Tax Implications of Incorporating a Michigan Farm

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The decision of whether to incorporate a farm in Michigan depends in part upon the rules regarding annual taxes. Since a corporation is a separate legal entity, it is also a separate taxpayer for most tax purposes with its own tax rates and rules. The owner-operators of an incorporated farm are employees of the corporation and their salary is subject to payroll and income taxes like any other farm employee; furthermore, farm earnings are taxed at corporate rates. When a farm is operated as a sole proprietorship (or partnership), all earnings are subject to the personal income taxes. The owner-operators are self-employed and not obligated for payroll taxes.

The taxation difference between corporate and sole proprietorship (or partnership) ownership can result in widely different annual tax obligations for the farm and its owners. It is important to consider the tax implications for the farm, along with other factors, when analyzing the relative merits of incorporating. The pros and cons of the corporate structure for your particular farm situation can be compared with other business types in making an informed decision. This fact sheet provides an explanation of the annual tax rules and a comparison of tax implications for the corporate farm owner and the self-employed farm owner.

Federal Income Taxes

A sole proprietor's business pays no federal income tax itself. Instead, the taxable income of the business is combined with the proprietor's personal income and tax is paid according to individual tax rates. Federal income taxes for a partnership are similar. The partnership files an information return showing the income and expenses, the names of the partners and the division of partnership earnings among the partners. The profits/losses, capital gains and losses, investment tax credit, etc. are allocated to partners according to the terms of the partnership agreement. The partners pay tax as individuals on their respective share of partnership income.

Federal income tax savings may occur if a farm incorporates and becomes subject to federal income taxation under Subchapter C of the Internal Revenue Code. Being a separate taxpayer, the corporation can split income among the corporation, owner-operator employees and shareholders. The corporation pays individuals for their contributions, employees a salary for their labor and management and shareholders a dividend for their capital investment. After all expenses are paid, the residual income is taxed to the corporation at corporate income tax rates.

The separate tax rates for individuals and corporations for 1984 are shown in Figure 1. Since tax rates are being reduced, the rates for earlier years are slightly higher. Corporate rates are lower than individual rates above $11,900 taxable income. Whether federal income taxes can be saved after incorporating depends upon the level and allocation of farm earnings.

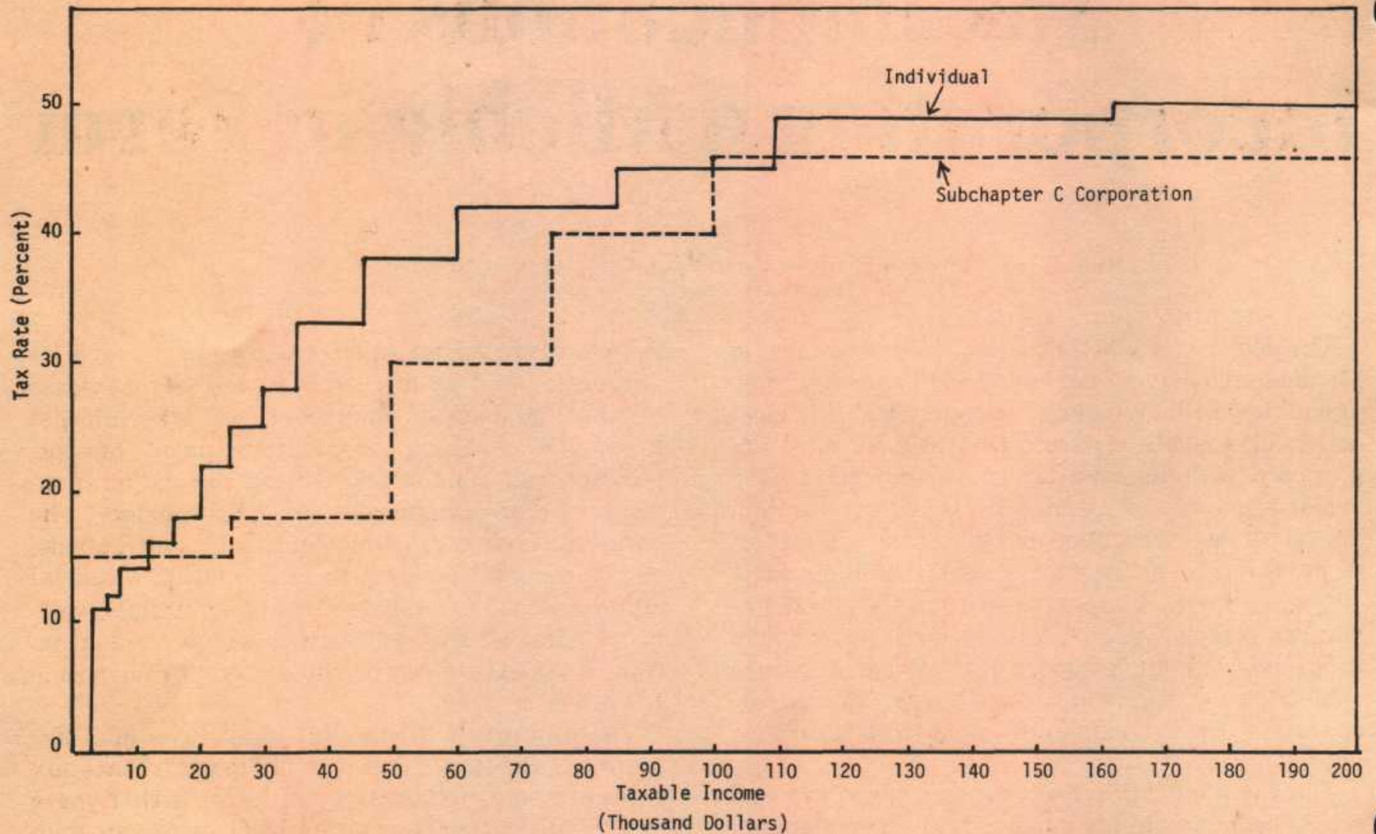
When the farm corporation is owned primarily by the family, the tax objective is to minimize the family's total annual income taxes. This means that the total taxes paid by the corporation plus the personal income taxes paid on the stockholder-employee's salary and any other personal income should be less than the total personal income taxes paid by the owners before incorporation.

