes, both state and federal, are minimized by lifetime transfers of stock, and under a farm corporation it is more likely that stock will be transferred during the farmer's lifetime. A farmer can give property valued up to $30,000 without paying a federal gift tax,[104] and he and his wife can give during their lifetime a total of $60,000 without paying federal gift tax.[105] In addition, each year a farmer and his wife may give up to $6,000 to one person or multiples of $6,000 to any number of

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[100] The trust or the written transfer arrangements under the Uniform Gift to Minors Act must be drawn carefully in order to avoid unnecessary income tax or estate tax attributions to the grantor-father. Jolly's Motor Livery Company v. Commissioner, 16 CCH T.C.M. 1048 (1957); Ralph R. Anderson v. Commissioner, 164 F.2d 870 (7th Cir. 1947); Sewell v. United States, 73 F.Supp. 957 (Ct. Cls. 1947); State Street Trust v. United States, 263 F.2d 635 (1st Cir. 1958). In determining whether or not the grantor is to be taxed either on the income or estate tax, the cases generally turn on the extent of economic benefits retained by the grantor in the form of constructively receiving dividends or retaining the right to control the stock.

[101] A Clifford trust is at least a ten year trust which meets the provisions of Internal Revenue Code of 1954 §§673(a), 674(a), 676(a) and 677(a), and Treas. Reg. §1.675-1(a). Thus, the grantor cannot have a reversion or interest; corpus or income of the trust for ten years; power to control beneficial enjoyment of the corpus or income; too broad administrative powers over the trust; or the power to revoke or receive income. Upon termination of the trust the stock can pass to the children or revert to the grantor, according to the provisions of the trust. In the latter instance, the corpus of the trust would be included in the grantor's estate if he died during the term of the trust. INT. REV. CODE of 1954 §2037(a)(2).

[102] INT. REV. CODE of 1954 § 1371(a)(2), Treas. Reg. §1.1371-1(g).

[103] Subchapter S provisions can still be elected if gifts to the children are made under the Uniform Gift to Minors Act. Rev. Rul. 54-400, 1954-2 CUM. BULL. 319; Rev. Rul. 59-357, 1959-2 CUM. BULL. 212; Rev. Rul. 57-366, 1957-2 CUM. BULL. 618; Rev. Rul. 56-484, 1956-2 CUM. BULL. 23; Rev. Rul. 56-86, 1956-1 CUM. BULL. 449.

[104] INT. REV. CODE of 1954 §2521.

[105] *Id.*

persons without paying federal gift tax.[106] A substantial amount of stock in the farm corporation can thus be given away each year over a long period of time without paying any gift taxes at all. If a farmer and his wife have four children, they could make four $6,000 stock gifts per year, or a total of $24,000 per year, without paying any federal or state gift taxes. If this program of giving $24,000 of stock to their four children is continued for ten years, $240,000 of farm property represented by stock in the corporation could be given away tax free and the farmer and his wife still would not have used their $60,000 combined lifetime gift tax exemption. The net effect is that their estate could be reduced by $300,000.

Disregarding for a moment the $30,000 lifetime gift tax exemption and the $3,000 annual gift tax exclusion that a person may take, a program of transferring part of the stock during lifetime and part at death would save substantial federal tax since the gift tax liability is 25 per cent less than the estate tax liability at all levels.[107] The difference between the gift tax and the estate tax for various taxable estates permits the possibility of large tax savings.[108] Thus, a program of giving part of the stock in a farm corporation or farm property during life with the remainder passing at death will save substantial sums of federal taxes while helping the farmer realize his other objectives.

C. Providing for Liquidity

The critical problem of liquidity facing the farmer in providing sufficient cash to pay the high death taxes results from the fact that most of his estate consists of land, buildings and farm machinery rather than liquid assets such as cash and stock and bonds. If a farmer's taxable estate is $100,000 over one-fifth of the estate will be used to pay federal death

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106 INT. REV. CODE of 1954 §2503(b). Gifts made by either spouse to a third person are considered as being made one-half by each if both spouses consent. INT. REV. CODE of 1954 §2513. Gifts of community property by husband and wife to third persons are automatically treated as being made one-half by each. 1 CCH FEDERAL ESTATE & GIFT TAX REPORTER ¶4021.12.

