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Special Problems of Farm Incorporation

by

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SPECIAL PROBLEMS OF FARM INCORPORATION

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> "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."[1]

Despite this sage admonition of Professors Bittker and Eustice, a substantial number of farm corporations come into existence each year. Their incorporators are probably looking only to the supposed "benefits" of such action while totally overlooking the very real problems of any corporate formation and operation. This is especially true considering the special problems a farmer will encounter by incorporating. It is the purpose of this Article to briefly outline the advantages of farm incorporation while analyzing those special problems a farmer will encounter in such a situation.

I. Why Incorporate?

Aside from a tendency to incorporate any business simply because "everyone else is doing it," farmers may find some valid reasons for such action. In making the decision to incorporate the farmer and his counsel must evaluate the advantages and disadvantages to arrive at the correct result. The major advantages seem to be: limiting liability, providing for continuation of the farm business by establishing a vehicle for the transfer of ownership in a simple fashion, and reducing income taxes.[2]

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1. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 2-4 (4th ed. 1979).

2. A number of authors have considered the advantages and disadvantages of farm incorporation. *See* Dietrich, *Estate Planning for Farmers and Ranchers*, 40 Mont. L. Rev. 189 (1979). *See also* Eckhardt, *The Farmer, Like Other Business Owners, Needs Expert Estate Planning Advice*, 15 J. Tax. 294 (1961); Eckhardt, *Should the Farmer Incorporate?*,

A. *Limitation of Liability*

The limited liability consideration may be more illusory than real. Generally, absent special statutory provisions, a shareholder is not personally liable for debts of a corporation, as his risk is limited to his investment.[3] However, any substantial loan to the corporation will undoubtedly be guaranteed by the corporate owner.[4] Further, many farm operators transfer virtually all of their operating assets to their newly formed corporation. A loss of those assets as a result of a judgment against the corporation can be virtually as unpleasant as outright personal liability.

One commentator suggests that the real importance of limited liability lies not in its actual protection of the shareholder from corporate obligations, but in its impact on the decision making of corporate management.[5] His theory is that the farmer, as a corporate officer, may be less conservative in making financial decisions "if it is known that a judgment creditor's search for assets would be confined to the corporate shell."[6] Whatever may be the merits of that thought, the real advantage to incorporation seems likely to be in areas other than limitation of personal liability. Furthermore, insurance against liabilities resulting from tortious conduct can cover a multitude of sins, be they corporate or individual.

B. *Continuation of the Farm Business*

Much can be said for the thought that the corporate form of existence is ideal for planning management and ownership succession over a period of time. In most instances farms are family owned and are transferred to the next generation. Where more than one heir is involved, particularly in the case where one heir is interested in the business but others are not, it is far easier to transfer corporate stock rather than individual assets.[7] This is also good business planning.

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1 PRAC. LAW. 61 (1955); Emry, *Tax and Estate Planning Consequences of Farm Incorporation*, 2 U.S.F. L. REV. 14 (1967); Harl, *Considerations in Incorporating Farm Businesses*, 18 U. FLA. L. REV. 221 (1965); Note, *Incorporating the Farm Business Part II: Tax Considerations*, 43 MINN. L. REV. 782 (1959).

3. United States v. Stanford, 161 U.S. 412 (1896).
4. *See* Eckhardt, *Should the Farmer Incorporate?*, *supra* note 2, at 61-62.
5. Harl, note 2 *supra*.
6. *Id.* at 224.
7. *Id.* at 227.

A transfer of partial ownership in the farming operation to the owner's children has several advantages. A farmowner may wish to encourage his children to remain in the business and to take an active interest in its operations, yet retain management control over important decisions. If control in the corporation is retained by the owner, these objectives can be attained.

Another reason for partial transfer is that death taxes will create liquidity problems when the original owner dies. If he has retained all ownership of the corporation the taxes are obviously going to be higher than if ownership had been previously diminished by intervivos gifts.

