

ARE YOU A MANUFACTURER? THE ANSWER MAY SURPRISE YOU

By Toni Porter, CPA, MST, AEP

Generally, if someone told an ag producer that Internal Revenue Code Section 199 manufacturing tax deduction was passed recently, it would be easy for them to assume that it did not apply to them and the conversation could quickly turn from this to a topic that was nearer and dearer to their hearts, like annual crop production. For this new law, we must reconsider the definition of manufacturing as it is commonly used.

The massive tax law passed in 2004, the American Jobs Creation Act, continues to work its way into the lives of many businesses as its provisions become effective and the IRS issues interpretative rules and regulations to govern its details. One of the major new business tax breaks in this category is the generous deductions allowed to *domestic manufacturers*. For 2005-2006, the deduction (commonly called the "manufacturing" deduction) equals 3 percent of the lesser of qualified production activities income, taxable income, or 50% of Form W-2 wages actually paid by the taxpayer. The percentage rises to 6 percent in 2007-2009 and finally to a hefty 9 percent in 2010 and thereafter.

The domestic production activities deduction, as it is formally called in the Internal Revenue Code, is broad reaching and covers considerably more than what is traditionally considered "manufacturing." For example, construction, engineering or architectural services, film production and *agricultural production* are all entitled to a share of the deduction as well as the manufacture of products.

The all-important computation. Qualified production activities income must be determined on an item-by-item basis, rather than on a transactional, divisional or product line basis. "Qualified production activities in-

come" in turn is equal to the domestic production gross receipts, reduced by the sum of:

1. the costs of goods sold that are allocable to such receipts; and
2. other deductions, expenses, or losses that are directly and indirectly allocable to such receipts.

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The portion of total receipts that are domestic production gross receipts must be determined. The method used to determine these receipts must be reasonable and accurately identify gross receipts derived from:

1. any lease, rental, license, sale, exchange or other disposition of qualifying production property which was manufactured, produced, grown or extracted in whole or in significant part within the U.S., any qualified film, software or sound recording produced, or electricity, natural gas or potable water produced in the U.S.;
2. construction performed in the U.S.; or
3. engineering or architectural services performed in the U.S. for construction projects located in the United States.

The IRS will consider a number of factors in determining whether or not your method of allocating these receipts and nonqualifying receipts is reasonable, including whether the

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most accurate information available is used, and the time, burden and cost of using other methods.

The guidelines generally provide that gross receipts derived from the performance of services (except for engineering or architectural services) are not qualifying receipts. However, gross receipts from a qualified warranty and a de minimis amount of gross receipts from embedded services for each item of property (in the case of a lease, rental, license, sale, exchange, or other disposition) may be included in domestic production gross receipts.

A safe harbor is provided for taxpayer-employers whose gross receipts are primarily domestic production gross receipts. If less than 5 percent of their gross receipts are from non-qualifying receipts, then they are not required to allocate gross receipts.

The guidelines also clarify the definitions of “gross receipts,” “manufactured, produced, grown or extracted,” “by the taxpayer,” “in whole or significant part,” “United States,” and “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property.”

It’s all about U.S. jobs. The deduction is limited to the lesser of the applicable percentage of qualified production activities income (QPAI) or domestic production gross receipts (DPGR) less cost of goods sold and other allocable expenses or 50 percent of the W-2 wages paid by the producer as an employer during the tax year. Underlying the justification for the manufacturing deduction is not to reward the manufacture of any particular product but rather to keep and increase U.S.-based jobs. Therefore, if the manufacturing process is so mechanized that your labor costs are minimal, the producer won’t be able to claim the full percentage otherwise allowed for the deduction.

“W-2 wages” are defined as the sum of the wages and elective deferrals that must be reported on Forms W-2, Wage and Tax Statement, with respect to the employment of employees during the calendar year ending during your tax year. The new guidelines provide three methods for computing W-2 wages that offer manufacturers in certain industries a welcomed degree of flexibility.

Special rules for partners and S corp shareholders. If the business entity in which the qualified domestic production activity takes place is a partnership or an S corporation, special pass-through rules apply. The deduction is determined at the partner or shareholder level in the case of a partnership or S corporation. Items attributable to the qualifying production activities of the partnership or S corporation pass through to the partner or shareholder according to the economic arrangement of the owners. It is the responsibility of each individual partner or shareholder to aggregate items allocable to the pass-through entity’s qualified production activities, expenses directly incurred by the partner or shareholder that are allocable to the pass-through entity’s qualified production activities, and items allocable to the partner’s or shareholder’s other qualified production activities.

