

# FARM PROGRAM PAYMENTS: RECENT CHANGES TO FSA'S PAYMENT LIMITATION RULES

By David E. Holland, Esq.

If you or your clients receive government payments from USDA's Farm Services Agency ("FSA"), you should be aware that FSA has issued new, more restrictive interpretations of its payment limitation rules, effective for the 2005 year. Many of these new restrictions target long-standing practices and organizational structures that westside farmers have used to maintain their eligibility to receive federal project water.

FSA's initial announcements early this year regarding the new restrictions created more questions than answers, and growers have been uncertain how to respond. However, after several months of discussion with agency personnel, the scope of the new restrictions is a bit clearer. This article does not cover all of the recent changes, but discusses the most critical issues. Growers and their advisors should pay particular attention to the following:

**1. Avoid loans to related entities that are secured by each other's crops.** Growers choose to divide their operations among several different entities for many reasons: estate planning, tax benefits, or the fact that some individuals may be involved in part but not all of the total operation. Growers who rely on federal project water often divide their operations among several entities to comply with the 960-acre limitations imposed by the Bureau of Reclamation. The related entities often receive their crop financing from the same bank. The bank, to strengthen its security position, will often "cross-collateralize" the loans; i.e., the assets of entity A secure the loan to entity B, and vice-versa.

Cross-collateralization of any type can create a problem under FSA's "separate person" rules. Briefly, in order to receive a payment,

each farming entity must be separate and distinct from any other person or entity, maintain separate and distinct bank accounts, funds, assets, etc. Loans that are cross-collateralized by equipment or other non-crop assets are problematic, but not necessarily fatal, if the related entities can demonstrate to FSA's satisfaction that they are in fact separate and distinct from each other.

Loans that are cross-collateralized by crops, however, are absolutely prohibited for 2005. The crops of entity A cannot secure a loan made to entity B. FSA personnel have literally referred to this arrangement as the "kiss of death." Loans cross-collateralized by crops will render all of the related entities ineligible for payment. (In past years, cross-collateralization has not been a major issue for growers farming their own land, because they were considered to be "actively engaged in farming" under the landowner exemption rules. For 2005, however, FSA has determined that even a landowner may run afoul of the "separate person" requirements.)

If FSA determines that the various entities are not separate from each other, the agency will take the position that it cannot tell which entity should be paid. Therefore, none of the entities will be eligible for payment. The affected growers will have to repay amounts already received for the year, and may face other penalties.

**2. Make sure that any transactions between related entities are structured and conducted at arm's-length (as though taking place between unrelated third parties).** FSA has indicated that it will pay particular attention to transactions between related entities, to determine if those entities should in fact be combined as

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one operation. This is another variation of the “separate person” issue. The best safeguard is to treat all transactions among related entities as if occurring between unrelated third parties. In general this means:

- (a) *Proper Documentation.* Document all transactions with traditional invoices, checks, receipts, etc. If unrelated parties would use a formal contract or lease in a given situation, the related entities should do so as well.
- (b) *Use market terms.* Transactions between related entities should occur on a market basis in terms of price. Time of payment is also critical: payment terms should not deviate so far from market that FSA could infer that one entity is essentially loaning funds to the other. The transaction should otherwise be on terms and conditions normal for the area. Unique accounting or billing practices among related entities will raise red flags with the agency.

FSA’s scrutiny is not limited to transactions between related farming entities that receive program payments. FSA will also look at related entities that do not receive payments. In particular, many growers use a separate custom-farming or service entity to perform various tasks on a fee-for-service basis. This entity is compensated only for the services that it provides, and has no interest in the crop itself, and thus is not a “producer” for FSA purposes. However, the agency will examine these arrangements with some scrutiny, to determine if a custom farmer that is providing services for several different entities in fact should be considered the “producer,” with the farming entities being disregarded (or, in the words of agency personnel, whether the custom farmer is actually the “mother ship”). Here again, if FSA determines that the entities are not separate from each other, none of the entities will be eligible for payment, and amounts received will have to be repaid.

