Agricultural Corporations in Oklahoma

by

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In December of 1962, the Secretary of State of Oklahoma and members of his staff[1] estimated that between ten and twenty agricultural corporations had filed their articles with that office, and had been issued corporate licenses. Various members of the departments of business law and agricultural economics at Oklahoma State University have made an even higher estimate of the number of agricultural corporations existing in this state. This trend may be largely attributable to the possibility of avoiding corporate income taxes by election under sub-chapter S, and recent developments in the area of corporate ownership of rural lands. It is the purpose herein to examine briefly by "scan," or "survey," and not in detail, the problems and opportunities connected with the use of the corporate entity by farmers and ranchers in this state. Many of the articles of incorporation also provide for ownership of rural land by the corporation.

The first problem which suggests itself is the existence of Article XXII, Section 2 of the Oklahoma Constitution and the statutory implementation thereof,[2] which purport to prohibit the corporate ownership of lands:

> "except such as may be located in such towns and cities and as additions to such towns and cities, and further except such as shall be necessary and proper for carrying on the business for which it was chartered or licensed; and provided further that under limitations prescribed by the legislature, any corporation may acquire real estate for lease or sale to any other corporation, if such latter corporation could have legally acquired the same in the first instance; nor shall any corporation be created or licensed to do business in this state for the purpose of acting as agent in buying and selling or leasing land for agricultural purposes."[3]

Further language in this section provides for real property acquired by

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[1] The Honorable William N. Christian, and members of the staff of the Corporate Records Division. Reference herein to members of the faculty of Oklahoma State University includes Professors Collins and Plaxico, Department of Agricultural Economics; Jeffreys, Extension Division; and Laughlin, Business Law. Professor Laughlin has done a study of the legal problems connected with the ownership of agricultural lands by corporations.

[2] 18 OKLA. STAT. §§ 1.20–.30 (1961).

[3] OKLA. CONST. art. XXII, § 2.

corporations in the collection of debts and for corporate trustees holding naked title. This provision is not self-executing[4] and its enforcement depends upon the statutory implementation referred to previously.

Omitting earlier decisions not deemed material,[5] it seems that three decisions of the Oklahoma Supreme Court have provided interpretation which probably changed the concept previously held by most persons concerned with the consideration of these provisions.

In *Texas Co. v. State ex rel. Coryell*,[6] the trial court had construed the constitutional provision above cited as stating cumulative limitations upon the corporate power to own real estate, that is, the trial court concluded that the Texas Company could not own land or real estate outside of incorporated cities and towns and additions thereto, the subsequent clauses after the first one in the provision being construed by the trial court as being "a further exception to the corporate privilege of owning real estate, to wit, real estate situated in incorporated cities and towns and additions thereto."[7]

The Oklahoma Supreme Court stated,

> "The conclusion of law is error. The constitutional provision deals with different types of corporations. The first is land companies. They shall have no corporate existence within this state to deal in other than real estate located in incorporated cities and towns and additions thereto. As to corporations in general, such as typified by the defendant corporation, it is not denied ownership of rural real estate, but it is limited under the further exception in its acquisition of such real estate 'as shall be necessary and proper for carrying on the business for which it was chartered or licensed'."[8]

The court then pointed out that under the trial court's view of the constitutional provision, oil companies could not own real estate outside of cities and towns and additions thereto which might be necessary for the location of refineries, gasoline plants, tank farms, warehouses, grain elevators, et

[4] Parwal Inv. Co. v. State, 71 Okla. 121, 175 Pac. 514 (1918).

[5] Simler v. Wilson, 210 F.2d 99 (10th Cir. 1954), *cert. denied*, 347 U.S. 954, 74 Sup.Ct. 681, 98 L.Ed. 1099 (1954); Simler v. Wilson, 110 F.Supp. 761 (W.D.Okla. 1953); National Bank of Commerce v. State *ex rel.* Garrison, 368 P.2d 997 (Okla. 1962); Schultz v. Morgan Sash & Door Co., 344 P.2d 253, 74 A.L.R.2d 967 (Okla. 1959); Goss & Hamlyn Home v. State, 285 P.2d 428 (Okla. 1955); State *ex rel.* Brett v. North Am. Life Ins. Co., 203 Okla. 672, 225 P.2d 796 (1950); Kurz v. Farmers United Co-Op. Pool, 199 Okla. 224, 184 P.2d 790 (1947); Natural Gas Co. v. State *ex rel.* Vassar, 187 Okla. 164, 101 P.2d 793 (1940); Marland v. Gillespie, 168 Okla. 376, 33 P.2d 207 (1934); State v. Prairie Oil & Gas Co., 64 Okla. 267, 167 Pac. 756 (1917); Local Inv. Co. v. Hunes, 51 Okla. 251, 151 Pac. 878 (1915).

[6] Texas Co. v. State *ex rel.* Coryell, 198 Okla. 565, 180 P.2d 631 (1947).

[7] *Id.* at 567, 180 P.2d at 634.