Taxes can be reduced by equalizing the rates at which income is taxed in the "hands" of the corporation versus the rates at which it is taxed in the "hands" of the individual stockholder-employees. This is usually done by adjusting the salary of major employees and/or adjusting lease or rental rates of assets (primarily land) owned by stockholders.

This cannot be done arbitrarily. Salaries must be established at the beginning of each corporate fiscal year. They cannot be increased or decreased within the year to reflect changes in the financial success of the business. However, considerable flexibility can be obtained by establishing a bonus or profit-sharing agreement based on either the farm's production or the farm's income.

FIGURE 1

Tax Rate Schedule for Married Individual Filing a Joint Return and a Corporation, 1984.



All salaries must be "reasonable" and paid only for work actually performed on behalf of the corporation. Several factors considered in determining the reasonableness of a salary are: the time and effort spent by the employee; the rates of pay by similar business organizations in the community for the same work; and the experience, age, and other abilities of the employee. If a salary is held to be unreasonable, the excess over that which is reasonable will be taxed as a dividend. Also, the corporation will not be able to deduct the excess salary as a business expense.

Leasing or rental rates must also be "reasonable." They must be similar to the rates of comparable property leased or rented in the community under similar circumstances.

Since corporate tax rates of a regular corporation are substantially lower than individual rates at higher income brackets, there can be considerable tax savings at high income levels. The income level at which tax savings result depends upon many things, including: number of personal exemptions, filing status (single or joint), amount of personal itemized deductions and income from other sources, salary level and amount of capital gain income.

Another tax advantage of incorporation is the increased business deduction available because the farm owners who work for the corporation become employees of the corporation. In addition to the employees' salary, the corporation can take a deduction for fringe benefits such as group life insurance plans, medical and hospital plans, and pension and profit sharing plans. It permits the corporation to use pre-tax dollars to pay for benefits received by a stockholder which the same individual not in a corporation would acquire by using after-tax dollars. This results in more after-tax total income available to the stockholder-employees.

A disadvantage of Subchapter C corporations is that double taxation is possible when corporations pay dividends to their shareholders. Dividends are distributed from the corporation's after-tax income and are not a deductible corporate operating expense. But, shareholders must include dividends in their taxable income. Thus, shareholders, in effect, pay taxes a second time on the same profits. Most closely-held farm corporations avoid double taxation by not paying dividends. Instead, they make all

distributions as salaries, bonuses, rent, interest on debentures, or wages to stockholders.

