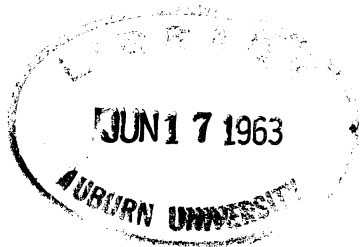


*Adaptability of*  
**CORPORATE**  
**ORGANIZATION**  
*To Family Farms*



AGRICULTURAL EXPERIMENT STATION  
AUBURN UNIVERSITY

E. V. Smith, Director

Auburn, Alabama



## CONTENTS

	<i>Page</i>
NATURE OF THE STUDY.....	3
PREVIOUS WORK.....	5
FRAMEWORK OF REFERENCE.....	6
Resource Accumulation Patterns.....	6
Alternative Organizational Structures.....	8
Attributes of the Corporate Structure.....	9
METHOD AND PROCEDURE.....	25
OBSERVATIONS.....	27
Brief Description of the Case Situations.....	27
Some General Findings.....	29
A Special Study.....	34
SUMMARY.....	36
LITERATURE.....	37

This study is reported with special reference to agricultural and business aspects of the problems involved. The need for assistance by an attorney with legal aspects of the individual business has not been alleviated. To the contrary, the authors emphasize the need for an individual to obtain the counsel and services of an attorney relative to the legal aspects in incorporating a business.

*Adaptability of*  
CORPORATE ORGANIZATION  
*To Family Farms\**

W. FRED WOODS, *Research Assistant\*\**

E. D. CHASTAIN, JR., *Associate Agricultural Economist*

NATURE OF THE STUDY

THE CORPORATION, extensively used by other industries, is receiving increased attention in agriculture. The extent of this interest is suggested by this statement by the Dean of Agriculture at the University of California: "Family corporations will be operating the family farm by 1975!" (2) Increased capital requirements, technological advancements, and relatively high taxes, combined with the growing need for more efficient farming and for continuity of the farm business, have caused dissatisfaction in many instances with the traditional sole proprietorship organization of family farms. Changes in Federal tax laws relating to corporations with 10 or fewer shareholders have also served as motivators for considering applicability of corporate farm organization.

The American system of agriculture has been, for the most part, organized around family farms with the business owned by the head of the family. Upon the death of the family head, the business was begun anew by a new operator. Traditionally, these

---

\* This publication resulted from Alabama Hatch Project No. 125, "The Influence of Business Arrangements on Capital Accumulation Opportunities and Difficulties in Farming." The authors acknowledge the assistance of several Extension Service agents who cooperated in the study and the assistance of the case study families who cooperated as the observations were made. The authors also acknowledge benefits of review (on a personal basis) by G. H. Wright, Jr., attorney-at-law, Auburn, Alabama. All responsibility for the publication lies with the authors.

\*\* Resigned.

farms have been refinanced every generation. During recent years, the beginning farmer's problem of acquiring needed resources has become increasingly difficult under this system. Likewise, older farmers have experienced more difficulty in maintaining productivity and economic efficiency of the unit.

There is a trend toward fewer farms, larger farms, and higher investment per farm. Total value of all farms and farm assets in the United States has risen 60 per cent during the past decade and is concentrated in about 20 per cent fewer farms. The often heard expression, "farming is big business," rings true in view of these observations and since capital investments of \$100,000 or more per farm are becoming more common.

Under the definition of a family farm given by Ackerman and Harris, the farm family provided the management and most of the labor for operating the farm, although a moderate amount of outside labor could be hired. Returns should be sufficient for the family to make a satisfactory living while maintaining farm productivity and farm assets (1). Zimmerman has given a broader, more "social" definition: ". . . a family farm is an organization of agriculture in which home, community, business, land, and domestic family are institutionalized into a living unit which seeks to perpetuate itself over many generations" (15). Both of the problems of concern in this study enter into the preceding definitions, perpetuating the farm unit and acquiring and maintaining farm assets (capital accumulation).

Some writers have argued that the family farm may be on its way to extinction. The term "corporation farm" has been generally associated with large-scale, non-family type farming. The more moderate approach, and the one pursued in this report, is that the family farm will continue to be the backbone of American agriculture, but that its organizational structure needs to be strengthened to provide for the increased size, productivity, and efficiency necessary for future success.

Corporation farming is not greatly important in the United States in terms of numbers of corporate farms compared with numbers of sole proprietorship and partnership farms. Until recently, perhaps as late as 1958, most corporate farms were operated by non-agricultural companies, by highly specialized farmers, and by wealthy individuals.

An analysis was needed to determine whether incorporation actually is a threat to the existence of family farms or if it offers a

means whereby family farms can continue to thrive and adjust more satisfactorily to changing economic conditions.

The objectives in this study were:

1. To outline fundamental attributes of the corporate form of business organization as applied to agriculture. Such information will serve as a framework of reference for developing and analyzing alternative solutions to problems of capital accumulation and intergeneration farm transfer.

2. To observe in detail the present business arrangements on selected family-operated farms and any problems under such arrangements.

3. To evaluate success of the corporate structure on incorporated case farms and its contribution potential on farms not already incorporated.

## PREVIOUS WORK

Although no previous research relating to the advisability of incorporating family farms has been conducted in Alabama or in the Southeast, several contiguous studies have been reported elsewhere. Several writers have considered incorporating farm businesses as a possibility for preserving and strengthening family farms (11,4,8). These and other writers, either at a popular or quasi-technical level, have essentially limited themselves to discussions of advantages and disadvantages of corporate farm organization and to a few isolated discussions of incorporated farms. Little research contact with farmers interested in the corporate structure is evident in their work.

In the early 1950's, Harris and Hill of Michigan State University wrote that the incorporation of farm businesses was decreasing rather than increasing in popularity. They apparently dismissed the idea as "complicated and somewhat expensive" and not appearing to be adaptable "to the usual size and type of farm business" (6).

The report by Eckhardt and associates included "an outline and evaluation of legal considerations that influence a farmer and his lawyer in deciding whether to incorporate a specific farm business." They reasoned that the desired form of organization was one that encouraged young farm people to stay at home and provide a stable and efficient labor supply, that promoted expansion

of the farm to an economical size, and that made possible a transfer of ownership and management of a complete farming unit between generations. Such an organization, they believed, would lead to more owner-operated farms and a more satisfactory level of productivity of the individual business (4).

Hubbard and Blanch's report included a discussion also of the corporation as an estate planning or estate management tool, being used in *inter vivos* transfers of property to eliminate estate taxes or reduce them to a desired minimum (8).

Many writers have recognized the problems facing the beginning farmer and the need for some type of assistance. A study by Arnold of Purdue University and a report by the North Central Farm Management Extension Committee are among those that have emphasized the importance of family assistance for beginning farmers. In four north central states, Reiss and associates found that about 80 per cent of all beginning farmers received substantial family assistance (3,10,13).

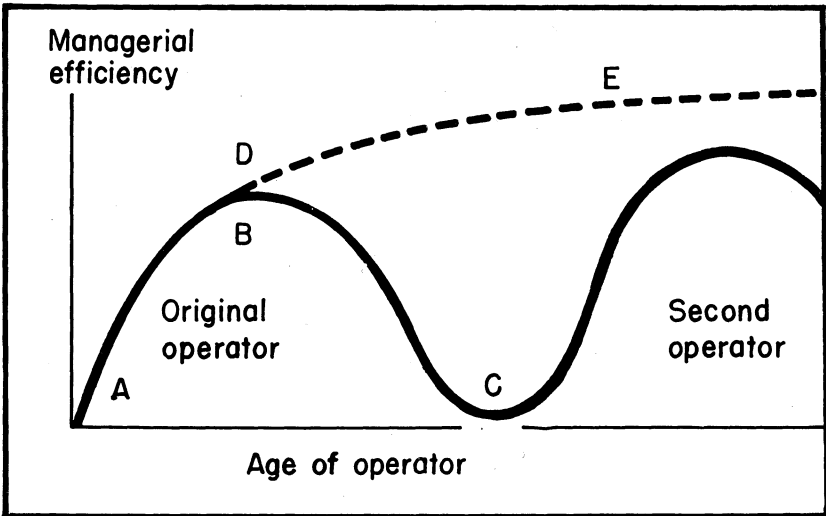
Hill pointed out how many farm parents, in attempting to avoid excessive costs to their heirs, tended to do things with their farm property that greatly reduced their own security and happiness during retirement (7).

