

The National Agricultural
Law Center



University of Arkansas · System Division of Agriculture
NatAgLaw@uark.edu · (479) 575-7646

An Agricultural Law Research Article

No Mere Yeoman: Incorporating the Family Farm –Consideration and Consequences

by

Eric Melgren

Originally published in WASHBURN LAW JOURNAL
24 WASHBURN L. J. 546 (1985)

www.NationalAgLawCenter.org

No Mere Yeoman: Incorporating the Family Farm— Considerations and Consequences

- I. Introduction
- II. The Corporate Farm: Reputation and Reality
 - A. Public Perception of Corporate Farming
 - B. Growth of Corporate Farming
- III. Advantages of Farm Incorporation
 - A. Estate Tax
 - B. Lifetime Transfers
 - C. Income Tax
 - D. Economic Efficiency
 - E. Limited Liability
- IV. Disadvantages of Farm Incorporation
 - A. State Regulation
 - B. Income Tax
 - C. Economic Implications
 - D. Control
- V. Corporate Liquidation and Dissolution
- VI. Conclusion

I. INTRODUCTION

“If God gave me the choice of the whole planet or my little farm, I should certainly take my farm.” Ralph Waldo Emerson.¹

Farmers have been romanticized as “the founders of human civilization,”² and “the chosen people of God.”³ The corporation, the personification of Big Business, has been condemned as being “[in]tolerable among the people who desire to be free,”⁴ and labeled as the “ogre of Wall Street.”⁵ It should not be surprising then, that the juxtaposition of the two—farmer and corporation—has been a stormy union.⁶ The incidence of corporate farms is not a recent one,⁷ but it is one that continues to spark public controversy,⁸ and one becoming an increasingly significant aspect of the American agriculture scene.⁹

The corporate form¹⁰ is only one of several business entities available for the farmer to conduct his business. The most common choice is that of the sole

1. E. MURPHY, 2,715 ONE-LINE QUOTATIONS FOR SPEAKERS, WRITERS, AND RACONTEURS 79 (1981).

2. J. Conlin, THE MORROW BOOK OF QUOTATIONS IN AMERICAN HISTORY 308 (1984) (quoting Daniel Webster).

3. *Id.* at 157 (quoting Thomas Jefferson).

4. *Id.* at 47 (quoting Justice Louis D. Brandeis; testimony before the committee on Interstate Commerce, 1911).

5. Harl, *Public Policy Aspects of Farm Incorporation*, 20 BUS. LAW. 933, 940 (1965) (quoting Gard, *Agriculture's Industrial Revolution*, 34 CURRENT HIST. 853 (1931)).

6. See, e.g., Harl, *Farm Corporations—Present and Proposed Restrictive Legislation*, 25 BUS. LAW. 1247 (1970). “Few topics today evoke a more heated response in farm circles.” *Id.* at 1247. See also *infra* notes 23-39 and accompanying text.

7. Wilbur Aldrich published his *Farming Corporations* in 1892. Harl, *supra* note 5, at 940 n.15.

8. The voters of the state of Nebraska approved a constitutional amendment restricting farm corporations in 1982. See *infra* notes 213-18 and accompanying text; see generally discussion *infra* at notes 178-218 and accompanying text.

9. See *infra* notes 40-58 and accompanying text.

10. The corporation is an artificial creation of the law, with the power to act on its own behalf in perpetuity. See generally Hopkins Fed. Sav. & Loan Ass'n v. Cleary, 296 U.S. 315, 336 (1935); Runyan v. Coster, 39 U.S. (14 Pet.) 122, 129 (1840); Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 524-27 (1819); Bank of United States v. Deveaux, 9 U.S. (5 Cranch.) 61, 64 (1809); KAN. STAT. ANN. ch. 17 (1981).

proprietorship.¹¹ Other choices generally listed¹² include the partnership,¹³ limited partnership,¹⁴ business trust,¹⁵ joint stock company¹⁶ and cooperatives.¹⁷ This Note will restrict its discussion to the corporate farm entity as it relates to the family farm.¹⁸ It is intended as a guide of appropriate considerations for the attorney counseling a client considering farm incorporation.

Despite historically hostile public perception,¹⁹ resulting in unparalleled statutory restriction on corporate farming,²⁰ the last two decades have witnessed a tremendous growth in farm incorporation.²¹ After examining these attitudes

11. In 1978, for instance, 87.8% of all farms were operated as sole proprietorships. U.S. DEPT. OF COMMERCE, 1978 CENSUS OF AGRICULTURE, VOL. 1, PT. 51, CH. 1, SUMMARY [hereinafter cited as 1978 CENSUS]. Sole proprietorship includes those farms in which property is held as joint tenants. 2 J. JUERGENSMEYER & J. WADLEY, AGRICULTURAL LAW 130 (1982).

12. 2 J. JUERGENSMEYER & J. WADLEY, *supra* note 11; Comment, *Farm Business Units in Kansas*, 7 U. KAN. L. REV. 348 (1959).

13. "A partnership is an association of two or more persons to carry on as co-owners a business for profit." KAN. STAT. ANN. § 56-306 (1983); Uniform Partnership Act § 6(1) (1914) is the "widely accepted definition" (59 AM. JUR. 2D *Partnership* § 4 (1971)) of partnerships today. Prior to this definition being settled on, although partnerships were commonly recognized, it was said that "[a] definition of partnership which is at once accurate, comprehensive, and exclusive is extremely difficult." *Wade v. Hornaday*, 92 Kan. 293, 140 P. 870 (1914) (syllabus). See also Bock, *Formalizing the Farm Partnership*, 54 NEB. L. REV. 558 (1975).

14. "A limited partnership is a partnership formed by two or more persons under the provisions of [this act], having as members one or more general partners and one or more limited partners. The limited partners as such shall not be bound by the obligation of the partnership." KAN. STAT. ANN. § 56-122 (1983), Uniform Limited Partnership Act (ULPA) § 1 (1916). See also KAN. STAT. ANN. § 56-1a101 (1983) (definition of terms under the Revised ULPA (1976)). Limited partnerships were unknown at common law, and are a purely statutory creation. *State v. Williams*, 196 Kan. 274, 282, 411 P.2d 591, 598 (1966).

15. A business trust is an unincorporated business association, also known as "common law trust" or "Massachusetts trust," under which property is managed by trustees for holders of transferable certificates evidencing beneficial interests in the trust estate. See KAN. STAT. ANN. § 17-2028 (1981). A farm business trust would be restricted by KAN. STAT. ANN. § 17-5904 (1981) in Kansas, and may be restricted in many other states as well. See generally *infra* notes 178-218 and accompanying text. See also *Hecht v. Malley*, 265 U.S. 144 (1924); N. LATTIN, *LATTIN ON CORPORATIONS* § 10 (2d ed. 1971); Strasser, *Agricultural Corporations in Oklahoma*, 16 OKLA. L. REV. 161, 165-67 (1963); Annot., 156 A.L.R. 22 (1945).

16. A joint stock company is "[a]n unincorporated association of individuals for the purpose of carrying on business and making profits, having a capital stock contributed by the members. . . . and governed by articles of association. . . ." 46 AM. JUR. 2D *Joint Stock Companies* § 1 (1969).

Generally, a joint stock company is an organization lying midway between a corporation and a partnership. *Id.* § 2. They are a common law entity and may operate where not prohibited by law, (*Betts v. Hackathorn*, 159 Ark. 621, 252 S.W. 602 (1923), N. LATTIN, *supra* note 15, at § 9), although Kansas would seem to characterize them as a corporation. KAN. CONST. art. 12, § 6.

17. Cooperatives, usually organized among several farms to provide needed services through combined efforts, must be incorporated in Kansas. KAN. STAT. ANN. § 17-1501 (1981). The identifying hallmark of a cooperative is its nonprofit status. See generally 2 J. JUERGENSMEYER & J. WADLEY, *supra* note 11, at ch. 32. See also Warlich & Brill, *Cooperatives Vis-A-Vis Corporations: Size, Antitrust and Immunity*, 23 S.D.L. REV. 561 (1978).

18. There seems to be no generally accepted definition of "family farm." This may be because different organizations define "family farm" differently to reflect their different purposes. See Wadley, *Small Farms: The USDA, Rural Communities and Urban Pressures*, 21 WASHBURN L.J. 478, 478-84 (1982). Many state statutes restricting farm incorporation (see *infra* notes 178-218 and accompanying text) carve out exceptions for family farms as defined in the statute. Such definitions are usually based on degree of relationship of the operators. In Kansas, for instance, a family farm would seem to be one owned by "persons related to each other, all of whom have a common ancestor within the third degree of relationship, by blood or by adoption, or the spouses or the stepchildren of any such persons, or persons acting in a fiduciary capacity for persons so related. . . ." KAN. STAT. ANN. § 17-5903(i)(1) (1981). Other statutory definitions are similar. See *infra* note 178.

19. See *infra* notes 23-39 and accompanying text.

20. See *infra* notes 178-218 and accompanying text.

21. See *infra* notes 42-57 and accompanying text.

and growth, this Note will discuss major advantages to the corporate form of operation, and some disadvantages. Although incorporation is not for everyone, some commentators have begun to recommend it.²² For a variety of reasons, perhaps even Emerson would find his "little farm" best preserved today as a corporation.

II. THE CORPORATE FARM: REPUTATION AND REALITY

A. Public Perception of Corporate Farming

The mistrust farmers and rural communities have for corporate farms is a predominately Midwest phenomenon²³ that can be traced to the beginning of the century.²⁴ The Great Depression, which saw a worsening of the farmers' plight, and large amounts of farmlands being foreclosed by financial institutions, intensified this attitude.²⁵ Strictly speaking, it has not been the corporate form of organization per se that has been mistrusted.²⁶ More accurately, it is a fear that allowing corporate involvement in agriculture will open the door for big business to dominate the land and the farm economy,²⁷ and destroy the way of life in rural communities.²⁸ Family farms, as corporations, are generally accept-

22. Israel, *Corporate Farming and the Money Tree*, 4 GA. ST. B.J. 335, 345 (1968) (incorporation is a tool for maintaining and increasing the efficiency of the family farm); Comment, *The South Dakota Family Farm Act of 1974: Salvation or Frustration for the Family Farmer?*, 20 S.D.L. REV. 575, 581 n.38 (1975) (incorporation of the family farm is described as beneficial, even ideal).

23. If state enactment of restrictive legislation regarding farm incorporation is an accurate indicator, it is the middle tier of states which are most alarmed. Most, though not all, of the states with such laws fall in the geographic region between the Great Lakes and the Rocky Mountains, from Canada to Mexico. See *infra* note 178.

24. In 1918, the New York Times reported:

Some regard the advent of corporate farming with alarm; they fear for the alleged independence of our farmers as a class; they see something ominous in the word "corporation." It is associated with Wall Street, which is held up to the farmer as a place where thieves assemble to divide the spoils.

Quoted in Comment, *Proposed Anticorporate Farm Legislation*, 1972 WIS. L. REV. 1189 n.1 (quoting Smith, *Corporate Methods as Regenerator of Farms*, N.Y. Times, Jan. 20, 1918, § 7, at 7, col. 1).

The seeds of this mistrust may have been planted even earlier, during the late 19th Century, when the land boom occurring in the Midwest was exploited by crooked land companies. This encroachment upon "The Land" by "Business" instilled a fierce protectionism in the settlers to preserve their land. Note, *Incorporating the Farm Business: Part I*, 43 MINN. L. REV. 305, 324-25 (1958) [hereinafter cited as Note, *Incorporating the Farm Business*]. This attitude, passed down from father to son, may be partially expressed today in restrictions on corporate ownership of farm land, and partially in restrictions on alien ownership of farm land. See Note, *Alien Ownership of Kansas Farmland: Can it be Prohibited?*, 20 WASHBURN L.J. 514 (1981).

Fears of big corporations "gobbling" up farm land were not just illusions. One western Kansas corporation, the Wheat Farming Co., expanded from 5,000 acres of land owned in 1927 to 65,000 acres owned in 1931. Harl, *supra* note 5, at 941 n.25. This directly affected Kansas legislation restricting farm corporations. See *infra* notes 193-212 and accompanying text.

25. Note, *Incorporating the Farm Business*, *supra* note 24, at 325 (the Depression Era was one of two periods in history contributing to the fear of large corporations swallowing up agricultural industry, the other being the 19th century land boom discussed *supra*, note 24).

26. Comment, *supra* note 24. "Clearly no one believes that the corporate form itself is responsible for the problems of the small family farm Rather corporate farms are condemned because it is believed that the 'objectionable' farms are incorporated." *Id.* at 1205.

27. Harl, *supra* note 5, at 940.

Countless American farmers in the wheat growing country are agitating against the corporation-owned farm and the chain farm. They see visions of gigantic tractors driving them and their families from the land, crushing the enterprises on which they have spent their best years, converting farms into factories with time clocks and wage slaves.

Id. (quoting Gard, *Agriculture's Industrial Revolution*, 34 CURRENT HIST. 853 (1931)).

