DTN/Progressive Farmer Ag Summit
Tax Habits of Highly Effective Farmers!

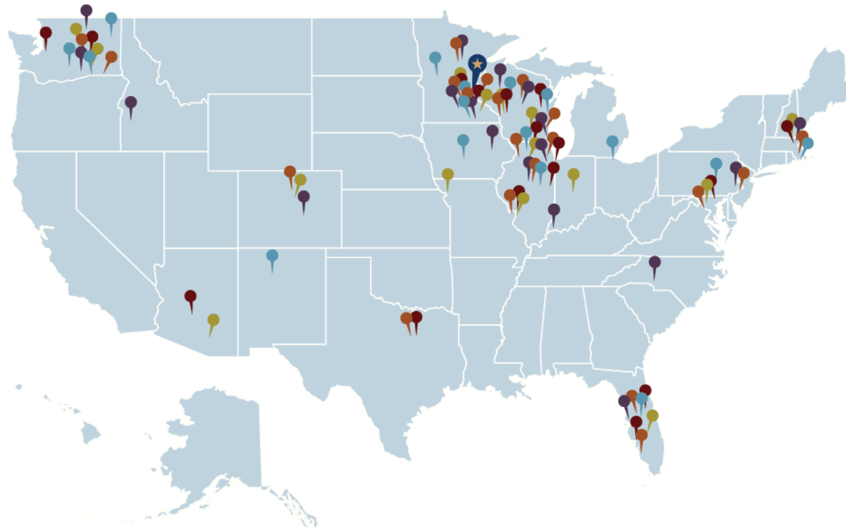
Paul Neiffer, CPA

December 8, 2015

Chicago, Illinois

About CliftonLarsonAllen

- A professional services firm with three distinct business lines
  - Wealth Advisory
  - Outsourcing
  - Audit, Tax, and Consulting
- 3,600 employees
- Offices coast to coast



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Agribusiness

Producer clients	• 5000+
Cooperative clients	• 250+
Processor clients	• 400+
Farm input clients	• 550+

CLA serves more agribusiness and cooperative organizations than any other firm in the country

Speaker Introduction

Paul Neiffer, Principal, CliftonLarsonAllen

– Frequent national speaker on taxation, agricultural, farm bill and estate tax topics
– Current chair of the AICPA National Agriculture Conference committee.
– President of Farm Financial Standards Council
– Author of the “FarmCPA” Top Producer column
– Primary source for nationally recognized blog “FarmCPAToday.com”


MASSEY - HARRIS

Highly Effective Farmers Take Advantage of:

- Cash Method of Accounting
- Entity Selection
- Tax Credits
- How Tax Reform May Affect Those Decisions
- FSA Planning (Can Be More Important Than Tax)
- Dealing with Land Trapped in a C Corporation
- IC-DISC Planning for Foreign Ag Sales
- DPAD and Cooperatives

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Cash Method of Accounting – The Holy Grail of Farm Taxes

Cash Method of Accounting

- Revenues recognized when received
- Expenses recognized when paid
- Depreciation allowed against cash net income
- Exceptions to Cash Method
  - Crop insurance deferral
  - Excess livestock sales
  - Capitalized fertilizer expenses
  - Capitalized repairs

Deferred Payment Contract

- Grain is delivered and sold in current tax year
- Payment is received in next tax year
- Farmer has option to report the sale on contract by contract basis
  - In year of payment (default for cash basis farmers)
  - In the year of sale (elect into current tax year)
- Allows farmer to increase income if so desired after current tax-year end

Deferred Payment Example

Item	No Sec. 179	Section 179
Grain Sold on Deferred Contracts	400,000	400,000
Equipment purchased	375,000	375,000
Grain reported in current year	-	375,000
Section 179 deduciton	-	375,000
Net farm income	-	-

Farmer should make sure to have multiple deferred grain payment contracts. In this example, perhaps 3 $100,000 contracts and 4 $25,000 contracts (rounded). Allows farmer to bring $375,000 into income in current year instead of $300,000 or $400,000 if there were only $100,000 contracts.

Crop Insurance Proceeds

- Farmers can elect to defer crop insurance for one year if:
  - Normal business practice to sell more than 50% after year of harvest
  - Deferral only available on yield loss
  - If received in year after claim, no extra deferral
  - Can accelerate into current year by “selling” claim
  - RP policies are both yield and price
    - ◊ Need to determine both components
    - ◊ Yield can only be deferred

Excess Livestock Sales

- Excess sales due to drought or other related issues
  - Can be deferred one year
  - Can be rolled over into other livestock
  - Can be rolled over into other farm assets
  - Can be rolled over into farm real estate
    - ◊ If due to land contamination

Capitalized Fertilizer Costs

- Farmers can elect to capitalize fertilizer costs
  - In any year
  - Amortize based on what is used
  - No disclosure on tax return
  - Should have an agronomist provide report
- Farmers can allocate excess fertility
  - To purchased land
  - Must have agronomist report
  - Be ready for an audit, especially at the state level

Capitalize Repairs to Optimize Farm Income

- New Repair Regulations allow farmers to elect to capitalize repairs
  - Great tool increase farm income
  - Then use Section 179 (at the $500,000 level) to deduct amount needed to optimize income
- New IRS announcement on $2,500 deduction on any new purchases
  - Per item
  - Can go over if it makes sense for your farm operation

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Which Entity is Best for Liability Purposes

Liability Reasons for Entity Selection

- Sole proprietors are subject to unlimited liability exposure
- Partnerships are even worse
  - Exposed to other partner issues
- Corporations limit exposure to investment
  - Guarantees are separate issue
- LLC, LLP and LLLP are essentially the same as corporations
- LP are hybrid of each
- Trusts may or may not provide protection

Conclusion

- Either a corporation or LLE is appropriate to limit liability to the owners
  - Needs bank account
  - Needs to be run like a business
  - Should have annual meetings and documentation
  - If not, then piercing the entity shield can and will occur

Payroll Tax Savings from Using An Entity

Payroll taxes

- Sole proprietors and partners are subject to 15.3% maximum FICA and Medicare on first $118,500 of income (2015 numbers).
- 2.9% or 3.8% on all income above that level
- Wage base may exceed $200,000 in less than 10 years

How Does Corporation Fix That?

