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Incorporate the Family Farm?

Interest is increasing in the corporate form of business for family farms. It isn't a "cure-all" but, in some cases, may provide a tool for strengthening and preserving the family farm. There are both advantages and disadvantages to be considered. Here are some of the things you should know.

by Neil E. Harl, John F. Timmons and John C. O'Byrne

TO MANY PEOPLE, corporations imply largeness, monopolies, complexities and the like. To farm people especially, the word "corporation" may imply large-scale farming and "outside interests"—considered particular threats to the traditional family farm.

Why, then, even consider such a thing as incorporating the family farm? First, incorporation itself isn't a threat to the family farm and indeed, in some cases, may offer a tool for preserving and strengthening the family farm. Second, a new law provides certain advantages for a small corporation.

Interest Increasing . . .

Use of the corporate form of business for farm operations hasn't been extensive in Iowa. It has been more widely used in the ranching states. In the past few years, however, interest has been increasing in family farm incorporations as a means whereby the family farm can continue to thrive and adjust to changing economic conditions. Recent changes in corporation and tax laws have also increased interest in the possibility of incorporating family farms.

In this article, we'll attempt to outline the nature of a corporation and some of the possible advantages and disadvantages of family farm incorporation. The corporation is essentially an alternative form of business structure—and one open to farm families as well as others. Some farm families—particularly those with most of their assets in land and who have operating and transfer problems—may find incorporation an answer to their problems of strengthening the family farm as a business and family enterprise; others won't. But here are some of the things to know.

What Is a Corporation?

The corporation is a legal and economic entity—separate from the individuals who own, manage and work for it. A corporation has a status similar to that of a person. It is capable of doing business, making contracts, being sued, suing others, borrowing funds and living indefinitely without interruption by change of its owners or officers. Thus, the corporation may be considered as a legal person, with a capacity similar in nature to that of an individual proprietor.

In Iowa, a corporation may be organized by any number of persons. Even one person can incorporate his farm. There's no minimum limit on the value or capitalization of a corporation.

The outstanding characteristics of the corporation are limited lia-
bility, continuing life and the separation of ownership and management. A sole proprietor owns his farm, equipment, livestock, etc., and makes the management decisions. In a partnership, the partners are the owners and decision makers. In a corporation, the shareholders are the owners but not the managers.

At the time of incorporation, shares of stock are issued, representing a share or fraction of the total worth of the farm business. A share of stock represents a percentage of total corporate worth, not an interest in individual assets. The shareholder is an owner of the corporation, but the corporation operates the farm and hires employees to carry on its business. The shareholders elect a board of directors to manage the corporation. The directors elect the officers who generally are responsible for the day-to-day operation of the corporate business.

In a large corporation such as General Motors, the separation between ownership and management is obvious and true in practice. In a small corporation, however, it often happens that a person is a shareholder, director and officer at the same time. So, in a small corporation, ownership and management may be merged in only one or more persons. If a corporation had only one shareholder, one director and one officer, ownership, management policy and day-to-day operation would be in the hands of one person. As the number of shareholders increases, the probability increases that some of the shareholder-owners will participate in management merely through their power to vote for the directors.

Most family farm corporations would be "closely held" corporations—with the stock owned by only a few persons and ownership of the business enterprise confined to a small group. Stock of a closely held corporation generally isn't available for purchase by the public. And stock transfer often is restricted by the articles of incorporation or by a shareholders' agreement to prevent the stock from falling into the hands of outsiders.

A closely held corporation, in its day-to-day operations, can function much like a partnership. The same corporate laws, however, apply to both big and small corporations, so certain corporate formalities must be observed.

**Advantages, Disadvantages...**

In considering the possibility of incorporation, it's important to look at the advantages and disadvantages of the corporate form of business. These will vary with individual farm family situations but should be considered in deciding whether incorporation would be an over-all advantage or not.

**Limited Liability:** Those considering incorporation often are seeking the limited liability that a corporation offers. Farmers operating their businesses as sole proprietors generally are fully liable for any and all liabilities arising from the business. Partners also generally are personally responsible for liabilities arising from the partnership business.

Shareholders in a corporation have only limited liability. Because the corporation is a separate and distinct entity, the shareholders aren't responsible for corporate debts or law suits except to the extent of their investment in the corporation.

This advantage, like others, will vary among individual farm families. Where all or nearly all assets of the parties are tied up in the corporation, this advantage loses much of its importance. Also, if shareholders in small family corporations find it necessary to commit personal assets to obtain credit or to avoid dissolution or bankruptcy, they have placed such assets at the risk of the business.

