Cattle Enterprise Tax and Financial Management

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I. Current tax situation for farmers
   A. Current tax rates for the year 2014
      1. Individual income tax rates (the brackets are indexed annually for inflation and will increase each year)
         a. Single
            1) 10% on taxable income from $0 to $9,075, plus
            2) 15% on taxable income over $9,075 to $36,900, plus
            3) 25% on taxable income over $36,900 to $89,350, plus
            4) 28% on taxable income over $89,350 to $186,350, plus
            5) 33% on taxable income over $186,350 to $405,100, plus
            6) 35% on taxable income over $405,100 to $406,750, plus
            7) 39.6% on taxable income over $406,750
         b. Married filing jointly or qualifying widow(er)
            1) 10% on taxable income from $0 to $18,150, plus
            2) 15% on taxable income over $18,150 to $73,800, plus
            3) 25% on taxable income over $73,800 to $148,850, plus
            4) 28% on taxable income over $148,850 to $226,850, plus
            5) 33% on taxable income over $226,850 to $405,100, plus
            6) 35% on taxable income over $405,100 to $457,600, plus
            7) 39.6% on taxable income over $457,600
      2. There are similar tax rate tables for married filing separately and head of household
      3. New additional Medicare tax rates
         a. 0.9% on earned income
            1) Married filing jointly: in excess of $250,000
            2) Single or head of household or qualifying widow(er): in excess of $200,000
         b. 3.8% on net investment income
      4. Capital gains tax rates
         a. Short-term gains are taxed at ordinary income tax rates
         b. Long-term gains are taxed as follows:
            1) 0% if taxable income falls in the 10% or 15% marginal tax brackets
            2) 15% if taxable income falls in the 25%, 28%, 33%, or 35% marginal tax brackets
            3) 20% if taxable income falls in the 39.6% marginal tax bracket
            4) 25% on depreciation recapture, IRC section 1250 gain
            5) 28% on collectables and qualified small business stock

5. Utilization of rates – planning opportunities
    a. Farmers and ranchers can utilize the marginal tax rates in determining how much additional tax they will pay on extra income earned and any tax gained from additional deductions
    b. There are special rules for agricultural businesses that will be covered later

B. Section 179 expensing
1. The section 179 deduction is still available, but at a much lower amount. For the year 2014 the deduction limit is $25,000, and the phase-out range is $125,000 – $150,000, significantly lower than the comparable amounts for 2013 of $500,000 and $2,000,000 - $2,500,000
2. Section 179 property is defined as depreciable tangible personal property required for use in a trade or business. The property can be new or used.

C. Medicare surtaxes
1. Medicare surtax of 0.9% - the new Medicare surtax of 0.9% is imposed on earned income and self-employment income over $200,000 for singles and $250,000 for joint filers. The surtax applies to employees only (no employer payroll matching requirements) and is withheld by the employer on wages over $200,000. In the case of married couples' filing jointly, the $250,000 threshold is applied to the combined wages and self-employment income of both spouses. Adjustments to over or under withholding due to the filing of a joint return, are made on the couples form 1040 when filed.
2. The 3.8% Medicare surtax on investment income applies to the **lesser** of: net investment income (NII) or, the excess of the taxpayer's form 1040 modified adjusted gross income (MAGI) over a threshold of $200,000 ($250,000 if married filing jointly). Net investment income includes, but is not limited to, gross income from dividends, interest, royalties, annuities, rents (not earned in the ordinary course of a business), and gains from the sale of property not used.

II. IRS issues

A. Form 1099 reporting-payment to veterinarians
1. IRS confirms payments of $600 or more to incorporated veterinarians are required to be reported on form 1099-misc
2. Only payments made in the course of the taxpayer's trade or business are reportable
3. IRS has determined veterinarian services fall within the meaning of "medical and healthcare services"
4. Payments in the course of a trade or business to unincorporated vets have always been considered reportable

B. Full-time employment vs. day labor
1. The Fair Labor Standards Act **does not** define full-time employment; however, 40 hours per week is the general norm. The Act requires employers to pay employees time-and-a-half for any hours worked over 40 per week.

