Through the Crystal Ball – Farm Business Structure After Tax Reform

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CONTROLLING CHAOS IN UNCERTAINTY

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Top Producer Seminar

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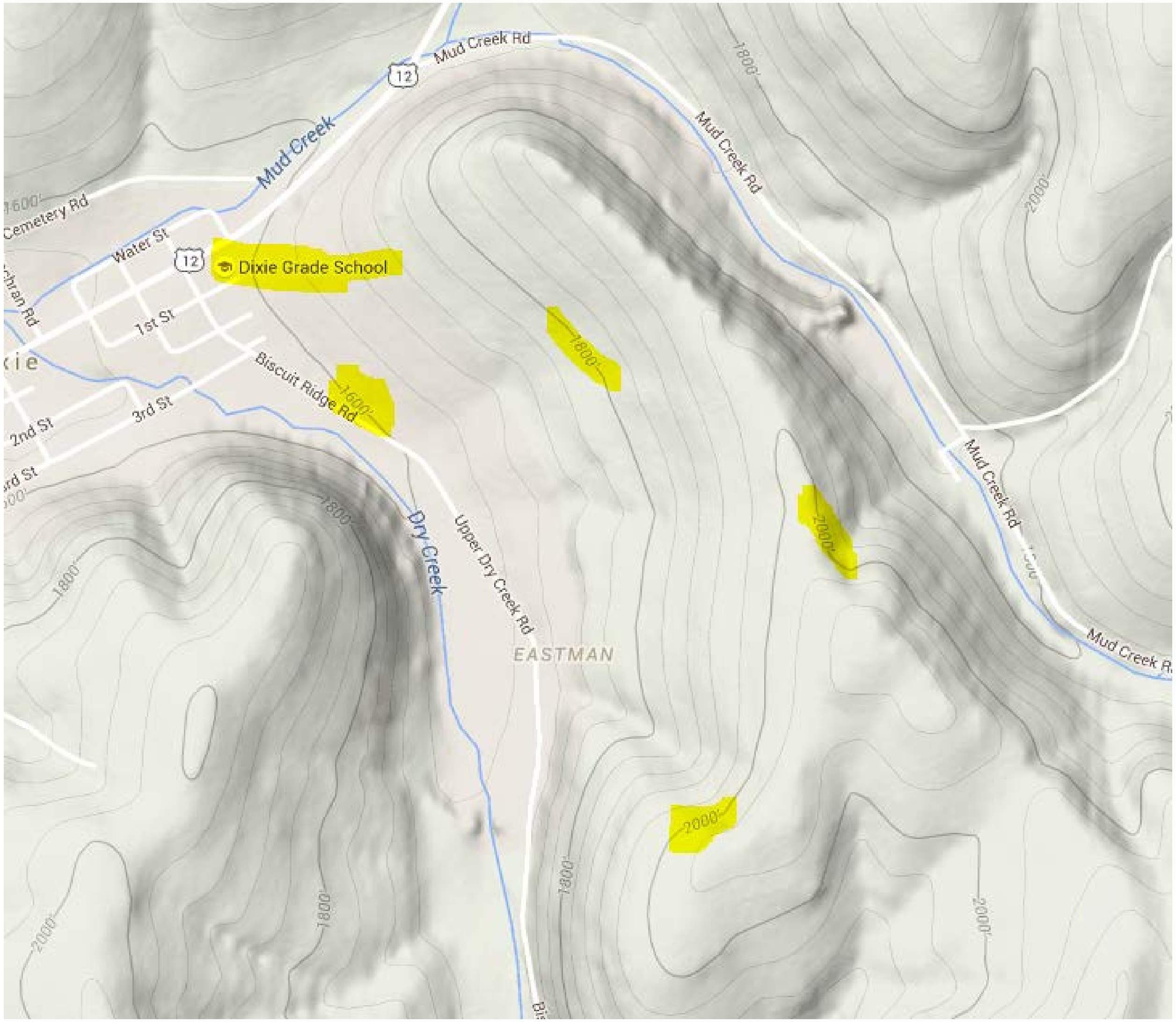
Speaker Introduction

