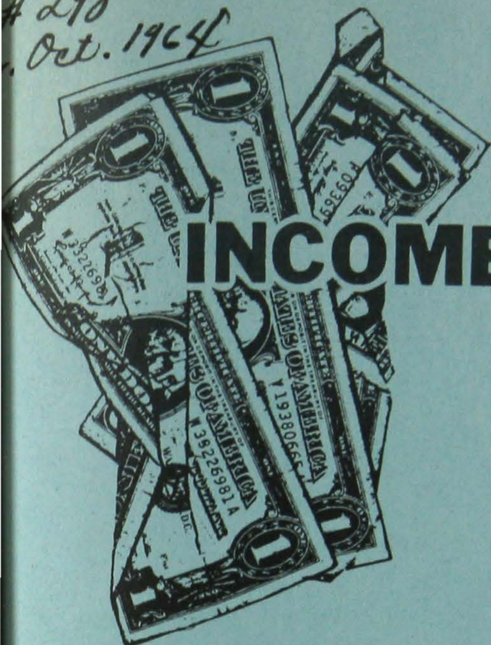
Minn. 3.3
298
Oct. 1964
UNIVERSITY OF HAWAII LIBRARY
OCT 21 '66
Nov 22 '66



INCOME TAX MANAGEMENT *for Farmers*

Extension Bulletin 2
Revised October 19
Agricultural Extension Serv
UNIVERSITY OF MINNESO

This archival publication may not reflect current scientific knowledge or recommendations.
Current information available from University of Minnesota Extension: http://www.extension.umn.edu.

NORTH CENTRAL REGIONAL PUBLICATION NO. 2

of the Agricultural Extension Services of

Illinois • Indiana • Iowa • Kansas • Kentucky
Michigan • Minnesota • Missouri • Nebraska • North
Dakota • Ohio • South Dakota • Wisconsin
Farm Foundation and United States Department of
Agriculture, cooperating

(Revised, 1964)

you and your taxes . . .

Like many other costs, income taxes can be reduced by good management. A good tax manager is one who "thinks taxes" all during the year, and he finds complete and accurate records very helpful. He does not rely on end-of-the-year decisions alone. There is little that can be done to reduce taxes after the close of the year's business. The "Farmer's Tax Guide" is most useful in keeping up to date on changes in the income tax laws.

A farmer need not be a tax expert, but he should know enough about taxes to recognize the income tax aspects of a farm decision. If he knows how to recognize tax problems, he will know when he needs tax advice. Tax management is becoming an important part of good farm management.

Some of the major tax planning decisions that farmers must face are discussed in this bulletin. There is a list of tax items often overlooked by farmers, and several tax management ideas on the last pages. Each idea that can be used on a particular farm saves tax dollars.

The income estimate sheets at the end of the bulletin are designed for farm tax planning. Careful use of the form will enable a farmer to see where he stands taxwise at any point during the year. With this information, and a knowledge of the tax effects of farm business decisions, a good farmer can become a good tax manager.

Income Tax

Since income taxes are levied upon the taxable income of the individual, they reduce the amount of money left for family living and increasing net worth. Income taxes, like farm costs, can be reduced by good management.

Farmers have many opportunities during the year to make business decisions that will affect the amount of their income tax. To make wise business decisions, from an income tax standpoint, they must become informed and know the tax consequences of various farm business transactions. The amount of the tax for the current year is determined, to a great extent, by the timing of these transactions.

In general, because of graduated tax rates, the less a farmer's net income fluctuates from year to year, the less income tax he will pay over a period of years. The farmer, or even the "tax expert," can do little to reduce the tax after the year's business is closed except for a few choices with depreciation and "income-averaging" under certain conditions (provisions of the income-averaging feature of the Revenue Act of 1964 are explained in the annual "Farmer's Tax Guide").

North Central Farm Management Extension Committee

Illinois .... Robert B. Schwart
Indiana .... Noah Hadley, Chairman
Iowa .... Everett Stoneberg, Vice Chairman
Kansas .... John H. Coolidge
Kentucky .... Wilmer Browning
Michigan .... John Doneth
Minnesota .... Paul Hasbargen
Missouri .... Charles Beer, Secretary
Nebraska .... Ted Nelson
North Dakota .... Fred Olson
Ohio .... Ray Krofta
South Dakota .... Arthur W. Anderson
Wisconsin .... Robert Rieck
Federal Ext. Service .... Buel Lanpher
Farm Foundation .... Joseph Ackerman, R. J. Hildreth
Administrative Advisor .... J. B. Claar (Illinois)

CONTENTS

	Page
Tax Management Is Part of Farm Management	3
Need for Records	3
Methods of Keeping Records	3
Managing Income To Minimize Taxes	
Increasing Income To Cover Allowable Personal Deductions and Exemptions	5
Increasing Deductions To Save Taxes	6
Net Operating Losses	8
Tax Management of Sales or Trades of Property	8
Tax Planning in Buying a Farm	8
Managing Income for Increased Social Security Benefits	9
Tax Management Tips	9
Tax Reporting Reminders	10
Cash Method Tax Estimate Worksheet	11
Accrual Method Tax Estimate Worksheet	12

Issued in furtherance of cooperative extension work in agriculture and home economics, acts of May 8 and June 30, 1914, in cooperation with the U. S. Department of Agriculture. Luther J. Pickrel, Director of Agricultural Extension Service, University of Minnesota, St. Paul, Minnesota 55101.

