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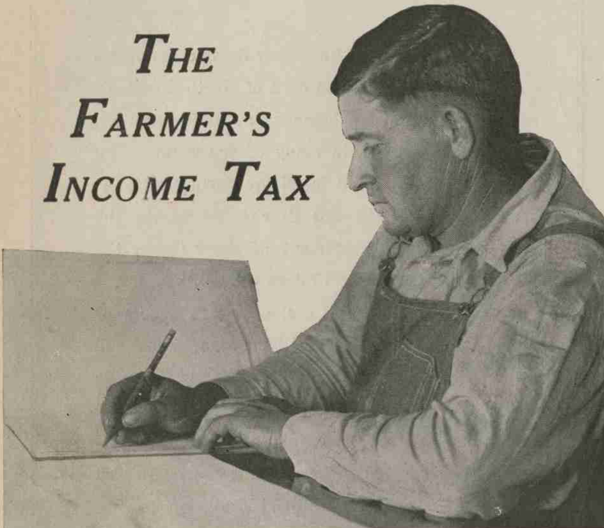
THE FARMER'S INCOME TAX



NORTH CAROLINA STATE COLLEGE OF AGRICULTURE AND ENGINEERING
OF THE
UNIVERSITY OF NORTH CAROLINA
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The Agricultural Extension Service maintains a county farm agent in each of North Carolina's 100 counties and a home agent in 94 counties. They are assisted, in many of the counties, by assistant agents and by Negro farm and home agents. The Extension Service represents the United States Department of Agriculture, the North Carolina State College of Agriculture and Engineering, and the local county. Farmers or other members of the rural family may secure full information about the Nation's War program as it relates to the farm family by discussing the matter with these county agents. Bulletins, printed material, and other information may be secured by writing to the Agricultural Extension Service, North Carolina State College, Raleigh, N. C.

Information for North Carolina Farmers on Federal and State Income Tax Returns

By

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The purpose of this publication is to give North Carolina farmers some information that will aid them in making Federal and State income tax returns for 1942. The information presented here is believed to be correct. However, it should not be used as a substitute for a careful reading of the instructions printed on the income tax blanks or for consultation with Federal and State income tax officials. The authors believe this publication will be helpful in making Federal and State income tax returns, but they assume no moral, financial, or legal responsibility for action based on their interpretations or suggestions. Such responsibility must rest with the individual.

The information in this publication deals with the usual situation that will be found in making an income tax return. Many unusual items will occur in the individual farm business. In such cases, the farmer should consult an income tax official and decisions concerning such items should be based on their judgment.

Copies of this publication may be obtained by residents of North Carolina at the offices of county agricultural agents or from the Extension Service of the North Carolina State College of Agriculture, Raleigh, N. C.

The Federal Income Tax[3]

1. Who must file a Federal income tax return?

A single person with a gross income of at least $500.

A married person living with husband or wife, or a head of a family with a gross income of at least $1,200.

2. What is meant by gross income?

Gross income includes all the receipts of the farmer from

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both farm and non-farm sources and also the value of merchandise received in exchange for farm products. Gross income does not include income exempt from tax by law.

3. What is meant by net income?

Net income is that part of the gross income remaining after certain deductions permitted by law, chief of which are business expenses, have been made.

4. Does every person filing a return pay a tax?

Not necessarily, his personal exemptions may equal his net income, or the deduction of business expenses may leave a net income less than the amount of the personal exemptions, or may even absorb the entire gross income.

5. When is the return due?

Two and one-half months after the close of the year covered by the return. This will be March 15 for most farmers, who will use the calendar year. Some farmers will find it easier to think in terms of a "farm year." The regulations permit the use of almost any 12-months period that fits the needs of the business. But once a fiscal period is established it must be used for all succeeding annual returns unless special permission to make a change is obtained from the Commissioner of Internal Revenue.

6. Where can income tax blanks be obtained?

The individual Income Tax Return (Form 1040) and the schedule of Farm Incomes and Expenses (Form 1040-F) can be obtained from any collector of internal revenue. In addition, these forms are usually available at banks, post offices, and similar places. In filing a return, a farmer must use Form 1040 whether he files on a "cash" or an "accrual" basis. Form 1040-F is also necessary when filing on a "cash" basis, but its use is optional when filing on an "accrual" basis. Form 1040-F is especially designed for reporting farm income.

7. If husband and wife have separate incomes, must two reports be filed?

No, a joint return may be made, but if they prefer, each may make a return. If separate returns are made, their combined personal exemption cannot exceed $1,200.

