

Tax Tips & Pitfalls-Prepays, deferring revenue & more



Executive Women in Agriculture
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Paul Neiffer, CPA
Yakima, WA

LarsonAllen
LLP
CPAs, Consultants & Advisors

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Objectives

- How to plan after year-end when the farmer is on the cash method of accounting.
- How to take advantage of your spouse and kids (in a good way).
- What might be the best entity for your farm operation?
- Are you ready for the Medicare Sur-tax?
- Other Farm Tax Tips

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Focus Areas:

- Electing out of Deferred Income
- Guidelines for Prepaid Expenses
- Spousal and Related Party Rents
- Spousal and Family Employment
- Entity Selection
- Medicare Sur-Tax Planning Tips
- Other Tax Tips and Traps
- Farm Income Averaging
- DPAD (Sec. 199) and Co-ops

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NOTICEABLY DIFFERENT

Constructive Receipt Income

- For Cash Basis Ag Producers
- Must Report Income in Taxable Year
 - Made available to the taxpayer so it can be drawn upon at any time
 - Made available so it could have been drawn if the taxpayer had given notice to the payor
 - Credited to the taxpayer's account
 - Set apart for the taxpayer
- Payment is considered received when the check is received, even though not deposited until after year end

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Deferred Sales

- Need contract prohibiting payment prior to stated date
- Can be interest bearing
- Enter multiple deferred payment contracts
 - Elect out of deferred tax treatment on the 2011 return if income is lower than expected
 - Multiple contracts makes it easier to target income (each contract is treated separately)

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Example - Deferred Sales

- Jane has cash sales of \$300,000 and five deferred payment contracts of \$10,000 each
- Cash expenses for 2011 are \$310,000

	Cash Method	Elect Out of Installment
Cash Income	\$300,000	\$300,000
Elect Out of Installment	0	50,000
Gross Income	300,000	350,000
Expenses	(310,000)	(310,000)
Taxable Income	\$(10,000)	\$ 40,000

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NOTICEABLY DIFFERENT

Year End Prepaid Farm Expenses

- Two limitations:
 - Three tests: Rev. Rul. 79-229
 - ◊ Purchase, not a deposit
 - ◊ Business purpose
 - ◊ No material distortion
 - Prepays may not exceed 50% of nonprepaid expenses (including depreciation)
- Both tests must be met
 - Second test usually not a problem

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Year End Prepaid Farm Expenses

- Expenditure must be an actual purchase, not a mere deposit
 - Must specifically state quantities and items, nonrefundable, nonsubstitutable
- Expenditure must be for a business purpose and not merely to avoid taxes
 - Examples include securing adequate quantities, early discounts, expectation of rising costs
- Expenditure must not result in a material distortion of income
 - General rule, it must be consumed within the next 12 mos.

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Year End Prepaid Farm Expenses

- Borrowed funds
 - Funds may not be borrowed from the vendor or payee as part of the same transaction (Pioneer Seed purchases financed by Pioneer's Financing affiliate?)
 - What about local bank / co-op financing programs?
 - Credit card charge considered payment when charge occurs, not when bill is paid

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Query:

Is it possible to prepay expenses to get the early payment discount, but not take the tax deduction?

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Get Prepay Discount Without Deduction?

- Create a “defective” prepayment
- Fail the Rev. Rul. 79-229 test
 - Purchase, not a deposit
- Document as a “deposit on account”
- Don’t buy a specific quantity or product

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Prepaid Rents

- Prepaid rent development
 - New “12-month rule” allows deductibility of prepaid rent
 - ◇ Cash method producers only
 - ◇ Not allowed for accrual method producers
 - Adds new tool for cash method producers
 - ◇ But: Acceleration of income to recipient

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Crop Insurance Deferral

- Elect to defer to yr. following *damage*
 - Need to ask what year damage was incurred
- Late payments not eligible for deferral
 - 2011 payments received for 2010 crop not eligible
- Elect in original or amended tax return
- Election includes private insurance and FSA disaster payments
- Watch netting of unpaid premium

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Crop Insurance Deferral

- Revenue Assurance (RA) and Crop Revenue Coverage (CRC) are insurance products that combine protection against low yields and low prices
 - Proceeds from RA and CRC eligible for deferral if based on weather event (drought or hail, etc)
 - Otherwise proceeds not eligible for deferral
- Eligible crop only if normally sell >50% after y/e
 - This rule is by each specific crop that farmer raises

