

# **A GUIDE TO FINANCIAL RECORD KEEPING FOR FARMERS AND RANCHERS**

Prepared by the Rural Coalition, Rural Coalition member groups and Intertribal  
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This curriculum and training guide is designed to introduce basic tax concepts related to farmers with a specific emphasis on small and limited resource farmers and ranchers. In order to accomplish this goal, we have used examples of tax consequences and definitions and concepts. We have made an effort to simplify IRS definitions, as well as highlight and elaborate on concepts especially applicable to small and limited resource farmers and ranchers. In addition, we have included an example of hypothetical records, loan applications, and a Farmer's Profit and Loss tax form for a fictional farm operation. In the typical case, farmers would review the definitions, concepts and examples and later apply the acquired knowledge to their specific farm operation. Due to our efforts to keep things simple, it is important to note the use of these concepts, definitions, and examples is limited since they are not specific to a particular farm operation, nor consider every conceivable tax definition or example. We strongly encourage each individual to seek tax advice from a competent farm tax accountant.

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This training is a fusion of training curricula provided by Intertribal Agriculture Council, Minnesota Food Association, Rural Community Development Resources and other sources. This is by no means a comprehensive tax training, but attempts to specifically address needs of our member group farmers. A great thanks to all the many people who contributed to this effort.

*A wise man should have money in his head, but not in his heart. ~ Jonathan Swift*

## **WHY RECORD KEEPING IS IMPORTANT**

It might not be something we would like to admit, but when dealing with money it is a good idea to keep track of where it is coming from and going to. In considering your farm or ranch, keeping good records will help you in making profitable business decisions, filing your taxes, and applying for loans. Recording all of your income and expenses will give you an accurate and sound financial view of your operation.

Typically, farmers and ranchers tend to focus on the production of their product rather than planning and record keeping. However, by keeping good records and compiling those numbers into statements and budgets, you will know exactly what areas of your operations are making you money and which parts are not. For example, you will be able to clearly see if it is cheaper to purchase hay from your neighbor rather than producing it yourself. Producers who keep accurate financial records have the ability to more easily check the performance of their business and recognize unnecessary expenses or areas where more revenue can be generated.

After making those business decisions and investments, when tax time comes it will be useful to file a Schedule F (Profit or Loss from Farming) so you do not pay more taxes than necessary. Your farm operating costs can be tax write-offs and credit your tax payments on your 1040 form. Also, such records can also serve you well if applying for a loan. By keeping records from year to year, you know approximately the amount of money you will need to borrow to operate your business for a year. Using your records to budget for the upcoming year will help eliminate cash-flow problems. Lending institutions will also want to know your financial situation.

Records and financial management are also important for participating in government programs, crop insurance, lease agreements, and organic certification, just to name a few others. The following pages will introduce you to financial concepts and definitions, outline the types of finances you should keep track of, suggest ways to record those finances, and make the connection between those financial records and important forms such as balance sheets, Schedule F tax form, and loan applications.

## **Challenge Story: Farmer 1**

For the past three years, the Indian Rancher has been raising calves from one day old to 300 pounds. He had been successful with this business and decided he wanted to expand his business. He had just enough to continue his operation, but not enough for the expansion. For that he needed a loan.

First, he contacted the National Tribal Development Association (NTDA) about a Farm Service Agency (FSA) loan. NTDA provided him with a list of items needed to complete the application. When he saw the list, he decided to try a local bank instead because he thought it would be easier.

The first thing the bank asked him for was his tax history. The Indian Rancher had not filed his taxes because he is not required to file Federal income taxes on income derived on Trust property. Therefore FSA erroneously determined that his application was incomplete.

The Indian Rancher found out that without an organized record keeping system, you could be prevented from applying for funding and other programs, which you would normally qualify. The Indian Rancher now understands the importance of record keeping.

## **Success Story: Farmer 2**

Yakama Indian Farmer had been working in the agriculture industry in the Yakima Valley for about 20 years. About 2 years ago, he decided he wanted to go into business for himself. With support from his employer, he decided to purchase the orchard operation of his employer.

Yakama Indian Farmer went to the NTDA, for assistance in applying for a Farm Service Agency (FSA) Loan for \$200,000 to purchase real estate and \$200,000 for operating expenses. This process can be quite extensive because of the amount of support documentation required by the FSA. They require five years of Income Tax, production reports and current personal asset and liability information as well as many other things pertinent to the operation.

Fortunately, the Yakama Indian Farmer had all of this information organized. The process of compiling the required information and inserting the information into forms was done quickly. This allowed the application to be submitted and processed. What could have been a 6-7 month process took about three months.

## CONCEPTS AND DEFINITION...

**Accounts Payable** – The amount you still owe someone for products they delivered or services they provided.

*The money Farmer John owes Farmer Daisy for the 50 bales of hay he bought from her.*

**Accounts Receivable** – The amount still owed to you for products you sold or services you have provided.

*The money Farmer Daisy has coming to her from Farmer John for the 50 bales of hay he bought from her.*

**Accrual Basis** – The method of business accounting in which you record revenues at the time they are earned and expenses at the time they are incurred, regardless of when you receive the cash or make the cash payment. Certain farm corporations and partnerships, and all tax shelters, must use an accrual method of accounting.

*A record keeping system where Farmer Leo records the money spent on seed at the time he plants, even if he bought the seed in December of last year; and records the money earned when he sells his produce, even if his neighbor doesn't actually pay him until two weeks later.*

**Accrued** – Earnings or expenses that have accumulated but have not yet been received or paid. For example, interest on your savings account accrues on a day-by-day basis, but is not paid until the end of a period.

*Earnings or expenses that keep building up. Farmer Jane's tab at the local hardware store is an accrued expense. The money your neighbor owes you from frequent visits to your vegetable stand is accrued earnings.*

**Assets** – Everything you own that has value, including physical objects (tangible assets) and rights (intangible assets). Assets are valued on the Balance Sheet and classified into the following categories:

*Land, house, breeding stock, tractors, cars, etc. are tangible assets; and rights to public lands, Native American treaty rights of timber, minerals, water, hunting, fishing, land, etc. are intangible rights.*

**Current Assets** – Cash and other non-capital assets that can be converted to cash during the next year without disrupting the ongoing business.

