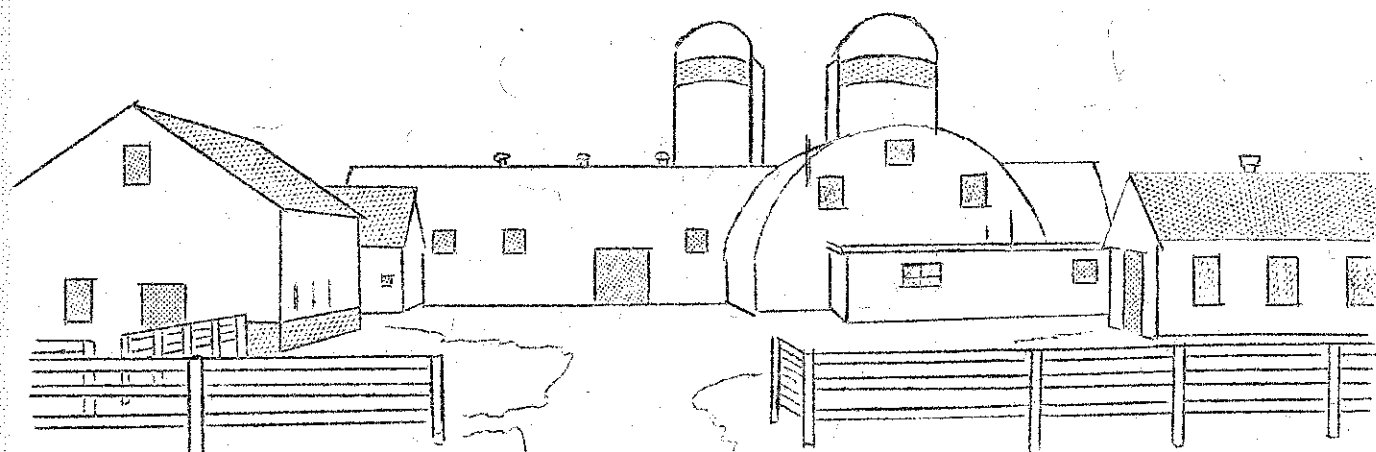
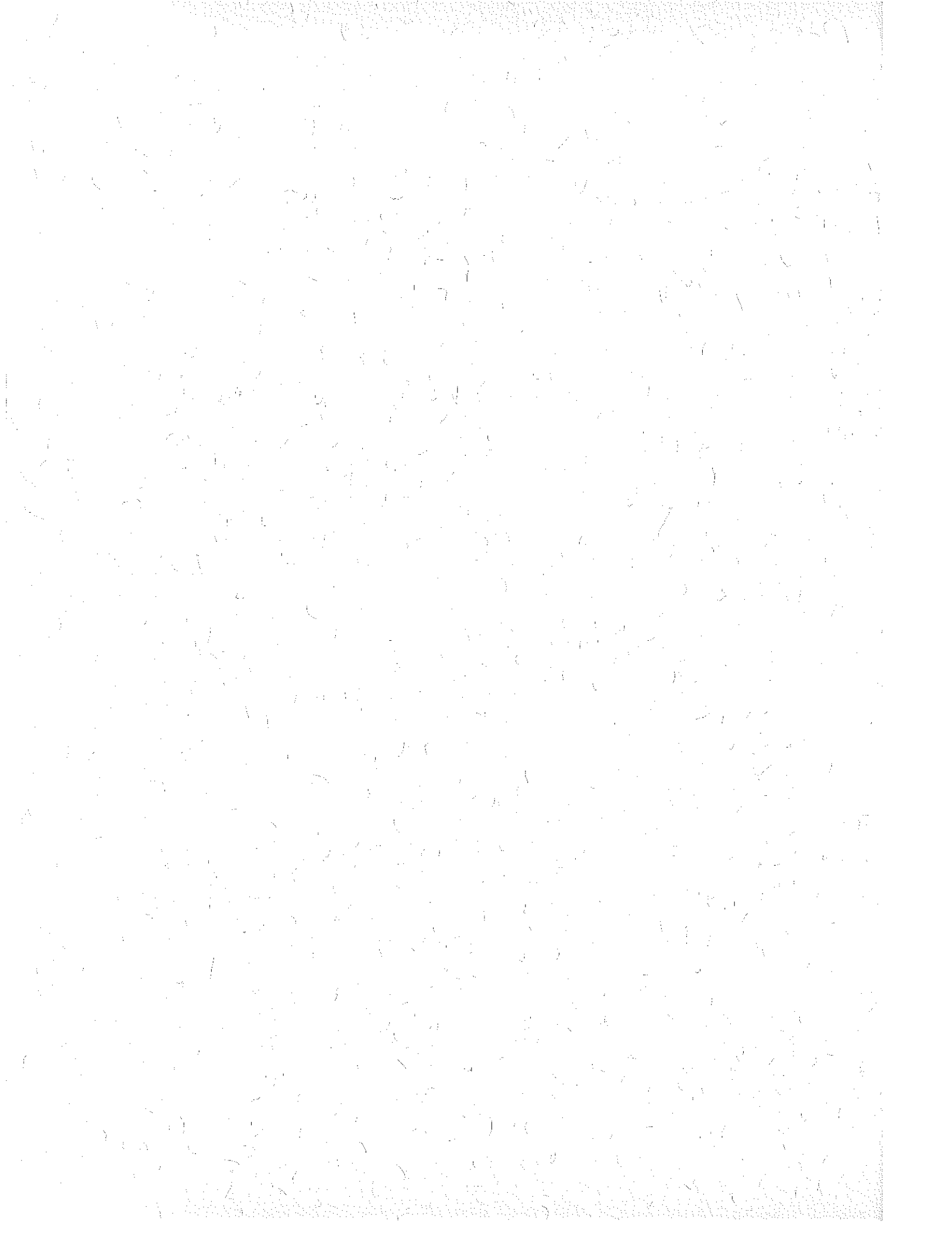


TAXMANSHIP IN FARM MANAGEMENT  
DECISION MAKING



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from month to month. It is also important that he be especially aware that most major management decisions do have strong income tax implications. One way of illustrating this fact is to cite some areas of decision making which have significant tax implications. These include but are certainly not limited to the following situations:

- When a change in form of business is being considered. If a son entering the business, a simple proprietorship may be changed to partnership or corporation. The tax advantages and disadvantages of various forms of business organization must then be weighed - partnership, corporation, small business corporation, or simple proprietorship.
- If a major business expansion is planned. Enlarging the business usually entails sizeable capital investments in both depreciable and nondepreciable property. It is important to know how fast these investments can be recovered, what the effect on cash flow will be and whether capital gain can be created at future disposition of the acquired items.
- In improving labor management practices. Increased efficiency in use of farm labor can often be attained with better labor management practices. Improved fringe benefits and an ownership share in the business may be considered for key employees. Tax consideration will influence the form that such compensation takes.
- When obtaining the use of major equipment items. It is sometimes possible to lease or rent large pieces of equipment as an alternative to outright purchase. It may be tax advantageous to rent rather than buy a large machine, or to lease on a long term basis rather than purchase outright.
- If a sale of a capital item is planned. The disposition of farm land or a herd of dairy or breeding animals certainly requires attention to the tax impact before the sale is consummated. Planning can often also reduce the tax bite when standing timber or a gravel deposit is sold.
- In planning for retirement. Farmers looking ahead to retirement can sometimes increase their retirement income and decrease current taxes by planning to postpone income until retirement years. This may be done directly through investing in approved retirement plans, or indirectly by using current income to build a larger business which will be disposed of at retirement.
- In weighing farm vs. off-farm investments. Successful farmers with money to invest weigh the advantages and disadvantages of investing in more farm property - including land - against investments in common stock, nonfarm real estate, and many other alternative investments. The question of the tax position of the income from and of the growth in these alternative investments must be a major part of the decision to invest.

- In estate planning. An important objective of estate planning for many farm owners is to arrange for ownership of the farm to pass to the next generation. Income taxes as well as estate taxes have a direct bearing on transfers of farm property. Even where there is no younger generation to take over, income tax is an important consideration in disposing of farm property for estate planning purposes.