Although the 1976 Tax Reform Act has taken much of the joy out of a program of gift giving, advantages to gifting still exist. For example, if husband and wife own as their community property a farm which has a present fair market value of $750,000 and (for purposes of simplicity) other assets which exactly equal all allowable deductions, the death of the first party will create an immediate federal tax liability of either $70,800 (for a 1980 death) or $66,300 (for a 1981 death).[8] Moreover, farmland has generally appreciated in value. Today's $750,000 farm may well be tomorrow's $1,500,000 farm.[9] If, in our example, the couple have three children to whom gifts can safely be made, they can effectively dispose of $6,000 to each child each year in farm values without even filing a federal gift tax return.[10] In short, we reduce the potential estate by $18,000 yearly without tax liability if such a program is faithfully carried out.

Much larger gifts may also be advantageously used to reduce the couple's taxable estate. Even though gifts which exceed the $3,000 yearly exclusion are added back to the ultimate estate tax base, those gifts are added back at date of gift value, not date of death value, if the donors live more than three years from the gift date.[11] With the present high threshold level before any federal tax

8. I.R.C. §§ 2001(c), 2010(b). The "credit" of § 2010(b) increases from $42,500 in 1980 to a maximum of $47,000 in 1981 and later years. For purposes of simplicity, the value is considered to be arrived at under § 2031, rather than the "special use" rules of § 2032A.

9. I.R.C. § 2032A should provide some relief for this type of appreciation.

10. *Id.* § 6019(a).

11. *Id.* §§ 2001(b)(1)(B), 2035(a). Problems of retained control under § 2036 are presumed to be avoided in this example.

is assessed on lifetime gifts, there is some tax advantage to gifting property which will likely appreciate in value.[12] However, it must be remembered that a transfer of this nature does remove the property from the donor's control, and that may be poor business planning.[13]

C. *Income Tax Considerations*

While estate tax planning benefits a decedent's heirs rather than the decedent, income tax planning certainly has its place in providing a tangible, monetary benefit for the client himself. There are two primary areas to consider: tax rates and employee benefits.

1. *Tax Rates*

A high-bracket farmer will be taxed individually at whatever rate he may attain. For example, a farm couple with total taxable income of $45,800 filing a joint return will pay total federal income tax of $12,720.[14] Any taxable income in excess of that amount will move, progressively, from the forty-nine percent bracket upward.[15] If the couple were to incorporate their farming operation and draw a salary of $20,200, their individual income tax "bite" would be lowered to $3,273, and their bracket would then be near the twenty-eight percent level.[16]

But corporations are "people" too.[17] A corporation's tax rates are often substantially less than an individual's. In our given example, the corporation would, after paying the $20,200 salary to its owners, have remaining taxable income of $25,600. The corporate tax on that amount of taxable income is $4,370, and its upper bracket is twenty percent.[18] We therefore have a combined tax of $7,643 rather than the nonincorporated individuals tax of $12,720. The advantage of the lower tax is obvious; the incorporators, how-

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12. The federal gift tax rates are now the same as the estate tax rates. *Id.* § 2502(a). Similarly, the credit for such gifts is also the same. *Id.* § 2505(a)-(b).

13. Imagine the effect of gifting 40% of one's farm interest to a child, who then becomes antagonistic. The client may not be pleased that the child owns the gifted stock.

14. I.R.C. § 1(a).

15. *Id.* There is a 50% limit on the upward trend for all personal service income under the maximum tax provisions of *id.* § 1348.

16. *Id.* § 1(a).

17. *See id.* § 7701(a)(1).

18. *Id.* § 11(b)(1), (2).

ever, must be willing to live on $20,200 rather than $45,800.