[8] *Ibid.*

cetera. The court thereupon concluded that the provision involved did not negative corporate ownership of rural lands, but amplified it.

In reviewing the debate of this particular constitutional provision in the constitutional convention, the court stated, "It is manifest from the quoted debates that there was a determination to prevent corporate ownership of farm lands because it was deemed to be inimical to home ownership and to promote tenancy in the farming class."[9] The court nonetheless concluded that corporations, generally, might own such rural real estate "as shall be necessary and proper for carrying on business for which it was chartered or licensed."[10] The court then applied its conclusions to the fact situation involved and found that some of the tracts in question were appropriate for ownership by the Texas Company in fee simple because they were "used in useful and proper and necessary general operations of defendant's business in this state."[11] Some tracts were found not to be necessary for the conduct of defendant's business.

In *United States Gypsum Company v. State ex rel. Rutherford*[12] the court held that United States Gypsum Company could own rural land in southwestern Oklahoma which it apparently intended to use for strip mining of gypsum, even though at the particular time and for several years preceding the institution of the action the corporation had not used the land for mining, and had in fact leased it out for farming and grazing to local people. The court stated that the phrase "necessary and proper" as used in the constitutional provision previously cited did not mean a use which was absolutely indispensably necessary, but only required that the land be held for a use which is proper, useful and suitable to the corporation and conducive to the accomplishment of its purpose.

The stage was thus set for the "white horse" decision in this area, *State ex rel. Reidy v. International Paper Company*,[13] in which the court held that the ownership of large areas of rural land by the International Paper Company was necessary and proper in the sense of the above constitutional provision for the corporate purposes of reforestation for the production of paper, and that further the severance of minerals from the fee was not justified inasmuch as the right of entry for mineral development inherent in separate ownership of the minerals would jeopardize this necessary and proper use and ownership of the surface.

[9] *Id.* at 570, 180 P.2d at 636.

[10] *Id.* at 570, 180 P.2d at 637.

[11] *Id.* at 574, 180 P.2d at 641.

[12] 328 P.2d 431 (Okla. 1958).

[13] 342 P.2d 565 (Okla. 1959).

A numerically strong[14] and vigorously written dissent by Justice Berry pointed out that the review of the constitutional convention in the *Texas Company* case had concluded that "there was a determination to prevent corporate ownership of farm lands because it was deemed to be inimical to home ownership and to promote tenancy in the farming class,"[15] and that the rationale of the majority decision would permit a corporation to properly own and farm any given number of acres of agricultural land. The dissent then went on to state that in the opinion of the dissenting Justices the purpose of the constitutional provision was to preserve agricultural lands for homes and deny it for vast commercial undertakings and that the phrase "except such as shall be necessary and proper for carrying on the business for which it was chartered or licensed"[16] must be construed as excluding the ownership of rural land that can be used as homes except for the uses of office buildings sites, warehouse sites, railroad right-of-ways, et cetera.

It is difficult to disagree with the minority statement that under the rationale of the decision it is legal for a corporation to own and farm rural lands in Oklahoma. This was also the conclusion reached by one of the long time authorities on constitutional law in Oklahoma, Mr. Fred Hansen, First Assistant Attorney General, when he wrote for that office an opinion addressed to The Honorable Martin E. Dyer, then a State Representative from Carter County, Oklahoma, in response to the question, "whether there is any limitation or restriction on corporations being formed in Oklahoma for the purpose of conducting a cattle ranch and whether or not it is lawful for an incorporated ranch company to own all of the real estate necessary for ranching operations?"[17] It was the opinion of the office of the Attorney General that,

> "in view of the principles of law announced in the majority opinion of the Supreme Court in the *International Paper Company* case, the Attorney General is of the opinion (although we fully realize that the issue involved is not free from doubt) that a corporation may be lawfully formed in this state for the purpose of conducting a cattle ranch and of acquiring and owning all real estate necessary for its ranching operations * * * * if the acquisition and ownership of said real estate will be * * * * actually and fairly proper, useful and suitable, and thus conducive to the proper carrying on of a lawful enter-

[14] This was a five-four decision, Davison, C.J., Welch, Halley, Johnson and Jackson constituted the majority and Williams, V.C.J., Blackbird, Irwin and Berry dissented.

[15] State *ex rel.* Reidy v. International Paper Co., 342 P.2d at 570.

[16] OKLA. CONST. art. XXII, § 2.

[17] Letter From The Honorable Martin E. Dyer to the Secretary of State of the State of Oklahoma, July 22, 1960.

prise within the legitimate purposes provided for in the Articles of Incorporation."[18]

On January 31, 1962, Mr. Hansen again signed an opinion for the Attorney General addressed to the Secretary of State, in which he stated that the articles of incorporation filed by W. E. Ranch, Inc. should be filed and a certificate issued thereupon. The opinion of August 2, 1960, was cited.

