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Farming the Fringe Benefit Rules for the Farm and Other Family-Owned Small Firms

by

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FARMING THE FRINGE BENEFIT RULES FOR THE FARM AND OTHER FAMILY-OWNED SMALL FIRMS

*L. Leon Geyer**

INTRODUCTION

Health insurance and other fringe benefits are of great interest to farm and small business owners. The high cost of health care and rising insurance premiums underscores the importance of these benefits. When recommending a form of business organization for farms and other firms, attorneys must consider not only the variety of available fringe benefits but also the tax treatment of these benefits. The use of fringe benefits as a tax expenditure and as a method of improving tax

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equity is under constant review by lawmakers and the Internal Revenue Service. Consequently, attorneys must be aware of changing law in this area.

This Article addresses the current availability and application of fringe benefits, makes comparisons of benefits depending on choice of business entity, and reviews issues of tax equity associated with employee benefits. The ability to shift income between a return to capital and a return to labor is an essential concern of many farm and small business entrepreneurs. This Article also discusses the particular considerations of owner/employees. Many employee benefits, while deductible to an employer, are not deductible to an owner/employee.

I. Fringe Benefits: The Extra Compensation

Employers constantly seek tax deductible employment benefits that are also tax free to the employee recipients. The Internal Revenue Code generally allows employers to deduct fringe benefits if ordinary and necessary for carrying on its trade or business.[1] However, deductibility varies depending upon the form of business organization.

In general, fringe benefits amounted to 27.3 percent of employee compensation in 1989.[2] These fringe benefits include all types of health insurance,[3] vacation, sick, and personal leave,[4] retirement and profit sharing plans,[5] employee counseling,[6] maternity and paternity leave,[7] tuition reimbursement,[8] prepaid legal services,[9] cafeteria benefit plans,[10] stock options,[11] employee stock ownership plans,[12] and day care services.[13]

Variable income and lack of profitability have made fringe benefits less attractive to farm employers versus non-farm employers. Historically, many farmers have not sought to develop retirement funds inde-

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[1] I.R.C. § 162(a) (1992).

[2] NEWS, U.S. BUREAU OF LABOR STATISTICS, EMPLOYER COSTS FOR EMPLOYEE COMPENSATION, March 1989, USDL 89-295 (June 15, 1989).

[3] *See generally* I.R.C. §§ 105, 106, 162 (1993).

[4] *See generally* I.R.C. § 162 (1993).

[5] *See, e.g.*, I.R.C. § 404 (1992); *see generally* I.R.C. §§ 401-420 (1993).

[6] *See generally* I.R.C. § 105, 162 (1993).

[7] *See generally* I.R.C. § 162 (1993).

[8] *See generally* I.R.C. §§ 127, 132, 162 (1993).

[9] *See generally* I.R.C. § 120 (1993).

[10] *See generally* I.R.C. § 125 (1993).

[11] *See generally* I.R.C. § 422 (1993).

[12] *See generally* I.R.C. § 409 (1993).

[13] *See generally* I.R.C. § 162 (1993).

pendent of farm ownership. After farm expenses, living costs, and payments for debt retirement, many farmers do not have money left for retirement programs and tend to rely on their land as their retirement plan.

Retirement plans, however, may provide short term tax benefits to profitable farms and small firm owners. And, as employees, farmers and small firm owners may also gain an acceptable level of tax preferred fringe benefits as part of the employment bargain.

The type and deductibility of major fringe benefits available to farmers and small firm owners are discussed below.

A. *Health Insurance*

The medical care price index indicates more than a quadrupling in expenditures for health care in the last twenty years.[14] Because of the high increase in medical costs, farmers and small firm owners must find creative ways to recoup part of the cost of health insurance premiums through the Code's fringe benefit rules. For the most part, the tax treatment of health insurance premiums depends on the business entity choice.

1. Partnerships

Amounts paid in cash or in kind by a partnership without regard to income, to or for the benefit of its partners for services rendered in their capacities as partners, are guaranteed payments.[15] The partnership may deduct such cost from partnership income.[16] However, the cash amount or the value of the benefit is included in the income of the recipient/partner, and the benefit is treated as a distributive share of partnership income.[17] For example, while A and B's partnership may deduct the cost of accident and health insurance premiums paid on behalf of partners A and B, the partners must include the cost of the premiums in their gross incomes.[18]

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[14] U.S. Dept. of Commerce, Bureau of the Census, STATISTICAL ABSTRACT OF THE UNITED STATES 99, Table No. 152, *Indexes of Medical Care Prices: 1970-1990* (111th ed. 1991).

[15] I.R.C. § 707(c) (1993).

[16] *Id.*; *see also* Treas. Reg. § 1.701-1(c) (as amended in 1983).

[17] Treas. Reg § 1.707.1(c) (as amended in 1983).

[18] *See* Rev. Rul. 91-26, 1991-1 C.B. 184, 186. In pertinent part, the regulation provides that

> [a]s guaranteed payments, the premiums are deductible by the partnership under section 162 (subject to the capitalization rules of section 263) and

For taxable years after December 31, 1986 and before December 31, 1994, a partner "employee" of the partnership[19] may take a deduction equal to 25% of the premiums or amount paid for medical care or insurance premiums paid during the taxable year.[20] Health insurance premium payments for partners are treated the same as payments made by self-employed individuals.[21]

A partnership must report the cost of accident and health insurance premiums that are guaranteed payments on its Schedule K-1 and 1065 forms.[22] The partnership is not required to file forms 1099 or W-2 for these payments.[23]

A partnership may account for premiums paid on behalf of the partner as a reduction of distributions to the partner.[24] Under this arrangement, the premiums are not deductible by the partnership. Thus, distributive shares of partnership income and deductions are not affected. Individual partners, however, may deduct the cost of premiums paid on that partner's behalf.[25]

2. S Corporations

For purposes of applying Code provisions relating to employee fringe benefits, an S corporation[26] is treated as a partnership,[27] and any shareholder shall be treated as a partner of a partnership. Since most, if

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> includable in the recipient-partner's gross income under section 61. The premiums are not excludable from the recipient-partner's gross income under section 106; however, provided all the requirements of section 162(1) are met, the partner may deduct the cost of the premiums to the extent provided by section 162(1).

[19] Within the meaning of § 401(c)(1), a self-employed individual is considered an "employee" in Code definitions relating to self-employed individuals and owner-employees. I.R.C. §§ 401 (c)(1)(A) & 162(l) (1993).

[20] Rev. Rul. 91-26, 1991-1 C.B. 184, 184-86.

[21] *Id.* at 185.

[22] *Id.* at 186.

[23] *Id.*

[24] *Id.* at 185.

[25] *Id.*

[26] To qualify for S corporation status, the following conditions must be met: 1. The corporation may not have more than 35 shareholders; 2. the corporation may not have more than one class of stock; 3. all shareholders of the corporation must be individuals or qualified estates or trusts; 4. no shareholder may be a nonresident alien; 5. the corporation may not be a member of an affiliated group of corporations. I.R.C. § 1361(b) (1993). The amount of the corporation's assets and income is immaterial. WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 71 (6th ed. 1988)

[27] I.R.C. § 1372 (1993).

not all, farm employees of S corporations are more than two percent shareholders, employee fringe benefits, such as health and accident insurance premiums for the shareholder/employee, will be considered payment for services rendered. For income tax purposes, these benefits will be treated as partnership guaranteed payments.[28] The S corporation is entitled to deduct the cost of such fringe benefits.[29] But, like the partnership, the two percent shareholder/employee will be required to include the value of the benefit in gross income.[30]

Thus, where C and D each own 49.5 percent and E owns one percent of an S corporation, C and D must include the insurance premiums in income, while E can exclude the premiums paid from income.[31] The corporation is allowed a deduction for all premiums paid for shareholder/employees.[32]

> Unlike a partnership, the S corporation may not account for the premiums paid on behalf of [C and D] as a reduction in distributions . . . because the . . . pro-rata share of S corporation income is not subject to employment taxes.[33]

The 25 percent deduction, available to two percent shareholder/employees for premiums paid, has been extended through December 31, 1993.[34] The S corporation must now file a W-2 form for C and D since they are both two percent shareholders.[35] Additionally, the W-2 forms must include the cost of the accident and health insurance premiums.[36]

In I.R.S. Announcement 92-16,[37] the IRS announced that health and accident insurance premiums paid by an S corporation on behalf of two percent shareholder employees are not subject to Social Security and

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[28] I.R.C. § 707(c) (1993).

[29] I.R.C. § 162(a) (1993); *see also* Rev. Rul. 91-26, 1991-1 C.B. 184, 186.

[30] Rev. Rul. 91-26, 1991-1 C.B. 184, 186.

[31] I.R.C. §§ 106, 1372(a) (1993). E has only a 1% share; therefore, E is not considered a partner for tax purposes. Because E is not a partner, E can exclude the health and accident coverage from income. *See* Rev. Rul. 91-26, 1991-1 C.B. 184.

[32] I.R.C. § 162(a)(1) (1993).

[33] Rev. Rul. 91-26, 1991-1 C.B. 184, 186.

[34] President's Message: Veto of H.R. 4210—Tax Fairness & Economic Growth Acceleration Act of 1992, 3 U.S.C.C.A.N. D18 (May 1992). President Bush vetoed H.R. 11, 102d Cong., 2d Sess. § 2135, (1992), which would have extended this provision to June 30, 1993. The Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §13174, 101 Stat. 312, 457 (1993), (codified as amended at 26 U.S.C. § 162(l) (1993)) retroactively made the deduction available from July 1, 1993 through December 31, 1993.

[35] Rev. Rul. 91-26, 1991-1 C.B. 184, 186.

[36] *Id.*

[37] I.R.S. Announcement 92-16, 1992-5 I.R.B. 53.