107 INT. REV. CODE of 1954 §§2001, 2501.

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Amount of Taxable Gift or Taxable Estate	*Gift Tax*	*Estate Tax*
$ 5,000.00	$ 112.50	$ 150.00
10,000.00	375.00	500.00
50,000.00	5,250.00	7,000.00
500,000.00	109,275.00	145,700.00
1,000,000.00	244,275.00	325,700.00

Thus, if a farmer has stock in a farm corporation worth $100,000 and makes a gift of it during his lifetime, the federal gift tax prior to gift tax exclusion and exemption will be $15,525.

taxes exclusive of credits,[109] not to mention possible additional state inheritance taxes. Providing for farm liquidity is a serious matter in most cases.

The farm corporation lends itself extremely well to providing liquidity to pay death taxes and secure a comfortable income for the surviving spouse. Such liquidity may be obtained by payments from qualified pension and profit sharing plans; deferred compensation agreements; stock redemptions in accordance with a restrictive buy-sell agreement or through the Internal Revenue Code Section 303 redemption,[110] or through various life insurance plans.

(1) Qualified Pension or Profit Sharing Plans

Providing for liquidity by the use of a qualified pension or profit sharing plan or deferred compensation retirement plan has already been discussed in Section V of this article. Although these plans were mentioned with regard to income tax advantages, it should be noted that they also provide a large source of ready cash which can be used to solve a liquidity problem at death because they are funded with earnings, insurance, or other investments.

(2) Restrictive Buy-Sell Agreements

Another method of providing liquidity is the employment of a restrictive buy-sell agreement between the stockholder and the farm corporation or among the stockholders. The price of the stock is established prior to death in the buy-sell agreement and the funds are generally provided through insurance on the life of the deceased stockholder or from earnings of the corporation.[111] The advantages of a buy-sell agreement are that the

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If the same $100,000 worth of property is included in his estate, the federal estate tax before estate tax exemption and deductions will be $20,700. However, if part of the stock is given away during his lifetime and part passes to his heirs at death, the combined federal gift and estate taxes prior to exclusions and exemptions would be only $12,250 due to dividing the property in half and applying each half at the lowest possible tax rates. (The $12,250 tax liability would have been further reduced if the gift tax on the original $50,000 transfer had been paid out of the remaining $50,000.

[109] INT. REV. CODE of 1954 §2001. The federal estate tax on a taxable estate of $100,000 is $20,700, exclusive of any credits.

[110] INT. REV. CODE of 1954 §3003.

[111] There are generally two kinds of corporate buy-sell agreements. Under the entity type of buy-sell agreement, the decedent-shareholder's estate usually agrees to sell to the farm corporation, which is obligated to purchase the shares. The other type of buy-sell agreement is the cross-purchase plan whereby generally the stockholders agree that upon the death of one of them the decedent's estate shall sell, and the remaining shareholders shall purchase, the stock, usually on a pro rata basis.

surviving spouse or the estate receives cash to provide for death taxes or immediate living expenses without being forced to sell farm assets or stock at a distress price; that the wife, who will often have a minority interest, will not be involved in farm management; that the stock is retained in the family with a guaranteed market; and that the stock valuation is established for estate tax purposes. The buy-sell agreement may be under a trust arrangement with a trustee acting as a third party to receive the insurance proceeds or other funds and to disburse them in accordance with the terms of the buy-sell agreement.

In a family farm corporation the entity-type buy-sell agreement[112] must be used with extreme caution, if at all, because under present rules the corporation's payment for the stock to decedent's estate will generally be considered taxable dividends, which would be disastrous.[113] Normally, in the absence of the attribution rules of Section 318(a) of the Internal Revenue Code, the sale of the stock by the estate to the corporation will not produce dividend income or capital gains to the estate because of the stepped-up basis provisions at death.[114] Insurance on the life of the deceased which is owned by the other stockholders or the corporation is not included in the estate of the deceased.[115] Valuation placed on the stock in the farm corporation by the buy-sell agreement will generally be used for determining the estate tax value if the agreement binds the estate to sell the stock on death, restricts disposition of shares of stock during lifetime, and the agreement is at arm's length, concluded in good faith, and supported by adequate and full consideration.[116] This is important in reducing estate tax and minimizing the prospects of litigation, for otherwise the valuation set by the Commissioner of Internal Revenue would in all probability be at a higher figure.[117]

