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Considerations When Incorporating the Family Farm

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CONSIDERATIONS WHEN INCORPORATING THE FAMILY FARM†

I. INTRODUCTION

The objective of this comment is to point out advantages and disadvantages and some of the problem areas which should be considered when contemplating incorporating a family farm. It necessarily follows to a large extent that these advantages, disadvantages, and problems are the same as for close corporations in general.

II. ADVANTAGES OF INCORPORATING

A. Limited Liability

1. *Contractual*

A primary advantage of incorporating is that the stockholders are exempt from individual liability for the corporation's debts or its torts beyond the amount of their agreed liability.[1] This limitation of liability is unavailable to a sole proprietor or to a partnership. Limited liability is very desirable in most farm and ranch operations because of the high degree of risk involved, and it is especially needed during the early years of a farmer's career when a single crop failure might cause financial disaster.

The concept of limited liability would not be meaningful however, if an entire farm and its operating equipment were transferred to the corporation, for all corporate assets are liable for its debts.[2] Further, if a farmer has to co-sign notes of a corporation

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[1] BALLANTINE, CORPORATIONS § 1 (rev. ed. 1946).

[2] If only the operation, or the operation plus only part of the assets is incorporated, and the corporation leases the rest of the farm from the incorporators, the concept of limited liability becomes very important. Also, rent paid by the corporation is deductible from gross income, so in this way the impact of double taxation can be reduced. See IV(B) *infra*.

before credit is extended to it, then practically speaking, limited liability becomes non-existent. This may be true when high-priced farm equipment, requiring a large investment, is purchased for maintaining efficient operation.

2. *Tort: Insurance*

A sole proprietor or a partnership can limit liability for torts through use of insurance so the significance of limited liability is questionable when considering whether to incorporate. It has been suggested that courts might refuse to extend limited liability to the sole shareholder in the one-man company with respect to strangers injured by a tort committed in the exercise of the corporate business, but judges so far have not made this distinction.[3]

3. *Limited Liability Denied*

a) Misuse of the Corporate Entity

If the corporate form is used to defraud or to promote injustice, the concept of the legal corporate entity may be disregarded in favor of third persons.[4] In such a situation the corporation and the individuals owning the corporate stock will be considered as identical and individual stockholders will lose their limited liability.

Similarly, if a corporation fails to carry on proper corporate formalities such as meetings of directors and shareholders and fails to keep separate books and accounts, the separation of the corporate entity from the individual shareholders will be disregarded in order to protect individual and corporate creditors.[5]

b) Under Capitalization

Limited liability also is denied to corporations when they are under capitalized.[6] Under capitalization may take either of two forms: (1) investment by the stockholders in any form, loans or stock, is inadequate, or (2) total investment by stockholders in

[3] Cataldo, *Limited Liability With One-Man Companies and Subsidiary Corporations,* 18 LAW & CONTEMP. PROB. 477 (1953).

[4] BALLANTINE, CORPORATIONS § 122 (rev. ed. 1946); 1 FLETCHER, CYCLOPEDIA CORPORATIONS § 41 (perm. ed. 1931). See Latty, *The Corporate Entity as a Solvent of Legal Problems,* 34 MICH. L. REV. 597 (1936).

[5] BALLANTINE, CORPORATIONS § 123 (rev. ed. 1946).

[6] I OLECK, MODERN CORPORATION LAW § 195 (1958).

both debt and equity securities is adequate, but the debt is excessive as compared to the equity capital.[7]

Although there is no single test to determine when a corporation is under capitalized, one test which is sometimes used in determining whether a certain security is debt or capital is the ratio of debt to capital.[8] This test seems unreliable because of the wide range of ratios which have been sanctioned.[9] In *Gilbert v. Commissioner*,[10] in determining whether an advance of money by a shareholder to a closely held corporation was a loan within the meaning of the Internal Revenue Code, the court gave consideration to "whether outside investors would make such advances."[11] It has been suggested that a farm corporation can probably justify its debt-equity designation if the amount of debt issued is no greater than that which could have been obtained from outside creditors on the same terms.[12]

During initial planning of the capital structure, care must be taken that debt obligations do not have any characteristics of stock[13] and that the formalities of loans are present.[14] A loan should have a fixed maturity date[15] and unqualifiedly obligate the debtor to make interest payments at predetermined times.[16] If money or property is advanced by shareholders in substantially the same proportion as their individual stock holdings, the courts would probably find that the transaction was not a loan but rather a contribution of capital.[17] Courts examine all characteristics of

[7] *Ibid.*

[8] This was considered in John Kelley Co. v. Commissioner, 326 U.S. 521 (1946).

[9] *E.g.*, In John Kelley Co. v. Commissioner, 326 U.S. 521 (1946), the ratio was four to one compared to a fifteen to one ratio in Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956); see I OLECK, MODERN CORPORATION LAW § 196 (1958).

[10] 248 F.2d 399 (2d Cir. 1957).

[11] *Id.* at 406.

[12] Note, *Incorporating the Farm Business*, Part II: *Tax Considerations*, 43 MINN. L. REV. 782, 809 (1958).

[13] I ONEAL, CLOSE CORPORATIONS § 2.11 (1958).

[14] See note, *Taxation—Close Corporations—Intent and Motive in the Determination of Debt Security for Federal Inome Tax Purposes*, 3 VILL. L. REV. 540 (1958).

[15] John Kelly Co. v. Commissioner, 326 U.S. 521 (1946).

[16] Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956).

[17] Alfred R. Bachrach, 18 T.C. 479 (1952), *aff'd per curiam*, 205 F.2d 151 (2d Cir. 1953), cited in I ONEAL, CLOSE CORPORATIONS § 2.11 (1958).

a particular security to determine whether it represents debt or stock.[18]

If loans are found to have the characteristics of stock, they are treated as equity by the Internal Revenue Service. Further, if it is found that the capital structure is composed of excessive loans, the claims of stockholder-creditors may be subordinate to the claims of outside creditors.[19]

B. Advantages of Debt Financing

If the capital structure is composed of legitimate debt which does not render the corporation under capitalized, there are certain tax advantages available. First, corporate earnings which are paid to shareholders as interest are deductible from corporate gross income.[20] Second, the risk of incurring a surtax on accumulated earnings is reduced because retention of earnings is not objectionable if they are to be used to pay debts.[21] Third, recipients will not be taxed when loans are repaid, but a stock redemption may be taxed as a dividend.[22] Fourth, if the corporation fails, the loss will be deductible by a shareholder-creditor if the loans were made in the course of business.[23]

It is important that lawyers incorporating family farms give full consideration to the problems which arise when setting up an acceptable capital structure. Debt financing will prove advantageous in many cases.

C. Flexible Transfer of Property

1. *Inter Vivos Transfers*

> Of all the suggested advantages to incorporating the farm business, the flexible transfer of property would seem to be the most practical.[24]

[18] I ONEAL, CLOSE CORPORATIONS, § 2.11 (1958). See Talbot Mills v. Commissioner, 326 U.S. 521 (1946).

[19] I OLECK, MODERN CORPORATION LAW § 195 (1958).

[20] INT. REV. CODE OF 1954 § 163(a).

