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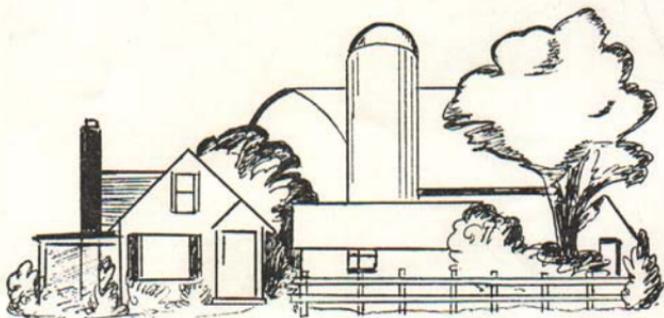
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Should We Incorporate the Farm Business
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INCORPORATE
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Should We Incorporate the Farm Business

By E. B. Hill

Department of Agricultural Economics

Interest in the corporate form of organization in farming has increased greatly in the past few years. This increase in interest is largely the result of (1) a search for ways of lessening the impacts of taxes and legal costs in estate settlement, (2) the 1958 federal tax law which exempts certain small corporations from double taxation, and (3) a need for a better way of organizing the farm business in this day of larger farms and larger investments. However, not many farms in Michigan are now incorporated.

The corporate form of farm organization does have merit for certain situations and little or no merit in other cases. Like many persons, you may believe that incorporating will solve many or all of your problems of intra-family farm transfer. You may look upon it as a way to reduce the impact of taxes and legal costs in estate planning. You may consider it a better way of doing business. However, it is not a cure-all for these problems. In some situations the corporate structure causes new problems not anticipated in the incorporation process. In other situations, the problem could be better solved by other methods.

DON'T RUSH INTO IT

The major problem is to decide if incorporation is or is not the best answer for your particular situation. Usually there is no need to hurry the decision. It is a relatively easy and quick process to incorporate. *It may or may not be so easy and quick to unincorporate.* Thus, if you are thinking about incorporating your farm business, be sure to take enough time to study the proper procedures of incorporation. Also weigh the pros and cons of the corporate structure for your own particular farm situation.

The First Step — The first step is to learn all you can about such items as: (1) incorporation procedure, organization and reports, (2) corporate finance and member contributions to the corporation, (3) kinds

and amounts of stock to be issued, (4) corporation taxes, and (5) management control.

If you are a prospective incorporator, study the general corporation laws of Michigan. They are presented in a 216-page book*, *Michigan General Corporation Laws*, available from the Michigan Corporation and Securities Commission, 300 East Michigan Avenue, Lansing. The cost is \$1.00.

This book presents the constitutional provisions as well as details of the laws of Michigan under which farm corporations in this state are organized and operate. It provides such information as the term of the corporation, required number of incorporators and directors, essentials in articles of incorporations, procedure involved in incorporating, corporate shares of stock, state corporation fees, etc.

The Second Step — The next important step in your decision would be to consider the finances involved. How much capitalization is anticipated? How much capital does each incorporator subscribe? What class, number and value of shares of stock are to be authorized? What valuation should be put on the assets to be included in the corporation? Should all of one's assets be put in the corporation? Should some of a member's assets such as land be rented to the corporation?

The Third Step — The next step would be (1) select an attorney to advise you and to provide legal services in the organization of the corporation (see page 10 for list of items requiring his advice) and (2) perhaps also select a certified public accountant to get your record books, inventories and finances in proper order.

KINDS OF FARM CORPORATIONS IN MICHIGAN

The kind of structure used in incorporating farms in Michigan is similar to that used by most other business enterprises, whether they are machine shops, clothing stores, or automobile manufacturers. The major difference is largely a matter of size.

Michigan farm corporations usually fall in one of three categories:

- (1) the "closely held" corporation where shareholders are family related
- (2) the "closely held" corporation in which the major shareholders are unrelated

*Particularly on pages 18 to 75, 125 to 135 and 186 to 191.

- (3) the farm corporation which is a subsidiary of another corporation such as a farm operated as a corporation by an elevator or feed company which is itself incorporated.

