

# People, Land and Activities – Part I

## A Framework for Understanding a Farm or Ranch Business

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POPPY DAVIS

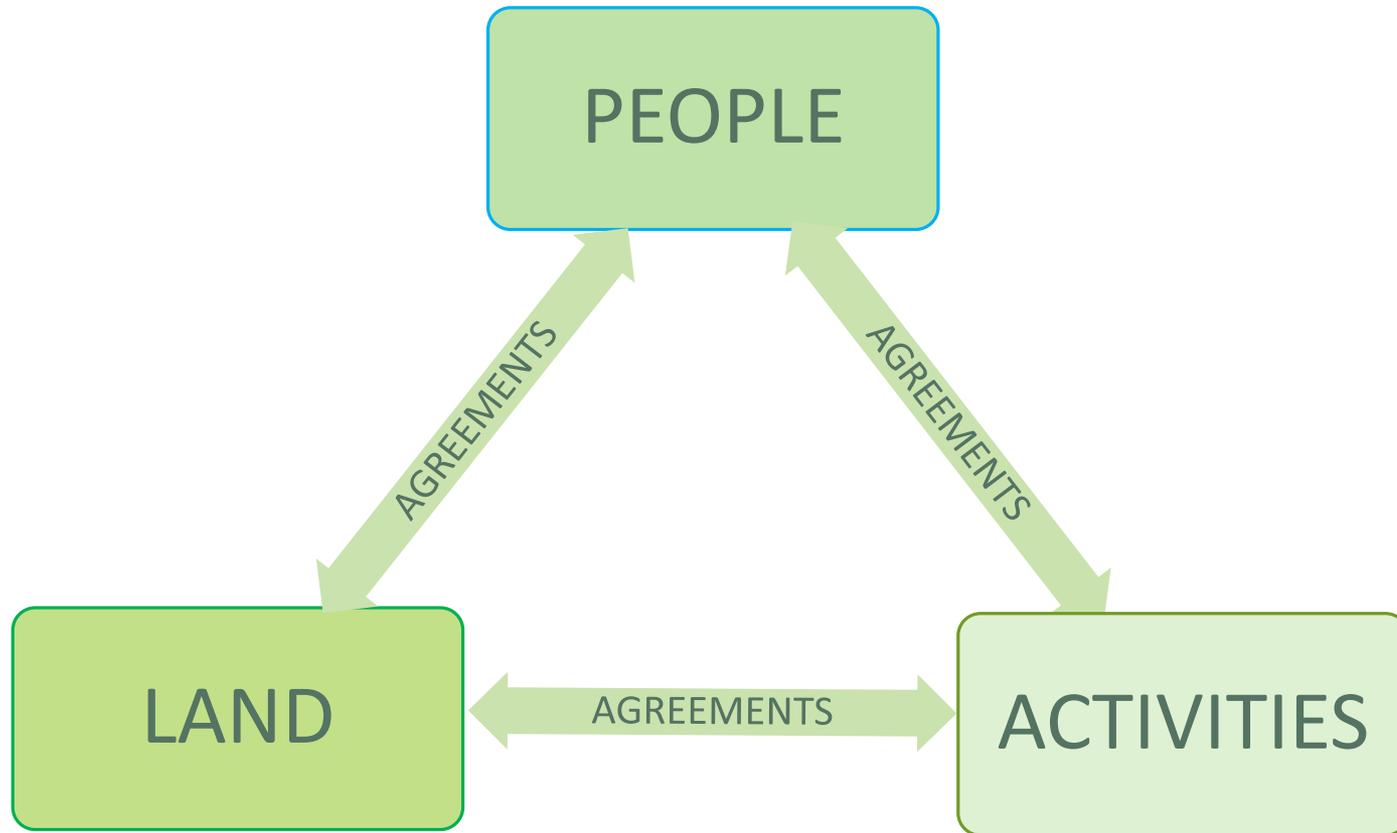
# Overview

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- Owning a business**
- Owning or leasing the land or facility where the business operates**
- Agreements between people**
- Managing business activities**

# Graphic Overview

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# PEOPLE, LAND, AND ACTIVITIES

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- What do you want to do? One or more activities.
- Where will you do it? On the land/In a facility.
- Who will you do it with? Other people. (Or not.)

# WHAT ARE YOU MANAGING FOR?

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A ***business model*** is how you use your assets, or capital, to create income, or revenue.

ASSETS -> INCOME

CAPTIAL -> REVENUE (same meaning)

# WHAT ARE YOU MANAGING FOR?

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An *investment model* is about using your income or assets to create more income or assets

INCOME -> ASSETS

# WHAT ARE YOU MANAGING FOR?

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One of the reasons farm and ranch management is a difficult field is most farmers and ranchers are always trying to do both at once – they use the land to create income, and the income to buy more land. It doesn't always work out for the best, especially when the owner's don't have a clear understanding of what they are trying to acquire and what they are trying to preserve.

What does it mean to own a business?

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An individual may own a business on their own, or in a partnership, or by owning shares in a corporation.

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*The key test to determine if it is a business is if the owners intend to profit.*

What is a  
profit  
motive?

One or both:

**Annual  
profits**

**Long term increase  
in net worth due to  
increase in value of  
assets.**

# What Makes an Endeavor a Business?

- ❖ **No profit motive = no business = a “hobby”**
  - Income is subject to income tax but *losses can not be used to offset earned income.*
  - Not eligible for many programs designed to assist farms or ranches or other small businesses.
  - May still be eligible for conservation programs designed to assist landowners.

