

Hot Tax Topics for Producers – Prepays, deferring revenue & more

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Objectives

- How to plan after year-end when the farmer is on the cash method of accounting
- How to properly advise farmers on what a hedge really is
- What is DPAD and why it is important
- How to take advantage of your spouse and kids (in a good way)



Focus Areas:

- Electing out of Deferred Income
- Guidelines for Prepaid Expenses
- Farm Income Averaging
- Hedging and Speculating Transactions
- Reminders regarding Crop Insurance
- Expensing / Capitalizing Fertilizer Costs
- DPAD (Sec. 199) and Co-ops
- Spousal and Related Party Rents
- Spousal and Family Employment





This is where I grew up

We delivered grain to that elevator every summer. My home place would be in the upper left corner.



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



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)



Example - Deferred Sales

- Steve 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





This is a toy for the farm boy

This combine is much nicer than the one I grew up with. However, it looks a little bit too clean.



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



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



Query:

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



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



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



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?





Apple and Pear Orchards

When we think of farming, I think we sometimes forget about orchard operations being a highly valuable part of farming.



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)



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

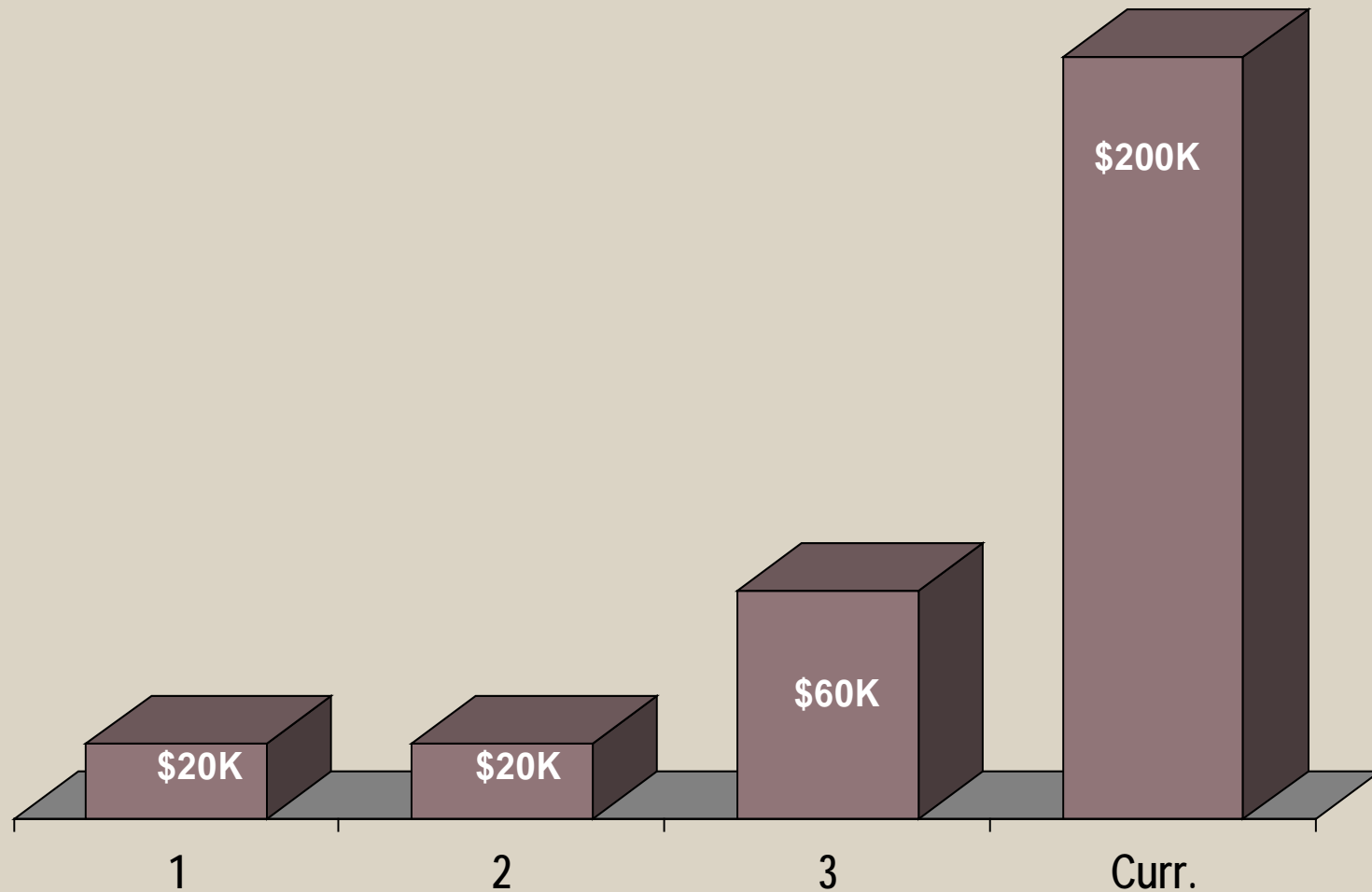


Farm Income Averaging

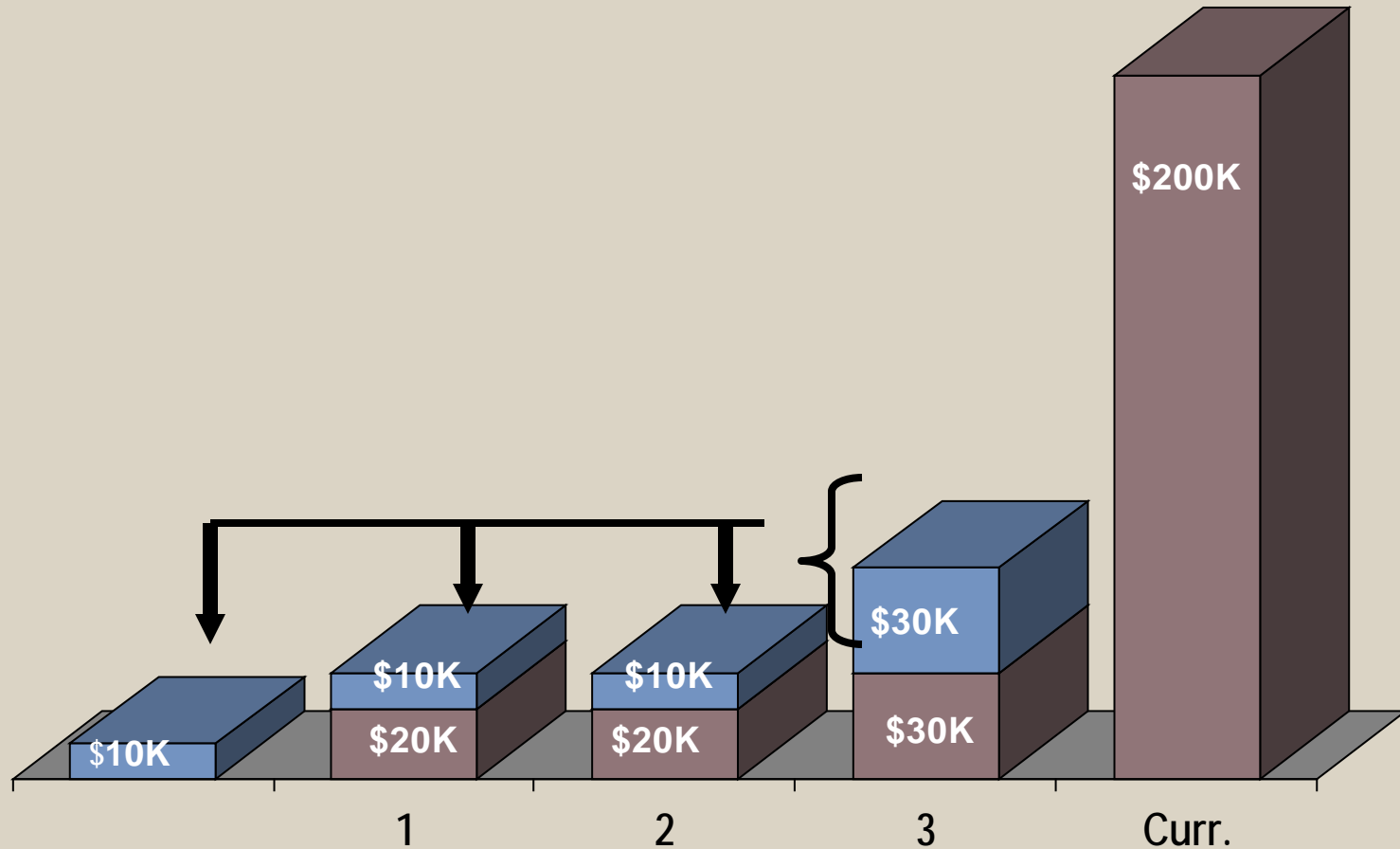
- Reality: Uneven base years
- Solution: Amend base years to reduce income
 - Late Section 179 depreciation election
 - Earlier averaging election (amended) to level base years



