FARM MANAGEMENT

FACTS ..... for reference

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THE CORPORATION VS. THE PARTNERSHIP IN FARMING

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The large amount of capital required in commercial farming and the difficulty of passing a farming business from one generation of a family to the next are increasing interest in partnerships and corporations. Each has advantages and disadvantages which should be carefully considered, with competent legal advice and assistance.

A partnership is a joint operation based on an agreement between two or more persons who furnish assets and services to the firm and share in its net income. Each partner is liable for debts of the partnership. A partnership must file an income tax return, Form 1065, to show its earnings and the share going to each partner, but it pays no income tax. Each partner pays income tax on his share of the earnings. A death or change in partners means the end of that particular partnership--a dissolution or a formation of a new partnership. Provision for this is usually made in partnership agreements.

A corporation is a legal entity, organized and chartered to do business under the laws of the state. It must operate formally with a board of directors elected by the stockholders. Minutes must be kept of meetings and financial records must be adequate, with an annual audit and statements. A corporation must file an income tax return, Form 1120, and is subject to a corporation income tax levied on its earnings with the following exception.

Option to avoid tax. Formerly, stockholders might be subject to double taxation to some extent through the corporation tax and again personally on dividends received. In 1958 income tax laws were changed to permit corporations that qualify to pay no corporation income tax, with earnings taxable as personal income of the stockholders. This removes a disadvantage as compared to partnerships.

To elect not to be subject to the income tax on corporations requires the following:

1. That there are not over 10 stockholders, all individuals; no nonresident aliens.
2. That the corporation is not a member of a group and has only one class of stock.
3. That not over 20% of gross income comes from rents, royalties, dividends, interest, annuities, and sale or exchanges of securities.
4. That all stockholders must agree to such election by filing signed statements with Form 2553 within a month before or after the first day of the year to which the election applies.

This election remains in effect in subsequent years. It can be revoked or terminated by failure to conform with the requirements, or by action of the stockholders or by failure of a new stockholder to agree to this election. Under this election there is no carryover or carryback of an operating loss by the corporation.

The relief from the corporation tax may not always be advantageous to the stockholders. They may pay more tax on large personal incomes than where they pay the corporation tax and leave most of the remainder in the corporation for growth and development.

Advantages of a Corporation over a Partnership:

1. Continuity of business despite death of a stockholder.
2. Easier adjustments and transfer of ownership through shares of stock. A father can gradually transfer ownership to his heirs through gifts and sales during his lifetime and provide for inheritance of his remaining shares upon his death.
3. Easier to expand to a more profitable size of business by obtaining new capital or assets through issuing stock.
4. Liability of stockholders is limited to the value of their stock. This may be of value to a stockholder with large nonfarm assets. It may, however, be offset by lenders requiring the stockholders to sign notes for a loan.
5. Upon incorporation the farmer can become a salaried employee and be covered by workman's compensation insurance.
6. The incorporated farmer can receive a salary and regularize his social security contributions, half of which are paid by the company. After retirement he can receive dividend income without reducing his social security benefits.

Disadvantages of the Corporation:

1. Incorporation and charter involve more legal services and costs in fees and tax on shares issued.
2. More formal operation required in elections, minutes, and financial records.
3. More reports to be filed under state and federal laws.
4. More difficult and expensive dissolution procedures with valuation and tax problems.
5. There may be estate tax disadvantages and a higher income tax on capital gains at times.
6. Corporations now pay a California income tax of 5½ per cent and there is no way to avoid it.

Every situation is different, so no blanket recommendation should be made. There are several factors that might be an advantage or a disadvantage. Where the joint operators are two or three and get along well and the business is small, a partnership would seem satisfactory for a while. Disagreement can be bad, either among partners or among stockholders and directors of a corporation. In a corporation, it can be resolved through the force of voting shares.

In efficiency and profitableness of farming operations, we see no advantage to either form of operation. Partnerships and corporations can employ partners or stockholders or outsiders in any service-rendering capacity and can lease land from individual partners or stockholders.

The great advantage of the corporation is that it can maintain a going farm business from one generation to the next. There are good farms that have become large and successful businesses over the years through the good management of a single farmer and his wife. They wish to leave this business to their children but a division can hardly be made and maintain the earnings of the business. Nor can one son buy out the other heirs. Formation of a corporation and a planned equitable transfer of shares and management responsibility seems the best way. But this involves careful study and planning.

University of California Circular 461, "Estate Planning for Farmers," discusses this entire subject more fully and recommends legal advice. California inheritance tax rates on page 8 were increased in 1959. Also, the new provision whereby certain corporations may not pay the federal corporation income tax will change the discussion on pages 30 and 31.