Another method of avoiding double taxation is to become a Subchapter S corporation. Corporate earnings in a Subchapter S corporation are only taxed once—to the shareholder. If a farm corporation elects to be taxed under the special tax option or Subchapter S method, it is not a taxpayer for income tax purposes. The income of the corporation "flows through" to the shareholders and each shareholder pays a tax on his or her prorated share of the corporation's earnings when he or she files the individual income tax return. All income is taxed the year it is earned, whether or not it is retained or distributed. Subchapter S rules are similar to partnership rules in that an information return is filed annually on behalf of the corporation.

Only certain types of small business corporations may elect to use the Subchapter S option. Several requirements must be met initially and on a continuing basis to be eligible:

1) The corporation can have no more than 35 shareholders.

2) Generally, only individuals, trusts or estates of individuals may be shareholders. Partnerships and corporations cannot be shareholders.

3) The corporation must be a domestic corporation (organized under the laws of one of the states or territories of the United States or under federal law) with no non-resident alien shareholders.

4) The corporation may have only one class of stock outstanding.

5) No more than 25% of the corporate gross receipts can be from passive sources. Passive sources are defined as royalties, dividends, interest, annuities, the sale and exchange of stocks and securities or rent. Income received under a farm corporation's lease arrangement is not "rent" if the corporation, through its officers and agents, participates materially in the production of income.

6) All of the shareholders of the corporation must consent to the election.

A Subchapter S corporation does not lose its other corporate characteristics. It hires employees and pays salaries and bonuses in the usual fashion and may declare dividends (without the dividend exclusion) to shareholders. Limited liability, transferring shares of stock, non-shareholder employee fringe benefits, and stock purchase agreements are all similar.

Although federal income taxes may be reduced by incorporation, not all taxes and costs will be reduced. There are a number of increased costs and taxes present with corporations. All of these must be examined in arriving at the total savings possible by incorporation.

Payroll Taxes

After incorporation, the farm business will have at least one additional employee, if not more, because the sole proprietor's or partner's status will change from employer to employee. This results in increased payroll taxes being paid by the farm business.

Social security taxes are also increased since the combined employee and employer rates under the corporate structure are higher than for self-employed farmers (partners or sole proprietors). Another social security tax disadvantage involves wages paid to a farm owner-operator's children under 21 years of age. Ordinarily, wages earned by a child under 21 are not subject to social security tax if the child works for his or her parent. However, if the owner-operator incorporates his or her business, all wages paid to the children are subject to social security tax.

Stockholder-employees of Michigan farm corporations have the option of paying worker's compensation on their salary and being entitled to benefits under the act. The exclusion from worker's compensation is extended to an employee of a corporation which has no more than 10 stockholders and who is an officer and stockholder owning at least 10 percent of the stock of that corporation. The board of directors of the corporation and the employee must give consent to the election. While the exclusion is in effect, the employee may not bring any worker's compensation action against the corporation.

A stockholder-employee's salary may also be subject to the unemployment compensation tax. Starting in 1978, agricultural employers are subject to the tax if they either: a) paid wages of $20,000 or more for agricultural labor during any calendar quarter in the current or preceding calendar year, or b) employed 10 or more individuals in agricultural labor for some part of the day on each of 20 days during the current or preceding calendar year with each day being in a different calendar week.

For Michigan employers, taxes for the first two years of an employer's participation is 3.4% (2.7% state plus 0.7% federal) of the first $6,000 in annual wages for each employee. This results in a maximum of $204 per employee. After the first two years of participation, the amount of tax is dependent, in part, on the benefit claims made by unemployed workers against the employer's account. If a liable employer had no claims against his account, his rate would fall slightly below 3% after the second year. If the employer had many large claims against the account, the rate could rise to almost 7% after the second year and almost 10% by the seventh year.

Incorporation becomes a disadvantage when the

addition of the stockholder-employee's salary to the farm business payroll is enough to cause the employer corporation to be liable for the tax. Of course, it is possible for the corporatin to layoff the employees during a slack period and collect benefits.

Another disadvantage to owner-operators after incorporation is that personal income taxes (Federal and Michigan) must be paid through quarterly estimates or withholding, rather than as a lump sum on March 1 as permitted by self-employed farmers.

Specifically, the law states that if a person's tax year starts January 1 and either: 1) at least two-thirds of the estimated gross income for the tax year is from farming, or 2) at least two-thirds of the gross income shown on the return for last year is from farming, the taxpayer has two choices. The farmer may either: 1) file an estimate of the tax and pay this amount on or before January 15, then file a yearly return and pay any balance by April 15; or 2) in lieu of an estimate, the taxpayer can filé his yearly return and pay the tax on or before March 1.

