Farm/Ranch Accounting and Tax 101

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The Agenda

- Tax Reform
- Basics of Accounting
- Documentation Basics
- Choosing an Accounting System
- Accounting Methods
- Reporting Farm Income
- Taking Advantage of Farm Deductions
- Accounting for Livestock
- Tax Calculations
- Get an Advisor!!!

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Tax Reform for Farmers

Summary

- Overall tax rates decrease
- New Section 199A 20% farm deduction
- Limitations on itemized deductions
- Double of lifetime estate/gift tax exemption
- All of above reverts back to current law in 2026
- Increased Section 179 and bonus depreciation
- Other provisions

Comparison of MFJ Rates: Old 2018 Rates vs. TCJA

Income range	Scheduled 2018 rate	TCJA
$1 to $19,050	10%	10%
$19,051 to $77,400	15%	12%
$77,401 to $156,150	25%	22%
$156,150 to $165,000	28%	22%
$165,001 to $237,950	28%	24%
$237,951 to $315,000	33%	24%
$315,001 to $400,000	33%	32%
$400,001 to $424,950	33%	35%
$424,950 to $480,050	35%	35%
$480,051 to $600,000	39.6%	35%
Over $600,000	39.6%	37%

Capital Gains and Kiddie Tax

- Capital Gains – No changes
  - Still retain Zero Tax Rate on effectively same income levels
    - Up to about $100,000 tax free for MFJ
    - Up to about $50,000 tax free for singles
  - Maximum rate still 20%
  - Retains Net Investment Income Tax of 3.8%
- Kiddie tax no longer tied to parent's income
  - Makes grain gifts taxed at Trust and Estate Tax Rates
    - Essentially 37% on gifts over $12,500

Standard Deduction: 2018

Standard Deduction
- MFJ = $24,000
- Single = $12,000
- H of H = $18,000

Personal Exemptions
- Repealed

Zero tax amount:	2017	2018
Joint	$20,800	$24,000
Single	$10,400	$12,000

Child and Family Tax Credits

- Child credit: increase from $1,000 to $2,000
  - No change to "qualifying child" definition: < age 17
- Plus $500 credit for dependent not a qualifying child for $2,000 credit
- Refundable portion = $1,400 & indexed
- Phase-out begins at MFJ of $400,000 AGI (up from $110K); Single at $200,000 (up from $75K)

Itemized Deductions: Taxes

- Allow aggregate deduction of $10,000 for income or sales tax, plus real property tax
- Does not affect payments for farmers, crop-share landlords and cash-rent landlords on their operations.
- This is only for Schedule A personal taxes

Estate, Gift, and GST Tax

- Doubled exclusion: $5M to $10M + indexing for estates between 1-1-18 and 12-31-25
  - Deaths in 2017: Present exclusion is $5,490,000
  - Will be **$11.2 million for 2018**
- Retain annual gift tax exclusion **($15K)**
- Reverts back to current law in 2026

AMT

- Retained for individuals
- Higher exemption amount
  - $109,400 up from $78,750 (MFJ)
  - $70,300 up from $50,600 (Single)
- Higher thresholds for phase-out
  - $1 million for MFJ, up from $160,900
  - $500,000 for singles, up from $120,700
- Likely eliminates AMT for most farmers, but not all

Corporate Taxes

- Flat 21% rate
- Corporate AMT repealed
- May be an actual 40% tax increase for most farmers who kept corporate taxable income under $50,000

Farm C Corporation Tax Example

Farm partnership with four equal C corporation owners

Partnership income of $200,000

Under old law, the corporations each paid $7,500 or $30,000 of total taxes

Under new law, each corporation pays $10,500 or $42,000 total, a 40% increase

Fiscal Year Calculation Example

ABC Farm Corp with a March 31, 2018 Year-End

Taxable income of $50,000

Pre 2018 Tax - $7,500 times ¾ (rounded)

$5,650

Post 2017 Tax - $2,590 for total tax of

$8,240

Section 179

- Bumps to $1 million in 2018 (indexed to inflation)
  - Phase-out starts at $2.5 million (indexed)
  - Adds roofs, HVAC, Sec. Systems
- Can be used to optimize taxable income if farmer elects out of bonus depreciation

Bonus Depreciation

- Expense 100% acquired and placed in service >9/27/17 and before 1/1/2023
  - Includes new and **used**
- Phased-out beginning in 2023
  - 80% in 2023
  - 60% in 2024
  - 40% in 2025
  - 20% in 2026
  - Zero thereafter

