

YEAR-END PLANNING, STRATEGIES AND NEW LAWS AFFECTING THE AGRICULTURAL INDUSTRY

By Toni Porter, CPA, MST, AEP

Congress has passed a number of major tax bills in recent years. The recent changes in Section 179 expensing have almost eliminated many farmers' need to pay any federal income tax, assuming they are making capital purchases. However, reducing income tax liability may not be sufficient reason to make additional investments in depreciable assets. In addition, eliminating one's tax liability for this year is not necessarily good tax planning. Good tax planning should seek to maximize after-tax wealth over time, not to minimize taxes paid in a particular year. With the changes that are occurring, farmers may need to update their tax planning techniques.

RECENT TAX LAW CHANGES AFFECTING BUSINESSES

Domestic Production Activities Deduction

Recent law provided a new income tax deduction (Section 199) for taxpayers involved in domestic production activities. This provision is intended to create incentives for greater employment in the U.S. economy. Crops and livestock produced in the U.S. do qualify as domestic production activities. Although the deduction is limited to 3 percent of the qualifying income for tax years beginning in 2005 and 2006, it increases to 6 percent for tax years beginning in 2007, 2008, and 2009. It further increases to 9 percent for tax years beginning after 2009. The domestic production activities deduction was discussed in a recent issue of AgriViews.

Depreciation and Section 179 Expensing

Section 179

Farmers and others in an active trade or business could elect under Section 179 to treat the cost of up to \$105,000 of qualifying property purchased during 2005 as an expense (rather

than as a depreciable capital expenditure). Because of the indexing for inflation, the limit on the Section 179 expensing is increased to \$108,000 for 2006. In 2008, the Section 179 limit was scheduled to revert to \$25,000. A law passed in 2006 allows the enhanced expense method depreciation amount under Section 179 (presently \$108,000) to remain in place through 2009 (instead of ending after 2007). The Section 179 expensing election can

Reducing income tax liability may not be sufficient reason to make additional investments in depreciable assets.

be made after the close of the tax year when completing the return or on an amended return. For 2005 and later, taxpayers no longer have the 30 percent and 50 percent additional first-year depreciation alternatives available. These provisions expired at the end of 2004 and were not extended. However, because of Section 179 expensing, farmers have considerable flexibility in managing their deductions and taxable income.

Section 179 expensing can be used for tangible personal property used in a trade or business. Farm machinery and equipment; livestock used for draft, breeding, or dairy purposes; grain storage; and single purpose livestock/horticultural structures all qualify for Section 179 expensing. General-purpose farm buildings, such as machinery sheds or hay barns, are not eligible for Section 179 expensing. Either new or used purchased property can be expensed under Section 179. Property previously used by the purchaser, inherited property or property acquired from a spouse, ancestors, or lineal descendants

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is not eligible for Section 179 expensing. On like-kind exchanges (swaps or trades), only the boot portion paid is eligible for expensing.

The entire Section 179 expensing election can be taken on one large item or on several small items in the year of purchase. Less than the full expensing election can also be claimed. The amounts expensed are treated the same as depreciation when the property is sold or traded and for depreciation recapture purposes. Generally, it will be more advantageous to allocate the expensing deduction to longer lived assets and to assets that are likely to be kept in the business for their entire depreciable life. The expensing election is phased out on a dollar-for-dollar basis if over \$420,000 of qualified property is placed in service during 2005 (\$430,000 in 2006). Only the boot portion on like-kind trades is considered for the \$420,000 limit.

The expensing deduction is limited to the taxable income from any active trade or business before any Section 179 expensing. A farmer's and/or spouse's off-farm wage or business income can be combined with a farm loss so that aggregate taxable income would be positive. Gain or loss from the sale of livestock, machinery, and other business assets is also included in taxable income for purposes of applying this taxable income limitation. Suspended losses from passive activities are not considered in determining the taxable income limit.

Current law provides greater flexibility with respect to late Section 179 elections and changes in Section 179 elections. Originally, Section 179 elections could be made only on the original return for the year and could not be changed on an amended return. Thus, if a return was audited and a change proposed, the taxpayer could not make or change the Section 179 election. Currently, a taxpayer may change, make, or revoke (one time per asset) a Section 179 election by the extended due date of the return or by filing an amended return for

tax years beginning after 2002 and before 2008.

