HOMESTEADING

Record keeping, Tax and Legal Issues

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Introduction

Good morning, my name is Dan Snyder. I have been a CPA and tax attorney for 45 years and have now semi-retired so I can work more on our homestead with my wife. My primary area of expertise is in international tax and have worked in public accounting as well as in advising governments on implementing tax systems. I have written IRS regulations, upon the breakup of the old Soviet Union advised the Czech Republic on creating a VAT system and the country of Uzbekistan on creating their entire tax system. I also negotiated with the Peoples Republic of China on tax withholding systems. So, I have had the privilege of seeing taxes from both the taxpayer side and the government side – in many jurisdictions. There are some systems that are easier than ours, but there are few systems that are more equitable than what we have in the US. Most of us don't like it (no one anywhere likes taxes), but remember, even Jesus paid taxes.

With all of that, how did we get here? My wife and I got involved in ranching and gardening (we didn't even know the term homesteading) with the intent of raising healthy food for our kids and grandkids about 10 years ago. I have only semi-retired, so I still work with about 250 clients in North Texas, most of which have ranching or farming issues on their tax returns. During Covid we began watching YouTube videos to focus more on our garden and I was particularly concerned about the lack of bookkeeping, legal and tax advice available and what I saw on YouTube was in many cases tragically wrong. We have been to several Homesteading events like this one and felt the business or tax information shared could be better. I felt like I needed to try to set the record straight so that you don't have to come to someone like me to fix your tax problems later. Please understand, I'm not here to try to convince you to be my client and I'm not here to argue whether we should or shouldn't pay taxes. I'm here to help educate you in the same way Leon helped us with our high tunnel and self-wicking tubs or Joel Salatin educated us on grazing animals in a healthy way. I'm happy to answer questions at the end and will be here for the entire event. We have business cards up front if you didn't get one with the website information which I will refer to later.

Bookkeeping

Had it been up to me when we started our garden, I probably would have gone to Tractor Supply, bought some seeds, taken them out the garden area and thrown them on the ground in November. When nothing came up in April I would have thought – Gee, maybe I should have done a little planning for this! Thankfully my wife is much smarter than I am, so she sketched out a garden area, rounded up our raised beds, bought some seed starter materials, arranged for me to pick up compost and then, at the appropriate time on our planting calendar we got out and planted our seeds and seedlings. We didn't start off knowing everything – for example now we know the miracle of weed cloth! Each year we learn more and do better in our garden. Gardening in Texas over the past 2 years has been challenging due to the extreme heat – but that doesn't mean we can't garden; it just means we must work on our strategies! Maybe 2 seasons of determinate tomatoes rather than trying to keep indeterminates alive for 8 weeks of 110 degrees plus weather.

Just as with gardening, if you want a good financial/tax result, you need to spend some time planning before you start. You don't need to become a CPA or a QuickBooks expert, you can start with some simple tools. On my website I have a link to a copy of this presentation and an excel spreadsheet that you are welcome to download and make your own. Now, one of the things I love about homesteading is that it means so many things to so many people. Can I get a show of hands – how many people are homesteading like my wife and I – to raise healthy food for your families? OK, now how many of you brave people are doing this to make a living? How many are somewhere in between? Maybe sell a few extra eggs during the summer or surplus produce? I am always humbled by those of you trying to make a living doing this. I know it's hard enough to do this just for the personal benefits, to make a living at this is hard work.

So why did I ask? If you are doing this for personal reward, you want to keep records, so you know how much things cost you. I remember when my wife and I got our first egg and told her that the first egg cost $1,000! But then I added, the next one would be cheaper! On the other hand, if you are doing this to make a living, then in addition to knowing how much things are costing you so you can figure out if what you are doing and how you are doing it is profitable, Uncle Sam wants you to tell him all about it. If you are in this to make a profit, my suggestion to you is first to have a separate checking account for your business. That way you can easily track your income and expenses using a simple spreadsheet. With good records, your tax advisor can help you plan how to make the best choices in filing your income tax returns to minimize your tax cost. Think about it, your income and social security tax could easily be 36% of your profit. If I told you I could help you reduce your feed costs by 35%, wouldn't you want to listen and spend some time working to make that happen? With no records, your advisor can't help you as well as they otherwise could.

Many of you may be in that "in between" area – you aren't doing this full time but making a little cash. The IRS would consider this a "hobby". You always want to report any income to the IRS BUT remember that to the extent you have expenses you can always deduct those up to the amount of your income, even if it is "just" a hobby. To report a loss, a loss which can offset maybe some income earned offsite of the homestead, you must be working with the intention of "making a profit". If you are doing that, and document it, then your tax losses may offset other income. The decision to change from treating the income as a "hobby" i.e. taking deductions up to your income just from homesteading to treating the income as from a business with which you intend to make a profit is an important one that should not be taken lightly.