The articles of incorporation submitted for approval proposed a stark, simple and direct issue: Article IV read "The purposes for which this corporation is formed are: Ownership of the following described real estate, to-wit: . . . [here follows detailed legal description of real estate] for the purpose of the utilization of said real estate and the other assets of said corporation for agricultural and general farming purposes and stock farm."

It therefore appears that there is a solid body of legal precedent and authoritative opinion supporting the ownership of agricultural lands by corporations and the utilization of such lands for that purpose in Oklahoma. This poses several other questions: Could General Motors or A. T. & T. own and farm rural real estate in Oklahoma? It would seem not, since their basic corporate purposes are not agricultural. Could a subsidiary, formed for agricultural or ranching purposes, of a major corporation own and operate farm lands in Oklahoma? Why not? As the constitutional provision involved requires legislative implementation, it would seem that the entire subject could be affected by reasonable legislative limitations.

There is, however, another form of "corporation," at least in the tax sense,[19] which has a clear and undisputable right in the state of Oklahoma to own rural real estate for agricultural or any other purpose, to the extent to which a natural person could. This is the "Business Trust," or "Massachusetts Trust," an entity which was confirmed in its right to own farm lands by the Supreme Court of Oklahoma[20] in a decision which held specifically that article XXII, section 2 of the constitution does not prohibit a business trust from owning land outside the city limits of a city or town, because a business trust is not a corporation.

Business trusts in some respects may offer a more convenient method of doing business for a farmer than do corporations. The statutes governing their creation, existence and operation[21] are four brief sections, and contain very few limitations on the manner in which this type of entity may

[18] Opinion of the Attorney General of Oklahoma dated August 2, 1960.

[19] A business trust is classified for tax purposes as "an association taxable as a corporation." Series "A" Trust v. Helvering, 126 F.2d 530 (D.C.C. 1942), *cert. denied*, 317 U.S. 649, 63 Sup.Ct. 45, 87 L.Ed. 522 (1942).

[20] State *ex rel.* Combs v. Hopping Inv. Co., 269 P.2d 997 (Okla. 1954).

[21] 60 OKLA. STAT. §§ 171–74 (1961).

function. The most noticeable disadvantage is a somewhat cumbersome and perhaps ambiguous limitation on the time of the business trust's existence,[22] which results from the application of the Rule Against Perpetuities to fiduciary trusts. However, an imaginative legal planner should have little difficulty, with careful drafting, in providing a period of life for a business trust which will be quite satisfactory and in fact quite possibly in excess of that fifty year period accorded to a business corporation. The ease with which a business trust can be operated through one or more trustees, its capacity for borrowing money as easily as the corporation, the apparently unlimited means of raising capital through any type of security or obligation which the imagination of the draftsman can suggest, and its apparent abilities to enjoy the tax advantages of a corporate structure make business trusts truly worth consideration for agricultural planners.

As noted previously, a business trust is considered by tax law to be, in the language of the Internal Revenue Code, "taxable as a corporation." Such associations, when they qualify as corporations for tax purposes, are clearly entitled to standard corporate benefits such as retirement plans, group insurance plans, and similar corporate deductions for personnel benefits, sub-chapter S elections, and almost any type of tax advantage enjoyable by a corporation, but are subject to some rather stringent treasury regulations.[23] These were promulgated as a result of developments in the field of tax planning in what is apparently the wealthiest profession, that of medicine. Some physicians in Montana several years ago attempted to form an association which would be taxable as a corporation in order that they might enjoy the benefits of tax deductible retirement plans. Their right to do so was upheld by the circuit court of appeals.[24] Dallas physicians obtained a similar favorable result in litigation in a federal district court.[25] These decisions caused the service to formulate and issue regulations, now known as the Kintner Regulations,[26] which stated in more detail the standards for determining whether any organization or business entity is taxable as a corporation. Among them are continuity of life, centralized management, free transferability of interests, and limited liability. The restrictions imposed by these regulations which a business entity must reportedly meet in order to qualify for corporate tax treatment seems to go considerably beyond requirements mentioned in either of the above mentioned decisions.

[22] 60 OKLA. STAT. § 172 (1961).

[23] Treas. Reg. § 301.7701–2 (1960).

[24] Kintner v. United States, 107 F.Supp. 976 (D.Mont. 1952), *aff'd*, 216 F.2d 418 (9th Cir. 1954).

[25] Galt v. United States, 175 F.Supp. 360 (N.D.Tex. 1959).

[26] Treas. Reg. § 301.7701–2 (1960).

However, a business trust is an entity which has no trouble meeting any of the requirements imposed by the regulations. In fact, it is difficult to see any major structural difference between the corporation and a business trust other than the fact that a business trust can clearly own any type of real estate for any otherwise legal purpose. Its flexibility is amazing, and promoters have sometimes found it to be convenient as an entity which could be operated without the necessity of answering to stockholders. This type of flexibility, of course, fits beautifully as a farmer or rancher might be inconvenienced by corporate requirements for annual meetings and other formalities with shareholders. In short, it is very difficult to see why a business trust is not a virtually perfect vehicle for the operation of farm and ranch activities where the benefits of the corporate business entity are appropriate. However, the deep and natural mistrust of that which is new will undoubtedly cause ranchers and farmers to be cautious in using this form of business organization.

