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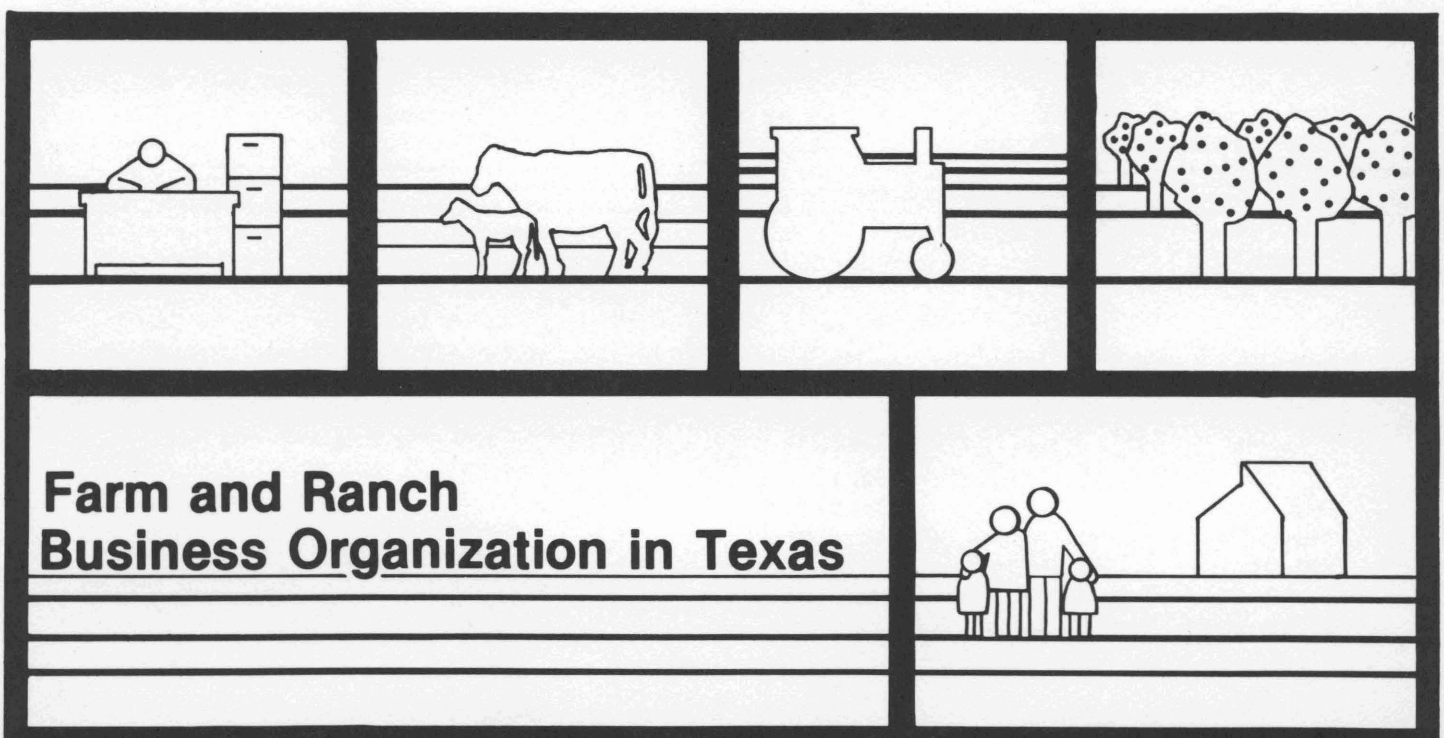
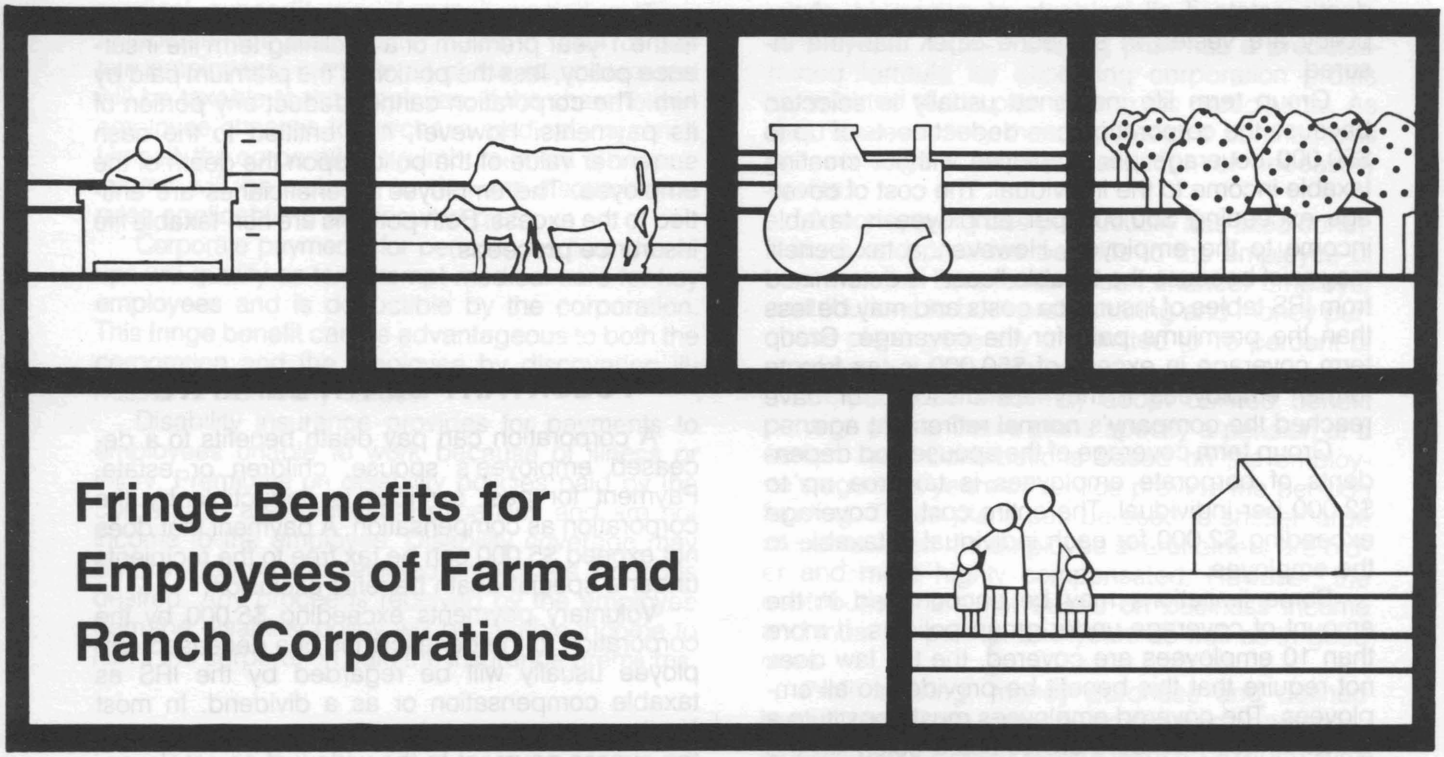
Fringe Benefits for Employees of Farm and Ranch Corporations



