RURAL TAX EDUCATION

RuralTax.org

Tax Guide

For Owners And Operators Of Small And Medium Size Farms

National Farm Income Tax Extension Committee

June 2023

Prepared by members of the National Farm Income Tax Extension Committee:

Acknowledgements and Funding Source

This guide was originally written by the **Land Grant University Tax Education Foundation Inc**. (LGUTEF). Special thanks to LGUTEF, Philip E. Harris, Linda E. Curry, Guido van der Hoeven, and other contributing authors for work on the original version of this Tax Guide. LGUTEF is a non-profit corporation organized by representatives of land grant universities that teach tax education programs for professional tax practitioners. Find more information at taxworkbook.com.

This material is based upon work supported by the U.S. Department of Agriculture, under agreement number FSA21CPT0012032. Any opinions, findings, conclusions, or recommendations expressed in this publication are those of the author(s) and do not necessarily reflect the views of the U.S. Department of Agriculture. In addition, any reference to specific brands or types of products or services does not constitute or imply an endorsement by the U.S. Department of Agriculture for those products or services. USDA is an equal opportunity provider, employer, and lender.

Contact authors:
Adam Kantrovich, Ph.D., Professor, Clemson University Cooperative Extension

JC Hobbs, Associate Extension Specialist, Oklahoma State University

info@ruraltax.org

Full Tax Guide can be found at RuralTax.org/SmallFarmTaxGuide

RuralTax.org
info@RuralTax.org

This information is intended for educational purposes only. You are encouraged to seek the advice of your tax or legal advisor, or other authoritative sources, regarding the application of these general tax principles to your individual circumstances.

Rural Tax Education is part of the National Farm Income Tax Extension Committee. In their programs and activities, the land-grant universities involved in this project do not discriminate based on race, color, religion, sex, national origin, age, genetic information, sexual orientation or gender identity/expression, disability, status as a protected veteran, or any other status protected by University policy or local, state, or federal law.

June 2023

Table of Contents

Table of Contents: Chapter 1

CHAPTER 1

OVERVIEW OF FARM MANAGEMENT

Introduction

Tax management is an integral part of *farm management*. For some production decisions, such as whether to plant corn or soybeans this year, tax considerations have little or no impact. But tax considerations may have a major effect on the timing of income and deductions. (See Chapter 5 in this guide for an in-depth discussion of timing.) As a result, tax considerations can be a major factor in determining how some farm transactions are structured, such as depreciating or expensing machinery and equipment, prepaying farm expenses such feed or fertilizer, or using a deferred payment contract (installment sale method) when selling raised production.

For example, a producer may take advantage of the like-kind exchange tax provisions to avoid recognizing gain when exchanging one parcel of land for another. The adjusted basis of the old parcel is subtracted from the gain to determine the amount of realized gain. The resulting realized gain reduces the basis of the new land parcel, and also the amount of taxable income that would have resulted from the outright sale of the land and purchase of the replacement parcel. The basis of the new land and the tax recognition is postponed until the new land is sold.

Farm managers can make two types of mistakes with respect to taxes:

1. They can ignore the tax consequences of their decisions entirely, so that after-tax income is lost by not taking advantage of tax-reduction opportunities.

2. They can focus so much on reducing taxes that after-tax income is reduced. Producers must be aware of taxes and tax laws, but they should not let tax considerations overly influence their decisions.

This chapter reviews basic farm-management concepts and how they may be affected by tax considerations. It also illustrates how managing taxes can increase a farmer's after-tax net income. Additionally, the purpose of this chapter is to create a baseline for the tax rules and tax management tools that are presented in this guide.

Budgeting

Budgeting is an analytical technique used to evaluate certain changes in the farm operation or to project farm income and cash flow. Budgeting can be done by hand or by computer. The four main types of budgets are enterprise budgets, partial budgets, total farm budgets, and cash-flow budgets. All of these budgets are based on estimates of future performance. Farmers should draw upon their own experiences and be as realistic as possible in this planning process. Tax considerations can be part of any of these budgets, reflecting changes in the farmer's tax situation that would occur as a result of the alternatives being considered.

(A number of tools are available at http://www.extension.iastate.edu/agdm/wdfinancial.html#analysis).

Enterprise Budgets

The enterprise budget projects the costs and returns of an activity, such as producing grain, raising livestock, or growing vegetables, during a production period. The budget for a specific production system includes the inputs and costs, as well as the production and expected returns. Comparing net returns among enterprises allows the operator to determine the most profitable allocation of the farm's resources over time. Most budgets are based upon a one-year production cycle and use a common measure of profitability, such as net return per acre or per head.

Partial Budgets

Partial budgets are used to make decisions involving only part of the farm business. Typically, the changes in receipts and costs of Alternative A are compared with the changes in receipts and costs of Alternative B, and the alternative with the higher net income is selected. Partial budgets do not take the time value of money into consideration.

Example 1.1: Corn vs. Soybeans

A farmer is comparing production of an acre of corn versus an acre of soybeans. The variable input costs (seed, fertilizer, chemicals, fuel, etc.) are about $680 per acre for corn and $360 per acre for soybeans. Each acre of corn is expected to produce about $1,340 of revenue, compared to $940 for soybeans. The per-acre return to the operator is $660 ($1,340 – $680) for corn and $580 ($940 – $360) for soybeans. A producer in this situation will tend to increase the acres planted in corn.

The expenses considered in Example 1.1 are ordinary current expenses, and the income for both crops is ordinary income. The tax treatment of expenses or receipts does not vary by crop. Thus, as noted in the introduction to this chapter, taxes have no effect on this decision.

In contrast, Example 1.2 looks at the tax impact of an equipment lease versus a purchase. An analysis tool to help with this comparison is accessible at http://www.farmdoc.illinois.edu/fasttools.

Example 1.2: Lease vs. Purchase of Machinery

A farmer can lease a $100,000 tractor for 5 years for a tax-deductible lease payment of $23,017 per year. Alternatively, the farmer could buy the tractor with a 30% down payment, signing a 5-year loan with a 6% interest rate with two payments due per year totaling $16,412. The interest and depreciation are tax deductible.

If farmer Anne's marginal income and self-employment tax rate is 42%, the after-tax net present value of the outflows (discussed later in the chapter) is $1,166 less with the lease than the purchase. In contrast, if farmer Ben's marginal income and self-employment tax is 15%, the after-tax net present value of the purchase is $1,214 less than the lease. Anne would generally prefer the lease, while Ben would generally prefer the purchase.

Cross-Reference

For a discussion of whether a transaction is a lease or a purchase, see Chapter 4 of this guide.

Total Farm Budget

Total farm budgets are typically prepared for decisions having a major impact on the farm. A whole farm budget summarizes the information for all the operation's enterprises, providing an estimate of the operation's net returns (profit). It is used for whole-farm planning. Receipts, expenses, returns, and taxes should be budgeted for the current and the alternative situations. If farm income changes substantially, the associated change in taxes may determine which plan is best to maximize after-tax net income. Go to http://www.extension.iastate.edu/agdm/wdfinancial.html#analysis for a discussion of budgeting procedures.

Cash-Flow Budget

Partial and total farm budgets address the question, "Will it pay?" Without a positive answer to that question, a producer should not proceed. However, the answer to the "Can I pay for it?" question must also be positive. The cash flow associated with an investment is critical when loans are used to implement a decision. A tax-deductible expense does not necessarily generate the funds needed to make scheduled loan payments.

Example 1.3: Tax Savings and Loan Repayment

Cecile paid $100,000 for a piece of farm equipment and will deduct $10,710, $19,130, and $15,030 in depreciation for years 1, 2, and 3, respectively. If Cecile makes a 30% down payment and finances the $70,000 balance over 5 years at 6%, the loan is amortized with two payments per year totaling $16,412. If her marginal tax rate (including federal and state income and self-employment taxes) is 35%, the tax savings from the depreciation deductions for the first 3 years will average $5,235 per year, and therefore will not generate enough tax savings to make the loan payments.

Decision-Making Considerations

Farmers must evaluate alternatives to make management decisions. Marginal analysis is commonly used in evaluating alternatives. For example, how many pounds of nitrogen should be applied per acre to a specific field of corn? Do the savings on inputs from variable-rate application cover the added costs of variable-rate application?

Many alternatives considered by farmers involve investments that have costs and returns spread over a number of years. The costs and returns may occur at different points in time, and the lives of the investments are likely to be different. This difference in timing adds complexity to comparing the alternatives, because a dollar to be received 10 years from today is not worth the same amount as a dollar received today. Discounting the costs and returns of each alternative to their present value allows an appropriate comparison of the alternatives.

Marginal Analysis

"Marginal cost equals marginal revenue" may bring back memories of Economics 101, but the message is an important one. Additional units of an input should be used as long as the additional cost is less than the additional revenue produced. Profit is maximized when marginal costs equal marginal revenue. If the producer's actions affect the prices of the product or costs of an input, the terms *marginal value product* and *marginal input costs* are typically used, but the underlying concept is unchanged.

The table in Figure 1.1 illustrates a classic example of marginal analysis with nitrogen applications on corn. If nitrogen application is increased from 200 to 240 pounds per acre at a marginal cost of $12, corn production increases by 7.2 (157.0 – 140.8) bushels per acre, which adds $28.80 of revenue for a $16.80 ($28.80 – $12) increase in profit. However, increasing the nitrogen application from 320 to 360 pounds, at a cost of $12, results in only $11.60 of additional income. Revenue from the last unit of nitrogen is less than the value of corn produced. Therefore, the last unit of nitrogen should not be applied.

Figure 1.1 Level of Nitrogen Fertilizer Application

Pounds of Nitrogen per Acre	Marginal Cost of Fertilizer	Bushels of Corn per Acre	Additional Bushels of Corn per Acre	Marginal Revenue from Corn
200	$60	149.8	149.8	$599.20
240	$12	157.0	7.2	$28.80
280	$12	163.4	6.4	$25.60
320	$12	167.2	3.8	$15.20
360	$12	170.1	2.9	$11.60

Time Value of Money

Farmers often postpone sales of raised commodities or use deferred-payment contracts to delay receipts into the year following the year of production. These techniques may be used to control the farmer's marginal tax rate.

Cross-Reference

See Chapter 5 of this guide for a discussion of managing the timing of income and deductions.

A secondary effect of such strategies is deferring the payment of income and self-employment taxes, which allows the farmer to use the deferred taxes interest-free for a year. As shown in Figure 1.2, the present value of a $1,000 payment deferred for a year with an 8% discount is $925.90, a savings of $74.10 ($1,000 – $925.90). If the deferral period is increased to 4 years, the net present value of $1,000 with a 6% discount rate is $792.10, a savings of almost $208. If the discount rate is 8%, the present value of a 4-year deferral is $735.

Figure 1.2 Time Value of Money

Year	Discount Rate	Present Value of $1,000			Amount of $1,000 at Compound Interest		
		4%	6%	8%	4%	6%	8%
1		961.50	943.47	925.90	1,040.00	1,060.00	1,080.00
2		924.60	890.00	857.30	1,081.60	1,123.60	1.166.40
3		889.00	839.60	772.20	1,124.86	1.191.01	1.259.71
4		854.80	792.10	735.00	1,169.85	1,262.47	1,360.48
5		821.90	747.30	680.60	1.216.65	1.338.22	1,469.32
10		675.60	558.40	463.20	1,480.34	1.709.84	2.158.92
20		456.40	311.80	214.50	2,191.11	3,207.12	4.660.94

Compound interest increases the return on some investments.

Farm Financial Statements

Records, whether from a computerized record system, a paper recordkeeping system, or even records provided by a recordkeeping service, document the farm's income and expenses, but they do not provide useful tools for analyzing the farm's operations.

The main reason most farmers keep records is for tax reporting — an after-the-fact method that does not provide any meaningful data by itself. Just tracking the figures needed to prepare a tax return typically does not allow analysis and decision-making throughout the year to handle the financial issues that transpire during the year. It also does not guarantee that all the farm's income and expenses are captured because there is no checks-and-balances system.

Lenders and agricultural consultants often are concerned that a farmer lacks adequate records to monitor and analyze the farming business's financial health. Lack of financial data makes it difficult to determine the farm's actual cost of producing the end product, to ascertain the farmer's ability to service debt obligations, and even to develop plans if the operation has major financial problems.

The recommended set of financial statements can help in analyzing an operation in a consistent manner. They include balance sheets, income statements, and cash flow statements for each farming operation. Combining these statements with financial measures (discussed later in this chapter) provides a base guideline to measure the data and provides useful decision-making information for farmers. They are a valuable way of highlighting areas to focus on in your analysis and decision making. Examining production and other information along with the financial measures can lead to robust decisions to maximize the operation's potential.