LLC or NO

Virtually every client that comes into my office to start a new business asks this question first – should I have an LLC? In my mind I'm thinking this needs to be discussed way later in the conversation, but I know if I don't address it, the client will not move past it. My response is always the same – Why do you think you need one? Some people want it for legal protection, some people want it to provide marketing advantages, some want it for supposed tax benefits others just think it's the thing to do. Each state has its own rules, and the costs vary widely. I work in Texas. To create a Texas LLC, we usually charge $1,200 which includes the $310 state filing fee, obtaining an IRS EIN for the entity, and drafting the Members

Agreement (an LLC's version of By Laws). Many people use online services such as LegalZoom. Not sure what they charge.

If you think you are going to be protected legally for everything you do using an LLC, I'm afraid you are going to be disappointed. While it may protect you from certain liabilities if you use it properly, it won't for others. For example, if you drive your car to a farmer's market and cause an accident, even though you may have been an employee of the LLC doing LLC business, you can still be sued personally because the accident was due to your negligence. An LLC will not help you with that sort of liability. On the other hand, if you have an employee and they were driving, then the employee and the LLC might be sued but not you personally. So yes, there may be some protection afforded by LLCs but in any event, you need to have insurance. The insurance should cover not just the liability, but you should get insurance to pay the legal fees. Anyone can sue, whether you did something wrong or not. If it takes $25,000 in legal fees to prove that you are innocent. You may still be going to be out of business because of legal costs. You may be innocent, but you are going to wish you had insurance in place to cover that legal cost. So, my question to you, if you are going to have insurance anyway, should you still use an LLC? It's up to you but be sure to speak to your attorney about this. I just want to point out that an LLC is not a cure-all for all legal liability exposure.

If you are planning to get marketing advantages because an LLC makes you look like a "real" business, then use an LLC. One good thing in this respect is that it allows you to preserve a name everywhere in your state. Once your company is created, no one else can use that name in your state. If instead, you are using a DBA, then, at least in Texas, that only covers the county you file in. We have 254 counties in Texas. At $25 each it would cost over $6,000 to register a DBA in every county – so you may as well use an LLC!

Finally, are there any tax advantages to using an LLC. Well, there is one main tax advantage left for using a corporate entity – either an Inc or an LLC – and that is to make what is known as a Subchapter S tax election for federal income tax purposes. I'll talk about that later. But for now, I just want you to understand that Inc, or Ltd, or LLC are all different types of legal entities. C Corp, S Corp, partnerships are all different types of tax statuses, not different types of legal entities. These two concepts are often confused – even by CPAs and attorneys.

There are a lot of other issues you need to be aware of so please, get a good lawyer. Remember, while no one likes to pay legal fees, lawyers need to eat too! Use the meeting as an opportunity to sell yourself to them and convert then to a customer. Many of my tax clients I do business with. I eat at restaurants owned by my clients, I buy replacement cows from my clients, I buy insurance from my clients. That way, we all benefit.

Tax Issues

After addressing the LLC issue, we then normally go into record keeping, including bookkeeping, and then on to tax issues. There are a lot of tax issues, this is a massive area to discuss, but for today I want to focus on 3 areas that you need to be aware of that can make a huge difference to your total tax liability. Before we get into these, I want to remind you that the best tax result comes with good records! So, keep up the good work. While you may think, oh, I can wait till later to work on my books, that's like saying oh, I can wait until later to get those weeds out of the ground. Yes, you can, but you may not like the results!

Also, I want to make sure you realize that showing zero income on a tax return is a quick way to the poor house. Let me ask everyone a question. If you are a married couple with three or more children, how much should your business income be to get the maximum refund assuming you didn't pay in any estimated federal income tax payments? If you show $0 of income, your refund will be zero. You won't qualify for the child tax credit or the earned income credit. So, any guesses? For a married couple with 3 or more children, the best refund you can get comes with adjusted gross income of about $25,450. That will maximize your credits. Anymore and your credits go down and taxes go up. Any less and your taxes go down but so does your credit. Keep that in mind when discussing tax elections, you can make which we will discuss later. Honestly, with the change in tax laws regarding the use of losses, showing a loss is the last thing you want to do. It's never been great, but now it's worse.