*The five acres of woodland you never use or a young heifer not ready to breed that you could sell and not disrupt your business.*

**Non-Current Assets** – Assets that serve your business for more than one year. Typically, you would not convert non-current assets to cash during a normal production cycle.

*The land you use for production or the tractor you use for planting that are essential to your operation.*

**Balance Sheets** – A financial record for a certain point in time. Using two columns, you list your assets and liabilities and their worth. Totals at the bottom of each column are suppose to “balance” out. This method is usually used in accrual accounting.

*A list of all you have and what it is worth with assets, such as cash, land, breeding stock, etc. on one side and liabilities, such as seed, beef cattle, etc. on the other. Ideally, the totals from each side balance out.*

**Base Value** – A cost value assigned to an asset that remains the same over time.

*Examples of things that have a base value include: land, well, buildings, etc. Items such as tractors and other equipment do not have a base value because they depreciate.*

**Book Value (Basis)** – The difference between the original cost of an asset and its accumulated depreciation. For example, if you paid \$20,000 for a piece of machinery and have taken \$15,000 of depreciation, it has a book value of \$5,000. This is also referred to as the “remaining cost” or “adjusted cost” of a capital asset. The basis for raised feeder livestock and grain is zero because they are not considered assets.

*The amount an item is worth at that moment. For example, a tractor you bought in 1995 for \$20,000, due to time and use (measured through depreciation), is now in 2004, only worth \$5,000; its book value is \$5,000.*

**Capital** – A general term referring to the financial resources invested in a business. Capital usually refers to assets that have a life beyond one year as in capital assets.

*Examples of capital include: Cash, Land, Unsold grain, etc.*

**Capital Expenditure** – The cash outlay for the purchase of a capital asset, such as machinery, breeding livestock, or land.

*The amount you spend on capital assets such as tractors, balers, land, livestock, etc.*

**Capital Gain or Loss** – The difference between the book value or basis of an asset and the sale price of the asset.

*How much you made or lost on the sale of a capital asset like your tractor, land, baler, etc. If you sell your 1990 tractor that’s presently worth \$5,000 (the book value) to your neighbor who could only afford \$3,500, you have a capital loss of \$1,500.*

**Capital Receipt** – Revenue generated by the sale of a capital asset, such as machinery, breeding livestock, or land.

*Money you receive from the sale of a capital asset. If you sold your 1990 tractor to your neighbor for \$3,000, your capital receipt is \$3,000, even though the tractor was worth \$5,000 and you have a capital loss of \$2,000.*

**Capitalized Asset** - An asset whose cost has **not** been deducted as an expense at the time of purchase or production. Rather, the amount of cost is accumulated in a special capital account and either depreciated or held there until the asset is sold. For raised livestock, the cost that is capitalized is the cost of raising that animal to the point of its use as a capital asset, i.e. as a breeding animal.

*The costs of feeding, housing, and caring for a breeder from calf to breeding age.*

**Cash Basis** – An accounting method in which you record revenue when you receive the cash and expenses when you make the cash payment.

*A record keeping system where Farmer Theo records money spent at the time he bought seeds regardless of when he plants them and records incoming money when he receives payment, regardless of when his neighbor got and ate the vegetables from Farmer Theo’s stand. Most small farm operators use a cash basis accounting system.*

**Cash and Cash Equivalents** – This refers to amounts shown in the Balance Sheet accounts “cash (on hand) or in checking” and “savings accounts and time certificates,” plus the amount of marketable securities.

*Money Farmer Sarah has in her pocket, in the bank, in stocks or bonds, on the dashboard of her truck, inside her mattress, etc.*

**Cash Flow** – The volume of cash transactions occurring in a business. These may be farm and non-farm cash flows into (cash inflows) or out of (cash outflows) the business. A business that will “cash flow” has enough cash inflow to cover the cash outflow on a timely basis.

*Like breathing, but with money – cash inflow is when money comes in for whatever reason and cash outflow is when money goes out for whatever reason. Cash flow can be an indicator for the health of your business; you’d like this to be nice and even.*

**Commodity Credit Corporation (CCC)** – Governmental financing institution created to help stabilize prices for agricultural projects. Administered by the Farm Service Agency with funds allocated by congress.

*Where USDA FSA loans come from.*

**Contributed Capital** – Equity capital in a business that came from owner’s or stockholder’s investment into the business, as opposed to equity that has been earned (i.e. retained earnings).

*Money from mechanic Bob’s business earnings spent on his wife’s, Farmer Daisy’s, hay production.*

**Constructive Receipt** – Income is constructively received when an amount is credited to your account or made available to you without restriction. Income is not constructively received if your control of its receipt is subject to substantial restrictions or limitations. For example, if a farmer’s contract says they he or she has the right to the proceeds from the sale of a crop at any time after the buyer receives the goods, the farmer must include the sale price in the year that the goods were delivered regardless of when the payment was actually received.

*Income is Constructively Receive when the farmer can claim the income, not when he actually does. For example, if your neighbor finally writes you a check in Dec. 2003 for all the produce he bought, but you would like to wait until Jan. 2004 to cash it, you are still obligated to record that income in your 2003 taxes because you could have cashed the check the day your neighbor gave it to you.*

**Debt Capital** – Capital that has to be paid back usually within a certain time period and with interest (i.e. loans).

*Farmer Lucy’s \$10,000 that she borrowed from the bank to expand her goose farm is debt capital. The cost of debt capital would be the interest Farmer Lucy would pay on her \$10,000 loan.*

**Deferred Tax Liability** – The estimated amount of income taxes you would owe if assets were liquidated at the market value shown on the Balance Sheet.