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Capitalize Current Year Fertilizer Costs

- IRC Sec. 180
 - Costs to enrich, neutralize, or condition land used in farming can be deducted or capitalized and deducted over the useful life of the materials
 - The standard approach is to capitalize and deduct over the useful life of the material (generally we put a statement in the return if selecting this approach)
 - Election to deduct in current year is made simply reporting it as an expense (this is the typical approach)
 - If purchasing a new farm, this can create an additional deduction separate from the land cost

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Effect of Capitalizing Fertilizer Costs

- Raises current year income
- Spreads costs out over the life of the fertilizer material (% of use of benefits each year)
- If costs are capitalized, seek help of an agronomist to determine portion to deduct each year
- All fertilizer costs incurred during the year are subject to the same treatment
- This decision can be made as late as the actual preparation of the return

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Spousal Rent / Rent to Partners

- Annual SE tax savings
- Favorable Courts and rulings:
 - Cox case (TC and CA-8) Attorney deducts wife's 1/2
 - Rev. Rul. 74-209: H&W Joint Tenants (1/2 okay)
 - Rev. Rul. 72-504: Rent paid to partnership OK
- Adverse Ruling:
 - TAM 9206008: Circular payment and no lease = disallowance (wife owned farmland)

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Spousal Rent Criteria

- Spousal ownership of land
- Written lease (clarify no labor as landlord)
- Reasonable rents
- Actual payment of rent
- Debt paid by spouse
- Issue 1099-MISC (put it in the right box)
- Retention of funds by landlord

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Commodity Wages

- Can be paid to family members or any employee
- Do not qualify for DPAD Wages
- Caution: Commodity wage guideline compliance
 - Employer recognizes income and offsets with labor exp.
 - Provide Bill of Sale and employer issues W-2
 - Wage Income is FMV on Date of Transfer
 - Should be a written employment agreement
 - Any gain or loss on subsequent sale is capital
 - Employee should pay holding costs after transfer

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Don't Overlook the Kids

- Payment of reasonable wage to a child
 - No payroll tax to child of proprietor under age 18
 - Wages deductible as a farm business expense
 - Generally tax-free to child due to standard deduction (\$5,800 in 2011)
 - Available for sole proprietorship, husband and wife partnerships and sole member LLCs.

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Gifts of Commodities

- Gifts of raised grain to help w/ college funding
 - Not available to corporations
 - Gift tax return > \$13,000

Farmer unsold grain



Donee

- | | |
|-----------------------|----------------------------|
| – No income or SE tax | – -0- basis |
| – Use prior yr. crop | – No SE tax |
| – Gift TR > \$13,000 | – Schedule D |
| | – Carryover holding period |

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Gifts of Commodities

- Gifts of unsold grain to child
 - Donor makes a gift of unsold inventory, using prior year crop
 - Donee independently and at a later date accomplishes the sale
- Note: Elevator must refrain from issuing a check to child without specific direction from child
- Most likely sale will be subject to “Kiddie Tax” calculations

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What is the Best Entity for Your Farm?

- The types available:
 - Sole Proprietor
 - Partnership
 - C corporation
 - S corporation
 - Limited Liability Company / Partnership

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Sole Proprietor

- Advantages
 - Simple
 - No wages required
 - Only file one tax return
 - Step-up in basis of assets upon death
- Disadvantages
 - Unlimited liability
 - Unlimited exposure to self-employment taxes
 - Reduced non-taxable fringe benefits

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Partnership

- Advantages
 - Simple to set up and does not require written agreement
 - Can allocate income between partners
 - Simple to get out of
 - Step-up in basis upon death of partner
- Disadvantages
 - Unlimited liability for business debt
 - Another tax return to file
 - Limited non-taxable fringe benefits

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C Corporation

- Advantages
 - Potential lower tax rates (15% on first \$50,000)
 - Non-taxable fringe benefits
 - ◊ Meals, lodging and other
 - Reduced exposure to self-employment taxes
 - Risk limited to investment in corporation
- Disadvantages
 - Another tax return to file
 - Never put land in corporation
 - Potential double tax (corporation pays tax, then shareholders pay tax on dividends)