2. Usually day laborers are considered independent contractors and are not employees. A cowboy is an independent contractor and provides his own horse, stock trailer, cow dog, and cattle supplies.
3. IRS uses a number of factors to determine if a worker is an employee or an independent contractor
4. ObamaCare defines full time employment as 30 or more hours per week. However, with all of the changes made to the law as of today, we have no idea what the final outcome will be.

C. New capitalization and repair regulations

1. The entire purpose of these new regulations is to reduce the amount of expense that can be claimed in any one year and force taxpayers to capitalize more expenditures. It also forces tax professionals to become compliance officers for the IRS.
2. The new Tangible Property Regulations (capitalize vs. expense) became effective January 1, 2014. The implementation of these new regulations had been delayed two years.
3. Virtually everyone in a trade or business will be affected by these new regulations
4. The new rules cover the broad areas of:
    a. Deductible repair and maintenance costs
    b. Timing for deducting materials and supplies
    c. How to treat the cost of rotable, temporary and standby emergency spare parts
    d. Capitalization in general requiring taxpayers to depreciate an asset over its tax recovery period as opposed to current expensing
    e. Amounts paid to acquire property and
    f. Amounts paid to improve property
5. Materials and supplies, even when values are significant, can be currently deducted if consumed within a twelve month period
6. A de minimis rule permits a current deduction of any single item under $500 in cost. A written policy must be in place and elected annually by the taxpayer.
7. Taxpayers claiming a loss on removing a portion of an asset are required to capitalize (ie: depreciate) any replacement. Replacement of a damaged roof caused by wind on which a casualty loss was claimed would require capitalization. The same would be true for the replacement of a tractor engine if it is a long-life replacement. A re-occurring replacement could be considered a repair.
8. Expenditures that adapt an asset to a new or different use must be capitalized. Some examples are a pole barn converted to a work shop with the installation of wiring, lighting and equipment, and a pole barn converted to a milking parlor, or a storage shed converted to an office.
9. An expenditure that **materially** expands or increases the capacity or efficiency of an existing asset also must be capitalized. A major addition to an existing building would require capitalization. Converting a tractor to a herbicide unit or

pole barn to a cattle working area including a squeeze chute would require capitalization. Expenditures that increase efficiency only marginally would not be a capital improvement, such as replacing a 1hp pump on a cattle watering well with a 2hp pump.

10. Expenditures that restore an asset to a like-new condition after its class life has expired would generally be considered a restoration, such as a John Deere 4020 tractor to a like-new condition. Similar work done during the assets class life might be considered a repair. The definitions of a restoration are not as clear as some other provisions of the regulations and will most likely cause controversies and challenges with the IRS over their interpretation.
11. Implementation is now here and all of us must address these new regulations, regardless of the challenges and complexities inherent in these new rules,we as ranchers and farmers are affected by these regulations

D. Audit issues
   1. Maintenance of proper records and supporting documents is essential
      a. Use of a separate checkbook and QuickBooks including a general ledger is recommended
      b. Keep a log of your activities to support your farming operations and any supporting data including a mileage log
      c. Keep all supporting documents of your income and expenses, plus any additional documentation supporting your income tax return
      d. The IRS will ask for and is entitled to any information concerning your farm operations kept in electronic media. The data must be kept at least 3 years and also the software needed to access the data.
   2. IRS will look for unreported income items such as sales of by-products and secondary sources of income. Some examples that have been identified are:
      a. Manure may be dried, packaged and sold as fertilizer; corn cobs may be sold for use in making plastics, perfumes, etc.; untilled land may be rented for pasture
      b. Dairy farmers may sell excess calves not required for their operations
      c. Dairy and beef farmers may sell excess raised hay and grain
      d. Farmers with excess wooded areas may sell off trees for lumber, firewood, and landscaping
      e. Soil may be sold as topsoil, sand, fill etc.
      f. Income from hunting privileges
      g. Barter income
      h. Unreported income may not be identifiable by looking at a tax return, but IRS examiners are trained to look for secondary income
   3. Business vs. hobby losses may become more of an issue as the government is looking for more tax dollars.
      a. A hobby is basically an activity not engaged in to make a profit and hobby losses can only be deducted to the extent of hobby income received. On the other hand, losses generated by an activity intended to make a profit can offset other income such as wages, salaries or income from another occupation.