28. Comment, *supra* note 22, at 577:

able;²⁹ they differ from their unincorporated neighbors only in structure, not content. They rightfully belong to the protected class, not the aggressor class.³⁰ It is the conglomerate,³¹ as farm corporation, with its vertical integration, absentee ownership and control, hired management and labor, industrialization, large size, and significant nonfarm investment capital,³² that is fought and feared. This anticorporation attitude is so ingrained in the agrarian mindset that, despite the increasingly commonplace role corporations play in the farm scene³³ and the increasing sophistication of the modern day farmer, the farm corporation continues to be perceived as a threat.³⁴ Legislators³⁵ and commentators³⁶ alike stress that positive action must be taken to prevent dissolution of family farms into large corporations. Ironically, the characteristics feared in corporations may be just as likely to come from limited partner structures,³⁷ but little has been done to restrict them. Meanwhile, as innocuous family farm corporations continue to proliferate,³⁸ dispassionate discussion of the topic remains rare.³⁹

B. Growth of Corporate Farming

Even as the controversy rages, the total number of corporate farms has been on the increase. In 1969⁴⁰ the census of agriculture⁴¹ reported a total of 21,513

In addition, corporations, in general, do not make good Main Street customers or good neighbors. They contribute little to a community in the way of church or school endeavors and they also are making it extremely difficult for young farmers to get started in farming or to expand their present farm unit to an adequate size because the giant corporate farms are generally able and willing to pay more than the going price to get what they want.

Id. (quoting Ben Radcliffe, President of South Dakota Farmers Union, testifying: *Hearings Before the Subcomm. on Monopoly of the Senate Select Comm. on Small Business on the Effects of Corporation Farming on Small Business*, 90th Cong., 2d Sess. 23, 25 (1968)). See also Comment, *supra* note 24, at 1203.

29. Comment, *supra* note 22, at 581:

The farmer . . . who incorporates his business is still the same independent, community-minded citizen that he was as a sole proprietor or partner. Few of the objections voiced against the farm conglomerate are applicable to the family farm corporation . . . Far from threatening rural life, the family farm corporation may well increase the viability of the family owned and operated farm.

Id.

30. See *infra* notes 178-218 and accompanying text.

31. Colton, *Old MacDonald (Inc.) Has A Farm . . . Maybe or Nebraska's Corporate Farm Bar: Is it Constitutional?*, 6 U. ARK. LITTLE ROCK L.J. 247, 251 (1983).

32. *Id.* See also Comment, *supra* note 24, at 1199.

33. See *infra* notes 42-57 and accompanying text.

34. In 1982, Nebraskans voted to amend their state constitution to restrict or forbid farm corporations. See *infra* notes 213-18 and accompanying text. See also *supra* note 28 (testimony before the South Dakota legislature).

35. See *infra* notes 140-69 and accompanying text.

36. Comment, *supra* note 24, at 1214. "Because our present institutional framework favors large industrial farms, to ignore the problem [of statutory regulation of corporate farms in order to preserve the family farm] would in reality be to choose to allow the small family farm to disappear." *Id.*

37. Limited Partnerships allow a large number of outside investors to pool their collective resources to form a large, industrialized operation that a single family could not construct or compete with. See Harl, *supra* note 6, at 1255-56. See also Comment, *supra* note 22, at 592-93.

38. See *infra* notes 42-57 and accompanying text.

39. See, e.g., Comment, *supra* note 22, at 577. See also Lake, *Constitutionality of "Initiative 300"*: *An Answer*, 17 CREIGHTON L. REV. 261, 263 (1984). *But cf.* Harl, *supra* note 6, at 1255-58 (a noted agrilaw scholar provides a clear and concise summary of the corporate farm controversy, and a plea for clear thinking on the issue).

40. The 1964 Census of Agriculture did not collect data on farm corporations.

corporate farms, or slightly over 1% of all farm operations.⁴² In 1974 there were 28,656 corporate farms, about 1.7% of all farm operations.⁴³ The 1978 census showed an increase to 51,270 corporate farms, 2.1% of all farms.⁴⁴ By 1982, the census reported 59,792 corporate farms, 2.7% of all farm operations.⁴⁵ Despite the seemingly small numbers of corporate farms in comparison to the total number of farms, the 1982 census showed the disproportionate role corporate farms play. For instance, although only 2.7% of all farms are corporate farms, they represent 13.7% of all land in farms, and 23.9% of the market value of all agricultural products sold.⁴⁶ The average size of a corporate farm is 2129 acres, versus just 330 acres for an individual or family farm.⁴⁷ The average value of a corporate farm's land and buildings is \$1,520,781 versus \$281,014 for an individual or family farm.⁴⁸

Does all this mean, then, that the business corporation with its larger, wealthier farms is replacing the traditional family farm, just as doomsayers have predicted?⁴⁹ Not quite. The expanded data reported on corporate farming in the 1982 census showed that of the 59,792 corporate farms reported, 52,652 of them (or 88.1%) were characterized as family farms.⁵⁰ Old McDonald hasn't been squeezed out—he's just become McDonald and Sons, Inc.!

Although the corporate farm generally tends to be larger and wealthier than the individually owned farm,⁵¹ corporate farming spans the full range in both amount of sales and size of acreage.⁵² While 58.7% of all corporate farms

41. The census of agriculture is conducted approximately every five years by the U.S. Dep't of Commerce, and provides exhaustive reporting of all facets of the American agricultural economy, both state-by-state and a summary of the nation as a whole. It is available at Government Document Depositories at most land grant institutions, among other places. Census information for this report was obtained from Kansas State University, Manhattan, Kansas.

42. U.S. DEP'T OF COMMERCE, 1974 CENSUS OF AGRICULTURE, VOL. 1, PT. 51, CH. 1, TABLE 14: FARM OPERATORS, TENURE AND CHARACTERISTICS: 1974, 1969, 1964 (includes only those farms with sales over \$2,500) [hereinafter cited as 1974 CENSUS].

43. *Id.*

44. 1978 CENSUS, *supra* note 11, at VOL. 1, PT. 51, CH. 1, TABLE 4: OPERATORS, TENURE, TYPE OF ORGANIZATION, AND CHARACTERISTICS: 1978, 1974, 1969. The 1978 and subsequent Census' considerably expanded reporting on corporate farming. They not only report the number of farm corporations by family-held with 10 or more stockholders, family-held with less than 10 stockholders, other than family-held with 10 or more stockholders, and other than family-held with less than 10 stockholders; but also report all of the size, value, sales, etc., information under these four categories (along with categories for sole proprietorships, partnerships and others). This expansion of corporate data indicates the growing importance of corporate farming in the American agricultural scene.

45. U.S. DEP'T OF COMMERCE, 1982 CENSUS OF AGRICULTURE, VOL. 1, PT. 51, CH. 1, TABLE 5: TENURE AND CHARACTERISTICS OF OPERATOR AND TYPE OF ORGANIZATION: 1982, 1978 and 1974 [hereinafter cited as 1982 CENSUS].

46. 1982 CENSUS, *supra* note 45, at TABLE 45: SUMMARY BY TYPE OF ORGANIZATION.

47. 1982 CENSUS, *supra* note 45, at TABLE 45: SUMMARY BY TYPE OF ORGANIZATION.

48. 1982 CENSUS, *supra* note 45, at TABLE 45: SUMMARY BY TYPE OF ORGANIZATION.

49. See *supra* notes 23-39 and accompanying text.

50. 1982 CENSUS, *supra* note 45, at TABLE 45: SUMMARY BY TYPE OF ORGANIZATION. Of even more significance is the fact that 50,842 of these farms, 88% of the total, were family corporations with less than 10 stockholders. The total breakdown is: family-held corporations with more than 10 stockholders—1,810 farms representing 12,793,725 acres; family-held with 10 or fewer stockholders—50,842 farms representing 100,664,435 acres; other than family-held with more than 10 stockholders—1,143 farms representing 5,797,237 acres; other than family held with 10 or fewer stockholders—5,997 farms representing 8,471,369 acres. *Id.*

51. See *supra* notes 46-48 and accompanying text.

52. A look merely at averages would seem to imply that incorporation is an option only for larger farms. In fact, farms of all sizes and production levels choose the corporate form of operation.

sold over \$100,000 of agricultural products in 1982, 12.7% of them sold less than \$10,000.⁵³ And while 31.5% held over 1,000 acres, 24.1% held less than 100.⁵⁴

The picture in Kansas is representative of the nation as a whole. Kansas has 1,876 corporate farms, 2.6% of the total.⁵⁵ They represent 3,452,797 acres, 7.4% of all farm acres.⁵⁶ The number of corporate farms in Kansas in 1982 is up from the 1,478 reported in 1978, which was double the 678 reported in 1974, which was also double the 328 reported in 1969.⁵⁷ Farm corporation data was not collected in 1964.⁵⁸

III. ADVANTAGES OF FARM INCORPORATION

There are a variety of reasons for the recent growth in farm corporations. Various authors⁵⁹ have attempted to compile a list of the advantages of incorporating the family farm. Discussion of the more predominate reasons follows.

A. Estate Tax

Because of the unique advantages a corporate farm structure provides to estate planning, estate and inheritance considerations⁶⁰ are probably the most

Size and corporate structure are not related. A farm operation need not be a certain size before it incorporates. Conversely, size alone is not a reason to incorporate.

53. 1982 CENSUS, *supra* note 45, at TABLE 45: SUMMARY BY TYPE OF ORGANIZATION.

54. 1982 CENSUS, *supra* note 45, at TABLE 45: SUMMARY BY TYPE OF ORGANIZATION.

55. 1982 CENSUS, *supra* note 45, at VOL. 1, PT. 16, CH. 1, TABLE 45: SUMMARY BY TYPE OF ORGANIZATION.

56. 1982 CENSUS, *supra* note 45, at VOL. 1, PT. 16, CH. 1, TABLE 45: SUMMARY BY TYPE OF ORGANIZATION.

57. 1978 CENSUS, *supra* note 11, at VOL. 1, PT. 16, CH. 1, TABLE 5: OPERATORS BY TYPE OF ORGANIZATION FOR FARMS WITH SALES OF \$2,500 OR MORE: 1978, 1974, 1969.

58. 1974 CENSUS, *supra* note 42, at VOL. 1, PT. 16, CH. 1, TABLE 14.

One indication of Kansas corporate farming before Census data was collected is available from a 1958 survey of land ownership in Kansas which revealed that "agricultural corporations" owned 1.3% of the land in the state with the average size of a corporate farm being 4,803 acres. Harl, *supra* note 6, at 1250 (quoting *Land Ownership in the Great Plains States*, 1958 STAT. BULL. 261 (Agr. Res. Serv., U.S.D.A., 1960)).

59. See generally 2 J. JUERGENMEYER & J. WADLEY, *supra* note 11, at ch. 30; Kramme, *16 Reasons to Incorporate*, SUCCESSFUL FARMING, vol. 70, no. 8, June-July 1972, at 9-12; Randall & DeSantis, *Special Problems of Farm Incorporation*, 15 GONZ. L. REV. 749 (1980); Comment, *Considerations When Incorporating the Family Farm*, 39 NEB. L. REV. 547 (1960) [hereinafter cited as Comment, *Considerations When Incorporating*]. See also Comment, *Sole Proprietor's Quandry: Opening the Close Corporations*, 54 NEB. L. REV. 527, 527-28 (1975) [hereinafter cited as Comment, *Sole Proprietor's Quandry*].

60. This Note is not an estate planning guide for the family farm. Several articles dealing specifically with that topic exist. For example, see Harl, *Special Use Valuation of Farmland Under I.R.C. Section 2032A with Emphasis on Planning to Meet Pre-death Requirements*, 16 INST. ON EST. PLAN. ¶ 1500 (1982); Harl, *Special Use Valuation: The Complexities of Economic Engineering*, 60 N.D. L. REV. 7 (1984); Huffaker, *Estate Planning for S Corporation Stock*, 42 N.Y.U. INST. ON FED. TAX'N 15.01 (1984); Kaplan, *Death and Taxes: Freezing the Estate Tax Value of Closely Held Business Entities Under ERTA, TEFRA and Evolving IRS Valuation Policy*, 19 REAL PROP. PROB. & TR. J., at 32 (1984); Kelley, *Planning for the Unlimited Marital Deduction in the Farm Estate*, 17 INST. ON EST. PLAN. ¶ 1500 (1983); Looney, *Farm Estate Planning After the Economic Recovery Tax Act of 1981: Is The Indefensible Thraldom At An End?*, 11 MEM. ST. U. L. REV. 503 (1981); Schleger, Owen & Watkins, *Freezing the Value of Closely Held Business Interests*, 61 TAXES 719 (1983); Uchtmann & Fischer, *Agricultural Estate Planning and the Economic Recovery Tax Act of 1981*, 27 S.D.L. REV. 422 (1982); Note, *Taxation: The Economic Recovery Tax Act of 1981: Its Estate, Gift, and Business Planning Implications for the Agricultural Sector*, 35 OKLA. L. REV. 721 (1982); Note, *The Effect of Corporate Control on Valuation of Closely Held Corporate Stock for Federal Estate and Gift Tax Purposes*, 1982 U. ILL. L. REV. 775; Note, *Will Substitutes in Kansas*, 23 WASHBURN L.J.

predominate reasons a farmer will decide to incorporate.⁶¹ One of the primary questions in considering incorporating the farm business is whether or not the farmer wishes to perpetuate the business. If he does, especially in a family situation, incorporation readily recommends itself.⁶² Estate planning purposes have been held proper as the sole justification for incorporating.⁶³

Today's farms are much larger and represent much more value than ever before. Although the increase of the federal estate tax exemption⁶⁴ in the 1981 Income Tax Reform Act has mitigated a great deal of the problems mentioned in commentary before that date, estate tax concerns are by no means eliminated. The estate tax problem is caused by the escalating value of farms in the last third of this century.⁶⁵ A writer in 1975 noted⁶⁶ that, since 1942 the average investment per farm had increased almost 1,000% while the then federal estate tax exemption of \$60,000 adopted in 1942 had remained unchanged.⁶⁷ The predominant element in the increased family farm wealth has been the dramatic inflationary rise in land value.⁶⁸ Unlike his grandfather, who was mainly concerned with managing labor, the modern farmer is primarily a manager of capital.⁶⁹ And as farm values have increased, the impact of estate tax on these inflated asset values has jeopardized the farm family's ability to preserve capital from one generation to the next.