- C corporate owners are only subject to payroll tax on actual cash wages paid
  - Excessive compensation issues
    - ◊ Rarely an issue with farm operations
  - Double tax on dividends
    - ◊ Offset by lower dividend tax rates
  - Built-in tax on land holdings
  - Commodity wages
    - ◊ Provides additional deduction to corporation and income to shareholder/employee, but no payroll taxes

How About S Corporations?

- S Corporations owners are only subject to payroll taxes on actual cash wages paid
  - Not enough (opposite of C corporations)
    - ◊ Rarely see a farmer paid more than $50,000 salary
  - Dividends are payroll “tax-free”
  - Commodity wages
    - ◊ Can still be used to reduce overall payroll taxes

Commodity Wages

- Commodity wages are deductible by employer, and
- Wage to employee, but
- No payroll tax is owed by employer or employee
- Wages are in Box 1 of W2, but not box 3 or 5, FICA or Medicare wages
- Employee is subject to market changes and must incur costs to hold
- Gain or loss on difference when sold
- Great for owners, can be issue for rank and file

How LLC Reduces Payroll Tax

- A properly structured "manager" managed LLC can substantially reduce payroll taxes
  - Must need at least 20% owned by non-managers working less than 500 hours to be most effective
  - Can Bifurcate Manager's interest into Managers and Non-managers interest
    - ◊ 1%, 49%, 50%
    - ◊ 15%, 35%, 50%
  - Great for Husband / Wife farm operations

Manager Managed Structure

- Two classes of members
  - Manager
  - Non-Manager
- Manager class subject to SE
- Non-manager class under 500 hours not subject to SE (except guaranteed payments)
- Non-manager class over 500 hours not subject to SE if non-managers hold more than 20% (except guaranteed payments)

Manager’s Interest

- Can be bifurcated into both manager and non-manager if other non-managers own more than 20%
  – Manager’s interest subject to SE tax
  – Non-manager interest not subject to SE tax

Manager LLC Example

- Beanstalk LLC is owned by Jack and Jill, who are married to each other. Jill is not active, but is an equal owner. Because Jill is not active & does not work more than 500 hours, Jack's membership interest can be structured as both a manager and non-manager interest. Jack is provided a 2% manager's interest and a 48% non-manager's interest. The manager's interest will be subject to SE tax, as will any guaranteed payments received by Jack for his services.
- As a result, the bottom line income will be shared pro-rata according to these percentages, with the 98% non-managers interest being exempt from SE tax.
- Jill's 50% non-manager's interest is exempt from NIIT due to Jack's material participation.

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Which Entity Works Best for Income Tax Purposes

Income taxes

- Sole proprietors are subject to ordinary income tax on all farm earnings
  - Husband and wife are added together
  - Sole proprietors can make wage payments to kids
    - ◊ Deductible by Mom and Dad
    - ◊ Most likely tax-free to kids
    - ◊ Can put wages into Roth
    - ◊ Should file W2s
- Partners are taxed the same

How C Corporation Helps?

- Income on first $50,000 is taxed at 15% and usually lower state income tax rates
- For lower income farmers with families may allow for Earned Income Tax Credit
- Tax-free fringe benefits such as:
  – Meals
  – Lodging
- Timing
  – C Corporation can have any year-end
  – Allows extra deferral period (if needed)

Employer-Provided Meals

- Must be C corporation
  - Must meet employer/employee relationship
  - S Corporations are treated like partnerships
- Tax-free to Employee
- Meals furnished to employee, spouse and dependents
- For convenience of employer
- On business premises

Employer Provided Lodging

- Must be owned or rented by employer (C corp. only)
- Can deduct all costs including:
  – Interest and real estate taxes
  – Utilities and insurance
  – Furnishings (can't take Section 179)
  – Depreciation (bonus depreciation is allowed)
- Needs to be on the farm
- Documentation, documentation, documentation!!!!!

Creative Use of Lodging?!

- Shareholder owns land – leases to C corporation on a 20 year lease
- Corporation builds residence, takes 50% bonus depreciation, depreciates remainder over 20 years
- At end of 20 years, residence reverts back to shareholder
- Shareholder has zero basis in home, lives in it for at least two years and sells it tax free (up to $250/$500,000 gain) under Section 121

C Corporation Example

		C Corporation	
	Sole Prop.	Corp.	Owner
Income	$ 100,000	$ 70,000	$ 30,000
Less tax-free fringe benefits	-	(20,000)	-
Gross Income	100,000	50,000	30,000
Less S/D and 5 exemptions	(32,600)	-	(32,600)
Less SE deduction	(7,650)	-	-
Taxable income	59,750	50,000	(2,600)
Income Taxes	9,188	7,500	-
Self-employment taxes	15,300	-	-
Earned income tax credit	-	-	(4,728)
Total income and SE taxes	$ 24,488	$ 7,500	$ (4,728)
Net savings		21,716	

Does a S Corporation Help?

- Not really
  - Unable to achieve tax-free fringe benefits to shareholders
  - All income or loss flows through to shareholders
  - Primarily payroll tax savings
  - Issues with stock/debt basis
    - ◊ Especially for farm operations with large Section 179 deductions and debt on equipment purchases, etc.
- If ownership is split among family members, then some tax savings can result
  - Have to watch out for Kiddie Tax

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Which Entity Makes Sense for Operating Assets?

