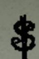
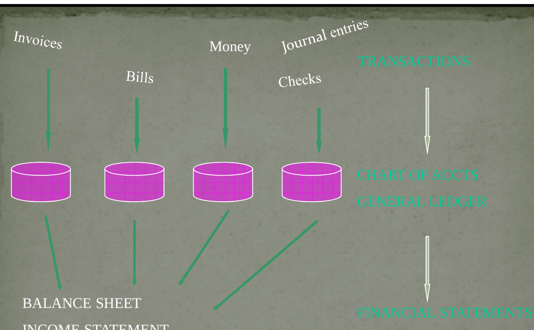
Ranch Accounting and Tax 101

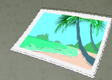
Overview



- Basics of accounting
- Documentation basics
- Choosing an accounting system
- Common tax issues
- Get an advisor!!!

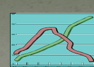


The Balance Sheet



- "Snapshot" of your financial position at any point in time.
- Assets-what the Ranch owns
- Liabilities-what the Ranch owes
- Equity-what would be left to you if all of your creditors were paid off.
  - Assets – Liabilities = Equity
  - Ex. Value of your home – value of your mortgage = your homeowner's equity.

The Income Statement



- Revenue and expenses for a period of time
  - Income statement: "I made $xxx this <u>month</u> or this <u>year</u>"
  - Balance sheet: "I have $xxx in the bank today"
- Revenue-income that the Ranch earns
- Expenses-what the association spent or incurred
  - Some items are "non-cash" expenses, like depreciation.

ACCOUNTS RECEIVABLE

- Money that is owed to the Ranch
  - Sale of livestock or hay on credit to someone.
- When you can't collect a payment
  - Write-off to expense!
  - No use in paying tax on what you can't collect.

Inventory

- Things that you own that you intend to resell
  - Raised livestock (not breeding livestock)
  - Baled hay
  - Stored crops
- The cost of these items is added included on the balance sheet until they are sold.
- The costs of inventory are considered an <u>asset</u> until they are sold.

Inventory sale - example

- Example:
  - Breeding costs - $300
  - Vaccinations - $100
  - Indirect costs per calf (feed, supplies, etc.) = $200
  - Total cost of calf included in inventory = $800
- Calf is sold for $1,000

Gross sales	$ 1,000	
Cost of sale	(800)	*reduces inventory, increases cost*
Gross profit	$ 200	

FIXED ASSETS

- "Things" the Ranch owns, has title to, and can sell
- Computers and office equipment
- Barns, buildings, fences, wells
- Vehicles, trailers, tractors and equipment
- <u>Breeding</u> Livestock
  - Really?!?!?!

*

Fixed Assets

- Repair vs. purchased asset
  - Use common sense!
  - Replace damaged shingles on a roof {repair – expense}
  - Replace entire roof {asset – capitalize and depreciate}
- Depreciation - the method of offsetting your fixed asset costs against your income.
  - Straight-line depreciation – the “expense” is allocated even across how long you expect to use the asset.
    - Tractor – useful life of 7 years
    - Cost - $21,000
    - Every year for the next 7 years you would reduce the value of the asset on the balance sheet by $3,000 and increase depreciation expense on the income statement by $3,000.

Liabilities

- What you owe others
  - Bills for utilities, feed, etc.
  - Amounts owed but not paid to employees or contractors for work performed
  - Mortgages and other notes payable
  - Deposits by customers for livestock or other products to be received in the future.
- When you incur a liability
  - Cash, fixed assets, or inventory is increased
  - Liability balance on your balance sheet is also increased
  - Payments on a note or mortgage are <u>not</u> an expense, but a reduction of what you owe someone else!
    - Exception: the interest portion of your payment is an expense.

Equity & Retained Earnings

- Life to date net income or loss of the Ranch
  - Each year the current income or loss is added to prior year balance
  - Example
- Checks written to owners are not “expenses” and cannot be deducted as such.
  - They are a decrease in the owner’s equity in the ranch.
  - Exceptions for corporations or partnerships.