Medicare withholding where the premium payments are not treated as wages under section 3121.[38] This section excludes from wages certain amounts paid by an employer to or on behalf of an employee, including insurance premiums and annuities, for medical and hospitalization expenses in connection with sickness or accidental disability.[39] For the exclusion to apply, the premium payments must be "under a plan or system for employees and their dependents generally or for a class (or classes) of employees and dependents."[40]

Presumably, the IRS would reach the same conclusion with respect to other fringe benefits that are not "wages" for employment tax purposes.

3. Limited Liability Companies[41]

Currently, thirty states have enacted legislation providing for the limited liability company entity choice.[42] Although generally available as a tool for farm and small businesses, at least one state specifically

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[38] I.R.C. § 3121(a) (1993).

[39] I.R.C. § 3121(a)(2) (1993).

[40] I.R.S. Announcement 92-16, 1992-5 I.R.B. 53.

[41] Limited liability companies are hybrid "state registered" entities that combine the tax advantages of a partnership with the corporate advantage of limited liability. Ronald P. Platner, *Limited Liability Companies are Increasingly Popular*, TAX'N FOR ACCOUNTANTS 364, 364 (1991).

[42] As of November 1993, 30 states have enacted some form of limited liability company legislation. See ALA. ST. §§ 10-12-1 to -62 (1993); ARIZ. REV. STATE. ANN. §§ 29-601 to -857 (1992); ARK. CODE ANN. §§ 4-32-102 to -1316 (1993); COLO. REV. STAT. §§ 7-80-101 to -913 (1992); CONNECTICUT, Public Act 93-267 effective October 1, 1993; DEL. CODE ANN. §§ 18-101 to -1107 (1992); FLA. STAT. §§ 608.401 to -471 (1990); GA. CODE ANN. §§ 14-11-1 to -19 (1992) (foreign limited liability company only); IDAHO CODE §§ 53-601 to -672 (1993); ILL. ANN. STAT. § 180/1-1 to -60-1 (1993); IND. CODE §§ 23-16-10.1-1 to -1.4 (1992) (foreign limited liability company only); IOWA CODE §§ 490A.100 to .1601 (1993); KAN. STAT. ANN. §§ 17-7601 to -7651 (1991); LA. REV. STAT. ANN. §§ 12:1301 to :1369 (1992); MD. CODE ANN., GENERAL CORP. LAW §§ 4A-101 to -1103 (1992); MICH. STAT. ANN. §§ 450.4101 to .5200 (1993); MINN. STAT. §§ 322B.01 to .955 (1992); NEB. REV. STAT. §§ 21-2601 to -2645 (1993); NEV. REV. STAT. §§ 86.011 to .571 (1992); N.H. REV. STAT. ANN. §§ 304-C:1 to 304-C:85 (1993); NEW JERSEY, P.L. Ch. 210 (S.B. 890) Laws 1993 (effective January 26, 1994); N. M. STAT. ANN. §§ 53-19-1 to -74; N. C. GEN. STAT. §§ 57C-1-01 to -07 (1993); N. D. CENT. CODE §§ 10-32-01 to -155 (1993); OKLA. STAT. §§ 2000-2060 (1992); R.I. GEN. LAWS §§ 7-16-1 to -75 (1992); S.D. COD. LAWS ANN. §§ 47-34-1 to -59 (1993); TEX. CODE ANN. §§ 1.01 to 9.02 (1991); UTAH CODE ANN. §§ 48-2(b)-101 TO -157 (1992); VA. CODE ANN. §§ 13.1-1000 to -1073 (1992); W. VA. CODE §§ 31-1A-1 to -69 (1992); WYO. STAT. §§ 17-15-101 to -136 (1990).

precludes farm operations from forming Limited Liability Companies.[43] Special consideration must be given to limited liability companies because of the way fringe benefits, specifically health insurance premiums, are treated for FICA and Medicare purposes. Since the limited liability company is generally taxed like a partnership,[44] presumably *all* members, not just those with two percent or more ownership, would be treated as having received guaranteed payments[45] includable in gross income.[46] Clarification from the IRS on this issue is in order.

4. Sole Proprietorships

Like S corporations and partnership owner/employees, sole proprietors may deduct up to 25% of the amount of medical insurance from their income tax until the taxable year ending December 31, 1993.[47]

5. C Corporations

Employee health insurance benefits are 100 percent deductible for owner/employees of a C corporation.[48] This factor may motivate many farmers and small firm owners to operate as a C corporation.

6. Health Insurance and Tax Reform

The Tax Reform Act of 1986 created the 25 percent deduction for health insurance costs of self-employed individuals to provide these individuals with favorable tax treatment accorded to employees insured

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[43] Minnesota, MINN. STAT. § 500.24 (1992).

[44] For federal income tax purposes, a corporation by definition must include more than two of the following four "corporate characteristics: i) continuity of life; ii) centralized management; iii) limited liability; and iv) free transferability of interest." Treas. Reg. 301.7701-2(a) (1)-(3) (1992). Because a limited liability company, by definition, lacks continuity of life and free transferability of interest, the entity is generally treated as a partnership, rather than a corporation, for federal tax purposes. *See, e.g.*, Rev. Rul. 88-76, 1988-2 C.B. 360. For example, Virginia, Rev. Rul. 93-5, 1993-3 I.R.B. 6; Nevada, Rev. Rul. 93-30, 1993-16 I.R.B. 4; and Colorado, Rev. Rul. 93-6, 1993-3 I.R.B. 8 are classified as partnerships for federal tax purposes; Delaware limited liability companies, Rev. Rul. 93-38, 1993-21 I.R.B. 4, may be classified as partnerships or corporations depending under which sections of the Delaware statutes the company is organized.

[45] I.R.C. § 707(c) (1993).

[46] I.R.C. § 61(a) (1993).

[47] I.R.C. § 162(1), (5)-(6) (1993). Subsequent to June 30, 1992, the authority expired but was retroactively extended from July 1, 1993 to December 31, 1993. *See supra* note 25.

[48] I.R.C. § 162(a)(1) (1993).

under an employer-provided plan.[49] The deduction was enacted on a temporary basis but has been extended several times including the latest extension to December 31, 1993.[50] Congress is currently considering an increase from 25 percent to 100 percent deductibility. Such an increase would cost the Treasury an estimated $3.6 billion over two years.[51]

The partial 25 percent deduction of health insurance costs by self-employed individuals, partners, and more-than-two-percent S corporation shareholder/employees had expired on June 30, 1992. During consideration of the Tax Fairness and Economic Growth Acceleration Act of 1992, the House and Senate agreed to extend the 25 percent deduction for self-employed individuals through June 30, 1993.[52] The bill was vetoed by former President Bush.[53] The 25 percent deduction was extended retroactively from July 1, 1992 through December 31, 1993.[54] Congress stated that the 25 percent provision was not extended for a longer period at this time because Congress expects that the deduction will be addressed as part of comprehensive health care legislation.[55] President Clinton's proposed Health Security Act[56] would require all employers[57] including self-employed individuals,[58] two percent shareholders of sub S corporations[59] and by implication partnership owner/employees to pay at least 80 percent of a basic health insurance package as defined in the Act[60] with a lower percent for part time employees and small employers.[61] Self-employed individuals[62] (including partners and two percent sub S shareholders) would be able to deduct an amount equal to 100 percent of funds spent on qualified health cov-

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[49] Tax Mgmt. (BNA), *Series V 102nd Congress* B-4:011 (1992).

[50] I.R.C. § 162(l)(6) (1993).

[51] Julie Rovner, *Insurance Reforms Slide By Senate Finance in Tax Bill*, 50 Cong. Q. 536, 536 (1992).

[52] H.R. 4210, 102d Cong., 2d Sess. (1992).

[53] President's Message: Veto of H.R. 4210—Tax Fairness & Economic Growth Acceleration Act of 1992, 3 U.S.C.C.A.N. D18 (May 1992).

[54] The Revenue Reconciliation Act of 1993, Pub. L. N. 103-66, § 13174, 107 Stat. 312 (codified at 26 U.S.C. § 162 (l)(6) (1993).

[55] H.R. Rep. No. 111, 103rd Cong., 1st Sess., at 632 (1993).

[56] H.R. 3600, 103rd Cong., 1st Sess. (1993).

[57] *Id.* §§ 1601 & 6121.

[58] *Id.* § 6126.

[59] *Id.* § 7141.

[60] *Id.* § 6122.

[61] *Id.* § 6123.

[62] *Id.* § 7203.

erage as defined in the Act.[63] The President's health proposal is not the only game in town. But 100 percent deductibility for qualified health insurance payments by the self-employed, partners, and two percent sub S shareholders and sub C corporations has bipartisan support[64] and may well be an outcome of health care reform.

B. Meals and Lodging

The value of meals furnished an employee by an employer for the employer's convenience and on the employer's premises is excluded from the employee's gross income.[65] The value of lodging furnished to an employee by an employer will be excluded from the employee's gross income[66] if three tests are met: 1) the lodging must be furnished on the employer's business premises; 2) the lodging must be furnished for the convenience of the employer; and 3) the employee is required to accept such lodging as a condition of employment.[67]

Where an employer provides such excludable meals and lodging to enable an employee to perform "around the clock" duties, certain ordinary and necessary occupancy expenses may be deductible including food, lodging, water, utilities, repairs, house insurance, real estate taxes, depreciation, and non-food items such as napkins, toilet tissue, and soap.[68]

Where a C corporation requires its farmer/employees to live on the farm as a condition of employment, those employees qualify for the meals and lodging deduction.[69] The meals and lodging deduction is not available to farm employees who are also S corporation shareholders

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[63] *Id.* §§ 1011, 1311, & 7203.

[64] House Minority Leader Robert Michel endorsed the concept before the American Medical Association. 139 Cong. Rec. E2308 (daily ed. Sept. 29, 1993) and The Health Equity and Access Reform Today Act of 1993 (Heart), S. 1770, 103rd Cong., 1st Sess. (1993) would allow for 100% deductibility of qualified medical plans. 139 Cong. Rec. S16938 (daily ed. Nov. 22, 1993) (statement of Sen. Chafee).