# The Hobby Loss Rule

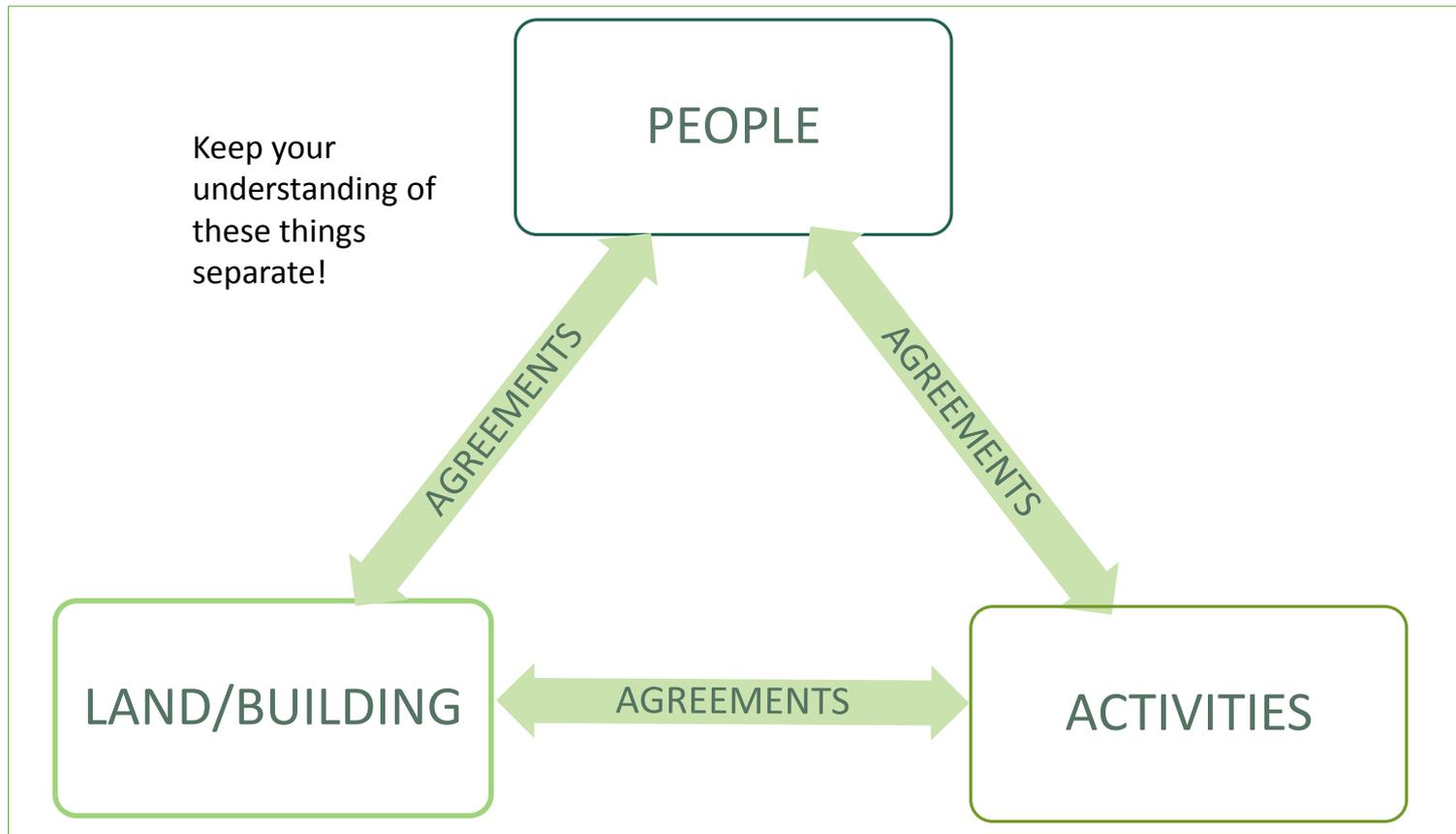
- ❖ You start out with the presumption that you are in it for profit. After 5 years you lose the presumption and you have to be able to make the case to the IRS that you intended to profit and you acted reasonably to attempt to make a profit. The only thing complicated about the rule is how you prove you intended to profit.
- Many people receive bad advice on this rule from tax preparers who do not want the extra work of preparing a farm return. **The Hobby Loss Rule does not say that if you lose money in 3 out of five years you are a hobby.** If anyone tells you that then you know they do not know what they are talking about.
- Look it up. See Pub 225.

# How do you show a profit motive?

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- ❑ Ability to articulate a theory about how you are going to sell your product for a price greater than the cost of production, or at a price that makes a material contribution to your overall costs to maintain and improve the property.
  - **You don't need a formal written business plan, but you need a plan.**
- ❑ A standard bookkeeping system appropriate to the scale of your operation.
  - **This alone will not suffice, but if you do not have this there is almost no chance you will not be able to prove your case.**
- ❑ Regular review of profit and loss and increase or decrease in asset value and adjustments to your business plan to reflect lessons learned.
- ❑ Acquiring and continually updating the skill and knowledge needed to run your business.