Smaller Operations

- For smaller operations with small children, it may make sense to use a C corporation due to:
  - Reduced payroll taxes
    - ◊ Commodity wages ($10,000 of cash wages)
  - Tax-free fringe benefits
  - Earned Income Tax Credit possibility
  - Fiscal year options

Medium & Larger Operations

- For medium and larger operations, my preference for entity selection is LLC due to:
  - Similar payroll tax savings to Corporation(s)
  - Flexibility in allocation of losses
  - Ease of transfer of assets in and out without tax cost
  - Step-up in basis in all assets owned by member at death
  - Legal protection same as corporation
  - Discounts for gift and estate tax planning
  - Ease of transfer of units to children and grandchildren

Machinery Options

- Machinery may be held in separate LLC entity:
  - Liability protection
    - ◊ Get Trucks and Trailers away from other assets
  - Flexibility in Section 179
    - ◊ Have to watch income limitations
  - Step-up of basis upon member's death
  - If your state has sales tax on machinery rents, then this is not a great option

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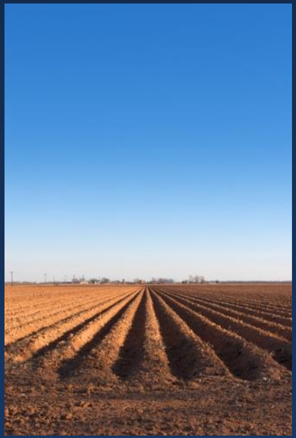
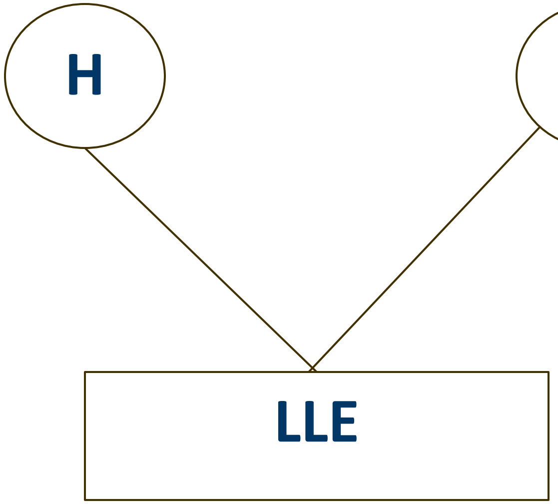
Does a Limited Liability Land Holding Entity Make Sense?



No Use of Entity

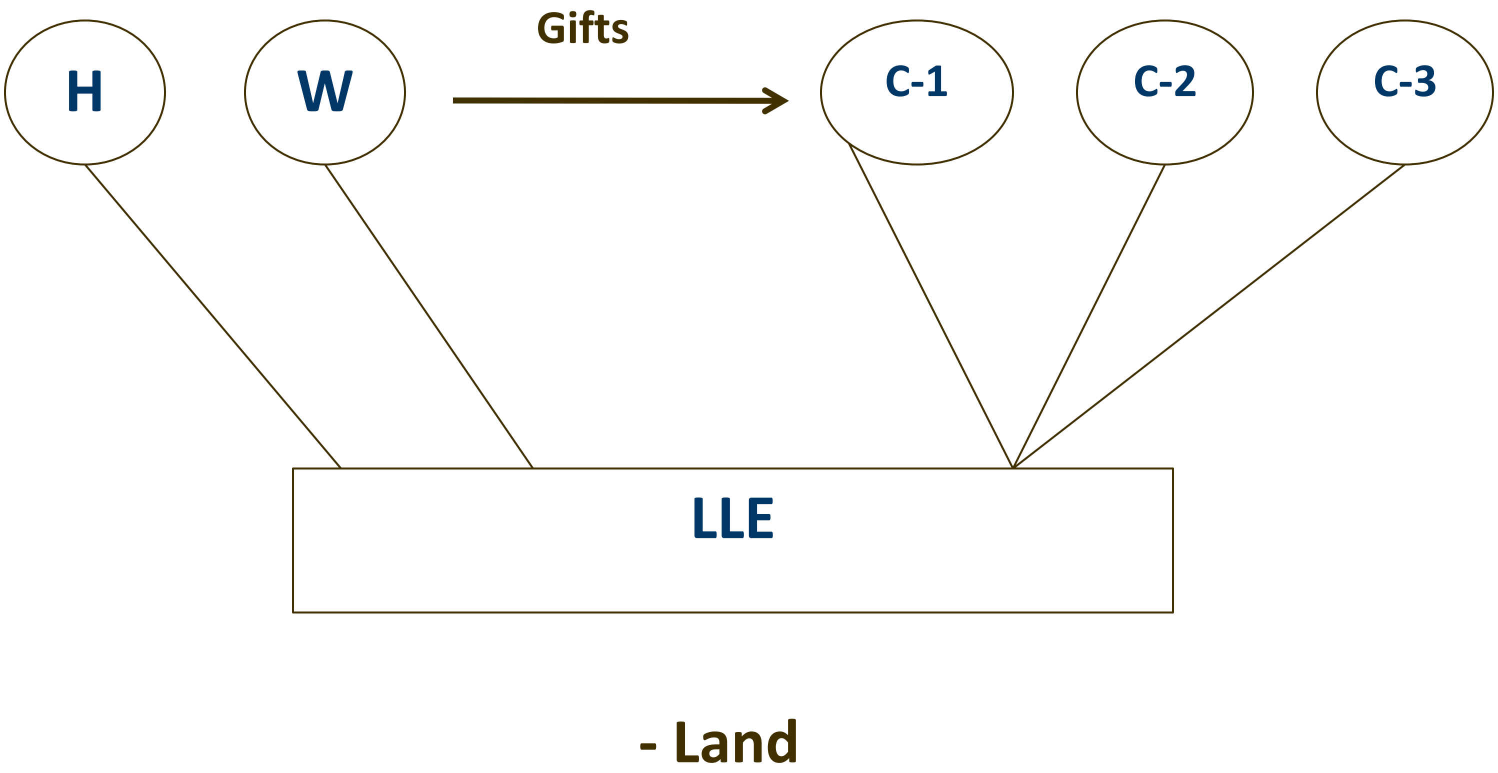
- Outright parcels to each child?
  - – Difficult to equalize values (quality of parcels)
  - – Greater production risks with fewer acres
  - – Centralized management impeded
  - – Spendthrift sale
- Undivided 1/3 interest to each child in each parcel?
  - – No mechanism for agreeing on lease terms
  - – No mechanism for agreeing on sale terms
  - – Possible partition issues

