

# Farm Income Taxation

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Income tax planning and management involves being aware of tax alternatives and knowing how to integrate them with other management data to accomplish the taxpayer's objectives.

## Federal Income Tax Structure

The basic structure of the income tax system is relatively simple. The sum of items constituting gross income is reduced by allowable deductions to calculate taxable income. The income tax imposed is determined by applying to the taxable income a rate based on the filing status of the taxpayer. Finally, the tax liability is determined by reducing the tax imposed by various credits.

## Reporting Farm Income

**Methods of accounting.** Almost all farmers and ranchers operate on the cash method of accounting. This means that they report income when it is received and claim deductions when payments are made. Conversely, taxpayers on the accrual method report income when it is earned and report expenses when incurred rather than when paid.

**The constructive receipt doctrine.** Cash basis taxpayers must take income into account when it is actually received as well as when it is constructively received. The constructive receipt doctrine can be a concern for farmers and ranchers, especially with respect to government price-income support payments and deferred sales of crops or livestock.

**Commodity Credit Corporation (CCC) loans.** The presumption is that every farm taxpayer treats CCC loans as loans for tax purposes. In this event, taxpayers on the cash method of accounting do not have taxable income until the year in which the commodity is sold or the crop is forfeited to CCC in full satisfaction of the loan. However, CCC loans may, by election, be treated as income in the year the loan proceeds are received. The election may be made only once during a taxpayer's lifetime and if the taxpayer does not elect to treat the loans as income, the income is reported in the year the commodity is sold or forfeited to the CCC.

**Payments-in-kind.** In general, any time a farmer or rancher receives a government benefit, the benefit is reportable as income whether it is received in cash or in-kind. Benefits are ordinarily included in income at the time they are received.

Under certain federal farm programs, especially those designed to provide environmental benefits, the USDA shares part of the expense of complying with the program. If certain requirements are met, the IRS permits some cost sharing amounts received by farmers and ranchers under several state and federal programs to be excluded from gross income.

**Self-employment income.** A tax is imposed on the income derived by an individual from a trade or business that the individual conducts. In general, income derived from real estate rents is not subject to self-employment tax unless the arrangement involves an agreement between a

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landowner or tenant and another party providing for the production of an agricultural commodity, and the landowner or tenant materially participates. In rental situations not involving the production of agricultural commodities and in which the taxpayer materially participates, rental income is subject to self-employment tax if the operation constitutes a trade or business "carried on by such individual." Similarly, an individual rendering services is subject to self-employment tax if the activity rises to the level of a trade or business. Most income received pursuant to a production contract is subject to self-employment tax. The tax court, in a significant 1998 case, ruled that CRP payments received by an active farmer are not subject to self-employment tax.

**Federal gas tax credit.** Farm owners, operators and tenants on the cash method of accounting can claim a credit against income tax for the federal excise tax paid on gasoline used on the farm or ranch and on diesel fuel, special motor fuels and aviation fuel used on a farm for farming purposes. Also deductible is the expense for the fuel.

**Crop insurance proceeds.** Proceeds from insurance, such as from hail or fire coverage on growing crops, are included in gross income in the year actually or constructively received. In effect, insurance proceeds received as a result of crop destruction or damage are treated as a "sale" of the crop.

**Weather-related sales of livestock.** If a farmer sells livestock (other than poultry) held for draft, dairy or breeding purposes in excess of the number that would normally be sold during the time period, the sale or exchange of the excess number may be treated as a nontaxable involuntary conversion if the sale occurs because of weather-related conditions and other requirements are satisfied. Under another provision, if farm and ranch taxpayers on the cash method of accounting are forced because of weather-related conditions to dispose of livestock, they may be able to defer reporting the gain until the following taxable year. The taxpayer's principal business must be farming in order to take advantage of this provision.

**Livestock sold or destroyed because of disease.** Livestock that are sold or exchanged because of disease may not trigger taxable gain if the proceeds of the transaction are reinvested in replacement animals within 2 years of the close of the tax year in which the diseased animals were sold or exchanged.

**Gain and loss from commodity futures.** Farmers and ranchers buy and sell commodity

futures to hedge against fluctuating prices. However, they also buy and sell commodities as speculators. The principal matter of concern from an income tax perspective is the line between hedging and speculation. Hedging transactions are defined in terms of reducing the risk of price (or interest rate) fluctuations in the ordinary course of the taxpayer's business. Gains and losses from hedging transactions generate ordinary income and loss. Gains and losses that do not qualify as hedges, but instead are speculation, and do not involve contracts primarily for sale to customers in the ordinary course of a trade or business, are treated as capital gains and losses.