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S Corporation

- Advantages
 - No double tax
 - Risk limited to investment
 - Losses flow through to shareholder
 - Reduced exposure to self-employment taxes
 - Income not subject to Medicare Sur-Tax in 2013 (if non-passive)
- Disadvantages
 - Limited non-taxable fringe benefits
 - Second tax return required
 - Do not put land in S corporation

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Limited Liability Company / Partnership

- Advantages
 - Taxed like a partnership, but legal protection like a corporation
 - If structured properly, may reduce self-employment taxes and not be subject to Medicare Sur-Tax
 - Step-up in basis upon member's death, including harvested crop
 - Can allocate income to reflect member's contribution:
 - ◇ Capital
 - ◇ Profits
- Disadvantages – similar to partnership

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Entity Recommendation

- In the Past
 - S or C corporation for farm operations
 - Partnership for land ownership
- Now
 - Leaning toward using LLC to both for the farm and the land ownership
- Watch Out For
 - Limits on FSA payments and other related farm program restrictions

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Medicare Sur-Tax

- Starting in 2013, there is a 3.8% Medicare Sur-tax on:
 - Capital gains
 - Rents
 - Dividends
 - Interest
 - Royalties
 - Passive activity income
- Imposed on the lessor of:
 - Net Investment Income
 - AGI in excess of \$250,000 (MFJ) / \$200,000 (Single)

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Medicare Sur-Tax (continued)

- Income it does not apply to:
 - Salaries and wages (separate Medicare surtax of .9% for this income)
 - Distributions from pension plans including IRAs
 - Income from partnerships and S corporations that is not passive
 - Tax free interest income

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Medicare Sur-Tax (continued)

- Planning considerations
 - Use an LLC to create earned income from the farm operation including the “rental” portion of the income
 - Maximize your contributions to your pension plan since these distributions will not be subject to the Medicare Sur-Tax
 - Use a C corporation to keep the overall income under the threshold levels
 - Try not to have a large state tax refund
 - Offset capital gains with capital losses

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Other Ag Tax Issues

- Non Corporate Lessor Rules
- Passive Classification of Bare Farm Land
- Recharacterization Rules for Rentals
- What year are Assets Placed in Service
- SE Tax on CRP Rentals
- Split Interest Land Acquisitions

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Non Corporate Lessor Rules

- Non Corporate Taxpayers are disallowed Sec.179 for property leased to others unless
 - The term of the lease is less than 50% of the depreciable life of the property, and
 - During the first 12 months of the lease, the operating expenses of the lessor with respect to the property exceed 15% of rental income
- This presents limitations for farm landlords purchasing tile, livestock buildings, and irrigation systems, etc

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Recharacterization Rules for Rentals

- Recharacterization Rules are a problem when the taxpayer has:
 - Certain rental property (discussed in the next two slides) that has income, and
 - Has passive losses from other activities in their return
- Rental income that is recharacterized into portfolio income rather than passive income takes away the ability to deduct the passive loss in the current return

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Recharacterization Rules for Rentals

- Bare Land Leases -
 - Rental activities where less than 30% of the unadjusted basis of the property is depreciable
 - ◇ Net Income considered **not** from a passive activity
 - Farm land is usually positive, so creates portfolio income
 - This portfolio income does not net with other passive losses
 - ◇ Net loss consider from a passive activity
 - A loss has to flow to Form 8582 to net there
 - ◇ Bare Land Lease includes cash rent and crop share leases
 - ◇ Caution should be used for pass-through entities

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Recharacterization Rules for Rentals

- Self Rental Property
 - Net rental income derived from rent for use in a business in which the taxpayer materially participates
 - ◊ Net Income considered **not** from a passive activity
 - ◊ Net Loss consider from a passive activity
 - Examples include a taxpayer or spouse leasing property owned personally to a proprietorship, partnership, S corporation, or C Corporation in which they materially participate

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What year are Assets Placed in Service?