Limited Liability Entity (LLE) Illustration

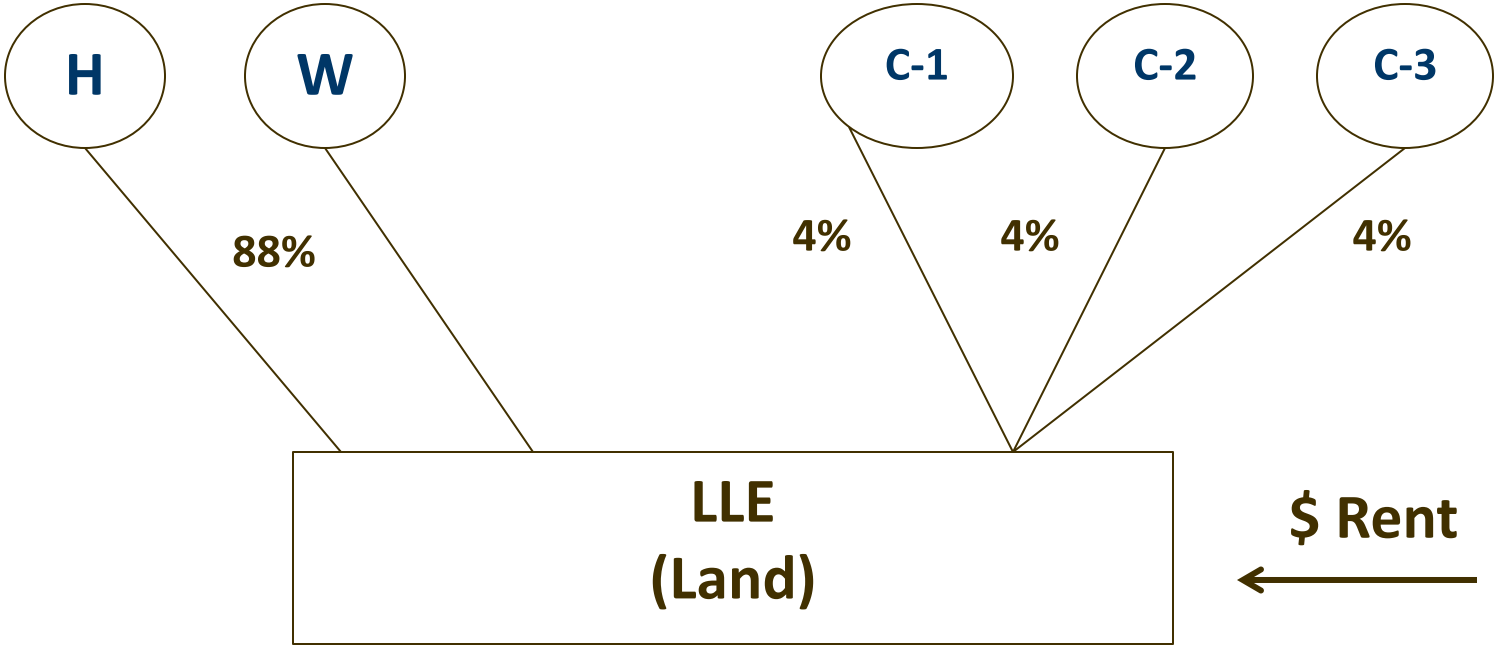


- Land

Limited Liability Entity (LLE) Illustration



Example 2: Limited Liability Entity



Cash distributions out of LLE allocated 88-4-4-4

LLE Advantages

- Facilitates gifts
  - Annual exclusion of $14,000
  - Discounts for minority and lack of marketability
- Most units non-voting (to allow management control to selected partners)
  - Centralized management
- Terms for buy-out of a member
  - Discount if early exit (e.g. 80%-90% of appraised value)
  - Specify pmt. terms (long term /low interest rate to preserve entity cash flow and to discourage exit)

LLE Advantages

- Include binding mediation/arbitration language if disputes arise
- Formation/design of LLE document should force family communication pre-death
  - Require each child to invest cash at formation to force legal and emotional buy-in to the operating doc.
  - 2nd generation part of negotiation of LLE terms
- Require super-majority to liquidate the partnership/distribute land

LLE Disadvantages

- Fees
  - Legal costs of document drafting/planning
  - Appraisal fee for land valuation
  - Appraisal fee for discount valuation
- IRS valuation disputes
- Annual partnership tax return
  - Separate checking account
- Proper allocations of any cash distributions each year

IRS Issues with LLEs

- Validity of marketability/minority discounts
  - Solution: Quality discount appraisal
- Retained income/distribution powers of senior generation and Sec. 2036 attack
  - Solution: Well-drafted LLE document
  - Solution: Bring 2nd gen. into voting/mgmt. group

    Example: 3 voting units: 1 Dad, 1 Mom, 1 Jr.
- Actual cash distributions to senior generation are excessive
  - Solution: Farmers must distribute pro-rata and have the tax advisor help reconcile annually