Subchapter S

In discussing LLCs earlier, I mentioned Subchapter S status. What is it and why should you care? A Sub S corporation/LLC is a flow through entity for tax purposes meaning the entity itself pays no income tax, only the owners do (normally). It offers one of the main, major tax benefits still available – the reduction of self-employment tax, that is not available to a self-employed person or a C corp. As a self-employed person, you pay two sets of tax – income tax as you do on your wages but also self-employment tax which the self-employed persons version of social security and Medicare taxes. When you are an employee, your employer withholds 7.65% of your wages for social security and Medicare. What you may not know is that your employer also must pay an additional 7.65% of your wages. The total paid is then 15.3%. As a self-employed person you get to pay both halves. The tax is calculated in a manner to give you a tax deduction for half of it – so I normally suggest you consider the self-employment tax to be a flat rate of 14%. I have many clients who do not ever pay income tax but pay $3-4,000 of self-employment tax each year.

How do the savings work? If you use a Sub S company to run your business, then there are 2 ways for you take earnings out of the business – as compensation (salary or 1099) or as a dividend. Now these dividends are not "qualified" dividends like Apple or IBM taxed at lower capital gains tax rates. Therefore, they are taxed at the same rate as your other ordinary income. The main difference is that these dividends are not subject to self-employment tax, saving you 14% in self-employment tax. Now, before you go say well let's take all my income as dividends, I have to warn you the IRS is looking for that. There is an old Texas tax saying – pigs get fat, hogs get slaughtered. So, we want to take some of the earnings in a manner that is not subject to self-employment tax and some that is, so we can be a pig but not get slaughtered. You can discuss the specifics with your tax advisor. But one very important point I'd like to make. Dividends from a Sub S company do NOT count towards social security retirement. Whether you believe there will be social security when you retire or not, if you don't pay into the system, you won't get any benefits.

Let's assume you made $60,000 in business income before making any payments to yourself. As a self-employed person, you would owe $8,400 in self-employment tax. Let's assume you have an S Corp now, and you pay half of that as salary and half as an S Corp dividend. You would save $4,200 in self-employment tax. Before you go to the casino with that $4,200, what I always tell my clients, if you save on self-employment taxes using a S Corp, be sure to put all those tax savings into a 401(k) or an IRA so there will be something when you retire. If you use a taxable 401(k) or IRA, then you get a second tax deduction on those contributions! Let's say you were in the 12% tax bracket, that $4,200 contribution to an IRA would save you $500. Take that money to the casino (vacation, pay bills whatever) don't spend the self-employment tax savings themselves. In the alternative, take those tax savings and buy that new piece of equipment, which itself may generate a tax deduction. It may not help you at retirement, but it may help you now. That is the benefit of doing this – it gives you options you wouldn't otherwise have. I'm not here to tell you how to spend your money, I'm just here to make sure you understand what options are on the table.

Allocation of Purchase Price

A tax advisor is only as good as the information you give him. If you take away anything from this presentation – please take that. One of the big things people forget to tell their tax advisors is what they bought. How many of you have recently purchased your Homestead? If you go into your tax advisor and say I bought a homestead, and leave it at that, he/she will have no idea what you mean. They may assume you bought a house with a half-acre lot in town. Your job is to tell him what you bought – better yet show him. Google maps are a great tool! You can tell your advisor - I bought 12 acres, 10 acres in hay, 1 acre in pecan trees with 3,000 feet of external fence, 1,500 feet of cross fence, a well, a haybarn, an old hay ring left behind, a loafing shed, an old dairy barn, 800 feet of water pipe, a concrete waterer for the cows and a house – then he will understand there is more to it. You can then have a discussion of what your business will be and which of these items might be used in the business and therefore generate a tax deduction.

Different types of assets may be eligible for a tax deduction called depreciation. We will discuss that next. This is an expense that doesn't cost you any additional cash (because you already bought the property) but can reduce your income for income and self-employment tax purposes. Different assets depreciate over different lives, so it is vitally important to identify all your assets. If I buy a property in May and cut hay in June, well, I bought the property with hay on it. Can I get a deduction for a portion of the purchase price associated with the hay? Not if you don't tell your tax advisor. What about existing fruit or nut trees? What about hardwood trees for lumber. As you can see, since every property is different, every tax deduction will be specific to two things: what you bought and what you are using for business. If you bought a property with 20 pecan trees but just pick nuts for personal consumption – no tax benefits. If you buy the property and sell 10,000 pounds of pecans each year, then we are going to want to allocate some of the purchase price of the property to those trees to reduce your income from that business.

