Incorporation Can Save Taxes

If your net farm income will total $25,000 or more this year, you probably can save money by incorporating.

Incorporation has long been popular among large farm businesses. But tax changes during the last decade now make it a smart move for many smaller farms as well, according to Iowa State University economist Michael Boehlje.

Owners of mid-size family farms may save taxes by incorporating for two reasons, he says. One is that congress has lowered corporate tax rates twice during the 1970s. The more inportant reason is "bracket creep," which occurs as individuals' incomes rise along with inflation, i.e., they move into higher brackets where taxes take a larger percentage of personal income.

Because of these factors, a farmer who files as a sole proprietor or partner may pay thousands of dollars more through the years than a farm owner who incorporates. The same may have been true in 1969—but not at the same real income levels.

For example, if your net farm income in 1969 was $14,000, you would have had to pay $1,874 or 13.4% in personal income taxes (with personal exemptions for a family of four and standard deduction for married taxpayers filing jointly). Incorporation would have saved you nothing.

By 1979, however, if your tax status has stayed the same and your income had kept up with inflation, the $14,000 would have become $27,720. You would have fallen into a much higher personal tax bracket, owing $4,543 or 16.4% of your income (using the standard deduction).

Could Have Saved $1,203

But suppose you had incorporated by 1979 and split the farm income between yourself (as the salaried owner-manager) and the farm corporation. Using the most favorable split, you could have lowered your total tax bill to $3,340 or 12% of your income. Your savings: $1,203.

Incorporation not only saves taxes but also allows a farmer to reinvest more to build up farm equity faster. During a 10-year period, this faster equity growth can be sizable. For instance, in what Boehlje identifies as a typical Missouri livestock operation, equity accumulation in 10 years may be $100,000 more if the owner incorporates rather than remaining a sole proprietor.

Incorporating has additional non-tax advantages. It may help keep a farm together when it passes from one generation to another.

"A farm corporation can pay non-farm heirs a competitive return on their inheritance," Boehlje stresses, so those heirs are more willing to maintain their financial interest in the business. Their return can take the form of interest if they inherit debentures (loan notes of a given term) or dividends if they inherit stock in the farm corporation.

To keep stock from going to outside investors, a buy-sell agreement can forbid selling to anyone except those who are already shareholders.

The method of determining the stock's selling price can also be set to guarantee that heirs not farming can get a fair price for their shares if they want to sell to heirs working the farm.

Other Advantages

Besides aiding in estate planning, incorporation enables a farm owner to transfer assets while alive. "Giving your son or daughter a few acres annually or a fraction of a tractor every year is possible under sole proprietorship," Boehlje says. But the process is very cumbersome. On the other hand, "Periodically giving shares of stock in a farm corporation is a relatively simple convenient way to transfer wealth." Gift tax limits are the same in both cases.

Tax experts say incorporation can offer even further advantages, although you may not qualify for all of them. By incorporating, you may be able to:

1. Deduct premiums on life, health and accident insurance for yourself.
2. Deduct depreciation, maintenance and repairs on your farmhouse.
3. Provide yourself retirement income as interest on corporate debentures.
4. Protect your non-farm assets from seizure to pay off farm debts unless the assets have been pledged as collateral for farm loans.

With all these advantages, it's not surprising that the number of incorporated farms nearly doubled from 1974 to 1978, according to the latest Census of Agriculture. And as the distinction between the family farmer and the incorporated farmer is blurred, corporate farming is losing its connotation of big business intrusion into agriculture.

Incorporating does have drawbacks. It may increase your chances of being audited by the IRS. In addition, the public disclosure some states require of corporations may be distasteful, especially if you value financial privacy.

Other Disadvantages

Also, your Social Security payments will increase with incorporation even if you have no employees except yourself. As a sole proprietor, you have to pay 9.3% of the first $29,700 you earn in 1981. Under a corporate structure, you are both employee and employer. In each role, you must contribute Social Security payments of 6.65% of your salary (up to the same $29,700 maximum) for a total of 13.3%.

Another drawback is that you'll probably need a lawyer to file your application to incorporate. Besides legal fees, you'll have to pay corporation charter fees. Once your farm is incorporated, you still may need the advice of a lawyer, accountant or other tax specialist to calculate the most favorable distribution of farm income and to stay informed on changes in tax laws.

You also may want help with keeping farm records and filing tax returns, although you can do these jobs yourself. Corporate record-keeping and taxes are more complex than those for sole proprietorships.

But even if incorporating necessitates legal or accounting services, Boehlje concludes, your potential tax savings probably will offset additional costs if net income is $25,000-$30,000 or more. And records required for a corporation may help you plan and monitor farm expansion more closely.

One additional consideration is that in any multi-owner business, even the majority shareholder does not have absolute control (although in practice there may be substantial agreement among family members). It is good business practice to consult other shareholders on management decisions.

Nevertheless, these drawbacks are the same as for any incorporated business. And increasingly, as many farm owners know, to succeed in farming you must succeed in business.