An estate advantage of incorporation is the ease with which various legal estates can be created through corporate stock. Joint tenancies,⁷⁰ tenancies in

132 (1983); Note, *Taxation: Valuation of Farmland for Estate Tax Purposes, Qualifying for I.R.C. § 2032A Special Use Valuation*, 23 WASHBURN L.J. 638 (1984).

61. A second major reason is income tax considerations. See *infra* notes 93-149 and accompanying text. See Comment, *supra* note 22, at 583. See also Comment, *Sole Proprietor's Quandry*, *supra* note 59, at 528.

62. Harl, *supra* note 5, at 943. "[T]he corporation may actually strengthen the family farm by permitting broader family ownership participation, facilitating the transfer of ownership of a complete farming unit from generation to generation and promoting expansion of the farm to an economic size." *Id.*

63. *Harrison Property Management Co. v. United States*, 475 F.2d 623 (Ct. Cl. 1973).

64. The Unified Credit Against Estate Tax, I.R.C. § 2010 (1982), effectively exempts estates of up to \$400,000 from tax in 1985, and will increase to a \$600,000 effective exemption by 1987.

65. A common expression in rural communities is that farmers "live poor and die rich." If today's farmer has an estate tax problem that his great grandfather did not have, it's not merely due to his increased efficiency or size (although those have occurred, see *supra* notes 40-59 and accompanying text). Rather, it is due to the increased value of his operation. An average sized farmer in 1880 may have had little value in his estate, but an average size farmer today finds that great granddad's land is suddenly worth a lot (see *infra* notes 66-69 and accompanying text). Due to this increase in value more than anything else the late 20th century farmer needs to be concerned with estate planning. "The most beneficial service which can be rendered a farmer today is to make him aware that he owns valuable property and should give thought to what will happen to it when he dies." Fleming, *An Overall Look at Estate Planning*, 45 ILL. B.J. 452 (1957).

66. Kelley, *The Farm Corporation as an Estate Planning Device*, 54 NEB. L. REV. 217 (1975). See also *supra* note 60.

67. Kelley, *supra* note 66. The exemption was substantially increased in 1981, so that by 1987 \$600,000 will be exempt from estate taxes. See *supra* note 62. Further aid to the farm estate tax plan is available through I.R.C. § 2032A (1982) which allows farmland to be valued according to its use, rather than fair market values based on "best and highest use value." It is obvious, though, that the increase in farm value has far outpaced the increase in the exemption, so the thrust of Kelley's argument is still valid.

68. Kelley, *supra* note 66, at 218. This is especially apparent when it is realized that the average rate of return on agricultural investments during this time has been only three percent. *Id.*

69. Harl, *supra* note 5, at 934.

70. Joint tenancies have been defined as:

An estate in fee-simple, fee-tail, for life, for years, or at will, arising by purchase or grant to

common,⁷¹ life estates with remaindermen⁷² and other legal estates common to estate plans are much more readily created out of shares of stock than out of grain, livestock, machinery and other personal property.⁷³ This is especially true when the value of stock is established in the corporate charter or bylaws. Doing so in effect "freezes" the value of each estate created,⁷⁴ while the wildly fluctuating value of farm products and equipment could wreak havoc with the most carefully constructed estate plan.⁷⁵ Such freezing of value can also be accomplished by selling stock to potential heirs at a fixed price on an installment contract, or through a binding buy-sell⁷⁶ option to purchase the stock. The same results can be accomplished through a combination of common and pre-

two or more persons. Joint tenants have one and the same interest, occurring by one and the same conveyance, commencing at one and the same time, and held by one and the same undivided possession. The primary incident of joint tenancy is survivorship, by which the entire tenancy on the decease of any joint tenant remains to the survivors, and at length to the last survivor.

Type of ownership of real or personal property by two or more persons in which each owns an undivided interest in the whole and attached to which is the right of survivorship. Single estate in property owned by two or more persons under one instrument or act. *D'Ercole v. D'Ercole*, D.C. Mass., 407 F. Supp. 1377, 1380.

BLACK'S LAW DICTIONARY 1313 (5th ed. 1979). See also KAN. STAT. ANN. § 58-501 to -506 (1983).

71. Tenancies in common have been defined as:

A form of ownership whereby each tenant (i.e., owner) holds an undivided interest in property. Unlike a joint tenancy or a tenancy by the entirety, the interest of a tenant in common does not terminate upon his or her prior death (i.e., there is no right of survivorship). Assume, for example, B and C acquire real estate as equal tenants in common, each having furnished one-half of the purchase price. Upon B's prior death, his one-half interest in the property passes to his estate or heirs.

Joint interest in which there is unity of possession, but separate and distinct titles. The relationship exists where property is held by several distinct titles by unity of possession, and is not an estate but a relation between persons, the only essential being a possessory right as to which all are entitled to equal use and possession. *De Mik v. Cargill*, Okl., 485 P.2d 229, 233.

BLACK'S LAW DICTIONARY 1314 (5th ed. 1979). See also KAN. STAT. ANN. § 58-501 to -506 (1983).

72. Life estates with remainders have been defined as:

An estate whose duration is limited to the life of the party holding it, or some other person A legal arrangement whereby the beneficiary (i.e., the life tenant) is entitled to the income from the property for his or her life. Upon the death of the life tenant, the property will go to the holder of the remainder interest or to the grantor by reversion.

BLACK'S LAW DICTIONARY 833 (5th ed. 1979). See also KAN. STAT. ANN. § 58-503 (1983).

73. Harl, *supra* note 5, at 934. "The ease with which corporate stock may be transferred makes possible the gradual transfer of ownership of the farm business as a whole, rather than transfer of specific assets." *Id.*

74. A variation on this theme involves issuing preferred stock to the older generation and issuing (or gifting the already issued) common stock to the younger generation. The value of the preferred stock is clearly set and frozen at a fixed sum, or a fixed rate of appreciation. Since the preferred stock value is set, and is given preference to the assets of the corporation over all other interests (though not over debts), the older generation's retirement income is guaranteed. But since all common stock has been transferred to the younger generation, they receive all appreciation in value that the entity might enjoy. This preferred stock issuance creates what is known in federal income tax parlance as "section 306 stock" which may have adverse consequences. See Rev. Rul. 77-455 (application of I.R.C. § 306 excised to a transaction by a family-held corporation). See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ch. 10 (1979), for a detailed discussion of "Section 306 stock."

75. See Kelley, *supra* note 66, at 226-32 for fuller treatment of the creation of legal estates through corporate stock.

76. The effect of buy-sell agreements have been defined thus:

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

ferred stock, voting and nonvoting stock, and multiple classes of stock or trusts.⁷⁷

A farmer may have several children whom he wishes to divide his estate among, but only one who wants to continue the farming business. Dividing up the land and machinery among all children can make it difficult if not impossible for the one to continue the farm as a viable business. But when it is stock, rather than assets, that are divided up, continuity is made much easier. Through stock bonus plans⁷⁸ for the second generation's work performance on the farm, or through separate classes of voting and nonvoting stock,⁷⁹ the heir/operator can be assured of control of the corporate entity, while including the other heirs in the estate. All children can be given a share of their parents' estate, without threatening the survival of the farm business.⁸⁰

B. Lifetime Transfers

As desirous as farmers may be to see their children succeed them in the farming business, they often may not be willing to further this end through inter vivos transfers of the farm assets,⁸¹ even if they fully understand the estate tax advantages such transfers provide and the psychological benefit of including their prospective heir in ownership early on. The reason for this reluctance may be the older farmer's fear of losing control of the farm, and of seeing a large, efficient operation broken up into smaller parcels.⁸² Incorporation can be an answer to these concerns. Through a corporate structure, a farmer can reduce the value of his estate⁸³ by inter vivos transfers of value through the gift⁸⁴ of stock shares.⁸⁵ Because it is shares, not assets, being given away, the operation

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.

Emry, *Tax and Estate Planning Consequences of Incorporation*, 2 U.S.F.L. REV. 14, 35 n.99 (1967). Buy-Sell agreements are also discussed at *id.*, 38-39; Lischer, *Buy-Sell Agreements for Closely Held Business Interests* 44 TEX. B.J. 283 (1981).

77. See generally Kelley, *supra* note 66, at 247-50.

78. A stock bonus is "[A] bonus paid to corporation executives and employees in shares of stock." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2247 (1976). Although not restricted to any type of corporation, some commentators suggest that stock bonuses may have little practical application in farm corporations since they are generally family-held or closely held. See Emry, *supra* note 76, at 27; Israel, *supra* note 22, at 349.

79. Hall, *Agricultural Corporations: Their Utility and Legality*, 17 OKLA. L. REV. 389, 393 (1964).

80. See, e.g., Randall & DeSantis, *supra* note 59, at 751.

81. Fleming, *supra* note 65, at 454.

82. Shoemaker, *Incorporation of Family Agricultural Businesses*, 30 ROCKY MTN. L. REV. 401, 407 (1958).

83. Since 1981 the size of the estate may be less of a problem for family farms. The Unified Credit Against Estate Tax, I.R.C. § 2010 enacted in 1981 provides a credit against estate taxes that in effect exempts estates up to a certain size from any estate tax. For 1985, the size of an estate that can pass tax free is effectively \$400,000, and it will increase to \$600,000 by 1987. *Id.* The increase in exemption will cease at that point, however, and as farm values continue to escalate, more farms may again find themselves with a valuation problem, assuming no further congressional action.

84. For optimum tax results, all gifts generally should stay within the tax free provisions of the Present Interest Exclusion, I.R.C. § 2503(b) (1982), allowing a gift of \$10,000 per year per donee to pass tax free, or \$20,000 if the donor's spouse elects gift splitting, I.R.C. § 2513 (1982).

85. Valuation of privately held, not actively traded shares of stock may be done by an asset valuation, arrived at by dividing the value of the corporation (assets minus liabilities) by the number of shares and stock issued, or by a capitalized earnings approach. D. HERWITZ, BUSINESS PLANNING 1-6 (Temp. 2d ed. 1984). But this standard valuation technique can be modified to reduce the value of the shares. See *infra* notes 88-92 and accompanying text.

is not parceled out.⁸⁶ As long as the transferor retains over 50% of the stock, he retains total control. Shares of stock are also an easier way to transfer value than through gifts of personal property (a tractor this year, twenty cows the next, ten acres of crop ground the next), even if partition is not a concern. This is especially true when the size of the gift is determined by the Present Interest Exclusion provision of the Internal Revenue Code,⁸⁷ which is the maximum amount that can be given away without being subject to a gift tax. That ceiling of \$10,000 per donee can be closely approached, without being exceeded, much more readily when it is shares of stock, rather than pieces of property being transferred.

In a close corporation, the concept of "discounting" allows even greater acceleration of asset transfer by tax free gifts. Discounting is based on the premise that "minority stock interests in a close corporation are usually worth much less than the proportionate share of the assets to which they attach."⁸⁸ The value of 100% of corporate stock has full asset worth value. The value of less than 33 1/3% of the stock of a close corporation is virtually worthless.⁸⁹ Recognizing this, buyers of minority interests of close corporations are hard to find. Therefore, such holdings are discounted below their share of asset value. Such discounting can be substantial,⁹⁰ and is commonly accepted by the courts and I.R.S.⁹¹ If a husband and wife owned 50% of the stock, after only a few gifts, their interests would be subject to sizable discounting,⁹² thereby increasing the amount of stock that could be transferred tax free each year.

86. Harl, *The Farm and Ranch Corporation—Business Organizational Form of the Future*, 43 NEB. L. REV. 365, at 379 (1963). Incorporation reduces the possibility of a real estate partition through which the donee or legatee of a minority interest in the farm may compel sale. *Id.*

87. *Id.* See also I.R.C. § 2513 (1982) for additional advantages available by spouse's electors to "gift split" in effect doubling the size of their gift that can pass tax free, to \$20,000 per donee.

88. *Cravens v. Welch*, 10 F. Supp. 94, 95 (S.D. Cal. 1935); see also *Kelley*, *supra* note 66, at 237-49.

89. One example values ownership accordingly:

<u>Percentage Ownership</u>	<u>Practical Worth</u>
100	Full ownership
66 2/3-100	Sell assets Authorize liquidation Subject to minority shareholder nuisance
50-66 2/3	Control of management Unable to liquidate or sell assets
50	Deadlock
33 1/3-50	Can't control operation Can block liquidation or asset sale
0-33 1/3	Worthless

Kelley, *supra* note 66, at 237-38.

