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ACCOUNTING FOR FARMERS AND RANCHERS

By SUE WEGENHOFT BRISCOE, C.P.A., Houston Chapter, ASWA

The farmer and the rancher have their tax problems too. There is probably less authoritative material on farm and ranch accounting and related tax procedures than in any other major field of business enterprise. This probably results from the fact that, as a whole, farmers and ranchers have no office outside their homes or cabins, and frequently their records consist of deposit slips, cancelled checks, and notes made in a little black book.

Like other taxpayers, the farmer and rancher have an election of two methods of keeping their records and preparing their income tax returns: (1) the cash receipts and disbursements methods, and (2) the accrual method.

If the cash basis is adopted, taxable income is not recognized until actually received, and expenses are not deducted until actually paid. The cash-basis farmer cannot charge off the purchase price of an animal until it either is sold or dies, and it is mandatory that he capitalize all animals purchased for draft, breeding, or dairy purposes; and depreciate them over their productive lives, with due regard to salvage value. Raised animals are treated differently from those which are purchased, with the cost charged to expense each year. Thus raised animals have a zero tax base. Taxable income may also be received in the form of property, other than cash, which has a fair market value at the date of receipt.

Although farmers have the option of reporting on the accrual basis rather than on the cash basis, adequate records must be kept before the accrual method can be used. Under this method, the farmer reports income as it is earned, whether received or not, and deducts expenses as they are incurred, even though actual payment has not been made. He computes his taxable income with the use of beginning and ending inventories, choosing one of the following four methods as a basis for costing: (1) unit livestock price, (2) farm price, (3) cost, (4) cost or market whichever is lower.

The unit livestock price method is probably the most popular. It is recognized that operating conditions existing in the livestock industry are such that actual costs are impossible to secure. Therefore, prices which reflect reasonable estimates of normal costs of production are acceptable. The raised animals are classified into different age groups. A taxpayer who determines that it costs approximately $15.00 to produce a calf and $10.00 a year to raise the calf could set up classifications such as: calves $15.00; yearlings $25.00; two-year olds $35.00; and mature animals $45.00.

The unit livestock price method can be used only for livestock raised on the farm, and, if used, must be applied to all animals raised, regardless of whether they are for sale, breeding, draft, or dairy purposes. If the unit price method is used, any livestock purchased must be included in inventory at cost. The exceptions are animals purchased for breeding, dairy, or draft purposes, which may be treated as depreciable assets. If the animals purchased are not mature, the cost must be increased at the end of each year in accordance with established unit prices.

The other inventory method most widely used is the farm price method. Under this method, inventories at the beginning and end of the year are valued at the market price, less selling expenses and cost of transportation. The inventory methods of cost, or cost or market, whichever is lower, are seldom used by ranchers because it is difficult to allocate cost in a livestock operation.

While the use of the cash receipts and disbursement method may result in distorted income from an accounting point of view, it may have substantial tax benefits. No tax need be paid on the value of livestock or produce on hand at the end of the year. Income may be deferred for a number of years by building up a herd, since no income is realized until the cattle are sold. In the case of breeding, dairy, or draft animals sold, only one-half of the income is taxable as long-term capital gain. If raised breeding stock is inventoried, the increase in inventory value each year is taken up in the tax return as ordinary income until the animal is grown. The inventory value at the end of the

preceding year is the cost basis. The difference between this basis and the sales price of the animal is reported as the sale of a capital asset which is only 50% taxable. When income is reported on the cash basis, the basis of the raised animal is zero, and the difference between this zero basis and the sales price is reported as the sale of a capital asset.

For example, in the case of a cow which had been kept for three years: if the rancher used the unit livestock price method and valued this animal at $15.00 as a calf, $25.00 as a yearling, and $35.00 as a cow, he would have reported $35.00 as ordinary income on his tax return. If he sold the cow for $100.00, the difference between the basis of $35.00 and sales price of $100.00 would be $65.00, which would be reported as capital gain or 50% taxable, and the rancher would pay a tax on $67.50 ($35.00 inventory value and $32.50 capital gain). It the rancher used the cash basis, the animal would have a zero basis, and he would report the $100.00 as capital gain, paying tax on $50.00 or on $17.50 less than under the accrual method. On the other hand, the accrual basis has the advantage of preventing income from being pyramided in certain years.

A cash-basis rancher treats purchased breeding, dairy, or draft animals as subject to depreciation, and the cost of raising breeding, dairy, and draft animals can be deducted as a current expense. An accrual-basis rancher may either inventory all breeding, dairy, and draft animals, or treat them as depreciable assets—the latter treatment being to his advantage taxwise.

If livestock used by a taxpayer for breeding, dairy, or draft purposes has been held for twelve months or more from the date of acquisition, it will be property used in a trade or business, and gain on the sale will be treated as capital gain and loss as an ordinary loss. The present law recognizes two tests which must be met before a capital gain can be claimed on the sale of an animal: (1) the animal must have been held for twelve months or longer; (2) the animal must have been held at the time of sale either for dairy, or draft purposes or as a member of a breeding herd, or as a future member. It is extremely helpful if the producer can point to his inventory records and establish the fact that he was carrying his young animals as a part of a breeding herd.