Tax Credits

Tax Credits

- A tax credit is much more valuable than a tax deduction
  - Offsets Tax Dollar for Dollar
  - Tax deduction times tax rate equals value
- Tax Credits for Farmers
  - Work Opportunity Tax Credit
  - Diesel and Gas Gallons consumed on farm
  - Various state tax credits
    - ◊ Can be more important than IRS credits

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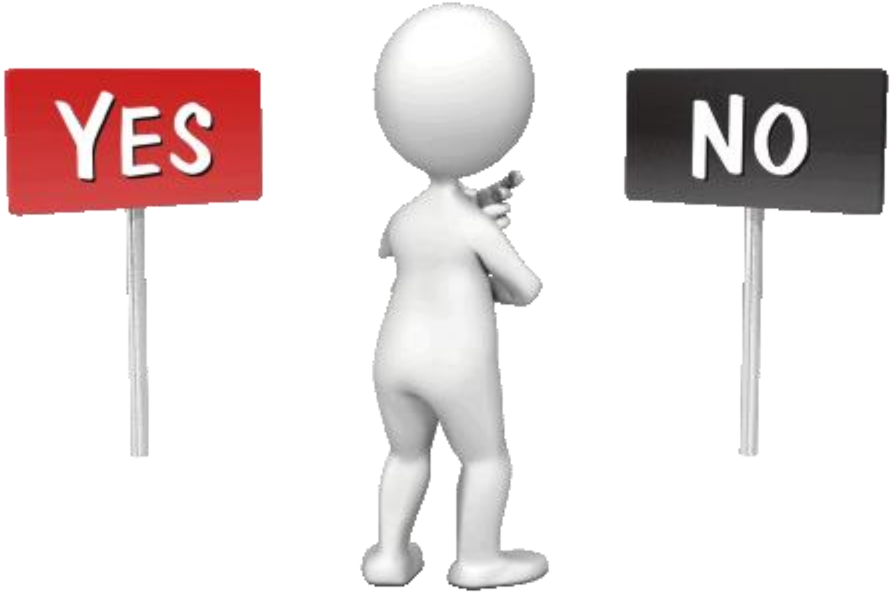
Major Tax Reform Issues for Farmers

Accrual Method of Accounting For Farmers

- Currently all farmers can use cash method of accounting
  - Exception for ______ with more than $___ million in sales
- Tax Reform Possibilities
  - Stay as is
  - Sole Proprietors OK
  - Under $10 million OK
  - Under $1 million OK

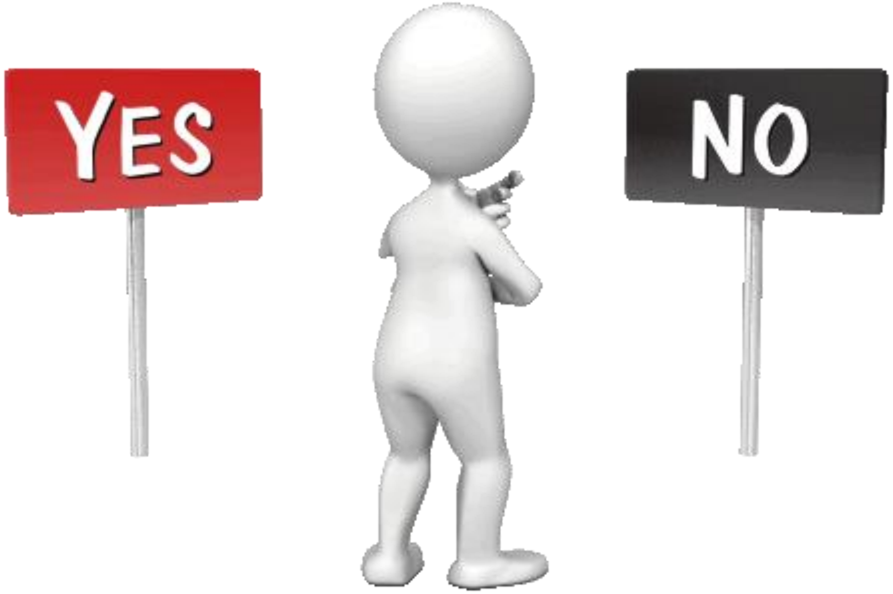
Will it Pass?



What Will Be the Top C Corp Tax Rate

- Currently 35% plus state rate
- Tax Reform:
  - 28%
  - 25%
- Timing
- Will Pass-through Entities have the same rate?

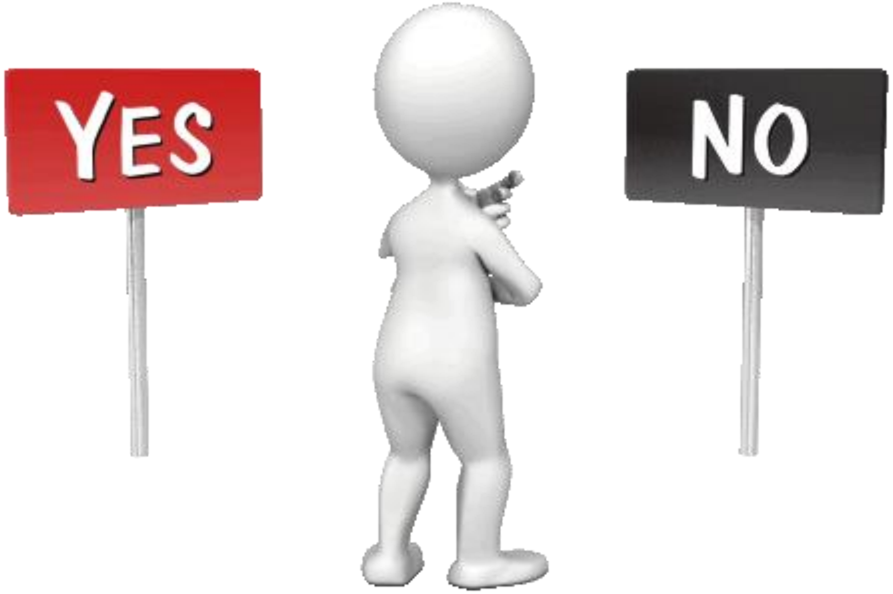
Will it Pass?