This report deals primarily with the "closely held" type of farm corporation in Michigan in either the related or the unrelated situation.

WHY SOME MICHIGAN FARMS INCORPORATED

The major reasons why four Michigan farms incorporated recently are as follows:

- (1) One farm business was incorporated in 1955 because the active participants, a father and four sons, considered it to be a more practical form of organization than a five-man partnership.
- (2) Another somewhat larger and more diversified farm business was incorporated in 1947 to help transfer the farm and farm business to the next generation in the same family.
- (3) One farm business was incorporated in 1957 by a farmer and a nearby business man. The farmer put in his farm and the nearby business man put in an amount of capital equal to that of the farm. The purpose of the arrangement was to gain additional capital and credit in order to quickly and greatly increase the size of business and to modernize the entire plant.
- (4) A fourth farm business was incorporated by a local elevator which itself is incorporated. This farm was incorporated for the purpose of producing hogs and particularly feeder pigs on a large scale. The corporate structure was considered to be the best arrangement to get the job done.

ADVANTAGES

What are some advantages of the corporate structure in farming? It may help:

- Obtain additional capital and credit to increase the size and efficiency of the farm business.
- Provide a better transfer arrangement for keeping a large farm in the family.
- Minimize the state inheritance and federal estate taxes for the owner.
- Provide a better and more efficient way of handling the farm business in a set-up where two or more persons are involved and where the business is on a large scale.

- Reduce individual liability in the business.
- Provide greater continuity of the farm business.

Note the words *may help* in the foregoing list of advantages. There are also situations in which incorporation may not help. There are also situations in which it may be easier to do the job some other way. Each one of these advantages will now be discussed in more detail.

Attaining Additional Capital and Credit — In some situations it may be possible to interest an outside business man in putting money in a corporate farm venture along with a good farmer who already has considerable assets. The outside business man may want to become closely associated with a farm but not wish to assume the responsibility of managing and operating the farm with a paid manager or with a tenant. Investing his money to help expand and modernize a going concern under good management may be just what he is looking for.

In addition, participating as a shareholder in a corporation rather than as a partner in a partnership will limit his liability to the extent of his assets in the corporation. Furthermore, bringing capital together under a single control may greatly improve the credit status of the business.

As an Intra-Family Farm Transfer Plan — One advantage often cited for the corporate structure is that it is an effective intra-family farm transfer arrangement. This advantage is essentially associated with large farms where other methods of transfer such as by sale, by land contract, by gift, by combination sale and gift, or by a will do not quite solve the problem.

It is physically easier to transfer either by sale or gift from parents to children one or more shares of capital stock at a time than it is to transfer one or more acres of land. Furthermore, it may be considerably easier for a young farmer to buy-in on a large farm at the rate of one or more shares of capital stock at a time than to buy-in on some other basis. For a small farm, that could be sold and purchased outright, however, the land contract might serve equally well or better.

With a larger farm, furthermore, the father may not want to give up management control until a later date and yet wishes to start the transfer process. This may be done by incorporating and either selling or giving to the children shares of stock in the corporation. By retaining over 50 percent of the stock in either or both of the parents' names, the father would have the controlling vote in the corporation and in the farming operations. It might be well in this situation to include in the corporation bylaws some provisions regulating the sale and transfer of shares by the shareholders.

A desirable feature in this connection might be a buy-and-sell agreement between a father and son. Suppose, for example, the farm was incorporated and 1,000 shares of stock issued to the father. The son could gradually purchase or be given 300 shares and then enter into a buy-and-sell agreement, with his father and mother allowing him to purchase an additional 300 shares at the death of the father. The remaining 400 shares could be left by the father's will to his widow. This would make the son a majority shareholder and as such he would have management control.

Minimizing the State Inheritance and the Federal Estate Taxes^o — Persons with fairly large estates — for example, estates of around \$60,000 to \$70,000 or more and particularly single persons with estates of that value — should consider plans for estate management. Such plans should have the following goals:

- Should be agreeable to entire family, if possible.
- Provide for a reasonable degree of security for the parents.
- Provide for a reasonable degree of security for the farm operating heirs.
- Minimize the impacts of taxes and legal costs in estate settlement.
- Provide for continuity of the home farm as a going concern.