Under the 1954 Code, the involuntary conversion provisions of the law have been enlarged to include the gain resulting from the forced conversion of livestock into money. If one collects insurance as a result of the death of the animal from disease or poisoning, and this also includes the compulsory selling of the animal because of said disease or poisoning, any gains fall under involuntary conversion. It is necessary, in order to prevent the recognition of gain under such conditions, that the amount received be reinvested in similar livestock within a specified time.

If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income may be computed upon the crop basis, provided the consent of the Internal Revenue Service has been obtained. The entire cost of producing the crop will be taken as a deduction in the year in which the gross income from the crop is realized. Under the crop basis of accounting, each crop is treated as a venture and an account kept for each.

Farmers have the option of expensing, rather than capitalizing, expenditures made during the taxable year for soil and water conservation and for the prevention of land erosion. The Internal Revenue Code recites the following as soil and water conservation expenditures: leveling, grading, and terracing; contour furrowing; the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds; eradication of brush; and the planting of windbreaks. This new provision in the Code provides that one can deduct such expenditures, in any one taxable year, in an amount not in excess of 25% of the gross income derived from farming for such year. In the event such expenditures exceed 25% of such gross income, any excess may be deducted in the succeeding years, although they will be subject again to such 25% limitation.

The optional deduction is important because the expenditures covered by the law are only those which are not otherwise deductible and which cannot be recovered through depreciation. Without the option a farmer would have to wait until he sold his property in order to regain these costs by virtue of the higher land basis. Under the provision, a farmer is able to convert ordinary income into capital gain. For

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TAX NEWS

By LOUISE A. SALLMANN, C.P.A., Oakland, California

The most important "Tax News" of 1958 will be the Mills Bill when, if ever, it is ground out of the Congressional mill. Recent word is that it is currently in the Senate Finance Committee and should have been fully processed the early part of June. As of this date, June 30, no definite action has been taken. A report on this bill should be deferred until such time as it has been signed by the President.

Another very important tax bill in process is the "Small Business Tax Adjustment Bill of 1958", S.2194. Some of the important features of this bill are the inclusion of a reinvestment allowance to permit small concerns to retain earnings for growth and expansion, a retirement program for all taxpayers, and a provision for installment payment of estate taxes. The "reinvestment allowance" would permit a deduction for 50% of the first $10,000, 30% of the second $10,000, and 20% of the third $10,000 which is reinvested in depreciable property or inventory. The allowance would be limited to a maximum of $10,000. The retirement program would allow an exclusion from gross income for deposits for retirement which would be limited annually to 10% of the taxpayer's net income or $1,000 whichever is less.

Other proposals encompassed by S.3194 are a rapid method of depreciation on assets acquired used, an election by unanimous agreement of corporation stockholders to be taxed as partnerships, and an increased minimum accumulated earnings credit for purposes of the tax on improper accumulation of surplus.

The Douglas Bill (S.2888) also in process at this time would apply to practically all employee pension, profit-sharing and welfare plans. Fines and imprisonment would follow conviction for failure to comply. Some of the highlights of the requirements of this bill are: (1) Registering the names and addresses of those in charge of managing the plan, their relationship to the employer or unions, etc. (2) Reporting payments, distributions, receipts, disbursements, assets, liabilities, etc. (certified by a CPA) and details on insurance and investments. (3) Disclosure of registration or report material via public inspection at the Department of Labor with copies available at principal offices of the plan for beneficiaries to examine. They could also get summaries on request. (4) Administration by Secretary of Labor who could investigate, subpoena, regulate, etc.; he could exempt plans covering less than 100 employees from items (1) and (2). (5) Effective term would be four years from date of enactment with recommendations or continuation, etc. made before 1961 by the Secretary of Labor.

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example, a farmer averages $20,000.00 annual gross income from farming. He buys a piece of farm land in need of development and uses it in connection with his farm operations. At the same time, he spends $5,000.00 in leveling and grading the property, and sells it in the following year. The $5,000.00 spent on leveling and grading is fully deductible from ordinary income, but the $5,000.00 or more gain he would realize on the sale of the property would be taxable only at capital gains rates.

If a farm is operated at a profit, the income will be taxed regardless of whether it is run as a hobby or as a business. If the farm shows a loss the loss is deductible from the taxpayers other income in the current year or other years only if the farm is operated on a commercial basis and not as a hobby. If the farm is operated as a hobby and the expenses exceed the receipts, the receipts are ignored and the expenses disallowed. The fact that repeated losses are sustained does not necessarily mean that the farm is a hobby, if the taxpayer has hopes of placing the farm on a paying basis. It is the expectation of gain, not the realization of gain, which is a determining factor. A special rule limits the loss deduction of farms which have losses in excess of $50,000.00 for five consecutive years. If a farm has lost this sum for the required number of years, the special limitation will apply even though the farm is carried on as a business.