## FRAMEWORK OF REFERENCE

The analysis of organizational problems confronting farmers and farm families required careful study of individual farm situations to determine the possible outcome under various organizational alternatives. To determine adaptability of the corporate form of organization to a particular situation necessitates the use of a framework of reference with which to compare the individual case study farming arrangements. The reference framework expressed herein contains attributes of the corporate structure that are applicable to farming situations.

## RESOURCE ACCUMULATION PATTERNS

The beginning farmer's problem of accumulating the resources needed for an economically efficient unit has become increasingly difficult in recent years. Older farmers have encountered more difficulty in maintaining productivity and economic efficiency of their units. The cyclical pattern representing these management problems is shown by curve ABC in Figure 1.



**FIG. 1.** Possible improvements in managerial efficiency under corporate organization are illustrated by the graph. Under single proprietorship organization, efficiency declines as the operator ages and continues to drop until the next operator takes over the business (segment BC) and reaches his peak. Corporate organization may aid in making the efficiency curve similar to segment DE.

A beginning farmer buys, inherits, or otherwise comes into possession of a rundown, low-producing farm at point A. The movement from A to B represents improvements made during the farmer's working years. At point B, the farmer has reached the height of his productive capacity, and thereafter, productivity and efficiency of the farm begin to decline, going through retirement, death, and estate stages (movement from point B to point C). Someone of the next generation then acquires the business in its rundown condition and starts the cycle again. The possibility being advanced for the corporate structure is outlined by segment DE. The exact location of the segment will differ for individual circumstances, since the model diagrammed represents the "general case" and not the exact pattern for an individual farming situation.

Laws of descent and distribution, as well as tradition, call for equal but not necessarily equitable subdivision of property among the heirs-at-law of a deceased. Each heir-at-law receives an undivided interest in the estate when the owner dies without a will, but empirical findings indicate that joint ownership, in this manner, is seldom retained for any considerable time (14). Since farm assets, particularly land, are largely indivisible, an heir can de-

mand money for his share. Unless the other heirs can buy his part, he can force a partitioning of the estate, thus dividing the farm into smaller, often uneconomic units. Although a will can provide for equitable distribution of property, this means of conveyance is often overlooked by farmers (14). Documents of a more non-reversible nature are believed to be even more unappreciated and unemployed.

#### ALTERNATIVE ORGANIZATIONAL STRUCTURES

The three principal types of farm business organization and ownership are sole proprietorship, partnership, and corporation. Other existing business forms are variations of these three types, such as the limited partnership and the "tax-option" or "close" corporation.

##### Sole Proprietorship

The sole proprietorship or single proprietorship is a one-man operation. Regardless of number of hired workers, the proprietor owns and operates his own business, which terminates upon his death. This is the predominate and simplest organizational pattern in American agriculture.

##### Partnership

A partnership is an aggregation of assets of two or more owners who contribute to the business and share in its management, profits, and losses. Each partner is liable for the partnership actions of all other partners except to the extent to which liability may be excluded by the partnership agreement. Limited liability can be attained in the limited partnership but only if the limited partner (or partners) does not participate in any way in management of the business. There must be a general partner who assumes unlimited liability.

The partnership is the form of business organization generally used where two or more people are farming together. Although partners are not necessarily related, most studies concerning farming partnerships have related to inter-family arrangements.

##### Corporation

The corporation is an artificial being created under state law. The main underlying idea is that of the collective person, or sep-



arate legal entity. Regardless of the number of members, owners, or stockholders in a corporation, it is regarded by law as a fictitious person entirely separate and distinct from those who compose it.

Use of the corporate structure for farm operations has developed slowly and is still of minor importance when evaluated on the basis of numbers of incorporated farms. Subject to some exceptions,<sup>1</sup> the corporate structure is available for use in agriculture just as it is in other industries.

### ATTRIBUTES OF THE CORPORATE STRUCTURE

The logic of incorporating a farm business depends to a great extent upon the volume and nature of the business and objectives of the owners. The attributes that follow are attributes of the corporate structure *per se* and may or may not be applicable in any given situation. Parties involved must judge the applicability of a particular attribute to their situation.

#### Continuity of Operation

A corporation is endowed with continuous life during the period of its charter regardless of the deaths or misfortunes of its stockholders, and regardless of any changes, substitutions, or replacements among them. This continuous life, or continuous succession, makes the corporation the most stable of all business forms; if chartered in perpetuity, it may conceivably go on forever — an impossibility for any other form. Most states (including Alabama) permit perpetual existence of farming corporations. Generally speaking the corporation can exist as long as the majority of its shareholders so desire and as long as it fulfills the requirements set forth by state corporation laws.

Continuous life must not be taken at face value, however, because the death of an important shareholder may have serious consequences in the absence of adequate prior planning. The corporation will not operate of its own accord, but its continuing nature offers a method for maintaining the farm business over successive generations and for avoiding the problems of business interruption that result upon the death of a sole proprietor or part-

<sup>1</sup>One state prohibits farming corporations; others impose limitations on the length of life.

ner. This disruption causes decreased productivity and deterioration of farm assets because heirs are unable or unwilling to make improvements or long-range plans during the period of uncertainty.

### Divisibility of the Unit

Ownership of the assets of a corporation is represented by shares of stock. The fact that stock represents shares of the entire business and not specific portions is one of the important attributes of a corporation. These stock certificates are evidence of ownership, determining it in a clear-cut and business-like manner. They also are used to provide a basis for division of profits, authority, and degree of ownership.

### Transfer of Ownership

Farm owners having one or more heirs are faced with several alternatives in transferring their property. They can: (1) make no preparation and, at death, let the property be distributed according to laws of descent and distribution; (2) make a will to transfer at their death the property to whomever they choose; (3) transfer their property before their death by sale or gift or some combination of the two; or (4) utilize some combination of these alternatives. A strong desire usually exists to keep the farm in the family.

The indivisible nature of most farm property makes for difficulty in dividing it equitably among several heirs; therefore, estate transferral is a matter for careful study by the farm owner.

Objectives that should be sought in estate transferral are:

- (1) Reasonable security for the parents during old age.
- (2) Equitable, but not necessarily equal, treatment for the children and other heirs-at-law.
- (3) Future ownership of the property and the facilitation of its transfer and management on a definite, pre-arranged basis.
- (4) Future ownership that will permit efficient use of the land and avoid undesirable and uneconomic sub-division.

**Intestate Inheritance.** Inheritance patterns of the United States emphasize equal sharing of property by heirs of a deceased, often to the degree of subdivision of real property. This subdivision

usually occurs with testate as well as intestate inheritance, although it could be avoided with the former.

**Testate Inheritance.** Disposition of estates through wills can be made satisfactorily in some instances. However, in 1947, Walrath and Gibson found that approximately three out of four active farmers in Virginia had made no preparation for the disposal of their estates after death (14).