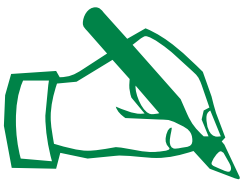
Final Quarter Limitation and Mid-Quarter Convention

The depreciation regulations generally allow one-half year's depreciation in the year of acquisition and one-half year's depreciation in the year of disposition. A special limitation on regular depreciation applies if more than 40 percent of the total depreciable bases of property acquired in a tax year is placed in service during the last three months of the year. Nonresidential real property and residential real property are excluded from this calculation. This final quarter limitation affects all assets acquired during the tax year and may substantially reduce the amount of depreciation allowed, especially on end-of-the-year purchases. The final quarter limitation is computed after the Section 179 expensing is applied. Whether Section 179 expensing is elected, which assets are selected for expensing, and whether the entire \$108,000 allowance for 2006 is used may have a considerable impact on the depreciation for the year. It may be possible to avoid application of the limitation by electing to apply Section 179 expensing to depreciable assets acquired in the final quarter of the year.

Alternative Depreciation Methods

Producers have considerable initial flexibility with respect to depreciation. Once a producer begins depreciating an asset using a particular method, that method must be continued for the life of the asset. However, decisions with respect to methods can be made when the asset is placed in service. Using some of the Section 179 expensing can result in much or all of the cost recovered in the year of purchase. For a 7-year asset depreciated under regular MACRS, nearly 60 percent of cost recovery occurs within the first four years. In contrast, with alternative MACRS (10 years), 65 percent of cost recovery is left after four years. It is impor-

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NATIONAL RAISIN COMPANY IS 2006 AG BUSINESS AWARD RECIPIENT

Baker, Peterson & Franklin, Certified Public Accountants, is pleased to announce the recipient of the 2006 BP&F Ag Business Award is National Raisin Company of Fowler.

National Raisin Company exemplifies a leading for-profit ag organization whose achievements and impact have significantly contributed to the ag industry and the Central Valley. The Baker, Peterson & Franklin Ag Business Award honors a for-profit service or product-related agribusiness or farming entity headquartered in the Central San Joaquin Valley. The award recipient is selected by a committee representing the local agribusiness industry and the BP&F Ag Department. The past ten recipients are Ballantine Produce Company of Sanger, Woolf Enterprises of Fresno, Producers Dairy Foods of Fresno, P-R Farms of Clovis, J&L Vineyards of Fresno, Fowler Packing Company, Joseph Gallo Farms of Atwater, Wawona Frozen Foods of Clovis, Wilbur-Ellis Western Division, and Zacky Farms of Fresno.

Over the last 37 years, brothers Ernest, Krikor and Kenneth Bedrosian have built National Raisin Company into one of the largest in-



dependent raisin processors in the industry. Starting as a humble farming business with a few employees, the company has grown into an operation with several hundred employees and substantial acreage in Fresno and Tulare counties.

Their 60-acre, state-of-the-art facility is lo-

cated in the heart of the fertile San Joaquin Valley and processes 50,000 – 60,000 tons of raisins annually. A 92,000-square-foot expansion for processing and cold storage is currently underway. National Raisin Company has consistently invested in innovation to lead the industry with superior farm practices, the most technologically advanced equipment, and food safety systems to supply the highest quality dried fruit today. They developed and introduced the poly paper tray, revolutionizing the sun-drying process and significantly reducing mold. The poly paper tray is now used throughout the raisin industry.



National Raisin Company President, Ernest Bedrosian (left), accepting 2006 Ag Business Award from Dennis Veeh, Ag Partner at Baker, Peterson & Franklin, CPA.

Their raisins are “Laser Kleen” to ensure they are “The World’s Cleanest Raisins” —100% of their raisins are scanned for maximum removal of foreign materials to ensure maximum food safety. Additionally, they have refined the Super-Vac cleaning system, Cap Stem and Whole Stem removal processes.

Under the Champion brand, National Raisin Company sells raisins, prunes, apricots, cranberries, mangos, pineapple and trail mix to the retail market. They are the #1 supplier of private label dried fruit products to U.S. retailers, and they export to 28 countries. Their organic dried

Their 60-acre, state-of-the-art facility is located in the heart of the fertile San Joaquin Valley and processes 50,000 – 60,000 tons of raisins annually.

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fruit products have the exclusive license for “Newman’s Own,” and they sell to industrial buyers such as General Mills, Kellogg, Sara Lee, and Nestles.

