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Should You Incorporate Your Farm?

Stephen F. Matthews and Timothy W. Triplett
*Department of Agricultural Economics, College of Agriculture**

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Because of high estate, gift, inheritance, and income taxes and other reasons, many Missouri farmers are interested in forms of business organization that help minimize taxes and maximize the inheritance for their children and other heirs.

Three basic forms of farm business organizations are (1) sole proprietorship, (2) partnership, and (3) corporation.

The sole proprietorship is a one-man operation. Other persons may be employed, but the proprietor runs, owns, and manages his own business.

A partnership is a collection of individual owners. Two or more persons contribute their assets to the business and share the management responsibility, profits, and losses. Each partner pledges his faith in his partners and stands liable for the actions of all partners, within the scope of partnership activities. For further information on farm partnerships, refer to Guides 510, 511, and 512.

The corporation is a third form of farm business organization. This Guide describes major characteristics of the regular corporation. See Guide 506 for information on Subchapter S corporations.

What is a Corporation?

A corporation is a legal entity, usually organized for the purpose of carrying on a business for profit. As such, it has distinct rights and duties. It has power to make contracts, transact business, and hold property in its own name. It has most of the rights and duties possessed by a person. It can sue and be sued. The concept of *legal separateness* is the main characteristic distinguishing a corporation from a partnership or sole proprietorship.

The Corporate Structure

The first step in forming a corporation in Missouri is the filing of *articles of incorporation*. The articles must be signed by one or more persons 18 years old or older who act as the incorporators for the new corporation. These incorporators do not later have to be shareholders, but they usually are. The articles must be filed in duplicate with the Missouri secretary of state and must be accompanied by payment of an incorporation tax and certificate fee.

The articles of incorporation include the corporate name and address, purpose, authorized shares, names and addresses of incorporators, number of people on the board of directors, rights and preferences associated with each class of stock, duration of the corporation (usually perpetual), and the name and address of the registered agent.

If the articles conform to the legal requirements, the secretary of state issues a certificate of incorporation. This certificate signifies the creation of a legally valid corporate business organization.

Each family should consider benefits and drawbacks of incorporating before deciding whether to incorporate the family farm. The following factors should be considered.

Estate Planning

Estate planning is one major reason farm families incorporate. This may be particularly true as a result of recent changes in both federal estate and gift tax laws brought about by the Tax Reform Act of 1976. This act "unified" the estate and gift tax systems by making estate and gift tax rates the same and by making gift transfers interrelated with estate tax calculations. Some objectives in using incorporation as an estate planning tool may be:

- to reserve resources to care for yourself during retirement;
- to transfer and distribute your property and assets to the person(s) of your choice; and
- to minimize expenses of property transfers, including state inheritance and federal estate taxes and expenses of probate court administration.

Retirement income. With proper planning, a corporation can help you meet financial needs during retirement. You may want to keep control over enough assets to assure you of an adequate retirement income.

Employees' retirement plans have become feasible and popular in small corporations. There are individual retirement plans for employees (Individual Retirement Accounts) and self-employed persons (Keogh Plans) who are not covered by a corporate retirement plan. See your accountant, banker, or insurance representative for more information.

If a corporate plan qualifies under Internal Revenue Service (IRS) regulations, the corporation may deduct current payments to the plan. Employees are taxed on the income after retirement only. A farm corporation may have a pension plan that requires a fixed contribution each year or a profit-sharing plan that requires only a share of profits. Any such plan must not discriminate in favor of shareholder-employees.

Transfer of assets. One main reason for estate planning is to transfer property to the person(s) of your choice.

Transferring one or more shares of corporate stock by sale or gift to children is generally easier than transferring one or more acres of land.

*This guide was originally prepared by Clem Koenig, Donald Levi, and Albert Hagan. Their contribution is acknowledged.

In addition, transferring a farming operation to the next generation by shares of stock allows you to retain control of the operation by keeping a majority of the shares. When those who are to receive the farming operation reach the point where they can effectively manage the operation, you can give up control.

Minimizing transfer expenses. Incorporating the family farm can minimize transfer expenses and conserve more of your estate for your survivors. Simplifying such property transfers is the reason most often given by farm owners for incorporating. Of all the costs associated with these transfers, federal estate and gift taxes usually have the greatest impact on large estates.

The federal estate tax is assessed at death and is generally based on the fair market value of assets subject to the tax. Basically, all assets held or controlled by the decedent or in which he or she retained a reversionary or life estate interest are subject to the federal estate tax at death. However, the Tax Reform Act of 1976 provides for a unified transfer tax *credit* of $38,000 for decedents dying in 1979 to cover any estate tax due at death or any gift tax due for taxable gifts made after 1976. This credit will increase to $42,500 in 1980 and finally to $47,000 in 1981 and after. A $47,000 credit will cover a taxable transfer of property worth roughly $175,600.