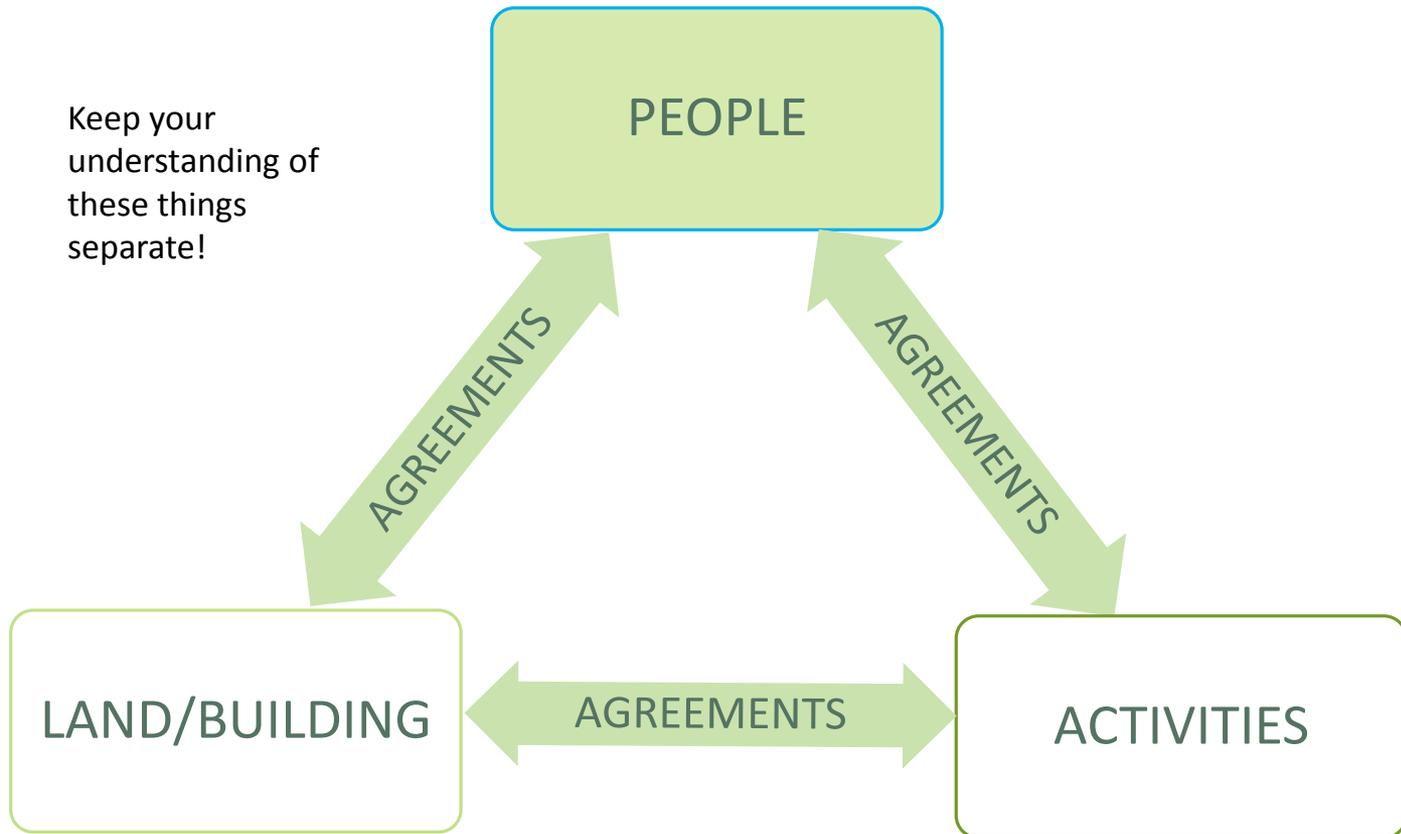
# Structuring Your Business



# People

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Keep your understanding of these things separate!



# FORMING A BUSINESS

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- One person may become:
  - ❑ A sole proprietorship - default, no action needed
  - ❑ A single member LLC - formed deliberately
  
- One or more people may become:
  - ❑ A partnership – default, no action needed
  - ❑ A limited partnership - formed deliberately
  - ❑ A limited liability company - formed deliberately
  - ❑ A corporation - formed deliberately

A governmental entity can also perform business functions.

# AGREEMENTS TO FORM ENTITIES

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## HOW ARE DECISIONS MADE?

- ❑ The partnership or incorporation agreement should specify.
- ❖ If it does not then governing federal, state or tribal law will fill in what owners did not specify.

# BUSINESS ENTITIES

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## INFORMAL

**Sole proprietorship** – Forms as soon as you start conducting activities with the intention of earning profits.

**Partnership** – Forms as soon as you and someone else start conducting activities together with the intention of earning and sharing profits.

### **Key characteristics of these types of entities:**

- ✓ Automatically formed
- ✓ Unlimited personal liability

# Unlimited Personal Liability

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- ❖ The proprietor of a sole proprietorship, and any partner in a general partnership, is both owner and manager, and is personally responsible for all of the debts and other liabilities of the business; this is called “unlimited liability.”
  - **All of your assets are on the line as well as future earnings or inheritance of yourself and possibly your spouse**
- ❖ In a partnership each partner has unlimited personal liability for all of the partnership.
  - **If the partnership is sued one partner may have to pay 100% of the judgment and collect against other partners later.**
  - **This personal liability extends to the partners’ spouses.**

# Partnerships

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- ❖ As soon as two or more people work together with the intention to share profits they have formed a partnership.
- This will be true if the partners know it or not, and whether they have a written partnership agreement or not.

# BUSINESS ENTITIES

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## Formal

- ❑ Limited Liability Company (may be single-owner)
- ❑ Limited Partnership
- ❑ Corporations Must be deliberately formed
  - If properly managed will limit owners' liabilities to the assets of the business.
  - Owners or state law will establish circumstances under which owners may or must contribute or withdraw funds.

# Limited Liability Companies and Corporations

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- ❖ A legal method for limiting personal liability.
- ❖ An individual or a group of individuals may become a formal entity by filing articles of incorporation in the state of choice.