Their dedication to the raisin industry is a legacy that will be associated with the Bedrosians for generations. In 1966, the leadership of President Ernest Bedrosian was instrumental in establishing the Raisin Bargaining Association to provide a unified voice to growers in establishing a fair price for raisins. National Raisin Company is well known for decades of civic commitment to the Valley, especially in the Fowler area. They contribute countless hours and product to local schools, community and cultural organizations, libraries, hospitals, churches, and Fresno State, and established a summer church camp for over 1,000 children in Armenia.

National Raisin Company has a long and distinguished record of positive leadership, entrepreneurship, and service to the agriculture industry and our community making them the 2006 Baker, Peterson & Franklin Ag Business Award recipient.

2006 Agriculturist of the Year & Ag Business Award Luncheon

National Raisin Company will be honored at the 25th Annual Agribusiness Management Conference Ag Awards Luncheon on Thursday, November 2, 12:15 – 1:30 pm at the Exhibit Hall in Fresno. The Baker, Peterson & Franklin Ag Business Award and the Fresno Chamber Agriculturist of the Year, Pat Ricchiuti, will both be presented. Luncheon tickets are \$40 and are available through the Fresno Chamber of Commerce, 559/495-4800.

The California Agricultural Issues and Outlook Conference will feature industry speakers in the morning, including economic futurist Dr. Lowell Catlett of New Mexico State University. Tickets for the conference include lunch and are \$100.

Kimberly Doyle was hired as a Senior I accountant for both the tax and accounting & assurance departments. She graduated from CSU Long Beach with a degree in business administration, emphasis in accounting. Prior to moving to Fresno, she worked for two and a half years at an accounting firm in Southern California.

Nikoyla Serdyuk has joined BP&F as a Senior I accountant in the accounting & assurance department. Nikoyla graduated from Fresno Pacific University with a degree in accounting/international business, and speaks Russian, Ukrainian and German. He worked for a Modesto accounting firm for two years.

Tracey Scharmann joined the firm as a staff accountant. She graduated from CSU Fresno with a degree in business administration, emphasis in accounting. Previously, she worked as a controller for a manufacturing company in the Bay Area.

Janelle Hixson, hired as a staff accountant, graduated from Fresno Pacific University in May 2006 with a degree in accounting. She is from Reedley, where her family farms almonds and citrus.

Romena Malek was hired as a staff accountant after graduating from CSUF in August 2006 with a degree in business administration, accounting emphasis. She also has a degree in general linguistics, and speaks Assyrian, Persian and German.

Adam Blitz joined the firm as a Senior I accountant in the tax department. Adam graduated from UC Santa Barbara with a degree in business economics, emphasis in accounting. He worked two years for an accounting firm in Los Angeles specializing in real estate, non-profit, and small business.



FOOD FOR THOUGHT

A FARMER'S WORK ETHIC

By Nancy Ervin, AVA

Sometimes, an idea is so obvious, you are almost embarrassed to share it. Kind of like when you call the computer tech because your lap top isn't working and he suggests you try rebooting it first. You want to tell him, if it were that simple you would have thought of it yourself. So you try it begrudgingly...and it works.

The same theory applies to a business book by Jim Collins called "Good to Great." In his book, Collins and his team of researchers identify what makes a company "great" and not just "good." There are several important factors identified: a certain style of leadership, having a passion for what they do, and a willingness to face facts even when they're not pretty.

When you hire the right people...they will be self-motivated by the inner drive to produce the best results.

But one concept, for me, really jumped out. And that is the concept of having the "right people on the bus." The book explains it like this:

The executives who ignited the transition from good to great did not first figure out where to drive the bus and then get people to take it there. No, they first got the right people on the bus (and the wrong people off the bus) and then figured out where to drive it. They said, in essence, "Look, I don't really know where we should take this bus. But I know this much: If we get the right people on the bus, the right people in the right seats, and the wrong people off the bus, then we'll figure out how to take it someplace great."

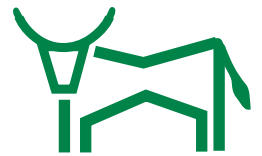
The reason I find this concept so perfectly simple is because I have seen it work. I know

companies that are simply interested in hiring the best and the brightest, whenever that person may present themselves, whether or not an actual position is available. They know that finding a position is infinitely easier than finding the right person.