While it may be desirable to plan to minimize the impact of taxes and legal costs in estate settlement, this consideration should usually be the last and not the first in making estate management plans. In this connection, it is well to know the Michigan inheritance tax, the federal estate tax, the federal gift tax, and the capital gains section of the federal income tax.

The Michigan inheritance tax allows an exemption of \$30,000 for the surviving spouse and \$5,000 for each child. The graduated tax rate is relatively low and starts at 1½ percent on real estate and 2 percent on personal property.

The federal estate tax allows an exemption of \$60,000 for a single person. A married person has the \$60,000 exemption and also a marital deduction of one-half of his adjusted gross estate if it is left to his surviving spouse. The federal estate tax is also a graduated tax and the rates are much higher than the rates of the Michigan inheritance tax.

The capital gains section of the federal income tax is involved only in the sale of the farm.

^oFor more detailed information on this subject, see Hill, E. B. "Impacts of Taxes and Legal Costs on Farm Transfers and Estate Settlements," Mich. Agr. Exp. Sta. Spec. Bul. 424, October 1959.

The federal gift tax is involved if the gifts exceed the allowable exemptions. With the federal gift tax, there is a yearly exemption of \$3,000 for a single person and \$6,000 for a married couple as a gift to any one person. For example, a farmer could give \$3,000 a year and he and his wife together give \$6,000 to each of any number of persons. In addition, the husband has a single life-time exemption of \$30,000 while for him and his wife together the life-time exemption is \$60,000 even though only one of them really owned the property given away.

Minimizing estate settlement costs by means of gifts is the procedure most often discussed in connection with the advantages of a corporation. Thus, if you wish to reduce the size of your estate during your life time by means of gifts, it is made easy through giving away shares of capital stock in the corporation. With smaller estates, much the same thing can be done by selling the farm on a land contract and then making gifts equal to a part or all of the current payments on the contract up to the exempted limits.

Providing a Better Way of Operating the Farm Business

— This advantage of a corporation might occur in a situation involving two or more persons and where the business is on a large scale. For example, a Michigan farmer and four sons wanted to conduct their business as one unit. They incorporated in 1955 and have been well satisfied with the results.

Reducing Individual Liability — This feature may or may not have significance. However, it is often cited as one of the big advantages of a corporation over a partnership. The liabilities may result from two aspects of the business, namely, (1) tort liability, that is, liability resulting from a personal injury and property damage and (2) liability by contract.

In this connection, it is possible through liability insurance to provide at least a fair amount of protection against actions resulting in personal injury and property damage. This type of insurance should be carried by a farm corporation, a farm partnership and by many individual farmers as well. However, an insured person in a sole proprietorship or in a partnership can never be sure he has full coverage since he will always be personally liable to the extent any judgment against him exceeds his insurance coverage. Therefore the limitation of tort liability of an incorporated farm business may be of real importance.

There is no insurance for liability resulting from contracts and debts. It is often customary, however, for creditors to require shareholders of "closely held" corporations to sign the corporation's contracts both personally and as agents of the corporation, thus making them guarantors of the corporation's obligation.

Also as compared to a partnership or a sole proprietorship, the individual's liability by contract may not be greatly reduced in a "closely held" farm corporation where the shareholders put all or most all of their assets in the corporation. In addition, every shareholder is individually liable for all labor performed for the corporation.

Continuity of Operation — One of the advantages often listed for the corporate structure in farming is the possibility of its continuity. Under the usual situation, farm ownership changes hands every generation. Young farmers often have to start all over again and attain ownership in the home farm. The corporate farm, on the other hand, could have practically a continuous life. This would more likely be the situation where there are two or more major shareholders. It would not likely be the situation, however, in corporations where there is only one major shareholder. The initial life term of a corporation with capital stock in Michigan is 30 years. The 30-year term may be renewed as many times as approval is voted by members holding two-thirds of the stock.

