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Income Tax Law and Farm Accounting Methods

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The Income Tax Law and Farm Accounting Methods

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An interesting problem that has come up since the enactment of the income tax law bears upon the method of reporting income from farming operations. Many large ranches have excellent accounting systems designed upon approved double-entry principles, which for the present discussion may be designated as class (*a*); while others, which may be called class (*b*), have scarcely the scratch of a pen to enable them to compute their income, much less to enable them to make a return of income for the purpose of the tax. Both classes, of course, swear to the accuracy of the return, however it is made. Class (*a*) takes annual inventory of stock at a fair market value, likewise of produce raised and on hand, at what time all expenses incurred and accruals applicable to the year are taken into account, from which a report of operations and net gain or loss is made, and a balance sheet is prepared as in other properly conducted business enterprises. Class (*b*) has no such basis of comparing one year with another; but, when it has any method at all, it ordinarily prepares a report by setting up the actual money paid out, if it can be ascertained at all, against the amount of money received, if, also, that can be ascertained, and the remainder is the amount of gain for the year.

Form No. 1040, of the treasury department, which is the one upon which individual returns are made, gives the following instructions upon page 4, which are interesting in connection with this discussion:

Article 11—The farmer, in computing the net income from his farm for his annual return, shall include all moneys received for produce and animals sold, and for wool and hides of animals slaughtered, provided such wool and hides are sold, and he shall deduct therefrom the sums actually paid as purchase money for the animals sold or slaughtered during the year. When animals were raised by the owner, and are sold or slaughtered, he shall not deduct their value as expenses or loss. He may deduct the amount of money actually paid as expenses for producing any farm products, live-stock, etc. In deducting expenses for repairs on farm property the amount deducted must not exceed the amount actually expended for such repairs during the year for which the return is made (See page 3, item 6). The cost of replacing tools or machinery is a deductible expense to the extent that the cost of the new articles does not exceed the value of the old.

Article 12—In calculating losses only such losses as shall have been actually sustained during the year covered by the return can be deducted.

The department of agriculture has issued a bulletin on farm bookkeeping which is also of interest at this time, inasmuch as it recommends the inventory method of determining annual profits on the farm. This is also the method advised by J. A. Bexell, of the Oregon agricultural college. While it is true that the farm that takes annual inventory and determines profits upon the basis of such inventory does not have to report its "income" upon that basis, yet it would be more convenient to do so, when all of its accounts have been arranged upon that basis.

The other class, (*b*), will report upon the basis of money received for livestock and produce sold and deduct costs and expenses paid, but the increase will not be reported until sales have been made and money collected for such sales. The following rates of depreciation are certainly a matter that cannot be overlooked: 5% on buildings (taking into consideration insurance and repairs); 10% on horses, above 5 years; 8% on milch cows, after the third year; 10% on machinery and tools (taking into account repairs and replacements). It would appear to the thinking person that some method of taking inventory of livestock and produce and other increases on the farm should be adopted, and that losses, by way of depreciation of animals used in farmwork, and also machinery, buildings, and losses of every kind, should be taken into consideration in arriving at "net profits."

The method of making returns for farming operations, as proposed by the treasury department, is, no doubt, the most practical method of securing approximate returns, but we must conclude that the increase of stock and produce on the farm is considered an accretion of capital and not subject to taxation unless expressly taken into the books by way of inventory. However, this certainly encourages poor business methods on the farm, where, of all places, there is great need of efficiency in operation. Personally, in the operation of a farm, I would want to know what my accrued profits were at the end of a fiscal period, which, according to the income tax law, is made

December 31, when most authorities agree that April 1 is a better time for taking an inventory upon the farm.

In connection with the subject of increment and income, Representative Hull, in his replies to questions asked by Representative Mann, said: " * * * in construing all these laws that I have observed * * * unless the unearned increment is expressly made income it is not considered income in any sense of the word, but simply increase of value or capital." While this expression, no doubt, had to do entirely with another matter —possibly the discussion of the value of real estate—still I do not see but that it applies to the increase of any capital asset.

It is my opinion that this ruling is a survival of that old difficulty: the confounding of two ideas of "income"— the one held by many lawyers and business men—that actual receipts of money constitute "revenue," when as a matter of fact "revenue" should be regarded as earned for the purpose of determining profits, whether it has been received or is receivable.