- Farmers often purchase equipment near the year end to obtain Sec. 179 depreciation expense or bonus depreciation
- To qualify:
 - the property must be purchased, and
 - ◊ It is paid for, or
 - ◊ The taxpayer has a legal liability for the purchase of the asset
 - the property must be placed in service
 - ◊ The asset must be available to the taxpayer for its intended business use

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SE Tax on CRP Rents

- Watch CRP Rents !
 - Active Farmer
 - ◊ Subject to SE Tax, until collecting SS Benefits
 - Land owner collecting Social Security Benefits
 - ◊ Exempt from SE Tax
 - Land Owner not collecting Soc Sec Benefits
 - ◊ If the land owner does not materially participate in the production from the land, it is rental income not subject to SE tax, but taxpayer should be cautioned the IRS may contest this position on audit
 - ◊ Watch reporting in Tax Return to avoid matching notices

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Land Purchase – Split Interest Purchase

- Split-interest purchase
 - Corporation buys term interest
 - Shareholder buys remainder interest
- Interest rate and IRS charts determine % of value term interest buyer and remainder interest pay
- Extracts value out of corporation to shareholder

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Land Purchase – Split Interest Purchase

- Cost of Land purchase to term interest holder is amortizable
- However, for term interests acquired after July 28, 1989, no amortization is allowed if the remainder portion is held, directly or indirectly, by a related party
- Disallowed amortization shifts to remainder holder's basis annually

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Wisdom of Avoiding Income?

- Need to focus on economics, not taxes
- 60% of “something” is better than 100% of “nothing”
- Avoid tax costs getting in the way of good business decisions
- Don't let tax tail wag the dog
- So, is there wisdom in thinking twice about planning income spike to use farm income averaging this year?

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Farm Income Averaging - IRC Sect 1301

- Individuals engaged in farming allowed to elect to average farm income over prior three years
- Applies lower income tax rates from prior three years to current year income
- Averaging OK in late or amended TR
- Not limited by Alternative Minimum Tax (AMT)

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Farm Income Averaging

- Electible Farm Income includes
 - Amount up to taxable income attributable to net farming activities
 - Gain on sale of property other than land used in farm business
 - Amounts from pass-through entities
 - Wages from S corp. engaged in farming

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Farm Income Averaging

- Reality: Uneven base years
- Solution: Amend base years to reduce income
 - Late Section 179 depreciation election
 - Earlier averaging election (amended) to level base years

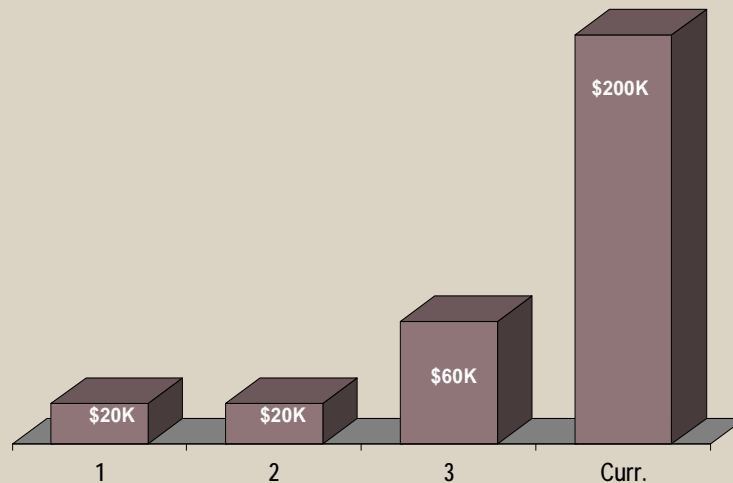
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Farm Income Averaging: Uneven Base



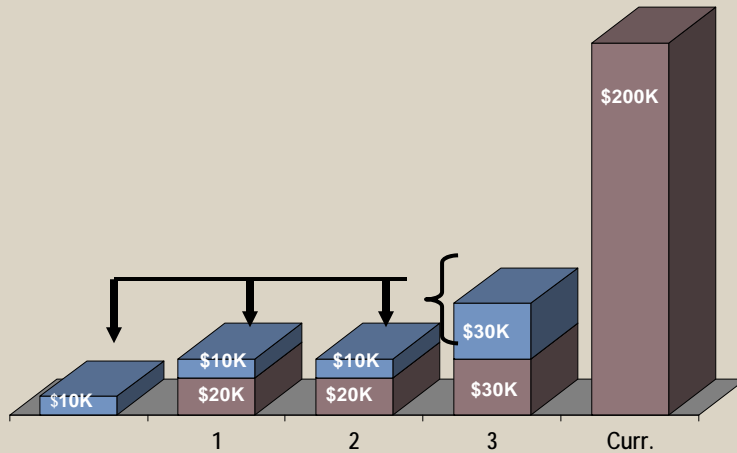
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Farm Income Averaging: Uneven Base



