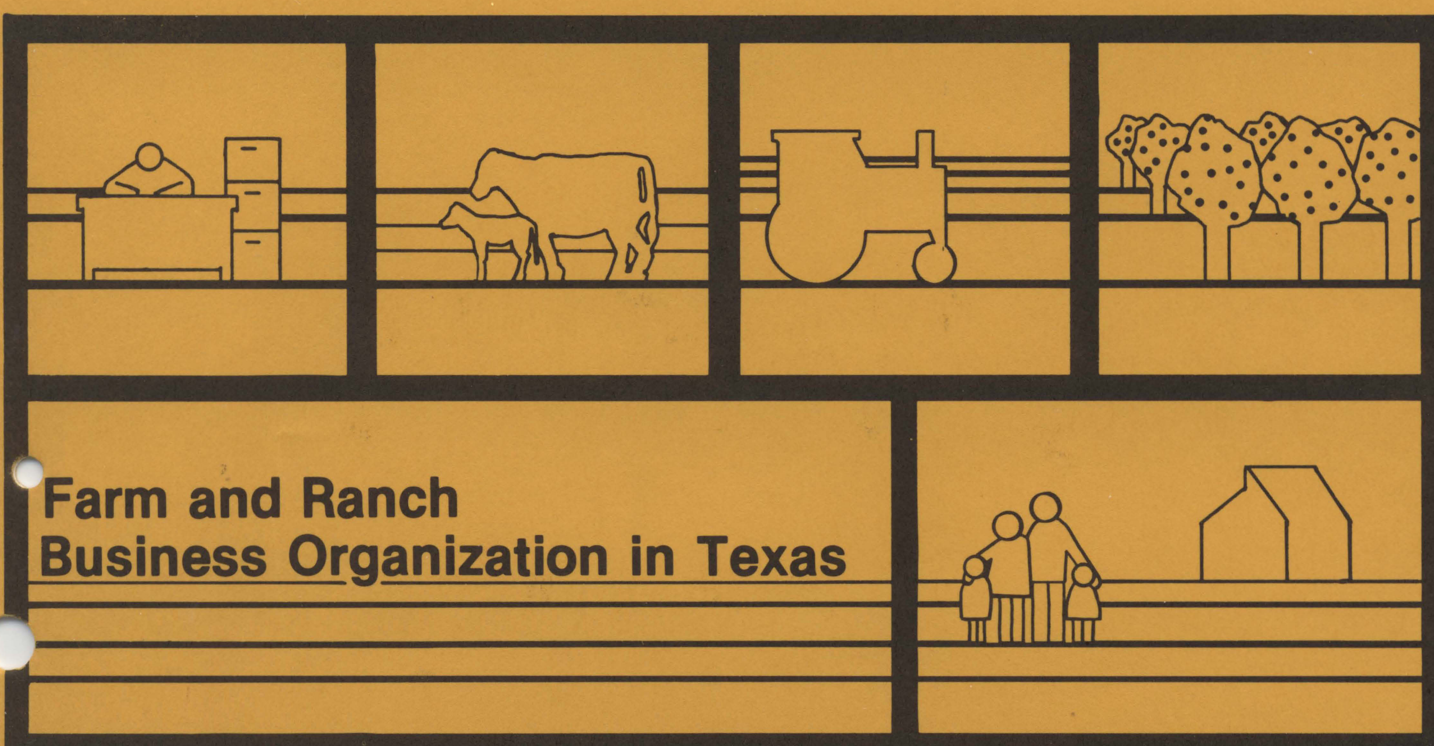
The Texas A&M
University System

Texas
Agricultural
Extension
Service

Director
Daniel C. Pfannstiel
College Station, Texas 77843

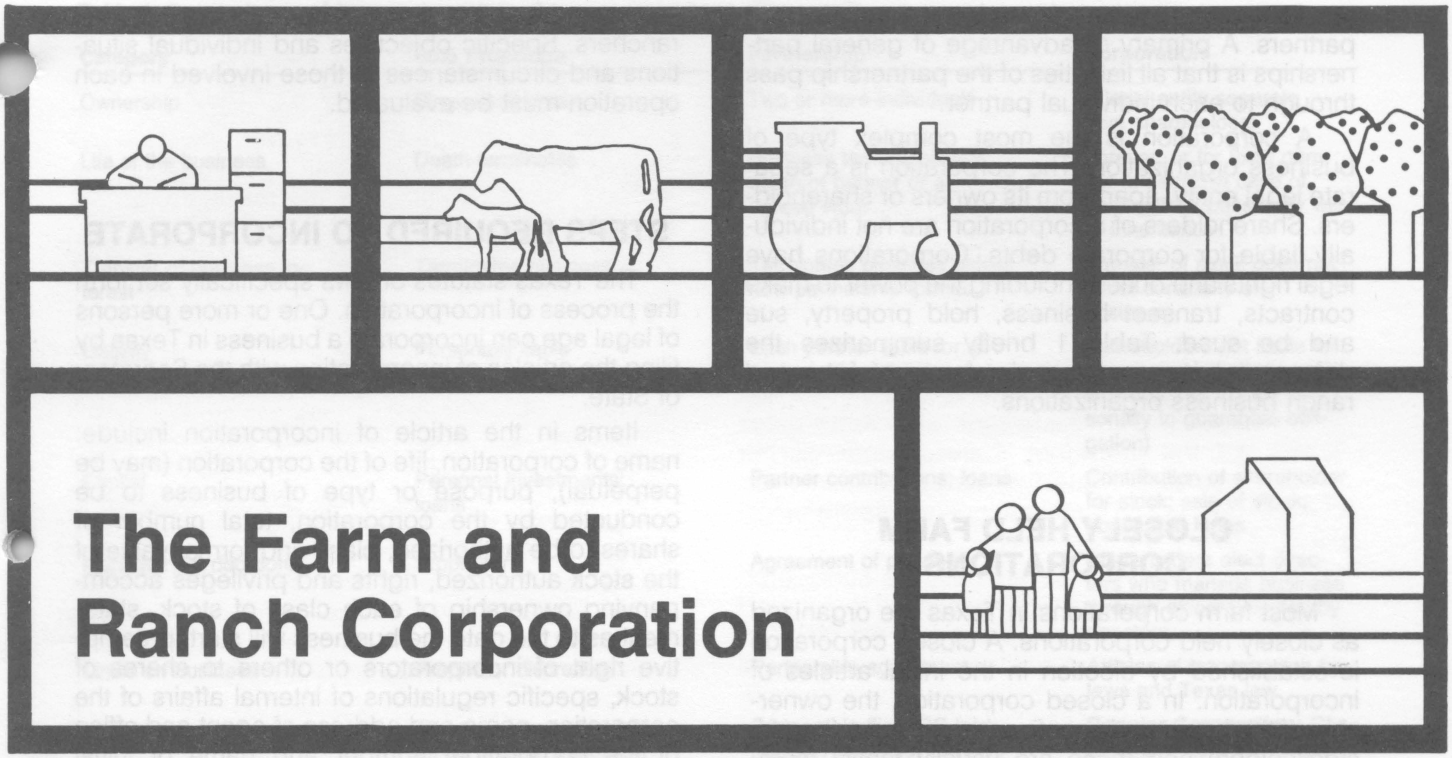
B–1302

The Farm and Ranch Corporation



Farm and Ranch Business Organization in Texas

CONTENTS



The Farm and Ranch Corporation

Norman Brints and Marvin Sartin*

As the family farm or ranch grows in size and complexity, many farm operators are examining the possibility of incorporating the business. Important aspects of a family farm corporation will be discussed in this publication so that operators will be more knowledgeable when seeking advice from an attorney, CPA, accountant, etc., concerning corporations. It is very important that anyone interested in forming a farm corporation seek competent professional advice. The organization of a corporation creates a new entity, separate and apart from the individual incorporators. To meet the requirements of operating within the corporate structure, a farmer must learn to plan ahead, rely on and use the counsel and advice provided by knowledgeable professional advisors. Proper maintenance of corporate formalities may be considered a disadvantage by some individuals. It should be viewed by the individual manager much the same as the adjustment of a complicated piece of machinery. Changes in methods of operating the business, some personal inconveniences and additional costs should be weighed against potential benefits of the alternative business structure. Immediate and long term savings in the area of income tax minimization, improved estate planning and increased efficiency in farm operation must be considered.

ALTERNATIVE FORMS OF BUSINESS ORGANIZATION

In Texas, the three most commonly used forms of business organization are sole proprietorship, partnership and corporation. The sole proprietorship and partnership are generally less complicated than a corporation and often are very informal in nature. The sole proprietorship provides the individual with the most flexibility in that he is responsible for all the management decisions of the business as well as paying the income taxes on the business income.

A partnership is more complex in that the partnership itself is not a taxpayer, although it is a tax entity. The partnership is responsible for the preparation of records of income and expense, but

*Area Extension economist—management and area Extension economist—management and C.P.A., The Texas A&M University System.

