AGRICULTURAL TAX PLANNING
EMPLOYING FAMILY MEMBERS ON THE FAMILY FARM
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In last months article we discussed tax deductibility of fringe benefits that are available to ranchers operating as corporations. This month we are discussing tax benefits related to hiring family members some of which are only available to ranchers operating as single proprietors. These articles highlight that the legal form that you choose for your operations makes a tax difference, a subject we can cover in a future article.

It is often said that the backbone of this country is the “American Farmer” and many of these farms and ranches are <u>family owned and operated</u>. Ranches are passed on from generation to generation. Children stay on the ranch; take over operations, and finally ownership. There is a period of time however, when the parents are running the ranch, but the children are old enough to work and contribute to its success. Additionally, there are certain payroll tax benefits to employing children in a family business if you are a single proprietor.

<u>Income Taxes - Employed Children</u>

Farmers and ranchers can turn high-taxed income into tax-free income or lower-taxed income by employing their children. The child’s work must be legitimate and the amount of compensation must be reasonable and customary for the wages paid to be deductible. The “kiddie tax” does not apply to earned income and is briefly discussed later in this article.

For example, consider a rancher in the 25% tax bracket. He can save $1,575 ($6,300 x 25%) in federal income taxes by hiring his 16 year old son to work part time during the school year and fulltime in the summer, at no tax cost to his son. The $6,300 the rancher pays to his son is the standard deduction (for 2016), and if his son has no other income, there is no tax. The rancher can save even more tax overall by paying his son a greater amount as long as the child’s earnings above $6,300 is subject to tax at a lower rate than his. In addition, if the rancher in the example above operates as a proprietorship, a child’s earned income is exempt from FICA, Medicare and FUTA (employment taxes) if the child is under age 18. This could be another $850 plus in savings. <u>If you are operating the ranch as a corporation or partnership, employment taxes will apply to wages paid to your child.</u> However, you still have the benefit of a deduction and the money paid to your child will most likely be taxed at a lower rate.

There is another advantage available to the child receiving earned income from a parent. The earned income allows the child to invest in a Roth IRA. Although contributions to a Roth IRA are not deductible, and as shown above no tax is due on the child’s earnings under certain amounts, the earnings on the invested funds are not taxed until withdrawn. If the funds are withdrawn to fund the child’s higher education costs, the earnings will be taxed as ordinary income but are exempt from the 10% early withdrawal penalty. However the kiddie tax would most likely apply to those earnings.

In some high income situations it may be beneficial for the parent to decline the dependency deduction of a student-child so that the child is eligible to claim either the American Opportunity Tax Credit (AOTC), maximum tax credit of $2,500; or the Lifetime Learning Credit. The election to forgo the child’s dependency exemption may not be detrimental to parents who face the phase-out of personal exemptions. Parents and grandparents can also sponsor a child participating in a 4H or FFA project where the child raises and cares for a calf or a pig for a year and then sells it for a capital gain.

The Kiddie Tax

I have mentioned the kiddie tax in this article. In very general terms the kiddie tax rules prevent parents and grandparents from transferring funds and other passive income producing property to their children or grandchildren to save tax dollars. Interest, dividends and capital gains on a child's return over $2,100 are generally taxed at the parent's tax rate. The Kiddie tax rule now applies to children under the age of 19 and full-time college students under the age of 24.

Spousal Employment

Many proprietors of family farms employ spouses in addition to children. Advantages of employing spouses are:

1. The employment of a spouse can allow the employer-proprietorship to provide tax free fringe benefits, such as medical insurance etc. that are fully deductible for income tax and SE tax purposes.
2. Also, wages paid to a spouse, combined with an optional SE election, can create earned income and qualify taxpayers with a loss on Schedule F for the earned income credit (EIC).

Agricultural Noncash Wages

FICA wages by regulations do not include remunerations in any form other than cash for agricultural employees. As an example, the compensation via the transfer of ownership of a commodity such as calves or cows are not subject to employment taxes. Hence, spouses as well as children can be paid in a medium other than cash. There are potential negative impacts such as limitations on the deductibility of any carrying cost of the commodities and the potential of producing capital losses since some form of risk of loss must be present. The IRS has issued guidelines for the proper reporting and treatment of noncash wages to be exempt from FICA tax which are complicated. However, with careful planning some payroll tax reduction may be realized using noncash wages for agricultural employees.

Summary

As shown above, the IRS has specific rules and regulations in place for reporting and treatment of wages paid to family employees. This should not be confused with a non tax deductible allowance paid to a child for household or minor farm chores where there is no tax consequence. When family members are hired as employees the proper rules must be followed in order to realize tax benefits. I have reviewed some of the major guidelines for reporting and treatment in this article, but it is not to be considered as an explanation or interpretation of the IRS rules and regulations on this subject. If you are employing family members to work on the family farm, be sure your tax professional is fully aware that you as a proprietor are doing so. My next article will be on the use of a C corporation as the entity for operating an agricultural business.

For more information on this topic and other tax planning for ranching, please contact me at (863) 640-2008 or Tom@beasleybryantcpa.com and/or Ryan Beasley at (863) 646-1373 or Ryan@beasleybryantcpa.com . Please visit our website at www.beasleybryantcpa.com for information on other relevant topics.

We at Beasley, Bryant & Company, CPA's, P. A. are experienced in agricultural business problems, tax issues or concerns, and are here to help you.

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