

EXTRATERRITORIAL INCOME EXCLUSION

By Dennis Veeh, CPA

Recent legislation enacted on November 16, 2000, created new rules for 2001 allowing certain income tax benefits for agricultural taxpayers who have foreign sales.

In 1984, Congress enacted rules establishing provisions for foreign sales corporations (FSC) which were allowed certain income tax benefits related to their foreign sales. However, the FSC provisions were eventually challenged in July 1998, when the European Union contended that FSC were prohibited export subsidies. In October of 1999, the World Trade Organization (WTO) agreed that the FSC provisions were prohibited export subsidies under the WTO Agreement on subsidies. The United States was given until October 1, 2000 to terminate the FSC provisions, which they did in November of 2000.

Instead of creating another type of entity, the United States drafted rules that excluded extraterritorial income based upon the models used by the European tax systems that exclude income from outside the taxing jurisdiction. This is a departure from the normal worldwide American approach that basically subjects all income (wherever earned) to tax, absent a specific exemption.

The new provisions allow taxpayers to exclude from gross income, extraterritorial income that is qualifying foreign trade income. Extraterritorial income is the gross income of the taxpayer attributable to foreign trading gross receipts. In order to determine the amount of income that can be excluded, the definition of "qualifying foreign trade income" is important.

Generally, qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of:

- 15% of foreign trade income

- 1.2% of foreign trading gross receipts, or
- 30% of foreign sale and leasing income

The 15% exclusion is generally defined as the taxpayer's net profit from foreign sales, taking into account all costs of purchasing or producing the product.

The 1.2% exclusion is calculated on only taxpayers' gross receipts derived from foreign sales.

The 30% exclusion is more restrictive, requiring the taxpayer to have a foreign presence outside the United States in obtaining and processing the foreign sale. Other restrictions and requirements relate to this 30% exclusion and are beyond the scope of this article.

The new rules generally allow a taxpayer to obtain the above exclusions without requiring a foreign economic presence outside the United States (except for the 30% exclusion) as long as a taxpayer's foreign gross receipts are less than \$5 million.

The new provisions allow taxpayers to exclude from gross income extraterritorial income that is qualifying foreign trade income.

The extraterritorial income exclusion applies to transactions entered into after September 30, 2000. Individuals, corporations (including "s" corporations), partnerships, and other pass through entities are entitled to the exclusion. I.R.S. Form 8873 is used to calculate the amount of extraterritorial income that can be excluded.

Please call us at (559) 432-2346 if you have any questions about these new provisions.

NEW SALES & USE TAX EXEMPTIONS

By Karen Morais, CPA

A purchaser who has inadvertently paid sales tax can obtain a refund by applying with the retailer.

Assembly Bill 426 provided a number of new sales and use tax provisions that were of interest to the farming community. These were effective as of September 1, 2001. Those applicable to the majority of farmers included:

- Exemption for the purchase of liquefied petroleum gas for certain household and agricultural activities
- Exemption for certain purchases of farm equipment and machinery
- Exemption for certain purchases of diesel fuel to be used in agricultural activities

These sound pretty straightforward. Unfortunately, the language in the bill is very general and open to interpretation. The State Board of Equalization (BOE) issued a Special Notice in August 2001 to provide some guidelines. Since that time, the BOE has held meetings with interested parties and issued two discussion papers and an Issue Paper on proposed regulations. On March 27th, the public will have the right to comment on the proposed language. After the BOE approves the proposed regulations, the Office of Administrative Law will have 30 days to approve or not approve the language.

One of the items that has come under scrutiny since the original notice in August is the definition of "marketplace" in providing an exemption for diesel fuel used in farming activities or food processing. Some legislators have indicated that their legislative intent was to provide an exemption that included transportation to the final consumer. The BOE staff has proposed regulations that define "marketplace as the place where a commodity is first sold for either resale or retail, or otherwise." This issue has not been resolved.

Another issue is protective clothing. BOE staff has proposed that protective clothing be

considered supplies and therefore not included in the partial exemption. Others feel that clothing designed to protect the wearer from agricultural chemicals should be included under the exemption.

With all the uncertainty on September 1, 2001 regarding items that qualified for the exemption, you may have inadvertently paid sales tax on qualifying items. The proposed regulations provide a mechanism for the refund of sales tax. If a purchaser has inadvertently paid sales tax, they can obtain a refund by applying with the retailer. The retailer has the mechanism to file a refund claim if they have paid the sales tax to the state.

We will keep you informed on these regulations as developments occur.

CALENDAR

March 1 – Due date for tax returns of taxpayers filing as farmers

March 6 – Common Threads event at CSUF.