90. See, e.g., *Estate of Ethel C. Dooly*, 31 T.C.M. (CCH) 814 (1972) where the court valued smaller blocks of stock at approximately 37% of their underlying asset value, and larger blocks at approximately 55%. Neither block represented power sufficient to liquidate the corporation. See also *Estate of Pearl Gibbons Reynolds v. Commissioner*, 55 T.C. 172 (1970) (first refusal restrictions on sale of stock, not constituting binding sale agreements, will depress the value of a close corporation's stock).

91. *Kelley*, *supra* note 66, at 243.

92. See, e.g., *Incorporation: 3 Little Known Money Savers*, SUCCESSFUL FARMING, vol. 76, no. 10:18 (Sept. 1978).

C. Income Tax

Farmers may choose to incorporate solely for the income tax savings that can be realized through the corporate income tax rate structure.⁹³ The top tax bracket for individuals is 50%,⁹⁴ but for corporations the top tax bracket is only 46%.⁹⁵ Especially for higher bracket farmers, significant savings could occur. Farm incorporation used to be recommended for farmers with annual taxable income in excess of \$25,000.⁹⁶ However, with the declining tax rate schedules for individuals implemented under the 1981 Tax Reform Act, the watershed income level is increasing.⁹⁷ Assuming no further tax rate changes,⁹⁸ incorporation can still pay off for higher bracket farmers, albeit at a later point than previously.

But the significant tax savings come not in computing tax on the taxable income of a sole proprietor versus a corporation, but in calculating the respective taxable incomes of the two. The farmer in a corporate situation is an employee of his corporate employer. His employer can provide as fringe benefits⁹⁹

93. By and large, federal income taxation of a farm corporation differs little from that of any corporation. Corporate tax is an entirely separate and exhaustive area of the law. This Note does not pretend to deal with the ramifications of corporate taxation, to farms or otherwise. For articles dealing specifically with that topic, see Eastwood, *The Farm Corporation from an Income Tax Viewpoint: Friend or Foe?*, 54 NEB. L. REV. 443 (1975); Lucas & Wilkinson, *Agribusiness: Operating as a Corporation*, 6 TAX ADVISOR 678 (1975).

94. I.R.C. § 1 (1982). State income tax is also due in addition to the federal rates. See, e.g., KAN. STAT. ANN. § 79-32,110(a) (1984). The effect of Federal and State income tax is to tax top bracket individuals at 59%.

95. I.R.C. § 11 (1982). State income tax for corporations also generally has a lower ceiling. See, e.g., KAN. STAT. ANN. § 79-32,110(c) (1984).

96. See, e.g., Wood, *How Incorporating Saved These Farmers One Million Dollars in Taxes*, SUCCESSFUL FARMING, vol. 79, no. 9:22 (Aug. 1981); *Federal Tax Cuts Push Farm Corporation Trend*, SUCCESSFUL FARMING, vol. 78, no. 12:15 (Nov. 1980).

97. In 1982, a corporate farm tax liability versus sole proprietor (married filing jointly) could be illustrated thus:

Income	Corporate Tax	Sole Proprietor Tax
\$15,000	\$2,400	\$1,823
25,000	4,000	4,153
40,000	6,850	9,195
60,000	11,750	17,705
90,000	22,250	32,449

I.R.C. §§ 1, 11 (1982). Obviously, under these schedules, a farmer with a taxable liability under \$25,000 would be subject to more tax in corporate form, but beyond that amount, could realize substantial savings.

By 1984, the comparison looked like this:

Income	Corporate Tax	Sole Proprietor Tax
\$15,000	\$2,400	\$1,581
25,000	4,000	3,565
40,000	6,850	7,858
60,000	11,750	15,168
90,000	22,250	27,900

Id. There are still substantial savings to be realized, but they accrue at a higher point than before.

98. The problem with incorporating solely for income tax reasons is that it's much easier for Congress (and the President) to change the tax structure than it is for a farmer to jump in and out of corporate clothes. A farmer considering incorporation *solely* for income tax reasons should be cautioned to consider potential tax changes before he adopts a business format that may well survive for decades.

99. See Emry, *supra* note 76, at 26-27; Hall, *supra* note 79, at 394; Israel, *supra* note 22, at 344-45; Randall & DeSantis, *supra* note 59, at 753-54; Strasner, *supra* note 15, at 176.

certain personal expenses¹⁰⁰ that are not deductible to the individual but may be deductible to the corporation that pays the expenses for the individual.¹⁰¹ Among these are health insurance;¹⁰² pension plans;¹⁰³ home maintenance, repair and depreciation;¹⁰⁴ and even meals and lodging under the right circumstances.¹⁰⁵ These serve to reduce taxable income by creating deductions where none were allowable before. Paying less tax conserves working capital, and allows faster business value appreciation.¹⁰⁶

Farm incorporation also provides for two ongoing methods of income allocation to reduce the overall tax burden: allocation to various family members, and allocation to different years.¹⁰⁷ Income paid in salaries¹⁰⁸ is a deductible expense to the business, avoiding the double tax problem¹⁰⁹ of getting money out of the corporation. And by paying a sum of money to not one family member but several, the family's overall tax burden is reduced due to the graduated nature of the income tax rates. This income splitting is available to the unincorporated farmer as well, but the incorporated farmer has one more "splittee" available to him: the business itself. Because the farm corporation is a separate taxable entity, the farmer is not taxed on what the corporation makes, but only on what it pays him. In higher income producing years, by paying out only part of the income as salary (deductible to the corporation) and by leaving part of it in the corporation (not taxable to the farmer), both the farmer's and the corporation's tax brackets can be lowered.¹¹⁰ This also helps level out farm income

100. Not only personal expenses, but an array of business expenses are also deductible by an incorporated entity. Israel, *supra* note 22, at 336 (an exhaustive list of expenses deductible by the corporation).

101. I.R.C. § 162 (1982) and accompanying treasury regulations. However, under new regulations issued by the treasury department for calendar year 1985, many such fringe benefits may become taxable to the farmer/employee as imputed income. *Taxation of Fringe Benefits*, 26 C.F.R. Parts 1, 31, 54 (1985).

102. Not just health insurance is deductible. A medical cost reimbursement plan may be maintained for employees, owners and their families and all expenses incurred be deductible by the corporation. Treas. Reg. § 1.162-10(a) (1984). Disability insurance and group term life insurance are also insurance-type expenses deductible by the corporation generally under I.R.C. § 162 (1982).

103. See Emry, *supra* note 76, at 27, 32, 38. The tax advantage of employer-provided pension plans is less significant now than it was before the enactment of I.R.C. § 219 (1982), the individual retirement (I.R.A.) provision. Previously, only a corporate or partnership employer could make tax deductible contributions to an individual's retirement program. The sole proprietor was forced to save for retirement with after tax dollars. So incorporation may have been undertaken solely to allow for pretax retirement savings. The I.R.A. provisions allow a sole proprietor to also make pretax savings now, so he need not incorporate to gain this advantage.

104. I.R.C. § 162 (1982). The taxpayer may be required to show that such expenses meet the "ordinary and necessary" test; that they were in fact business expenses. See *R.E.L. Finley v. Commissioner*, 27 T.C. 413, 425-26 (1956) (to be deductible, expenses must be for a business, for producing income), *aff'd on other grounds*, 255 F.2d 128 (10th Cir. 1958).

105. If the meals and lodging are furnished for the convenience of the employer, made a condition of employment, and are located on the employment premises, they are not only deductible to the corporation (I.R.C. § 162 (1982)), but are not included as income to the employee (I.R.C. § 119 (1982)).

106. Emry, *supra* note 76, at 16. See also Wood, *supra* note 96.

107. Emry, *supra* note 76, at 24-25.

108. The employee must be paid for work actually performed in a reasonable, businesslike manner. Salaries that the IRS determines are not compensatory, but are excessive, will be disallowed as deductions to the corporation. See, e.g., *B.H.W. Anesthesia Found., Inc. v. Commissioner*, 72 T.C. 681, 686 (1979) (even if salaries are reasonable, it must be determined whether they are merely a disguised distribution of profits).

109. See *infra* note 219.

110. See Israel, *supra* note 22, at 339-40. But see *infra* note 226.

between good and bad years.

By electing a different fiscal year for the corporation than for the farmer, additional allocation of income benefits can accrue.¹¹¹ This is especially so if the corporation is on a cash basis method. Although farm corporations are generally required to compute taxable income on an accrual basis,¹¹² exceptions are made for family corporations¹¹³ allowing them to elect the cash method. Cash basis reporting for farm income is popular¹¹⁴ because of the significant tax savings that it can accrue.¹¹⁵ There can be operational dangers if a farmer relies too much on the cash basis, though.¹¹⁶

Other significant tax related advantages to incorporation lie in social security and workers' compensation. The over-65 farm corporation owner can receive income from the farm in the form of dividends or corporate retirement plans without affecting his social security payments.¹¹⁷ In case of on-the-job injury or death, workers' compensation payments are available to the farm corporation operator, while the sole proprietor is excluded.¹¹⁸

In addition to ongoing tax savings realized through incorporation, certain savings can be realized at the point of incorporation.¹¹⁹ The farmer can avoid recognition of gain on the initial transfer into the corporation of appreciated property with a value in excess of his basis, if he complies with section 351 of the

111. Different taxable years between the corporation and the farmer allow several planning possibilities. For example, assuming a calendar year farmer, a corporation with a fiscal year ending November 30 could (if on an accrual basis) accrue a salary/bonus expense to the farmer on that date, which would be deductible from its income for Fiscal Year Ending (FYE) November 30, but by delaying payment until January 15, the farmer delays paying tax on the income. Or, a cash basis corporation with a FYE January 30 could make the payment on January 15, recognize it immediately as a deduction on its year and tax return, and still allow the farmer to delay his tax recognition on receipt of the income. Emry, *supra* note 76, at 20-21. *But cf., infra* note 147.

112. I.R.C. § 447(a) (1982).

113. *Id.* at § 447(c). This section's definition of family (*see supra* note 18) is an exceptionally loose one. Subsection (d) defines family broadly enough to include second cousins, and multiple families are allowed joint ownership in subsection (h), with certain restrictions (two families owning at least 65%, or three families owning at least 50%; with the rest of the ownership being held actively or constructively by the corporation's employees).

114. *See Miller, Why Farmers Use the Cash Basis*, 12 J. TAX'N 122 (1960).

115. Lucas & Wilkonson, *supra* note 93, at 679.

Use of the accrual inventory method for income tax purposes restricts flexibility in regulating taxable income from year to year and transforms capital gain into ordinary income. This undesirable transformation may be illustrated by assuming the sale of a cow or bull raised within the business. Under the cash method the entire proceeds of this sale (assuming the animal was held for at least 24 months) would result in capital gain. Under the accrual method, however, only the difference between the sales price and the inventoried amount would receive capital gain treatment. The inventoried amount would increase ordinary income in current or prior periods.

Id.

116. *See Israel, supra* note 22, at 336 (the privilege of not keeping complete records by using cash method accounting over the accrual method, is not all it may seem to be, since the farm operator must have good records to obtain tax deductions).

117. A sole proprietor or partner continuing to operate the farm may have his social security benefits cut depending on how much earned income he received from the farm operation. 42 U.S.C.S. § 403(b) (1973). Retirement or death benefits are not considered wages affecting benefit payment, though. 42 U.S.C.S. § 409(m) (1973). Dividends from shares of stock are also excluded. 42 U.S.C.S. § 411(a)(2) (1973). *See discussion, Emry, supra* note 76, at 42, 43; Harl, *supra* note 86, at 375.

118. *See Harl, supra* note 86, at 376; Strasner, *supra* note 15, at 171. *See also* I.R.C. § 105(c)(d) (1982).

119. Emry, *supra* note 76, at 24-25.

Internal Revenue Code.¹²⁰ Or, the farmer may have business reasons for wanting to recognize gain at that time.¹²¹ Planning at the time of incorporation can also yield tax savings later on. If the corporation is financed in part by loans rather than equity contributions from the owner,¹²² later earnings by the corporation can be distributed without the double tax¹²³ problem—earnings paid as interest are deductible by the corporation as a business expense,¹²⁴ and repayment of the principal is just return of capital, not income (like dividends would be) to the recipient.¹²⁵ Should the enterprise fail completely, the entire loss on the loan would be deductible as a bad business debt by the lender.¹²⁶ Finally, by retaining some assets in his personal name at the time of incorporation, and leasing them to the corporation instead, the farmer can receive earnings from the corporation in the form of rent payments, which are a deductible expense to the corporation.¹²⁷

When considering incorporation, one potentially advantageous¹²⁸ method that should not be overlooked is the election of S corporation status.¹²⁹ Formerly called subchapter S corporations, their provisions were significantly amended in 1982¹³⁰ to relax the requirements and make S corporation status more attractive.¹³¹ S corporations have the advantages of standard corporations, except that they are not taxed as such.¹³² Instead, all income or loss, though determined at the corporate level is passed through pro rata to the shareholders for taxation purposes,¹³³ much like in a partnership. Only small business corporations can elect S corporation status,¹³⁴ but most corporations which meet stringent state law requirements for farm corporations¹³⁵ could easily qualify for S corporation status.¹³⁶ To elect, all shareholders must file notice of elec-

120. I.R.C. § 351(a) (1980). See also Randall & DeSantis, *supra* note 59, at 754-60.

121. 2 J. JUERGENSMEYER & J. WADLEY, *supra* note 11, at 153.

