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family farming incorporated

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Family Farming Incorporated

An initiated measure adopted in 1932 prohibits domestic corporations from engaging in the business of farming or agriculture in North Dakota. (Sections 10-0601, revised code of North Dakota, 1943)

Incorporation has unique features that adequately cope with many problems of organizing and operating the farm business. And recent tax laws favorable for the small corporation have prompted a new look at incorporated farming.

Some basic characteristics of Corporations are explained and discussed briefly in this circular. Although the same rules and legalities apply to any business that's incorporated, the purpose here is to relate the legal factors and associated circumstances regarding possible adaptation of the corporation to the needs of family farming.

The corporation is a tool for doing business. Its use varies from (a) "publicly owned" businesses with thousands of shareholders to (b) a "closely held" business, such as the family farm, where shares and stock transfer can be limited to members of the immediate family. This range of flexibility in the corporate form of business is a big reason for its popularity.

Most incorporated farms come under the heading of a "closely held" corporation. The articles of incorporation or shareholder's agreement usually prevent outsiders from buying in. Complete control is kept within the family. In fact, the same person can be a shareholder, director and officer. Day to day operations of the incorporated farm can function like a partnership.

WHAT IS A CORPORATION?

In law, the corporation is a separate legal person. It has certain rights and duties. It can make contracts and buy or sell property. Likewise, it has liabilities and legal responsibilities. It is taxed on its income. Operational activity of the corporation is determined by its charter from the state. This legal existence of its own is an important concept of the corporation even though it's only a device for actions of its human agents and employees. Also, this factor makes the corporation significantly different from other forms of business organizations such as the partnership or sole proprietorship.

An outstanding feature of the corporation is its separation of ownership and management. When a corporation is formed, it issues shares of stock, each of which represents a fraction of the total worth of the business. These stocks are held by shareholders who are then owners of the corporation.

The shareholders elect a board of directors to manage the business. The directors, in turn, elect officers who are responsible for day-to-day operations. Thus, shareholders are owners but not managers, at least on a formal basis.

However, in a small or "closely held" corporation, the same person often is a shareholder, a director and an officer. This permits ownership and management to be merged in one or more persons. But each person so involved handles the different functions of the business according to the respective position he represents. In handling corporate business, he acts as a manager and not as an owner or officer. Accordingly, daily operations are done as an officer and not as an owner or manager.

If state law allows only one person to form a corporation, he has complete control over ownership, management and day-to-day operations. Under present law, a minimum of three incorporators of legal age are needed to organize a corporation in North Dakota.

GOVERNING LAWS

A corporation is governed by two sets of laws. One of these is state law which determines the legality of initial organization. State law sets forth the requirements for purposes under which a corporation may be formed. It outlines the number of incorporators needed, procedures for incorporation, provisions of the articles of incorporation and matters concerning periodic inspections, reports and fees.

In addition to direct state jurisdiction, the corporation has an internal set of governing laws contained in its articles of incorporation and corporate by-laws. These internal laws become effective after the corporation has been formed. Some of the provisions they set forth are specific agreements among shareholders, duration of office terms, restrictions on stock transfer, aggregate number of shares to be issued, various meeting dates and regulation of daily affairs. All of these provisions must, of course, conform with state law.

FEATURES OF INCORPORATED FARMS

Whether the choice of business form is sole proprietorship, partnership or corporation, it is important to consider the advantages and disadvantages of each. Some unique characteristics of incorporating as applied to family farming are described here.

Limited liability: Since the corporation is a separate legal entity, it is responsible for debts of the corporation only. That is, costs and benefits of the business accruing to each shareholder are limited by the amount of shares or equity that he owns in the corporation.

If total shares are equally distributed among three shareholders, the extent of personal liability for each is one-third of the corporation's debts. However, if a shareholder has all his assets invested in his shares, the advantage of limited liability is of little or no value except that he is protected from personal liabilities of other shareholders.