In some "closely held" corporations, the shareholders often have a buy-and-sell agreement to help provide for continuity of the corporation in case one or more shareholders die. If the shareholders are not too old and if they are somewhat near the same age, the corporation may agree to carry life insurance on the lives of the individual shareholders to help finance the buy-and-sell agreement. The beneficiary of the policy could be the corporation, the surviving shareholders, or an independent trustee. The proceeds of the life insurance policy of a deceased shareholder would provide funds with which to pay the heirs or legal representatives for the value of his shares in the corporation.

In Michigan we have no experience to indicate how corporate farms work out in continuity. Theoretically, their continuity could be continuous. Actually, however, it would depend on the decisions of the majority of shareholders. Corporations are made up of a person or persons. How long and how well the corporation functions depends on the wishes of the person or persons involved rather than on the type of organization. Belonging to a corporation does not change human nature. Evidence of this situation is seen in the dissolution of Seabrook Farms Co., as a family enterprise of New Jersey, early in 1959 after a life of 65 years, largely because of disagreement within the family. The Seabrook Farms Co. is a large producer of vegetables and also operator of the world's largest farm-to-freezer operations.

DISADVANTAGES

Some of the disadvantages of incorporating the farm business are

- (1) problems involved in setting up the corporation

- (2) book work, complete records of meetings and the annual financial report to the state Corporation and Securities Commission
- (3) the initial and recurring costs involved such as the franchise and filing fees, the federal stamp tax on the issuance of stock, the federal tax on stock transfers, the annual privilege and filing fees
- (4) corporation profit taxes
- (5) the problem of management control of a minority shareholder
- (6) problems of dissolution.

Problems in Setting up the Corporation — A formal organization is involved in setting up the farm corporation. For this purpose it would be well to retain an attorney who is familiar with the corporate law of the state, and preferably one who also knows something about farming. He will advise you on steps to follow in forming a corporation such as selecting a corporate name, statement of purpose, corporation address, class, number and value of shares of stock to be issued, appraisal value of assets to be put in the corporation, election of directors, adoption of bylaws, etc.

Michigan forms for reporting Articles of Incorporation are available from the Michigan Corporation and Securities Commission, 300 East Michigan Avenue, Lansing, Michigan. Many prospective incorporators in the early stages of deliberation prepare a *preincorporation (shareholder's) agreement*. In this manner, many essential features of the corporation procedures can be adopted informally before making out the final papers. Some incorporators also hire a certified accountant for general counsel, to assist in appraising the assets, and in getting their record books in proper order.

Accounting and Book Work — If you incorporate your farm business, then you must act like a corporation. This involves doing business in accordance with the corporation laws of the state. Among other items, you will have to:

- Keep an acceptable set of records of the assets, expenses and income from the business.
- Prepare and keep a stock book showing names and addresses and amount of stock held by each shareholder.
- Hold an annual meeting.
- Keep minutes of the meeting.
- Do business as ordered by the directors.
- File the annual report which includes among other items a complete and detailed statement of the assets and outstanding liabilities on the date required by law.

You may find this necessary routine rather irksome.

Initial and Recurring Costs — Actually, for the usual size of farm corporation, money costs involved in organizing, chartering and doing business are not large. Ordinarily they are only a minor disadvantage. The initial costs would be:

Attorney fees

Accountant's fees

Charges for printing stock certificates

Franchise fee of one-half mill on each dollar of authorized stock with a minimum fee of \$25 in Michigan

Filing fee of \$10

Federal stamp tax on the issuance of stock at the rate of 10° cents per \$100 of face value (the rate is somewhat comparable for stock without par value)

It is probable that the initial expense of organizing a corporation would usually be from \$350 to \$500.

The recurring costs in Michigan would be the annual privilege fee of 4 mills on each dollar of paid-in capital and surplus, and also the annual filing fee of \$2. There is also a federal tax on stock transfers at the rate of 4°° cents per \$100 of face value.

Corporation Profit Taxes — At the present time there is no Michigan tax on corporation profits.