122. See I.R.C. § 385, where Congress authorized the Secretary of the Treasury to issue treasury regulations to determine whether an interest in a corporation is to be treated as stock or indebtedness. Comprehensive regulations were issued (Treas. Reg. §§ 1.385-1 to -10) and then withdrawn (Treas. Dec. Int. Rev. 7747). To date, no effective regulations have been issued in their place. But the congressional authorization to issue still stands, and the regulations, though withdrawn, may be viewed as indicative of Treasury's thinking on the matter.

123. See *infra* note 219.

124. I.R.C. § 163 (1982).

125. *Id.* at § 61. Definition of gross income centers on "gain derived"; not return of capital, but gain from capital. Eisner v. Macomber, 252 U.S. 189 (1920).

126. I.R.C. § 166 (1982). See Comment, *Considerations when Incorporating*, *supra* note 59, at 548-50, for a fuller discussion of loss deductibility.

127. I.R.C. § 163 (1982).

128. 2 J. JUERGENSMEYER & J. WADLEY, *supra* note 11, at 130.

129. I.R.C. §§ 1361 to 1379 (1982).

130. The Subchapter S Revision Act of 1982, P.L. 97-354.

131. S. BULLARD, S CORPORATIONS—THE NEW LOOK FOR CLOSELY HELD BUSINESSES 2 (KMG/Main Hurdman 1982).

132. I.R.C. § 1363(a) (1982) exempts S corporations from all federal tax, except in certain, limited circumstances. Thus, the double taxation disadvantage of corporations (see *infra* note 219) is avoided.

133. *Id.* at § 1366.

134. *Id.* at § 1361(b). To qualify the corporation must: a) have 35 or fewer shareholders; b) all shareholders must be individuals, estates or qualified trusts; c) no alien may be a shareholder; and d) only one class of stock may exist. *Id.*

135. See *infra* notes 178-218 and accompanying text.

136. Note, *Statutory Treatment of The Kansas Close Corporation*, 13 WASHBURN L.J. 494, 504 (1974).

tion of S corporation status.¹³⁷ Status can be terminated by a shareholder revocation,¹³⁸ disqualification,¹³⁹ or by failing the passive income test.¹⁴⁰ Upon termination, the S corporation becomes a standard corporation. There is a corrective provision to allow the S corporation to avoid inadvertent termination by correcting its problem,¹⁴¹ but once terminated, the corporation cannot elect S status again for five years.¹⁴²

The S corporation can be beneficial to farmers for whom the requisite formalities of incorporation may be too demanding,¹⁴³ or for new businesses who anticipate beginning years' losses that the owner would like to be able to recognize personally. There are some disadvantages to S status, though. Tax savings through fringe benefits¹⁴⁴ are severely restricted in an S corporation¹⁴⁵ for any owner of over 2% of the stock. The advantages of separate fiscal years¹⁴⁶ may be limited for an S corporation.¹⁴⁷ In case of repeated years of losses, an S corporation may be declared as "not engaged in for profit"¹⁴⁸ and have the deductibility of its excess losses denied.¹⁴⁹

D. *Economic Efficiency*

Radford and Martha Dunning of Atlanta, Indiana,¹⁵⁰ saw the tax and estate planning advantages of incorporation. But they didn't stop there. To them, incorporation was also a good business move. Along with their three children and their children's spouses, the Dunning family operates not one but four business structures.¹⁵¹ The Dunnings know what businessmen have long known,

137. I.R.C. § 1362(a) (1982).

138. *Id.* at § 1362(d)(1). Revocation takes the affirmative consent of the holders of a majority of the stock.

139. *Id.* at § 1362(d)(2). The requirements imposed on a business wanting to elect S corporation status (*see supra* note 134) must be continually maintained; the corporation will be disqualified upon the lapse of any requirement.

140. *Id.* at §§ 1362(d)(3), 1375. Generally speaking, no more than 25% of corporate receipts for each of three successive years may be from passive income sources such as rents or royalties.

141. *Id.* at § 1362(f).

142. *Id.* at § 1362(g).

143. *See infra* notes 241-43 and accompanying text. The significant relaxing of formalities in an S corporation may be a major factor for a farmer considering incorporation to evaluate.

144. *See supra* notes 99-106 and accompanying text.

145. I.R.C. § 1372(a) (1982). Taxable income, insofar as fringe benefits are concerned is computed for the S corporation exactly like partnership income is computed: only deductions allowable to an individual are allowed the corporation. For instance, rather than being able to deduct the entire cost of health insurance provided for its employees, an S corporation could only deduct so much of the expenses as exceeded 5% of the corporation's adjusted gross income. I.R.C. § 213(a) (1982).

146. *See supra* note 111.

147. I.R.C. § 1378(b) (1982). An S corporation is required to elect a fiscal year ending (FYE) December 31, unless it can establish to the satisfaction of the Internal Revenue Service the business purpose of any other FYE.

148. *Id.* at § 183(a).

149. *Id.* This section is not applicable to standard corporations.

150. Brunoehler, *One Family = 3 corporations and 1 partnership*, SUCCESSFUL FARMING, vol. 78, no. 7:22 (May 1980).

151. *Id.* Dunning Farms, Inc. owns all the livestock and grain machinery. It holds the main operation of the farm, and all families participate in it. Most of Radford and Martha's land is held by Radford Dunning Land Corporation. The parents make continual gifts of stock from this corporation to their children as part of an estate plan. Dunning, Smith, and Dunning, Inc., is a corporation owned by the three children formed for their land purchases. Finally, Radford and his oldest son, Rex, have a partnership hog farm operation: D&D Partnership.

and farmers are finding out: corporations can be a benefit to business management.

Incorporated farms are generally more efficient than unincorporated farms.¹⁵² They can provide a structure for growth and expansion plans,¹⁵³ especially when those plans involve additional people as owners or employees.¹⁵⁴ Because a corporation requires increased record keeping,¹⁵⁵ the operator gains a better financial picture of his business, enabling him to be a better manager.¹⁵⁶ And like a limited partnership, a corporation provides a convenient framework for bringing in outside investor capital through equity financing. A farm operator can sell shares of stock to outside¹⁵⁷ investors to finance his business. As long as the operator retains a majority of the stock, he retains total control of the operation. For some, this may provide an attractive alternative to debt financing.

Incorporated farms may also find credit for debt financing easier to obtain, if for no other reason than the increased efficiency and better record keeping that is required by incorporation.¹⁵⁸ Mere conversion from the sole proprietorship to the corporate form won't automatically improve the credit standing of a bad credit risk.¹⁵⁹ But adherence to the requirements of incorporation may serve to improve both credit standing and debt availability.¹⁶⁰ One commentator suggests an additional advantage: lenders' thinking patterns are oriented to dealing with the corporate borrower.¹⁶¹ Corporate form presents the lenders with more avenues for protecting their investment.¹⁶²

152. This frequently asserted claim seems to be supported by the 1978 CENSUS, *supra* note 11, at VOL. 1, PT. 51, CH. 1, TABLE 30: SUMMARY BY TYPE OF ORGANIZATION. The chart for the average value of land and buildings per farm in 1978 lists an average value of \$1,099,835 per corporate farm (\$1,038,086 per family corporate farm), and just \$221,147 per individual farm. But the same chart listed per acre shows the corporate farm has its assets spread proportionately over a larger acreage. Individual farms had an average value per acre of \$697, while the corporate farms average value was just \$475 (\$458 for a family corporation—the lowest of any category). This can be explained in part by economy of scale, and in part by the probability that it is efficient farmers who are more likely to incorporate.

153. Harl, *supra* note 5, at 943. "[A]s a device for organizing resources of production, the corporation may, with proper planning, lead to . . . larger farm operations." *Id.*

154. The use of stock bonus plans, and voting/nonvoting shares of stock for successor operators or employees, can allow involvement of several people in one ongoing operation. See generally discussion *supra* notes 60-92 and accompanying text.

155. Increased record keeping requirements can also be a disadvantage. See *infra* notes 241-43 and accompanying text.

156. Hall, *supra* note 79, at 394. "It would seem quite likely that the efficiency of an incorporated farm or ranch would exceed that of its individually owned and operated counterpart because of the detailed record keeping required of corporations . . ." *Id.*

157. Bringing in outside investors may be an attractive option to farm families. See Israel, *supra* note 22, at 338 (farmers may find nonfarming family members or other persons interested in investing in the farm, and corporate farmers can sell their shares of stock for investment purposes without transferring control). "Outsiders" may be restricted from investing in a farming corporation, though. See KAN. STAT. ANN. §§ 17-5903(j), 5904 (1981) (authorized nonfamily farm corporations), and discussion, *infra* notes 178-218 and accompanying text.

158. See Hall, *supra* note 79, at 394; Harl, *supra* note 5, at 947-48.

159. See Comment, *supra* note 22, at 583 for an argument that incorporation won't make credit any easier to obtain.

160. See Hall, *supra* note 79, at 394. The argument is that increased record keeping required of corporations will provide farmers with more information to make them better managers and as better managers, better credit risks.

161. Strasner, *supra* note 15, at 170.

162. A business entity structured as a corporation is more amenable to investment-protecting controls. Corporate resolutions or bylaws can place limits on salaries and other major expenses.

The consolidation of several smaller operating units into one consolidated business can also save the corporate farmer money through the "economy of scale" advantages it gives him.¹⁶³ Resources can be pooled to eliminate wasteful duplication; savings in purchases can be realized, both through better buys with larger quantities, and through the decreased need to purchase duplicate items that would be required were the farms still separate business units.¹⁶⁴ Having more products to buy can also earn the corporate farmers premiums unavailable to the smaller operator. And having more produce to sell may open up larger, more attractive markets.¹⁶⁵ Naturally, none of these "economy of scale" advantages apply where an ongoing operation as a sole proprietorship is reconstructed as a corporation. These are advantages based on size, not business format, and the mere reconstruction of the format of a business entity without increasing its size will not incur additional "economy of scale" benefits where none existed before. Only when several small operations are joined together into one corporate unit,¹⁶⁶ or when incorporating provides the structure for rapid expansion that the sole proprietorship didn't lend itself to, will these benefits accrue.

E. Limited Liability

A common reason for incorporating any business entity is the protection against tort and contract liability a corporation provides its owners.¹⁶⁷ In farm corporations, though, this is a rather illusory¹⁶⁸ advantage. A family farm corporation's liability being limited to the amount of the family's investment in the corporation is of little significance if all of the family's assets are in corporate

Lenders can be given a place on the board of directors. Corporate income can be restricted in its application. Furthermore, the lender is protected by insuring a business which will not cease to exist upon the death of the key operator. See Strasner, *supra* note 15, at 170.

One additional advantage corporate borrowers have over individuals is freedom from usury laws. See, e.g., KAN. STAT. ANN. § 17-7105 (1981). Lenders who perceive risks in a loan may not be willing to advance the funds without the greater return on their loan as compensation for the risk. In such circumstances, only corporate borrowers could obtain funds.

163. Comment, *supra* note 24, at 1193-95. *But cf.* Comment, *supra* note 22, at 596. "Current studies of size in farm production reveal that in most situations, all of the economies of size can be achieved by modern and fully mechanized one-man or two-man farms." *Id.* Of course, this size-advantage is the very aspect of corporations that is feared by those concerned about corporations in the farm economy. See Comment, *supra* note 24, at 1193. See also *supra* notes 23-39 and accompanying text.

164. Harl, *supra* note 5, at 943.

165. Comment, *supra* note 24, at 1193. "[R]esults from improved organization or methods of production . . . are realized through advantages of volume in selling or purchasing." *Id.*

166. For examples of combining several separate operations together into one unit, see Shoemaker, *supra* note 82, at 404-05 & n.12.

167. "A leading purpose of such [corporation] statutes and of those who act under them is to interpose a nonconductor, through which in matters of contract it is impossible to see the men behind." *Donnell v. Herring-Hall-Marvin Safe Co.*, 208 U.S. 267, at 273 (1908). "Limited liability in the tort and contract fields is one of the standard reasons given for incorporation." Hall, *supra* note 79, at 390.

There is no doubt that as a general principle the members are not liable for a corporation's debts; it was so stated in the Digest of Justinian, and has been consistently repeated in modern jurisprudence. The principle is sometimes known as the rule of "limited liability," because it does not relieve corporate members of liability for the amounts they have promised to contribute as the dues of membership or in consideration for shares.

A. CONARD, CORPORATIONS IN PERSPECTIVE § 270 (1976). See also N. LATTIN, *supra* note 15, at § 11.

168. See Israel, *supra* note 22, at 339; Randall & DeSantis, *supra* note 59, at 750; Comment, *Sole Proprietor's Quandry*, *supra* note 59, at 552-56.

form. For this advantage to have any meaning, the stockholders must have retained some assets in their own name, distinct from the farm corporation.¹⁶⁹ But the more likely incidence is that, when the corporation was formed, all land, livestock, machinery, crops and buildings were transferred into it. Subsequent acquisitions are then almost always made by the corporation, rather than by individuals. In this case, the difference between the corporation having all of its assets levied on, and the corporate owner having all of his assets levied on, is nil.