Example of Basic Financial Statements

Assets		
Cash in bank	$	5,000
Accounts receivable		2,000
Stores crop/baled hay		1,500
Land		300,000
Buildings and fencing		75,000
Computers & furniture		3,000
Tractors and equipment		30,000
Vehicles		20,000
Breeding Stock		15,000
Accumulated depreciation		(40,000)
TOTAL ASSETS	$	411,500
Liabilities and Equity		
Accounts payable	$	1,500
Credit cards payable		800
Payroll taxes payable		600
Deposits received		2,000
Notes payable		20,000
Mortgage payable		280,000
Total Liabilities		304,900
Retained earnings		156,600
Owner distributions		(50,000)
Total Equity		106,600
TOTAL LIABILTIES & EQUITY	$	411,500.00

Income Statement		
Income		
Sales of cattle/hay		100,000
Cost of cattle/hay sales		(60,000)
Gross profit		40,000
Expenses		
Bad debts		2,000
Fertilizers		800
Feed		3,000
Gasoline and fuel		2,000
Insurance		2,000
Interest expense		18,000
Payroll costs		
Wages		5,000
Contract labor		2,000
Payroll taxes		383
Repairs & Maintenance		2,000
Supplies		600
Property Taxes		1,500
Total expenses		39,283
NET INCOME (LOSS)	$	718

Selection of Accounting Software

- Software packages greatly aid in the recordkeeping function
  - Increase efficiency of reporting and profitability analysis
  - Allow better substantiation of costs
- Some include the ability to attach electronic documentation support to the "checkbook" transaction.
- Common applications
  - Quickbooks by Intuit (not Quicken)
    - Select Farm/Agriculture when setting up Chart of Accounts for the first time.
  - Peachtree by Sage
  - Ranching and Farming specific applications
    - Numerous options with varying price ranges and application.

Documentation

- One of the primary reasons that tax deductions are denied to taxpayers is lack of appropriate documentation!
- Every expenditure for the ranch should have a invoice or receipt showing what was purchased. This applies to both checks and credit card purchases.
  - If the purchase is non-descript, make sure that you write what is was for on the documentation.
  - If checks are printed, staple this documentation to the check stub.
  - If checks are hand written, be sure to write the check number and date paid on the documentation.

Documentation, Cont.

- Handwritten notes do not constitute a substitute for adequate documentation.
- Proper support should detail:
  - Date of the transaction
  - Parties involved
  - Product or service that was exchanged
  - Quantity of product or service that was exchanged
  - Total amount
- Be especially careful about documenting expenses paid to related parties.
  - Reasonable and necessary
  - Inline with fair market values

Documentation, Cont.

- Carefully document and record non-cash or "in-kind" expenses.
  - Loans repaid with labor or goods.
  - Use of ranch assets as repayment for services or goods
- Be sure that there is not an "income" factor as well
  - Barter, or exchange or one set of goods or services for another

Documentation, Cont.

- Vehicle mileage logs
  - Keep a detailed log of the mileage driven on any vehicle used for ranch purposes.
  - At a minimum, include:
    - Where driven to
    - Whether trip was business or personal
    - Beginning odometer reading
    - Ending odometer reading
    - Subtotal miles driven during the trip
- Employee documentation

Introduction to Farm Taxation

- Reporting Farm Income and Expenses
  - Ranch income and expenses are primarily reported on the Schedule F.
  - Overview of the Schedule F
- Further details regarding reporting schedule F income and loss can be found in the IRS Publication 225, *Farmer's Tax Guide*
  - http://www.irs.gov/publications/p225/index.html

Tax Depreciation

- Calculated using the MACRS system, which is more accelerated in deducting depreciation than straight line depreciation
  - Assets encounter the most wear and tear in the first few years of use.
- Taxable lives are set by the IRS. Examples:
  - Cattle, breeding or dairy – 5 years
  - Horses < 12 years old – 7 years
  - Horses > 12 years old – 3 years
  - Equipment – 7 years
  - Vehicles – 5 years (subject to certain limitations)
  - Computers – 5 years
  - Land improvements – 15 years
  - Farm equipment, including grain bins and fencing – 7 years
  - Farm buildings – 20 years

Tax Depreciation, Cont.

- Special depreciation
  - Sec. 179 depreciation – allows the entire cost of purchasing an asset to be deducted in the year of purchase.
    - Subject to income limitations
      - Can only reduce income to zero
      - Deduction "phases out" when income exceeds $800,000
    - Restricted to certain assets
  - Sec. 168(k) "bonus" depreciation
    - Allows deduction of additional depreciation
    - Income limitations do not apply
  - Different rules apply to special depreciation for assets inside an entity (i.e. an S-Corporation or partnership)

Wages: Employee vs. Contractor?

- Consideration has to be given to whether a worker is an employee or a contractor
  - How is the worker paid? Is there a consistent relationship?
  - What degree of control does the worker have over the work being performed?
  - Does the ranch or the worker bear the financial responsibility of business aspects of the job (i.e. tools, supplies, etc.) ?
  - Additional employee benefits exist with wages?
- If an employee, the ranch is responsible for withholding payroll taxes from the employee's wages, matching those taxes, and paying unemployment taxes.
  - Common error among employers, and a costly one.

