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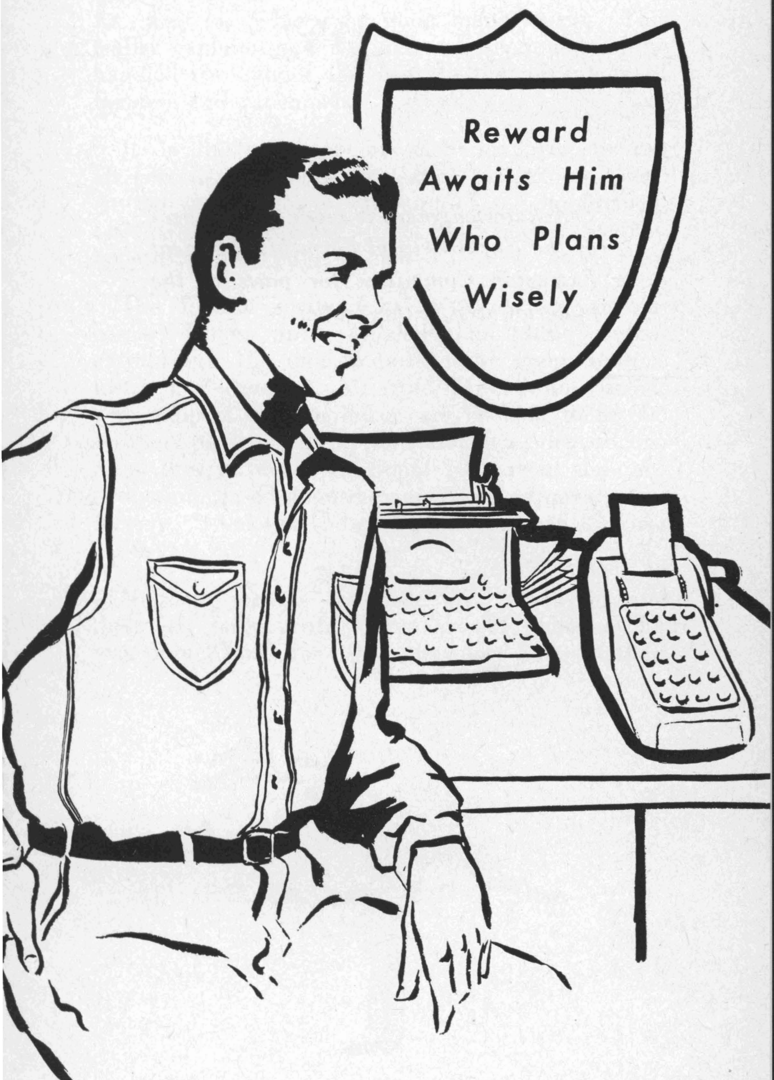
Farm and Ranch Income Tax Management



TEXAS AGRICULTURAL EXTENSION SERVICE

J. E. Hutchison, Director, College Station, Texas

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Farm and Ranch Income Tax Management

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LIKE OTHER FARM AND RANCH COSTS, income tax may be reduced by good management. This leaflet explains how business transactions may be handled throughout the year to the advantage of farmers and ranchmen.

It is the privilege of each taxpayer to use all permissible means to reduce his income taxes. At the same time, the amount of self-employment tax paid determines credit for social security benefits. (See pages 6 and 7.)

The federal income tax is levied on net income. Unless this is higher than *total personal exemptions*, the unused portion of exemptions is lost. For example, Mr. and Mrs. John Farmer who support three children are entitled to $3,000 on their personal exemptions and three dependents. Also, they have an additional 10 percent standard deduction, based upon the amount of *adjusted gross income*. (Amount shown on line 11, page 1, Form 1040.)

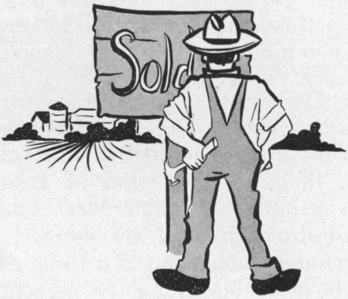
If their income is solely from farming and their net farm profit (summary of Schedule F) was only $2,650 for 1957, they lost $350 of their

personal exemptions ($3,000 − $2,650 = $350). Furthermore, they lost another $265 since they were entitled to 10 percent standard deduction on the $2,650 farm income.