Farm Income Averaging: Uneven Base



Farm Income Averaging: Uneven Base

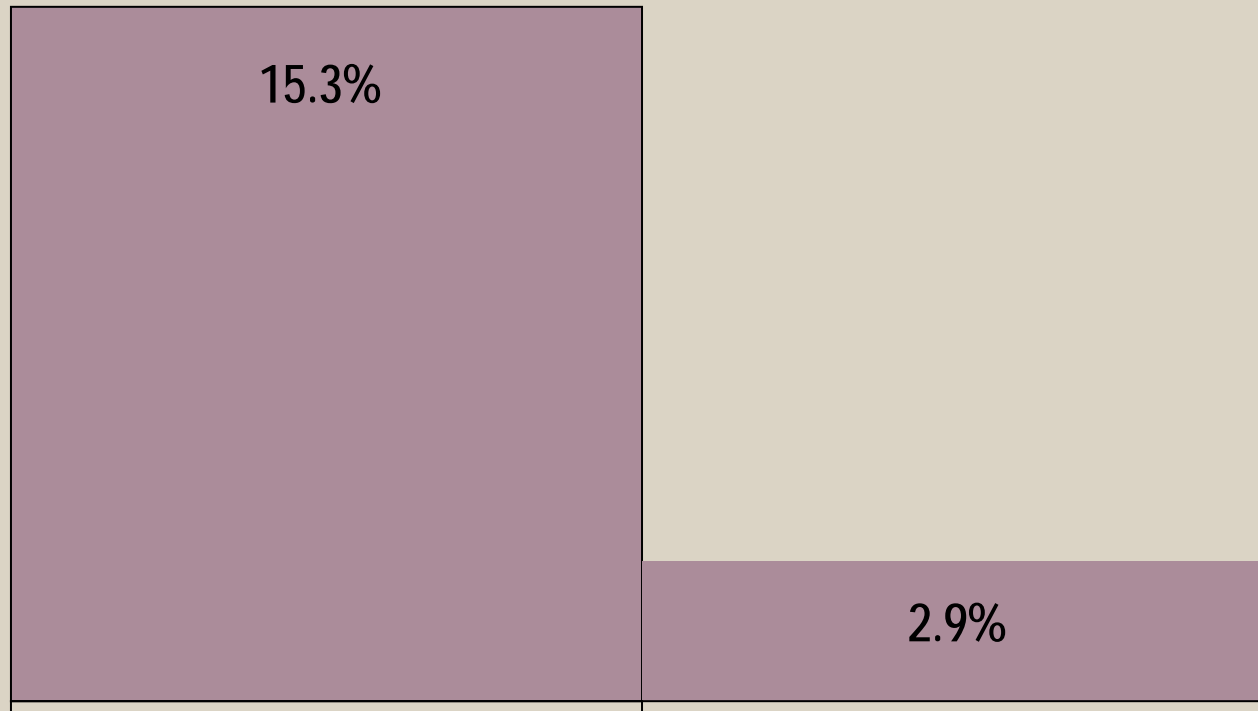


Farm Income Average / SE Tax Strategies