*The amount of taxes Farmer Luke would have to pay if he sold everything, his land, tractor, cattle, everything.*

**Depreciation** – Decreasing the value of an assets to reflect wear, deterioration or obsolescence. Capital assets are expensed over time through depreciation. (IRS Form 4562)

*The 1990 tractor that you bought for \$20,000 over 9 years has depreciated in value to now be worth \$5,000.*

**ACRS** – Accelerated Cost Recovery System

**MACRS (ADS)** – Modified Accelerated Cost Recovery System (more details found on p. 43-44 in IRS Publication 225)

*Both the ACRS and MACRS allow the farmer take depreciation in an accelerated time period. For example if you have a tractor that depreciates in 7 years – you can take it in one year or spread it out through the 7 years. Some suggest that if it is equipment that you use frequently, you want to use accelerated depreciation.*

**Discharge of Indebtedness Income** – If your debts are paid by another person or canceled by your creditors, you may have to report part or all of this debt relief as income. If you receive income in this way, you constructively receive the income when the debt is canceled or paid.

*If Farmer Lucy's goose farm loan of \$10,000 is excused by the bank, she essentially received \$10,000 and will have to pay taxes on that income.*

**Earned Income Credit** – A tax credit meant to offset self-employment taxes and benefit low-income taxpayers and households with children. Income and family size determine the amount of the credit. The checklist on the last page of IRS Publication 596 may be used to quickly determine eligibility for the credit.

*As a tax credit this can decrease the amount of taxes you have to pay. If the credit exceeds the amount of tax you need to pay, you can get a refund. For example, if Farmer Steven has to pay \$257 in taxes, but because he is a parent of two children and makes under \$34,000, he gets a tax credit of \$300 and therefore receives a refund of \$43.*

**Equity Capital** – The owner's claim on the assets of the business (as contrasted to liabilities, which represent creditor's claims on the assets). Owner equity is the difference between total assets and total liabilities calculated on either a cost or market value basis.

*Equity Capital also known as Net Worth is the value of what you have minus what you owe. An example would be land plus buildings plus equipment minus your loans. Farmer Lucy's equity capital would be the total of the market value of her land, geese shelters, and geese, minus the \$10,000 loan.*

**Enterprise** – Any crop, livestock, product and/or service to which resources are devoted. Enterprise examples include corn, tomatoes, goat meat, CSA sales.

*Farmer Cindy grows hogs, watermelons, and tomatoes. Cindy has 3 enterprises: hogs, watermelons, and tomatoes.*

**Enterprise records** – Income and expense information for each crop sold and for every animal raised and sold.

*Farmer Cindy would have three, detailed enterprise records, one for hogs, one for watermelons, and another for tomatoes. This would allow her to track what exactly she is spending and making money on. When Cindy decided to lease another acre of land, she could see that she was making the most profit on her watermelon production and should use that additional acre for more watermelons.*

**Expenditure** – Money you pay for any purpose.

*Example of expenditures include: seed, gasoline, paying someone to bale your hay, the hospital bill from the stitches in your thumb, your child's new tennis shoes, etc.*

**Expense** – Goods and services you use up (consume) in the production of income. An expense may be cash or non-cash. Not all expenditures are expenses.

*Examples of expenses include: seeds, gasoline, paying someone to bale your hay, etc. but would not include personal expenses because they do not contribute to the production of income.*



**Expense Adjustment** – A process to match the expenditures of a period to the period in which the associated revenues are earned. Expense adjustments are necessary to convert cash basis accounting to accrual basis financial statement. For example, the expenditures for fall fertilizer, when paid in the fall of one period, is actually an expenses associated with producing the crop in the next period. Therefore, an expense adjustment is necessary to offset the overstatement of the current period's fertilizer expense.

*An expense adjustment is usually used in accrual accounting. If Farmer Poe buys fertilizer in the fall for his spring crop, he would record the expense of the fertilizer in the spring when he uses it to offset or even out the money earned from the production of his crop.*

**Family Living Expenses** – Household and personal expenses unrelated to the farm business.

*Examples of family living expenses include: grocery bills, home utility bills, payment and gas for your family car, little Bobby's piano lessons, etc.*

**Family Living Withdrawals** – the total amount of money withdrawn from farm and non-farm revenues for personal consumption.

*Farmer Daisy and her husband, mechanic Bob, make about \$53,000 together. They invest about \$5,000 into Daisy's hay production and \$10,000 into Bob's shop, leaving them with \$38,000 for family living withdrawals such as house payments, groceries, and weekend trips to Vegas.*

**Farm Income** – Profit or money generated from the farm business that is available to pay for family living expenses or other financial goals.

*Farmer Steven makes \$33,000 from his farm operation, but has to pay a total of \$23,000 to keep his farm going (i.e. loan payments and other operating expenses) leaving Steven with a \$10,000 farm income.*

**Feasibility** – The ability to meet cash obligations when they become due.

*When Farmer Ben sells a truckload of hogs and has a burst of income, his feasibility is high because he can easily make his loan payments. However come November when Ben's money from the hog sell is low and holiday expenses are coming up, his feasibility is low.*

**Gross Income** – Cash income or revenue from all crop and livestock-related sales.

*Farmer Lynn makes \$45,000 from selling her beef cattle. Even though she has to pay operating expenses of \$15,000 and is left with \$30,000, her gross income is \$45,000.*

**Income** – This term broadly refers to the difference between revenues and expense. For example, income from farm operations denotes the value of farm production minus operating expenses.

*If Farmer Lynn makes \$45,000 minus \$15,000 spent on operating expenses, her income is \$30,000. Plus her husband Bill's \$30,000 from teaching, together they have a \$60,000 income.*

**Income Averaging** – Farmers have the option of income averaging (with their farm income over a 3 year period) as a way to avoid variability in tax payments (i.e. high tax payments in high income years).

*Rebekah had an especially good year with her organic vegetable production; the weather was ideal and prices were up. So she wouldn't pay a load of taxes she elected to income average. Using Schedule J and help from [www.irs.gov](http://www.irs.gov) and the IRS helpline (800.829.1040) she used the farm income from two years ago as her base income. This*

*allowed her to redistribute her income and not require her to pay such a hefty tax bill this year.*

**Income Statement** – This financial statement reflects all revenues, expenses, expense adjustments and taxes associated with net income for a given period of time, usually a calendar year.