Balance Sheet Shows Stability

A balance sheet has two parts that must equal, or "balance", each other. This financial report provides indications about the farm's ability to support its ongoing operations, which helps determine how stable the farming operation is. This guide presents a book-value balance sheet and a market-value balance sheet, and discusses how the values differ between the two. The reason for presenting the two is to provide a basis for understanding the reporting of income tax liability associated with normal business activities and the deferred tax liability that would exist in the event of a deemed sale or liquidation.

How the Balance Sheet Works

The following equation divides the balance sheet into two parts. The totals of each of the two parts must be equal.

Assets = Liabilities + Owner's Equity

The balance sheet is presented as a snapshot of the operation's financial position at a single point in time, but it carries over from year to year as the farmer buys and sells assets or pays down debt. Figure 1.3 shows the organization of a balance sheet. The two main sections, Assets and Liabilities, are organized by timeframes. For assets, the gauge is liquidity, or how easily the asset can be converted to cash. For liabilities, the measure is the length of the loan, from the shortest to the longest.

Figure 1.3 Balance Sheets

Book Value Balance Sheet
Business Assets and Liabilities as of December 31, 20XX

ASSETS		LIABILITIES	
Cash	$ 20,883	Accounts Payable, Crops	$ -
Accounts Receivable, Crops	$ 4,200	Accounts Payable, Livestock	$ 2,631
Accounts Receivable, Livestock	$ -	Notes Due Within One Year	$ 38,228
Inventories, Crops	$ -	Current Portion of Term Debt	$ 23,126
Inventories, Feed	$ -	Accrued Interest, Notes Due Within One Year	$ 1,354
Inventories, Livestock	$ -	Accrued Interest, Noncurrent Loans	$ 9,976
Inventories, Supplies	$ -	Income Taxes Payable	$ 6,859
Prepaid Expenses	$ -	Self-Employment Tax Payable	$ 4,208
Cash Investment in Growing Crops	$ -	Deferred Tax on Current Assets	$ -
Other Current Assets	$ -	Other Accrued Expenses	$ -
		Other Current Liabilities	$ -
Total Current Assets	**$ 25,083**	**Total Current Liabilities**	**$ 86,383**
Breeding Livestock	$ 108,739	Noncurrent Portion, Notes Payable	$ 26,503
Machinery & Equipment	$ 152,966	Noncurrent Portion, Real Estate Debt	$ 200,747
Investments in Cooperatives	$ 11,105	Deferred Tax on Non-Current Assets	$ -
Real Estate	$ 464,896	Other Noncurrent Liabilities	$ -
Buildings & Improvements	$ 23,696		
Other Assets	$ -		
Total Noncurrent Assets	**$ 761,403**	**Total Noncurrent Liabilities**	**$ 227,250**
		Total Business Liabilities	$ 313,633
		Farm Business Equity	$ 472,853
Total Business Assets	**$ 786,486**	**Total Business Liabilities & Owner Equity**	**$ 786,486**

Market Value Balance Sheet
Business Assets and Liabilities as of December 31, 20XX

ASSETS		LIABILITIES	
Cash	$ 20,883	Accounts Payable, Crops	$ -
Accounts Receivable, Crops	$ 4,200	Accounts Payable, Livestock	$ 2,631
Accounts Receivable, Livestock	$ -	Notes Due Within One Year	$ 38,228
Inventories, Crops	$ 35,500	Current Portion of Term Debt	$ 23,126
Inventories, Feed	$ 13,130	Accrued Interest, Notes Due Within One Year	$ 1,354
Inventories, Livestock	$ 20,700	Accrued Interest, Noncurrent Loans	$ 9,976
Inventories, Supplies	$ 1,019	Income Taxes Payable	$ 6,859
Prepaid Expenses	$ 18,000	Self-Employment Tax Payable	$ 4,208
Cash Investment in Growing Crops	$ 14,160	Deferred Tax on Current Assets	$ 31,225
Other Current Assets	$ -	Other Accrued Expenses	$ -
		Other Current Liabilities	$ -
Total Current Assets	**$ 127,592**	**Total Current Liabilities**	**$ 117,608**
Breeding Livestock	$ 119,240	Noncurrent Portion, Notes Payable	$ 26,503
Machinery & Equipment	$ 291,200	Noncurrent Portion, Real Estate Debt	$ 200,747
Investments in Cooperatives	$ 11,105	Deferred Tax on Non-Current Assets	$ 110,291
Real Estate	$ 992,000	Other Noncurrent Liabilities	$ -
Buildings & Improvements	$ 83,130		
Other Assets	$ -		
Total Noncurrent Assets	**$ 1,496,675**	**Total Noncurrent Liabilities**	**$ 337,541**
		Total Business Liabilities	$ 455,149
		Farm Business Equity	$ 1,169,118
Total Business Assets	**$ 1,624,268**	**Total Business Liabilites & Owner Equity**	**$ 1,624,268**

Assets

Assets are the items that help you operate the business and produce the farm's income. They consist of cash (your checking account), inventories, noncurrent assets (land, equipment, etc.) and more. As you can see in Figure 1.3, assets are reported on the left side of the balance sheet and are classified as current and noncurrent assets.

Current Assets

Current assets have a life of less than one year and are liquid, meaning they can be converted to cash relatively easily. The most typical current assets are the farm checking and savings accounts, inventories (for market-based balance sheets), and prepaid expenses.

Noncurrent Assets

Noncurrent assets are considered fixed assets which are assets with useful lives extending beyond one year. These assets are also not considered easily convertible to cash. Noncurrent assets are the tangible capital assets that farmers use to produce their end product or commodity. They include machine sheds, barns, tractors, fencing, tiling, cattle, land, and other assets. The amounts reported for these assets are their original costs reduced by accumulated depreciation (the sum of the depreciation deductions taken each year since an asset was acquired). (Refer to Chapter 4 of this guide for more information covering depreciation.)

Valuing Assets on the Balance Sheet

The value used in a book value balance sheet is the cost of the asset or, in the case of depreciable assets such as machinery and equipment, purchased breeding livestock, buildings, etc., the value is the asset's cost less accumulated economic depreciation. Economic depreciation is the decline in an asset's value due it's to use. For example, a tractor purchased for $100,000 might be expected to decline in value by 10 percent annually using the prior year's ending value. Thus after 3 years of ownership, the tractor would be valued at $72,900 on the balance sheet. In addition, inventories of crops, livestock, feed, other supplies, cash invested in growing crops, and prepaid expenses are not included in the book value balance sheet.

A market value balance sheet requires the use of current market values for both the current and noncurrent assets. Current market prices are needed for all the assets. It will be necessary to get reasonable values for market livestock, stored grain, feed and supplies on hand, machinery, equipment, buildings, land, etc. The market value balance sheet provides a better representation of the value of the business after adjusting for liabilities, which are discussed next.

Liabilities and Owners' Equity

Liabilities and the owners' equity are reported on the right side of the balance sheet, and their total must equal the assets reported on the left side of the balance sheet. The most basic thought process in reporting transactions on the balance sheet is this: If the asset side is increased (for example, by purchasing a tractor), then the liabilities/owners' equity side must also increase (for example, by taking out a loan for the tractor). Note that if the tractor is not financed, there is no increase in total assets. Instead, there is a reduction of one class of assets such as cash and a corresponding increase in noncurrent assets.

The liabilities portion of the balance sheet is sorted into current liabilities and noncurrent liabilities. The noncurrent liabilities section is similar to noncurrent assets, defined as liabilities with due dates extending beyond one year. This could be the outstanding principal balance of land or equipment notes.

Current liabilities are those that are due within one year. They include accounts payable (amounts due to suppliers, vendors, or agencies, such as the feed mill or repair shop) and the portion of long-term debt that is due in the current year (such as the principal and interest payment due on an operating note). Also included in the current liabilities is the amount of current income taxes and self-employment taxes payable. The amount to be reported here is based upon the net farm income from the current year's operations that will be paid to the United States Treasury in the coming year. In addition, the market value balance sheet will show a deferred tax liability amount. The deferred tax amount is based on the taxable amount derived from the liquidation of all the current assets in the case of a deemed sale or structured liquidation of the business. The deferred tax liability will not appear in the book value balance sheet.

Noncurrent liabilities include the outstanding principal balances for loans secured by noncurrent assets, such as land, breeding livestock, machinery, equipment, buildings, etc. In addition, the market value balance sheet will have an amount for deferred taxes in the noncurrent liabilities section. This value reflects the tax liability associated with a deemed sale or structured liquidation of the business.

In the event of a structured liquidation of the business, there are a variety of taxable events that occur. The tax liability associated with the sale of land and raised breeding livestock will use the actual sale values (which should be relatively close to the values shown on the market value balance sheet) less the cost as shown on the book value balance sheet. The sale of machinery and equipment, buildings and improvements, purchased breeding livestock, etc. will use the actual sale values (which should be relatively close to the values shown on the market value balance sheet) less the adjusted tax basis shown on the tax depreciation schedules. The amount shown on the book value balance sheet is the cost of the asset adjusted for economic depreciation and not tax depreciation. Again, the deferred tax liability will not appear in the book value balance sheet.

Another way to understand the liabilities section is to think about what liabilities truly are: the debts incurred to support or fund your assets to carry on the farming operations.

Owners' equity is just one name for the equity section of the balance sheet. It is also called net worth, shareholders' equity, or net assets, depending on the structure of your business and purpose for which you are creating the balance sheet. Owners' equity is calculated by subtracting total liabilities from total assets (assets minus liabilities equal owners' equity). It consists of the initial amount of money and property invested into the business plus the annual net profits (net earnings) of the business. If at the end of the business's accounting year, you decide to retain the profits within the business, they are transferred from the income statement (described next) onto the balance sheet into the owners' equity account as retained earnings. These funds can be held for future expansion, investment, debt servicing, or other uses.

Income Statement Shows Consumption

In a business setting, *consumption* is an expense incurred during the fiscal year for goods and services used to satisfy the needs of the business. To consume, you must have sales or income. One way to think about the income statement versus the balance is to think of a building and the daily operations happening inside. The building is emblematic of the balance sheet: It is the stable asset that allows the operations to continue. The daily operations happening inside the building (repairing equipment, for example) are the continual consumption phase.

The income statement has several different names that vary according to the structure of the entity and the resulting activity. It is also known as the profit and loss statement, statement of income, statement of operations, or statement of earnings. Figure 1.4 is an example of an income statement for a sole proprietorship.

Figure 1.4 Income Statement

Income Statement as a Proforma Form 1040, Schedule F (Cash Basis) for the period January 1, 20XX through December 31, 20XX

Revenues			
Crop Sales		$ 203,807	
Market Livestock Sales		$ 47,251	
Raised Breeding Livestock Sales	$ 8,400		
Purchased Breeding Livestock Sales	$ 3,166		
Less Net Book Value of Purchased Breeding Livestock Sales	$ (4,016)		
Total Breeding Livestock Revenue		$ 7,550	
Crop Insurance Proceeds	$ -		
Ag Program Payments	$ 18,534		
Patronage Dividends	$ 1,320		
Other Operating Revenue	$ -		
Total Other Operating Revenues		$ 19,854	
Gross Revenues			**$ 278,463**
Expenses			
Operating Expenses		$ 186,532	
Feed Purchases		$ 12,633	
Feeder Livestock Purchases		$ -	
Depreciation Expense		$ 26,882	
Total Operating Expenses			**$ 226,046**
Net Income from Operations			**$ 52,416**
Other Revenue (Expenses)			
Interest Income	$ -		
Interest Expense:			
Interest on Current Loans	$ (752)		
Interest on Noncurrent Loans	$ (14,335)		
Amortization of Loan Fees	$ -		
Net Interest Income (Expense)		$ (15,087)	
Sales of Farm Assets	$ -		
Less Net Book Value of Farm Assets Sold	$ -		
Total Gain (Loss) on Sale of Farm Assets		$ -	
Other Miscellaneous Income (Expense)		$ -	
Total Other Revenue (Expenses)			**$ (15,087)**
Income before Income Tax (Net Farm Income)			**$ 37,330**
Income Tax Expense			
Income Taxes		$ 6,859	
Self-Employment Tax		$ 4,208	
Total Income Tax Expense			**$ 11,067**
After-Tax Net Income			**$ 26,262**

The income statement is a picture of farm production (revenue/sales/income) over the year, reduced by what the production costs (expenses), to yield the net income.

Most farmers do a good job of tracking their income and expenses because this information can be retrieved from the farm checking account, operating line of credit, and long-term loans. However, they may not be accurately measuring the farm's economic performance or reporting their income or expenses correctly because they aren't using a checks-and-balances system.