# Limited Liability Companies /Corporations

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- ❖ State statutes make the incorporated entity into a distinct legal “person” who may own property or conduct business, and who may sue and be sued.
- ❖ The separate legal status of the incorporated entity allows individuals to invest in ownership without subjecting themselves (or their spouses) to unlimited personal liability.
- ❖ But the corporate status never protects owners from personal liability for their own bad acts.
- ❖ And corporate status will not be valid if you have not done what is required under state law to maintain corporate status:
  - Maintain a separate accounting
  - Do not co-mingle and co-use corporate and personal assets
  - All transactions between corporation and owners are as if at “arm’s-length”
  - Annual meetings and minutes

# FORMING A BUSINESS WITH OTHERS – How will you be taxed?

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- ❑ Sole proprietorship -> 1040 Schedule F (or C for non-farm)
- ❑ General partnership -> 1045 Schedule F
- ❑ Limited partnership-> 1045 Schedule F
- ❑ Limited liability corporation -> **Elect 1040/1045 OR 1120-S**
  - For federal tax purposes this type of entity may elect to be taxed as a partnership or as an “**S-Corporation**” this is an important and technical decision – you will need to seek the advice of a tax expert to decide.
- ❑ Corporation - Corporations are often described in terms of which section of the Internal Revenue covers them
  - C corp – mostly for large businesses
  - S corp – usually the best choice for small business - but not to own land
  - T corp – a cooperative
  - A not for profit corporation exempt under IRC 501(c)(3).

# LLCs and Taxation

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- ❖ Form an LLC under state law and **elect under federal law to be taxed as a partnership or as an S-corporation.**
  - ❑ The IRS automatically taxes single-member LLCs as sole proprietorships and multi-member LLCs as partnerships.
  - ❑ **OR** an LLC can **make an election** with the IRS choosing to be taxed as an S- corporation.
  - ❑ **Which to choose? *Complicated and depends!***

# AGREEMENTS TO FORM ENTITIES – How will you be taxed?

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- ❑ Federal taxation will depend on the type of business entity you form.
- ❑ State taxation generally follows federal taxation – but post 2017 more states are “de-coupling” from federal rules.
- ❑ In some cases the new tax law makes one type of entity more advantageous for federal purposes, but state tax rates favor a different entity type.
- ❑ New tax law made the decision **more complicated** because it is more dependent on your income.
- ❑ Consult with a knowledgeable tax preparer who knows the tax law for your state.

# OTHER AGREEMENTS BETWEEN PEOPLE

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- Employment Contracts
- Land rents (Lease payments)
- Contracts to sell or buy
- Contracts for services

# OWNERS AND EMPLOYEES

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## OWNERS

- ✓ Have invested capital
- ✓ Share in profits and losses
- ✓ Often don't get paid

OWNERS CAN ALSO BE EMPLOYEES.

# OWNERS AND EMPLOYEES

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## EMPLOYEES

- ✓ Protected by federal employment law
- ✓ Must be paid at least minimum wage
- ✓ Employer must withhold certain payroll taxes and pay payroll taxes and workers comp insurance
- ✓ Employer must comply with other health and safety laws to protect workers

OWNERS CAN ALSO BE EMPLOYEES.

# OWNERS AND EMPLOYEES

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CONTRACTORS ARE NEITHER.

(From your perspective.)

From their perspective they are owners or employees of the company you contracted with.

- ❖ **Don't pretend your employees are contractors- you will owe back payroll and back payroll taxes with interest and penalties compounding daily back to the day you first should have paid.**
- ❖ **Workers compensation liability may be an even bigger issue.**
- Several tests – mostly around how much control you have over when and how an employee's work is done, versus how much independence a contractor has to determine when and how to do the work.

# Wage and Labor Protections

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- ❖ There is no such thing as an independent contractor field laborer, dishwasher, line worker, cook, or server working regularly on a farm or in a food business.
- Typically problems arise when a worker is injured and they or their family need workers compensation coverage.
  - They will likely be deemed “statutory employees” and you will be liable for all wages, payroll taxes, and workers comp coverage.
  - The other common methods of discovery are drive-by enforcement (common in CA) or a worker becoming disgruntled and reporting or filing for unemployment insurance.

# Wage and Labor Protections

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- ❖ Most states define agricultural laborers as distinct from other types of workers and give them substantially fewer protections than other types of workers.
- ❖ If the state provides no protections then federal law provides minimal protections.
- ❖ You must understand the definitions under state and federal law, just because someone works on a farm does not mean they will meet the definition.
  - ✓ Be particularly careful of the definition for anyone who does office work or any type of marketing (i.e. selling at a farmers market).

# Wage and Labor Protections

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- ❖ For purposes of avoiding worker protections for agricultural laborers you need to understand exactly how your state defines an agricultural worker for each of the following types of protections:
  - Minimum Wage
  - Overtime
  - Occupational Health and Safety Protections
  - Workers Compensation Insurance
  - Housing
  - Payroll deductions and other items the state may regulate

# Wage and Labor Protections

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- ❖ Wage theft and even slavery is a real and current problem in American agriculture. Any way you can think of to get around laws to protect farmworkers has already been used and abused and the employer found guilty.

# Interns, Apprentices and Volunteers

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- ❖ Interns and Apprentices must be enrolled in an accredited program which gives them that legal status under state law to exempt them from state employment law protections.
  - If not then either they meet your state's exemptions for agricultural laborers or they are "statutory employees"
  - Statutory employees means it does not matter you did not think they were employees, the state deems them to be employees and you are liable for minimum wage, payroll taxes, covering them with workers comp insurance and any other state or federal mandated protections.
- ❖ Volunteers only have that legal status when working for a valid not for profit entity (an exempt religious or charitable institution with that legal status)
  - If not they are "statutory employees" as above.

# Owners and Employees Made Simple

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Is someone doing work that benefits you or your business?

Then they need to be one of four things:

1. An owner of the farm or ranch (or an owner's spouse or child).
2. A legitimate independent contractor (they are an owner, just of another business).
  - ✓ You have a reasonable belief that they meet the tests for an independent contractor. If in doubt seek legal advice.
3. An employee on payroll subject to all applicable wage and labor law.
4. Exempted from employment protections as defined by state law in your state or if fully exempt in your state also exempt for federal purposes.