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Farm Income Average / SE Tax Strategies

- Report high income Schedule F
 - High Schedule F income
 - Taxable Income approaching \$200,000
- Income above SE limit (\$106,800 for 2011) taxed at 2.9% SE tax rate
- Use income averaging to control income taxes
 - If base years are in \$20,000 to \$30,000 range
 - Four years of taxable income all in 15% tax bracket

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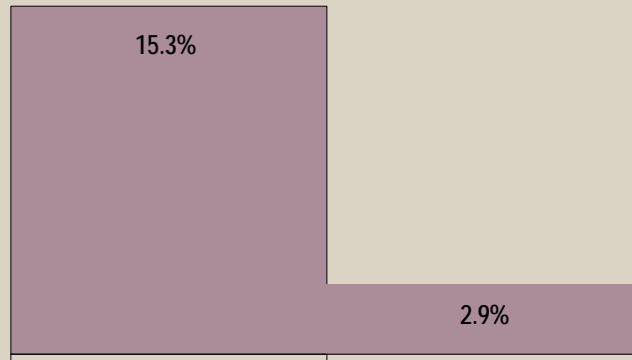
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Self-employed Soc. Sec. Tax



\$106,800
SE Income: 2011

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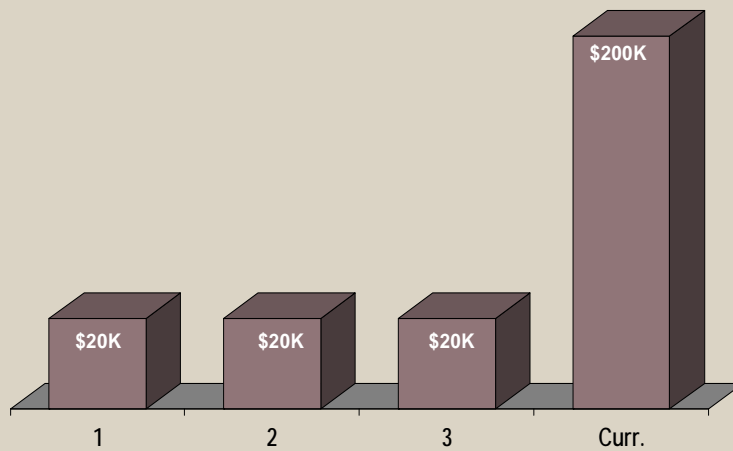
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Farm Income Averaging



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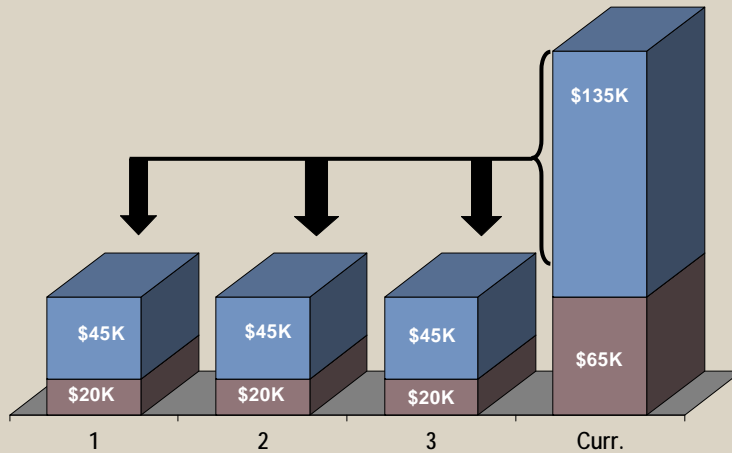
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Farm Income Averaging



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Farm Income Averaging

Opportunities:

- Beginning farmers with low but rising incomes
- Machinery auctions (incl. bins, barns, etc.)
- Retiring farmer with carryover grain
- Spike Schedule F above \$106,800 to minimize SE tax
 - Example: \$200K for SE tax (so about \$95K at 2.9% Medicare), but income averaging to lower income tax rates

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Deduction for U.S. Production Activities - Sec. 199

- Deduct % of the lesser of:
 - Qualified production activities income, or
 - Taxable income (or mod. AGI for individuals)
- 3% for 2005 and 2006
- 6% for 2007-2009 (twice as good!!)
- 9% after 2009 (three times as good!!!)