**Transfer Before Death.** Transfer of partial or complete interest to the heir or heirs of an estate during the lifetime of the family head may be desirable. First, the heir or heirs are able to acquire ownership and the responsibility of management at an earlier age and when the father's supervision is available; second, the decline in farm productivity associated with aging of the operator can be offset; third, efforts of the farming son (or sons) can be rewarded, thus giving him (or them) added incentive; and fourth, estate planning goals (e.g., reduction of inheritance taxes) can be accomplished.

These *inter vivos* transfers of property can be made through outright sales, sales contracts, or gifts. Regardless of method of transfer, it is vitally important that a deed or contract be used to protect the interests of all concerned.

**Transfer Under the Corporate Structure.** Shares of stock representing indivisible portions of the whole economic unit can be bought, sold, given as gifts, willed, or passed by inheritance laws at death without disrupting the farm business in any way. Shares of stock can be distributed to equalize the treatment of a farmer's children. Gifts of stock in a family farm corporation can be made by the parents to equalize such advantages given to children as education and getting started in a business.

It is not generally desirable or economically feasible to divide the family farm into several units. Although it is possible to transfer small undivided interests in the farm assets regardless of the form of business organization, corporate organization greatly facilitates this transfer. The incorporated farm can be divided among as many owners as there are shares of stock, with practically unlimited arrangements and divisions of ownership.

Under this organization, children living off the farm and essentially disinterested in its operation could share in ownership and profits with a farming son. The son operating the farm could

receive a salary as a corporation officer or employee and the corporate profits could be distributed to the stockholders in relation to the number of shares owned. In this manner a son living on the farm would share income with other owners in proper relationship to amount of labor expended and shares of the business owned by each.

The gradual transition of ownership and responsibility of management can take place through periodic gifts or sales of stock, even while the owner maintains majority interest and control. Ultimate control ordinarily rests with 51 per cent of the stock, although a stockholder can temporarily grant his voting rights to another in a voting trust agreement.<sup>2</sup> In this manner a father could dispose of virtually all his stock and still maintain final control. This method would be advantageous when the value of 51 per cent of actual stock ownership represents an estate sufficiently large to create major tax problems.

### Stock Transfer Agreements

An agreement among incorporators to keep ownership of stock within the group is usually desirable since farming corporations are likely to be closely-held or family corporations. For this purpose, stock purchase plans and transfer agreements embodying stock transfer restriction clauses can be devised to facilitate purchase of the stock of a deceased or withdrawing stockholder.

Stock transfer restriction agreements may include the following provisions:

(1) Estates or heirs of a deceased can be assured of a market for their stock at a fair price. This provision affords valuable protection for the widow of a stockholder in a close corporation, or in a regular corporation where corporate earnings are paid as salaries and little or no income is distributed as dividends to the shareholders.

(2) Establishment of stock prices for transfer agreements may assist in establishing an evaluation for estate tax purposes. For this reason, it is best to use conservative values. The manner in which the evaluation is to be made should be stated in the restriction clause. Value of close corporation stock can be based on fair market value, mutual agreement, appraisal, or arbitration.

---

<sup>2</sup> Legal counsel is essential here; reservation of voting rights might void the "corporation-taxed-as-a-partnership" status.

(3) Surviving stockholders can be assured of continuity of ownership and operation since stock cannot be sold to outsiders who could become disinterested or dissenting stockholders.

(4) The restriction clause is usually in the form of a buy-sell agreement, giving the corporation or the other shareholders first option to buy any stock offered for sale, with time limitations specified.

(5) Buy-sell agreements are often supported by life insurance policies on the lives of the major stockholders. Policies may be owned by the corporation and premiums charged off as a business expense.

(6) Stock transfer restriction agreements may facilitate keeping the number of shareholders within the maximum of 10 to qualify to be taxed as a partnership.

### Method of Raising Capital

The capital of several individuals may be combined into a unified operation under the corporate structure. Generally, however, either the returns per dollar invested in farms are lower than with many alternative stocks or the size of the operation is too small to attract outside investors. Then, too, most farmers are unwilling to accept outside investors. Few farm families would want to give up even partial ownership of their business. However, non-farming family members and other relatives may be more willing to retain an interest or invest in an incorporated farm than one with less formal organization.

Issuing preferred or non-voting stock for sale to non-family members is a possible means of obtaining outside capital without relinquishing control. However, it is unlikely that investors would be willing to buy this type of stock in a family farm.

**Credit Status.** The stable nature of the corporation may have a favorable influence on banks and other lenders. Lenders may be inclined to extend more liberal credit if assured of continual management. However, size of operation and reputations and net worths of the owners will remain primary considerations in determining amount of the loan.

Corporations are not eligible for certain types of government loans, such as Farmers Home Administration loans for farm ownership, farm housing, and farm operation. However, incorporated

farms are eligible for FHA conservation loans, special livestock loans, and emergency loans in designated disaster areas. Regulatory requirements that are subject to administrative interpretation include: (1) loans are available only if the borrower cannot obtain a loan of the desired size at reasonable interest rates from other lenders, and (2) after obtaining the Farmers Home Administration loan, the borrower must refinance the loan with another lender when he is financially able.

Farming corporations are eligible for Federal Land Bank Association and Production Credit Association loans provided the farming operations comprise the major part of the corporate activity. Seventy-five per cent of the value of the corporation's stock must be owned by persons who are actively engaged in the farming operations.

**Other Capital Aspects.** Additional financial arrangements are available. Certain property, e.g., land, buildings, and machinery, may be leased or rented to the corporation for regular rental payments. Farm assets may be sold to the corporation under long-term contracts requiring regular installment payments. Loans, leases, and sales to the corporation may be made by the shareholders, but care must be taken that the transactions are sound from legal and business viewpoints.

#### Limited Liability

The liability characteristic of partnerships and sole proprietorships may be alleviated by corporate organization. Stockholders in a corporation have limited liability in that they are liable only for the shares of stock they own. Other property, such as securities, home, or other business interests, is protected. In the case of the partnership and sole proprietorship, future as well as present assets may be made subject to forfeiture for meeting liability judgments. Even though all of his assets may be used in the business, the farmer may prefer to retain title to some of the property and rent these assets to the corporation.

Advantage of the limited liability feature for the corporate shareholder is frequently diminished by lenders who will extend credit to small corporations only if the majority stockholder (in most cases the head of the family) co-signs the note with the corporation. The supposed corporate insulation is thus often nullified in practice.

Protection of the corporate stockholder is provided in the case of a judgment awarded by a jury on a tort claim. In some cases, however, the amount of the claim may be larger or an unfavorable court decision more probable because the claim is against a corporation. The suit is no longer against a "poor farmer," but judged to be against a "large, wealthy, impersonal corporation." Limited liability is, nevertheless, a valuable attribute with useful possibilities in agriculture.

### Possibility of Increased Efficiency

The corporation may provide for increased efficiency since this organization compels keeping accurate records, which give the operator a more sound basis for making decisions. The keeping of accurate records, advance planning, and reporting of results are more easily neglected, or done in a slipshod manner, under other business systems. On the other hand, corporate organization may result in decreased efficiency because of possible complexities arising through decisions being made by a board of directors.

The by-laws of a corporation usually designate how authority will be delegated and what organizational and operational procedures are to be followed. This aids in reducing duplication of effort and conflict of policy that may be present in more casual types of business organization. Although incorporation is not a substitute for friendly relations between business associates, its formal nature can reduce sources of friction prevalent in less formal organization and present an easier means of settling business disputes.

### Control of the Corporation

Management decisions may be made for the farm corporation just as with any other type of ownership, but corporate management may involve more group management. For small farms, however, there are probably no differences in management between the corporate structure and other organizational forms.

