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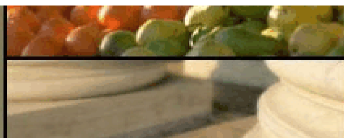

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TAXATION OF THE FAMILY FARM CORPORATION AND PARTNERSHIP: VARIATIONS ON A THEME

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INTRODUCTION

Subsequent to the second World War the family farming operation in the United States has undergone radical change. An ever increasing mechanization of the processes of farming has resulted in better means of production. Because the actual work of farming has become less burdensome and time consuming, there has been a pronounced tendency to enlarge the size of the agricultural unit. Because of the increased costs of farming and the increase in acreage size of the farming unit, the one man farm is becoming less economical and is being replaced by a larger family farming unit. While in 1920, farm population comprised 30.1% of the total population of the United States, in 1958 the farm population only comprised 12% of the total American population.[1] In North Dakota the total number of farms had decreased from 83,000 in 1930 to 62,000 in 1954 while the size of the average North Dakota farm rose from 512.9 acres in 1940 to 676.1 acres in 1954.[2]

Parallel to these economic and sociological changes has been the development of the family farming unit. Several types of business associations are available for the family farming unit to select as the most suitable type of organization for its particular needs. Possible business associations which might be elected are: the corporation; the partnership, both limited and general; and the cooperative. Our discussion will be limited to only the corporation and the partnership. Factors to consider in selecting the appropriate unit of family farm production are: 1) what do the parties seek to achieve, 2) do the parties wish to perpetuate their farming operation or do they intend that it cease upon the death of one of the parties, 3) what are the possible problems of tort liability, and 4) what are the estate planning and tax considerations. In most states the choice

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1. U. S. Department of Commerce, *Statistical Abstract of the United States*, (1959), Table 806 at 613. (In the course of its history, the Bureau of the Census has employed several definitions of a farm. According to the latest definition (used in the 1950 and 1954 Censuses) a farm is all the land on which some agricultural operations are performed by a person, either by the operator or with the assistance of household or hired labor. Places of 3 acres or more are considered farms if their production is valued at a minimum of $150.00 exclusive of that from a home garden. Places of less than 3 acres must have sold a minimum of $150.00 of their production to be classified as farms. *Id.* at 611).

2. *Id.* Table 812 at 616.

of the family farming unit from the tax standpoint lies between the farm partnership and the farm corporation.

FAMILY FARM CORPORATION

What are the prime advantages of corporate family farming? The principal advantages are three fold: 1) limited liability on the part of the participants, 2) flexibility in the expansion of business, and 3) facility in problems of estate planning. The principal disadvantages of corporate farming are: 1) double taxation, 2) disadvantage of fixed salaries. The advantages of corporate farming may be secured to a substantial degree by use of the limited partnership agreement in place of the corporation. The chief disadvantage, however, of the limited partnership agreement is that it is unsatisfactory if the limited partner or partners wish to participate in the management of partnership operation.[3]

In creating a family farm corporation it is possible to include both the land itself and the actual farming operation within the corporation. If this is done, the income derived from the corporate operations reaches the individuals participating in the corporate enterprise through salaries or dividends or both. If within a family farm corporation, only the land itself is incorporated, the corporation will receive rental income which will reach the shareholders through dividends and salaries, although the salaries will be much lower. If the farm land itself is not incorporated, but the farming operation is incorporated, the corporation in addition to dividends and salaries must pay rent for the use of the land.

In 1958 amendments were made to the Internal Revenue Code of 1954 by the addition of the so-called "Subchapter S."[4] Prior to the enaction of these amendments the difference taxwise between the small corporation and the partnership was that the earnings of the small family corporation could be taxed twice, once to the corporation itself and again when the corporate earnings were distributed to the shareholders. Also, generally the minimum corporate tax rate is considerably higher than the minimum individual tax rate. Thus prior to 1958 unless the tax disadvantages were outweighed by other considerations, it was not desirable for the small family farming unit to incorporate.

Since the enactment of Subchapter S, it is possible for a small

3. See Note, *A Tax Comparison of the Limited Partnership and the Subchapter S. Corporation*, 43 Minn. L. Rev. 964 (1959). See also Heard, *How to Avoid the Taxation of Limited Partnerships as Corporations*, 6 J. Taxation 298 (1957). North Dakota has adopted the *Uniform Limited Partnership Act*. Laws of N.D. Chap. 326, § 45-1001 et seq. (1959).