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112 Under the entity type of buy-sell agreement, the corporation owns a life insurance policy on the lives of the stockholders and pays the premium. If life insurance is used to pay for stock in a cross-purchase plan, stockholders purchase and pay for life insurance on the lives of the other stockholders with the proceeds used to pay the decedent's estate for the stock.

113 INT. REV. CODE §§318(a) and 302(c) likely preclude application of §302(b)(3), and §302(d) then requires §301 dividend treatment.

114 INT. REV. CODE §1014(a) which provides that the basis of the property acquired by the decedent shall be its fair market value at the date of decedent's death or the value at the date of the alternate valuation date provided in §2032.

115 Simmons, FEDERAL TAXATION OF LIFE INSURANCE 195 (1966).

116 Treas. Reg. §20.2031-2(h).

117 May v. McGowan, 194 F.2d 396 (2nd Cir. 1952); Commissioner v. Bensel, 100 F.2d 639 (3rd Cir. 1938). Rev. Rul. 65-193, 1965-2 CUM. BULL. 370 was recently issued affirming the Commissioner's method of estate tax valuation of stock as set forth in Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.

(3) IRC Section 303 Redemptions

A third way by which a farm corporation can provide liquidity other than by qualified pension or profit sharing agreements or use of a buy-sell agreement, is through a Section 303 redemption.[118] A redemption of corporate stock under Section 303 will be tax free to the extent that the amount paid for the stock does not exceed its value for federal estate tax purposes.[119] A Section 303 redemption may be used in conjunction with a cross-purchase buy-sell agreement so that payment by the remaining stockholders of decedent's stock will not be as large, and therefore their outlay of cash not as great. Similarly, the premiums on decedent's life insurance will not be as burdensome if the cross-purchase agreement is funded by life insurance. In addition, a Section 303 redemption might be used where members of the farmer's family other than his spouse are still too young to manage the farm and a buy-sell agreement is inappropriate. A Section 303 redemption can be effectuated by any corporation, including a Subchapter S corporation,[120] and such redemption can take place after the death of a stockholder without having an enforceable agreement prior to death.

Neither Section 303 nor any other section requires that the property distributed in accordance with the redemption be used to actually pay death taxes and other costs. Money or property received from the corporation upon redemption can be used for any purpose or given to the heirs, and thus a Section 303 redemption provides another way of obtaining corporate earnings and surplus from the corporation without payment of any tax. In addition, the corporation in a Section 303 redemption need not distribute cash, but can transfer property to the estate.[121]

Section 303(c) permits a redemption of new stock from the decedent's estate acquired either through a corporate recapitalization or issuance of

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[118] INT. REV. CODE of 1954 §303 provides for a corporate redemption within three years and ninety days from the date of filing the Federal Estate Tax Return of the stock of the corporation to the extent of federal and state death taxes and administration expenses, if the value of the corporate stock for federal estate tax purposes is more than 35 per cent of the value of the gross estate of the decedent or more than 50 per cent of the taxable estate. (The Estate Tax Return must be filed within fifteen months after the date of decedent's death. INT. REV. CODE of 1954 §6075(a)).

[119] This is due to the stepped-up basis provisions of Internal Revenue Code §1014(a) and the nonapplicability of the attribution rules of §318(a) to §303 redemptions.

[120] Stoeber, *Planning Section 303 Redemption,* J. OF AMERICAN SOCIETY OF CHARTERED LIFE UNDERWRITERS 65–66 (Jan. 1967).