On the one hand, I have worked with companies that struggle to fill a position, desperate to hire the "next warm body that walks through the door," and yet somehow surprised when that person is under productive, unmotivated and on their way out.

Jim Collins recognized that when you hire the right people, they don't need to be tightly managed; they will be self-motivated by the inner drive to produce the best results and to be part of creating something great.

I found it interesting that the author of the book chose Nucor Steel Company as one of their Great companies. They chose Nucor because this company built its entire system on the idea "that you can teach farmers to make steel, but you can't teach a farmer's work ethic to people who don't have it in the first place." So, instead of setting up mills in traditional steel towns like Pittsburg, they located their plants in places like Norfolk, Nebraska, or Crawfordsville, Indiana—places full of real farmers who go to bed early, rise at dawn, and get right to work without fanfare. Nucor discovered that "Gotta milk the cows" and "Gonna plow the north forty before noon" translated easily into "Gotta roll some sheet steel" and "Gonna cast forty tons before lunch." People who did not share this work ethic were asked to leave, generating an employee turnover as high as 50 percent the first year, followed by many years of very low turnover as the right people settled in for the long haul.



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To attract and keep the best workers, Nucor paid its steelworkers more than any other steel company in the world. They built a pay system around a team-bonus mechanism, with 50 percent of a workers' compensation tied directly to the productivity of his or her work team. Consequently, Nucor team members would usually show up for work thirty minutes early to arrange their tools and prepare to blast off the starting line the instant the shift gun fired.

Keep in mind, the Nucor system did not aim to turn lazy people into hard workers, but to create an environment where hardworking people would thrive and lazy workers would either jump or get thrown off the bus.

The concept is simple, and easier to execute than you may think. If you want to know more, give me a call. Or pick up the book and discover the simple truth for yourself.

You can't teach a farmer's work ethic to people who don't have it in the first place.

RELATED PARTY LIKE-KIND EXCHANGES

by Dennis Veeh, CPA

IRS has privately ruled in PLR 200616005 that the exchange of like-kind properties between two related parties via a qualified intermediary results in non-recognition treatment under Code Section 1031 for each related party if they each hold their respective replacement properties for two years.

One of the limitations under Code Section 1031 is the requirement of holding the properties for at least two years when exchanging with a related party.

The key to this private letter ruling is the fact both of the related parties intended to keep their replacement property for two years. Neither related party is "cashing out" their like-kind position, which the IRS indicated was an important factor in their conclusion.

In the facts of this private letter ruling, two related parties exchanged like-kind properties by using a qualified intermediary to accomplish this exchange. One of the related parties was not interested in receiving and keeping the exchanged property. Instead the related property substituted and received other like-kind property from a third party using a qualified intermediary.

Even though there was an exchange between related parties with one of the properties not being retained for two years, the IRS ruled that the exchange qualified for non-recognition treatment. The IRS conclusion was based upon the fact that neither related party "cashed out," a qualified intermediary was used and each related party intended to hold their replacement like-kind property for two years.

It would be wise to review this private letter ruling to see the applicability to any taxpayer considering like-kind exchanges with related parties.

tant to determine what method is best for each taxpayer. If taxable income is low or negative, the tax saving effect of this depreciation may be largely wasted. For example, if taxable income is low, the income tax savings on another dollar of depreciation may be 10 or 15 percent or nothing. However, if the depreciation deduction were postponed until a year when income was higher, the savings could be 25 percent or more.

There are also trade-offs between the value of tax-savings of deductions for income and self-employment tax purposes in one year versus those deductions being spread over several future years. Both time value of money considerations (a dollar to be received in 2010 is not worth as much as a dollar in hand today) and expected future income are important in making these decisions. If the farmer's marginal tax rate or tax bracket is unchanged, then tax benefits from Section 179 expensing are higher for MACRS assets with longer class lives. In general, the expensing election is applied to the qualifying property with the longest lives and those assets that are the least likely to be resold or traded. If the current marginal tax rate is low, relative to the anticipated tax rate for future years, then slower methods of depreciation are likely to result in greater tax savings.

Fuel Excise Taxes

The Transportation Act changes farm diesel fuel tax refund procedures for sales after September 30, 2005. Under prior law, if previously taxed diesel fuel was used in a nontaxable use, a refund of the tax paid was payable to the ultimate purchaser; however, only the ultimate vendor could make the claim. The new law allows the ultimate user to file Form 8849 for an annual claim or Form 8894 for a quarterly claim of at least \$750. Previously, aerial applicators were allowed to claim refunds of tax on aviation gas only with written consent of the farmer/customer. The new law allows the aerial applicator to claim the exemption without written consent

of the farmer. The exemption is expanded to include fuel consumed flying between farms where chemical are applied and the airport used by the applicator.

