Payment of Wages with Commodities and Gifting of Grain

Kristy Maitre
Tax Specialist
Center for Agricultural Law and Taxation
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Agenda

- Benefits of gifting agricultural commodities
- Making gifts of commodities
- Advantages and disadvantages of paying commodity wages
- Sample Form W-2
- Pitfalls of both and the proper tax procedures
- Documentation required

Charitable Contributions or Gifting Commodities – Which Way Do We Go?
Background

- **Cash Method**: Farmers can save on two tiers of taxes:
  - Income taxes can be reduced if:
    - Taxpayer only use the standard deduction
    - Reduces AGI for other tax calculations
  - Reduces self-employment income and SE tax by the value of the gift

Difference Between Gifting Grain or Making a Charitable Contribution

- A cash contribution to an eligible non-profit generates a potential itemized deduction saving income tax
- If an individual cannot itemize – no tax benefit
- Gifting a commodity eliminates the reporting of the sale as income but still allows the farmer to deduct the costs of the production of the commodity
- In addition, this reduces farm income and thus generates saving for both income tax and self-employment tax

No Charitable Contribution

- This eliminates the charitable contribution deduction – after all no double dipping but they save twice
  - 15.3% of self employment tax
  - Percentage of income tax based on tax bracket
Example

- Farmer Josh would annually make a $20,000 cash contribution to his church
- Cash is tight this year and Josh has grain setting at the elevator or in bins on the farm property
- Current market price of corn is $4.00 a bushel
- Josh gifts 5,000 bushels of corn to his church

Example Part 2

- Josh must be careful in how the transaction is conducted
- The charity must have legal right or own the grain that is being gifted to them so ownership must pass to the charity

Dot Your I’s and Cross Your T’s

- Present a letter to the charity advising they are being gifted with 5,000 bushels of corn
- The charity takes possession of the grain and will arrange for the transportation if stored on the farm or inform the elevator of payment arrangements
- A warehouse receipt should be issued in the name of the charity
Dot Your I’s and Cross Your T’s

- Once the transaction/transfer is completed the charity should provide a statement of receipt to Josh detailing the receipt of the commodity and the charitable contribution.

Key Points

- The donor must be an active cash basis farmer engaged in farming activity.
- Charitable contribution issues - Form 8283 does not need to be filed with the return or an appraisal obtained – less paperwork.
- No charitable deduction is taken.
- There cannot be a prior sale commitment.
- A farmer cannot sell the grain and then order the proceeds to be sent to the charity.
- The gift must be unsold grain in the farmers inventory from the current year or previous years crop.

Key Points

- The farmer must give up control and ownership of the grain and the farmer cannot provide guidance on the sale.
- The charity must direct the sale from start to finish, they must decide what to do with the donation and when to sell.
- Once ownership has passed the charity assumes responsibility for costs of:
  - Storage
  - Transportation
  - Marketing
  - Risk
Key Points

- Documentation must show the charity is owner of the grain – control must pass from the farmer to the charity
- Warehouse receipt or a notarized letter of transfer of crops must be issued if crops are stored on the farm
- The original sale invoice should list the charity
- A letter of understanding or documentation of the Requirements for Consideration and Acceptance of Crop Commodities should be provided

Farmer Josh - Savings

- Farmer Josh would annually make a $20,000 contribution to his church
- Cash is tight this year and Farmer Josh has grain available to gift
- Current market price of corn is $4.00 a bushel
- Josh gifts 5,000 bushels of corn to his church

Tax Savings

- $20,000 X .9235 = $18,470 X .153 = $2,826 - self employment tax
- $20,000 X .25% tax bracket - $5,000 income tax
- Total savings of $7,826
Tax Savings

- If Farmer Josh was in the 25% bracket a charitable deduction of $20,000 would generate a tax savings of $5,000
- An additional tax savings of $2,826 was generated in addition to the deduction of all expenses associated with the growth of the grain added further tax savings
- The grain had 0-basis
- Do not forget state income tax savings as well

Inventory vs. Rent

- Charitable contribution of commodity only effective if it is considered inventory of a farmer
- A contribution of unsold-crop share rents triggers taxable income to the farmer with an offset charitable donation – must meet certain requirements if crop share is involved

Commodity Gift Summary (cont.)