### TAX MANAGEMENT STARTS WITH GOOD RECORDS

All taxpayers, including farmers, are required to keep records which will enable them to accurately prepare an income tax return. Account books suitable for keeping a record of cash receipts and expenses and of annual farm inventories are available at county and agricultural college extension service offices. Also available to farmers are the services of various electronic-data mail-in record keeping systems. Most of these are designed to fit needs for income tax reporting and management. Farm operators mail data monthly to a central record keeping center, where it is fed into a computer. Summaries are periodically mailed back to farmer-members, allowing them to check results against expected performance throughout the year. This also places the manager in a good position to plan for tax management as he has current data on which to base his decisions.

Farmers have other uses for financial records which are equally as important as tax reporting. These include use as a diary, to determine the strengths and weaknesses of the business, for the purpose of obtaining and using credit, as a basis for partnership operation, for adjusting claims in case of fire or other casualty, and for estate settlement. No farmer should or wants to keep a separate set of records for each purpose. Yet a system ideally suited for tax reporting does not provide all the information needed for other uses of records. By making a few adjustments, however, substantially the same set of records may be used for all the purposes listed.

### A Permanent Record of Depreciation and All Capital Transactions is Important

Annual tax returns form a part of a permanent record keeping system. These returns should be kept as long as the business continues. The depreciation schedule on the tax returns will provide needed information upon final disposition of the property, but the depreciation record alone will not provide all the necessary information when the property is sold.

In addition to a record of receipts, expenses, and depreciation, it is important for tax purposes to keep a permanent record of purchases, improvements, and sales of real estate and other capital items. When a farm is bought, a permanent record should be made of the allocation of purchase price to land, each building, fences, orchards and growing crops. Also, an accurate record of all capital improvements should be kept. This record of capital items has taken on added importance with recent changes in the law affecting capital gain.

# RECORD OF REAL ESTATE PURCHASES, IMPROVEMENTS, AND SALES

Date	Item	Cost or Sale Price	Notations
1964	Bought 300A farm, \$100,000		
	Allocation: Residence	\$ 6,500	
	Tenant house	3,500	
	Dairy barn	20,000	
	Other barns & sheds	5,000	
	2 Silos	10,000	Investment credit taken
	Fences	4,000	Investment credit taken
	Tile drains	4,000	Investment credit taken
	Wells	2,000	Investment credit taken
	Growing crops	3,000	Taken as expense, 1964
	Wood and timber	1,000	Return
	250A tillable land	38,000	Est. value of standing timber at purchase
	45A wasteland & woodland	2,000	
1965	New kitchen, residence	1,500	
1966	Building lot sold	500	$\frac{1}{2}$ A, see 1966 tax return
1966	40A land	6,000	
1967	Silo	12,000	Investment credit taken
	Sale of 50' strip to state to widen highway	2,500	About 3A sold, see 1968 Return
1968	Machinery storage shed	2,000	
1969	Sale of right of way, 10A	6,000	Not reported, reduced Basis
1970	Sale of timber	1,000	Ordinary income, \$500 depletion

There are some items of capital expense that are easily forgotten because they are not depreciable items. Some of these are in connection with the operator's house. The cost of a new bathroom, extensive remodeling of the kitchen, a new furnace, or other similar items is just as important to record as is the cost of a new barn. Even though these are not business expenses, they should be added to the cost of the farm to determine the adjusted basis. If the farmer sells his farm, the adjusted basis is subtracted from the sale price to determine the capital gain. If he has not recorded these expenses, his capital gain will be increased and he will pay more tax than necessary.

Another item that can be missed is soil and water conservation expense. These expenses cannot be depreciated, so if they are not deducted as operating expenses in the year the work is done, they should be added to the cost basis of the farm.

Maintaining a relatively simple record of real estate transactions in a form such as shown in the example on page 4 is of great value. Such a record should be brought up to date each year and might be kept in the file with tax returns.

### The Farm Manager and The Tax Counselor

Good records are essential to accurate tax reporting, but they don't guarantee it. Even though records are the biggest roadblock to good tax reports, many farmers with adequate records are still paying too much or too little income tax. Tax regulations governing farmers continue to become more complicated, and errors in farm tax reports due to lack of understanding of the law are too common.

Every commercial farmer ought to have a general knowledge of the farm income tax rules and regulations. If he completes his own tax returns, he obviously must understand reporting procedures as well as keep good records. If he hires his tax work done, he still must understand the general tax effects of each major purchase, sale, or other management decision.

### THE FARM MANAGER AND THE TAX COUNSELOR

Good tax management requires that the farm owner and manager know when and how to employ the services of a qualified tax counselor. The farm manager must know enough about tax management and his tax position to make decisions intelligently. He cannot adopt the attitude that he can hire a tax consultant to do his tax work and then stop thinking about taxes. The manager who recognizes the importance of tax management and considers tax consequences prior to each major management decision is in a position to make excellent use of professional tax assistance.

A tax expert earns his fee in three ways: First, by helping the manager estimate tax consequences of major management decisions before the move is made; second, by using his knowledge to help the farmer minimize taxes at tax reporting time; third, by supporting the taxpayer if and when his tax procedure is questioned by I. R. S. If a tax expert is hired to do the farm tax reports, his knowledge should be used in tax planning and management as well.

The advisability of hiring a tax consultant depends upon the ability and interest of the farm manager (or his wife) in tax management and tax reporting, and the size and complexity of the business and business transactions. Probably most farm businesses grossing \$50,000 can benefit from hiring professional tax assistance annually. Whenever a farm is sold or purchased, outside tax advice as well as legal assistance is a must. Farms operated as partnerships or corporations are likely to require outside tax assistance on a continuing basis, and where a partnership or a corporation is being initiated, a tax professional should definitely be consulted.

Not all tax practitioners who accept fees from farmers are competent in retaining a tax consultant, a farmer should look for one experienced in farm tax reporting and management, and should not expect to hire highly skilled advice for a very low fee. Tax counselors who accept farm business have a responsibility to gain some understanding of farm finance as well as tax problems peculiar to farm businesses.

### CASH OR ACCRUAL METHOD OF FARM ACCOUNTING

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 made the choice, they are not allowed to change without written consent from Internal Revenue. To obtain this consent, a written application must be filed within the first 90 days of the tax year affected. Permission to change is not readily obtained.

A farmer on the cash basis reports income when received in cash or equivalent, and reports expenses when paid. A farmer on the accrual basis reports income in the year it is earned even though not actually received, and reports expenses when incurred, even though not paid for. On the accrual basis, an inventory must be kept of livestock, unsold crops, feed, and supplies. An increase in the value of these items at year's end is included in income, and a decrease as a reduction in income.

To illustrate the difference between cash and accrual reporting, assume a farmer buys \$100 worth of feed on December 15th, but does not use the feed until January. If he is on the cash basis he can pay for the feed in December and lower his current taxable income by \$100 or pay for it in January and reduce his next year's taxable income by \$100. If he is on the accrual basis, the December purchase will not affect his current taxable income, because the feed will appear in his inventory at year's end. If he pays for it in December, the expense will be offset by the addition to inventory. If he does not pay for it in December, the \$100 will be added to accounts payable. Thus on the accrual basis, purchase of the feed will not affect taxable income until the year it is used. Income is treated similarly. If a sale of grain is made in December, but payment is not available until January, the accrual method farmer reports the income in December and adds the amount to accounts receivable. The cash basis farmer makes no report until the cash is received in January.

### Advantages of the Cash Method

A vast majority of all farmers use the cash method of accounting and reporting. Farmers have found several significant advantages to the cash method which include:

- (1) Simplicity. Fewer records need to be kept, and the problem of maintaining inventories is largely avoided.



- (2) An aggressive farmer who is continually investing in and building up his business pays less tax currently, because the increase in his inventories is not recognized. He thus postpones payment of tax until business property is liquidated.
- (3) Under the cash method, there are greater opportunities to even out income from year to year and avoid high tax-brackets in years of best crops or prices.
- (4) Sales of raised dairy or breeding livestock result in less tax if the cash method is used. This is because these animals have a zero basis when sold, while under the accrual method, the last inventory value is the cost basis for determining gain. The cash basis farmer can in effect convert more ordinary income to capital gain through raising dairy or breeding livestock than can the accrual basis farmer, who has less gain to report when such livestock is sold.
- (5) Upon death of a farmer using the cash basis, 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 of fair market value at death. The accrual basis farmer has already included these items as income year by year.

The accrual method may have advantages in some unusual situations, for example, a crop farmer who sometimes holds his crops for sale into the following year will automatically avoid the problem of reporting income from two crops in one year if he is on the accrual basis. For a great majority of farmers, however, cash basis accounting offers significant tax advantages.