[121] *Id.* at 70. Thus, a surviving spouse might receive land or machinery which she could in turn lease to the corporation with the corporation deducting the rental payments.

non-voting preferred stock or non-voting common stock, which basis is determined by reference to the basis of the old stock.[122] A corporation can recapitalize after death of the farmer and issue part non-voting preferred stock and part common voting stock for the redeemed stock, and then redeem the non-voting stock under Section 303. Thus, the estate or surviving spouse could have control of the corporation and at the same time receive corporate funds tax free.[123]

In the alternative, a preferred stock dividend could be issued after death on the stock held by the estate and others. The preferred stock could be subsequently redeemed within the provisions of Section 303 and provide the estate with cash or property.[124]

(4) Life Insurance Plans

Solving the liquidity problem in the farm corporation can be accomplished through the use of increased personal life insurance coverage, group term or group permanent life insurance, and through use of the split-dollar life insurance[125] with or without what is known as the fifth dividend option.[126] For personal life insurance, the usual arrangement is to have the corporation pay premiums for life insurance on the employee with proceeds payable to the employee's estate or his beneficiary, with

[122] *Id.* at 70. The new stock issued either as part of a recapitalization or as dividend stock will be considered as being included in the decedent's estate by Internal Revenue Code §303(c). The basis of the new stock would be determined in part by reference to the basis of the old stock under the provisions of §358 or §307.

[123] INT. REV. CODE of 1954 §368(a)(1)(E). The corporation must show a proper business purpose for the recapitalization. Rev. Rul. 54-13, 1954-1 CUM. BULL. 109; Rev. Rul. 55-112, 1955-1 CUM. BULL. 344.

[124] The issuance of a preferred stock dividend is tax free. INT. REV. CODE of 1954 §§305(a), 311(a). No business purpose is required for declaring a stock dividend and the subsequent redemption of the preferred stock would be tax free within §303 even though the preferred stock was "tainted §303 stock." Treas. Reg. §1.303-2(d). The sale or exchange of "tainted §303 stock" creates ordinary gain instead of capital gain. INT. REV. CODE of 1954 §306.

[125] A split-dollar insurance plan is a type by which both the farm corporation and the employee pay the premiums with the corporation receiving upon the employee's death a portion of the insurance proceeds equal to the cash surrender value of the policy, and the employee's beneficiary receiving the difference between the face amount of the policy and the cash surrender value. The remaining proceeds of the policy are received by the farm corporation. Simmons, FEDERAL TAXATION OF LIFE INSURANCE 141 (1966). Effective November 13, 1964, no limitations were placed on the split-dollar plan to the extent that employees are taxed annually on an amount equal to the cost of one year term insurance. Rev. Rul. 64-328, 1964-2 CUM. BULL. 11, *revoking* Rev. Rul. 55-713, 1955-2 CUM. BULL. 23.

[126] A fifth dividend option is one granted by a life insurance policy to use the dividends to purchase one year term insurance in an amount to exceed the cash value of the policy with the remainder of the dividends to accumulate to cover future term insurance premium rates. *See* Simmons, FEDERAL TAXATION OF LIFE INSURANCE 141 at 145-6.

either the corporation or the employee owning the policy. Or, the farm corporation may purchase group term or group permanent life insurance for its employees as a means of solving the liquidity problem. Group permanent insurance differs from the temporary protection of group term in that the employees usually have the benefit of increasing values of paid-up permanent insurance and certain limited rights to buy individual policies.[127] By using the fifth dividend option with a split-dollar insurance program, the corporation receives a portion of the death proceeds equal to the cash surrender value while the employee's beneficiary receives a portion equal to the face of the policy. The reason for the increased benefits is that the insurance dividends are used to buy one-year term insurance.

To protect themselves against financial as well as managerial loss upon the death of a key stockholder-employee, many corporations purchase key man insurance which enables them to receive funds to sustain the corporation until it gets back on its feet or brings in new management. This type of insurance is solely for the farm corporation's benefit and only indirectly benefits its shareholders. The corporation takes out a policy on the key stockholder-employee's life, owns the policy, pays the premiums, and is the beneficiary. This type of insurance does not solve the liquidity problem for the farmer, but it may mean the difference between continuation or termination of the business if the children are not old enough to assume farm management.