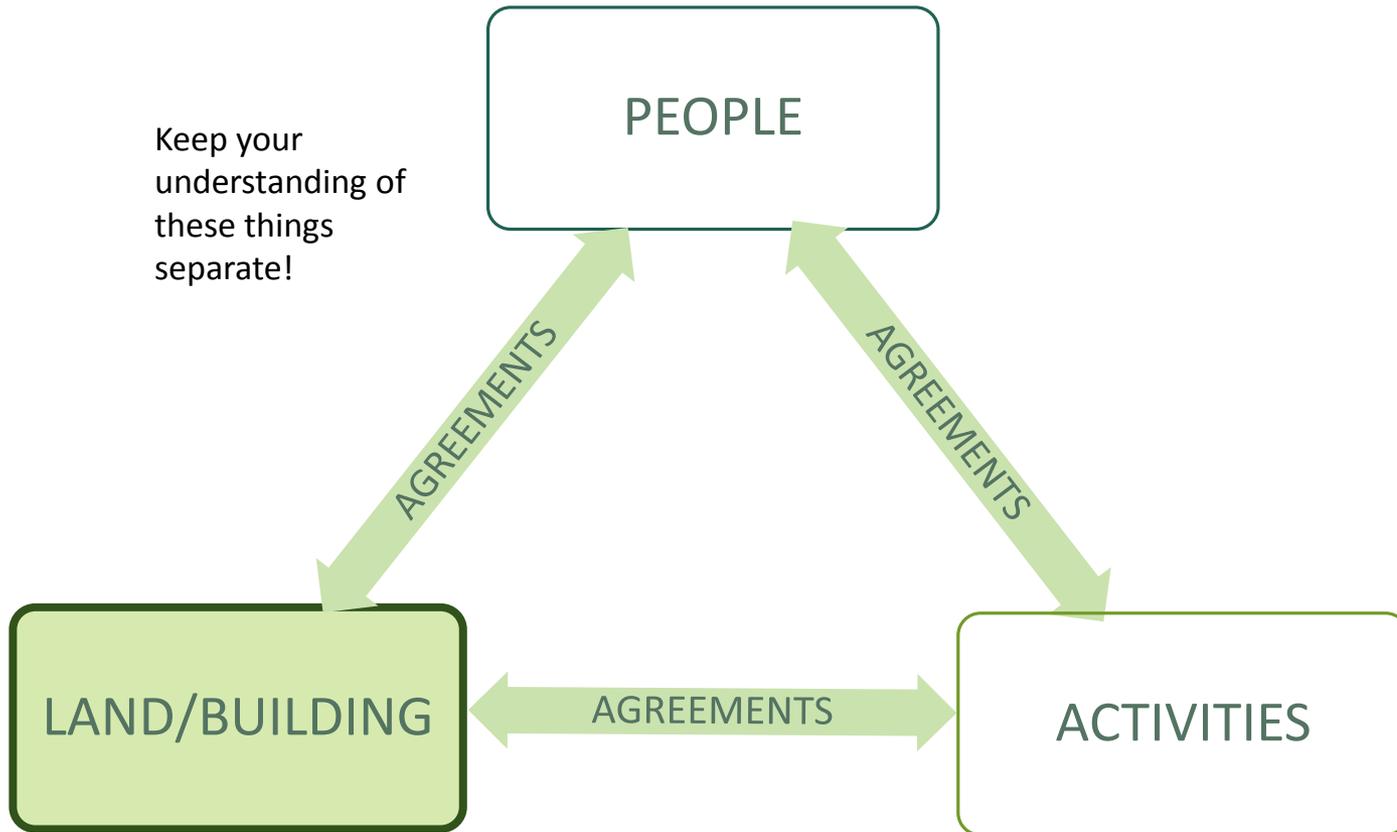
***“But everyone else is doing it.”***

***What did your mother say about that?***

# LAND

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Keep your understanding of these things separate!



# OWNING LAND OR BUILDINGS

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- ❖ You may form a business entity to own real property - but you don't need to.
  - Be very careful when forming an entity that will own land. There are significant and complex tax planning considerations.
  - Consult with an attorney and a Certified Public Accountant.
  
- ❖ Land may be owned as a:
  - JOINT TENANCY
  - TENANCY IN COMMON
    - These are simpler to create and manage and have fewer tax planning complexities, but it is still strongly advised to consult an attorney and a Certified Public Accountant when going into a land purchase, especially with others.

# OWNING LAND OR BUILDINGS

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- ❖ You may own a property that is both a personal residence and the place where you do business.
  - This is for sure one of the times in your life you will need to consult with a Certified Public Accountant to ensure you are set up to take the correct deductions for the entire time you own the property.
  - The tax implications of this type land ownership are now even more complex and even more important. This requires professional consultation and careful advance planning.