A farm corporation employee is not a "farmer" for this purpose. A corporation employee must file a declaration of estimated tax and make quarterly payments or have federal income taxes withheld from the salary.

Michigan Income Taxes

Michigan income tax laws relating to corporate taxes have changed dramatically in the last few years. Currently, the tax laws are quite favorable toward farm incorporation. However, this wasn't the case before 1977.

Up to 1976, the state franchise fee was an extreme disadvantage to incorporating a farm operation in Michigan. In 1976, this annual corporate franchise fee and the state corporate income tax were eliminated and replaced by a single business tax (SBT). The SBT is a value added tax levied on all entities doing business in Michigan—this means sole proprietorships and partnerships along with corporations. It is levied at a rate of 2.35% and is a tax upon the privilege of doing business and not upon income.

Michigan agriculture was hit particularly hard by this tax. Even though individuals received a tax credit against their state tax, a sole proprietor or partner had to pay two state taxes—the SBT for the farm business **and** the personal state income tax. A farm corporation paid the SBT and the stockholder-employees, paid a state individual income tax.

This double form of taxation put Michigan agriculture at a comparative disadvantage to agriculture in other states. As a result, farm businesses were declared exempt from the SBT in 1977. However, this exemption applies only to farm business carried on at the wholesale level. For example, a farmer packing apples for neighboring farmers (along with his own apples) pays the SBT on that portion of income received from doing business for others. Farms that have processing facilities and/or operate part of their business at the retail level are also subject to the SBT.