b. Proper planning and conducting your activity as a for-profit small business at the start can preserve your business deduction and aid in preventing problems in the future
c. If your activity generates a profit in 3 out of 5 consecutive years, your activity is generally presumed to be a for-profit business. For breeding purposes profits must be made in 2 out of 7 consecutive years.
d. If the taxpayer does not meet the above general test or refutes the presumption that his or her activity does not have a profit motive, the IRS will look at nine relevant factors. They are as follows:
    1) The manner in which the taxpayer carries on the activity
    2) Expertise or experience of taxpayer or advisors
    3) Time and effort expended
    4) Expectation that assets may appreciate in value
    5) Success in operating similar activities
    6) History of losses
    7) Occasional profits
    8) Financial status of owner and
    9) Presence of entertainment or personal recreation

III. Farmers Taxes

A. Accounting methods
    1. Most farmers use the cash method of accounting as it is easier to keep records. Cash basis farmers are not generally required to compute inventories of growing crops or raised livestock.

B. Farm income and expense
    1. Income from farming includes amounts received from cultivating, operating, or managing a farm for profit
        a. This includes income from operating a cattle, dairy, poultry, fish, fruit, or truck farm and income operating a plantation, ranch, range or orchard
        b. It also includes income from the sale of crop shares if you materially participate in producing the crop
        c. Nurseries specializing in growing ornamental plants
    2. Farm income does not include gains or losses from the sale or other dispositions of the following farm assets
        a. Land
        b. Depreciable farm equipment
        c. Buildings and structures
        d. Livestock held for draft, breeding, sport or dairy purposes

Table 1. Where to report the sales of farm products

Item Sold	Schedule F	Form 4797
Farm products raised for sale	X	
Farm products bought for sale	X	
Farm assets not primarily for sale, such as livestock held for draft, breeding, sport, or dairy purposes (bought or raised)		X

3. Land preparation-capitalize vs. current expense
    a. Capital costs are paid or incurred for the acquisition, improvement or restoration of an asset having a useful life of more than one year
    b. The following must be capitalized (total costs include materials, shipping & handling, sales tax, hired labor and installation costs):
        1) Clearing land for farming (survey and layout of field)
        2) Laying and conditioning land (fumigation and discing)
        3) Purchasing and planting trees and vines (digging)
        4) Building irrigation canals and ditches
        5) Laying irrigation pipes and installing drain tile
        6) Modifying channels, streams and dams
        7) Constructing earth, masonry or concrete tanks and reservoirs
        8) Generally fertilizer and lime application benefits that last substantially longer than one year
4. Land expenses currently deductible
    a. Common reoccurring land expenses are deductible in the year in which they are paid or incurred where the benefits are generally about one year or less. For crops like vineyards or orchards these expenses are currently deductible after the plants are producing at marketable quantities. Types of common reoccurring expenses are:
        1) Pesticides, herbicides, and other chemicals applied yearly
        2) Discing for weed control and ground maintenance
        3) Insecticide spraying and dusting, and
        4) Fertilizer, lime and other materials that enrich, neutralize, or condition farmland
    b. Generally, expenses incurred by a taxpayer engaged in farming or soil and water conservation may be currently deductible
    c. Expenses such as leveling land or breaking up the “hardpan” below the surface, are currently deductible even though it made the farmland usable for other crops for which it was not previously suited
    d. Usually, these costs are currently deductible if the land has previously been used for farming, although the courts are divided if there has been a long period of time between farming use of the land. Changing the use from farming to raising cattle may also limit current deductions.
5. Uniform capitalization IRC Section 263A

