Incorporating the Farm Business Part II: Tax Considerations

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Incorporating the Farm Business
Part II: Tax Considerations†

The author of this Note discusses the major tax disadvantages of incorporating a farm and how to minimize them, the tax problems in transferring assets to the new corporation, and the important income and estate tax factors related to designing the capital structure of the farm corporation.

Tax consequences should be a major consideration in determining whether or not to incorporate a farm. Although in some cases tax benefits may be derived from incorporating, the main concern of an attorney must be to avoid the substantial disadvantages which could result and more than nullify any tax benefits or other advantages following incorporation. And even if the decision to incorporate is based exclusively on nontax factors, reducing anticipated tax liability will still be an important consideration in planning the capital structure and operating policies of the new farm corporation.

At the outset, it should be made clear that there is no tax law of peculiar applicability to the farm corporation; the few unique tax characteristics of a farm are not lost by incorporating.¹ Since the special tax provisions relating to farms have been extensively treated elsewhere,² this Note is limited to a discussion of those problems peculiarly arising out of the incorporation of farms. Furthermore, though this Note deals with tax considerations of incorporating a farm—as part of the broader study of incorporation of

† Part I of this Note, discussing limited liability, transferability of ownership, and other important considerations bearing on the question whether or not a particular farm business should be incorporated, appeared at page 305 of this volume of the Minnesota Law Review.

¹ The Internal Revenue Service has ruled that "all individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers." Treas. Reg. § 1.61-4(d) (1957). (Emphasis added.) Therefore, those special tax provisions relating to farmers will be applicable whether the farm is being operated as a proprietorship, partnership, or corporation.

the agricultural enterprise—it is obvious that most of the discussion is also applicable to the incorporation of any closely held business.\(^3\)

I. MAJOR TAX DISADVANTAGES IN INCORPORATING: HOW TO MINIMIZE THEM

A. INCOME TAX DISADVANTAGES

There are a number of distinguishing features of the income tax imposed on the unincorporated farm as compared with the tax imposed on the corporate farm. Many of these differences are relatively unimportant—for example, the differences in filing estimated tax returns\(^4\)—and will have little or no bearing on the decision whether or not to incorporate a farm. However, two disadvantages created by incorporation—“double taxation” and unfavorable capital gains treatment—are highly significant and will be discussed in detail here.

**Double taxation: means for reducing**

When the progressive individual rates\(^5\) and the corporate rates\(^6\)

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3. A close corporation does not mean a corporation where, by manipulation of the voting rights, a select few can control the corporation’s operations. “In other words, a ‘close corporation’ means, in the vernacular, a corporation in which the stock is held in few hands, or in few families, and wherein it is not at all, or rarely, dealt in by buying or selling.” Brooks v. Willcuts, 78 F.2d 270, 273 (8th Cir. 1935).

“The tax provisions of the Internal Revenue Code apply to the closely-held corporation in the same manner, with minor exceptions, as they do in the case of large public corporations. However, since the stockholders of a close corporation are few in number, the close relationship between the stockholders and the corporation give rise to tax problems unlike and in addition to those faced by large public corporations.” Brafford, *The Constructive Receipt of Dividends by Stockholders of a Closely Held Corporation*, 46 Ky. L.J. 515, 518 (1958).

4. The filing of declaration of estimated tax statements is required for all individuals whose income is expected to consist of more than $5,000 in wages ($10,000 if a joint return is filed) if income other than wages is less than $100; for all individuals whose income is expected to consist of in excess of $100 from sources other than wages and exceeds an amount equal to $600 times the number of exemptions plus $400; and those corporations reasonably expecting to do over $100,000 of business during the taxable year. *Int. Rev. Code of 1954*, §§ 6015, 6016. The corporation must file on September 15 of the taxable year and the individual on April 15. *Int. Rev. Code of 1954*, §§ 6072, 6074. However, special treatment is given the individual farmer who need not file until January 15 following the close of the taxable year. Thus, though the incorporated farm would have the advantage of not having to file an estimated return until in a high income bracket, the individual farmer has some advantage in being able to more reasonably and accurately determine his income making it less likely that he would be subject to a penalty for underpayment of estimated tax. The discussion of penalties is found in *Int. Rev. Code of 1954*, § 665.

5. Individual rates range from 20% on income of $2,000 or less to 91% on income in excess of $200,000. *Int. Rev. Code of 1954*, § 1. The same rates will apply to a partnership since it is not a taxable entity and “as such shall not be subject to the
are set side by side, they seem to warrant the conclusion that farmers having low or average incomes would not benefit by incorporating, while farmers having large incomes would find it advantageous to do so. However, this comparison is misleading because it fails to consider the tax results when the corporation pays out income to its stockholders. Any apparent advantage of the corporate farm on the basis of the comparison of tax rates alone vanishes if the income received by the corporation is taxed twice: first as corporate income and again when paid out as dividends and taxed as income to the stockholder at his individual rate. The chart below indicates how the total amount of tax paid on corporate income is substantially increased if all income left after payment of corporate taxes is distributed to the stockholders in the form of dividends.


6. There is a normal tax of 30% on all corporate income plus an additional surtax of 22% imposed on all corporate income in excess of $25,000. Int. Rev. Code of 1954, § 11.

7. To illustrate this comparison the following chart shows the tax paid by a married farmer filing a joint return as contrasted with the incorporated farm’s tax liability before the latter has distributed any income. It is assumed that the unincorporated farmer has two children, thus allowing him to take a total of $2,400 in exemptions, Int. Rev. Code of 1954, § 151, and takes the standard deduction, i.e., 10% of adjusted gross income or $1,000, whichever is less. Int. Rev. Code of 1954, § 141. The chart is based on tax rates imposed on individual and corporate income by Int. Rev. Code of 1954, §§ 1, 11.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax:</th>
<th>Tax:</th>
<th>Advantage:</th>
</tr>
</thead>
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<tr>
<td></td>
<td>Unincorp.</td>
<td>Incorp.</td>
<td>Corporation</td>
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<tr>
<td>10,000</td>
<td>1,372</td>
<td>3,000</td>
<td>-1,628</td>
</tr>
<tr>
<td>20,000</td>
<td>4,124</td>
<td>6,000</td>
<td>-1,876</td>
</tr>
<tr>
<td>30,000</td>
<td>7,918</td>
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<td>-2,182</td>
</tr>
<tr>
<td>40,000</td>
<td>12,718</td>
<td>15,300</td>
<td>-2,582</td>
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<tr>
<td>50,000</td>
<td>18,294</td>
<td>20,500</td>
<td>-2,206</td>
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<tr>
<td>60,000</td>
<td>24,332</td>
<td>25,700</td>
<td>-1,368</td>
</tr>
<tr>
<td>70,000</td>
<td>30,610</td>
<td>30,900</td>
<td>-200</td>
</tr>
<tr>
<td>80,000</td>
<td>37,134</td>
<td>36,100</td>
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<tr>
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<td>100,000</td>
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<td>46,500</td>
<td>+13,382</td>
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<tr>
<td>200,000</td>
<td>131,682</td>
<td>98,500</td>
<td>+33,182</td>
</tr>
</tbody>
</table>

10. The members of a partnership operating a farm or an unincorporated farmer operating alone may be taxed at a high individual rate if they receive a large amount of income, but will only be taxed once. Thus, an accurate comparison of corporate and noncorporate tax rates must consider as the effective corporate rate the tax paid
assume:
1. sole stockholder
2. married
3. two children
4. files joint return
5. takes standard deduction

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Taxable Income</th>
<th>Total Tax:</th>
<th>Tax:</th>
<th>Remainder after Corp. Tax</th>
<th>Individual Tax on Farm</th>
<th>Total Tax:</th>
<th>Corp. Farm</th>
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</thead>
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<tr>
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<td>Farm Incorp.</td>
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<tr>
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<td>98,500</td>
<td>101,500</td>
<td>52,272</td>
<td>150,772</td>
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</tr>
</tbody>
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Therefore, it can readily be seen that the possibility of double taxation is one of the most critical tax problems for a farm corporation, and its avoidance will be a prime consideration for the farmer contemplating incorporation.

(1) Subchapter S. The closely held farm corporation now can completely avoid double taxation, though by so doing it may lose certain other tax advantages. The 1958 addition of Subchapter S to the 1954 Internal Revenue Code makes it possible for certain small corporations to elect to be taxed in a manner similar to the taxation of partnerships. For purposes of this act, "small" does not have reference to assets and income of the business; a corporation with extensive holdings and large earnings may still be eligible to make the election.

It must be stressed that any reference made to a corporation electing under Subchapter S to be "taxed as a partnership" is a reference made for semantic convenience only. Nowhere in Subchapter S is the term "partnership" mentioned. Concededly, the basic procedural method of taxing the income of the electing directly on the corporate income coupled with the anticipated tax on dividends to be paid.

11. See note 7 supra.
13. Int. Rev. Code of 1954, §§ 1371(a), 1372. And, of course, the corporation with only one stockholder would, in fact, be a corporation electing to be taxed as a sole proprietorship.
corporation is like that of a partnership. However, there is no indication that the partnership provisions of the Code, that is, Subchapter K, are applicable to an electing corporation. Thus, it would appear that the electing corporation will continue to retain its corporate identity for tax purposes with only those exceptions expressly stated in Subchapter S.

To qualify for the election, the corporation must (1) have only one class of stock and (2) no more than ten shareholders who (3) must be individuals or estates and (4) who must unanimously agree to the making of the election. Under these limited requirements, a very substantial number of farm corporations clearly would qualify to make the election; however, many corporations might find it undesirable to do so. The requirement of a single class of stock would prevent the small closely held farm corporation from utilizing desirable estate planning and income splitting programs which require two classes of stock. Furthermore, effective estate planning and income splitting might be further inhibited by the rule that stock in the electing corporation cannot be held by a trust.

If the corporation’s stockholders unanimously consent to be taxed as a “partnership,” each stockholder must include in his gross income a pro rata share of the corporation’s undistributed net income each taxable year during the election. If the retained earnings on which

15. The taxing of corporate income to shareholders as if each had received his share according to his stockholdings as described in Int. Rev. Code of 1954, § 1373(b) is analogous to the method in which partnership income is taxed under Int. Rev. Code of 1954, §§ 701-04.
17. For exceptions, see Int. Rev. Code of 1954, § 1373(d).
20. Int. Rev. Code of 1954, § 1371(a)(2). There is also a qualification that the individual holding stock cannot be a nonresident alien. Int. Rev. Code of 1954, § 1371(a)(3). Technical Information Release 113 issued by the Internal Revenue Service attempts to answer some questions arising from these requirements. The release indicates that there will only be one class of stock where a corporation has “class A common and class B common with equal dividend rights, equal liquidation preferences, and equal voting rights except that each class has the right to elect half the members of the board of directors.” It further states that if a husband and wife hold stock under community property laws, in joint tenancy, cotenancy, or tenancy in common, each spouse is considered to be a stockholder for purposes of the election. The same is true if stock is owned by two or more minors but held in the name of a guardian. That release will be found in MERTENS, LAW OF FED. INC. TAX—RULINGS, Misc. Announcements 192.
individuals have paid tax are subsequently distributed while the election is in effect, no further tax will have to be paid. However, the proposed regulations indicate that the right to a tax-free distribution of the taxed income is a personal right accruing only to the shareholder who actually pays the tax, and such right can not be transferred to a purchaser of that stock.