Paul Neiffer, Principal, CliftonLarsonAllen

- Frequent national speaker on taxation, agricultural, farm bill and estate tax topics
- Current chair of the AICPA National Agriculture Conference committee.
- Past - President of Farm Financial Standards Council
- Author of the “FarmCPA” Top Producer column
- Primary source for nationally recognized blog “FarmCPAToday.com”


MASSEY-HARRIS


Mud Creek Rd
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Mud Creek
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Water St
Dixie Grade School
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Biscuit Ridge Rd
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Dry Creek
Upper Dry Creek Rd
EASTMAN
Mud Creek Rd
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Paul’s Crystal Ball

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Individual Tax Reform Proposals

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Tax Rates For Individuals

- Individuals would now have tax rates as follows:

Tax Brackets Under the House GOP Tax Plan, 2016			
Ordinary income	Capital gains, dividends, and interest	Single filers	Married joint filers
12%	6%	$0 to $37,650	$0 to $75,300
25%	12.5%	$37,650 to $190,150	$75,300 to $231,450
33%	16.5%	$190,150+	$231,450+
Note: Dollar thresholds refer to dollars of taxable income. This table assumes that the 12% bracket replaces the existing 10% and 15% brackets, the 25% bracket replaces the 25% and 28% brackets, and the 33% bracket replaces the 33%, 35%, and 39.6% brackets.			

Note interest income is now taxed same as dividends and long-term capital gains

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Other Individual Provisions

- Increase standard deduction to:
  - $12,000 for singles
  - $24,000 for married couples
  - $18,000 for head of household
- Eliminates the personal exemption
- Increases the child credit to $**1,500** and adds $**500** credit for dependents that are not children
- Eliminates all itemized deductions other than **mortgage interest** and **charitable deductions**
- **Eliminates the Alternative Minimum Tax** (AMT)

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Which Entity is Best for Liability Purposes

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Liability Reasons for Entity Selection

- Sole proprietors are subject to unlimited liability exposure
- Partnerships are even worse
  - Exposed to other partner issues
- Corporations limit exposure to investment
  - Guarantees are separate issue
- LLC, LLP and LLLP are essentially the same as corporations
- LP are hybrid of each
- Trusts may or may not provide protection

Conclusion

- Either a corporation or one of the limited liability entities (LLE) is appropriate to limit liability to the owners
  - **Needs bank account**
  - **Needs to be run like a business**
  - Should have annual meetings and documentation
  - If not, then piercing the entity shield can and will occur

Estate Taxes

- Likely eliminated (perhaps for only 10 years)
- Gift Tax may still be around
- May have a capital gains tax upon gift or at death
  - May not apply to individuals under $10 million of net worth
- May eliminate step-up at death
- Be Careful For What We Wish For
  - Elimination of estate taxes may result in a lot more income tax being owed

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Payroll Tax Savings From Using An Entity

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Payroll taxes

- Sole proprietors and partners are subject to **15.3%** maximum FICA and Medicare on first $**127,200** of income (2017 numbers).
- 2.9% or 3.8% on all income above that level
- Wage base may exceed $**200,000** in less than 10 years

How Does Corporation Fix That?

- C corporate owners are only subject to payroll tax on actual cash wages paid
  - Excessive compensation issues
    - Rarely an issue with farm operations
  - Double tax on dividends
    - Offset by lower dividend tax rates
  - **Built-in tax on land holdings**
  - **Commodity wages**
    - Provides additional deduction to corporation and income to shareholder/employee, but no payroll taxes

How About S Corporations?

- S Corporations owners are only subject to payroll taxes on actual cash wages paid
  - Not enough (opposite of C corporations)
    - **Rarely see a farmer paid more than $50,000 salary**
  - **Dividends are payroll "tax-free"**
  - Commodity wages
    - Can still be used to reduce overall payroll taxes

Commodity Wages

- Commodity wages are deductible by employer, and
- Wage to employee, but
- **No payroll tax is owed by employer or employee**
- Wages are in Box 1 of W2, but not box 3 or 5, FICA or Medicare wages
- Employee is subject to market changes and must incur costs to hold
- Gain or loss on difference when sold
- Great for owners, can be issue for rank and file