A checks-and-balances system reconciles or balances accounts on a monthly basis to be sure each item is captured. Accounting software programs are often the most efficient means to achieve the checks and balances required to assure that the records are kept accurately. Further, preparing this information only for tax purposes does not offer any guidance in the decision-making process for the farm as a whole.

Most farm income statements are organized to match the operation's entity structure for tax purposes, and are created for *book purposes*. Book purposes means that records are based on actual purchase and sales prices. Other types of income statements are created for *management purposes*. Different income statements, based on the fair market value of your operation, are used for *lending purposes*.

The following section describes the entries for the sole proprietorship income statement shown in Figure 1.4. The modifications required for other entity types are also discussed briefly.

Income

- Include total income received from the sales of both raised livestock and livestock purchased for resale. Also include the total cash receipts from the sales of breeding livestock.
- Do not include proceeds from outstanding loans in cash income (even if you report CCC loans as income for tax purposes).
- Both the cash and noncash portions of cooperative stock received are included in income. When amounts are moved to the balance sheet, the cash portion is included in your farm checking account (a current asset), and the noncash portion is included as a noncurrent/other asset.
- Report gross sales of cattle, milk, and other commodities, and enter the corresponding expenses. Even though the effect on income is the same if amounts are netted, entering both the income and expenses aids in determining the correct financial picture.
- Do not include sales of land, machinery, or other depreciable assets, loans received, or income from nonfarm sources in your gross farm income. Doing so overstates your farm operating income. These items are reported in the "Other income and expenses" section of the income statement.

Expenses

- Depreciation is a noncash expense that reduces the balance-sheet value of an asset over its life.

Several accounting methods can be used to write off an asset's depreciable cost over its useful life. Depreciation frees up cash flow by reducing the company's reported income without a cash expenditure. Depreciation is discussed in Chapter 4 of this guide.

- Insurance costs for the owner's life and disability insurance are not tax deductible in most situations. Therefore, these costs should be paid from the personal checking account, taken as a distribution from the business, or added to the owner's Form W-2 income, depending on the entity structure.

- Do not include the death of purchased livestock as an expense; these costs are captured through the noncurrent assets section of the balance sheet. You must note these deaths, however, to be certain they are captured correctly.

- The owner's federal and state income taxes and self-employment taxes are personal expenses and should not be reported as a farm expense. If the entity structure is a corporation, the employer share of social security and Medicare taxes is reported as an expense.

- Interest paid on all farm loans, land contracts, and farm-related charge cards is an expense on the income statement, but principal payments are not. The principal payments impact the balance sheet by decreasing the liability for the balance of the loan.

- Do not include the purchase of capital assets with a useful life longer than one year (such as machinery replacements) as a farm expense. The cost of these assets is accounted for on the balance sheet under noncurrent assets. It is expensed out via depreciation over the assets' designated useful lives. Land purchases do not depreciate but are included on the balance sheet as noncurrent assets.

- Family living costs (personal expenses, such as college tuition and cable television) are shown as draws from the equity section if a sole proprietor farmer does not maintain separate business and personal checking accounts. However, the farming operation should have a separate account so that business and personal expenses are paid from different accounts.

Points to Remember

- You are creating your records for analysis. To achieve an accurate end result, you must enter accurate information.

- Schedule F (Form 1040), Profit or Loss From Farming, is not an income statement because it shows only part of your income for the year. For example, a dairy farmer includes only milk, crop, and feeder livestock sales on Schedule F (Form 1040). Sales of cull cows held longer than 24 months and sales of machinery, as well as various other transactions, are shown on different forms and schedules, including Form 4797, Sales of Business Assets, Schedule D (Form 1040), Capital Gains and Losses, and Form 6252, Installment Sales.

Statement of Cash Flows

The balance sheet and income statement provide valuable insights into your business, but one more statement—a statement of cash flows—is necessary to accurately determine if a farm is fiscally fit. The accounting events and transactions reported on the income statement do not necessarily coincide with the actual receipt and disbursement of cash. The income statement measures profitability, not cash flow.

A cash-flow statement is used to predict future cash flow, which helps with budgeting, expansion plans, debt pay-down decisions, and much more. For lenders, the cash flow reflects a farm's financial health and suggests areas to strategize with farmers.

The cash-flow statement is derived from the income statement. Its preparation starts with net income or earnings and then adds and subtracts changes in assets and liabilities from the beginning and ending balance sheets for the accounting period being analyzed. Cash flow leaves little room for manipulation by the owners or operations. Unless it is altered by outright fraud, this statement gives a true picture of cash ins and outs for the farm—either the farm has cash, or it does not.

Figure 1.5 shows a cash-flow statement with a section for each of the three means by which cash enters and exits a business—*core operations*, *investing*, and *financing*. It makes adjustments to net income by adding or subtracting the differences in income, expense, and credit transactions that occur from one accounting period to the next. Not all transactions involve actual cash changing hands; therefore, many items need to be analyzed for the proper treatment.

Figure 1.5 Cash-Flow Statement

Statement of Cash Flows for the period January 1, 20XX through December 31, 20XX

Cash from Operating Activities	
Cash Provided by:	
Crop & Livestock Sales	$ 251,058
Other Operating Income	$ 19,854
Other Miscellaneous Income	$ 2,000
Cash Used for:	
Feed Purchases, Feeder Livestock Purchases, and Other Items for Resale	$ (12,633)
Operating Expenses	$ (186,532)
Interest Expense	$ (16,314)
Income Taxes	$ (5,908)
Net Cash from Operating Activities	
Cash from Investing Activities	
Cash Provided from Sale of:	
Breeding Livestock	$ 11,566
Machinery & Equipment	$ -
Real Estate & Buildings	$ -
All Other Investments	$ -
Cash Used for Purchase of:	
Breeding Livestock	$ (2,000)
Machinery & Equipment	$ -
Real Estate & Buildings	$ (14,000)
All Other Investments	$ -
Net Cash from Investing Activities	
Cash from Financing Activities	
Cash Provided by:	
Operating Loans	$ 38,228
Term Debt Financing	$ -
Nonfarm Income Contributed to the Farm Business	$ 11,236
Capital Contributions, Gifts, Inheritances	$ -
Cash Used for:	
Principal on Term Debt	$ (40,370)
Repayment of Operating and CCC Loans	$ (29,900)
Owner Withdrawals	$ (27,368)
Dividends and Capital Distributions	$ -
Net Cash from Financing Activities	

Operations

The first section of the statement reflects how much cash is generated from the farm's products or services—the *normal operations* of the business, meaning the inflows and outflows of cash based on the day-to-day business dealings. Generally, changes between the beginning and ending balances in accounts receivable, depreciation, inventory, and accounts payable are reflected in cash from operations.

Depreciation is not a cash expense. It is deducted as an expense on the income statement, and it adds to accumulated depreciation on the balance sheet, but because cash didn't change hands, the depreciation taken as an expense in the current accounting period is added back to cash flows. The only time an asset is accounted for in cash flows is when the asset is sold.

A decrease in accounts receivable implies that cash has been collected from customers who are paying amounts due on invoices. This difference is added to cash because the farm business has received cash. Accounts payable has the opposite effect. A decrease in accounts payable implies that cash has been taken out of the business to pay down bills. Thus, this difference is subtracted from cash.

Investing

The investing section typically consists of the purchase or sale of assets, such as changes in equipment, buildings, or investments (securities). Cash changes in this section are reductions when assets are purchased. When a farm sells an asset, the cash increases this section.

Financing

This section shows changes in debt or loans. It measures the flow of cash between the business and its owners and creditors. When principle is paid down on a loan, cash decreases because it is used to pay the liability. When additional funds are borrowed, cash increases.

The cash-flow statement in Figure 1.5 shows that the cash flow for the year 202X was $65,401. The positive cash flow is from the cash earned from operating the farm, which is a good sign. It means that the core operations of the farm are generating profits, which allows the farm to invest in expansion, future advancements or equipment, or pay down debt. Lenders will also be pleased because there is cash available to service debt.

Although all cash-flow statements do not show a positive cash position, a negative cash flow should not automatically be deemed to be a poor outcome without further analysis. Sometimes a negative cash flow is a result of a farm's decision to expand, which can take a considerable sum of cash and be good for the future of the operations. Analyzing cash flow and changes from one accounting period to the next gives the farmer, lender, and other decision-makers a better idea of how the business is performing and how it is being managed, as well as whether it may be on a successful path.

Points to Remember

- Cash flow is purely the cash coming in and the cash being spent.
- Cash flow does not include any amounts for *future* incoming or outgoing cash (credit transactions). It is like a checkbook register.
- Cash is not the same as net income. Net income is shown on the income and balance sheet, and includes both cash sales and sales made on credit.
- If all cash flows are accurately recorded, the total sources of cash equal the total uses of cash. If a significant difference exists, the records should be carefully reviewed for errors and omissions.

Summary

Each financial statement is just one piece of the financial puzzle. It is imperative to understand the interrelation among the reports to analyze the farm's financial position. To benefit even more from these financial statements, you can create a detailed analysis that provides additional information to gauge your performance.

Appendix

Measures Used in Analysis

1. **Liquidity**: The ability of the farm to meet financial obligations as they come due.
2. **Solvency**: The ability of the farm to pay all its debts if it were sold tomorrow.
3. **Profitability**: The difference between sales and the expenses incurred to produce those sales (net profit).
4. **Repayment Capacity**: The ability to repay term debt from farm and non-farm income.
5. **Financial Efficiency**: The effectiveness of assets used to generate income; the ability to use assets to their maximum potential.

The Farm Financial Scorecard developed by the Center for Farm Financial Management and University of Vermont Extension (which can be accessed at https://cffm.umn.edu/wp-content/uploads/2019/02/FarmFinanceScorecard.pdf) presents 21 financial measures in those five general categories to analyze the financial performance and stability of a farming operation. The desirable ranges and percentages vary significantly by the type of farm, entity structure, seasonal issues, scale of business, and more. Trends across years demonstrated in a farm's operation are most important because they can identify areas that need improvement.

A key question in analyzing your own operation is, "How accurate are the financial statements used to develop the measures?" Unless the financial statements use accurate data, the financial measures may have little validity. After accurately preparing the balance sheet, income statement, and cash-flow statement, it is a good exercise to apply the following standard financial measures to your operation. Each accounting period can then be gauged on the prior period to determine the operation's progress. You will be well on your way to making better and more focused decisions. These financial measures are useful to highlight areas to focus on in your analysis and decision making. Examining production and other information along with the financial measures can lead to robust decisions to maximize the operations potential.

Liquidity

1. **Current ratio** = total current farm assets divided by total current farm liabilities. The desired range is 2.0 or larger.

2. **Working capital** = total current farm assets minus total current farm liabilities. The desired range is a positive amount that is stable. This ratio is calculated based on dollars and therefore is dependent on the farm's size.

3. **Working capital to gross revenues** = working capital divided by gross farm income. The desired range is 30% or larger.

Solvency

4. **Farm debt to asset ratio** = total farm liabilities divided by total farm assets. The desired range is 30% or less.

5. **Farm equity to asset ratio** = total farm equity (net worth) divided by total farm assets. The desired range is 70% or larger.

6. **Farm debt to equity ratio** = total farm liabilities divided by total farm equity (net worth). The desired range is .43 or less.

Profitability

7. **Rate of return on farm assets** = (net farm income from operations plus farm interest expense minus value of operator labor, unpaid family labor, and management) divided by average value of farm assets. The desired range is 8% or larger.

8. **Rate of return on farm equity** = (net farm income from operations minus value of operator labor, unpaid family labor, and management) divided by average farm equity (net worth). The desired range is greater than the rate of return on farm assets in item 6 or 10% or larger.

9. **Operating profit margin** = (net farm income from operations plus farm interest expense minus value of operator and unpaid family labor) divided by gross cash farm income plus/minus inventory change of crops, market livestock, breeding livestock, and other income items minus feeder livestock purchased minus purchased feed. The desired range is 25% or larger.

Repayment Capacity

10. **Term debt and capital lease coverage ratio** = (net farm income from operations plus net non-farm income plus depreciation expense plus interest on term debt and capital leases minus total income tax expense minus family living withdrawals) divided by scheduled principal and interest payments on term debt and capital leases payments. The desired range is 1.75 or larger.

11. **Capital replacement and term debt repayment margin ratio =** (net farm income from operations plus net non-farm income plus depreciation expense plus interest on term debt and capital leases minus total income tax expense minus family living withdrawals divided by (scheduled principal and interest payments on term debt minus payments on capital leases plus unfunded capital replacement purchase allowance). The desired range is 1.50 or larger.