Other Payroll Issues

- Other income inclusions (these must be included on the employees W-2):
  - Personal use of ranch vehicle.
  - Payment of housing, food, or gasoline as part of work agreement.
    - Per diem costs for short-term work are excluded
  - Free use of ranch assets
  - Other non-cash benefits provided as part of agreement to work.
- Remember – whether the worker is an employee or a contractor, there is still an annual information return filing requirement.
  - Contractor – 1099s
  - Employee – quarterly 941 payroll tax returns, annual W-2s

Special Tax Provisions – Hobby Losses

- Tax definition of Farmer/Rancher – based on the raising or growing of an agricultural or horticultural product.
  - Not sufficient to merely sell or process an agricultural product; it is generally necessary to participate in the process.
- Hobby – "activity not engaged in for profit"
  - Schedule F losses have frequently been disallowed as "hobby losses"
  - Most frequently raised as question against horse breeding and showing and cattle-raising activities.

Special Tax Provisions – Hobby Losses

- Questions to ask:
  - Legitimate profit or gain motive?
  - Complete and accurate books and records maintained?
  - Prior expertise in the business?
  - Seek advice from qualified advisors?
  - Devote substantial time to the activity?
  - Employ others to carry on the activity?
  - Reasonable expectation of asset appreciation?
  - Taxpayer previously turned an unsuccessful business into a profitable one?
  - Losses attributable to unusual circumstances?
  - Taxpayer lack substantial income from other sources, such that farm income is meaningful part of overall income?
  - Profit substantial in relation to losses and taxpayer investment?
  - Profit motives outweigh any elements of personal pleasure or recreation associated with the activity?

Special Tax Provisions – Hobby Losses

- Safe Harbor
  - Must show a profit three out of the five years
  - However, losses for the other two years cannot be substantial in relation to the income shown in three years.
- Other considerations
  - Considering the costs of the cattle or horse activity compared to the costs of carrying the real estate, where the land is held with the intent to profit from increase in its value.
  - The farming activity and the holding of land may be considered as one activity as long as the income from farming exceeds the deductions attributable to farming activity which are not directly attributable to the holding of the land.

Special Tax Provisions – Hobby Losses

- What if you <u>do</u> have a hobby loss?
  - Do not include expenses on Schedule F which can be included elsewhere.
    - Real estate taxes, mortgage interest
  - Offset income with remaining farm expenses in order to bring net income to zero.
- Consider putting the farm into a S-Corporation or Partnership

Special Tax Provisions – 5 year Carryback of Net Operating Loss

- Special tax rules allow significant losses to be "carried back" to prior tax years where taxable income was shown. This generates a refund of the tax paid in the prior years.
- General NOLs can only carryback for 2 years. However, farming losses can be carried back for up to five years.
- The carryback is limited to the lesser of the NOL if only items attributable to farm income are taken into account or the regular NOL for the tax year.
  - Including regular business NOLs.
  - Any regular business NOLs must be separated from farming NOLs for purposes of the carryback.

Special Tax Provisions – Deferring Income due to Drought Losses

- Due to significant drought losses, special provisions exist which allow income from the forced sale of cattle to be recognized in the next year.
- Conditions:
  - Forced to sell livestock early due to drought, flood, or other weather conditions.
  - Sale would not have occurred in the current year if not for the weather conditions.
- The income deferred to the next year is the gain attributable to the excess of the number of livestock sold over the number that would have been sold.

Special Tax Provisions – Deferring Income due to Drought Losses

- Alternately, instead of claiming the income in the subsequent year, the taxpayer can elect the "involuntary conversion" rules.
  - No income recognized if purchase of cattle to replace those sold occurs within four years.
  - If replacement does not occur within four years, the tax return must be amended and re-filed.

Get a good CPA advisor!

- Being proactive in discussing issues with your CPA can save you tax dollars.
- Many problems can be avoided!!!
  - Always better to ask
  - If you do get into trouble…

- What to look for in a CPA
  - Knowledge of your business
    - Farm and ranch business is a unique industry. An advisor who doesn't understand your operations is not in a position to give you the best advice!
    - What is the composition of their farm and ranch client base?
  - Service model – what do you need?
  - Professional reputation
    - Ask around! A good advisor is never concerned about inquiries into their reputation.

Questions?

Megan Terrell, CPA
Megan.Terrell@sbf-cpa.com

Sanford, Baumeister & Frazier, LLP
512 Main St. Ste 1500
Fort Worth, TX 76126
817-877-5000 ext. 320