   a. Annual planters, those that have preproductive periods of less than two years are not subject IRC Section 263A. Some example crops are corn, wheat, tomatoes, etc.
   b. Vineyard and orchard growers having a preproductive period greater than two years are subject to IRC Section 263A
   c. The IRS has identified a number of crops, the raising of which are subject to the 263A rules. The list includes, but is not limited to, blueberries, grapefruit, grapes, lemons, mangoes, and oranges.
   d. Costs subject to IRC Section 263A include seed, seeding, or plant, and costs of planting, cultivating, maintaining, or developing such plants during the preproductive period. These costs include but are not limited to irrigation, pruning, soil and water conservation, fertilizing, spraying, harvesting storage upkeep, repairs, electricity and overhead.
6. Domestic Production Activities Deduction
   a. A taxpayer is allowed a deduction of 9% of the lesser of, Qualified Production Activities Income (QPAI) for the year or the taxable income of the taxpayer (for individuals AGI)
   b. QPAI is defined in general as the taxpayer's Domestic Production Gross Receipts for the year less the sum of all costs allocable to those receipts including costs of goods sold
   c. There is one other major limitation, the deduction cannot exceed 50% of the Form W-2 wages of the taxpayer/employer for the year
7. Income Averaging: Farmers and ranchers can reduce their federal taxes by use of income averaging, a tax benefit that is not available to most other taxpayers
   a. Income averaging permits farmers and ranchers to obtain a benefit by applying lower marginal income tax rates from the three prior years to current year taxable farm income
   b. Income averaging applies to almost all farm income except the gain on the sale of land
   c. Income averaging deserves greater attention now as higher tax rates became effective in 2013 to 2014
8. Income Deferral
   a. Cash basis farmers have the ability to sell crops in one year and receive payment in the subsequent year (i.e.: crop insurance deferral)
   b. Ranchers can defer income for one year due to weather related conditions, if designated by the federal government
   c. Taxpayers are allowed to defer gains realized from involuntary conversions under IRC section 1033 assuming all election requirements are met
9. Prepaid Farm Expenses: Farmers and ranchers may deduct prepaid farm expenses where there is a legitimate business purpose for the prepaid expense and gain an income tax advantage at the same time. Certain tests must be met and there are limitations, but a little planning and due care can result in a tax savings. They are:

a. There must be an actual purchase, not just a deposit
b. Must be for a legitimate business purpose
c. The expenditure cannot result in a material distortion of income
d. Prepaid farm expenses cannot exceed 50% of deductible non prepaid expenses for the taxable year
e. There are two exceptions to the 50% test:
    1) An eligible farmer, who fails the 50% test due to a change in business operations directly attributable to extraordinary circumstances, including government crop diversion programs, may ignore the test
    2) An eligible farmer who satisfied the 50% test on the basis of the three preceding taxable years is also exempt
f. Farm syndicates cannot deduct prepaid expenses, deductions are allowed only in the years the supplies are used or consumed

10. The IC-DISC: The original DISC rules have been in place for decades, but rule modifications in 1984 brought about the Interest Charged Domestic International Sales Corporation (IC-DISC). The repeal of the Foreign Sales Corporation and most of the other export benefits, has led to a resurgence of the IC-DISC. The IC-DISC is the only remaining export incentive available to companies exporting products and is designed to benefit small businesses.
    a. The IC-DISC can be set up in a few days
    b. Is exempt from federal taxation
    c. Qualified IC-DISC corporations may defer up to $10 million of income derived from qualified export receipts. In addition, and possibly the greater benefit, the owner of the IC-DISC is eligible for the lower qualified dividend tax rate on distributions from the IC-DISC Corporation. If you are exporting Ag products; cattle export, semen export, ag. grown products or a combination of grown products and do not have an IC-DISC, you may be missing out on this tax benefit
        1) The qualified dividend benefit
        2) Establishing an IC-DISC
        3) Export property
        4) Commission paid to the IC-DISC

IV. The year 2014 and future

A. Do not expect any tax legislation to be enacted in 2014
B. The government is looking for more tax dollars and wealthier taxpayers appear to be the target
C. The 100% deferral of capital gains via like-kind exchanges may be on its way out