Since income is not taxed to the corporation under this act, neither the corporation nor the shareholders will be able to take advantage of the usual credits and exemptions for interest and dividends. But, although corporate long-term capital gains are taxed as ordinary income when distributed, the shareholder of the electing corporation will be taxed at regular capital gain rates. In addition, although shareholders are generally not allowed any deduction for a corporate net operating loss, stockholders of the electing corporation may take the carryover and carryback deductions for corporate net operating losses.

A serious problem could arise from requiring unanimous agreement among the stockholders of the corporation to make the election. Conceivably a stockholder could coerce unreasonable concessions from the other stockholders who favor the election by merely threatening to dissent. This situation might be avoided by including a provision in the stock agreement which authorizes the board of directors of the farm corporation to call any stock at will. In this way, the corporation could redeem the shares held by a dissenting stockholder, and obtain the desired "unanimity."

Redemption clauses in preferred stock have generally been held

Subchapter S must be made during the first month of a taxable year and is effective for that taxable year and all succeeding taxable years. Int. Rev. Code of 1954, § 1372. For the actual mechanics of making this election, see T.D. 6317, 1958 Int. Rev. Bull. No. 41, at 77.

(e) Benefits not transferable. A shareholder’s right to nondividend distributions under this section is personal and cannot in any manner be transferred to another. If a shareholder transfers part but not all of his stock in an electing small business corporation his net share of previously taxed income is not reduced by reason of the transfer and the transferee does not acquire any part of such net share. If a shareholder transfers all of his stock in an electing small business corporation, any right which he may have had to nondividend treatment upon the receipt of distributions lapses entirely unless he again becomes a shareholder in the corporation while it is subject to the same election.

27. Int. Rev. Code of 1954, § 1375(a). This section is applicable whether the gains are distributed in the form of dividends or not.
28. See Int. Rev. Code of 1954, § 1374. An interesting feature of this provision is § 1374(c) which provides for the allocation of the loss among all those who were shareholders during the taxable year including those shareholders who no longer hold stock.
valid.\textsuperscript{30} And, in at least one instance, the validity of the provision in a common stock agreement was recognized.\textsuperscript{31} However, there are cases holding such a redemption clause invalid as an unreasonable restraint of the stockholders' rights.\textsuperscript{32} But, it is interesting to note, courts which have invalidated a redemption clause have often suggested that the result might be different if the court could "find justification in the reasonable needs and welfare of the corporation"\textsuperscript{33} for retaining power of recall.\textsuperscript{34} Perhaps, then, such a clause could be valid in the common stock agreement of a corporation electing under Subchapter S; reasonable financial needs of the new farm corporation will sometimes require making the Subchapter S election, and may justify controlling minority stockholders for that purpose.\textsuperscript{35}

Even after the election under Subchapter S has been made, each stockholder in the corporation has power to terminate the election against the will of the other stockholders. Since the election can be voluntarily revoked only by a unanimous consent of all shareholders,\textsuperscript{36} the dissenting stockholder alone cannot revoke the election merely by expressing his objection. But the Code provides that an \textit{involuntary} revocation takes place when a \textit{new} shareholder does not consent to the continuance of the election,\textsuperscript{37} as well as when the company "ceases to be a small business corporation."\textsuperscript{38} Therefore, a single stockholder in the corporation could terminate the election by selling stock to a new shareholder who would refuse to consent to the continuance of the election, to enough "outsiders" to bring the number of stockholders to more than ten, or to a corporation or trust.\textsuperscript{39}

\textsuperscript{30} See the accumulation of cases and discussion of various aspects of redemption clauses in preferred stock agreements in Annot., 88 A.L.R. 1131 (1934).
\textsuperscript{32} E.g., Greene v. E. H. Rollins & Sons, 22 Del. Ch. 394, 2 A.2d 249 (Ch. 1938).
\textsuperscript{33} Id. at 401, 2 A.2d at 255.
\textsuperscript{34} Of course, Int. Rev. Code of 1954, § 302(a), which makes certain stock redemptions dividends in the hands of the recipients, should be avoided. If all of the shareholder's stock is redeemed, section 302 will not apply. Int. Rev. Code of 1954, § 302(b)(3).
\textsuperscript{35} Care must be taken in using this argument to state that the reason for the insertion of the clause was solely for the reasonable needs of the business and that there was no attempt made to simply eliminate a minority from the business. The courts are unfavorably influenced by clauses which appear to have been inserted to allow one group of stockholders to remove another. See Starring v. American Hair & Felt Co., 21 Del. Ch. 380, 191 Atl. 887 (Ch. 1937) (dictum).
\textsuperscript{36} Int. Rev. Code of 1954, § 1372(e)(2).
\textsuperscript{37} Int. Rev. Code of 1954, § 1372(e)(1).
\textsuperscript{38} Int. Rev. Code of 1954, § 1372(e)(3). The election is also terminated if more than 80% of the corporation's income is derived "from sources outside the United States," Int. Rev. Code of 1954, § 1372(e)(4), or twenty percent is personal holding company income. Int. Rev. Code of 1954, § 1372(e)(5).
\textsuperscript{39} With more than ten shareholders or any shareholders who are trusts or corporations, the company can no longer meet the necessary requirements of the small business corporation as defined in Int. Rev. Code of 1954, § 1371(a).
To prevent stockholders effecting an involuntary revocation, the corporation might find it necessary to insert a clause in the stock agreement requiring that the shares be offered to present shareholders before they are sold to outsiders. This type of clause is more commonly found in common stock agreements than the redemption clause discussed above, and its validity is generally recognized. Insertion of such a clause in the corporate stock agreement is highly desirable for maximizing the probability of continuing the election under Subchapter S.

If a corporation terminates the Subchapter S election, problems are likely to arise in subsequent years in connection with the withdrawal of undistributed taxed income accumulated while the election was in effect. As stated above, retained earnings on which shareholders have paid a tax are distributed tax-free during the period of election. However, once the election is terminated undistributed earnings already taxed apparently cannot be distributed tax-free until retained earnings accumulated before and after the election are distributed. The Code provides that earnings retained at the close of the taxable year are reduced during the period of the election by the amount of earnings on which the shareholders have paid tax; apparently this undistributed taxed income then becomes a form of capital. Thus, since distributions must be made from accumulated earnings before they are made out of capital, no undistributed taxed income could be paid out until earnings accumulated after and before the period of election have been distributed. Furthermore, the proposed regulations seem to indicate that subsequent to termination of the election, no undistributed taxed income could ever be distributed tax-free even after all other retained earnings are exhausted.

A current release issued by the Minnesota State Commissioner of Taxation says, in effect, that Subchapter S will not be recognized for Minnesota state income tax purposes. Under this ruling, a corporation electing to be taxed under Subchapter S must still pay state tax on all corporate income earned during the year without being allowed a credit for any tax paid by the shareholders. Furthermore, all distributions to shareholders will be taxed as dividends, and no

41. I.R.C. § 1377(a).
42. I.R.C. § 316(a) provides that “every distribution is made out of earnings and profits and from the most recently accumulated earnings and profits.”
43. Proposed Treas. Reg. § 1.1375-4(a), 24 Fed. Reg. 1802 (1959): If an election is terminated under section 1372(e), the corporation may not, during the first taxable year to which the termination applies or during any subsequent taxable year, distribute previously taxed income of taxable years prior to the termination as a non dividend distribution pursuant to this section.
deduction from income is allowed for federal tax paid on undis-
distributed corporate income.\textsuperscript{44} If other states follow, there could be a
significant disadvantage in electing under Subchapter S in those
states where income taxes rates are high.\textsuperscript{45}

The advantages of Subchapter S go beyond eliminating double
taxation if the new law will allow a corporation to be taxed in the
same manner as a partnership, while still permitting it to take ad-
tantage of the desirable fringe benefit treatment allowed only to
corporations.\textsuperscript{46}

A major benefit provided by the Code is the opportunity for the
corporation to defer taxation of a portion of an employee’s income
until he has retired.\textsuperscript{47} If the corporation sets up an employees’
pension trust plan that qualifies under the Code,\textsuperscript{48} the payments made to

\textsuperscript{44} See Tax Research Institute, Inc., Partnership or Corporation Under the 1958 Tax Law 25 (1958).\textsuperscript{45} The requirements for qualifying such a plan are set forth in Int. Rev. Code of 1954, § 401. The detailed procedure the Commissioner of Internal Revenue has set forth for drawing up such a plan is found at Rev. Rul. 57-168, 1957-1 Cum. Bull. 128.
that plan may be deducted from corporate taxable income.\textsuperscript{49} Still the employee-beneficiaries will not be taxed until they receive payments from the fund;\textsuperscript{50} the total tax paid by the employee will very likely be decreased since he may be in a lower income bracket until retirement.

The Code further provides that taxable individual income will exclude amounts received from certain employee benefit plans: (1) payments to an employee under accident and health plans;\textsuperscript{51} (2) payments of up to $100 a week to an employee under a wage continuation plan;\textsuperscript{52} (3) amounts up to a maximum of $5,000 received by the employee’s beneficiaries through a death benefit plan set up by the employer.\textsuperscript{53} The employer may also deduct from its gross income the amounts paid on all of the health and accident plans set up for employees.\textsuperscript{54}

It has long been established that, for the purpose of calculating fringe benefit deductions, a working partner “cannot be considered as an employee of the firm in the sense that he is in the service of another.”\textsuperscript{55} But a shareholder-employee can receive compensation in wages or fringe benefits from the corporation.\textsuperscript{56} Therefore, a corporation can reduce its own taxable income, and that of its shareholders, when supplying fringe benefits; a partnership cannot. Apparently a corporation electing to be taxed under Subchapter S can also take the fringe benefit treatment normally allowed other corporations. Since Subchapter S deals with the distribution of taxable income, and since deductions for payments made to employee benefit plans are taken in determining taxable income,\textsuperscript{57} payments by an electing corporation for these fringe benefit plans presumably will be deducted in calculating taxable income in the usual manner for corporations.\textsuperscript{58}

(2) \textit{Salary deductions.} Subchapter S will probably eliminate one of the most formidable tax obstacles to incorporating the average farm: double taxation. But corporations that cannot or do not

\begin{itemize}
  \item \textsuperscript{49} INT. REV. CODE OF 1954, § 404(a).
  \item \textsuperscript{50} INT. REV. CODE OF 1954, § 402(a)(1).
  \item \textsuperscript{51} INT. REV. CODE OF 1954, §§ 104(a)(8), 105(a).
  \item \textsuperscript{52} INT. REV. CODE OF 1954, § 105(d).
  \item \textsuperscript{53} INT. REV. CODE OF 1954, § 101(b).
  \item \textsuperscript{54} INT. REV. CODE OF 1954, § 106.
  \item \textsuperscript{55} Estate of S. U. Tilton, 8 B.T.A. 914, 917 (1927).
  \item \textsuperscript{56} See notes 59 to 76 infra and accompanying text.
  \item \textsuperscript{57} It is clear that the deduction is to be taken from gross income. INT. REV. CODE OF 1954, § 106.
  \item \textsuperscript{58} This conclusion appears to be consistent with the recently proposed regulations on Subchapter S. Proposed Treas. Reg. § 1.1372-1(c)(6), 24 Fed. Reg. 1795 (1959) provides: “Except as provided in section 1377, earnings and profits of an electing small business corporation are computed in the same manner that they would have been computed had no election been made.”
\end{itemize}
choose to make the Subchapter S election continue to face the double taxation problem.