[65] I.R.C. § 119(a)(1) (1993).

[66] I.R.C. § 119(a)(2) (1993).

[67] Treas. Reg. § 1.119-1(b) (1993).

[68] Jacob v. United States, 493 F.2d 1294, 1298 (3d Cir. 1974) (holding the value of non-food stuffs to be "meals" under I.R.C. § 119); Harrison v. Commissioner, 41 T.C.M. (CCH) 1384, 1390-91 (1981) (holding groceries to be "meals" under I.R.C. § 119); McDowell v. Commissioner, 33 T.C.M. (CCH) 372, 378 (1974) (holding utilities and depreciation to be "lodging" under I.R.C. § 119).

[69] *Harrison*, 41 T.C.M. (CCH) at 1390-91 (1981). *See also* Steven C. Thompson & Randall K. Serrett, *Operating in Corporate Form May Enable Farmers and Ranchers to Deduct Expenses for Meals and Lodging*, 13 J. AGRIC. TAX'N & LAW 258, 262-66 (1991).

owning more than 2 percent of the corporation.[70] FICA and FUTA taxes do not apply to meals and lodging qualifying under section 119.[71] Meals and lodging furnished by the employer—but not for the convenience of the employer—are subject to FICA and FUTA.[72]

To support the exclusion, the corporation and employees should have an agreement requiring the employee to live and to eat on the premises as a condition of employment.[73] The agreement will not be enough to support the exclusion without a strong and believable fact situation supporting the need of the employee/shareholder to be present around the clock.[74] Needs of dairy, livestock, poultry, hog, and grain-drying operations should create a defensible fact situation.[75]

C. *Educational Assistance Programs*

An educational assistance program is an employer's separate written plan providing educational assistance for the exclusive benefit of employees.[76] The Code provides that employees may exclude up to $5,250 per year of education assistance from gross income through December 31, 1994.[77] This includes amounts paid for tuition, fees, books, supplies and equipment, unless tools or equipment are retained after completion of the course.[78] The amount does not include meals, lodging, or transportation.[79]

Tax rules prohibit more than 5 percent of the amount paid by the employer to go to individuals who are shareholders, owners[80] or those who own more than 5 percent of the stock, capital, or profits of the business.[81] Therefore, educational assistance programs have little value

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[70] THOMPSON & SERRETT, *supra* note 58 at 267.

[71] *See, e.g.*, Rowan Co. v. United States, 452 U.S. 247, 257-58 & n.12 (1981).

[72] Rev. Rul. 81-222, 1981-2 C.B. 205. Of course, meals and lodging not furnished for the employer's convenience are also subject to federal income tax.

[73] 208-4th Tax Mgmt. (BNA), *Farm and Ranch Expenses and Credits*, at A-28 (1987).

[74] *Id.*

[75] J. Grant Farms, Inc. v. Commissioner, 49 T.C.M. (CCH) 1197, 1202 (1985) (holding that swine and grain-drying operations require constant presence); Johnson v. Commissioner, 49 T.C.M. (CCH) 1203, 1207 (1985) (holding that position of farm operator/manager requires constant presence).

[76] I.R.C. § 127(a) (1993).

[77] *Id.*

[78] I.R.C. § 127(c)(1) (1993).

[79] *Id.*

[80] Owners for this purpose include the owner's spouse or dependents. I.R.C. § 127(b)(3) (1993).

[81] *Id.*

to most farm businesses as children of owners are excluded as long as the child is a dependent of the owner/parent.[82] But by implication, a child over 18 and not a dependent of parents who is employed by the parents' business is eligible to exclude employer/parent educational assistance from income.[83] Educational expenses that do not qualify for the educational assistance exclusion, such as meals, lodging, supplies, transportation, including payments in excess of $5,250 may be excludable as working condition fringes if the requirements for the working condition fringe exclusion are met.[84]

D. *Group Legal Services*

An employer may provide a qualified group legal services plan[85] for employees, spouses, or dependents of the employees.[86] Neither the amount contributed nor the value of the services provided under a qualified plan is included in the employee's gross income.[87]

The contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees.[88] Additionally, no more than 25 percent of the amounts contributed under the plan may be provided to persons owning 5 percent or greater of the stock, capital or profits in the business.[89] Because most farmers or small business employees may be considered "officers" or "highly compensated employees," this fringe is of limited benefit to them.

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[82] Treas. Reg. § 1.127-2(f) (1993).

[83] *Id.* and I.R.C. § 127 (1993).

[84] I.R.C. § 132(j)(8) (1993).

[85] The Code defines a qualified legal services plan as:

> a separate written plan of an employer for the exclusive benefit of his employees or their spouses or dependents to provide such employees, spouse, or dependents with specified benefits consisting of personal legal services through prepayment of, or provision in advance for, legal fees in whole or in part by the employer . . . .

I.R.C. § 120(b) (1993).

[86] *Id.*

[87] I.R.C. § 120(a) (1993).

[88] I.R.C. § 120(c)(1) (1993). For this purpose, a highly compensated employee (HCE) is defined in I.R.C. § 414(q) (1993). An HCE is any employee who, during the year or the preceding year, was at any time a 50% owner, received more than $75,000 in compensation, received more than $50,000 in compensation and was in the top paid group of employees for the year, or was at any time an officer and received greater than 50% of i) $90,000 or ii) 100% of his or her average compensation for his or her highest three years. I.R.C. § 414(q)(1) (1993).

[89] I.R.C. § 120(c)(3) (1993).

E. *Dependent Care Assistance Program*

A dependent care assistance program[90] is available for employees and may provide assistance up to $5,000 per year or $2,500 per year in the case of a separate return filed by a married individual.[91] For the assistance payment to be excluded from an employee's gross income, the employee must provide the name, address, and taxpayer identification number of the provider on the employee's income tax return.[92]

This dependent care benefit is of limited value to most farmer/shareholders because the Code prohibits an employer from providing these benefits in a manner that discriminates in favor of certain owners. No more than 25 percent of the amounts paid or incurred by the employer for dependent care during the year may be provided to the shareholders, owners, or to those who own more than 5 percent of the stock, capital or profits of the business.[93] Presumably, this deduction would not be available to most farmers because most farmers are sole proprietors, partners, or majority S corporation shareholders. The discrimination rules would probably deny the farmers any dependant care assistance deduction.[94]

F. *Cafeteria Plans*

A cafeteria plan is a fringe benefit arrangement where all the participants are employees. The employees can choose among two or more benefits consisting of cash and certain fringe benefits.[95] Cafeteria plans are designed to permit "employees to choose only among benefits that would not be currently taxed due to fear that an employee would be taxed, based on the doctrine of constructive receipt[96] if [the employee]

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[90] A dependent care assistance program is a "separate written plan of an employer for the exclusive benefit of his employees to provide such employees with dependent care assistance." I.R.C. § 129(d)(1) (1993). "Dependent care assistance" is payments for services that would be considered expenses for household and dependent care services incurred to enable the taxpayer to be gainfully employed. I.R.C. § 129(e)(1) (1993). These services are those that the taxpayer would normally provide if the taxpayer was not working. *Id.*

[91] I.R.C. § 129(a)(2)(A) (1993).

[92] I.R.C. § 129(e)(9)(A) (1993).

[93] I.R.C. § 129(d)(4) (1993). For this purpose, "owner" includes spouses and dependents. *Id.*

[94] *Id.*

[95] I.R.C. § 125(d)(1) (1993).

[96] The general rule regarding when income is taxed is based on the notion of constructive receipt. Income that is constructively received by the taxpayer must normally be included in taxable income. Treas. Reg. § 1.451-1(a) (as amended in 1978). Income

could elect between taxable and non-taxable benefits."[97]

A cafeteria plan by itself does not determine whether a specific fringe benefit is or is not taxable. A cafeteria plan is simply a collection of individual fringe benefits that are organized in a fashion that allows the employee to choose which benefit the taxpayer desires.[98] If the particular benefit chosen would have been taxable to the employee because it is not available for exclusion under the Code section regulating that benefit, the fringe benefit would still be taxable to the employee under the cafeteria plan.[99]

As discussed in each respective fringe benefit topic, owner/employees may be unable to reap the tax savings of fringe benefits because of the discrimination rules. The Code often denies any deduction for fringe benefits when the benefits are provided in a manner that discriminates in favor of the owners.[100] As such, for farmers the benefit of cafeteria plans may be *de minimis* at best.[101]

G. *Disability*

An employee may receive and exclude from gross income payments from an employer for permanent loss, loss of use, or loss of function of a body part, or for permanent disfigurement.[102] Disability payments are computed with reference to the nature of the injury, without regard to the employee's absence or lost wages.[103] This benefit is not available to self-employed persons.[104] Other disability benefits, such as short-term disability, long-term disability, and wage continuation are fully

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is constructively received when it is made available to the taxpayer. Treas. Reg. 1.451-2(a). As a result, if the taxpayer had a right to choose cash under a cafeteria plan all benefits under the plan would be taxable to the employee—they would be constructively received. This harsh result is alleviated by I.R.C. § 125 (1993).

[97] Paul M. Glick, *Close Corps. Must Reconsider Cafeteria Plan Benefits in Light of Prop. Regs.*, 16 ESTATE PLANNING 282 (1989) (arguing that potential economic exposure of an employer offering a cafeteria plan may outweigh the benefits of the plan to the employees); *see also* I.R.C. § 125 (1993).

[98] I.R.C. § 125(d)(1)(a) (1993).

[99] I.R.C. § 125(a) (1993).

[100] I.R.C. § 125(b) (1993) reinforces the notion that cafeteria plans are not to discriminate in favor of the owners. If the benefit of the plan discriminates in favor of highly compensated or key employees, no deduction is allowed. *Id.* Most farmers would be considered highly compensated or key employees.

[101] *See generally* Glick, *supra* note 97, at 282.

[102] I.R.C. § 105(c)(1) (1993).