**3. All related entities must have separate bank accounts.** This item is yet another variation on the “separate person” requirement, but of critical importance to FSA. Funds should be deposited and withdrawn from these accounts on a traditional basis.

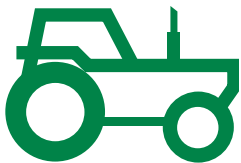
**4. Equipment obtained through a custom farmer is no longer considered a “contribution” of equipment.** This change will most affect growers who must comply with FSA’s “cash rent tenant” rule. In general, growers who lease land on a cash basis must make a “significant contribution” of equipment to the farming operation, both in order to receive the payments generated from the leased land and to avoid a reduction in payments for non-compliance. In the past, FSA has allowed growers who contract for custom farming services to count the equipment used by the custom farmer as part of the grower’s equipment contribution. Beginning in 2005, the custom farmer’s equipment can no longer be used to satisfy the cash rent tenant rule, and growers must use owned or leased equipment for the necessary equipment contribution.

**5. Update the 502s.** It is very important that the grower’s forms CCC-502 (i.e., the “Farm Operating Plan”) accurately reflect the current state of the farming operation. FSA has made clear that any overpayments that result from outdated paperwork will be considered a “scheme or device” to avoid the payment limitations, regardless of whether the overpayment is the result of fraudulent intent or an honest oversight. If FSA determines that a grower has engaged in a “scheme or device,” the grower may not be eligible to receive payments for the next several years.

**6. Make sure the 502s explain the farming operation in detail.** Compliance with FSA’s regulations has always been difficult, and unfortunately is becoming more so. The best defense is a full and complete description of the farming operations, particularly of the lending relationships, equipment sources, labor sources,

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**Unique accounting or billing practices among related entities will raise red flags with the agency.**



## STAFF NEWS

Congratulations to Claudia Ruiz on obtaining her CPA license. Claudia is a senior accountant in the Accounting and Assurance department. She has been working at BP&F since 2001 and her experience includes working with many agricultural clients.

Julie Maldonado, BP&F Marketing Director, is a judge for the Fresno County Farm Bureau 2005 Media Awards. Award criteria is high ethical standards, concern for agriculture, demonstration of knowledge, and an unbiased opinion. The media categories are general media publications, agricultural trade publications, and electronic media. The winners will be recognized at FCFB's Annual Media Appreciation Night on Thursday, July 28 at 5:30 p.m. at Fresno Equipment Co.

Nancy Ervin has recently earned her Accredited Valuation Analyst (AVA) designation with the National Association of Certified Valuation Analysts (NACVA). Requirements to earn the AVA designation include holding a business degree from an accredited university, possessing a prerequisite understanding of accounting fundamentals as applied to business valuation theory and practice, and demonstrating substantial prior experience in business valuation. The final step in earning the accreditation is the successful completion of NACVA's comprehensive examination. Business Valuations are often required for estate and gift taxes, as well as in buy/sell agreements, succession planning, and reorganization.

Toni M Porter, CPA, MST, AEP is newly certified as an Accredited Estate Planner. This designation is a graduate level specialization in estate planning. This accreditation is bestowed by the National Association of Estate Planners and Councils (NAEPC), a national organization of professional estate planners and affiliated Estate Planning Councils focused on establishing and monitoring the highest professional and educational standards.

Nineteen members of BP&F's Ag Department and professional staff recently enjoyed a tour of the Fresno State Farm as part of its continuing "ag education." The tour included everything from the apple orchard to the zucchini field, as well as the winery and Farm Store. We ended the tour with a picnic lunch complete with Fresno State ice cream.

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### *Farm Program Payments – continued*

and ongoing transactions with related entities. Growers should also describe any "master contract" relationships—where a group of growers (related or not) has a single contract with a supplier, buyer, or processor. Such contracts would include bulk purchases of fertilizer, sale contracts for tomatoes, etc. Again, these items go to whether the farming operation is sufficiently "separate and distinct" from other operations.