Many corporations can avoid double taxation entirely by paying salaries to stockholder-employees rather than by distributing dividends;59 a farm corporation, like any other corporation, is entitled to deduct from taxable income “a reasonable allowance for salaries or other compensation for personal services actually rendered.”60 As a result, only the stockholder-employee, not the corporation, will be taxed on income distributed in the form of salaries. The crucial problem then becomes determining the meaning of the term “reasonable,”61 for the deductions from taxable income will be disallowed if the salaries fail to satisfy the reasonableness requirement.62 Though some general criteria for determining “reasonableness” have been advanced,63 in actual practice that determination turns on the circumstances of the particular case.64 It is clear, however, that payments of salary to a stockholder employee are not deductible if they are “extraordinary, unusual, and extrav-

59. For example, assume that income before deductions for salaries and dividend distributions equals $100,000.

Situation 1. a. No salary paid to stockholder.
   b. $20,000 in dividends distributed to stockholder.
      The tax will be applied on $100,000:
      
      $30\% \times $25,000 = $7,500
      $52\% \times $75,000 = 39,000
      
      Total = $46,500

Situation 2. a. $20,000 in salary paid to stockholder.
   b. No dividends distributed to stockholder.
      The tax will be applied on $100,000 less a $20,000 deduction for salary expense, or $80,000.
      
      $30\% \times $25,000 = $7,500
      $52\% \times $55,000 = 28,600
      
      Total = $36,100

60. INT. REV. CODE OF 1954, § 162(a)(1).
61. The commentators indicate that the problem of reasonableness is, in effect, a problem for the closely held corporation alone. As one writer has expressed it:
   While this question of reasonableness of salary theoretically is not confined to salaries paid to stockholders, but applied to salaries paid to any officer, as a practical matter salaries are seldom questioned unless the officer or his family is interested in the corporation. Ordinarily if the officer is a stranger to the owners of the corporation dealing at arm’s length, the Agent will not question the salary paid.

Smith, Transactions Between a Corporation and a Stockholder, Division of General Extension, University of Georgia, Proceedings of the Fifth Annual Georgia Accounting Institute and The First Georgia Tax Institute 93, 96 (October 25–27, 1951).
gant... having no substantial relation to the measure of their services and being utterly disproportioned to their value."

In determining reasonableness, courts are influenced by comparing compensation paid to employees of the corporation with the salaries received by persons holding comparable positions in other corporations of the same nature; however, this evidence is not conclusive.

The form of payment will not be decisive in showing whether or not it was intended as a distribution of income. Of course, salaries which are paid in direct proportion to stock holdings or in the nature of contingent profit sharing plans will be carefully scrutinized to determine whether such compensation is actually payment for services. Such compensation agreements will be upheld if the corporation can show that they were made before the services were begun, and that the sole purpose was to give fair compensation.

The regulations provide that bonuses made in good faith as additional compensation for services actually rendered will be allowed as deductions from taxable income. But gifts made to employees and others which do not serve as compensation for services are not deductible. Where year-end bonuses are in “almost direct proportion of stock holdings without regard to services performed,” they will probably not be allowed as deductions.

The Tax Court has decided two cases dealing with the reasonableness of salaries paid by a closely held farm corporation. In Currier Farms, Inc., a family farm corporation initially authorized an annual salary of $7,500 to a major stockholder who was, in fact, the sole operator of the farm. Some months later, the board of directors authorized a change in salary from the original amount to seventy-five percent of net profits. The court disallowed the increase, holding that its purpose was to reduce taxable income and not to reasonably compensate the operator for his services.

In E. H. Mettler & Sons, the petitioner was a large farm corporation whose officer-employees were the father of the family and his four sons and sons-in-law. Though the five varied considerably in age, education, farming experience, and responsibility in man-

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71. Ibid.
73. 7 CCH Tax Ct. Mem. 677 (1948).
74. 8 CCH Tax Ct. Mem. 829 (1949).
aging the corporation, each was paid $35,000 in the year in question. The court disallowed two-thirds of that total compensation on the grounds that the compensation agreement was clearly designed to distribute profits to avoid corporate tax.\textsuperscript{75}

It seems clear that a farm corporation may reduce its taxable income by paying salaries to employees, whether they are shareholders or not. However, the corporation will have the burden of showing the payments are reasonable compensation for services rather than profit distributions designed to evade double taxation.\textsuperscript{76}

(3) Rental expense deduction. The farm owner may be well advised to rent his farm property to the corporation, rather than to exchange it for stock, since proper rent payments are deductible from corporate income as ordinary and necessary business expenses.\textsuperscript{77} There would be no double taxation on these payments.

The rent deduction is available only when the business has no title to or equity in the property.\textsuperscript{78} Although an individual operating his farm as a sole proprietorship or with another as a partnership could not pay rent to himself for the property he owns,\textsuperscript{79} there is nothing to prevent a farm corporation from paying rent to a shareholder, an officer, or anyone else closely related to the business.\textsuperscript{80} It is true, however, that where a close relationship exists between the lessor and the lessee, the rental payments will be subject to scrutiny to “determine whether the sum paid is in excess of what the lessee would have been required to pay had he dealt at arm's length with a stranger.”\textsuperscript{81}

Here again the corporation must be prepared to show that payment of rent is not solely a means for distributing profits to avoid

\textsuperscript{75} Id. at 330. A total of $175,000 was claimed. The court ruled that reasonable compensation was a total of $68,500, and disallowed the remaining $106,500.

\textsuperscript{76} Botany Worsted Mills v. United States, 278 U.S. 282 (1929).

\textsuperscript{77} INT. REV. CODE OF 1954, § 162(a)(3).

The code does not limit deductions for rental payments to “a reasonable allowance” as in the case of salary or compensation, but at the same time the code does not preclude the . . . [commissioner] from examining the facts relating to such payments for the purpose of determining their true character and from disallowing deductions claimed as rents where the payments were of a character not permitted as deductions by the code.

\textsuperscript{78} INT. REV. CODE OF 1954, § 162(a)(3).

\textsuperscript{79} He obviously would have equity in or title to the property, thus violating the Code’s provisions.

\textsuperscript{80} See, e.g., Jos. N. Neel Co., 22 T.C. 1083 (1954).

\textsuperscript{81} Roland P. Place, 17 T.C. 199, 203 (1951). In Pennock Plantation, Inc., 10 CCH Tax Ct. Mem. 1077 (1951), the court disallowed part of rent paid to another corporation, made up of the same four stockholders as the lessee farm corporation, stressing the petitioner’s failure to present expert testimony or evidence of comparable rentals.
double taxation. There must be proof that a valid rental agreement exists, that actual payments have been made, and that the payments were both fair and reasonable. Thus, where the farm corporation is paying an absurd amount of rent to a shareholder, officer, or other person related to the business, a reasonable allowance will be granted for rental expense, but the excess will be disallowed.

(4) Retention of earnings by the corporation. In order to reduce double taxation, a corporation may choose to accumulate earnings and use them for expansion purposes, working capital, or reserves for possible contingencies. Of course, if the accumulated earnings are eventually paid out as dividends, they will be taxed at the regular rate. But if earnings are accumulated until the corporation liquidates or until the individual stockholder sells his shares, there very likely will be a tax benefit derived from capital gain treatment of the accumulation. The individual stockholders also may prefer to have the corporation temporarily accumulate earnings rather than distribute them as dividends during a year when the stockholders' other income is high.

In accumulating earnings, the farm corporation must take care to avoid the accumulated earnings or personal holding company taxes. Only the very large farm corporation need be concerned with the accumulated earnings tax which is imposed on earnings retained in excess of $100,000 if the amount accumulated exceeds the "reasonable needs" of the business. However, if the farm

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82. Le Moyne v. Commissioner, 47 F.2d 539 (7th Cir. 1931); Orange & Domestic Laundry Co., 6 B.T.A. 646 (1927).
86. The proceeds from corporate liquidation distributed to the stockholders or from the sale of stock by shareholders will be taxed at the capital gain rate. This would result in an ultimate tax saving for the shareholder whose income is taxed at more than the 25% rate. See Inr. Rev. Code of 1954, § 331. Also see more detailed discussion of capital gain treatment in following paragraphs. For a general discussion of corporate liquidations, see Beck, Problems in Liquidation of a Corporation and Continuation of the Business, N.Y.U. 10th Inst. on Fed. Tax. 1207 (1952).
87. If the income is retained, it will only be taxed for income tax purposes at the corporate level at that time. In some situations, stockholders may wish to gradually sell off part of their shares of stock as they appreciate in value, with the income from the sales being taxed at capital gain rates.
88. Inr. Rev. Code of 1954, §§ 532, 533, 535(c)(2). This tax is imposed in addition to regular taxes at the rate of 27% of the accumulated taxable income not in excess of $100,000 and 38% of accumulated taxable income in excess of $100,000. Inr. Rev. Code of 1954, § 531.

The 1954 Code provided that the burden of proof, with some qualification, will
corporation can show that it needs substantial working capital to operate the farm, that it is maintaining a consistent dividend policy and has a definite plan for expansion in the immediate future, or that it is trying to protect against contingencies, the reasonable needs requirement should be satisfied.

Though satisfying the "reasonable needs" requirement of the accumulated earnings tax, accumulated earnings of a corporation could be subject to a crippling eighty-five percent tax if the corporation is classified as a personal holding company. A corporation is a personal holding company if a minimum of fifty percent of its stock is owned by five or less individuals and at least eighty percent of its gross income is personal holding company income.

In general, personal holding company income is income from investment or personal services. Since income from farming is not investment or personal service income as defined by the Code, be on the Internal Revenue Service to show that the accumulated retained earnings from farm income were unreasonable and subject to the accumulated earnings tax. The pre-existing law dealing with the burden of proof, see Pelton Steel Casting Co., 28 T.C. 153 (1957). Whether an accumulation of earnings is reasonable or not is a fact question with final determination in the hands of the Tax Court. McCutchen Drilling Co. v. Commissioner, 143 F.2d 480 (5th Cir. 1944).

90. Ibid.
92. Millane Nurseries & Tree Experts, Inc., 1 CCH Tax Ct. Mem. 228 (1942); C. R. Burr & Co., 9 P-H B.T.A. Mem. 354 (1940). These two cases dealt with the particular problems of the agricultural industry as found in the tree nursery business. The court in each case held that an accumulation of earnings was necessary to protect against the contingencies of weather injury and business condition fluctuation.
93. For an excellent discussion of the entire problem of the accumulated earnings tax, see Holzman, THE TAX ON ACCUMULATED EARNINGS (1950).
94. Int. Rev. Code of 1954, § 541. Actually the tax is 75% on the first $2,000 accumulated and 85% thereafter.
95. By ownership, the Code also includes constructive ownership which is defined in Int. Rev. Code of 1954, § 544(a).
97. Int. Rev. Code of 1954, § 543 defines personal holding company income as consisting of the following:
   (1) dividends, interests, royalties (other than mineral, oil, or gas royalties), and annuities . . .
   (2) gains from the sale or exchange of stock or securities.
   (3) gains from future transactions in any commodity . . .
   (4) gains from the sale or other disposition of any interest in an estate or trust.
   (5) [Income from personal service contracts if 25% of the corporation's stock is owned by the person who is to perform (or who has performed) or who may designate who is to perform such contract].
   (6) [amounts received for use of corporate property by one who holds 25% or more of the corporation's outstanding stock].
   (7) rents, unless constituting fifty percent or more of the gross income.
   (8) mineral, oil, or gas royalties, unless . . . [more than 50% of gross income comes from that source or allowable business expense deductions, excepting personal service compensation paid to shareholders, amount to more than 15% of gross income].
the ordinary farm corporation engaged primarily in the business of farming need not be concerned with the personal holding company tax in accumulating earnings.98

Capital gains and losses

Special tax treatment is given to receipts from the sale of property classified either as capital assets or "1231 assets."90 Much of the farmer's property, except farm products inventoried for sale in the regular course of business, will fall into one of these two categories.109 In many cases, the difference in tax treatment of corporate and noncorporate gains from sales of this property will make incorporating of the farm disadvantageous.