*The forms included in this curriculum (Worksheet D) could serve as an income statement.*

**Income Taxes** – Portion of all revenue earned that is owed to federal and state governments annually.

*If you and your spouse made \$40,000 you would most likely pay around 15% in income taxes, which would be \$6,000.*

**Inflows (cash inflows)** – Money received regardless of how it was generated. Inflows include loan proceeds, capital receipts, and cash from selling crops and livestock.

*Cash Inflow is money coming in; examples include: sells of crops or livestock, money for the tractor work you did for your neighbor, the five dollars you won in a bet, etc.*

**Input** – Anything tangible used to produce a crop and/or manage livestock.

*Examples include labor, equipment, seed, chemicals, fencing, fuel, water, etc.*

**Interest** – The expense you incur from borrowing money or the revenue you generate from lending money; the dollar amount paid for the use of money.

*The money you pay to use someone else's money – whether it be the bank's, USDA's, or your neighbor's.*

**Inventory** – Farm products you own, regardless of where they are stored.

*Your inventory is the things you own, your assets – seed, crops, cattle, etc.*

**Liabilities** - The same as debts: obligations incurred by you, which require you to pay money to someone else. Liabilities on the Balance Sheet are classified into the following categories:

*Some liabilities are bills, loans, or the cost of hired labor.*

**Current Liabilities** – Obligations which must be paid during the next 12 months.

**Non-Current Liabilities** – Obligations due after one year of whose original maturity was beyond one year.

**Line-of-Credit Financing (Credit of Money Line)** – A financing agreement whereby you arrange in advance to borrow money up to pre-set limit.

*Your credit card has a line of credit, or maximum you can take your tab at the local hardware store is a line of credit. Your line of credit is usually determined by your feasibility (your ability and likelihood of paying the money back).*

**Liquidate** – To convert to cash, to sell.

*If Jill sold the five acres of woodland she never used, she liquidated that asset.*

**Liquidity** – 1) The ease with which you can convert assets to cash without disrupting an ongoing business. 2) A measure of your ability to meet your obligations as they are due.

*Similar to feasibility. Liquidity is higher if you have more assets to liquidate; Jack with 10 acres of unused woodland has more liquidity than Jill with her 5 acres.*

**Loss** – Negative net farm income

*Daisy (and Bob) spent \$18,000 on her hay operation, but only made \$15,000; she had a loss of \$3,000.*

**Marketable Bonds and Securities** – Stocks, bonds, and other negotiable instruments easily sold on public stock exchanges and bond markets.

*Any stocks or bonds that you own and can sell; if you're using a bond as collateral, you don't have the right to sell it and it would not be marketable.*

**Market Value** – The estimated amount of cash you would receive for selling an asset today, usually a fair market price.

*Jill's 5 acres of woodland was sold for \$100,000. That was the market value; Jill was not desperate to sell it and the buyer wasn't desperate for land, so they were both able to get a fair price.*

**Net Farm profit or (loss) (net farm income)** – The difference between all revenues generated by farm operations and all expenses incurred as a result of farm operations. Off-farm income, interest income, income taxes and other non-farm financial matter do not affect net farm income.

*If Farmer Lynn makes \$45,000 minus \$15,000 spent on operating expenses, her net farm profit or income is \$30,000.*

**Net Income** – The total of net farm income plus net non-farm income after income and social security taxes, but before family living withdrawals. Gross income less all farm expenses.

*If Farmer Lynn makes \$45,000 minus \$15,000 spent on operating expenses, her income is \$30,000. Plus her husband Bill's \$30,000 from teaching, their net income is \$60,000.*

**Net Operating Income** – Another term for “income from farm operations,” which is gross revenue minus operating expenses, before financing expenses (interest) are deducted.

*If Farmer Lynn makes \$45,000 minus \$15,000 spent on operating expenses, her net farm profit or income is \$30,000.*

**Net Operating Loss** – When your farm expenses are more than your farm income for the year, you have a loss. If your loss is more than your other income for the year, you may have a net operating loss. You may also have a net operating loss if you had a casualty or theft loss that was more than your income. (negative figure appears on line 37 of Form 1040).

*Daisy (and Bob) spent \$18,000 on her hay operation, but only made \$15,000; she had a loss of \$3,000. If Bob didn't have a mechanic job that provided supplemental income, they would have a net operating loss.*

**Net Worth** – Another term for equity capital or owner equity. Net worth represents the owner's claim on the assets of the business (as contrasted with liabilities, which represent creditor's claims on the assets). Net worth may be calculated on a cost basis or market value basis: it is the difference between total assets and total liabilities.

*Net Worth also known as Equity Capital is the value of what you have minus what you owe. An example would be land plus buildings plus equipment minus your loans. Farmer Lucy's net worth would be the total of the market value of her land, geese shelters, and geese, minus the \$10,000 loan.*

**Notes Payable** – The amount of money you owe that is evidenced by formal written promises to pay.

*The money Farmer John owes Farmer Daisy for the 50 bales of hay he bought from her. She recorded the sell in a receipt book, giving a copy to John and keeping a carbon copy for herself.*

**Notes Receivable** – The amount of money others owe to you, evidenced by formal written promises to pay.

*The money Farmer Daisy has coming to her from Farmer John for the 50 bales of hay he bought from her. She recorded the sell in a receipt book, giving a copy to John and keeping a carbon copy for herself.*

**Operating Expense** – Expenses incurred in the normal production cycle.

*Examples of operating expenses include: gas for the tractor, seeds, feed for cattle, barn maintenance, marketing, etc.*

**Operating Receipts** – Revenue generated from the normal production cycle. This excludes money received from the sale of capital assets.

*Examples of operating receipts include sales of crops, livestock, custom work, etc. but would not include the sell of the 5 acres of woodland.*

**Outflows (cash outflows)** – all expenditures, regardless of how they were generated.

*Outflows include operating expenses, livestock and feed purchases, capital expenditures such as purchasing land, family living, loan payments, etc.*

**Output** – Total volume and/or value of production measured as crop yield or animal rates of gain, pounds of milk, etc.