Thus, unless part of the farm business falls into the above category, a farm business itself—be it a sole proprietorship, partnership. Subchapter C or S corporaton—currently pays no state income tax. Of course, a sole proprietor, partner, or shareholder of a Subchapter S corporation must still pay individual state income tax on any net farm earnings. The only income subject to state tax for a stockholder-employee of a Subchapter C corporation is the employee's salary along with any other income received from the corporation such as land rental payments, dividends, etc. This represents an advantage to profitable farm businesses operating as Subchapter C corporations since these corporations would most likely pay less State income tax per person (owner-operator) than a farm business operating as a sole proprietorship, partnership or Subchapter S corporation.

Other Michigan Taxes

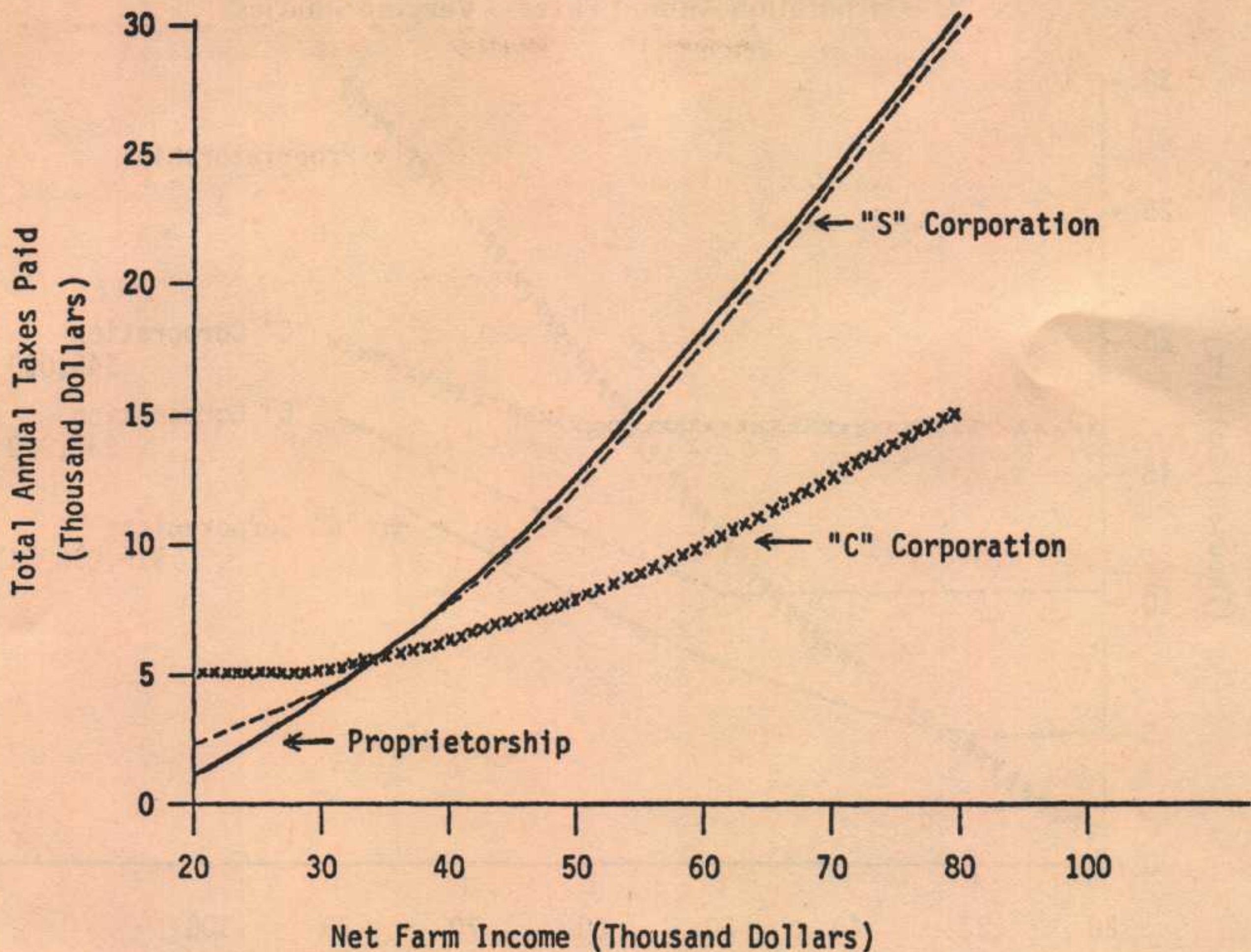
Shares of stock in the hands of the shareholder are personal property subject to tax. There is a Michigan Intangibles Tax on income producing intangibles. This includes stocks, bonds, notes, accounts receivable, annuities, and any other form of income producing intangibles. Thus corporate stock of a farm corporation would be subject to the tax. The tax rate is 3½% of income but not less than 1/10 of 1% of the face value of the intangible. There is a $350 deduction for a husband and wife filing a joint return.