Bonus Depreciation Examples

- Farmer purchases $500,000 of used equipment, $350,000 of new equipment, and buys land with a machine shed worth $500,000
  - Under old law, could only deduct $175,000 on the new equipment using 50% bonus depreciation.
  - Under the new law, the farmer can fully depreciate all $1,350,000 using 100% bonus depreciation
  - Or can elect out of bonus on any of the assets on an asset by asset basis (7, 15 and 20 year property)

Larger Farmer Taxes – Old Law & New Law

	Old Law	New Law
Sales	10,000,000	10,000,000
Normal Costs	(6,000,000)	(6,000,000)
Section 179	-	(325,000)
Bonus Depreciation	(1,075,000)	(3,250,000)
Regular Depreciation	(198,884)	-
Net farm income	2,726,117	425,000
Other income	500,000	500,000
Section 199/199A deduciton	(245,350)	(85,000)
Standard deduction	(12,700)	(24,000)
Taxable Income	2,968,067	816,000
Income Tax	1,120,585	241,299
	Savings	879,286
	Savings if income is exactly the same	83,021

Business Interest Expense

- Disallowed: excess of 30% of business adjusted taxable income
  - Determined without interest expense, interest income, NOL, depreciation, amortization, depletion (EBIDTA)
    - EBIT is used beginning in 2022 (depreciation is deducted)
  - Determined at tax filer level (1065, 1120-S)
  - Excess carried forward
- No disallowance for businesses with average gross receipts <$25 million

Special Farmer Interest Provision

- If gross revenue over $25 million, then farmer can elect to deduct 100% of business interest expense
  - Must use ADS for depreciation of 10 year + assets (longer lives)
  - Farm equipment still enjoy shorter life
  - Can't take bonus depreciation on 10 year or longer life assets

Sec. 263A Exemption

- If farmer's gross revenues less than $25 million:
  - Can expense all preproductive costs
  - Take 100% bonus on cost of plants
  - Take 100% bonus on all other costs
- Not sure if farmers who elected out under old law can now "elect" back in
- Need IRS guidance

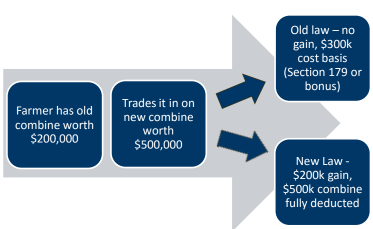
Loss Limit Provisions

- Maximum Business Loss in one year - $500,000
- Net Operating Loss: limited to 80% of pre-NOL taxable income
- Pre 2018 NOLs still allowed at 100% (FIFO)
- Repeal carrybacks for non-farmers
- Allows two-year carryback for farms
- However, carryback can only offset 80% of taxable income on both carrybacks and forwards

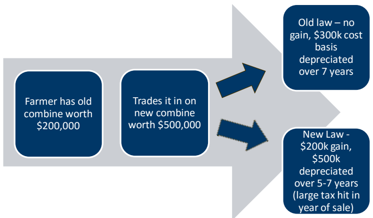
Other Business Changes

- Section 1031 exchanges for only real property
  - Personal property exchanges taxable; but asset expensing offsets the gain
- Drops **NEW** farm machinery from 7 years to 5
- Allows for 200%db method for farm equipment, etc.
  - Was 150%db since 1987

Section 1031 Equipment Exchange Example



Section 1031 Equipment Exchange Example – State Law



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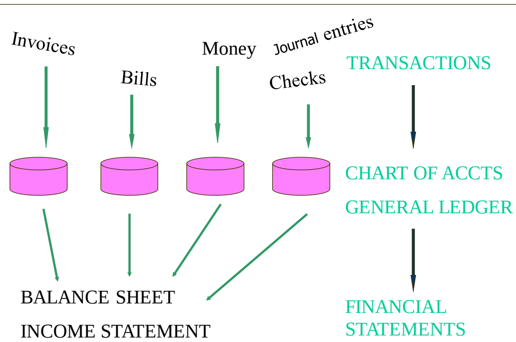
Basics of Accounting



The Balance Sheet

- “Snapshot of your financial positon at any point in time
- Assets – what the Farm/Ranch owns
- Liabilities – what the Farm/Ranch owes
- Equity – what would be left if all of your creditors were paid off
  - Assets – Liabilities = Equity
    - ◊ Example: Value of your home – balance of your mortgage = your homeowner’s equity