There are three distinct groups in a corporation: stockholders, directors, and officers. Stockholders do not participate directly in ordinary corporate management. All stockholders' business must be transacted at authorized meetings unless an individual stockholder has been given express authorization to act as an

agent of the corporation. Stockholders' chief function is the election of directors, which gives the stockholders indirect control of the corporation. Desired changes in the certificate of incorporation must be approved by the stockholders unless specific powers to make these changes are granted to the directors. A meeting of stockholders at least once a year is required by law.

Directors receive their authority from the corporate charter or articles of incorporation. They are charged with the responsibility of establishing a management policy for conducting the corporation's business. The directors select and appoint or hire a manager of the business.<sup>3</sup>

All officers are employees of the corporation and are responsible for day-to-day operation and management of the business within the policy framework established by the directors. Powers of the officers are specified in the articles of incorporation or the corporation by-laws. The officers, as well as directors, act as agents of the corporation and are not personally liable for authorized acts performed in managing the business when they have exercised reasonable care.

In a family farm corporation the same people will probably comprise all three groups. Some states have restrictions both on the number of officers and directors and the number of positions filled by one individual, but aside from specifying a minimum of three directors, Alabama has no such requirements. Even though each group may consist of the same persons, certain rights and responsibilities exist in each position.

### Corporate Taxation

Specific statements concerning corporate taxation are difficult to make because of the complexities and intricacies of the problems. The statements that follow are necessarily of a general nature. Until recently, tax laws have not compensated for differences in size of corporations, taxing all at the same rate. A step toward recognizing differences in the features of large and small corporations was made in 1958 and other adjustments are under consideration.

A corporation is subject to Federal income taxes the same as an individual, but at different rates. Federal corporate tax rates for

---

<sup>3</sup> In the family farm one of the corporate officers usually functions as the manager. Unless either partially or wholly retired, the family head normally would have this position.



ordinary income are currently 30 per cent on the first \$25,000 and an additional surtax of 22 per cent on taxable income over \$25,000.

The corporation may provide income tax savings by stabilizing taxable income from one year to the next. Farm income usually fluctuates from year to year because of price changes and biological factors, but the family members, as corporation officers or other employees, are entitled to salaries determined in advance. If this causes the corporation to have a loss, it may be carried forward as an operating loss to offset a profit the next year.

Although corporate income is subject to double taxation (once as corporate income and again as personal income when paid out as dividends to stockholders), corporate organization offers a means for reducing income taxes through division of income among family members. Usually most of the incorporated farm's income is paid to members of the family as salary from the corporation. Federal tax laws require that such salaries be reasonable and just compensation for work actually performed. The double taxation feature need not be an insurmountable problem even if the corporation should not elect or could not qualify to be taxed as a partnership.

Other than salaries and rentals, other possibilities for minimizing corporate income taxes are bonuses and retained earnings. If made in good faith and as additional compensation for work actually rendered by the employee, bonuses are deductible as a corporate business expense. The employer should avoid making the bonuses in proportion to stock holdings without regard to services performed as they will probably be disallowed as deductions.

Some corporate earnings may be retained for expansion or other reasonable business needs. Retention of earnings may function to reduce the tax burden of the business. Although an accumulated earnings tax is imposed to prevent a corporation from "purposely" avoiding taxes, a small farmer who incorporates can use any surplus earnings to: (1) set aside funds for future expansion, (2) provide additional working capital, or (3) create reserves for unforeseeable emergencies. Even if the corporation has to distribute the retained earnings as dividends, it may postpone the action until periods when the stockholders sustain losses or suffer other reductions in their outside earnings.

**Capital Gains.** If the retained earnings are carried until the corporation dissolves or the individual stockholder sells his shares,

individual stockholders receive a tax benefit through capital gains treatment. However, the corporation itself has been at a disadvantage in having to pay a higher-than-individual tax rate on long-term capital gains. To the individual, long-term capital gains are usually taxed at a lower rate than ordinary income.

Returns qualifying as long-term capital gains to the corporation are taxed at the "alternative rate" of 25 per cent. An exception is that any excess of net long-term capital gains over the corporation's taxable income will be taxed as ordinary income. Individuals with taxable incomes of \$18,000 or less or married taxpayers with taxable incomes of \$36,000 or less add one-half the net gain to their ordinary income and pay tax according to their individual tax bracket. If taxable income exceeds the above amounts, the corporate rate applies. The effective capital gains tax rate will be less than the "alternative rate" for any individual in a tax bracket less than 50 per cent.

**Social Security.** Incorporation will not change social security benefits, but being an employee of a corporation may facilitate the farmer's receiving the \$4,800 maximum income subject to social security. This is especially true where the self-employed farmer's income is normally subject to fluctuations.

However, the total cost of social security benefits is greater to the incorporated business. In 1962, a self-employed farmer paid a 4.7 per cent social security tax. For this same period, a corporation employee paid  $3\frac{1}{8}$  per cent and the corporation paid  $3\frac{1}{8}$  per cent for a total of  $6\frac{1}{4}$  per cent. A farm family may find the difference undesirable, since no greater benefits result from the larger tax payments.

Reduction in social security benefits occur if retired persons between the ages of 65 and 72 earn more than \$1,200 annually; however, dividends from a corporation are not treated as earned income and thereby afford a means of exceeding the \$1,200 earnings limitation.

**Alabama Corporate Income Tax.** Alabama levies a 3 per cent tax on corporate net income. The option of being taxed as a partnership for income tax purposes is not recognized by this State.

#### Gift and Estate Taxes

Type of business organization does not affect the amount of gift or inheritance taxes paid by an individual or estate. Theoretically,

property, whether represented by corporate securities or owned as a sole proprietor, is valued and taxed at the same rates. Use of corporate securities, however, facilitates flexible estate planning and particularly the making of gifts.

**Gift Taxes.** Each individual has a lifetime Federal gift tax exemption of \$30,000. For a man and wife, the combined total is \$60,000. In addition, each individual may claim an annual exclusion of \$3,000 (\$6,000 for a man and wife) for each complete gift to each different individual. Therefore, a husband and wife can jointly give each child a gift valued at \$6,000 each year without incurring any Federal gift tax. This annual gift is in addition to the \$60,000 lifetime exemption.

Gifts from one spouse to the other are taxable on only half of their value; this provision is known as the marital deduction. Gift tax returns must be filed and tax paid on or before April 15 of the year following the year in which the gifts were made. Unless the heirs can prove otherwise, gifts made within 3 years of death are presumed by law to be made in contemplation of death and will be included as part of the taxable estate.

**Estate Taxes.** A Federal estate tax is imposed upon the taxable estate of a deceased regardless of identities of the beneficiaries. In computing the taxable estate certain deductions are allowed. These include all debts and expenses of the estate, charitable and public bequeaths, and a marital deduction for certain property interests passing from the decedent to his spouse. In addition to the allowable deductions, each individual's estate is entitled to an exemption of \$60,000.

The Alabama estate tax is the maximum amount allowable as credit when computing the Federal estate tax. As such, it does not impose an additional tax burden on an estate.

That creation of a corporation does not eliminate or generally reduce gift and estate taxes deserves reemphasis. However, the use of corporate securities greatly facilitates the division and transferral of ownership if the intent of the parties involved coincides with opportunities for tax savings.

### Close Corporations

An all-purpose definition of the close corporation is, at best, difficult. It has been judicially defined as "a corporation in which

the stock is held in few hands, or in few families, and wherein it is not at all, or only rarely, dealt in." The close corporation attempts to achieve the dual advantages of the corporation and partnership, eliminating the major disadvantages of each. Until recently, legislative and judicial bodies have, as a whole, refused to recognize the real differences between a corporation with thousands of widely scattered stockholders and one having a few stockholders actively engaged in its daily affairs.

