

FEDERAL ESTATE AND GIFT TAX—REPEAL OF ESTATE TAX TAKES EFFECT JANUARY 1, 2010—IS REINSTATEMENT LIKELY?

By Toni M. Porter, CPA, MST, AEP

The situation which almost no one believed would occur when Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 has become a reality. Because Congress failed to act, the estate and generation-skipping transfer (GST) taxes are repealed for the estates of decedents dying after December 31, 2009, and before January 1, 2011.

The Democratic Congressional leaders have indicated that they plan to revisit the estate tax early in 2010 and will likely approve reinstatement of the taxes. However, they will face opposition from some congressional leaders. If the estate and GST tax is retroactively reinstated, it would likely face constitutional challenges in court. Although Congress has passed retroactive tax laws before, lawmakers have often issued some sort of formal statement expressing their future intent before the law expires. To date, no formal statement has been issued, although words to that effect were exchanged during Senate debate.

As of January 1, 2010, the current transfer tax regime has changed significantly. Because of the change in basis rules from step-up basis to carryover basis, more estate beneficiaries could be affected under the laws in 2010 than in 2009.

Estate, Gift, and GST Taxes

Under current law, both the estate and GST taxes are repealed for the estates of decedents dying after December 31, 2009, and before January 1, 2011. The gift tax will be retained, but its top rate will drop to 35%, and the exemption amount will continue to be \$1 million. This change in the law would allow donors in 2010 to gift assets to skipped per-

sons at a rate of only 35%, once the gifts have exceeded the annual exclusion and the lifetime exemption amounts. If no action is taken by Congress in 2010, the estate and GST taxes will come back into force in 2011. The estate and gift tax applicable exclusion amounts would be reunified at \$1 million, and the top marginal tax rate would be 55%, resulting in a much higher estate tax and one that would affect many more decedents.

Carryover Basis – effective January 1, 2010

Effective for the estates of decedents dying after 2009, the step-up basis rules will be repealed and replaced with a modified carryover basis system. Instead of taking the fair market value of the property at the date of the decedent's death, beneficiaries will take the lesser of (1) the adjusted basis of the property in the hands of the decedent, or (2) the fair market value of the property on the date of the decedent's death. The executor will be able to increase the basis of the decedent's property up to \$1.3 million and up to \$3 million for a surviving spouse.

The situation which almost no one believed would occur has become a reality.

Thus, an estate will be allowed to increase the basis of property transferred to a surviving spouse by as much as \$4.3 million. The basis of an asset cannot be adjusted above its fair market value at the date of the decedent's death.

The modified carryover basis at death rules do not apply to property acquired by a decedent

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Only time will tell how this tax issue will be resolved.

by gift or by lifetime transfer, for less than adequate and full consideration in money or money’s worth, during the three-year period ending on the date of the decedent’s death. However, this prohibition does not apply to property received by the decedent from his or her spouse during the three-year period, provided that the spouse did not acquire the property in whole or in part by gift or by lifetime transfer for less than adequate and full consideration.

In addition, executors will be required to file an informational return detailing transfers at death of non-cash assets in excess of \$1.3 mil-

lion, as well as appreciated property received by the decedent within three years of death for which a gift tax return was required to be filed. The IRS has not yet issued or provided any sort of guidance on this informational return.

Conclusion

Only time will tell how this tax issue will be resolved and whether the estate and GST taxes will be reinstated. Because of the uncertainty, planning during this time may be a challenge—one that we would be happy to help you with. Watch for future updates, or call us to discuss your personal situation.

AG BUSINESS STRATEGIES

By Don Hofstrand

The following article was written by Don Hofstrand of Iowa State University, and reprinted here with his permission. If you have any questions about the various types of business strategies discussed, or how they might apply to your ag business, please contact us.

Business strategies focus on the direction of the business in terms of expansion, maintenance, contraction, etc. Your business strategy should create and sustain a competitive advantage that enables you to consistently earn above-average returns.

Five types of strategies are discussed below. They are:

- Growth Strategies – expanding the size of the business
- Stability Strategies – maintaining the size of the business
- Restructuring Strategies – refocusing the business for improved performance
- Succession Strategies – transferring the business to the younger generation

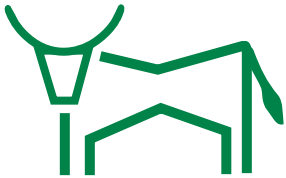
- Exit Strategies - ending and leaving the farm business

Ag business strategies are part of the strategic planning process. An overview of strategic planning for ag business and the factors that lead into selecting the strategy follow below.

