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## Year-end Tax Management for Farmers

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# Economics Newsletter

Economics Department

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## YEAR-END TAX MANAGEMENT FOR FARMERS

Tax management at the end of the year is limited in scope. It consists primarily of timing transactions between two years in order to avoid extreme fluctuations in income. The timing of transactions can play an important role in the short run but we should not overlook the fact that complete tax management is a continuous process. In the long run, tax management involves much more than just timing transactions. It involves all farm management decisions that affect net income after taxes.

### Good Records are a Necessity

Wise tax management decisions depend upon good records carefully kept through out the year. Such records permit one to make a preliminary estimate of taxable income before the close of the year. If taxable income is expected to be unusually high a decision may be made to delay additional sales until after the end of the year or make additional purchases before the end of the year. Conversely, if an estimate reveals an unusually low net income, sales may be speeded up to include them in the current year's income and expenditures may be postponed until the next year.

### Cash vs Accrual Accounting

Under the accrual method any unsold produce or unused supplies are included in the year's ending inventory. The accrual method of accounting credits the farm business with income in the year in which it is earned (accrued to the bus-

iness). The cash method permits postponing credits or debits to the farm business until a cash transaction is made. For example, suppose \$500 worth of feed is purchased on December 15. The purchase is charged and the feed delivered to the farm. The farmer receives a bill for the feed in January and pays the bill at that time. With the cash method this is a farm expense in January when the bill is paid. With the accrual method the \$500 expense is a deduction in December when the obligation to pay was incurred or "accrued".

### Year-End Deductions

Payment of many farm expenses including taxes, repairs, fuel bills, supplies and feed for livestock may frequently be postponed until next year or paid in the current year, depending upon the income situation. However, care should be exercised in making year end purchases to be claimed as deductions. The Internal Revenue Service may challenge any deduction that is not an "ordinary" and "necessary" expense. Payment for feed supplies to be delivered in 1973 may be considered an ordinary and necessary expense if it does not take the form of a deposit on account. Proof of obligation to accept and pay for the feed on order is required. This may be done by taking delivery on the feed in the current year and signing a written and binding sales ticket that does not permit refunds or accept the payment as a deposit "on account".

### Depreciation

Machinery purchases made in high income years may also help to increase deductions on taxable income. At the end of the year a decision must be made as to what rate of depreciation is to be claimed on new machinery purchased. Higher or faster rates of depreciation will increase the deductions that may be made this year but it will decrease the amount of depreciation that can be taken in later years. Decisions on choosing a method of depreciation must relate the expected future income pattern to the amount of depreciation that will be available over the years. If more depreciation is to be taken now, rather than later, it may be done by choosing either the declining balance or sum-of-the-digits method. In addition one can take the 20 percent first year write-off depreciation and also take advantage of the 10 percent salvage rule.

Additional tax advantages from new capital purchases may be realized through investment credit. The credit applies to most tangible personal property, on-the-farm improvements, machinery and certain livestock. This was discussed in the last Economics Newsletter.

### Deferred Income

If taxable income is expected to be unusually high in 1972 it may also be possible to defer product sales until 1973. Actual postponement of the sale creates no problem but difficulties could arise if a deferred sale contract is used. Such a contract would be used if one desires to sell at present prices but not receive payment until 1973. Tax counsel would be advisable in structuring such a transaction to the satisfaction of the IRS.

Under the new tax law crop insurance proceeds may now be reported in the year following the year of loss if it can be shown that income from the damaged crop would ordinarily be received in the year following the year of production.

### Summary

This newsletter has attempted to enumerate a few of the year-end tax management considerations. For a more detailed discussion, a copy of Income Tax Management for Farmers can be obtained through your county extension office or by writing to Bulletin Office, South Dakota State University, Brookings, South Dakota 57006.

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