PREFACE

This publication is one of a series on the incorporation of farms and ranches and is intended for laymen who want to develop an understanding of the basic tax issues encountered by incorporated businesses. The authors have attempted to interpret our complex and technical tax law into understandable language and concepts. However, any dilution of the complexities of the law will necessarily involve omission of some details and exceptions to general rules. This publication is intended to convey the type of information useful to businessmen who are considering the organization of a corporation or who currently are operating a corporation. It is not intended as legal advice nor should it be construed as an exhaustive treatment of tax implications.

While the authors have written in a manner that should be understandable by most persons who are concerned with the incorporation of a business, certain terminology that is common in tax matters is used. These terms may not be used often in the everyday conversations of farmers and ranchers. However, as businessmen, farmers and ranchers should develop a basic understanding of this terminology so they can effectively communicate with their professional advisors. For those not intimately familiar with such terms, this publication may not be easy to read. Even so, the technical nature of the subjects treated herein require some of them, and the benefits that the readers can acquire through development of the ability to use these terms outweigh the initial detriment.



Fringe Benefits for Employees of Farm and Ranch Corporations

Marvin Sartin and Norman Brints*

The organization of a farm business as a corporation provides employee-shareholders with expanded opportunities to receive fringe benefits. Generally, fringe benefits include all benefits provided to employees in addition to wages and salaries. Specifically, corporations can provide larger pension plans, health and accident plans, group life insurance and, in some cases, corporate ownership of residences and automobiles.

