11-1-1964

Farmers' Federal Income Tax

R. N. Weigle

B. F. Jones

http://docs.lib.purdue.edu/agext/554

For current publications, please contact the Education Store: https://mdc.itap.purdue.edu/
This document is provided for historical reference purposes only and should not be considered to be a practical reference or to contain information reflective of current understanding. For additional information, please contact the Department of Agricultural Communication at Purdue University, College of Agriculture: http://www.ag.purdue.edu/agcomm
This document has been made available through Purdue e-Pubs, a service of the Purdue University Libraries. Please contact epubs@purdue.edu for additional information.
FARMERS' FEDERAL INCOME TAX

-Discussion Outline-

Prepared by R. N. Weigle and B.F. Jones

Department of Agricultural Economics

This publication attempts to consolidate and condense those federal income tax regulations which are most applicable to Indiana farmers. Also, it attempts to clarify regulations by use of appropriate examples. There are many opportunities for farmers to reduce tax obligations by good tax management. However, this publication treats tax management to only a very limited degree. Its primary function is to clarify the mechanics of the federal income tax as related to farmers.

I. Managing income to minimize tax.
A. Using up allowable personal deductions and exemptions.
   1. Example: Taxpayers A and B each have a wife and two children.
      Allowable deductions

      | Taxpayer (joint return) | First year net income | Second year net income | 2-year average net income | 2-year tax | 2-year tax savings
      | A | $3000 | $4000 | $3000 | $3000 | $500
      | B | $3000 | $4000 | $3000 | $3000 | 0

B. Income Averaging For Higher Incomes.
1. All types of income eligible except capital gains, wagering gains, income from gifts and bequests and premature distributions received by owner-employees under a pension plan.
2. To benefit, "averagable income" for 1964 must be over $3000. With moderate fluctuation in income, not very important. With wide variations in income, tax savings would be substantial.
3. Averagable income, generally, is the excess of 1964 income over 133 1/3% of the average of income for the four prior years excluding income not included in section 1 above for the four years.
4. Example: Married taxpayer filing joint return had average annual taxable income for the period 1960-63 of $4,500. In 1964 his taxable income is $10,000.
   a. Calculate Averagable Income
      Taxable Income for 1964 $10,000
      4/3 of $4500 average base period income 6,000
      Averagable income 4,000
   b. Calculate Tax on 1/5th of averagable income.
      Tax on $6800 (4/3 of $4500 + 1/5 of $4000) 1,240
      Less tax on $6000 (4/3 of $6000) 1,080
      Tax on 1/5th of averagable income 160
   c. Calculate Total Tax.
      Tax on $6,000 (4/3 of $4500) 1,080
      Tax on averagable income (5 X $160) 800
      Total Tax 1,880
   d. Tax saved by averaging.
      Tax on $10,000 without averaging 1,950
      Tax with averaging 1,880
      Tax saving with averaging 70
5. If have capital gain, income from gifts and bequests, etc., the tax is still the sum of tax on 4/3 of average base period income and tax on the averagable income. However with above types of income, taxable income must be set up in layers and tax computed on each layer (See Internal Revenue Document 5553).

1/ The assistance of P.R. Robbins and C.A. Sargent of the Department of Agricultural Economics is acknowledged.

II. Classification of farmers' income and expenses (cash method).

A. Farmers' income

1. Farm business income (Report on 1040 F).
   a. Sale of production.
      (1) Crops and produce raised--CCC loans may be treated as income in year the loan is received or in year the grain is delivered. Once treated as income when loan is received, it must be treated as such thereafter unless get IRS permission to change.
      (2) Raised market livestock.
      (3) Profits from sale of purchased feeding livestock.
   b. Miscellaneous farm income.
      (1) Receipts from custom work and machine hire.
      (2) ACP payments (in money or materials), conservation reserve payments, feed-grain and wheat program payments, wool subsidies, gas tax refunds, cropland conversion payments, etc.
      (3) Patronage dividends from cooperatives whose tax year began after Dec. 31, 1962.
         a. Patronage dividends received in money are includible as income when received.
         b. Qualified written notices of allocation are included as income when received at their stated dollar value. (Qualified written notices are notices of rights of redemption (20% or more of which is paid in cash) given by the cooperatives separately to each patron. They are redeemable in cash within a period of at least 90 days after issuance, unless you have consented with the cooperative to include such notices to the extent of their stated dollar value. All other notices are nonqualified).
         c. Nonqualified notices are not included in income when received. Only when payment is received is it included in income.
         d. Dividends received as a result of purchase of capital assets, or depreciable property used in business and taxable under above rules are not reported as income but reduce the purchase price or basis of such assets by amount of the dividend. If dividends received exceed the unrecovered cost the excess must be included as income.
      (4) Constructive receipt--if seller has right to collect from purchaser anytime after delivery of commodity.
      (5) Sale of soil, loam, fill dirt, and gravel--depletion allowed.
      (6) Sale of sod--ordinary income and no depletion allowed.