The money retained in the corporation can be used for corporate expansion or other corporate activities. It should not be permitted to accumulate to the extent that the corporation would be subject to accumulated earnings tax penalties,[19] nor should it later be extracted in the form of dividends, which are not deductible at the corporate level and are taxed as received by the shareholders.[20]

An attempt to avoid the accumulated earnings tax, or "double tax," through dividend distributions by electing Sub-Chapter S treatment at the corporate level takes much of the joy out of incorporating. Shareholders are currently taxed on all income of an electing Sub-Chapter S corporation, whether distributed or not.[21]

2. *Employee Benefits*

The incorporated farmer is an employee of his corporation. As an employee, he is eligible for various corporate fringe benefits which would not be available to the sole proprietor. Included among these benefits are group term life insurance plans,[22] health and accident plans,[23] and, possibly, tax-free occupancy of corporate property if furnished for the benefit of the employer.[24] All of these corporate fringe benefits create a deduction at the corporate level if they constitute valid business expenses.[25]

The primary fringe benefits which have attracted potential in-

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19. *Id.* § 531. These "penalty" taxes are imposed in any instance where the corporation is "formed or availed of" to avoid shareholder income taxes. As a practical matter they apply only when the accumulated taxable income of the corporation exceeds the accumulated earnings credit. The credit will be equal to the reasonable business needs of the corporation, with a safe harbor of $150,000 of accumulations. *See generally* B. Bittker & J. Eustice, *supra* note 1, at 1-39.

20. A minimal credit of $100 per year exists on dividend income received by a corporate shareholder for all dividends received during the taxable year. Where husband and wife jointly own the stock, the credit is $200. I.R.C. § 116(a).

21. *Id.* § 1373.

22. *Id.* § 79(a) excludes premiums paid to acquire group term coverage of up to $50,000 from an employee's gross income. However, if there are other farm employees, they must also receive insurance benefits. Treas. Reg. § 1.79-1(b)(1) (1972).

23. I.R.C. § 106. This is now limited somewhat by the nondiscrimination provisions of § 105(h) for self-insured plans.

24. *Id.* § 119. For an extreme example of the usage of this provision, see McDowell v. Commissioner, 33 T.C.M. (CCH) 372 (1974).

25. I.R.C. § 162(a).

corporators are the pension or profit-sharing plans permitted under the Internal Revenue Code.[26] Properly structured, they permit the corporation to deduct contributions to a trust under a plan which would insulate the income earned by the trust from taxation, and delay the imposition of a tax on the amount contributed to or earned by the trust as to the employee until distribution.[27] Since relatively similar benefits are now available for self-employed individuals, this particular advantage may not be as important as it was in the past.[28]

II. TAX PROBLEMS OF INCORPORATING

A. *Section 351*

After weighing the advantages and disadvantages of incorporating, if the "lobster" wishes to enter into the pot, the entry is not terribly difficult. Aside from the mechanics of doing so,[29] however, there is a potential tax impact simply by virtue of the transfer. In most instances the value of the property transferred will exceed its adjusted tax basis. In exchange, the transferor will receive corporate stock, which in theory should have a value approximately equal to the value of the transferred assets. When this occurs, the general rule is that the transferor realizes a gain, measured by the difference between the adjusted basis of the transferred property and the fair market value of the property received.[30] Unless another Code provision can be found, the gain realized will also be the gain recognized for income tax purposes.[31]

This adverse tax effect can be avoided in the case of a properly planned incorporation, where the transferor is in control of the corporation following the transfer.[32] The term "control" means an

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26. *Id.* § 401.

27. *Id.* §§ 402, 404, 501(a).

28. *Id.* § 404(e). However, this section does provide a lesser exemption than does an employer-supplied plan.

29. Deeds must be drawn to transfer real property to the corporate name, minutes drafted to reflect the receipt of assets, and vehicle titles transferred.

30. I.R.C. § 1001(b).

31. *Id.* § 1002.