*This would be the amount of crop you harvest or the size and number of livestock you can sell.*

**Owner Equity** – Another term for equity capital and net worth.

*Owner Equity also known as Net Worth or Equity Capital is the value of what you have minus what you owe. An example would be land plus buildings plus equipment minus your loans. Farmer Lucy's equity capital would be the total of the market value of her land, geese shelters, and geese, minus the \$10,000 loan.*

**Pension plans** – A retirement plan that many business invest in for their employees.

*You can draw on a pension plan at the age of 59, however for the first few years if you make additional income over a certain amount the IRS may take 40% of that additional income. Being self-employed, some farmers encourage you to put money from your income into your pension plan. This is something you can draw on in the future and a good place to save money.*

**Pre-paid Expense** – Services or products you have paid for but have not yet used up or received.

*Farmer Levi had a good year and brought in quite a bit of income, to offset his income he decided to buy seed and fertilizer that he could use for next year's crop. To be able to claim those expenses on this year's taxes, Levi has to be sure that the total of his pre-paid expenses is equal to or less than half of his total expenses. For example, Levi's total expenses are \$6,000; he buys 4 pounds of seed totally \$1,600 and \$1,000 worth of fertilizer. He has spent \$2,600 on pre-paid expenses; this is less than half of his total expenses (half of \$6,000 is \$3,000), therefore Levi can claim his pre-paid expenses as*

*expenses in this tax year, bringing up his expenses to \$8,600 and off-setting his income. Any pre-paid expense over Levi's \$3,000 would have to be recorded in next year's taxes.*

**Principal Source of Income** – a code from the list of Principal Agricultural Activity Codes (page 2 of Schedule F) is needed on line B of Schedule F

*Although Farmer Cindy has three enterprises: hogs, watermelons, and tomatoes, she increased her watermelon production because that is where she was making the most profit and that became her main source of farm income. On line B of Schedule F she would enter code 111210 for Vegetable and Melon farming.*

**Profit** – Money generated from the farm business after all cash expenses have been paid. Also called “net farm income”.

*If Farmer Lynn makes \$45,000 minus \$15,000 spent on operating expenses, her profit is \$30,000.*

**Retained Earnings** – The amount of net income that has accumulated in a business since it began that has not been withdrawn by the owner or paid out as dividends to stockholders. Retained earnings are a part of total owner equity.

*If Farmer Theo is able to save \$5,000 every year he has been in operation (15 years) he has retained earnings of \$75,000. He could use that money to reduce the amount of borrowing or as collateral since it is considered an asset.*

**Repayment Capacity** – The ability to generate cash to make payments on debts as they become due.

*Very similar to feasibility, when Farmer Ben sells a truckload of hogs and has a burst of income, his has a high repayment capacity because he can easily make his loan payments. However come November when Ben's money from the hog sell is low and holiday expenses are coming up, his repayment capacity is low.*

**Revenue** – Gross receipts from the sale of farm products, services, participation in government programs, and other business operations.

*Total money you have coming in – from sale of crops or livestock, loans, etc.*

**Return on Assets (ROA)** – The percentage rate earned on the total assets invested.

*Interest earned on saving accounts, stocks, bonds, etc.*

**Schedule C** – Federal tax reporting form used by business owners. Also called the “Profit or Loss From Business” form. You would use Schedule C instead of Schedule F if your *principal source* of income is from providing agricultural services such as soil preparation, veterinary, farm labor, horticultural, or management for a fee or on a contract basis, or if you are engaged in the business of breeding, raising, and caring for dogs, cats, or other pet animals.

*Although Jim grows corn and has a few beef cattle, because his main source of income comes from the custom hire work he does, such as baling hay and plowing fields, he should file a Schedule C.*

**Schedule F** – Federal tax reporting form used by farmers. Also called the “Farm Profit and Loss” form. Helps determine your net farm profit or loss.

*Because Farmer Daisy filed a schedule F, she and her husband, Mechanic Bob, were able to report the loss from Daisy's hay production on line 18 of their 1040 form and did not have to pay as much tax on their income.*

**Solvency** – The ability to meet all obligations in the long run. Solvency is evaluated by comparing the value of all assets to the amount of total liabilities.

*Solvency can also be seen as the health of your business. You don't want your liabilities to be more than your assets.*

**Statute of Limitations** - The IRS allows you to go back and amend or change your tax return for up to 3 years.

*After talking to his neighbor, Luke realized he could have counted more expenses than he did on last year's taxes. If he had recorded those costs, he could have received a \$200 refund, but instead he paid \$100 to IRS. Luke has up to 2 years to file a 1040X to get his money back.*

**Valuation Equity** – The portion of total owner equity on a market value basis that has come from an increase in the value of assets above their original cost or adjusted cost.

*How much your business is worth – all your assets, how much money you will make, etc.*

## WHAT TYPE OF FINANCES TO RECORD AND HOW TO DO IT

Simply put, you will want to track money coming in (revenues) and going out (expenses or cost of production). Be sure to save all receipts, invoices, credit card statements, and make copies of checks. Some accountants suggest avoid using cash and pay all your expenses with checks or debit card, therefore allowing you to use your bank statement in double checking your monthly expenses. With that said and to make things a bit more difficult, when tracking your income and expenses, you should look at the money in a more abstract way rather than your tangible dollars leaving your wallet. This is especially true when considering depreciation.