2. Income from sale of farm capital (Report on Schedule D).
   a. Gains from sale of farm and other real estate /1/ (except gains from sale of residence under certain conditions, See Section IV B 4) are taxable. (Recapture of depreciation provisions apply on sales of depreciable real property after December 31, 1963 (See Section III A 5).
   b. Gain from sale of machinery and equipment. /1/ (Recapture of depreciation provisions apply on sales after December 31, 1962 (See Section III A 4).
   c. Gains on sale of livestock, held for dairy, breeding, or work purposes. /2/

   a. Stock dividends, interest, rents, off-farm work, etc.

---

/1/ If held six months or less, 100 percent of income taken into account for taxes. If held over six months, only 50 percent taken into account.

/2/ If held less than 12 months, 100 percent taxable. If held 12 months or longer, only 50 percent taxable.
B. Farmers' expenses (Cash Method).

1. Expenses fully deductible in year expenses are paid.
   a. Hired labor, including amounts paid to dependent children.
      (1) Reasonable wages may be paid dependents for work actually
      done as long as there is a true employer-employee relation-
      ship.
   b. Feed purchased, fuel, oil, grease, and supplies.
   c. Repairs of machinery, equipment and improvements (except tax-
      payer's dwelling), and machine hire.
   d. Seeds, fertilizer and lime applications.
   e. Veterinary, breeding fees and livestock advertising.
   f. Farm share of telephone, electricity and auto expense.
   g. Insurance, property tax and interest on indebtedness (farm business).
   h. Social security taxes on farm workers.
   i. Purchased feeder livestock if sold in year purchased.
   j. Other miscellaneous expense.

2. Expense deductible at a deferred date.
   a. Cost of purchased feeder livestock if sold in later year than purchased.
   b. Advance payments of rent and farm insurance premiums.

3. Expenses that can be charged off through depreciation.
   a. Improvements such as buildings (except taxpayer's dwelling),
      fences and tile drains.
   b. Machinery and equipment.
   c. Development costs of tiling, masonry work and tree planting.
   d. Purchased dairy, breeding and work stock.

4. Expenses which have alternative tax treatments.
   a. Soil and water conservation practice costs on farm land.
      (1) Defined as costs of (a) leveling, grading, terracing
      and contour furrowing; (b) construction, control and
      protection of diversion channels, open drainage ditches,
      earthen dams, water courses, outlets and ponds; (c) erad-
      ication of brush; and (d) planting of windbreaks on land
      that has previously been used in farming.
      (2) Tax treatment.
      a. May elect to treat as operating expenses up to 25 percent
         of gross farm income in year expenses are made, if not
         capitalized in prior years.
         (1) Expenses in excess of 25 percent of gross income
         are carried to next year as an operating expense.
      b. May elect to capitalize and become an addition to cost of
         land, if not treated as operating expense in prior years.
   b. Clearing land to make suitable for farming.
      (1) May elect to deduct expenditures for the eradication of trees,
      stumps and brush; the treatment or movement of earth; and the
      diversion of streams and water courses to make land suitable
      for farming up to 25% of taxable income from farming or
      $5,000, whichever is less. Balance must be capitalized.
      (2) May elect to capitalize entire amount. Cannot recover cost
         until farm is sold.

5. Expenses not deductible until farm is sold.
   a. Cost of land.
   b. Cost of improvements to dwelling occupied by taxpayer.

6. Expenses not deductible.
   a. Cost of purchasing or raising produce or livestock for family
      consumption.
III. Major considerations in computing net farm income for tax reporting.