32. *Id.* § 351. Sections 1245(b)(3) and 1250(d)(3) will prevent any depreciation recapture if the transition meets § 351 requirements. *See also* Treas. Reg. § 1.47-3(f)(1) (1972) (investment credit recapture).

ownership interest in the transferor of at least eighty percent.[33] If the transferors have control, then section 351 may shield the transfer from taxation. Section 351, however, is not a complete shield against the imposition of taxes at the time of incorporation. The typical farmer will transfer not only operating assets, but also growing crops (whose costs may have already been deducted by him) accounts receivable, and other depreciated property, all of which would have created ordinary income if sold or collected by him. This form of "midstream" incorporation has definite problems.[34]

The incorporating farmer who transfers these types of assets faces the possibility that the nonrecognition of gain provisions of section 351 are subordinate to certain basic judicial doctrines, such as the assignment of income doctrine, or the tax benefit principle.[35] In addition, the Commissioner of Internal Revenue has several very important statutory tools at his disposal to prevent improper assignments to the corporation. Sections 446(b) and 482 permit the Internal Revenue Service to make adjustments to the tax approach taken by a taxpayer in order to properly reflect the taxpayer's income.[36] An analysis of the scope of these provisions is important.

B. *Sections 351 and 482*

Probably the most significant case dealing with a farm incorporation is *Rooney v. United States.*[37] In *Rooney* the taxpayers, on the cash basis of accounting, individually deducted the costs of raising their crop and then transferred the crop to their corporation in the middle of their taxable year. The corporation then reported the income from the sale of the harvested crop.[38] By virtue of the substantial crop preparation costs which the taxpayers claimed on their income tax return, a net operating loss resulted which the taxpayers sought to carry back for two prior years.[39]

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33. I.R.C. §§ 351(a), 368(c).

34. *See* B. BITTKER & J. EUSTICE, *supra* note 1, at 65-70; Note, *Section 351 of the Internal Revenue Code and "Mid-Stream" Incorporations*, 38 CIN. L. REV. 96 (1969).

35. *See* B. BITTKER & J. EUSTICE, *supra* note 1, at 66.

36. I.R.C. §§ 446(b), 482.

37. 305 F.2d 681 (9th Cir. 1962), *aff'g* 189 F. Supp. 733 (N.D. Cal. 1960).

38. *Id.* at 682.

39. I.R.C. § 172 contains the present carryback language applied by the taxpayer in *Rooney*, then contained in § 112(b), INT. REV. CODE of 1939.

Employing section 45 of the Internal Revenue Code of 1939, the forerunner of today's section 482, the Commissioner reallocated the expenses of growing the crop to the corporation.[40] Such reallocation effectively eliminated the individuals' claimed net operating loss. Both the district court and the Ninth Circuit Court of Appeals rejected the taxpayers' argument that section 112, today's section 351, overrode the Commissioner's statutory authority to allocate expenses pursuant to the predecessor of section 482.[41]

The district court made the following observation:

> To have been technically correct, plaintiffs should have reported the costs of growing the crop . . . by setting the value of the stock of the corporation equal to the cost basis of the assets transferred in exchange for the stock . . . . Plaintiffs would have reported neither a net gain, nor a net loss, from their growing and disposing of the crop. The corporation could have offset the cost of growing the crop against the profit derived from its sale.[42]

On appeal the Ninth Circuit held that section 482 was applicable. The court rejected the taxpayers' argument that their sole proprietorship ceased existence at the time the corporation was formed, making section 482 inapplicable: "This contention is without merit. For purposes of federal taxation, there were two entities in existence for the tax year in question, *i.e.*, the individuals and the corporation. Each entity is required to file an income tax return."[43] The Ninth Circuit further concluded that "section 482, Internal Revenue Code of 1954 . . . will control when it conflicts with section 351, Internal Revenue Code of 1954 . . . as long as the discretion of the Commissioner in reallocating is not abused."[44]

The one exception appears to be a factual pattern which involves an abuse of discretion by the Commissioner.[45] It would seem

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40. INT. REV. CODE of 1939, § 45.

41. I.R.C. § 351 provides in part: "No gain or loss shall be recognized" due to a transfer of assets to a controlled corporation. The language of § 112 of the 1939 Code was identical.

42. 189 F. Supp. 733, 734 (N.D. Cal. 1960).

43. 305 F.2d at 683. This raises the interesting question of whether I.R.C. § 482 would be inapplicable had the transfer occurred precisely at the end of the individual's taxable year.

44. 305 F.2d at 686. *See also* Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1952). *But see* Bielec v. Commissioner, 35 T.C.M. (CCH) 1691 (1976).