Since you will have receipts, checks, invoices, etc. piling up, you will want to create a filing system that works for you. It may be useful to split your expenses up into categories. In the record keeping sheets included, we've used the categories from the FSA Farm Family Record Book along with each category code (expense distribution codes) needed for FSA loan application forms as well as Schedule F categories and line numbers. These categories along with a few examples are:

Labor Hired ( <i>farm labor, piecework, contract labor</i> )	Livestock Expenses ( <i>veterinary, breeding, medicine</i> )
Equipment Repair ( <i>tractor repair, sprayer repair</i> )	Custom Hire (Machine Work) ( <i>baling hay, plowing field</i> )
Farm Building & Fence Repair ( <i>barn roof, new fence post</i> )	Gasoline, Fuel, Oil ( <i>for farm equipment</i> )
Interest ( <i>from bank loans, car loans</i> )	Taxes ( <i>state, local, real estate tax</i> )
Rent ( <i>land, animals, machinery</i> )	Water Charges ( <i>irrigation charges</i> )
Feed Purchased ( <i>for livestock not for personal consumption</i> )	Insurance (other than personal) ( <i>on farm buildings, equipment, crops</i> )
Seed & Plants Purchased ( <i>for production, not personal use</i> )	Utilities ( <i>water, electricity, telephone for farm</i> )
Fertilizer ( <i>fertilizer and lime</i> )	Supplies Purchased ( <i>livestock supplies such as bedding</i> )
Chemicals ( <i>pesticides, herbicides</i> )	Car and Truck Expenses ( <i>if used 50% or more for farm</i> )
Conservation Expenses (only 25% farm income) ( <i>soil and water, like diversion channels</i> )	Depreciation (form 4562) ( <i>on vehicles and machinery</i> )
Employee Benefit Plans ( <i>health insurance for workers</i> )	Freight and Trucking ( <i>shipping, trucking</i> )
Pension and Profit-Sharing Plans ( <i>retirement</i> )	Storage and Warehousing ( <i>grain storage</i> )
Other Cost ( <i>marketing</i> )	

You could also organize your expenses by month. Using categories to record your expenses allows you to see how much you are spending in a specific area or enterprise, whereas recording your expenditures by month can give you view of your finances in a desired time frame (month, quarter, or year). The record keeping sheets provided here allow you to categorize your expenses as well as track them by month. It may be easiest to label your

file folder/receipt organizing device by categories and make a commitment to tally your expenses and income monthly. Some choose to keep their financial records in a ledger, which is set up more like a money journal. You would record the date, a description of the financial transaction, and the amount of transaction under income or expense. Which ever form you choose, stick to it and include details; it will help you when it comes time to do the paperwork.

Attached are some sheets to help you in your recording efforts.

### **Recording Expenses - See worksheet A**

You can use any system for record keeping, but use it every day.

- ❖ Have a notebook with pockets for receipts - organize them according to the Farm Operating Cost Codes used by USDA - See Cost Codes in Appendix
- ❖ Write down all cash expenses - ask for a receipt
- ❖ Use a credit card for purchases - keep the receipts
- ❖ Use a bank account for farm expenses

### **Recording Income - See Worksheet B**

- ❖ Keep all papers related to sales including product that goes into storage, a warehouse or terminal.
- ❖ Be sure to count the number of items sold (i.e. boxes sold to the warehouse).
- ❖ Copy all checks received.
- ❖ Write down cash sales.

### **Compiling the information for Taxes, Loans and Crop Insurance - See Worksheet C or D**

Worksheet C provides the same categories and codes for expenses that are used in FSA loan applications.

Worksheet D is similar to Worksheet C; in addition to the FSA loan categories and codes, it includes categories from Schedule F Farm Profit and Loss Statement.

## **FILLING OUT THE FORMS...**

As mind boggling as forms can be, there are instructions and books to help guide you through the paper work. The government has put together a book, "Farmer's Tax Guide", Publication 225, to help farmers file their taxes, including the Schedule F form ([www.irs.gov/publications/p225/](http://www.irs.gov/publications/p225/)). It is a great reference if you have in depth questions and want detailed explanations. IRS also has line-by-line instructions for Schedule F ([www.fsa.usda.gov/dafn/forms%20list.htm](http://www.fsa.usda.gov/dafn/forms%20list.htm)) and a helpline (800.829.1040).



## EXERCISES AND EXAMPLES

*Following are exercises and examples that can be used in small groups to help in explaining and understanding some key concepts.*

### ***Claiming Operating Expenses/Prepaid Expenses***

In tax year 2001, Debra, a wealthy watermelon farmer located in the eastern portion of the state of Shock, got wind of a new variety of seedless watermelon seeds being sold, at below market prices, in the western state of Disrepair. In an effort to corner the watermelon market, Debra purchased 2000 lbs of the seedless watermelon seeds in tax year 2001 at a cost of \$4,000. However, the seeds in question would not be planted nor would the crop be harvested until April of 2003 since Debra would be taking time off to learn more about backwoods moon shine production. Debra comes to you and asks if she can deduct the \$4,000 costs of the seeds on her 2001 schedule F. What is your advice to Debra, discuss fully? Explore the difference if Debra is a small farmer or if she farms under a corporate structure and has farm income in excess of \$2.5 million dollars annually.

The following may guide your discussion:

“Farmers who use the cash method of accounting cannot deduct prepaid expenses for feed, seed, fertilizer, or similar supplies beyond half of their total farm expenses (excluding the prepaid amount) until the inputs are actually used. An amount is a prepaid expense if the supplies are not used or consumed during the year. Therefore, although farmers can prepay some expenses to manage their tax liability, the deductible amount of prepaid expenses is limited to half of the total of nonprepaid expenses. An exception, however, allows a taxpayer whose principal occupation is farming to exceed this limitation if (1) the prepayment limitation has been met for the 3 preceding tax years or (2) the excess prepayment is due to a business operations change caused by extraordinary circumstances such as fire, storm, casualty, disease, drought, or government crop diversion program.” (Economic Research Service/USDA p. 17)

### ***Constructive Receipt***

Quinton, a local corn producer, consistently paid the IRS \$46,000 in taxes during tax years 1999 to 2002 as a result of his successful corn production operation. Sick of paying such high taxes, in tax year 2003 Quinton sought out ways to pull a slick one on Uncle Sam by delaying payment for his corn sales until after December 31, 2003. In order to carry out his tax equalization scheme, Quinton entered into the following written agreement with Kiah, a mega purchaser of corn: Kiah agrees to pay Quinton for the purchase and sale of Quinton's corn at any time Quinton demands payment after delivery of the corn is accepted by Kiah. Quinton and Kiah both signed the agreement. On October 31, 2003, Quinton delivered to Kiah corn shipments valued at \$120,000 along with the following note to Kiah, “If you want to buy corn from me in the future, you had better not send my check until February 2, 2004!” Fearful of losing the business, Kiah complied with Quinton's demand, and Quinton did not include the \$120,000 of income on his 2003 schedule F. During an audit, the IRS required Quinton to amend his 2003 return by including the \$120,000 as income in tax year 2003. Knowing that you're an expert, Quinton comes to you to seek your opinion on his chances of overturning the IRS decision. What advice do you give?

