Introduction to Farm and Ranch Taxes

Lesson 2: Records Training

UNIVERSITY OF ARKANSAS
School of Law

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This presentation is intended to provide general information on agricultural income tax issues and should not be construed as providing legal advice. It should not be cited or relied upon as legal authority. State laws vary and no attempt is made to discuss state specific laws. For advice about how these issues might apply to your individual situation, consult an attorney.

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Program Overview

1. Filing: Federal Income Tax Filing Requirements
2. **Records: Recordkeeping Requirements** <- We are here.
3. Taxes: Individual Federal Income Tax Return
4. Entities: Business Entities and Federal Tax
5. Agricultural Income: Special Rules

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Overview of Lesson 2: Records Training

A. General records requirements

B. Requirements for records related to business items

C. Special requirements:

- C1. Assets
- C2. Travel, Gifts,
- C3. Supplies, and Value-Added Inventory

D. How long to keep records

E. Financial record keeping methods and practices

F. Options for preparing your income tax returns

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A. General Records Requirements

The need to substantiate claims made on an income tax return

The IRS requires you to have evidence sufficient to demonstrate that the statements on your income tax returns are true and accurate.

The rules for what kind of evidence you need to have include general rules and special rules for certain types of transactions.

Requirements for records related to filing status and dependents

- You may need documents such as birth certificates and proof of residence to show that you are entitled to claim a particular filing status or take an exemption for a dependent.

Requirements for records for income reported on an individual income tax return

If you have wages, dividends and interest, an interest in a partnership, LLC filing as a partnership, or an S-Corp, or disbursements from pension or retirement funds you should receive a notice of those earnings. You may also receive notice of other types of earnings including payments from the USDA.

- Wages -> W-2
- Gambling winnings -> W2G
- Other earnings -> Form 1099
- Share of partnership, LLC filing as partnership, or S-Corp earnings -> K1

The IRS will receive the same notice at about the same time.

The notice you receive is usually sufficient evidence to document those items of income.

Requirements for records for itemized deductions reported on an individual income tax return

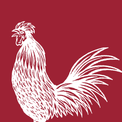
Itemized deductions are not the same as business deductions.

The IRS Form 1040 has lines for various items of income totaling to your Adjusted Gross Income or AG.I Your net business income is one item among many that makes up your AGI.

You may deduct from AGI either:

- The Standard Deduction amount (from the IRS tables)
- Or itemized deductions you detail on Schedule A.

B. Requirements for records related to business items



Basic requirements for business records

- You must keep business records related to all items of income and expense for any business or rental income reported on Schedule 1.
- If you report additional items of income on Schedule 1, keep records proving the amounts reported for three years after you file your return.

Basic requirements for business records - income items

The following are examples of minimum required documents to prove income items:

- Checking and savings account statements
- Receipts from sales showing if the sale was paid in cash or "on account" meaning the customer will pay later
- Records showing amounts received from sales made "on account"
- Records of bad debts or amounts sold on account but never paid

Basic requirements for business records - deductions

- The IRS is generally concerned with over-stated deductions. However, you may be asked to prove you have not underreported expenses.
- You are required to take deductions for all the expenses that are rightfully associated with the business income you report.
- It is not enough to prove that an expense was incurred or paid, you often need additional records to show how the expense relates to the business.

Example of records needed to substantiate business expenses

- *You go to a farm supply store and buy bulk seed and fertilizer.*
- *You go to an all purpose store (Target, Walmart) and buy cleaning items and office supplies.*

What business expenses may be deducted?

- You may, and in fact you ***must*** deduct expenses that are ordinary and necessary and reasonable for your business.
- You must be able to show evidence that:
  1. The transaction actually occurred,
  2. It was for the amount claimed, and
  3. That it was for the business purpose claimed.

C.1 Special requirements for transactions involving assets

What are depreciable assets?

- Depreciable assets are things that have lasting value to the business and have an “ascertainable useful life in excess of one year.”
- Assets are not expensed (deducted) when purchased. Instead you take a “depreciation deduction” using special forms that are part of your tax return.

Special treatment of animals

- Breeding and working animals are assets and are depreciated
- Animals held for sale are typically not treated as assets even though you may own them for more than one year.

Special requirements for transactions involving assets

- You should keep a detailed list of all the depreciable assets used in your business.