Management for Farmers

J. H. Coolidge, Arthur W. Anderson, Robert Schwart,
Ray Krofta, and Fred Olson*

Tax Management Is Part of Farm Management

Management of a modern farm business requires the handling of a large volume of money and the investment of large amounts of capital. The tax consequences of farm business decisions have a greater impact on net income as the volume of business continues to expand.

Farm business records show that net farm income varies considerably from year to year. This fluctuation of net income results from differences in farm production, changes in prices received for their products, and changes in operating costs.

Tax management is more than merely postponing the income tax. In the long run it is a determined effort to maximize "after-tax" income and net worth. In the short run it is an attempt to maintain an annual net income that will at least equal the year's allowable non-business deductions and personal exemptions, and yet avoid extremely high taxable incomes. It is equally desirable to have a net income which approaches or equals the maximum earnings (from self-employment plus wages) eligible for Social Security credit ($4,800 in 1964 and may be raised by Congress at any time). It assumes that the individual farmer can do a better job of income and expense management than that resulting from chance or unplanned business operations.

Tax management, however, has some limitations. If decisions are made and business transacted solely in an effort to reduce tax, net income after taxes may actually be lower. For example, if a decision results in the saving of $100 in income tax, but a larger amount is lost by a lower selling price of a farm product, the net income after taxes is reduced. Frequently there is no conflict between a wise tax decision and a good farm business decision, but when a choice must be made, the one resulting in the larger net income **after taxes** should be followed.

Need for Records

Successful tax management depends upon complete records kept regularly and carefully throughout the year. With good records it is easy to make periodic checks of income and expenses to determine the approximate taxable income to date. This enables one to make business decisions which will result in the greatest net income after taxes.

If a preliminary check indicates an unusually high net farm income, the decision may be made to delay additional sales beyond the end of the year or to increase deductible expenditures before the end of the year. Such procedures are more advantageous to farmers using the cash method, since under the accrual method unused items purchased would be included in their inventory at the end of the year.

Since depreciation of farm improvements, machinery, equipment and purchased breeding, dairy and work stock are allowable business deductions under both methods, farm records should include a detailed record of these capital investments. Such a depreciation record should include (1) date of purchase, (2) cost, (3) depreciation claimed to date, (4) remaining cost, and (5) any investment credit taken.

Occasionally bank statements are examined when tax returns are audited. Deposits shown on these statements are usually assumed to be taxable income unless they are proved to be otherwise. Therefore one should clearly identify all deposits, including borrowed money, repayment of loans made to others, bonds cashed, gifts received, inheritance, and other non-taxable receipts as well as farm receipts.

Account books suitable for keeping adequate records for tax purposes and farm business analysis as well as **Farmer's Tax Guides** are available at all county agricultural Extension offices. The "Farmer's Tax Guide" is an annual publication of the Internal Revenue Service designed especially for farmers. It contains current information, examples, and illustrations to guide farmers in preparing their income tax returns.

Methods of Keeping Records

Farmers may keep records and report their income on either the cash or accrual method. They make their choice when they file their first farm tax return. Having chosen one method they must continue using that method unless they get written consent from the Commissioner of Internal Revenue, Washington, D. C., to change methods. To get this consent, an application must be filed with the Commissioner within the first 90 days of the taxable year in which the change is desired to be made.

A farmer keeping records and reporting income on the "cash" method treats receipts as income when received in cash or its equivalent, and treats expense items as deductible when they are paid. This is sometimes called the "cash receipts and disbursements" method.

In the "accrual" method of keeping records and reporting income, items are reported as income when earned even though not actually received, and deductions are claimed when the expense is incurred even though not yet paid. A farmer using the accrual method of keeping records must take inventory of his livestock, unsold crops, feed, and supplies on hand at the end of each year. An increase in the value of the inventory during the year results in additional taxable in-

* Extension Economists in Farm Management in Kansas, South Dakota, Illinois, Ohio, and North Dakota respectively. Revised from 1960 edition by A. M. Nichter, J. H. Coolidge, John C. O'Byrne, and Geo. B. Whitman.

come that year. A decrease in inventory would reduce the income for that year.

The main difference between the cash and accrual method of computing income can be easily illustrated. For example, a farmer buys $100 worth of feed on December 15, but charges the purchase. The feed store sends a bill on January 2 and it is paid in January. If the farmer is using the cash method, he counts it as a farm expense in January when he pays the bill. A farmer using the accrual method, however, would have claimed the $100 expense deduction in December, when the obligation to pay was incurred or "accrued." He then would include any of the feed still on hand in his ending inventory, and the $100 debt in his accounts payable. Taxes, too, are deductible "when paid" by a farmer using the cash method, but only as they "accrue" (a full year's taxes each year) if computing income by the accrual method, even if only a half year's taxes are paid in one year and 1½ years' taxes paid in another calendar year.

Income is similarly treated. Suppose a sale of grain was actually made on December 15, but by approved written contract the buyer and seller agreed that the grain would not be paid for until January 15 of the following year. The cash method farmer will report income in January when he receives payment. The farmer using the accrual method reports it as December income when the sale was made. He would then list it as an account receivable on his ending inventory, and will **not** include it again as farm income in January when he receives payment of the account.

Inventories also make a difference. Suppose a farmer raised livestock during the year, but did not sell any. By the cash method there is no income until he actually sells the livestock. By the accrual method there is income in the amount of any increase in value of the livestock during the year, and the value of the current year's crops or new livestock on hand at the end of the year.

A. *Cash Method*

When the cash method is used, gross farm income includes: (1) receipts from the sale of all crops and market livestock produced on the farm, and (2) profits (selling price less cost) on sales of livestock and other items purchased for resale. Allowable deductions include: (1) those farm operating expenses that were **paid** during the year, regardless of when they were **incurred,** and (2) depreciation expense allowable on farm improvements, machinery, equipment and purchased dairy, breeding and work stock.