Prior to 1958, corporate earnings were taxed as corporate income and, after distribution as dividends, as personal income to the stockholder. However, in 1958 Congress enacted Subchapter S of the Internal Revenue Code to make possible selection of corporate business organization without reference to tax consequences. The amendment allows corporations meeting certain basic requirements to elect to be treated as partnerships for taxation purposes.

These close corporations, also known as pseudo-corporations, tax-option corporations, small business corporations, or corporations-taxed-as-partnerships, must meet the following requirements:

- (1) The corporation cannot have more than 10 stockholders. If the number increases to more than 10 after the election, then the close corporation election is terminated.
- (2) All outstanding stock must be of one class. If there are differences in voting rights, dividend rights, or liquidity rights within the shares of stock, for the purposes of this law, two classes of outstanding stock are considered to exist.
- (3) Shareholders must be individuals or estates. The ownership of shares of stock by other corporations, partnerships, associations, or trusts renders the corporation ineligible for Subchapter S benefits. However, shares held for minors by a guardian or custodian do not disqualify the corporation.
- (4) The corporation may not have a non-resident alien as a stockholder.
- (5) The corporation must be a domestic corporation of the United States and not a member of an affiliated group.
- (6) Corporations with income from sources outside the United States amounting to more than 80 per cent of their gross receipts are disqualified.

(7) Corporations deriving more than 20 per cent of their gross receipts from rents, royalties, "personal holding" income, dividends, interest, annuities, or sales of stock are also disqualified. Therefore, a farm corporation that derived more than 20 per cent of its gross receipts from renting farm land or machinery would be ineligible.

(8) All the stockholders must agree to be taxed as a partnership. Should any new stockholder be admitted, he must file his consent within 30 days or the election is terminated. If the stockholders desire to terminate the tax option, all must sign a statement consenting to the revocation. Termination of the option will occur automatically in event any of the above requirements are exceeded.

Taxable income of such corporations for the taxable years during which the election is effective is taxable directly to shareholders. Undistributed taxable income is taxed to shareholders as a constructive dividend. Shareholders on the last day of the tax year are taxed on their full allocable share of the entire year's earnings even though they may have owned stock less than the full year.

Similarly, if the corporation shows losses during such years, the loss is treated as the shareholder's loss, but not to exceed the basis of his investment. Shareholders cannot avail themselves of any loss carryover from years prior to those during which the election is effective and the election has no application to previously accrued earned surplus.

Capital gains are given more favorable treatment in the close corporation than in the regular corporation. Long-term capital gains are passed through to the shareholder in accordance with the number of shares of stock owned by each.

To qualify to be taxed as a partnership, the corporation files Internal Revenue Form 2553 to indicate the consent of each shareholder. This form, along with a signed statement of consent of the shareholders, their names, addresses, number of shares, and dates of acquisition, is filed with the District Director of Internal Revenue. The election by a corporation must be made: (1) within the first month of the taxable year, or (2) during the month immediately preceding the first month of the year for which the election applies.

Except for detailed provisions relating to the determination of

amount of income taxable to each shareholder and of the tax basis of his stock, the business continues, in all other respects, to be treated as a corporation. Accordingly, an electing corporation obviates double taxation and leaves shareholders in a position where, unlike partners or sole-proprietors, they can continue to receive "fringe benefits" available to corporate employees.

### Fringe Benefits of Corporations

A corporation may deduct as business expenses such fringe benefits as sick-pay exclusion, medical payment plans, employee death benefits, group life insurance, and deferred compensation plans. Such benefits are either not available or cannot be deducted as business expenses by sole proprietorships or partnerships.

Deferred compensation plans may be considered in retirement planning. Advantages of such a plan include: (1) the employer can deduct his contributions to a qualified plan immediately for income tax purposes; (2) the trust fund of a qualified plan is exempt from income tax; (3) employees are not taxed on distributions from the fund until they are actually received or made available; and (4) in some cases, the long-term capital gains rate applies.

Pension and stock bonus plans have little place in the usual farm corporation, but the profit-sharing plan is a practical type of retirement program. Profit-sharing is a means of allowing employees to share in the employer's profits. Contributions are paid into a trust where they must be allocated to participants' accounts by a fixed formula and distributed after a fixed number of years or upon the occurrence of some event, such as illness, disability, retirement, death, or severance.

To qualify, the plan must: (1) be in writing, (2) be communicated to employees, and (3) consist of a domestic trust making it impossible for the funds to be used for purposes other than exclusive benefit of employees or their beneficiaries. The most emphasized requirement is that the plan may not discriminate against employees who are minor stockholders or are not stockholders, nor discriminate in favor of officers, supervisors, or highly compensated employees.

Some flexibility in coverage is permitted. Employees who customarily work less than 20 hours per week, those who customarily

work no more than 5 months in any calendar year, and those who have not been employed the minimum period required by the plan (not to exceed 5 years) may be excluded.

Although the employer does not have to undertake a definite obligation to contribute to maintain the plan, contributions must be substantial and recurring, not merely occasional. Contributions need not be made every year, but the plan must be permanent to qualify. Finally, the employer may reserve the right to amend or terminate the plan.

Profit-sharing plans may be complex or relatively simple. Normally a simple plan will work just as well as a complex one for a small corporation and the legal fee for establishing it will be substantially less.

Another attribute entails the ease of shifting income. A parent may, by giving his child shares in the farm corporation, enable the child to participate in income already earned or to be earned and to pay a lower tax, if any, on that income than the parent would have paid; also, the parent may possibly be dropped to a lower tax bracket. Shifting of income is permissible in both regular corporations and close corporations. Internal Revenue officials may question similar arrangements under sole proprietorships and partnerships including non-participating family members.

#### Process and Costs of Incorporating

In Alabama three or more persons (at least three must be over 21 years of age) may become a body corporate for operating any lawful business upon preparing and filing a certificate of incorporation pursuant to the provisions of the Alabama Business Corporation Act.

Contents of the certificate of incorporation include: (1) the name of the corporation; (2) object or objects for which it is formed; (3) its location; (4) amount of capital stock, both authorized and paid in, **which shall in no case be less than one thousand dollars (\$1,000)**; (5) the officer to receive the subscriptions to the capital stock; (6) a list of incorporators and their shares; (7) the time limit, which is normally perpetual; and (8) any special provision that the incorporators choose to insert for regulation and conduct of the corporation, its directors, stockholders, and employees.

The corporation must pay certain fees and business taxes not

required of other types of business organizations. These costs vary from state to state, thus some states are more popular havens for corporations than others. The estimated costs of incorporating a \$60,000 farm business in Alabama are presented in Table 1.

The franchise tax and fee for the permit to do business are annual taxes, due the first of each calendar year. The remainder are one-time costs, to be paid only at the time of incorporating.

Legal fees vary widely according to such things as how well the incorporators know their attorney, the nature and detail of the corporation, and the incorporator's knowledge concerning what is desired. Attorneys generally operate under a fee schedule for the individual county and considerable variation in rates among counties and states exists.

There is a Federal stamp tax on issuance of stock at the rate of 11 cents per \$100 of face value of stock certificates. Another expense is the purchase of a corporate minute book. These books cost \$10-\$25 and include the corporate seal, stock certificates, minute sheets, by-laws, and stock transfer sheets.