tax liability is passed through to the individual partners. A primary disadvantage of general partnerships is that all liabilities of the partnership pass through to each individual partner.

A corporation is the most complex type of business organization. The corporation is a separate legal entity, apart from its owners or shareholders. Shareholders of a corporation are not individually liable for corporate debts. Corporations have legal rights and duties, including the power to make contracts, transact business, hold property, sue and be sued. Table 1 briefly summarizes the difference between the major forms of farm and ranch business organizations.

CLOSELY HELD FARM CORPORATIONS

Most farm corporations in Texas are organized as closely held corporations. A closed corporation is established by election in the initial articles of incorporation. In a closed corporation, the ownership of the business is confined to not more than 35 stockholders and these are usually family members. The stock is not available for purchase by the public and stock transfer usually is restricted by the articles of incorporation. Therefore, the articles of incorporation usually specify that a stockholder cannot sell stock outside of the family. The shareholders serve as the board of directors and also serve as officers of the corporation.

In contrast with closely held corporations, publicly owned corporations may have thousands of stockholders or owners in all parts of the country. The stockholders are free to sell their shares of the corporation to anyone in and outside of the corporation.

Business affairs of the closed corporation are managed by a board of directors consisting of one or more members. The number of directors is elected in the manner provided in the articles of incorporation or the bylaws.

REASONS FOR INCORPORATION

Farmers and ranchers incorporate for several reasons, but the four most important ones are estate planning, income tax minimization, limiting liability and financial management. Historically in Texas, the corporate business structure has been chosen to meet estate planning objectives. Only in recent years have farmers and ranchers looked to the corporate organization as a vehicle to accomplish other objectives. Incorporating the family farm may not be advantageous for all farmers and ranchers. Specific objectives and individual situations and circumstances of those involved in each operation must be evaluated.