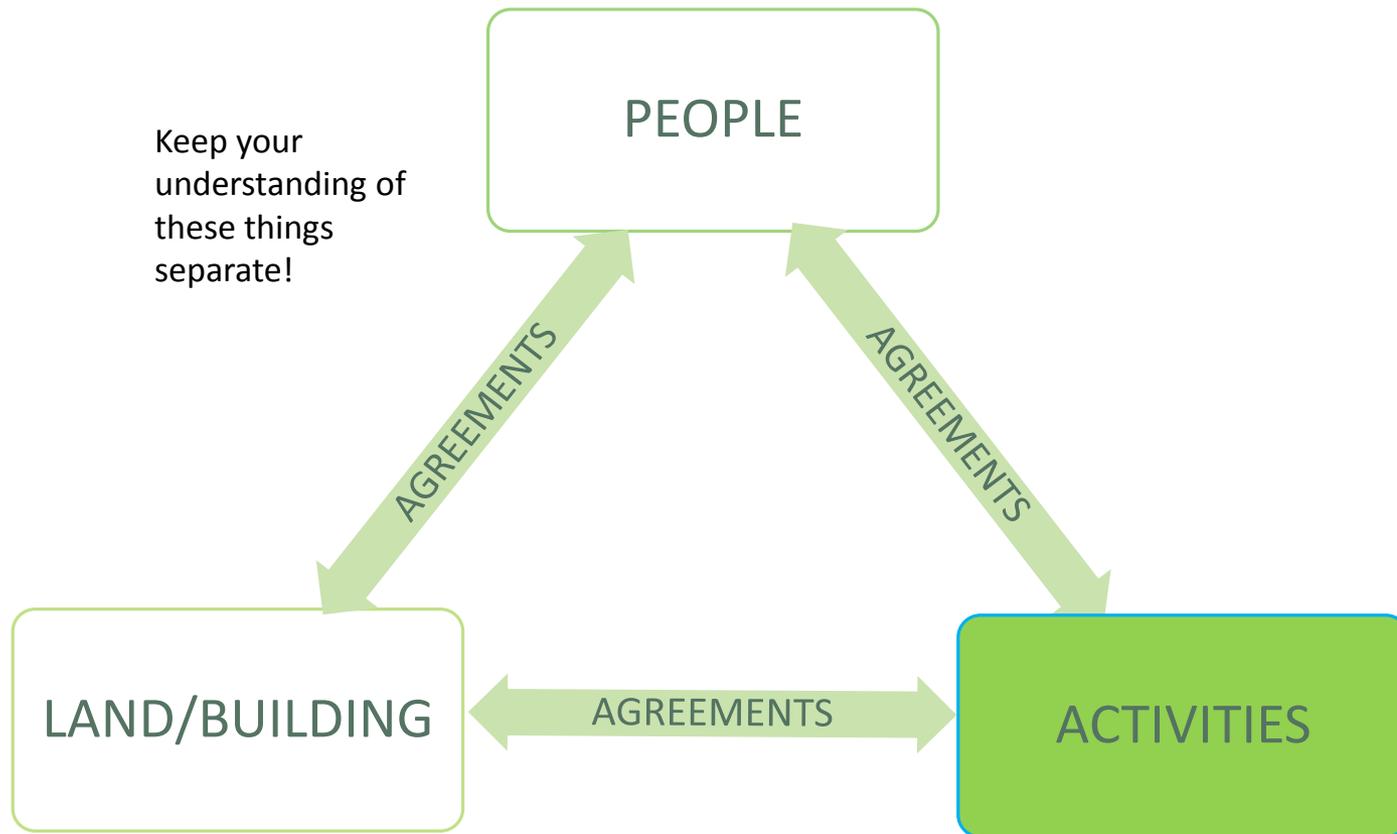
# LEASING LAND OR BUILDINGS

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- ❖ You do not need to own land to farm; you can lease land.
- ❖ You do not need to own the building where you manufacture food or run a restaurant; you can lease it.
- ❖ If you own land or a building you can lease it to the business you also own – you keep the land or building ownership separate from the business activities.
  - ✓ **This is the preferred set up to limit legal liability.**
    - You need to pay some rent if you want the limited liability protection of keeping the land separate from the business – the question is if it makes sense to pay yourself as much or as little rent as is reasonable.
  - ✓ Maximizing self-paid rent used to be a simple way to reduce income taxes as rental income was taxed at a lower rate.
  - ✓ Under the new tax law the effects of reducing self-employment income by paying rent to yourself are now significantly more complex and require a professional consultation and advanced planning to decide how much rent to pay and what effect it will have on your taxes.

# Activities

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# Accounting as the key to understanding your business

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Bookkeeping

Financial Accounting

Tax Accounting

Managerial Accounting

# Accounting as grammar

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❖ The present tense:

***I own this barn right now – it is on my Balance Sheet.***

❖ The perfect present tense:

***I have worked hard this quarter – it is on my Income Statement.***

# Accounting as grammar

## Pro Formas and Credit

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❖ The future perfect tense.

***If I take out this mortgage and build this facility then my Balance Sheet will show more assets and more liabilities.***

❖ The future conditional tense.

***I think I will be able to pay down my operating loan next year if my operation matches my budget.***

# Financial Accounting

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**Financial accounting is the process of preparing financial statements.**

Requires formal understanding of the accounting formula.

Required formal understanding of typical adjustments made to bookkeeping data

- Correcting assets for items that have been recorded as expenses or should have been recorded as expenses
- Correcting the balance of a loan payable to adjust for the interest portion of the payment
- Correcting the recording of owner's personal expenses mixed with business expenses, or the recording of owner's contributions or draws

# Financial Accounting

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## Monthly, quarterly and annual financial statements

- ❖ Depending on the size of the business, the bookkeeper's skill and the owner's desire monthly and quarterly financial statements are produced "in house" by the bookkeeper and reviewed by owners.
- ❖ At least annually an outside accountant should review the books of the company and make any needed adjustments to produce year-end financial statements.
  - For most small businesses this should be done by a CPA at the same time the tax returns are prepared.
  - Some larger businesses will need to have a CPA prepare formal financial statements separate from preparing tax returns. (Often a loan requirement.)

# Reading a Balance Sheet

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**Did cash go up or down? How does the change in cash relate to net income or loss?**

**Did fixed assets (equipment and land) go up or down?**

**Did you take on new debt or pay down old debt?**

- Did accounts receivable go up or down?
- Did accounts payable go up or down?

**Did you or another owner put cash or other assets into the business?**

- As an equity investment? As a loan?

**Did you or another owner take cash or other assets out of the business?**

- As payroll? As draws? As loans?