Farm corporations, just as other corporations, are required to keep correct and complete records and minutes and they must make an annual stock assessment report each fall. The tax return, together with a profit and loss statement and a net worth statement, is sent to the state department of revenue for the actual

TABLE 1. ESTIMATED COSTS OF INCORPORATING A \$60,000 BUSINESS IN ALABAMA\*

Type of Cost	Amount
To Probate Judge	
Initial tax (\$1 per \$1,000 of capital stock).....	\$ 60.00
Examining charter.....	2.50
Recording charter (\$.15 per 100 words).....	3.00
Filing statement of incorporation with Secretary of State.....	2.50
To State Department of Revenue	
Annual franchise tax, formed before July 1** (\$2.50 per \$1,000 of capital stock).....	\$150.00
Annual fee for permit to do business (based on paid capital stock).....	30.00
TOTAL FEES TO COUNTY AND STATE.....	\$248.00
Estimated attorney's fee and associated costs.....	85.00
ESTIMATED TOTAL COSTS.....	\$333.00

\* Because of variations in rates among counties and states and among individual attorneys, an estimate for the individual farm situation should be obtained. The estimate given excludes the Federal stamp tax on issuance of stock.

\*\* A corporation organized after July 1 is required to pay only one-half of the first year's tax.



assessment. In Alabama, the report is then returned to the county of residence where the tax is levied.

Some operators of incorporated farms hire a professional accountant to handle the annual paperwork and filing of reports incidental to being incorporated. On other farms this duty is undertaken by a member of the family. Size and complexity of the business and capability of the family member govern the choice of agents.

### METHOD AND PROCEDURE

A common criticism of farm management research has been associated with the tendency of researchers to seek the relatively easy method of direct comparison of organization and management of individual farms (5,9). Under this method, findings are based on the experiences of a large number of farmers who are operating under similar conditions. The weakness of this method is the assumption that farms and farm operators can be classified into homogeneous groups. In this study, an attempt was made to recognize the inherent differences existing between individual farms.

An adequate analysis required that individual farm situations be carefully studied in relation to possible outcome under various organizational alternatives. To facilitate this intensive approach, the case study method was used. The number of case studies was limited to permit an intensive study of pertinent details of business arrangements and family situations on each farm. Use of the more extensive survey method would have precluded an analysis in sufficient detail to meet the needs of the study.

An intensive examination was made of available literature on the subject of corporations including previous studies of farming corporations. Drawing on the material examined, a framework of reference was developed in which the fundamental attributes of the corporate structure were outlined in a perspective relative to the family farm business.

The corporation files in the office of the Secretary of State were checked to determine the extent to which the corporate structure had been used by Alabama farm owners. Questionnaires were mailed to county agents regarding identified corporations whose corporate charter indicated that they may have engaged in farming.

The term "family farm" has been used with so many different

meanings attached that some economists feel it useless to even attempt a specific definition (12). However, for the purposes of this study, a family farm was defined as a farm business owned and managed by members of a single family or members of more than one family (e.g., father-son arrangement) farming as a unit. Under this definition, family members furnish some of the labor, **although no limit** is imposed on the amount of hired farm labor that may be used. Normally, more than 50 per cent of the family income comes from farming.

The case farms studied included both incorporated farms and farms on which the corporate structure was being considered as a possible alternative to a family partnership or sole proprietorship. Incorporated farms were located as a result of the preliminary study of existing corporations in the State and unincorporated farms were located through the assistance of county agents and students at Auburn University. For each of the 11 farms, the initial contact suggested adaptability of the corporate structure to the farm and revealed the farm family's interest in the study.

Prior to the first visit to each case study farm, the county agent was familiarized with the project. He usually made arrangements for the initial visit and was present for the first interview. In addition, he was notified in advance when subsequent visits were to be made, although he was not always present for these interviews. Case studies were limited to farms operating on a business basis rather than as residential or subsistence farms. Two of the farms did not meet the definition for the purposes of the study;<sup>4</sup> however, they were included in the belief that observations of these two farms would be helpful in appreciating the opportunities and problems on family farms.

The initial visit to the case study farms was to familiarize the families with the objectives of the study and to obtain a general idea of the existing business arrangement, family situation, and objectives sought by the families.

An informal interviewing procedure without a predetermined written list of questions was used. The interview technique was adjusted to coincide with the needs of each individual situation as the study progressed. The parties involved were encouraged to discuss various aspects of the farm business and family situation.

---

<sup>4</sup> These farms were family-operated, but received less than 50 per cent of the family income from farming.

## OBSERVATIONS

An examination of incorporation records in Alabama revealed that 270 corporations formed since 1900 had farming operations listed in their objects of incorporation. It was difficult to determine whether a corporation was still active because of lack of records of dissolution in many cases, but apparently at least 50 of the 270 were still active.<sup>5</sup> Only five of these were incorporated prior to 1950. Fifteen corporations engaged in farming were classified as family farms. Three of these were included in the cases studied. Eight additional farms that were not incorporated were included in the study.

Eleven farming situations were examined and recognized as case studies A through K. Observations of each case study were analyzed relative to family situations and operating arrangements in the interest of determining the logic of incorporation under the conditions of each individual farm.

## BRIEF DESCRIPTION OF THE CASE SITUATIONS

As a background for the analysis that is to follow, a short identification statement about each case situation is given.

*Case Study A* was an incorporated poultry farm operated by parents. Their two grown children are shareholders but are not active participants. The parties involved had experienced favorable results with corporate structure. A stock restriction clause was included. The father was retirement age and continuation of business was a problem since children were not interested in managing the business.

*Case Study B* was a partnership without a written agreement. The father-son partners were primarily engaged in operating a dairy farm. The parents also had three daughters, one of whom was high school age. Although the partnership had made considerable progress, depth interview disclosed points of dissension and lack of understanding, partially traceable to lack of explicit agreement. A high capital investment was involved with separate ownership of real estate. The joint ownership arrangement for personal property appeared susceptible to dispute.

<sup>5</sup> Legally in Alabama a corporation must file a net worth statement annually for determining the capital stock tax. In many cases the statement is not filed because of the absence of business activity. Also dissolution papers may not have been filed. Thus it is difficult to determine the status of corporations.

*Case Study C*, a single proprietorship beef operation, was classified as a non-family farm because of percentage of income from non-farming sources. Close association with corporate structure came from non-farm interests. Two sons were involved in the farm operation. Any incorporation problems apparently could be handled on a routine basis.

*Case Study D* had progressed from single proprietorship, to partnership, to corporation since soon after World War II. The parents and their three sons were active in the business, a large-scale dairy. Their partnership organization had proved unsatisfactory because of limitations of the partnership structure. The parties involved were pleased with their operations under corporate organization.

*Case Study E*, a sole proprietorship dairy farm operated by a father and three sons, was a successful business from the standpoints of production and economic returns. An appropriate arrangement was still in the early discussion stage. Parties involved were conscious of weaknesses in their present organization. Salaries paid the sons compared favorably, however, with what they might have been paid in other employment. There was evidence of a desire by all four parties to establish the business on an equitable, participating basis.

*Case Study F* was an incorporated dairy farm. Principal shareholders were the operator and his father, with the additional shares being owned by the operator's wife. The corporate structure had proved useful to this family and statements indicated that without incorporating, the joint venture would have terminated. The operator's brother was employed by the firm as a laborer following unsuccessful business experience elsewhere.

*Case Study G* was a single proprietorship with plans for formation of a partnership or corporation. Principal parties were the father and his son, a recent agricultural graduate of Auburn University. The parties involved were carefully considering incorporating as an initial alternative to the partnership. The principal income source was from dairying. All parties appeared highly conducive to development of a strong business arrangement.

*Case Study H*, a single proprietorship, produced peanuts, cotton, hogs, and beef cattle as major sources of income. Interest was expressed in determining a satisfactory arrangement whereby the son, who was graduating from college in agriculture, could satisfactorily participate in the business. The father was willing

to reach a strong arrangement, but was skeptical of a weak and incomplete arrangement. The need for an intermediary arrangement prior to any incorporating procedures was required by the father and from all observations logically so.