Financial Efficiency

12. **Asset turnover ratio =** value of farm production divided by average farm assets. The desired range is 45% or larger.

13. **Operating expense ratio** = (farm operating expense excluding interest minus depreciation) divided by gross farm income. The desired range is 60% or less.

14. **Depreciation expense ratio** = depreciation expense divided by gross farm income. The desired range is 5% or less.

15. **Interest expense ratio** = farm interest expense divided by gross farm income. The desired range is 5% or less.

16. **Net farm income from operations ratio** = net farm income from operations divided by gross farm income. The desired range is 20% or larger.

The Farm Financial Standards Council (https://www.ffsc.org) publishes financial guidelines and management accounting guidelines for agricultural operations. The Financial Guidelines for Agricultural Production provides recommended standards for format and content of financial reports, recommended financial measures common to all sectors of agriculture, and example statements and measures. The Management Accounting Guidelines for Agricultural Production responds to the ever-increasing need for consistent, reliable, and accurate management information systems to support day-to-day production decisions.

Table of Contents: Chapter 2

CHAPTER 2
OVERVIEW OF TAXES

Introduction

Farmers, as well as other taxpayers, pay a wide variety of taxes to federal, state and local governments. This chapter provides a brief overview of those taxes to help you understand the context of the tax planning discussed in the chapters that follow.

Property Taxes

Property taxes are imposed on the value of the property you own. The most common property tax is the real property tax imposed by local governments. This tax is generally the principal source of revenue for local governments. Some jurisdictions also impose a property tax on the value of certain personal property, such as motor vehicles licensed for use on public roads and equipment used in a business.

In most jurisdictions, property tax is computed annually by multiplying the assessed value of the property by that year's tax rate. The local government sends a tax bill to each property owner that details how the tax is calculated and when the payment or payments are due.

A failure to pay property taxes results in a tax lien on the property. The lien allows the local government to foreclose on the property, sell it at a public auction, and apply the sales proceeds to the unpaid taxes.

Local governments typically set the tax rate by dividing their approved budgets by the total assessed value of the real property subject to the tax. Therefore, the tax you pay depends on the assessed values of your property relative to the assessed values of all the other property in the local government's jurisdiction. If the assessed value of all property in a jurisdiction increases by 10% but the government's budget does not change, the amount of tax due on each property stays the same because the tax rate decreases by the same 10%.

In some states, land used for farming purposes is assessed at its use value rather than at its fair market value. The use value reflects the value of the property to a farming business rather than the amount a buyer would pay for it for an alternative use, such as recreation or development. The formula for computing the use value of farmland is typically based on commodity prices, farmland rental rates, or other measures of the ability of the land to produce income in a farming business. The threshold requirements for use valuation vary by state, but they generally involve evidence of agricultural use, such as planting crops or grazing livestock.

Planning Pointer

Satisfy Use-Value Requirements

In some cases, a small change in your use of land may make it eligible for use valuation and a reduction in property taxes. Changes that cost you less than the taxes you save increase your after-tax income.

Sales Taxes

Most state governments and many local governments impose a sales tax on purchases of goods and some services. The sales tax is collected at the point of purchase by the vendor, who then remits the taxes to the government.

A number of goods are exempt from sales taxes for a variety of reasons. The most common exemption is food purchased in grocery store. Goods purchased as an input for manufacturing are exempt because sales tax will be collected when the final product is sold. Most states have a sales tax exemption list of farm inputs, such as equipment, seeds, feed, fertilizer, lubricants, animal bedding, and livestock drugs. To qualify for a sales tax exemption that is based on the buyer's use of the good, the buyer generally must provide the seller an exemption certificate or other evidence that the purchase is sales tax-exempt.

In most states, farmers who regularly sell goods that are subject to sales tax may be required to obtain a seller's permit, an identification number and, in some states or municipalities, a business license, and they must collect the sales tax at the point of sale. The collected sales taxes must be remitted to the government periodically with a tax return that reports the taxable sales.

Sellers are not required to collect sales tax on goods shipped to out-of-state buyers if the seller does not have a sufficient physical presence in the buyer's state to be treated as doing business in that state.

Use Taxes

Purchases that would be subject to a state or local sales tax if the seller had a physical presence in the buyer's state are subject to an equivalent tax called the use tax. Buyers are responsible for self-reporting and paying use tax, generally when they file their state income tax returns. Unlike sales tax, use tax is not collected at the point of sale, and unlike property tax, the government does not send a use-tax bill.

Example 2.1: Use Tax

Seth Shapiro bought a computer from an out-of-state seller that had no retail location in Seth's state. The seller was not required to collect—and did not collect—sales tax on Seth's purchase. If Seth purchased the computer from a seller in his own state, the seller would collect a 6% sales tax from Seth and remit it to the state government. Seth must report the purchase to his state government and pay a 6% use tax.

Excise Taxes

Like sales taxes, excise taxes are usually collected by the seller from the buyer at the point of sale. However, an excise tax differs from a sales tax in three ways:

1. An excise tax applies to a narrow range of products, such as tobacco products. A sales tax applies to most goods and some services.
2. An excise tax is based on the number of units purchased, such as cartons of cigarettes or gallons of gasoline. A sales tax is based on the amount paid.
3. An excise tax is usually a much greater proportion of the total sales price than a sales tax.

Fuels used in farming are not subject to the federal excise tax that is collected on fuels used in vehicles driven on public roads. Farmers can claim a credit on their federal income tax returns for the excise taxes they paid when they purchased the gasoline if they use the gasoline for a farming purpose. If farmers purchase diesel fuel and use it for a farming purpose, they can either claim a credit on their federal income tax returns or file a refund claim for the excise taxes paid on the diesel fuel.

Cross-Reference

See Chapter 14 of IRS Publication 225, *Farmer's Tax Guide*, for more details on the excise taxes on gasoline and diesel fuel.

Gift Taxes

A gift tax is imposed on the value of gifts made during the donor's life. The federal government and several states collect a gift tax. The amounts that can be given tax-free and the gift tax rates vary from state to state. This brief overview discusses only the federal gift tax.

Annual Exclusion

The federal gift tax rules include an annual exclusion. For 2022, donors may exclude from the gift tax the first $16,000 given to each of any number of individuals. The $16,000 amount is adjusted for inflation, so it may be a different amount in future years, but it will always be an even multiple of $1,000. In addition to the $16,000 (as adjusted for inflation), payments for the benefit of another individual are excluded from taxable gifts if they are made directly to an institution of higher learning or to a person or entity that provides medical care to the individual.

Example 2.2: Gift Tax Annual Exclusion

Guaming Yang gave $116,000 to each of her three children in 2022, for a total of $348,000 being gifted. Guaming's taxable gifts for 2022 total $300,000. Since the first $16,000 transferred to each child is excluded from taxable gifts, that leaves $100,000 per grandchild as taxable for a total of $300,000.

Gifts Between Spouses

Gifts of any amount to the donor's spouse are excluded from taxable gifts. Therefore, spouses can give as much as they want to give to each other, and they will not be subject to the federal gift tax on those gifts. This is the unlimited marital deduction provision of the tax law.

Gifts to Charity

Gifts of any amount to qualified charities are excluded from taxable gifts. Therefore, an individual can reduce his or her taxable estate without paying any gift tax by making donations to qualified charities.

Federal Gift Tax Rate

The effective federal gift tax rate for taxable gifts in 2022 range from 18% to 40%. There are some very specific rules for various purposes that may require or exclude/exempt federal gift taxes from being owed. Please refer to the Instructions for IRS Form 709.

Applicable Exclusion Amount (Lifetime Exclusion Amount)

An applicable credit amount offsets the federal gift tax using the first $5,000,000 base that has increased for inflationary purposes. In December of 2017, the Tax Cuts and Jobs Act doubled the lifetime exclusion amount for a limited time. Beginning on January 1, 2026, the personal lifetime exclusion amount will again revert to the $5,000,000 base plus appropriate inflationary adjustments. The 2022 per person lifetime exclusion is $12,060,000. Unlike the annual exclusion, each donor has only one applicable exclusion amount for cumulative taxable gifts made to all donees. The applicable exclusion amount for gifts in any tax year is reduced by the donor's prior taxable gifts that were tax-free because of the gift tax applicable exclusion amount in effect at the time of the prior gifts.

Example 2.3: Gift Tax Applicable Exclusion Amount

John James made no taxable gifts before 2020, when he gave each of his three children $215,000. The 2020 annual exclusion was $15,000, which reduced each taxable gift to $200,000, for a total of $600,000 of taxable gifts. The $11,580,000 lifetime applicable exclusion amount for 2020 resulted in no gift tax on the $645,000 taxable gifts.

In 2021, John gave his children another $515,000 in taxable gifts for each of the three children for a $1,545,000. The annual exclusion amount for 2021 was also $15,000 which brings the total to $1,500,000 that is applied to the lifetime exclusion along with the $600,000 from 2020. The $11,700,000 applicable lifetime exclusion amount for 2021 is reduced by the $600,000 2020 gift and the $1,500,000 2021 gift. Therefore, $2,100,000 ($600,000 + $1,500,000) is subtracted from the $11,700,000 which leaves at least $9,600,000 that can be gifted or passed through the estate after John's death tax-free if John were to die before 2026.

If John provided only one gift in the year 2021, of $5,000,000 to each of the children then John would have exceeded his life-time exclusion amount by $3,300,000. The tax rate on the $3,300,000 is 40% since the value is above $1,000,000, which would equate to a gift tax of $1,320,000 that would need to be paid by John. For further details please see IRS Instructions for Form 709.

Planning Pointer

Opportunity in 2002 through 2025

Taxpayers may want to make gifts prior to 2026 to take advantage of the higher lifetime applicable exclusion amount. Congress could increase the applicable exclusion amount for 2026 and later years but that is not a guarantee. Pay attention to future legislation for any possible changes that may occur.

Estate Taxes

An estate tax is imposed on the value of a decedent's taxable estate. The federal government and several states collect an estate tax. The amounts that can be passed tax-free and the estate tax rates vary from state to state. This brief overview discusses only the federal estate tax.

Note

Rules are More Complex

The rules for computing the estate tax are more complex than this summary indicates, but this summary explains the effect of those tax rules. See IRS Publication 950, *Introduction to Estate and Gift Taxes*, and IRS Publication 559, *Survivors, Executors, and Administrators*, for more information on estate taxes.

Gross Estate

For purposes of the federal estate tax, a decedent's gross estate includes the value of all property the decedent owned—directly or indirectly—at the time of death. In addition to the decedent's tangible assets (such as cash, bank accounts, personal property, and real estate), the gross estate includes intangible assets (such as life insurance owned by the decedent) and annuities payable to the decedent or the decedent's heirs.

> **Note**
>
> ***Probate Estate is Different***
>
> Some assets that are excluded from a decedent's probate estate are included in the decedent's federal estate tax gross estate. For example, if the decedent owned a life insurance policy on his or her life and the proceeds are payable to a beneficiary other than the decedent's estate, the policy is excluded from the probate estate, but it is included in the federal estate tax gross estate.

Taxable Estate

A decedent's taxable estate is the gross estate reduced by deductions for debts owed by the decedent, funeral expenses, amounts going to a charity, and state death taxes. The value of the estate going to the spouse may not be taxable to the estate dependent on facts and circumstances. Present (2022) Estate and Gift Tax law allows for the deceased spouses' unused lifetime exclusion amount to be transferred to the surviving spouse; this is called "portability". Although gifts made while alive to a spouse are tax free, the overall value of the estate's assets is potentially taxable above the lifetime exclusion limit. Portability allows the unused portion of the deceased lifetime exclusion amount to be transferred to the spouse and added to the spouse's individual exclusionary amount. This does require tax form(s) to be filed within a specified period to make use of portability.

Applicable Exclusion Amount

An applicable credit amount offsets the federal estate tax on the first $12,060,000 of the taxable estate for deaths in 2022. The applicable exclusion amount is scheduled to be cut in half for deaths after 2025. The applicable exclusion amount is reduced by the donor's taxable gifts that were tax-free because of the gift tax applicable exclusion amount in effect at the time of the gifts.

Inheritance Taxes

An inheritance tax is imposed on a person who inherits property. There is no federal inheritance tax, but some states impose an inheritance tax on the value of money and other property that is inherited from a decedent.

