SELECTED TOPICS IN FARM INCOME TAXATION

Presented by

Terrance A. Nemec, CPA
Nemec & Associates
3300 E 26th Street, Suite 201
Sioux Falls, SD 57103
terry@nemeccpa.com
Office: 605.275.4033

SELECTED TOPICS IN FARM INCOME TAXATION

Presented by
Terrance A. Nemec, CPA

I. Hiring children to Work in the Business

A. Hiring Children can be a means of reducing the family tax burden

a. The 2009 standard deduction for a child who can be claimed as a dependent on the parent's return is the greater of (a) $900 or (2) $300 plus the child's earned income not to exceed $5,450.

b. The kiddie tax does not apply to earned income.

c. Child's earnings become a wonder source to start making IRA, particularly Roth IRA, contributions for the child.

d. Wages paid to the child can be deduction for self-employment tax purposes to the hiring parent.

e. Child's wages are not subject to FICA taxes if the child is under age 18 and the business is operated as a sole proprietorship, or partnership where the parents are the only partners.

i. Also not subject to FUTA if under age 21.

ii. These exemptions from FICA do not apply if the business is operated as a C or S corporation or the partnership includes partners other than the parents.

B. Important that the child is working at an appropriate level for their age and being paid an appropriate level of wage for that work. Documentation of the type of work and the hours worked is extremely helpful.

II. Medical Reimbursement Plans

A. Great tax savings strategy to hire the owner's spouse as a legitimate employee and compensating the employee through medical expense reimbursements.

    a. Works with Schedule C or F sole proprietorship or single member LLC reported as such.

    b. Can also work with Schedule E activity but without the SE tax savings.

B. Essentially make family medical expenses, including health insurance premiums, deductible as a business expense.

C. Implementation of the plan

    a. Hire the spouse as a legitimate employee of the business. Preferred to have a written contract specifying the employee's duties and work hours.

    b. Create a self-insured medical expense reimbursement plan that is part of the employee's compensation package. (Section 105 plan). It is an absolute must that it is a written document.

        i. Self-insured means the reimbursements (not the medical expenses) are paid out of the business checkbook rather than from insurance.

        ii. The plan allows the employee to be given tax-free reimbursement for substantiated medical expenses incurred for the employee-spouse, the spouse-owner and the employee's dependent children.

        iii. The plan must cover all employees of the business. Generally, you would not expect to implement such a plan where the business had other employees besides dependent family members

D. Compensation of the spouse-employee must be reasonable considering the reimbursements under the plan along with any other cash or non-cash compensation.

    a. May be advisable to have the plan cap the maximum amount of reimbursements per year.

    b. Beneficial to have documentation of the employee-spouse's work duties and hours.

E. It is vital that the rules be followed and everything be documented properly.

a. The employee-spouse must pay all insurance premiums and medical expenses that are intended to be covered by the plan from non-business funds.

b. The business should then issue a check to reimburse the employee-spouse for documented expenditures

c. The insurance policy should be in the name of the business or the employee-spouse, not the business owner. If the policy has to be purchased in the name of the business owner, the strategy will likely not pass IRS scrutiny.

d. Reimbursed insurance premiums and medical expenses should be substantiated with copies of billing notices and invoices. These should be retained as part of the business records. The employee-spouse should maintain records showing they paid the expenses with personal funds before being reimbursed.

e. Payroll tax deposits and returns must be filed timely and properly. This includes Form W-2, Form 943, Form W-4 and Form I-9.

F. The IRS acknowledges that medical reimbursement plans are allowed under the tax law, BUT they don' t like them. They have been attacking them at every opportunity. The importance of following the rules and maintaining documentation cannot be over emphasized.

III. Opportunity to convert accrual method farmers to cash method

A. While most farm and ranch taxpayers are on the cash method of accounting there are a few that still use the accrual method.

a. In the past, the conversion of an accrual method farming operation to the cash method have only been available under automatic procedures if average gross receipts were under $1 million.

b. Any other farm operation required the use of either a non-automatic procedure or an advance consent procedure, including a filing fee.

B. In 2008, the IRS release Rev. Proc. 2008-52 updating and consolidating accounting method changes.

a. Paragraph 14.13 of the Appendix to Rev. Proc. 2008-52 describes the procedures to change to the overall cash method for farmers.

b. The Section 481(a) adjustment period for the net reduction in income to reverse the asset and liability accruals can be claimed as an immediate deduction in the year of change.

c. If changing from the crop method, that portion of the change is made using the cut-off method.

d. No user fee is required.

e. Form 3115 may be filed any time during the year up to the filing date, including extensions.

IV. Tax savings still available for "Heavy" SUV's, Pickups and Vans

A. We are all familiar with the luxury auto depreciation limits. They are so restrictive that it has been said "The average client may not live long enough to fully depreciate a really expensive car."

B. For used cars and light trucks, the depreciation limits are as follows:

Year	Used Cars	Used Light Trucks
1	2,960	3,160
2	4,800	5,100
3	2,850	3,050
4 and after	1,775	1,875

C. When a vehicle is used over 50% for business and is not classified as a passenger auto, the more generous MACRS rules can be used.

a. GVWR of over 6,000 pounds

b. Five-year property

c. 50% bonus depreciation for 2008 and 2009 for new vehicles

d. Section 179 for new and used vehicles limited to $25,000 per vehicle.

i. GVWR of 14,000 pounds or less.

e. Vehicles not considered to be SUV's

i. Cargo area not readily accessible from the passenger compartment and that is at least six feet in length. Many pickups with full-size cargo beds will qualify for this exception. Some "quad cabs" and "extended cabs" with shorter cargo beds many not qualify.

ii. Two other exceptions generally not relevant to farmers. Shuttle vans and delivery vans.

iii. Vehicles qualifying for this exception are eligible for the full amount of the Section 179 limit for the year. $250,000 in 2009.