8. What is the penalty for not filing a return?

"Severe penalties are imposed for failing to file a required return, for late filing, and for filing a false or fraudulent return." (Taken from instructions on Federal Income Tax Form 1040.)

"CASH" OR "ACCRUAL" BASIS IN FILING RETURNS

9. What basis may a farmer use in filing returns?

Farmers may compute their income on either the "cash receipts and disbursements" basis or on the "accrual" basis. Most farmers in North Carolina will find it more feasible to make their returns on a "cash" rather than an "accrual" basis since the latter involves a more complete set of accounts.

10. What is the major difference in reporting on the "cash" and on the "accrual" basis?

On a *cash basis,* gross income includes all cash received during the taxable year from sales of farm products which were raised during the taxable year or prior years, but does not include products sold on credit or changes in the inventory value of livestock held on the farm. The allowable business expenses include all expenses paid in cash during the year, for that year or any other year, but do not include expenses incurred and not paid.

On an *accrual basis,* gross income includes all income received or earned during the taxable year from *that year's business only.* This includes income from cash sales, from increases in the inventory value of livestock, supplies, and produce, plus any other income earned but not received. The allowable business expenses include all expenses for *that year's business only,* regardless of whether these expenses were paid or incurred and unpaid.

11. What farm records are needed to report on a cash basis?

Cash farm receipts, cash farm expenses and inventories of buildings, fences, machinery, and tools for the purpose of estimating the amount of depreciation.

If a farmer does not have written records, he will need to prepare the best possible statement of his income and expenses. The burden of proof is upon the individual if the collector raises any questions about the return.

12. What farm records are needed for reporting on an accrual basis?

The same records as for the cash basis with the addition of accounts receivable, accounts payable, and a complete inventory of all farm property.

13. Can a farmer shift from the cash to the accrual basis, and vice versa?

Yes, provided the permission of the Commissioner of Internal

Revenue is obtained and the proper adjustments made. However, he cannot continue to shift back and forth from year to year. If one wishes to change his method of reporting, application must be made to the Collector of Internal Revenue in North Carolina, within *90 days after the beginning* of the taxable year.

14. What system of records should a farmer adopt in order to collect the facts needed to file his 1942 income tax return?

Any system of records and accounts started now will be of little value in filing income tax returns for 1942. However, a good farm account book will be very helpful in suggesting various items that may have entered into income and expenses. The same book used next year will furnish valuable information for the 1943 income tax report.

15. Are there record books available that will be of use in filing income tax returns in future years?

Yes, the North Carolina Farm Record book published by the North Carolina Agricultural Extension Service is available to North Carolina farmers. A special record book is also published by the Extension Service that is useful for income-tax purposes. A farmer keeping either of these record books throughout 1943 will have enough data to file his income tax return on either a cash or an accrual basis at the end of 1943. In addition, such records supply valuable information which can be used to an advantage in the management and planning of the farm business.

STEPS IN MAKING A FEDERAL INCOME TAX RETURN

16. How should a farmer go about making the Federal Income tax return?

Get 2 copies each of the Federal Form 1040 and Federal Form 1040-F.

Assemble all available information concerning the farm business for the taxable year, including record books, cancelled checks, check books, bills or statements, rceeipts and the like.

Read carefully all the instruction on Form 1040 and 1040-F and underline all the items that apply to the farm business or personal affairs.

Study the directions given for the items underlined.

Fill out one set of Forms 1040 and 1040-F in pencil so that erasures can easily be made.

Recheck the blanks carefully noting the accuracy of each item and whether all items are filled out.

Make ink or typed copies of both Form 1040 and 1040-F. Keep one copy of each form, as they may be useful in answering questions about the return, and will also be needed in preparing next year's return. Also this information will be helpful in filling out the State income tax return.

CALCULATION OF INCOME ON THE CASH BASIS

17. What items are included in farm income when reporting on the cash basis?

For income tax purpose, farm income on the cash basis is the sum of four groups of items:

(1) The amount of cash or the value of merchandise or other property received from the sale of livestock raised during the taxable year or in prior years. This would include ordinary farm sales of livestock made during the year, including both livestock raised and that purchased for farm purposes.

(2) The amount of cash or the value of merchandise or other property received from the sale of livestock products, crops and other farm products raised or produced during the taxable year or in prior years. This would be the actual value of crops and livestock products sold for cash or traded for products during the year. If crops or products are produced during the year for sale and not sold, receipts from them are not reported until the year they are sold.

(3) The profits from the sale of any livestock or other items which were purchased. Income reported under this section is principally for farmers who are also cattle dealers, local agents for feed and fertilizer and the like, and for others, for reporting profits made in dealing in cattle or other products purchased for resale. Livestock bought and sold as a part of the farm business, such as dairy cow replacements bought and surplus of cull cows sold should be reported as a part of item one above.