STEPS REQUIRED TO INCORPORATE

The Texas statutes of laws specifically set forth the process of incorporation. One or more persons of legal age can incorporate a business in Texas by filing the articles of incorporation with the Secretary of State.

Items in the article of incorporation include: name of corporation, life of the corporation (may be perpetual), purpose or type of business to be conducted by the corporation, total number of shares to be authorized, class and formal value of the stock authorized, rights and privileges accompanying ownership of each class of stock, statement as to the date the business will start, preemptive right of incorporators or others to shares of stock, specific regulations of internal affairs of the corporation, name and address of agent and office of the corporation, number and name of initial directors and name and address of each incorporator.

After the articles of incorporation have been received by the Secretary of State and the required filing fees are paid, a certificate of incorporation will be issued. A certificate of incorporation indicates the creation of a corporation.

Filing fees are determined by the State Legislature and are listed in the Texas Business Corporation Act. The filing fee for the initial article of incorporation is $100, and the fee for reserving a corporation name is $10. Fees for cancellation or withdrawal of shares, reduction of capital and amendments range from $10 to $100.

After the corporation has received for the issuance of its shares a minimum of $1,000 in money, labor or property, it can begin doing business in Texas. An organizational meeting must be called by the initial board of directors with at least 3 days' notice to the incorporators. This organizational meeting is for the purpose of adopting the bylaws, electing officers of the corporation and conducting other business that may be appropriate.

Transfer of Assets

After the decision to incorporate has been made, the question remains as to which assets and liabilities should be transferred from the individual to the corporation. It usually is desirable that the transfer of an asset into the corporation in exchange for corporate stock or securities occurs without creating an income tax liability. This tax-free

Table 1. Comparisons of farm and ranch business organizations

Category	Sole Proprietor	Partnership	Corporation
Ownership	Single individual	Two or more individuals	A legal entity separate from shareholders
Life of the business	Death terminates	Business terminates with death of partner or at agreed time.	Forever, or for fixed number of years; in case of death, stock passes by will or inheritance
Transfer of business interest	Terminates business	Terminates business unless new partnership formed	Transfer of stock does not affect continuity of business
Liability	Personally liable	Each partner liable for all partnership obligations	Shareholders not liable for corporate obligations (unless required to sign personally to guarantee obligation)
Capital	Personal investments; loans	Partner contributions; loans	Contribution of shareholder for stock; sale of stock, bonds and loans
Management decisions	Proprietor	Agreement of partners	Shareholders elect directors who manage business through officers elected by directors
Limits on business	Proprietor discretion	Partnership agreement	Articles of incorporation bylaws and Texas law
Income taxes	Tax on income of individual; 60 percent deduction for long-term capital gain	Partnership files IRS Information Report but pays no tax; each partner reports his or her share of partnership income or loss, capital gains, etc.	**Regular Corporation:** Corporations file a tax return and pay tax on income; salaries to shareholders and employees deductible (See Table 2 for tax rate.); capital gains offset by capital losses and no 60 percent deduction on capital gains; shareholders taxed on dividends received **Tax-Option Corporation:** "Subchapter S" Corporation files IRS information report but pays no tax. Each shareholder reports shared income, operating loss and long-term capital gain
Effect of death	Liquidation	Liquidation or sale to surviving partners	No effect on corporation; stock passes by will or inheritance

transfer is accomplished by the use of the provisions on IRS Code Section 351. For example, land purchased several years ago at a cost of $50,000 may have a fair market value of $100,000 when transferred to the corporation. If only stock or securities in the corporation is received (no "boot") in exchange for the land, no income tax liability is generated. The basis for the stock obtained would be $50,000 — the same as the cost of the land being transferred.

Table 2 illustrates the transfer of assets under varying situations. Note that the quantity of stock issued to each shareholder depends only on that person's net contribution (fair market value minus indebtedness). Tax basis does not limit the amount of stock issued for property transferred to the corporation.

There are several rules that must be followed to insure that a tax-free transfer under Section 351 is achieved. Briefly, the section requires that:

- One or more persons must transfer property to the corporation.
- Stock issued must be for property and not for services.
- The person(s) who transfers property into a corporation must be "in control" of the corporation immediately after the exchange. Control from this standpoint means ownership of at least 80 percent of the total of all classes of stock.

The transfer of liabilities along with assets, or the transfer of assets subject to liabilities, can trigger recognition of gain. Transfer of liabilities in excess of the cost basis in the assets will create a tax liability for the individual. Careful study of the factors required for qualification as a tax-free exchange is a must for anyone contemplating incorporating the family operation.

A number of other factors must be considered when deciding which assets should be transferred to the corporation. In many situations, the decision of which assets to transfer to the corporation will represent a compromise between income tax consequences and estate planning objectives. See the Estate Planning and Income Tax sections of this publication.

Capitalization of Corporation

The capitalization of the corporation is an important consideration. In exchange for property transferred to the corporation, a shareholder(s) can receive common stock, preferred stock, a combination of common and preferred stock, or a combination of stock and securities (debt).

Ownership in a corporation is evidenced by a stock certificate. The most usual class of stock is common stock, but in many cases preferred stock can be issued to advantage. The differences between common stock and preferred stock relate to priority in the distribution of dividends and in the sharing of the assets of the corporation upon liquidation. A brief description of some of the characteristics of these classifications of stock follows.

Common stock usually is issued with voting rights so that ownership of the common stock controls the corporation. However, there is no requirement that voting rights be vested in the common stock. Common is the residual claimant upon the assets of the corporation in liquidation. Growth in net worth of the business, therefore, vests in the common stock.

