Tax Savings Tips
2012 Top Producers Conference
February 2, 2012
Chicago, IL

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Yakima, WA

Background on CliftonLarsonAllen

- Merger of Larson Allen with Clifton Gunderson
- Effective January 2, 2012
- Almost $600 million in revenue and 3,600 employees
- In 25 states and high concentration of offices in the corn belt
- Largest CPA firm whose primary focus is on privately held businesses (especially farms and farm families)
Objectives

- What’s new for 2012/13
- How to plan for the 2013 Medicare Sur-tax
- How to maximize your tax-free fringe benefits
- How to plan after year-end when the farmer is on the cash method of accounting.
- What might be the best entity for your farm operation?
- Other Farm Tax Tips and Traps
What’s New For 2012/13

• Section 179 expensing lowered to $139,000 and phase-out starts at $560,000
• Bonus Depreciation
  – Now 50% for 2012 instead of 100%
  – Applies to New Assets only
  – All farm buildings should qualify (including employer provided housing)
  – Must be placed in service

What’s New For 2012/13 (continued)

• Take advantage of New Hire Credit on Form 5884-B
• DPAD remains at 9%
• Always review Farm Income Averaging
• Capital gains and qualified dividends still taxed at maximum 15%
  – Consider making a dividend out of C corporation
  – Sell capital assets before year-end
  – If in 15% tax bracket, this income is taxed at zero percent
What’s New For 2012/13 (continued)

• Estate and Gift Tax Lifetime Exclusion is now $5.12 million (up from $5 million in 2011)
  – With proper discounts, may be able to transfer close to $10 million in value
  – Reverts back to $1 million on January 1, 2013
  – Now is a great time to consider gifting farmland that will remain in the family for multiple generations

• Annual gift exclusion remains at $13,000, probably will go to $14,000 in 2013

What’s New For 2012/13 (continued)

• Grouping elections for passive activities
  – Farm S corporation with LLC owning land
  – May want to consider grouping rental property with operating entity
  – Takes this income out of Medicare Sur-Tax in 2013
  – Complicated rules, need to review with your tax advisor
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)

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
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

Tax-Free Fringe Benefits

• If you farm as a C Corporation, you have the following tax free fringe benefits:
  – Corporate provided housing
  – Corporate provided meals
  – Health insurance
  – Cell phones and related
  – Miscellaneous other

• Not available to other entity types such as partnerships, S corporations or most LLC’s
Corporate-Provided Meals and Lodging

- Employers are allowed to provide tax-free fringe benefit to employees for meals and lodging at the business premises
- Proprietors and partners lack the necessary employee status to qualify for this fringe benefit
- The Code prohibits S corporation employees who own more than 2% from having these tax free fringe benefits

Corp. Provided Meals and Lodging (cont.)

- Therefore, only C corporation can provide these benefits if it meets the following (Code Section 119):
  - Furnished to an employee, their spouse or dependents
  - Must be furnished “for the convenience of the employer” and “as a condition of employment”, and
  - The meals and lodging must be furnished on the business premises of the employer
Tax Free Meals and Lodging – (continued)

- **Housing**
  - Should be owned by the corporation and located on farm property (you can rent your home to the corp, but less tax advantages)
  - Can deduct:
    - ◊ Interest and real estate taxes
    - ◊ Repairs
    - ◊ Insurance
    - ◊ Depreciation
  - New house built in 2011 qualifies for 100% bonus depreciation, in 2012 qualifies for 50% bonus depreciation
  - If house sold for gain, then it is fully taxable

Tax Free Meals and Lodging – (continued)

- **Tax Free Meals**
  - Provided with furnishing of lodging allows deduction of meals on non-working days and to spouse and children
  - Grocery purchases are allowed if the corporation has an employment agreement with spouse to convert into meals and provide to corporate employees
  - 100% deductible if meals are provided to all employees
Commodity Wages

- Commodity wages paid to agricultural employees are not subject to FICA, FUTA or FWHT
  - Employer must recognize income on the amount paid to employee in commodities
  - Employer receives a wage deduction offset for the amount paid to the employee
  - Employer must issue a from W-2 to the employee. Commodity wage is reported in box 1 for income tax purposes, but zero of these wages are reported for FICA or Medicare wages.
  - The fair market value of the commodity on date of transfer is the wage income amount.

Commodity Wages (continued)

- Any gain or loss on the subsequent sale of the commodity by the employee is reported as capital gain or loss (could be long-term if held more than a year).
- Any carrying costs associated with the commodity, such as storage or marketing costs, must be reported as miscellaneous itemized deduction on Schedule A.
- Written employment contract should specify that there is an employer/employee relationship and the quantity or percentage of commodity that will be paid for the upcoming year.
Commodity Wages (continued)

- The employee must actually receive ownership of the commodity from the employer prior to sale and must bear all risks associated with marketing the commodity.
- The period the employee holds the commodity between the date of transfer and sale may be scrutinized by the IRS. The longer held the better.
- The source of the commodity must be raised by the employer, not purchased specifically to accomplish the employee compensation in kind.