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Deduction for U.S. Production Activities – Sec. 199

- What income qualifies?
 - Raised crops and market livestock - OK
 - Crop ins. and FSA subsidies - OK
 - Hedging transactions - OK
 - Raised vs. purchased breeding stock
 - ◊ Sale of raised breeding stock - OK
 - ◊ Sale of purchased breeding stock – NOT OK
 - Purchase-resale, seed sale commissions – NOT OK
 - Custom livestock finishing – NOT OK
 - Coop patronage dividends – see slide coming
 - <5% gross income from nonqualifying activity - IGNORE

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Deduction for U.S. Production Activities – Sec. 199

- Deduction limited to 50% of total wages paid
 - Requires CASH wages subject to FICA/Federal withholding (this excludes commodity wages or wages to your children under age 18)
 - To get max deduction for 2010 and later years, need cash wages > 18% of net farm income

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Deduction for U.S. Production Activities – Sec. 199

- Small Business Simplified Overall and Simplified Deduction Methods of allocating costs of sales and expenses include all business activity of a taxpayer
- At the Individual 1040 level, this requires considering farm and non farm sources of business activity

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Sec. 199 and Coop Patronage Dividends

- Some coops have qualified to take deduction considering all grain/dairy purchased from members
- Deduction can be used in Co-op's tax return or passed out to producers on 1099
- Farmer cannot use those sales to Co-op in calculating his own 199 deduction
 - Okay if Co-op passes out its 199 deduction
 - Can be bad answer for farmer if Co-op retains its 199 deduction

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1099-PATR

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1 Patronage dividends		OMB No. 1545-0118	
Farm Cooperative		\$ 2,850		2009 Form 1099-PATR	
550 South Soybean Road		2 Nonpatronage distributions			
New Ulm, MN 56073		\$			
PAYER'S federal identification number		3 Per-unit retain allocations		Taxable Distributions Received From Cooperatives Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.	
22-5689562		\$ 435,925			
RECIPIENT'S identification number		4 Federal income tax withheld			
452-22-3355		\$			
RECIPIENT'S name		5 Redemption of nonqualified notices and retain allocations		6 Domestic production activities deduction	
Quentin B. Jones		\$		\$ 6,865	
Street address (including apt. no.)		7 Investment credit		\$	
559 Winter Wheat Avenue		\$		9 Patron's AMT adjustment	
City, state, and ZIP code		8 Work opportunity credit		\$	
Montgomery, MN 56069		\$		10 Other credits and deductions	
Account number (see instructions)		9 Patron's AMT adjustment		\$	
28		\$		\$	

Form 1099-PATR (keep for your records) Department of the Treasury - Internal Revenue Service

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Interpreting 1099-PATR

- Line 3 – Amount of sales made from producer to coop that are ineligible for DPGR at producer level
- Line 6 – Amount of 199 deduction that producer is allowed; no wage limit at producer level
 - Caution regarding Line 3 – Fiscal year Recipients (C Corporations) may need to calculate Non-DPGR for sales to that coop based on their fiscal year
 - Caution regarding Line 6 – Fiscal year Recipients (C Corp's) need to know when DPAD was allocated out to recipients to get it in the corp's correct fiscal year

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Re-think DPAD Opportunity This Year?

Now that DPAD rate is 9%, when does it make sense to pay spouse cash wages vs. commodity wages?

Proprietor is under \$106,800 of SE Income

- Commodity Wages save 15.3% SE Tax
- Spousal cash wages cost the 15.3% SE Tax, but DPAD potentially only saves up to half of Federal tax rate (15%) of wages paid

Conclusion: Pay spousal wages based on other considerations – DPAD not worth chasing

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Summary

- Thanks for participating
- Questions?
- For PDF of presentation, send e-mail to me

Paul Neiffer, CPA

pneiffer@larsonallen.com

Ph 509-823-2920

Blog <http://www.larsonallen.com/agribusiness/> or
www.farmcpatoday.com

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