*Case Study I* concerned a manager who was part owner and had responsibility for large acreage owned by several relatives on various arrangements. The operation was primarily a beef cow-calf business with a large part of the land in timber. The management could not be considered as being on a sound business basis. Major obstacles to reaching such an arrangement included: (1) customs and traditions of the area relative to business organization, and (2) attitudes toward farming as a business as contrasted to capital gain from owning real estate.

*Case Study J* was a single proprietorship in a transition stage of property transfer between generations. A widowed mother and three daughters were involved. A son-in-law was the manager, and the only male member of the families with farming interests. The provisions of the will of the deceased father, the action by the mother relative to her life estate, the cooperation demonstrated by the other two children who held remainder interest, and the aggressive business-like approach of the manager had contributed to reestablishment or transfer of the business in a relatively short time. Principal sources of income were cotton and a beef herd with custom work developing into a significant income source.

*Case Study K* involved an operation that was in the process of being incorporated at the time of the study. Because of extensive non-farm interests, this farm did not meet the family farm definition used in this study. This was a large-scale farm with major income sources from cotton, dairying, poultry, feeder hogs, and feeder steers. Service industries to agriculture of the area were sources of non-farm income. The business had originally been operated on a partnership basis, but currently three children of one original partner had active managerial roles with four other children maintaining silent interests.

#### SOME GENERAL FINDINGS

##### Criteria for Business Success

The conditions generally ascribed for a successful business and for business endeavors where more than one party is involved

(e.g. father-son farming arrangements) were not or would not be alleviated by use of corporate structure. These conditions refer to volume and efficiency of the business, attitudes toward the farming occupation, living arrangements, willingness to participate in and obtain a satisfactory joint farming arrangement, and ability and willingness of the parties involved to plan and work together. Any differences between the corporation and other forms of business organization lie with the ease with which these conditions may be met. The stability and degree of understanding associated with corporate structure can reduce the opportunities for misunderstanding as was conspicuous in Case Study F.

### Management

In general, the corporate farm faces the same management decisions as does a farm under any other organizational form. Incorporated businesses usually make decisions in a different way. This is not necessarily true with a family farm, because the same people are usually at all levels in the corporation — manager, stockholder, and director. This was true for all major stockholders in the incorporated farms studied and would be true if the others were to incorporate.

### Legal Requirements

The partnership and sole proprietorship can exist without a formal document. This is not true with a corporation. It is generally recommended that a partnership also have a formal partnership document. The legal requirements of incorporation are easily handled by a competent attorney. The authors observed that the agricultural and business details of an arrangement would be easier handled by an attorney under the corporate form of organization than under the partnership.

### Cost of Incorporation

The cost of incorporating a business did not appear to be a major point of concern with the families. Elements of previous association with the corporate structure, confidence in legal procedures, and general willingness to take action were more paramount than cost consideration. This cost element would probably have been conspicuous on farms where volume building and income were more acute problems than was true with the cases studied.

### Capital Accumulation

The opportunity for capital accumulation varied widely. In Case Study H, the father was seeking a sounder basis for bringing the son into the business than had been the case when he entered such an arrangement with his father. Weaknesses in the single proprietorship and the partnership relative to their needs were conspicuous to the father. Also, he was conscious of the needs for observing his son under a preliminary type of arrangement prior to making him a significant partner or major stockholder. Use of the corporate structure from the beginning to provide a sound basis for a joint endeavor was observed in Case Study G. Amiable conditions were conspicuous and the desire to move aggressively from the start was characterized by confidence, willingness, and desire for action.

### Subdivision Tendency

The subdivision tendency for each generation can be averted with organization other than the corporate form, as evidenced by Case Study K with the partnership and Case Study J with the sole proprietorship. Ease of transfer and convenience in operation was evidenced in Case Study K where the parties involved were undertaking incorporation proceedings at the time of the study. The framework for transfer was earlier cited relative to Case Study D where understanding existed on this topic as contrasted to Case Study E where appropriate protective action had not been taken.

### Intergeneration Transfer

The ease of transfer of businesses between generations under the corporate structure is frequently discussed as an advantage of this system. That this form of organization does not necessarily solve the problems involved was observed in Case Study A. The manager was in his early 70's and had not been able to locate family or non-family members to become associated with the business as a part owner-manager. If a young man who would meet the needs of the firm became associated with the business, then the usefulness of the corporate structure relative to transfer as evidenced in Case Study D would apply.

The opportunity for satisfactorily obtaining the objectives in continuance of the farm as an aggressive firm was evidenced in

Case Study J, but the risks that were involved were acute and preferably should have been reduced. The difficulties involved were portrayed by Case Study I, Figure 2. This business included 3,330 acres of land, 2,600 of which was timberland with the remainder being largely in unimproved pasture. Although the land was operated on a single managerial basis, six different ownership patterns were included in the business. The particular arrangements on each, shown in Figure 2, were:

Area A — 612 acres were owned one-half by the manager's unmarried aunt and one-half by the manager, his brother, and his sister. The manager paid \$200 cash rent to the aunt in return for grazing rights.

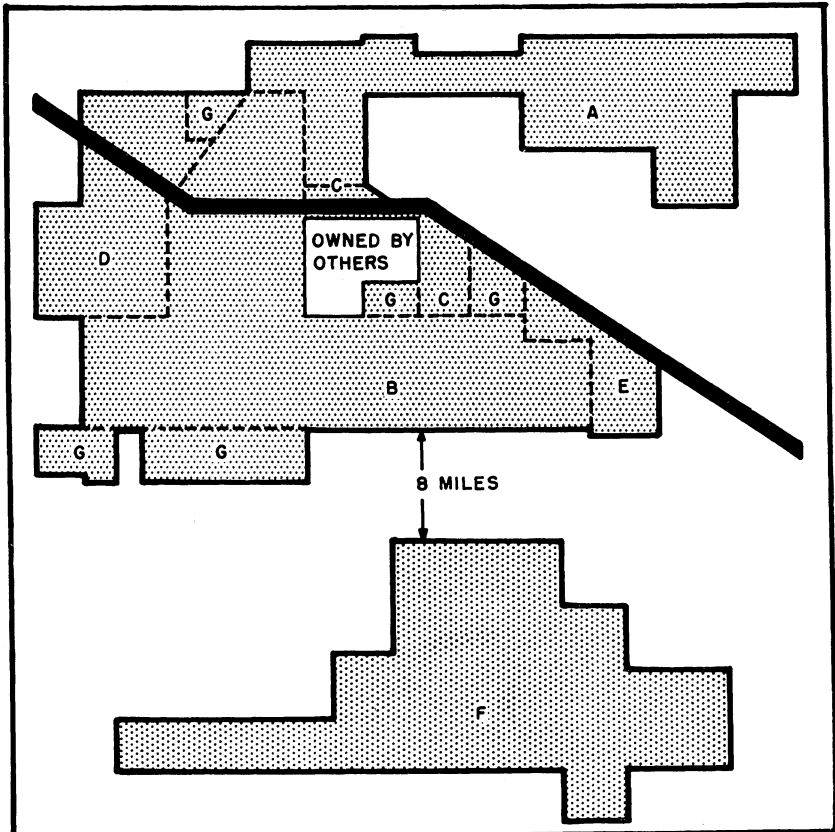


FIG. 2. Ownership pattern of farm land making up Case Study I is illustrated by the above drawing. Tract F is located about 8 miles from the other holdings.



Area B – The manager, his brother, and sister had one-half interest in 1,230 acres; the mother held one-half interest as a life estate with the remaining interest going to her children.