Ticket information (559) 278-4266

10:00 – 10:45 a.m. – "Understanding

Planned Giving and Its Benefits" workshop

10:45 – 11:30 a.m. – "Sharing Their Passion for Giving" panel

12:00 – 1:30 p.m. – Common Threads

Honoree luncheon

March 15 – Due date for tax returns of calendar year-end corporations

April 15 – Due date for individual tax returns

September 8 – Ag Boosters' Barbecue, Coombs

Ranch in Madera. Ticket information

(559) 432-2346 or (559) 278-4266

September 18 – BP&F Neil Harl Farm Income

Tax Seminar. Reservation information

(559) 432-2346

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

6 to 7 years

- Bank deposit slips
- Bank statements
- Bonds, cancelled
- Cancelled checks
- Claims, closed against company
- Credit files
- Employee records (terminated)
- Inventory records
- Invoices, copy of order
- Invoices, paid
- Payroll

7 to 8 years

- Accounts, charged off
- Commission statements
- Cost account records
- Entertainment records
- Expense reports, employees
- 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 register
- Voucher, A-Z copy

10 years

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

17 years

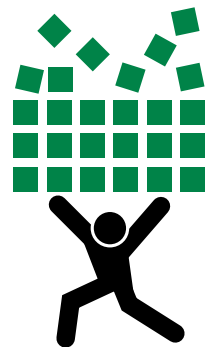
- Agreements, licenses

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
- Taxes: federal, state, property, sales and use
- Taxes: audit reports
- Tax and legal correspondence

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



CREDIT: IT'S NOT ALL DOOM AND GLOOM...IT'S WORSE

By Rich Featherstone, CPA, ABFA

A recent survey of America's top lending banks offered disappointing news for borrowers. About 48% of responding banks indicated that they plan to lend less in 2002 than in 2001. And 2001 was the "recession" year, remember?

Credit quality, Enron, Tyco, recession, write-offs and restructuring are all we hear about these days. And what about agriculture?

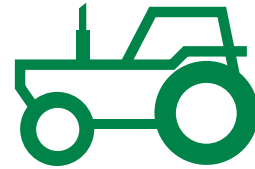
You don't have to tell Valley farmers and ranchers just how difficult it is to get credit—the credit crunch hit them more two years ago. So what can agriculture do to get the precious funds they need to survive, let alone prosper?

One solution is to approach non-traditional sources of financing you've never considered before. There are many sources of ag credit outside of traditional banks. Some farmers have successfully restructured their debt with alternative lenders to solve their crop and operating line of credit difficulties.

There are "searching specialists" who have multiple sources of ag financing. Every day, one agricultural lender is reducing their ag loan portfolio while another might be increasing their portfolio. For example, one equipment lender who never offered agriculture loans or leases received \$600 million to finance new and used farm equipment nationwide. But who knew about these available funds? Not many farmers did, although a few sources in the Valley who regularly work with this lender were aware of the program. These "sourcing" firms brought certain farmers to the lender and then assisted in structuring the financing of equipment to generate enough cash (term debt) to meet their operating line needs.

Another farmer is seeking an altogether different type of lending structure to replace the need for operating lines. Again, this financing "source" not only introduced the lender to the farmer, but helped negotiate and structure the loan to the farmer's liking.

There are ag financing alternatives—the difficulty is in finding them. If you need assistance, call any of our staff at Baker Peterson & Franklin. They can assist you in finding credit with the help of BP&F's affiliated firm, Accountants Financial Services, (559) 446-2005.



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CREATING BUSINESS VALUE

By Nancy S. Ervin, Ag Business Consultant

What is value? Value is an expression of the worth of something. It can be measured in different ways. For example, a family heirloom may have great sentimental value but little financial value. Your business has value, too. But do you know what creates value, how to build it, or even how to measure the value of your company?

For some, the value of the business may be based upon cash flow—is there enough money in the bank to pay the bills and provide an income for the family? Others measure value by the net worth accumulated on their balance sheets.

For publicly traded companies, measuring value is easy. It is reflected in the movement of their stock price—the daily scorecard of their performance. Private companies, however, lack this market feedback and direction. Their shareholders seldom understand what their company is worth or clearly see what drives its value.

According to Revenue Ruling 59-60, *Fair Market Value* is defined as:

The price at which a property will 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.

This “market value” may or may not have anything to do with the “book value” of the business. Instead, it is based upon a number of factors, including the company’s size, asset appreciation, access to capital, depth and breadth of products and services, quality of management, market share and customer base, levels of liquidity and financial leverage, and overall profitability and cash flow as a stand-alone business.

Unfortunately, most private business owners are unaware of the true worth of their enterprises until they are forced into a position where they have to consider selling their businesses. By that time, many of the factors listed above have been ignored to the point that the value of the business as a going concern is less than its liquidation value.

On the other hand, strategic managers consider value creation as their primary mission, and in the process, create focus and direction for their company.

The first step is determining the current value of your business. There is an old adage, “You cannot manage what you do not measure.” You may want to consider using a business appraisal expert for this process. Their job is to estimate the company’s true economic return, usually an adjusted form of net cash flow. This “benefit stream” is then discounted by a required rate of return, which reflects the risk or likelihood that the estimated net cash flows will be received in future periods. The result is the current value of the entity.

Current value can then be benchmarked against other businesses of similar size in the same industry. Although benchmarking ag businesses is uniquely challenging, relevant data is available, depending on the crop or services provided. This process will help determine which value drivers are weakest and need the most improvement. Shareholders can then establish reasonable goals for the economic performance of their company.

Finally, in order to continually build value in their business, managers must monitor the factors that affect value, such as changes in the market place and general economy, as well as operational and financial changes within the company.

For more information on business valuation, call Nancy Ervin at (559) 432-2346. She is available to discuss the unique aspects of appraising your agricultural entity.

Shareholders seldom understand what their company is worth.

Strategic managers consider value creation as their primary mission.



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