A. Depreciation.

1. Methods of computing depreciation.
   a. Straight-line method.
      (1) Amount depreciated each year equals cost or other basis, 
          less estimated salvage value, divided by estimated years 
          of life.
      (2) On new or used personal property (other than livestock) with 
          a useful life of three years or more which was acquired 
          during 1964, salvage value may be reduced by any amount up to 
          10% of the basis of property. However total depreciation 
          deducted may not exceed adjusted basis less salvage.

   b. Declining balance method.
      (1) A constant percentage of the remaining value taken each year. 
          Rate may not be more than twice the normal straight-line rate if 
          purchased new and not more than one and one half times the 
          normal straight line rate, if used before purchased.
      (2) Example of a new item with an estimated eight year life:

          | Value  | Depreciation | Amount of  |
          | 1st of year | rate | end of year |
          |          |          | 25% | depreciation |
          | 1st yr. | $2000 | X | 25% | = | $500 |
          | 2nd yr. | 1500 | X | 25% | = | 375 |
          | 3rd yr. | 1125 | X | 25% | = | 281 |
          Value at end of year: 844

   c. Sum of year's - digits.

2. Depreciation of property held less than full year.
   a. Computed for nearest number of whole months.

3. Additional first-year depreciation of tangible personal property.
   a. May elect to deduct twenty percent of cost in first year, (a bonus) 
      in addition to regular depreciation on the balance.
      (1) If property has a useful life of six years or more.
      (2) Total cost of such properties eligible in one year, 
          limited to $10,000 ($20,000 joint return).
      (3) Property must have been purchased, not acquired by gift 
          or inheritance. Property cannot have been acquired from 
          wife, husband, parent, child or other ancestor or lineal 
          descendant, or in transactions between certain related 
          partnerships, partners, corporations or stockholders, or 
          certain beneficiaries, fiduciaries, or grantors of trusts.
      (4) In case of trade-in, only cash difference paid is subject to 
          ruling.
      (5) Ruling applies to used as well as new property.

   b. Examples of additional first-year depreciation.
      (1) Tractor with an estimated life of 8 years, purchased July 3, 1964 
          cost $5,000. The depreciation allowance for 1964 may be computed 
          as follows:

          Additional First Year Depreciation $5000 X 20% -- $1000
          Regular Depreciation (declining bal.)
          $4000 ($5000-$1000) X 25% X 6/12------------------ 500
          Total Depreciation for 1964. $1500
(2) Same $5000 tractor, acquired by trading old tractor with an unrecovered cost of $1600, on which $2500 boot was paid. Depreciation allowance for 1964 may be computed as follows:

\[ \frac{\$1600 + \$2500 = \$4,100 \text{ cost basis of new tractor}}{\text{Regular Depreciation (Declining Balance)}} \]

\[ \frac{\$2500 \times 20\% \times 6/12}{\$950 \text{ Total Depreciation for 1964}} \]

4. Tax treatment of gains from depreciable personal property (except livestock) disposed of after December 31, 1962. Includes fences used in connection with raising livestock and storage facilities such as grain bins and silos (Section 1245 property).

a. Gain from sale or exchange of property must be reported as ordinary income, unless the depreciation (after 1961) on the property is less than the gain. In that case, gain to the extent of the depreciation since 1961 is ordinary income and any excess would be capital gain.

b. Example - Tractor sold January 2, 1964:

<table>
<thead>
<tr>
<th>Original cost basis</th>
<th>$3000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$2000</td>
</tr>
<tr>
<td>Total depreciation taken</td>
<td>1800</td>
</tr>
<tr>
<td>Unrecovered cost</td>
<td>$1200</td>
</tr>
<tr>
<td>Depreciation prior to 1962</td>
<td>1200</td>
</tr>
<tr>
<td>Total gain</td>
<td>$800</td>
</tr>
<tr>
<td>Depreciation 1962 and 1963</td>
<td>600</td>
</tr>
<tr>
<td>Ordinary income</td>
<td>600</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$200</td>
</tr>
</tbody>
</table>

c. Reported in Part II, Schedule D.

5. Tax treatment of gains from real depreciable property after December 31, 1963 (Section 1250 property)

a. If held 10 years or more or if property is held less than 10 years and was depreciated exclusively under the straight line method, gain is capital gain and entire gain is included in comparison of gains and losses.

b. If property is held less than 10 years, and depreciation after 1963 exceeds the depreciation that would have been allowable under the straight line method, the applicable percentage of the amount of depreciation that exceeds straight line depreciation (additional depreciation) must be included as ordinary income. Balance would be included in comparison of gains and losses.