Preferred stock, as the name implies, has preference over common stock in the distribution of dividends and in the recovery of a fixed amount in the event of liquidation. Preferred stock may be cumulative or noncumulative with regard to dividend payment. If the stock is cumulative, any dividends that are not paid annually to the extent of the preferred stock's stated yield accumulate in arrears. These amounts must be paid before dividends can be paid to common stockholders. Since dividends usually are a minor concern for closely held corporations, the ability to vest voting rights in preferred stock, which has a fixed value, is one approach to limiting the growth of an estate while maintaining control of the corporation.

Reasons that a family corporation may consider taking some debt include:

- Smaller amount of investment is needed to acquire control of the corporation. The ratio of debt to equity will need to be considered to avoid being classified as a "thin" corporation.
- Provides parents a fixed retirement income.
- For off-farm heirs, after the death of parents, debt securities may provide a greater assurance of income and less right to participate in the management of the corporation.
- For on-farm heirs, as the corporate net worth increases, the value of the stock should increase, thereby providing motivation or incentive.

Table 2. Tax free Incorporation (Section 351 Exchange)

Property Contributed	Tax Basis	Fair Market Value	Indebtedness	Net Contribution (column 3 – column 4)	Shares of Stock ($100 Per Share)	Tax Basis of Stock Received	Corporation's Basis for Property Received[1]	Corporation's Indebtedness Assumed[2]
Land	$ 50,000	$100,000	$ -0-	$100,000	1,000	$ 50,000	$ 50,000	-0-
Land	150,000	200,000	30,000	170,000	1,700	120,000	150,000	$30,000
Machinery	40,000	80,000	10,000	70,000	700	30,000	40,000	10,000
Livestock	8,000	10,000	-0-	10,000	100	8,000	8,000	-0-
Cash	10,000	10,000	-0-	10,000	100	10,000	10,000	-0-

[1]Same as tax basis in column 2

[2]Same as indebtedness in column 4

Care must be taken to insure that the debt security in the corporate capitalization structure will be treated as a debt capital. An important factor to be considered is the ratio of debt to equity capital. If the corporation is undercapitalized, repayment of the loans may be treated as a distribution of dividends to the extent of the corporation's earnings and profits. Also, there must be a reasonable expectation that the debt will be repaid, regardless of business income or losses. There should be a written instrument setting forth the specific date certain sums of money are due, the payment period of the loan and the amount of interest applicable. These only highlight some considerations of the use of debt in capitalization of the corporation. The use of this tool lends flexibility in the planning process of a corporation and should be considered. However, competent assistance should be obtained from advisors before final decisions are made.

ESTATE PLANNING CONSIDERATIONS

The objective of estate planning usually is a compromise between minimization of federal estate tax liability, transfer of property to designated heirs and maintenance of lifetime financial security. The corporate business structure contains several features that may enable a taxpayer to better meet the objectives of his estate plan.

In addition to stock, the original shareholders may receive bonds, debentures, notes or other obligations issued by the corporations. Holders of such debt obligations are creditors of the corporation and not owners. Therefore, a family wishing to establish a farm corporation can use a combination of stock and debt for capitalization of the corporation. The holders of the debt security, whether or not they are shareholders, are eligible to receive payments of interest and repayment of principal. Interest paid on any bonafide debt is a deductible expense to the corporation and will not be considered a dividend, provided specific rules are met. The repayment of the principal of a loan is not taxable income to the family member making the loan.

An objective of most closely held corporations is to minimize the payment of dividends. Dividends create double taxation of income because the corporation is taxed on its earnings before dividends are paid and then the shareholders are taxed on dividend income.

By structuring the capitalization of the corporation to include debt to the shareholder(s), additional opportunities to provide a cash flow from the corporation to the family member without double taxation exist. Interest payments and repayment of principal to the shareholders during retirement would not reduce their Social Security benefits.

The main differences between the debt and equity are shown in Table 3.

Table 3. Comparison of debt and equity capitalization.

Characteristic	Equity	Debt
Participation in management decisions	Voting	None
Right to annual income	At the direction of the board	Fixed obligation
Terms of commitment	Indefinite	Fixed term
Right to assets on liquidation	No priority	Priority

Gifts of Stock

Most farm or ranch estates consist largely of fixed assets such as land, livestock and machinery. Even though a farmer may have paid very little income tax throughout his lifetime, the value of his estate may be substantial. Since the estate is composed of fixed productive assets that are intended to pass to the next generation, there often are few liquid assets that are easily transferable during life to reduce the estate or to pay federal estate taxes after death. If the business is incorporated, the individual assets consist of shares of stock that can be readily transferred during life.

Through the ready transferability of stock certificates, small portions of a corporation can be given annually to stay within the $3,000 annual gift exclusion. This enables a taxpayer to reduce the size of his estate by transferring shares to children or other designated heirs prior to death. At the same time, the taxpayer may still have control of the family farm corporation if he owns more than 50 percent of the voting stock.

The benefit of making gifts prior to death can result in the transfer of an asset at a lower value than it would be valued at the time of death. For example, under the tax reform act of 1976, all gifts prior to death are added back to the estate to determine the estate tax liability. However, if the donor dies at least 3 years following the gifts, the gifts are brought back into the estate at their value at the time of gift rather than at the time of death. This can make a substantial difference, especially for assets such as land that are expected to increase in value rapidly.