Inheritance tax rules vary from state to state, but most states have an exemption amount that is not taxed and tax rates that increase as the amount that is inherited increases. Exemptions and rates often vary by the relationship of the heir or beneficiary to the decedent. An inheritance from a spouse might not be taxed, and an inheritance by a child might have a large exemption amount and low tax rates on the amount above the exemption amount. The exemption amount might decrease, and the tax rates increase for inheritances from more distant relatives, with the lowest exemption amount and the highest tax rates applying to an inheritance from an unrelated decedent.

Income Taxes

An income tax imposes a tax on the taxpayer's income. The federal government, most state governments, and some local governments collect an income tax. Many state and local income taxes are based on the federal income tax rules, with varying adjustments. This brief overview discusses only the federal income tax.

Figure 2.1 summarizes the income tax computation by outlining the steps taxpayers follow on Form 1040, U.S. Individual Income Tax Return.

Figure 2.1. Outline of Federal Income Tax Calculation

Gross Income
– Above-the-line deductions
= Adjusted gross income
– Standard deduction or itemized deductions
– Personal and dependent exemptions deduction (due to the Tax Cuts and Jobs Act, there are no Personal exemption deductions through the 2025 tax year).
= Taxable income
× Income tax rates
= Income tax
– Credits
+ Other taxes
= Total tax
– Tax payments during the tax year
= Tax due with return or tax refund

Gross Income

The Sixteenth Amendment to the United States Constitution gives Congress the power to collect taxes on income. Congress used that power by defining gross income as "all income from whatever source derived." Because of that broad definition, an increase in wealth is included in taxable income unless it is specifically excluded. For example, Congress excludes an increase in the value of property from gross income until there is a taxable event, such as a sale.

Form 1040 provides separate lines to report several categories of income, such as wages, interest, dividends, refunds, alimony, distributions from retirement plans, unemployment compensation, and social security benefits.

An individual's gross income from a sole proprietorship is reported on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship); Schedule E (Form 1040), Supplemental Income and Loss; or Schedule F (Form 1040), Profit or Loss From Farming. The related business expenses, which are some of the above-the-line deductions, are also reported on those forms. Only the net business income is reported on Form 1040.

Similarly, proceeds from selling assets that qualify for capital gain treatment are reported on Schedule D (Form 1040), Capital Gains and Losses. The income tax bases of those assets are also reported on Schedule D (Form 1040) and subtracted from the sale proceeds before the net amount is carried to Form 1040.

An individual's share of income from flow-through entities, such as partnerships, S corporations, and trusts, is reported first on Schedule E (Form 1040) and then carried to Form 1040.

Gross income that does not fall within any category on the itemized lines on Form 1040 is reported on a line called "Other income" (line 8 on the 2022 form).

Because deductions are subtracted from business income before it is reported on Form 1040, an individual's total gross income does not show up in any one place on the income tax return, and there is no line labeled "gross income." The sum of the income and losses that are reported in the income section of Form 1040 (line 9 on the 2022 form) is appropriately labeled "total income."

Adjusted Gross Income

Adjusted gross income (AGI) is an important number in the income tax calculation because it is used as a base for some other calculations. For example, medical expenses can be deducted only to the extent they exceed 7.5% of AGI. Most miscellaneous itemized deductions reduce taxable income only to the extent the total exceeds 2% of AGI.

AGI is calculated by subtracting any remaining above-the-line deductions from total income (business expenses and the bases of assets were already deducted on other schedules). The remaining above-the-line deductions include educator expenses, health savings account contributions, moving expenses, one-half of self-employment taxes, the cost of self-employed health insurance, certain retirement plan contributions, interest paid on student loans, deductible tuition and fees, and Section 199, 199a, etc.. Due to tax law changes, alimony may or may not be included as an above-the line deduction due to facts and circumstance primarily based on the date and the language of the divorce decree.

Including a deduction in the above-the-line category, rather than as an itemized deduction, has three effects on tax liability:

1. Above-the-line deductions can be claimed even if the taxpayer claims the standard deduction instead of itemizing deductions.
2. Above-the-line deductions are not subject to the floors that reduce some itemized deductions.
3. Above-the-line deductions reduce AGI, which affects other tax calculations as described earlier.

Standard Deduction

If a taxpayer does not elect to itemize deductions, he or she subtracts the standard deduction from AGI. Standard deductions vary by filing status, dependency status, and the taxpayer's age, and are increased for taxpayers who are legally blind.

Cross-Reference

See Figure 13.1 in Chapter 13 of this guide for a list of the 2022 standard deductions.

Itemized Deductions

Itemized deductions are personal expenses for which Congress specifically allows a deduction. They include medical and dental expenses (to the extent the total exceeds 7.5% of AGI); state and local taxes; interest on a home mortgage; gifts to charities; casualty and theft losses of property used for personal (rather than business) purposes; employee business expenses; investment expenses; and tax preparation expenses.

In most cases, taxpayers should elect to itemize their deductions if the total exceeds their standard deduction. However, a married person who files separately cannot itemize his or her deductions if his or her spouse claims the standard deduction.

Standard Deduction & Dependent Exemptions Deduction

Because of the Tax Cuts and Jobs Act of December 2017, there are no personal deductions allowed through tax year 2025. But there is an available deduction for some dependents of those taxpayers. The taxpayer (parents/guardians) are eligible for a standard deduction with a value determined by filing status. For example, a married couple with three children who file a joint income tax return can claim three dependent exemptions. For 2022, their standard deduction is $25,900, and dependent exemptions deduction is up to $1,150 for qualifying dependents. This would total a deduction of $29,350: ($25,900 + ($1,150 x 3)).

Taxable Income, Income Tax Rates, and Income Tax

Taxable income is the remainder after itemized deductions or the standard deduction and the personal (following 2025 tax year) and dependent exceptions deduction are subtracted from AGI. It is the base to which the tax rates are applied to compute income tax liability.

The income tax rates are graduated, which means that a higher tax rate applies to higher levels of income. The higher rates apply only to the income above the threshold for each rate and not to the income below that threshold.

Example 2.4: Income Tax Rates

Victor and Maria Gomez reported $150,000 of taxable income on their 2021 joint income tax return. For 2021, the joint return tax rate on the first $19,900 of taxable income is 10%. The tax rate for the next $61,150 is 12% and the final $68,950 is taxes at a rate of 22%. Therefore, the Gomezes' 2021 income tax is $24,497, as shown below.

Tax on first $19,900 of taxable income ($19,900 × 10%)		$1,990
Tax on amount over $19,900		
12% tax bracket: $81,050 - $19,900 =$61,150	$61,150 * 12%	$7,338
22% Tax bracket: $150,000 - $81,050 = $68,950	$68,950 * 22%	$15,169
Total tax		$24,497

The federal income tax rate on long-term capital gains and qualified dividends is the lesser of the ordinary income tax rate or the tax rate for long-term capital gain. For 2022, the tax rate for most long-term capital gains is 0% for eligible gains and dividends included in total taxable income that does not exceed the $83,350 for Married Filing Jointly (MFJ) filed returns or $41,675 for single individuals. It is 15% for eligible long-term capital gains and dividends included in income that would be above $83,350 for MFJ filed returns or above $41,675 for single filers.

Figure 2.2. 2022 Long Term Capital Gain Rates

2022 Long Term Capital Gains Rates	Single/Individual		Married Filing Jointly		Head of Household	
	Above	Top	Above	Top	Above	Top
0%	$ -	$ 41,675.00	$ -	$ 83,350.00	$ -	$ 55,800.00
15%	$ 41,676.00	$459,750.00	$ 83,351.00	$ 517,200.00	$ 55,801.00	$ 488,500.00
20%	$459,751.00	And Up	$517,201.00	And Up	$ 488,501.00	And Up

*There are higher capital gain rates for collectibles. Long-term capital gains for C-corporations are treated at the same tax rate as ordinary income.

Example 2.5: Tax Rates for Capital Gain

In 2022, Victor and Maria Gomez have $25,000 of long-term capital gains, in addition to $80,000 of ordinary income. The top of the 0% tax rate for long-term capital gain is $83,350 (total of ordinary income and capital gain income) for married filing jointly; any gain that falls above that amount will be treated at a 15% tax rate until $517,200 of total income, where a 20% tax rate will be applied.

The Gomez's have $80,000 of ordinary income and $25,000 of long-term capital gain income. Since the $80,000 of ordinary income is below the $83,350 (see below) there is $3,350 of the long-term capital gain income that will be taxed at a 0% tax rate and the remaining long-term capital gain income will be taxed at a 15% tax rate since it is below the $517,200.

Ordinary Income ($80,000)		
Tax on Ordinary Income		
$20,550 at 10% (of the $80,000)	$2,055.00	
$59,450 at 12% ($80,000 - $20,550)	$7,134.00	
Total Tax Owed on Ordinary Income	$9,189.00	$9,189.00
Long-Term Capital Gain (LTCG) ($25,000)		
$3,350 of capital gain ($83,350 – $80,000) = ($3,350 * 0%)	$0.00	
$21,650 ($25,000 - $3,350) * 15%	$3,247.50	
Total Tax Owed on Long-Term Capital Gain	$3,247.50	$3,247.50
Total of all Taxes Owed ($3,247.50 LTCG + $9,189 Ordinary Inc):		$12,436.50

Credits

If the alternative minimum tax (see Chapter 9 of this guide) is owed, it is added to the income tax liability before nonrefundable credits are subtracted. These credits include the foreign tax credit; the credit for child and dependent care expenses; education credits, such as the Hope credit and the lifetime learning credit; the retirement savings contribution credit; the child tax credit; residential energy credits; and others.

The order in which credits are subtracted is important because some credits are refundable and some are not. If the amount of tax due before a refundable credit is applied is less than the refundable credit, the excess amount of the credit can be received as a refund. By contrast, if a nonrefundable credit exceeds the amount of tax due, the credit can be used only to reduce the tax to zero. The excess is not refundable.

Observation

Benefit of Credits

Because tax credits offset tax liability, the benefit of a credit is the same for both high- and low-bracket taxpayers if there is a tax liability for the credit to offset or if the credit is refundable. By contrast, the benefit of a tax deduction depends on the tax bracket of the taxpayer. A $100 deduction from income in the 35% bracket saves the taxpayer $35 of taxes. A $100 deduction from income in the 12% bracket saves the taxpayer $12 of taxes.

Other Taxes

Taxes that cannot be reduced by nonrefundable credits are added to the net tax due after the credits are subtracted. These taxes include the self-employment tax; social security and Medicare taxes that were not already paid on tips and wages; and other taxes.

Total Tax, Tax Payments, and Tax Due

Payments include withholding and estimated payments and refundable credits. They are subtracted from the total tax liability to arrive at the tax balance that is due with the return or the tax refund that the IRS will send to the taxpayer.

Employment Taxes

Most wages paid to employees are subject to Federal Income Contributions Act (FICA) taxes and Federal Unemployment Tax Act (FUTA) taxes.

Cross-Reference

See Chapter 13 of IRS Publication 223, *Farmer's Tax Guide*, for more information on FICA and FUTA taxes.

FICA Taxes

Both the employer and the employee must pay FICA taxes on the employee's wages.

The FICA tax is comprised of two taxes. One is the social security tax (also called old-age, survivors, and disability insurance), which funds social security benefits, including disability, retirement, and survivor benefits. Since 1990, the social security tax rate has been 6.2% for both the employer and the employee. The social security tax applies only up to an inflation-adjusted wage base, which is $147,000 for wages paid in 2022.

The second tax included in FICA taxes is the Medicare tax (also called hospital insurance), which funds Medicare payments. Since 1986, the Medicare tax rate has been 1.45% to be paid by the employer and 1.45% paid by the employee for a total of 2.9%.

Unlike the social security tax, there is no wage limit for the Medicare tax. Employers and employees owe this tax on all of wages paid/received.

Combined, the social security tax and the Medicare tax impose a 7.65% tax on both employers and employees for the first $147,000 (for 2022) of wages. There is an additional 0.9% Medicare Tax for those that that earn above $200,000, this is to be paid by the employee not the employer.

Employers must withhold the employee's share of FICA taxes from wages and remit both the employee's share and the employer's share to the United States Treasury. Employers then report the wages and taxes on employment tax returns filed with the IRS.

FUTA Taxes

Farmers must pay FUTA taxes if they meet either of the following tests:

1. They pay $20,000 or more to farmworkers in any calendar quarter during the current or preceding calendar year, or
2. They employ 10 or more farmworkers for at least some part of a day during any 20 or more different calendar weeks during the current or preceding calendar year.

FUTA is paid only by the employer, not the employee. There are some limitations, such as being able to subtract from the federal percentage of 6% (for 2022) on the first $7,000 (for 2022) of wages by taking a credit for State Unemployment funds paid, up to a limit of 5.4% for 2022. The caveat to this is "as long as the state that SUTA was paid into is not determined to be a credit reduction state". Please see IRS Instructions for Form 940.