In cases in which the use of a corporation for farm purposes seems beneficial, obviously it is not mandatory that the corporation own the land involved; in the case of a business trust it has been noted that ownership does not present the problem which was long thought to be involved in the use of a corporation. However, either entity could lease land from the farmer-owner, in which case the rental payments presumably would be income to the owner deductible by the corporation. Other arrangements might suggest themselves as alternatives to ownership of the farm land by the corporation, and it is submitted that the language in article XXII, section 2, which states: "nor shall any corporation be created or licensed to do business in this state for the purpose of acting as an agent in buying and selling or leasing land for agricultural purposes" under the present state of the law will not preclude an agricultural corporation whose articles include such authority from itself directly leasing and using land for its own agricultural purposes.

Since an agricultural corporation, therefore, probably has the option of either owning the land involved, or part of it, let us pass to considerations of other problems involved. Potential tax problems are, of course, numerous in the formation of any corporation, but in the case of agricultural corporations there are likely to be present some non-tax problems which should be considered. For example, the homestead laws will need to be considered if farm land on which the farmer lives is to be conveyed to the corporation; there are costs involved in the formation of the corporation;[27] records probably more stringent and detailed than those maintained by an

[27] Insofar as legal fees are concerned this consideration may not cause most of us so much concern.

individual partnership will need to be maintained by the corporation; there may be problems connected with the dissolution of the corporation, if this step becomes advisable; the control exercised by the controlling shareholders in a corporation is substantially greater, insofar as minority shareholders are concerned, than the control which the owner of a larger undivided interest in land might be able to exert, since the threat of partition by one joint tenant is a formidable weapon not readily available to a shareholder. Reports have to be made by a corporation which are not required from an individual, although this is not nearly so great a problem in Oklahoma as in some other states. A substantial psychological problem which should be considered prior to the recommendation of a corporation for a farmer or rancher is the possible reaction of the client to the more rigid and formalized procedures likely to be involved in the use of a corporate form, although this probably will prove to be less of a problem than many lay clients might fear. Fortunately, Oklahoma does not face some of the corporate problems involved in surrounding states such as submission of annual balance sheets, mandatory cumulative voting, and stringent requirements of shareholder approvals of various routine corporate actions.

One non-tax problem which is very relevant to the consideration of incorporating, so far as the rancher-farmer is concerned, is the effect that the use of the corporate entity might have on the Department of Agriculture support programs. In some articles on this subject it has been pointed out that there were present some restrictions on government lending to farm corporations.[28] This means, of course, that the possibility for obtaining Federal Land Bank and other of the various types of government credit available might be affected by the use of the corporate structure and a check with the departments involved to determine the current status of corporations for the credit being dispensed by each particular agency might be in order. Of course restrictions and regulations involved in problems of this type are extremely changeable and present rules in these regards might be changed at any time.

However, insofar as the Department of Agriculture support programs are concerned it would seem that there is no impediment to the use of a corporation. A copy of the current Department of Agriculture regulations was furnished to this writer in December of 1962 by the Department of

[28] For excellent articles on business and tax implications involved in agricultural corporations see, Cavanaugh, *State Limitations on the Size and Existence of Agricultural Corporations*, XV BUSINESS LAWYER 900 (1959–1960); *Panel Discussion on Agricultural Corporations, Annual Meeting of the Section of Corporations, Banking & Business Law*, Vol. XVII, *supra* at 221; Watkins, *To Incorporate or Not? Special Problems of Farm or Ranch Affecting the Usual Rules*, 16 J. TAXATION 118 (Feb. 1962).

Agriculture.[29] An "eligible producer" is defined in section 421.1104(a) as including "an individual, partnership, association, corporation, estate, trust or other legal entity."

In addition to these non-tax problems there are of course the tax factors which must be considered in the organization of a corporation. An active agricultural corporation which realizes its income from farming, ranching and related activities will not be faced with the problem of a personal holding company status[30] although a corporate owner of agricultural land who rents it to others might very well be falling into this classification. In any event because of these stringent penalties involved, this point should certainly be checked if rent, interest, dividend, or personal service income will be realized to any substantial percentage by the corporation. A farmer who uses a corporation should be aware that he may be subject to more stringent requirements with respect to the time available for estimating his personal income if a large percentage of his personal income comes from the corporation in the form of salary or dividends, although the corporation itself will have more time in which to pay income taxes due unless it becomes a very large tax payer quickly. Too, the law[31] penalizing unnecessary accumulation of surplus in corporations should be consulted prior to organization if the corporation is a large one with a probable large income, and it expects to accumulate rather than distribute its earnings. These items are mentioned because the degree to which farming can become big business, particularly in the northern and western portions of the state, may be quite surprising. The farmer should know prior to incorporating that any withdrawal after incorporation, or use of corporate facilities or loan from the corporation may result in the imposition of a tax on such proceeds or use as though the individual had received dividends from the corporation.[32] Corporations are subject to some extra taxes, such as franchise taxes, and lose some deduction privileges available to an individual, such as capital loss and charitable deductions. The individual may want to consider the formation of more than one corporation for the operation of a large agricultural enterprise if there are logical business reasons for divisions, particularly if the individual's tax bracket is so high that a sub-chapter S election being taxed as a partnership is not advisable.