Through the use of different types of stock, other objectives of the taxpayer may be met. For example, voting stock may be given to children who want to remain on the farm so that they receive income from the farm and are actively involved in management decisions. On the other hand, children who have no interest in farming can receive income rights through nonvoting stock without having managerial input.

Continuity of Operation

Because a corporation is an entity separate from the shareholders, this form of business provides for continuation of the operation of the farm as a unit after an individual's death. In some situations, this is desirable from the standpoint of long range management decisions as well as for obtaining financial assistance for the operation and expansion of the business.

Estate Tax Implication

Code Section 303 provides a vehicle for taking cash out of a corporation for payment of death taxes and certain administrative expenses without the stock redemption being treated as a dividend. To qualify, the corporation stock must represent more than 50 percent of the decedent's gross estate, reduced by allowable funeral and administrative expenses. In some cases, the corporation may actually provide insurance on the shareholder to compensate for the value of the stock that would be redeemed to pay the estate tax following death.

The corporate structure does not prevent the executor of an estate from using the Code Section 2032A, which is the alternate use value of farmland. This section of the code provides for the value of farmland at death to be based on its agricultural use rather than fair market value, thereby reducing the value of the estate. In some situations, this can be of major benefit if the family members plan to continue to participate in the farm business.

The executor also can use the extended pay out period for federal estate tax to lessen the initial tax burden upon the estate. The use of the extended pay out options requires careful planning to maintain eligibility for their use.

INCOME TAX CONSIDERATIONS

Interest in farm corporations has grown since 1978 because of changes in the income tax rate structure. Potential advantages of the splitting of income between two tax entities (corporation and the individual) were enhanced by the corporate tax rate changes in the Revenue Acts of 1975 through 1978. Since 1978, the first $100,000 of corporate taxable income is taxed at rates less than 46 percent. As shown in Table 4, the first $25,000 corporate taxable income is taxed at a rate of 17 percent, with the tax rate increasing for each $25,000 increment of income until taxable income exceeding $100,000 is taxed at 46 percent. The average tax rate on the first $100,000 of corporate taxable income is 26¾ percent. In many cases, splitting the income between the corporation and the individual will result in significant income tax savings. This is accomplished by paying a portion of the business income as salaries, wages, rent or interest to the major shareholders. These amounts are deductible by the corporation and create taxable income for the individual. The corporation can retain a portion of the profits, taxed at the corporate rates, to be used in the business. Thus, the combined tax rate is smaller because of the "splitting of income."

If an individual proprietor or partner consistently has a minimum taxable income of $30,000 or more, incorporating may be a viable alternative to reduce the amount of income tax.

Table 4. Corporate tax rate structure.

Taxable Income	Prior to 1975	1975 - 1978	1979 and After
First 25,000	22%	20%	17%
25,000 - 50,000	46%	22%	20%
50,000 - 75,000	46%	48%	30%
75,000 - 100,000	46%	48%	40%
100,000 +	46%	48%	46%

Dividends

Care must be taken in the distribution of cash or property out of the corporation to insure that the income is not taxed twice. Income distributed by the corporation as a dividend is taxed to the individual as a dividend, but is not deductible to the corporation before corporate income tax is calculated. Therefore, it is advantageous for most family-held corporations to keep dividends to a minimum. As long as payments made to the shareholders by the corporation for salaries, wages, rent and interest remain reasonable, they will not be construed as dividends. The double tax on dividend income to shareholders is offset only to the extent of the $100 dividend exclusion per individual taxpayer.

Careful planning can reduce tax problems associated with distributions. To illustrate, consider the following two alternate corporate structures and transfer of income from the corporation to the shareholder.

First, suppose the farm business owners transfer $400,000 in cash and property to the corporation solely in exchange for stock. If they later wish to permanently remove money from the corporation for their personal use, dividend treatment would likely result to the extent of earnings and profits of the corporation.

On the other hand, suppose the farm business operators transfer $400,000 worth of property in exchange for $200,000 of stock and $200,000 of securities (debt instrument) from the corporation. If the shareholders later want to remove money from the corporation, payment of the debt constitutes a nontaxable return of capital to the extent of a given shareholder's basis in the loan. Interest payments received on the notes are taxable income to the shareholder, but the corporation can deduct interest expense.

In summary, income tax savings result from the division of taxable income between the corporation and the individual and the avoidance of the double taxation on corporate profit. This requires careful planning and the combined use of:

- Fair salaries paid to shareholders who are also employees.
- A reasonable lease payment made to the owners of equipment, or real estate leased to the corporation.
- Interest payments made on qualifying debentures or loans.

Constructive Dividends

In a closed corporation, shareholders may view the corporation as an extension of themselves. Because corporate income is taxed to the corporation as earned and again to the shareholders when received as dividends, there is strong incentive for providing the shareholders with economic benefits that are not characterized as dividends. A simple example of a constructive dividend would involve a corporation which pays its sole shareholder a salary of $90,000 for services worth only $10,000. The extra $80,000 is not taxed at the corporate level, leaving the shareholder-employer with substantially more funds at his disposal than if the corporation had paid tax on the $80,000 and distributed the remainder as a dividend.

In the example above, the $80,000 excess salary would be classified as a constructive distribution and be subject to the general IRS Code provisions on corporate distributions. Special scrutiny is given to compensation paid by closely held corporations to their shareholders.

