Incorporate your way to tax savings

LANCASTER — If your net farm income will total $25,000 or more this year, you can probably 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 Economist Michael Boehlje.

Owners of midsize family farms may save taxes by incorporating for two reasons, he says. One is that Congress has lowered corporate tax rates twice during the 1970's.

The more important reason is "bracket creep" which occurs as individuals' incomes rise along with inflation. They move into higher tax 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 over 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 $1874, or 13.4 percent, 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 had 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 $4543, or 16.4 percent of your income, using the standard deduction.

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 $3340, or 12 percent of your income. Your savings: $1203.

Incorporation not only saves taxes, but also allows a farmer to reinvest more to build up farm equity faster. Over 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 over 10 years may be $100,000 more if the owner incorporates rather than remaining a sole proprietor.

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

"A farm corporation can pay nonfarm heirs a competitive return on their inheritance," Boehlje stresses, so that 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 their heirs not farming can get a fair price for their shares if they want to sell to heirs working the farm.

Besides aiding in estate planning, incorporation enable 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 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:

Deduct premiums on life, health, and accident insurance for yourself.

Deduct depreciation, maintenance, and repairs on your farmhouse.

Provide yourself retirement income as interest on corporate debentures.

Protect your nonfarm 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 that some states require of corporations may be distasteful, especially if you value financial privacy.

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 percent 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 percent of your salary (up to the same $29,700 maximum), for a total of 13.3 percent.

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 may still 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 may also want help with keeping farm records and filing tax returns, although you can do these jobs yourself. Corporate recordkeeping 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 will probably offset additional costs if your net income is $25,000 to $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 also succeed in business.