[29] Letter to the writer, dated December 3, 1962, from Edward M. Glickman, Deputy General Counsel, U. S. Dep't of Agriculture, in which reference is made to the section of regulations referred to in the text.

[30] 26 U.S.C. § 542 (1958) is the key section.

[31] 26 U.S.C. § 531 (1958).

[32] Basic statutory definition of dividends is contained in 26 U.S.C. § 316 (1958) and § 301 begins the treatment of distributions. Distributions of property in kind are involved in §§ 301, 311 and 312.

The client may want to look at his future cash needs carefully inasmuch as stock of an agricultural corporation is probably not going to be very marketable, and the difficulty previously referred to in withdrawing cash from the corporation on other than a taxable compensation basis, may make such withdrawals difficult; he therefore may want to consider a loan to the corporation or corporations, to be discussed subsequently. He will probably not want to assign contracts to the corporation in order to avoid "pyramiding" income, particularly if a sub-chapter S election is not used, and finally will undoubtedly want to incorporate at a time when an otherwise available operating loss carryover will not be wasted.

We have passed gradually from reasons for not using a corporation under any circumstances in the agricultural business to cautions and pitfalls to be watched for when a corporation will be used; now it is appropriate to consider some of the advantages inherent in the corporate structure, or available through careful planning. Since farming has become big business for many people, and ranching has become even bigger in many cases, the non-tax advantages of a corporate structure have become significant. The financing of sizeable businesses is planned and geared to loans to corporations, and even though in many instances individual guarantees, either by endorsement or separate agreement, of the obligations of the corporation might be required from the individual owner, the thinking patterns of many commercial lenders are oriented to dealing with the corporate borrower. A corporation's property and assets can be "frozen" or made subject to liens to no greater extent than the property of an individual, but the lender's control of corporate property can be accomplished more easily where the lender is interested in preserving the identity, use and location of such property as collateral for his loan. Lenders can be given representation on boards of corporate borrowers, the corporate income can be restricted in its application, limits can be placed on salaries drawn by owner-employees of corporate borrowers and, extremely important from a lender's viewpoint as well as from that of the business man who wishes to see his business possess continuity, the death of a key person may be disastrous if he is an individual borrower, while his death as an officer of a corporation may have a minimal effect on the continuity of the business. Applied to the advantage of perpetual life which corporations possess, this can have another effect; the business unit is preserved from the standpoint of size. The division of a farm or ranch into small inefficient units through the death of an owner or joint tenant can be most unfortunate, whether or not the heirs get along with each other, and if they do not, it can be disastrous. Forgetting about the pure tax advantage of using a corporation for estate planning, which will be discussed below, and assuming that a farmer

who incorporates does wish to minimize his estate taxes by the transfer of property to his heirs during his lifetime, a corporation will of course allow him to make gifts of stock,[33] without losing control of any portion of the property, as he would by giving either parcels of real estate, units of personal property, or undivided interests which could be subjected to partition. Many agricultural operators are of sufficient size, too, that they would realize considerable benefit from the use of a corporation in the management of widely separated business activities. Control of either large sized or scattered business enterprises, and many agricultural operations are both, is greatly facilitated by the use of the corporate organization, through which permanent duties and responsibilities become attached to an office which may be refilled by a different individual when vacated by the death or incapacity or absence of the incumbent. The "chain of command" is more easily delineated in a corporation, and particularly is this true where multiple ownership is involved.

Last, but probably not least to ranchers and farmers, a significant non-tax benefit of the corporate form may be realized through the limitation on liability which was one of the primary reasons for the birth of the corporation as a business entity. Some extremely dangerous work is involved in agricultural operations and while the possibility of falling under workmen's compensation coverage at sometime may be a disadvantage, it may also be an advantage in some circumstances. The danger which causes greatest economic concern, however, is the danger to third parties and the general public when large machinery and equipment is moved or used where others are present. Large numbers of seasonal temporary employees are used in many agricultural operations, and the use of one or more corporation offers the farmer or rancher an opportunity to limit his liability for the actions of these people. Liability insurance can, of course, be obtained for an individual or a corporation but is obviously no substitute for the limited liability inherent in the corporate structure.