A corporation may not deduct unreasonable compensation paid to an employee, yet it is ordinarily includable in the employee's gross income. If such compensation bears a close relationship to the employee's stockholdings, it may be treated as a dividend. Factors indicating such a close relationship include compensation being closely proportionate to shareholdings, compensation set to leave no profit, and no history of dividend payments.

In a sales transaction between a corporation and a shareholder, the corporation may attempt to make a distribution by consumating the transaction for consideration not equal to the fair market value of the property involved. For example, if a shareholder sells an asset with fair market value of $10,000 to his corporation for $20,000, the shareholder would like the additional $10,000 to qualify as capital gain or loss. Because the corporation and the shareholder are related parties, the payment in excess of the fair value of the asset is a dividend to the extent of corporate earnings and profits.

Employee Benefits

Shareholders of a corporation can be employees of their corporation and be eligible for employee benefits. Qualified employee retirement plans are feasible in many small corporations and are deductible expenses to the corporation. The employees are taxed on the income only at retirement. Such plans must not discriminate in favor of shareholder-employees against other employees.

Retirement plans are usually one of three types. A "pension" plan that requires a fixed contribution each year, a "profit sharing plan" that requires only a share of profits, if any, to be set aside in the retirement fund or an employee stock ownership plan ("ESOP'S") or a plan designed to invest primarily in qualifying employer securities.

Additional benefits for employees may include tax-free medical benefits from the corporation under a reimbursement plan or a plan for payment of medical insurance premiums. Under certain circumstances for the convenience of the employer, the employee may receive tax-free meals or lodging. Upon the death of a corporate employee, his or her estate or beneficiaries can be paid death benefits up to $5,000, free from income tax.

The corporation also may provide group term life insurance plans for its employees. To be deductible under IRS rules, these plans must meet specified requirements that relate insurance coverage to compensation so that discrimination does not exist in favor of highly paid employees.

Problem Areas

Care must be given at time of incorporation to insure that taxable income is not created by a transfer of assets into the corporation. Most of the income tax consequences of transferring assets under Code Section 351 were discussed earlier. However, a situation that can occur in agriculture involves the transfer of property subject to indebtedness in excess of its cost basis. For example, assume that the cost basis in land is $15,000, and it has a current mortgage against it of $25,000. A

$10,000 taxable gain will be recognized if the land and the mortgage are transferred to a corporation. If the debt can be retained by the individual in this situation, no tax liability will be incurred.

When growing crops are transferred into the corporation, care must be taken to prevent distortion of income. When a farm has growing crops that are transferred to the corporation after most of the operating expenses have been incurred, the IRS may allocate income and deductions between the corporation and the individual transferring the crop to prevent major distortion of income. The IRS may disallow crop expenses to the individual and assign them to the corporation or may allocate the income from the sale of the growing crop back to the individual.

Some caution should be used when transferring assets that qualified for investment credit in the hands of the individual to the corporation. When incorporating an ongoing business, substantially all of the assets of the existing business must be transferred to the corporation or recapture of investment credit could be initiated. Careful planning at least a year in advance of incorporating may be required to minimize the recapture of investment credit consequences.

Careful planning during the operation of the corporation also is required to avoid the accumulated earnings tax. If the corporation has been formed for the purpose of avoiding income tax to its shareholders, an accumulation of earnings and profits by the corporation may be subject to an accumulated earnings tax. To avoid this tax, the accumulated earnings must be to meet reasonable business needs. The reasonable needs of the business may be for bonafide expansion of the business; to acquire a business enterprise through the purchase of stocks or assets; to pay back debts; to provide working capital for the business; or to provide for loans or investment to suppliers or customers necessary to maintain the business of the corporation. This usually does not include loans to shareholders or friends or relatives of shareholders. The accumulated taxable income is corporate income retained after the deduction of dividends paid and the $150,000 exemption during the lifetime of the corporation.

When applicable, a tax is levied at the rate of 27.5 percent of the first $100,000 "accumulated taxable income" and at the rate of 38.5 percent of any income above $100,000. The basic purpose for the accumulated earnings tax is to discourage the use of the corporation as a vehicle to accumulate and shelter income for individual stockholders who have high personal income tax rates. Proper planning and records should be maintained during the operation of the corporation to substantiate reasonable business needs.

Extreme caution should be taken when the family farm corporation has passive income, i.e., mineral interest, rents, interest, etc. A corporation may be declared a personal holding company and any undistributed income taxed at a rate of 70 percent. Since almost all closely held corporations meet the stock ownership test, the income requirement may determine the personal holding company status. Regulations affecting personal holding companies are numerous and complex and beyond the scope of this publication. Corporate advisors must be very careful, especially when including mineral interest in the corporation, or the risk of attaining personal holding company status can be great.

Financial Reasons for Incorporating

The primary impetus for the formation of many agricultural corporations in Texas has been requirements of lenders that the business be incorporated as a condition to the extension of credit. High interest rates and the Texas usury laws on maximum rates of interest for loans to individuals create a problem for lenders and borrowers alike. The usury limits do not apply to loans to corporations; therefore, pressure to incorporate farm businesses has been extensive.

In many cases, the farmer has little knowledge of the complexities of forming a corporation, spends little time investigating them and is motivated primarily by the need to borrow operating capital. The organization of these corporations generally takes two forms: (1) transfer all business assets to the corporation and (2) put only $1,000 in the corporation and lease the assets to the corporation.