The one asset that gives rise to no tax deductions, except in very rare circumstances, is dirt. So, buying dirt, while possibly a great financial decision, does not help you tax-wise. For young farmers starting out, renting is a better tax decision because all the rental cost is tax deductible.

Let me give you an example. So, my wife and I sold our house in town and bought our homestead for $360,000. So, what did we buy? We got 44 acres (a big backyard in Texas and Oklahoma), perimeter fencing, some cross fencing, 2 concrete cattle water tanks, a well, an old dairy barn, a hay barn, some old hay rings, 2 old oil tanks, an enclosed fenced area that used to have a mobile home (so it had water and electric) that we now use as the garden, hay on the ground in the pasture and one measly pecan tree – hey, we were thankful for that and later discovered we also had a pear tree. We must determine how much of the price we paid is associated with each asset; this is called asset allocation. We can assign some of the cost to our stand of hay, some to the pecan trees, some to the fencing and so forth. What tax benefits we get from these allocations depend upon what business we choose to go into. If we don't need a fence for our business, then we don't get a deduction for it. But, for example, let's assume that out of the $360,000, we allocated: $55,000 for the mobile home, $14,500 for the hay barn, $28,300 for the dairy barn, and so forth. At the end we assigned $17,000 of the cost to the land our house sits on, $205,470 to the land the farm is on i.e. the dirt. By doing all of this, we have helped our tax advisor create $82,500 worth of potentially depreciable assets that we can take a tax deduction for. It will reduce both self-employment tax to 14% and income tax to 22%. Over time, we will save about $30,000 in taxes because we took the time to do this. You can too.

BUT, you may say loudly, I bought my place three years ago. Have I lost out? The good answer is no. You can always go back three open years and amend your tax returns to claim these deductions. Now, due to what all has happened over the last 3 years, that may not be the best idea. But the short answer is, you haven't lost the opportunity to do so. Plus, depending upon what business you started in, you may not have needed all these assets so technically you may not have "placed them in service". Once again, talk to your tax advisor!

Depreciation

The last specific tax item I want to talk about is depreciation. I mentioned this earlier. What is depreciation? It is a tax deduction, over time, for the cost of an asset with a useful life of over 1 year. Technically, a hammer is a piece of equipment – but we don't depreciate it because it is likely you will lose it before it breaks! Plus, it's what $15? But that is the basic rule.

What is special about depreciation is that you get to make choices and these choices can increase or decrease your tax liability. Every year in December I get the same phone call from dozens of my farming clients: Dan, should I get a new ____ (truck, tractor, trailer, hay baler, combine) whatever their eye has been on. My response is always – Do you need a new ____? If so, and you want to spend the money, then do so. Can a $90,000 truck do any more than a $9,000 used truck – not for me, but maybe for my clients. The tax consideration is one of timing – if you are going to buy it sometime in the next 6 months then we should consider the best time to buy. Many times, December is the right time. But there are also many situations you may wish to wait until January because of your specific tax situation. Once you purchase the asset – are you stuck? Well, in some respects yes in others no.

Let's talk about the choices you can make. In the year you purchase an asset, technically it's when you "place the asset in service", that is when you start to depreciate it. You can use different methods of depreciation. There is straight line depreciation. Let's assume you buy a tractor for $28,000. Tractors are depreciated over a 7-year life. You could take straight line depreciation so each year for 7 years you would deduct $4,000. You could use an accelerated depreciation method such as the 150% declining balance method. That would give rise to a $6,000 deduction in the first year with a declining amount thereafter. You may have the choice to take a deduction of the entire $28,000 in the year you purchase it as either bonus or what's known as section 179 depreciation. So, your income could vary by up to $24,000 depending upon the elections you make. If you are trying to hit the $25,450 sweet spot of business income I mentioned earlier, you may choose to take less depreciation, or more, depending upon the rest of your income. If you have an outside job and you had a phenomenal bonus such that you are in the 30% tax bracket instead of the 10% bracket, you may want to take the entire $28,000, an absolute tax savings of $5,600!

Wrap Up

I know I covered a lot of ground. Usually, this conversation with a new client lasts 2.5-3 hours! Your tax advisor needs information. He/she needs to know what the business plan is. Are you selling eggs? Meat birds? Bacon, sides of beef, vegetables? Are you a YouTuber planning to make money selling yourself online, selling merch? Are you running a virtual petting zoo? If so, are you a homesteader, Hunter, fisher, equipment driver – or maybe you are just Daniel Arms and do it all! Whatever your plan, be sure to tell your advisor and best to tell him before you do it so he/she can help you structure things to your best result. I appreciate your time and if you have any questions, I am happy to try to help.

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