[21] See Lion Clothing Co., 8 T.C. 1181 (1947), cited in I ONEAL, CLOSE CORPORATIONS § 2.99 (1958).

[22] See INT. REV. CODE OF 1954 § 302.

[23] INT. REV. CODE OF 1954 § 166(a).

[24] Shoemaker, *Incorporating the Family Agricultural Business*, 30 ROCKY MT. L. REV. 407 (1958).

Stock ownership of the family farm offers an opportunity to give individual family members an interest in the operation by gift. Even though it is possible to convey an undivided interest in farm property by deed, a transfer of corporate stock, representing ownership of the farm would seem to be a more satisfactory method.[25] ". . . (T)he principal problem is in retaining control over the farm property as a unit. . . ."[26] Incorporation provides an excellent method of solving this problem. By retaining a majority of the voting stock, the transferor can keep control of the entire operation and, through the use of restrictions on the transfer of shares, can be sure that outsiders will not obtain an interest in the farm.[27]

2. *Estate Planning*

Shares of stock in a farm corporation also provide a suitable way for passing the farm to the next generation. Often a farm owner does not desire to divide his farm between his children who may sell their inherited portions to strangers. In addition, he realized the problems which frequently arise when a farm is jointly owned by two or more children. Therefore, if the farm has not already been divided among the intended beneficiaries by inter vivos transfers, he could, after incorporation, will a certain number of shares to each of his children. If the corporation has two classes of stock,[28] the problem of controlling the operation could be alleviated by bequeathing a majority of the voting shares to the child whom the farm owner wishes to stay on the farm.

D. Improved Credit

In most cases, management of an incorporated farm is more efficient than that of individually owned and operated farms. This is partly because of the detailed system of keeping records which is required by a corporation. Also, management of the incorpo-

25 Eckhardt, *Should the Farmer Incorporate?*, I PRAC. LAW. 63 (1955).

26 Note, *Incorporating the Farm Business*, 43 MINN. L. REV. 305, 318 (1958).

27 See part III (c) *infra*.

28 NEB. REV. STAT. § 21-135 (Reissue 1954) provides that every stockholder shall have a right to vote in all elections for directors. However, the sixty-ninth session of the Nebraska Legislature passed L.B. 659 providing for submission to the electors at the general election in November 1960, amendments to Art. XII, sec. 5 and 6 of the Constitution of Nebraska to provide that preferred stock may not have a vote and that the value of preferred stock may be different than the value of other stock if the corporation desires.

rated farm is uninterrupted by death whereas the individual farm operation will be disrupted at least to some extent during administration of a deceased farm owner's estate. For these reasons credit institutions frequently may be more likely to extend credit to a farm corporation than to an individual farmer.

However, certain Federal loans are available to the individual farmer which are not available to the farm corporation. Such corporations are ineligible for both Federal farm acquirement and improvement loans and for production and subsistence loans which are available to qualified individual farm operators.[29]

E. FRINGE BENEFITS

Incorporation may make it possible for the owners to participate in employee benefit plans as employees of their corporation—a privilege not available to a sole proprietor or a partner. Perhaps the most important of these benefits are those available under a qualified pension plan.[30] Employees are able in this way to defer a part of their income until they have reached the age when they are in a lower income bracket.

In addition to the benefits under a pension plan, employees are able to receive certain payments from the corporation tax free. Such payments include: (1) payments from an employer-financed accident and health plan to reimburse an employee for actual expenses incurred for medical care of himself and his family[31] (2) payments for permanent injury or loss of bodily function[32] (3) payments up to $100 a week for wages during a period in which the employee is absent from work on account of personal injury or sickness[33] and (4) death benefits to the beneficiary or estate of the employee up to $5,000.[34]

F. SOCIAL SECURITY

Even though farmers are covered under the Social Security Act,[35] a farmer who incorporates his farm may have some ad-

[29] The Bankhead—Jones Farm Tenant Act, 7 U.S.C. § 1018(a)(1) (1958).

[30] INT. REV. CODE OF 1954 § 404(a). The requirements for a qualified plan are set out in the INT. REV. CODE OF 1954 § 401.

[31] INT. REV. CODE OF 1954 §§ 105(a) and (b).

[32] INT. REV. CODE OF 1954 § 105(c).

[33] INT. REV. CODE OF 1954 § 105(d).

[34] INT. REV. CODE OF 1954 § 101(b).

[35] 42 U.S.C. § 411 (1958).

vantages. The corporation could pay a salary to the operator which would provide him maximum coverage under the act. The salary has to be paid by the corporation even though it is operating at a loss. If the farm were unincorporated, it might be difficult in some situations to have an income for the required period which is high enough to provide the maximum benefits.[36]

If the farmer is 65 years of age, but less than 72, he cannot earn more than $1,200 per year and still receive the maximum payments.[37] However, if the farm is incorporated, farm profits above a salary of $1,200 could be paid to him in the form of dividends allowing him thereby to receive full benefit under the Social Security Act. Salaries paid by the corporation, however, will be subject to a six per cent tax[38] compared to the four and one-half per cent paid by a self-employed farmer,[39] and the Social Security Administration would carefully scrutinize any transaction which had no corporate purpose but merely constituted a scheme or device to secure coverage benefits.

G. Workmen's Compensation

Although not mandatory, employers of agricultural labor may voluntarily elect to come within the provisions of the Nebraska Workmen's Compensation Act.[40] The farm corporation could, by electing to come under the act, provide workmen's compensation insurance for all employees, including the operator who would be excluded from coverage if the farm was not incorporated.

36 See 42 U.S.C. §§ 414-15 (1958).

37 42 U.S.C. § 403 (1958).

38 INT. REV. CODE OF 1954 §§ 3101-11.

39 INT. REV. CODE OF 1954 § 1401; See generally U.S. BUREAU OF OLD-AGE AND SURVIVORS INSURANCE, U.S. SOCIAL SECURITY ADMINISTRATION, U.S. DEPARTMENT OF HEALTH EDUCATION AND WELFARE, FARM PEOPLE AND SOCIAL SECURITY (1958). This publication, directed primarily to those who assist farm people in understainding their rights and complying with their obligations under the social security law, is available for 15 cents from the U.S. Government Printing Office.

40 NEB. REV. STAT. § 48-106 (Reissue 1952).

III. INITIAL FEES

Attorney's fees[41] and filing fees[42] are usually the most significant initial expenses of incorporating. These fees will normally run in the neighborhood of $200 to $300. However, it would seem that only in the case of a very small operation would these costs make incorporation unattractive. In addition to attorney and filing fees there are nominal charges for a certificate,[43] for recording,[44] and for publication.[45]

IV. PROBLEMS CONCERNING CONTROL OF THE FARM OPERATION

It is likely that minority stockholders in a farm corporation will want more control than is normally available to them. For example, if two or more family farms are incorporated together, the farmer receiving the minority of shares (who is accustomed to making his own decisions) probably will want an equal voice in management and in all probability he will continue to look upon the farm as "his" even though it is now in the eyes of the law, the property of the corporation, with management decisions to be made by a board of directors.