Before discussing specific considerations of these types of organizations, it is appropriate to make some general observations on incorporation. Many farmers who incorporate to obtain credit are very casual about the complexities they are dealing with and are unaware of the potential consequences.

Some incorporators subsequently disregard the formation of the corporation and continue to operate as they have in the past. A corporation that is established (and used to borrow operating funds) cannot be disregarded. The failure to file timely corporate income tax and franchise tax reports accrues liabilities for penalties and interest. More importantly, the corporate tax on the earnings must be paid and taxes based on the receipt of any constructive dividends will be imposed on the individual.

Because a corporation is a separate entity, its financial resources must be respected. Some farmers have difficulty accepting the importance of this concept because it is *their* corporation. They owned the assets that were transferred to the corporation, and now they own the stock. It is their business, but it must be treated as another individual. Any use of the corporation's assets for personal purposes creates potential dividend income to the shareholder. This includes purchase of personal items with corporation's money, converting corporate assets to personal uses, informal loans from the corporation to the shareholder or his family, etc.

The formation of a corporation by transferring all farm assets to it can create substantial problems if the assets inflate in value and the corporation must be liquidated. Without overriding estate planning implications, the inclusion of farmland in the corporation often is not advised by professional advisors. When the primary reason for incorporation is to secure credit for the operator, contributing farmland to the corporation can create a severe penalty in the future. However, the prospects of recapturing investment credit when "substantially all" assets are not transferred to the corporation may make this alternative painful, too.

To circumvent these two problems, some "$1,000 corporations" have been formed. This approach also seems beset with problems. If a corporation with a net worth of only $1,000 borrows substantial operating monies with support of a cosignature from the owner of the corporation, economic reality suggests that the loan is, in substance, to the individual. When the corporation subsequently repays the owner's liability, dividend treatment is likely. Since the usury problem prevents the individual from borrowing the funds, a minimum capital contribution seems to involve some substantial risks of adverse income tax consequences.

The decision to incorporate a business is a serious and complex matter. Very often there are no quick and easy solutions to the interrelated complexities that are involved. Beware of tendencies to act in this regard without thorough investigation and planning.

Miscellaneous Items

One disadvantage of incorporation is that an operating loss of the corporation cannot be used by the shareholders to offset their income. A corporate loss must be used to offset corporate income in past or future years. Also, net long term capital gains of corporations are taxed at a maximum tax rate of 28 percent while long term capital gain to an individual receives a 60 percent exclusion before being taxed.

The corporation will be treated as a farmer for most income tax purposes. A farm corporation is required to file an estimated income tax return and make quarterly payments of estimated tax. Corporate returns must be filed by the 15th day of the third month following the close of the fiscal year. Also, the farm corporation is limited to $2,000 of additional first year 20 percent depreciation. The farm corporation generally may elect the cash or accrual basis of accounting, and can select a fiscal year for tax reporting different from that of any previous business organization. Corporations are not required to withhold federal income tax on wages paid to agricultural employees.

Sub-Chapter S Tax Option

Sub-chapter S is a tax option provided for by the Internal Revenue Service that enables a corporation to pass its operating earnings and losses through to the individual shareholders without first being taxed at the corporate level. The corporation acts as a conduit for ordinary income, capital gains, operating losses and investment tax credit to be passed to the shareholders for inclusion in their individual income tax returns. The Sub-chapter S corporation is a corporation for every purpose except income tax payment and is formed under regular corporation rules. Although operating losses pass through to the shareholder, capital losses do not pass through. The capital loss must be absorbed by the corporation by applying it against capital gains in the year of loss or in one of the five succeeding years.

To qualify for Sub-chapter S, several requirements must be met: (1) There must be no more than 15 shareholders. (2) There can be only one class of stock issued and outstanding. (3) Shareholders must all be individuals or the estates of individuals. (4) All shareholders must consent to the election. (5) No more than 20 percent of the corporation's gross income can come from passive investment such as rents, royalties, dividends, interest, annuities and sales or exchanges of stock or securities. This may create a major problem if rent, royalties or minerals interest is received from land owned by the farm corporation. The corporation must materially participate in the production of income under the lease if income from the lease is not to be deemed rent income.

The election to be a tax option corporation is made through a formal document filed with the Internal Revenue Service. The election can be made at any time during the previous year or the first 75 days of the year of election. The election can be terminated voluntarily by shareholder action or involuntarily by failing to meet the requirements of the Sub-chapter S election. New shareholders have 60 days after acquiring stock in the Sub-chapter S corporation to file their disapproval of the election and ask for a re-election.

All of the requirements of Sub-chapter S election are extremely technical in nature and must be complied with very carefully. A taxpayer involved in such a corporation must appreciate these requirements and work closely with his tax advisors. Tax advantages can be significant in limited situations, but penalties for failure to adhere to requirements are severe.

The greatest advantage of a Sub-chaper S option is the ability to pass through an operating loss from the corporation to the individual. Other advantages of the Sub-chapter S option include: (1) assistance in elimination of double taxation; (2) a vehicle for income splitting between family members; (3) passing of long term capital gains through to the stockholder with the favorable 60 percent capital gain deduction; (4) accumulated earnings tax is not a factor for Sub-chapter S corporations; (5) investment tax credits are passed through to the shareholders on qualified investments.