4. Int. Rev. Code of 1954, § § 1371-1378.

business corporation which has issued only one class of stock and whose total number of shareholders does not exceed ten, to avoid the problem of double taxation by electing taxation like that applicable to a partnership and its partners. The corporation must file notices of its election to elect under the provisions of Subchapter S and this election must be agreed to by all of the corporate shareholders.[5] The net result of the small corporation electing to be taxed as a partnership is that during the taxable years in which this option is elected, the corporation itself does not pay tax or corporate earnings but rather each shareholder pays tax on both his share of the corporate earnings which he has received and his pro-rata share of the undistributed income of the corporation.[6] The disadvantageous aspect of this election to the individual shareholder is that the individual shareholder must also take his proportionate share of any corporate loss which is attributable to him as a net operating loss.[7] The corporation must make an election during the month immediately prior to the taxable year.[8]

Whether the election between a family farm corporation or a family farm partnership is available to members of a family agricultural unit in North Dakota is a matter of speculation. The North Dakota Revised Code of 1943 contains Chapter 1006 which is entitled "Corporate Farming Law."[9] The corporate farming act has been at least partially litigated in several instances.[10] It is submitted that the tenor of these cases has not been one of encouragement to would-be corporate farmers.

FAMILY FARM PARTNERSHIP

Thus in North Dakota the principal business association which a family farming unit may consider is that of the partnership. A partnership is defined by the Uniform Partnership Act which North Dakota has adopted as, " . . . an association of two or more persons to carry on as co-owners a business for profit."[11] The definition is qualified by the statement, "But any association formed under any

5. Int. Rev. Code of 1954, § 1372 (a).
6. Int. Rev. Code of 1954, § 1372 (b).
7. Int. Rev. Code of 1954, § 1374.
8. Int. Rev. Code of 1954, § 1372 (c). Form 2553 is used for making this election. This form is filed by the corporation itself, but the individual assents of the shareholders must be appended to the form. Temp. Reg. 18.-1 - 1, T. D. 6317 (filed 9-25-58).
9. The "Corporate Farming Law" originated as an initiative measure and was approved by the people of North Dakota on June 29, 1932 by a vote of 114,496 in favor to 85,932 opposed. (Session Laws N.D. 1933, 494 at 495). While this measure has been amended several times, the basic proviso concerning corporate farming has not changed.
10. See Asbury Hospital v. Cass County, 72 N.D. 359, 7 N.W.2d 438 (1943), appealed on merits 73 N.D. 469, 16 N.W.2d 523 (1944) affirmed, 326 U.S. 207 (1945). See also Loy v. Kessler, 73 N.D. 469, 16 N.W.2d 523 (1949).
11. Laws of N.D. Chap. 326, 45-0505 (1959).

other statute of this state, or any statute adopted by authority, other than the authority of this state, is not a partnership under this Act, unless such association would have been a partnership in this state prior to the adoption of this act; but this Act, shall apply to limited or special partnerships except insofar as the statutes relating to such partnerships are inconsistent herewith."[12] A limited partnership is defined as " . . . a partnership formed by two or more persons . . . 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."[13] The definition of partnership to be found in the Internal Revenue Code, "includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation, or a trust estate . . ."[14]

Since the Uniform Partnership Act and hence the law of North Dakota defines a partnership as an association as contrasted with the Internal Revenue Code's definition of the term partnership as an "other incorporated organization," the question arises whether the definition of the Code enlarges the definition as set forth in the Uniform Partnership Act. It is submitted that under the various income tax regulations, rulings and decisions, the term "partnership" for tax purposes is not limited in scope to the common law concept of this particular business association. This is particularly true since the Internal Revenue Code of 1954 prescribes its own definitions and tests of classification of a "partnership" without taking cognizance of any local law definitions of this particular form of business association. Thus the definition appearing in the Code appears much broader than that definition used in the Uniform Act and hence in current North Dakota Law.

The problem then exists concerning the definition of a farm partnership. It has been suggested that "a farm partnership is a legal form of doing business in which two or more persons join together to carry on the farming business for profit as co-owners. In a farm partnership agreement the partners agree to do business as partners and: 1) to contribute capital or services or both to the farming operation, 2) to share profits and losses, 3) to permit the other partners to act in the name of the business, and 4) to be individually and jointly responsible for all debts and liabilities

12. Ibid.
13. *Id.* at § 45-1001.
14. Int. Rev. Code of 1954, § 7701 (a) (2).

arising from business. Since a partnership agreement is a contract, the partners have great freedom to determine how the business shall be run."[15] It is important to remember that this definition only applies to a general farm partnership and not one of limited nature.