There are certain advantages of the cash method which should be carefully considered in tax planning:

(1) The young farmer, who is building up his business, has a smaller taxable income and less tax, because only his actual sales are taken into account. The increase in value of his inventories is not recognized. He thus postpones payment of higher taxes until later years when he sells the production which he has carried over from prior years.

(2) The cash method affords a greater opportunity to even out income from year to year. For example, part of the crop or livestock production in good years may be held over for sale in years of lower production. One may also delay expenditures, postpone payments or make certain cash purchases before actually needed. Items such as feed, seed, fertilizer, and repairs may be purchased in the latter part of the year, even though they might not be used until the next taxable year.

Caution should be exercised, however, in making such expenditures. It is usually good management for a livestock feeder to purchase needed feed grain at harvest time in November and December when prices are normally lower than in the following spring months. Advantages would depend upon prices, storage, and of course, financial situation of the individual.

Fuel and oil or other such items purchased should be actually acquired and preferably delivered to the farm. They must be bona fide irrevocable obligations, not advance payments on "orders to be placed," or purchases which may be made in the succeeding year. Expenditures will not be allowed until the debt is actually incurred.

(3) Sales of raised breeding, dairy and work stock, treated as capital assets, result in a lower tax liability if the cash method is used. This is because these animals have a zero cost basis when sold, while under the accrual method the last inventory value is the cost basis for determining gain. Breeding, dairy, and work animals purchased and depreciated to salvage value by a "cash basis" farmer will often have a lower cost basis at time of sale than similar animals held in an inventory by the farmer using the accrual method. However, with permission of the Commissioner of Internal Revenue, a farmer using the accrual method can avoid part of this disadvantage by removing these animals from inventory as soon as they are selected for breeding or dairy purposes, and placing them in the depreciation schedule. Their basis can then be gradually reduced to normal salvage value. This procedure, however, is not permissible when the unit-livestock-price method of inventory is used.

(4) Fewer records are necessary, as no inventories are needed for tax reporting.

(5) Upon the death of a farmer using the cash method, his unsold livestock, crops and other farm commodities pass to his estate free of income tax because the estate takes the property with a tax basis equal to the fair market value at death. The accrual method farmer would have included the value of these items as income year by year.

B. *Accrual Method*

By the accrual method gross farm income includes: (1) all income from sales made during the year, regardless of when payment is received, plus (2) the inventory value of market livestock, crops, feeds and supplies on hand at the end of the

year, less (3) the cost of market livestock purchased during the year and (4) the inventory values of such properties on hand at the beginning of the year. To arrive at net income the allowable deductions include: (1) all operating costs and expenses incurred during the taxable year, whether paid or not, and (2) depreciation—the same as allowable under the cash method. Costs of purchased feeder livestock are subtracted in the year purchased, then will be included in the inventory at the end of the year if not yet sold. (By the cash method these costs are not deductible until the year in which the animals are sold.) See also the discussion of "Accounting Methods" in the **Farmer's Tax Guide.**

Some advantages of the accrual method include:

(1) Cash crop farmers who store some crops and sell them in the next year may level out their income to some extent by counting the production of a given year as income the year of their costs. They may thus avoid having to pay income tax on the sales of more than one year's production in one year, for example, two calf crops or some grain held over plus the current year's production.

Livestock feeders who have their heavy expenses in the latter part of one year, but sell the livestock early in the following year may prefer the accrual method. Thus they could count the increased value of the animals in their ending inventory and offset the costs which may already be paid. Farmers who report on the Accrual Method have their income tax paid more "up to date" than do farmers who use the Cash Method who deduct all costs but hold back unsold production from one year into the next.

(2) Men starting farming with inadequate financing may desire to use the Accrual Method in order to keep their income and their taxes on a more current basis, rather than postpone taxes until the year in which production is sold. They may need to count the increase to cover farm expenses, also their allowable deductions and annual personal exemptions.

MANAGING INCOME TO MINIMIZE TAXES

Increasing Income To Cover Allowable Personal Deductions and Exemptions

When a preliminary check of income indicates a probable net taxable income less than the total amount allowed for personal deductions and exemptions, consideration should be given to increasing the income.

Since personal deductions and exemptions are allowed annually, any credit for such exemptions not absorbed by current income is automatically lost; that is, unused exemption credits cannot be carried over and applied against income of another year. The following example illustrates this principle:

John and Mary Jones have two children—

	First Year	Second Year	Average Income	Two Year Tax
Net Income	0	$6,000	$3,000	$500*

Jim and Jane Smith, also with two children—

	First Year	Second Year	Average Income	Two Year Tax
Net Income	$3,000	$3,000	$3,000	0

* Using standard deductions and tax rates for 1964.

The Joneses paid more income tax than did the Smiths, even though they had the same total net income for the two years. In the first year they paid no tax, but failed to use the $3,000 that tax regulations permitted them to earn before paying any income tax. ($600 standard deduction for four people, plus the $2,400 personal exemption for a family of four.) In the second year their exemptions amounted to only half their income, so they paid taxes on the other half.

A. *Using the Cash Method*

If John and Mary Jones were using the cash method of reporting, they could have remedied the situation before the end of the first year by doing one or more of the following:

(1) Made additional sales before the end of the year. In many cases livestock feeders may have livestock about ready for market which can be sold either in December or January. Sale of some of these animals in December may be desirable from a tax standpoint, even though they bring less income. Other possibilities include selling grain or other farm products, culling dairy and breeding stock or poultry flocks, disposing of other undesirable animals, collecting money due for labor or custom work done, doing additional off-farm work, or selling capital items not needed in the business and on which a gain can be realized.