# Statement of Cash Flows and Cash Flow Budgeting

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- ❖ **A Statement of Cash Flows** is a document that explains all the changes on the balance sheet between the end of one year and the end of the next year in terms of how cash was used in the business.
  - ❑ It provides a summary showing the cash effect of changes to accounts receivable and accounts payable, the amount of cash used to buy equipment or pay down debt, and the cash generated and used by business operations.
  - ❑ What it does not do is tell you in which months you were or will be out of cash. **For that you need a cash flow budget.**

# Cash Flow Budgeting

	Jan	Feb	Mar	...	Dec.
Cash Received From Operations	-	1,000	2,000	4,000	2,000
Less Cash Paid Out For Operational Expenses	<u>(1,500)</u>	<u>(2,000)</u>	<u>(3,000)</u>	<u>(1,500)</u>	<u>(1,500)</u>
<b>Equals NET CASH FLOW FROM OPERATIONS</b>	<b><u>(1,500)</u></b>	<b><u>(1,000)</u></b>	<b><u>(1,000)</u></b>	<b><u>2,500</u></b>	<b><u>500</u></b>
<b>BEGINNING CASH</b>	<b>5,000</b>	<b>3,500</b>	<b>500</b>	<b>500</b>	<b>2,000</b>
PLUS OR MINUS: NET CASH FLOW FROM OPERATIONS	<b>(1,500)</b>	<b>(1,000)</b>	<b>(1,000)</b>	<b>2,500</b>	<b>500</b>
PLUS: Other Cash Receipts					
From Borrowing			<b>1,000</b>		
Personal Contributions to Business					
LESS: Other Cash Paid Out					
To Acquire Land, Buildings, or Equipment		(2,000)			
To Pay Debt				(1,000)	
For Personal Use /Owner Draw					<u>(2,000)</u>
<b>EQUALS ENDING CASH</b>	<b><u>3,500</u></b>	<b><u>500</u></b>	<b><u>500</u></b>	<b><u>2,000</u></b>	<b><u>500</u></b>

# Tax Accounting

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- ❖ **The records produced from the company's bookkeeping system should be sufficient to produce MOST of a complete and accurate tax return.**
  - Additional records are required for owners to take advantage of all tax deductions available.
  - Typically certain "out of pocket" tax deductions are not recorded in the bookkeeping system but the bookkeeping records should be adjusted at year end with journal entries to align the bookkeeping records to the tax records.

# Tax Accounting

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## Typical tax items not recorded in the bookkeeping system:

- Depreciation expense (including Section 179 total expensing)
- Allocated share of property expenses if farm or ranch is on a property that is also the owner(s)' residence
- Deduction for use of office in home
- Owner(s)' miles in personal vehicle
- Owner(s)' out of pocket meals expense
- Owner(s)' travel days eligible for per diem rate deductions

# Managerial Accounting

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- ❖ **Managerial Accounting is any number of processes and procedures that owners/managers deem necessary or important to their ability to make decisions and guide the business.**
- ❖ Typically the most important managerial accounting functions are:
  - Cash flow budgeting
  - Enterprise accounting
  - Cost of production (for farming and ranching) or cost of inventory
  - Determining the cost of marketing

# Managerial Accounting

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## Cash Flow budgeting from QuickBooks

Limited functionality – generally you are better off doing this in Excel.

**Why?** QuickBooks has detailed (down to the penny) past information but for cash flow budgeting you need summary estimates about what is going to happen.

The past is some indication of what is going to happen but you as a manager are the one with the ability to think about how current plans will affect future outcomes – this just is not something QuickBooks can do for you.

# Managerial Accounting

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## Enterprise Accounting

- ❖ Goal is to see income and expense for different profit centers
- ❖ Careful not to confuse profit centers with products
- ❖ In a diverse farming operation enterprises might include:
  - row crops
  - poultry
  - cattle
  - field crops
  - value added production (not technically farming or ranching)
  - agri-tourism (not technically farming or ranching)
- ❖ QuickBooks can easily accommodate this. Each enterprise is set up as a “class.”
- ❖ Remember this level of information is typically not provided to prepare financial statements for lenders or to prepare income tax returns.

# Managerial Accounting

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## Cost of Production/Cost of Marketing Analysis from QuickBooks

- ❖ You can also use QuickBooks classes to separate crops or major market channels. If you have multiple enterprises you can do crops or livestock types as “sub-classes” of a class category for the enterprise “row crops” or “livestock”
- ❖ Works better in theory than in practice. Most significant expenses benefit the whole operation or the whole class – the bookkeeper needs detailed information to know how to divide an expense across classes and sub-classes. That information is external to QuickBooks – it is usually a record of hours spent working on each enterprise or product.
- ❖ If you want to get detailed managerial data from QuickBooks you need a carefully considered plan.

# Managerial Accounting

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**Cost of Production Analysis – What are you after?**

- By crop
- By field
- By planting

*For all of these the main cost is labor.*

**How will you allocate labor cost to different crops, fields, or plantings?**

Once you know that you can allocate other costs such as rent, supplies, water, equipment use. But probably easier to do it in Excel than in QuickBooks.

# Managerial Accounting

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## Cost of Marketing Analysis – What are you after?

By crop

By vendor

By market outlet

- ❖ You can easily get income by crop, vendor or market. ***But how do you associate costs with these markets?***
- ❖ Most important factors are packaging, labor, and transportation time – but many of these are shared.
- ❖ Best option is to do an analysis in Excel making cost allocations based on estimates. You can pull income data from QuickBooks.

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# How To Get Help

# Choosing a System

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## Keep your goals in mind:

### **Readable financial statements**

- Balance Sheet should be one page
- Income Statement should be two pages maximum

### **Complete and accurate tax returns**

### **Managerial accounting functions will be done in Excel – do not overload your basic accounting system trying to make it perform managerial accounting functions.**

# Software

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How much software you need depends on the size and complexity of your organization

- QuickBooks is widely used
  - Easy to hire someone who already knows how to use it
  - Can handle most small and mid-sized business.
  - Has real limitations as your business becomes more complex.
- Peachtree, SAGE and other mid-range systems are good for more complex operations.
- High end systems are expensive and hard to use and understand. They are not needed until you have something at the scale of a tribal government or college or a corporation with multiple divisions.