[103] I.R.C. § 105(c)(2) (1993).

[104] I.R.C. § 105(g) (1993).

taxable.[105]

H. Physical Examinations

If examinations are provided through third-party insurance, the value of the examinations is excluded from employee income.[106] Reimbursement to an executive for a physical examination is tax-free as long as the examination is performed at a doctor's office or medical facility.[107] Considering potential chemical and other farm health hazards to farmers, this is an important benefit.

I. Severance Payments

Severance payments are taxable as wages to the employee.[108] These are of little value on the farm.

J. De Minimis Fringe Benefits

An employee's gross income does not include *de minimis* fringe benefits.[109] Property or services provided to an employee qualify as *de minimis* fringe where the total value is "so small as to make accounting for the benefit unreasonable or administratively impracticable."[110]

The regulations provide a host of examples of *de minimis* fringes. Such examples include: occasional typing of personal letters by a company secretary; occasional personal use of an employer's copying machine if the employer restricts the employee's personal use and the machine is used at least 85 percent for business; occasional cocktail parties, group meals, or picnics for employees and their guests;[111] traditional birthday or holiday gifts of property of small value; occasional tickets for theater or sporting events; coffee, donuts, and soft drinks; local tele-

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[105] I.R.C. § 105(d) provides that in some instances these benefits could be excluded from taxation. Treas. Reg. § 1.105-4 (as amended in 1975). However, since § 105(d) was repealed in 1983, the benefits are now fully taxable.

[106] I.R.C. § 105(b) (1993).

[107] Treas. Reg. § 1.105-11(g) (1993).

[108] I.R.C. § 61(a) (1993).

[109] I.R.C. § 132(a)(4) (1993).

[110] I.R.C. § 132(e)(1) (1993).

[111] Normally, any deductions for the employer for meals and entertainment provided to employees is limited to 80% of the total cost. I.R.C. § 274(n)(1) (1993). This limit, however, does not apply to *de minimis* meals and entertainment provided to employees. I.R.C. § 274(n)(2)(B) (1993). For example, food and drinks provided at an annual company picnic are excludable from the employee's income and fully deductible by the employer without regard to the 50% limitation.

phone calls; and, flowers, fruits, books, or similar property given in special circumstances such as illness, outstanding performance, or family crisis.[112]

K. *Working Condition Fringes*

1. Club memberships

Prior to December 31, 1993, when more than 50 percent of a club membership was used to conduct the employer's business, the portion of recurring dues which represent the percentage of direct business use was a working condition fringe.[113] It was of limited value to most farmers, except those farmers who conducted direct marketing and other nontraditional farm activities. This provision was repealed effective December 31, 1993, and no deduction is now allowed.[114] Recreational, social or similar activities including the creation of such facilities on site primarily for the benefit of employees may be deducted.[115] The deduction is denied for highly compensated individuals[116] and any individual owning a 10 percent interest in the taxpayer's trade or business as a shareholder of other owner (or owning such an interest by family attribution rules).[117]

2. Parking

Employer-provided parking is another working condition fringe.[118] Employer-provided parking may be a useful benefit for small town firms where convenient parking is a cost to the owner/employee. The expense is deductible by the firm and is excludable from the income of the owner/employee.[119] The benefit will be of little consequence to the ordinary farm operation.

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[112] Treas. Reg. § 1.132-6(e)(1) (as amended in 1992).

[113] Treas. Reg. § 1.132-5(a)(1)(iii) (as amended in 1992); Treas. Reg. § 1.274-2(e)(4)(iii)(b) (as amended in 1985). The deduction for meals permitted under this section is subject to the 50% limitation. I.R.C. § 274(n) (1993); *see also supra* note 112.

[114] I.R.C. § 274(a)(3) (1993).

[115] I.R.C. § 274(e)(4) (1993).

[116] I.R.C. § 414(q) (1993).

[117] *Id.* & I.R.C. § 267(c)(4) (1993).

[118] I.R.C. § 132(f) (1993).

[119] Treas. Reg. § 1.132-5(p)(1) (as amended in 1992).

3. Conventions, Meetings, and Continuing Education

Reasonable payments for travel,[120] meals,[121] and lodging[122] to attend business meetings are excludable from the employee's gross income as working condition fringes so long as attendance benefits the employer's trade or business.[123] However, the employer may only deduct 50 percent of the costs of the meals and entertainment.[124] The travel and lodging would be fully deductible.[125]

4. Professional Dues and Journals

Membership dues in professional organizations, subscriptions to trade journals, and seminar expenses are working condition fringes by virtue of their deductibility as trade or business expenses.[126] These expenses would thus be excludable from the employee's gross income[127] and deductible to the employer.[128]

5. Achievement Awards

With certain limitations, achievement awards are deductible to the employer[129] and tax-free to the recipient.[130] Such awards include items of personal property for length of service, safety, or other achievements. These awards, however, must be part of a meaningful presentation, such as an awards banquet, and cannot be disguised compensation.[131] Additionally, expenses for qualified plans for achievement are deductible to the employer and not taxable to the employee.[132] Non-qualified plan awards are limited to $400 per year per employee.[133] Qualified

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[120] I.R.C. §§ 132(d), 162(a)(2) (1993).

[121] *Id.*

[122] *Id.*

[123] *Certain Fringe Benefits*, (1993) 2 Stand. Fed. Tax. Rep. (CCH) ¶ 7438.07 (Jan. 1, 1993).

[124] I.R.C. § 274(n) (1993).

[125] *See Id.*

[126] *See generally* I.R.C. § 132(d) (1993); I.R.C. § 162 (1993). For cases allowing deductions for professional dues, see Stand. Fed. Tax. Rep. (CCH) ¶ 8472.2335 (1993).

[127] I.R.C. § 132(a)(3) (1993).

[128] I.R.C. § 162(a) (1993).

[129] I.R.C. § 274(j)(2) (1993).

[130] I.R.C. § 74(c)(1) (1993).

[131] I.R.C. § 274(j)(3)(A) (1993).

[132] I.R.C. § 274(j)(1) (1993).

[133] I.R.C. § 274(j)(2)(A) (1993). A non-qualified plan is simply an award that is not given as part of a qualified plan. *See Id.*

award programs must be part of an established written plan and not discriminate in favor of highly compensated individuals as to eligibility or benefit.[134] Qualified plan awards are limited to aggregate awards of $1600 per year per employee, and the average value of each award must be $400 or less.[135]

L. Retirement Plans

Retirement plans for small businesses constitute an important part of the fringe benefit picture. Consequently, retirement planning should be a part of each farm or small business operation. Retirement planning may provide the entrepreneur with the following: 1) a diversification of investment alternatives; 2) protection of some assets from business failure;[136] 3) investment of pre-tax dollars on amounts currently contributed;[137] 4) deduction by the employer for contributions to various plans;[138] and 5) exemption from taxation of income earned by an employee trust until distribution.[139]

For example, assets rented to a corporation result in rental income and not self-employment income; therefore, the renting of assets provides a method for capital holders to receive unearned income. This method is of particular interest to retirees between retirement age and seventy because if they receive earned income over a set governmental cap, their social security benefits will be reduced.[140]

Similarly, tax rules governing retirement plans may differ depending on whether the business is a sole proprietorship, partnership, S corporation, or C corporation. The nondiscrimination rules imposed by the Code require that the contributions or benefits do not discriminate in favor of owners of the business over ordinary employees.[141] Although historically the pass-through entities of sole proprietorships, partnerships, and S corporations received less favorable tax treatment for retirement benefits than owner/employees of C corporations,[142] much of

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[134] Susan Katz Hoffman & Deborah Lerner, *Many Tax-Free Fringe Benefits Are Still Available*, 46 TAX'N FOR ACCOUNTANTS, 276, 283-84 (May 1991).

[135] I.R.C. § 274(j)(2)(B) (1993).

[136] *See, e.g.*, Patterson v. Shumate, 112 S. Ct. 2242, 2249-50 (1992).

[137] *See* I.R.C. § 402(a)(1) (1993).

[138] *See* I.R.C. § 404(a) (1993).

[139] *See* I.R.C. § 501(a) (1993).

[140] CHARLES DAVENPORT, FARM INCOME TAX MANUAL, § 1125 (1992).

[141] I.R.C. § 401(4) (1993).

[142] Charles K. Kerby, III, *Retirement and Welfare Plans: Design Considerations For Sole Proprietors, Partnerships and Closely Held Businesses*, in N.Y.U. 49TH ANNUAL INSTITUTE ON FEDERAL TAXATION § 31.01 (1991).

the disparity was eliminated in the 1980's.[143] Nevertheless, S corporations, sole-proprietorships and partnerships, because the entities have no stock, are barred from stock bonus plans or employee stock ownership plans.

Defined benefit and defined contribution plans are two basic types of pension plans available to small business and farm operations.[144] Future benefits under defined benefit plans are established in advance by a formula, and employer contributions are treated as the variable factor.[145] Defined contribution or money purchase plans provide an individual account for each participant.[146] Benefit losses are based solely upon the amount contributed to the participant's account, and any expense investment return is allocated to the participant's account.[147] The defined contribution may be profit sharing from the employer plus earnings that have accumulated under the plan.[148] Contributions may be discretionary, and participants may elect to defer a portion of their salary on a pre-tax basis and/or make voluntary after-tax contributions.[149] Under a money purchase plan, the employer must make a fixed contribution, usually a fixed percentage.[150] A money purchase pension plan and a profit sharing plan may be combined to provide both security and flexibility.

Pension plan alternatives deserve careful attention and consideration.[151] Because careful retirement planning allows basically the same investment opportunities regardless of entity choice, retirement vehicles do not encourage one form of entity over another. More importantly, all farmers, self-employed individuals, and small business firms should have a retirement or pension plan as an alternative investment vehicle. By implementing these plans, entrepreneurs can not only limit tax liabilities but also attract and retain higher quality employees.