#### YEAR END TAX MANAGEMENT

A farmer, like other businessmen, has some flexibility in management of his income and expenses. This flexibility should be used to even out his taxable income from year to year. If he allows his taxable income to fluctuate widely from year to year, he may be subject to high-bracket tax in the best years. The result is more total tax over a period of years.

In the last few weeks of his tax year, a farmer who reports on the cash basis can make many moves to bring his income more in line with past years and what he expects for the next year. In attempting to make adjustments in income or expenses for income tax purposes, a farmer should keep in mind that an adjustment to minimize taxes can result in an unprofitable decision for the business, and that attempts to minimize taxes in the current year may mean larger taxes in the future years.

#### An Example of Year End Tax Planning by a Farmer on the Cash Basis

Assume that at the end of November, dairy farmer Joe James decided to plan ahead for income tax purposes. Joe is married and files a joint

return with his wife, and has a total of four exemptions. He has a profitable business and has been paying income tax of \$1,000 to \$1, annually, but he expects this year his tax will be higher than usual. He uses his records to complete a worksheet.

In sizing up the situation, Joe James found that the current tax will be significantly higher than usual for his business. Federal Tax on the estimated \$11,500 of taxable income will be \$2,257. Crops, improved milk production and smaller than usual machinery purchases for the year will result in income tax about double the usual unless Joe makes some moves in December.

Here are some expense adjustments he might consider for December

- Purchase feed which he will use in January and February amounting to \$1,400
- Arrange for tractor repairs in December which he has planned for February or March, estimated cost \$500
- Buy part of fertilizer needed for spring, cost \$1,500
- Pay up all December bills for gasoline, breeding fees, and other accounts before January 1st, estimated total of \$250
- Review machinery inventory, decide what major items must be purchased within next 6-9 months. Decision might be to purchase item or items at cost of \$9,000 in December instead of in the period January 1st to July 1st of next year.

Machines purchased are eligible for 20% first year special depreciation and a part or whole month of regular depreciation. Result would be increase depreciation of about \$1,900

Total increased expense \$1,900  
\$5,800

In addition to adjusting expenses upward, Joe James could make the following adjustments to reduce expected receipts:

- Postpone sale of remainder of bean crop until after January 1st. Market is not expected to change \$1,000
- Postpone culling of four raised dairy cows until after January 1st. Milk they produce in the next month will offset feed costs

Total reduced receipts 400  
\$1,400

Income Tax Estimate Form -- Cash Basis

	Amounts to date Jan. to Dec.	Estimated rest of year	Estimated year's total
<u>TOTAL ITEMS</u>			
: sold	\$34,000	\$3,500	\$37,500
: held for sale	750	150	900
: sold	1,400	1,000	2,400
: miscellaneous	600	--	600
<u>AL ITEMS</u>			
: on sales of purchased	200	--	200
: livestock	--	--	--
: on sale of machinery	1,000	400	1,400
: of cows raised for	--	--	--
: dairy \$ ____ + 2 =	--	--	--
: gain on sale of real estate	\$39,600	\$5,200	\$44,800
: \$ ____ + 2 =			
<u>TOTAL INCOME</u>	\$ 2,750	\$ 250	\$ 3,000
<u>PENSES</u>	1,500	100	1,600
Labor	1,800	200	2,000
Repair & Maintenance, Equipment	100	--	100
Interest	7,200	800	8,000
Rent	450	--	450
Feed	1,600	--	1,600
Seeds and Plants	300	--	300
Fertilizer and Lime	350	50	400
Machine hire	350	50	400
Supplies	600	100	700
Breeding Fees	1,000	150	1,150
Veterinary and Medicine	--	--	--
Gasoline and Oil	1,100	--	1,100
Storage and Warehousing	700	--	700
Taxes	650	100	750
Insurance	400	50	450
Utilities	--	--	--
Trucking	200	--	200
Conservation Expense	450	100	550
Auto Expense	350	--	350
Livestock Testing, Etc.	700	100	800
Crop Spraying	750	50	800
Building and Fence Repair	23,300	2,100	25,400
Miscellaneous	--	--	--
<u>TOTAL FARM EXPENSES</u>	\$23,300	\$2,100	\$25,400
<u>NON FARM BUSINESS EXPENSES</u>			
<u>TOTAL EXPENSES</u>		4,400	\$29,800
<u>Depreciation</u>			
Estimated new depreciation			
<u>TOTAL EXPENSE, INCLUDING DEPRECIATION</u>			

(continued)

A.	Total Receipts		
B.	Total Expenses Plus Depreciation		
C.	(Line A - Line B) ADJUSTED GROSS INCOME		
D.	Less Standard Deduction*		
E.	(Line C - Line D) ADJUSTED GROSS INCOME	1,000	
F.	Less Standard Deduction		
G.	Total Personal Exemptions* \$625 x 4 exemp.	2,500	
	Line E - Line F) Estimated Taxable Income**		
*	Maximum standard deduction and personal exemptions increase after 1970 tax year.		
**	Net farm profit, on which self employment tax is based, will be this amount reduced by sale of capital items and nonfarm income.		

If all these possible changes were made in receipts and expenses, Joe's adjusted gross income would be reduced by \$7,200 and his taxable income would be reduced to \$4,300 reducing his income tax for the year to \$677.

Because all of the adjustments considered would have the effect of increasing income tax in the following year, Joe might decide to follow a middle course, and make only enough adjustments to lower his income tax for the current year to the \$1,000 - \$1,200 range, which would be normal for his business.

#### Plan to Use All Tax Free Income

Since personal exemptions and deductions are allowed annually, any credit for such exempt income which is not absorbed by current income is lost. The 1969 tax law provided for gradually increasing personal exemptions to \$750 in 1973 and the standard deduction to 15% or a \$2,000 maximum in 1973. The law also instituted a new low income allowance. All three of these changes make it even more important to plan to use up all tax free income each year.

With a 15% standard deduction and a \$750 personal exemption, a farmer with 5 personal exemptions could have \$4,400 of adjusted gross income and pay no tax. If he failed to use tax planning to even out income, he might have zero adjusted gross income in one year followed by \$8,800 the next year, with a tax the second year of \$696. The increased exemptions will also provide additional incentive for farmers and other taxpayers to plan for their children to earn some income which would otherwise accrue to themselves. Table 1 shows the amount of tax free income allowed under the 1969 law.

MAXIMUM INCOMES NOT SUBJECT TO TAX,  
1970-73 AND THEREAFTER

Number of Exemptions	1970	1971	1972	1973 and Thereafter
Individual	\$1,725	\$1,700	\$1,700	\$1,750
Married Couple	\$2,350	\$2,350	\$2,400	\$2,500
Head of Household	\$3,600	\$3,650	\$3,800	\$4,000

Source: Woods, W. Fred, The Tax Reform Act of 1969 - Provisions of Significance to Farmers, ERS-441, Economic Research Service, U.S.D.A.

Income Averaging and Year End Tax Management

Income averaging, instituted in 1964 and liberalized in 1969, is designed to ease the income tax burden of taxpayers whose incomes fluctuate widely from year to year. Income averaging is not a substitute for year end tax management. The later will benefit many farmers whose incomes are not great enough and whose incomes do not fluctuate violently enough to benefit materially from income averaging. Good Tax strategy dictates that the farm manager first make an effort to erase fluctuating income through year end tax management, then resort to income averaging if it is needed.

Although income averaging is somewhat complicated, a general understanding of its application may be gained from the following simplified example. These points will help to illustrate the method:

- Income for the four years prior to the current year is averaged.
- In the current year, only income in excess of 120% of this "base period average" is eligible for averaging.
- Averaging is not available at all unless current income exceeds base period income by \$3,000.

Here is an example where the current income is \$22,000 and the base period average was \$10,000:

Example

Steps

1. Taxable income for the previous 4 years is averaged
2. Multiply average by 120% to get nonaverageable income
3. Subtract nonaverageable income from current income. The remainder, as in this case must exceed \$3,000 to be subject to averaging.

$$\frac{\$8,000 + 12,000 + 9,000 + 11,000}{4} = \$10,000$$

$$\$10,000 \times 120\% = \$12,000$$

$$\$22,000 - \$12,000 = \$10,000$$

4. Add 1/5 of averageable income to nonaverageable income
5. Compute tax as follows:

$$\$12,000 + 2,000 = \$14,000$$

A - Tax on \$14,000	\$2,760
B - Less tax on \$12,000	<u>2,260</u>
Difference equals tax attributable to 1/5 of averageable income	
C - \$500 x 5 = tax on all averageable income	\$ 500
D - Add tax on \$12,000 (nonaverageable income)	\$2,500
E - Total tax equals sum of C + D	<u>2,260</u>
	\$4,760

The tax on current income of \$22,000 without averaging is \$5,020.  
The tax saving through averaging in this example is \$260.