Noncash Wages

Noncash wages paid to farmworkers may not be subject to FICA or FUTA taxes. Noncash wages include food, lodging, clothing, transportation passes, commodities, and other goods and services. There are some very specific rules that must be followed especially if products, such as grain or livestock, are being used as wages for it to not be subject to FICA and FUTA. Further details can be found in Chapter 3 Wages and Other Compensation within IRS publication 51 (Circular A), Agricultural Employer's Tax Guide

Planning Pointer

Social Security Benefits

Paying noncash wages to farmworkers may save FICA taxes for both the employer and the employee and may save FUTA taxes for the employer. However, noncash wages are not counted as earned income for calculating social security benefits. Therefore, employers and employees should compare the FICA and FUTA taxes saved with the social security benefits lost by paying noncash wages.

Self-Employment Taxes

Instead of paying FICA taxes on wages, self-employed individuals pay self-employment tax on their self-employment income. Like the FICA tax, the self-employment tax is comprised of the social security tax and the Medicare tax. The social security and Medicare tax rates equal the sum of the rates paid by the employer and the employee on wages. Therefore, the self-employment tax rate is 12.4% and the Medicare tax rate is 2.9%, for a total of 15.3%.

The wage base that limits the social security tax to the first $147,000 (for 2022) of wages also limits the social security component of the self-employment tax to the first $147,000 (for 2022) of self-employment income. If a taxpayer receives both wages and self-employment income, the base for self-employment taxes is reduced by the wages he or she receives.

Cross-Reference

See Self-Employment section/chapter of IRS Publication 225, *Farmer's Tax Guide*, for more information on the self-employment tax.

Summary

Farmers must pay several different taxes that vary in their complexity and the way they are collected. Effective farm management includes minimizing taxes. However, some taxes are easier to manage than others. It is highly recommended that each farmer and rancher is able to have a tax professional that is familiar with agricultural taxation and that a tax management strategy meeting is held at least 30-60 days prior to the conclusion of the tax year.

Table of Contents: Chapter 3

CHAPTER 3

FARM INCOME

Introduction

In preparing their federal income tax returns, farmers are required not only to report all of their income but also to determine the income's character so that they can apply the proper tax rates. Some income is eligible for the more favorable tax rates on capital gains rather than the tax rates on ordinary income. Some income is subject to self-employment tax as well as to income tax.

Cross-Reference

For more information on where and when to report income, see Chapter 13, "Tax Reporting and Payment," in this guide.

Tax benefits that are available only to farmers include income averaging, postponed recognition of gain from weather-related sales of livestock, and carrying net operating losses to additional prior tax years. These provisions help farmers cope with the uncertainty of their income resulting from fluctuations in both yield and the price of commodities. Appendix A at the end of this chapter is a complete list of special federal tax provisions for farmers.

Defining Farm and Farming

Taxpayers must meet specified requirements to qualify as farmers. However, all the special provisions do not use the same definitions of *farm*, *farmer*, and *farming*. The rules vary from one provision to another.

Definition of *Farm*

A definition of *farm* is contained in the estate tax valuation rules. It reads as follows:

> The term "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.

This definition, with some variations, is also used in several other tax provisions.

Definition of *Farming*

In an IRS discussion of prepaid expenses, *farming* is defined as follows:

> The term "farming" means the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals. For purposes of the preceding sentence, trees (other than trees bearing fruit or nuts) shall not be treated as an agricultural or horticultural commodity.

This definition, with some variations, is also used in other tax provisions.

It is possible for a taxpayer to be considered a farmer for one tax provision and not for another. Taxpayers must determine whether an activity meets the definition of *farm*, *farming*, or *farmer* when deciding whether to report income and expenses on Schedule F (Form 1040), Profit or Loss From Farming, or on another tax form. Once that determination is made, the tax treatment for most items listed in Appendix A falls into place.

To help you determine whether to report income and expenses on Schedule F (Form 1040), the following discussion uses examples to illustrate the results of several court cases. In some cases, a small change in your facts may qualify you for one or more of the favorable tax provisions.

Illustrations and Examples

The Tax Court regards a farmer as any taxpayer who both participates to a significant degree in the farming process and bears a substantial risk of loss in the process. As a result, a taxpayer who operates a feed yard for profit is considered a farmer, as is a taxpayer who enters into a maintenance contract with a nursery to bud and cultivate the taxpayer's seedlings on the nursery's premises. A very liberal definition of a farmer was applied to a doctor who leased brood cows for the purpose of developing a herd and contracted the cattle-breeding and management responsibilities to an independent third party, with the taxpayer taking delivery of the calves once they were weaned. The court concluded that the manager acted at the doctor's discretion and the doctor bore the risk of loss.

Example 3.1: Farm Supply Outlet

Herb O'Sides operates a local company, Herb's Ag Products, which sells seeds, herbicides, fertilizers, pesticides, tools, and equipment to farmers. Local farmers, to whom Herb also provides many services, value his expertise. Herb visits customers' farms daily, inspects their soil and crops, takes leaf and soil samples, and advises them about fertilizers, herbicides, and pesticides. Herb does not charge for this advice. He often provides financial assistance to farmers, giving them credit and sometimes cosigning notes for them. Herb thinks that Herb's Ag Products qualifies as a farming business.

However, Herb's Ag Products is not a farming business. Even though Herb participates in the growing process (through farm visits and consultation) and bears a substantial risk of financial loss (by advancing credit and cosigning notes), his company did not cultivate, operate, or manage a farm for profit as an owner or tenant. The company's business is merchandise sales, not farming. Herb's Ag Products does not bear a substantial risk of loss from farming. Farmers have no recourse if their crops fail or the market for crops is poor. As a creditor, Herb has liens, collateral, security interests, and other rights and protections that farmers do not have.

This specific situation was addressed in court, and the court concluded a grain elevator or feed store that sells grains or feed to farmers and has no control or management of a farm operation does not qualify as a farm or farmer.

Example 3.2: Custom Harvester

Grim Reaper is a grain harvester who contracts with other individuals to cut their grain and haul it to sites designated by the individuals. Grim is paid an established amount per acre harvested. When Grim finishes cutting and hauling one individual's grain, he repeats the activity in another individual's fields. Grim has the equipment and work crews necessary to complete his work. Grim does not raise or grow the grain he cuts and hauls, and he does not own or lease the land on which the grain grows.

Grim is not engaged in a farming business. Some confusion can result, however, because Treasury regulations define a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity, and examples include the raising or harvesting of crops. However, Grim is not using his equipment in a farming business. Grim's trade or business is not farming—he is not raising or growing the grain he harvests and hauls. Instead, Grim merely provides a service by cutting and hauling grain.

Example 3.3: Processing Commodities

Zoe Zinfandel started raising grapes years ago. She sold her grapes to a local winery and properly reported her income and expenses on Schedule F (Form 1040). A few years ago, she not only sold grapes to the winery, but also began processing some of her grapes on her farm and selling grape juice and wine to a grocery store in the nearby town. She lets the wine age for 2 years before she sells it.

The grape juice and wine production is not part of her farming business because a farming business does not include the processing of commodities beyond the activities that are normally part of the growing, raising, or harvesting of such products.

Zoe also raises beef cattle. Her husband, Merlot, has a full-time job as an engineer at a local manufacturing plant. They file a joint income tax return. Their income and expenses from various sources for a typical year are shown in Figure 3.1.

Figure 3.1. Zinfandels' Income and Expenses

	Gross	Basis or Expenses	Net
Merlot's Wages	$26,000	$0	$26,000
Calf Sales	6,000	4,800	1,200
Grape Sales to Winery	23,000	15,000	8,000
Juice and Wine	13,000	6,000*	7,000
Cull Beef Cows	5,000	1,000	4,000
Total	$73,000	$26,800	$46,200

***$2,000 of this amount is the wholesale value of the grapes used in juice and wine production.**

Question 1

Where should the income and expenses be reported on Zoe and Merlot's joint tax return?

Answer 1

- Merlot's wage income is reported on the front of Form 1040.
- The calf sales and the grape sales are both reported on Schedule F (Form 1040).
- Zoe's sales of grapes to the local winery are also reported on Schedule F (Form 1040), because she has not processed those grapes.
- Zoe's juice sales are reported on Schedule C (Form 1040), Profit or Loss From Business, because she has processed them beyond the normal stage for preparing grapes for sale from the farm.
- The wholesale value of the grapes used for juice and wine ($2,000) is reported as an inventory purchase on Part III, Cost of Goods Sold, of Schedule C (Form 1040) and as income on Schedule F (Form 1040).
- The cull beef cow sales are reported on Form 4797, Sales of Business Property.

(continued)

Example 3.3 Processing Commodities (*continued*)

Question 2

Can Zoe use the cash method of accounting?

Answer 2

Yes. Subject to some exceptions, she is a farmer and can use the cash receipts and disbursements method of accounting that is included in the list of permissible methods that most taxpayers can use for computing taxable income. Zoe does not fall within any of the exceptions to this general rule and can therefore use cash accounting.

Question 3

Can Zoe pay commodity wages to her employees to avoid FICA tax liability on the wages?

Answer 2

Zoe and her employees can avoid FICA taxes (social security taxes and Medicare taxes) on wages paid as commodities for agricultural labor, which is defined as "services performed … in connection with raising or harvesting any agricultural or horticultural commodity." Therefore, the wages that Zoe properly deducts on her Schedule F (Form 1040) qualify for the exception to FICA taxes if they are paid in commodities. However, the wages that she properly deducts on her Schedule C (Form 1040) do not qualify for the exception to FICA taxes, even if she pays them in commodities.

Planning Pointer

Income Tax Withholding Exemption

Wages paid for agricultural labor that are not subject to FICA tax are also not subject to income tax withholding.

Observation

Activities Incident to Growing and Harvesting

Any processing that is part of growing and harvesting a commodity is included in the term *farming business*. For example, the extraction of oil from mint plants occurs in conjunction with the harvest; therefore, the extraction process fits within the definition of *farming*. The processing of grapes into wine, however, is not necessary to place the grapes into their first marketable state. Thus, such processing does not fall within the definition of *farming*.

Contract Farming

Farm producers have entered into arrangements with seed companies, canneries, and packers of chickens and hogs that reduce some of the risk and result in a farmer making both fewer management decisions and no marketing decisions. Producers should be careful to retain as many characteristics of a farming business as possible to still qualify as a farmer and take advantage of favorable tax treatments.

Defining Farm Income

The Internal Revenue Code and Treasury regulations use "gross income from farming" and "farm income" as part of the threshold requirements for several income tax provisions. Those terms have slightly different definitions for some of the provisions. This section discusses and applies those definitions.

Separate definitions of *gross income from farming* are used for

- Relief from estimated tax penalties,
- Soil and water conservation expenditures, and
- The limit on deducting a charitable contribution for a conservation easement. The term *farm income* is also used in the following provisions:
- Income averaging for farmers
- Deferral of weather-related sales of livestock
- Farm optional method for self-employment tax

Estimated Tax

The most commonly used income tax advantage for farmers is a special rule for estimated taxes. Instead of the generally required four estimated tax payments, farmers and fishermen have two options:

1. Make a single estimated payment of two-thirds of the tax due by January 15 of the following year.
2. Skip all estimated payments but file the annual income tax return and pay 100% of the tax due by March 1 of the following year.

The second option is used by most farmers, but choosing the first option in a low-income year when the amount of tax is low provides more time for filing the return.

To qualify as a farmer or fisherman, at least two-thirds of the taxpayer's *total gross income* for either the year of the estimated payment or the preceding tax year must come from farming or fishing. Total gross income is all income that is not exempt from income tax, whether received in the form of money, goods, property, or services. If a joint return is filed, total gross income includes the gross income of both spouses. Because total gross income is not reduced by losses (business, capital, or other), gross income for estimated tax purposes is **not** the same as the total income shown on line 9 of Form 1040, U.S. Individual Income Tax Return.

Gross income from farming includes gross farm income from Part I of Schedule F (Form 1040); line 7 of Form 4835, Farm Rental Income and Expenses; gross farm income from Parts II and III of Schedule E (Form 1040), Supplemental Income and Loss; and gains from the sale of livestock used for draft, breeding, dairy, and sporting purposes, reported on Form 4797. Gross farm income does not include wages received as a farm employee or gains from the sale or exchange of land or depreciable farm machinery.