A proprietor or partner must purchase his own insurance with after-tax income and is limited in tax sheltered retirement plans to HR-10 plans, Simplified Employee Pension Plans (SEPP) or Individual Retirement Accounts (IRA's). A corporation can provide benefits to employees, treat the costs as ordinary business expenses and not create taxable income to the recipient. Thus, these benefits increase the employees' real income at less cost than increasing salaries to that level.

For example, assume a corporation with a 40 percent marginal tax rate provides non-pension fringe benefits costing $2,000 per year to an employee with 50 percent personal tax rate. The after-tax cost to the corporation of providing these benefits is $1,200. Assuming that none of these benefits would be tax deductible for the individual, his salary would have to be increased by $4,000 to provide an after-tax increase of $2,000. The after-tax cost to the corporation of the increased salary is $2,400. A net savings of $1,200 ($2,400 – $1,200) is achieved by having the corporation provide the benefits.

Realistically, incorporation of a business includes both advantages and disadvantages. Each individual must weigh the relative importance of these to determine if the action is warranted. The discussion which follows will explain specific types of fringe benefits that have general application in agricultural corporations and some of the rules governing their availability.

LIFE INSURANCE

Life insurance coverage is one of the most common and valuable benefits that employers provide employees. Insurance proceeds received by the insured's beneficiaries at his death are exempt from income taxes and can be excluded from the dece-

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dent's estate if all incidents of ownership of the policy are vested in someone other than the insured.

Group term life insurance usually is selected because the corporation can deduct costs of up to $50,000 coverage per employee without creating taxable income to the individual. The cost of coverage exceeding $50,000 per employee is taxable income to the employee. However, a tax benefit may exist because the taxable "cost" is determined from IRS tables of insurance costs and may be less than the premiums paid for the coverage. Group term coverage in excess of $50,000 is tax free to former employees if they are disabled or have reached the company's normal retirement age.

Group term coverage of the spouse and dependents of corporate employees is tax free up to $2,000 per individual. The entire cost of coverage exceeding $2,000 for each individual is taxable to the employee.

Some limitations may be encountered in the amount of coverage under group policies. If more than 10 employees are covered, the tax law does not require that this benefit be provided to all employees. The covered employees must constitute a group whose members are selected solely on the basis of age, marital status or "factors related to employment." Thus, the group cannot be based on the employee's status as a stockholder or family member, but it can be based on employment-related duties or compensation received.

If a group has fewer than 10 members, all employees must be covered except those employed full time for less than 6 months, part-time employees working 20 hours or less per week and not more than 5 months in any calendar year, those electing not to be covered and those over age 65. The only evidence of insurability that can be required is a medical questionaire to be completed by the employee. Also, the amount of insurance coverage must be either a uniform percentage of salary or on the basis of coverage brackets established by the insurance company. No bracket may exceed two and one-half times the next lower bracket and the lowest bracket must be at least 10 percent of the highest bracket.

There usually is no tax advantage in having the corporation provide ordinary life insurance to its employees. The corporation can deduct the premiums, but that amount is taxable income to the employees. If ordinary life policies are preferable to term insurance, "split dollar" insurance may provide benefits. Split dollar insurance requires that the corporation pay the portion of the premium equal to the increase in cash surrender value in that year. The remainder of the premium is paid by the individual. The employee must pay a substantial part of the premium in the first year or two, but his share will decrease rapidly.

The employee will be taxed on an amount equal to the 1-year premium of a declining term life insurance policy, less the portion of the premium paid by him. The corporation cannot deduct any portion of its payments. However, it is entitled to the cash surrender value of the policy upon the death of the employee. The employee's beneficiaries are entitled to the excess. Both portions are non-taxable life insurance proceeds.

VOLUNTARY DEATH BENEFITS

A corporation can pay death benefits to a deceased employee's spouse, children or estate. Payment for past services is deductible by the corporation as compensation. A payment that does not exceed $5,000 can be tax free to the recipients under a special death benefits exclusion.

Voluntary payments exceeding $5,000 by the corporation to the beneficiaries of a deceased employee usually will be regarded by the IRS as taxable compensation or as a dividend. In most family corporations, it is difficult to document that the excess payment to the widow of an employee-shareholder was a gift made from "detached and disinterested generosity."

The death benefits will not be included in the employee's estate for estate tax purposes if the payment is wholly voluntary. If the corporation had a contractual obligation to pay the benefit, the value would be included in the estate.