### Cash Flows and Year End Tax Planning

The objective of year end tax management is to manage the business so as to reduce the net taxable income. Cash income must be temporarily foregone, expenses raised, or both. This obviously requires larger than usual cash inputs and/or lowers the normal cash-inflow.

These measures are undertaken during the closing months of the business year, which on most farms coincides with the time when advance purchases of seeds, spray materials, fertilizer and other items are desirable because of attractive seasonal discounts. To take advantage of these discounts requires more cash at a time when even profitable farms are liable to be hard pressed for funds.

In order to insure a cash reserve sufficient to the needs, it would seem obvious that cash flow planning well in advance of the need is crucial. The inability to secure the cash at year end to make moves which will minimize income tax and maximize Social Security benefits over time is an indication of poor management. The need for forward planning of cash flows for year end tax management seems more urgent than ever before and at the same time offers increased rewards to the successful manager.

### NET OPERATING LOSSES

Farmers frequently fail to take advantage of net operating loss provisions, and thus pay more taxes than necessary over a period of years. Every attempt should be made to even out income from year to year through

management, and thus avoid operating losses. Unless there is sufficient taxable income from other sources, a farm operating loss result in the loss of tax exempt income in the form of exemptions deductions. Where it is impossible to avoid operating losses, they and should be used to offset income in previous or future tax years.

An operating loss must first be carried back three years and applied against taxable income. If the income of that year is not sufficient to absorb the loss, it is then carried to the second preceding year, then to the immediate past year. Any excess of loss over total taxable income of the previous three years must be carried forward to future years. If necessary, it can be carried a maximum of five following years to offset income.

If a net operating loss is carried to a prior year to offset income, a claim for refund must be filed to recover tax previously paid. A claim for refund based on carry back of an operating loss can be filed any time within three years of date of filing of the return on which the loss was assessed. Tax forms 1045 or 843 are used for this purpose. Farmers sometimes are reluctant to file for a refund based on an operating loss for fear of other adjustments this may bring about on past returns. Good tax management requires that the taxpayer be willing to claim tax adjustments to which he is entitled.

#### SELECTING METHODS AND RATES OF DEPRECIATION

A farmer operating a large farm business invests several thousand dollars in depreciable business property each year. Various options are open to him in selecting methods and rates of depreciation on these newly acquired items. While most tax management aimed at leveling out or postponing income tax must be done before the end of the tax year, selection of methods and rates of depreciation on new items does not take place until time to file the tax returns. Much can be accomplished in adjusting taxable income for the past year through careful selection of depreciation methods.

Depreciation is not optional. It must be claimed on all depreciable property. But if a buyer neglects to take depreciation when it is due, he will not be allowed to recover that lost depreciation in a later year. It is imperative to establish reasonable depreciation schedules in the year of acquisition.

The common methods of depreciation are straight line, declining balance, and sum of the year's digits. As these are explained and illustrated in detail in many publications, including the Farmers' Tax Guide, published annually by I.R.S., they are not illustrated here. The straight line method has the great advantage of simplicity, the others have the advantage of allowing more rapid recovery of cost. A special 20% first year allowance is available in many instances on machinery and equipment. Where this is available, it is a very useful tool in managing taxable income. The 20% special allowance can be taken on up to \$10,000 of eligible property on a single return or \$20,000 on a joint return.

Much of the equipment a farmer buys is eligible for 20% first special depreciation. Coupling double declining balance and the first year special allowance instead of using straight line depreciation accomplish much in adjusting income. Assuming a 10-year life and no salvage value, then for each \$1,000 item of newly acquired property subject to both special 20% and double declining balance, the allowance is only \$100 or \$260 less. A farmer with a sizeable business normally purchases several thousand dollars of such equipment each year. He can, therefore, adjust taxable income upward or downward by as much as one to three thousand dollars through selection of methods of depreciation. He can make a separate selection on each item acquired. His current tax position will probably influence to a degree the length of life selection on some articles, and this will also be reflected in the total depreciation available for the year.

In estimating useful lives, for purposes of depreciation, the taxpayer may be influenced by the guidelines for depreciation as published by I.R.S. These guidelines are not inflexible, and the taxpayer must select his own rates based on his past experience and his reasonable expectations for use of the newly acquired property.

Generally, a taxpayer will benefit by selecting reasonably rapid rates and methods of depreciation. Rapid depreciation has the effect of postponing tax to be paid rather than reducing it. It gives the taxpayer use of tax money for a period of time before turning it over in taxes. The following table illustrates the benefits of postponing tax by selecting rapid depreciation methods. This illustration assumes the taxpayer will be able to earn 8% on the postponed tax dollars invested in his business.

POSSIBLE SAVINGS FROM FAST DEPRECIATION  
\$10,000 Item, 10-Year Life, No Salvage Value  
Taxpayer in 25% Tax Bracket

(1) Year	(2) Depreciation S-Line	(3) DD-Balance and 20% Special	(4) Tax Reduction	(5) Present Value Factor	(6) Present Value of Tax Difference
1	\$1,000	\$3,600	\$650	\$.93	\$+604
2	1,000	1,280	70	.86	+ 60
3	1,000	1,024	6	.79	+ 5
4	1,000	819	- 45	.74	- 33
5	1,000	655	- 86	.68	- 58
6	1,000	524	-119	.63	- 75
7	1,000	524	-119	.58	- 69
8	1,000	524	-119	.54	- 64
9	1,000	524	-119	.50	- 60
10	1,000	526	-119	.46	- 55
Total	\$10,000	\$10,000			
0 Net present value of Tax postponement					= \$255



Column 3 shows the recovery of \$10,000 over 10 years, starting with 20% special and double declining balance, then switching to straight in the 6th year. Column 4 is the annual tax reduction, in this case of the difference between column 5 and column 3. Column 5 contains factors for the present value of future sums, assuming 8% as the owner's cost of capital. For example, the factor .46 on line 10 of column 5 shows that the present worth of a dollar to be received in ten years is 46 cents, if we assume an earning rate of 8%. Column 6 is calculated by multiplying the figures found in columns 4 and 5. The sum column 6 is the net present value of postponing tax through fast depreciation.

In this illustration, the savings from fast depreciation are significant (\$255). If the taxpayer can put the deferred tax dollar to work in his business at better than 8%, or if the taxpayer is in a higher tax bracket, the savings will be greater. If the taxpayer is paying no tax, cannot use the deferred tax dollars profitably, there are no savings.

It is also true that in this illustration use of the first year 20% special depreciation allowance is a big factor. This allowance is available only for equipment and purchased livestock, and only then on the boot price where a trade is involved, and is limited to use on \$20,000 of eligible property on a joint return.

If rapid recovery of investment is the first principle in setting rate and method of depreciation, then simplicity is a second principle. The straight-line method, though resulting in slower recovery of capital, has the big advantage of simplicity. Use of faster methods may also, in the case of real estate, result in a portion of any gain realized on subsequent sale being classified as ordinary gain rather than capital gain.

It is not always best for the taxpayer to select the method and rates of depreciation which will result in rapid recovery of investment. Rapid recovery will usually benefit when the taxpayer is (a) regularly paying income tax, (b) expects less taxable income in the future than at present, (c) is willing and able to use the deferred tax dollars for profitable investment, or (d) when he is planning to give up ownership of the property before the end of its useful life. On the other hand, if the taxpayer expects to have more taxable income in later years, slow recovery may be most beneficial in the long run. An example of a farmer who would benefit from slow recovery of cost is a young man, regularly investing in depreciable assets, with a number of personal exemptions, and a heavy debt load with accompanying interest deductions.

#### MANAGING INCOME TO INCREASE SOCIAL SECURITY BENEFITS

Farmers are allowed an optional method of computing their self-employment Social Security tax. If net farm profit for tax purposes is less than \$1,600, then the farmer may report two-thirds of his gross, but not over \$1,600, as "earnings" for Social Security purposes. Thus any farmer with gross income of \$2,400 or over is assured annual earnings of \$1,600.

Social Security retirement and survivorship benefits are based on average earnings over a period of years. By using the optional method, a farmer who occasionally has years of very low net earnings can base his average earnings at a higher level, and eventually receive high retirement benefits.