Previous to 1958, corporation profits at the federal level were taxed twice — once as corporate profits and again when these profits were distributed to shareholders as dividends. This is no longer true for all corporations. The 1958 Federal Tax Law provides for a "Pseudo Corporation" insofar as federal income tax on corporation profits is concerned. Certain small corporations may elect not to be taxed as a corporation but as a partnership. The election must be made within the two-month interval between a month before the start of the corporation's taxable year and a month after.

Such corporations, however, will not be eligible for the so-called tax-option benefits if they are in the process of complete or partial dissolution. In such situations, the undistributed gains or profits when distributed as dividends would still be subject to "double taxation" as corporate profits.

The requirements necessary for a corporation to elect not to be taxed as a corporation are as follows:

*Previous to January 1, 1959 the rates were 11 cents.

**Previous to January 1, 1959 the rate was 5 cents.

- That there will be no more than 10 stockholders.
- Only one class of stock outstanding.
- All shareholders are individuals or estates.
- Corporation is not a member of an affiliated group of corporations tied to a parent company.
- All shareholders must agree to the election to treat the corporation as a "pseudo corporation".

Management Control and Continuity — One of the real serious problems of the corporate structure of the farm business is the problem of control. Supposing, for example, the parents decided to incorporate their farm business to make the intra-family farm transfer process easier and to provide for better continuity of the business. Suppose also that at the death of the parents there were three or more children inheriting or owning the corporate stock on an equal basis. Suppose further that one of the children was the one operating the home farm and who hoped to continue to operate it in the future. If, by chance, the farm-operating heir was a minority shareholder, his continuity on the home farm could be cut rather short if the majority shareholders became dissatisfied and wanted a change. They could either sell out the business or get a new manager.

Furthermore, any minority shareholder is in a rather weak position. In many instances, "closely held" corporations usually pay fewer and smaller dividends; thus there is a correspondingly smaller market for minority stock.

One solution to the management control problem would be to have two classes of stock, common and preferred. Holders of the common stock would have the vote and management control. Holders of the preferred stock are entitled to receive dividends. Usually such dividends must be paid before (1) any dividends can be paid on the common shares or (2) earnings be accumulated in the corporation. Having two classes of stock, however, would void the exemption of the "closely held" farm corporation from the federal income tax on corporation profits.

If you are operating as a sole proprietor or as one of two partners, you have become accustomed to a good deal of independent action. This will not be the case where there is more than one important shareholder and where you become a shareholder-employee. Accustomed to your former independence, you might find it difficult to consider yourself as only a shareholder-employee of the corporation and not the corporation itself. As an employee, you would be subject to the board of directors. If your farm is incorporated, then the farm business *must* be conducted like a corporation and conform to the laws and regulations thereof.

In the usual situation, however, once the corporation is organized, the farm operation will continue much the same as it would as a partnership or as a sole proprietorship. The same management decisions must be made. The differences pointed out above may or may not be of any great importance.

Problems of Dissolution of a Corporation — The two major problems of the dissolution of a corporation are the legal requirements and the tax angle.

The basic statutory (legal) requirements for dissolution are (1) consent of the holders of two-thirds of each class of stock; (2) three weeks publication of notice for benefit of creditors; (3) notification of known creditors by registered mail; (4) continuation of the corporation for three years after dissolution for suit purposes; and (5) deposit of corporate records with a trustee for a 10-year period.

The tax angle involves the "double" taxation on undistributed gains or profits if the corporation is in the process of complete or partial dissolution. In such a situation, the undistributed gains or profits of the "Pseudo Corporation" are first subject to the federal corporation profits tax and later to the individual's federal income tax when received as dividends.

ALTERNATIVES

From the standpoint of farm operations, the most feasible alternative to a corporation is the partnership. There are three types of partnerships, namely: (1) a *general partnership* such as between a father and son, two or more brothers or two or more non-related persons; (2) the *limited partnership*; and (3) the *partnership association*.