MEDICAL AND DISABILITY BENEFITS

Medical benefits for employees and their families can be paid by the corporation and be tax free to employees if they are made under a health and accident plan. Plans may be insured or non-insured, and different types of plans can be adopted for various classes of employees. Coverages can be determined to include only work-related illness and injury or can be comprehensive enough to cover all medical and dental expenses. Such payments are usually tax deductible expenses of the corporation.

Insured plans can be set up to cover only selected employees. The corporation is not limited to group policies or ordinary health insurance contracts. Individual policies can be tailored to provide coverage to fit specific needs. An insured medical accident and health plan can cover a few or only one employee of a closely held corporation.

Uninsured or self-insured plans provide for the corporation to reimburse the employee for certain medical expenditures. If a self-insured medical reimbursement plan discriminates in favor of certain employees, some or all of the reimbursement will be taxable to the employee. If the shareholder-employee chooses to purchase medical insurance himself, the corporation's reimbursement of his premiums will be subject to the anti-discrimination rules applicable to self-insured plans.

Corporate payments for periodic medical checkups will qualify as tax-exempt medical care for key employees and is deductible by the corporation. This fringe benefit can be advantageous to both the corporation and the employee by discovering illnesses in their early stages.

Disability insurance provides for payments to employees unable to work because of illness or injury. Premiums on disability policies paid by the corporation are deductible expenses and are not income to the employee. Disability coverage may be provided only to selected employees if such is desired. Any proceeds received by the employee from the disability policy will be taxable income to him if the corporation paid the insurance premiums.

RETIREMENT BENEFITS

The primary advantages of retirement plans for employees of a farm corporation are in qualified plans that allow greater annual contributions than HR-10 plans and/or are more flexible concerning the coverages of various employees. The following discussion focuses on the types of plans that produce current tax deductions for the corporation and do not produce taxable benefits to the employee until the proceeds are actually received.

Table 1 lists some of the characteristics of Corporate Profit Sharing Plans and Corporate Money Purchase Plans along with those of IRA's, Hr-10's and SEPP. If a person selects an IRA, he can deposit 15 percent of his annual income, to a maximum of $1,500 ($1,750 for a husband and wife) per year.

An employer wanting to tax shelter a larger amount and selecting an HR-10 or SEPP plan, must cover all employees who have at least 3 years of service. He must deposit the same percentage of the compensation paid to the employees for their retirement as he deposits for himself. The first $100,000 of business income may be used to compute the rate. Thus, if the business produced more than $100,000 of income and the owner wished to deposit $7,500 in a HR-10 or SEPP, the rate would be 7.5 percent. A deposit of 7.5 percent of the employee's compensation also must be made into retirement accounts for them, and it vests immediately.

A farm corporation can use SEPP's, or institute profit sharing plans or money purchase plans for employees. A profit sharing plan has a predetermined formula for allocating corporation profits contributed to the plan among the participants. As the name implies, the corporation's contributions are contingent on the realization of necessary profits.

A money purchase plan usually has fixed contributions and provides benefits to the employee of whatever the contributions can finance. Employer contributions to both profit sharing and money purchase plans generally are limited to 15 percent of employee's compensation.

Corporations also may adopt defined benefit pension plans. These plans specify a pension of a certain size. Contributions based on the employee's age and years of service provide the pension funding. These plans can be used to shelter large amounts when the employee shareholders are older and more highly compensated. However, the contributions are not based on business income and must be paid in bad years as well as in good ones.

Profit sharing, money purchase and defined benefit plans may cover all employees or any designated classification of employees provided they do not discriminate in favor of officers, shareholders or highly compensated employees. The plans can exclude employees under 25 years of age who have not completed 1 year of service. Various alternatives are available for the vesting of these benefits. However, the greatest length of time allowed for the employee to acquire 100 percent vesting is 15 years of service. For most small corporations significantly more rapid vesting is usually required.

Corporate pension plans can be integrated with social security to provide greater benefits to employees with higher salaries (above the social security base level). Money purchase and profit sharing plans can be set up so that the salaries in excess of the integration level (social security base is the maximum level) will receive an allocation equal to 7 percent more than the base salaries. For example, assume a corporation with four employees and total salaries as shown in Table 2 ($25,900 integration level).

Employee A has $74,100 of salary in excess of the social security base. Seven percent of this amount is $5,187. Employee B's excess is $24,100 and a 7 percent contribution of that amount equals $1,687. Since only 15 percent of total compensation can be sheltered (.15 × $185,000), the aggregate contribution cannot exceed $27,750. The balance ($27,750 − $6,874 = $20,876) is prorated among the four employees based on total compensation. Employee A is able to shelter an additional $1,471, B's contribution is $171 less, and C and D together shelter $1,300 less than a straight 15 percent of compensation would provide.