- 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



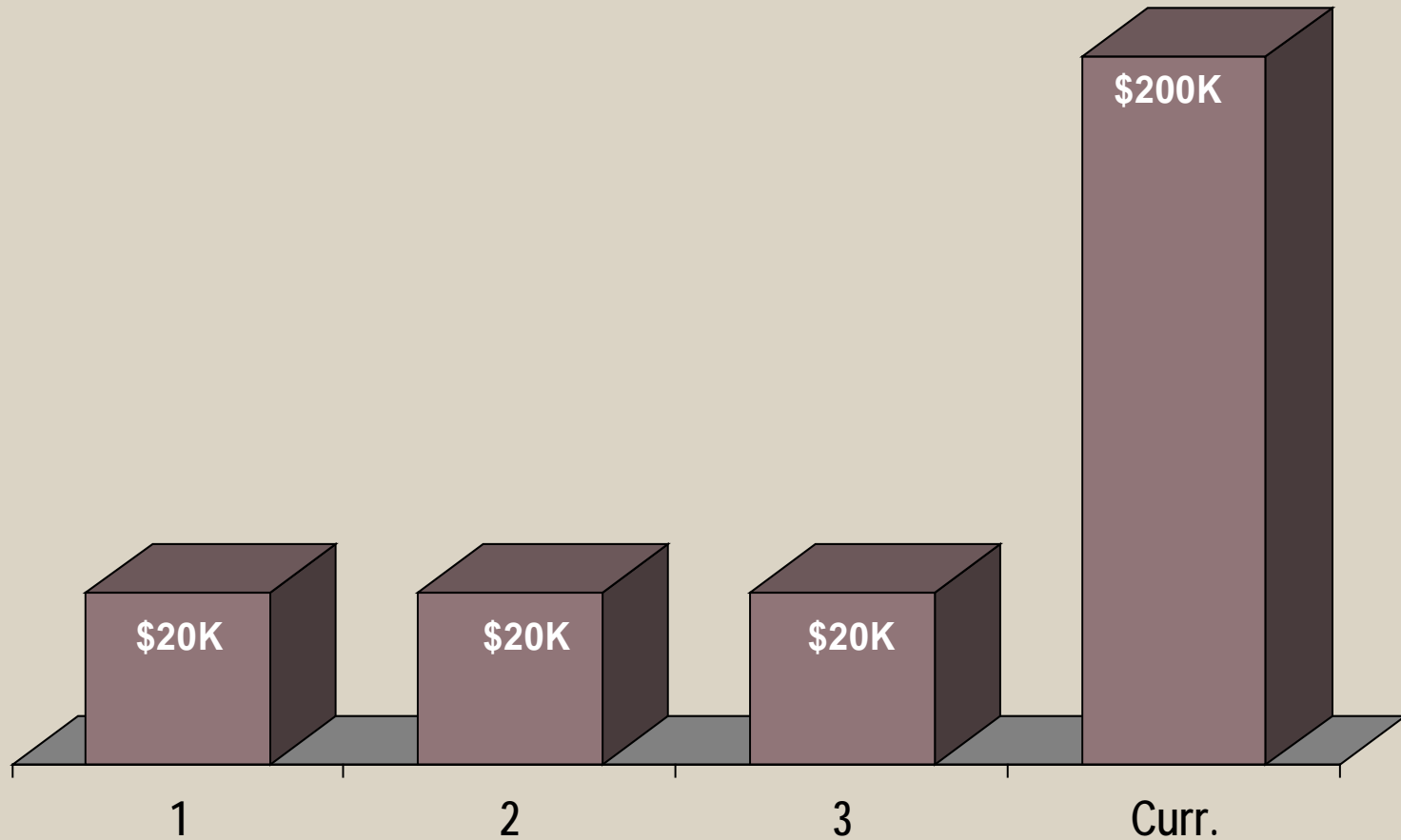
Self-employed Soc. Sec. Tax



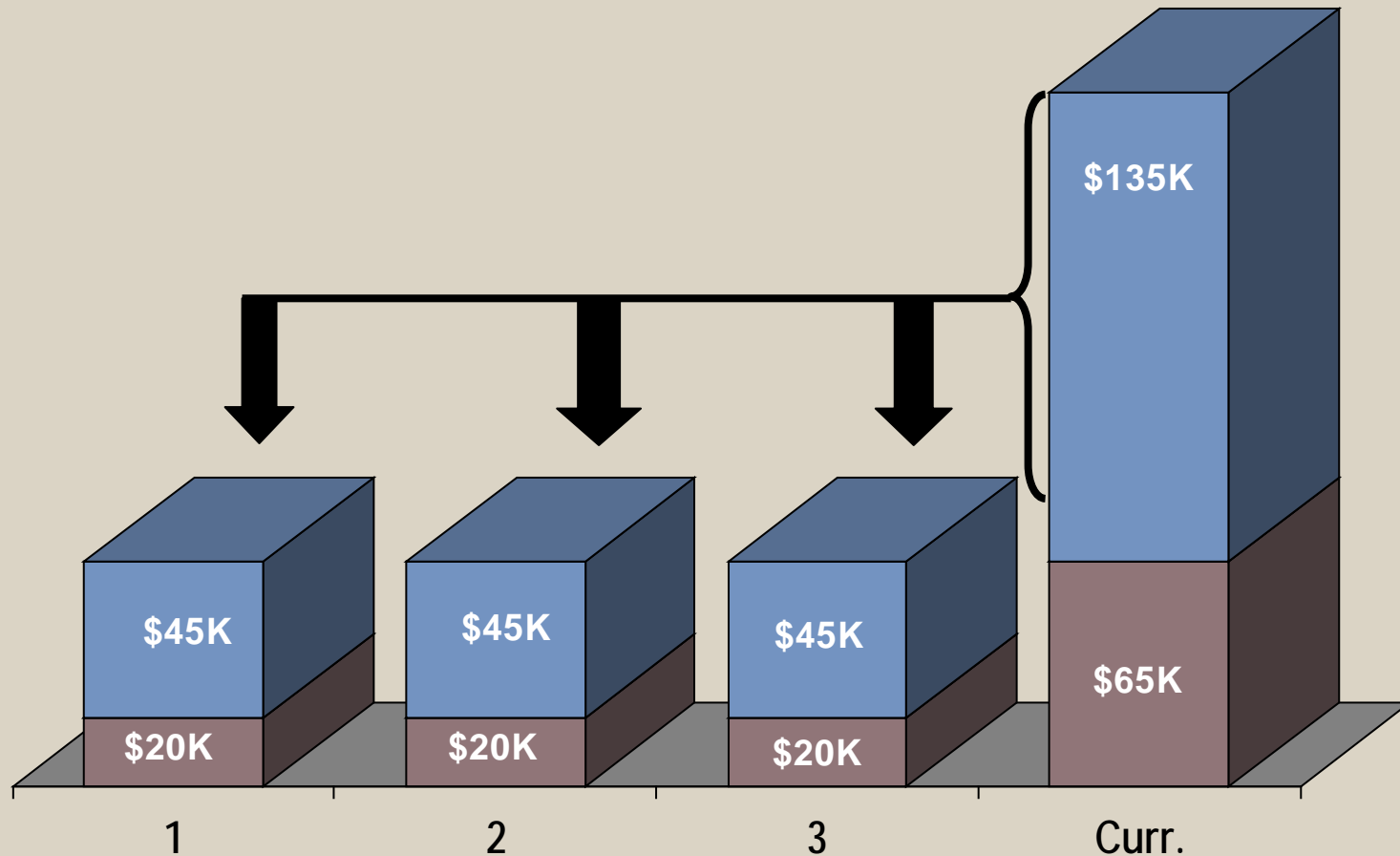
\$106,800
SE Income: 2011



Farm Income Averaging



Farm Income Averaging



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





Some red machines to offset the green!