(4) Any other farm income. Other farm income includes all miscellaneous cash receipts from such items as machine work, AAA payments, hire of teams, breeding fees, work off the farm, and the like. In general, anything of value received instead of cash must be treated as income to the extent of its market value.

CALCULATION OF INCOME ON THE ACCRUAL BASIS

18. How does the procedure for calculation of income on an accrual basis differ from the procedure on the cash basis?

The gross income on the accrual basis is all income *for the current year's business only.* This includes cash receipts from farm products, income earned but not received, and increases in the inventory value of livestock supplies and other farm products.

The expenses on the accrual basis include all expenses *for the current year's business only,* regardless of whether these expenses were paid in cash or incurred and unpaid.

19. Are the rules and regulations for making the returns on the accrual basis different in other ways?

No, the principal difference is in the type of records needed to report on each basis.

SPECIAL PROBLEMS OF INCOME

20. Should the value of farm products consumed in the household be reported as income?

No, however, the cost of producing these products must not be included in the farm expenses.

21. If an insurance company pays a farmer for loss on a crop, must he include this sum in his income?

Yes, hail or fire insurance receipts for crops or animals destroyed should be included in gross income to the amount received in cash or the cash equivalent if paid in kind.

22. How is an insurance payment for a fire loss on farm property treated?

An insurance payment for a fire loss is not entered as a direct receipt, but it is included in determining the amount of depreciation for the year.

23. Should income from non-farm sources such as dividends received or jury duty be reported?

Yes, but not on Form 1040-F. This income is reported on Form 1040.

24. Should income of minor children be reported?

Yes, unless the minor has a sufficient income to be required to file a return of his own.

FARM EXPENSES

(for reporting on either the cash or the accrual basis)

25. What farm expenses are allowable as deductions in arriving at the net farm profit?

A farmer operating a farm for profit is allowed to deduct all necessary expenses in operating the business in arriving at the net farm profit. This includes expenses for the cost of fertilizer, feed, seed, hired labor, gas and oil, taxes and insurance paid, and the like. Expenses are also allowed for depreciation on farm buildings, machinery and equipment, and other capital investments.

26. What type of expenses are not deductible?

Expenses for the farm home, such as taxes and insurance on the farmer's dwelling and contents, and expenses for groceries, clothing and the like are not deductible. Expenses for certain items in the farm home such as electricity and telephone may be divided between the farm and the home and the farm share deducted. Expenses for automobile, if used partly for personal use may be divided between the farm and the home.

The value of the unpaid labor of the operator and his family are not allowed as an expense. If a man's child is paid a cash wage, the wage is allowable, but the $350 personal exemption for this child should not be claimed. The value of work of older children is allowable only when paid as an actual wage.

The amount spent as investments of capital such as the purchase of a new tractor cannot be deducted as a business expense. However, depreciation for the current year can be claimed as an expense.

The total loss by storm, flood, fires, etc., of a prospective crop is not a deductible loss in computing net income. Neither is the loss for animals that die during the year except as such loss is reflected if an inventory is used.

27. Must farm expenses be classified according to the headings on page 3 of Form 1040-F?

No. These headings are merely suggestions. If desired, the farm expenses may be classified as the farmer has them in his records.

28. Does the treatment of depreciation of farm buildings, machinery and equipment differ between the cash and accrual basis of reporting?

No. The table on page 3, Form 1040-F, "Repairs and Depreciation" should be filled out in the same manner whether the return is on the cash or on the accrual basis.

29. How should depreciation be calculated?

A useful procedure in preparing the first income tax return is the following:

Record, on a piece of scratch paper, the total value of the real estate at the time it was acquired, using cost if purchased and market value if inherited. If acquired before March 1, 1913 (the date the income tax law first became effective), use the market value on that date, or the original cost less depreciation that occurred on buildings and other improvements from date acquired to March 1, 1913. It is to the taxpayer's advantage to use the larger of these two figures.

Divide the total value of the real estate between the land, the dwelling house, other farm buildings, fences, and drains. Depreciation cannot be claimed on land or the farm home, but can be claimed on barns and other farm buildings, and on fences.

Record, on a piece of scratch paper, the present value and original cost of the different larger pieces of farm equipment, such as tractors, trucks, automobiles (farm share only), and the present value of the total of all other farm equipment. Then record on scratch paper the value of these items at the beginning of the taxable year. Values used should be taken from farm-inventory records if available; if no inventories are available, estimates may be used. Accounts kept by farmers indicate that the annual depreciation on the average lot of farm equipment, some old and some new is about 10 per cent per year of the inventory value at the beginning of the year.