Notwithstanding the instructions of the treasury department, I still believe that livestock and farm products may be safely inventoried at market prices, and gross profit computed to include profits by increase figured on the same basis, otherwise it would seem difficult to provide a balance sheet "showing the condition of a business as at a given moment of time." If sales should not keep pace with increase, a large secret reserve would result in a number of cases under our observation. Omission of inventories on farms and ranches has a direct effect on general taxes, inasmuch as there is scarcely any way of verifying assessment lists, or at least confirming them. Some accounting practice should be definitely outlined upon the question of computing profits for this type of business, which up to this time seems to be a subject upon which very little accounting literature exists.

As these questions are constantly recurring in ranch accounting, I have taken this means of presenting these views on the subject, not thinking that this is the final word upon the subject, but hoping rather that some one may further elucidate the principles involved.

The following is illustrative of the two methods of making the income tax return by two farms having the same transactions, but different accounting methods:

(*a*)*

Gross income per operating account		$7,126.14
Allowable deductions:		
Repairs	$ 150.00?	
Interest	350.00?	
Taxes	600.00	
Wages	1,000.00	
Deprec'n	100.00?	
Total deductions		$2,200.00
Net income		$4,926.14
Less: Specific exemption		3,000.00
Taxable income		$1,926.14

1% on $1,926.14 is $19.26, the amount class (*a*) will pay.

(*b*)†

Gross income (cash receipts from sales)		$4,000.00
(In addition to the above sales, there is $1,300 in accounts receivable on the books representing sales made, but not yet collected, and which are not included in above "income.")		
Allowable deductions:		
Repairs paid for	$ 100.00	
(Balance $50 due but not paid for, hence not reported.)		
Interest paid	300.00	
($50 accrued but not yet paid.)		
Taxes	600.00	
Wages	1,000.00	
Total allowable deductions		$2,000.00
Net income		$2,000.00

The following illustration is not based upon actual figures, but is simply prepared to show the two methods that have been used in making returns of income tax for 1913. Column 1 shows the figures for transactions on two farms, while column 2 shows the transactions which affect the report of class (*b*):

* Class (*a*) is making his report upon the basis of his books closed at the end of a fiscal period. Allowable deductions are shown in detail and not as required by schedule No. 1040, upon which individual returns are made.

† As the specific exemption is $3,000 in both cases, it will be noted that, (not taking into consideration the deductions of five-sixths of the income and five-sixths of the "specific exemption") class (*b*) has no tax to pay, while class (*a*) will have to pay $19.26.

		(1)	(2)
Dec. 31, 1912,	Inventory of grain	$ 507.86	
	" of stock	1,966.00	
	" of machinery	900.00	
1913,	Purchases of stock	400.00	$ 400.00
	" of machinery (new)	200.00	
	" " " (replacements)	100.00	100.00
	" " " (repairs)	50.00	50.00
	Interest paid	300.00	300.00
	" accrued (payable)	50.00	
	Taxes	600.00	600.00
	Wages	1,000.00	1,000.00
	Depreciation of machinery	80.00	
	" of stock	20.00	
	Sales of grain	1,500.00	1,500.00
	" " stock	3,800.00	3,800.00
	Grain fed to stock	700.00	700.00
Dec. 31, 1913,	Inventory of grain	4,400	
	" of stock	300.00	

OPERATING STATEMENT

Class (*a*)

			Grain	Stock
Sales			$1,500.00	$3,800.00
Inventory			4,400.00	300.00
Grain fed			700.00	
			$6,600.00	$4,100.00
Grain fed		$ 700.00		
Purchases		400.00		
Inventory	$ 507.86	1,966.00	507.86	3,066.00
Gross trading profit			$6,092.14	$1,034.00

PROFIT & LOSS:

		$6,092.14
		1,034.00
Gross trading profit brought down		$7,126.14
Expenses and losses:		
Repairs and replacements	$ 150.00	
Interest	350.00	
Taxes	600.00	
Wages	1,000.00	
Depreciation of stock	20.00	
" of machinery	80.00	
Total losses		$2,200.00
Net profit, 12 months		$4,926.14