Farmers whose net incomes fall between \$1,600 and the maximum (currently \$7,800) must decide whether it is best to strive to increase their net taxable income in order to increase Social Security benefits or to strive to decrease their net taxable incomes in order to save income tax. If the decision is to strive to increase net taxable incomes, the management of income and expense items will generally be just the opposite of the moves suggested for reducing taxes.

Although farmers approaching retirement are most concerned with increasing Social Security earnings levels, it should be remembered that the survivorship benefits provided under Social Security can be extremely valuable for farmers with young children.

### BUSINESS ORGANIZATION AND TAX MANAGEMENT

A farm business may be operated as a proprietorship, partnership, or corporation. The choice of form of business organization is not primarily a tax management question but tax considerations influence the decision. Most farm businesses are operated as simple proprietorships because that form is the simplest and fills the needs of a large majority of farm owners.

Farm partnerships are commonly formed when two or more members of a farm family, usually father and son, want to own and operate a farm business jointly. The initiation of a farm partnership may pose some income tax problems. The transfer of individually owned farm property to a partnership may be a taxable exchange or a non-taxable exchange. Such a transfer can also result in recapture of tax investment credit. Qualified tax counseling is a must when a farm partnership is contemplated.

A partnership pays no income tax, but because the total farm profit may be divided between family members differently after a partnership has been formed than before it was formed, income tax to be paid by each family member may be substantially altered with the forming of a partnership.

Owners of highly profitable unincorporated farm businesses should consider incorporating as a tax management device. Corporate ownership and operation of a family owned farm offers added flexibility in managing income to minimize taxes. After incorporation, such a business can choose to be taxed as a regular corporation, or as a small business corporation. The latter is taxed much like a partnership. That is, in a small business or subchapter S corporation, the corporation pays no tax but instead passes all profit on to the stockholders to be taxed. In a regular corporation,

first \$25,000 of profit is taxed currently at 22%. All profit over \$25,000 is taxed at 48%. With a highly profitable unincorporated business, the individual owner or owners may be in tax brackets well above the 22% rate.

In such a case, it is often taxwise to form a regular corporation and distribute total farm profit between the corporation and family members working for the corporation in such a way as to maximize the amount of profit which is taxed at 22% or below. Corporate profit and individual incomes can be manipulated to some degree by salary levels for family employees.

The general tax advantages of corporate operation are:

- Creation of an additional taxpayer (The corporation) for spreading of income,
- the likelihood that some expenses which are personal in an unincorporated business may be allowable business expenses in a corporation. These may include expenses on residences owned by the corporation and occupied by family employees,
- the possibility of fringe benefits to family employees which may qualify as corporate expense. They may include group health and term life insurance.

Although these appear to be significant tax advantages to corporate operation, the issue is far from clear cut. In a regular corporation, capital gain receives much less favorable treatment than when taxed to an individual. This is a serious tax disadvantage of a corporation if the business expects to incur significant capital gains, such as from sale of raised livestock.

Choice of business form is an important consideration in tax management. The question is too complex to receive detailed analysis in this publication. Owners and managers of highly profitable farms should carefully examine the advantages and disadvantages of corporate ownership with the assistance of legal and tax consultants.

### TAX CONSIDERATIONS IN BUYING A FARM

In buying a farm, a farmer is buying not only a business property, but he is buying a tax situation. It is very important that he realize the tax responsibilities which go with the ownership and operation of the farm as a business. It is also important to his welfare that he carefully study the alternatives open to him in calculating and reporting income tax resulting from the business. A number of major tax decisions have to be made at time of purchase or before the first tax return is filed following purchase.

### Division of Total Financial Consideration Between Sale Price and Interest

It is sometimes beneficial to buyer, seller, or both, to make adjustments between interest rates and sales price. For example, a seller might offer \$110,000 for a farm, offering \$10,000 down payment, \$10,000 annual principal payments, and interest on the unpaid balance at 6% annum. Total payments of interest and principal over the period of the contract would be \$143,000. The seller might make a counter proposal of \$118,800 sale price, with interest on the unpaid balance of 4% per annum, \$8,800 down payment, and principal payments of \$11,000 each year. Total payments under these terms would also be \$143,000.

Lowering the interest rate and raising the sale price would have these major effects on the tax positions of seller and buyer:

- For the seller, it would convert \$10,800 of ordinary income (interest) to capital gain (principal).
- For the buyer, the \$10,800 converted from interest to principal would have to be recovered as depreciation or at subsequent sale instead of as annual expense.

It would generally be to the seller's advantage to convert interest to principal in this way. It would occasionally be to the buyer's advantage also, depending upon other factors affecting his tax position over time.

If interest in a deferred payment contract such as described in this example is unrealistically low, or is unstated in the contract, Internal Revenue Service may arbitrarily stipulate an interest rate and divide total payments received under the contract between interest and principal in accordance with the stipulated interest. A stated interest rate of 4% will probably satisfy I.R.S. and avoid imputed interest at a higher rate.

### Allocation of Purchase Price

In buying farm property, the buyer is faced with the necessity of allocating total price among various elements of the property purchased. If real estate and personal property are purchased in a package, allocation may or may not have been made in the contract between real and personal property. In any case, the buyer must usually go much further in his breakdown. Price paid for farm real estate, for example, must be allocated between various depreciable structures and improvements and land before the first tax return is filed.

Some elements of the purchased property will not be depreciable and thus will not appear on the annual tax returns. Even so, it is imperative that a permanent record be kept of the allocation of price to all elements of the property.

For real estate, the breakdown will often include the following items:

Non-Depreciable  
idence or residences of owners  
d  
iber  
owing crops

Depreciable  
Farm buildings  
Tenant house or houses  
Silos and other storages  
Fences, tile drains  
Wells  
Orchards and vineyards  
(exclusive of land)

It is sometimes advisable to make a further breakdown. For example, if there are several barns of varying age and condition, it may be best to treat each as a separate depreciable item. The farm land may be divided at purchase if the expectation is that some will be sold or used for a different purpose.

There is no established guide for determining how to divide the total price among the different elements. It will usually be to the buyer's advantage to allocate as much as is reasonable, first to items which will be sold quickly and produce ordinary income and secondly to items which are depreciable. If growing crops are purchased with the land, price allocated to these crops will be charged off as an expense against ordinary income. Allocating more to growing crops and less to land will have the effect of reducing ordinary income and increasing capital gain. That part of the price allocated to depreciable property will be recovered through depreciation over time. Again, allocating more to buildings and less to land will reduce ordinary income and increase capital gain.

An informed buyer will be inclined to allocate purchase price heavily to growing crops and depreciable property, with comparatively less left for land and the farm residence.

When large sums are involved, the buyer should give careful thought to allocation before deciding how much he can pay for the property. The effect of the purchase on his tax position may influence the amount he can afford to pay.

The taxpayer has flexibility in deciding whether to group depreciable items on his tax return, or list them item by item. Some grouping is desirable for the sake of simplicity. I.R.S. will allow grouping to a large degree. All farm machinery and equipment may be listed in one class, as one item; all depreciable livestock as another. Grouping to this extent will complicate calculations at the time individual items are sold. A reasonable procedure would be to group purchased livestock by age groups, list large items of equipment separately, and make one or more groups of smaller equipment. Farm structures may also be grouped, or listed separately.

Internal Revenue Service Position on Allocation of Basis

In farm sales, buyer and seller stand to gain or lose in tax position through the allocation of total sales price of a group of assets to individual assets.

The official position of I.R.S. on allocation of basis is summed in the following quotation from I.R.S. publication Tax Guide for Small Business:\*

"ASSETS ACQUIRED IN GROUPS. If you purchase a going concern you will probably acquire several kinds of property, and the purchase price may be attributable to intangible assets such as leaseholds, patents, covenants not to compete, goodwill, etc., as well as buildings, equipment and other tangible assets. Usually the amount paid will be the total fair market value of the assets, and the basis of each is its proportionate part of the total purchase price.

A bargain purchase of a business does not justify a basis for assets in excess of their cost, even though the fair market value of the assets exceeds the cost. The actual cost must be allocated to the assets in the same proportion that the fair market value of the assets exceeds the cost. The actual cost must be allocated to the assets in the same proportion that the fair market value of each asset bears to the total fair market value of all the assets."

It is obvious from these quotations the I.R.S. expects a reasonable allocation of total price to the various items transferred. If buyer and seller attempted to make two different allocations, it would not be expected that I.R.S. would view both as reasonable. Further, where allocation is stipulated in the contract of sale, it would appear binding on both parties in allocating for tax purposes.