Table 1. Characteristics of alternative retirement plans

	Individual Retirement Account	Simplified Employee Pension Plan
Who can use	Individual not actively participating in another qualified retirement plan	Proprietorship, partnership corporation
Maximum annual contribution	15 percent of compensation to $1,500	15 percent of compensation to $7,500
Eligibility	Not applicable	Each employee 25 years old who has worked 3 out of last 5 years
Vesting	100 percent	100 percent
Social Security integration	Not applicable	Contributions for employees can be reduced by employer's social security liability
Income tax treatment on payout	Ordinary income	Ordinary income

Table 2. Compensation of pension contributions with integration with social security.

Employee	Compensation	Excess Over Integration Level	7 percent of Excess	Balance	Combined
A	$100,000	$74,100	$5,187	$11,284	$16,471
B	50,000	24,100	1,687	5,642	7,329
C	20,000	0		2,257	2,257
D	15,000	0		1,693	1,693
	$185,000				$27,750

Profit sharing plans can be used in combination with money purchase plans and defined benefit plans. When combinations of plans are used, the total tax sheltered contribution can be greater than with any individual plan, but limitations are imposed to prevent the allowable contributions from totaling 30 percent. Generally, a profit sharing plan with a 15 percent contribution can be combined with a money purchase plan requiring a 10 percent contribution. The total sheltered contribution could be 25 percent of compensation. The limitations that apply when defined benefit plans and money purchase plans are combined are more complex and beyond the scope of this publication.

The Employee Stock Ownership Plan(ESOP) is a stock bonus plan or a combination of a stock bonus plan and a money purchase plan. It is designed to invest primarily in employers' securities for the benefit of the employees or their beneficiaries. The purpose of ESOP is to build equity ownership of shares of the employer corporation for its employees in a non-discriminatory manner. The deduction to an ESOP plan is limited to 15 percent of the compensation of the employees covered by the plan. ESOP plans are advocated by some tax advisors for their financial and estate planning characteristics.

The details of specific corporate retirement plans involve complex factors. The determination of specific annual contributions may require the services of an actuary. The selection of a specific type of plan or combination of plans depends upon

HR-10 Plans	Corporate Profit Sharing Plans	Corporate Money Purchase Plans
Proprietorship, partnership	Corporations	Corporations
15 percent of income to $7,500	Regular Corp.: 15 percent of compensation Subchapter S Corp.: 15 percent of income to $7,500	Regular Corp.: 15 percent of compensation Subchapter S Corp.: 15 percent of income to $7,500
All employees with 3 or more years of service	Any designated class of employees, provided it does not discriminate in favor of officers, shareholders or highly compensated employees	Any designated class of employees, provided it does not discriminate in favor of officers, shareholders or highly compensated employees
100 percent	Up to 15 years for complete vesting	Up to 15 years for complete vesting
Essentially none	7 percent above Social Security taxable wage base	7 percent above Social Security taxable wage base
10-year averaging on lump sum distributions, otherwise ordinary income	10-year averaging on lump sum distributions, otherwise ordinary income	10-year averaging on lump sum distributions, otherwise ordinary income

the age of the primary employee(s), salary levels, reliability of business profits and several other factors. For purposes of this discussion, let it suffice to emphasize that the potential contribution to a retirement plan is far greater if the business is a regular corporation rather than a proprietorship, partnership or a Subchapter S corporation. A specialist in the area of retirement and pension plans should be consulted before commitment to a specific action.

Qualified retirement plans can produce income tax advantages when distributions of the benefits occur. If the distribution is a lump sum, special 10-year averaging can be used to compute the income tax liability. Accumulations in a plan prior to 1974 can be treated as capital gains.

To qualify as a lump sum distribution, the entire sum must be received within one taxable year, and the distribution must be made because of death of the employee, attainment of normal retirement age (at least 59½), separation from service (employees) or the disability of a self-employed person(s). Generally, at least 5 years of participation in the plan is required to receive these tax benefits.

If a distribution is a lump sum or is made within an employee's taxable year because of termination of the plan, all or a portion of the distribution may be rolled over into an IRA or another qualified plan. The amount that is rolled over will not be included in gross income for tax computation.

All distributions that do not qualify for capital gains, for 10-year averaging or as a roll-over into another qualified plan, are taxed as ordinary income. However, if the employee also has made contributions to the plan with after-tax income, a portion of each installment is considered a return of his contribution and is not taxable.