LIKE-KIND EXCHANGES

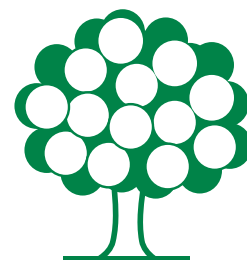
Exchanges of Personal Property

Determining whether property is like-kind property can be difficult. The Farm Machinery and Equipment category includes combines, tractors, planters, tillage equipment, manure spreaders, livestock equipment, and haying machinery. Thus, essentially any machinery or equipment manufactured by a farm machinery and equipment manufacturer would meet the like-kind test. Different sex livestock are specifically defined as not being like-kind property. Different species of animals are defined as being in different classes and thus do not meet the like-kind test. Because of this industry-based approach, the definition of like-kind property is very broad for agriculture.

In a like-kind exchange, the farmer typically trades in the old asset for the asset to be acquired and pays additional money. Because this qualifies as a like-kind exchange, the gain is not recognized, and the tax basis of the replacement asset equals the adjusted tax basis of the asset traded in plus the cash boot. Under current law, the taxpayer must continue to depreciate the adjusted basis of the asset that was traded in as if it had not been traded. Only the cash boot would be depreciated as the new asset. The IRS recently issued regulations that allow a taxpayer to elect out, on an asset-by-asset basis, from the general procedures of the new regulations. This considerably simplifies the depreciation schedule for an individual involved in a number of trades with only a small reduction in the initial depreciation deduction.

Exchanges of Real Property

For real property, like-kind is interpreted very



If taxable income is low or negative, the tax saving effect of this Section 179 depreciation may be largely wasted.

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broadly. Any real estate can be exchanged for any other real estate and qualify as like-kind as long as the property given up was, and the acquired property is, used in a trade or business or held for investment. Thus, farm land can be traded for an apartment complex or real estate with improvements can be traded for unimproved real estate. As with like-kind exchanges of personal property, the gain or loss on the relinquished property (property given up) is deferred, and the basis of the replacement property is adjusted. The basis of the replacement property is generally the basis of the relinquished property plus the value of any additional boot.

The three primary problem areas associated with like-kind exchanges of real property are the timing associated with completion of the transaction, the potential for depreciation recapture under Section 1245 and Section 1250 and special rules relating to exchanges between related parties. Farm properties that are given up can also involve recapture of soil and water conservation expenditures or exclusion of conservation cost-sharing payments. This can result in some tax even if there is a like-kind exchange.

A like-kind exchange of real property could, but does not necessarily, involve two property owners simply swapping properties. The most typical situations involve a non-simultaneous or deferred exchange. In a deferred exchange, first the relinquished property is transferred, and then the replacement property is acquired. For such a transaction to qualify as a like-kind exchange, certain rules must be followed with respect to timing, and actual or constructive receipt of the proceeds must be avoided by the first property owner.

Like-kind exchanges offer the possibility of deferring gains on the exchange of property. These are usually quite simple and straightforward for personal property. Transactions involving real estate can be more complex, and the

tax implications may be much larger. Taxpayers need to proceed carefully, usually with expert assistance, to ensure that the necessary procedures are followed.

RECENT TAX CHANGES AFFECTING PRODUCERS

Farm Income Averaging

Farm income averaging has undergone a number of changes that have been favorable to producers. The most recent change, effective for 2004 and later tax years, involves the AMT calculation. The AMT was instituted to require individuals receiving substantial tax preferences to pay some income tax. Individuals computed their regular tax and their AMT tax liability and paid the higher amount. Farmers often found that the tax reduction from farm income averaging was eliminated when the AMT was calculated. Beginning with tax year 2004, a farmer's regular tax liability was determined without regard to farm income averaging and compared with the AMT liability. As a result, the farmer receives the full benefit of income averaging in reducing regular tax, while the AMT, if any, is unchanged.