Expressed another way, Mr. and Mrs. Farmer would not have paid any income tax had they managed to make a *net farm profit* of $3,300 because of these privileges:

5 exemptions @ $600	$3,000
10% standard deduction on $3,300	330
Total exemptions before tax applies	$3,330

So, if drouth or other conditions limited his farm income, Mr. Farmer might have sought off-farm employment or other means of increasing his earnings to at least $3,330. Thus, he could have avoided any loss on permissible exemptions for 1957, which cannot be carried over to 1958.



- Farm and ranch operators should consider the options open to them in order to plan wisely and check with a tax consultant on possible tax savings.

- The government expects only the amount of tax due. If overpayment is made because of oversight or improper reporting, no refund will be made unless an amended return is submitted within 3 years showing the correct tax liability.

- Adequate records are necessary to substantiate tax reports. Items of taxable income and business deductions must be shown accurately.

Tax Management Opportunities

1. *In case of farm or ranch sales,* consider using the installment sales method to spread liability on

gain over a period of years. This method can be used only if payments received in the year of sale are not more than 30 percent of the selling price. (See example on page 29 of Farmers' Tax Guide.)

2. *If a farm is bought,* promptly divide on your records the total cost of the farm among: (a) growing crops, (b) depreciable improvements, (c) dwelling and site and (d) remainder of land. (See pages 31 and 32, Farmers' Tax Guide.) These allocations will affect the depreciation allowed, deduction for crop expense and other items. Complete records may save worry and time in determining capital gain in case the property, or portion thereof, is sold later.

3. *Use depreciation method most suited to your operations.* The declining balance method gives the highest depreciation during the first few years. Another rapid write-off is the "sum of years digits" approach. The straight-line method keeps it uniform; hence it is simpler to maintain in records. Decide whether you would be benefited more by recovering costs quickly or having depreciation spread over the entire life at a constant rate. You can use the *straight-line method* for some items and *declining balance* on other items of new equipment. Also, you may use declining balance for the first year or two, then shift to straight-line for the remainder of its useful life. (See page 23, Farmers' Tax Guide.)

4. *Plan personal deductions so that you get maximum benefits* by itemizing them. Items such as charitable contributions, personal property taxes and organization dues might be prepaid so that itemization reduces the current year's taxes. The following year the standard deduction, 10 percent of adjusted gross income, but not to exceed 1,000, can be taken.

5. *Make expenditures for optional items during years of high gross income.* The costs of painting buildings, minor repairs on improvements and equipment, small tools, seeding legumes or grasses do not come every year. However, these costs are deductible the year they are paid.

6. *Consider paying wages to your children* for work performed on the farm or ranch. Such payments for bona fide services count as farm labor expense even though you list these children as dependents.

7. *Work out arrangements to spread income to more family members.* For example, give children

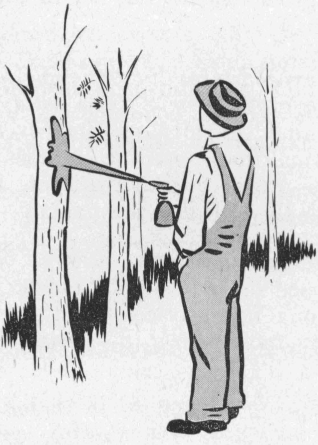
part of your income-producing property—land, cattle or machinery and let them report income from their work and capital. Family partnerships sometimes are used for this. Keep in mind that such arrangements, as well as gifts, must satisfy certain legal requirements.

8. *If you sell timber, use the optional method of reporting* that will benefit you. For the small owner with lower income level, it might be desirable to count timber sales as ordinary income the way you would count other crops, eggs or pecans. The higher income will increase social security credits for those having less than $4,200 net income. The special capital gains treatment may be helpful to those in higher brackets. The method chosen must be continued in later years, unless consent to change is granted by the district director, Internal Revenue Service.

9. *In years of unusually big crops or favorable prices, consider holding over a portion of storable commodities* for sale the following year (for cash basis taxpayers). Or you can sell a portion with buyer contracting to make payment the following year. This will assure some cash income for the next year as "insurance" against crop failure or low yields. Many producers in high risk areas use this method to level out tax liability over the good and bad years.