- For Home Storage:
  - The commodity needs to be segregated and identified as belonging to the charity (e.g. create a bill of sale to transfer title to the charity)
  - The charity needs to arrange for the sale of the commodity, together with incurring carrying costs, including insurance and disposal costs
  - Risks can be associated with a sale of the commodity back to the farmer
  - Preference is sale of commodity to unrelated third party
Commodity Gift Summary

• Other Points
  • Gifted commodities must not be collateral for CCC Loans
  • Must not be under a Loan Deficiency Payment contract
  • If delivered to the co-op, make sure the value does not show up on Form 1099-PATR

Summary

• Timing
• Unsold Commodity
• Physical delivery
• Control has passed
• Documentation
• Storage, transportation and risk

Farm Crop Share Leases - Landlords
Farm Crop Share Leases - Landlords

- Cash share leases – pay a fixed dollar for rent
- Crop share leases
- Hybrid of the two
- A crop share landlord would not be eligible to receive the tax benefits of gifting grain
- Rental income – not materially participating
- No SE tax

Materially Participation of Landlord

- The rental income is derived from an arrangement under which the lessee shall produce agricultural commodities on the land
- The arrangement calls for the material participation of the owner in the production or management of the production of the agricultural commodity
- The owner does in fact materially participate in the activity
- Document, Document, Document

IRS Regulations

- Does the landlord materially participate?
- Factors to consider include making management decisions about
  - (1) when and what to plant
  - (2) rotation of crops, and
  - (3) the kinds of machinery to be used
- According to IRS Regulations and Publication 225, a landlord materially participates and is subject to SE tax if just one of the following conditions is met:
Conditions

- The landlord does any three of the following:
  - (a) pays or stands for at least half of the direct costs of producing the crop
  - (b) furnishes at least half of the tools, equipment, and livestock used in the production of the crop
  - (c) advises or consults with the tenant; or
  - (d) inspects the production activities periodically
- The landlord regularly and frequently makes or takes an important part in making management decisions that contribute substantially to the success of the enterprise

Hours Become Important

- The landlord works for 100 hours or more over a period of five weeks or more in activities connected to the production of the crop
- The landowner’s activities demonstrate that he is materially and significantly involved in the production of farm products
- Therefore SE tax would apply and they would be eligible to gift a commodity

Example – Thomas – no Material Participation

- Thomas owns 5,000 acres of farmland
- During 2017 he enters into an agreement with Jerry whereby he leases Jerry 1,500 acres to grow corn in exchange for 20% of the corn harvest for the year
- Thomas does not materially participate in the production or management of the crops
Example – Thomas – no Material Participation

• Jerry harvests 200,000 bushels of corn in 2017 and delivers Thomas his 20% share or 40,000 bushels
• Thomas sells his bushels by Dec. 31 of 2017
• Thomas would recognize income of 40,000 bushels at $4.00 per bushel or $160,000 of income from crop-share rentals in 2017
• Thomas will report the income on his tax return (Form 4835 – Farm Rental Income and Expenses)
• Since Thomas did not materially participate, his income is not subject to SE tax
• He cannot participate in the gifting of commodities

Let’s Change Our Example a Bit

• Assume the same facts except Thomas provides all the equipment to Jerry to plant the corn, advises with Jerry on when and what crop to plant in the field, and after the crop was planted, Thomas frequently walked the field to inspect the crop for potential insects and disease
• Thomas would be considered materially participating since he met three of the four conditions defined in the IRS regulations Publication 225
• Thomas would report income $160,000 and the income would also be subject to self-employment tax of approximately $22,607
• Tomas and Jerry could participate in commodities gifting

Commodities

• Some commodities are easier to gift and meet the conditions required than others
• A charity delivering grain or arranging for delivery of grain can be easily accomplished – it’s grain, it does not spoil fast, storage is easier and they do not have to feed it, clean it or pick up after it
• When it comes to livestock, a limited timeframe commodity like milk or a commodity that is hard to store like eggs it is much more difficult to store, transport and there may be a greater risk of spoilage
Other Issues to Consider

