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FARM CORPORATIONS, RECENT DEVELOPMENTS AND ECONOMIC CONSIDERATIONS

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The legal status and powers of farm corporations in Oklahoma continues to be uncertain. In spite of a number of farm corporations now chartered in Oklahoma, legal opinion remains divided as to their power to own land outside city boundaries. This is substantiated by two recent developments. A suit for penalty has been filed by the County Attorney in Osage County against a farm corporation.[1] In another development the Secretary of State has denied an application for a farm corporation in Grant County.[2] His disapproval is being appealed to the district court of Grant County. The decision is expected to be appealed to the Oklahoma Supreme Court. This reportedly is a friendly suit; the purpose is to determine the legality of farm corporations to hold and own land in Oklahoma. Also, 5 or 6 Supreme Court cases which may have a bearing on the problem were split decisions.[3]

In spite of the uncertainty of the legal status, questions continue to be raised about the economics of farm corporations compared to other types of business organizations.

Management decisions may be more complex under a corporation. The sole proprietor can make decisions quickly, whereas, the major decisions in a corporation are made by the directors who are elected by the shareholders. Since majority shareholders control the operations, this can be a significant factor among non-related shareholders. This probably would not be as important when all of the stock was owned by members of the same family.

The tax aspects of a farm corporation compared to a sole proprietor should not be overlooked. Double taxation is usually listed as one of the disadvantages of a corporation. A corporation is taxed on its earnings, and the dividends based on those same earnings are then taxed to the shareholders. However, there are certain steps that the directors can take to offset much of the disadvantage.

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[1] State of Oklahoma Ex Rel William H. Mattingly, County Attorney of Osage County versus Oklahoma Land and Cattle Co. a corporation. District Court of Osage County, Case No. 23308.

[2] LeForce Land, Inc., Grant County versus Secretary of State. District Court of Grant County, Case No. 8886.

[3] For example, in the International Paper Company case, Davison, C. J., Welch, Halley, Johnson and Jackson constituted the majority and Williams, V. C. J., Blackbird, Irwin and Berry dissented. In the International Paper Company case the Court held the ownership of large areas of rural land was necessary for purposes of reforestation for the production of paper. It also held it was not necessary to separate minerals from the surface. In this connection it held that ownership of the mineral estate was reasonable to protect use of the surface of rural land.

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For example, the stockholders, if employed by the corporation, can each receive a salary, they can loan money to the corporation and receive interest and they can lease land or other property to the corporation and receive rentals. These items are deductible in determining income for the corporation. Taxpayers in the higher brackets may find an advantage in a regular corporation, especially if income is to remain in the business.

The first $25,000 taxable corporation income is taxed as 22%, all additional income is taxed at 48%. The personal tax for a married person filing a joint return is 28% on income between 16 to 20 thousand dollars. A corporation would pay $5,000 on a $25,000 income. A married person filing a joint return would pay $5,276 on a $25,000 net income. A corporation has no personal or non-business deductions.

A corporation must pay a 4% Oklahoma Income Tax on its net income. The dividends are not taxable in Oklahoma if 5% or more of the entire gross income of the corporation in the preceding taxable year was attributed to Oklahoma and subject to taxes.

Each year a corporation must pay a state franchise tax. This is at the rate of $1.25 per $1,000 of net capital employed in Oklahoma.

Unlike individuals, corporations are not entitled to a deduction of 50% of the long term capital gains. Corporate net long term capital gains are taxed at a flat 25%.

A corporation may pay social security tax on each employee up to $6,600 per year even though the corporation had a net operating loss. Whereas in a sole proprietorship operation, social security taxes could be paid on two-third's of the gross sales up to $2,400, if the operation had a net loss. The social security tax on a self-employed person is 6.15% in 1966 and the total tax for a corporation on one of its employee's would be 8.4%; half of it is withheld from the employees wages and half paid by the employer.

Problems arise concerning the value of corporation stock for gift estate tax purposes. Some factors to be considered in determining the fair market value of these stocks are as follows:

1. The company's net worth
2. The goodwill of the business
3. Economic outlook in the particular industry
4. The degree of control of the business represented by the block of stock to be valued
5. The book value of the company's stock
6. The prospective earning power and dividend paying capacity

It has been reported that in some cases estate taxes are sometimes less in a corporation than a similar business operated as a sole proprietor. On the other hand a corporation loses the new cost basis of inherited property that the recipient of the non-incorporated farm or ranch receives.

Briefly some of the advantages and disadvantages of a corporation are as follows:

ADVANTAGES OF A CORPORATION

1. Limited liability -- A shareholder generally is not liable for corporate debts and a corporation has no liability for a shareholder's personal obligations. If a corporation becomes insolvent, its shares are worthless. The benefits of limited liability will vary with the assets and investment of the individual.