Payments to independent contractors and self-employment income, including guaranteed payments to partners, are not included in determining W-2 wages for the purpose of the limitation on the deduction. In addition, an owner of a pass-through entity need not be engaged directly in the entity’s trade or business in order to claim the deduction.

This deduction applies to the tax years of pass-through entities beginning after December 31, 2004. For example, if a pass-through entity has a tax year end of June 30, the deduction first applies to its tax year beginning July 1, 2005. The deduction for this entity is not available to a calendar year taxpayer-owner until 2006.

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The proposed regulations provide additional guidance on the three methods of allocating income and deductions for computing QPAI. Because of the complexity of these provisions and of the W-2 limitations on the deduction, it is important to understand the specific effect of this deduction on a business.

Special rules for agriculture. The calculation of the domestic production activities deduction by taxpayers involved in agriculture and horticulture was one such industry explicitly addressed in the proposed regulations. Specifically, rules have been provided for agricultural and horticultural cooperatives. These rules address the definition of qualified activities eligible for the deduction, the patron notice requirement, accounting for the deduction at the cooperative level, the election by the cooperative to pass-through the deduction, and the wage limitation from the cooperative to the patron. As these rules are complex, it is important that producers are alerted to the rules' existence so they benefit from the deduction based not only on their direct sales but also those that are handled by cooperatives.

For businesses involved in agriculture or horticulture, these proposed regulations will assist in determining the qualification for the domestic production activities deduction. The proposed regulations are effective for tax years beginning after December 31, 2004, and are intended to be used by taxpayers for their 2005 tax returns. Therefore, the information provided in the proposed regulations and the corrections to Section 199 provided in the Gulf Opportunity Zone Act (GO Zone Act) of 2005, which may be relied upon until the final regulations are issued in 2006, may be beneficial for the 2005 tax year and thereafter.

If you have any questions about how this deduction applies to you, or about the computations under the recently-issued IRS guidance, please contact our office at (559) 432-2346.

STAFF NEWS

Darla Weiser, CPA, has recently joined BP&F as a Tax Manager. Darla has 26 years of experience in public accounting in the Fresno area, including 17 years as a self-employed CPA. She specializes in taxation, specifically in the area of small to medium size businesses including various ag industries (from grower and producer to distributor). Darla is a Fresno State graduate with a degree in business and an emphasis in accounting. She is currently pursuing a second degree in Plant Science, and is a member of the American Agricultural Economics Association, the California Society of CPAs and the AICPA.

BP&F is pleased to announce the hiring of three staff accountants—Jennifer Brandon, Lisa Graham and Jennifer Vogt. Jennifer Brandon graduated in May from Fresno State with a degree in Business Administration and an emphasis in accounting. Jennifer was active in Beta Alpha Psi and served as the VP of Programs. Lisa Graham graduated from Fresno State in December with a degree in Business Administration and an emphasis in accounting. Lisa was also active in Beta Alpha Psi, serving as Past President and the Database Committee Chair. Jennifer Vogt graduated from Fresno State in December with a degree in Business Administration and an emphasis in accounting. While at Fresno State, Jennifer was active in IMA (Institute of Management Accountants).



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WHAT IS YOUR BUSINESS WORTH?

By Nancy Ervin, MBA, AVA

The value of a business depends largely on your pool of potential buyers.

If you own a business or farm, there will come a time someday when you (or your estate) will need to know the value of that enterprise. There are a variety of events that can trigger the need for a business valuation: gifting, selling your business, divorce, liquidation or eventually, estate tax.

The question is—do you have any idea what your business is really worth? The answer is—it depends.

It depends largely on the underlying purpose of the valuation. If you are selling your custom farming business to another grower, it will be worth more than if you are valuing a minority interest for gifting purposes. Why? Some might believe it's because of the "magic" of discounting. Of course, we all know that the IRS doesn't believe in magic, so it's important to understand not only how a business is valued, but why.

Value to whom?