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[143] DAVENPORT, *supra* note 140, § 424.

[144] Alan L. Gustman & Thomas L. Steinmeier, *The Stampede Toward Defined Contribution Pension Plans: Fact or Fiction?*, 13 INDUS. REL. L.J. 361 (1992).

[145] I.R.C. § 401(1)(3) (1993).

[146] I.R.C. § 414(i) (1993).

[147] Gustman & Steinmeier, *supra* note 144, at 362.

[148] I.R.C. § 401(a)(1) (1993).

[149] Jerry K. Fellows & Anne M. Parchriarela, *Setting Up Retirement Plans After Tax Reform*, 23 THE PRACTICAL ACCOUNTANT, 19 (June 1990).

[150] *Id.*

[151] For an excellent comparative chart of IRA's, SEP's, Keogh, 403(b), 401(k), and other plans, see DAVENPORT, *supra* note 140, at 564-71.

M. Automobiles

Personal use of an automobile is not deductible;[152] however, business use is deductible.[153] Thus, corporations may deduct the expense of an automobile used in its business. This benefit is reported as other compensation on the W-2 form.[154]

N. Wages Paid in Kind

With current levels of FICA tax, compensation paid in kind creates a substantial tax savings for employers.[155] Sole proprietorships, partnerships, and corporate employers may provide this fringe to all employees.

The drawback of payment in kind is that employees do not accrue as many social security survivorship or retirement benefits. Thus, payment in kind is harmful to farm employees who already work in one of the lowest wage industries.[156] These employees will accrue fewer survivorship or retirement benefits due to payments in kind.

The proposed Revenue Act of 1992 would have included in kind distributions in wages paid after December 31, 1992.[157] As wages, payments in kind would generally be subject to FICA[158] and FUTA[159] taxes. Meals, lodging, and section 132 *de minimis* and working-condition fringe benefits would remain exempt.[160] The proposal for inclusion of in kind wages had strong Treasury and IRS support.[161] The current practice of in kind wages may be indefensible because the taxpayer is excluding major amounts of income from the wage base.

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[152] I.R.C. § 262(a) (1993).

[153] I.R.C. § 162(a) (1993); Treas. Reg. § 1.162-1(a) (1993). *See generally* Std. Fed. Tax. Rep. (CCH) ¶¶ 8540.01-.027, at 21,821-29 (1993).

[154] DAVENPORT, *supra* note 140 § 420.

[155] *See* I.R.C. §§ 3121(a)(8), 3306(b)(11) (1993).

[156] U.S. Bureau of Economic Analysis and Survey of Current Business (July 1989). The average agricultural wage for 1988 was $12,111. This is $3,030 less than the next closest domestic industry (retailing) and one half of the average of all domestic industry wages.

[157] H.R. 11, 102d Cong., 2d Sess., 3005 (1992).

[158] I.R.C. § 3101 (1993).

[159] I.R.C. § 3301 (1993).

[160] H.R. Rep. No. 631, 102d Cong., 2d Sess., 353 (1992).

[161] *Id.* The issue has not been resurrected in the Clinton Administration's first major piece of tax legislation. Personal Conversation, Tom Bouthal, Joint Committee on Taxation, May 25, 1993. See also H.R. 1960, The Revenue Reconciliation Act of '93. 103rd Cong., 1st Sess., (1993).

O. Self-Employment Taxes and Choice of Entity

The term "net earnings from self-employment" means "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed [by the Code] which are attributable to such trade or business."[162]

The rise in social security tax liability, both as a percent of FICA tax owed and as a level of the self-employed or wage base subject to FICA, has risen dramatically in the past thirty years. This liability has increased for the self-employed from a maximum payment of $216 in 1960 to $8491.50 in 1992.[163] Similarly, for employer/employee contributions, liability for self-employment has risen from $288 in 1960 to $8491.50 in 1992 for the maximum employer/employee contribution.[164] The social security taxes imposed on both the employer and employee and the self-employed actually consist of two taxes— "OASDI" (old-age, survivor and disability insurance) and "HI" (Medicare hospital insurance). The OASDI tax rate has remained 6.2 percent for employer and employee[165] and 12.4 percent for self-employed[166] since 1990 and the HI rate for 1.45 percent[167] for employee and employer and 2.9 percent[168] for the self-employed since 1986. But, the wage base has been increasing by the amount of inflation as determined by statute[169] over the years such that the total amount paid by the employee and employer or the self-employed has increased and will continue to increase. For 1993, 1994 the OASDI base was $57,600[170] and is $60,600[171] respectively for a maximum of $3,471.20[172] for employer and employee in 1993 and $3,757.20[173] for employer and employee in 1994. For the self-employed, the amount is $7,142.40[174] for

[162] I.R.C. § 1402(a) (1993).

[163] Maximum social security payments for the self-employed were $538.20 in 1970, $2,097.90 in 1980, and $7,848.90 in 1990. Statistical Abstract of the U.S., 1990 and Annual Statistical Supplement to the Social Security Bulletin.

[164] *Id.* Maximum liability for employer/employee contributions for self-employment reached $748.80 in 1970, $3,175.34 in 1980, and $7,848.90 in 1990.

[165] I.R.C. § 3111(a) (1993).

[166] I.R.C. § 1401(a) (1993).

[167] I.R.C. § 3111(b) (1993).

[168] I.R.C. § 1401(b) (1993).

[169] I.R.C. § 3121(x)(1) (1993).

[170] *Id.* See also I.R.S. Pub. Circular E. and A. (1993).

[171] *Id.*

[172] *Id.*

[173] *Id.*

[174] *Id.*

1993 and $7,514.40[175] for 1994. The Medicare amount was applied to the first $135,000[176] in 1993 for a maximum employer/employee or self-employment contribution of $3,915.00,[177] but, for years after 1993, there is no wage or self-employment dollar limit on the wages subject to the HI tax.[178] Therefore, the maximum employee/employer and self-employed contribution for OASDI and HI for 1993 was $11,057.40 and the amount is open ended after 1993 without the wage cap on HI taxes. If the individual's wage base was at the wage cap level in 1993 and 1994, the maximum OASDI and HI tax imposed by law would be $8,812.80 and $9,271.80[179] respectively. Assuming a family of four, an income equal to the maximum wage base under OASDI, and the standard deduction, the maximum income tax imposed is $6,970 and $7,810[180] for 1993 and 1994 respectively. This affirms that for many, OASDI and HI taxes are a greater burden then federal income taxes.

The increases in social security tax liability create an incentive for business owners to consider incorporating. When a business incorporates, the owner and the business are legally separate as compared to a business that is operated as a sole proprietorship.[181] Because of this legal distinction, a sole shareholder of a corporation can tap into certain code provisions unavailable to the sole proprietorship owner.[182] For example, a corporation can rent assets from its owner(s). This allows the owner to funnel cash out of the corporation without paying social security taxes. The corporate owner's rental income would only be subject to income tax.[183] Another method of funneling cash out of the corporation is through dividends, a method that allows the corporate owner to lower net social security liability.

Consider the following hypothetical. Three farmers, A, B, and C, operate three identical farms. Each farm earns $50,000 after all direct farming costs are paid. Farmer A operates his farm as a sole proprietorship. Farmer B operates his farm as a subchapter S corporation. Farmer C operates her farm as a subchapter C corporation.

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[175] *Id.*

[176] I.R.C. § 3121(x)(2) (1993).

[177] *Id.* and I.R.S. Pub. Circular E (1993).

[178] The Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13207(a)(2), 107 Stat. 312, 467-468 (1993).

[179] I.R.C. §§ 1401, 3111, 3121(x) (1993) and I.R.S. Pub. Circular E (1993).

[180] Computed by the author using the 1040 for 1993 and I.R.S. published Tax Tables imposing the tax under I.R.C. § 1 (1993).

[181] *See, e.g.*, I.R.C. §§ 1, 11 (1993).

[182] *See generally* I.R.C. §§ 161, 1361 (1993).

[183] I.R.C. § 61(a)(5) (1993).

Farmer A donates the farmland to the business. However, because his business is a sole proprietorship, there is no legal distinction between his personal affairs and the business. He is unable to rent assets to the farm or pay himself a salary. All of the net $50,000 income earned by Farmer A's operations is subject to social security tax.[184]

Farmer B decides not to donate his farmland to his S corporation but, instead, to rent the land to the farm for $25,000 per year. The rent payment by the business would be a business expense[185]and would reduce Farmer B's income subject to self-employment tax. As a result, Farmer B would only have to pay social security tax on $25,000.

Farmer C, like Farmer A, is very generous. She rents the land to the corporation for $25,000. However, Farmer C pays $25,000 in dividends. She pays the remaining $25,000 to herself as a salary. In this instance, the rent would not be subject to social security taxes. Social security taxes must be paid on the $25,000 salary.

Thus, by incorporating, Farmers B and C will be able to reduce the amount of income subject to social security taxes by one-half. Farmer A would still pay social security taxes on the entire $50,000. This example demonstrates that one of the incentives to incorporate is the treatment under the I.R.C. of return to capital from the return to labor for farmers and small businesses as impacted by the choice of entity.