**Other income items.** Most farmers and ranchers have a number of other items that produce income. These may include breeding fees, mineral and soil sales, crop share rents, sale of livestock and produce raised and held primarily for sale, and sale of farm business assets.

## Deductions From Income

The largest category of tax savings is deductions. Generally, expenditures associated with the farming or ranching operation are deductible, but only to the extent the taxpayer has an income tax basis in the item. Capital improvements to property increase the basis by the cost of such improvements, and allowable depreciation reduces the basis.

**Depreciation.** Over time, assets wear out or cease to be useful. In effect, their value is consumed during their period of usefulness in the farming or ranching business. To recognize this cost, an annual deduction for depreciation is allowed. In general, depreciation is allowable on all tangible and intangible property with a limited useful life of more than 1 year that is used in the trade or business of farming or ranching or held for the production of income. A depletion deduction may be claimed for the removal and disposition of natural resources such as sand, gravel, oil and minerals.

## Miscellaneous Farm and Ranch Business Deductions

In general, any expense associated with the business that has a useful life of less than 1 year is deductible against gross income. Depreciation or amortization is required if an asset has a useful life of more than 1 year. These are the most common deductions associated with farm and ranch taxpayers:

- **Soil and water conservation expenses.** Taxpayers engaged in the business of farming can deduct soil and water conservation

expenses in the year incurred under a one-time election, rather than capitalizing the expenditures.

- **Pasture maintenance.** Expenses associated with routine brush clearing and other ordinary pasture maintenance related to property already used in farming are deductible to the extent the expenditures are ordinary and necessary business expenses.
- **Lease payments.** Rental payments for leased assets are deductible under a bona fide lease, but only depreciation, interest, repairs, taxes and insurance are deductible if the transaction amounts to a sale of the property with a security interest retained by the seller.
- **Labor costs.** Labor costs, including reasonable wages paid to children, are an allowable business deduction except for labor used for maintaining the personal residence.
- **Fertilizer and lime.** Fertilizer and lime are allowable business deductions as an election.
- **Taxes.** Real property taxes incurred in the business of farming are deductible on Schedule F. Property taxes attributable to the personal residence are deductible as itemized deductions on Form 1040. Sales taxes on purchased items are deductible if the item itself is deductible.
- **Prepurchased or prepaid inputs.** In order to obtain a deduction for prepurchased inputs such as fertilizer, seed or chemicals, the prepurchase must be made in accordance with a binding contract, must have a business purpose, and must not materially distort income.
- **Interest.** Personal interest is not deductible unless the debt is secured by a mortgage on the principal residence. Investment interest is deductible to the extent of the taxpayer's net investment income. Business interest is fully deductible.
- **Business trips, conventions and cruises.** Expenses associated with business travel within the United States are deductible as a cost of doing business.
- **Meals and entertainment expense.**
- **Expenses attributable to business use of the home.**
- **Environmental clean-up costs.**
- **Rent paid to a lessor spouse.**

## Losses

**Hobby losses.** Losses are deductible if they are attributable to a business. An activity is presumed to be a business if there is net income or profit for 3 or more of the last 5 years. For activities consisting of breeding, showing or raising horses, the presumption arises if there is a profit in any 2 out of the last 7 years. The IRS can rebut the presumption by carrying the burden of proof and establishing a lack of profit motive. If the presumption does not resolve the issue of whether a farm is being operated for pleasure or recreation and not as a commercial enterprise, a determination must be made as to whether the taxpayer was conducting the activity with the primary purpose and intention of realizing a profit.

Other deductible losses include:

- **Operating losses.**
- **Casualty and theft losses.**
- **Passive losses.**

## Reducing Tax Imposed on Income

A number of provisions are available to reduce tax liability. Some of the more popular provisions are:

- **Earned income credit.**
- **Child tax credit.**
- **HOPE scholarship credit.**
- **Lifetime learning credit.**
- **Income averaging.**
- **Farmer IRAs (proposed).**

## Capital Gains Taxation

Capital assets are subject to different income tax treatment than noncapital assets. Capital assets include all property held by the taxpayer except stock in trade or inventory property and property held primarily for sale to customers in the ordinary course of business (such as grain). It is important to meet the holding period requirement in order to be entitled to long-term capital gain treatment. For most assets, the holding period is more than 1 year; for livestock the holding period in order to qualify for capital gains treatment is 24 months or more for cattle and horses and 12 months or more for other eligible livestock such as sheep and hogs. Net capital losses can offset capital gain, but are capped at \$3,000 against ordinary income, which is the most that is deductible if it is a capital loss. Legislation enacted in 1997 and 1998 made significant changes in the area of capital gains taxation.

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