The farmer is now ready to fill out the depreciation schedule on page 3 of Form 1040-F. Proceed as follows:

First, list the different items such as barns, fences, tractors, and other machinery, in column 1 of the depreciation schedule.

Enter in column 2 dates the buildings and larger pieces of farm machinery were acquired. No date is necessary for the item of "all other farm equipment."

Transfer from scratch paper to column 3 the original cost or original value for buildings, fences, and the like, and also similar figures for the larger pieces of farm equipment. For "all other farm equipment," use the inventory value at the beginning of the taxable year.

Enter no entries in column 4 unless there are items on hand which have been fully depreciated in previous tax returns.

List in column 6 the value of all items at the beginning of the taxable year. Subtract the different items in column 6 from corresponding items in column 3, and enter the differences in column 5 (depreciation allowed or allowable in previous years).

Enter in column 7 estimates of the total length of life for buildings, fences, and the like, and also for the larger pieces of equipment. It is not neccessary to do this for "all other farm equipment."

Enter in column 8 for all items except "all other farm equipment" the years of life remaining at the beginning of the taxable year.

Enter in column 9 the "depreciation allowable this year." Calculate this for buildings, fences, and the like, and also for the larger pieces of equipment by dividing items in column 3 (cost) by column 7 (total years of life). For "all other farm equipment," use the difference between the value at the beginning of the taxable year (column 6) and the value at the end of the year as recorded on scratch paper.

For the benefit of persons who have filed returns in previous years, items in columns 1, 2, 3, and 7 in the depreciation table should be the same each year, except for the addition of new items or for the omission of items which have been destroyed or completely depreciated.

Repairs are annually recurring expenses. They are to be distinguished from capital improvements of long life such as a new building or a new tractor. Thus a coat of paint on a barn or a plow point is a repair, and hence an expense; but a new shed or a tractor purchased is a capital improvement and should be listed in the first column as subject to depreciation.

COMPUTING THE FEDERAL TAX ON FORM 1040

30. After net income from the farm business is calculated, where should it be entered?

It should be transferred to Form 1040.

31. What types of items are deductible from gross income on Form 1040?

Contributions paid to organized charitable and religious organizations, interest on personal indebtedness, extraordinary medical expenses for the care of the taxpayer and his family, certain taxes not previously deducted on Form 1040-F, bad debts and losses not previously deducted as farm expenses. In the case of medical expense, deduction can be made only for the amount that exceeds 5 per cent of the taxpayer's net income. Such deductions are limited to $2,500 for a married person living with husband or wife, or a head of a family, and $1,250 for other individuals.

32. What taxes are not deductible?

Special assessment taxes on real estate for improvement of property such as drainage taxes may not be deducted. Estate, inheritance, legacy, succession and gift taxes are not deductible but the amount of income from such sources is not included for the purpose of taxation. Federal income tax may not be deducted but state income taxes are deductible.

33. What deductions can be made from "net income" in determining the amount of income subject to normal tax and the amount subject to the surtax?

For the amount subject to normal tax, deductions are personal exemptions, credit for dependents, and earned income credit. Only personal exemption and credit for dependents can be deducted from net income in determining the amount subject to the surtax.

34. How much is allowed for "personal exemption"?

$500 if single.

$1,200 if married or a head of a family.

35. How much is allowed as "credit for dependents"?

$350 for each child under 18 years of age.

$350 for each dependent adult incapable of self-support because mentally or physically defective.

36. What is the "earned income credit" of a farmer?

The earned income credit is 10 per cent of any net income up to $3,000.

For net income of more than $3,000, the "earned income credit" is 10 per cent of the net income or 10 per cent of "earned net income," whichever is less. The credit so obtained is subject to limitations. It cannot be less than $300 or more than $1,400. "Earned income" is payment for personal services not done in connection with the farm business, plus not more than twenty per cent of the net farm profit as transferred from Form 1040-F. "Earned net income" is the amount of earned income in excess of the amount of "earned income deductions," which are ordinary and necessary expenses chargeable against earned income.

37. What is the normal income tax rate?

Six per cent. This rate is applied to the amount of income remaining after personal exemptions, credits for dependents and earned income credit has been deducted. The normal rate is the same regardless of the size of the income.

38. What are the surtax rates?

Surtax rates are applied to the amount of income remaining after personal exemptions and credits for dependents have been made. The surtax rates are variable depending on the amount of net income subject to surtax. A rate of 13 per cent is charged on the first $2,000 subject to surtax. This rate increases according to brackets depending on the size of the income. The highest rate is 82 per cent, charged on income in excess of $200,000.

