Agricultural Income Tax Issues

- An Educational Module Offered by the University of Wyoming –

Important Aspects of Financial Records

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Keeping financial records on a farm or ranch is essential to good management; helpful when communicating with partners, family members, creditors, and others; and filing accurate income tax returns. The following slides cover a few of the important aspects of agricultural record keeping. This is an educational module pertaining to record keeping for income taxes issues.

Individual circumstances may demand a specific type of records and/or particular sets of information. Everyone should evaluate his or her own operation and needs, set financial goals, seek additional information as needed, and then maintain a good set of financial records.

Accounting Methods

1. Cash

2. Accrual

There are two basic accounting methods for determining when and how income and expenses are reported:

1- cash method and

2 - accrual method.

A taxpayer must choose an accounting method for the farm or ranch business when he files his first income tax return that includes a Schedule F. However, certain farm corporations and partnerships, and all tax shelters, must use an accrual method of accounting.

Accounting Methods - Cash

- Used by most farmers.
- Income reported in year received (constructive receipt).
- Expenses deducted in year actually paid.
  - Some expenses must be capitalized
  - Some payments are limited.
- Special cases.
  - Cattle purchased for resale (e.g. yearlings)
    - Purchase costs carried forward to year of sale.
  - Winter Wheat
    - Income reported in year crop is sold.
    - Expenses reported in year paid.

The cash method of accounting is used by most farmers because they find it easier to keep cash method records.

Income is reported in the year it is actually or constructively received. Constructive receipt is when an amount is credited to an account or made available without restriction. Possession of money is unnecessary. Certain government payments are not constructively received because the taxpayer may have had the option to receive it in the year before it was required to be paid. Furthermore, a person cannot hold checks nor postpone taking possession of similar property from one tax year to another to avoid paying tax on the income.

Expenses are generally deducted in the year they are actually paid. However, certain expenses paid in advance or required to be capitalize certain costs may not be deductible. Also, the amount of certain expenses that can be deducted in the year incurred are limited.

The purchase costs of items purchased for resale (yearling cattle, for example) are carried forward to year in which the items are sold. In cases like the production of winter wheat, income is usually reported in the year the product is sold. Expenses are usually deducted in the year they are actually paid. Consequently, there may be higher expenses in one year and higher income in the subsequent year.

Accounting Methods - Accrual

- Income reported in year earned.
  - Included in tax year in which all events that fix right to receive income occurred.
- Expenses deducted in year incurred.
- Inventories increase/cause income.
- Expenses and interest owed a related person using cash method are not deductible until actual payment is made and income included.

Under the accrual method of accounting, income is generally reported in the year earned and expenses are deducted or capitalized in the year incurred. The purpose of an accrual method of accounting is to correctly match income and expenses.

Income is included in the tax year in which all events that fix the right to receive the income occurred. Increases in inventories generally cause income to have occurred.

Expenses are deducted or capitalized in the tax year when all events have occurred that fix the fact of liability, the liability can be determined with reasonable accuracy, and economic performance occurred. However, business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until actual payment is made and the income is includible in the related person's gross income.

Reasons for Keeping Records

- Determining profits.
- Planning the future.
- Determining long-term progress.
- Communications.
- Reporting taxes.

It is important to first determine why you will be keeping financial records. Only then can you set up a record keeping system to meet your needs. Some purposes need specific information.

Some primary reasons include:

- determining business profits.
- planning for your future and/or that of the business.
- determining long term progress in reaching one’s goals.
- communications with family members, partners, lenders, others.
- reporting taxes.

Essentials of Good Records

- Accuracy.
- Completeness.
- Arrangement.
- Permanency.
- Neatness.
- Legibility.
- Simplicity.
- Consistency.

There are a few essential aspects of any good record keeping system.

1 -- Accuracy. The old adage of “garbage in garbage out” is very appro po.
2 -- Completeness. Records must contain all relevant data. Incomplete or partial records reduces accuracy and one’s ability to utilize the records for any purpose. Also, incomplete records raise the level of suspicions by anyone looking at the records, such as tax preparers, bankers, others.
3 -- Arrangement. The records must be arranged in a manner that is useful and easy to use.
4 -- Permanency. Records should be permanent. This doesn’t mean that pencils or editable data files are unacceptable. It means that records editing following the close of business that that year is limited or nonexistent.
5 -- Neatness. Records should be neat and well organized. Coffee stains, burn marks, water damaged pages, etc. are not good.
6 -- Legibility. Records should be legible. Hard to read information leads to mistakes and additional time by the record keeper and record user to discover the right answer to any questions.
7 -- Simplicity. Records should be as easy to use. The easier it is to enter data the more willing the record keeper will be to keep current the information.
8 -- Consistency. Similar data should be entered the same throughout the year.

Good Records

- Meet the needs of:
  - You.
  - Lender.
  - Tax preparer.
  - Other.
- Are required by the IRS to be kept for 3 years after date of filing
  - 7 years in cases of suspected fraud.
  - Applicable years regarding capital assets.