Section 179

- Current Law
  - 2014 - $500,000 (phase-out beginning at $2 million)
  - 2015 - $25,000 (phase-out beginning at $200,000)
- Tax Reform
  - Permanent at $1 million indexed to inflation (probably in $100,000 increments)

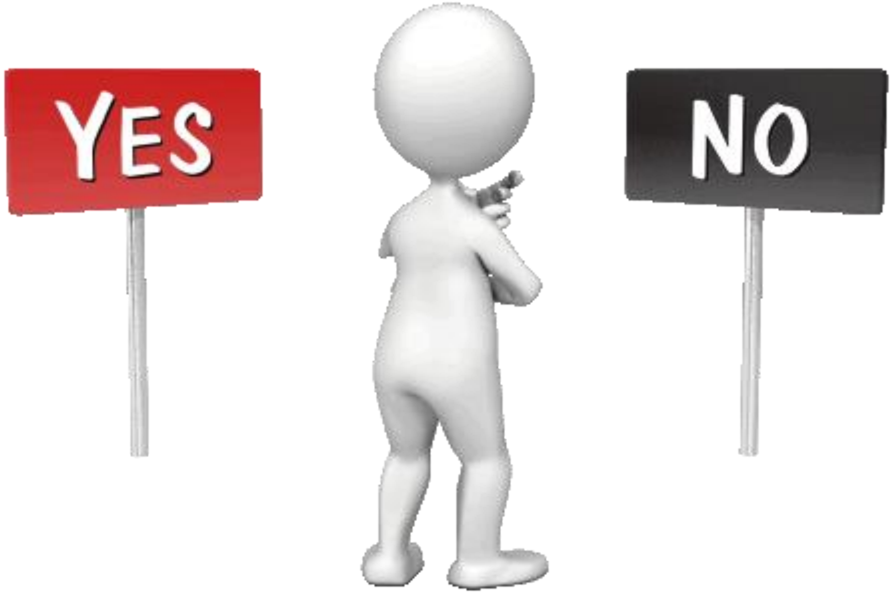
Will it Pass?



Building Depreciable Lives?

- Current Law
  - SPAS – 10 year straight-line
  - Ag Buildings – 20 year 150% db
- Tax Reform
  - Up to 40 years on all buildings including SPAS
  - May have to switch mid-stream
- Bonus Depreciation
  - May not be there

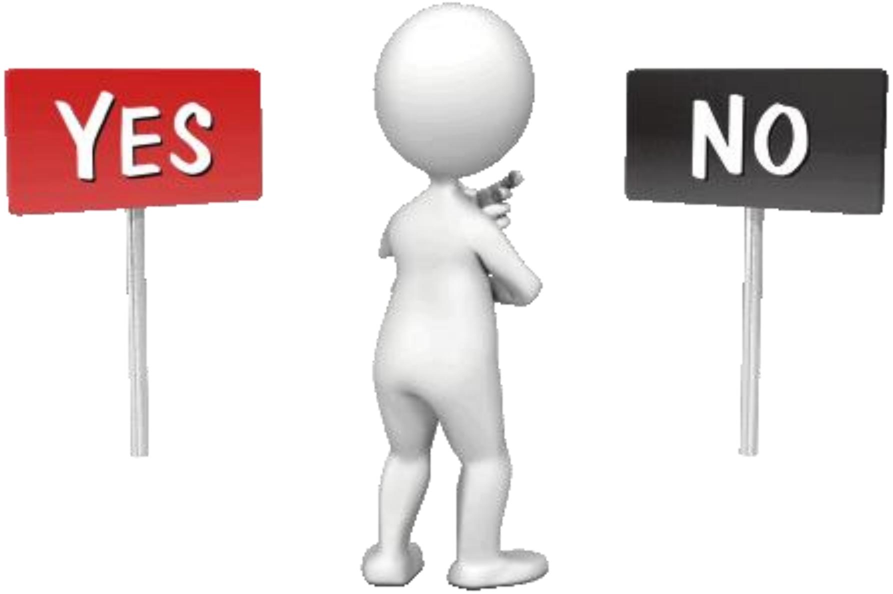
Will it Pass?



1031 Tax Deferred Exchanges?

- Current Law
  - Allowed to roll over gain on equipment, land, etc. into like-kind property
- Tax Reform
  - Limited Amount of Gain
  - Not allowed
  - Part of "fixed asset pooling" for farm machinery trade-ins

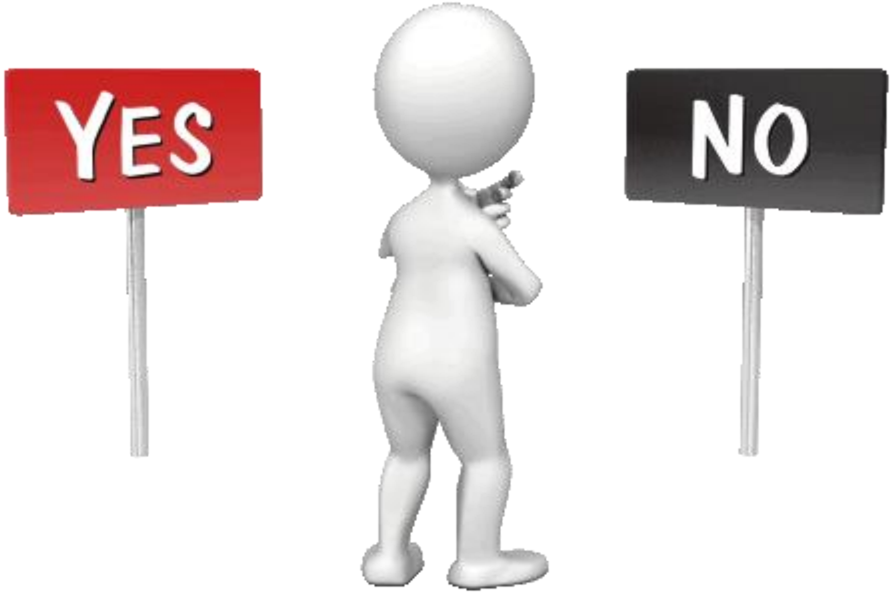
Will it Pass?