Growth Strategies

Growth strategies involve various ways of expanding the size of the ag business. Growth may take many forms and directions. Some of the common growth strategies are discussed below.

- **Capacity Expansion** – With this strategy, the current enterprises are expanded. It means more acres of crops or more head of livestock. In essence, it is “more of the same.” It is a horizontal form of expansion as opposed to a vertical expansion which moves up or down the supply chain. A capacity expansion strategy may be designed to take advantage of economies of size. Efficiency is also achieved because management is just focused on the existing enterprises.



- **Replicate** – This is a form of capacity expansion where the existing operation is replicated at a different location. This strategy is often used for livestock or dairy operations when further expansion at the current location is not feasible.
- **Intensify/Modernize** – This is another form of capacity expansion where the real assets of the business are not expanded. Rather, they are modernized so more production can be pushed through a fixed asset base. This can occur in both crop and livestock operations, but is more common in permanent crop production.
- **Diversify** – This is another form of horizontal expansion. However, instead of expanding the existing enterprises, new enterprises are added. A diversification strategy may be designed to make use of economies of scope and other synergies between the enterprises to achieve low cost status. However, efficiency may be reduced because management is spread over more enterprises.
- **Specialize/Focus** – This strategy involves reducing the number of enterprises in the business. These few enterprises are expanded through horizontal strategy such as capacity expansion or a vertical strategy such as integration. One or just a couple of enterprises receive all of the management attention. This is the opposite of the diversification strategy.
- **Integrate** – Integration is a vertical strategy because it may move forward into the processing of products or commodities, or it may move backwards into the input/supply segment of the supply chain. This strategy often involves a group of farmers working together to move up or down the supply chain. It may also involve joint ventures with existing companies in the supply

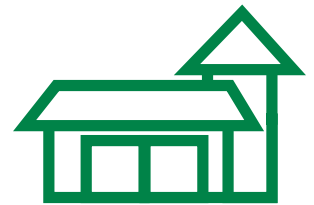
chain. Potential strategies may include the following:

- Become indispensable in the chain
 - Get to the ends of the chain
 - Control the chain
 - Reduce the number of links in the chain
 - Become part of a chain that will produce the next product
- **Networking** – This involves working with others to gain advantages not available to individuals. Networking may leverage the activities and resources of your business operation. It may also increase the efficiency of the business operation. Networking can be used for either vertical or horizontal expansion. Networking can be accomplished through information arrangements, contracts or various types of joint ventures.

Stability Strategies

Stability strategies involve various ways of maintaining the size and organization of the business at its current level. Stability strategies sometimes occur after a long period of growth. Or they may occur from the beginning of the business. It often depends on the goals and ambitions of the owner/operator.

- **No Change** – The current operation meets the needs of the farm family.
- **Full Employment** – The operation is expanded until the family members are fully employed. At this point, expansion stops and is maintained at this level as long as everyone is fully employed. Full-time hired labor to expand further is not considered as an option.
- **Adequate Income** – The operation is expanded until it generates adequate income levels for the owner/operator and family.



However, if adequate income levels are not maintained over time, the business may be expanded until it does.

- **Profit** – After a period of expansion, the owner/operator may decide to sacrifice future growth by not reinvesting in the business but using all business returns for consumption.
- **Pause** – After a period of rapid expansion, the owner/operator may decide to pause for a period of time before continuing to expand.
- **Wait and See** – The owner/operator considers the current economic and business environment to be too uncertain for expansion at this time. So it is decided to wait until the future is more certain before expanding. However, if not managed correctly, the owner/operator may wait too long and miss the opportunity for expansion.

Restructuring Strategies

Restructuring strategies are used when the ag business is not performing as it should. Performance problems will range from inadequate income levels to the major threat of insolvency and bankruptcy. If the business cannot feasibly be restructured, it is liquidated.

- **Refocus** – This strategy is used to refocus the activities of the business. It usually involves changing the mix of enterprises including the primary enterprises on which the business is built. It is used for farm businesses that are solvent (adequate equity) but not profitable.
- **Retrenchment** – This strategy usually involves three sequential phases of contraction (liquidate part of business), consolidation (restructure business) and rebuilding. This strategy is used for farms that are neither profitable nor financially sound.

- **Liquidation** – If the business is neither profitable nor financially sound, and a retrenchment strategy is not deemed to be feasible, the decision is made to liquidate the business before the owner/operator loses all equity in the business.

Succession Strategies

These are strategies for transferring an ag business (not just the assets but the ongoing business) from one generation to the next. The younger and older persons are often related but don't need to be. Succession strategies are often combined with estate planning by the parties.