(2) If they are eligible for a CCC loan they might have secured a loan on some of the grains before the end of the year and elected to treat the amount of the loan as income. Once made, the election to treat CCC loans as income in the year received must be followed in future years.

(3) Delayed some expenditures and postponed payment of charged operating expenses until the next year. In many cases farmers charge repairs, fuel, feed for livestock, fertilizer, and farm supplies when purchased. Arrangements may be made for carrying such accounts beyond the end of the taxable year. In some states it is optional to delay payment of half of property taxes until the following year, without interest or penalty.

B. *Using the Accrual Method*

If John and Mary Jones were using the accrual method, the opportunities for increasing income late in the year are more limited, since gross income is primarily determined by actual production of the farm whether sold or still on hand at the end of the year. Possible ways of increasing their net income in the first year would include:

(1) Doing off-farm or custom work which would increase cash receipts.

(2) Buying feeder stock or other inventory property which would increase in value by the end of the year.

(3) Incurring as few deductible expenditures as possible during the balance of the year.

(4) Making sure that the ending inventory is fully complete.

(5) By not taking the additional first year depreciation allowance on eligible items.

Increasing Deductions To Save Taxes

A. *Planning Farm Operating Expenses*

Some expenditures which are not necessarily made every year are nevertheless deductible in the year in which they occur. Such expenditures include painting buildings, minor repairs on improvements, many small shop tools, increased seedings of legumes and grasses, and (within limits) costs of soil and water conservation practices. Farmers can manage to make many expenditures of this type in years of high gross income to reduce their taxable income.

B. *Investment Credit Reduces Taxes*

The "Investment Credit" is a provision of the Revenue Act of 1962 and revised in 1964. The tax change allows a direct credit of a percentage of the investment against one's income tax liability. The amount of the tax credit is 7% of the "qualifying investment." The full amount ($70 per $1,000 of new investment) is allowable only on items which will have a useful life of 8 years or more. On items with a 6- or 7-year life, count only two-thirds of the amount, only one-third on items with a 4- or 5-year life, and none on items with less than a 4-year life. In case of trades for new equipment, it applies to the total cost which is the unrecovered cost in the old item, plus the cash difference paid in trade. If used equipment is acquired by trade, it applies only to the difference (boot) paid.

QUALIFYING PROPERTY —property eligible for the investment credit includes tangible personal property (except livestock) and certain real property (except buildings) used for production, processing, or storage of farm products. This includes practically every item a farmer would put on his depreciation schedule except breeding, work or dairy animals, and major farm buildings and their structural component parts, such as wiring, plumbing pipes, ducts, etc. All machinery and equipment, such as feed processing equipment, feeding floors, feed bunks, fences, silos, and drainage tile should qualify.

The investment credit may make it profitable to own a piece of equipment that would not quite be profitable without the credit. Since the credit is a deduction from tax, not from taxable income, it is of equal value in any year when it may be applied to tax liability. The critical judgment is whether the tax deduction reduces the cost of the equipment enough to make its ownership profitable.

The tax credit must be computed in the year in which the property is "placed in service." This is interpreted to mean (1) the year your depreciation on the item begins or (2) when it is "put in readiness" for use. The carry back-carry forward feature assures that the investment credit will reduce income tax for 1962 or later years as needed. Amended returns may be filed back to 1962, since any credit which exceeds the current year's income tax liability may be carried back for three years (but not farther than 1962) and then if unused, to offset tax for five years forward. Any excess of credit over tax in 1963, 1964, or 1965 will all carry back first to recover tax paid on 1962 income, then any unused amount would be carried forward. Amended returns may be filed to claim investment credit that was not used in the proper year, until the statute of limitations expires and would prevent further changes. Use of the investment credit does **not** reduce the "cost basis" for depreciation of "qualifying property" purchased after December 31, 1963. On items purchased, and to which the investment credit was applied in 1962 and 1963 the amount of the credit taken is to be **restored** to the remaining cost as of January 1, 1964, so that it is now available for depreciation in 1964 and later years.

See the "Farmer's Tax Guide" (IRS Publication 225) for further details and limitations on the investment credit.

C. *Claiming Depreciation*

Depreciation is the amount or portion of the cost of a capital asset that is used up or which disappears with use or age. For income tax purposes it is expressed in dollars and includes obsolescence as well as normal "wear and tear" due to use. By claiming depreciation as a farm business expense, a farmer recovers the costs of farm improvements, machinery, equipment, and purchased breeding, dairy and work stock during the years of their useful life in his business. Farmers should avail themselves of every opportunity to reduce their taxable income by claiming all allowable depreciation.

RECAPTURE OF DEPRECIATION BY SALE

There is little advantage, however, in depreciating an item below its *estimated market value*, since the recovery (by cash sale) of depreciation claimed in 1962 or later years is treated as ordinary income rather than as capital gain.

Suppose a machine had been depreciated down to $400 by December 31, 1960. Depreciation of $100 was claimed in 1961, and another $100 was claimed in 1962. It was then sold in July 1963 for $400 cash. Since the sale price exceeded the cost basis ($200 on January 1, 1963) no depreciation was allowed for the year of sale. On the tax return for 1963, the $100 of 1961 depreciation was still allowed as a capital gain ($50 taxable), but the $100 of 1962 depreciation was restored as ordinary income (Part II of Schedule D). Thus if excessive depreciation is claimed, it will be restored to income in full should it be "recaptured" by a sale. This should encourage farmers not to claim depreciation below a reasonable salvage value.