Example: A sells depreciable real property on Jan., 1, 1968. Property was purchased on Jan., 1, 1963. A deducted depreciation using declining balance method for the years 1964-67 of $1200. Allowable straight line depreciation for this same period was $800. Additional depreciation would be $400 ($1200-$800).

c. If property is held for one year or less prior to sale or disposition, the entire amount of depreciation is considered additional depreciation. In other cases, the applicable percentage is 100% minus one percentage point for each full month after the date property has been held for 20 months. After 10 years applicable percentage is reduced to zero.

Example: Depreciable real property purchased on Jan. 1, 1963 was sold on Jan. 1, 1966. The twenty month holding period would be up Aug. 31, 1964. Thus applicable percentage applied to any additional depreciation would be 84% (100%-16%).

d. Reported in Part II, Schedule D.
B. Purchases and sales of livestock (cash method of reporting only).

1. Purchased livestock.
   a. Feeding livestock and other livestock bought for resale.
      (1) Cost is deducted in year of sale, in Schedule F, (Form 1040).
      (2) Profits are fully taxable--reported on Page 1, Schedule F.
   b. Livestock purchased for dairy, breeding or work purposes.
      (1) If held 12 months or more
         a. Costs entered in depreciation schedule. When sold, sale is reported in Part I, Schedule D.
         Gain is sale price less unrecovered cost and cost of sale.
      (2) If held less than 12 months.
         a. When sold, reported in Part III, Schedule D.

2. Raised livestock.
   a. Feeding livestock and other livestock held for sale.
      (1) Sales reported in Schedule F.
   b. Animals held for dairy, breeding and work stock.
      (1) If held 12 months or more.
         a. Sales reported in Part I, Schedule D.
         b. Gains realized = selling price less cost of sale.
      (2) If held less than 12 months.
         a. Sales reported in part III, Schedule D.

C. Involuntary conversion of property (real or personal property).

1. Gains realized may not be recognized if other property, which is similar or related in service or use to the property converted, is purchased to replace it between date of disposition or threat of condemnation and one year after the close of taxable year in which gains are realized.
   a. Gain only if amount realized exceeds cost of replacement.
   b. Cost basis of property converted is transferred to replacement property.

IV. Other income tax reminders:

A. Investment credit (file on Form 3468).

1. A credit against tax liability - applies to "qualified investment" in new and to a limited extent used tangible personal property which is depreciable or amortizable farm machinery and equipment. Livestock does not qualify. Neither do most permanent buildings, except storage facilities (silos, grain-bins, corn cribs). Feed and watering troughs for livestock and fences for livestock also qualify.

2. Amount of tax credit is 7% of qualifying investment. Must be claimed in the year which property is "placed in service".

3. Property must have estimated useful life of four years or more. Percentage of basis or cost varies with useful life:

   Useful life, years | % of basis counted
   -----------------|------------------
   8 or more         | 100
   6--8              | 66 2/3
   4--6              | 33 1/3
   less than 4       | none

4. Investment credit is subtracted dollar for dollar from federal tax. Unused credit may be carried back 3 years (but not beyond 1962 tax year). If any excess remains, may be carried forward to the 5 succeeding years until absorbed.

Example: Purchase tractor in 1963 for $5,000 with useful life of 10 years. Tax liability before credit $1,000. Investment Credit--7% X $5,000 = $350. Tax liability after Investment Credit--$1,000-$350 = $650.
5. Tax adjustment may be necessary if property is disposed of early or ceases to be qualified property.