- **Multi-person** – A younger person is brought into the business, and the current operator and the young person farm together in the same business. At the retirement of the older person, the younger person takes over the operation of the entire business. So the life of the business continues beyond the retirement of the current operator. Arrangements for transferring ownership and management of the business from the older to the younger person are developed.
- **Spin-off** – A younger person initially returns to the farm business but after a year or so starts his/her own farm business. The younger and older parties may work together and share machinery, equipment, etc. However, each party operates his/her own business. At the retirement of the older party, the younger person merges the two businesses together and operates them as one business.

Exit Strategies

These are strategies for ending the ag business. This usually occurs at the retirement of the farm owner/operator, but the strategy may start to be implemented several years before retirement.

- **Holding Pattern and Exit** – The farming

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operation is not expanded or contracted for several years prior to retirement. The operation is maintained at its current level until retirement by the owner/operator. At retirement the assets are sold, often at a farm auction. The business ends abruptly.

- **Use-up Capital Assets and Exit** – No additional money is invested in the farm business (machinery, equipment, etc.). All profits are milked from the business with no reinvestment. At retirement, any remaining value of the assets is liquidated. The business ends abruptly.
- **Wind-down Business and Exit** – The size of the business is reduced by reducing the number and size of the enterprises. For example, livestock enterprises may be eliminated first, then rented land may be let go. Business activity is reduced gradually over time until it is ended at the owner/operator's retirement.
- **Create Marketable Operation** – With this strategy, the business is sold as a business unit to another party. For this strategy to work, the business must be structured or organized so that the business unit is of greater value than the collective value of the individual assets.

Final Thought – Strategies Change

Business strategies are often closely tied to the life cycle of the farm operator. As the operator goes through the various phases of his/her life, the type of strategy often changes due to the operator's preference and planning horizon.

HOW THE FRAUD TRIANGLE IS FORMED

And Why You Need to Prevent It

by Brandon Vance, CPA, CFE

The current economic climate has forced many businesses, and entire industries, to fully examine their operations and downshift from the period of growth experienced in the years preceding the downturn. This has resulted in a reduction of new business ventures, production and, unfortunately, an increase in employee layoffs. While probably not in the forefront of any strategic or business planning session, it is extremely important to remember fraud. It is commonly agreed upon by most fraud experts that there is an inverse relationship between the economy and fraud. This means that, while the economy is struggling, the occurrence of fraud is increasing.

Fraud can be very detrimental to any company. The median losses experienced by small businesses (those with fewer than 100 employees) tend to be the greatest at \$200,000 per fraud scheme.

In fact, according to the Association of Certified Fraud Examiners "2008 Report to the Nation on Occupational Fraud & Abuse" (the Report), it is estimated that companies in the United States lose 7% of their annual revenues to fraud. Fraud can be very detrimental to any company, but according to the Report, the median losses experienced by small businesses (those with fewer than 100 employees) tend to be the greatest at \$200,000 per fraud scheme (mostly check tampering and fraudulent billing schemes). The Report also indicates that fraud schemes tend to go undetected for several years and are most often committed by the accounting department or upper management personnel (those in position to perpetrate the fraud). While we now under-



stand the pervasiveness of fraud, let's examine why fraud can occur in the first place...the phenomenon known as the fraud triangle.

The fraud triangle was developed by criminologist Donald Cressey in his quest to determine why a person commits fraud. The fraud triangle identifies three factors which are usually necessary in order for fraud to occur:

- perceived **incentive or pressure** facing the person
- perceived **opportunity** to commit fraud
- the person's **attitude or rationalization**

Incentives or pressures that typically lead a person to commit fraud may be financial in nature, such as personal debt levels, divorce, or sheer greed. They can also be related to personal habits, such as gambling, alcohol or drug abuse. Additionally, work related pressures such as being overworked, underpaid or not promoted can also provide incentives for an employee to commit fraud.¹

Opportunities to commit fraud typically occur when an employee is trusted too much or internal controls are weak or nonexistent. The high level of trust and/or lack of controls provide the opportunity because the employee has no reason to fear being caught. Thus, it is important to remember that opportunities for employees to commit fraud are limited to the means available to them.¹

The third leg of the fraud triangle is entirely dependent upon an employee's personal integrity and ethics. If a person is unable to somehow rationalize the act of committing fraud because of their own personal morals, then they will not be able to act on the pressures facing them and the opportunities that they have.¹