The following may be helpful in guiding your advice to Quinton:

“Income is constructively received when an amount is credited to your account or made available to you without restriction. Income is not constructively received if your control of its receipt is subject to substantial restrictions or limitations. For example, if a farmer's contract says that he or she has the right to the proceeds from the sale of a crop at any time after the buyer receives the goods, the farmer must include the sale price in the year that

the goods were delivered regardless of when the payment was actually received.” (IRS Publication 225)

### ***Discharge of Indebtedness Income***

Smith owns and operates a 60 acre sheep farm in west Exus. In 1997 Smith took out state sponsored loans in the amount of \$567,000 to purchase land, equipment and animals. In 1998, Smith became a member of a very large class action law suit instituted to remedy state sponsored discrimination in farm programs conducted by the state of Exus. In 1998, Smith owed \$568,000 on the agriculture loan. As a part of the settlement, the State of Exus agreed to forgive all of Smith’s state sponsored agriculture loans. While having coffee in a local diner, Smith smiled and said to all who were present, “This place is not so bad after all; I just save a bunch of money by becoming a part of that farmer settlement.” Unbeknownst to Smith, a federal IRS agent overheard Smith’s statement and shouted, “I bet you will not be smiling when I tax your butt on the entire debt forgiveness.” Concerned about the IRS agent’s statement, Smith comes to your office and asks if the agent knows what he is talking about. Must Smith report the loan forgiveness on his tax returns?

The following may guide your advice to Smith:

Generally, a transfer of collateral to a lender of an asset or debt write down or debt forgiveness by a lender is treated as income.

Exceptions. – (a) reduction of the purchase price under an installment contract. For example, the seller would reduce the selling price to and calculate the gain or loss on any future payments based on the new selling price. (b) purchases of inputs and accrued interest. For example, if a fertilizer supplier wrote off the bill, the producer would not have discharge of indebtedness income because the producer would have been allowed a deduction for the fertilizer bill if it had been paid. Also, if farmers who have restructured loans with accrued interest in the past and then have debt forgiven may be able to avoid recognizing income for tax purposes. (c) Bankruptcy trustee abandonment of assets. This results in the asset and the associated debt going back to the debtor. The lender may simply take the asset in satisfaction of the debt. However, the borrower is treated, for income tax, as having sold the asset for the value of the loan. Commonly this generates a taxable gain the borrower has no proceeds to pay the tax due.

### ***Casualty and Theft Deductions***

*Use IRS Form 4684 --(Think in terms of Homeland Security)*

For years, Russ, a Texas peanut farmer, had harbored a deep sense of resentment and jealousy towards Lorette and her successful farming operations located just north of Syracuse, NY. Russ’ jealousy intensified when Lorette became the first NY farmer to produce coffee in the United States with the intent to market internationally. During tax year 2001, Russ decided, by use of a depraved and unusually scheme, to teach Lorette a thing or two about competition in the Ag sector. In order to harm Lorette’s coffee production operation, Russ paid Randy, a struggling crop duster, \$8 per acre to fly over Lorette’s coffee crop and disperse a fine aflatoxin mist that would surely kill the coffee plants. Lorette’s future income from the coffee crop would have been \$1.5 million dollars. She did not purchase crop insurance. Lorette would like to know if she can deduct all of her \$1.5 million loss on her schedule F for tax year 2001.

The following may guide your advice to Lorette:

Losses of livestock, plants, produce and crops raised for sale are generally not deductible if you report your income on the cash method. You have already deducted the cost of raising these items as farm expenses. For plants with a reproductive period of more than 2 years, you may have a deductible loss if you have a tax base in the plants. See IRS Publication 225.

Assume that Lorette coffee crop was covered by a valid crop insurance policy in the year in which Randy dispersed the mist. Assume further that Lorette received a payment of \$1 million from her crop insurance agent. Would Lorette be required to report in the crop insurance indemnity on her Schedule F for tax year 2001?

The following may guide your advice to Lorette:

For Farmers who use cash accounting, there is an exception to the general rule that payments must be reported in income for the year in which they are received. If a substantial portion (generally more than 50 percent) of the receipts from the crop would normally be reported in a year following the year of production, reporting of the crop insurance proceeds can be deferred until the following year. That exception applies to crop insurance payments received when crops cannot be planted or are damaged or destroyed by a natural disaster such as a drought or a flood. The exception apparently does not apply where the crop insurance indemnity is due to a low price, such as may occur with the Crop Revenue Coverage (CRC) or Income Protection Plan (IPP) programs. Some payments due to both low prices and low yields may have been made under these programs. Only the portion due to physical loss would be eligible for deferral if the other requirements were met. Insurance proceeds received in the year following the year of damage or low prices must be reported in the year of receipt.

***Reporting income from providing farm services: Schedule C or Schedule F***

Father Randy's crop dusting business continues to sputter along at a steady pace. Crop Dusting is Father Randy's only farm related job. Should Father Randy complete Schedule F or Schedule C? Please Explain.

***Net Operating Losses***

In the year 2001, Frances, an electrical engineer, worked the night shift at a hog processing facility in the western state of Denton. Her salary was \$75,000 annually. During the day, Frances operated her own hog farm, which earned \$175,000 in taxable income during tax year 2001. Frances' tax liability (the amount paid to IRS) for tax year 2001 was \$78,000. In tax year 2003, Frances' hog operation made a turn for the worse. Her operating expenses increased by 30% and the prices for pork went to the tank as a result of cheap imports. In tax year 2003, Frances' hog operation was \$60,000 in the red. Frances knows she can count her losses, but since she paid so much in taxes in 2001, she wants to know if she can apply the losses from 2003 to the 2001 tax year and re-coup some of what she paid. What would you say to her?