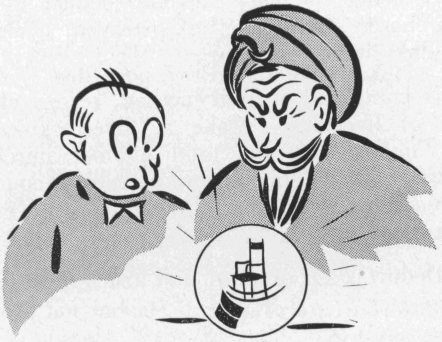
Managing Income to Aid Social Security Benefits

Farmers and their families may desire to increase income to be eligible for the highest pos-



sible social security benefits. If the present income level is subject to tax, an income boost automatically will increase income taxes. However, some may prefer to pay these increased taxes to become eligible for higher retirement and survivor's benefits. Many operators with dependents must pay a self-employment tax on net income without paying any income tax. The starting rate for federal income tax is 20 percent and the self-employment rate will increase from 3⅜ percent to 3¾ percent beginning January 1, 1959.

Persons seeking to increase their income by changing enterprises should make certain that estimated profits are based on reasonable expectations. Plans for enterprise changes might be discussed with the local county agricultural agent who can give helpful suggestions. Also, these



persons should determine if the added income can be counted for self-employment credit. County agricultural agents, lawyers, bankers and other professional persons can assist with such questions. The staff of the social security offices is not in a position to suggest methods of increasing benefits. Their primary job is checking compliance and certifying applicants for benefits.

Where the method of handling certain expense items is optional, the farmer seeking to increase taxable income may choose the method giving smaller deductions. Examples include: (1) shifting from rapid depreciation method to slower straight-line method, (2) electing to treat soil and water conservation costs as capital investments rather than as annual operating expenses, (3) disposing of some depreciable capital items to reduce total depreciation deductions and (4) in general, reducing operating costs to a minimum.

Tax Reporting Reminders

1. If board is furnished to hired help, the portion which is purchased is a deductible business expense.

2. Amounts paid to a tax consultant for help on income tax returns is a deductible farm expense; also include record books and fees for management service or to organizations such as the Dairy Herd Improvement Association.

3. Itemize personal deductions for merchandise, livestock or tract of land given to church or educational institutions.

4. Be sure that Commodity Credit Corporation loans are not counted as income twice (in 1 year when borrowed and next year when crop is sold).

5. If using the cash method, deduct the cost of purchased livestock lost, strayed, stolen or which died during the year.

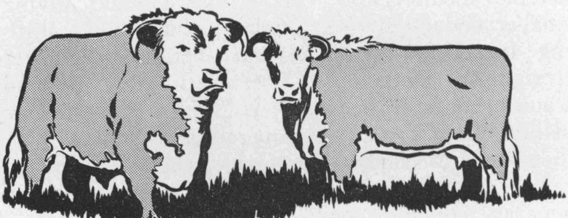
6. If using the accrual method, record all purchases of livestock. Make a "livestock number check" to see that the total number purchased, born and on the beginning inventory equal the total number sold, died, butchered and on the ending inventory.

7. Deduct cost of auto and truck licenses, insurance, etc.

8. Deduct auto, utilities and telephone expenses which are actually used in the farm business (half is not enough in many cases).

9. Take all depreciation allowable on depreciable improvements, machinery and equipment and on purchased draft, breeding and dairy livestock. Accrual basis taxpayers may remove purchased as well as raised animals from inventory at maturity and put them on a depreciation schedule.

10. Keep records to insure deduction of easily overlooked items such as farm magazines, organi-



zation memberships, bank service fees, overnight business trips, portion of dwelling used for farm use and losses on household goods used for feeding or lodging hired help.

11. Keep records of source of bank deposits such as gifts, borrowings, sale of bonds, etc., so that they will not be considered taxable farm income.

12. Keep records of all medical, dental and hospital bills, including payments for accident and health insurance.

13. Keep exact records of dates of purchase, cost, date of sale and sale price on all items sold.

14. Do not include in income any indemnity for diseased animals if the payment has been or will be used to purchase "like or similar" animals within 1 year.

15. Records should be kept carefully. Keep all paid bills, invoices, canceled checks, etc., for at least 5 years, including checks used to pay income taxes. Pay bills by check whenever possible. Record all other payments in an account book. Get the bank statement each month and check it against the farm account book.

16. Establish a charge account at a hardware store, elevator or other places where considerable business is done during the year. Pay this account by check upon receipt of monthly statements. This prevents the omission of many small expense items which might otherwise be paid by cash and the tickets lost. Every dollar of cost not deducted will result in at least 20 cents unnecessary income tax being paid.