41 The 1959 Advisory Fee Schedule of the Nebraska State Bar Association provides as follows:

Preparation of Articles, Notices and Minutes of

Organization Meeting	$200
Amendments to Articles	$100
Dissolution	$200
Preparing Corporate Minutes	$24
Attendance at Meeting and Preparation of Minutes	$50

42 NEB. REV. STAT. § 33-101(4) (Reissue of 1952) sets forth the following fees for filing articles of incorporation:

Capital Stock	Filing fee
To and including $10,000	$10
$10,001 to $25,000	$20
$25,001 to 100,000	$50

There is a charge of 50 cents for each additional $1000 or fraction thereof of capital stock in excess of $100,000.

43 NEB. REV. STAT. § 33-101(1) (Reissue 1952) provides for a fee of $1 for certificates with seal.

44 NEB. REV. STAT. § 33-101(5) (Reissue 1952) provides for a recording fee of $1 for the first 200 words and 10 cents for each additional 100 words.

45 NEB. REV. STAT. § 21-1,149 (Reissue 1954) requires notice of incorporation to be published. NEB. REV. STAT. § 33-141 (Reissue 1952) sets out the legal rates for the publication of all legal notices.

A. Minority Representation on the Board of Directors

In most cases, cumulative voting, will guarantee a minority shareholder a place on the board of directors.[46] However, if the minority shareholder does not own enough stock to benefit from cumulative voting, other devices are available to guarantee him representation on the board. Methods often employed in close corporations are: high quorum or high voting requirements, voting trusts,[47] and agreements between the stockholders to elect certain directors.[48] In *E. K. Buck Retail Stores v. Hackert*,[49] the Nebraska Supreme Court held a control agreement providing that each of two contracting stockholders who owned a majority of the stock would designate two members of a four-man board was not against public policy and did not violate Article XII, section 5, of the Nebraska Constitution which requires cumulative voting.

B. Other Control Devices of a Minority Stockholder

Representation on the board of directors, however, may be insufficient to give the desired control. For example, the minority shareholder will very likely want assurance of a certain salary from the corporation. Because the majority of the board of directors manage the corporation, minority representation on the board, alone, would not give the minority shareholder this security. The problem may be circumvented by an agreement between all of the shareholders to elect officers at determined salaries[50] or by a greater than majority requirement for action by the board of directors.[51] It is doubtful if the shareholders may by agree-

46 NEB. REV. STAT. § 21-135 (Reissue 1954) provides for cummulative voting.

47 However, voting trusts cannot be used if a corporation intends to receive subchapter S treatment and be taxed as a partnership because a trust is not an individual or an estate. See Part IV (B) (d) *infra*.

48 I OLECK, MODERN CORPORATION LAW § 198 (1958); I ONEAL CLOSE CORPORATIONS §§ 409, 512, 531 (1958).

49 157 Neb. 867, 62 N.W.2d 288 (1954).

50 See Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936). For citations of other cases to this effect see Logan, *Methods to Control the Closely Held Kansas Corporation*, 7 KAN. L. REV. 405, 429 (1959); Annot., 45 A.L.R.2d 801 (1956).

51 NEB. REV. STAT. § 21-113 (Reissue 1954) provides that ". . . a majority of them (board of directors) shall constitute a quorum for the transaction of business, unless the by-laws shall provide that a different number shall constitute a quorum, which in no case shall be less than one-third of the total number of directors nor less than two directors." This seems to imply that a provision in

ment, control other powers of the directors and remain within the statutory norm[52] which requires the board of directors to manage the corporation.[53]

Of course, a natural consequence of giving "veto" powers to minority shareholders will be an increase of deadlocks. Because of this, it may be necessary to dissolve the corporation in order to settle the disputes. In some states arbitration may furnish a successful method of settling the differences that arise. However in Nebraska, it has been held that arbitration provisions are not enforceable, and are not available to the parties in an action growing out of the contract.[54]

C. Stock Transfer Restrictions

Stockholders in a farm corporation normally will desire to keep control of the farming operation within the family, and, consequently, want some type of restriction on the transferability of stock.

Absolute restrictions are invalid as undue restraints upon the alienation of property.[55] However, reasonable restrictions may

the by-laws requiring a greater than majority for a quorum would be valid. § 21-106 provides that "The articles of incorporation may also contain (1) any provision which the incorporators may choose to insert for the management of the business and for the conduct of the affairs of the corporation, and any provisions creating, defining, limiting and regulating the powers of the directors . . . ; Provided, such provisions are not contrary to the laws of this state;" A requirement of a greater than majority vote for action by the board of directors would seem to fall within these provisions.

52 "The business of every corporation organized or operating under the provisions of this act shall be managed by a board of directors, except as hereinafter or in its articles of incorporation otherwise provided." NEB. REV. STAT. § 21-111 (Reissue 1954).

53 A leading case to this effect is Long Park, Inc. v. Trenton - New Brunswick Theaters Co., 297 N.Y. 174, 77 N.E.2d 633 (1948). For some articles dealing with the subject of control in close corporations see generally, Israels, *The Close Corporation and the Law,* 33 CORNELL L. Q. 488 (1948); Hornstein, *Stockholders Agreements in the Closely Held Corporation,* 59 YALE L. J. 1040 (1950); Logan, *Methods to Control the Closely Held Kansas Corporation,* 7 KAN. L. REV. 405 (1959); Winer, *Proposing a New York "Close Corporation Law"* 28 CORNELL L. Q. 313 (1943); O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions,* 18 LAW & CONTEMP. PROB. 451 (1953).

54 See Shrandt v. Young, 62 Neb. 254, 86 N.W. 1085 (1901); Butler v. Green, 49 Neb. 280, 68 N.W. 496 (1896).

55 12 FLETCHER, CYCLOPEDIA CORPORATIONS § 5453 (perm. ed. rev. 1957).

be imposed by the articles of incorporation or by-laws or by agreement between the stockholders.[56] In *Elson v. Schmidt*,[57] the Nebraska Supreme Court upheld a restriction where the stock was to be first offered at par to the stockholders and then, if not purchased by them, it could be sold to persons outside the corporation. The court distinguished *Miller v. Farmers Milling and Elevator Co.*[58] where the by-laws prohibited Miller from selling the stock to anyone without the consent of the directors.

Usually the shareholders are the only parties to restrictive agreements, but it appears that a better practice is to have the corporation also made a party, especially if it has duties under the agreement.[59]

Section 15 of the Uniform Stock Transfer Act, which Nebraska has adopted,[60] requires that restrictions upon transfer of shares must be stated on the stock certificate and the restrictions are held unenforceable where this requirement is not met.[61] In *Sorrick v. Consolidated Telephone Co.*,[62] even though the plaintiff had notice of the restrictive provision, he was given relief because the defendant had not met the requirements of the Michigan law. Although Section 15 requires the restriction *to be stated*[63] on the certificate, a notation on the certificate referring to the restriction has been held sufficient.[64] Even if the requirements of the Uniform Stock Transfer Act are complied with, an otherwise unreasonable restriction is not validated.[65]

1. *First Option Plans*

The most common type of restriction used is one which provides that a shareholder shall not transfer his stock to outsiders without first offering it to the other stockholders or to the corpo-

56 II ONEAL, CLOSE CORPORATIONS, § 7.13 (1958).

57 140 Neb. 646, 1 N.W.2d 314 (1941).