This may help:

"A net operating loss (NOL) occurs when business expenses exceed gross income. As mentioned previously, each year about two-thirds of all farm sole proprietors report a net farm loss on schedule F. However, not all of these farms create, nor do all of their losses represent, a net operating loss. Most losses from schedule F are used to offset nonfarm income in the same tax year. Only about 10 percent of those losses become net operating losses, with nearly 100,000 farmers affected. Under current tax law, net operating losses from farming can be carried back 5 years and forward 20 years. Carrying back NOL creates a refund of taxes paid in previous years, while carrying forward a NOL can reduce future taxable income. Farmers receive special treatment for NOL carry-back because other taxpayers are able to carry back losses only 2 year. The longer carry-back period increases both the likelihood of a tax refund and the amount of a potential refund if the NOL is especially large. The NOL rules primarily benefit farmers with large farm losses who do not receive much nonfarm income but who have paid taxes in previous years.

Generally, farms with these characteristics include primary occupation small farms and some limited-resource or retirement farms.” (Economic Research Service/USDA p.22)

*Below are just examples with no exercises.*

### ***Cash vs Accrual***

“Under the cash method of accounting, expenses are deducted in the year they are paid and income is recognized in the year it is received. Inventories of both inputs and products are ignored in determining farm income. This greatly simplifies the record keeping requirement for farmers. However, it also permits individuals to mismatch income and expenses by deducting expenses in the current year and recognizing income that was produced by those expenses in a later year. For some agricultural enterprises, cash accounting can allow large deductions during the early years of an investment and deferred recognition of income by building inventories of the products produced. This can cause the accumulation of larger inventories than would be justified without the tax interaction... Because most farmers are sole proprietors, cash accounting remains the most common method of accounting in production agriculture. This provides the vast majority of farmers some flexibility to prepay expenses and time income receipts to optimize their current-tax burdens. A relatively small number of very large family farm corporations – mostly raising livestock, fruit, or vegetables – are required to use the accrual method of accounting which is the standard method for most nonfarm businesses with inventories.” (Economic Research Service/USDA p.17).

### ***Deducting Fuel Costs***

Farm owner Nancy Blue hired custom operator Harry Steele to cultivate the soil on her farm. Harry used 200 gallons of gasoline that he purchased to perform the work on Nancy’s farm. In addition, she hired Contractor Brown to pack and store her apple crop. Brown bought 25 gallons of gasoline to use in packing the apples. Nancy can claim the credit for the 200 gallons of gasoline used by Harry on her farm because it qualifies as fuel used on the farm for farming purposes. No one can claim a credit for the 25 gallons used by Brown because they were not used for a farming purposes.

### ***Depreciation***

“Expenditures to purchase assets that will produce income over a long period of time are capital expenses and generally must be apportioned over the life that the asset is expected to produce income. This apportionment, known as depreciation, deducts only a portion of the cost each year over the life of the asset and helps match the income generated by an asset to the expense of purchasing the asset as the value of the asset decreases over its usable life. Capital expensing is a faster way of recovering costs by immediately deducting a specified dollar amount in the year an asset is purchased... The capital cost recovery system has a substantial influence on the amount and composition of farm business investment. It specifies the timing of tax depreciation deductions and the levels of investment tax credits, if any. It is therefore a primary determinant of the actual tax burden on income from investment in depreciable farm capital... Most farm assets including many farm structures used in dairy, poultry, and hog production could be written off over 5 years, despite significantly longer economic lives.” (Economic Research Service, p. 18)

### ***Employee withholding***

#### ***International Taxpayer – Foreign Agricultural Workers***

Foreign agricultural workers temporarily admitted into the United States on H-2A visas are always exempt from U.S. social security and medicare taxes. However, the payor is required to report the wages paid to H-2A alien agricultural workers on form 1099 MISC if

the amount paid to the H-2A alien agricultural worker during the calendar year equals or exceeds \$600.00. The only exception to this occurs if the payee neglects or refuses to give the payor an SSN or an ITIN, and if the aggregate annual payments made to this particular payee equals or exceed \$600. Then the payor must do back up withholding on the payment(s) at the rate of 28%. The payor will report the backup withholding on forms 945 and 1099-MISC. The payor who neglects or refuses to do backup withholding when required will himself be held liable for the amount of he backup withholding which should have been withheld from the agricultural employee's wages. (See [www.irs.gov/business/small/international/article](http://www.irs.gov/business/small/international/article)).

### ***Soil and Water Conservation Deductions***

“Examples of expenses have included leveling, grading, terracing, custom furrowing, planting windbreaks, and constructing, controlling, and protecting diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds. The list of potential eligible expenditures includes all conservation expenditures that taxpayers would normally add to the basis of land and deduct for tax purposes when the land was sold. Deductions are not allowed, however, for land not used in farming, for draining or filling wetlands, or for preparing land for center-pivot irrigation systems. Depreciable conservation assets such as pipes, tiles, pumps, and other non-earthen structures are also not deductible, except for some assessments by soil and water conservation districts... Cost sharing is another method that Federal, State, and local government programs use to encourage farmers' soil and water conservation improvements. As an alternative to deducting soil and water conservation expenses, farmers may be eligible to exclude all or a portion of the government cost-share payment from their taxable income.” (Economic Research Service/USDA p. 20)

### ***Weather-Related Livestock Sales***

“Selling livestock because of weather-related disasters can create tax timing problems because unusually large sales may cause marginal income tax rates to increase. A special rule applicable to involuntary conversions allow farmers who are forced to sell livestock due to weather-related conditions (such as drought, floods, and other weather-related disasters) to defer recognizing that income until the following year. To qualify, the farmer must show that, under normal business practices, the sale would not have occurred during the current tax year and that weather conditions caused the area to become eligible for Federal assistance. The gains realized from selling more breeding or dairy livestock than would normally have been sold can also be deferred indefinitely by purchasing similar livestock within 2 years.” (Economic Research Service/USDA p.20)

*Save a little money each month and at the end of the year you'll be surprised at how little you have.* ~ Ernest Haskins

*I'm living so far beyond my income that we may almost be said to be living apart.* ~ e.e. cummings

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