

Farm Income Taxation

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Overview

Income tax planning and management involves an awareness of available income tax alternatives and the ability to integrate those alternatives 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 produce taxable income. The income tax imposed is determined by applying to the taxable income a rate table 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 payment is 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. While cash basis taxpayers must take income into account when it is actually received, income must also be accounted for 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. For tax years before 2002, the election, once made, applied to all subsequent taxable years unless permission was obtained from the IRS to change back to treating CCC loans as loans. Effective for taxable years ending on or after December 31, 2001, the IRS has ruled that a taxpayer reporting CCC loans as income can switch automatically to treating CCC loans as loans.

Payments-in-kind. In general, any time a farmer or rancher receives a governmental benefit, the benefit is reportable into income whether it is received in cash or in-kind. The time at which the amounts are received or made available is ordinarily the time the payments are to be included in income.

Under certain federal farm programs, especially those programs designed to provide environmental benefits, the USDA shares in part of the expense associated with 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 landowner or tenant and another party providing for the production of an agricultural commodity and the landowner or tenant materially participates. For rental situations not involving the production of agricultural commodities where 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. Also, under a 2003 IRS Chief Counsel ruling, all USDA land diversion program payments received under a program requiring the land to be devoted to conservation purposes are subject to self-employment tax. That would include Conservation Reserve program payments, Wetlands Reserve program payments and similar program payments.

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. Fuel expense is also deductible.

Crop insurance proceeds. Proceeds from insurance, such as from hail or fire coverage on growing crops, are includible in gross income in the year actually or constructively received. In effect, destruction or damage to crops and receipt of insurance proceeds 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 two 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 with their cost, in effect, being 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 one 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.

On March 9, 2002, legislation was signed into law allowing a 30 percent extra depreciation amount for regular tax and AMT purposes. Eligible property is property for which the original use commences with the taxpayer, and includes depreciable property with a recovery period of 20 years or less, computer software, water utility property and qualified leasehold property. With one exception, property subject to alternative depreciation is ineligible for the 30

percent allowance. To be eligible for the additional 30 percent depreciation, the property must be required by the taxpayer after September 10, 2001, and before September 11, 2004. The 30 percent limit is claimed after expense method depreciation and before regular depreciation for the year.

Under legislation enacted on May 28, 2003, the 30 percent provision was increased to 50 percent for property. The original of which commenced with the taxpayer after May 5, 2003, if the property was acquired by the taxpayer after May 5, 2003, and before January 1, 2005.

For tangible depreciable personal property, all or part of the income tax basis can be deducted currently in the year in which the property is placed in service. For 2003 through 2005, the aggregate basis amount eligible for the deduction is \$100,000, subject to a dollar-for-dollar phase-out for taxpayers with cost of qualifying property exceeding \$400,000 per taxable year.

Miscellaneous Farm and Ranch Business Deductions

In general, any expense associated with the business having a useful life of less than one year is deductible against gross income. Depreciation is required if an asset has a useful life of more than one year, but expenses are current costs and any cost that produces a benefit lasting more than one year, is generally not currently deductible, but must be depreciated or amortized over the period of benefit or use. The following is a list of 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 onetime election, rather than capitalizing the expenditures.
- **Pasture Maintenance.** Expenses associated with maintenance of pastures for routine brush clearing and other ordinary maintenance activities related to the 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. Both the IRS and the Tax Court specify factors for determining the existence of a "true lease."
- **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.** Special rules apply for meals provided to employees, as well as entertainment expenses incurred for business purposes.
- **Expenses attributable to business use of the home.** Taxpayers with an office in the home that is maintained regularly and exclusively for business purposes may deduct the costs associated with that office. The office must be the principal place of business for the taxpayer or it must be a place of business used by patients, clients, or customers in the normal course or the taxpayer's trade or business.
- **Environmental cleanup costs.** A taxpayer can deduct costs associated with cleaning-up property that the taxpayer contaminated, but not costs expended in cleaning up property that was not contaminated by the taxpayer. Under 1997 rules, "qualified environmental remediation expenditures" may be treated as currently deductible by election.
- **Rent paid to a lessor spouse.** A deduction is allowed if the amount paid is reasonable, the arrangement between the spouses is a bona fide landlord tenant relationship and the spouses have consistently treated each spouse's interest as separate rental property.

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 profits for three or more of the last five years. For activities consisting of breeding, showing, or raising horses, the presumption arises if there

is a profit in any two out of the last seven 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. The following lists some of the more popular provisions.

- **Earned income credit.**
- **Child tax credit.**
- **Coverdell Education Savings Accounts (CESA).**
- **HOPE scholarship credit.**
- **Lifetime learning credit.**
- **Higher Education Expense Deduction.**
- **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 one year, but 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, 1998 and 2003 made significant changes in area of capital gains taxation. Long-term capital gains are taxed at 5 percent (for those in the 10 or 15 percent income tax bracket) and 15 percent (for taxpayers in higher income tax brackets).

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