Another liability aspect involves the shareholders' personal obligations. In a sole proprietorship or partnership, business assets can be reached to satisfy personal obligations. If these are substantial, the business could be terminated. Because a corporation shareholder's ownership is in his shares of stock, creditors of individual shareholders would have to seek satisfaction from the stock—not from the assets of the corporation.

But the freedom from shareholders' personal problems isn't foolproof since a creditor might obtain an interest in or even control of a corporation in this manner. If the corporation or some shareholders had some kind of a "buy-out" agreement, it's possible that they might be forced to buy the stock to prevent an outsider from becoming a shareholder.

**Access to Capital:** Obtaining sufficient credit is a serious problem facing many farm operators. Inadequate capital for expansion and for financing livestock and equipment limits the size of many farm enterprises. Obtaining credit sometimes is easier for a corporation than for an individual.

Nonfarming members of the family may be encouraged to invest or retain an interest in the farm business by the use of the corporation. Investments can be made by stock purchases or by loans to the corporation. An investor in stock runs an owner's risk and receives a share of the profits as dividends. One loaning funds to the corporation would receive a fixed rate of return as interest.

The farm corporation could also be used to pool land, machinery, livestock and capital to achieve the efficiency and economy of a larger operation. Established farmers of one or more families might merge their assets into a single corporate organization.

The continued life of the corporation may act to decrease the risk of extending credit. This may or may not be true, depending on the attitude of the lending agency. Some lenders may require shareholders of a closely held corporation to sign as personal surety for corporate debt obligations.

Some corporations insure the lives of principal shareholders. This tends to lend stability to the corporation. The funds can be used to tide the corporation over a period of change in management by death or to underwrite a stock purchase plan at death. Such "buy-out" or stock purchase plans made mandatory at death can assure that management responsibility won't go to inexperienced
shareholders. A bank or other agency may be inclined to extend credit more liberally to the corporation if assured of continued management responsibility.

Also, incorporated farm operations aren't eligible for certain types of FHA loans, and this might affect some families adversely.

Continuing Operation: To some farm families, the corporation may offer a tool for maintaining a going farm business in the family circle—bringing management responsibilities to younger members and easing the transition at death. As a sole proprietorship, the farm business is usually interrupted and often dispersed with the death of the individual operator.

Thus, land holdings, livestock operations, equipment and sound business organization built up over a lifetime may disintegrate at the death of the owner. The heir remaining on the farm may be left with heavy encumbrances in payouts to other heirs. This can restrict his farming operations for several years and, in some cases, jeopardize his continued ownership of the farm. Also, uncertainties of potential heirs who may expect to operate the farm after death of the parents may prevent the making of improvements and long-run investments and plans necessary in today's farming.

A partnership terminates at the death of a partner. Similar problems arise even if a new partnership is formed by taking in the estate or successors of the deceased partner.

Some of these difficulties in the transfer of farm property between generations can be overcome, or at least tempered, by the corporate form of organization. A corporation may be formed for a definite period of years or indefinitely. So its continued life isn't dependent on the lives of people.

Since ownership in the corporation is represented by shares of stock, shares may be given away, sold during life or transferred at death without upsetting the continuity of farming operations.

A new tax provision, added by 1958 amendments to the Internal Revenue Code, permits estate taxes on a decedent's business to be paid in installments over a 10-year period if the business continues. This applies to any type of business organization. But the corporation often makes continuation easier.

Gradual Transition: Farm operators seldom retire abruptly, but gradually reduce the burden of participation in the work and management on their farms. Oftentimes, the farm has been the "savings bank" for the father and mother who have invested a lifetime of labor and savings in the home farm.

The corporation permits the division of ownership, control and management among parents, children and perhaps others in varying proportions. In receiving some of the stock, the younger shareholders obtain interests and a sense of responsibility that can become a strong motivation for work, saving and planning for the future. The separation of ownership and management in a corporation makes arrangements possible whereby ownership of the corporation is shared while voting control—the power to select the managers—is retained.

Sharing ownership of a corporation also means sharing the income after salaries are paid to the managers. Say, for example, that a father incorporates his farm, issuing 100 shares of stock to himself. The father and his only son operate the farm. The son gradually purchases 30 shares and then makes a "buy and sell" agreement with the father whereby the son could buy 30 additional shares at the death of the father.

This purchase would provide funds for the daughter's share of the estate. The remaining 40 shares could be left to the widow by the father's will, and she would be entitled to a share of the profits after the son is paid a salary. At her death, the widow might leave her stock to the son. Or she could leave some to the daughter and give the son an option to buy it from the daughter. Many different plans may be built around the corporate structure to share farm profits among members of the family with fair treatment to the persons who'll remain at home to operate the farm.

Transferring ownership gradually through lifetime gifts of shares within the allowances of federal gift tax laws may have a tax advantage over death taxes. Your attorney can furnish details on this.