The excess of net long-term gains on the sale of farm capital assets and "1231 assets" over the net short-term capital losses on sales of these assets is includible in the farm corporation's taxable income.101 These gains are taxed at a rate of twenty-five percent, regardless of what the tax rate on ordinary income might be.102

On the other hand, the capital gains of the unincorporated

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98. If, however, the farm corporation has expanded its holding so that farming income constitutes only a small minority of total taxable income, it must take great care to avoid the personal holding company "pitfall" because of the crippling effects such a tax could have on a corporation. For an example of a farm corporation forced to pay this tax because its farm income was less than 20% of total income, see Woodside Acres, Inc., 46 B.T.A. 1124 (1942), aff'd, 134 F.2d 793 (2d Cir. 1943).

99. INT. REV. CODE OF 1954, §§ 1201(a), (b). A capital asset includes all property held by a farmer with the major exceptions of property includable in inventory, property held for sale in the regular course of business, business accounts receivable, real property, and property subject to depreciation. INT. REV. CODE OF 1954, § 1221. However, real property and property subject to depreciation would fall within § 1231 of the Code providing that net gains on the sale of certain assets used in the trade or business and held for over six months will be treated as gains from the sale of capital assets. INT. REV. CODE OF 1954, §§ 1231(a), (b)(1). "1231 assets" also include livestock held by the farmer for over twelve months for "draft, breeding, or dairy purposes," INT. REV. CODE OF 1954, § 1231(b)(8), and unharvested crops sold with land which was held at least six months. INT. REV. CODE OF 1954, § 1231(b)(4).

100. INT. REV. CODE OF 1954, §§ 1221(1), 1231(b)(1)(B). Farmers are constantly seeking to have other property classified as capital assets to receive the favorable tax treatment when it is sold. See Halstead, Capital Gains of Farmers, 25 So. CAL. L. REV. 96 (1951). But the discussion above is limited to the tax treatment of what is known to be a capital or "1231 asset," and leaves the determination of what is such an asset to the extensive writings on the subject which include: RESEARCH INSTITUTE OF AMERICA, INC., CAPITAL GAINS OPPORTUNITIES FOR THE AVERAGE TAXPAYER (1955); MALESON, FARMERS AND THE FEDERAL INCOME AND RELATED TAXES, 8 SYRACUSE L. REV. 145, 150-55 (1957); SUTHERLAND, TAXATION PROBLEMS OF FARMERS, DIVISION OF GENERAL EXTENSION, UNIVERSITY OF GEORGIA, PROCEEDINGS OF THE SEVENTH GEORGIA TAX INSTITUTE 41, 50-60 (October 23-24, 1953).

101. "Net long-term capital gains" is the excess of gains from sales of capital assets held over six months reduced by losses on sales of capital assets also held over six months. INT. REV. CODE OF 1954, §§ 1222(3), (4), (7). "Net short-term capital loss" is the excess of gains on sales of capital assets held less than six months reduced by gains on the sale of capital assets also held less than six months. INT. REV. CODE OF 1954, §§ 1222(1), (2), (6).

102. INT. REV. CODE OF 1954, § 1201(a).
farmer will be taxed at (1) a rate of twenty-five percent, or (2) one-half his regular income tax rate, whichever is less. Thus, there may be a substantial tax saving over the corporate treatment of capital gains if the unincorporated farmer’s total income is being taxed at a rate less than fifty percent.

Though the likelihood of a capital loss is not great for the average farmer, there is a slightly more favorable tax treatment for the unincorporated farm if such losses do occur. If either a corporate or noncorporate sale of capital assets results in a loss, it may be deducted to the extent of any capital gain in that taxable year. However, the unincorporated farmer may deduct capital losses equal to the amount of capital gain plus $1,000. In both cases, an excess still existing after a deduction of the allowable capital loss may be added to the capital loss in the succeeding five years, or until exhausted.

Clearly then, the treatment of capital gains and losses allowed to the unincorporated farmer is as good as, or better than, that allowed the farm corporation. And the advantage of the unincorporated farm is increased even more if income from corporate capital gains is paid out as dividends to the stockholders and taxed at regular individual rates.

B. ESTATE TAX DISADVANTAGES

The estate tax is imposed on property left by an individual at death. As such, it has no effect on the tax liability of a farm

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<td>or</td>
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<tr>
<td>b. may include 50% of capital gain in taxable income to be taxed at regular rate.</td>
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Though it is entirely possible for farm capital and “1231 assets” to be disposed of at a loss, it is suggested that the frequency of losses will not be great since the basis for a good deal of the farm property may have been reduced by depreciation deductions.

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103. INT. REV. CODE OF 1954, §1201(b)(2).
104. INT. REV. CODE OF 1954, § 1201(b)(1).
105. For example, assume: a. $20,000 in net capital gain.
    b. individual being taxed at 30% rate.
106. Though it is entirely possible for farm capital and “1231 assets” to be disposed of at a loss, it is suggested that the frequency of losses will not be great since the basis for a good deal of the farm property may have been reduced by depreciation deductions.
108. INT. REV. CODE OF 1954, § 1211(b). However, if taxable income is less than $1,000, the amount of taxable income is the maximum deduction allowed.
109. INT. REV. CODE OF 1954, § 1212. A five year carryover is the maximum permitted.
business, whether incorporated or not. However, particular Code provisions can have a very material effect on the amount of income tax to be paid on the sale of certain farm assets subsequent to the farm owner's death.

The basis of farm property held by the owner of an unincorporated farm is generally its cost.\textsuperscript{111} However, after the farmer dies, the basis of property acquired from his estate is its fair market value at the date of death, no matter what the basis may have been during the decedent's lifetime.\textsuperscript{112} This fair market value is presumed to be the same as the value of the property for estate tax purposes.\textsuperscript{113} Thus, when the property is subsequently sold, the tax assessed will be imposed only on an amount equal to the difference between the estate tax valuation and the selling price.

To illustrate this more fully, consider the case of an individual who is the sole owner of a farm engaged in raising livestock and a variety of crops. If the farmer is keeping his books on a cash basis, the costs of raising the livestock and crops will be expenses, and the assets will be carried on the books at a basis of zero.\textsuperscript{114} If such a farmer has livestock with a fair market value of $10,000 ready to be sold, the sale of such assets would result in income taxation of the full $10,000 of receipts. But if he were to die before the sale, the property would pass to the estate with a basis of $10,000, assuming that to be the fair market value at date of death. Thus, a subsequent sale of the property for $10,000 by his estate or heirs would result in no taxable gain.

The value of a decedent's estate may also be determined at an alternative valuation date within one year after the decedent's death.\textsuperscript{115} Thus, property belonging to an unincorporated farmer that appreciates rapidly in value, such as young livestock, would have a basis equal to the fair market value on the date of sale if sold within one year after the owner's death. The increase in

\textsuperscript{111.} \textit{Int. Rev. Code} of 1954, § 1012.
\textsuperscript{112.} \textit{Int. Rev. Code} of 1954, § 1014(a).
\textsuperscript{113.} This is a rebuttable presumption that on occasion the courts have allowed to be refuted by the showing of proof that the fair market value at date of death was in excess of the estate tax valuation. See, \textit{e.g.}, Elizabeth G. Augustus, 40 B.T.A. 1201 (1939); but generally the estate tax valuation prevails. See, \textit{e.g.}, Isabelle B. Krome, 9 CCH Tax Ct. Mem. 178 (1950). If a federal estate tax return need not be filed, the value of the property at decedent's death for state inheritance tax purposes is presumed to be the fair market value. Treas. Reg. § 1.1014-3 (a) (1957).
\textsuperscript{114.} A complete discussion of cash and accrual tax accounting for farmers will be found in O'Byrne, \textit{Farm Income Tax Manual} (1958).
\textsuperscript{115.} \textit{Int. Rev. Code} of 1954, § 2032. "However, the election is not effective for any purpose unless the value of the gross estate at the time of the decedent's death exceeded $60,000, so that an estate tax return is required to be filed under section 3018." Treas. Reg. § 20.2032-1 (b)(1) (1958). A discussion of the problem as applied to farmers will be found in Rev. Rul. 58-498, 1958 \textit{Int. Rev. Bull.} No. 35, at 8.
value of the livestock during the year following the farmer’s death would be tax-free.

Incorporation of the farm could change this situation considerably. True, when the stockholder of a corporation dies, the basis of stock which passes to his heirs is also the fair market value at the date of his death.\textsuperscript{116} And if the heirs later sell the shares, the tax is assessed on the difference between the selling price and the estate tax valuation. But when the farm property itself is sold by the corporation, the tax will be applied to the difference between the basis of that property to the corporation and its selling price.\textsuperscript{117} This could be a definite disadvantage for a farm business with a good deal of property likely to be disposed of in the near future. In the example above, when livestock and crops worth $10,000 at the date of the sole stockholder’s death are sold by the incorporated farm, the income tax will be levied on a $10,000 gain — the difference between the original basis of zero and the selling price of $10,000. Consequently, the tax which would be paid by the unincorporated farm on the property sold would be markedly less than that paid by the incorporated farm. However, when the value of products will have increased very little from time of acquisition to time of sale, this difference may be of only slight significance.

C. Excise Tax Disadvantages

The federal and state governments have imposed special taxes on the corporate entity and its stock that are not imposed on the unincorporated business. Though the tax burden of the farm business will be slightly increased by the imposition of these taxes, the total amount of excise taxes a farm would be liable for will probably be insignificant for the vast majority of closely held farm corporations. Therefore, the discussion below is notably brief since such taxes will probably have little material effect on the decision to incorporate the farm.

Federal taxes

A newly organized farm corporation will be subject, at the time stock is first issued, to a federal tax of eleven cents per hundred dollars of par or stated value of its original issue of stock.\textsuperscript{118}

\textsuperscript{116} Inr. Rev. Code of 1954, § 1014(a) provides that all property is valued at the date of decedent’s death, and does not distinguish between real and personal property.

\textsuperscript{117} The original basis is maintained because the corporate entity is not affected by any transactions between stockholders, and valuation of a particular stockholder’s shares will not affect the value of the corporate assets.

\textsuperscript{118} Inr. Rev. Code of 1954, § 4301. And a tax of $.11 per $100 of face value is imposed on the issuance of certificates of indebtedness. Inr. Rev. Code of 1954, § 4311.
The relative unimportance of this tax is easily illustrated by the fact that a farm incorporating with $100,000 of capital stock need only pay $110 of tax.

The capital stock transfer tax of $.05 per hundred dollars of par value of each transfer of stock\textsuperscript{119} has little or no consequence for the farm corporation that is closely held. On the rare occasions when stock is transferred, the tax would be negligible.