The limited liability clause is illustrated in this example: The Smith brothers have been operating a farm as a partnership and each brother owns and operates another farm by himself. Since a partnership makes each brother liable for the other's business actions, their risk is not limited to their investment in the partnership. If one brother is sued for an act or contract that involves only him, the other brother also stands the risk of losing his own farm in addition to the investment he has in the partnership farm. If the brothers formed a corporation of the farming business they operate together, each one's assets are protected from liabilities that other shareholders may have outside of the corporation.

Multiple Ownership: Family problems commonly arise where one son remains on the family farm and the other children establish homes and a livelihood elsewhere. All of the children are entitled to equal inheritance but the capital required to buy out the other children may be out of reach for the son who remains on the family farm. Too, the other children may necessarily not want to sell their stake but prefer an operation where they have a fair say in management.

In this case, incorporating may be an answer because ownership and management are separated in a corporation. Each heir as a shareholder or owner would elect a board of directors among themselves to be responsible for over-all management. The son remaining on the farm would be a shareholder, would likely be on the board of directors, and would likely be the officer responsible for day-to-day operations. As an employee or officer of the corporation, he would be paid for his labor in addition to sharing the corporation profits as a shareholder.

Transfer of Ownership: A typical problem in many farm families is for parents to provide sufficient incentive to one or more sons to remain on the family farm or return after graduation from school. Often, parents have their lifetime savings represented by the family farm and they are reluctant to give up full control or management of the farm in exchange for operating responsibilities assumed by a son.

By incorporating, the parents can establish their farm in the form of shares. In this way, they can gradually retire by periodically issuing shares to the son or sons helping to operate the farm. The parents still retain a certain amount of control in the farm business and the son or sons have an increased incentive, through ownership, to staying or coming back and operating the family farm. Complete family participation in ownership and management is thus on a formal and business-like basis by forming a corporation. Also, this gradual transfer of stock reduces the gross estate of the parents and thereby reduces federal estate taxes upon their death.

Tax Treatment: The Small Business Tax Revision Act of Congress in 1958 permits corporations to be taxed as a partnership if so elected by the corporation. Before a corporation can elect to be taxed as a partnership, some requirements it must fulfill are (1) have only individuals or estates as stockholders, (2) have no more than 10 stockholders, (3) have only one class of stock issued and (4) the corporation's income from rent, royalties, dividends, interest and annuities cannot exceed 20 per cent. In other words, a corporation taxed as a partnership cannot own land and rent it out if this rent exceeds 20 per cent of the corporation's gross receipts.

The amount of tax for regular corporations is 30 per cent on the first $25,000 and 52 per cent on all income over $25,000. Under this method, salaries or wages paid to officers or employees are deductible by the corporation but are taxed as regular income to the individual employees. Also, shareholders must pay tax on their dividends even though this income was taxed to the corporation. Regular taxing for corporations may, however, provide cheaper after-tax dollars for expanding the farm business. If the amount of income over $25,000 is used for expansion rather than dividends, the tax rate will be straight 30 per cent.

In comparison with regular taxing of corporations, the partnership form of taxing permits each shareholder to be taxed essentially as he would under sole proprietorship or a partnership. That is, income isn't taxed both as corporation income and as dividends; long term capital

gains are entitled to the 50 per cent deduction rather than a flat 25 per cent tax of the gains; capital losses offset capital gains plus $1,000 of other income rather than offsetting capital gains only.

Since tax laws are quite detailed and complicated, a tax consultant should be contacted to fully describe, review and compare all the tax possibilities for a corporation. Only a few general tax features are mentioned here.

Fringe Benefits: Certain fringe benefits regarding retirement are possible under the corporate structure because a shareholder can be also an employee in a corporation. Retirement plans can be set up whereby contributions made by the corporation are tax deductible and the shareholder-employee pays tax on this retirement income when he receives it. Shareholder-employees may receive also medical and disability benefits and the employee's beneficiary may be paid tax-free death benefits up to $5,000 by the corporation. For social security purposes, shareholder's income does not qualify as self-employment income nor does it reduce social security benefits after retirement. The obvious procedure here is that a person can be a shareholder-employee before retirement, thus allowing employee income for social security, and a shareholder only after retirement which gives him ownership income without reducing the social security benefits.