Full disclosure gives FSA staff the opportunity to spot problems before payments are made, that can hopefully be addressed in a manner that works for both the grower and the agency. Also, if FSA misses a problem that has been adequately disclosed, the grower generally will not be responsible for past overpayments.

*Dave Holland is a partner with the law firm of Baker, Manock & Jensen. His practice focuses largely on agribusiness. In addition to farm program compliance, Mr. Holland specializes in water law, real estate matters and financing. He has served as a co-chair of the Agribusiness Committee of the California Bar Association's Business Law Section, and as chair of the Agricultural Law Section of the Fresno County Bar Association.*

*This article is informational in nature and should not be used as a substitute for legal advice. For more information, please contact Mr. Holland at (559) 432-5400, or by e-mail at deh@bmj-law.com.*

***If FSA misses a problem that has been adequately disclosed, the grower generally will not be responsible for past overpayments.***

# RESEARCH AND EXPERIMENTATION TAX CREDIT: A DOLLAR-FOR-DOLLAR TAX REDUCTION

By Janell Attebery

*There have been talks of making the research tax credit permanent, but that has not yet happened.*

**W**ould you like to reduce the amount of money your company pays in federal and state taxes? You may be able to do that if you qualify for the Research and Experimentation Tax Credit.

**Wait!** Don't stop reading just because your company is not developing the next best disc drive, router, or computer chip. You may still qualify for the credit. Companies that engage in product development or process improvement activities such as warehouse, distribution, manufacturing process innovation or software development may be eligible.

The Research and Experimentation Tax Credit was developed to encourage businesses to increase their research and development spending in the United States. The credit has been part of the Internal Revenue Code since 1981; however, many companies have not taken advantage of this provision. This is because the credit is very volatile, the rules are confusing, and it requires accounting firms to have specialized expertise in this area.

Since inception, the credit has expired 11 times, only to be extended each time. Most recently, the credit expired June 30, 2004 and was extended to December 31, 2005. There have been talks of making the research tax credit permanent, but that has not yet happened. The rules surrounding the credit, when originally written, were vague and caused a lot of confusion as to what products and processes might qualify. Only recently, additional guidance and changes in federal rules have made it clearer and easier for companies outside of the high-tech industry to qualify.

In order to qualify for the credit, the research activities must be performed in the United States and meet the following four-part test:

1. Functional Development – the development activities must relate to a new or improved business component. A business component is any product, process, computer software, technique, formula, patent, or invention.
2. Research or Experimental Expenditures – the expenditure must be a deductible research expenditure (IRS Code § 174).
3. Process of Experimentation – it must involve a process of evaluating different alternatives to reach a desired result.
4. Technological in Nature – the research must be undertaken to discover information that relies on the principles of the physical, biological, engineering or computer sciences.

If it is determined that an activity meets the four-part test listed above, then the following expenditures may be included in the credit calculation: wages, supplies, and contract research.

Due to the additional guidance and the possibility of making the credit permanent, we want to ensure our clients are aware of this tax saving opportunity. This is a tax credit, which translates into a dollar-for-dollar reduction in your tax liability. If you feel that your company may be performing activities that qualify for the research tax credit, please call Janell Attebery or Bill Fink at (559) 432-2346. An initial assessment can be done to determine whether the expenditures fall under the research credit definitions and if there is a tax savings opportunity.

# CALIFORNIA SALES AND USE TAX: TAXPAYERS URGED TO REPORT USE TAX LIABILITIES

By Toni Porter, CPA

In a recent news release, the California State Board of Equalization (SBE) urges taxpayers to report and pay their California use tax liabilities on their state income tax returns or on a use tax return filed with the SBE at the same time as they report and pay their income taxes. Use tax, according to the SBE, is the sales tax equivalent for online, mail order, or other out-of-state purchases of tangible personal property intended for use in California. Many out-of-state businesses do not collect use tax and pay it to the state. The SBE advises that purchasers should not mistakenly believe such purchases are tax-free simply because use tax was not collected at the time of purchase.