Example 3.4: Gross Income from Farming

Ben and Sally Martinez are married and file a joint return. During a calendar tax year, Sally earned a $40,000 off-farm salary and the couple had $1,000 of interest income, a $3,000 capital loss on the sale of stock, $150,000 of gross farm income on line 9 of Schedule F (Form 1040), a $5,000 gain from the sale of raised breeding cows, and a $2,500 gain on the sale of a used tractor.

As shown below, their gross income is not reduced by the $3,000 capital loss. The $2,500 gain on the sale of the used tractor is included in total gross income but not in gross income from farming. Ben and Sally's gross income from farming is $155,000, which is 78.1% of their $198,500 total gross income. Because more than two-thirds of their gross income in the current year is from farming, they are qualified farmers for estimated tax purposes.

Total Gross Income and Gross Income from Farming

Income Item	Tax Return Income	Total Gross Income	Gross Income from Farming
Sally's off-farm salary	$ 40,000	$ 40,000	
Interest income	1,000	1,000	
Capital loss on stock	– 3,000		
Gross farm income	150,000	150,000	$150,000
Gain of sale of breeding stock	5,000	5,000	5,000
Gain on sale of used tractor	2,500	2,500	
Total	$195,500	$198,500	$155,000

Planning Pointer

Retiring Farmers

When farmers retire or sell their businesses, the sale of land or depreciable farm machinery may prevent them from meeting the two-thirds of gross income from farming rule. However, because taxpayers qualify for the farm rule if two-thirds of their gross income is from farming in **either** the current year or the previous year, they often still meet the requirements for the farm exception to the underpayment of estimated tax penalty.

Soil and Water Conservation Expense

Congress limits the deduction of qualified soil and water conservation expenditures to 25% of gross income from farming. For this provision, *gross income from farming* is defined as income derived from the production of crops, fish, fruits, other agricultural products, or livestock. Gains from the sale of draft, breeding, and dairy livestock are included, but gains from the sale of assets such as farm machinery or the land are not included.

Observation

Small Difference in Concept

The only difference between the definitions of *gross farm income* for the estimated tax provision and the soil and water conservation deduction is that gain from the disposition of sporting livestock is included for estimated tax purposes but not for soil and water conservation deductions. Thus, for the vast majority of taxpayers, gross farm income is the same for these two provisions.

Conservation Contribution Deduction

The deduction for charitable contributions is generally limited to 20%, 30%, or 50% of a taxpayer's adjusted gross income (AGI), depending on the type of contribution, with a 5-year carryover of excess amounts. Charitable contributions include the value of a contribution of a qualified interest in real property that is made exclusively for conservation purposes. A special rule for conservation contributions made before 2019 increases the deduction limit for qualified farmers and ranchers to 100% of their AGI.

Qualified farmers or ranchers for this provision must derive more than 50% of their total gross income for the year from the trade or business of farming. *Farming* is defined by reference to the definition in the estate tax special-use valuation rules. It includes cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm; handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity; and planting, cultivating, caring for, or cutting trees, or the preparation (other than milling) of trees for market.

Example 3.5: Expanded Definition of Gross Income from Farming

Jim and Betty Forester are married and filed a joint return. Betty earned a $40,000 off-farm salary; they have $1,000 of interest income, a $3,000 capital loss on the sale of stock, a $5,000 gain on the sale of breeding stock, and a $2,500 gain on the sale of a used tractor. Their farm income on line 9 of Schedule F (Form 1040) is $50,000, and they have a $75,000 sale of timber, as shown below. If the sale of timber was not included as gross income from farming, Jim and Betty would have only $55,000 of gross farm income [$50,000 from Schedule F (Form 1040) and $5,000 from sale of breeding livestock], and less than 50% of their total gross income would be from farming. However, the sale of timber is included as farm income for the conservation contribution deduction. Therefore, more than 50% of their gross income is from farming, and they are qualified farmers for this expanded deduction limit.

Total Gross Income and Gross Income from Farming

Income Item	Tax Return Income	Total Gross Income	Gross Income from Farming
Betty's off-farm salary	$40,000	$40,000	
Interest income	1,000	1,000	
Capital loss	– 3,000		
Gross farm income	50,000	50,000	$50,000
Gain of sale of breeding stock	5,000	5,000	5,000
Gain on sale of used tractor	2,500	2,500	
Sale of timber	75,000	75,000	75,000
Total	$170,500	$173,500	$130,000

Note

Estimated Tax Rule is Different

Although Jim and Betty Forester in Example 3.5 qualify as farmers for the charitable deduction of a conservation easement this year, they do not qualify as farmers for estimated tax purposes based on this year's income. They might qualify based on their previous year's income.

Farm Income Averaging

Individuals engaged in a farming business may be able to average the tax rates that apply to some or all of their farm income by tapping their tax brackets from the 3 prior years (base years). There is no threshold requirement that the taxpayer is a *farmer*, but only *electible farm income* is eligible to be taxed in unused brackets from the 3 previous years.

For this provision, *farm income* includes items of income, deduction, gain, and loss attributable to the individual's farming business. Income from a farming business is the sum of any farm income or gains minus any expenses or losses allowed as deductions in computing taxable income. Gains from the sale or other disposition of farm property (other than land) that has been regularly used for a substantial period in a farming business are included. Gains from the sale of timber are excluded. The amount of farm income that the taxpayer elects to have taxed at the base years' rates is *elected farm income*. Any type of income (e.g., capital gain other than gain from the sale of land or timber) attributable to the farm business can be designated as elected farm income. The mechanics of farm income averaging are discussed in Chapter 7.

Weather-Related Sales of Livestock

Cash-basis taxpayers whose principal trade or business is farming may defer reporting the sale of animals in excess of their normal business practice if the sale results from drought or other weather-related conditions. To qualify, the taxpayer must show that the sale is related to weather conditions that caused an area to be declared eligible for federal assistance. *Farming* for this provision is defined in very broad terms similar to those discussed earlier: It is defined as activities by the owner, tenant, or operator in connection with cultivating the soil and raising or harvesting any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife. Farming also includes handling, drying, packing, grading, or storing commodities in their unmanufactured state. Finally, farming also includes planting, cultivating, caring for, or cutting trees, or preparing (other than milling) trees for market, incidental to farming operations.

In one situation, a cattle rancher had a full-time job from which he earned an average salary of $65,000. The ranch generated $121,000 of average annual gross income. The taxpayer participated in the activity of raising livestock for 750–1,000 hours per year, and the taxpayer's spouse devoted 200–300 hours to the ranch during each tax year. Because the gross income generated by the cattle ranch was approximately two-thirds of the taxpayers' total annual gross income, and given the taxpayers' material participation, the taxpayer's principal trade or business was held to be farming and the couple was eligible to defer reporting some income because of weather conditions.

Observation

Principal Business Activity

A taxpayer's principal business activity (PBA) is based on sources of gross receipts. The PBA is the activity from which the largest percentage of receipts is derived during the prior year or prior 3-year period.

Farm Operating Income

Farm accounting data serves three purposes.

First, farms using cash accounting should reconcile their cash flow and their bank records (i.e., reconcile the cash flow to zero). This means that the cash amount in the accounting records at the beginning and end of each month agrees with the bank amount after reconciling all cash inflows and outflows. A positive cash balance may mean that cash inflow was double counted, and a negative cash balance may mean that cash inflow was missed. The alternative is that some expenses have been missed or double counted.

A second purpose is to accurately reflect the taxable income upon which income taxes and self-employment taxes must be paid. Not all cash coming in is taxable, and some income is taxable with no cash coming into the accounting system, so that offsetting inflows and outflows must be entered into the accounting system to make this correct.

A third purpose uses information from the accounting system to analyze the profitability of the farm business. While money in a checking account may be an indication that the farm operation is making a profit, that is not necessarily the case. The cash may be a result of borrowing money or selling farm assets, rather than a result of operating profits. The following discussion concentrates on the second purpose, but the other purposes are also important.

Schedule F (Form 1040) Income

The income reportable on Schedule F (Form 1040) is used to compute net profit or loss. This profit is subject to income tax at ordinary tax rates, as well as to self-employment (SE) tax.

A checkbook represents a starting point for looking at income. Money coming into the checking account is cash flowing into the business. Much of it is taxable income, including proceeds from crop sales, livestock sales, culled breeding or dairy animals, agricultural program payments, crop insurance proceeds, rental income, and custom hire income. But some of the money coming into the checking account is not taxable or is not reported on the Schedule F (Form 1040). For example, borrowed funds may increase cash in the checking account but they are not taxable income. Consider the specific sources of money flowing into the checking account.

Raised Agricultural Products

Crops or agricultural products raised and sold by a farmer are the major cash source on most farms. This income, which is reported in Part I of Schedule F (Form 1040), includes sales of grains, vegetables, fruit, bedding plants, milk, calves, raised market livestock, eggs, and hay. Sales of farm products that were raised on the farm are offset in Part II of Schedule F (Form 1040) by the expenses of raising the products (covered in Chapter 4), so there are subtractions to arrive at net income.

Purchased for Resale

Sales of livestock or other items that were bought for resale are handled differently. When the item is sold, the full sales price is reported in Part I of Schedule F (Form 1040), but the original cost (or other basis) is also reported in Part I and subtracted from the sales price to arrive at gross income. The most common mistakes happen when animals are purchased in one tax year and sold during the next tax year.

Cooperative Distributions

Cooperative distributions—patronage dividends and per-unit retain allocations—are reported to the IRS on Form 1099-PATR. Some distributions may be in cash, which is, of course, taxable. But some distributions may be noncash allocations that are currently taxable but are not immediately reflected in the checkbook. Although you are required to pay income tax on the allocations now, you do not receive any money until some point in the future. For accounting purposes, you are loaning the allocated funds back to your cooperative (which is partially owned by you). The cooperative then has working capital and does not have to borrow it from a bank or other lending institution. In the future, when your cooperative does send you the cash, the payment is not income because it has already been taxed. Don't count it as income a second time.

Agricultural Program Payments

Agricultural program payments are reported by the agency to you and to the IRS on Form 1099-G, Certain Government Payments. Most of these payments are taxable income to be reported on Schedule F (Form 1040). Expenses incurred for adopting an agricultural practice or undertaking a project often offset the income from the related payment. Payments for certain conservation projects or depreciable improvements (such as manure storage or chemical containment) may qualify for a cost-sharing exclusion from income.

Note that if a cost-sharing payment is not counted as income, the costs paid with that money cannot be deducted or depreciated. If the government payment is treated as income, you can deduct or depreciate the qualifying costs paid with those funds.

CCC Loans as Income

Farmers who receive Commodity Credit Corporation (CCC) loans on their crops can elect to report the loans as income rather than as loans. If you do not elect to report CCC loans as income, the loans are not included in income and repayments of the principal are not deductible. (However, interest payments are a deductible expense.) If you do not elect to report the loan as income and later forfeit the commodity instead of repaying the loan, you are treated as selling the commodity for the amount of the loan and must report that deemed sale on your Schedule F (Form 1040).

If you elect to report the loan as income, you acquire an income tax basis in the commodity that secures the loan. The basis is the amount of the loan that you reported as income. If you later sell the commodity, you subtract your basis in the commodity from the sales price and report any excess sales price as additional income or any deficit as a loss. If you forfeit the commodity instead of repaying the loan, there is no income or loss to report because your basis in the commodity equals the deemed sale price. If you feed the commodity to livestock, you can deduct your basis in the commodity as a farm expense.

Crop Insurance and Disaster Payments

Crop insurance and disaster payments are normally income when the check is received. Under some circumstances, the crop payment inclusion as income may be deferred to the following year, if the later year is when the crop is normally sold. Payments from revenue insurance that covers the combination of yield risk (poor crop yields) and price risk (low prices) can be postponed only to the extent they are paid for yield risk.

Custom-Hire Income

Custom-hire income includes machine work done for someone else. It might be just harvesting, or it could be an agreement to perform all of the work of tillage, planting, pest control, harvesting, and hauling. It is not entirely clear when custom work becomes a separate business that is reported on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship). If custom work is a small part of the total farm operation, then the income is reported on Schedule F (Form 1040).

Although the tax rules do not include a clear threshold, if more than half of a farmer's income comes from custom hire, the farm and nonfarm businesses should be reported separately on Schedules F and C (Form 1040). Be aware that reporting income and expenses on Schedule C (Form 1040) sacrifices some tax advantages of being a farmer and causes different employment rules to apply to employees of the nonfarm business.

Other Income

Other income reported on Schedule F (Form 1040) includes farm operating income that is not specifically listed on Schedule F (Form 1040), such as state and federal fuel or gasoline credits. These may be received as a check or as a credit that reduce taxes. The fuel credit is income because it is a refund of fuel taxes already paid and deducted as an expense, even though the credit may never go through the checkbook. Income from activities such as ag tourism should be reported on Schedule C (Form 1040) since it is not related to farm production.