I grew up driving a international 453 combine so there is farm color beside green.



Hedging vs. Speculation

- Hedging

- Definition

- ◇ a “hedging transaction” is “any” transaction entered into by the taxpayer in the normal course of the taxpayer’s trade or business primarily to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer IRC Sec. 1221(b)(2)(A)

- Same-day Identification

- 35-day rule: Notations

- Lack of Identification and Notations results in transaction being called Speculative

- Hedge transactions are not capital assets IRC Sec. 1221(a)(7)



Hedging vs. Speculation

- Hedging
 - Must be within taxpayer's range of production
 - Must be opposite the taxpayer's physical position in commodities on hand or to acquire
 - Future and Option Contracts are typically seen
 - New style of transaction is an Over-the-Counter Hedge



Hedging vs. Speculation

- Hedge Accounting

- Not subject to Marked to Market Rule at Year End

- Accounting For Hedge Transactions

- ◊ **RULE:** Report gain or loss on hedge transactions when item of inventory is sold or consumed into production. Reg 1.446-4(e)(3)(i)

- ◊ **EXCEPTION:** Report gains and losses when realized Reg 1.446-4(a)(1)

- If cash method of accounting or use special farm inventory methods and meet < \$5,000,000 gross receipts test of IRC 448(c)

- Those eligible for the exception can

- use the rule if they elect to do so, if they elect in first year reporting a hedge

- Takes Advance Consent 3115 to change methods



Hedging vs. Speculation

- Hedge Accounting

- Example – Grain Inventory

- ◇ Hold 5,000 bu. 2010 raised corn to be sold sometime between winter 2010 to summer 2011
 - ◇ In Aug. 2010, sell Dec. 2010 Futures Contract
 - ◇ Nov. 2010, buy Dec. 2010 Futures Contract – loss of \$6,000
 - ◇ Nov. 2010, sell July 2011 Futures Contract
 - ◇ July 2011, buy July 2011 Futures Contract – gain of \$1,000
 - ◇ Sell 5,000 bushel grain inventory in July 2011 - \$25,000
 - RULE - \$0 T.I. 2010 and \$20,000 T.I. 2011
 - EXCEPTION - (\$6,000) T.I. 2010 and \$26,000 T.I. 2011



Hedging vs. Speculation

- Speculative:
 - Always a capital asset
 - Marked to market at year-end
 - 40% short-term; 60% long-term
 - Reported on Form 6781 – Gains and Losses from Section 1256 Contracts and Straddles – which flows automatically to Schedule D





Harvesting Sugar Cane

I'm going to go visit my sugar cane farmer in Louisiana in October.



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)



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





Cotton Picking Machine

I think you can pick more cotton with this machine than by hand.



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!!!)



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
 - Bad answer for farmer if Co-op retains its 199 deduction



1099-PATR

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. Farm Cooperative 550 South Soybean Road New Ulm, MN 56073		1 Patronage dividends \$ 2,850	OMB No. 1545-0118 2009 Form 1099-PATR
		2 Nonpatronage distributions \$	
		3 Per-unit retain allocations \$ 435,925	
PAYER'S federal identification number 22-5689562	RECIPIENT'S identification number 452-22-3355	4 Federal income tax withheld \$	
RECIPIENT'S name Quentin B. Jones		5 Redemption of nonqualified notices and retain allocations \$	6 Domestic production activities deduction \$ 6,865
Street address (including apt. no.) 559 Winter Wheat Avenue			7 Investment credit \$
City, state, and ZIP code Montgomery, MN 56069		8 Work opportunity credit \$	9 Patron's AMT adjustment \$
Account number (see instructions) 28		10 Other credits and deductions \$	

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.