D. Social Security Benefits

Any estate plan should take into consideration the effect that such a plan will have on Social Security benefits and retirement income. If the farmer operates the farm as a sole proprietor or a partnership he can only earn up to $1,500 per year from ages 65 to 72 without reduction in Social Security benefits.[128] However, the same farmer may receive more than $1,500 per year income from his farm corporation and not lose Social Security benefits. Any income he receives from qualified pension and profit sharing payments[129] or from a deferred compensation agreement or salary retirement payment plan[130] will not affect his Social Security benefits. Further, the farmer may receive any amount of dividends from his farm corporation without losing Social Security benefits.[131] All of these forms of supplemental income are not considered "earned income" and are eligible

127 FEDERAL TAXATION OF LIFE INSURANCE, *supra* note 126 at 133.

128 42 U.S.C.A. §403(b).

129 42 U.S.C.A. §409(3).

130 F. Ford v. Ribicoff, 199 F.Supp. 822 (N.D. Tenn. 1961).

131 42 U.S.C.A. §4011(a)(2).

for retirement credit.[132] Thus, a great deal of income can be received by the retired farmer without losing any benefits to which he has a right but which he could not obtain as a sole proprietor or in a partnership. The same results are obtainable even if the farm corporation elects Subchapter S status, for the amount of income required to be included in the gross income of a shareholder each year from such a corporation does not constitute "net earnings from self employment."[133]

VII

DISADVANTAGES OF FARM INCORPORATION

Although there are many tax advantages to farm incorporation, there are numerous disadvantages as well, several of which are imposed by the Internal Revenue Code. The disadvantages of farm incorporation can be classified in four categories: cost involved, loss of some tax benefits, less organizational flexibility and double taxation.

A. Costs

Farm incorporation requires an immediate outlay of cash, although this must be weighed against long range cost savings and tax savings which can be obtained from farm corporation. Various expenses include legal work, franchise taxes payable to the state of incorporation, recording and filing fee, and the expenses of an annual corporate license fee.[134] The annual license fee is a recurring fee, for it must be paid each year of the corporation's existence. These costs of incorporating will vary with the size of the corporation's capital structure.

Another cost is the increased Social Security expense. The farmer as a self-employed person pays for Social Security and hospital insurance at a combined rate of 6.4 per cent,[135] while the total rate to the farmer operating in a corporate form is 8.8 per cent.[136] Normally, the employee and the corporation split the cost of Social Security, but in a close family corporation the total cost factor of 8.8 per cent must be used. The present 2.65 per cent differential in Social Security costs should be analyzed with the greater benefits that are obtainable through a farm corporation without reduced Social Security benefits.

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132 INT. REV. CODE of 1954 §37(c).

133 Rev. Rul. 59–221, 1959—1 CUM. BULL. 225.

134 CCH CORPORATION LAW GUIDE, ¶691. Nearly all the states impose these fees. In addition, some states impose an excise tax on the value of the property transferred to a corporation.

135 1 CCH 1967 FEDERAL TAX REPORTER, ¶112. The rate is applied to the first $6,600 earned.

136 1 CCH 1967 FEDERAL TAX REPORTER, ¶113. Likewise, the earnings base is $6,600.

The last expense is the cost involved in corporate dissolution, should this become necessary.

B. Loss of Certain Tax Benefits

The second disadvantage of farm corporation is the loss of certain tax benefits otherwise obtainable; but, again, tax benefits must be measured against the tax savings realized from farm corporation. First, a tax benefit is lost for farmers depending on their tax bracket if much of their income consists of long term capital gains. When he incorporates, the farmer will lose capital gains tax advantages if he is in a tax bracket lower than 44 per cent.[137] If the farmer reports large amounts of annual capital gain and is in a tax bracket lower than 44 per cent he will lose by having the farm corporation pay the capital gains tax. In addition, if the farm corporation has taxable income over $25,000, those farmers who are in a tax bracket lower than 50 per cent will similarly lose.

