I. Goals and Objectives

A. Learn the most common types of taxable income, deductible expenses, how they are reported and applicable IRS rules.
B. Learn about miscellaneous business deductions, losses, and credits.

II. Description/Highlights

A. While many taxpayers hold as an objective the maximization of after-tax income, emphasis should be placed on the notion that income tax saving or postponement at the expense of overall profitability of the farm or ranch business may be unwise. Because many income tax decisions are conditioned by expectations with respect to income and cost levels for current and future years together with anticipated changes in tax rates, the focus is on those provisions of the Internal Revenue Code that influence the handling of income and deductions. The goal is to raise participants’ level of awareness of tax planning possibilities in agriculture and sharpen their ability to spot potential problem areas and deal with them more effectively.

B. Federal income tax structure. The method utilized to compute taxable income depends on whether a particular taxpayer’s itemized deductions exceed the allowable standard deduction. The standard deduction is a fixed amount associated with the taxpayer’s filing status and is indexed for inflation. Taxable income for individuals who do not itemize deductions differs in one respect from the method for individuals who itemize: adjusted gross income is reduced by the standard deduction amount rather than the amount of itemized deductions.

Reporting farm income.

C. Methods of accounting. With two exceptions, a farm corporation with gross annual receipts of more than $1 million must use the accrual method of accounting. The decision of what type of accounting will be used is made on the first return that is filed and, if a change is desired, IRS Form 3115 must be filed, generally within the first 180 days of the tax year affected.

D. Constructive receipt doctrine. Income is considered to be constructively received when it is credited to the taxpayer’s account, set apart for the taxpayer, made available so the taxpayer can draw on it, or made available so the taxpayer can draw on it if notice of
intent to withdraw is given. However, income is not constructively received if the taxpayer’s control of receipt is subject to substantial limitations or restrictions.

E. If government price-income support payments are made available in a year before the time of regular payment with the recipient having an option to accept payment currently or to defer payment to the following year, the amount made available is includible in income in the earlier of the year of actual payment or the year made available to the taxpayer. Perhaps the best approach to handle deferred payment contracts is to treat them as an installment sale. For individuals utilizing the cash method of accounting, since 1980 it has been permissible to sell grain or livestock on the installment method just as real estate can be sold in the installment method. The same rules apply.

F. Self-employment income. A significant 1998 Tax Court decision held that CRP rents received by an active farmer are not subject to self-employment tax. This conflicts with the IRS’s longstanding position on the issue.

G. Federal gas tax credit. The amount of the federal gas tax credit is includible in gross income for the taxable year in which a timely return is filed on which the credit is taken.

H. Crop insurance proceeds. Taxpayers on the cash method of accounting may elect to include crop insurance and disaster payments in income in the taxable year following the crop loss if it is the taxpayer’s practice to report income from sale of the crop in the later year. Included are payments made because of damages to crops or the inability to plant crops. The deferral provision applies to federal payments received for drought, flood or “any other natural disaster.” Deferral is available only for payments directly tied to the insured’s actual loss. Accordingly, payments made under new types of crop insurance that are not directly associated with an insured’s actual loss, but are instead tied to low yields and/or low prices, likely do not qualify for deferral.

I. Weather-related sales of livestock. The livestock sold or exchanged must be replaced within two years after the year in which proceeds were received with livestock similar or related in service or use. The new livestock must be held for the same purpose as the animals disposed of because of the weather-related condition. In that event, the gain on the animal’s disposed of is not subject to tax, but is deferred until the replacement animals are sold or exchanged in a taxable transaction.

Deductions from income.

J. Basis issues. A taxpayer’s basis in an item of property depends upon how the taxpayer acquired the item. For purchased property, the taxpayer’s basis is ordinarily what the taxpayer paid for the property. For property received by gift, the donor’s basis becomes the basis of the person to whom the property is gifted. For inherited property, the heir’s income tax basis is the value of the property at the time of the decedent’s death as determined for federal estate tax purposes.

K. Depreciation. A good way to think of depreciation is that the tax law is structured to tax income less the cost of producing the income. Among these costs are the
operational costs of both tangible and intangible assets that assist in producing income. The modified accelerated cost recovery system (MACRS) applies to depreciable property placed in service after 1986. The MACRS system is an eight-class system. Under MACRS, the cost of an asset may be depreciated or recovered over a period shorter than the asset’s useful life. All property fits into one of the eight depreciation classes. The cost of eligible property placed in service after December 31, 1986, can be recovered over 3, 5, 7, 10, 15, 20, 27 ½ or 29 years. Most farm property is seven-year property.

Miscellaneous

L. In general, any expense associated with the business that has a useful life of less than 1 year is deductible against gross income. The most common deductions are: soil and water conservation expense, lease payments, interest, meals and entertainment expense and rent paid to a lessor spouse.

M. Losses are deductible if they are attributable to a business. Please refer to how the IRS defines a business. Common deductible losses include hobby losses, operating losses, casualty and theft losses and passive losses.

N. The following provisions are available to reduce tax liability: earned income credit, child tax credit, HOPE scholarship, lifetime learning credit, income averaging and farmer IRAs.

III. Potential Speakers

A. Local CPA
B. Extension Tax Specialists

IV. Review Questions

A. To deduct a depreciation expense, the property must have a useful life of more than ______ year(s).

Answer: The property must have a useful life of more than one year.

B. Gains and losses from hedging transactions are treated as:
   A. ordinary income or loss
   B. capital gains or loss

Answer: A. Hedging gains and losses are treated as ordinary income. Gains and losses from speculative transactions are treated as capital gains or losses.

V. For More Details

None available at this time.
Reporting Farm Income

- Methods of accounting
- The constructive receipt doctrine
- Commodity Credit Corporation (CCC) loans
- Payments-in-kind
- Self-employment income
- Federal gas tax credit
- Crop insurance proceeds
- Weather-related sale of livestock
- Livestock sold or destroyed because of disease
- Gain and loss from commodity futures
- Other income items
Deductions From Income

! Depreciation

! Miscellaneous Farm and Ranch Business Deductions

- Soil and water conservation expenses
- Pasture maintenance
- Lease payments
- Labor costs
- Fertilizer and lime
- Taxes
- Pre-purchased or prepaid inputs
- Interest
- Business trips, conventions and cruises
- Meals an entertainment expense
- Expenses attributable to business use of the home
- Environmental clean-up costs
- Rent paid to a lessor spouse
Losses

- Hobby losses
- Operating Losses
- Casualty and theft losses
- Passive losses

Reducing Tax Imposed on Income

- Earned income credit
- Child tax credit
- HOPE scholarship credit
- Lifetime learning credit
- Income averaging
- Farmer IRAs (proposed)
Capital Gains Taxation

Assets subjects to capital gains tax

Capital losses

Capped at $3,000