The estate tax marital deduction remains under the new law, altered only to increase the maximum marital deduction for estates smaller than $500,000. The maximum marital deduction is now $250,000 or one-half of the adjusted gross estate, whichever is greater.

Assets which may be included in your estate at death include:
- property held in sole ownership at death;
- *taxable* gifts you made within three years of your death; (See Guide 503, *Lifetime Gifts,* for more information.)
- life insurance proceeds;
- jointly owned property which automatically passes to surviving co-owners; and
- property transferred to others in which you have retained a life estate.

A more detailed explanation of exempt assets and those subject to federal estate taxes appears in UMC Extension Manual 68, *Estate Planning for Missouri Families*.

All assets subject to the tax will be lumped together, and after certain deductions, the tentative federal estate tax will be calculated. Against this tentative estate tax, you apply the unified transfer tax credit discussed above.

Federal estate taxes can be reduced by making substantial gifts during your lifetime. However, the federal gift tax is designed to make up for the loss of estate tax revenue. The federal gift tax requires the gift giver to pay a gift tax based on the fair market value of the property at the time a taxable gift is made. Even though federal estate and gift tax rates are now the same (after 1976), there are still several tax advantages to making lifetime gifts:
- Every donor may make gifts of up to $3,000 per donee each year without paying gift taxes.
- Spouses may "join in" a gift made by the other spouse. This can double the annual gift tax exclusion from $3,000 to $6,000 per donee.
- Gifts are valued at the time they're made. If appreciating assets are held until death, the value of the asset may have increased, causing an increased tax liability.
- A gift tax marital deduction exists for gifts between spouses. The gift tax marital deduction amount is (a) 100 percent of the first $100,000 of gifts; and (b) none of the next $100,000 of gifts; and (c) 50 percent of the amount of all gifts over $200,000. However, use of the gift tax marital deduction may reduce the maximum federal *estate* tax marital deduction. Your attorney can tell you when this may occur.
- Gifts to charity are exempt from the federal gift tax.

Incorporation may allow a major shareholder (landowner) to transfer $3,000 of shares in the incorporated farming operation each year by gift without paying any gift taxes. These annual gifts of $3,000 of stock would, of course, reduce the value of the estate subject to tax at the shareholder's death.

Other transfer taxes. Your estate may be subject to the Missouri inheritance tax. Normally, all property going through probate court will be subject to this tax. The Missouri inheritance tax rate increases as the value of the assets increases and as the degree of blood relationship of your heirs decreases.

Generally, property subject to the Missouri inheritance tax is:
- property solely owned at death;
- life insurance proceeds of which the estate is the beneficiary;
- your share of property held in tenancy in common (co-ownership without right of survivorship); and
- gifts made in "contemplation of death." For Missouri inheritance tax purposes, any gift made within two years of death is presumed to have been made in contemplation of death.

Income tax basis for heir vs. donee. Those receiving property will have a different income tax basis for inherited assets than for lifetime gifts. The tax basis is essentially the owner's investment in the property. The tax basis for lifetime gifts will be the same as that possessed by the donor at the time the gift was made. In the case of inheritance, the tax basis will be stepped up to the value of the asset included in the gross estate, at least for property of decedents dying before January 1, 1980. After that date, a "fresh start basis" rule will apply unless new legislation delays or changes existing law. See Extension Manual 68 for more information.

An attorney is the only person legally qualified to create an estate plan; advise one of your goals and all other relevant information. An attorney can set up a plan which will help minimize the total transfer costs of your estate, including federal estate, federal gift, and Missouri inheritance taxes.

Corporate Income Tax Treatment

For federal income tax purposes, the farm corporation may be taxed in either of two ways—as a "regular" corporation under Subchapter C of the Internal Revenue Code or as a Subchapter S corporation.

Subchapter C (regular). Amounts paid by the corporation as salaries, wages, rents, and interest are deductible by the corporation as expenses when figuring taxable income. Under the 1978 Revenue Act, the regular corporation pays tax at these rates:

Rate	*Taxable Corporate Income*
17%	0 - $25,000
20%	$25,000 to $50,000
30%	$50,000 to $75,000
40%	$75,000 to $100,000
46%	more than $100,000

The corporate capital gains tax rate is 28 percent under the 1978 revisions.

Corporate income distributed as dividends may be taxed twice. First, the corporation must pay income tax on its earnings. Second, the shareholders have to pay income tax on corporate earnings distributed to them as dividends. Amounts paid to shareholders as dividends are not deductible by the corporation as operating expense. However, if all "profits" are paid out as salaries, rents, interest, or wages, the corporation will have no taxable income for income tax purposes.