Retirement Planning: The prospect of an adequate retirement income frequently is an inducement for the older shareholders to turn over ownership and control of the business operation to younger shareholders at an earlier time.

Incorporating the farm business permits the establishment of an employees' pension or retirement plan which may include owner-employees. If the plan is qualified under the tax law, payments to the plan by the corporation are tax deductible. Individual farm operators and partnerships may also have pension and profit-sharing plans for employees, but the owners aren't allowed to participate under existing law.

A sizable estate may be built up tax free for corporate participants because of the favorable tax features of retirement plans. The retirement program for shareholder employees in a family farm corporation could include payments from a retirement or pension fund, dividends from stock and the maximum corporate salary consistent with full social security benefits.

Another social security feature of the corporation is its ability to even out income by paying fixed salaries. This may be important to farmers nearing 65 who are anxious to qualify for maximum social security benefits. If the corporation can justify a salary of $4,800 per year, the shareholder-employee's social security taxes are paid on that amount, even though farm income from the corporation varies from year to year.

Income Tax: Usually there's no income tax gain or loss on the formation of a corporation. A person transferring his farm business to a corporation in exchange for stock has no gain, even though the assets have increased in value. The corporation continues to use

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the tax base the property had for depreciation and sale.

On termination or liquidation of a corporation, stockholders will have a capital gain or loss measured by the difference between the basis of stock held and the amount of money or property received on termination. If the corporation redeems all of the stock of a shareholder or if the shareholder sells his stock, he'll have a capital gain or loss on the deal.

Regular corporations pay an income tax of 30 percent on the first $25,000 of taxable income and 52 percent on the rest. Before 1958, one argument against incorporation was that some corporate income was taxed twice—once when earned by the corporation and again when received as dividends by the shareholders. The 1958 Small Business Tax Revision Act, however, permits a closely held corporation with no more than 10 shareholders and only one class of stock to be taxed like a partnership.

If all shareholders elect this method of taxing, the corporate income is channeled on paper to method of taxing, the corporate

losses and long-term capital gains. The corporation was that some corporate income was taxed twice—once when earned by the corporation and again when received as dividends by the shareholders. The 1958 Small Business Tax Revision Act, however, permits a closely held corporation with no more than 10 shareholders and only one class of stock to be taxed like a partnership.

More Complex: Other than for paying taxes, the law requires very little of one who owns and manages his farm as a sole proprietorship—"it's assumed that a mistake in judgment or management will harm only the operator. Some what more is required of a partnership. And since the corporation is a legal creature—existing apart from its owners and managers—it becomes more complex in formation and dissolution. The law seeks to protect creditors, owners and others connected with the corporation.

Incorporation requires the preparation of articles of incorporation which are submitted to the Iowa Secretary of State for approval and registration. The Secretary of State then issues a certificate of incorporation. The articles of incorporation represent the agreement among the shareholders and establish the rights and powers of the corporation. In addition, a corporation has a set of by-laws containing additional details of operation and management.

Articles, by-laws and minutes of the first meeting are prepared by the attorney for the incorporators. Thereafter, most corporations have their attorneys prepare or at least review the minutes of all subsequent meetings. Minutes of the meetings of the shareholders and board of directors are carefully kept in written form. Since the corporation is an artificial person, responsible to its shareholders, all important decisions of the directors and stockholders are made at special or annual meetings and recorded in the minute books.

If there are to be pension plans, stock sale restriction agreements, "buy-out" plans, etc., the attorneys for the corporation and the shareholders will have to work these out. Once the corporation is organized, the farm operation will run much the same as it did as a partnership or sole proprietorship except that more formal meetings will be held and more formal records of decisions will be kept.

Operational and tax records are about the same for any form of farm business organization, but there's a tendency for corporations to keep better records than individuals alone might keep. The Secretary of State also requires certain corporate reports, including a simple annual report.

Costs of Incorporation: As a more formal and complex legal creature than the sole proprietorship or partnership, the corporation involves greater cost of organization. Under the new Iowa Corporation Law which takes effect July 4, 1959, the fee for filing articles of incorporation is $20. In addition an annual fee based on stated capital is imposed on corporations. Your attorney can furnish additional details on these and other fees required by law.

The costs of organizing a corporation are deductible for income tax purposes over the first 5 years of corporate life.

In Summary . . .

Industry began using the corporate form of business extensively in the 1800's to solve some of the problems of individual industrial proprietors and as a means of adjusting to economic and technological change. Some farm families, likewise, may be able to obtain advantages and benefits by incorporation of the family farm, though the advantages and disadvantages should be weighed carefully.

An incorporated farm needn't cease to be a family farm and may, in fact, increase family participation. The main question is whether or not the corporate form of business is a better tool than the present form for a particular family farm business.