How LLC Reduces Payroll Tax

- A properly structured “manager” managed LLC can substantially reduce payroll taxes
  - Must need **at least 20%** owned by non-managers working **less than 500 hours** to be most effective
  - Can Bifurcate Manager’s interest into Managers and Non-managers interest
    - 1%, 49%, 50%
    - 15%, 35%, 50%
  - Great for Husband / Wife farm operations

Payroll Taxes After Tax Reform

- May eliminate the extra .9% Medicare tax on earned income over:
  - $200,000 for single taxpayers
  - $250,000 for married couples
- May require 70/30 (or other %) of all flow-through income to be subject to payroll taxes

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Payroll Taxes After Reform Example

- Farmer John operates as an S corporation. He pays himself a $36,000 wage and the S corporation earns $200,000 during 2017
  - Under tax reform, 70% of the total income of the S corporation of $236,000 may be subject to payroll taxes. This increases FICA and Medicare payroll taxes from $5,508 ($36,000 X 15.3%) to $20,564 ($127,200 X 15.3% + $38,000 X 2.9%).

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Which Entities Work Best for Income Tax Purposes

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Income taxes

- Sole proprietors and partners are subject to ordinary income tax on all farm earnings
  - Husband and wife are added together
  - Sole proprietors can make wage payments to kids
    - **Deductible by Mom and Dad**
    - **Most likely tax-free to kids**
    - **Can put wages into Roth**
    - **Should file W2s**

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How C Corporation Helps?

- Income on first $50,000 is taxed at 15% and usually lower state income tax rates
- For lower income farmers with families may allow for Earned Income Tax Credit
- **Tax-free fringe benefits such as:**
  - **Meals**
  - **Lodging**
- Timing
  - C Corporation can have any year-end
  - Allows extra deferral period (if needed)

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Employer-Provided Meals

- **Must be C corporation**
  - Must meet employer/employee relationship
  - S Corporations are treated like partnerships
- **Tax-free to Employee**
- Meals furnished to employee, spouse and dependents
- For convenience of employer
- On business premises

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Employer Provided Lodging

- Must be owned or rented by employer (C corp. only)
- **Can deduct all costs including:**
    - **Interest and real estate taxes**
    - **Utilities and insurance**
    - **Furnishings (can't take Section 179)**
    - **Depreciation (bonus depreciation is allowed)**
- Needs to be on the farm
- **Documentation, documentation, documentation!!!!!**

Creative Use of Lodging?!

- Shareholder owns land – leases to C corporation on a 20 year lease
- Corporation builds residence, takes 50% bonus depreciation, depreciates remainder over 20 years
- At end of 20 years, residence reverts back to shareholder
- **Shareholder has zero basis in home, lives in it for at least two years and sells it tax free (up to $250/$500,000 gain) under Section 121**

C Corporation Example

	Sole Prop.	C Corporation Corp.	C Corporation Owner
Income	$ 100,000	$ 70,000	$ 30,000
Less tax-free fringe benefits	-	(20,000)	-
Gross Income	100,000	50,000	30,000
Less S/D and 5 exemptions	(32,600)	-	(32,600)
Less SE deduction	(7,650)	-	-
Taxable income	59,750	50,000	(2,600)
Income Taxes	9,188	7,500	-
Self-employment taxes	15,300	-	-
Earned income tax credit	-	-	(4,728)
Total income and SE taxes	$ 24,488	$ 7,500	$ (4,728)
Net savings		21,716	

Do S Corporations Help

- Not really
  - **Unable to achieve tax-free fringe benefits to shareholders**
  - All income or loss flows through to shareholders
  - Primarily payroll tax savings
  - **Issues with stock/debt basis**
    - **Especially for farm operations with large Section 179 deductions and debt on equipment purchases, etc.**
- If ownership is split among family members, then some tax savings can result
  - Have to watch out for Kiddie Tax

C Corporations After Tax Reform

- Likely to be either current structure with a maximum tax rate of around 15%,

OR

- A new "Destination-Based Cash-Flow Tax" (DBCFT)

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Destination-Based Cash-Flow Tax (DBCFT)