P. Summary of Fringe Benefit Taxation

Although S corporation owner/employees are treated for corporate law purposes as C corporation owner/employees, the S corporation owner/employees are treated differently for tax law purposes. Special tax rules limit fringe benefit deductions for S corporation owner/employees, minimizing the attractiveness of S corporations for owner/employees with a greater than two percent interest.[186] The IRS could treat employee fringe benefits under an S corporation as third-party payments to the shareholder/employee,[187] guaranteed payments,[188] or distributions of corporate income.[189] In most instances, the IRS has chosen to treat these benefits as guaranteed payments.[190]

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[184] I.R.C. § 1401(a) (1993).
[185] I.R.C. § 162(a)(3) (1993).
[186] I.R.C. § 1372(a) (1993).
[187] I.R.C. § 707(a) (1993).
[188] I.R.C. § 707(c) (1993).
[189] Treas. Reg. § 1.707-1(c) (as amended in 1983).
[190] *See* Rev. Rul. 91-26, 1991-1 C.B. 184. *See also* Bravenec & Lassila, *Can Fringe Benefits of S Corporation Shareholder-Employees Be Guaranteed Payments?* 1 J. S

The guaranteed payment approach for fringe benefits has generally been applied to health and accident insurance benefits. However, IRS reasoning presumably extends to tax treatment of other fringe benefits given to the owner/employee of the S corporation or limited liability company. Therefore, few fringe benefits are free to the S corporation owner/employee. Section 1372[191] neither defines nor identifies the specific fringe benefits it covers. The legislative history of section 1372, however, indicates that the statute intends to govern the following fringe benefits: 1) the $50,000 income exclusion for employer-provided group term life insurance;[192] 2) the $5000 exclusion for employer-provided death benefits;[193] 3) payments made under employer accident and health plans for medical care, permanent loss or loss of use of a body member or function, and permanent disfigurement;[194] 4) employee meals and lodging furnished for convenience of the employer;[195] and 5) employer provided health or accident plans.[196]

The preceding list illustrates the intent to limit benefits for owner/employees. By implication, similar statutory fringe benefits would also probably be excluded. Examples include: 1) group legal services provided by the employer;[197] 2) cafeteria plan benefits;[198] 3) employer-provided services, employee discounts, and *de minimis* fringes;[199] 4) employer-provided dependent assistance up to $5,000 annually;[200] 5) employer-provided educational assistance;[201] and 6) accident or health insurance payments for personal injuries or sickness.[202]

Arguably, owner/employees and partners could be eligible for certain exclusions provided by section 132, including no-additional-cost services, qualified employee discounts, working condition fringes, *de minimis* fringes, and qualified transportation fringes. Section 132 applies to partners who perform services for the partnership, and, by extension, to two percent shareholder employees of S corporations. Al-

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CORP. TAX'N 33 (1989).

[191] Pub. L. No. 97-354, § 2, 96 Stat. 1682 (1982).

[192] I.R.C. § 79(a)(1) (1993).

[193] I.R.C. § 101(a)(1) (1993).

[194] I.R.C. § 105 (1993).

[195] I.R.C. § 119 (1993).

[196] I.R.C. § 106 (1993).

[197] I.R.C. § 120(a) (1993).

[198] I.R.C. § 125(a) (1993).

[199] I.R.C. § 132(a) (1993).

[200] I.R.C. § 129(a) (1993).

[201] I.R.C. § 127(a) (1993).

[202] I.R.C. § 104(a)(3) (1993).

though section 132 fringes enhance employee income,[203] the benefits are of limited value to most farm S shareholder/employees or partners because the type of fringe benefits in section 132 are not applicable to farming operations.

II. Choice of Entity for the Farm and Small Business Firm

A. *Moving Targets*

As a result of the changing tax laws and the particular tests and circumstances surrounding each situation, every farm or other small business owner should carefully consider the choice of business entity. The most tax efficient manner of drawing cash out of the business may dictate this decision. The form of payment to the owners of the firm in the nature of salary, rent, interest, dividends, or fringe benefits, and the amount of "profit," if any, to distribute are consequential management decisions for the owner. Because C and S corporations differ only by tax treatment of income,[204] the tax considerations are of key importance in deciding which of these business forms to use. One tax issue the business owner should consider in choosing the form of entity is what effect the entity form may have on the owner's estate. This consideration actually involves both tax and nontax issues.

With regard to tax issues, the business owner may strive to split income into different areas. Income splitting may be used to offset the progressivity of the income tax structure.[205] Income can be split in a variety of ways. For example, the business owner can shift income between businesses to achieve the lowest tax rates, or the business owner may employ his children on the farm. Employing one's children enables an owner to account for the labor on the farm in addition to capital

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[203] Such § 132 fringes include benefits such as employee discounts, "no-additional-cost-service," eating facilities provided on premises, parking, and on-premises gyms. I.R.C. § 132 (1993).

[204] *See* 2 Robert J. Haft, Venture Capital & Small Business Financing, Ch. 1A (1991) (discussing the tax advantages of the S Corporation). ***But see*** George N. Buffington, ***Corporate Form Still Offers Many Planning Opportunities Despite Recent Changes***, 18 Tax'n For Law 26 (1989) (arguing that a C Corporation is better situated than partnerships, S corporations, and sole proprietorships to take advantage of the tax code's rules on fringe benefits).

[205] *See* Pfluger v. Commissioner, 840 F.2d 1379, 1384 n.10 (7th Cir. 1988). "By splitting one's income between two entities or people, a taxpayer gets two trips through the lower brackets, resulting in a lower overall tax bill." *Id.* This advantage has diminished since the Tax Reform Act of 1986, which compressed the tax brackets to three. *See* I.R.C. § 1 (1986 and 1993).

costs.[206] The income is also taxed at the child's lower rate.[207] Accounting for the labor may also allow the owner to maximize the tax-free fringe benefits.[208] In light of the imposition of the "Kiddie Tax,"[209] restrictions on interest-free loans,[210] and restrictions on the use of Clifford trusts,[211] few tools remain to shift income to family members.[212]

The farmer's or small business person's dual role as investor and laborer may not be separately acknowledged for tax filing purposes.[213] Further, a farmer or small business person, like other entrepreneurs, will seek compensation for investments, labor and management activities similar to those sought by other businesses. A careful balancing of both tax and nontax considerations must be undertaken by the farmer or small business owner in developing an optimal organizational structure.

Entity choices concerning the operation of the farm business are influenced by factors such as 1) combining capital; 2) increasing borrowing limits; 3) giving family members or preferred employees a proprietary interest; 4) splitting income; 5) facilitating estate planning or asset disposition;[214] and 6) fringe benefits.

In general, a farm corporation is entitled to the statutory benefits for farmers and is subject to any farm taxpayer limitations.[215] Loose han-

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[206] Payment for labor is deductible as an ordinary business expense. I.R.C. § 162(a)(1) (1993). The income received by the child for services rendered to the farm is included in the child's gross income but not the parents'. I.R.C. § 73(a) (1993).

[207] Assuming the child has no other outside income, the child may fall into the 15% tax bracket. For income limits on the 15% tax bracket, see I.R.C. § 1 (1993).

[208] *See* William D. Samson & Robert W. McLeod, *Choosing Between C versus S Corporate Status in the Closely Held Corporation*, J. AM. SOC. OF CLU & CHFC, Sept. 1990, at 62 (discussing an economic analysis of break-even decisions to make in deciding which tax option to choose).

[209] I.R.C. § 911(d)(2) (1993).

[210] I.R.C. § 7872 (1993).

[211] I.R.C. § 672(d)(2) (1993).

[212] *See* Debbie Smith et al., *Intra-Family Transfers Continue to Provide Tax Saving Opportunities*, 18 TAX'N FOR LAW 284 (1990) (discussing techniques still available for shifting income among family members).

[213] This circumstance may arise if the individual fails to choose and maintain a corporate business entity and is required to account for both business and personal activities on the individual tax form without taking advantage of the deductions available to a corporate entity. *See e.g.*, I.R.C. § 132 (1993) (providing for certain fringe benefit deductions).

[214] *Farm and Ranch Expenses and Credits*, Tax Mgmt. (BNA) No. 208-4th, at A-5 (Oct. 8, 1990).

[215] DAVENPORT, *supra* note 140, § 1000 (1992).

dling of a farm corporation is troublesome.[216] The farmer, spouse, and heirs must understand the reason for the adoption of the corporate structure.

While most corporations—other than S corporations—must use the accrual method of accounting,[217] most farm businesses may use the cash method.[218] For practical purposes, accounting methods are not considerations in the choice of entity for the "traditional" farm family because either cash or accrual methods are available.[219] The accrual method might, in fact, more clearly state farm income and avoid the distortion of income characteristics resulting from the cash method.[220] The perceived "complexity" of the accrual method and the perceived "simplicity" of the cash method should have no impact on entity formation decisions.[221]

To be classified as a corporation for tax purposes, a business entity must have an objective to carry on a business for profit and have more than two of the following four characteristics: 1) continuity of life; 2) centralized management; 3) limited liability; and 4) free transferability of interest.[222] A comparison on nontax considerations on the choice of entity can be readily found and reviewed.[223]

Land ownership may take on a variety of entity forms: partnerships, tenancies by the entirety, joint tenancies, or sole proprietorships.[224]

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[216] *See, e.g.*, Sparks Farm, Inc. v. Commissioner, 56 T.C.M. (CCH) 464 (1988).

[217] I.R.C. § 448 (1993).

[218] Treas. Reg. §§ 1.446-1(e), 1.471-6(a) (1993). The cash method of accounting requires "all items which contribute gross income (whether in the form of cash, property, or services) . . . to be included for the taxable year in which actually or constructively received" and expenditures "are to be deducted for the taxable year in which actually made." Treas. Reg. § 1.446-1(c)(1)(i) (1993). *See also* I.R.C. § 451 (1993); Treas. Reg. § 1.451-1 to -2 (1993). Entities that use an accrual method of accounting include income items in gross income "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Likewise, these entities deduct expenses when "all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." Treas. Reg. §§ 1.451-1(a), 1.461-1(a)(2) (1993).

[219] Treas. Reg. §§ 1.446-1(e), 1.471-6(a) (1993).

[220] *See* Donald H. Kelley et al., *Tax Accounting Rules For Farmers & Ranchers*, 31 S.D. L. REV. 255 (1986) (discussing the accounting alternatives available to farmers and the ability to defer income by the use of the cash method).

[221] *See generally* DAVENPORT, *supra* note 140, §§ 102-108.

[222] Treas. Reg. § 301.7701-2 (as amended in 1983).

[223] *See, e.g.*, *Choice of Entity*, Tax Mgmt. (BNA) No. 456, at A-7 (Mar. 12, 1990).