Farm Commodity Payment Worksheet

<table>
<thead>
<tr>
<th>Transfer Data</th>
<th>Sale Data</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COMPUTATION OF QUANTITY TO BE PAID</strong></td>
<td><strong>EMPLOYER USE ONLY</strong></td>
</tr>
<tr>
<td>Annual production (average acres times yields)</td>
<td>Please provide a copy of the worksheet to your employer at year-end or retain a copy for administrative purposes.</td>
</tr>
<tr>
<td>Prior production (average acres times yields)</td>
<td></td>
</tr>
<tr>
<td>Quantity to be paid to employer</td>
<td></td>
</tr>
<tr>
<td><strong>RECORD OF PAYMENTS TO EMPLOYER</strong></td>
<td></td>
</tr>
<tr>
<td>Quantity to be received (see computation above)</td>
<td></td>
</tr>
<tr>
<td>Plus: Quantity of unharvested or unharvested from previous year</td>
<td></td>
</tr>
<tr>
<td>Less: Quantity not transferred</td>
<td></td>
</tr>
<tr>
<td>Adjusted quantity to receive payment</td>
<td></td>
</tr>
</tbody>
</table>

**RECORD OF PAYMENTS TO EMPLOYER**

<table>
<thead>
<tr>
<th>Date</th>
<th>Quantity Received</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Total value per crop: \( \text{Reported in 3rd slant} \)

**Expense Incurred to Employer**

<table>
<thead>
<tr>
<th>Date</th>
<th>Quantity</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Total: \( \text{Reported in 3rd slant} \)
Hire Your Spouse and Children

• Hire your spouse to prepare the meals, keep the books, etc. Pay a reasonable wage for these services.
  – If a sole proprietor, may allow you to deduct medical costs

• Hire your appropriate age children for farm chores, etc. If the amount paid is less than the standard deduction ($5,800 in 2011), wage is tax-free to child
  – If sole proprietor and children under age 18, then wages are not subject to FICA and other payroll taxes
  – Consider funding a Roth IRA with the wages paid
  – Be in compliance with your state child labor laws

Examples

<table>
<thead>
<tr>
<th></th>
<th>Farming As Proprietorship</th>
<th>Farming As C Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farm Income</td>
<td>125,000</td>
<td>125,000</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regular wages</td>
<td>10,000</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Commodity wages</td>
<td>20,000</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Wages to spouse</td>
<td>5,000</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Wages to three kids</td>
<td>-</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Tax-free meals</td>
<td>-</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Tax-free housing</td>
<td>-</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Net farm income</td>
<td>125,000</td>
<td>35,000</td>
</tr>
<tr>
<td>Income Tax</td>
<td>13,906</td>
<td>463</td>
</tr>
<tr>
<td>Self-employment taxes</td>
<td>14,455</td>
<td>-</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>-</td>
<td>1,685</td>
</tr>
<tr>
<td>Child Credit</td>
<td>(2,650)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Earned Income Tax Credit</td>
<td>(2,859)</td>
<td></td>
</tr>
<tr>
<td>Total taxes (refund)</td>
<td>25,711</td>
<td>(3,771)</td>
</tr>
<tr>
<td>Grand total</td>
<td></td>
<td>9,705</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5,024</td>
</tr>
</tbody>
</table>
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)

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
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

<table>
<thead>
<tr>
<th>Cash Method</th>
<th>Elect Out of Installment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Income</td>
<td>$300,000</td>
</tr>
<tr>
<td>Elect Out of Installment</td>
<td>0</td>
</tr>
<tr>
<td>Gross Income</td>
<td>300,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>(310,000)</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$(10,000)</td>
</tr>
</tbody>
</table>

Year End Prepaid Farm Expenses

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

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
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

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
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

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
What is the Best Entity for Your Farm?

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

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
**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

**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)
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

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
Recommended Entity for 2012

- C corporation to take advantage of tax-free fringe benefits and reduce payroll taxes
- LLC to own farmland
- Consider using LLC with manager management to reduce payroll taxes and maximize estate tax savings
  - May use C corporation as the manager to take advantage of tax-free fringe benefits, etc.

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)
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

Gifts of Commodities

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

<table>
<thead>
<tr>
<th>Farmer unsold grain</th>
<th>Donee</th>
</tr>
</thead>
<tbody>
<tr>
<td>No income or SE tax</td>
<td>-0- basis</td>
</tr>
<tr>
<td>Use prior yr. crop</td>
<td>No SE tax</td>
</tr>
<tr>
<td>Gift TR &gt; $13,000</td>
<td>Schedule D</td>
</tr>
<tr>
<td></td>
<td>Carryover holding period</td>
</tr>
</tbody>
</table>
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

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
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

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
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

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
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

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
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

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!!)
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

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
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

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
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

1099-PATR

<table>
<thead>
<tr>
<th>Recipient's Name</th>
<th>Federal Income Tax Account Number</th>
<th>Federal Income Tax Identification Number</th>
<th>Amounts:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quentin B. Jones</td>
<td>25-5005678</td>
<td>123-45-6789</td>
<td>$2,850</td>
</tr>
</tbody>
</table>

Department of the Treasury - Internal Revenue Service
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

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
Summary

• Thanks for participating
• Questions?
• Send e-mail to me or give me a call anytime

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