58 78 Neb. 441, 110 N.W. 995 (1907).

59 II ONEAL, CLOSE CORPORATIONS § 7.15 (1958).

60 NEB. REV. STAT. §§ 21-201 - 224 (Reissue 1954).

61 Age Publishing Co. v. Becker, 110 Colo. 319, 134 P.2d 205 (1943); Peets v. Manhasset Civil Engineers Inc., 68 N.Y.S.2d 338 (1946).

62 340 Mich. 463, 56 N.W.2d 713 (1954).

63 Emphasis added.

64 Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812 (1957).

65 First Nat'l. Bank of Canton v. Shanks, 34 Ohio Op. 359, 73 N.E.2d 93 (1945).

ration.[66] In setting up the restriction, it is important to specify (1) the parties who have the option, (2) the transfers covered by the restriction, (3) the length of the option period, and (4) a method for determining the option price.

a) Who Should Have the Option

It has been suggested that it is wise to give the option directly to the shareholders.

> For one thing, it dodges the problem whether a corporation may purchase its own shares[67] and obviates the risk that the corporation, conceding that it has power to purchase its own shares, may not have a sufficient surplus for this purpose at the time when a member retires and offers his interest for sale. However, it opens the question whether the members are entitled to purchase the retiring members' shares pro-rata, in proportion to their holdings in the enterprise.[68]

Unless it is provided that stockholders may in each case purchase pro-rata, normally a sale to another stockholder will be sanctioned.[69] The buying shareholders should be required to purchase all of the shares of the deporting shareholder or he should not be required to sell to them at all, because to do so might deprive him of a market for his remaining shares.[70]

b) What Transfers are Covered by the Restriction?

Because public policy disfavors restraints on the alienation of property such restrictions are strictly construed.[71] Therefore, if the restriction is intended to apply to dispositions by wills, pledges,

[66] For a collection of cases holding these restrictions valid, see Cataldo, *Stock Transfer Restrictions and the Closed Corporation,* 37 VA. L. REV. 229 (1951). See, generally, note, *Stock Transfer Restrictions in Closely Held Corporations,* 10 U. FLA. L. REV. 54 (1957).

[67] NEB. REV. STAT. § 21-140 (Reissue 1954) provides that a corporation can purchase its own shares when it will not cause an impairment of its capital.

[68] Cataldo, *Stock Transfer Restrictions and the Closed Corporation,* 37 VA. L. REV. 229, 246 (1951).

[69] See note 73 *infra.*

[70] See II ONEAL, CLOSE CORPORATIONS § 7.18 (1958).

[71] II ONEAL, CLOSE CORPORATIONS, § 7.18 (1958); 12 FLETCHER, CYCLOPEDIA CORPORATIONS § 5453 (perm. ed. rev. 1957); Oakland Scavanger Co. v. Gandi, 51 Cal. App.2d 69, 124 P.2d 143 (1942); McDonald v. Farley & Loetscher Mfg. Co., 226 Ia. 53, 283 N.W. 261 (1939); Guarantee Laundry Co. v. Pullman, 198 Okla. 667, 181 P.2d 1007 (1947).

gifts, or sales by one shareholder to another, this should be indicated in the restriction.[72] Provisions requiring that stock first be offered to the other shareholders before being sold to outsiders have been construed not to apply when one shareholder sells to another shareholder without giving other shareholders an opportunity to purchase proportionately.[73] However, a restriction requiring that the company have an opportunity to purchase before a transfer is made to outsiders may be construed to cover transfers from one shareholder to another.[74]

c) How Long Should the Option Period Be?

If the time limit is excessive the restriction may be considered unreasonable.[75] The usual option is open from 10 to 90 days,[76] but provision should be made for waiving this period by unanimous consent so that it will be unnecessary for an intended purchaser to wait the entire length of the period before making a purchase which is acceptable to the other shareholders.[77]

d) How Is the Option Price Determined?

It is important that the buy-sell agreement contain a method for arriving at the price of the stock to be sold. If this is omitted, the agreement may be unenforceable on the ground of vagueness.[78] There is no one method of price determination that will be useful in all cases. Among the methods most often used are: (1) flat price, (2) book value, (3) a formula expressed as a multiple of average net earnings, (4) and par value of shares.[79] Appraisal or arbitration often is used in conjunction with one of

72 II ONEAL, CLOSE CORPORATIONS § 7.18 (1958).

73 Guarantee Laundry Co. v. Pullman, 198 Okla. 667, 181 P.2d 1007 (1947); See Serota v. Serota, 168 N.Y.Misc. 27, 5 N.Y.S.2d 68 (1938); Rychwalski v. Milwaukee Candy Co., 205 Wis. 193, 236 N.W. 131 (1931).

74 See Baumohl v. Goldstein, 95 N.J.Eq. 597, 124 Atl. 118 (1924).

75 See Hays, *Corporation Cake with Partnership Frosting,* 40 IOWA L. REV. 157, 169 (1954).

76 II ONEAL, CLOSE CORPORATIONS, § 7.19 (1958).

77 *Ibid.*

78 *Supra,* note 74.

79 12 FLETCHER, CYCLOPEDIA CORPORATIONS § 5457 (perm. ed. rev. 1957); For an excellent discussion of the various price fixing methods, see Page, *Setting the Price in a Close Corporation Buy-Sell Agreement,* 57 MICH. L. REV. 655 (1959).

the above but may be used as an independent method of determining price.[80]

2. *Agreements to Purchase Upon the Death of a Shareholder: Business Insurance*

If an agreement makes provision for the survivors to buy the business interest of a decedent upon his death, the decedent's estate usually is obligated to sell and the survivors are obligated to buy.[81] When the agreement is between shareholders it is called a "buy and sell" agreement. If the agreement provides that the corporation will purchase the interest of the deceased, it is called a "stock retirement agreement."[82] Business insurance is often used to provide the needed cash to purchase the interest of the decedent. Two types of arrangements can be used: (1) each shareholder buys life insurance on the life of the other, naming himself as beneficiary; or (2) the corporation buys life insurance on the lives of each of the shareholders naming itself as beneficiary.[83]

V. TAX CONSIDERATIONS

A. TAX-FREE TRANSFER OF THE PROPERTY TO THE CORPORATION

Generally, no gain or loss is recognized when property[84] is transferred to the farm corporation solely in exchange for its stock or securities[85] if, immediately[86] after the exchange, the

80 Page, *Setting the Price in a Close Corporation Buy-Sell Agreement,* 57 MICH. L. REV. 655, 672 (1959).

81 Note, *Tax Aspects of Business Purchase Agreements Funded with Life Insurance,* 9 VAND. L. REV. 373 (1956).

82 *Ibid.* For a comparison of buy-sell and stock retirement agreements with the advantages and disadvantages of each, see page 379.