B. Sale or exchange of farm.
1. Gains subject to tax.
   a. Held six months or less--fully taxable.
   b. Held for more than six months--50 percent taxable.
   c. Part of gain on depreciable real property may be ordinary income.
      (See III A 5 above).
2. If unharvested crops are sold with farm, cost of raising them is added to cost basis of land and is not deductible as an ordinary farm expense. Cost basis of farm to purchaser is reduced by amount allocated to unharvested crops.
3. Installment sale of farm.
   a. To qualify, payments received in year of sale cannot exceed 30 percent of contract price.
   b. Spreads income of sale and tax liability over several years.
   c. May result in large tax savings.
   d. Example of installment sale.
      Selling price of farm sold in 1964.................. $50,000
      Seller's cost basis.................................. 30,000
      Gain realized........................................ $20,000
      Percent gain realized $20,000 = .................. 40%
             $50,000
      Payments received in 1964.......................... $15,000
      Gains realized in 1964 = $15,000 X 40% ........ $ 6,000
4. Gains on taxpayer's residence must be excluded.
   a. If, within one year after (or before) sale, buys another residence, gain from sale of old residence must be excluded from income if cost of the residence equals or exceeds sale price of old residence. Applies also if construction is started on a new residence within one year before or one year after sale of old residence and is occupied within eighteen months of sale.
   b. Illustration:

<table>
<thead>
<tr>
<th></th>
<th>Farm with Residence only</th>
<th>Farm without Residence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price in 1964</td>
<td>$50,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Cost basis plus sale expense</td>
<td>30,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Gain</td>
<td>$20,000</td>
<td>$ 4,000</td>
</tr>
</tbody>
</table>
   c. In above illustration $4,000 gain on residence excluded if $10,000 or more is invested in other residence.
   d. If 65 or over and adjusted sales price does not exceed $20,000 and has been residence of taxpayer 5 of last 8 years, may elect not to include gain even though no other residence is acquired. If over $20,000, only the pro-rate share of gain is taxed.

5. Property exchanges.
   a. If farm is traded for other farm or business property.
      (1) Gains on old property recognized if "boot" is received.
         Cost basis of new property equals cost basis of old property less "boot" received.
      (2) No gains recognized if difference is paid on new property.
         Cost basis of new property equals cost basis of old property plus difference paid.
   b. If farm is traded for non-business property.
      (1) Gains on farm must be recognized as if sold.
   c. Similar regulations apply to exchanges of personal property used in farm business.
C. Net operating losses.
   1. First applied against other income received.
   2. If in excess of other income, excess or "net operating loss" is:
         excess still remains, it is carried over until absorbed as a
         deduction from income for years 1964 through 1969.
      b. Reported on Form 1045, filed within 12 months after end of
         tax year.

D. Income taxes of an incorporated farm business.
   1. If a corporation has no more than 10 shareholders, the shareholders
      may elect to include in their own income for tax purposes the current
      taxable income of the corporation, both the part which is distributed
      and that which is not.
      a. Corporation tax is eliminated—no double taxation.
      b. Dividends to shareholders not eligible for a dividend received
         credit nor retirement income credit.

E. Individual tax rates reduced.
   1. 1964 - Minimum of 16% to maximum of 77%.
   2. 1965 and later years - minimum of 14% to maximum of 70%.

F. Minimum Standard Deduction.
   1. For all taxpayers except married individuals filing separate returns,
      it is $200 plus $100 for each exemption.
   2. May not exceed $1,000, just as for 10% standard deduction.
   3. Example: Married taxpayers with 3 children file joint return showing
      $6,000 adjusted gross income. If do not itemize deductions minimum
      standard deduction would be $700 ($200 plus an additional $100 for each
      of their five exemptions. 10% standard deduction would be $600. Thus
      taxpayers' standard deduction would be the $700 minimum standard deduction.

Forms Used for Farm Income Tax Reporting

Schedule F--to report farm income and expenses and to compute net farm profit or loss.
Schedule F-1--to compute farmers self-employment tax.
Schedule D--to report gains and losses from sales of property used in the business,
    such as farm machinery, dairy cows and breeding stock.
Form 1040--to list the farm profit (or loss) from Schedule F, gains or losses from
    Schedule D, other items of income and personal deductions and to figure the tax due.
Form 1040 ES--to declare an estimate of tax. Permits farmers to postpone filing
    final report from February 15 to April 15. Must be filed by January 15.
Forms 1096 and 1099--to report payment of $600 or more in wages, interest or rent
    to individuals. Both forms forwarded to Internal Revenue Service by February 28.
Copy of Form 1099 to be furnished to each individual reported.
Form 1065--for filing partnership reports.
Form 843--for filing a claim for refund.
Form 1045--for handling "net operating losses," to claim a quick refund.
Form 450--to report payment of over $100 social security tax on employees, if
    occurs before December 1.
Form 943--to make final social security report on employees.
Form 3468--to compute investment credit.