# QuickBooks Set Up

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- ❖ This is a good job for an accounting firm or an expert bookkeeper.
- ❖ Not a good idea for someone without formal accounting training to do the initial set up of the chart of accounts.
- ❖ Bad idea to use the QuickBooks default chart of accounts for your farm or ranch (or any other business)— it has both ***unnecessary detail*** and ***is missing meaningful detail.***

# Which Version of QuickBooks?

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	Online "Essentials"	Desktop "QuickBooks Pro"
Create invoices, manage accounts receivable	Yes	Yes
Track income and expenses	Yes	Yes
Manage accounts payable	Yes	Yes
One-click reports	Yes	Yes
Work from a PC or Mac	Yes	PC only
Work from smartphone	Yes (limited)	No
Continuous file access for accountants	Yes	E-mail or upload instead
Cloud access (hosting)	Yes - but also no offline access	Available for a fee
Number of users included	5 (distinct logins)	3 (install on three devices)
Cost	\$40/mo	\$200 one time

# QuickBooks Set Up – Additional Functions

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Data you can use to do supplemental cost of production/cost of marketing analysis in Excel

- ❑ You can set up “classes” in QuickBooks to get special managerial income and expense reports – but be strategic about how many classes you set up and how consistently you use them.
- ❑ If you invoice customers you will be able to run reports by vendor
- ❑ If you set up the items you sell as “items” in QuickBooks you will be able to run reports by item.
- ❑ Typically items and vendor invoicing go together – but be careful each item comes with a price and as prices change through the season you can quickly end up with dozens of QuickBooks “items” for one actual item.

# How To Get Help

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For your continued learning

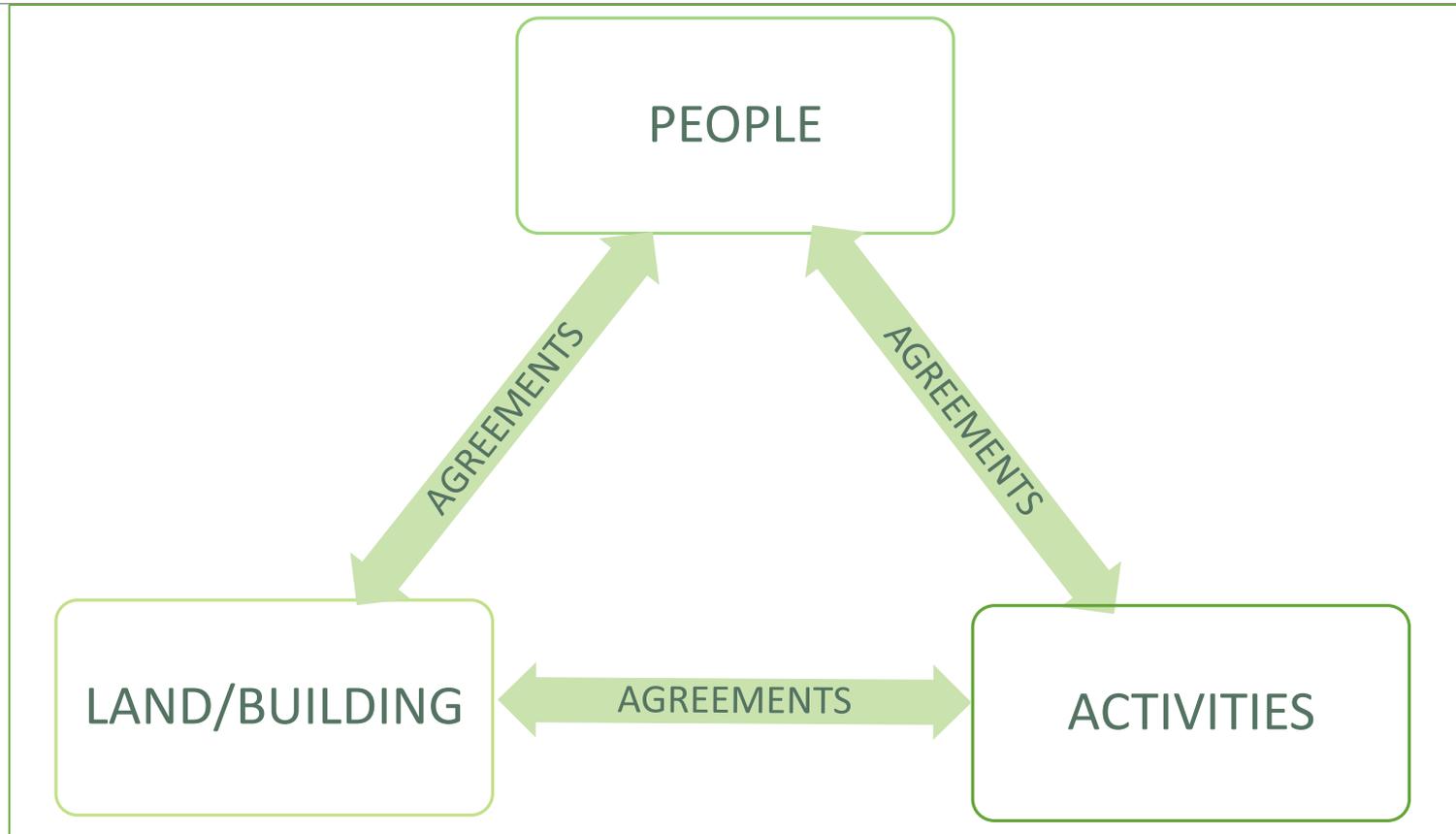
<https://www.accountingcoach.com/>

<https://www.accountingtools.com/bookkeeper-library/>

## Professional Services

- Bookkeeper
- Unlicensed Accountant
- Unlicensed tax preparer
- Enrolled Agent (a licensed tax preparer who is not a CPA)
- Certified Public Accountant

# Questions?



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*Thank you!*