Farm income is based on taxable farm income. It includes all income, gains, losses, and deductions attributable to any farming business. Landowners whose income is based on a share of production can treat that income as farm income. (For 2003 and later years, the landowner must have a written lease agreement with the operator before significant activities begin in order to treat that income as farm income for income averaging.) Gain from the sale or other disposition of land is not included, nor is the sale of timber. Farm income from flow-through entities such as S corporations and partnerships does qualify. Wages and other compensation received as a shareholder in an S corporation engaged in farming are also farm income. Farm income averaging is not available to regular

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corporations, trusts, or estates. Cash rent landowners are also excluded from farm income averaging.

A farmer may elect to average part or all of the farm income in the election year, e.g., 2006, and have that elected farm income treated as if it have been earned equally over the preceding three base years, 2003 to 2005, and taxed at the respective income rates for those years. The elected income is allocated equally over the three prior or base years. If one of the three preceding years has a very low income or loss, there is no possibility of allocating more of the elected farm income to that year. Income averaging has no effect on self-employment tax liability for the year of the election or any base year. Farmers can elect, subject to some restrictions, the amount and type of income that they wish to average.

Income averaging can be used even if it does not reduce tax liability for the current year. An

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individual might be in a situation in which taxable incomes in the three base years were very low. If 2005 farm income were averaged, this might not reduce the 2005 tax liability. However, reducing 2005 income for future income averaging might increase potential tax savings for an individual who expected a substantially higher farm income in a future year. Individuals do not have to have been in farming in the base years to qualify for farm income averaging but only farm income is eligible for income averaging. Retiring farmers and others disposing of assets may also be able to take advantage of income averaging. Depreciation recapture on machinery, equipment, buildings, and purchased breeding stock qualifies as farm income. Dispositions of assets for up to a year after an

individual ceases farming are presumed to be within a reasonable time and would be eligible for farm income averaging. Depending on individual circumstances, dispositions of assets over longer periods may also be acceptable for income averaging.

Weather-Related Sale of Livestock

The gain on weather-forced sale of livestock held for draft, breeding, or dairy purposes does not need to be reported as income if the proceeds will be used to buy replacement livestock. Originally, the replacement period was two years after the end of the tax year of sale. This has now been extended to four years following the year of sale. A producer must replace the excess animals sold because of weather-related conditions with at least the same number of animals. If fewer animals are acquired or the amount invested is less than the amount received, then income must be calculated and reported. The new law also provides greater flexibility by allowing reinvestment in similar or related use property if the producer is unable to replace the livestock sold.

Revoking Election to Treat CCC Loans as Income

Many producers use the Commodity Credit Corporation (CCC) loan program, in which commodities are used as security for loans at or after harvest. Producers can treat those loans in one of two different ways for tax purposes. Under the “loan” method, the CCC loans can be treated as other loans: loan proceeds are not treated as income, and loan repayment is not a deductible expense. Alternatively, a farmer could elect under I.R.C. Section 77 to treat the loan proceeds as income when received—the “income” method. Under previous law, once the election to treat a CCC loan as income had been made, it could not be revoked without the IRS Commissioner’s permission. Revenue

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Procedure 2002-9 added the Section 77 election to the changes in accounting methods that receive the automatic consent of the Commissioner for 2002 and later years. This makes revoking the election an alternative to be considered.

Producers have flexibility in reporting future CCC loans. If a producer revokes the Section 77 election for 2004 and uses the loan method, nothing prevents that producer from electing to report 2005 CCC loans as income. Presumably, this new election could be revoked for the 2006 tax year.

Self-Employment Tax Update

Many farmers continue to be concerned about the self-employment (SE) tax. For 2005, earnings of up to \$90,000 are subject to the 12.4 percent tax for social security, and all earnings are subject to the 2.9 percent Medicare tax. For 2006, the maximum social security portion will increase to \$94,200.

Farmers with SE earnings of less than \$400 and gross farm income (receipts) of more than \$2,400 may use the optional farm method and pay SE tax on \$1,600 of earnings.

There has been on-going litigation on the rental of land to an entity in which the landowner materially participates. For many years, landowners would rent land to farm-operating entities (partnerships or corporations) in which they were involved. Although the rental payments were subject to income taxes, the rental payments were not included as earnings for self-employment tax. Recent litigation has resulted in leases of real property to entities that the taxpayer controls constituting material participation and consequently being subject to self-employment tax.