83 For an excellent discussion of the tax aspects as well as the unfairness which may result from the use of insurance to fund purchase agreements see, Note, 71 HARV. L. REV. 687 (1958). See also Eichenbaum, *Contracts to Purchase with Insurance Proceeds,* 5 ARK. L. REV. 302 (1951).

84 INT. REV. CODE OF 1954 § 351(a); "For purposes of this section stock or securities issued for services shall not be considered as issued in return for property."

85 "(U)nsecured short time obligations have been regarded as not coming within the meaning of "securities" since they do not furnish any such continuity of interest as is required to satisfy that term." Lloyd Smith v. Commissioner, 116 F.2d 642 (2d Cir. 1941), *cert. denied* 313 U.S. 588 (1942); and see cases cited therein. However, "the test as to whether notes are securities is not a mechanical determination of

transferors are in control.[87] To be in control they must possess at least 80% of the total combined voting power and at least 80% of the total number of shares of all other classes of stock.[88] If other property or money is received by the transferors in addition to securities, any gain will be recognized which does not exceed the amount of money received plus the fair market value of such other property received.[89] For example, if a stockholder transfers property to the corporation which cost him $50,000 in return for stock worth $55,000 plus $5,000 cash and he is in control of the corporation immediately after the exchange, there is a gain of $10,000, but only $5,000 (i.e., not to exceed the amount of money plus the value of other property received) is recognized. For tax purposes, the valuation basis for the property acquired by the corporation is the same as it would be in the hands of the transferor increased in the amount of gain recognized to the transferor.[90] The basis of securities received by the transferor is the same as the property exchanged by the transferor plus the amount of recognized gain minus the fair market value of any property and money received.[91] Therefore, in the example above the basis would be the value of the property exchanged plus the gain of $5,000, minus $5,000, the amount of money received, or $50,000.

Although the control requirements normally would be met to make the exchange of property tax-free, nevertheless, in some situations, it may be advantageous if the transfer is not tax-free.[92]

the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purposes of the advances, etc." Camp Wolters Enterprises v. Commissioner, 230 F.2d 555 (5th Cir. 1956), *cert. denied,* 352 U.S. 826 (1957).

86 Where the recipient of stock on exchange of property for stock in a corporation has not only legal title to stock immediately after exchange but also the legal right then to determine whether to keep stock with control that flows from such ownership, no gain or loss on the transaction can be recognized irrespective of how soon thereafter recipient elects to dispose of stock and whether such disposition is in accord with a preconceived plan not amounting to a binding obligation. Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir. 1942) *cert. denied* 317 U.S. 655 (1943).

87 INT. REV. CODE OF 1954 § 351(a).

88 INT. REV. CODE OF 1954 § 368(c).

89 INT. REV. CODE OF 1954 § 351(b).

90 INT. REV. CODE OF 1954 § 362(a).

91 INT. REV. CODE OF 1954 § 358(a).

92 "A taxable transfer of depreciable property to a farm corporation

B. METHODS TO REDUCE DOUBLE TAXATION

1. *Salary Deductions*

Until recently, perhaps the prime deterrent to a farmer who wished to incorporate his farm was the aspect of double taxation.[93] Corporations pay a tax of 30% against their entire taxable income plus a surtax of 22% on all taxable income in excess of $25,000.[94] In other words, a 30% rate applies against the first $25,000 of taxable income and a 52% rate against the balance. This income is then taxed again to the stockholders when received as dividends.[95]

Double taxation will not be the great obstacle it is generally thought to be because the Internal Revenue Code allows a corporation to deduct the necessary expenses of a taxable year in carrying on a trade or business, including "a reasonable allowance for salaries or other compensation for personal service actually rendered."[96] The reasonableness of a salary is determined by the circumstances of each case,[97] with the burden of proving reasonableness on the corporation.[98]

may be advisable if the market value of that property is substantially in excess of the transferor's basis. If the transfer were taxable, the corporation could take advantage of a stepped-up basis for depreciation deductions from its ordinary income, while the gain on the transfer would be taxable to the transferor only at a capital gains rate. However, if more than eighty per cent of the farm corporate stock is owned by the transferor, his spouse, or minor children or grandchildren, the proceeds from a sale of depreciable property to a corporation will be classified as ordinary income rather than capital gain. Thus, generally no benefit would have been realized from the taxable transfer." Note, *Incorporating the Farm Business Part II: Tax Considerations,* 43 MINN. L. REV. 804 (1958).

93 For a tax comparison of corporations and partnerships see Ray and Hammons, *Corporation or Partnership: Tax Considerations,* 36 TAXES 9 (1958). For computation of taxes at various levels, see Garcia, *When Should a Sole Proprietor Incorporate his Business to Save Income Taxes?,* 35 TAXES 110 (1957).

94 INT. REV. CODE OF 1954 § 11.

95 INT. REV. CODE OF 1954 §§ 11, 61(a)(7).

96 INT. REV. CODE OF 1954 § 162(a)(1).

97 Treas. Reg. § 1.162-7(b)(3) (1958); In E. H. Miller & Sons, 49,078 P-H Tax Ct. Mem. (1949), where a father and four sons and sons-in-law each had received a $35,000 salary the court disallowed 2/3 of the total salaries on the grounds that the agreement was designed to distribute profits to avoid tax.

98 Shield Co., 2 T.C. 463 (1943). For factors to be used in determining the question of reasonableness, see Bafford, *The Constructive*

2. *Employee Bonuses*

Reasonable employee bonuses also "will constitute allowable deductions from gross income when made in good faith and are additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries do not exceed a reasonable compensation for the services rendered."[99]

3. *Retained Earnings*

A farm corporation, in many cases, will be able to retain all of its earnings above those which are paid as salaries in order for individual shareholders to be taxed at capital gains rates which can be accomplished by selling the shares to outsiders[100] or by liquidating the corporation.[101] However, as a practical matter in a farm corporation, it will be difficult to obtain capital gains rates because shares will seldom be sold to outsiders because of the desire to keep control within the family. A corporation must avoid incurring the penalty tax on an unreasonable accumulation of earnings[102] and it is a question of fact in each case whether an accumulation of earnings exceeds the reasonable needs of the business.[103]

4. *Subchapter S Election*

Even if double taxation cannot be completely avoided by the use of salary deductions, this can be accomplished by electing to come under the provisions of Subchapter S of the Internal Revenue Code, which was enacted as part of the Technical Amendments Act of 1958.[104] A qualifying farm corporation can elect not to be taxed on its income and the shareholders are then taxed

Receipt of Dividends by Stockholders of a Closely Held Corporation, 47 KY. L. J. 17 (1958). See also, Gardner, *Some Tax Problems of Closely Held Corporations*, 13 THE ALA. LAW. 26 (1952). Although it is not conclusive, courts consider the compensation paid to persons holding comparable positions in other corporations, Gieger and Peters, Inc., 27 TAX CT. 911-21 (1957).

99 Treas. Reg. § 1.162-9(1958).

100 INT. REV. CODE OF 1954 §§ 1201-23.

101 INT. REV. CODE OF 1954 § 331(a).

102 INT. REV. CODE OF 1954 §§ 531-37.

103 Egan, Inc. v. Commissioner, 236 F.2d 343 (8th Cir. 1956). Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121 (8th Cir. 1958).