Sub-chapter S of the Internal Revenue Code enacted in 1958 as part of the Technical Amendments Act,[34] allows corporations with ten stockholders or less to avoid corporate income tax by electing to be taxed as partnerships. Actually, the corporation's income or loss in terms of gross profits or losses before taxes is simply transferred at the end of the corporation's fiscal year to the shareholders, and shows up for that tax year on the shareholder's personal return. The corporation itself is, of course, then exempted from corporation income tax for that particular year. There are several pitfalls to be observed in the use of a sub-chapter S election. Only

[33] 26 U.S.C. § 2501 (1958).
[34] 26 U.S.C. §§ 1371–76. (1958).

"small businesses" are eligible, of course, but this term is defined in the law in terms of the number of shareholders and as a corporation having only one class of stock. Shareholders must be either natural persons or estates and no nonresident alien may be a shareholder. The chief pitfalls, however, for a farmer or rancher would seem to be: the privilege given to the secretary of the treasury or his delegate to apportion income of the corporation among members of a shareholder's family if he determines that such apportionment is necessary in order to reflect the value of the services rendered to the corporation by other members of the family who are also shareholders; the rules relating to the time of an election to be taxed under sub-chapter S, which is the month before the beginning of the taxable year for which the election is made or during the first month of the taxable year; and the fact that the election, once terminated, precludes another such election for five years. There is also a prohibition on corporations receiving personal holding company income, which is defined for purposes of *this* law as "gross receipts more than 20% of which is derived from royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities," but this should not adversely affect many farm or ranch corporations. Obviously the use of the sub-chapter S or "pseudo" corporation is not an extremely simple matter, but many writers in the area of agricultural corporations[35] feel that it will be of prime utility for farmers and ranchers who want to use the corporate form for their business.

It is this writer's opinion that there might be an appreciable number of farmers and ranchers in Oklahoma whose personal incomes put them in the 50% or higher bracket, and who might want to consider an election under sub-chapter R[36] to be taxed as a corporation. Many others might wish to use the corporate form, but not to elect under sub-chapter S.

Moving to other tax considerations pertinent hereto, it is often pointed out that there are potential tax advantages which may be realized by the manner in which a corporation is formed.

A new corporation can, of course, select a new fiscal year. A true corporation might make a short period return and thereby put itself in a lower tax bracket than might otherwise be the case for its first fiscal year, and a pseudo or sub-chapter S corporation might be able to select a time toward the end of the calendar year in which to pass on a net loss deduction to its individual shareholders, or might elect to have its fiscal year end in the first few months of the calendar year and thereby gain a long delay in the payment of tax earned because the calendar year individual tax payer would report income received in that manner in January, for example, on

[35] Watkins, *supra* note 28.

[36] 26 U.S.C. § 1361 (1958).

his return filed possibly over a year later. This may require consideration of such factors as the estimation requirements, and all of the potential advantages which may be realized in setting up a new corporation require careful planning. However, such privileges as the foregoing, and the right to choose an accounting method, the possibility of loaning two or three dollars for each dollar invested so that deductible interest is paid out by the corporation rather than a non-deductible dividend to the shareholder, the possibility of amortizing the corporation's organizational expenses over a five year period or more by electing to do so in the return for its first taxable year, and the possibilities in unusual situations of forming a corporation as a subsidiary of an existing corporation or having its stock held by an existing corporation, are just a few examples which illustrate some of the possibilities for tax savings which may be realized at the time the corporation is formed.

A possibility which exists for some tax saving at the time the corporation is formed and possibly merits separate mention is the issuing of up to 20% of the capital stock of a corporation to non-contributing parties. That is, one person can receive 80% of the stock issued in return for his contribution of all the corporation's physical assets, which leaves a little planning possibility of issuing as much as 20% to other members of a family who may enjoy low bracket tax rates. The issuance starts the running of a ten year period, after which some redemptions by the corporation of stock issued to family members can be made at a capital gains tax. The big utility here, however, is probably the benefit potentially available in distributing for estate tax purposes property which might otherwise be includible in the 80% shareholder's taxable estate. Issuance of stock in return for services by family members is, of course, the preferable way to proceed, but a disproportionate issue to the interest of the transferor will result only in the imposition of a gift tax. In this regard it is well to remember that stock at its issuance will presumably have a much lower value than it may have at a later date, such as at the time of the death of the major shareholder.

Some of the finest tax advantages of the corporate form of doing business lie in the area generally referred to as "fringe benefits." In its broader and generally used sense, this phrase includes those wonderful tax shelters, the corporate retirement plans. There are two basic types of so-called "qualified" retirement plans, although as will be seen below, others are also available. These two basic types are the pension plan, which is funded by periodic contributions to a trust or periodic payments of insurance premiums to an insurer by the corporation, based on the computations of an actuary as to what sums are necessary to pay the liabilities to the beneficiaries of the plan. A profit sharing plan is the contribution by the corpo-

ration of an amount of up to 15% of the company's total payroll to a trustee or insurer, and both types of retirement plan are susceptible of being approved in advance by the Internal Revenue Service without any real risk of loss to the corporation. Both types of plans can involve considerable flexibility of contribution. For example, the contribution to a profit sharing plan can be less than the maximum in one year, and a previously made but not deducted excess contribution from a past year can then be added in and deducted by the corporation for that year. A considerable degree of flexibility is also possible insofar as contributions to a pension plan are concerned, at least much more than is generally realized. Persons who are officers and employees of a small closely held corporation can expect their corporation's retirement plans to be scrutinized, and cannot discriminate under the terms of the plan for stockholder employees. However, plans with as few beneficiaries as one stockholder employee have been approved by the service.[37] A sub-chapter S election will not preclude the corporation's use of retirement plans and similar legitimate fringe benefits.