D. *Additional First Year Depreciation*

Any taxpayer, except a trust, may deduct an additional 20 per cent first year depreciation allowance on new or used tangible personal property purchased after December 31, 1957, provided:

(1) The property has a useful life of six years or more.

(2) It is applied to the total cost of such properties of not more than $10,000 for a separate return ($20,000 on a joint return).

(3) Property is not acquired from spouse, parent, child, or other ancestor or lineal descendant.

(4) Property is not acquired in transactions between certain related partnerships, partners,

corporations or stockholders or certain beneficiaries, fiduciaries, or grantors of trusts.

(5) If property is acquired through a trade, only the difference paid is subject to this additional depreciation.

This additional depreciation may be taken **only** in the first year that some regular depreciation deduction is allowable on the property. After taking this 20 per cent depreciation, regular depreciation may be taken on the remaining cost from the date of purchase to the end of the year.

Farm equipment, machinery and purchased dairy and breeding livestock qualify if thev will have a useful life to you of six years or more. Buildings, fences, structures and other farm improvements that become a part of the real estate are **not** eligible for this additional depreciation.

It would not, of course, be advantageous to take the additional first-year depreciation if there is no tax to pay in the year of its purchase, or if you expect your income to be higher in future years. This feature of the tax law is not a valid inducement to purchase equipment in a low-income year, but it **may** be an inducement to buy a piece of equipment in a high-income year, since the allowance reduces income subject to the highest tax rate bracket applicable that year.

E. *Depreciation Methods*

While the actual dollars invested in depreciable items are all that can be recovered, the law provides several choices as to methods used in figuring the annual depreciation. The best method for each farmer depends upon his income situation, his financial position, and his income expectations.

The **straight line method,** which is most commonly used, provides for distributing the cost of an item less its salvage value, if any, equally each year, over a period of years representing its estimated useful life. Salvage value should represent the estimated value of an item at the end of the estimated total life used in computing depreciation.

"The 10% Free Salvage Rule"—In establishing a depreciation schedule for new or used personal property (acquired since October 16, 1962) with a useful life of **three years** or more salvage value up to 10% of the basis may be ignored. Total depreciation claimed over the years of useful life of the property, however, may not exceed the cost **less the salvage value.** For example, consider a machine costing $5,000 with an estimated useful life of ten years, and a reasonable salvage value of $500 or less. The 7% investment credit will be available, but it will **not** reduce the basis for depreciation. It may still be set up for annual depreciation of $500 a year (straight line method). Thus, $4,500 depreciation would be claimed in nine years, but none would be claimed in the tenth year, unless condition of the machine or its estimated market value at that time indicated that salvage value should be reduced. Prior to this change the $500 salvage would have had to be set back (or subtracted) and only $450 a year would have been claimed for ten years before reaching the $500 salvage value. See the "Farmer's Tax Guide" for a more complete discussion of depreciation and salvage value.

The Internal Revenue Code of 1954 provides two additional methods of claiming depreciation on new depreciable items purchased after December 31, 1953. These are called the **"declining balance"** method and the **"sum-of-the-digits"** method. Each of these provides for a more rapid recovery of cost in the early years of the life of the item, thus reducing the tax liability and increasing spendable income.

The following example illustrates the difference in the amount of depreciation allowed each year by using different methods of depreciation. A new machine is purchased early in January costing $5,200, which will be kept for at least eight years. With a life of eight years or more, the full 7% investment credit of $364 is available to apply directly to income tax liability (use Form 3468), and beginning in 1964 it will not reduce the basis of the machine for depreciation. Now by the 10% rule, if reasonable salvage value after eight years of use would be not over 10% ($520), it can be ignored in determining the annual rate of depreciation.

ANNUAL DEPRECIATION
Machine Cost $5,200

Year	Straight Line 12½%	Declining Balance 25%	Sum of Year's Digits
1st	$650	$1,300.00	$1,155.52
2nd	650	975.00	1,011.08
3rd	650	731.25	866.64
4th	650	548.44	722.20
5th	650	411.34	577.76
6th	650	308.49	346.80*
7th	650	231.27	.00*
8th	130*	173.55†	.00*
Total	$4,680	$4,679.34	$4,680.00
Salvage Value	$ 520	$ 520.66	$ 520.00

* More may be claimed if a lower salvage value can then be justified.

† May continue claiming depreciation after 8th year if salvage value is lower.

Using the **straight line** method, the annual depreciation will be $5,200 × 12.5% (or divided by 8 years) or $650 for seven years. Salvage value will be reached during the eighth year, so unless the machine is junked or the salvage value is reduced, we can claim only $130 the eighth year, leaving it on the depreciation schedule at $520.

By the **declining balance** method, the depreciation rate is double the rate for the straight line method, so the first year's depreciation is $5,200 × 25% (or divided by 4) $1,300. In the second year the $1,300 is subtracted from $5,200, leaving $3,900 (the remaining or declining balance of the cost) to be divided by four to give $975 for depreciation. In each succeeding year this procedure is repeated.

The **sum of the digits** method is described in the "Farmer's Tax Guide." By using this method the cost is recovered even faster so the salvage value is reached in the sixth year, and no more may be taken (unless it is determined that due to excessive hard use, or obsolescence, the true salvage value is less than $520 by that time).