[224] *See* Andrew M. Curtis, *Planning When Real Property is a Major Asset of an Estate*, 18 EST. PLAN. 348 (1991) (discussing the tax advantages of holding property in various entity forms).

Within these entities, a return of capital is garnered by rent, and the return of labor and management is garnered by the corporation and paid in the form of wages. Farm land, as capital, is a "material income producing factor" and not incidental to the performance of a service.[225] Land and machines required on a farm make capital a material, income-producing factor.[226]

B. *Leases of Property*

Multiple entities offer one advantage for the farm corporation by allowing the farmer to split income between capital and labor and by allowing landowners to receive a return on a land investment apart from the "farm" or firm production unit. Normally, a corporation that leases property used in a trade or business and pays rent for the use of property may deduct a reasonable amount of rent as a business expense.[227] The same rule would apply to "reasonable rent"[228] paid to a shareholder of an S corporation.[229] Leases between partnerships and partners may be treated as a partner acting in a "non-partner" capacity[230] or, possibly, as a guaranteed payment for use of capital.[231] A "reasonable" farm rental payment should be deductible by the partnership to allow a land-owning partner to participate in a "non-partner" capacity.[232]

S corporations, partnerships and limited liability companies using the accrual method must postpone any deduction for rent owed—but not paid to a cash-method taxpayer—until the taxable year in which the payee reports income.[233] The deduction is taken when the amount is included in the payee's gross income.[234]

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[225] Woodbury v. Commissioner, 49 T.C. 180, 191 (1967) (interpreting Treas. Reg. § 1.704-1(e)(1) (1960)).

[226] *Id.*

[227] I.R.C. § 162(a)(3) (1993).

[228] "Reasonable rent" would presumably constitute rent charged for similar land in the local area. For example, rent of $90 per acre for land would be reasonable where county rents ranged form $85 to $110 per acre for similar land.

[229] I.R.C. § 162(a)(3) (1993).

[230] I.R.C. § 707(a)(1) (1993).

[231] I.R.C. § 707(c) (1993).

[232] I.R.C. § 707(a) (1993).

[233] I.R.C. § 267(a)(2) (1993).

[234] *Id.*

C. *Advantages of Family Partnerships or Corporations*

Farmers or small firm owners may also find advantages in establishing a family partnership or corporation. These advantages include income shifting opportunities and transfers of interest to eligible heirs to promote efficient estate planning.

1. Income Shifting

The formation of a family partnership to own the land may enable the family to deflect income to spouses, family members, off-farm heirs, retired parents, and grandparents.[235] Such deflected income may result in lower tax rates.[236] The deflection may allow retired family members to receive rental income not subject to FICA,[237] allow on-farm members to split income between a return to capital and return to labor[238] and allow for an orderly receipt of income by the off-farm heir without involvement in farm operations.[239]

The 1986 Tax Reform Act reduced the value of general income shifting by reducing the number of tax brackets from fifteen to three.[240] The Act also provided for a "Kiddie Tax" which imposed the parents' top marginal tax rate on the unearned income of children under the age of fourteen.[241]

2. Estate Planning

A partnership owning land, coupled with a separate operating entity, is a valid method to allow off-farm heirs to own a piece of the family business without participating in management of the operation.[242] Part-

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[235] UNIF. PARTNERSHIP ACT § 18(a), 6 U.L.A. 213 (1969). Section 18(a) provides that, absent an agreement to the contrary, all partners share equally in the profits.

[236] Lower tax rates would result from the spreading of the farm's total income among a number of individuals.

[237] FICA applies to wages earned as remuneration for employment. I.R.C. § 3121(a) (1993).

[238] The splitting would result from the receipt of rent payments to the partnership and wage payments to farm members as employees.

[239] A partnership agreement may provide that a member of a partnership is not required to actively participate in the business operations. UNIF. PARTNERSHIP ACT § 18(e), 6 U.L.A. 213 (1969).

[240] Pub. L. No. 99-514, § 101, 100 Stat. 2096 (1986). Prior to the 1986 Act, the marginal tax rate ranged from 11% to 50%. The Act narrowed this range from 15% to 31%. *Id.*

[241] Pub. L. No. 99-514, § 1411(a), 100 Stat. 2714 (1986).

[242] A family partnership owning land and having off-farm heirs will be recognized as a legitimate partnership as long as Treas. Reg. § 1.704-1(e)(1)-(2) is satisfied. This

nerships, trusts, and corporations can be used to transfer a percentage interest to the next generation[243] and to avoid gift and estate tax.

Partnerships can be used to avoid the creation of a minority interest that has little access to the underlying capital asset.[244] This is becoming an increasing conflict in closely-held family corporations where needs of on-farm and off-farm parties conflict and where few, if any, dividends are paid to minority shareholders.

D. *Incorporation Trends*

The trend towards incorporation on the farm is upwards among family firms with ten or fewer shareholders. While the number of sole proprietorships decreased from 1982 to 1987, the number of family farm corporations with ten or fewer shareholders increased.[245]

E. *Salary Compensation*

Compensation, in the form of salary and bonuses, is not considered avoidance of dividend income, where the taxpayer shows that the compensation is reasonable.[246] A number of factors are considered in determining whether compensation is reasonable.[247] For example, an individual's qualifications for employment and the nature and scope of the employee's work are relevant factors.[248] The size and complexity of the business as well as prevailing general economic conditions are also rele-

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regulation provides that, in order to be a valid family partnership, each partner must be recognized as having received a complete transfer of an interest in the income producing capital asset. Further, this transaction must be a bona fide transaction which vests dominion and control of the partnership in the donee or transferee. The regulation provides for an ownership test to determine whether the transaction is a sham.

[243] Treas. Reg. § 1.704-1(e)(1)-(3); *see* Garcia v. Commissioner, 48 T.C.M. (CCH) 425, 434-37 (1984).

[244] This objective could be achieved through express provisions in the partnership agreement. Where no express provisions exist, the Uniform Partnership Act provides that the partners may share equally in the profits of the partnership. UNIF. PARTNERSHIP ACT § 18(a), 6 U.L.A. 213 (1969).

[245] The number of farm sole proprietorships decreased from 1,945,639 in 1982 to 1,809,324 in 1987. The number of farm partnerships decreased from 223,274 to 199,559 during the same period. From 1982 to 1987, family farm corporations with ten or fewer shareholders, however, increased from 50,842 to 59,599. U.S. DEP'T OF COMMERCE, BUREAU OF CENSUS, 1 GEOGRAPHIC SERIES, PT. 51 (1984), *Id.* (1989).

[246] Vanderpol v. Commissioner, 54 T.C.M. (CCH) 1021 (1987).

[247] *See* Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949) (stating a number of factors often considered in determining the reasonableness of compensation).

[248] *Vanderpol*, 54 T.C.M. at 1025.

vant.[249] Salary comparisons are also considered, including comparisons between salaries and gross and net income, along with comparisons between salaries and shareholder distributions.[250] Other relevant factors include the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and, in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.[251]

Average annual compensation in the agricultural sector would suggest a low level of compensation for shareholder/employees. In the four year period from 1985 to 1988, annual wages and salaries in agriculture were $11,086, $11,464, $11,877, and $12,111.[252] Where low wages are paid, the shareholder/employee might urge the corporation to establish a retirement plan.

F. *Other Considerations in Entity Formation*

The repeal of the "General Utilities" doctrine[253] by the Tax Reform Act of 1986 generally makes a C corporation an unfavorable vehicle to hold appreciable real estate.[254] Since the advent of the 1986 Tax Reform Act, "conventional wisdom" has advised that the best choice for multi-owner real estate investment is a partnership and the best choice for most other closely-held business operations is an S corporation.[255]

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[249] *Id.* at 1026.

[250] *Id.* at 1026-27.

[251] Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949); *see also* Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1245-48 (9th Cir. 1983).

[252] *U.S. Dep't. of Commerce, Bureau of Economic Analysis* 69, *Survey of Current Business*, Num. 7 (July, 1989).

[253] The "General Utilities" doctrine permitted, under certain circumstances, a corporation to distribute appreciated assets to its shareholders without recognizing gain. *See* I.R.C. § 337 (1954) (codifying holding of General Util. & Operating Co. v. Helvering, 296 U.S. 200 (1935), *repealed by*, I.R.C. § 311(b) (1986)).

[254] As a result of the repeal of the "General Utilities" doctrine, the liquidation of corporate assets results in the potential for double taxation. Double taxation occurs where a tax is applied on the appreciation of the assets against the corporation at sale or liquidation and a tax is applied against the shareholders for any appreciation which occurs in the corporation's stock value at the time of sale of the stock. Mark J. Silverman & Kevin M. Keyes, *Leveraged Buyouts & Other Corporate Structurings, Restructurings and Financing*, TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, FINANCING, JOINT VENTURES, REORGANIZATIONS, AND RESTRUCTURINGS 1992, at 477, 331 PLI Tax Law & Estate Planning Course Handbook Series No. J4-3661, 1992.

[255] Dudley M. Lang, *Comparison of S Corporations, C Corporations and Partner-*

However, for corporations with annual taxable income below $100,000 and no intent to distribute earnings in the near future, near term benefits may be achieved by C corporation organization. Such an organizational decision must weigh the impact of the repeal of the "General Utilities" doctrine and second tax on earnings at a later time.[256]

Another tax planning device allows the shareholder to sell the principal residence at fair market value to the corporation and exclude up to $125,000 of gain from the sale if the former homeowners/incorporators are 55 years of age or older.[257] This tool is often overlooked because of reluctance to sell the family home to the corporation. Generally, upon incorporating, operating assets are transferred, but often land, farm buildings, and the family home are not transferred. Transferring these assets would provide significant tax benefits as a result of the exclusion.[258]

The tax consequences of an asset sale and the concern over the liquidation of a C corporation, in light of the repeal of the "General Utilities" doctrine, often determine the choice between a C and S corporation election.[259] For farm incorporation, a C corporation may be a useful vehicle for splitting income if it is carefully structured with only the "right" assets inside the operating entity. For example, land that generally appreciates over time generally should not be placed with corporations. Depreciable equipment or cattle may be appropriate assets of a farming corporation. Because no immediate taxable gain is recognized at the shareholder level in a C corporation sale of assets, it may be more advantageous to have the gain taxed to a C corporation.[260] By not distributing the proceeds from the sale of assets to the shareholder, the C corporation can defer the tax recognition by the shareholder.[261]

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ships, 48th Annual N.Y.U. Institute § 9.01, (1990).