The fact remains, however, that even two disinterested appraisers could arrive at significantly different allocations, and seldom does a contract of sale breakdown the total price to all the items included in a farm sale. For these reasons, buyer and seller often have considerable flexibility in allocation of basis in transferring groups of farm assets.

Selecting Method and Rate of Depreciation After Purchasing a Farm

Allocation of purchase price establishes the depreciable basis of farm buildings, storages, wells, fences, drains, orchards, vineyards, and also of depreciable personal property such as machinery and dairy or breeding livestock. Methods of depreciation and the general advantages of rapid depreciation have already been discussed.

\* Tax Guide for Small Business, I.R.S. Publication 334, 1970 Edition, Chapter 27, page 111.

### Reporting Methods and Periods

The buyer of a farm, if he is initiating a new business, has the option of choosing between the cash or accrual method of reporting and choosing the calendar year or a fiscal year reporting period. Buying property to add to an already established farm business does not require the farmer these options, and he must continue with his established reporting method and period unless he receives permission to change from S.

Most farmers report on a calendar year basis. There are minor advantages in keeping in step with the majority. It is simpler to obtain information on rule changes, and to obtain tax forms at the time they are needed when filing on the calendar year basis. Choosing a fiscal year beginning March 1 or April 1 may more clearly show the normal annual cycle of many farm businesses. It also may be easier to secure the services of a professional tax consultant when he is not overburdened with other tax turns.

The comparative advantages of cash basis reporting have already been discussed. It has been pointed out that it is difficult to secure permission from I.R.S. to change once a method has been selected. Therefore, a man buying a farm to start a new business is faced with an important decision in selecting a method.

When buying a farm, it is imperative that a record be made of the price paid and the allocation of the price to various classes of property. Additional entries should be made on this record whenever real estate items are acquired or sold. A relatively simple record of real estate transactions can be kept in a form such as shown on page 4. Such a record should be brought up to date each year and kept in the file with tax returns.

### TAX CONSIDERATIONS IN SELLING A FARM

The sale of a farm usually results in tax consequences with which the seller has had little experience. The method of sale will materially affect his tax liability, and therefore the tax implications should be thoroughly explored before the deal is made.

Income tax resulting from the sale of a farm can often be minimized by spreading the income over a period of years. Income can be spread in one of two ways. If all the property has to be sold in one year, payments may be received and taxable income reported over a period of years if certain conditions are met which will qualify the transaction as an "installment sale." Another way of spreading taxable income over a period of years is to split up the farm property and sell it piecemeal. For example, a dairy farmer might find it advantageous to sell his herd and farm machinery in one tax year and his real estate in the next.

In order to show some of the calculations necessary and possible implications, a simplified example of the sale of an entire farm is presented. In the example, a farmer negotiates for the sale of his farm

business -- lock, stock, and barrel -- and has received an offer of \$110,000.

In order to estimate the tax consequences of the sale, he must determine what he is selling, allocate the sale price to the different kinds of property, determine the adjusted tax basis for each kind of property, and calculate the gain as follows:

	<u>Selling Price</u>	<u>Adjusted Basis</u>	<u>Ga</u>
Real Estate - personal residence	\$ 8,000		
All Farm Real Estate	47,000	\$ 4,000	\$ 4,000
Raised Livestock, Dairy and Breeding		25,000	22,000
Purchased Livestock, Dairy and Breeding	26,000	0	26,000
Farm Machinery and Equipment	4,000		
Harvested Crops	20,000	2,000	2,000
Total	5,000	18,000	2,000
	<u>\$110,000</u>	<u>0</u>	<u>5,000</u>
		<u>\$49,000</u>	<u>\$61,000</u>

In most instances, a great deal of effort is required to arrive at the figures as presented here. This is particularly true if the farm was acquired at a much earlier date, or acquired by gift or inheritance.

#### Allocation of Sale Price

Allocation of sale price is the first step. In the illustration, the sale price of \$110,000 has been broken down as far as is necessary to calculate gain on each class of items. In some cases a further breakdown would be necessary. In every case, the total price should be broken down into the following categories: Farm land and buildings; residence; farm machinery and equipment; harvested crops; livestock held for sale; purchase of livestock held for dairy or breeding and raised livestock held for dairy or breeding. In many cases a separate calculation to determine gain or loss must be made on each item of machinery, or each purchased animal or group of purchased animals. If rapid depreciation has been used on some farm buildings a separate calculation is required on each. A part or all of the investment credit claimed on property subsequently sold prior to expiration of its estimated life may be recaptured, and added to the tax in the year of the sale. This will be true when the sale occurs earlier than the estimated life used in originally calculating the credit. Thus if the estimated life was eight years or more, and the sale occurs in six or seven years, one-third of the 7% credit must be repaid. If the sale occurs in four or five years, two-thirds must be repaid. If it occurs in less than four years, the entire 7% credit must be repaid.

The seller of a farm often has flexibility in allocating the total sale price received among the various classes of property sold. In this example, the farmer agreed to sell his herd of dairy cattle and complete line of farm machinery for \$50,000. The buyer may have agreed to the price, believing the machinery to be worth \$25,000 and the cattle to be



\$25,000. In allocating total sale price, the seller believed the value of the cattle sold to be \$30,000 and of the equipment, \$25,000. He so stipulated in the contract.

Result of Two Divisions of \$50,000 Price for Cattle and Equipment:

	<u>Contract Allocation</u>			<u>Alternative Allocation</u>		
	<u>Price</u>	<u>Gain</u>	<u>Taxable Gain</u>	<u>Price</u>	<u>Gain</u>	<u>Taxable Gain</u>
Used Dairy Cattle	\$26,000	\$26,000*	\$13,000	\$21,000	\$21,000	\$10,500
Purchased Dairy Cattle	4,000	2,000**	1,000	4,000	2,000	1,000
Machinery & Equipment	20,000	2,000***	<u>2,000</u>	25,000	7,000	<u>7,000</u>
Total Taxable Gain			\$16,000			\$18,500

In this example, the difference in allocation resulted in a difference of \$2,500 in taxable capital gain. If the allocation is not in conflict with a contract of sale, and if it is within reason, it is not likely to be challenged.

- \* All raised cattle sold were held at least two years for dairy purposes, so gain is all capital gain.
- \*\* In this example, all gain is capital gain. Where depreciation has been taken on cattle after 1969, part or all of the gain will be ordinary and fully taxable.
- \*\*\* In this example, all gain is ordinary, because depreciation taken since 1961 exceeded gain on all items.

It is obvious that the seller will benefit by allocating larger shares of the total sale price to property which qualifies for capital gain treatment. Farm real estate and raised dairy and breeding livestock generally does qualify, as do growing crops sold with the farm. Inventory items, stored crops, farm machinery and equipment and purchased livestock generally do not qualify for capital gain treatment.

#### Determining the Adjusted Basis of Property Sold

The adjusted basis must also be determined before the tax consequences can be estimated. The adjusted basis of the farm real estate is determined by adding the basis of each item of real estate at acquisition, adding the cost of any capital improvements made, and subtracting depreciation allowable or allowed and adjusting for any sales of real property.

Suppose in this case the facts are as follows:

<u>Item</u>	<u>Cost or Other Basis</u>
Main farm, inherited in 1945	\$15,000 (value at de previous ow
Additional 40A and tenant house, purchased 1955	5,000 (purchase pri
Barn addition and new silo, 1964	10,000 (actual cost)
Capital improvements to residence, 1965	4,000 (actual cost)
	<u>34,000</u>
Less depreciation allowed or allowable on farm buildings and fences, since 1945	<u>-4,500</u> (from past tax returns)
Less adjusted basis of building lots sold, 1964	29,500
	<u>-500</u> (from past tax returns)
Adjusted basis, farm real estate	\$29,000

It may be found that a portion of the gain attributable to farm buildings will be classified as ordinary rather than capital gain because of a 1963 rule on treatment of gain from sale of depreciable real estate. However, if only straight-line depreciation has been used, and all of the depreciable realty has been held one year or more as in this example this rule has no effect.

Finding the adjusted basis of the other classes of farm property is not as difficult. For cash basis farmers, livestock raised always has a zero basis, as do harvested crops. The adjusted basis of purchased livestock and all farm equipment can usually be determined by reference to the depreciation table on the last tax return (except for purchases during the current year).

