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## **\$\$ Income Tax \$\$**

# **DON'T OVERPAY THE BILL!!**

**Stan Falke and Ray Prigge**

Income tax liability is as much a cost of operating a farm or ranch as is the cost of seed, fertilizer, labor and borrowed money. Overpaying the income tax bill reduces net income as much as overpaying the seed or fertilizer bill. The primary difference between the tax bill and other farm bills is that you are required to compute your own tax bill while the other bills are computed by the selling company. Therefore, when you are computing your income tax bills, you should make every effort to minimize that liability.

A good example of overpayment involves the tax treatment of existing fences on purchased farms or ranches. Although existing fencing may lead to a substantial tax benefit to the purchaser of a farm or ranch, the buyer often disregards the fences when dividing total costs of the farm into its component parts of land, buildings, personal residence, etc. The result may be an overpayment of income taxes.

Fencing, in most cases, qualifies as investment credit property while buildings and land do not. In general, the investment credit provision of the code allows the taxpayer to deduct from taxes owed an amount equal to 10 percent of the value or purchase price of property qualifying for investment credit. Since the investment credit is a direct reduction of taxes owed rather than an expense deductible from gross income, the identification of investment credit property (in this case, fencing) becomes extremely important. In addition to the investment credit, yearly depreciation on fences can be computed and deducted as an expense from gross income — thus leading to even greater tax savings.

An example of the tax value of existing fencing on a purchased farm will better illustrate the point. Assume the following:

a. A 500-acre farm is purchased for \$300,000.

- b. The farm includes 28,000 feet (approximately 5.3 miles) of fencing and no buildings.
- c. The value of fences if \$.50 per foot.
- d. The net taxable yearly income from operation of the farm is \$50,000.

Then compute the income tax owed to the U.S. Treasury under two assumptions (Table 1):

- I. The buyer ignores the value of the existing fences and assigns the entire \$300,000 to the value of the land.
- II. The buyer assigns a value of \$14,000 (28,000 feet x \$.50 per foot) to the fences and a value of \$286,000 to the land.

Table 1. Example of two different tax computations.

|   | Assumption I                            | Assumption II                                |
|---|---|--|
|   | Fence value \$0<br>Land value \$300,000 | Fence value \$14,000<br>Land value \$286,000 |
| Taxable income                              | \$50,000                                | \$50,000                                     |
| Less depreciation<br>on fences <sup>1</sup> | 0                                       | 2,000  |
| Taxable income<br>(after depreciation)      | \$50,000                                | \$48,000                                     |
| Tax after depreciation                      | \$17,060                                | \$16,060                                     |
| Less investment credit <sup>2</sup>         | 0                                       | 1,400  |
| Net tax <sup>3</sup>                        | \$17,060                                | \$14,660                                     |
| Tax Savings (first year) = \$2,400          |   |  |

<sup>1</sup>Yearly depreciation on fences computed by using straight line depreciation; 7-year life; no salvage value.

<sup>2</sup>Investment credit (10 percent of \$14,000).

<sup>3</sup>Income tax liability computed using "married filing joint" tax schedule.



Table 2. Total tax savings — 7-year fence life.

| Tax year          | Taxes saved by Investment credit | Taxes saved by Depreciation | Total yearly tax savings |
|-------------------|----------------------------------|-----------------------------|--------------------------|
| 1                 | \$1,400                          | \$1,000                     | \$2,400                  |
| 2                 | —                                | 1,000                       | 1,000                    |
| 3                 | —                                | 1,000                       | 1,000                    |
| 4                 | —                                | 1,000                       | 1,000                    |
| 5                 | —                                | 1,000                       | 1,000                    |
| 6                 | —                                | 1,000                       | 1,000                    |
| 7                 | —                                | 1,000                       | 1,000                    |
| Total tax savings | \$1,400                          | \$7,000                     | \$8,400                  |

<sup>1</sup>\$2,000 of fence depreciation per year is equivalent to a \$1,000 tax savings per year for the taxpayer in the 50 percent tax bracket.

The example shows that the farm buyer would pay \$17,060 in federal income taxes the first year if he ignored the value of the fences. However, by assigning a value of \$14,000 to the fences, he can save \$2,400 on his tax bill the first year. Each of the next 6 years (the remaining life of the fences) also yields a tax saving because of the yearly depreciation expense allowed for the fences (Table 2).

In other words, if the buyer ignores the value of the fences, he will pay \$119,420 in taxes during the first 7 years. When he values his fences at replacement cost, his tax bill for the 7-year period will be reduced

to \$111,020. Therefore, in this example, the taxpayer would actually overpay his tax bill by \$8,400 over the first 7 years of farm operation if he ignores the value of existing fencing.\*

The example illustrates how a taxpayer can benefit by proper treatment of a particular tax situation. However, the division of total cost between land and fences cannot be made arbitrarily. In this example, the fences were assumed to be relatively new, having an expected life of 7 years, and the replacement cost was estimated at \$.50 per foot. In all cases values assigned must be reasonable and must take into account age and remaining useful life. But the important aspect is that existing fences do have a value that can lead to substantial tax savings.

When purchasing a farm, you should also give attention to the tax implications of items other than existing fencing. Farm machinery, irrigation ditches and equipment, growing crops, livestock and water systems provide similar opportunities to reduce the tax bill. Your tax advisor can best assist you in complying with the requirements of the tax code and obtaining maximum tax savings.

To ignore possible tax savings is to overpay your tax bill. *Don't overpay the bill!*

\*A sale of the farm could lead to depreciation recapture on the fencing. This would partially offset the total long run tax savings.

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