The unincorporated farmer must pay a self-employment social security tax of three and three-fourths percent on his income up to $4,800.\textsuperscript{120} Subsequent to incorporating, a stockholder-employee need pay only two and one-half percent of his wages for social security taxes.\textsuperscript{121} However, the corporation in its capacity as an employer must pay an equal sum;\textsuperscript{122} thus, a total of five percent tax is paid on income up to $4,800. This difference will be slight except in those infrequent situations where there are many owner-employees of the farm corporations.\textsuperscript{123}

State taxes

Most states impose a franchise tax on domestic corporations and/or a license tax on foreign corporations doing business within the state.\textsuperscript{124} Only a few states, such as Minnesota,\textsuperscript{125} have neither tax. The basis for application of the tax varies from state to state, though it is commonly the value of the capital stock of the corporation.\textsuperscript{126} The rates also differ considerably.\textsuperscript{127} For any but the largest farm corporation, this tax will probably be nominal.\textsuperscript{128}

In five states, the shareholder in a farm corporation would also be liable for a state stock transfer tax upon transfers of stock to another.\textsuperscript{129} Such a tax may be imposed either as a stated amount

\begin{itemize}
  \item \textsuperscript{119} Int. Rev. Code of 1954, § 4321.
  \item \textsuperscript{120} Int. Rev. Code of 1954, § 1401.
  \item \textsuperscript{121} Int. Rev. Code of 1954, § 8101.
  \item \textsuperscript{122} Int. Rev. Code of 1954, § 8111.
  \item \textsuperscript{123} Where an individual's income from farm work is at least $4,800, the unincorporated farm will pay $180 tax while the total tax paid by the employee and the corporation will be $220.
  \item \textsuperscript{124} See generally State Summaries, CCH State Tax Guide (2d ed.) §§ 5-200 to -951.
  \item \textsuperscript{125} However, since Minnesota's corporate income tax is one of the highest in the country, it should compensate for any loss of revenue the state might suffer because it does not have a franchise tax.
  \item \textsuperscript{126} See generally State Summaries, CCH State Tax Guide (2d ed.) §§ 5-200 to -951.
  \item \textsuperscript{127} Ibid.
  \item \textsuperscript{128} E.g., The Mississippi Franchise Tax is $2 per $1,000 of the value of the capital used, invested or employed in Mississippi. The minimum tax is $10. Miss. Code Ann. § 9314 (Supp. 1956). Even if the value of the capital was $100,000, the cost would only be $200 per year.
  \item \textsuperscript{129} Alabama, Florida, New York, South Carolina, Texas. See State Summaries, CCH State Tax Guide (2d ed.) §§ 58-200 to -951.
\end{itemize}
for each share transferred or upon the basis of a graduated scale of rates determined by the face value of the shares. The rates of these taxes range from $.033 per hundred dollars of face value in Texas to $.25 per hundred dollars of par value in Alabama. However, these taxes are so small that it is unlikely that they would have any considerable effect on the determination whether to incorporate a farm.

II. TRANSFER OF ASSETS TO THE NEW FARM CORPORATION

A. TAX-FREE EXCHANGES

Once a farm owner decides to incorporate, he must initially consider problems arising from the transfer of assets from the unincorporated farm to the new corporation. The bookkeeping procedure for accomplishing this transfer is a relatively simple one. However, the tax factors are somewhat more involved.

The basic rule of tax-free exchanges, as stated in Code section 351, is that no gain or loss is recognized if property is transferred to a corporation solely in exchange for stock or securities in that corporation. However, this rule is only applicable if, immediately after the exchange, the transferors are in control of the corporation. To be "in control" the transferors must own at least eighty percent of the voting stock and at least eighty percent of the shares of all other classes of stock. Thus, if the transfer of property is to be tax-free, the incorporating farmer cannot bring other

130. Ibid.
133. Every state has some form of property tax. See generally State Summaries, CCH State Tax Guide (2d ed.) §§ 20-200 to -964. However, to avoid the double taxation of corporate property and the stock of that corporation, most states exempt stock in domestic corporations from the personal property tax. See, e.g., Minn. Stat. §§ 285.01-021 (1957). Because of this exemption, a discussion of these taxes is omitted (even though they may form a significant expense for the farmer) since they will probably be no different for the incorporated farm than for the unincorporated farm and will not affect the farmer's decision to incorporate.
135. The transfer may be made by one or more persons. As used in this section, "one or more persons" includes individuals, trusts, estates, partnerships, associations, companies and corporations. Treas. Reg. § 1.351-1(a)(1) (1955).
137. Ibid.
138. Int. Rev. Code of 1954, § 368(c). The amount of control is determined by considering only the amount of stock issued, not the amount authorized. American Bantam Car Co., 11 T.C. 397 (1948), aff'd per curiam, 177 F.2d 519 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950). However, where the transferors are under a pre-existing commitment to dispose of their stock, the amount of stock so committed will not be regarded as held by the transferors in determining control. See S. Klein on the Square, Inc., 14 T.C. 786 (1950), aff'd, 188 F.2d 127 (2d Cir. 1951); Mennon & Sons, Inc., 12 T.C. 837 (1949).
members of his family into substantial corporate ownership at time of incorporation; he will be unable to give them more than twenty percent of the stock issued. However, the incorporation exchange generally would not be made taxable if the transferor gave or sold stock at a time subsequent to the completion of the exchange with the corporation.\footnote{129}

In order for an exchange to be tax-free, those persons who received stock or securities in exchange for property must be in control after the transfer.\footnote{140} The Code specifically provides that stock issued to a transferor solely in return for services is not stock issued in return for property.\footnote{141} Thus, if the corporation issues more than twenty percent of the stock to persons who contribute no property, but only services rendered or to be rendered to the farm business, the exchange will not be tax-free.\footnote{142}

A definitional problem also exists in ascertaining the meaning of “stock and securities” as that term is used in section 351 of the Internal Revenue Code. Since the term “stock” clearly covers the normal equity shares of a farm corporation, there would be no problem for the farm corporation issuing only capital stock in return for property received. However, since there can be substantial tax advantages from debt financing,\footnote{143} the question of what type of debt obligations satisfy the “securities” requirement arises. Apparently, the term “securities” includes long-term obligations such as bonds, indentures, and notes;\footnote{144} short-term obligations probably will not meet the test.\footnote{145} However, the period of the ob-

\footnote{129. A transfer of interests to a corporation is not taxable if the transferors have control immediately afterward regardless of what might take place subsequently. Ethel Cary, 18 B.T.A. 1294 (1930). Even if the subsequent sale of the stock was contemplated at the time of incorporation, this will not make the transfer tax-free. W. M. Smith Electric Co., 13 CCH Tax Ct. Mem. 646 (1954). However, if there is a binding agreement at the time of incorporation to sell stock to another party, the fulfillment of that agreement will be considered part of the exchange, and the determination of control will not be made until that agreement is carried out. May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953). However, a mere option to buy where the third party is not obligated will not have any effect on the tax-free transfer. Robert J. Harder, 17 CCH Tax Ct. Mem. 494 (1958).

140. See Int. Rev. Code of 1954, § 351(a). Cash is now held to be property.


142. See discussion in Repetti, Using the Corporation to Operate a New Business, N.Y.U. 15th Inst. on Fed. Tax. 401 (1957). However, if more than a nominal amount of property is also transferred along with the services to the corporation, the transfer will then be tax-free. See Trens. Reg. § 1.351–1(a)(2) (example 3) (1935).

143. See notes 164 to 167 infra and accompanying text.


145. Cf., Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1932). Though there is no hard and fast rule as to what short-term obligations are not securities, the accumulated cases at 2 P-H 1959 Fed. Tax Serv. § 9514 indicate that notes with a term of less than five years have generally been held not to be securities.
ligations will not be conclusive, and the general nature of the obligation will be considered to determine whether they represent real "investment in the business" rather than "temporary advances for current corporate needs."

Though the Code exempts only exchanges solely for stock and securities, receipt by the transferor of money or other property in addition to stock and securities does not make the entire exchange taxable. However, gain must be recognized, but not in excess of the fair market value of the other property plus the amount of cash received. The farm corporation's basis for the transferred property will be the transferor's basis plus the amount of recognized gain. And the basis of the stock and securities the transferor receives is the same as the basis of the property he transferred plus the amount of gain recognized on the exchange decreased by the fair market value of the other property and money he received.

The 1939 Internal Revenue Code specifically provided that where individuals transferred property to a corporation, the transfer was tax-free only if the amount of stock and securities received by each individual was substantially in proportion to his interest in the property transferred. This provision was eliminated in the 1954 Code, so that a disproportionate receipt of property does not make the exchange taxable. However, the Internal Revenue Service may treat the exchange as if the stock and securities had been received in the proper proportion but with the transferors making subsequent transfers among themselves. For example, if A and B are equal owners of farm property which they transfer to a new farm corporation, and A receives seventy-five percent while B receives twenty-five percent of the stock issued in exchange for the property, the transfer may be tax-free; but B may be liable for a gift tax on an amount equal to twenty-five percent of the stock issued.

**B. Taxable Transfer of Assets**

In some instances a taxable transfer of assets to a new corporation may be advantageous. A taxable transfer of depreciable property to a farm corporation may be advisable if the market value of

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149. INT. REV. CODE OF 1954, § 362(a).
150. INT. REV. CODE OF 1954, § 358(a).
151. See INT. REV. CODE OF 1939, § 112(b).
153. Ibid.
that property is substantially in excess of the transferor’s basis.\textsuperscript{155} If the transfer were taxable,\textsuperscript{156} the corporation could take advantage of a stepped-up basis for depreciation deductions from its ordinary income, while the gain on the transfer would be taxable to the transferor only at a capital gains rate. However, if more than eighty percent of the farm corporate stock is owned by the transferor, his spouse, or minor children or grandchildren, the proceeds from a sale of depreciable property to a corporation will be classified as ordinary income rather than capital gain.\textsuperscript{157} Thus, generally no benefit would have been realized from the taxable transfer.\textsuperscript{158}

C. SELECTION OF ASSETS TO BE TRANSFERRED

Property owners will probably find it advisable to transfer no appreciated assets to the farm corporation which are unnecessary to the business and will probably be sold in the near future. Transfer to and sale by the corporation could subject the gain to double taxation, since the corporation would be taxed on the sale of the property and the stockholder would also be taxed on the proceeds if distributed. A high bracket taxpayer may also wish to retain assets which will be sold at a loss. A loss realized on assets used in a trade or business is an ordinary loss,\textsuperscript{159} and may be used to greater advantage for setting off the individual’s income rather than the corporate income.

As discussed earlier,\textsuperscript{160} the farm owner may also wish to retain some assets for rental to the corporation, so that he can receive some income from the corporation not subject to “double taxation.”