Even if the farmer has sizable assets separate from the corporation, he may find that they are not automatically protected from the corporation's creditors. In a tort action, the owner/operator of a closely held corporation¹⁷⁰ is likely to be named along with the corporate entity.¹⁷¹ The usual form of protection from tort actions for a farm is insurance,¹⁷² be the farm privately held, or organized as a corporation.

Likewise, a farmer's separate holdings are not necessarily protected in a

169. If all the property involved in a going operation is owned by the corporation . . . the limitation may be somewhat pointless If the operation itself is all that is incorporated, however, and the land remains in the hands of the original owner or even another corporation, the concept of limited liability may be quite important.

Hall, *supra* note 79, at 390-91.

But cf. Colten, *supra* note 31, at 248-49; Strasner, *supra* note 15, at 171, where the limited liability of a farm corporation is called a "significant nontax benefit of the corporate farm." *Id.* According to a Minnesota survey of twenty-six farm incorporations in 1958, limited liability was the most important reason for incorporating twelve of them, more than any other single reason. Other reasons listed as the primary reason for incorporation were estate settlement, (seven); income tax advantages, (six); and social security purposes, (one). Note, *supra* note 24, at 308 n.18.

If limited liability is a primary motivational factor for farmers' decisions to incorporate (assuming for purposes of argument that a 1958 survey of 26 Minnesota farmers is representative of all farmers today), it should not be. Modern commentators seem to emphasize the income tax and estate planning advantages of incorporation, and to de-emphasize, if not dismiss altogether, the assumed advantage of limited liability. See, e.g., Randall & DeSantis, *supra* note 59, at 750-54. The reason for this shift in emphasis over the last quarter of a century must be more deduced than discovered. In part, it may have to do with the increasingly predominant role taxation has come to play in virtually everything. Income tax is more a factor to be considered now than it may have been twenty-five years ago. It also might result from the practical experience of the liabilities incurred by farm corporations, legal theories and technical safeguards notwithstanding. Doubts about the practicality of this advantage were expressed early on, as well. See, e.g., Shoemaker, *supra* note 82, at 404.

170. The standard definition of a close corporation was stated in *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 586, 328 N.E.2d 505, 511 (1974). "We deem a close corporation to be typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation." *Id.* See also *Brooks v. Willoots*, 78 F.2d 270, 273 (8th Cir. 1935); KAN. STAT. ANN. § 17-7201 to -7216 (1981) (separate statutory provisions relating to Kansas close corporations); Comment, *Close Corporations And The South Dakota Business Corporation Act: Time For Reform?*, 23 S.D.L. REV. 427 (1978); Comment, *Sole Proprietor's Quandry*, *supra* note 59.

171. If not originally named, the owner may be included in the suit personally under the various judicial doctrines of "piercing the corporate veil," or being the "alter ego" of the corporation. Or, the corporation may be disregarded as a "mere instrumentality" or "dummy." See generally A. CONARD, *supra* note 167, at §§ 271 to 277; N. LATTIN, *supra* note 15, at §§ 14 to 20.

The mere incidence of sole ownership of the corporation does not *de facto* result in disregarding the corporate form, however. A. CONARD, *supra* note 167, at § 272. See also *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, at 255 (E.D. Wis. 1905).

[A] corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as [merely] an association of persons.

Id.

172. See Hall, *supra* note 79, at 390; Randall & DeSantis, *supra* note 59, at 750; Shoemaker, *supra* note 82, at 404.

contract action. Most lending institutions will require a farmer to individually cosign on any corporate loans,¹⁷³ and farmers, more concerned with the success of the enterprise that represents their livelihood than with theoretical notions of limited liability, may be only too willing to cosign. Such action, of course, defeats any protection from liability the corporate farm structure may provide for its investors. Therefore, while a family farm corporation may provide some liability protection, it generally will not. If limited liability were the only reason to undertake incorporating the farm, the farmer would be best advised not to incorporate.¹⁷⁴

IV. DISADVANTAGES OF FARM INCORPORATION

The fact that 97.3%¹⁷⁵ of all farm operations in the country are *not* incorporated does not imply that those operations are either too small or too stupid to seize these advantages. Rather, there are very good reasons for not incorporating, and some distinct disadvantages to the corporate form of farming as well. Many farmers may have seriously considered incorporation and decided it was not for them. Others incorporated, decided it was a mistake,¹⁷⁶ and then faced the dilemma of continuing under an awkward form of business enterprise, or of facing the problems of dissolving their corporation.¹⁷⁷ Discussion of the common disadvantages to incorporation follows.

A. State Regulations

Business lawyers and experts on corporate law who are unfamiliar with agricultural regulations might be shocked to discover the type of restrictions placed on farm corporations. A dozen states¹⁷⁸ have enacted statutes specifi-

173. Hall, *supra* note 79, at 340.

174. See *supra* note 169 and accompanying text.

175. See *supra* note 45 and accompanying text.

176. Cain, *The Unsuccessful Corporations*, SUCCESSFUL FARMING, vol. 77, no. 1:30 (Jan. 1979).

177. For the problems of corporate liquidation and dissolution, see *infra* notes 254-64 and accompanying text.

178. 2 J. JUERGENMEYER & J. WADLEY, *supra* note 11, at 154-69. The state, year restrictions were first enacted, and statutes are: Iowa, IOWA CODE ANN. § 172C (West Supp. 1984) (enacted 1975). The stated purpose of the statute is "to preserve free and private enterprise, prevent monopoly, and protect consumers." IOWA CODE ANN. § 172C.2 (West Supp. 1984). The statutes regulate corporations and partnerships but provide several exceptions. *Id.* at § 172C. Kansas, KAN. STAT. ANN. §§ 17-5902 to -5904 (1981) (enacted 1931). See discussion *infra* notes 193-212 and accompanying text. Minnesota, MINN. STAT. ANN. § 500.221 subd. 2 (West Supp. 1985) (enacted 1973). The statute restricts corporations, partnerships, trusts, and other business entities from acquiring title, legal or beneficial, to agricultural land unless 80% of the beneficial interest of the ownership is held by citizens or permanent residents of the United States. A few limited exceptions are provided. *Id.* Missouri, MO. ANN. STAT. §§ 350.010 to .030 (Vernon Supp. 1984) (enacted 1975). No corporation is allowed to engage in farming, but those already so engaged on September 28, 1975 were grandfathered in. Exceptions are made for encumbrances, family farms, and "authorized" farms among others. *Id.* Nebraska, NEB. REV. STAT. §§ 76-1501 to -1517 (1981) (enacted 1975). The stated purpose of the statutes is "to nurture the free enterprise system, to provide for the continued existence of the family farm against potential monopolization of the agricultural industry and to protect against alien ownership of Nebraska agricultural land." *Id.* at § 76-1501 (1981). Despite the broad intent of that purpose statement, the statutes are only a filing requirement for corporations, and some restrictions on trusts. *Id.* at §§ 76-1501 to -1517. In 1982, a constitutional amendment was voted on to further restrict agricultural lands. See *infra* notes 213-18 and accompanying text. North Dakota, N.D. CENT. CODE §§ 10-06-01 to -06-15 (1981) (enacted 1932). See discussion *infra* notes 184-92 and accompanying text. Oklahoma, OKLA. STAT. ANN. tit. 18 §§ 951-56 (West Supp. 1984) (enacted 1971). Foreign farm corporations are prohibited but certain domestic corporations

cally regulating corporate farming in ways no other corporation is regulated.¹⁷⁹ Most statutes place limitations on the size of the corporation,¹⁸⁰ the number of stockholders,¹⁸¹ form of ownership,¹⁸² limitations on the type of activities they're allowed to engage in¹⁸³ or other such limitations.

Two of the earliest states to impose such restrictions were Kansas and North Dakota.¹⁸⁴ Both statutes seem to have been enacted in response to the escalating number of farm foreclosures during the Great Depression. North Dakota's provision,¹⁸⁵ which was approved by the voters in 1932, prohibited any corporation from owning more land than necessary for their business, from engaging in the business of farming or agriculture, and required all corporations holding farmland in violation of the statute to divest themselves of such land within ten years.¹⁸⁶ The statute was interpreted not as a ban to a corporation taking title to farmland, as in a foreclosure action, but as a basis for action requiring divestiture of land held in violation of statute.¹⁸⁷ The statute strictly forbade any farming business being organized as a corporation. In 1967 the North Dakota voters were again presented the issue, this time in the form of a bill allowing certain restricted types of corporate farming.¹⁸⁸ They rejected it by

are allowed. No corporation other than a farm corporation is allowed to hold land beyond what is reasonable for their business purpose, and any resident of the county is authorized to bring divestment action. *Id.* OKLA. CONST. art. XXII, § 2 had been interpreted as preventing corporate ownership of farm lands (Texas Co. v. State *ex rel.* Coryell, 198 Okla. 565, 570, 180 P.2d 631, 636 (1947)) until 1969 (LeForce v. Bullard, 454 P.2d 297 (Okla. 1969) and Oklahoma Land & Cattle Co. v. State, 456 P.2d 544 (Okla. 1969)) when the Oklahoma Supreme Court held that the provision did not prohibit land holding or ownership by farm corporations. The statute was enacted two years later. See Harl, *supra* note 6, at 1251 for further discussion. Oregon, (1977 Oregon Laws ch. 49). Oregon formerly imposed reporting requirements on any corporation owning or leasing over 40 acres of farmland, but the act expired by its own terms on July 1, 1981. South Dakota, S.D. CODIFIED LAWS ANN. §§ 47-9A-1 to -23 (1983) (enacted 1974). "The legislature of the state of South Dakota recognizes the importance of the family farm . . . and recognizes that the existence of the family farm is threatened by conglomerates in farming." *Id.* at § 47-9A-1 (1983). The statutes in general bar any corporation from being in farming, or obtaining any title or interest to farm ground. Trusts, encumbrances, family farms, and "authorized" farms are excepted. *Id.* at § 47-9A-1 to -23. See Comment, *supra* note 22, at 575-78 for discussion on the enactment of these provisions. Texas, TEX. REV. CIV. STAT. ANN. art. 2.01(b)(3)(A) (Vernon 1980) (Business Corporation Act) (enacted 1955). Only corporations whose business is both raising cattle and owning land therefore *and* operating stockyards and slaughter houses are prohibited. *Id.* West Virginia, W. VA. CODE § 11-12-75 (1983) (enacted 1939). An additional tax is imposed on corporations holding over 10,000 acres of land. *Id.* Wisconsin, WIS. STAT. ANN. § 182.001 (Supp. 1984) (enacted 1974). No corporation or trust is allowed to own farm land or carry on farming operations, unless on a sizable list of exceptions. Family farms aren't specifically excepted, but corporations with 15 or fewer shareholders are, and for that purpose all family members up to first cousins are considered one shareholder. Corporate land owned before June 5, 1974 is also excepted in enacting this legislation. *Id.* See Comment, *supra* note 24 for a discussion of legislative considerations in enacting this legislation.

In addition to these statutory restrictions the constitution of Kentucky imposed broad restrictions on corporate ownership of land in general. KY. CONST. § 192.

179. Ridenour, *Kansas Farm Corporations: Some Observations and Recommendations*, 44 J.B.A.K. 241 (1975) (no other business enterprise is regulated the way farm corporations are).

180. See, e.g., W. VA. CODE § 11-12-75 (1983).

181. See, e.g., KAN. STAT. ANN. § 17-5903(j)(1) (1981).

182. See, e.g., *id.* at § 17-5903(1)&(m).

183. See, e.g., *id.* at § 17-5904.

184. 2 J. JUERGENSMEYER & J. WADLEY, *supra* note 11, at 154.

185. N.D. CENT. CODE §§ 10-06-01 to -06-06 (1943) (repealed 1981).

186. Note, *North Dakota's Corporate Farming Statute: An Analysis of the Recent Change in the Law*, 58 N.D.L. REV. 282, 284 (1982).

187. Loy v. Kessler, 76 N.D. 738, 39 N.W.2d 260 (1949).

188. 1967 N.D. Sess. Laws ch. 1238.

more than a three-to-one margin.¹⁸⁹ In 1981, without consulting the voters, the North Dakota legislature changed the law¹⁹⁰ to permit incorporation of farms which meet certain requirements.¹⁹¹ For the first time in a half century, it was possible to have a farm corporation in North Dakota. Still, any type of corporation not specifically included in the statute is prohibited from farming.¹⁹²

Although North Dakota is unique in the length of time they strictly prohibited farm incorporation, the restrictions themselves are not unique. Kansas, which was the first state to enact statutory regulation specifically on farm corporations,¹⁹³ virtually barred corporate farming from 1931 to 1965.¹⁹⁴ Prior to 1932, no Kansas statute specifically addressed corporate farming, although the statutes on corporations in general listed "encouragement of agriculture and horticulture" as a purpose for which corporations could be formed.¹⁹⁵ But the statute enacted in 1931 prohibited corporations from engaging in most types of agriculture.¹⁹⁶ In addition, *State v. Wheat Farming Co.*,¹⁹⁷ decided in 1933, held that over thirty years of interpreting "encouragement of agriculture and horticulture"¹⁹⁸ as involving farming for profit did not bar a different interpretation, and ordered corporate farms to divest within a reasonable time.¹⁹⁹

Kansas farm corporations are currently governed by *Kansas Statutes Annotated (K.S.A.)* §§ 17-5902 to -5904 adopted in 1981. These statutes prohibit trust or corporate ownership, acquisition, or leasing of agricultural land unless the corporation is one of five excepted types: family farm corporation,²⁰⁰ authorized farm corporation,²⁰¹ family trust,²⁰² authorized trust²⁰³ or testamen-

189. Note, *supra* note 186, at 282 n.4. Apparently the old fear of corporate farms was still alive in North Dakota.

190. 1981 N.D. Sess. Laws. ch. 134, S.B. 2233. Codified at N.D. CENT. CODE §§ 10-06-01 to -06-15.