The Income Statement

- Revenue and expenses for a period of time
  - Income statement: “I made $XXX this <u>month</u> or this <u>year</u>”
  - Balance sheet: “I have $XXX in the bank today”
- Revenue: Income that the Farm/Ranch earns
- Expenses: What the Farm/Ranch spent or incurred
  - Some items are “non-cash” expenses (such as depreciation)

Accounts Receivable

- Money that is owed to the Farm/Ranch
  - Sale of livestock or hay on credit to someone
- When you can’t collect a payment
  - Write-off to expense
  - No use in paying tax on what you can’t collect

Inventory

- Things that you own that you intend to resell
  - Raised livestock (not breeding livestock)
  - Baled hay
  - Stored crops
- The cost of these items is included on the balance sheet until they are sold
  - The costs of inventory are considered an asset until they are sold

Inventory Sale example

- Example:
  - Breeding costs - $300
  - Vaccinations - $100
  - Indirect costs per calf (feed, supplies, etc.) - $200
  - Total cost of calf included in inventory = $600
- Calf is sold for $1,000
  - Gross sales - $1,000
  - Cost of sale - ($600)
  - Gross Profit - $400

FIXED ASSETS

- "Things" the Farm/Ranch owns, has title to, and can sell
- Computers and office equipment
- Barns, buildings, fences, wells
- Vehicles, trailers, tractors and equipment
- Breeding Livestock

Fixed Assets

- Repair vs. purchased asset
  - Use common sense!
  - Replace damaged shingles on a roof {repair – expense}
  - Replace entire roof {asset – capitalize and depreciate}
- Depreciation - the method of offsetting your fixed asset costs against your income.
  - Straight-line depreciation – the "expense" is allocated even across how long you expect to use the asset.
    - ◊ Tractor – useful life of 7 years
    - ◊ Cost - $21,000
    - ◊ Every year for the next 7 years you would reduce the value of the asset on the balance sheet by $3,ooo and increase depreciation expense on the income statement by $3,000.

Liabilities

- What you owe others
  - Bills for utilities, feed, etc.
  - Amounts owed but not paid to employees or contractors for work performed
  - Mortgages and other notes payable
  - Deposits by customers for livestock or other products to be received in the future.
- When you incur a liability
  - Cash, fixed assets, or inventory is increased
  - Liability balance on your balance sheet is also increased
  - Payments on a note or mortgage are <u>not</u> an expense, but a reduction of what you owe someone else!
    - ◊ Exception: the interest portion of your payment is an expense.

Equity & Retained Earnings

- Life to date net income or loss of the Ranch
  - Each year the current income or loss is added to prior year balance
  - Example
- Checks written to owners are not "expenses" and cannot be deducted as such.
  - They are a decrease in the owner's equity in the ranch.

Example of Basic Financial Statements

Assets		
Cash in bank	$	5,000
Accounts receivable		2,000
Stores crops/baled hay		1,500
Land		300,000
Buildings and fencing		75,000
Computers & furniture		3,000
Tractors and equipment		30,000
Vehicles		20,000
Breeding Stock		15,000
Accumulated depreciation		(40,000)
TOTAL ASSETS	**$**	**411,500**
Liabilities and Equity		
Accounts payable	$	1,500
Credit cards payable		800
Payroll taxes payable		600
Deposits received		2,000
Notes payable		20,000
Mortgage payable		280,000
Total Liabilities		304,900
Retained earnings		156,600
Owner distributions		(50,000)
Total Equity		106,600
TOTAL LIABILTIES & EQUITY	**$**	**411,500.00**

Income Statement		
Income		
Sales of cattle/hay		100,000
Cost of cattle/hay sales		(60,000)
Gross profit		**40,000**
Expenses		
Bad debts		2,000
Fertilizers		800
Feed		3,000
Gasoline and fuel		2,000
Insurance		2,000
Interest expense		18,000
Payroll costs		
Wages		5,000
Contract labor		2,000
Payroll taxes		383
Repairs & Maintenance		2,000
Supplies		600
Property Taxes		1,500
Total expenses		39,283
NET INCOME (LOSS)	**$**	**718**

Documentation

- One of the primary reasons that tax deductions are denied to taxpayers is lack of appropriate documentation!
- Every expenditure for the farm/ranch should have a invoice or receipt showing what was purchased. This applies to both checks and credit card purchases.
  - If the purchase is non-descript, make sure that you write what is was for on the documentation.
  - If checks are printed, staple this documentation to the check stub.
  - If checks are hand written, be sure to write the check number and date paid on the documentation.