A farm corporation in Michigan must, of course, pay property taxes on any real property owned, just as an individual or partnership must. However, farm corporations do not qualify for the Homestead Property Tax Credit. If the corporation owns the farm real estate, the corporation foregoes the potential to save up to $1,200 on the property taxes from the Homestead Property Tax Credit. Nevertheless, a corporate land owner, like an individual landowner, does qualify for the Farmland and Open Space Preservation Act—P.A. 116.

Tax Comparison

Since farm characteristics and business structures vary tremendously, it is difficult to be explicit about the tax consequences. Case examples, however, will provide a general idea of the key consequences of

FIGURE 2
Annual Tax Comparison by Business Organization.



annual taxes by different business organizational types. The examples demonstrate the need for a complete tax analysis of each individual farm situation when deciding whether to incorporate the farm.

All examples take into consideration the federal income taxes, Michigan income taxes, social security and worker's compensation. The first example assumes a farm with no capital gain income, all farm assets owned by the corporation and one owner-operator who receives a $15,000 salary.

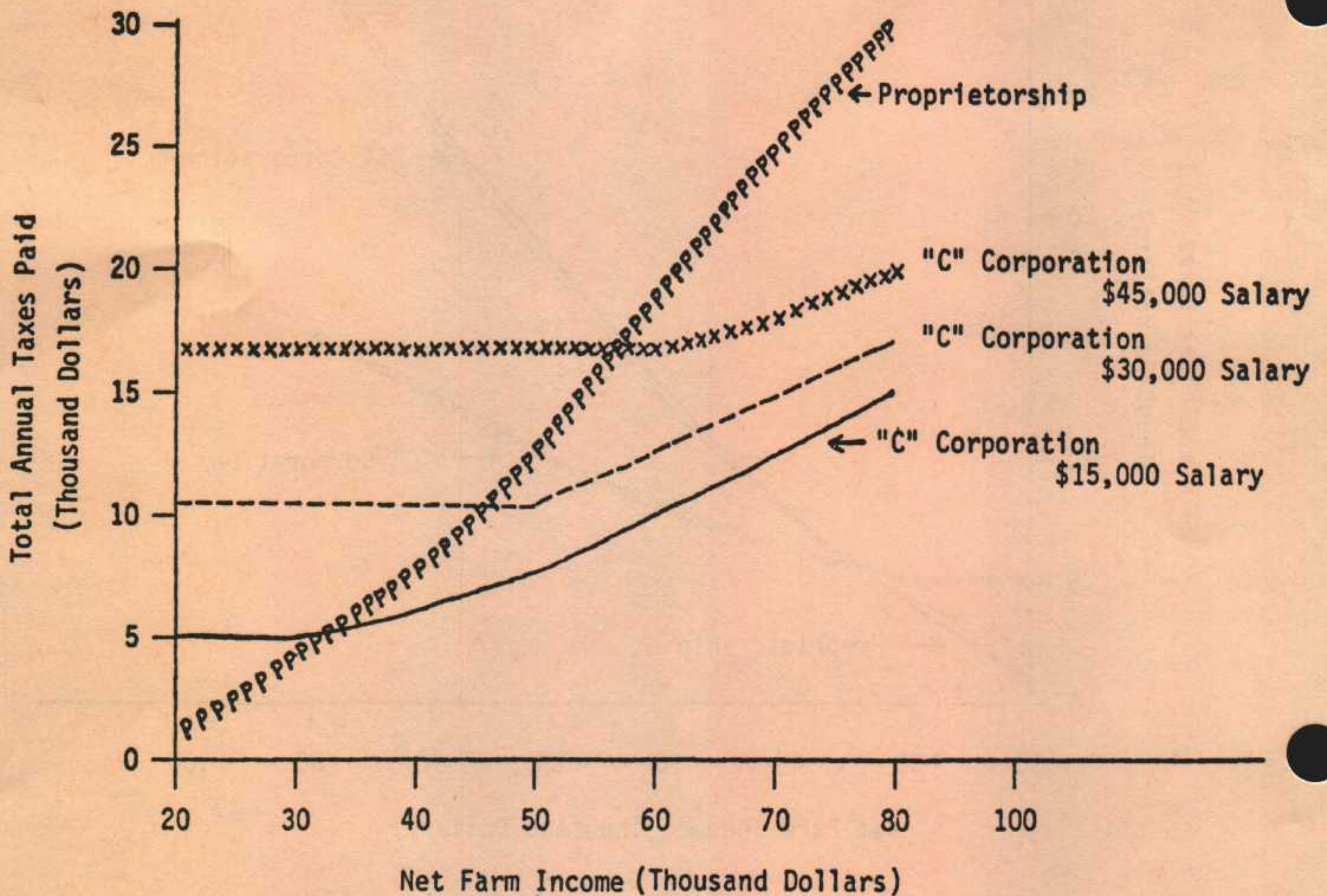
Figure 2 depicts the total annual taxes paid for net farm income levels ranging from $20-$80,000 for a sole proprietorship, "C" corporation and "S" corporation. A "C" corporation results in the lowest taxes at income levels above $35,000 (break-even point). In fact, at $80,000 net farm income—the "C" corporation results in a total tax savings of approximately $15,000 over a sole proprietorship or "S" corporation.

However, at lower levels of net farm income, a "C" corporation results in the farm business paying more total taxes than a proprietorship or "S" corporation. For example, at the $20,000 net farm income level, the farm business would pay almost $4,000 more in total taxes if it is organized as a "C" corporation rather than as a proprietorship.

Note also that the total taxes paid by a farm business organized as an "S" corporation are almost the same as for a sole proprietorship. The reason is that an "S" corporation pays no income taxes itself. Instead, it allocates all taxable income to its stockholders. The slight difference in total annual taxes paid between a proprietorship and an "S" corporation is due to payment of workers' compensation tax and half of the social security tax on the stockholder-employee's salary. These extra costs, in turn, affect the total amount of Michigan and federal income tax paid. The total tax difference is greater at lower levels of net farm income because additional social security and worker's compensation taxes do not reduce the amount of state and federal taxes paid as much as they do in the higher marginal tax brackets.

Figure 3 shows the tax effects of increasing the salary level for the one stockholder-employee in a "C" corporation in $15,000 increments. The pro-

FIGURE 3
"C" Corporation Annual Taxes - - Varying Salaries.