104 Act of September 2, 1958, 72 Stat. 1606.

on the distributed or distributable income of the corporation at their individual rates.[105] Thus the benefit of doing business in the corporate form may be obtained without income tax penalty. To qualify, a corporation must be a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not have:

1. More than 10 stockholders,
2. A shareholder, with the exception of an estate, who is not an individual,
3. A non-resident alien as a stockholder,
4. More than one class of stock.[106]

The code puts no limitations upon the size of a corporation wishing to come within the provisions of Subchapter S in respect to either income or assets. An election can be made for any taxable year at any time during either the first month of such taxable year, or during the month preceding it.[107] After the election is made, corporation profits then are taxed to individuals who are shareholders *at the end*[108] of the taxable year.[109] It has been pointed out that this creates unusual benefits for the taxpayer, and it is possible that this section of the law will be changed.[110]

[105] INT. REV. CODE OF 1954 § 1373.

[106] INT. REV. CODE OF 1954 § 1371(a); A corporation having a partnership as a shareholder cannot qualify as a small business corporation under this section of the code. Rev. Rul. 59-235, 1959 INT. REV. BULL. NO. 28, at 13. In determining the number of shareholders of a small business corporation, a husband and wife owning stock jointly or as community property are counted as one shareholder. Public Law 86-376, 59 INT. REV. BULL. NO. 45 at 22.

[107] INT. REV. CODE OF 1954 § 1372(c)(1).

[108] Emphasis added.

[109] INT. REV. CODE OF 1954 § 1373(b).

[110] ". . .(F)or instance, an individual about to engage in a highly speculative venture could organize a corporation with himself as sole stockholder and elect to be taxed as a psuedo corporation. If the corporation earns substantial sums, the stockholder could give the stock to his children one day before the close of the fiscal year of the corporation, and if the children 'elect' to have the corporation taxed as a psuedo corporation, then all profits of the corporation for that year would be taxable to the children and not to the original stockholder. If on the other hand the venture proved unprofitable, the stockholder could retain the stock himself, and (assuming that he had substantial other ordinary income) derive all the tax benefits from the resulting loss." Rosenfelt, *Tax Savings Through Psuedo Corporation, Estate Digest* 2 (April 1959).

However, if a corporation has a net operating loss during a taxable year, any person who was a shareholder *at any time*[111] during the year can receive a deduction for his portion of the loss.[112]

The individual stockholders may carry excess net operating loss back and then forward the same as the corporation could have done.[113] Once a corporation has elected to come under the provisions of Subchapter S it will be treated as such for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation unless the election is revoked or terminated.[114] Section 1372(e) provides: (1) for termination by persons who become shareholders after the election is made if they do not consent to the election, (2) for revocation by unanimous consent of the shareholders, and (3) for termination if the corporation ceases to be a small business corporation as defined in § 1371(a).[115] Other than by consent of the Commissioner of Internal Revenue, the revocation or termination of an election prohibits another election prior to the fifth taxable year for which the termination or revocation is effective.[116]

An election by a farm corporation to come under the provisions of Subchapter S would seem to be advantageous overall. The corporation could retain limited liability, provide fringe benefits for its employees, and at the same time eliminate double taxation. Another major advantage is the opportunity for the family to split its income by making gifts of its shares to family members because a gift of stock to a member of the family will carry with it income which is already earned.[117]

111 Emphasis added.

112 INT. REV. CODE OF 1954 § 1374(b); "(A) shareholder's pro rata share of the corporations net operating loss is the sum of the portions of the corporations daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year . . . . (T)he corporation's daily net operating loss is the corporation's net operating loss divided by the number of days in a taxable year." INT. REV. CODE OF 1954 § 1374(c)(1).

113 INT. REV. CODE OF 1954 § 1374(d)(2).

114 INT. REV. CODE OF 1954 § 1372(d).

115 For example, this would result if stock is transferred to a shareholder who is not an individual, or if the number of shareholders becomes more than ten.

116 INT. REV. CODE OF 1954 § 1372(e)(10).

117 Plowden-Wardlow, *Election of Certain Small Business Corporations as to Taxable Status*, 23 ALBANY L. REV. 245, 251 (1959).

Along with the many advantages there may also be some undesirable results. Major problems may arise upon the unexpected termination of the election. For example, if a shareholder should sell his shares before the end of the year anticipating benefits from a loss, he could be deprived of such benefit if a share of stock were sold to one who did not consent to the election,[118] or if the election is terminated "no distribution of previously taxed income will be given non-dividend treatment. It will be treated as a fully taxable dividend to the extent that the corporation has earnings and profits."[119]

C. Estate and Gift Taxes and Stock Valuation Problems

1. *Estate Tax*

A Federal tax is imposed on the transfer of an estate by Section 2001 of the Internal Revenue Code of 1954. However, sizeable deductions and exemptions are available to the taxpayer. The taxpayer is entitled to a $60,000 exemption[120] plus a deduction equal to the value of any interest in property which passes to a surviving spouse [121] (which must not exceed 50% of the value of the adjusted gross estate.)[122] The marital deduction, in some situations, may not be a tax saving. This is because the property which is not taxed in the estate of the husband may however be taxed in the estate of the spouse at a higher rate because it has been added to the survivor's own estate. However, it has been pointed out that this normally will not be the case because the wife's estate is usually rather insignificant.[123] Therefore, the marital deduction, if taken, plus the $60,000 specific ex-

[118] Rosenfelt, *Tax Savings Through Psuedo Corporation,* ESTATE DIGEST 2 (April 1959). See note 11 *supra.*

[119] *Supra* note 117 at 284. See Hoffman, *Let's Go Slow with Tax Option Corporations,* 37 TAXES 21 (1959) where the author reviews the problems and pitfalls that need review before and after a small business corporation elects to come under the provisions of Subchapter S and suggests that the practitioner be extremely cautious in recommending the use of the electing corporation.

[120] INT. REV. CODE OF 1954 § 2052.

[121] INT. REV. CODE OF 1954 § 2056(a).

[122] INT. REV. CODE OF 1954 § 2056(c)(1). Adjusted gross estate is computed by subtracting the amount of administrative expenses, funeral expenses, indebtedness, and losses during administration from the gross estate. INT. REV. CODE OF 1954 § 2056(c)(2)(a).