Farmers' main objections to the corporation have been (a) double taxation of corporate income distributed as dividends, (b) less favorable treatment of long-term capital gains, and (c) no flow through of operating losses of the corporation to the shareholder.

Subchapter S. A corporation meeting the requirements of Subchapter S of the Internal Revenue Code may elect to be taxed in a manner similar to a partnership. Those requirements are discussed in detail in UMC Guide 506, *Subchapter S Corporations*.

Continuity of Management and Ownership

Missouri law permits perpetual existence of a corporation. A corporation exists as long as the shareholders desire, if it continues to meet requirements of the law.

A major reason for requiring a decedent's estate to go through probate is to keep the title to his assets clear. The complexity of probate is greater when land, machinery, livestock, and other items must pass through probate court. Thus, the process is simplified when only corporate stock is subject to probate.

The fact that specific assets are not required to go through probate permits those making farm management decisions to do so without the legal constraints of probate. Therefore, the corporate form of business may have greater continuity of management and less possibility of a temporary reduction in current income.

The loss of an important shareholder and the entry of a new shareholder may have serious consequences in the absence of adequate planning. But the continuing nature of the corporation offers a method of maintaining the farm business as a going concern and avoiding the problems of business interruptions that result from the death of a sole proprietor or partner. The continuity also helps managers make long-range plans and keep pace with technical advances in agriculture.

Continuity of existence may present a danger for the minority shareholder. Unlike a partner or a joint tenant or tenant in common, the minority shareholder is unable to quit or partition and take his share of the assets of the enterprise. If there is no ready market for his stock, he can be "locked in" the corporation subject to the rule of the majority. Also, as a general rule, he has no power to force directors to pay dividends on his common stock.

A binding buy-sell agreement can require or permit the purchase of stock by the corporation or the remaining shareholders if one shareholder dies or wishes to sell his stock.

Limited Liability

An important feature of the corporation is the limited liability of the shareholders for acts or obligations of the corporation. This is because the corporation is a separate legal entity which exists apart from its shareholder-owners.

A shareholder's assets invested in the corporation are placed at the full risk of the business. If a shareholder is required to sign personally for corporate obligations, he extends his personal credit and will be liable if the corporation fails to perform. Lenders may demand a shareholder's guarantee. If so, part of the advantage of limited liability is forgone by the one who signs personally.

An employee, officer, or director may be personally liable for his negligent actions even though the corporation is also liable. In this way, a shareholder could be held liable, not as a shareholder-owner, but in his other capacity as an employee, officer, or director.

Your attorney has further details on liability limitations.

Credit

Adequate financing is essential to the success of any farming operation. Thus, find out whether corporate credit is available before incorporating.

One would think incorporating a business would increase its attractiveness to lending agencies because a corporation is of greater permanence than other forms of business organization. However, a contrary view is often taken of small business corporations, simply because the management of the corporation is usually of greater concern to lenders than is perpetual life. Thus, small farm corporations with only one shareholder or with no plans for continuity of competent management may not provide lenders with the security they desire.

Lending institutions often place restrictions on loans to farm corporations. The Federal Land Bank and the Production Credit Associations may require principal shareholders to personally sign corporate notes. In addition, a corporation must meet *at least one* of the following requirements to be eligible to borrow:

- More than 50 percent of the value or number of shares of its outstanding voting stock or equity is owned by the individuals conducting the farming or livestock operation;
- More than 50 percent of the value of its assets consists of assets related to the production of agricultural products; or
- More than 50 percent of its income originates from production of agricultural products.

Farmers Home Administration loans are not available to farm corporations, except for some emergency loans. Small Business Administration loans also are not available to farm corporations unless the corporation conducts non-farm business accounting for more than 50 percent of corporate income.

Ability to obtain credit from a bank is usually not affected by incorporation, because such loans are primarily based on business risks. The principal shareholder is almost always required to co-sign, thereby making him personally liable if the note is not paid.

A disadvantage of incorporating: Corporate borrowers generally are not subject to the state usury law. Rather, lenders may charge higher interest rates than they can legally charge individuals. However, this may be an advantage if credit is otherwise unavailable.

Records and Reports

Doing business as a corporation forces one to keep better records. The formation of the corporation requires a listing of all assets to be transferred to the corporation, the value of each, and other data that establish the beginning assets and liabilities.

A corporation files a federal and state income tax return and has property tax liability just like any person. A corporation is required to file an antitrust affidavit and a farm corporation form with the director of agriculture and an annual report with the secretary of state.

Most farmers who incorporate do not find the reporting or book systems any more troublesome than the well run partnership or sole proprietorship. The fact that doing business as a corporation requires one to keep better records may be an advantage. Credit eligibility may be increased by a good record system.