Farmers might well consider using one of these more rapid methods on some new items, particularly motorized machines such as tractors, combines, and trucks as well as

high-priced purchased breeding stock. The methods can be applied to individual items and may be an advantage when income fluctuates widely.

Faster depreciation may help the farmer who expects to retire before the useful life of the item is expended. It may also be of advantage to young farmers in keeping their tax bill lower and leaving them more cash available for debt retirement and business expansion.

On the other hand, if a farmer is expanding his business or expects higher income in future years, he may prefer to continue using the straight-line method on newly purchased items in order to have more depreciation deductions in future years.

Net Operating Losses

Farmers often pay more taxes over a period of years than required by law because they fail to take advantage of net operating loss provisions. If a farmer has a net operating loss in a given year, such loss can be used to reduce net farm income of other years.

The loss must first be carried back three years and applied against taxable income of that year. If the taxable income of that year was not sufficient to offset the operating loss, the remaining excess of the loss is carried to and applied against the income of the second preceding year and then to the immediate past year. If there is still a remaining excess of loss over the total taxable income of the three prior years, it is then carried forward to each of the next five years, or until all is used to offset income.

When a net operating loss occurs, a claim for refund must be filed to recover any tax paid in prior years and to establish the amount of loss, if any, to be carried forward to offset future income. Some adjustment of taxable income of prior years may be required. A qualified tax consultant or an Internal Revenue Service agent should be consulted. If the loss is substantial, this opportunity to recover income tax paid in prior years should not be overlooked. The claim can be filed at any time within three years after the return for the year of loss was filed. Special tax forms are used for this purpose.

Tax Management of Sales or Trades of Property

A. *Sale or Trade of Real Estate*

In case a farm is sold or traded for another farm or business property, it is necessary to establish the cost basis of the farm disposed of in order that the actual gain or loss on the transaction can be determined and that no unnecessary tax be paid. In order to establish this cost basis, it is necessary to have a record of the original cost, the costs of all improvements made on the property since it was acquired, and of all depreciation claimed.

Improvements made on farm land may be of three types:

(1) Improvements subject to depreciation — such as farm buildings, silos, fences, tile drains, etc. made of wood, concrete, brick, masonry, or metal.

(2) Improvements which are not depreciable, such as cost of clearing land not previously used for farming, constructing open ditches, and soil and water conservation expenditures if it was decided to capitalize them instead of deducting them as farm operating expenses. Costs of such improvements are added to the original cost. This total investment is then reduced by the amount of all depreciation previously deducted or allowable. If any item has been deducted as an expense, such as soil and water conservation expenditures, it cannot be included in the cost basis. Thus, it is important to have a complete record of all depreciation and capital expenditures during the entire period of ownership. Some states have special Depreciation and Investment Record books available at County Extension offices.

(3) Improvements to the farmer's personal dwelling. Except for a part used for the farm business office or for hired labor, these are not depreciable for tax purposes. Their cost should be added to the original investment to determine the basis for gain or loss when sold. (Gains would be taxable as a capital gain, but losses on one's personal dwelling are not deductible.)

B. *Trading a Farm*

There is frequently a tax advantage in trading a farm for another farm, rather than selling one and buying another. In case of trade all or part of the tax liability is postponed. No gain is recognized for tax purposes unless a difference in cash or certain nonbusiness property is received in the transaction.

In particular cases it may be more desirable in the long run to sell, and pay taxes on the gains in order to get a higher cost basis on the new farm or business property. This might apply in case an unimproved farm is exchanged for a well improved farm or business property.

C. *Installment Sales*

In selling a farm the tax liability on the gain can be spread over a period of years and in many cases can be reduced by use of the "installment sales" method. To qualify for such tax treatment, the payments received in the year of sale must not exceed 30 per cent of the selling price. The remaining income above cost will be taxable as received in later years.

In all cases where the farmer's personal dwelling is part of the farm which is sold, any gain realized on the dwelling may be postponed for tax purposes, if all of the proceeds from the dwelling are reinvested in a new dwelling, purchased and occupied by the farmer, within one year prior to or after the date of sale of his original dwelling. He has 18 months to build and occupy a new dwelling. If neither is done within the allotted time. any tax on the transaction becomes due in the year of sale.

Tax Planning in Buying a Farm

The year in which a farm is purchased is the time when tax saving can be initiated. At the time of purchase the buyer should allocate the total cost of the farm to: (1) growing crops, if any, (2) depreciable improvements, (3) dwelling, and (4) land.

From a tax management viewpoint, the amounts allocated to the different items are handled differently. The cost assigned to the growing crops

is an offset (shown on Schedule F) against the selling price of the crop in the year of sale. Of course, the cost basis of the farm is reduced by the amount allocated to the growing crop. Costs assigned to fences for livestock and possibly certain other improvements would qualify for the investment credit.

The part of the "cost" allocated to land will not be recovered until the farm is sold, since land cannot be depreciated. So, too, the portion allocated to the dwelling is not depreciable if used as the buyer's personal residence. A tenant house is depreciable for tax purposes. Cost allocated to depreciable improvements will be recovered through depreciation. Recovery of cost is faster on short-lived improvements than on long-lived ones.

Of course, for management and tax purposes, the "cost" must be broken down and allocated to each particular structure or improvement. In allocating cost to depreciable improvements the following procedure may be helpful: (1) figure the present cost of replacing the improvement (2) establish the years of normal useful life (3) determine the age of the present improvement (4) determine remaining years of life of the improvement and (5) compute the present value of present improvement. The following is an example using the 25-year life for farm buildings from the new "Guideline Rules" for depreciation by the Internal Revenue Service:

(1) Replacement cost of barn —$7,500 (2) Useful life of new barn—25 years (3) Age of present barn—15 years (4) Remaining life of present barn—10 years and (5) Value of present barn—10/25 of $7,500 = $3,000. When reasonable salvage value of 10% ($300) or less is reached, no further depreciation would be claimed unless a lower salvage value could be justified at that time.