Good records meet the needs of all people who will use the information. As the business owner or manager, your needs are primary. Good records will meet your needs to make more informed decisions. Lenders may request certain information, and, of course, tax preparers or accountants will need specific information to accomplish their tasks. Other people using information from the records may be landowners, insurance providers, partners, family members, and ex-family members.

The Internal Revenue Service requires that you keep your records and tax returns for three years after the date on which the tax return was due (not when you filed the return). The IRS can look at seven years of records in cases of suspected fraud.

Records pertaining to capital purchases, capital sales, improvements, etc. must be kept for the period of ownership plus the normal three years after the date of filing the tax return.

Records

- Hand Kept
  - Inexpensive.
  - Access.
  - Time consuming.
  - Subject to math errors.

Handkept records are generally inexpensive. They can be plain or columnar paper or account books available from lending institutions, universities, or other businesses.

Handkept records are easy to put in a briefcase, take with you, or move around the house.

Handkept record keeping is time consuming in that you have to write the data and then use a calculator to do the math.

Handkept records tend to be subject to math and other errors.

Records

- Computerized
  - More information, faster.
  - No math errors.
  - Can be expensive.
  - May be time consuming.

With today's advancements in technology, there are many computer programs available to the general public at a wide range of prices. There are record keeping (financial, production, etc.) software, accounting software, and income tax computing software.

Software should be carefully reviewed to determine if it meets the needs of the user. How easy is the program to use? Who will input the data? What support is available? What output and output formats can be generated? Will the output meet the needs of all users – business owner, partners, lenders, tax preparers, others? It is also necessary to remember "garbage in garbage out."
Computerized records are generally more expensive than handkept records. One must purchase software and a computer.

Computerized records almost never contain math errors. Calculations are performed automatically by the record keeping program.

It is generally easy to get many different reports of information from computerized records. Many programs have already designed reports and can export data to spreadsheets or other programs.

Computerized record keeping may be time consuming, especially as the record keeper learns to use the program or even a computer.

Quicken & QuickBooks

- Used by many people.
- Easy to use.
- Reasonably priced
- Readily assessable
  - Many stores
  - Internet
- Trainings
  - Cooperative Extension
  - Consultants
  - Others
- Meet most, if not all, needs
- Good support
  - Company
  - Universities
  - “neighbors”
  - Consultants
- Output can be electronically exported
  - To income tax preparation software
  - To spreadsheets

This is not an endorsement of these products.

Two commonly used record keeping programs are Quicken and Quikbooks. While not promoting any particular products, these programs have many desirable attributes:

-Easy to use.

-Reasonably priced.

-Good support from the company, universities (such as Damona Doye’s website at Oklahoma State University), and individuals.

-Trainings are commonly conducted by Cooperative Extension personnel and others.

-Provide most, if not all, the output needed for making management decisions, meeting the needs of partners and lenders, and computing income tax liabilities.

-Output can be electronically exported to income tax preparation software and spreadsheets.

Records

- Commercial
  - Less time consuming.
  - Second opinion.
  - Expertise.
  - Cost?

A third method for keeping records is to hire a person or company to enter the data and generate reports.

Generally, this method is the least time consuming. You simply give the data to the commercial firm and receive back the reports you want or need.

Hiring an outside person (or firm) to keep your records provides a neutral, unbiased review of the information.

A recordkeeping service may have more expertise than you pertaining to record keeping and generating usable reports.

Using a commercial record keeping service (firm or individual) may be more expensive than recording the data yourself. Prices vary according to transactions, reports, demands by you, etc.

Records

Income Categories

- Schedule F
- Breeding animals
- Machinery/Equipment
- Non-farm

Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 11.)
Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.

1	Sales of livestock and other items you bought for resale	1	
2	Cost or other basis of livestock and other items reported on line 1	2	
3	Subtract line 2 from line 1		3
4	Sales of livestock, produce, grains, and other products you raised		4
5a	Cooperative distributions (Form(s) 1099-PATR)	5a	5b Taxable amount 5b
6a	Agricultural program payments (see page F-2)	6a	6b Taxable amount 6b
7	Commodity Credit Corporation (CCC) loans (see page F-3):		
a	CCC loans reported under election		7a
b	CCC loans forfeited	7b	7c Taxable amount 7c
8	Crop insurance proceeds and Federal crop disaster payments (see page F-3):		
a	Amount received in 2005	8a	8b Taxable amount 8b
c	If election to defer to 2006 is attached, check here ▶ ☐		8d Amount deferred from 2004 8d
9	Custom hire (machine work) income		9
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)		10
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If you use the accrual method, enter the amount from Part III, line 51 ▶		11

Financial records need cash inflow and cash outflow categories. The income categories from IRS Form 1040 Schedule F serve as a basic, or minimal, set of cash inflow categories.

Additionally, financial records need to include ways to account for cash inflows from sales of capital assets – breeding animals, machinery and equipment, land, etc. There should be categories to allow recording of non-farm cash inflows.