The value of a business depends largely on your pool of potential buyers. This is defined as the Standard of Value. In some cases, the standard could be legally mandated, such as in IRS cases. Or, the standard could be a function of the parties involved in the actual transaction. Following is summary of several different Standards of Value:

- Fair Market Value – Assumes hypothetical persons dealing at arm's length and is the standard required by most US Regulatory services. Fair Market Value is defined as "the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."¹

- Investment Value – Defined as the value to a particular investor based on his or her investment requirements, perceived synergy or other strategic advantage and aversion to risk.²
- Intrinsic Value – A concept of value commonly used by an analyst in evaluating a publicly held security. For example, if a stock is trading on the NYSE at \$30 per share, and a security analyst says, "I believe it is worth \$40 per share based upon my fundamental analysis," the \$30 is fair market value, and the \$40 is that analyst's estimate of intrinsic value.
- Fair Value – No consensus on definition, but is the statutory standard of value applicable in the US in cases of dissenting stockholders' appraisal rights.

Value under what circumstances?

Value can also be influenced by the underlying circumstances or "premise of value." First we must determine if circumstances require us to value a control or minority interest. Then we must ask—are we valuing the business as a going-concern or do we want to know the liquidation value? This question is particularly relevant to valuing farming companies which may have very low earnings but high asset values. Properly defining the Premise of Value can have a huge impact on the outcome of appraisal.

Example 1:

Let's say you own an 85% interest in a partnership that owns 1,200 acres of wine grapes that currently appraise for \$4,500 per acre. The Partnership rents the land to another grower for about \$350 per acre. You want to sell your interest to the grower. What would be the standard and premise of value?

- Investment value



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- Controlling interest
- Ongoing or liquidation value (whichever is higher)

Depending on other relevant issues, the appraised value of the enterprise could be between \$4 million and \$6 million. Why? The land is worth more than the cash flow it is currently generating. However, to a majority owner who can either continue to farm the property as usual, change operations, or sell off assets, the value of the enterprise will be mostly driven by the value of the underlying assets.

Example 2:

Now let's say you want to gift 10% interest in the same Partnership. What would be the standard and premise of value?

- Fair market value
- Minority interest
- On-going concern

Depending on other relevant issues, the appraised value of the enterprise could be between \$1 million and \$2 million. Why? Because Fair Market Value requires us to assume that it is a hypothetical buyer, meaning it could be someone who knows nothing about farming, they are only buying a minority interest, they have no access to assets, they can't force liquidation, and they are relying on management to earn a profit on their investment. Therefore, the value of the enterprise will be driven by ongoing cash flow and associated risks.

If you are interested in finding out more about business valuations and how they can affect your long-term strategic planning, please call (559) 432-2346.

¹ Revenue Ruling 59-60: 1959-1, Congressional Bulletin 237.

² The Institute of Business Appraisers, Business Appraisal Workshop (R-11/99) #8001.

TAX TIDBITS

By Dennis Veeh, CPA

Constructive receipt of income by a cash basis farmer from the sale of his crops can create unexpected results. Income is constructively received when it is:

1. Credited to the farmer's account
2. Set apart for the farmer
3. Made available so the farmer could have drawn on it, or
4. Could have been received if notice of intent to receive it had been given

Constructive receipt of crop proceeds can be avoided if the farmer's control of its receipt is subject to substantial limitations or restrictions.

Where a bona fide contract exists, deferring crop proceeds to the year subsequent to sale, the courts, and more recently the IRS, have not deemed income to be constructively received in the year of sale.

Care should be taken in drafting deferred payment contracts so as to avoid constructive receipt. The contract should be executed well in advance of the farmer having the right to receive any proceeds and should include language that indicates the contract is non-signable and nontransferable.

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SUGGESTED RETENTION SCHEDULE FOR BUSINESS RECORDS

An agricultural business handles a tremendous volume of records. Whether you use a simple filing system or sophisticated electronic equipment to record your data, the basic problems remain—what records do you need, why do you need them, and how long should you keep them?

The following checklist is designed to help you determine what records to keep and how long to keep them. These time periods represent a consensus and are not absolutes to be followed without question.