Show:
1. Description
2. Purchase date
3. Purchase amount
4. Depreciation deduction taken each year
5. Date sold or taken out of service

Special requirements for transactions involving assets

- When you sell an asset the income is not part of your business income, it is reported separately as Capital Gains Income.
- Capital Gains are taxed at a lower rate than self employment income.
- Capital Gains Income is:

Gross sales price Less your basis in the asset Less costs of the sale

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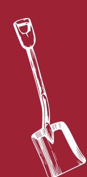
Equals: Capital Gains Income

(or Loss)

C.2 Travel, meals, gifts



Vehicle - related deductions

- There are two methods for calculating vehicle-related deductions: Actual and Mileage.
  1. Actual method allows you to take a depreciation deduction to recover the cost of the vehicle and to deduct all fuel and maintenance expenses - but you have to keep records of all the miles driven showing the business purpose of the trip AND you must also keep all of the receipts for fuel and maintenance.
  2. The Mileage method allows you to calculate your deduction by multiplying the IRS mileage rate (published at least annually) by the business miles driven.

Travel Expenses

- You may deduct travel expenses that relate to conducting your business including ordinary and necessary expenses associated with traveling to do the ordinary and necessary activities of your business.
- The key documentation you need, in addition to receipts, is something to substantiate the business purpose of the trip.

Special requirements to substantiate business meals expenses

- You may take a deduction for a business meal if the primary purpose of the meal is to conduct business or further some purpose of the business.
- You may take a deduction for meals eaten while traveling away from your "tax home."
- You must be able to substantiate the business purpose of the meal. You may compensate your employees for their meals and incidental expenses when they are away from your tax home, traveling for you on work.
- Provided you have written documentation showing the business purpose of the trip and the date and place of the trip, you do not need to include the value of the payment to the employee in their taxable W-2 wages or pay payroll taxes on that amount.
- Business meals deductions are limited to 50% of the actual amount or the amount on the GSA table.

Special requirements to substantiate meals provided to employees

- If you provide meals to employees for YOUR convenience (yours not theirs) then those meals are deductible subject to the 50% limitation for meals.
- Further, the value of the meals provided to your employees is not included in their taxable wages.
- You must be able to document that the meals were provided for your convenience.

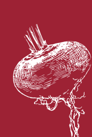
Special requirements to substantiate business gifts

- As long as you can make the connection between the person receiving the thank you gift and a legitimate business purpose (including promoting your business to potential customers) you may deduct business gifts of up to $25.00 per recipient.

Is it entertainment or something else?

- Entertainment expenses are not deductible.
- There are two important examples of ordinary and necessary business expenses that are fully deductible, but may look like entertainment:
    1. Promotional events for customers
    2. Recreational, team-building, or appreciation events for employees

C.3 Supplies, and Value-Added Inventory



Special requirements when you have business supplies on hand at the end of the year

- Generally you deduct the cost of materials and supplies you consume and use in your business during the tax year, but often you have some left at the end of the year.
- If you keep no records of how much of the supplies you have on hand and how much you use, you may deduct the full cost in the year it is paid.
- If you keep any records that show inventory on hand and inventory used there is a general rule for all taxpayers, and a special rule for farmers.

Special requirements when you have business supplies on hand at the end of the year

Special rule for prepaid farm expenses (feed, seed, fertilizer, or other similar farm supplies): Your deduction is capped at 50% of your total other farm expense deductions unless one of the following is true:

1. 50% of other expenses exception
2. 3 year total rule

AND one of the following apply:

- principal residence is on the farm
- principal occupation is farming
- taxpayer has a family member who lives on the farm or whose principal occupation is farming

No deduction is allowed if the payment is only a deposit, and the supplies must be intended to be used in the business within 12 months.

Special requirements when you have value added inventory

- If at the end of the tax year you have value added inventory intended for sale you may not be able to deduct all of the costs you incurred in order to have the inventory.

D. How long should you keep records?

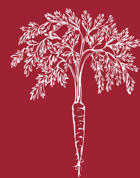
How long should I keep records?

- Keep most records for 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later, if you file a claim for credit or refund after you file your return.
- Keep employment records for four years.
- Keep records for 7 years if you file a claim for a loss from a bad debt.
- Keep records related to depreciable assets as long as you keep the assets.
- Keep records related to asset sales for three years after the sale.
- Keep records related to land for as long as you own the land and seven years after the sale of land.