Deferred Payment Contracts

- Current law
  - Can defer sale of farm products to next year
  - Can elect to bring into current year
- Tax Reform
  - No longer allowed

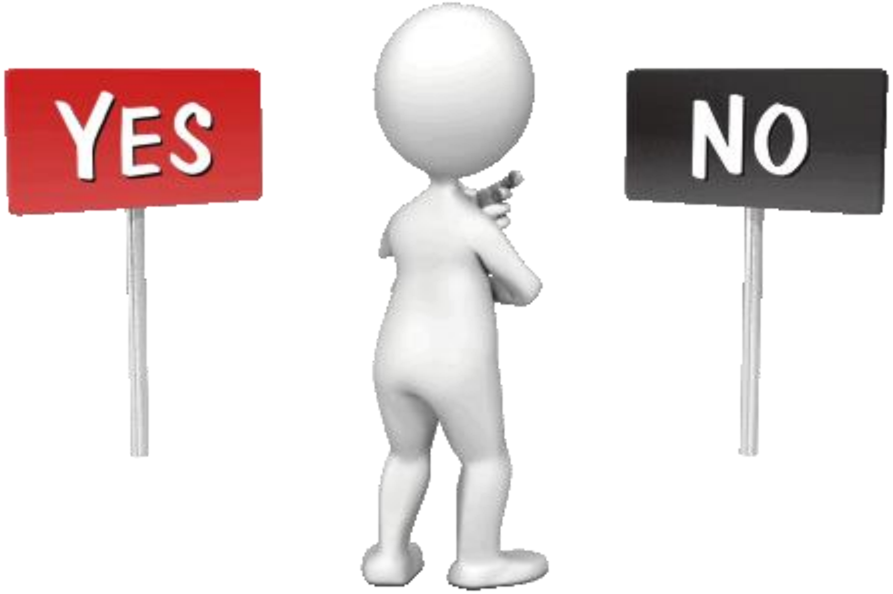
Will it Pass?



Prepaid Feed and Other Farm Expenses

- Current law
  - Can prepay feed and other farm expenses
    - ◊ Up to about 50% on annual basis
    - ◊ Must be payment for goods and feed, not a deposit
- Tax Reform
  - Likely curtailed or eliminated (accrual method)

Will it Pass?



Putting It All Together

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FSA Considerations

2014 Farm Bill

- AGI Limits
- Payment Limits
- Additional spousal limits
- Additional limits from Crop Sharing
- Entity Planning
  - CRP
  - Farm Programs

AGI Limits

- Old Farm Bill had three AGI limits
  - $500,000 non-farm income
  - $750,000 farm income
  - $1 million for conservation programs
- New Farm Bill replaces with one overall $900,000 limit for all programs
- Based on trailing three year average (2014 based on 2010-2012 average).
- S corporations and LLCs taxed as partnerships do not include Sch. K deductions (179)

Payment Limits

- Farm programs now have one $125,000 limit per entity/person
  - Entity level first, then to owners to four levels
  - Partnerships and joint-ventures have no limit
- CRP retains the old $50,000 limit
- EQIP and other conservation programs have various annual/total limits

Payment Limitation Illustration

Farm Entity Structure
General Partnership V. LL()

General Partnership	Totals	25.00% Owner 1	25.00% Owner 2	25.00% Owner 3	25.00% Owner 4
Total FSA Payment for entity	$ 500,000				
General Partnership	$ 500,000	$ 125,000	$ 125,000	$ 125,000	$ 125,000
Joint venture	$ 500,000	$ 125,000	$ 125,000	$ 125,000	$ 125,000
C corporation	$ 125,000	$ 31,250	$ 31,250	$ 31,250	$ 31,250
S corporation	$ 125,000	$ 31,250	$ 31,250	$ 31,250	$ 31,250
Limited partnership	$ 125,000	$ 31,250	$ 31,250	$ 31,250	$ 31,250
Limited liability company	$ 125,000	$ 31,250	$ 31,250	$ 31,250	$ 31,250
Limited liability partnership	$ 125,000	$ 31,250	$ 31,250	$ 31,250	$ 31,250
Limited limited liability partnership	$ 125,000	$ 31,250	$ 31,250	$ 31,250	$ 31,250

Attribution Limitation Illustration

		ABC LLC	DEF S Corp	XYX GP
Ownership %				
John		33.33%	50.00%	25.00%
Paul		33.33%	0.00%	50.00%
Jones		33.33%	50.00%	25.00%
Gross payment earned		$ 225,000.00	$ 300,000.00	$ 150,000.00
Payment allowed to be allocated		$ 125,000.00	$ 125,000.00	$ 150,000.00
Allocation of payment				
John	$ 141,667	$ 41,667	$ 62,500	$ 37,500
Paul	$ 116,666	$ 41,666	$ -	$ 75,000
Jones	$ 141,667	$ 41,667	$ 62,500	$ 37,500
Totals	$ 400,000	$ 125,000	$ 125,000	$ 150,000

John and Jones would have to give up $16,667 each allocated between ABC LLC and DEF S Corp