Charitable contributions of commodities can reduce taxes for cash basis farmers, especially those who do not itemize deductions. If a farmer makes a donation of commodities in the

year following the year of production, costs are deducted in the year of production, reducing income for both income and self-employment tax purposes. There is no income to report in the year of the gift. The farmer's basis in the commodity is \$0. By gifting the \$0 basis commodity to a charity, the farmer gets no charitable deduction, but the farmer avoids having income for both income and self-employment tax purposes. The commodity should be transferred to the charity, rather than having the farmer sell the commodity and have the check made out to the charity. One way that this could be handled would be to write a letter to the charity informing them that they had X bushels of commodity Y that the farmer would deliver as instructed. The charity could make arrangements for the sale and then have the farmer deliver the commodity for them.

TAX MANAGEMENT

Most farmers use the cash method of accounting. Farm expenditures are normally deductible when paid. Receipts are generally reported as income in the year in which they are received. As a result, farmers have the opportunity to review their net income, and make adjustments for taxes. That window of opportunity closes for all practical purposes with the end of a farmer's tax year. So November-December is the time to review and adjust if necessary.

One's tax management goal should be maximizing after-tax income or wealth over time, not minimizing taxes in any one year. Some people get so concerned about saving a few dollars in taxes this year that they miss the big picture. Because of the higher Section 179 expensing limits, many farmers may simply assume that they will not have a tax problem, instead of viewing each year as a tax-planning opportunity.

Keeping taxable income relatively stable year-to-year has been a key to effective income

November-December is the time to review taxes and make adjustments if necessary.

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tax management in the past, because of the progressive nature of income tax rates. Recent tax law changes have “flattened” tax rates, reducing the progressiveness of income tax. Wide swings in taxable income are likely to result in higher taxes, although farm income averaging may help. The amount of income that is tax free because of personal exemptions and the standard deduction has increased due to law changes and inflation. One should plan to report at least this tax-free amount of income each year. Self-employment taxes are larger than income taxes for many farmers and may be more difficult to manage because of no exemptions and limited deductions.

Depending on the income situation, additional sales may be made on or before December 31, 2006 or delayed into 2007. The Section 179 expensing deduction can have a major impact on taxable income, and the decision can be made after the close of the tax year. However, the depreciable assets must have been placed in service before the end of the year. December purchases of feed, fertilizers, and chemicals to be used in 2007 can, up to a limit, also affect the taxable income. Although delivery of inputs purchased before January 1, 2007 is not required for a tax deduction, a purchase of specified products, rather than just a deposit, must be made in order to claim a deduction for prepaid expenses. This means that the invoice

should list specific products, and quantities and the arrangement should not accrue interest to the purchaser.

Deferral of income and income taxes can still be an effective tax management strategy. If income taxes are deferred, even for a year, this is an interest-free loan from the government. Although the estimated tax payments required to avoid penalties have been increased to 90 percent of the tax liability, farmers continue to have an exception. If two-thirds or more of gross income is from farming, farmers can pay the income tax due by March 1 and avoid estimated tax penalties. Although farmers must file and pay by March 1, the due date of their return for many other purposes, such as retirement plan contributions, is April 15.

Tax implications of major decisions should still be considered before the transactions are finalized. Installment sale contracts often have tax benefits because the taxable gain on the sale is spread pro rata over the tax periods in which the contact payments are received, with certain exceptions. Tax-free or like-kind exchanges, such as the trade-in of machinery and equipment, may reduce taxes, but farmers need to consider both income and self-employment tax impacts. Because of the complexity of the tax laws and regulations, competent professional tax advice is generally a very worthwhile investment.



CALENDAR

- October 4 – 15** Big Fresno Fair, Fresno Fairgrounds
- October 16** Due date for 2005 individual tax returns, including extensions
- October 27** Ag One Fresno-Madera Alumni and Friends Wine Tasting, California State University, Fresno Winery. Reservation information, call (559) 278-4266.
- November 2** Agribusiness Management Conference and 2006 Agriculturalist of the Year & Ag Business Award Luncheon. Fresno Convention Center Exhibit Hall. For more information, call (559) 495-4825.
- November 14** Napa Valley Viticultural Fair, Napa Valley Exposition Fairgrounds. For information, call (707) 227-9997.
- November 15 – 17** Central Coast Cotton Conference, Monterey Plaza Hotel in Monterey. Reservation information, call (805) 239-8200.
- November 29 & 30** Central California Winegrowers Winegrape Dinner & Symposium, Pardini's in Fresno. For information, call (559) 618-1856.

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