Documentation, Cont.

- Handwritten notes do not constitute a substitute for adequate documentation.
- Proper support should detail:
  - Date of the transaction
  - Parties involved
  - Product or service that was exchanged
  - Quantity of product or service that was exchanged
  - Total amount
- Be especially careful about documenting expenses paid to related parties.
  - Reasonable and necessary
  - Inline with fair market values

Documentation, Cont.

- Carefully document and record non-cash or “in-kind” expenses.
  - Loans repaid with labor or goods.
  - Use of ranch assets as repayment for services or goods
- Be sure that there is not an “income” factor as well
  - Barter, or exchange or one set of goods or services for another

Documentation, Cont.

- Vehicle mileage logs
  - Keep a detailed log of the mileage driven on any vehicle used for farm/ranch purposes.
  - At a minimum, include:
    - ◊ Where driven to
    - ◊ Whether trip was business or personal
    - ◊ Beginning odometer reading
    - ◊ Ending odometer reading
    - ◊ Subtotal miles driven during the trip
- Employee documentation

Selection of Accounting Software

- Software packages greatly aid in the recordkeeping function
  - Increase efficiency of reporting and profitability analysis
  - Allow better substantiation of costs
- Some include the ability to attach electronic documentation support to the “checkbook” transaction.
- Common applications
  - QuickBooks by Intuit (not Quicken)
    - ◊ Select Farm/Agriculture when setting up Chart of Accounts for the first time.
  - Peachtree by Sage
  - Ranching and Farming specific applications
    - ◊ Numerous options with varying price ranges and application.

Accounting Methods

- Cash method of accounting
  - Advantages:
    - ◊ Avoids the uncertainties of valuing inventories
    - ◊ Better control of sales and expense recognition
    - ◊ Stabilization of income from year to year
  - There are many specific exceptions to the use of the pure cash method which are discussed throughout this presentation

Accounting Methods

- Accrual method of accounting
  - Required for:
    - ◊ Farm corporation with gross receipts over $25 million,
    - ◊ Farming syndicates and tax shelters,
    - ◊ C corporations, and
    - ◊ Partnerships with corporate partners
- Modified cash/modified accrual

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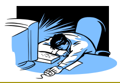
Reporting Farm Income

Introduction to Farm Taxation

- Reporting Farm Income and Expenses
  - Ranch income and expenses are primarily reported on the Schedule F.
- Further details regarding reporting schedule F income and loss can be found in the IRS Publication 225, *Farmer's Tax Guide*
  - http://www.irs.gov/publications/p225/index.html



Reporting Farm Income

- Revenue recognition generally follows normal accounting rules based on the farmer's method of accounting…

Except when it doesn't

- Generally, under the cash method when money is received it is income

Reporting Farm Income

- Patronage dividends
  - Most cooperatives will pay out earnings to members (patrons) each year to avoid paying tax on the retained income
  - Reported on Form 1099-PATR
    - ◊ Cash
    - ◊ Qualified written notice of allocation (future payouts currently taxed)
    - ◊ Nonqualified written notice of allocation
      - Reported on Form 1099-PATR, box 5
      - Future payouts not currently taxed, but taxed upon receipt
    - ◊ Per unit retains
      - Reported on Form 1099-PATR, box 3
      - Taxable ordinary income

Reporting Farm Income

- Deferred and installment payments
  - Normally “inventory” is excluded from installment sale treatment, but farmers get special treatment
  - Payment for the sales of raised commodities in years subsequent to sale are tax in the year of receipt
  - Great opportunity for controlling income by electing out of installment sale treatment on some contracts, but not others
    - ◊ You will need a good accounting system

Reporting Farm Income

- Deferred and installment payments
  - Sales of other farm assets can also be eligible for installment sale treatment
    - ◊ Good candidates include:
      - Farm land
      - Land improvements with limited depreciation recapture potential
      - Buildings
      - Equipment with limited depreciation recapture potential
    - ◊ Artful allocation of bulk sales can result in tremendous tax savings

Reporting Farm Income

- Deferred and installment payments
  - So why/why not?
    - ◊ Increasing/decreasing tax rates in future years
    - ◊ Increase/decrease in income in the next year
    - ◊ Managing cash flow
    - ◊ Depreciation recapture
    - ◊ Age and health of the taxpayer
    - ◊ Alternative minimum tax (AMT)
    - ◊ Net Investment Income Tax (ACA)

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Reporting Farm Deductions

Farm Deductions

- Prepaid expense limitation
  - Cash basis – normally deduct expenses when paid
  - With a few exceptions, the deduction for prepaid expenses related to farming are limited to 50% of other deductible expenses
    - ◊ Feed
    - ◊ Seed
    - ◊ Fertilizer
    - ◊ Supplies

  - Remaining expenditure is deferred until the item is actually consumed

Farm Deductions

- Capitalization of fertilizer costs
  - Normally fertilizer costs are expensed when paid
  - An election can be made to capitalize the cost and amortize it over the consumptive life
    - ◊ What is the consumptive life?