45. *See, e.g.*, Vardeman v. United States, 209 F. Supp. 346 (E.D. Tex. 1962).

likely that in the majority of cases involving factual situations similar to *Rooney* such abuses will be difficult to establish. Section 482 is a "one-way" provision. There is nothing that *permits* a taxpayer to unilaterally make his own allocation within its confines. In fact, the applicable regulations expressly prohibit such action.[46]

This raises the interesting question as to precisely how a taxpayer who has incurred crop expenses should treat those expenses when he forms a corporation and transfers the growing crop into the corporation. The lower court opinion in *Rooney* seems to suggest that the incorporating taxpayer should report the expenses of growing the crop, while reflecting the transfer itself as triggering income equal to the crop's value at the time of incorporation.[47] It is difficult to be certain that this is the import of the lower court holding, because its language speaks of "setting the value of the stock of the corporation equal to the cost basis of the assets transferred in exchange for the stock."[48]

Perhaps the real difficulty with the suggestion of the lower court is the effect of its application. According to *Rooney* the transfer of the growing crop into a controlled corporation would trigger income at the time of incorporation. This would seem to be in complete derogation of section 351, which specifically prohibits the recognition of gain or loss at the time of transfer. There does not appear to be any authority to alter this result unless section 482 is in fact applicable.[49]

Further compounding the confusion that results from the *Rooney* holding is a private ruling which permitted a taxpayer to do precisely that which the taxpayers could not do in *Rooney*: deduct the crop-raising expenses and have their newly formed corporation recognize the income from the crop.[50]

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46. Treas. Reg. § 1.482-1(b)(3) (1962).

47. 189 F. Supp. at 734.

48. *Id.*

49. The district court in *Rooney* stated that the taxpayers would have reported "neither a net gain, nor a net loss, from their growing and disposition of the crop." 189 F. Supp. at 734. Arguably, because no gain is being recognized, § 351 does not prohibit such an approach. It does suggest that all appreciation of the crop, over cost, will be taxed to the corporation, not the individuals involved. *See also* B. BITTKER & J. EUSTICE, *supra* note 1, at 67-68.

50. Letter Ruling 7805009, *reprinted in* [1978] I.R.S. Letter Rul. (CCH) pt. II.

For the adventuresome, one method of complying with the district court suggestion in *Rooney* while staying within the confines of section 351 is for the transferor to "sell" his crop to the newly formed corporation. Assuming the transferor receives a short-term obligation which does not constitute a "security" for section 351 purposes,[51] gain will be recognized on the transaction.[52] The difficulty with this proposal is that the gain will be allocated among all appreciated assets transferred to the corporation,[53] with the very real possibility of triggering depreciation recapture in the case of section 1245 assets.[54]

Carrying the thought of treating the transfer of the crop as a sale slightly further, some attention should be given to the provisions of section 268 of the Code. The provision is specifically directed at a sale of an unharvested crop, and prohibits the deduction of presale production costs.[55] The result then follows that if the transfer agreement specifies that the crop is being sold to the corporation as part of the incorporation, section 268 would apply. The ultimate result would be that which the district court suggested would be the proper method to apply in *Rooney*.[56] There is no real authority for the allocation approach, and it may fail due to the lack of an arm's length situation which would exist between the incorporator and his controlled corporation.[57]

The most interesting aspect of section 268 is its result: if it *does* apply, the transferor is precluded from deducting *his* expenses of raising the crop, while the corporate transferee's cost basis in the crop would equal the disallowed deductions to the transferor.[58] In point of fact, it can be argued that section 268 will apply whether or not "boot" is received on the exchange. The section itself speaks in terms of a "sale," but the underlying Treasury regulation expands that definition to include an "exchange,"[59] thus concurring with a section 351 transfer which is expressly an ex-