Disadvantages that should be considered include: (1) The primary disadvantage is the unforgiving nature resulting from failure to meet the continuing eligibility requirements for the election; (2) The limitation placed on the flowthrough of net operating loss can present problems in some areas because the passthrough is limited to the shareholder's tax basis in the corporation, plus any indebtedness running to the taxpayer from the corporation; (3) If election is terminated, previously taxed undistributed earnings lose their character. Although there is a means by which some of these limitations can be avoided, the losses that do occur may be lost forever by both the shareholder and the corporation.

The taxpayer contemplating use of the Sub-chapter S option should seek competent assistance in evaluating its economic benefits. The complexity and detail required to maintain eligibility under the Sub-chapter S tax option may negate its usefulness.

THE COST

A corporation will incur certain costs not required for other types of business organizations. Cost of incorporating varies with the circumstance and complexity of the corporation.

Professional Services

An attorney must be employed to prepare and file articles of incorporation, draft the bylaws and generally oversee the transfer of property in exchange for corporate shares. The cost of setting up a corporation will vary, depending on the amount of work performed by the attorney. The organizational cost can be amortized as business expenses over a period of not less than 5 years.

After the corporation is formed, other costs will be incurred on an annual basis. Corporate reporting requires a more complete accounting system and tax records than many farmers and ranchers maintain. The corporation must keep minutes of board meetings throughout the year. These additional requirements may require the assistance of an attorney and an accountant on a continuing basis.

Franchise Tax

Every corporation doing business in Texas is required to file an annual report and pay a franchise tax to the State Comptroller for the period of May 1 through April 30. The franchise tax can be computed on the basis of taxable capital or, in some cases, by an optional method based on total assets. The franchise tax for the initial year of operation must be paid within 90 days after the end of the year following the date the charter was filed or the certificate of authority was granted. The second year's tax must also be paid in advance at that time. Both the first and second year's tax is based on the first year's business.

The amount of tax will be the greater of the following: (1) The basic tax which is $4.25 per thousand dollars of "taxable capital." Taxable capital is defined as the sum of stated capital, surplus, and undivided profits. (2) Four dollars and twenty-five cents per thousand dollars of the assessed value for county ad valorem tax purposes of the real and personal property owned by the corporation. (3) Fifty-five dollars. In lieu of the franchise tax based on taxable capital, a corporation which has paid a franchise tax in Texas in the past with total assets less than one million dollars may elect to pay franchise tax based on the total asets. This option must be accompanied by a federal income tax return. Table 5 shows an optional annual corporation franchise tax effective January 1, 1980, based on total assets.

LIQUIDATION

A corporation is dissolved and liquidated when its existence is terminated, its charters extinguished, its affairs wound up and its assets distributed among the creditors and shareholders. Liquidation may be either voluntary, by shareholder vote, or involuntary.

Liquidation may have important income tax implications to the shareholders. Generally, cash and value of property received by the shareholders in excess of the tax basis of their stock results in a taxable gain, usually at capital gain rates. Under a special liquidation provision, land, machinery and other assets that have appreciated in value can be received without recognizing the gain if the shareholders agree to treat the undistributed earnings of the corporation as ordinary income. Needless to say, there are several provisions in the IRS code that should be considered prior to any liquidation process.

Farm corporations must exercise great care when faced with a situation in which liquidation is anticipated. This also is true when redeeming stock is held by one or more of the shareholders or when one or more of the shareholders plan to sell stock. One area of concern is to make sure that upon liquidation the corporation does not constitute a collapsible corporation. Briefly, this means that income tax advantages from capital gains cannot be obtained on any gain realized by an individual by sale or exchange of his stock.

During the initiation stage of a corporation, the taxpayer should make sure that the common stock issued qualifies for Code Section 1244 treatment. This enables a loss on the sale of such stock to be treated as an ordinary loss rather than a capital loss. This is important in the event that the stock is sold or the corporation is liquidated for less than the shareholders' basis in the stock. For taxable years after 1978, the total amount that may be treated as an ordinary loss under Section 1244 is $100,000 for a husband and wife filing a joint return. To qualify for Section 1244, the corporation generally must be a domestic corporation — be considered a small business corporation with contributed capital and paid-in surplus not exceeding one million dollars.

The complete legal and tax considerations of liquidation is beyond the scope of this bulletin. Because of the complexity of transactions involved in liquidation, both legal and tax advice should be sought.

Table 5. Optional annual corporation franchise tax based on total assets, effective January 1, 1980

If Total Assets Are At Least	But Less Than	The Tax Shall Be
$ 0.00	$ 15,000.00	$ 35.00
15,000.00	20,000.00	45.00
20,000.00	25,000.00	55.00
25,000.00	30,000.00	70.00
30,000.00	40,000.00	90.00
40,000.00	50,000.00	115.00
50,000.00	60,000.00	140.00
60,000.00	70,000.00	165.00
70,000.00	80,000.00	190.00
80,000.00	90,000.00	215.00
90,000.00	100,000.00	240.00
100,000.00	110,000.00	265.00
110,000.00	120,000.00	290.00
120,000.00	130,000.00	315.00
130,000.00	140,000.00	340.00
140,000.00	150,000.00	365.00

"Total assets" used in this table means the total of all items reported or reportable as assets on the corporation's Federal income tax return on the last day of the corporation's reporting period for Federal income tax purposes.

[Blank Page in Original Bulletin]

[Blank Page in Original Bulletin]

Cooperative Extension Work in Agriculture and Home Economics, The Texas A&M University System and the United States Department of Agriculture cooperating. Distributed in furtherance of the Acts of Congress of May 8, 1914, as amended, and June 30, 1914.
5M—12-80, Reprint AECO