17. Remember to check special provisions relating to damages to land from pipe lines, oil wells, rights of way and similar circumstances.

Other Important Items

NONTAXABLE TRADES AND EXCHANGES

When property is traded or exchanged for other property, or for services, the transaction may result in an *ordinary* gain or loss, or a *capital* gain or loss.

There are certain trades and exchanges which postpone the gain or loss, until the property received is sold. These transactions are those which result in a continuation of your original investment in about the same form. For example, if you trade your farm for another farm, your investment is still in the same kind of property as before. The trade involving no "boot" produces no taxable gain or loss even though the farm received may be worth more or less (on a cash market) than the one traded.

Three points to keep in mind *on trades* are:

1. For gains to be nontaxable, it is necessary that the property exchanged be of "a like kind." (See pages 34 and 35 in Farmers' Tax Guide.)

2. Property must be held for trade or business or for investment.

3. If any "boot" is received, the gain, if any, is taxable to the extent of the "boot." The "boot" may be cash or other property not of "like kind."

FORCED SALES OR INVOLUNTARY CONVERSIONS

If property is either partially or totally destroyed, stolen, seized, requisitioned or condemned and other property or money (such as insurance proceeds and condemnation awards) is received as payment, the former property is said to have been "involuntarily converted" into other property. (See pages 35 and 36, Farmers' Tax Guide.) Extraordinary sales of livestock because of drouth constitute "involuntary conversion" after December 31, 1955.

INVOLUNTARY CONVERSIONS RESULTING IN GAIN

To treat an involuntary conversion, first determine whether such conversion results in a gain or a loss. To do this, a comparison must be made between the adjusted basis (remaining cost) of the property converted and the proceeds received, as if the property were voluntarily sold or exchanged.

If the conversion results in a gain, whether the gain is taxed depends upon the circumstances in the case. For example, if the property is converted solely into other property which is similar or related in service or use to the property converted, the gain is not *included in income*. But, if the property is converted into money or other property not similar or related in service or use to the property converted, the *gain must be included in income* unless within the time explained in the following paragraphs, the amount of proceeds are invested in similar property as "replacement." The term *proceeds* means money plus the value of any dissimilar property.

REPLACEMENT PROPERTY

For property to qualify as replacement property it must be similar or related in *service or use* to the property converted. This test requires that the new property be functionally the same as the property converted. Thus, dairy cows must be replaced with dairy cows, etc.

PURCHASING OTHER PROPERTY

Usually the taxpayer has 1 year after the close of the taxable year in which gain from involuntary conversion is received. For example, if 30 cows are sold on June 25, 1957 because of drouth conditions, the owner has until December 31, 1958 to purchase replacements, assuming his tax year is on a calendar year basis. Under certain conditions this period may be extended by the Internal Revenue Service upon application by the taxpayer.

GAIN FROM RESIDENCE-FARM SALE

Any gain from the voluntary farm sale used as business property, unless the taxpayer resided thereon, is subject to taxation in the year of sale or in which any part of gain is received. (See exception on installment sales, pages 4 and 5.)

A personal residence does not constitute property used in trade or business, but is a *capital asset*. If the farmland and the residence are sold together, the *nonrecognition of gain* provisions—that is, not taxable if reinvested in 1 year—*apply only to that part of the property used as a residence*. The portion of the selling price and the cost or other basis which are allocable to the residence involved must be determined. (See example on page 28, Farmers' Tax Guide.)

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Farmers and ranchmen do not have to be "tax experts" to find simple ways to minimize their income tax. Study of publications such as the Farmers' Tax Guide, available free of charge from the Internal Revenue Service or from county extension offices around December 10, will be profitable to every taxpayer engaged in agriculture. If further information is desired about points mentioned in this leaflet, discuss them with a competent tax consultant, an area internal revenue agent or write to one of the following:

District Director, Internal Revenue Service, Austin 14, Texas

District Director, Internal Revenue Service, Dallas 1, Texas

Publication No. 17, "Your Federal Income Tax for Individuals," also may be helpful to individual taxpayers. This bulletin can be ordered from either of the district offices for 35 cents per copy or from some large newspapers around the first of the year.

Keeping accurate records is advantageous in tax management. Like other practices, when the decision is made to start, the "reward of doing is within one's grasp."

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