Area C – The mother had a life estate in 30 acres, which was the home place. The remainder interests were held by her children.

Area D – One-third of 420 acres was owned by the manager's four cousins, one-third by the aunt, and one-third by the manager and his brother and sister. One-half of the timber receipts went to the aunt with the concurrence of the cousins, and one-half to the manager, his brother, and sister on an equal basis.

Area E – 58 acres were owned by the manager.

Area F – 904 acres were owned equally by the manager, his brother, and his sister. Thirty-five acres of cropland were rented for \$200, which was used to pay taxes on the land.

Area G – 77 acres were owned jointly by the manager, his brother, and his sister.

Beef cattle and timber were the primary sources of income. Approximately 200 head of grade beef brood cows were owned by the manager and his mother, two-thirds by the manager and one-third by the mother. The receipts were divided accordingly. Another 50 brood cows were owned jointly by the manager and his aunt and returns from these were divided equally. The manager paid all expenses in connection with the livestock enterprise, and exercised general supervision of timber transactions without special charge. The receipts from timber were divided according to the manner in which title to the property was held.

### Liability

Liability is a major factor with the partnership and single proprietorship. The corporate structure facilitates reduction in the extent of liability. The liability of concern appeared to rest with disinterested parties rather than with the liability that may be incurred by association with the parties involved in the business. The extent to which liability can be reduced under the partnership remains a topic for debate. Questions of liability were raised when several of the observations were being made.

## Federal Income Taxes

Income tax differences under corporate organizations have created much interest. However, taxes for the incorporated family farm may not differ basically from those paid under partnership or single proprietorship. Under certain conditions, which family farms usually meet, the corporation may elect to be taxed as a partnership. A partnership files a tax return but pays no taxes. Taxes are paid by members of the partnership on individual earnings from the partnership. As a second alternative, income of the family corporation can be paid as reasonable salaries to the parties involved, rather than as dividends. The double taxation feature normally associated with corporations is eliminated by accounting.

Income tax differences were not a point of major concern in consideration of the corporate structure by the families studied.

### A SPECIAL STUDY

Two case studies are further described for contrast benefits. These were selected because of close similarities in many respects. Insights relative to the differences arising from the business organization are outlined.

<i>Characteristic</i>	<i>Case Study D</i>	<i>Case Study E</i>
Present organization	Corporation	Single proprietorship
Present success of business	Impressive	Impressive
Age of father	Early 70's	Early 50's
Principal income source	Dairy	Dairy
Principal parties	Parents and three sons	Parents and three sons
Other heirs of parents	None	Three daughters
Activity of father	Overall general management and general consultation	Manager
Ownership of parents	Two-fifths of business	All by father
Ownership of sons	One-fifth of business each	None
Compensation for sons	Monthly salary plus returns as owners	Monthly salary
Residence of sons	Separate housing owned by occupant	Separate housing, but owned by father

<i>Characteristic</i>	<i>Case Study D</i>	<i>Case Study E</i>
Past organizations	Corporate structure had been compared by use with single proprietorship and partnership and the corporate structure was preferred	Consideration of formal partnership and corporation without any formal action
Transfer plan	A satisfactory and successful estate transfer plan that favored continuance of the farm as a unit had been planned and was being implemented during the father's lifetime	Adequate plans had not been made and the future of the business in event of the father's death was questionable
Business continuity	Continuity of the farm business in event of death of a shareholder-employee had been assured through an insurance plan and a stock transfer restriction plan	Arrangement for operation of the business would have to be developed in event of the death of the manager
Prospective profits	Possibility for fall in business profits with retirement or death of father had been reduced if not eliminated	Presence of sons with present arrangement would tend to maintain profits during father's lifetime but the consequences on father's death not determined or relatively unassured
Protection of heirs	Protection for the heirs of a deceased shareholder had been provided	Provisions for the heirs of a deceased son were not developed
Incentives	The corporate structure provided incentive for the sons who remain on the farm	Elements of dissension were detected because of lack of equity accumulating provisions in the arrangements for the sons

## SUMMARY

Three forms of business organization are available to the family farm: the sole proprietorship, the partnership, and the corporation. The sole proprietorship has been the predominate and simplest form of organization in American agriculture. Special problems in resource accumulation and intergeneration property transfer have prevailed under the sole proprietorship. This study has focused attention upon the corporate structure as an alternative solution to these and other problems.

Observations of actual farm conditions disclosed that the corporate structure can be a desirable form of business organization. However, problems of accumulation and transfer are solvable under the sole proprietorship and the partnership. The act of adopting any one of the three business organization forms does not assure problem solution. The differences concern the ease and business-like basis by which objectives may be accomplished under the corporate structure.

Broad generalizations relative to what family farms may best be incorporated appear not to have great value. The individual case study approach characteristic of farm management endeavors of the past has use also in decision-making pertaining to the form of business organization. In decision-making, observations and analysis of the corporate structure and the alternatives to it relative to the problems of the individual farm are required.

Incorporating may have much to offer individual family farms, but it should not be viewed as the solution to all contemporary maladjustments in American agriculture. Adoption of the corporate structure offers possible solution to serious organizational problems through minor modifications of family farm organization.

Corporate farming does not signify the end of the traditional family farm. Rather, it may be a major tool for maintaining and increasing efficiency of the family farm unit.

## LITERATURE

- (1) ACKERMAN, J., AND HARRIS, M. Farm Family Policy. The Univ. of Chicago Press, Chicago. p. 7. 1947.
- (2) ALDRICH, D. G., JR. As Quoted in Better Farming Methods. 33:108. 1961.
- (3) ARNOLD, L. L. Problems of Capital Accumulation in Getting Started in Farming. Purdue Univ. Agr. Expt. Sta. Bul. 638. 1957.
- (4) ECKHARDT, A. G., AND THE LAW REVIEW SEMINAR. Family Farm Corporations. Wisconsin Law Rev. 1960.
- (5) FELLOWS, I. F. Developing and Applying Production Functions in Farm Management. Jour. of Farm Econ. 31:1059. 1949.
- (6) HARRIS, M., AND HILL, E. B. Family Farm-Transfer Arrangements. Illinois Agr. Ext. Ser. North Central Reg. Pub. 18. 1951.
- (7) HILL, E. B. Impact of Taxes and Legal Costs on Farm Transfers and Estate Settlements. Michigan Agr. Expt. Sta. Spec. Bul. 424. 1959.
- (8) HUBBARD, D. W., AND BLANCH, G. E. The Farm-Ranch Corporation: A Tool for Financial Planning and Management. Oregon Agr. Expt. Sta. Bul. 576. 1961.
- (9) JAMES, H. B. Limitations of Static Economic Theory in Farm Management Analysis. Jour. of Farm Econ. 32:115. 1950.
- (10) KANEL, D. Opportunities for Beginning Farmers, Why Are They Limited? Nebraska Agr. Expt. Sta. North Central Reg. Pub. 102. 1960.
- (11) KRAUSZ, N. G. P., AND MANN, F. L. Corporations in the Farm Business. Illinois Agr. Ext. Ser. Cir. 797. 1958.
- (12) MCPHERSON, W. K. A Critical Appraisal of Family Farms as an Objective of Public Policy. Jour. of Farm Econ. 34:311. 1952.
- (13) REISS, F. J., *et al.* Getting Started and Established in Farming With and Without Family Help. Illinois Agr. Ext. Ser. North Central Reg. Ext. Pub. 8. 1960.
- (14) WALRATH, A. J., AND GIBSON, W. L., JR. Farm Inheritance and Settlement of Estates. Virginia Agr. Expt. Sta. Bul. 413. 1948.
- (15) ZIMMERMAN, C. C. Family Farm. Rural Sociol. 15:216. 1950.