The General Partnership — At the present time in Michigan the general partnership is the usual form of organization where more than one person is actively engaged in the management, operation and in capital participation in the farm business. Most typical of these arrangements are the father-son farm partnership and partnership between brothers. Within the last two or three years there has been a good deal of interest in partnerships between brothers who take over the farm when their father reaches 65 and wishes to retire and participate in the social security benefit payments.

Blank forms helpful in setting up partnerships with father and son or sons, and with brothers either owning or renting the farm are available from your County Extension Office or from the Agricultural Economics Department at Michigan State University. Buy-and-sell agree-

ment forms containing provisions for partnership insurance are also available from these sources.

Some persons, particularly lawyers, are cautious in recommending and setting up farm partnerships. Their caution is occasioned by the unlimited liability feature of a partnership in which one partner is liable for any wrongful act committed by the other partner or partners in the conduct of the business. These wrongful acts may be for personal injury and property damage, torts, and for contractual and debt liabilities in connection with the farming operations. As mentioned, the partnership can and should carry adequate amounts of liability insurance as protection against wrongful acts by others resulting in personal injury and property damage. However, there is no insurance or protection against liability for farm debts and contracts.

Extensive experience with partnerships in Michigan shows little if any liability difficulties resulting from farm partnerships. However, in many father and son farm partnerships the net worths of the partners are vastly different. The parents usually have most of the net worth and the son usually has or at least should have the ambition and skill to help make the business go. It is very obvious that in such an agreement the parents would be the heavy losers if there is any partnership liability.

Thus one should not enter into a general partnership with any person unless the greatest mutual confidence exists between them with respect to their sense of honesty and responsibility.

In a rather complicated set-up or in a rather large farming operation, however, the partnership arrangement may not result in as good a farm business organization as would the corporation, as for example, in the father-and-four-son farming operation mentioned on page 5.

The Limited Partnership — This type of partnership is a sort of cross between a general partnership and a corporation. It is formed under the statutory provisions of the Uniform Limited Partnership Act. The general partner in a limited partnership is in much the same position as is a general partner in a general partnership. That is, he manages and operates the business, and assumes the liability risk as in a general partnership. The limited partner provides capital investment and shares in the returns. His liability for losses, however, is limited to the amount of his capital investment in the venture. Persons contemplating setting up a limited partnership should do so only with the aid of a lawyer.

The Partnership Association - Michigan statutes also provide for "partnership associations." This is another form of a limited partnership. In this situation, the liability of each partner may be limited to the amount of his capital investment in the association. Statutes require that the word "limited" shall be the last word in the name of every

partnership association organized under the laws of Michigan. The limited partnership association is so similar to a corporation insofar as advantages and disadvantages are concerned, that it will not be discussed in this publication*. There are but few, if any, limited farm partnership associations in Michigan.

TRANSFER BY LAND CONTRACT

As an intra-family farm transfer arrangement, a sale by land contract has much to commend it in many situations. If the major goal is to reduce taxes and legal costs, the land contract will do the job as well as, if not better than, the corporation for the average size of farm in Michigan. With the land contract sale a current value for the farm would be established on which to base the income tax on capital gains when the farm is later sold. In addition, the parents can make annual gifts to the farm-operating heir equal to a part or all of the land contract payments. This corresponds with the gifts of shares of capital stock of the corporation farm as a tax-saving device.

IN CONCLUSION

The "closely held" corporation fits some farm situations in Michigan. Whether it is advisable in any particular situation must be determined by the facts involved and by the family situation, and probably more so than in any other type of business.

Where many of the children are leaving the farm, there are not many advantages in having the parents' farm incorporated. If, however, all or most of the children will continue in the business and wish to farm together on the home farm, then the corporate structure does have definite advantages. However, even here the problems of management and ownership control are major considerations.

Also, the corporate structure may best fit the situation where the farm business is rather large and where three or more men are involved.

In any event, it is relatively easy and quick to incorporate a farm business. It may be considerably less easy to unincorporate. Thus it is a plan that needs lots of study and discussion. There is usually no need to hurry.

*The Michigan statutes relative to the formation of partnership associations are presented on pages 135 to 144 of the book "Michigan General Corporation Laws."