Farm Deductions

- Tax Depreciation
  - Calculated using the MACRS system, which is more accelerated in deducting depreciation than straight line depreciation
  - Assets encounter the most wear and tear in the first few years of use.
  - Taxable lives are set by the IRS. Examples:
    - ◊ Cattle, breeding or dairy – 5 years
    - ◊ Horses < 12 years old – 7 years
    - ◊ Horses > 12 years old – 3 years
    - ◊ Equipment – 5 or 7 years
    - ◊ Vehicles – 5 years (subject to certain limitations)
    - ◊ Computers – 5 years
    - ◊ Land improvements – 15 years
    - ◊ Farm equipment, including grain bins and fencing – 7 years
    - ◊ Farm buildings – 20 years

Farm Deductions

- Special tax depreciation
  - Sec. 179 depreciation – allows the entire cost of purchasing an asset to be deducted in the year of purchase.
    - ◊ $1,000,000 and $2,500,000 amounts (indexed for inflation) are now permanent
    - ◊ Can only reduce income to zero
  - Sec. 168(k) "bonus" depreciation
    - ◊ 2018-2022 – 100%
    - ◊ 2023 – 80%
    - ◊ 2024 – 60%
    - ◊ 2025 – 40%
    - ◊ 2026 – 20%
      - Applies to ***"new"*** and "***used"*** assets
      - Allows deduction of additional depreciation
      - Income limitations do not apply

Farm Deductions

- Soil and water conservation expenditures
  - Generally currently deductible
    - ◊ The taxpayer must be in the business of farming and the land that is improved must be used for farming purposes
    - ◊ The expenditures must be qualified deductible conservation expenses
    - ◊ The expenditures must meet the definition of, or be consistent with, an agency-approved plan
    - ◊ The deduction cannot exceed 25% of gross income from farming, excluding gains from the sale of farm machinery and equipment and the sale of farm land

Farm Deductions

- Net operating loss (NOL) carryforwards
  - Farmers are allowed a 2-year carryback
- 199A Deduction
  - 20% Above the line deduction

Accounting For Livestock

- Purchased for resale
  - Like any inventory, the cost is deducted only in the year of sale
    - ◊ Exception for hens and chicks
  - Cost includes purchase price plus costs of transportation

Accounting For Livestock

- Purchased for resale
  - Typical COGS calculation:

	Beginning inventory
+	Purchases
=	Total cost
-	Ending inventory
=	Cost of livestock sold

  - Reported on Schedule F as ordinary income
  - Subject to self-employment tax

Accounting For Livestock

- Sale of livestock held for breeding, dairy, sporting, or draft work
  - Treated like the sale of a fixed asset
  - Reported on Form 4797
    - ◊ Losses and gains from livestock held less than 12 months are treated as ordinary
      - 24 months for horses and cattle
    - ◊ Gains from livestock held 12 months or more are capital in character

Tax Calculations and Credits

- Estimated taxes
  - Only one estimate needed if remitted by January 15th
    - ◊ Tax return must be filed by April 15th
    - ◊ Payment must equal two-thirds of the current year tax, or 100% of the prior year tax
  - No estimates are required if the tax return is filed and all tax paid by March 1

Tax Calculations and Credits

- Self-employment tax
  - FICA (Social Security) – 12.4% up to a wage base
    - ◊ 2017 - $127,200
    - ◊ 2018 - $128,400
  - Medicare – 2.9% with no limit
  - Generally income from farming and ranching reported on Schedule F is subject to SE tax
  - While land rents and self-rental arrangements may not be subject to SE tax, the IRS has challenged such arrangements

Tax Calculations and Credits

- Net investment income tax
  - 3.8% of the lesser of:
    - ◊ Net Investment Income, or
    - ◊ The excess of Modified Adjusted Gross Income (MAGI) over the “threshold amount”
      - Threshold amount = $200,000 single, $250,000 Married, $125,000 Filing separate, $12,300 trusts
  - Includes land rent income recharacterized as not passive
  - Does not include self-rental income

Wages: Employee vs. Contractor?