Other Issues that Should Be Considered

- Landowners under the age of 66 or 67 may see a reduction in their Social Security benefits (make to much income) - gifting may be an good option
- Landowner’s who have not attained full retirement age are limited to the amount of active (self-employed or W-2) income a person can make (2016 it is $15,720)
- For every $2 over the limit, $1 is withheld from benefits

Other Issues that Should Be Considered

- In addition, if the income is significant enough, then the landowner will be subject to an additional 0.9% Medicare tax on the portion of self-employment income in excess of $250,000 for joint filers, $125,000 for married filing separately and $200,000 for all others
- Crop-Share arrangements should be carefully considered and documented as to not rise to the level that creates material participation – a contact that details the arrangement is a must
Issues to Remember

- The gift of grain by farmers and materially participating landlords does not trigger gain on the contribution to the charity
- Since expenses for the production of the commodity have been deducted via the Schedule F the grain has a zero basis
- Taxable income and self-employment income is eliminated on the sale of the grain

Gifts of Commodities to Non Charitable Entities

Gifts of Commodities to Family Members

- Rev. Rul. 55-138 and 55-531
- The fundamentals are much the same as gifts of commodities to a charity
- Two Step Process
  - The farm producer conveys the title to the unsold commodity to the donee; and the donee separately and independently sells the commodity
  - There are several additional hoops associated with family gifts that are not an issue with charitable gifts
Gifts of Commodities to Family Members

- Gifts to family members should be made after the end of the year in which the costs of raising those commodities have been deducted.
- If the gift is made in the same year as the commodity is raised, some of the farmer’s costs of production must shift to the donee.
- Much different then with the case with charitable gifts, which can be made at any time.

Gifts of Commodities to Family Members – Gift Tax Issues

- The gifts to any one individual that exceed $14,000 within a calendar year, requires the filing of a federal gift tax return.
- The amount of the gift in excess of the $14,000 amount will consume a portion of the estate tax exemption in the future.

The Corporation Entity Has Some Special Rules

- Farm proprietors, partnerships and corporations can make charitable gifts of unsold commodities.
- Generally, only farm proprietors and partners (who have received distributions of grain from their partnership) can make gifts to family members.
- If a corporate entity owns the grain, the corporation is taxed on the value of the grain distributed as a gift to a family member of an owner.
**Tax Consequences to the Family Member**

- The family member who receives the commodity will pay tax when the grain is sold, the grain will have a zero basis.
- If the recipient of the commodity is not engaged in the business of farming they will not be subject to self-employment tax.

**IRS View**

- Substance and form are critical, but substance seems to always out-weigh form.
- The IRS will analyze the substance of a transaction among family members to determine if the transaction is a mere mechanism for tax avoidance that lacks any economic substance or independent significance.

**IRS View**

- IRS will look at three factors with the gifting to family members:
  - Detached and disinterested generosity and the donor expects no economic benefit.
  - Has the donor completely given control, title and right to the property to the family member.
  - Finally, does the transaction have an economic substance or independent significance aside from tax avoidance.
Children – Kiddie Tax

• When we have children who under age 19 at year end or college students under age 24, the "kiddie tax" will apply at the parental tax rate rather than the child's rate to this income
• The recipient reports the sale of the grain on Schedule D as a short-term capital gain, reporting the sale price of the grain against a zero tax cost.

Tax on a Child's Investment and Other Unearned Income (Kiddie Tax)

• If the child’s interest, dividends, and other unearned income total more than $2,100, part of that income may be subject to tax at the parent’s tax rate instead of the child’s tax rate or
• If the child’s only income is interest and dividend income (including capital gain distributions) and totals less than $10,500, the child’s parent may be able to elect to include that income on the parent’s return rather than file a return for the child
• Form 8814 (PDF), Parents’ Election To Report Child’s Interest and Dividends