Examples of transactions in which taxpayers unknowingly acquire use tax liabilities include:

- (1) a Placer County resident who purchased and received merchandise for \$60 from an online retailer who did not collect tax at the Placer County rate of 7.25% would be liable for \$4.35 in use tax; and
- (2) a consulting business in Torrance that purchased and received equipment for \$75,000 from an out-of-state retailer who did not collect tax at the Torrance rate of 8.25% would be liable for \$6,187.50 in use tax.

Since tax was not collected in either hypothetical situation, the purchaser would be liable for the use tax at the local rate where the item was first used.

Purchasers may use the California income tax return or file a use tax return (Form BOE-41-DS) with the SBE to report and pay the use tax. Purchasers with a seller's permit from the SBE must report and pay their use tax liabilities on their sales and use tax returns.

There are a limited number of exceptions to the use tax requirements. Examples of some of the exceptions include:

- If, in any 12-month period, a person not otherwise engaged in an activity requiring the holding of a seller's permit makes more than two sales in substantial amounts of tangible personal property (except for vessel, aircraft, vehicles that need to be registered with the Department of Motor Vehicles, certain off-highway vehicles, mobile homes, and commercial coaches required to be registered with the Department of Housing and Community Development), the first two sales are exempt occasional sales, but the operator is required to hold a permit for the third and subsequent sales during any 12-month period. The gross receipts from the third and subsequent sales during any such 12-month period are subject to tax, unless otherwise exempt.
- 90 day rule – property purchased outside of California which is brought into California is regarded as having been purchased for use in this state if the first functional use of the property is in California. For purposes of this regulation, "functional use" means use for the purposes for which the property was designed. Except as provided in subdivision (b)(5) of this regulation, when the property is first functionally used outside of California, the property will nevertheless be presumed to have been purchased for use in this state if it is brought into California within 90 days after its purchase, unless the property is used, stored, or both used and stored outside of California one-half or more of the time during the six-month period immediately following its entry into

**There are a limited number of exceptions to the use tax requirements.**



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# FOOD FOR THOUGHT

By Nancy Ervin, Business Consultant

*When was the last time you thought about your business strategy?*



How well do you know your customer? I'm not talking about the broker or packing house who buys your product, but the end-user, the bargain hunter who has two kids, twenty minutes and 40,000 products<sup>1</sup> to choose from on a typical shopping trip.

It is probably fair to say that production agriculture, for the most part, is far removed from the end consumer. Once upon a time, the grower and the consumer were largely the same person. People knew where their food came from—because they grew it. Today, we have industrialized agriculture to the point where we have to teach children that milk comes from cows, and we have to teach some adults that agriculture is not a dirty word.

Here's a good example:

I met someone who criticized the "California Happy Cows" commercial for being unrealistic. Curious, I asked them why they felt it was *unrealistic*. "Because," they answered, "the cows are shown freely grazing in green pastures when in reality cows are raised by corporate dairy factories and confined to small dirt pens."

"That's interesting." I replied. "I guess I realized that it was a commercial and not a documentary about the time they showed the cows *talking!*"

How do we bridge a gap of this magnitude between the reality of agriculture and today's consumer? Like any business, the key is to **listen to the customer.**

Of course, each customer may not be saying the same thing. Some patrons don't care where a cow lives, as long as they can buy a gallon of milk without taking out a home equity loan. On the other hand, some people do care, and are willing to pay a premium (as much as 59% more<sup>2</sup>) for milk that comes from truly happy

cows; or for apples grown without pesticides; or tomatoes without herbicides; or beef without hormones...well actually, the last example is impossible since hormones are produced naturally by the animal. So to raise a hormone-free steer would be like trying to raise a boneless chicken. But that's a whole other issue.

The point is that in ag-business, like any business, we have to occasionally touch base with our end user and make sure that we are taking to market a product that fulfills a need. It might be a nutritional need, or an emotional, financial, or psychological need.