III. SELECTION OF CAPITAL STRUCTURE

A major problem confronting the organizers of a farm corporation is the planning of the new corporation’s capital structure. Of course, a new corporation’s capital structure can be most easily set up by issuing one class of common stock in return for all the money or property contributed to the corporation. And, of course, one class of stock must be utilized if the Subchapter S election is desired. However, more diversified capital structures may be attractive taxwise in some situations. Substantial savings in future

\textsuperscript{155} For a brief discussion of this point see Repetti, supra note 142, at 409.
\textsuperscript{156} Generally transfers can be made taxable by issuing sufficient stock for services to persons who contribute no property, or only nominal property, thus defeating the control requirements.
\textsuperscript{157} Int. Rev. Code of 1954, § 1239.
\textsuperscript{158} There may still be some benefit in the situation where the individual is in an income bracket substantially lower than the corporation.
\textsuperscript{159} See Int. Rev. Code of 1954, § 1231(a).
\textsuperscript{160} See notes 77–85 supra and accompanying text.
income and estate tax payments for the corporation and its stockholders are related to the corporation's capital structure. Furthermore, many such tax advantages can be obtained only at the time of the initial organization of the capital structure.\textsuperscript{161}

The treatment below of capital structure as a means for reducing taxes has been subdivided into the categories of income and estate tax problems. However, it will be apparent that such a division is purely artificial since many of the considerations will necessarily overlap. Any final decision on capital structure should be made only after weighing the various alternatives to determine what is the best over-all structure for tax purposes in each particular situation.

A. INCOME TAX CONSIDERATIONS

Advantages of debt financing

The determination of the amount of capital needed to currently finance a new farm corporation will generally be based on nontax considerations.\textsuperscript{162} However, it is important to determine for tax purposes whether the stockholders' contributions of capital should be characterized as stock or, in part, as loans to the corporation. Clearly the Internal Revenue Code favors the corporation (and its stockholders) which is debt financed:\textsuperscript{163} certain well-recognized tax advantages will result. First, interest the corporation pays on the loans will be deductible from gross income as a necessary business expense;\textsuperscript{164} it has long been recognized that dividends paid on stock are not deductible.\textsuperscript{165} Second, repayment of the loans will not be taxed to the recipients, though, in some instances, partial redemptions of stock will be classified as dividends.\textsuperscript{166} Finally, debt financing would be a permissible variant of the simple capital structure required to make the Subchapter S election; two classes of stock would not satisfy that requirement.\textsuperscript{167}

\textsuperscript{161} Advance planning is of the utmost importance in this case since in no field of the tax law is the opportunity to back up and start over less readily available. It is of the utmost importance, therefore, that careful consideration be given to the tax results of alternative courses which may be available, as well as the tax consequences of the desired procedure where only one choice is available.

\textsuperscript{162} For example, two important considerations would be the need for immediate working capital, and the anticipated profits of the new corporation.

\textsuperscript{163} However, with the addition of \textsuperscript{\textsuperscript{1244}} to the Code (see note \textsuperscript{167 infra}) the advantages of debt financing may not be as strong as before.

\textsuperscript{164} Int. Rev. Code of 1954, § 163(a).

\textsuperscript{165} E.g., Badger Lumber Co., 23 B.T.A. 362 (1931).

\textsuperscript{166} See Int. Rev. Code of 1954, § 302, which requires certain “redemptions” of stock to be taxed as dividends.

\textsuperscript{167} See Int. Rev. Code of 1954, § 1371(a)(4). Another suggested advantage of debt financing is the fact that if the loan was made in the course of a trade or business and the corporation fails, the loss is fully deductible. See Int. Rev. Code of
Notwithstanding the benefits that accrue to the corporation, great care must be taken in using debt financing to avoid the problem which has been labelled “thin incorporation.” If the corporation is “too thinly incorporated,” the debt will be treated by the Internal Revenue Service as equity and the benefits mentioned will be lost. On innumerable occasions, courts have considered what was allegedly debt financing to be equity, under this somewhat nebulous principle. The term “thin incorporation” originally referred only to an excessive debt to equity ratio in the corporation; however, because of the broader use of that term recently, it is used in this Note to identify a court’s classification of debt as equity for any reason whatever.

Though there has been much litigation on this point, there are few “hard and fast” rules of law which will aid in answering the question “what is too thin incorporation?” Excellent articles have been written on the subject, but by the authors’ own admissions “it is impossible to lay down any rules that will explain all the past cases, or to put up any sure signposts for the future.” This Note will only discuss a few of the highlights of the problem, concluding with what is thought to be a conservative approach to the problem.

The “thin incorporation” problem prior to 1946 was somewhat more limited than it is today. It is true that courts considered the question whether the interest of an investor in a corporation was debt or equity security. But the question was confined to determining whether the security met the formal requirements of a loan to the corporation. These pre-1946 cases are still relevant today, since the courts continue to disallow the classification of in-

1954, § 166(a). If not incurred in a trade or business, such a loss is treated as a short-term capital loss. See Int. Rev. Code of 1954, § 166(d). A loss on worthless securities may be treated as a long-term capital loss. See Int. Rev. Code of 1954, § 165(g). However, the possibility of having a loss fully deductible is not great because a shareholder in a farm corporation will find it difficult, if not impossible, to show that he is in the trade or business of lending money to the farm corporation. Furthermore, any apparent advantage existing (even if an ordinary deduction is allowed) may have been nullified by the recent addition of § 1244 to the Code, which will allow an ordinary deduction for loss on stock in most small business corporations.

168. As a matter of fact, probably no other tax topic has so often appeared in legal periodical literature.
170. For an excellent discussion of the current status of the problem see Kahn, How to Plan a Safely Thin Corporation in the Face of Today’s Obstacles, 8 J. Taxation 341 (1958).
171. Bryson, supra note 169, at 735.
172. See, e.g., Haffenreffer Brewing Co. v. Commissioner, 116 F.2d 465 (1st Cir. 1940); Helvering v. Richmond, F. & P. Ry., 90 F.2d 971 (4th Cir. 1937).
vestments as debt when they fail to meet the formal requirements. Although there are no set rules for determining the requirements of debt, there are certain factors which have often reappeared in the cases. In an excellent opinion by one court, the most commonly recurring factors were stated to be:

The name given the instrument, the presence or absence of fixed maturity date, whether annual payments are dependent upon earnings, the credit status of the holders of the instruments, that is, whether they are superior to or inferior to other creditors of the corporation, and whether the instrument carries with it any right to participate in the management of the company.

These factors indicate that the formalized requirements can be satisfied by setting up debt financing in the same manner as when receiving capital from independent investors. Furthermore, all routine procedures of recording and paying the interest liability should be followed.

Since 1946, the thin incorporation issue has centered around the question whether a particular security should be treated as stock equity even though it satisfies the formalized requirements for debt discussed above. On numerous occasions courts have held an investment to be equity mainly because there was an excessive debt to equity ratio. But these cases are unreliable for several reasons. First, the courts have not agreed what an acceptable debt to equity ratio is; the ratios that have been disapproved vary a great deal. Second, there is some ambiguity as to what is “equity” for purposes of determining the debt to equity ratio, that is, should equity include all of net worth or something less? And, finally, many courts have given greater weight to other factors, such as (1) the unity of interest between the stockholders and creditors where the corporation is debt financed, (2) the fact

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173. See, e.g., Crawford Drug Stores, Inc. v. United States, 220 F.2d 292 (10th Cir. 1955).
175. In 1946, the question of debt-to-equity ratios was considered for the first time by the Supreme Court in the well-known case, John Kelly Co. v. Commissioner, 326 U.S. 521 (1946) (considered jointly with Talbot Mills v. Commissioner).
177. For example, in Robert L. Osborne, 13 CCH Tax Ct. Mem. 428 (1954), the investment was held to be stock where the debt-to-equity ratio of 2,500 to 1 existed. This was also the holding in Briggs Co., 5 CCH Tax Ct. Mem. 366 (1946), but there the debt-to-equity ratio was only 4 to 1. Of course, as in all other thin incorporation cases, factors other than the bare ratios were considered.
178. For a discussion of this point, see Bittker, Thin Capitalization: Some Current Questions, 34 Taxes 839 (1956).
179. Gooding Amusement Co., 23 T.C. 408, 418 (1954), aff'd, 236 F.2d 159 (9th Cir. 1956). The Tax Court stated that "the most significant aspect of the instant
that the use of debt financing had no valid business purpose, and (3) the fact that stockholders held debt in exact ratio to their equity holdings.

Notwithstanding the apparent confusion in this area of the law, a 1957 decision in the Second Circuit, Gilbert v. Commissioner, posed a test for determining the nature of investments that seems both reasonable and workable. In that case, the court said that the major consideration in deciding if investment is debt or equity was "whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business." The court stressed the fact that all of the factors that have already been mentioned were relevant since each had some bearing on the element of risk involved in the investment. Furthermore, one of the additional factors considered was "whether outside investors would make such advances." Though all factors would be important in determining what the maximum of allowable debt would be, the last mentioned consideration alone appears to be the decisive element in deciding what the "safe," or minimum, amount of allowable debt would be. In judging whether the investor can reasonably expect repayment, the most reliable test appears to be whether independent outside investors are willing to lend the amount and on the terms that the corporate shareholders have invested. Thus, under the Gilbert test, a farm corporation can probably justify its debt-equity designation if the amount of debt issued is no greater than that which could have been obtained from outside creditors on the same terms.

Income splitting

The income tax burden of a family farm corporation and its stockholders can be relieved somewhat by "splitting income," that is, by channeling earnings directly to members of the controlling stockholder's family without increasing the amount of his own income. Obviously, if the recipient is taxed at a lower rate than the controlling stockholder, there will be a saving on the net tax paid on the income received from the farm business.

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180. 1432 Broadway Corp., 4 T.C. 1158 (1945), aff’d per curiam, 160 F.2d 885 (2d Cir. 1947).
181. R. M. Gunn, 25 T.C. 424 (1955), aff’d per curiam, 244 F.2d 408 (10th Cir. 1957). For an excellent index of all factors considered in the cases on thin incorporation see 2 P-H 1959 Fed. Tax Serv. § 13,096.
182. 248 F.2d 399 (2d Cir. 1957).
183. Id. at 406. (Emphasis added.)
184. Id. at 406.
Income splitting can be achieved by paying interest on debt security held by shareholders and members of their families, thus avoiding the double taxation problem due to distributing dividends. But the amount of income that can be channeled out of the corporation in this fashion is limited by the possibility that debt will be classified as equity for tax purposes. Furthermore, the rigidity of certain characteristics of debt, such as fixed interest rates and payment dates, renders a debt-based income splitting plan relatively inflexible. Therefore, other means of splitting income might have to be considered if such a program is desired.

(I) Use of equity in splitting income. The problem of splitting income is not applicable to all family corporations. The major stockholder in the farm corporation is ordinarily the director of farm operations and will receive a salary for his services. It is far more desirable to receive salaries than dividends since the combined corporate and individual taxes on dividends will be greater than the tax paid on compensation. Therefore, as a practical matter, the need for splitting income is found in the situation where dividends must be paid because the shareholders cannot withdraw the desired amount from the corporation in the form of interest on debt or compensation for services.

If the corporation has only one class of stock, and the controlling shareholder desires to distribute income to members of his family through dividends, he will also be increasing his own income when dividends are paid, thus forcing himself into a higher income tax bracket. Furthermore, the controlling owner could never give away as many as half the shares and still retain complete control over the farm operations.

The owner of the farm can probably split income more effectively by incorporating with a capital structure comprised of two classes of stock. If the two classes are voting common and non-voting common or preferred, the farmer could retain complete control over the farm operations by distributing only the nonvoting stock to members of his family. Then, by declaring dividends on the nonvoting stock, he could distribute corporate earnings to his family without increasing his own income.

Regardless of the capital structure used in splitting income, it is by no means certain that the validity of transfers of stock to members of one’s family will be recognized for income tax purposes. Thus, consideration must be given to factors which will be

185. See discussion of debt financing and its advantages at notes 162 to 184 supra.
186. For a discussion of reasonable salary deductions see notes 59 to 76 supra and accompanying text.
188. Moreover, he might have to pay gift taxes on the transfer.
considered in determining the validity of intra-family gifts, and the
effect which the form of capital structure will have on the validity
of those gifts.