[123] TRACHTMAN, ESTATE PLANNING 25-27 (July 1955).

emption will, in many cases, make the transfer tax free. Added to the above two deductions are deductions for:

1. expenses and debts, including administrative charges, lawyers' fees, the executor's commission, decedent's personal debts, mortgages and liens on property,
2. casualty and theft losses during administration,
3. charitable contributions and bequests.[124]

In addition, the gross estate does not include that part of the value of an annuity or other payment receivable by any beneficiary (other than the executor) under an employees' trust forming part of a qualified pension, stock bonus, or profit sharing plan,[125] which is attributable to contributions made by the decedent's employer.[126]

2. *Gifts*

In the case of a large family farming operation, it will be advisable in many instances for the husband and wife to transfer part of the property to intended beneficiaries by gift and thereby reduce or eliminate any estate tax. Gift tax rates are fixed at three-quarters of the estate tax rates. However, gifts may eliminate more than 25% of the potential estate tax. This is because (1) the taxpayer has a specific $30,000 exemption which may be used at any time during his life,[127] and (2) the amount of the gift is taxed at the lowest gift tax rates whereas the donated property is removed from the highest estate tax bracket.[128]

In addition to the specific exemption, the donor may exclude the first $3,000 of a gift of a present interest in property made to any third person.[129] However, the code makes provision for splitting gifts made by a husband or wife with the spouse.[130] Therefore, by splitting the gift a husband could make a gift of $66,000 tax free to a third person. One-half of the gift, or $33,000,

124 INT. REV. CODE OF 1954 §§ 2053(a), 2054, 2055.

125 INT. REV. CODE OF 1954 § 401(a) sets out the requirements for a qualified plan.

126 INT. REV. CODE OF 1954 § 2039(c).

127 INT. REV. CODE OF 1954 § 2521.

128 BOWE, TAX PLANNING FOR ESTATES 29 (rev. ed. 1955).

129 INT. REV. CODE OF 1954 § 2503(b).

130 INT. REV. CODE OF 1954 § 2513(a).

131 INT. REV. CODE OF 1954 § 2523(a).

is considered as being made by the wife. The remaining $33,000 would not be taxed because of the specific $30,000 exemption and the annual exclusion of $3,000. If the specific exemption has been used then of course the maximum tax-free gift to a third person in any one year will be $6,000.

Gifts made to one's spouse are only deductible at one-half their value[131] compared to the full value deduction available if they are included in a decedent's gross estate.[132] Therefore, unless the specific $30,000 exemption is used, a gift of more than $6,000 in any one year to one's spouse will be taxed. The deduction of one-half of the gift would leave $3,000, the amount of the annual exclusion. Gifts which are made within a period of three years prior to the donor's death, unless shown to the contrary, will be deemed to have been made in contemplation of death and be included in the value of his gross estate.[133]

If an employee exercises an election or option whereby an annuity or other payment under a qualified pension, stock bonus, or profit sharing plan will become payable to any beneficiary at or after the employee's death, it will not be considered a transfer for purposes of the gift tax.[134] However, the exclusion from the tax only applies to the proportion of the annuity or other payment which is represented by contributions of the employer.[135] For example, if the value payable to the beneficiary is $24,000 and the employee has paid $20,000 into the plan and the employer has paid $40,000 or two-thirds of the total contributions, the amount of the payments excluded from the tax is therefore two-thirds of the value of the benefits or $16,000.

3. *Valuation of Close Corporation Stock*

Because the stock of closely held corporations normally is not listed on exchanges, problems arise concerning the value of the stock for gift and estate tax purposes. The property which is to

[132] This is true if the amount is not in excess of 50% of the value of the adjusted gross estate. See note 122 *supra*.

[133] INT. REV. CODE OF 1954 § 2035(b); A transfer in contemplation of death is a disposition of property prompted by the thought of death (although it need not be solely so prompted). A transfer is prompted by the thought of death if (1) made with a purpose of avoiding death taxes (2) made as a substitute for a testamentary disposition of the property, or (3) made for any other motive associated with death. Treas. Reg. § 20.2035-1(c) (1959).

[134] INT. REV. CODE OF 1954 § 2517(a).

[135] INT. REV. CODE OF 1954 § 2517(b).

be made the subject of a gift or to be included in the gross estate is taxed on the basis of the value of the property at the time of the decedent's death,[136] the alternate date, which is one year later, [137] or the date of the gift.[138] The Internal Revenue Code provides that value is to be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or similar lines of business which are listed on an exchange.[139] Family farming corporations, of course, are seldom listed on an exchange. Other factors to be considered in determing the fair market value of corporate stock are:

1. The company's net worth,
2. The good will of the business,
3. The economic outlook in the particular industry,
4. The company's position in the industry and its management,
5. The degree of control of the business represented by the block of stock to be valued,
6. The book value of the company's stock,
7. The prospective earning power and dividend-paying capacity.[140]

However, the weight to be accorded such comparisons or any other evidentairy facts considered in the determination of value depends upon the facts of each case.[141] "A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the

[136] INT. REV. CODE OF 1954 § 2031(a).

[137] INT. REV. CODE OF 1954 § 2032(a).

[138] INT. REV. CODE OF 1954 § 2512(a).

[139] INT. REV. CODE OF 1954 § 2031(b).

[140] Treas. Reg. § 25.2512-2(F) (1959), Rev. Rul. 59-60 § 4.01, 1959 INT. REV. BULL. NO. 9 at 8. "Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition." Rev. Rul. 59-60 § 4.02(e), 1959 INT. REV. BULL. NO. 9 at 8. It has been suggested that the above sentence is clearly a step in the right direction because of the need of the closely held company to have a conservative dividend policy in order to obtain outside capital, whereas publicly held corporations can improve their chance of equity financing by having liberal dividend policies. Wood, *New Tax Valuation Rules for Closely Held Stock,* ESTATE DIGEST (June 1959).

[141] Treas. Reg. § 25.2512-2(F) (1959).

process of weighing those facts and determining their aggregate significance."[142]

If there is an agreement providing for purchase of the stock upon the death of a stockholder, by the corporation or by other stockholders, the price fixed under the agreement may be effective to establish the value of the decedent's interest for estate tax purposes, depending upon the nature of the agreement and the relationship of the parties to the agreement.[143] The agreement may be viewed as a tax avoidance scheme unless bona fide and made at arm's length. In order for a buy and sell agreement to be a controlling factor in valuation for estate tax purposes, the following four conditions usually must be met:

1. The agreement must be bona fide and at arm's length.
2. The price must be reasonable considering other yardsticks of value.
3. The purchaser must be in a position to compel the estate to make the sale to him.
4. The sale or transfer of the interest during the owner's lifetime must actually be restricted.[144]

D. Capital Gain and Losses

The Internal Revenue Code gives a special tax treatment which places a 25% ceiling on the excess of all net long-term capital gain[145] over all net short-term capital losses,[146] if a capital

142 Rev. Rul. 59-60 § 3.01, 1959 INT. REV. BULL. NO. 9 at 8.

143 See part III (C) (b) *supra*.

144 See, TAXES AND ESTATES 2, April 1956.

145 The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year. INT. REV. CODE OF 1954 § 1222(7). The term long-term capital gain means gain from the sale or exchange of a capital asset held for more than six months, if and to the extent such gain is taken into account in computing gross income. INT. REV. CODE OF 1954 § 1222(3). The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than six months, if and to the extent that such loss is taken into account in computing taxable income. INT. REV. CODE OF 1954 § 1222(4).