METHOD OF PAYING FEDERAL INCOME TAX

39. When and how must the Federal income tax be paid?

Payment of the tax may be in full at the time of filing the return, or in four equal installments. If paid in installments, the first installment must accompany the return, and other payments are due each three months after the due date of the return. Remittance should be made payable to the "Collector of Internal Revenue."

FEDERAL INCOME TAX RETURNS FOR A DECEASED TAXPAYER

40. Must a return be filed for a farmer who has died during the year?

A return must be filed for a deceased taxpayer if his gross income is more than his personal exemption accrued to the time of his death. In a return for a deceased taxpayer, the income and the deductions are accrued to the date of death, regardless of whether the taxpayer has been filing his return on the "cash" or "accrual" basis.

Harvested crops are accrued income. Crops not harvested are not income until harvested. Livestock and crops raised and on hand at the time of death are accrued income at the time of the death if taxpayer files returns on the "cash" basis. If he files on the "accrual" basis, the accrued income from this source would be reflected in the inventory taken at the time of death. A return from the estate is required from the administrator or executor.

FEDERAL INCOME TAX RETURNS FOR FARMERS WHO ARE PARTNERS

41. Do farmers who are in partnership report farm and taxable income on the same forms as an individual.

No. Income tax return for partnerships are made on Form 1065 which is in itself not a taxable return, but a return of information showing the net income of the partnership and how it is distributed between the partners. The individual partners use Form 1040 and 1040-F.

42. How is farm partnership income computed?

In the same way as any farm income. Form 1040-F may be used on either the cash or the accrual basis and attached to the partnership schedule to show returns from farming. Form 1040 is required of each partner if his total income is sufficient to require a return. Each partner may claim 20 per cent of his share of the income from the partnership as earned income in addition to any salaries or wages from other sources.

The North Carolina State Income Tax

Regulations for making a State income tax return, insofar as farmers are concerned, are not greatly different from Federal. The information used in filling out the Federal return is sufficient to make out the State return.

43. Who must file a State income tax return?

Every resident having a net income during the income year in excess of $1,000 if single, or $2,000 if a married man living with wife on December 31st, or $1,000 if a married woman with a separate income.

Every resident professional individual or person in business with a gross income of $5,000 or more.

Every non-resident receiving a net income during the income year from within this State in excess of the pro rata exemption as the income in this State relates to the total income.

A joint return for husband and wife may be filed if the income is received from jointly owned property or stocks. If a joint return is filed, the personal exemption for husband and wife is limited to $2,000.

44. Does the gross and net income mean the same for State as Federal returns?

Yes, for all practical purposes.

45. What forms does a farmer use in making his State return?

Every farmer must file a copy of State Form 173. There is no special State form for a farm. State Form 173 contains about the same information as contained on Federal Forms 1040 and 1040-F.

46. Must the State return be filed on the same basis as the Federal return?

Yes, however, most state reports are made on a "cash" basis. If a farmer has been accustomed to using the accrual basis for his Federal return, he can make his State return on the "accrual" basis.

47. Are the same items deductible in calculating the amount subject to tax on the State return as on the Federal return?

No. The State does not allow deductions for extraordinary medical expenses. The State allows deductions for property taxes but does not allow deductions for gasoline taxes, automobile licenses, registration fees, inheritance, sales, gift and income taxes. Loss from bad debts cannot be deducted unless they were previously included in gross income reports filed in other years.

48. What are the credits for personal exemptions and dependents on the State return?

$1,000 if single with no dependents.

$2,000 if head of a family with no dependents.

$200 for each child under 18 years of age.

$200 for each dependent adult incapable of self-support because mentally or physically defective.

49. When is the State return due?

Two and one-half months after the close of the year covered by the return. This will be March 15 for most farmers who use the calendar year.

50. When and how must the State Income tax be paid?

The payment of the tax is required to be made at the time the return is filed if the amount of tax is less than fifty dollars. If the amount of the tax is more than fifty dollars, payments may be made in two installments; one-half on the date the return is filed and one-half on or before September 15th following. Interest at 6 per cent per annum is charged on the deferred payments. Payment is made to the Commissioner of Revenue, Raleigh, N. C.

51. Where may report forms be obtained?

From the North Carolina Department of Revenue, Raleigh, N. C.

52. Do farmers who are in partnership report incomes on the same forms as an individual?

No. Income tax returns for partnerships are made on Form 172 which is designed for reporting partnership returns. Farmers in partnership are required to file a return regardless of the size of their gross or net incomes.

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