Records – Income Categories

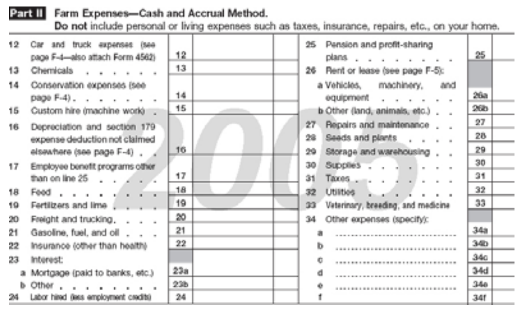
- Grain
- Hay
- Cattle
- Custom work
- Gov't payments
- Insurance
- Breeding animals
- Feeder animals
- Other

Expanding the categories beyond the needs for completing a Schedule F will aid in analysis and making management decisions. More detailed records will contain categories for grain, or even for each grain crop, hay, cattle, custom work, government payments, and insurance proceeds. As indicated on an earlier slide, information pertaining to sales of breeding animals and items purchased for resale. Of course there is always need for flexibility in the records to account for unusual needs.

Records

Expense Categories

- Schedule F
- Breeding livestock
- Feeder livestock
- Family living


Part II Farm Expenses—Cash and Accrual Method.
Do not include personal or living expenses such as taxes, insurance, repairs, etc., on your home.

12 Car and truck expenses (see page F-4—also attach Form 4562) 12	25 Pension and profit-sharing plans 25
13 Chemicals 13	26 Rent or lease (see page F-5):
14 Conservation expenses (see page F-4) 14	a Vehicles, machinery, and equipment 26a
15 Custom hire (machine work) 15	b Other (land, animals, etc.) 26b
16 Depreciation and section 179 expense deduction not claimed elsewhere (see page F-4) 16	27 Repairs and maintenance 27
	28 Seeds and plants 28
	29 Storage and warehousing 29
17 Employee benefit programs other than on line 25 17	30 Supplies 30
	31 Taxes 31
18 Feed 18	32 Utilities 32
19 Fertilizers and lime 19	33 Veterinary, breeding, and medicine 33
20 Freight and trucking 20	34 Other expenses (specify):
21 Gasoline, fuel, and oil 21	a 34a
22 Insurance (other than health) 22	b 34b
23 Interest:	c 34c
a Mortgage (paid to banks, etc.) 23a	d 34d
b Other 23b	e 34e
24 Labor hired (less employment credits) 24	f 34f

Financial records need cash outflow categories. Farm expenses are the "ordinary and necessary costs of operating a farm or agricultural enterprise. Expense categories on Schedule F are a great source of cash outflow categories.

Depreciation, while not a cash expense, is included as a farm expense. However, any depreciation taken in a particular year reduces the basis of appropriate assets.

There needs to be ways to record purchases of capital assets, items purchased for resale, and family living (non farm) expenses. Money spent on capital improvements is not considered farm expenses. Rather, such outflows of money increase the basis of applicable assets.

Recording the costs of purchasing items for resale, such as feeder cattle, has unique needs. You must be able to carry forward the costs associated with purchasing the items. It may be necessary to even carry purchase information forward to the following year.

Records – Expense Categories

- Auto
- Chemicals
- Custom hire
- Feed purchased
- Fertilizer
- Freight and trucking
- Fuel
- Insurance
- Interest
- Labor
- Rents and leases
- Repairs
- Seed and transplants
- Supplies
- Taxes
- Utilities
- Veterinary
- "Other"

Form 1040 Schedule F has good categories for expenses or cash outflows.

More detail, such as repairs for each piece of equipment, may be desired. However, the hassles of keeping such detail may exceed the benefits derived from analyzing the information. One suggestion is to record the repairs into a single expense account and to add detail via the "memo" section. Then a person conducting an analysis of the data can ferret

More Information

See your tax preparer.

Visit the IRS.

- Telephone
- Website (www.irs.gov)
- Publications and Forms (Publication 225,farmers tax guide)

University.

- Cooperative Extension
- Departmental faculty
- Jeff Tranel (www.coopext.colostate.edu/tranel/)

Management of one's income taxes is important for the success of the business and improvement of financial condition.

Everyone's business and personal situations are unique. The impacts of tax management strategies can be much different for one person than for another. Thus, taxpayers are strongly encouraged to visit with their personal tax consultant **prior to** implementing any tax management strategy.

The Internal Revenue Service (IRS) is a good resource for income tax issues, but not for tax management advice. The IRS can be reached via the telephone or internet. The website contains forms, publications, tax court rulings, etc. Publication 225 (Farmer's Tax Guide) can provide excellent information pertaining to farm tax issues.

Many land grant universities have people working on educational and research aspects of income taxes. Cooperative Extension personnel conduct educational programs and provide valuable advise and assistance to the IRS in the development of this Publication 225. Some campus departments offer for-credit classes addressing income tax issues.