*When was the last time you thought about your business strategy? Where is your industry going? Is there demand for your product? If not, where is the demand? In agriculture, it may not be easy to adjust our product line for fickle consumers, nor is it a good idea to chase after fads, but it is always a good idea to listen to our customer's needs.*

Of course, there is the rare occasion when the consumer didn't even realize that they had a need, until someone comes along and demonstrates how absolutely vital their product really is. Like Pinot Noir wine. Before the movie *Sideways*, most people outside of Santa Barbara didn't even know how to pronounce Pinot Noir. Now the wine is enjoying a 22% growth over last year, and even has its own fan club!<sup>3</sup> Amazing what two minutes of screen time can do for a lonely grape varietal.

## Footnotes

<sup>1</sup> Steven M. Cristol and Peter Sealey. "Sample Text for Simplicity Marketing: End Brand Complexity, Clutter, and Confusion" <http://www.loc.gov/catdir/samples/simon051/00042188.html>.

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this state. Except as provided in subdivision (b)(5) of this regulation, prior out-of-state use not exceeding 90 days from the date of purchase to the date of entry into California is of a temporary nature and is not proof of an intent that the property was purchased for use elsewhere. Except as provided in subdivision (b)(5) of this regulation, prior out-of-state use in excess of 90 days from the date of purchase to the date of entry into California, exclusive of any time of shipment to California, or time of storage for shipment to California, will be accepted as proof of an intent that the property was not purchased for use in California.

- Commencing on and after September 1, 2001, Section 6356.5 of the Revenue and Taxation Code partially exempts from sales and use tax the sale, storage, use, or other consumption in this state, of farm equipment and machinery, and parts of farm equipment and machinery purchased for use by a qualified person to be used primarily in producing and harvesting agricultural products.

If you have any questions about whether or not you might be subject to California Use Tax, don't hesitate to call us at (559) 432-2346.

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*Food For Thought – continued*

<sup>2</sup> According to Joan Obra of the Fresno Bee, a half-gallon of Horizon Milk at Whole Foods in Fig Garden was \$3.49 compared to a half-gallon of full-fat milk from Producers Dairy at \$2.19, "Dairy Dispute Touches Valley Farmers," Fresno Bee, June 15, 2005.

<sup>3</sup> <http://www.sidewayswineclub.com>

## DID YOU KNOW?

**3** The difference in ounces between a medium-sized egg and a large-sized. There is a similar difference between large and extra-large eggs.

**13** The amount in cents of each consumer dollar spent on food in 2003. That compares with 32 cents in 1950 and 43 cents in 1901.

**41** The percentage of the American food dollar spent on restaurant dining and takeout food in 2003. That's up from 21 percent in 1960.

**8** The percentage of the American food dollar that goes for packaging the food you buy.

**51** The percent of yearly disposable income that consumers in India spend for their food. Americans spend 10 percent.

**1.5** The yearly per capita consumption in pounds by Americans of California-grown nectarines.

**45** The percentage of California Grade A milk used to make cheese. It takes five quarts of milk to make a pound of cheese.

**650** The number of recorded varieties of olives. California farmers primarily grow four of them.

**40** The percentage of the recommended daily amount of calcium for your diet contained in a dried fig.

**61** The pounds of milk a dairy cow produces each day. That's about 7 gallons of milk.

**20** The ranking of lemons on California's top 20 commodity list.

# CALENDAR

- July 4** Independence Day – BP&F office closed.
- July 28** Fresno County Farm Bureau Media Appreciation Night at Fresno Equipment Co. Information 237-0263.
- September 5** Labor Day – BP&F office closed.
- September 11** Ag Boosters' Barbeque, Dennes Coombs' Ranch in Madera. Ticket information (559) 432-2346 or (559) 278-4266.
- September 15** Due date for 2004 calendar year end corporations, including extensions.
- October 15** Due date for 2004 individual tax returns, including extensions.
- October 27** Ag One Fresno-Madera Alumni and Friends Wine Tasting, California State University Fresno Winery. Reservation information (559) 278-4266
- November 3** 24<sup>th</sup> Annual AgriBusiness Management Conference, sponsored by California State University, Fresno and Bank of America Corporation. Reservation information (559) 278-4405

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