- Consideration has to be given to whether a worker is an employee or a contractor
  - How is the worker paid? Is there a consistent relationship?
  - What degree of control does the worker have over the work being performed?
  - Does the ranch or the worker bear the financial responsibility of business aspects of the job (i.e. tools, supplies, etc.) ?
  - Additional employee benefits exist with wages?
- If an employee, the ranch is responsible for withholding payroll taxes from the employee’s wages, matching those taxes, and paying unemployment taxes.
  - Common error among employers, and a costly one.

Other Payroll Issues

- Other income inclusions (these must be included on the employees W-2):
  - Personal use of ranch vehicle.
  - Payment of housing, food, or gasoline as part of work agreement.
    - ◊ Per diem costs for short-term work are excluded
  - Free use of ranch assets
  - Other non-cash benefits provided as part of agreement to work.
- Remember – whether the worker is an employee or a contractor, there is still an annual information return filing requirement.
  - Contractor – 1099s
  - Employee – quarterly 941 payroll tax returns, annual W-2s

Special Tax Provisions – Hobby Losses

- Tax definition of Farmer/Rancher – based on the raising or growing of an agricultural or horticultural product.
  - Not sufficient to merely sell or process an agricultural product; it is generally necessary to participate in the process.
- Hobby – "activity not engaged in for profit"
  - Schedule F losses have frequently been disallowed as "hobby losses"
  - Most frequently raised as question against horse breeding and showing and cattle-raising activities.

Special Tax Provisions – Hobby Losses

- Questions to ask:
  - Legitimate profit or gain motive?
  - Complete and accurate books and records maintained?
  - Prior expertise in the business?
  - Seek advice from qualified advisors?
  - Devote substantial time to the activity?
  - Employ others to carry on the activity?
  - Reasonable expectation of asset appreciation?
  - Taxpayer previously turned an unsuccessful business into a profitable one?
  - Losses attributable to unusual circumstances?
  - Taxpayer lack substantial income from other sources, such that farm income is meaningful part of overall income?
  - Profit substantial in relation to losses and taxpayer investment?
  - Profit motives outweigh any elements of personal pleasure or recreation associated with the activity?

Special Tax Provisions – Hobby Losses

- Safe Harbor
  - Must show a profit three out of the five years
  - However, losses for the other two years cannot be substantial in relation to the income shown in three years.
- Other considerations
  - Considering the costs of the cattle or horse activity compared to the costs of carrying the real estate, where the land is held with the intent to profit from increase in its value.
  - The farming activity and the holding of land may be considered as one activity as long as the income from farming exceeds the deductions attributable to farming activity which are not directly attributable to the holding of the land.

Special Tax Provisions – Hobby Losses

- What if you <u>do</u> have a hobby loss?
  - Do not include expenses on Schedule F which can be included elsewhere.
    - ◊ Real estate taxes, mortgage interest
  - Offset income with remaining farm expenses in order to bring net income to zero.
- Consider putting the farm into a S-Corporation or Partnership

Special Tax Provisions – Deferring Income due to Drought Losses

- Due to significant drought losses, special provisions exist which allow income from the forced sale of cattle to be recognized in the next year.
- Conditions:
  - Forced to sell livestock early due to drought, flood, or other weather conditions.
  - Sale would not have occurred in the current year if not for the weather conditions.
- The income deferred to the next year is the gain attributable to the excess of the number of livestock sold over the number that would have been sold.

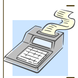
Special Tax Provisions – Deferring Income due to Drought Losses

- Alternately, instead of claiming the income in the subsequent year, the taxpayer can elect the “involuntary conversion” rules.
  - No income recognized if purchase of cattle to replace those sold occurs within four years.
  - If replacement does not occur within four years, the tax return must be amended and re-filed.

Get a good CPA advisor!

- Being proactive in discussing issues with your CPA can save you tax dollars.
- Many problems can be avoided!!!
  - Always better to ask
  - If you do get into trouble…

- What to look for in a CPA
  - Knowledge of your business
    - ◊ Farm and ranch business is a unique industry. An advisor who doesn't understand your operations is not in a position to give you the best advice!
    - ◊ What is the composition of their farm and ranch client base?
  - Service model – what do you need?
  - Professional reputation
    - ◊ Ask around! A good advisor is never concerned about inquiries into their reputation.



Questions??

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