The beautiful aspects of retirement plans are: the contribution is tax-deductible by the corporation, up to the legal maximum limits; the income earned by a contribution after it becomes a part of the retirement plan is not taxed to the plan; the employee for whose benefit the contribution to the retirement plan is made is not taxed during the year of contribution for that portion which is set aside for him until he starts receiving retirement payments after his retirement, when he merely pays normal income tax on his retirement income (usually being in a lower income tax bracket then) or when he withdraws his lump sum aggregate benefits upon his retirement and pays a capital gains tax on the accumulated earnings on the amounts which have been contributed for him (not computed on the value of the contributions themselves). This last advantage is one of the targets of the administration's tax planners at the time this article is being written, and may be watered down somewhat.

Refinements of these two basic types of retirement plans have been developed which seem to offer considerable benefit. A trust type of retirement plan can, if the transaction is at arms length and on reasonable business basis, purchase real estate and lease it back to the corporation. The lease rentals paid by the corporation to the retirement trust should be tax deductible, but the income to the trust is exempt. Excess accumulated funds in profit sharing plans can be used to purchase insurance on the lives

[37] Rev. Rul. 81, 1955-1 CUM. BULL. 392 is the only known reported ruling involved in the 1939 Code; however, it should be applicable under the 1954 Code, and some one man retirement plans are known to the writer to have been approved by the Service.

of the employees covered by the plan, and similar refinements will suggest themselves. One major advantage which should be mentioned before being passed over is the fact that corporate retirement plans of a closely held corporation can be of tremendous benefit in an estate planning sense; a covered employee's accumulated benefits (contributions which have been made by the corporation for his benefit during the years and accumulated earnings thereon) will pass to the beneficiaries named by such employee upon his death prior to retirement free from estate tax.

It can not be said, of course, that retirement plans are free from problems; if permanent full time employees are employed by a corporation, they must all be covered without discrimination in favor of higher salaried personnel, particularly shareholders. Many ranch and farm corporations, however, will be using part time and temporary employees for a great deal of the corporation's work, and retirement plans for such corporations could quite often probably be restricted to shareholders because they might be the only full time employees of the corporation. Contributions must become "vested" for a plan to be "qualified" for the tax deductions previously outlined; that is, the employee's right to the contributions must, within a very few years, become the property of the employee or his death beneficiary, even if he is later discharged by the corporation. These plans, nevertheless, obviously offer a major incentive for the use of the corporation in any business and are obviously worth establishing, problems and all, for a closely held corporation with very few employees and even a moderate sized annual income. There is a choice between the use of a trustee and an insurer. One of the advantages of the retirement trust has been mentioned in that it is sometimes possible for it to own property leased back to the corporation, or to purchase obligations and securities of the corporate employer, but the insured plans will also have advantages in some situations. This subject has become practically a separate body of knowledge.

Non-qualified plans have some value for estate planning purposes and unusual situations involving closely held corporations, and should not be forgotten for these purposes, but do not have any of the other tax advantages possessed by a qualified retirement plan. There are, however, other types of retirement plans available, known generally as "deferred compensation" plans. These plans take the form of a contract obligating the corporation to make payments to an employee for a certain period following the termination of his employment. Any arrangement "having the effect of a plan" may be treated by the I.R.S. as a deferred compensation plan, and each stands on its own merits; however, there is a rather definitive Revenue Ruling which is considered to be the most reliable guide to date.[38]

[38] Rev. Rul. 31, 1960-1 CUM. BULL. 174. See also, 26 U.S.C. § 404 (1958) and Treas.

The particular value of deferred compensation plans to employees, of course, lies in the fact that if carefully drawn the plan will result in a commitment by the corporation to pay compensation to the employee, but the compensation will not be taxed to the employee during the years in which the corporation is funding the "plan," but will be taxed to him only when actually received by him following the termination of his employment. He obviously will otherwise be in a much lower tax bracket at this time. An "employee," of course, can include a shareholder employee of a farm or ranch corporation. Various situations arise with respect to arrangements which do not fall into the category of either a qualified retirement plan or a deferred compensation plan, but are classified in the areas of annual bonuses, vacation pay, and similar arrangements. For the most part, the effect of such arrangements is to allow the corporation a deduction, but to impose on the employee a tax as on income of any other type received at the time.