Credit: Availability of credit for the farm business may be improved through incorporation. Corporations are required to keep records of the farm business and management is under unified control; duration of the corporation can be perpetual, which means that the business is not dissolved upon the death of a stockholder. A potential lender may look with favor on these features of a prospective borrower. Also, personal debts and liabilities of the individual shareholder do not impair the credit of a corporation.

For some farming situations, federal loans are an important source of credit. However, certain types of federal loans are not available to corporations. Farm corporations are not eligible for Farmers Home Administration ownership and operating loans. But they are eligible for production emergency loans that are granted by the Secretary of Agriculture when widespread disaster occurs in a certain area and other sources of credit are not readily available.

Records and Reports: Because of the business structure of a corporation, increased farming efficiency is likely to result from incorporation.

For example, assurance of complete and accurate records is a big aid in guiding the business to more profitable avenues of operation. Both efficient and inefficient practices can be pin-pointed through proper use of adequate records. Under a corporate business, complete and up-to-date records of the business are required by law. These records are periodically inspected not only by managers of the corporation but also by state agents. Thus, detailed information for analyzing operational efficiency of the business is always readily available.

Other efficiencies can result from incorporation by the pooling of land, machinery, livestock and working capital. In some cases, management specialization can result by each man in the corporation concentrating his managerial abilities on a specific enterprise such as dairy, hogs, beef, crops and so on.

GENERAL CONSIDERATIONS

The decision of whether or not to incorporate the family farm depends on each particular farm situation. For some cases, incorporation may provide a useful way of keeping the family farm intact and improving its efficiency. For other cases, the reverse may be true. Usually, the type of farms that gain most by incorporating are relatively larger farms involving high risks. But the alternative of a corporate business can be examined and compared for all faming situations to determine where it fits and where it doesn't.

CAN NORTH DAKOTA'S "COOPERATIVE LAW" BE USED IN FARMING?

Although the Corporate Farming law in North Dakota prohibits corporation farming, this same law exempts cooperatives from not engaging in farming provided that 75 per cent of the members or stockholders are actual farmers living on farms or depending principally on farming for their livelihood (Section 10-0604 revised code of North Dakota, 1943).

For the family farm operation, cooperative farming appears to have less favorable features than the corporation business structure. For example, a minimum of five adult members is needed to form a cooperative, whereas three members can form a corporation. Also, at least 75 per cent of the cooperative's stockholders must be resident farmers or receive their principal income from farming. The corporation structure has no residence or income requirements for any of the stockholders; thus, some of the heirs can be engaged in a non-farm occupation and still retain their share of control in the farm business.

In a corporation, management control of any shareholder is geared to his number of shares because each share is allowed one vote. In a cooperative, each shareholder has only one vote regardless of number of shares. For some family situations, this difference in voting power has some significance as it relates to the previous discussion of "transfer of ownership" from parents to children.

Other features such as limited liability, multiple ownership, income tax, fringe benefits and credit are much the same for both corporations and cooperatives. Cooperatives cannot be taxed as a partnership under the new tax law but other tax electives for cooperatives can be equally beneficial to its shareholders.

SOME DIFFERENCES IN CORPORATE AND COOPERATIVE ORGANIZATIONS

	Corporation	Cooperative
Minimum number of shareholders	3	5
Occupational restrictions of members	None	75 per cent must be actual farmers residing on farms or depending principally on farming for their livelihood
Voting rights of members	One vote per share	One vote per member regardless of number of shares owned
Tax privileges	Can be taxed as a partnership if so desired	Taxed as an ordinary corporation unless operations of the business allow tax-exemption privileges
Minimum capital stock	$1,000	None

When considering the pros and cons of either corporations or cooperatives as a business form for the family farm, the first step to follow is this: CONSULT AN ATTORNEY.

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