Additional Spousal Limits

- A spouse with ownership in farm ground, etc. is automatically allowed an additional $125,000 limit
  - Needs to be signed up with FSA
  - Has separate AGI calculations
  - Husband/Wife LL(E) has only one $125,000 limit
  - Single member LLC limits total payments to $125,000

Crop Sharing Options

- Crop-share landlords are considered producers and can share in payments
  - Farmer Entity is Tenant Farmer
  - Farmer (land holdings entity) is landlord
  - Results in additional limits

Crop-Share Limit Planning Illustration

	Cash Rent Farmer	50/50 Crop Share Farmer	50/50 Crop Share Landlord
Gross Payment	$ 250,000	$ 125,000	$ 125,000
Payment Allowed	$ 125,000	$ 125,000	$ 125,000

Assumptions:

Farmer is an entity (S corp, LLC, etc) owned 50/50 by husband & wife

Landlord is LLC owned 50/50 by husband and wife

Entity Planning

- CRP
  - For married couples, need to maintain joint ownership to maximize $100,000 limit (2 $50,000 limits)
- Farm Programs
  - If operation is fairly small, then about any entity will work
  - If medium or larger size operation, need to maintain partnership or joint venture structure

Medium/Large Operation Example

- Partnership structure for farm operating entity
  - Each partner may be single member LLC to preserve liability protection
  - To maximize SE tax savings may have two husband/wife LLCs as partners (creates two more tax returns)
  - Or use corporations and commodity wages
- Utilize crop-share arrangement to create additional limit(s) if needed
- Be careful of attribution of limits

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Dealing with Land Trapped in a C Corporation

C Corp. with Land Inside: No Successor

- Liquidate grain/livestock inventory & equip. as a C corp.
  - Use C corp. lower tax rates
  - Possible offsetting compensation deductions for past underpaid services to employee-shareholders?
  - Qualified retirement plan funding
  - Two or three year process?

C Corp. with Land Inside: No Successor

- Convert to S corporate status after disposition of all operating assets
  - S corp. holds land only; becomes landlord entity
  - Net rent income flows through to corp. owners
  - But S corp. must be "active" (crop share rents) <u>or</u> pay out its prior C corp. earnings as a dividend to avoid Sec. 1375 excess passive gross receipts tax

S Corp. with Land in Rental Status

- Sec. 1375 imposes a 35% corp. tax if have C corp. AE&P <u>and</u> passive gross receipts (rent)

<u>Solutions:</u>

- Active rental business: Provide significant services or incur substantial costs as landlord
  – Crop share <u>may</u> achieve this <u>OR</u>
- Distribute former C corp. AE&P as a dividend
  – Use deemed dividend election

S Corp. with Land in Rental Status

- Deemed dividend election by S corp. with old C corp. AE&P:
  - Elect to treat current distributions as not from AAA but from AE&P
  - Elect to distribute some or all of C corp. AE&P as a deemed dividend

C Corp. with Land Inside: No Successor

	C Corporation	S Corporation
Fair market value of land	$10,000,000	$10,000,000
Cost basis	$500,000	$500,000
Net Gain	$9,500,000	$9,500,000
Income tax (combined 43% federal & state)	$4,085,000	N/A
Basis in stock	$10,000,000	$19,500,000
Gain/(loss) on liquidation	($4,085,000)	$(9,500,000)
Net gain (gain from sale of land less liquid.)	($4,085,000)	Zero
How many years to use up loss @ $3,000/yr	1,362	Zero

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Interest-Charged Domestic International Sales Corporation

IC-DISC (Interest Charged-Domestic International Sales Corporation)

- No, it is not a Frisbee
- If you have more than $1 million of direct foreign exports
- Commission paid by farm is deductible
- Commission income to IC-DISC is tax-free
- Dividend to farmer is taxed at lower rate
- Permanent 20-25% savings per year
- Allows payments to next generation at 20% rate, while current generation gets full ordinary deduction

IC-DISC (continued)

- Commission is greater of
  - 4% of total export sales
  - 50% of net foreign income
- Costs
  - $3-5,000 to set up
  - $2-3,000 annual
- Tax savings are permanent
- Owner of IC-DISC can be kids, grandkids

IC-DISC Example

	Maximum Tax %	15% & 25% Tax
Foreign sales (non GMO soybeans)	$4,000,000	$4,000,000
Commission allowed	$160,000	$160,000
Tax on commission (23.8% & part zero &15%)	$38,080	$12,750
Tax savings on deduction	$63,360	$32,500
Self-employment taxes saved	$6,080	$19,335
Total tax savings	69,440	$51,835
Net tax savings	$31,360	$39,085

DPAD and Cooperatives

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DPAD

- Domestic Production Activities Deduction
  - Based on Net Farm Income
  - Deduction equal to
    - ◊ 9% of net farm income (with certain adjustments), or
    - ◊ 50% of cash wages, whichever is smallest
  - Cooperatives may report grain sales as Per Unit Retains on Form 1099-PATR
  - If so, farmer must reduce their DPAD by the percentage of grain sales reported on Form 1099-PATR
  - Matching issue with IRS if done incorrectly
  - Coop may pass through DPAD deduction which is allowed even if no farm wages

Farm DPAD Deduction Example

Item	No PUR-PIM	PUR-PIM
Farms sales	1,500,000	750,000
Grain sales to Coop	-	750,000
Total Sales	1,500,000	1,500,000
Expenses allowed	1,200,000	600,000
Net	300,000	150,000
Times 9%	27,000	13,500
DPAD flow through	-	3,500
Total Maximum DPAD Deduction	27,000	17,000

Note, calculated farm deduction may be limited to 50% of cash wages, the $3,500 DPAD deduction flowing through from Coop is allowed in full, no matter the amount of actual farm cash wages.

Questions?

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