Post death distributions from a qualified plan to a participant's beneficiaries can be excluded from the participant's estate for estate tax computation. If the beneficiary receives a lump sum distribution of the retirement benefits, favored income tax treatment alternatives must be foregone to have the value excluded from the decedent's estate. Thus, the beneficiary cannot use 10-year averaging or capital gains treatment of pre-1974 contributions.

Usually, the beneficiary will not wish to receive a lump sum. Installment payments to a surviving spouse or children usually are preferable when the employee dies during his productive years. With proper planning, a substantial sum can be passed to a subsequent generation without income tax or estate tax liability within the generation earning it. Generally, the value will not be excluded from the estate if the decedent had a right to receive benefits before his death and chose not to receive them. A continued close association with professional advisors is required to assure that all of your objectives are met.

SOCIAL SECURITY

Greater social security benefits may accrue to owner-employees as their salaries usually exceed the social security base level, while self-employment income often fluctuates widely. Because both employer and employee portions of the tax must be paid after incorporation, the net effect of social security may not be a benefit. Wages earned by a child under 21 years of age are not subject to social security if the child is employed by his parent. However, wages paid by a corporation do not escape this tax.

MEALS AND LODGING

Meals and lodging can be furnished to employees (including shareholder-employees) of a corporation without creating taxable income to the employee if they are on the business premises for the convenience of the employer and the employee must accept them as a condition of employment. An important concept embodied in this rule is that the employee must reside at the business location to properly conduct his duties.

One example is an isolated ranch requiring the employee to live at that location to care for the livestock. In this situation, the lodging should not produce taxable benefit to the employee, and some courts have included groceries purchased by the corporation as tax exempt. A cash crop farm seems less likely to qualify, especially as the tendency in many areas is for farmers to live in town and to commute to the farm.

Corporate ownership of a residence should be approached cautiously. The corporation can deduct depreciation and maintenance on the dwelling, but, if the lodging is not tax-exempt, the fair rental value will be taxable to the employee. A farmer also must consider the future. At retirement, continued use of the corporate property may generate constructive dividends to him. Corporate ownership of the dwelling precludes the use of the once-in-a-lifetime $100,000 exclusion of gain on the sale of the principal residence by an individual.

OTHER BENEFITS

Other fringe benefits to shareholder-employees include company vehicles, membership dues, subscriptions to trade journals, group legal services, liability insurance for officers and directors, reimbursement of moving expenses to a new job location, reimbursement for "loss" on sale of residence because of job transfer, and low interest loans from the corporation.

The corporation can furnish vehicles to employees who require them to carry on the corporation's business. If the vehicle is used for personal purposes, the employee would be taxed on the rental value for that personal use.

It has long been common practice for closely-held corporations to make loans to shareholder-employees at a low interest rate or even with no interest at all. Historically, the courts have upheld the propriety of these loans, but there seems to be renewed interest in this area by IRS. While this can be a very valuable fringe benefit, anyone considering such action would be wise to confer with a professional tax advisor to ascertain the latest court position.

SUMMARY

Farmers and ranchers traditionally have operated proprietorships and partnerships limited in the fringe benefits that can be provided to the owners. Agricultural production is now big business, and many owners are considering incorporation. The corporate organization can provide shareholder-employees with a large array of fringe benefits.

The primary advantage of the corporation's furnishing fringe benefits is to obtain business tax deductions for expenditures that would be nondeductible personal expenses if made by an individual. Group term life insurance, disability insurance and medical plans are the most important non-pension benefits.

Corporate retirement plans are more flexible than HR-10 and Simplified Employee Pension Plans. Corporate plans can be profit sharing or defined benefit which requires fixed annual contributions. Corporate plans can be integrated with social security to benefit higher compensated employees, and the allowable annual tax-sheltered contribution is higher under a corporate plan.

Even though the fringe benefits available to corporate employees greatly exceed those available to a proprietor or partner, they are only one factor to consider in the decision to incorporate the business. Income tax consequences, estate planning considerations, required formalities of corporate organization and additional legal and accounting expenses also must be considered.

Sophisticated retirement plans, insurance programs and other fringe benefits increase the complexity of the business. As a business becomes more complex, additional emphasis must be given to obtaining the services of specialized advisors and to maintaining a continuing relationship with them. However, these requirements and expenses may be more than offset by the benefits obtained.

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