146 The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year. INT. REV. CODE OF 1954 § 1222(6). The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than six months, if and to the extent that such loss taken into account in computing taxable income. INT. REV. CODE OF 1954 § 1222(2). The term "short-term capital gain"

asset or property which is treated as a capital asset has been held for more than six months before the sale. A capital asset includes any property held by the taxpayer (whether or not connection with his trade or business) with certain exceptions.[147] These exceptions for a farming operation are principally property which would be included in a farm inventory[148] and property which is held primarily for sale to customers in the course of business.[149]

Under section 1231 certain property is treated as capital assets and net gains on the included property are treated as capital gains. The included types of property most applicable to farming operations are: (1) Property used in the trade or business on which depreciation is allowable, (2) real property used in the trade or business and not held regularly for sale to customers, (3) unharvested crops sold with land if the land has been held for more than six months, (4) livestock held for draft, breeding or dairy purposes held for 12 months or more, but poultry is specifically excluded.

The owner of an unicorporated farm may have a lower tax rate on capital gains than a farm corporation. A farm corporation would be taxed at a flat 25%[150] whereas an unincorporated farmer pays a tax at his individual income tax rate on an amount equal to one-half the gain[151] or an alternative tax of 25% whichever is less.[152] A fortiori, if a taxpayer is in a tax bracket with

means gain from the sale or exchange of a capital asset held for not more than six months, if and to the extent such gain is taken into account in computing gross income. INT. REV. CODE OF 1954 § 1222(1).

147 INT. REV. CODE OF 1954 § 1221.

148 INT. REV. CODE OF 1954 § 1221(1).

149 *Ibid.*

150 INT. REV. CODE OF 1954 § 1201(a).

151 This is because § 1202 allows a deduction of 50% of the amount of the excess net long-term capital gain over the net short-term capital loss. This deduction is available to the taxpayer who is taxed at his individual rates as provided in § 1201(b).

152 INT. REV. CODE OF 1954 § 1201(b). This computation is arrived at by reducing the taxable income (which already includes a deduction of 50% of the excess of the net long-term capital gain over the net short-term capital loss as provided by § 1202) by an amount equal to 50% of such excess. The taxpayer is therefore taxed at his individual rate on his ordinary income plus an amount equal to 25% of the excess of the net long-term capital gain over the net short-term capital loss.

a rate of less than 50%, his capital gains tax would be lower than that of a corporation.[153]

Losses from sales or exchanges of capital assets are allowed to a corporation up to the extent of gains from such sales or exchanges.[154] However, in the case of the individual taxpayer, the losses are allowed to the extent of the gains from such sales and exchanges plus (1) the taxable income of the taxpayer without regard to gains or losses from sales and exchanges and without regard to available deductions; or (2) $1,000 whichever is less.[155]

Both the individual taxpayer and the corporation may carry the net capital loss of a taxable year forward up to five years until the losses are absorbed.[156] It is apparent that the treatment of capital gains and losses is more favorable for an individual farmer than it would be for a farm corporation.

E. Income Tax Consideration under Section 691

Under Section 691 of the Internal Revenue Code income "in respect of a decedent" is taxed to the person who actually receives it. Generally, the term "income in respect of a decedent" refers to those amounts to which the decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death, or for a previous taxable year under the method of accounting employed by the decedent.[157] The question arises whether crops and livestock on hand at the death of a farmer, who had reported his income on a cash method of accounting would be considered as "income in respect of a decedent."[158] In *Estate of Tom*

[153] Any individual rate less than 50% taken times one-half the excess of the net long-term capital gain over net short-term capital loss will necessarily be less than the flat rate of 25% paid by a corporation.

[154] INT. REV. CODE OF 1954 § 1211(a).

[155] INT. REV. CODE OF 1954 § 1211(b).

[156] INT. REV. CODE OF 1954 § 1212.

[157] Treas. Reg. § 1.691(a)-(1)(b).

[158] Generally, under the cash receipts and disbursements method in the computation of income tax, all items which constitute gross income (whether in the form of cash property or services) are to be included in the taxable year in which they are actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. Treas. Reg. § 1.446-1(c) (1) (1) (1958). Under Treas. Reg. § 1.471-6(a) (1958) it is optional with a farmer whether he uses the inventory method of accounting or the cash receipt and disbursements method. Other types of businesses do not have this option, but must generally use an inventory method. Treas, Reg. § 1.446-1(a) (4) (1) (1958).

L. Burnett v. Commissioner,[159] it was held that the fair market value of livestock and crops unsold at the date of the decedent's death did not represent income accrued up to the date of the decedent's death and was not includible in computing the net income of the decedent for the taxable period in which the date of his death fell. Revenue Ruling 58-436 states that the principles of the *Burnett* case, although decided prior to the enactment of section 691 of the 1954 Code are still applicable and announces that livestock and farm crops which a decedent, who had reported his income on the cash method of accounting, owned at the time of his death, constitute items of property or inventory and not rights to, or items of, income in respect of a decedent.

The failure to tax the income included in this inventory may make the use of the corporate form unattractive for the cash basis farmer.

> When the corporate form is used, the corporation continues in spite of the death of a stockholder and the estate of the deceased consists of only the capital stock, and other securities, of the corporation. No income escapes taxation. Farmers who have accumulated considerable amounts of livestock or crops on the cash basis and who are in ill health or are advanced in years will want to avoid incorporating their farms or adopting the accrual basis.[160]

F. EXCISE TAXES

1. *Federal*

Section 4301 of the Internal Revenue Code imposes a tax on each original issue of shares or certificates of par value stock issued by a corporation of eleven cents on each $100 or fraction thereof of the par or face value of each certificate or share. A similar tax on each $100 of face value or fraction thereof is also imposed on all certificates of indebtedness issued by a corporation.[161]

A sale or transfer of shares or certificates of stock, or of rights to subscribe for or to receive shares or certificates issued by a corporation is taxed five cents on each $100 or fraction thereof of the par or face value of each certificate or share except in the case of a sale at $20 or more per share which is taxed at a rate of

159 2 T.C. 897 (1943).

160 Raymond, M. A. Thesis (unpublished thesis in Love Library, Univ. of of Neb., Lincoln, Neb.) p. 188 (1959).

161 INT. REV. CODE OF 1954 § 4311.

six cents.[162] The rate of tax on a sale or transfer of any certificate of indebtedness is five cents per $100 or fraction thereof of the face value.[163]

2. *State*

In addition to the Federal Excise taxes, the farm corporation will have to pay an annual occupation tax to the Secretary of the State of Nebraska.[164] The amount of this tax is relatively small. For example, if the paid-in capital stock is $100,000 the tax is $50. It is readily seen that these taxes are quite nominal and usually will not be of significance in deciding whether to incorporate.

VI. CONCLUSION

In most situations incorporating the family farm will prove to be advantageous. The farm corporation will have the advantages of doing business in the corporate form and can avoid the burden of double taxation by electing to come within the provisions of Subchapter S of the Internal Revenue Code of 1954.

However, incorporation of the very small operation may be unattractive because of initial fees and taxes. Also, some corporate advantages, such as limited liability, for all practical purposes, may be non-existent. But even small operations, the advantage of having an easy method for transferring ownership through the medium of corporate stock will be desirable in many cases and often may increase family participation in the enterprise. Thus the closely held family agricultural corporation continues to be a family farm.

Richard E. Petrie, '60

[162] INT. REV. CODE OF 1954 § 4321.

[163] INT. REV. CODE OF 1954 § 4331.

[164] NEB. REV. STAT. § 21-303 (Reissue 1954).