(2) Validity of intra-family gifts: effect of capital structure. Prior
to 1948, the salient question in the area of income splitting was
whether gifts of stock made by a husband to his wife should be rec-
ognized as valid transfers.\footnote{See, e.g., Sewell's Estate v. Commissioner, 151 F.2d 806 (5th Cir. 1945).} However, this question is no longer im-
portant since a husband and wife may now split income by filing
a joint return without any transfer of income-producing property
from one to the other.\footnote{Int. Rev. Code of 1954, § 6013.} The key question today is whether a gift
of stock to a \textit{child} is a valid transfer for income tax purposes when
the transferor has legal control over the child.

The courts have generally taken the position that income from
stock given to a minor child will be taxed to that child if the stock
transfer was a \textit{bona fide gift}.\footnote{E.g., Emil Frank, 27 B.T.A. 1158 (1933).} In general, the requirements for a
valid gift are: a clear intent on the part of the donor to make a
gift, delivery and acceptance of the stock, and a complete transfer
of the donor's dominion and control over the stock.\footnote{For an excellent discussion of what constitutes a gift of stock see Apt v.
Birmingham, 89 F. Supp. 361 (N.D. Iowa 1950).} The transfer
of dominion and control is obviously the key element, and most of
the cases tend to single out the question of whether there was an
actual relinquishing of the transferor's rights under the stock.\footnote{See, e.g., Howard B. Lawton, 6 T.C. 1099, 1101 (1946), aff'd, 164 F.2d 380 (6th Cir. 1947).}

Since a parent continues to exercise general legal control over
his minor child, it is not surprising that the case law indicates that
a person making a gift of stock to his child will have difficulty show-
ing that he has not retained its economic benefits. The two prin-
cipal considerations appear to be whether the transferor of the stock
is constructively receiving dividends,\footnote{See Jolly's Motor Livery Co., 16 CCH Tax Ct. Mem. 1048 (1957).} and whether he has re-
tained the right to control the voting of the stock.\footnote{See, e.g., Ralph R. Anderson, 5 T.C. 443 (1945), aff'd, 164 F.2d 870 (7th
Cir. 1947).} Regardless of
the capital structure of the company, if the above elements are not
present in a transfer the validity of a gift for tax purposes can be
predicted with reasonable certainty. For instance, in \textit{Lewis W. Welch}\footnote{See, e.g., 8 T.C. 1139 (1947).} a sole shareholder transferred \textit{less} than a majority of
corporate stock to members of his family in trust, retaining no pow-
ers to reinvest the income in himself or change the beneficiaries

\begin{footnotes}
\footnote{See, e.g., Sewell's Estate v. Commissioner, 151 F.2d 806 (5th Cir. 1945).}
\footnote{Int. Rev. Code of 1954, § 6013.}
\footnote{E.g., Emil Frank, 27 B.T.A. 1158 (1933).}
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Birmingham, 89 F. Supp. 361 (N.D. Iowa 1950).}
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\footnote{See Jolly's Motor Livery Co., 16 CCH Tax Ct. Mem. 1048 (1957).}
\footnote{See, e.g., Ralph R. Anderson, 5 T.C. 443 (1945), aff'd, 164 F.2d 870 (7th
Cir. 1947).}
\end{footnotes}
of the trust; the court had little difficulty in finding the transfer valid. However, where the transferor retains control over the use of the dividends received from the stock and the donee takes no active part in the business by failing to exercise his voting rights, the transfer of the stock is not likely to be recognized for income tax purposes.\footnote{197}{See Sewell v. United States, 73 F. Supp. 957 (Ct. Cl. 1947). In that case the transfer was to petitioner's wife, but its principle would be equally applicable where the transfer is to one's minor children.}

Where the farm corporation uses two classes of stock, such as voting and nonvoting common,\footnote{198}{Of course nonvoting preferred stock could also be used; however, such stock should be of the standard nature. The transfer of stock "not authorized or issued as a legitimate attempt to broaden the capital base of the corporation but . . . [as] merely a device or subterfuge to divert income . . . " will very likely not be recognized for income tax purposes. Babson v. Delaney, 56-2 U.S. Tax Cases 56,160, 56,161 (D. Mass. 1956).} the donor may retain the voting rights and give only the nonvoting stock to his child. Since the voting power would no longer be an incident of ownership which the donor must give up to make an effective transfer, the critical question will then be whether the donor retains the right to the use and disposition of the income from the stock. Thus, the problem of validity of gift transfers is apparently simplified where there are two classes of stock. However, it is by no means certain that the validity of transfers of stock will be recognized simply because two classes are used in the income splitting procedure. If the nature of the stock transferred and the power over that stock retained by the donor indicate that he still exercises substantial ownership, the transfer will undoubtedly be a nullity for income tax purposes.\footnote{199}{See, e.g., Carlton B. Overton, 6 T.C. 304 (1946). In that case the court held that the transfer of a second class of stock to the voting shareholders' wives was not effective for income tax purposes. However, the taxpayer was placed in the unenviable position of having to also pay a gift tax on the transfer.}

\section{Use of trusts in making intra-family gifts of stock.} If control of the donated stock is not necessary to control the business operations,\footnote{200}{This would be true where less than 50% of the stock in a corporation having only one class is transferred and where nonvoting stock is transferred in the corporation having two classes of stock.} the donor might be satisfied by creating an irrevocable trust with a qualified independent trustee holding the stock. \textit{Regardless of the type of capital structure}, apparently a transfer of stock to an irrevocable trust is more likely to be recognized as valid for income tax purposes than an outright gift. The validity of such gifts may also be recognized if made to an independent guardian according to local law or to a custodian under the Uniform Gifts to Minors Act.\footnote{201}{See, e.g., MINN. STAT. §§ 527.01-.. (1957). Thirty states have adopted
of making a gift to an independent guardian and the still uncertain tax results of gifts made to a custodian under the Uniform Gifts to Minors Act would, at the present time, appear to indicate use of a trust rather than either of those devices.

The rules resulting from the famous Clifford case make it clear that a transfer of stock will be recognized for tax purposes if the applicable provisions of the Internal Revenue Code are carefully complied with. Subject to certain statutory exceptions, the donor of stock to a trust for the benefit of his minor child will be taxed on the income from the trust if he retains (1) a reversionary interest in the corpus or the income to take effect within ten years after the transfer; (2) a power to control the beneficial enjoyment of the corpus or income; (3) administrative powers over the trust “exercisable primarily for the benefit of the grantor rather than the beneficiary of the trust”; (4) a power to revoke the transfer to the trust; and (5) the right to receive income from the trust. If none of these five factors are present, the transfer will probably be valid. Of course, a corporation with a trust as a shareholder will be disqualified from making the Subchapter S election, and the relative value of assuring the validity of the gift for income splitting purposes should be carefully compared with the advantages of making the election.

B. ESTATE TAX CONSIDERATIONS

In general

The estate of the owner of a small farm usually will not be

this act since 1957. For a collection and discussion of these state laws, see 9B Uniform Laws Annotated (Supp. 1958, at 16).
204. Helvering v. Clifford, 309 U.S. 331, 336 (1940). In that case the court said that in determining who was the real owner of stock held in trust,

no one fact is normally decisive but that all considerations and circumstances . . . are relevant to the question of ownership and are appropriate foundations for findings on that issue. Thus, where, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband [donor] was the owner of the corpus. . . .

subject to any federal estate taxes, particularly if his wife survives him. Substantial exclusions and deductions are allowed in determining the value of the taxable estate for federal estate tax purposes: (1) deductions for estate settlement expenses and losses; 211 (2) deductions for charitable transfers; 212 (3) a general $60,000 exemption; 213 and (4) a marital deduction for the full amount of property left to one’s spouse, 214 subject to the limitation that such a deduction cannot exceed fifty percent of the adjusted gross estate. 215 Consequently, if a married farmer with a $120,000 estate gives $60,000 to his wife and $60,000 to others, the entire estate would be exempt from taxation, since a $60,000 marital deduction would be allowed in addition to the general $60,000 exemption for the gross estate. Finally, certain credits are allowed to further reduce the actual tax liability. 216

However, the estate tax will still be a significant consideration for the owner of a large farm. Obviously, the easiest way for the farm owner to avoid paying estate taxes is to dispose of property during his lifetime. 217 The tax liability for gifts will be twenty-five

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216. A credit is allowed for the tax which has been paid on gifts given to others but included in the gross estate, i.e., gifts in contemplation of death. Int. Rev. Code of 1954, § 2012. A credit is also allowed for the amount of any state death taxes paid on property included in the gross estate. Int. Rev. Code of 1954, § 2011(a).

At one time the size of the state death tax credit was a very substantial amount, but now it is relatively small. See Int. Rev. Code of 1954, § 2011(b). For example, if the taxable estate is equal to $100,000, the maximum state death tax credit as provided for in section 2011 is $2,000.

Another credit is the tax, or a percentage thereof, paid on the transfer of property included in the taxable estate when such property had been received from the estate of another within ten years before or two years after the decedent’s death. Int. Rev. Code of 1954, § 2013.

217. In so doing, however, the transferor must take care that the gift is not made in such a way as to be called a gift “in contemplation of death.” If avoidance of the federal estate tax is found to be the dominant consideration in making a gift, it will be classified as having been made in contemplation of death and will be includible in the decedent’s estate along with property in which he had an interest at the time of his death. Int. Rev. Code of 1954, §§ 2031(a), 2035.

“Contemplation of death” means that the gift was prompted by the thought of impending death and made with the purpose of avoiding estate taxes when the donor dies. Treas. Reg. § 20.2035-1(c) (1958). If a gift is made more than three years prior to the decedent’s death, the gift will not be included in the gross estate. Int. Rev. Code of 1954, § 2035(b). However, any gift which was made less than three years prior to death is considered to be a gift in contemplation of death unless the petitioner can show otherwise. Int. Rev. Code of 1954, § 2035(b). For an interesting case dealing with stock in a farm corporation as the subject of a gift see Bertha Dederick Ten Eyck v. United States, 49–2 U.S. Tax Cases 13,392 (N.D.N.Y. 1940).
percent less than the estate tax liability for property passing by will or by intestacy. But even the amount of gift tax can be substantially reduced or eliminated, since a married farmer may give away up to $6,000 annually tax-free to each of as many different individuals as he desires. He may also use an additional exemption for gifts totalling $30,000 over the period of his lifetime. Furthermore, if a substantial part of the farmer’s property is taxed under the gift tax statutes and a substantial part under the estate tax statutes, the total tax liability will be less than if all property were to be taxed under either one alone. Thus, even the owner of a large farm will be able to avoid a substantial part of the taxes on his estate if he can make tax-free gifts of his property during his lifetime.