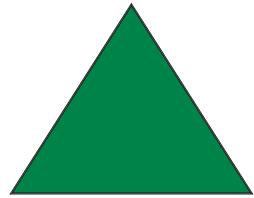
Let's take a look at an example of the fraud triangle. Due to the downturn in the economy,

assume that your company as part of its strategic planning and cash flow considerations decided to eliminate certain positions and not to award raises to your employees this year. The loss of certain employees and the chaos of keeping the company afloat have eliminated certain segregation of duties internal controls, and relaxed normal office procedures. Bob, your long-time and trusted Controller, has taken on many additional responsibilities and transaction approval duties. Unfortunately, Bob has his own personal debts to pay and was counting on the "normal" raise he had been receiving to keep his family afloat. Without the raise, Bob now has the **incentive or pressure** of helping his family as a reason to commit fraud. Bob's position of Controller and your trust in him also affords him the **opportunity** to commit fraud and manipulate the records to cover his tracks. Additionally, with the increased responsibilities and stress, Bob is able to **rationalize** that the company is overworking and under-appreciating him and owes him for the work he is doing, thereby creating the third and final leg of the fraud triangle.

While the foregoing is a relatively simple example, there are a myriad of pathways that allow the fraud triangle to develop and exist in a company. Therefore, it is imperative to take steps to help prevent the fraud triangle from forming including:

- Creating an ethical environment
- Reducing employees' opportunities to commit fraud
- Monitoring pressures on employees to commit fraud

Creating an ethical environment really starts with the company's core values and ensuring that those values are properly communicated throughout the organization. Nowhere within the company is it more important to project the company's values and ethics than from its



The fraud triangle identifies three factors which are usually necessary in order for fraud to occur: incentive or pressure, opportunity, and attitude or rationalization.

owners and top management. This ensures that employees realize the importance of the company's values and creates the "tone at the top" environment, where the employees will follow the examples of its leaders. Part of this leadership includes establishing the mentality that fraud is not tolerated and that any instances will be dealt with swiftly and decisively. A company can also establish policies and procedures to help improve the quality of its employees, including integrity testing, investigating new hires and employees, performing drug tests, implementing an ethics policy and prosecuting fraud perpetrators, among others.¹

A lack of adequate internal controls is the most common factor that allows fraud to occur.

Reducing employees' opportunities to commit fraud is really centered on internal controls. The Report cited a lack of adequate internal controls as the most common factor that allowed fraud to occur, which emphasizes their importance. Internal controls in a company should be designed to both prevent fraud from occurring and to timely detect when fraud has occurred. Ensuring that a proper segregation of duties exists is an example of controls established to help prevent fraud from occurring, while monitoring types of controls, such as owner approvals and timely review of monthly financial information, are examples of controls designed to detect fraud. Establishing a whistleblower program or fraud hot line are two excellent examples of procedures a company can implement to detect fraud. In fact, the Report indicates that the majority of fraud is discovered through some form of tip or complaint.¹

While possibly the most difficult of the steps a company can take to help prevent the fraud triangle from occurring, monitoring the pressures on employees to commit fraud can be achieved. These steps include establishing personnel policies and procedures and ensuring that they are carried out and applied fairly and equitably to all employees. Additionally, providing counseling services to help employees with personal problems such as alcohol abuse, gambling and marital problems can go a long way in communicating their value to the company and can help an employee overcome and prevent the pressures to commit fraud.¹

The Consulting and Litigation Department at Baker, Peterson & Franklin is experienced in fraud prevention and available to help you assess whether the fraud triangle has formed at your company. Through procedures such as internal control reviews and fraud risk assessments, we can help you identify and address weaknesses that can go a long way in preventing fraud. If you would like to discuss the fraud triangle, fraud prevention or internal controls, please contact Brandon Vance, our Certified Fraud Examiner.

¹ Excerpts taken from Practitioners Publishing Company's "Guide to Internal Control and Fraud Prevention," Chapter 6 "Fraud Prevention," June 2009.



CALENDAR

- February 9-11** World Ag Expo, Tulare. For information, call 800.999.9186 or visit www.worldagexpo.com.
- February 27** Ag One Foundation Community Salute honoring Ed Baloian at Pardini's. For tickets, call Ag One at 559.278.4266.
- March 1** Deadline to file income tax returns for taxpayers filing as farmers.
- March 15** Deadline to file income tax returns for calendar year end corporations.
- April 15** Deadline to file individual and partnership income tax returns.
- April 16** Common Threads Luncheon honoring women in agriculture at CSUF. For tickets, call Ag One at 559.278.4266.
- April 16** Tax holiday. Baker, Peterson & Franklin office closed.

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