Exceptions to records requirements

- You have the right to take deductions based on a "reasonable reconstruction of expenditures" if your original records are lost due to circumstances beyond your control such as theft, fire or flood.
- If records are incomplete due to the taxpayers own negligence but the taxpayer can demonstrate that some expenses were actually incurred the taxpayer is entitled to some amount of deduction, but the amount will be limited to the smallest amount reasonable

E. Financial record keeping methods and practices



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Financial record keeping methods and practices

- You are required to use a method that **clearly and accurately** reflects your gross income and expenses and allows you to report asset purchase and sales separately from other business transactions.

Ok for a very small operation in its first year of operations

- Keep sales and purchase receipts, sort them into groups corresponding to categories on the tax return.
- You can give these receipts to a tax preparer or, total each grouping and report that number if you prepare your own return or use a computer program to help you prepare your own return.

Works ok in some small operations but inefficient and usually inaccurate

- Use paper or a spreadsheet program to create a register showing date, payee or payor, amount and purpose of each transaction and code each transaction to an appropriate category on the tax return.
- You can give this register to a tax preparer to total but they may make mistakes and they will charge you for that time.
- You can total each grouping yourself if you prepare your own return.
- You can give this register to a bookkeeper to input into a double-entry bookkeeping system - but there are more efficient ways to get the bookkeeper the information they need. (More on this in a minute).

Work well in some small operations but likely to be inefficient and inaccurate

- Use a simplified manual or computer-assisted bookkeeping system such as the products offered by Dome.

Standard best practice is using a double-entry bookkeeping

- Use a double-entry bookkeeping system to record all of your transactions.
- A double-entry bookkeeping system relies on a simple mathematical formula and two fundamental financial statements: the balance sheet and the income statement (also called the profit and loss statement or P&L).
- Each transaction is recorded in a way that keeps the balance sheet and income statement mathematically balanced, this increases the accuracy and utility of what you record.

Standard financial statements

- A balance sheet shows all of your assets (cash, accounts receivable and equipment) and your liabilities (accounts payable, other debts owed). The difference between all your assets and all your debts is your equity, or the value of your ownership in the business.
- An income statement (also called a P&L or Profit and Loss statement) shows your income and expenses.
- One of the benefits of a double-entry bookkeeping system is that producing these two reports is the main function of the bookkeeping system - and these are the reports you need to manage your business and to prepare your tax returns.

Additional standard bookkeeping practices

- The most important bookkeeping activity besides entering transactions in the bookkeeping system is performing a monthly reconciliation of all bank accounts and credit card accounts. This is an activity a bookkeeper can do for you or teach you how to do for yourself.
- Another important part of bookkeeping is maintaining all of the source documents that were used to generate the entries into the bookkeeping system.

F. Options for preparing your income tax returns

Options for preparing your federal income tax return

- Filling in the IRS forms using a pen or pencil or a fillable pdf.
- Having your tax return prepared at a Volunteer Income Tax Assistance (VITA) clinic

Options for preparing your federal income tax return

- Using tax preparation software like Turbo Tax or H&R Block.
- If you have a fairly simple business and cannot find a tax preparer who you want to work with, this may be a good option.

Options for preparing your federal income tax return

- Using an Enrolled Agent (EA) including a tax preparation service like H&R Block or Jackson Hewitt.
- This can be a good economical option and a good option if you are not comfortable using tax preparation software yourself or if you are unable to find or afford a CPA.
- Many EAs also provide bookkeeping services if you do not keep your records in a way that allows you to summarize your income and expense and asset-related transactions into standard categories.

Options for preparing your federal income tax return

- A Certified Public Accountant is the best option if your records are in good order and:
  - You have a partnership or an LLC with more than one owner
  - You and your spouse farm together and both of you want to pay into Social Security and Medicare
  - The year you buy a house or a property where you will farm or ranch
  - Any year you have substantial asset purchases or sale,
  - You have or plan to have orchards or vineyards,
  - You have value-added activities such as making wine and cheese
  - You want to decide if you should file taxes as an S-corporation
  - The first year after you marry or divorce
  - You want to explore your best options for saving for retirement or college
  - You want advice on purchasing or financing a significant new asset
  - You want help with bringing on a new business partner or selling your business
  - You are creating an estate plan

Questions?

Thank you!

How do I learn more about federal income taxes and my farm or ranch?

There are a total of five lessons in this series. For each lesson there is a short set of questions you can answer to help you decide if the training will be useful to you.

You can access the questions and the trainings at: https://law.uark.edu/academics/llm-food-ag/llm-projects-agftap.php

Additional Project Resources are available here: https://agftap.org/

How do I learn more about federal income taxes and my farm or ranch?

- IRS Publication 225, The Farmers Tax Guide
- RuralTax.org
- IRS website and publications