[256] *Id.* at § 9.05(3)(b).

[257] I.R.C. § 121(a) (1993).

[258] *Id.* For definition of principal residence, see Treas. Reg. § 1.1034-1(c)(3) (1993).

[259] The choice has tax significance because the S corporation is a pass-through entity that would not suffer the potential double taxation to which the C corporation is exposed. But this advantage was limited by the Tax Reform Act of 1986 which imposed tax consequences on the liquidation of corporate assets of S corporations formed after 1986. As long as the S corporation was formed prior to 1986, the pass-through benefits remain. *Liquidating S. Corp. Gain Passes to Shareholder*, 49 TAX'N FOR ACCT. 118 (1992).

[260] The advantage may result if the corporation, although taxed at 34%, is operating at a net loss or at a small profit as the result of the use of legitimate tax deductions.

[261] I.R.C. § 311 (1993).

Although a non-liquidating C corporation may be subject to personal holding company tax,[262] it may be a small price to pay especially if the stock would pass through an estate and receive a stepped-up basis.[263] Most highly appreciable assets would not be placed inside the "Farm" C corporation in any case.

The accumulated earnings tax should not be a concern for carefully structured farm corporations.[264] The penalty can be avoided by dividend payout and raising rent paid to leased assets so that accumulated earnings do not reach the threshold level for imposing the tax. The penalty is not assessed unless accumulation of earnings exceed $250,000 or the reasonable needs of the business.[265] Few farms accumulate $250,000 inside the corporation and aggressively-leveraged entities can survive the "reasonable" business needs test.

G. *Summary of Choice of Entity*

For S corporations, the value of fringe benefits—otherwise available to C corporation shareholder/employees—are not available to shareholder/employees, owning 2 percent or more of the enterprise.[266] Such S corporation shareholder/employees are treated as partners.[267] Thus employer-provided medical insurance, group term life insurance, death benefits, meals, and lodging may not be provided tax-free to S corporation owner/employees. Benefits provided tax-free to partners such as working condition or *de minimis* fringes are available to S corporation owner/employees and partnership owners.[268]

Fringe benefits can be extremely valuable to owner/employees because of the deduction allowed the corporation and the income exclusion available to the employee.[269] Although the S corporation and the limited liability company must include most major fringe benefits in the shareholder/employee's income, an S corporation's ability to avoid the

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[262] I.R.C. § 541 (1993).

[263] *See* I.R.C. § 1014 (1993).

[264] I.R.C. § 531 (1993). An accumulated earnings tax of 28% is imposed on accumulated taxable income as defined in I.R.C. § 535 (1993).

[265] I.R.C. § 535 (1993).

[266] I.R.C. § 1372(a) (1993) (treating 2% shareholders in an S corporation as partners for purposes of employee fringe benefits).

[267] *Id.*

[268] I.R.C. § 132(a)(3)-(4) (1993).

[269] *See* I.R.C. § 132 (1993) (excluding from gross income, fringe benefits that qualify as a no-additional cost service, qualified employee discount, a working condition fringe, or a *de minimis* fringe); I.R.C. § 162 (1993) (delineating the deductibility of trade and business expenses).

C corporation's potential for double taxation should be carefully considered in comparing the choice of entity. If the corporation is planned for the purpose of paying dividends, double taxation may arise from the corporation paying tax on business income[270] and the shareholder paying tax on the dividend.[271] On the other hand, though many farm corporations escape the double tax on dividends because C corporations do not pay dividends, where low profitability or no profitability occurs,[272] farm corporations can be carefully structured with the rental resources outside the corporation[273] and can use "reasonable" compensation to reduce the ability to pay dividends.[274]

Capital accumulation, estate planning, and limited liability are often cited as reasons for incorporation, but the value of fringe benefits must also be considered.

At least one commentator has argued that the Tax Reform Act of 1986 signaled a major shift in agricultural tax policy "from subsidizing agricultural producers through the tax system to a policy of encouraging such producers to rely on economic realities."[275] If this is true, then farmers, like all other taxpayers, should find that the income tax structure does have an "ability-to-pay" basis and that there is equal access to "benefits received."[276]

Most farm and family enterprises must address additional concerns. The owner must determine whether the off-farm heir should have a current or future role in farm operations. The owner may wish to buy out the off-farm heir. The enterprise will need adequate income for the present and the future. The enterprise must also consider tax matters including the separation of the return to labor and the return to capital in future tax filings. Additionally, benefits paid on the farm and benefits paid off the farm must receive equal treatment. Finally, since the return to capital is often improperly accounted for in farms and small

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[270] I.R.C. § 61(a)(2) (1993)(including "income derived from business" in definition of gross income).

[271] I.R.C. § 61(a)(7) (1993)(including "dividends" in definition of gross income).

[272] REVISED MODEL BUSINESS CORP. ACT § 6.40(c) (1980). This section provides that a corporation may not make a distribution if the corporation would not be able to pay its corporate debts in the ordinary course of business or if corporate liabilities would exceed assets. *Id.*

[273] *See supra* note 182.

[274] *See generally* Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1243 (9th Cir. 1983).

[275] Andrew L. Sobotka, *Recent Changes in Agricultural Tax Policy Encourages Reliance on Economic Realities*, 13 J. OF AGRIC. TAX'N & LAW 35, 65 (1991).

[276] *Id.*

businesses, the owner must ensure accounting accuracy.

III. Fringe Benefits and Future Tax Equity: A Proposal

Because exclusion of fringe benefits from taxable income significantly reduces the tax base, the taxation of fringe benefits is often under review.[277] One alternative for revising taxation of fringe benefits would be to allow fringe benefits of up to 10 percent to 20 percent of salary for all employees as non-taxable perks regardless of form of business organization. Additional fringe benefits would be income, taxed as salary or profit to the employee. If the individual is self-employed, a different approach would be used. The government could set an amount of wage income such as a national average of wages, industry average wage, or wage amount that could serve as an index upon which to calculate nontaxable benefits. Upon this "set wage," the nontaxable fringe benefit percentage could be applied.

The following hypothetical illustrates this concept. Susan, a self-employed individual, reported $50,000 of Schedule F income in the current year. The industry average wage set by the government is $20,000. Susan would be entitled to a deduction from income of up to 20 percent of $20,000 or $4,000, for fringe benefits *paid* by her business to herself. Susan paid Fred, one of her employees, $15,000 in wages and $4,000 in benefits. Fred's taxable income would consist of his total salary ($15,000) plus benefits received which exceed 20 percent of salary ($1,000) for a total of $16,000 of taxable income.

In the alternative, a statutory base could be set for all self-employed individuals and employees that would be used to calculate the maximum amount of nontaxable fringes for benefit deductions. This would parallel the approach used for social security and other employment taxes.[278] Historically, the Internal Revenue Code has treated the self-employed individual differently than an employee to make the burden similar between the two.[279] This might encourage fringe benefits plans

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[277] Exclusion of these benefits from taxable income increases the federal deficit, encourages over-spending on tax-preferred activities, and potentially increases horizontal and vertical inequities. Conversely, nontaxation of benefits may result in a higher tax rate than is necessary on taxable income. U.S. GAO, *Effects of Changing the Tax Treatment of Fringe Benefits*, TAX POLICY 17 (1992).

[278] *See, e.g.*, I.R.C. § 86 (1993). Social security benefits received above the base amount set in § 86(c) are includable in gross income. *Id.* § 86(a).

[279] For example, employees pay a different rate for employment taxes, otherwise known as FICA (Federal Insurance Contribution Act) taxes, than do self-employed individuals. For employees, the employee and employer each pay half of the total tax. For 1992, each will pay 7.56% on the employee's wages, amounting to a combined

that would allow the employee to choose among alternative benefit packages, allow Congress to more fairly determine an equitable tax base, and assure equitable treatment of tax payers by reducing the incentive to make business structure changes hinge on tax benefits of fringe benefits.

Although there seems to be discomfort with the idea of granting deductions, legitimate business deductions are not generally denied or limited because the deductions have a greater impact at higher brackets. Where elements of personal consumption are involved, however, adjustments to some deductions can be made. Current examples of this approach include the 50 percent portion of business meals disallowed to reflect personal consumption elements[280] and the 7.5 percent floor for medical deductions.[281] A base could be established, similar to that used for life insurance benefits for employees,[282] to reduce vertical equity concerns.

IV. SUMMARY

The tax favored treatment of fringe benefits provides one additional reason for farmers and small firms to incorporate. However, with constant changes in the tax code, the current movement to allow for 100 percent deductibility of qualified health premiums regardless of choice of entity, and attempts to assure vertical and horizontal fairness, the role of fringe benefits in determining the type of business entity may diminish in the future. The ability to separate the return to capital and the return to labor in many small closely held businesses may also encourage and determine a specific type of entity choice for taxation purposes.

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employment tax of 15.3%. I.R.C. § 3101(a),(b) (6) (1993). Self-employed individuals must pay self-employment taxes of 15.3% calculated upon net self-employment income. I.R.C. § 1401(a), (b) (1993). As a result, self-employed individuals and employees have the same employment tax rate applied to this income. The only difference arises as to who funds the actual payment.

[280] I.R.C. § 274(n) (1993).

[281] I.R.C. § 213(a) (1993).

[282] I.R.C. § 246 (1993). Section 264 applies to insurance contracts. Payments on behalf of an employee are generally not allowed as deductions. *Id.*