The term "fringe benefits," however, includes a number of other very real benefits which may be extended to a stockholder employee or officer as well as to any other kind; while a stockholder-employee of a closely held corporation can expect the utmost scrutiny, such incidental fringe benefits as health, accident, group life insurance (deductible by the corporate employer), "split-dollar" life insurance, and benefits necessarily incidental to the particular employment duty involved, are all tax-free to the recipient. This type of benefit brings the planner well into the area of situations which stand on their own particular facts. Well established fringe benefits by virtue of other tax laws, such as "sick pay," which do not individually constitute a large factor for the average rancher or farmer, may nonetheless in the aggregate cause favorable consideration of the use of the corporation when considered with all other available benefits.

The last "fringe benefit" considered herein is the stock option; the restricted stock option is another target of administration tax planning at the time of the writing of this article. However, some benefit will undoubtedly still continue to be available to the corporate employee, regardless of congressional action in the present session. Stock options granted to employees, if unrestricted, will generally defer tax but not result in a change of the classification of benefit from income to capital gain. A restricted stock option provision, of course, allows the employee receiving it to treat profit realized through the exercise of his option as a capital gain.[39]

Regs. 1.451–1(a) (1957) and 1.404(a)–12 (1956) for a starting point on deferred compensation and retirement plans. See discussion, Kahn, *Corporate Recapitalization as a Tool in Estate Planning*, 16 J. AM. SOC'Y C.L.U. 153 (Spring 1962).

[39] 26 U.S.C. § 421 (1958).

The chief problem connected with a stock option, from the standpoint of shareholder-employees of agricultural corporations, is likely to be the provision that a 10% owner of the voting stock of an employer corporation must take a restricted option at a price at least equal to 110% of the fair market value of the stock at the time the option is granted, and the option by its terms must not be exercisable after five years from the date it was granted. For persons owning 10% or less of the voting securities of a corporation, the restricted option offers a great deal more attraction in that it can be granted on the basis of a price equal to 85% of the fair market value of the stock at the time the option is granted. Although there are other restrictions on the time within which a disposition may be made of the option, both a minimum and maximum limitation, this particular type of "fringe benefit" is likely to prove worthy of consideration for shareholder-employees of corporations, and for employees who are not shareholders or are very minor shareholders, from a standpoint of retaining their services. If a non-restricted stock option is issued, the question of whether or not the value of the option is taxable to the employee at the time he receives the option will depend on whether or not it has a "readily ascertainable" fair market value when granted.

Fringe benefits such as the possibility of using corporation-owned physical facilities at various farming or ranching locations, being furnished transportation to and from the site of various operations and similar obvious possibilities are not explored in detail here. For that matter, the foregoing is obviously only a brief survey of corporate fringe benefits and does not purport to be detailed or exhaustive. A brief look at one more aspect of the potential benefits involved in the use of a corporate structure may be in order however. There seem to be several possibilities for improved estate planning through the use of one or more corporations for agricultural operations. One such device, otherwise unavailable, is a corporate reorganization.[40] Assuming that the tax savings possible through issuance of stock originally to heirs had been realized to the maximum, there remains the further possibility of corporate reorganizations on the basis of the issuance of preferred stock to the original shareholders and older persons, and the issuance of common stock likely to increase in value to the heirs of such persons. The Code and regulations establish reasonably clear guide posts as to what may constitute a non-taxable "recapitalization" which is included as a "reorganization." The possibility of making a gift each year of corporate stock in an amount just under the gift tax exemption is an obvious and well-known possibility. The myriad possibilities developed by

[40] For excellent discussion of §§ 354, 368 of the Code, the basic corporate reorganization sections, and of the use of recapitalization in estate planning, generally, see Kahn, *supra* note 38.

the fertile imagination of the members of the insurance industry, such as the various plans developed for the purchase of insurance on the life of a shareholder by the corporation, with the agreement that the corporation will use the proceeds of such policy on the insured shareholder's death to purchase his stock and thus provide liquidity for the payment of estate taxes by his estate also offer obvious incentives for the use of a corporation in estate planning. Considering the other estate planning tools available for the average large farmer and rancher, such as the sale of real estate to potential heirs through private annuities,[41] the use of custodial or trust gifts under the gift to minors laws,[42] and the use of the funded and unfunded life insurance trust, one might well conclude that the tools for adequate estate planning for farmers and ranchers are available if utilized to the optimum by a legal profession.

The foregoing is intended merely to suggest possibilities, is in the nature of a brief survey, and is certainly not intended as a specific recommendation for or against the use of a corporation by any farmer or rancher in this state. However, it is the conclusion of this writer that the use of a corporation or business trust for farm and ranch clients is perhaps not as wide spread as it should be in Oklahoma.

[41] Under which farm land, for example, might be sold to younger members of a family on the basis of annual payments computed by dividing the fair market value of the land by the number of years in the life expectancy of the seller on the basis of a prescribed table.

[42] 60 OKLA. STAT. §§ 401–10 (1961).