A partnership is then perhaps the most satisfactory form of business association from a tax standpoint for a family farming unit to adopt. While a farm partnership, is quite similar to a share-lease arrangement in its daily operations it is different in that the landlord under a share-lease arrangement has not accepted all the responsibilities of a partner. These responsibilities may be aggregated in the statement that the landlord and tenant in a share-lease arrangement are not really the co-owners of the farm business as the farm partnership partners are.

An important factor for the family to consider is a determination of the parties who may be proper partners in a family farm partnership in the light of existing tax law. While the courts have upheld in principle the existence of family farm partnerships for tax purposes,[16] areas exist where some family farm partnerships which might be valid under local law are not recognized for tax purposes.[17] The status of a partner under local law will vest a partner, even one not recognized for tax purposes, with rights in the partnership—specifically the partner's rights in certain partnership property, his interest in the partnership and his participation in the management of the partnership.

No significant advantages from a tax standpoint will accrue to a family farm partnership composed only of a husband and wife since the same advantages generally are available to a husband and wife by the filing of a joint return. The wife is not generally treated as self employed for income tax purpose unless the wife has an actual cognizable separate business[18] or if the wife has entered into a valid partnership with her husband. A husband-wife partnership will be scrutinized carefully by the Commissioner in determining whether a valid partnership has been created in accordance with the 1954 code.

Contrasted with the husband-wife family farm partnership is that partnership which is composed of a father and one or more sons. Here, if the partnership is bona fide for tax purposes, there may be

15. O'Bryne, *Farm Income Tax Manual* (*Revised Edition*) (1958), § 1106 at 502.
16. See Comm'r v. Tower, 327 U.S. 280 (1946); Lusthaus v. Comm'r, 327 U.S. 293 (1949).
17. See discussion in Comm'r v. Culbertson, 337 U.S. 733 (1949).
18. An example might be the raising of poultry and/or the selling of eggs.

substantial tax savings available. The use of the term bona fide implies that there must be a substantial contribution of capital by all partners or a substantial contribution of labor and management by a partner if there is no contribution of capital by one or more partners.[19] An important factor to consider in creating a family farm corporation is that the capital of one of the partners may be an outright contribution or it may be in the form of a valid trust. If the gift is to minors without the creation of a valid trust, then the minor must be competent to act as a partner in the management of the partnership at the time of the gift if a valid partnership for tax purposes is to be created.

If a partner contributes services or capital or both and in return for his contribution receives a share of the partnership income, the income is usually considered to be self-employment income for social security purposes.[20] The particular role played by the individual partner has no bearing on determining whether the partnership produces self-employment income. Rather the Code considers the partnership as a business unit and considers the partners as sharing whatever income the partnership produces.

Not all forms of family farm ownership and operation which appear to be partnerships are defined by the Code as actual family farm partnerships. A profit-sharing arrangement which appears on the surface to be a family farm partnership may really be for tax purposes: 1) a creditor arrangement with payment of principal or interest based upon a share of the profits; 2) a simple joint ownership of property; 3) rent paid to a landlord; 4) wages paid to an employee; or 5) an installment sale of property.[21] These arrangements may be based upon a share of the profits but are not actual partnerships because the parties do not really intend to be partners with each other. Hence the intent of the participants is the determining factor in considering whether a bona fide partnership exists for tax purposes.

The partnership is a logical method of spreading income among a family farming unit or among several family farming units. The partnership is a particularly advantageous method of the family farming unit engaging in various joint enterprises. The use of the partnership form allows operating losses to be used advantageously by individual partner-taxpayers in high individual tax brackets since

19. Int. Rev. Code of 1954, § 704 (b) (1); Reg. 1.722-1 (TD 6175) and Reg. 1.723 (TD 6175).
20. Int. Rev. Code of 1954, § 1402 (c).
21. See O'Bryne, *op. cit. supra*, at § 1106.

the partnership losses may be offset against income. Where a transfer of interest takes place a stockholder in a family farm corporation would normally have his gain from sale of stock in the particular business treated as a capital gain while when a partner sells his partnership interest he will usually be taxed at ordinary rates or gains attributable to the partnership, unrealized receivables or inventory materials which have substantially increased in value.[22]

Although the partnership doesn't pay any tax, it may select a taxable year as if it were a taxpayer.[23] Under the 1954 Code the partnership taxable year may not be changed to a taxable year other than that of the principal partners unless the consent of the commissioner is obtained upon his being shown a valid business reason for the change.[24] The Code defines a "principal partner as a partner having an interest of 5% or more in partnership profits or capital."[25] Farming operations which have marked seasonable characteristics, often provide strong reasons to change the taxable year of the partnership to the particular crop cycle of the farming operation.[26]