Another tax benefit partially lost to the farmer when he incorporates is the stepped-up basis provisions for farm land, buildings, machinery, equipment, livestock and crops that are in the corporation.[138] This may be a disadvantage to the farmer in two ways: (1) where there is a large amount of farm property likely to be disposed of in the near future without selling or disposing of any of the corporation's stock, and (2) where there is growing livestock or harvested, but unsold, crops at the date of death.[139]

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[137] Hall, *Agricultural Corporations: The Utility & Legality,* 17 OKLA. L. REV. 389 at 400 (1964). For individuals other than heads of households, the breaking point of 44 per cent occurs at taxable income of $18,800. This may be illustrated by the following two examples:

Example 1: Net Capital Gain $20,000 —
Individual Rate 30 Per Cent

Unincorporated Farmer:	*Farm Corporation:*
Pays lower of:	Pays lower of:
a) 25% of $20,000 = $5,000 tax	a) 25% of $20,000 = $5,000 tax
b) Includes $10,000 in taxable income and pays 30% of it = $3,000 tax.	b) 22% of $20,000 = $4,400 tax

Example 2: Net Capital Gain $20,000 —
Individual Rate 44 Per Cent

Unincorporated Farmer:	*Farm Corporation:*
Pays lower of:	Pays lower of:
a) 25% of $20,000 = $5,000 tax	a) 25% of $20,000 = $5,000 tax
b) Includes $10,000 in taxable income and pays 44% of it = $4,400 tax	b) 22% of $20,000 = $4,400 tax

[138] INT. REV. CODE of 1954 §1014(a). However, the corporate stock in the decedent's estate receives a stepped-up basis which reflects the value of all the farm land, buildings, equipment, livestock and crops held in the corporation.

[139] In such a case there would be no stepped-up basis for the corporate property including the crop to be sold after death as there would be in a sole proprietorship. However, in David-

Aside from the major tax benefits that a farmer may lose by incorporating the farm business mentioned above, minor tax benefits may also be lost. If the farm corporation does have capital gains or tax-exempt interest income, their identity as such will be lost when these earnings are passed on to shareholders in the form of dividends except to the extent provided in Subchapter S provisions.[140] By the same token, it has been shown that the shareholders can receive capital gain treatment out of ordinary earnings by the sale of their stock or through qualified pension and profit sharing plans. If the farm has a capital loss it can only be used to offset capital gains unless Subchapter S provisions are again elected.[141]

C. Loss of Organizational Flexibility

The farm corporation is a more formal method of conducting business. There must be officers and a board of directors, and each group has its functions, duties and responsibilities. This formalistic structure is the reason for many of the advantages in conducting a business in a corporate form, but the farmer will correspondingly not be as free to treat property in the same way he could as a sole proprietor. Additional reporting requirements exist, corporate minutes must be maintained, and reports concerning financial position and taxable income must be filed with various financial governmental agencies.

D. Double Taxation

Another possible disadvantage in incorporating is the concept of double taxation. The corporation pays a tax on the farm earnings and when stockholders receive farm earnings in the form of dividends they are taxed again under personal income tax.[142] However, double taxation need not create a problem for the farm corporation, for two reasons. First, many farm corporations will not have such large earnings that they will be forced to pay dividends after paying salaries and bonuses, making contributions to qualified pension or profit sharing plans, and providing for reserves for crop failures or crop insurance or reserves against unstable agricultural conditions. Secondly, there are various ways of getting earnings out of a corporation without double taxation, as was discussed in Section II above.

son Estate v. United States, 292 F.2d 937 (Ct. Cls. 1961) it was held that decedent's right to receive crop shares as rent from a tenant was income in respect of decedent under Internal Revenue Code §691 and hence there was no stepped-up basis received at death to a sole proprietor either.

43 Neb. L. Rev. 365 (1964).

140 Harl, *The Farm and Ranch Corporation—Business Organizational Form of the Future,*

141 Int. Rev. Code of 1954 §§1211(a), 1374.

142 Int. Rev. Code of 1954 §§61(a)(2), 61 (a)(7).

Thus, with proper tax planning and by use of the methods suggested above, the disadvantages of the double tax concept are not as hazardous as they at first may appear.

VIII

CONCLUSIONS

In summary, there are many attributes and benefits of farm corporation that should be carefully investigated. Whether or not a farm corporation is particularly suited for a farmer depends upon each farmer's particular situation. No general rules can be given. However, every farmer should have his situation and his needs and future goals analyzed in light of the opportunities available to him from farm incorporation.