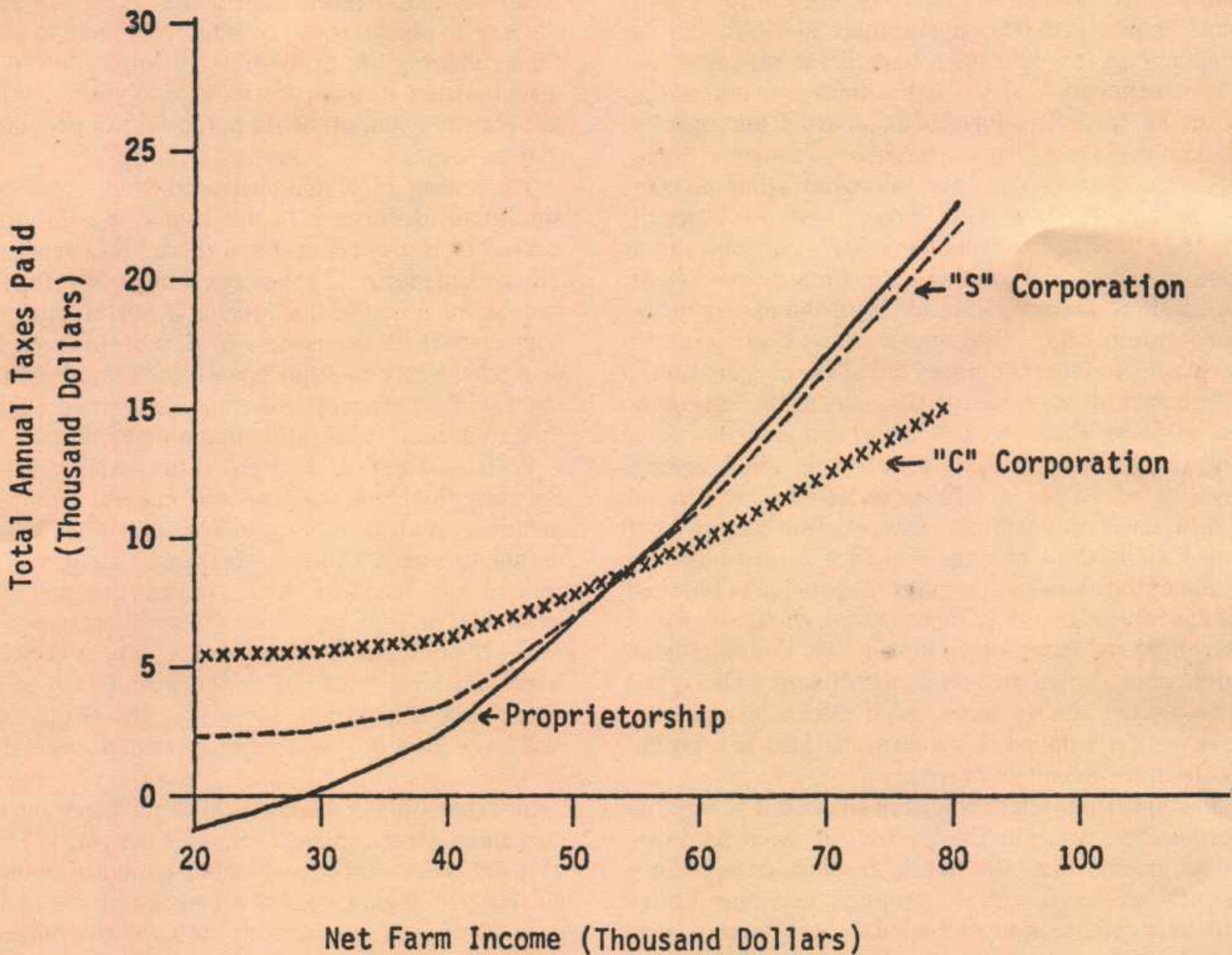


prietorship line gives us an idea of the "break-even" points. As would be expected, the graph shows that the total amount of taxes paid increases when salary levels increase. However, even a $45,000 salary results in tax savings over a proprietorship at net farm income levels above $60,000.

Figure 4 depicts the total annual taxes paid for net farm income levels ranging from $20-$80,000 for a sole proprietorship, "C" corporation, and "S" corporation for a dairy farm with $20,000 of capital gain income included in net farm income. The "break-even" point (approximately $55,000 net farm income), where tax savings are achieved by forming a "C" corporation is over $20,000 higher than for a farm without capital gain income. In fact, annual taxation for the "C" corporation is extremely costly at the lower income levels. For instance, at $20,000 net farm income, a dairy farm organized as a "C" corporation would pay over $6,500 more annual taxes than a sole proprietorship and over $2,800 more taxes than a "S" corporation. Even at $40,000 net farm income, the difference in total taxes paid by a "C" corporation and a proprietorship is over $3,000.