51. Adams v. Commissioner, 58 T.C. 41 (1972).
52. I.R.C. § 351(b).
53. Rev. Rul. 68-55, 1968-1 C.B. 140.
54. I.R.C. § 1245(b)(3). *See also id.* §§ 1239, 1250(d)(3).
55. *Id.* § 268.
56. 305 F.2d 681 (9th Cir. 1962).
57. B. Bittker & J. Eustice, *supra* note 1, at 24-25.
58. Treas. Reg. § 1.1016-5(g) (1971).
59. *Id.* § 1.268-1 (1957).

change.[60] Unfortunately, there is nothing in the legislative history of section 268 which would support this proposition.[61]

The theory of section 268 has also been applied to a sale which was nontaxable under the provisions of section 337.[62] However, the court noted: "[S]ection 268 applies only where the unharvested crop is sold."[63]

C. *Assignment of Income and Section 351*

It is notable that *Rooney* involved an allocation of expenses, not income, from the transferor to the new corporation.[64] It does not involve an allocation of the income from the crop *back* to the persons who incurred the crop expenses. In *Hempt Bros., Inc. v. United States* the taxpayer unsuccessfully sought to cause an allocation of income to be made.[65]

In that case a cash basis partnership had transferred, among other things, accounts receivable to a newly formed corporation. The corporation took the position that the partnership rather than the corporation should be taxed on the receivables.[66] The *Hempt Bros.* court held that, limited to these facts, section 351 prevented the incorporators from incurring any tax liability when the receivables were transferred to their newly formed corporation, but seemingly left the door open to reach a contrary result should other factors be present.[67]

It is very clear that an incorporator who transfers only his growing crops, retaining the land on which they are situated, *will*

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60. I.R.C. § 351(a).

61. INT. REV. CODE of 1939, § 24(f), which corresponds with I.R.C. § 268, was aimed at correcting possible abuses, whereby a farmer might currently deduct his costs in raising a crop, then convert his gains into capital gain by selling the land and crop prior to harvest. S. REP. No. 781, 82d Cong., 1st Sess. __, *reprinted in* 1951-2 C.B. 458, 491-92.

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

63. *Id.* at 944. Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963), notes that a liquidation under I.R.C. § 336 is similarly not a "sale" of unharvested crops so as to bring *Id.* § 268 into play. *Id.* § 336 has a striking similarity to *id.* § 351 in its terms.

64. 305 F.2d 681 (9th Cir. 1962).

65. 490 F.2d 1172 (3d Cir. 1974).

66. *Id.* Although the court expressly refused to specifically consider the fact that the statute of limitations had evidently run as to the partners involved, one wonders if this did not have some bearing on the outcome. *Id.* at 1174 n.4.

67. *Id.* at 1176. *See also id.* at 1178 n.9 for the position of the I.R.S.

be taxed when the crops are harvested.[68] From a practical standpoint, this leaves the incorporating farmer who has growing crops, somewhat "betwixt and between." Since he really does not have the authority to unilaterally assign the expenses of the crop back to himself under section 482,[69] and apparently should not take back a note or other property for the value of the crop,[70] he must consider what it is he should do. As indicated previously, section 268 probably does not apply to his situation[71] and a theory based upon assignment of income concepts is evidently contrary to section 351.[72]

Short of seeking a ruling as to how to best proceed, arguably the only remaining course of action available to the incorporating farmer is to wait and see whether the Commissioner will ultimately apply section 482 to his situation. If his transfer does not create some form of net operating loss, as in *Rooney*, his problem may be resolved by acceptance by the examining agent of his procedure.

Another possibility is to initially elect the provisions of Sub-Chapter S of the Internal Revenue Code, which would result in his actually being taxed on the crop proceeds, a factor which might dissuade the agent from any further adjustment to his method of accounting.[73] However, none of these alternatives are totally appealing.

D. *Section 357(c) and Liabilities*

It is one thing to experience the problems of section 482 and the assignment of income theory, and another to find that the initial incorporation was *not* tax-free at all, triggering substantial

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68. Weinborg v. Commissioner, 44 T.C. 233 (1965). The court in this case further noted that the crops had evidently been sold prior to the transfer, and that only the proceeds from the sale were transferred. *Id.* at 241-42. *See also* B. BITTKER & J. EUSTICE, *supra* note 1, at 67.