191. Among the requirements are limits on the number of shareholders, limits on the relationship of shareholders to each other, requirements that the officers and directors be actively involved in farming, and limits on the outside income a farm corporation can earn. See N.D. CENT. CODE § 10-06-07 (1981).

192. *Id.* Creditor corporations are allowed to acquire title to farmland in enforcement of liens, but must dispose of it within three years. *Id.* at -13.

193. See *supra* note 178.

194. Ridenour, *supra* note 179, at 243. In 1965 KAN. STAT. ANN. § 17-202(a) was amended to list forbidden agricultural pursuits for domestic and foreign corporations, and KAN. STAT. ANN. § 17-2701 was amended, making an exception for corporations with ten or fewer stockholders if they were all individuals or trustees or executors for individuals; were all residents of the state; did not own stock in any other corporation; and if the corporation did not "own, control, manage or supervise" over 5,000 acres. 1965 Kan. Sess. Laws ch. 149.

195. REV. STAT. 1923 § 17-202(4); G.S. 1909 § 1699(H).

196. REV. STAT. 1923 § 17-202a (1931).

197. 137 Kan. 697, 22 P.2d 1093 (1933).

198. See *supra* note 195.

199. 137 Kan. at 714, 716, 22 P.2d at 1101, 1102.

200. A family farm corporation is defined as one founded for the purposes of farming in which the majority of the stock is held by, and the majority of the shareholders are related to each other within the third degree (by birth, adoption or marriage), or fiduciaries for such; all of the stockholders are natural persons or fiduciaries for natural persons; and at least one of the stockholders is residing on the farm and actively engaged in the labor or management of the farming operation. KAN. STAT. ANN. § 17-5903(i) (1981).

201. An authorized farm corporation is defined as a corporation other than a family farm corporation, founded by only Kansas residents for the purpose of farming and owning agricultural land in which there are no more than fifteen stockholders; all stockholders are natural persons or fiduciaries for natural persons or nonprofit corporations; and at least 30% of the stockholders are residing on the farm and actively engaged in the day-to-day labor or management of the farming operation. *Id.* at § 17-5903(j).

tary trust.²⁰⁴ Excluded from the statute's coverage are a variety of instances, including creditors' encumbrances,²⁰⁵ and land held by corporations as is necessary for the operation of a nonfarming business.²⁰⁶ The latter is in response to *State of Kansas v. E.I. Du Pont DeNemours & Co.*,²⁰⁷ which was the catalyst for the 1981 change.²⁰⁸ The prior statute prohibited a corporation from "directly or indirectly engaging in the agricultural or horticultural business . . ." ²⁰⁹ The present statute more clearly defines what is and is not considered "farming"²¹⁰ and sets out a variety of exceptions to the statutory restrictions,²¹¹ including the one that qualifies Du Pont's ownership.²¹²

In contrast to recent actions by Kansas and North Dakota relaxing their regulations on farm corporations, Nebraska, in 1982, enacted a constitutional amendment²¹³ by referendum²¹⁴ restricting farm corporations. The amendment restricts both the operation of farms and the ownership of agricultural lands,²¹⁵ although a major exception is made for family farm corporations.²¹⁶ A declaratory judgment action has been filed²¹⁷ by the Omaha National Bank contending

202. A family trust is defined as a trust in which the majority of the equitable interest is held by, and the majority of the beneficiaries are, persons related to each other within the third degree (by birth, adoption or marriage) or fiduciaries for such; and in which all of the beneficiaries are natural persons, fiduciaries for family members, or nonprofit corporations. *Id.* at § 17-5903(1).

203. An authorized trust is defined as a trust with no more than fifteen beneficiaries; all of whom are natural persons or fiduciaries for such, or nonprofit corporations; and which is not exempt from Kansas or federal income tax. *Id.* at § 17-5903(m).

204. A testamentary trust is defined as a trust created by a will, as defined in the Kansas Probate Code. *Id.* at § 17-5903(n).

205. Bona fide encumbrances taken for purposes of security for a debt are excluded from the statutory restrictions. *Id.* at §§ 17-5904(a)(1), (4).

206. *Id.* at § 17-5904(a)(3).

207. No. 80 CV 893 (unpublished decision, Shawnee County Dist. Ct., Second Division Feb. 18, 1981).

208. The case deals with the then existing law, KAN. STAT. ANN. § 17-5901(a) (repealed 1981). The statute prohibited all but certain types of corporations (of which Du Pont clearly was not one) from "engag[ing] in . . . agricultural or horticulture business . . ." *Id.* The court, aware of the change in the statute then pending in the legislature, sidestepped the issue of whether or not defendant was actively engaged in farming by controlling the production of crops on the land, and accepted defendant's contention that the statute did not specifically prohibit the corporate ownership of agricultural lands. The main purpose of the attorney general's office in bringing this action apparently was to encourage a change in the then existing law, under which the secretary of state annually reported to the attorney general numerous suspected violators, whom it was felt did not warrant prosecution. (Interview with Deputy Attorney General Wayne Hundley at the Kansas Attorney General's Office, April 12, 1984).

209. KAN. STAT. ANN. § 17-5901(a) (1973); repealed 1981 Kan. Sess. Laws ch. 106.

210. KAN. STAT. ANN. § 17-5903(g) (1981).

211. *Id.* at § 17-5904(a).

212. *Id.* at § 17-5904(a)(3).

213. Initiative Petition No. 300, which was approved by the Nebraska voters, amends article XII of the Nebraska Constitution. Its basic prohibition is that: "No corporation or syndicate shall acquire, or otherwise obtain an interest, whether legal, beneficial or otherwise, in any title to real estate used for farming or ranching in this state, or engage in farming or ranching." Brown & Brown, *Constitutionality of Nebraska's Initiative Measure Prohibiting Corporate Farming and Ranching*, 17 CREIGHTON L. REV. 233, 234 (1984). The complete initiative provision is reprinted, *id.* at 256-59.

214. The process of constitutional amendment by the initiative process in Nebraska is guaranteed by NEB. CONST. art. III, § 2.

215. Brown & Brown, *supra* note 213, at 257. See also Colton, *supra* note 31, at 253.

216. Brown & Brown, *supra* note 213, at 257. See also Colton, *supra* note 31, at 255.

217. *The Omaha Nat'l Bank v. Douglas* (No. 372-191 Dist. Ct. of Lancaster County, Neb., filed July 6, 1983). On January 31, 1985, Judge Endacott issued an order in the case substituting Eugene Crump for the named defendant; announcing that Professor James Lake had accepted the court's invitation to participate as *amicus curiae* (see Lake, *supra* note 39 for an indication of what his

that the enactment conflicts with provisions of the Nebraska and United States Constitutions and with the National Bank Act.²¹⁸

B. Income Tax

The primary income tax disadvantage to incorporation is double taxation.²¹⁹ The farm corporation must pay taxes on its profit, and any dividends it pays to its shareholders are again taxable to them. This double taxation may offset the income tax advantages incorporation can bring.²²⁰ The standard method for avoiding this problem, especially with close corporations, is to avoid dividend payments and pay most of the corporate earnings to the owner/operator in salary, which is a deductible expense to the corporation.²²¹ This is not a complete answer, though. During times of high profit, the owner must either take money beyond his reasonable salary through dividends, and endure the double taxation, or leave the profits in the corporation and be potentially subject to the accumulated earnings tax.²²² In times of low earnings, the opposite problem occurs. Even though the corporation is earning little or no money, the owner/operator is still being paid a salary, and is taxed on that salary. This may be irksome to the farmer who feels he is both losing money and paying income taxes.²²³

A significant income tax disadvantage to incorporation is the unavailability of capital gains deductions.²²⁴ Additionally, corporate capital losses are deductible only to the extent of capital gains.²²⁵ Other tax disadvantages are the potential of an accumulated earnings tax,²²⁶ and a potential personal holdings company tax.²²⁷ The aggregate social security taxes may be higher as well, since payments for both employer and employee contribution must be made.²²⁸ Even some income tax advantages to incorporation may have less favorable aspects. For example, corporations can elect either cash basis or accrual basis accounting,²²⁹ but by electing cash basis they may be subject to an excess deductions amount (EDA) conversion.²³⁰ The farm operating as a corporation is safe from

amicus curiae brief will probably say), and ordering parties to submit and exchange simultaneously their initial briefs no later than March 18, 1985, their responses no later than April 2, 1985, and to have the matter ready for the court by April 3, 1985.

218. Brown & Brown, *supra* note 213, at 233. See also Lake, *supra* note 39.

219. The so-called double taxation problem occurs when a corporation pays tax on its profits, then distributes the after tax profits as dividends to its shareholders, to whom the receipt of such dividends is also taxable.

220. See *supra* notes 93-127 and accompanying text.

221. I.R.C. § 162(a) (1982). *But cf.* Harold's Club v. Commissioner, 340 F.2d 861, 867 (9th Cir. 1965) (to the extent that a salary is unreasonable it is not deductible). See also Rev. Rul. 59-110, 1959-1 Cum. Bull. 45.

222. See *infra* note 226.

223. See *Farm Corporation Losses*, SUCCESSFUL FARMING, vol. 78, no. 9:7 (Aug. 1980).

224. I.R.C. § 1202(a) (1982). See Emry, *supra* note 76, at 44 n.137.

225. I.R.C. § 1211(a) (1982). Losses from sales or exchange of capital assets are allowed only to the extent of gains from such sales or exchanges.

226. *Id.* at § 531. The tax is imposed on corporations, who are improperly accumulating a surplus. The tax is an additional 27 1/2% of accumulated earnings up to \$100,000, and 38 1/2% thereafter. "Excess accumulation" is excess beyond the reasonable needs of the business, as defined generally I.R.C. §§ 531-37 (1982). See Israel, *supra* note 22, at 339-40.

227. I.R.C. §§ 541-47 (1982).

228. See discussion, Emry, *supra* note 76, at 43.

229. See *supra* notes 111-16 and accompanying text.

230. I.R.C. § 1251(b) (1982). The "EDA" is a provision converting potential capital gain into

the application of the "hobby farm" provision²³¹ denying loss deductibility, but the Commissioner may achieve the same result by a different route.²³²

C. Economic Implications

Several nontax economic disadvantages exist for the farm in corporate form. Under state law, they will be subject to a variety of fees for being formed and continuing in existence.²³³ The difficulties in getting earnings out of the corporation²³⁴ may be especially burdensome in the case of early year losses.²³⁵ Those difficulties can also be a problem when it comes time to provide for the retirement income of the older generation of an ongoing enterprise.²³⁶ S corporation status may be a solution to these earnings distribution problems, but not all corporations can, or want to, qualify.²³⁷

Certain protections provided for the farmer as an individual, such as the bankruptcy protections of homestead²³⁸ and freedom from involuntary bankruptcy,²³⁹ are available only to individuals, not to corporations or holders of corporate stock. Corporations formerly were restricted in their access to federal loan programs by federal loan and regulation,²⁴⁰ and although those restrictions are now all repealed, some state credit agencies may still restrict or look unfavorably on farm corporations.

D. Corporate Control

As a sole proprietor, a farmer can mingle personal and business funds. The same checking account can be used to buy a new tractor or to buy Junior's

ordinary income in the event of gain from the disposition of property in the same year a net farm loss is reported. See Lucas & Wilkonson, *supra* note 93, at 679.

231. I.R.C. § 183(a) (1982). See *supra* note 148.

232. Deductions may be disallowed under I.R.C. § 269 (1982) if the principal purpose of procuring the benefit of a deduction is the evasion of federal income tax. See *Borge v. Commissioner*, 405 F.2d 673, 677-79 (2d Cir. 1969) (a part-time business setting used for tax avoidance purposes, deductions not allowed).

233. See, e.g., KAN. STAT. ANN. §§ 17-7502 (1981) (initial \$50 recording fee); 17-7503(c) and -7505(c) (annual franchise tax of \$20 to \$2,500); and 17-7506 (filing fee for corporate documents). These additional costs may deter some farmers from incorporating. Harl, *supra* note 5, at 945.