Total annual taxes paid by a "C" corporation dairy farm is higher because of the long term capital gain income. In a sole prorietorship, partnership, and "S" corporation—40% of the gain is allocated to the individual taxpayer and then it is taxed according to the individual's marginal tax rate. This can be contrasted to a "C" corporation where the capital gain is taxed at the lesser of ordinary income tax rates where the capital gain is combined with ordinary income or a 20% tax rate. Therefore, since a "C" corporation does not get a 60% reduction of the capital gain and its income tax rates are higher at lower income levels than those of an individual, it follows that higher taxes are paid by a "C" corporation at lower income levels, when a part of the net farm income is capital gain income.

FIGURE 4
Annual Tax Comparison by Business Organization — Dairy Example.



Annual Tax Savings

Even though it is very difficult to draw specific conclusions about the tax consequences for each of the three farm business organizational types, several general guidelines can be drawn from the cases. There are no annual tax benefits available through forming a regular corporation for any type of farm operation, unless the net farm income level is above $35,000 per owner-operator. For farm operations with high amounts of capital gain income (swine, dairy, beef cow-calf), the net farm income level must be slightly higher ($55,000) in order to achieve tax savings.

Each example assumed the farm operation consisted of one owner-operator who owned 100% of the business. If we assume more than one owner-operator, adding partners or stockholders generally does not greatly change the annual tax consequences *per person*.

For example, for the assumptions made in the first farm example, the result was that beyond $35,000 net farm income, a sole proprietorship could achieve annual tax savings by forming a subchapter "C" corporation. Now if one made all the same assumptions, except assumed two owner-operators instead of one, the "break-even" amount would be approximately double that for one owner. That is, beyond $70,000 net farm income, two owners operating in a partnership could achieve annual tax savings by forming a Subchapter "C" corporation.

The amount of annual tax savings available at various farm income levels is relatively straightforward. The higher the annual net farm income level, the greater the possibility for savings. In fact, the savings at high income levels (above $60,000 per owner-operator) can be quite substantial.

This can create problems. After a year or two of high income, many farmers see the possibilities for

tax savings and incorporate. A few years later, two problems often emerge: a) Net farm income declines for any number of reasons and the result is lost tax benefits; in fact, if the net farm income level falls much below $35,000, the annual tax bill will be higher than it would have been if the business had not incorporated; b) The shareholders are unhappy with the corporate form of business. This dissatisfaction may stem from any number of reasons. Sometimes the shareholders find the corporation too complicated and they don't know how to properly manage it. Other shareholders can't get used to the idea of living on a salary and being an employee. Often there is dissatisfaction with the assets in the corporation, i.e., they wish they had left the farmland and/or machinery out of the corporation.

Problem (a) may emerge because, at the time of incorporation there was little or no consideration given as to the probability of obtaining a high income level in future years. Of course, no one can predict the future with certainty. Even so, one can at least make an attempt by examining the future business plans of the owners. If a major expansion is planned in the future, this may increase tax deductions and thus may reduce taxable income. Or the expansion might also involve bringing others (many times it is a son or sons) into the business. If this is the case, the greater the number of owners, the less will be the net taxable income per owner.

Problem (b) often develops in situations where the corporation was hastily drafted to avoid paying a large income tax bill. Again, in such cases, there usually was a failure to properly consider future business plans, and the goals, preferences, and capabilities of the business owners. Even though it can be tempting to reduce the tax bill, this savings can be dwarfed by the emergence of other, more complex problems related to the corporation.

Therefore, rather than incorporating, it may be wiser to spend more time using other tax saving devices to level out the income from year to year—thus reducing the probability of falling into a high marginal tax bracket for only one year. Year end tax planning can alleviate potential tax problems in many years.

The cases also demonstrated that there is no significant difference in the annual tax liability incurred by a proprietorship and an "S" corporation. Thus, considering annual tax, there is little or no reason for a sole proprietor or a partnership to incorporate the business as an "S" corporation. However, there may be other benefits attainable by forming an "S" corporation—employee fringe benefits, limited liability, and estate planning benefits.

When evaluating the annual tax impact of incorporating the farm business, pay careful attention to deciding upon the salary levels, as well as whether or not to incorporate the farmland along with the rest of the business. The greater the deductions available on the farmland (interest, property tax, etc.)—the more advantageous it is, annual taxwise, to leave the farm "out" of the corporation. The cases also demonstrated that the higher the annual salary level, the greater the amount of annual tax liability.

Incorporating a highly profitable farm business can make good business sense. However, it's probably not wise to do so just because income taxes can be reduced during a year or two of high net farm income. Nor is it desirable to do so if the corporate form of business will cause serious problems for the owners.

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