Form **1099-PATR**

(keep for your records)

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





Strip Till System

In our area, we have mostly no-till and very little strip-till



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





No-till System with Air Seeder

If you add a fertilizer system, you probably have more than 100' of equipment lined up.



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



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)



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
- Use prior yr. crop
- Gift TR > \$13,000

- -0- basis
- No SE tax
- Schedule D
- Carryover holding period



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





About \$6,000 of Corn

Between the corn in the combine and the corn in the grain cart, I figure there is about \$6,000 worth of corn.



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 – IRC Sect 179(d)(5)

- 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** - Reg 1.469-2T(f)(3)
 - 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
 - ◇ Make sure these rental activities get coded correctly in the tax software
 - ◇ Caution should be used for pass-through entities



Recharacterization Rules for Rentals

- **Self Rental Property** Reg 1.469-2(f)(6)
 - 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
 - Again, be sure to get the right code in the passive activity coding in the tax software



What year are Assets Placed in Service?

- Farmers often purchase equipment near the year end to obtain Sec. 179 depreciation expense
- 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
IRC Sect 1402(a)(1)
 - ◇ 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



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 Sec. 167(e)
- Disallowed amortization shifts to remainder holder's basis annually Sec. 167(e)(3)





Now this is a Toy for the Grown Up Farm Boy

My two cousins just bought tractors similar to these last year. I hope to get to drive one next week when I help in harvest.





JUL 30

The Pacific NW Wheat Harvest is Late!

By Paul Netffer | [Trackback URL](#)

No Comments +

My wife and I rode our motorcycle from Yakima to Lewiston on Thursday with a stop in Walla Walla. Normally this time of year, wheat harvest would be in full throttle, however, I noticed very little harvesting going on that day.

I visited with my Uncle and Aunt at their house on Thursday and spoke with my cousin. Usually wheat harvest would start around the 15th of July (some years around the 4th even) but this year, they will be starting their first field for harvest sometime next week. This is by far that latest harvest that I can remember for this area.

The good news is that the average yield should be on the high end, but a lot of wheat is down on the ground and it will be harder to harvest. One of my least favorite things growing up on the farm was harvesting downed wheat. Usually this wheat would have high yields unless it went down too soon, then it would not finish filling out.

I will be driving combine around the 10th of August and will let you know how the fields look.

My wife and I spent the night in Lewiston and then headed down to Enterprise and Joseph, Oregon which has some of the prettiest scenery in America. This area is called the Alps of America and if you ever get out this way, you need to check it out. I noticed several combines harvesting grass seed over in the LaGrande area and based upon the straw I saw, the yields look good there, but you never know for sure with straw.

Then as we got closer to home along the Columbia River, the onion harvest was in full swing and when you are on a motorcycle, you can really smell that harvest.

Categories: [Demographics](#), [Farm Industry Trends](#), [Farm Operations](#), [Farm Trends](#)

JUL 27

Frozen Garbanzo Beans to Hit the Market This Year

By Paul Netffer | [Trackback URL](#)

No Comments +

I grew up in the Walla Walla area and several farmers are now producing Garbanzo Beans on about a 1,000 acres for the fresh frozen market.

Normally, garbanzo beans are held to maturity and harvested dry and then shipped around the world. The Middle East is a large consumer of these beans and in the US they are primarily used in soups and salads.

Work started in 2000 to come up with the method to freeze the beans for the fresh market. They have just now perfected the process and you will be able to buy fresh garbanzo beans in a market near you.

The beans are harvested using the normal green pea combine (which cost over \$500,000 new) and then chilled to about 36° near the Walla Walla airport. After chilling, the beans are then transported to Ellensburg, Washington about 150 miles away to be frozen and then shipped to customers. I am impressed that they can get these things harvested with a green pea combine since the plants are only about a foot tall, but the picture in the article indicates they can get most of the plant into the combine.

On a personal note, the farmer Ron Flan quoted in the story is my cousin. Here is the article.

Categories: [Commodity Marketing](#), [Demographics](#), [Farm Industry Trends](#)

JUL 27

Summary

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

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