### Classification and Reporting of Gain

Income from the sale of land and buildings held at least one year and used in the farm business, from raised livestock held for dairy or breeding purposes for two years or longer, (one year if acquired prior to 1970) and from unharvested crops sold with the farm generally receives capital gain treatment, and thus only one-half the gain is taxable. The same is true concerning gain on purchased livestock held at least two years for dairy or breeding purposes except for gain which is offset by depreciation taken after 1969. Gains and losses on all these items, and on casualty losses and condemnations, must be grouped to determine net

or loss. If gains exceed the losses, as they almost always will in the event of a farm sale, all items are treated as capital gains and losses. In some cases, such as where a large casualty loss occurs, losses will be deducted from capital gains, and then none of the items receive capital gains treatment. The classification and reporting of gain on each item in the example used here is ascribed below.

Residence - In this case there is \$4,000 gain on sale of the residence. As the residence is a capital item, and was held more than six months, the gain is capital gain to be reported on Schedule D of Form 1040.

Frequently on the sale of a farm, the owner purchases another residence, and can substitute one residence for another if the second is purchased within one year before or after the sale. In this example, if another residence is purchased or built for \$8,000 or more, the gain is postponed and no tax paid at that time.

If the farmer selling is 65 or over, he may exclude the entire gain on the residence if the sale price does not exceed \$20,000, whether or not he buys another residence.

All Other Farm Real Estate - In the example, the \$22,000 gain is to be reported on Schedule D and all of the gain is capital gain because only straight-line depreciation on buildings had been used. If rapid depreciation had been used, and the buildings held for less than ten years, part or all of the gain could be ordinary instead of capital gain.

Raised Livestock Held for Dairy and Breeding Purposes - All gain is to be reported on Schedule D. In this case, all such cattle were held two years or more, so the gain is capital gain. If held for less than two years the income would be reported on Schedule D, but treated as ordinary gain.

Purchased Livestock Held for Dairy or Breeding Purposes - The income is to be reported on Schedule D. As this livestock was held for two years or more, and as none of the gain was offset by depreciation taken after 1969, all gain receives capital gain treatment. For sale after the 1970 tax year, part or all of the gain from sale of livestock will be ordinary gain.

Farm Machinery and Equipment - When a complete line of farm machinery is sold, the first calculation and tax entries must be made on Schedule D. Any gain on the sale up to the amount of depreciation taken since 1961 is ordinary gain. Any excess over that amount is capital gain.

In the example, the \$2,000 gain on equipment is ordinary gain because depreciation taken since 1961 exceeded \$2,000. In almost all cases, gain on farm equipment sales will all be ordinary gain.

Harvested Crops - Income from sale of harvested crops is always ordinary income, to be reported on Schedule F, Form 1040. Income from sale of purchased items held in inventory, such as fertilizer, is also ordinary income.

Tax Consequences When Sale is a Cash Transaction in One Year

In this example, if the entire \$110,000 farm business is sold for cash in one year, the tax consequences in the year of sale would be severe. To estimate, the following additional assumptions will be made:

- Farm owner is married, and files a joint return, and both taxpayers are under age 65.
- The farm residence is replaced with another residence costing more than \$8,000.
- Only straight-line depreciation was taken on farm buildings and improvements, all of which had been held for more than one year.
- Investment credit to be recaptured on machinery sold was \$500.
- Total taxable income without the sale was \$2,000.

The result will be:

Ordinary income from sale of farm --		
Harvested crops	\$5,000	
Machinery	<u>2,000</u>	
Capital gain from sale of the farm --		\$ 7,000
Real estate	\$22,000	
Cattle	<u>28,000</u>	
Capital gain	\$50,000	
One-half taxable		<u>\$25,000</u>
Total taxable gain		\$32,000
Income tax with the farm sale (on \$34,000)	= \$ 9,500	
Plus recaptured investment credit on sale of machinery		<u>500</u>
Total tax due		\$10,000
Income tax without the sale (on \$2,000)	= \$ 290	

The sale resulted in moving the taxpayer from the 15% tax bracket to the 42% tax bracket.

# Consequences When Sale is a Cash Transaction in Two Years

If the same farmer sold the same farm property in cash transactions, divided the sale into two tax years, the tax consequences would be severe.

To illustrate, it is assumed that machinery and livestock are sold in one tax year, and farm real estate and harvested crops are sold in the following tax year.

Tax results, first sale year:

Ordinary income from sale of machinery	\$28,000	\$ 2,000
Capital gain from sale of livestock		14,000
One-half taxable		<u>2,000</u>
Other taxable income		\$18,000
Total taxable income		\$3,820
Income tax, first sale year		<u>500</u>
Plus recaptured investment credit on sale of machinery		\$4,320

Tax results, second sale year:

Ordinary income from harvested crops	\$ 5,000
Capital gain from sale of real estate	11,000
Other taxable income	<u>2,000</u>
Total taxable income	\$18,000
Income tax, second sale year	\$3,820

## Tax Consequences When Sale is on the Installment Basis

The tax consequences of a major farm sale can be minimized by making the sale on the installment basis and thus avoiding a very large taxable income in one tax year.

To qualify for installment sale treatment, the following conditions must be met:

- Payments in year of sale must not exceed 30%.
- Sale must be for more than \$1,000, if personal property.
- Harvested crops and assets held primarily for sale will not qualify.
- It is important that the election for installment treatment be made on the tax return in the year of sale.

In order to calculate the tax effects of an installment sale, assume that payment for the \$110,000 business will be on the basis of \$10,000 down, and \$10,000 additional on the anniversary of the sale, with interest at 5%, each succeeding year for 10 years.

#### Applying the 30% Test

Total selling price =	\$110,000	
Less harvested crops	-5,000	(this is 4.5% of 110,000)
Amount of sale qualifying for installment treatment	\$105,000	

\$10,000 (down payment) reduced by 4.5% (part attributable to harvested crops) = \$9,523 (down payment for property sold on installment).

Because the payment in year of sale of \$9,523 is less than 30% of \$105,000, the 30% test is met.

#### Determining the Contract Price

In this case, no mortgage was assumed by the buyer, so the selling price and the contract price are one and the same. If the buyer had assumed a mortgage of \$10,000, the contract price would be \$100,000 (\$110,000 - \$10,000).

#### Calculating the Gross Profit Percentages

In order to know what portion of each installment payment is gain, gross profit percentages must be calculated as follows:

<u>Asset Class Sold</u>	<u>Gain divided by contract price</u>	<u>Gross profit percentage</u>
Capital asset - residence	\$ 4,000 / \$110,000 =	3.6%
Hybrid assets - farm real estate, cattle	50,000 / 110,000 =	45.5%
Hybrid assets - machinery	2,000 / 110,000 =	1.8%

#### Installment Income in Year of Sale

Because the residence is to be "traded" for another residence, no gain on the residence need be reported in year of sale.

Reportable gain on the farm real estate and cattle is calculated by multiplying sale income for year (\$10,000) times gross profit percentage (45.5%) \$10,000 x 45.5 = \$4,550 hybrid income for year of sale.

Gross profit on the machinery is calculated separately because the new requirement that gain due to depreciation after 1961 is ordinary income. In this case  $\$10,000 \times 1.8\% = \$180$  -- gain from machinery, year sale. As this is all offset by depreciation taken after 1961, it is ordinary gain, reported on Schedule D.

Total Income to be Reported, Year of Sale, Installment Method

Income from sale of harvested crops		\$5,000
Installment portion, gain on machinery sale		180
Installment portion, gain on hybrid assets	\$4,550	
Assume all of this receives capital gain treatment	$\div 2$	<u>2,275</u>
		\$7,455

Additions to taxable income due to sale

Income tax with the sale on installment (\$9,455) =	\$1,700
Plus \$500 recaptured investment credit on sale of machinery	<u>500</u>
	\$2,200
Income tax without the sale (on \$2,000)	\$ 290

Income to be Reported, Year After Sale

The gross profit percentages already calculated will be used in each subsequent year to determine the amount of installment income to be reported.

	<u>Gross profit percentage</u>	<u>Annual payment</u>	<u>Installment income</u>
Hybrid assets, farm real estate, and cattle	45.5	x \$10,000	= \$4,550
Hybrid assets, farm machinery	1.8	x \$10,000	= \$ 180

Assuming the taxpayer's other taxable income remained unchanged at \$2,000, and tax rates remained the same as for 1970, his tax would be as follows:

Taxable income from sale - \$4,550	$\div 2$	= \$2,275
		+ 180
		\$2,455
		\$ 705

Income tax on \$2,000 + \$2,455 =

Interest income which the seller would receive on the unpaid of the sale price is ignored, as it is assumed that if the sale had on the cash basis, the proceeds of sale would have been invested at equivalent interest received.