2. Easy distribution and transfer of ownership -- The assets of a corporation are divided into parts and called shares. The shares are represented by certificates of stock. A share can be easily transferred by assigning and delivering the certificate to the new stockholder who causes the transfer to be registered on the corporation's books.

A person may sell it, leave it by his will, give it away or let it go to heirs by law of descent without disturbing the business operation.

3. Continuity of operation -- It can continue to function throughout changes in ownership caused by one generation replacing another or by stock transfers.

4. Possible increased efficiency -- It encourages keeping accurate records, planning and reporting results which tend to promote efficiency.

5. Means of pooling capital -- Several people could combine their resources to produce a more efficient unit. Some credit lending institutions might be inclined to extend more liberal credit if assured of continued management responsibility.

6. Fringe benefits -- Social security, sick pay, health insurance and death benefits may be paid. The expense of the fringe benefits can be charged as a business expense.

7. Taxes -- Under certain conditions there may be tax advantages in a regular corporation. Also by meeting certain regulations, corporations may qualify to be taxed like a partnership. (see paragraph on "Corporations Taxed Like Partnerships)

DISADVANTAGES OF A CORPORATION

1. Legal Status -- For years many people were under the impression that a corporation could not own land in Oklahoma for farming purposes. Today there is a difference of opinion and the legal status of a farm corporation owning land in Oklahoma is not clear. If the acquiring and holding of farm lands by a corporation for farming purposes should be held illegal by the State Supreme Court, the penalties could be severe. The penalties are based on valuation of the real estate for advalorem taxes.[4] The penalty increases at the rate of one percent per year, starting at one and increasing to the level of six percent per year. At these rates 10 years of improper holdings result in the amount of 45 percent of the assessed value of the real estate.

2. Taxes -- Double taxation as previously discussed is considered a disadvantage; however, see paragraph on "Corporations Taxed Like Partnerships".

3. Possible Capital Gains Tax -- If the corporation is dissolved, a capital gains tax may have to be paid if ranch or farm has appreciated. The over-all result may be that family has saved no taxes or even pays extra taxes.

4. Records and Reports -- Records of minutes of meetings of shareholders, board of directors, and all records of the business must be kept. Such extra red tape might seem cumbersome to many farmers.

5. Added Costs -- There are certain costs associated with farm corporations which are not required for other types of business organizations. In addition to lawyers fees, (minimum fee is about $250) which will vary with the complexity of the corporation, costs will be incurred for filing of the Articles of Incorporation. The fee payable to the Secretary of State of $ 1.00 per $1,000.00 plus $8.00 on authorized capital with a total minimum fee of $11.00. Additional costs will include federal stamp tax, corporate books and seal. Other costs for amending articles, changing registered office, changing registered agent, and preparing articles of dissolution may be incurred if later found necessary.

CORPORATIONS - TAXED LIKE PARTNERSHIPS

(Sometimes referred to as a "pseudo corporation" or Subchapter S)

In 1958 Congress amended the Internal Revenue Code to permit a corporation with only one class of stock and 10 or fewer stockholders to elect a special method of taxing. This amendment allows the stock-

[4]Title 18, Oklahoma Statutes, 1961, Sec. 1.23

[5]Internal Revenue Code, Sec. 1371 through 1377.

holders to be taxed substantially as a partnership. The income of the corporation is channeled on paper to the shareholders, and each shareholder pays tax on his share of corporate income at his individual tax rate. The election must be made the first month or the first month preceding the taxable year.

The long range tax picture must be considered because it is possible for a small business corporation to become ineligible to be taxed as a partnership in future years. Some of the reasons are:

(a) A new stockholder refusing to consent
(b) A corporation or trustee becoming a stockholder
(c) Rents or royalties becoming more than 20% of a total income
(d) More than 10 individuals becoming stockholders. For example, a stockholder dies and his stock is distributed to his children
(e) The law is subject to change

Most of the points discussed in this article are only briefly touched upon. They are not complete and are intended to be only a brief review of some of the points to consider. See references listed below for a more complete discussion. Individuals seriously considering incorporating should by all means consult their attorney and accountant.

Hall, James L. "Agricultural Corporations, Their Utility and Legality", Oklahoma Law Review, No. 1964.

Strasner, Stuart B. "Agricultural Corporations in Oklahoma", Oklahoma Law Review, May 1963.

Title 18, Oklahoma Statutes 1961, Section 1 through 1.250

Vliet, R. Dale. "The Oklahoma Business Corporation Act" (A Series)
2 Oklahoma Law Review 1 (1949);

2 Oklahoma Law Review 177, (1949);

3 Oklahoma Law Review 51, 269, 400 (1950)

5 Oklahoma Law Review 204.

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