D. Caveats

a. Heavy SUV's, pickups and vans are still considered "listed property".

b. This means they are subject to the business-use substantiation rules.

c. Personal use by a shareholder-employee with greater than 5% ownership must be reported as taxable compensation income.

V. Taking advantage of accelerated depreciation rules

A. 50% bonus depreciation has been extended through 2009.

a. Due to budget constraints it is doubtful to be extended to 2010.
b. Applies to qualified property.

i. Original use (i.e. new) of the asset must commence after December 31, 2007 and before December 31, 2009

ii. Eligible Section 168 recovery property with a MACRS recovery period of 20 years of less.

iii. Includes new general purpose buildings used in agriculture

iv. However, farmers who elect under the UNICAP rules of Section 263A(d)(3) are required to use ADS, which makes them ineligible for bonus depreciation.

v. No AMT adjustment required.

vi. May elect out of bonus depreciation.

B. While we are on the subject of the depreciation.

a. Seeing too many returns included farm returns prepared with straight-line depreciation over the extended recovery period.

b. While this may be easier to calculate depreciation , we are usually not serving clients effectively by not using accelerated depreciation methods for them.

VI. Noncash Wages

A. The use of noncash wages is an excellent tool for compensating employees but we need to continue to be reminded of the requirements for using this planning technique.

a. Again, while it is a valid, legal strategy, the IRS does not like it so they will find any little miscue to reject the transactions.

b. The contentious issues generally are one of two issues

i. Whether the employee exercises dominion and control over the commodity, and

ii. Whether the payment is equivalent to cash

B. Noncash wages paid to farm employees are taxable income reported on Form W-2 but not subject to social security and Medicare taxes or income tax withholding.

C. Exercise of Dominion and Control by the Employee

a. Existence and Extent of Documentation

i. Documentation of employment relationship

ii. Documentation of transfer of commodities

iii. All relevant records should be maintained. Receipts, contracts, bills of sale, scale records, vet inspections, etc.

iv. Release of security interests under by a lender.

v. Substance of the transaction must indicate a bona fide transfer has taken place.

1. Employee's payment of costs associated with storing and maintaining the commodity.

b. Employee Marketing and Negotiation of Sale

    i. Independent sale transactions by the employee are essential to bona fide transfer.

    ii. Employee must not sell commodity in unison or in collaboration with employer

    iii. Single payment to one payee is strong indication of marketing by employer.

    iv. Employee should not sell the commodity back to the employer.

c. Shifting the risk of gain or loss to the employee.

    i. Employee must assume the risk of loss for both price fluctuation and change in quality of the commodity from the time transferred to sale by employee.

    ii. Employer who indemnifies employee against loss or deterioration has not transferred dominion and control.

    iii. Employee can receive a percentage of production is at risk as long as employer does not guarantee replacement or minimum units of production.

d. Length of time between Employee's Receipt and Sale of the Commodity

    i. Length of time is an important consideration for determining a bona fide transfer.

        1. The longer the better.

        2. Employee should have time to exercise dominion and control over the commodity.

e. Employee Bears the Cost of Ownership

    i. Employee should be responsible to maintain the commodity after receipt.

        1. Storage fees for grain

        2. Feed and care of animals

    ii. Use of employer's facility should be arranged in an arm's length transaction.

f. Identification of the In-Kind Payment

    i. Should be for the transfer of a specific, identified commodity.

    ii. Livestock should be tagged, branded, or segregated at time of transfer and documented. Bill of sale should specify the number along with quality or grade.

    iii. Fungible farm products should be specified by nature, grade and quality along with location and means of segregation . Best if moved to employees separate storage or commercial storage under a separate account.

D. Cash Equivalency

a. The following are indication that the in-kind payment is equivalent to cash

    i. Specific dollar quantity of commodity

    ii. Cash advances or guaranteed cash payments

    iii. Readily negotiable documents

    iv. The immediacy of how and when commodity converted to cash

    v. If in-kind compensation is the only source of income

    vi. Deferred payment contracts because sale has already occurred

    vii. Generic commodity certificates because employee never owns the commodity.

E. Tax Reporting

a. Filing of Form W-2 and Form 943 are essential parts of the documentation.

VII. Section 199 Domestic Production Deduction

A. Most farm and ranch businesses will qualify for this deduction based on sale of their production and limited to 50% of wages paid.

   a. For 2009 the deduction percentage is 6%, increasing to 9% in 2010.
   b. Usually wages paid will be a significant limiting factor for traditional farm clients to take this deduction.

   c. However, has agribusiness changes many are paying significant wages so we need to be sure to not overlook this deduction.

   d. Dairy operations seem to be the one to make the most use of this deduction with certain hog operations also utilizing it.

B. Cooperatives are permitted to "pass-through" to its patrons all or a portion of its Section 199 deduction.

   a. Some recent changes to how they compute the deduction may make it more beneficial so we will see more cooperatives passing the deduction through to members.

   b. It is to come through on Form 109-PATR.

C. Schedule K-1's from other entities

   a. Most ethanol or other energy related investments made by farmers will have the Section 199 deduction passed-through on the Schedule K-1

      i. The Schedule K-1 passes through the components of the computation and the farmer includes those with other amounts on their own Form 8903