What Is a Corporation?

A corporation is a separate and distinct entity from the individuals who own it, operate it, or work for it. Corporations provide operating and tax alternatives that differ from operating your business as a self-employed individual or partnership.

Corporations are established under state law. Each state permits corporations the right to do business. A corporation consists of owners who are called shareholders. The shareholders are the basic decision-making group. They elect a board of directors to act for them on most operational decisions. Majority vote governs corporate decisions. Ownership of 51 percent of the stock gives you control. Minority shareholders have little if any decision-making control unless permitted by the majority shareholders.

How Does It Operate?

Once a corporation is created, it functions much as a self-employed individual might. It, however, usually has multiple owners and is controlled by a board of directors or their chosen designee. Corporations must establish their own name and bank accounts. The corporation can become an employer, a lessor or lessee, a buyer or seller, or engage in any other business activity.

Two different taxation structures are available to corporations. A regular "C" corporation pays taxes on its own. An "S" small business corporation pays no tax itself, but passes all income through to shareholders on a proportionate basis.

Why Do Farms Incorporate?
Farms incorporate for many reasons. For example:

- It is easy to transfer shares. Shareholders can gift or sell shares to others as they see fit. Up to 49 percent of the shares can be transferred without losing control of the business.

- A corporation may simplify estate settlement, in that it is easier to transfer shares than various other farming assets.

- Most farms lower their income taxes when they form a "C" corporation. They, in effect, are creating a new taxpayer which is currently taxed at 15 percent on the first $50,000 of income. Spreading income over several 15-percent-bracket taxpayers reduces income taxes for many middle to large income farms.

- Self employment (SE) taxes can be reduced with a corporation structure. Instead of paying SE tax on all the Schedule F income as a self-employed individual, the farmer becomes an employee of the corporation and Social Security (SS) taxes are paid only on wages paid. The corporation can also rent land or machinery from shareholders. Land rent is not subject to SE tax when received by the shareholders. Machinery rented to the corporation, however, may be subject to SE tax. See fact sheet #5, Transferring Breeding Stock and Machinery, for more information.

- Meals, groceries, and lodging furnished the employees of a corporation are generally deductible to the corporation, but are not taxable income to the employee. If lodging is provided on the farm and is a condition of employment, the depreciation, heat, electricity, and interest become deductible to the corporation.

- Fringe benefits are deductible to "C" corporations. Health, accident, and term life insurance up to $50,000 are deductible to the corporation, but not taxable to employees.

- A corporation can afford some liability protection not available to self-employed individuals. Generally, assets owned individually by shareholders (except for corporate shares) are protected from liability claims made through the corporation.

- The corporation offers perpetual life, some economic efficiencies regarding capital acquisition, and provides income and SS tax flexibility.

**Concerns With Farm Corporations**

- Getting into a corporation is a tax-free event; getting out is a taxable event. Don’t start a corporation unless you plan to continue it for many years.

- If your corporation is profitable but isn’t growing and acquiring new assets, it can be troubled with excess profits. Profits paid out to shareholders are taxed twice—once as income in the corporation and again as dividend income to the shareholders.

- You have a different set of rules, regulations, and paperwork when you incorporate. Corporate meetings, extra record keeping, and income tax returns along with state reporting requirements and quarterly tax estimates are part of corporate life. Complying with extra legal and regulatory requirements costs time and money each year.
Minority shareholders have no power in directing the corporate business and can be easily "frozen out." A majority shareholder (farming heir) can direct that no dividends be paid. Minority shareholders (off-farm heirs) who own shares which don’t generate income, hold shares with practically no value.

Corporate ownership of a house eliminates the use of the once in a life time $125,000 exclusion of gain on a sale of a personal residence.

Corporate ownership sometimes reduces independence and individual pride of ownership. These concepts may have to be sacrificed, however, to build a family business that can compete in the years ahead.

When incorporating, determine which assets should be put into the corporation and which should be held out. Generally, operating assets are included while capital assets such as land are kept out.

The farm corporation can be a valuable tool in tax planning and in the transfer process. However, it is a major commitment and a complex task to start a farm corporation. Before starting a corporation, make sure it fits your goals, objectives, and business personality.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

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3. Major Tax Considerations When Transferring Assets (FS-6304)
4. Selling the Crops and Market Livestock (FS-6305)
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