69. Treas. Reg. § 1.482-1(c) (1962).

70. *See* notes 51 and 52 *supra*.

71. *See* notes 58-60 *supra*.

72. *See* notes 62-64 *supra*.

73. I.R.C. § 1373. The problem here is that *id.* § 482 could still be applied if the deductions and the income fall in different taxable years. This could also result in substantial deductions with no offsetting income, and income with no offsetting deductions. Perhaps the net operating loss carryover rules will provide some relief, but the loss initially will be carried *back*, not *forward*. *Id.* § 172 (b).

gain to the incorporator at the time of incorporation. Section 351 will generally prevent this result, but where liabilities as well as assets are put into the corporate entity there exists a real danger that section 357(c) will apply.[74]

Section 357 traces its origins to a provision which was intended to reverse a decision of the United States Supreme Court that the assumption of liabilities by a corporation represented "boot," resulting in gain to the transferor.[75] The relief accorded taxpayers under the predecessor of section 357 was a little too broad, leading to an exception, now found in section 357(b), which treats the assumption of liabilities as "boot" if the taxpayer transferred the liability to avoid federal income tax on the exchange.[76] Except for the greedy, this should rarely be a problem.

It is true that the taxpayer must show by more than the usual degree of proof required of persons contesting IRS determinations that tax avoidance was not the principal purpose of the transaction.[77] If a valid business reason existed for the creation of the liability that burden will ordinarily be met.[78]

On the other hand, section 357(c) is a very real problem in some circumstances. Under that provision if the sum of the liabilities assumed exceeds the total adjusted tax basis of transferred property, the excess is treated as a gain on the sale or exchange of the property.[79] This is not done on an asset by asset basis, but rather on the total of the liabilities involved and the total of the adjusted basis of the transferred assets.[80]

As an illustration, assume that the farmer exchanges property with an adjusted basis of $25,000 and a fair market value of $100,000 (but subject to a mortgage liability of $30,000) for all of the corporate stock. The farmer's *realized* gain on the exchange would be $45,000—the difference between his adjusted basis of

74. *Id.* § 357(c).

75. United States v. Hendler, 303 U.S. 564 (1938). For a complete discussion of the case and its background, see Surrey, *Assumption of Indebtedness in Tax-Free Exchanges*, 50 YALE L.J. 1 (1940).

76. I.R.C. § 357(b).

77. *Id.*

78. B. BITTKER & J. EUSTICE, *supra* note 1, at 27, 28.

79. I.R.C. § 357(c).

80. *Id. See also* Treas. Reg. § 1.357-2 (1961).

$25,000 and the fair market value of the stock received, $70,000. Under section 357(c) he will *recognize* gain of $5,000, the difference between his adjusted basis and the mortgage liability the property was subject to.[81] If the property were section 1245 property, the gain recognized would be treated as ordinary income to the transferor.[82]

A problem exists where a cash basis taxpayer transfers accounts receivable having a "zero" basis along with accounts payable which exceed the basis of all assets transferred.[83] Unless the account payable which is transferred would give rise to a deduction when paid, the general rule of section 357(c) will create "boot" in those cases where total liabilities exceed total adjusted basis.[84]

An even more complicated problem exists where some, but not all, of the farmer's assets are placed in corporate solution, yet an underlying indebtedness applies to all of the assets. Assume a farmer transfers farm machinery and equipment into his corporation under section 351, but retains the farm land, either for estate or income tax purposes, or perhaps to avoid the *Rooney* difficulty mentioned above. The machinery and equipment have a basis of $100,000 and the land a basis of $200,000, with a total fair market value of $1,000,000. As the result of a loan incurred to provide irrigation for the fields, the land, machinery and equipment are subject to a mortgage liability of $500,000. If the machinery and equipment are transferred into the corporation, they are technically "subject" to the overall liability for the land, the machinery, and the equipment.