Form 8615 Tax for Certain Children Who Have Unearned Income

• The child’s unearned income was more than $2,100
• The child meets one of the following age requirements:
  • The child was under age 18 at the end of the tax year
  • The child was age 18 but less than 19 at the end of the tax year and the child’s earned income didn’t exceed one-half of the child’s own support for the year (excluding scholarships if the child was a full-time student), or
  • The child was a full-time student who was at least 19 and under age 24 at the end of the tax year and the child’s earned income didn’t exceed one-half of the child’s own support for the year (excluding scholarships)
• At least one of the child’s parents was alive at the end of the tax year
• The child is required to file a tax return for the tax year, and
• The child doesn’t file a joint return for the tax year
Form 8615 Tax for Certain Children Who Have Unearned Income

- A child required to file Form 8615 may be subject to the Net Investment Income Tax (NIIT)
- NIIT is a 3.8% tax on the lesser of net investment income or the excess of the child's modified adjusted gross income (MAGI) over a threshold amount
- Form 8960 Net Investment Income Tax is used to figure the tax

Parent's Tax Return

- A parent may be able to avoid having to file a tax return for the child by including the child's income on the parent's tax return
- Use Form 8814 Parents' Election to Report Child's Interest and Dividends and note the income on Form 1040
Condition to Report on the Parent's Tax Return

- At the end of the tax year the child was under age 19 or under age 24, if a full-time student
- The child's interest and dividend income was less than $10,500 for the tax year
- The child had income only from interest and dividends, which includes Alaska Permanent Fund dividends and capital gain distributions
- No estimated tax payments were made for the tax year, and no prior tax year's tax overpayment was applied to the current tax year estimated tax, under the child's name and social security number

Condition to Report on the Parent's Tax Return

- No federal income tax was withheld from the child's income under backup withholding
- The child is required to file a return unless the parent makes this election
- The child doesn't file a joint return for the tax year
- The parent is the parent qualified to make the election or files a joint return with the child's other parent

Form 8814
Summary

Advantages

- Move income to lower tax brackets (Kiddie Tax may apply)
- Eliminate SE tax on amount of gift
- Assist for College funding
- Strategy effective for cash basis active farmer

Tax Effects to Donor

- No income/deduction reported by farmer
- Reduces SE taxable income
- Should be gift of prior year crop
  - If current year crop, then must allocate cost to crop
- Must file gift tax return if gift exceeds annual gift exclusion (currently $14,000)
Tax Effects to Donee

- Child has zero basis for prior year crop
- Child has basis in current year crop based on allocated cost.
- Sale of crop is short/long-term capital gain
- Holding period based on date of harvest
- “Kiddie” tax will apply in almost all cases

Other Issues

- Livestock may be tougher to gift
  - Too much control may create SE tax
- Material participation share-rent landlords usually have an assignment of income issue
  - Negative tax benefits

Ag Wages In-Kind
Ag Wages In-Kind
- Employer recognizes income on amount of transfers
- Employer receives wage deduction equal to income amount
- Must issue W-2 to employee and include wages in Box 1
- FMV is based on date of transfer
- Title must pass to employee
- Employee must have control of commodity, sell the commodity and incur the costs of holding the commodity

Paying Ag Wages In-Kind
- Sale by employee results in short/long term capital gain/loss
- Should have written employment agreement specifying the commodity terms
- The commodity should be raised by the employer
- Do not need to allocate costs for current year crop
- Note:
  - In-kind wages don’t count as W-2 wages for purposes of the DPAD (I.R.C. § 199)

Social Security
- In-kind wages paid to agricultural labor
  - Key points:
    - Proper identification of commodity
    - Documentation of transfer
    - Whether the payment is intended as a substitute for cash
    - Who negotiates the subsequent sale of the commodity
    - Who bears risk of loss
    - Who bears cost of ownership
    - Time interval between receipt of commodity and conversion into cash
In-Kind Wage Arrangements

- Employer has income (as if commodity is sold) with offsetting wage deduction (labor expense)
- FMV of commodity reported on Form W-2 as “other income” -- no FICA or FUTA tax paid or withheld
- Provide a bill of sale
- Wage income is the FMV on the date of transfer
- Employee reports FMV of commodity as wage income (FMV is basis)
- Employee should pay holding costs after transfer
- Subsequent gain or loss reported on Schedule D