Farm partnerships like other types of partnerships are allowed to select any acceptable accounting method at the start of the partnership with the exception of the crop basic accounting method which must be approved by the Commissioner[27] and this method selected must be continued unless permission to change is granted by the Commissioner.[28]

Every partner in the family farm corporation must file an income tax return. Filing the partnership return service serves to make the preparation of the individual's return amount to little more than an acknowledgement of the individual's share of the partnership income and a statement of expenses. It may be presumed that even if the income of a two-member family farm partnership is not recognized for tax purposes and is attributed to only one of the partners alone, the partnership must still file a partnership return (Form 1065).[29] Form 1065 is soley an informational return and no actual tax computation is made on this return. The partnership return simply furnishes information regarding the shares of the

22. Int. Rev. Code of 1954, § 751 (a).
23. Int. Rev. Code of 1954, § 706 (b) Reg. 1.706-1 (b) (1) (i).
24. Int. Rev. Code of 1954, § 706 (b) (3); Reg. § 1.706-1 (b).
25. Int. Rev. Code of 1954, § 706 (b) (3); Reg. § 1.706-1 (b) (3).
26. Reg. § 1.706-1 (b) (4) (iii).
27. Int. Rev. Code of 1954, § 446 (a) and (c); Reg. 118, § 39.22 (a) - 7 (c) and § 39.41-2 (c).
28. Int. Rev. Code of 1954, § 446 (a) and (e), Reg. 118 § 39.41-2 (c).
29. See Reg. 1.6031-1 (1959) (query whether this regulation excuses the partnership from filing a return).

partners in the ordinary income of the partnership and such other matters as charitable contributions and capital gains of the partnership. Salary and interest payments are usually considered expenses to the partnership and income to the receiving partner. Distribution of profits and losses may be charged as the partners agree until such time as the tax return is due. Many items in a partnership return must be separately listed and may not be aggregated into partnership.

"Upon the death of a partner several things can happen: 1) Installment payments in money may be paid to the decedent's successor in interest over a period of years. 2) Payment in property or a money payment in a single year may be made to the decedent's successor in interest. 3) The partnership may be continued with the estate or the successor in interest of the deceased partner as new partner. 4) The partnership may be terminated and liquidated (either by terms of the partnership agreement or the agreements of the partners themselves)."[30]

Under the internal revenue rulings, if some positive act is not performed to terminate the partnership, it will continue with the decedent's estate or successor-in-interest treated as a partner for tax purposes, even though the original partnership consisted of only two partners.[31] If the terms of the partnership agreement provide that upon death the business clearly ceases operation as a partnership, then death will terminate the partnership and the properties of the partnership will be treated for tax purposes as distributed.

Under the 1954 code, the deceased estate's share of partnership assets, including the inventory, is entitled to a step-up in the basis of the filing of an election to be taxed as a partnership[32] or by the filing of an election involving the distribution of the assets of the partnership.[33]

A definite pattern is also provided for the tax treatment of payment made by the partnership to retiring partners or to the estate of a deceased partner. Generally payments made for the retiring or deceased partner's share in partnership assets may not be deducted by the remaining partners and are treated as realized from the sale of capital assets by the recipient.[34] A notable exception is provided for payments in exchange for the retiring or deceased partner's

30. O'Bryne, *op. cit. supra*, § 914.
31. Reg. § 1.708-1 (b).
32. Int. Rev. Code of 1954, § 754.
33. Int. Rev. Code of 1954, § 732 (d).
34. Int. Rev. Code of 1954, § 736.

interest in unrealized receivables, but not his interest in inventory items.[35]

CONCLUSION

Rising land values, greater mechanization of the farming operation, the cost of mechanization and the resulting growth in the average size of farms have combined to greatly increase the capital investment which a farming operation requires. Parallel to the development of these phenomenon in agriculture has been the increase of taxation and a greater complexity of the various taxing laws and regulations. The family farm unit has been forced to examine the possibility of organizing itself into some type of a business association in order to both secure more easily the capital which larger scale farming requires and to alleviate as much as possible some of the tax laws and regulations which affect the family farming unit in an unfavorable way.

The family farm corporation and the family farm partnership are the two paramount possibilities from the standpoint of tax advantages in the selection of a form of business association for the family farming unit. In North Dakota it would seem that the obvious form of business association for the family farming unit to choose is that of the partnership. It is hoped that this discussion will serve to stimulate interest in the increased adoption in North Dakota of the family farm partnership as a form of business association.

35. Int. Rev. Code of 1954, § 736 (b) (2).