Consideration of the utility value of a particular improvement to the farm may materially reduce the "present value" of the improvement. Another guide in allocating costs is the reasonable insurance values of insurable property. Care should be taken to see that in the final allocation the amount allocated to the bare land represents a reasonable value for similar land in the community.

The proper allocation of cost may help determine the price a buyer will pay for the farm. This is particularly true where the buyer is looking to future farm income after taxes to pay off the purchase price.

Closely related is the manner of payment of the purchase price. In computing taxable income the buyer deducts interest payments, but not payments on principal. The seller treats interest as ordinary income, while principal payments in excess of his cost basis are capital gains.

Managing Income for Increased Social Security Benefits

As older farmers approach retirement age, they may wish to maximize their net farm income to as near $4,800 as possible in order to secure maximum social security benefits (maximum can be increased by Congressional Amendment). In so doing they will automatically increase their income taxes; however, they may prefer to do so to gain the additional retirement benefits. Many of these farmers are more interested in methods of increasing rather than decreasing their taxable income.

Some of the means for increasing income which should receive consideration are: (1) renting and operating additional land (2) intensifying and expanding present enterprises (3) adding new enterprises (4) electing to report sales of forest products as ordinary income (5) selling more young stock (6) doing custom work or other off-farm work, and (7) contracting pasturage and services together, so that the income is recognized as self-employment income and not considered to be rental income.

Where choice of method of handling certain items of expense is optional, they may choose the method which gives the smaller deductions. Examples of such would include: (1) shifting from a rapid depreciation method to the slower straight-line method for improvements, machinery, etc., (2) electing to treat soil and water conservation costs as capital investments rather than as current operating expenses, (3) disposing of some depreciable capital items to reduce the total depreciation deductions, and (4) in general reducing operating costs to a minimum.

Tax Management Tips

1. Pay reasonable wages to your children for farm work actually done by them, so long as there is a true employer-employee relationship, assign definite jobs or responsibility, agree on wages and pay them regularly as you would any other employee. Wages paid by parents are not subject to social security tax until the child reaches age 21; neither are they counted on the child's social security record.

2. A child under 19 or regularly enrolled in school or in an accredited on-farm training program can earn over $600 and the parent still gets an exemption for the child as a dependent as long as he pays over half the child's support. This makes possible two $600 exemptions (one by the child if he earns over $600, and files his own return, and the second as a dependent of his father. An individual's total tax-free earnings may now be $900. The $300 minimum standard deduction plus the $600 personal exemption).

3. Give income producing property to children, e.g., land, cattle, machinery, and let them report income from their work and capital. Family partnerships and farm corporations through stock transfers are sometimes used to do this. It is another way to spread family income over the lower brackets. Remember, gifts and partnerships must be legally sound to achieve tax savings.

4. If age 63 or 64, postpone income to age 65 to take advantage of the $1,200 personal exemption. Persons approaching retirement, however, may want to maintain income as near as possible to the maximum for social security in these years ($4,800 in 1964).

5. In these late years—as you approach retirement, plan for more income from rents, divi-

dends, interest, and pensions which qualify for the retirement income credit. This can save considerable income tax as earned income is replaced by investment income.

6. Do not hold breeding stock used for production of market livestock too long. By selling sows after only a few litters, more breeding animals will qualify for capital gain treatment over a period of years.

7. Buy machinery and equipment in years of high income and take the additional 20 per cent first-year depreciation in addition to the regular depreciation allowable.

8. Remember to add back to the depreciable balance (remaining cost) as of January 1, 1964, all 7% investment credit that was subtracted before depreciation of items purchased in 1962 or 1963.

9. If selling or cutting timber, report as capital gains.

10. Manage sales of farm machinery, equipment, land and breeding and dairy stock. These can result in capital gains or ordinary losses. Livestock must be held for 12 months or more to qualify for capital gains treatment. Other depreciable items must be held more than six months.

11. Plan personal deductions. Many payments that are normally spread over two years can be paid in one year and itemized as deductions. In the next year the standard deduction may be taken if higher than actual deductions. Farm produce given as charitable contributions has a tax advantage over cash donations, especially when there is little current year's production cost to be subtracted from farm expenses.

12. Plan to have enough income to use up the personal deductions that are allowed (see Smith example on page 5).

13. Avoid wide fluctuations in income from one year to the next (see example on page 5).

14. Accelerated depreciation can be used on newly acquired machinery and equipment.

15. Installment sales of property can be used to spread income over a period of years and thus avoid high income in one year.

16. The amount of income subject to capital gain treatment can frequently be increased on the accrual basis by setting up a depreciation schedule for purchased draft, breeding, and dairy animals. By doing this the remaining cost is less at the time of sale.

17. Understand the effect of rapid depreciation on improvements, machinery, and equipment. Decide whether to recover costs quickly or spread them out against farm production over a longer period.

18. Check loss years in the past. Is there an unused net operating loss deduction (see page 8). Remember that claims for refund may bring an audit.

19. Remember social security in tax planning (see page 9).

20. Use work sheet on page 11 or 12 to plan tax savings.

Tax Reporting Reminders

1. Be sure that CCC loans are not counted as income twice (in one year when borrowed and next year when crop is sold).

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

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

4. Deduct farm share of the cost of auto and truck licenses, insurance, etc.

5. Deduct as much expense of auto, utilities, telephone, etc., as is actually used in the farm business (half is not enough in many cases).