4 to 5 years

Bills of material
Bond, paid-interest coupons
Cash slips
Claims, closed by company
Correspondence, general
Customer account records, closed
Delivery receipts
Freight bills
Inspection records
Manifests
Petty cash records
Purchase orders
Receiving reports
Remittance statements
Requisitions
Sales slips
Service reports
Shipping tickets
Time cards

5 to 6 years

Complaint records
Correspondence: license, purchase and traffic
Credit memos
Employees' daily time reports
Monthly trial balance
Price exceptions and adjustments
Safety reports

7 to 8 years

Accounts, charged off
Bank deposit slips
Bank statements
Bonds, cancelled
Cancelled checks
Claims, closed against company
Commission statements
Cost account records
Credit files
Employee records (terminated)
Entertainment records
Expense reports, employees
Inventory records
Invoices, copy of order
Invoices, paid
Payroll
Purchase orders for capital expenditures
Sales sheets
Specification sheets

8 to 9 years

Agreements, leases (after expiration)
Salary and rate changes
Vouchers, cash
Vouchers, numeric copy

9 to 10 years

Voucher, A-Z copy
Voucher register

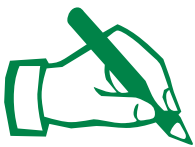
10 years

Claims, workers' compensation
Employee tax withholding statements
Insurance claims (after settlement)
Vouchers, capital

17 years

Agreements, licenses

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2006 COMMUNITY SALUTE TO HONOR JACK WOOLF, WESTSIDE PIONEER

For more than 30 years, Jack Woolf and his family have been an integral part of the development of diversified agriculture on the westside of Fresno County. He also has been an active fixture in helping make the communities of Fresno County and the agricultural industry a better place through his service on numerous boards of organizations and associations.

It is only fitting that Woolf has been selected to be recognized as the 2006 Community Salute honoree by the Ag One Foundation. The special event is slated for Friday, May 12 at the Fresno Convention Center, New Exhibit Hall.

A native of Arizona, Woolf has almost a lifetime of involvement in the cotton industry, having started out working for the Anderson Clayton Corp., after serving in World War II. That involvement led him to Russell Giffen, who brought Woolf to the westside to work for the large farming operation.

In the 1970s, as the breakup of larger landholdings occurred on the westside, Woolf began to farm on his own. Today, Woolf and his family oversee a diversified farming enterprise that includes tomatoes, garlic, cotton, wheat, wine grapes, almonds and pistachios. In addition, he is involved in the Harris Woolf California Almond processing plant, Huron Ginning Company, Woolf Nursery, and Los Gatos Tomato Products.

The Community Salute will recognize Woolf for his many accomplishments. Proceeds from the event will be used to benefit students pursuing a degree in the College of Agricultural Sciences and Technology.

There are several sponsorship opportunities available at \$5,000, \$2,500, \$1,000, and \$500. Tables of ten will be available for \$1,000 and individual tickets for \$100. Contact the Ag One office at (559) 278-4266.

Suggested Retention Schedule – continued

Permanent

Accident reports
Agreements, deeds
Applications filed with regulatory agencies
Contracts and leases
Corporate stock records
Engineering & research projects
Financial statements
Insurance policies, all types
Labor contract and collective bargaining records
Ledgers and journals: cash, general, customer journal, payroll, plant, etc.
Minutes: executive, directors and stockholders
Patents, records and assignments
Pension records
Plant surveys
Proxies
Real estate records
Tax and legal correspondence
Taxes: audit reports
Taxes: federal, state, property, sales and use

Other

Certificates of insurance – Period of coverage, plus 4 years
Depreciation schedules – Life of asset, plus 4 years
Insurance claims – 3 to 5 years after settlement

Source: *Ag Executive*, 2005



CALENDAR

- March 15** Due date for tax returns of calendar year-end corporations.
- March 30** Ag One, Stanislaus County Alumni & Friends Dinner, Durrer's Barn, Modesto. For further information contact Christy Melvold at (559) 278-4266.
- April 7** 10th Annual Common Threads workshop and luncheon, California State University, Fresno. For further information contact Christy Melvold at (559) 278-4266.
- April 17** Due date for individual tax returns.
- April 18** Tax holiday. Baker, Peterson & Franklin office will be closed.
- May 5** 35th Annual Ag One Turf Day Golf Classic, Madera Golf and Country Club. For further information contact Christy Melvold at (559) 278-4266.
- May 12** Ag One Foundation's Community Salute honoring Jack Woolf, Fresno Convention Center. For further information contact Christy Melvold at (559) 278-4266.
- May 19-21** 10th Annual Anderson Valley Pinot Noir Festival, Philo, CA. For information call (707) 895-WINE.
- May 19-21** Paso Robles Wine Festival. For information call (805) 239-8463.
- May 29** Memorial Day. Baker, Peterson & Franklin office will be closed.

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