CAUTION

- In-kind wages paid to agricultural labor
- Payments in the form of livestock or livestock products are usually more difficult to bring under the rules
- Agricultural employees receiving wages in-kind do not build up retirement or disability credit under the Social Security system

Other Points

- Potential Self-employment tax treatment to employee if employee uses the commodity to produce other grain or to conduct a business
- Exposure limited to appreciation of commodity after receipt
- Have written employment contract detail relationship and quantity or percentage of commodity paid in exchange for labor
- The longer the employee holds the commodity generally the better based on how IRS views the transaction, but not always based on the market
- Tougher to accomplish with livestock
Advantages

- Compensation paid to agricultural labor in a non-cash form is exempt from Social Security and Medicare (FICA), federal income tax withholdings, and federal unemployment taxes
- FICA is exempt for both the employee’s withholdings as well as the employer’s contribution
- When an employee is paid in a commodity they must have a legal title to that commodity
- They then have the ability to sell it in the market when they deem fit

Disadvantages

- Scrutiny by the IRS upon audit
- If the employee decides to play the commodity market after being paid and it decreases, they may end up having to realize a loss
- Weather can also be a factor in the long run, if crop is effected employees income is reduced
Example

- When the commodity is paid to the employee the market price is used to determine the amount of compensation paid
- For example, if the employee is compensated with 1000 bushels of corn, and the local granary is buying corn at $4.00/bu the employee will have $4,000 of additional compensation as commodity wages

Farmer Result

- In this scenario, the farmer is viewed as having sold his crop for $4,000
- The farmer would record $4,000 of income and would have an equal amount of compensation expense
- The result is a net zero transaction for the farmer, however, it should be recorded for bookkeeping purposes to tie out wages for payroll reporting purposes

Form W-2
Example

- Madison an employee of the My Farm
- My Farm paid her $12,000 of cash wages and 100 bushels of corn
- The corn’s FMV was $5,000 ($50 per bushel × 100 bushels) on the date she received it
- My Farm reports $17,000 ($12,000 + $5,000) in box 1 of her Form W-2
- Only the $12,000 of cash wages is subject to social security and Medicare tax withholding and reported in boxes 3 and 5

Form W-2

What Is The Most Important Issue to Remember

- Documentation
CALT Website

http://www.calt.iastate.edu/

Tour of the CALT Website

The Scoop – Upcoming Dates

- July 5
- July 19
- August 2
- August 16
- August 30
- September 13
- October 4
- October 18
- November 1
- Held at 8:00 am and 12:00 pm Central time
Up Coming Webinars
http://www.calt.iastate.edu/calendar-node-field-seminar-date/month

• Handling Tax Returns for Religious Groups – Amish and Mennonite
  • June 29
• Net Operating Loss Basics July 6 and 7th
• Form 1099 Preparation July 13
• Tax Basis for Farmers July 24
• Reconstructing Records for Tax Compliance August 17
• Uber/Lyft Drivers and Business Expenses August 22
• Tax Reform and New Law Update October 17
• New Partnership Audit Rules October 19

Iowa Taxpayer Advocate - Tomorrow

• Online Free Webinar: 4th Annual Taxpayer Advocate Town Hall Meeting - June 28, 2017

Upcoming Seminars – Mark Your Calendar – Final Dates

• S Corporation – July 20-21, 2017, Live and Webinar
• September 21, 2017 Ag Law Seminar, Live and Webinar
• September 22, 2017 Farm and Estate Tax Review, Live and Webinar
• Retirement and Social Security Issues(Webinar) = October 10-11, 2017
The Schedule is Finalized for the 44th Annual Federal Income Tax Schools

- November 2-3, 2017 – Maquoketa, Iowa – Centerstone Inn and Suites
- November 6-7, 2017 – Le Mars, Iowa – Le Mars Convention Center
- November 8-9, 2017 – Atlantic, Iowa – Cass County Community Center
- November 9-10, 2017 – Mason City, Iowa – North Iowa Area Community College
- November 16-17, 2017 – Ottumwa, Iowa – Indian Hills Community College
- November 20-21, 2017 – Waterloo, Iowa – Hawkeye Community College
- December 11-12, 2017 – Ames, Iowa and Live Webinar – Quality Inn and Suites