Estate and gift tax problems in selecting capital structure

(1) Gift valuation problem. The individual seeking to take full advantage of the $3,000 or $6,000 annual exclusion allowable in calculating gift tax liability must determine what property he can give that will equal the full amount of the exclusion but not

<table>
<thead>
<tr>
<th>Amount of Taxable Gift or Estate</th>
<th>Gift Tax</th>
<th>Estate Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 5,000</td>
<td>$112.50</td>
<td>$ 150</td>
</tr>
<tr>
<td>10,000</td>
<td>375</td>
<td>500</td>
</tr>
<tr>
<td>50,000</td>
<td>5,250</td>
<td>7,000</td>
</tr>
<tr>
<td>500,000</td>
<td>109,275</td>
<td>145,700</td>
</tr>
<tr>
<td>1,000,000</td>
<td>244,275</td>
<td>325,700</td>
</tr>
</tbody>
</table>

218. See Int. Rev. Code of 1954, §§ 2001, 2502. For example:

219. The donor of gifts may annually exclude the first $3,000 of gifts given to any person. Int. Rev. Code of 1954, § 2503(b). The exclusion is allowed only for gifts of present interests in property. The only exception to this is where a gift of an interest in property is given to a minor child to take effect when he reaches majority. For purposes of the exclusion, this is not a future interest. Int. Rev. Code of 1954, § 2503(c).

However, there is a further provision that a gift made by one spouse to a third party may be "split" for gift tax purposes between husband and wife. Each spouse would then be considered as making one-half the gifts thus increasing the exclusion for gifts to third parties to $6,000 per year. Int. Rev. Code of 1954, § 2513(a). Other subdivisions of this section deal with the formalized procedure necessary for the spouse not making the gift to consent to the "splitting."

220. The donor-taxpayer is entitled to a $30,000 "specific exemption" to be taken once during his lifetime. Int. Rev. Code of 1954, § 2521. This $30,000 exemption is entirely apart from the $3,000 exclusions which are allowable in every taxable year. The "specific exemption" may be taken in one year or spread out over several years. However, once taken, it is permanently exhausted.

221. For example, assume that A has property valued at $100,000 and that all gifts are taxable.

a. If A makes gifts totalling $100,000, he will pay $15,525 in gift taxes.
b. If A leaves the $100,000 of property in his estate, the estate will pay $20,700 estate taxes.
c. But if A makes gifts totalling $50,000, and $50,000 in property passes through the estate, the total gift and estate taxes paid will only be $12,250.


222. See note 219 supra.
exceed it. Although the donor of the gift will naturally seek to value property as low as possible to reduce or eliminate gift taxes, failure to correctly estimate the value of the gift could put the donor in the undesirable position of having to dispose of other property in order to pay an unexpected gift tax.

A farm corporation with only one class of stock may face a very serious valuation problem. The value of property donated as a gift is the fair market value at the date of the gift.223 Where stock is closely held,224 the Code provides that fair market value is to be determined by considering, along with other factors, "the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange."225 But since few farm corporations list their stock on a public exchange, valuation of stock in most farm corporations must turn on other factors. The tax regulations provide that valuation should be determined on the basis of "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors."226 No single factor will be controlling,227 and a court will decide what is "fair and proper under the facts and circumstances as they appear in each particular case."228

Although the value of common stock depends on these continually fluctuating factors, preferred stock "ordinarily has a fixed redemption price and a specified liquidation value, and its value generally remains fairly constant."229 Therefore, if the farm incorporates with two classes of stock, and a gift is in the form of preferred stock, it will undoubtedly be easier to determine the value of the gift.

Of course, the farm owner may feel that he can best minimize the taxes on his estate by passing property at death the value of which is easily determined. The farm owner may then wish to retain the preferred stock while giving away the common, feeling that any gift tax to be paid by a miscalculation of gift value would be nominal compared to a miscalculation of estate valuation.

(2) Lack of funds to pay estate taxes: possible loss of control. The
farmer who has incorporated may leave an estate consisting largely of stock in the farm corporation. Since estate taxes are paid before distribution of the estate property, a sizable portion of the stock might have to be disposed of in order to pay the taxes. The stock need not be sold but could be redeemed with the corporation, for section 303 of the Code provides that stock redeemed to pay a shareholder's death taxes is an exchange in payment for the stock, not a dividend. Thus, the redemption of a sole shareholder's stock could never result in the shareholder's estate losing control of the farm. However, when the farm has incorporated with only one class of stock held by more than one individual, a necessary redemption or sale of the majority stockholder's shares could reduce his holdings so that his estate no longer had control. However, if the controlling shareholder were to die leaving an estate consisting of two classes of stock—one voting and the other non-voting—the latter could always be sold or redeemed to cover payment of estate taxes and administrative expenses, without affecting the ultimate control of the farm corporation.

(3) Possible limitations on amount of gifts. With only one class of common stock, the amount of gifts is limited to less than fifty percent of the stock, if the donor wishes to retain control over the farm.

If the farm corporation issues nonvoting preferred or common stock along with voting common, a sole stockholder could give away all of the nonvoting stock and less than fifty percent of the voting stock without losing control of farm operations. Since the farmer could give away well in excess of half the equity in the corporation while retaining control, he can substantially reduce the value of his taxable estate at death.

(4) Desire to pass on control of farm operations to children best qualified. It is common for a father to have trained certain of his children in the technical operations of the farm enterprise, and he would probably desire to give them control of the farm after his death. But at the same time, he might be hesitant to do so if he could not be assured that his other children would receive income.


231. Obviously, if one person holds all shares issued by the corporation, he is in control regardless of the number of those shares which the corporation redeems.

232. For example, assume that A owns 60% (60 shares) of X Corporation's stock and B owns 40% (40 shares). If A dies and his estate must sell or redeem more than twenty shares of stock, this will obviously put B into control and will prevent A's passing on control of corporate operations to members of his family.


234. This would be particularly true because of the well-recognized fact that the young people are emigrating from the farms to the urban areas.
from the farm, even though they would have no voice in the management. The farmer might wish to spread the wealth of the corporation among all his children while centralizing control in those he has selected as best qualified to carry on the business.

If the farmer's children are young at time of incorporation, he will not know which one of them will someday be qualified to operate the farm. Thus, he will not be able to make any more than nominal gifts of voting shares to his children until some time later when he will be able to decide who is qualified to manage the farm. Even then, with only one class of stock, he would be forced to relinquish control if he desired to give away more than half of the stock. If the farmer must delay in making gifts, he will pay a larger gift tax if the stock increases in value.

If the farm incorporates with two classes of stock, the nonvoting stock can be given to all those members of the family who are to receive income from the farm. And "the voting common can then be given to the member of the family who is qualified to participate actively in the management of the business."\(^{235}\) The father is then able to begin distributing the nonvoting stock to his heirs, in the form of gifts, long before he has made a final determination of who should control farm operations; thus, he will probably save on the amount of both gift and estate taxes he or his estate must pay.\(^{238}\)

(5) Major disadvantage of two class stock structure: double taxation. If the second class of stock is cumulative preferred, the dividends on this stock would begin immediately. If this is a farm corporation where income splitting is desirable,\(^{237}\) the major stockholder can use the payment of preferred dividends to facilitate the splitting of income. However, if income splitting is not desired at that time, the resulting double taxation of the dividends received may be tax unnecessarily paid; the stockholders might have obtained adequate income in the form of salaries not subject to double taxation.\(^{238}\) Furthermore, regardless of the nature of the second class of stock, the corporation would not be eligible to make the Subchapter S election which would completely eliminate double taxation.\(^{239}\)

\(^{235}\) Casner, Estate Planning 276 (2d ed. 1956).

\(^{236}\) Of course, he might be hesitant to distribute any stock if he feels that those persons holding the voting stock would receive adequate compensation in the form of salaries for operating the business, and would not need, nor want, dividend income. He might then wish to delay his decision as to who should receive stock until he can determine who is best qualified.

\(^{237}\) See discussion of desirable situations for income splitting at notes 185 to 188 supra.

\(^{238}\) See discussion of reasonable salary deductions at notes 59 to 76 supra.

\(^{239}\) See discussion of Subchapter S at notes 12 to 58 supra.
Perhaps the disadvantages of the two class stock structure can be minimized if the farmer incorporates with only one class of stock and subsequently recapitalizes with a two class capital structure. The Subchapter S election could then be made, and double taxation avoided for the period prior to reorganization. However, the preferred stock issued when the corporation finally does recapitalize may be “306 stock,” and under section 306 of the Code a subsequent sale or redemption of such stock results in ordinary income, rather than capital gain.\footnote{240} Though this section does not apply to common stock, the use of common stock as the second class of stock might not satisfy the farm owner’s other estate planning aims.\footnote{241} Of course, any preferred stock passing through the estate of the stockholder after his death loses the “taint” of “306 stock” and any gain from its subsequent transfer would be a capital gain.\footnote{242} However, “306 stock” which the shareholder gives away during his lifetime is still subject to the section 306 provisions.\footnote{243} Furthermore, assuming the value of common stock increases with the growth of the corporation, the gift tax which would be paid on such a gift could be substantially higher than if the stock had been given at time of incorporation.

The importance of all these considerations depends, of course, on the particular situation, for the saving on estate and gift taxes may in many instances be subordinated to other estate planning wishes of the owner of a farm business.

**IV. Conclusion**

In concluding this survey of major tax problems to be considered in the incorporation of a farm business, the following summary statements appear to be justified:

(1) The tax problems of the closely held farm corporation are fundamentally the same as those of any small closely held corporation. However, in some instances, the unique problems of the

\footnote{240.} \footnote{241.} \footnote{242.} \footnote{243.}
farm business will require slightly different tax planning than other closely held corporations.

(2) The major tax disadvantage in incorporating the farm business is the double taxation of corporate income when paid out in the form of dividends. However, the addition of Subchapter S to the Code allowing a corporation to elect to be taxed like a partnership eliminates this problem for the farm corporation qualifying for and actually making the election. In addition, Subchapter S might allow the electing corporation to take advantage of the favorable fringe benefit treatment allowed only corporations while the farm income is being taxed like that of a partnership.

(3) However, there are sufficient problems in making the Subchapter S election to dissuade some qualifying farm corporations from doing so. Such corporations, as well as those not qualifying to make the election, can still substantially reduce double taxation by paying salaries to shareholder-employees and rent to shareholder-property owners. If such payments are reasonable, they will be deductible from corporate taxable income and will be taxed only to the recipient.

(4) In the lower income brackets, the capital gains treatment for the corporate farm is not as desirable as that allowed the unincorporated farm. In such cases, if the farm corporation regularly disposes of capital or “1231” assets, it will pay substantially more tax than would the unincorporated farm.

(5) The death of the owner of a corporate farm will not result in a stepped-up basis of the farm property; thus, generally higher taxes will be paid on the sale of that property than if the same property were disposed of by the unincorporated farm.

(6) The additional excise taxes to be imposed on the farm when it is incorporated are insignificant in amount and, for purposes of determining the merits of incorporation, may be disregarded.

(7) A tax on the transfer of assets from the unincorporated farm to the corporation can be completely avoided by strictly conforming to the provisions of section 351 of the Code.

(8) The farm corporation will find it advantageous for tax purposes to use debt financing in addition to stock. However, the thin incorporation problem must be carefully avoided. The best approach is to set up the debt financing on the terms and in the formalized manner that a loan from an independent investor would be set up.

(9) A two-class capital structure will best facilitate income splitting. However, the validity of intra-family gifts can only be assured when the gift is in the form of nonvoting stock given to
an irrevocable trust having an independent trustee where the donor retains none of the incidents of ownership in the stock.

(10) Generally, using two classes of stock will reduce the farm owner's estate tax liability, mainly by facilitating gifts during the farmer's lifetime. However, the resultant loss of the Subchapter S election, and the possibility of double taxation must be carefully weighed against any benefits derived from the estate tax saving.