- Would abolish the current corporation income tax
- Replace it with Destination-Based Cash-Flow Tax at a 20% rate for corporations / 25% for unincorporated businesses
- Essentially a Value Added Tax (VAT) with a deduction for wages paid
- Eliminate taxes on returns to investment and would treat debt and equity equally
    - Business interest expense is only deductible against business interest income can be carried forward

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DBCFT (continued)

- Costs paid for imported goods would be non-deductible
- Sales from goods exported would be non-taxable
- All business investments including intangible investments (other than land) would be fully deductible
- Eliminates the corporate alternative minimum tax
- Allows net operating losses to be carried forward indefinitely and increased by a factor reflecting inflation and the real return to capital

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DBCFT (continued)

- Does not allow net operating losses to be carried back
- Restricts the deduction for NOLs to 90% of taxable income
- Eliminates the Domestic Production Activities Deduction

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DBCFT – Example of Tax Savings

	Current Law	DBCFT
Grain Sales:		
Consumed in US	1,000,000	1,000,000
Exported	750,000	-
Total grains sales subject to tax	1,750,000	1,000,000
Expenses		
Cash expenses for US produced	600,000	600,000
Cash expenses for imports	200,000	-
Business interest	75,000	-
Section 179	300,000	-
Equipment purchases	-	300,000
DPAD deduction	60,000	
Total deductions	1,235,000	900,000
Net income	515,000	100,000
Net corporate income tax	180,250	20,000

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DBCFT – Example of Tax Increase

	Current Law	DBCFT
Grain Sales:		
Consumed in US	1,750,000	1,750,000
Exported	-	-
Total grains sales subject to tax	1,750,000	1,750,000
Expenses		
Cash expenses for US produced	500,000	500,000
Cash expenses for imports	350,000	-
Business interest	125,000	-
Section 179	500,000	-
Equipment purchases	-	500,000
DPAD deduction	35,000	-
Total deductions	1,510,000	1,000,000
Net income	240,000	750,000
Net corporate income tax	79,600	150,000

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Example of Net Tax After Dividends

	Current Law	DBCFT
Income taxed at C corporation	100,000	100,000
Income taxes paid by C corporation	22,250	20,000
Net cash available to shareholders	77,750	80,000
Taxes at shareholder level		
Low brackets (15%/12%)	-	4,800
Medium brackets (25%/25%)	11,663	10,000
Higher brackets (33%/33%)	14,617	13,200
Net Cash After All Taxes:		
Low brackets (15%/12%)	77,750	75,200
Medium brackets (25%/25%)	66,087	70,000
Higher brackets (33%/33%)	63,133	66,800

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What About S Corps, LLCs and Partnerships

- Maximum tax rate would be 25% on business income
- Some allocation of net taxable income subject to FICA and Medicare tax (70%/30% is likely)
- Income taxes may go down, but SE tax may go up
- Restrictions likely in place to prevent wage earners at 33% top rate to convert to business to be taxed at top rate of 25%

Other Provisions

- Section 1031 exchanges
  - No need for these (other than perhaps land) since all business assets can be immediately deducted
- Cash Method of Accounting
  - Likely to remain, however, may be limited to certain size operations
- Commodity Wage Exemption from Payroll Taxes
  - May be retained

Other Provisions - Continued

- Section 179
  - No longer needed. All business investments other than land will be 100% deductible. This includes
    - Equipment
    - Buildings
    - Water Rights (if not considered land)
    - Goodwill, customer lists, etc.
  - However, all sales of these business assets will be ordinary income (amounts in excess of original cost may be capital gains, not known yet)

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Other Provisions - Continued

- Section 263A on Pre-Productive Costs
  - Eliminated since all business investments can be deducted immediately
- Deferred Payment Contracts
  - Not sure
    - If the commodity is exported, will not count as income anyway
- Prepaid feed and other farm expenses
  - Likely unlimited deduction for these “investments”
  - However, imported goods such as fertilizer, fuel, etc. may not qualify for deduction

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Other Provisions - Continued

- Business Interest Expense
  - Only can be deducted against business interest income
  - Any net remaining amount can be carried forward to deduct against business interest income in that year
  - Eliminates incentive to finance business purchases with interest versus equity
- State income and personal real estate taxes
  - Not allowed as deduction for individuals

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