Costs

A corporation has certain costs not required for other types of business organization. The cost of incorporating varies with the circumstances. An attorney must be employed to prepare and file the articles of incorporation, to draw up the

bylaws, and generally to oversee the transfer of property in exchange for corporate shares. The costs will vary but usually run from $300 to $800 for an uncomplicated incorporation.

After the corporation is formed, other costs include franchise taxes, antitrust affidavits, and possibly others. These costs are relatively low and should not be a major factor in weighing the decision to incorporate.

Being an Employee

A sole proprietor or partner cannot be an employee of himself or his partnership; but, since a corporation is an "artificial person," it can do business only through its employees. A sole proprietor may want to consider several factors before incorporating because his status changes from employer to employee. These factors include: the cost of paying the social security tax as an employer and an employee; the ability to take advantage of tax-deferral qualified pension plans that are available only if you are an employee; the availability of group life insurance plans and the income tax deductions from an employer's earnings for the cost of such plans; and possible tax-free benefits to surviving spouses of employees.

For 1979, a regular corporation must pay social security taxes of 6.13 percent on wages of shareholder-employees up to a *wage base* of $22,900. Employees must also pay this 6.13 percent rate on wages up to $22,900. By contrast, a self-employed person currently would pay social security at the rate of 8.1 percent on wages up to $22,900.

Thus, the combined employer and employee tax is higher than an individual's self-employement tax. If you are the sole or majority shareholder of a corporation and an employee of that same corporation, this means you would pay an effective social security rate of 12.26 percent in 1979. The social security paid by the corporation is, however, deductible by the corporation when figuring taxable income.

The wage base and the tax rate for self-employed persons and for employers and employees is due to increase each year for the next several years. Before incorporation, check the current social security tax rates and wage base.

Formality of Organization and Operation

State corporation statutes set forth the general requirements for incorporating a business. The successive steps to be taken in the formation of a business corporation within the state are:

Pre-incorporation agreement. This document should outline the major rights and duties of each party once the corporation has come into legal existence.

Subscription agreement. Although this may be a part of the pre-incorporation agreement, it may be a separate document. In this agreement, each party legally binds every other party to accept a given number of shares at a given price once the corporation comes into existence. Since the beginning success of the corporation depends somewhat on each subscriber accepting his shares to insure adequate operating capital, a subscription agreement becomes a practical necessity in the process of incorporating.

Articles of Incorporation. These are filed with the corporation department of the secretary of state's office. Once that department determines the articles meet all legal requirements, the secretary of state issues a certificate of incorporation, which is evidence of the legal existence of the corporation. A minimum original incorporation tax of $50 (based on $30,000 or less authorized capital stock) and a $3 certificate of incorporation fee must be paid before the secretary of state will approve articles of incorporation. Missouri no longer has a minimum corporate capitalization requirement.

Meeting of shareholders. The execution of the property exchanges called for in the subscription agreement should occur at or shortly after the first meeting of the shareholders. This meeting is organizational, and at this time the board of directors is elected. In a small, closely held farm corporation, the directors elected to manage the corporation's affairs are usually the principal shareholders.

Bylaws of the corporation. Another major item of business at the first meeting of the shareholders should be adoption of bylaws. These set out the basic rules, which, in addition to state law, will govern the internal conduct of the corporation. They may provide for such things as the time and place for the annual shareholders' meetings, the quorum requirements at both the shareholders' and directors' meetings, the delineation of the corporate offices and the duties of each officeholder, and the selection of a fiscal year.

First board of directors' meeting. The major business items for the first meeting are the election of corporate officers and the sale of corporation stock. A corporation must have at least two officers, a president and a secretary, who must not be the same person. In the family farm corporation, the directors, officers, and shareholders are usually the same persons. This first meeting will usually mark the initiation of doing business in the corporate name.

Summary

Should you incorporate your farm? There is no general single answer to the question. The advantages of incorporating the farm business depend, to a great extent, on the size and nature of your farm business unit and on your objectives. An advantage of incorporation to one farmer may be a disadvantage to another.

Consider the following questions before making a decision to incorporate:

(1) Would your estate be subject to the highest of the "death taxes, " federal estate tax, if you should die tomorrow?

(2) If you estate is subject to estate taxes, can you easily transfer assets under your present organization and, if you want, make gifts to the person(s) of your choice?

(3) Would limited liability be an advantage to you?

(4) Will your farm be maintained as a going concern at your death?

(5) Would you like retirement and medical benefits to be farm business expenses?

(6) Are you in a high enough income tax bracket that Subchapter C could save you tax dollars?

(7) Are you willing to give up "some" control of management?

(8) Would the efficiency of your farm unit be increased by keeping better records?

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