Under a strict reading of section 357(c), the incorporator has placed assets into the corporation with an adjusted basis of $100,000 which are subject to a mortgage liability well in excess of that amount, due to the mortgage on both the land and the machinery and equipment. He therefore would have a recognized gain of $400,000. Further, the gain may well be subject to section 1245 depreciation recapture.[85] There is no authority on point, but the

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81. I.R.C. § 357(c).
82. Treas. Reg. § 1.1245-4(c) (1972).
83. I.R.C. § 357(c)(3) (added by Pub. L. No. 95-600, § 365(a)(c), 92 Stat. 2854).
84. *Id.*
85. Treas. Reg. § 1.1245-4(c) (1972).

danger is such that this type of transaction should be avoided.[86]

E. Investment Credit Recapture

If the incorporating farmer has property for which investment credit has been claimed, but the full amount of the credit has not yet been earned,[87] a transfer of such property will create immediate tax liability for the unearned portion of the credit, subject to certain exceptions.[88]

The general exception to this rule is found in the last portion of section 47(b), which states:

> [P]roperty shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.[89]

In most farm incorporations this should present no difficulty, particularly if all of the farm property, including machinery and equipment, is transferred into the corporation pursuant to section 351.

However, there are instances where tax planning may suggest that some of the property be retained by the individual. As an example, the farmer may be quite willing to transfer his machinery and equipment into the corporation, but wish to retain ownership of the farm land, which he will lease to the corporation.[90] Under the applicable regulations "substantially all the assets (whether or not section 38 property) necessary to operate [the] trade or business" must be transferred.[91] The IRS position as to what "substantially all" means is quite strict. In a recent revenue ruling the IRS took the position that the regulation was not complied with when a dentist transferred his office and dental equipment to his new cor-

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86. Testor v. Commissioner, 327 F.2d 788 (7th Cir. 1964).

87. I.R.C. § 47(a)(1). This section really speaks in terms of an "early disposition" of section 38 property prior to the close of the computation period.

88. *Id.* § 47(b).

89. *Id.*

90. This approach has income tax planning value. The continuing danger that paid compensation is unreasonable can be reduced if part of what is paid to the incorporator is rental.

91. Treas. Reg. § 1.47-3(f)(1)(ii)(c) (1967).

poration, but retained and leased his office building to the new entity.[92] Since the value of the building was roughly thirty percent of the total value of the dental business assets, the IRS held that the "substantially all" test was not met and that investment credit recapture would occur.[93]

A fair argument can be made that with a lease of the real property of a sufficiently long term to the corporation even the literal language of the cited ruling is met.[94] Absent such arrangement, the IRS will likely take the position that recapture will occur because "substantially all" of the prior business assets were not transferred to the newly formed corporation.[95]

The legislative history behind section 47(b) is of no great assistance in determining whether the IRS position will be upheld, when challenged.[96] It may well be that the regulation and revenue ruling are too limiting on the general language of section 47(b). If so, a transfer of less than all of the farm assets may still not trigger investment credit recapture. The likelihood of litigation is such, however, that counsel for the taxpayer should warn his client of the obvious hazards.

III. CONCLUSION

The special problems of a farm incorporation are really very much like those found in any situation where an individual is trying to decide whether to incorporate or to retain his or her present business form. Once counsel has weighed the benefits of incorporating, including the possibility of limiting liability, providing for ease of gifting the subject property and so forth, against the hazards and disadvantages, the answer may still not be certain. It is clear, however, that the problem of the growing crop, the danger of liabilities exceeding basis in some instances, and the possibility of investment credit recapture must be carefully considered prior to arriving at that answer.

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92. Rev. Rul. 76-514, 1976-2 C.B. 11.

93. *Id.*

94. *Cf.* Treas. Reg. § 1.1031(a)-1(c) (1967) (30-year lease treated as similar to an exchange of a fee interest).

95. I.R.C. § 47(a)(1).

96. S. REP. No. 1881, 87th Cong., 2d Sess. __, *reprinted in* [1962] U.S. CODE CONG. & AD. NEWS 3304, 3452-54.