

CONTRYMAN
ASSOCIATES, P.C.

The Contryman Farm Account

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New Tax Law

The Production Deduction

As you may have read, there is a new deduction added to the tax law beginning in 2005. This new deduction is available to all businesses that manufacture, produce, grow or extract property within the U.S. It begins at a modest 3% of net income for the years 2005 and 2006, but then moves to 6% for three years and finally reaches 9% in 2010 and after. The good news is that farmers and ranchers, whether engaged in grain or livestock production, are classified as growers eligible for this new deduction.

For most of our farm and ranch clients, we expect that this new subtraction will be a relatively straight forward calculation that is simply part of the tax return preparation. In most cases, it should not be necessary to

undertake any special planning or recordkeeping. However, there are two situations where some ag producers will need to take special action.

The Wage Limit

This new deduction is limited to 50% of the business's qualifying wages for the year. Recent guidance from the IRS indicates that only wages subject to payroll taxes count for this limit. Thus, ag wages paid in commodities are not considered. Also, many farm proprietors and partnerships do not issue any wages because all labor is provided by the self-employed owners. In these cases, it will be important to consider the merits of establishing some small wage amounts to family members before

the end of the year, in order to qualify for this new production deduction. For example, it may be possible to pay a small wage to family members who provide services to the farming business in order to assure that the full production deduction is available.

We can assist in identifying the appropriate amount of payroll to assure that the deduction is available, and also identify whether the extra payroll tax costs (vs. the income tax savings of the new benefit) merit this action.

Nonqualifying Activities

While growing and manufacturing activities qualify for this new deduction, providing services to others, as well as retailing and wholesaling activities, do not qualify. Examples of nonqualifying activities would include significant trucking/grain hauling services for other producers, or the purchase and resale of seed or chemicals. If these nonqualifying activities represent over 5% of gross receipts for the year, that portion of your net income, after allocation of expenses, must be segregated from your other farming activity and is ineligible for the new deduction. For those with these nonqualifying activities, it is important to keep your books and records in a manner that allows easy identification of the net income attributable to the nonqualifying activity.

If you have any questions, or need assistance in determining either the merits of adding wage expense or discussing recordkeeping for nonqualifying activities, please contact the farm tax professionals at Contryman Associates, P.C.

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Depreciation Incentive Update

In an earlier issue we discussed the depreciation incentives created by the Jobs and Growth Tax Relief Reconciliation Act of 2003.

50% Bonus Depreciation

For qualifying property placed in service between May 5, 2003 and December 31, 2004 an additional 50% depreciation deduction was allowed. Generally qualifying property was new property of a type that is normally depreciated over a life of 20 years or less. Since qualifying purchases had to be made by December 31, 2004, this incentive is no longer available. Taxpayers will get to recover the add-back depreciation on later year Nebraska returns.

\$100,000 Section 179 Expensing Option

The 2003 Act also increased the first year expensing election from \$25,000 to \$100,000 (\$105,000 for 2005 as indexed by inflation). Qualifying property eligible for this write-off can be new or used. The allowable deduction cannot exceed business net income and is reduced to the extent qualifying property acquisitions exceed \$420,000 for 2005. The American Jobs Creation Act of 2004 has extended this provision through tax years beginning before January 1, 2008.

New Limitation on Use of Section 179 for Certain Passenger Vehicles

Previously, vehicles not subject to the luxury vehicle depreciation limits could use the \$100,000 expensing limit. Now, for purchases after October 22, 2004, generally vehicles over the old 6,000 pound unloaded gross weight limit

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Depreciation Incentive Update

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and under 14,000 pounds gross vehicle weights are limited to a \$25,000 Section 179 write-off. An important exception is available for pickups over the 6,000 pound limit that have cargo areas at least 6 foot in interior length. Pickups qualifying for this exception can continue to use the \$100,000 limit.

Extended Election, Revocation, or Amended Provisions for Section 179

The 2003 and 2004 tax legislation allow taxpayers to revoke the Section 179 election on an amended return for years 2003 – 2007. New IRS regulations also allow taxpayers to amend 2003 – 2005 tax returns to make a late Section 179 election or change the amount of Section 179 expensing claimed. These provisions give taxpayers a lot more flexibility. For example, if the taxpayer has an item of late appearing income that requires an amended return, additional Section 179 expensing could be claimed to offset the income (assuming the taxpayer did not originally maximize the section 179 limit). Another example is where a piece of equipment that was fully expensed in the prior year is unexpectedly sold, resulting in a large gain. The taxpayer can now go back and switch the prior year Section 179 to another qualifying asset and just take regular depreciation on the asset that is sold.

Year-End Tax Planning

Prepaid Expense Guidelines

To obtain a current year income tax deduction for your prepaid expenses, you must follow these **four guidelines**:

1. Purchase, not deposit. The expenditures must be an actual purchase of specific goods, not a mere deposit to buy in the future. A cash method farmer should secure an invoice that clearly specifies a definite quantity, quality, and unit price for the items purchased. There should be no right to refund or repurchase noted on the invoice.

2. Business reason. The expenditure must be for a business reason and not merely to avoid taxes. Examples of typical business reasons for year-end ag prepayments include achieving a discount, securing access to a good or service that might be unavailable in future months, or a desire to lock in a price for an item that might be more costly in the future.

3. No material distortion of income. In general, a prepaid item does not constitute a distortion of income if the item or service is reasonably expected to be consumed or received within the next 12 months. IRS regulations have clarified that a prepayment is deductible if it does not extend beyond either 12 months from when the taxpayer first realizes the benefit or beyond the end of the year following the year of payment.

4. 50% prepaid limit. The prepaid amount may not exceed 50% of the non-prepaid expenses incurred for the year. In measuring the non-prepaid items, depreciation can be counted, as well as other farm expenses for which the good or service has been received or consumed during the year.

Other Rules

While the preceding four tests are the cornerstone rules, there are additional caveats:

- Prepaid interest can never be deducted, as a matter of law. However, any other deductible expenditure, even including rent, can be prepaid, assuming the preceding four tests are met.

- Payment is considered made when a check is mailed or delivered to the payee, even though not cashed until a later date. However, a check which a taxpayer directs the payee to hold for some period of time is not deductible.

- An overdrawn account does not prohibit the deduction in the current year if sufficient funds can be made available for payment, such as by a bank line of credit when the check is presented or by deposits that allow the check to be promptly paid by the bank.

- Payment may be made with borrowed funds, but those funds should not be borrowed from the vendor or payee with whom the taxpayer conducts the prepaid transaction.

- Charging a purchase on a credit card is considered to be payment at that point, not later when the credit card bill is paid.

A Final Word

An IRS audit examination typically involves close scrutiny of transactions at year-end. Farm prepaid expenses are often a significant amount, and it is important to follow the guidelines noted above, in order to prevent the IRS from disallowing your prepaid deductions.

The Contryman Farm Account Newsletter

The **Contryman Farm Account** has been developed to address issues specific to the needs of our farmer friends and clients. It will be sent to you free of charge several times each year. Also, if you have farmer friends or relatives that you believe would benefit from the information in the **Farm Account**, please let us know and we will add them to our mailing list. If you would prefer not to receive this publication, we will be happy to remove your name.

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation with a tax professional. For additional information, contact our firm.