234. See *supra* notes 219-21 and accompanying text. See also *supra* notes 122-27 and accompanying text.

235. Lucas & Wilkonson, *supra* note 93, at 681.

Potential danger always exists for the agribusiness that has incorporated after several years of high income. The corporation, during its first few years, could incur large losses due to depressed prices or adverse weather conditions While carryover provisions [of I.R.C. § 172] would be applicable, no immediate cash relief through tax refunds may be obtained by the corporation. Significantly, many ranchers who have incorporated since mid-1973 have experienced this adversity.

Id.

236. Conceptually, the problem of providing income for the older farmer may be a problem with no good solutions. He can have dividends paid on his stock, assuming the corporation has the money, but to do so he must be willing to accept the double tax bite. Payment to him in the form of salaries can only be in an amount commensurate with the services he performs (see *supra* note 221). Preplanning for passive income avenues from the corporation (see *supra* notes 122-27 and accompanying text), or for pension plans (see *supra* note 103) may alleviate this problem, but if not done initially, they probably can't be done.

237. See *supra* notes 128-49 and accompanying text.

238. See KAN. CONST. art. 15, § 9; KAN. STAT. ANN. § 60-2301 (1983).

239. 11 U.S.C. § 303(a) (1982). See *In re Lake Jackson Sugar Co.*, 129 F. 640, 643 (S.D. Tex. 1904).

240. Harl, *supra* note 6, at 1253, n.37-39.

shoes. As a corporation, that laxity is not available.²⁴¹ Not only must separate accounts and separate books be kept for the farmer and for the corporate farm, but one account cannot be used to pay bills properly belonging to the other. Before the corporate farmer pays any bill, he must determine whether it is essentially a personal obligation, or a business one. If the business has plenty of cash on hand at a time when the farmer's personal account is lean, or vice versa, he cannot simply pay one's bills with the other, or transfer funds without justification. He must learn to think of himself separately from the farm.²⁴² For family corporation owners, it may be difficult to comprehend this separation. Because of the independence they became accustomed to as sole proprietors, because of the personal identity they have with a farming operation that may have been in their family for generations, this unnatural separation of farm and farmer may prove to be an insurmountable obstacle.²⁴³

A separate, but significant problem of control exists from the minority stockholder's position. A partner who is dissatisfied with the partnership can terminate it and recoup his interest.²⁴⁴ A stockholder in a publicly held corporation who disagrees with the operation of the corporation has a ready market in which to sell his stock and recoup his interest. But a minority stockholder in a close corporation is in a helpless position. There is no ready market for his shares; in fact, there may be no market at all. He doesn't have enough votes to affect policy decisions on the board of directors, so he must live with whatever the others may decide. And he has no power to dissolve the corporation.²⁴⁵ This lack of power, coupled with the policy of most close corporations to pay few, if any, dividends results in the minority stockholder finding his investment locked in. Instead of a share of land and personal property he would have otherwise had, he has a worthless piece of paper.²⁴⁶

These problems can be mitigated somewhat by advance planning. Through stockholder agreements, high quorum or high voting requirements, or cumulative voting, the minority stockholder may be assured of meaningful representation on the board.²⁴⁷ The corporate charter or bylaws can give the minority stockholder a veto power on corporate action,²⁴⁸ although this may increase corporate deadlocks. Stock buy out²⁴⁹ provisions can also be included in the charter, to provide the minority stockholder with a way to recoup his investment. But absent specific provisions such as these, a minority stockholder may

241. Emry, *supra* note 76, at 45.

242. Eastwood, *supra* note 93, at 530, "Incorporating a business which has traditionally been commanded by a single individual or a select group of individuals involves a nearly total change in business philosophy." *Id.*

243. Shoemaker, *supra* note 82, at 402. "Unfortunately, incompatibility problems are difficult to predict prior to incorporation." *Id.*

244. KAN. STAT. ANN. § 56-331(a)(2) (1983).

245. Note, *supra* note 136, at 502.

246. Shoemaker, *supra* note 82, at 414.

247. Comment, *Close Corporations and The South Dakota Business Corporation Act: Time For Reform?*, 23 S.D.L. REV. 427, at 437 (1978) noting that the most common type of shareholder agreement is a voting contract regarding election of directors. *Id.*

248. *Id.* at 443-44.

249. See Lischer, Jr., *Buy-Sell Agreements for Closely Held Business Interests*, 44 TEX. B.J. 283 (1981).

find himself in a disadvantageous position,²⁵⁰ especially in the case where the minority stockholder is an off-farm heir subject to the control of a co-heir who is the farm operator. If the majority stockholder/operator chooses to pay out all corporate profits in salary,²⁵¹ and declare no dividends, the off-farm heir may find their legacy worthless.²⁵²

V. CORPORATE LIQUIDATION AND DISSOLUTION²⁵³

"Decisions to embrace the corporate form of organization should be carefully considered, since a corporation, like a lobster pot, is easy to enter, difficult to live in, and virtually impossible to get out of."²⁵⁴

Despite the potential advantage of incorporation, some farmers may be concerned with the seeming permanence of incorporating their farm. A farm partnership can be easily entered and left, without any serious consequences. But a farmer wishing to dissolve his corporation may find himself faced with unacceptable tax consequences.²⁵⁵ A farmer in corporate form wishing to liquidate under federal tax law,²⁵⁶ has several options. The easiest way to dispose of the corporation is to sell all the shares of stock in the corporation. This doesn't affect the operation of the farm, but merely transfers ownership and control of it, and is only feasible if a buyer can be found who wants to acquire an ongoing concern. This method of liquidation puts the farmer out of farming, and that may not be what he wanted.

If a buyer of stock as such could not be found, the farm corporation could sell all of its property, and then distribute the proceeds of sale to its shareholders, leaving an empty corporate shell that may be maintained or terminated under state law²⁵⁷ as the shareholders wish. The tax consequences of a sale/distribution may be prohibitive, though. On sale, the corporation is taxed to the

250. *But see* KAN. STAT. ANN. § 17-6516 (1981) allowing stockholders to petition the district court for appointment of a custodian in case of dissension and deadlock problems.

251. Comment, *supra* note 247, at 445.

In fact, a secure job with the corporation may be the shareholder's only return on his investment, given the usual practice of distributing a high percentage of close corporation earnings in the form of salaries rather than as dividends. Furthermore, the firing of a minority shareholder-employee is a favorite "squeeze-out" tactic and when coupled with deliberate dividend withholding and unmarketable shares it can mean economic disaster to the 'squeezee.'

Id.

252. Of course, the minority stockholder position can be an advantageous one in estate planning, when it is the grantor, not heir, as minority stockholder. *See supra* notes 88-92 and accompanying text.

253. "Liquidation" of a corporation is a federal income tax term, denoting an emptying of assets from the corporation to the shareholders in a distribution or redemption in partial or complete liquidation. "Dissolution" of a corporation is a state law term, denoting an ending of the corporation's legal existence. The two terms should not be confused. A complete liquidation of a corporation without a corporate dissolution is possible, and not unusual. Owners may liquidate the corporation to cease the business activity it's been conducting, but leave the "corporate shell" in existence as a framework for a possible new business venture later on. In either liquidation or dissolution, applicable statutes must be closely studied and carefully complied with.

254. B. BITTKER & J. EUSTICE, *supra* note 72, at 2-4.

255. *See generally* Hood, Shors & Triplett, *Tax Consequences for Corporate Divisions of the Family Farm Corporation*, 4 J. CORP. L. 1 (1978).

256. I.R.C. §§ 331-46 (1982) (the tax code's provisions on corporate liquidations: Subchapter C, Part II).

257. *See* KAN. STAT. ANN. §§ 17-6801 to -6813 (1981). *See infra* notes 260-63 and accompanying text.

extent proceeds of sale exceed its basis, and then the shareholder is taxed again on distribution.²⁵⁸ Two escape hatches²⁵⁹ are available to avoid this result, and they are relatively easy to qualify for. But if they are not complied with, the double taxation problem returns with a vengeance: the farm could have practically nothing left after paying all the taxes.

Should the farmer also decide to dissolve his corporation under state law, he may (in Kansas) petition the district court to appoint a trustee or receiver to take charge of corporate property during the dissolution.²⁶⁰ The trustee or receiver pays the debts of the corporation and distributes the remaining property to shareholders.²⁶¹ A corporation is not dissolved until all taxes and fees owed the state are paid,²⁶² and is considered to continue in existence for three years after dissolution for the purpose of prosecuting and defending suits.²⁶³

Should a farmer decide to dissolve his corporation, careful planning and individual consultation with the farmer's attorney and accountant are necessary to determine the most favorable course for him.²⁶⁴ No farmer should undertake incorporating without at least being made aware of the complexities of dissolution, should that need arise. In short, the would-be corporate farmer would do well to remember the lobster, and plan his escape before he enters the structure.

VI. CONCLUSION

Although it still represents a small part of the total farm picture, farm corporations are a growing segment of American agriculture, popular among the larger farms, and certain to be around for some time. Incorporation has many advantages to recommend itself to a farm operation. Predominate among these is the income tax savings potential. Corporate tax rates can be lower than individual rates, but the real savings comes in a corporation's ability to create deductible expenses out of previously nondeductible expenses. The corporate form can also make dividing up a farm operated among farming and nonfarming heirs

258. The shareholder is taxed on the distribution either as a dividend, in which case it is taxable as ordinary income to the extent of the corporation's earnings and profits (see I.R.C. §§ 301(c), 316 (1982)); or as a redemption of the shareholder's stock by the corporation, in which case it is taxable as capital gains to the extent proceeds exceed the shareholder's basis in stock (See I.R.C. § 302 (1982)).

If the corporation distributes property "in-kind" to its shareholders instead of selling it, then to the extent the property's fair market value (what it could have been sold for) exceeds the corporation's basis in that property, gain would be recognized to the corporation. I.R.C. § 311(d)(1) (1984).

259. The Internal Revenue Code provides two "escape hatches" allowing corporate liquidation to be undertaken without double taxation. The most common one is the "12 month liquidation" (I.R.C. § 337 (1982)). This allows the corporation to sell or distribute all of its assets without recognizing any taxable gain at the corporate level. Basic requirements of this section are: formal adoption of plan of liquidation by corporation; complete liquidation of corporation; and completion of plan no later than twelve months after its adoption.

The one month liquidation (I.R.C. § 333 (1982)) provides very favorable tax treatment of the distributions to shareholders *providing* the corporation has little if any earnings and profit, and little cash, stock and securities. Use of section 333 would be especially helpful in liquidating a new corporation, or an "S Corporation," both of which would have low earnings and profits. For more detailed treatment of corporation liquidations, see B. BITTKER & J. EUSTICE, *supra* note 72, ch. 11; Lucas & Wilkonson, *supra* note 93, at 683-84.

260. KAN. STAT. ANN. § 17-6808 (1981).

261. *Id.* at § 17-6810.

262. *Id.* at § 17-6806.

263. *Id.* at § 17-6807.

264. Cain, *supra* note 176.

an easier task, and one less threatening to the viability of the farm as an operation. Incorporation may provide the tools necessary to improve management and efficiency of a farm. It also provides a vehicle for infusing nonfarm investor capital into an operation without threatening the original operator's control.

This latter potential advantage, and farm incorporation in general, may be restricted by stringent state law requirements. Several states, as recently as the 1970's, have enacted restrictive statutory requirements on farm incorporation. The apparent motivation for such restrictions has been a desire to "save the family farm" from "big-moneyed" investors. If that is their purpose, the statutes are both under-inclusive and over-inclusive. They are under-inclusive because corporate ownership is only one way such investors can become involved in farming. Through limited partnerships, leasing instead of owning farm operations, or marketing contracts for farm production, the "big-moneyed" investors can have as much involvement in farming as if they'd used the corporate form of operation. On the other hand, restrictions on farm corporations may actually hurt the family farm they were designed to help. Debt financing as a means of sustaining or expanding a farm operation may not be feasible due to high interest costs or high debt service payments required. Equity financing, through non-farm investor capital, or through neighboring farms combining operations to eliminate wasteful duplication, could be an attractive alternative to such indebtedness. But in states where farm corporations are restricted, many avenues of such equity financing may be foreclosed. By denying these opportunities to the family farmer, the state may have harmed the farmer more than they've helped him. This does not seem to be generally realized, though, and it would not be surprising to see the current farm crisis spawn more such restrictive laws.

A farm need not be of a certain size, or market a certain amount of products before it can consider incorporation. Small or large farms may benefit from choosing a corporate structure. But incorporation is not for everyone. Before undertaking incorporation, each farmer should seek individual professional advice to enable him to accurately assess the effect such a move would have on his operation. Tax savings (or losses) should be weighed against increased costs incurred by incorporating and the burden of maintaining corporate records. The farmer's mode of operation, expansion plans and estate considerations should be evaluated against the corporate form to determine whether incorporation would aid or hinder this particular operation. Liability, bankruptcy and tax risks of incorporation should be considered to determine if they outweigh incorporation advantages. The ability of the operator to adhere to the formalities a corporate structure requires should also be honestly assessed. Finally, the farmer should have a good reason for incorporating. He should have some discernible gain he hopes to derive from the change in business format. Incorporating just because the neighbors are incorporating may not be enough reason. The attorney counseling the farmer should discourage change just for change's sake; corporate expenses and formalities are too significant for that.

Farm incorporation, despite its problems and requirements, can provide a host of advantages and benefits to the farm operator. But it is not for everyone.