6. Take all depreciation allowable on depreciable improvements, machinery, equipment and on purchased breeding, dairy, and draft animals.

7. Keep records to insure deduction of easily overlooked items such as farm magazines, farm organization dues, bank service charges, overnight business trips, portion of dwelling used for farm business use, household goods used for hired help, and cash outlay to board hired workers.

8. Itemize on bank deposit slips all gifts, borrowings, savings bonds cashed, etc. so that there is no chance they will be considered taxable income.

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

10. Keep exact records of date of purchase, cost and date of sale on all items purchased for resale.

11. Establish a charge account at 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 tickets lost.

12. Pay bills by check whenever possible. Write down all cash expenditures at once in an account book. Get "Receipts" wherever possible. Get your bank statement each month and check it against the farm account book.

13. Do not include in income any indemnity for diseased animals if payment has been or will be used to buy "like or similar" animals within one year.

14. Deduct social security tax paid on wages of hired help.

15. Do not report as income capital gains on sale of your dwelling if you plan within a year to buy, or within 18 months to build and occupy another dwelling that will cost as much or more than the selling price of your present dwelling.

16. Keep all "paid" receipts, invoices, cancelled checks, etc. for at least five years, including checks in payment of income taxes. Receipts for purchase of items on which investment credit was taken should be kept for eight years (or until the property is disposed of) as evidence of purchase or cost of improvements for as long as the property is held.

17. Remember that if you have income subject to tax, every dollar of cost not deducted will result in unnecessary income taxes.

Income Tax Estimate Worksheet

Cash Method

Receipts:	Amounts to date		Estimated rest of year	Estimated year's total
Sales of products raised and miscel. receipts				
Cattle, hogs, sheep and wool	$____		____	____
Poultry, eggs and dairy products	$____		____	____
All crop sales	$____		____	____
Custom work done	$____		____	____
Prorations and refunds	$____		____	____
____	$____		____	____
Total of sales of products raised, etc.	(1) $____		____	____
Sales of purchased market livestock .... $____				
Purchase cost (subtract) .... $____				
Gross profits on purchased livestock sold	(2) $____		____	____
Total net gain on sales of property, including dairy and breeding stock*	(3) $____		____	____
Net non-farm income (labor, rents, etc.)*	(4) $____		____	____
Total Receipts (1+2+3+4)		(5) $____	____	____
Farm Expenses:				
Hired labor	$____		____	____
Feed purchased	$____		____	____
Seed, fertilizer, lime, etc.	$____		____	____
Repairs on machinery and improvements	$____		____	____
Fuel and oil for farm use	$____		____	____
Veterinary and livestock expense	$____		____	____
Taxes, interest, insurance and rent	$____		____	____
Truck and machine work hired	$____		____	____
Farm share of auto expense	$____		____	____
Farm share of utilities	$____		____	____
Soil and water conservation expense	$____		____	____
Other farm expenses	$____		____	____
Capital losses*	$____		____	____
Total Cash Farm Expenses	(6) $____		____	____
Depreciation, including dairy and breeding stock	(7) $____		____	____
Total of Items 6 and 7		(8) $____	____	____
Adjusted Gross Income (item 5 less item 8)		(9) $____	____	____
Less Standard Deduction *10% of item 9†*	$____			
$600 X____ Personal Exemptions	$____			
Total Deductions		(10) $____		____
Taxable Income (item 9 less item 10)		(11) $____		____
Estimated Income Tax (figure from tax computation table for current year)		(12) $____		____

* Not included in computing self-employment (social security) income.
† Optional—$200 plus $100 for each exemption (limit $1,000).

Income Tax Estimate Worksheet

Accrual Method

Receipts:	Amounts to date		Estimated rest of year	Estimated year's total
Sales of products raised and miscel. receipts				
Cattle, hogs, sheep and wool	$			
Poultry, eggs and dairy products	$			
All crop sales	$			
Custom work done	$			
Prorations and refunds	$			
	$			
Total sales of livestock, crops, etc.		(1) $		
Estimated inventory (current or end of year)		(2) $		
Total net gain on sales of property*		(3) $		
Net non-farm income (labor, rents, etc.)*		(4) $		
Total Receipts (1+2+3+4)		(5) $		
Beginning-of-year inventory	$			
Livestock purchased	$			
Total Deductions		(6) $		
Gross Income (item 5 less item 6)		(7) $		
Farm Expenses:				
Hired labor	$			
Feed purchased	$			
Seed, fertilizer, lime, etc.	$			
Repairs on machinery and improvements	$			
Fuel and oil for farm use	$			
Veterinary and livestock expense	$			
Taxes, interest, insurance and rent	$			
Truck and machine work hired	$			
Farm share of auto expense	$			
Farm share of utilities	$			
Soil and water conservation expense	$			
Other farm expenses	$			
Capital losses*	$			
Total Farm Expenses	(8) $			
Depreciation (last year's plus depreciation on new items)	(9) $			
Total of Items 8 and 9		(10) $		
Adjusted Gross Income (item 7 less item 10)		(11) $		
Less Standard Deduction 10% of item 11†	$			
$600 X ____ Personal Exemptions	$			
Total Deductions		(12) $		
Taxable Income (item 11 less item 12)		(13) $		
Estimated Income Tax (figure from tax computation table for current year)		(14) $		

* Not included in computing self-employment (social security) income.
† Optional—$200 plus $100 for each exemption (limit $1,000).