### Comparison of the Tax Results of Three Ways of Selling the Farm

In this example, it was assumed that the seller's taxable income exemptions and the tax rate remained unchanged over the entire period covered by the three methods of sale. While this is extremely unlikely it does provide a basis for comparison.

<u>Method of Sale</u>	<u>1st yr.</u>	<u>2nd yr.</u>	<u>Income Tax</u> <u>3rd - 11th yr. 11-yr. to</u>
Cash sale, all farm property sold in one year	\$10,000	\$ 290	\$290 \$12,900
Cash sale, divided in two consecutive tax years	4,320	3,820	290 10,750
Installment sale over eleven-year period	2,200	705	705 9,250

In this example, tax savings realized by splitting the cash sale in two tax years were \$2,150, as compared with tax savings of \$3,650 when the installment sale method was used.

In cases where greater tax liabilities would result, savings would be greater from the installment method.

It is a fact that tax savings are never the only consideration and seldom the most important in selling a farm. The seller can seldom afford to sacrifice on price or run the risk of financing a financially unsound buyer in order to consummate a sale on the installment basis.

### Postponing Gain by Reinvestment Proceeds of Sale

Many farmers mistakenly believe they have the unrestricted right to sell their farm or herd of cows voluntarily and postpone reporting of gain if they buy another farm or another herd with the proceeds.

Reinvestment of proceeds of sale results in postponement of tax on gain only under special circumstances. The three common circumstances are as follows:

1. That portion of the gain attributable to the farm residence may be postponed by reinvesting in another residence.



2. If the sale of the farm or farm property was an involuntary conversion, the proceeds may be reinvested in like property within a specified period. For example, where land is taken in a condemnation proceeding by a public authority.
3. If the farm or farm property is actually exchanged for other property of similar nature and value, the gain need not be recognized, because such a trade is classified as a nontaxable exchange.

#### Gain on the Sale of Personal Residence

A farmer's personal residence is a capital asset. If the sale of farm includes sale of the residence, the portion of the selling price of the cost or other basis allocable to the residence must be determined.

If there is a gain on the sale of the residence, and a new residence purchased or constructed within one year before or after the sale, tax the gain must be postponed.

Example:

Farm Sale	\$110,000	
Allocated to Residence		\$8,000
Adjusted Basis of Residence		<u>4,000</u>
(Cost plus capital improvements)		
Gain on Residence		\$4,000

If another residence is purchased or constructed within one year before or after the sale, tax on the gain must be postponed. The rule is not optional in the case of a residence.

Example:

New Residence Purchased for	\$12,000	
Adjusted Basis of Old		\$4,000
Plus Difference Between Sale Price		<u>4,000</u>
of Old and Purchase Price of New		
Adjusted Basis of New Residence		\$8,000

#### Special Rule for Taxpayers Over 65:

If the farmer is 65 years of age or over at time of the farm sale, and the sale price of the residence does not exceed \$20,000, the gain on sale of the residence may be excluded, and never taxed.

If the sale price exceeds \$20,000, a portion of the gain is excluded. The calculation is made as follows:

$$\frac{\$20,000}{\text{sale price}} \times \text{profit} = \text{amount excludable from gain}$$

In this calculation, "profit" is the difference between the a basis and sale price.

This provision for exclusion of gain for taxpayer's over 65 is limited to one residence.

### Gain From An Involuntary Conversion

If farm property is converted to money through condemnation or a casualty loss, such as a fire, tax on gain realized may be postponed reinvesting the proceeds in like property.

Whenever an involuntary conversion occurs, gain or loss must be determined just as in a voluntary conversion. If the entire proceeds are to purchase replacement property within the specified replacement period the taxpayer may elect to postpone tax on the gain. In this case, the postponement is optional.

The definition of "like property" is more restrictive for personal property than for real estate. Money received from an involuntary conversion of livestock must be reinvested in livestock of a like kind dairy cows for dairy cows. Money received from an involuntary conversion of farm real estate may be reinvested in any other real estate which is intended to produce income. If farm land is condemned for a highway, the proceeds could be reinvested in rental property in town, for example.

The replacement period begins with the date of disposition or date of threat of condemnation, whichever is earlier, and ends two years after the close of the tax year in which gain is realized.

Some common examples of involuntary conversions of farm property are

- Whole farms or farm land taken for highways or public buildings.
- Farm buildings destroyed by fire.
- Livestock destroyed by fire, lightning, or by public order due to disease.

Any one of these events has serious economic consequences. The right to postpone tax on gain realized in such an event is intended to provide tax relief in a situation not of the taxpayer's making.

### Nontaxable Exchanges

Gain or loss is not recognized if a farmer exchanges or swaps business property for other business property of a like kind.

Trading a tractor for a tractor is a nontaxable exchange, but if the taxpayer receives cash in addition, the exchange is taxable to the extent

the cash or other property involved. Trading a tractor for acreage is considered trade of property of a like kind. Property exchanged must be held for business use - personal auto will not qualify. Property held primarily for sale will not qualify.

### TAXPAYER MAY LOSE HIS STATUS AS A FARMER IN YEAR OF FARM SALE

A taxpayer who receives at least two-thirds of his gross income from the business of farming is exempt from filing quarterly tax estimates and paying the estimated tax by quarters. A farmer, by this definition, who reports on the calendar year, may file an estimate and pay the estimated tax by January 15, and pay the balance and file his final return by April 15th, or he may file his return and pay the tax by March 1st. Most farmers choose to ignore tax estimates and file and pay by March 1st.

A farm owner who sells his farm during the tax year may fail to meet the I.R.S. definition of a farmer even though his entire income for the year is derived from farm income prior to sale and proceeds of the sale. Gross income from farming does not include gains from sales of farm land and depreciable farm equipment. It does include gains from sales of draft, breeding, or dairy livestock.

Because gain from sale of farm real estate and machinery does not qualify as "farm" income, the farmer who sells out may not receive two-thirds of his gross income from farming in the year of sale. If he does not, he is liable for quarterly estimates. A farmer in this position should file a quarterly estimate on the first quarterly filing date following his sale, in order to avoid penalty.

INCOME TAX ESTIMATE FORM -- CASH BASIS  
Actual and Planned Receipts for 19\_\_

INCOME	Amounts to date January to	Estimated rest of year	Estim year's
Livestock Products Sold	\$ _____	\$ _____	\$ _____
Crops Sold	_____	_____	_____
Livestock Held For Sale	_____	_____	_____
Raised Dairy or Breeding	_____	_____	_____
Livestock Held 2 yrs.	_____	_____	_____
Gain on Sale of Real Estate	_____	_____	_____
\$ _____ ÷ 2 =	_____	_____	_____
Gain on Sales of Purchased	_____	_____	_____
Livestock Held 2 Yrs. for	_____	_____	_____
Dairy or Breeding	_____	_____	_____
Gain on Sale of Machinery	_____	_____	_____
Miscellaneous Farm Income	_____	_____	_____
Net Nonfarm Income	_____	_____	_____
(Labor, Rent, etc.)	_____	_____	_____
TOTAL INCOME	_____	_____	_____
EXPENSES			
Labor	_____	_____	_____
Repairs and Maintenance	_____	_____	_____
Interest	_____	_____	_____
Rent	_____	_____	_____
Feed	_____	_____	_____
Seeds and Plants	_____	_____	_____
Fertilizer and Lime	_____	_____	_____
Machine Hire	_____	_____	_____
Supplies	_____	_____	_____
Breeding Fees	_____	_____	_____
Veterinary and Medicines	_____	_____	_____
Gasoline, Fuel and Oil	_____	_____	_____
Taxes and Insurance	_____	_____	_____
Utilities	_____	_____	_____
Trucking	_____	_____	_____
Conservation Expense	_____	_____	_____
Other Farm Expense	_____	_____	_____
TOTAL CASH EXPENSE	_____	_____	_____
DEPRECIATION	_____	_____	_____
DEPRECIATION & CASH EXPENSE	_____	_____	_____
Total Income Less Total Expense	_____	_____	_____
Less Standard Deduction	_____	_____	_____
Less \$ _____ x _____ Exemptions	_____	_____	_____
Total Deductions	_____	_____	_____
Estimated Taxable Income	_____	_____	_____