Other income reportable on Schedule F (Form 1040) does not include the following items that are reportable elsewhere on the tax return:

- Gain or loss from selling breeding livestock, equipment, land improvements, or land used in a farming business
- Investment income, such as timber sales
- Rental income
- Wages received for working for someone else

Barter Income

Other income reportable on Schedule F (Form 1040) includes farm barter income if it is not already included as the sale of agricultural products. Barter income results from trading farm products or your labor for other farm products, property, or someone else's labor. If you receive farm products or labor, you must include the fair market value (FMV) of the products or labor you received in income.

Although barter income and expenses often offset each other and do not change taxable income, reporting them is not only a tax law requirement, but it is often beneficial to you.

Example 3.6: Corn Exchanged for Hay

Derry Aire traded $10,000 of his corn for $10,000 of his neighbor's hay. If Derry does not report the deemed sale of the corn and the deemed purchase of the hay, his net farm profit on Schedule F (Form 1040) does not change because the omitted income and deduction offset each other.

However, not reporting the corn sale reduces Derry's gross income from farming by $10,000. This reduces the amount of soil and water conservation expenses he can deduct, and it may disqualify him for the exception to the underpayment of estimated tax penalty because it reduces the income included in the numerator of the two-thirds test by $10,000.

In some cases, barter income is not offset by a barter deduction, and failing to report the barter transaction incorrectly reports income. For example, if you trade a bull for some hay, the income from the deemed sale of the bull is not subject to SE tax, while the deemed cost of the hay is deducted from income that is subject to SE tax. Failing to report the barter transaction would incorrectly report too much SE income and too little income that is not subject to SE tax.

Not reporting barter income and expense can also lead to an incorrect business analysis because it underreports income from one enterprise and expenses for another enterprise. Be sure to include barter income in both your accounting and tax records.

Cancellation of Debt Income

Generally, if a debt is forgiven or canceled the debtor has taxable income equal to the amount of debt that is canceled. Although it seems counterintuitive to treat a canceled debt as income, the logic for this rule is as follows: When a taxpayer receives a loan, the amount received is not included in income because there is an obligation to repay the loan. If the loan is canceled without being paid, the taxpayer's wealth increases by the amount of the canceled debt.

Several exceptions to the general rule that canceled debt must be included in income are discussed and illustrated in Chapter 12 of this guide.

Refunds or Reimbursements

Taxpayers who receive refunds or reimbursements for expenses they deducted on their income tax returns for a prior year must generally include the refund or reimbursement in income. For example, if you paid $400 for a load of hay in December, but $50 was refunded in January because the cost was only supposed to be $350, you must report the $50 as income for the tax year that includes January. If the $50 refund were paid in the same tax year as the $400 payment, the deduction for the hay expense is reduced from $400 to $350.

Insurance Received

Taxpayers who receive insurance payments for casualties, thefts, and losses generally have to report the insurance payments as income to the extent it exceeds their income tax basis in the property that was damaged or destroyed. This rule and the exceptions to it are discussed in Chapter 9 of this guide.

Disposition of Property Used in Farming

When farmers sell assets they use in the course of their business (such as equipment, breeding livestock, land, and buildings), the gain or loss is not subject to self-employment tax. Consequently, the sale is reported on Form 4797, Sales of Business Property, instead of on Schedule F (Form 1040).

Gains or losses from assets that do not meet a required holding period are ordinary gains or losses. The required holding period is more than one year for all assets except livestock. The required holding period for livestock other than cattle or horses is 12 months, which is one day less than the required holding period for other assets. For cattle and horses, the required holding period is 24 months.

Gains and losses from assets held for the required holding period are netted for each tax year. If there is a net loss from these assets, the net loss is deducted from ordinary income. If there is a net gain from these assets, the gain generally is treated as long-term capital gain, which is subject to a lower tax rate than ordinary income. However, if the taxpayer deducted net losses from these assets in the previous 5 years, the gain is treated as ordinary income to the extent of those losses.

If the asset was depreciated, part or all of the gain may have to be reported as ordinary income under the depreciation recapture rules. For buildings, gain equal to the depreciation claimed in excess of straight-line depreciation is treated as ordinary income. For other depreciable assets (such as equipment and draft, breeding, dairy, or sporting livestock), gain equal to all of the depreciation claimed is treated as ordinary income.

The following examples illustrate these rules.

Example 3.7: Bare Land

Sandy Beach sold an 80-acre parcel of land with no improvements for $320,000 ($4,000 per acre). Her income tax basis in the land is her $80,000 ($1,000 per acre) purchase price 20 years ago. Her gain from the sale is $240,000 ($320,000 – $80,000)

Sandy reports the sale in Part I of Form 4797 because the land was held longer than one year. The $240,000 gain is netted with the gains and losses from the sales of other assets that meet the holding period.

Example 3.8: Raised Cow

Marjorie Lucero culled a raised dairy cow during her fourth lactation. Marjorie held the cow almost 6 years, so she met the 24-month or more holding period for cattle and horses. The cow was sold for $400, and Marjorie's basis was zero because she had deducted all the costs of raising the cow as feed, labor and other costs. Therefore, Marjorie must report $400 of income in Part I of the Form 4797.

Example 3.9: Purchased Bull

Joe Running Bear purchased a yearling bull for $1,500 in year 1 and sold him in year 2 for $2,000. Direct expensing and depreciation reduced Joe's basis in the bull to $500 at the time the bull was sold. Because the bull was held fewer than 24 months, Joe reports the sale in Part II of Form 4797 and the $1,500 ($2,000-$500) gain is taxed as ordinary income.

Example 3.10: Machinery

Ben Yang purchased a new haybine for $25,000 5 years ago and sold it this year for $12,000. Direct expensing and depreciation reduced the basis from $25,000 to $10,000. Pete reports his $2,000 ($12,000 – $10,000) gain in Part III of Form 4797. Because the $2,000 gain is less than the $15,000 depreciation Ben deducted, all of the gain is depreciation recapture that is taxed as ordinary income.

Investment Income

Some gains or losses, such as gain or loss from the sale of standing timber, qualifies as capital gains or losses and are reported on Schedule D (Form 1040), Capital Gains and Losses. If the asset was held more than one year, the gain or loss is long term. If the asset was held one year or less, the gain or loss is short-term.

Summary

Farmers can save income taxes by taking advantage of tax law provisions that give them favorable tax treatment. Savings can result from avoiding self-employment taxes and from taking advantage of the rules that allow income to be taxed as capital gain.

To qualify for the special tax advantages, farmers must meet certain requirements. However, the qualifying requirements differ among the various tax provisions. Therefore, an individual farmer may be eligible for some of the tax benefits but not others.

Appendix A: Special Tax Provisions for Farmers

The special federal income tax provisions for farmers include the following items:

- Exclusion of income from discharge of indebtedness [I.R.C. §§ 108(a)(1)(C) and 1017(b)(4)]
- Limit on deducting charitable contribution of a conservation easement [I.R.C. § 170(b)(1)(E)(iv)]
- Carryback of net operating losses [I.R.C. § 172(b)(1)(G)]
- Soil and water conservation expenditures [I.R.C. §§ 175 and 1252]
- Expenditures for fertilizer, lime, and other materials to enrich, condition or neutralize soil [I.R.C.
- § 180]
- Domestic production activity deduction [Treas. Reg. § 1.199-4]
- Uniform capitalization of reproductive expenses [I.R.C. § 263A]
- Record keeping for business use of vehicles [Treas. Reg. § 1.274-6T(b)]
- Method of accounting for corporations engaged in farming [I.R.C. § 447]
- Cash method of accounting [I.R.C. § 448 and Treas. Reg. § 1.471-6(a)]
- Material participation for purposes of the passive loss rules [I.R.C. § 469(h)(3)]
- Crop insurance or disaster payments [I.R.C. § 451(d)]
- Weather-related sales of livestock [I.R.C. §§ 451(e) and 1033(e)]
- Deduction of prepaid expenses [I.R.C. § 464(f)]
- Application of the at-risk rules [Temp. Treas. Reg. § 1.465-1T and Prop. Reg. § 1.465-43]
- Livestock destroyed by disease [I.R.C. § 1033(d)]
- Disposition of converted wetlands or highly erodible croplands [I.R.C. § 1257(c)(1)(B)]
- Imputed interest rules [I.R.C. § 1274(c)(3)(A)]
- Farm income averaging [I.R.C. § 1301]
- Self-employment tax on rent [I.R.C. § 1402(a)]
- Special use valuation of real estate for estate tax purposes [I.R.C. § 2032A]
- FICA taxes on commodity wages [I.R.C. § 3121(a)(8)(A)]
- FUTA taxes [I.R.C. §§ 3306(b)(11) and 3306(k)]
- Excise tax on gasoline and diesel fuel used on farms [I.R.C. §§ 6420 and 6427(c)]
- Relief from estimated tax penalties [I.R.C. § 6654(i)]

Table of Contents: Chapter 4

CHAPTER 4
FARM DEDUCTIONS

Introduction

In preparing their federal income tax returns, farmers are allowed to deduct certain expenses incurred when carrying on a trade or business. Some income tax deductions, although available to all business taxpayers, have special rules for farmers. Other deductions, such as soil and water conservation expenses, are available only to farmers and ranchers. This discussion is intended to help operators of farms and ranches optimize deductions to reduce their tax liability.

Some deductions discussed in this chapter are not claimed on Schedule F (Form 1040), Profit or Loss from Farming. However, farmers need to be familiar with these possible deductions, such as the Qualified Business Income Deduction (QBI). Alternatively, not all deductions available on Schedule F are examined in this chapter.

Planning Pointer

Deductions

The deductions discussed in this chapter pertain to a sole proprietorship form of ownership. The deductibility and/or reporting of specific expenses may vary depending on the form of ownership (sole proprietorship, limited liability company, partnership, trust, etc.)

Ordinary and Necessary Business Expenses

The Internal Revenue Code allows taxpayers to deduct "ordinary and necessary expenses paid . . . in carrying on any trade or business." These ordinary and necessary expenses include fertilizer, pesticides, lime, seeds, repairs to equipment, and other costs of operating a farm business. This chapter explains how you determine whether an expense is "ordinary and necessary" and therefore deductible from gross farm income.

The portion of Schedule F Part II (Form 1040) shown in Figure 4.1 itemizes most of the deductible expenses that are likely to be incurred in a farming business. Farmers can use line 32, "Other expenses," to claim deductions that are not listed on lines 10 through 32.

Figure 4.1. Part II of Schedule F (Form 1040)

Part II **Farm Expenses—Cash and Accrual Method.** Do not include personal or living expenses. See instructions.

10	Car and truck expenses (see instructions). Also attach **Form 4562**	10		23	Pension and profit-sharing plans . .	23	
11	Chemicals	11		24	Rent or lease (see instructions):		
12	Conservation expenses (see instructions)	12		a	Vehicles, machinery, equipment . .	24a	
13	Custom hire (machine work) . . .	13		b	Other (land, animals, etc.)	24b	
14	Depreciation and section 179 expense (see instructions)	14		25	Repairs and maintenance	25	
15	Employee benefit programs other than on line 23	15		26	Seeds and plants	26	
16	Feed	16		27	Storage and warehousing . . .	27	
17	Fertilizers and lime	17		28	Supplies	28	
18	Freight and trucking	18		29	Taxes	29	
19	Gasoline, fuel, and oil	19		30	Utilities	30	
20	Insurance (other than health) . .	20		31	Veterinary, breeding, and medicine .	31	
21	Interest (see instructions):			32	Other expenses (specify):		
a	Mortgage (paid to banks, etc.) . .	21a		a		32a	
b	Other	21b		b		32b	
22	Labor hired (less employment credits)	22		c		32c	
				d		32d	
				e		32e	
				f		32f	

Reporting all farm income and expenses on the proper lines allows you to compare line entries from one year to the next to ensure that you have not missed a deduction and to make management decisions about optimizing your expenses. The farm accounting records can be set up in such a way to match the lines of Schedule F to make it easy to transfer and compare the book records to the tax records. There will be some differences and additional detail with the book records, but doing this can reduce the administrative time spent on the tax return.

Some farm expenses, such as interest paid, are reported in subcategories on Schedule F (Form 1040). The mortgage interest that banks, farm credit associations, and other financial institutions report to you and the IRS on Form 1098, Mortgage Interest Statement, is entered on line 21a so that the IRS can match the Form 1098 amount with the amount you report on your tax return. Line 21b records other interest paid in your farming business that is not reported on a Form 1098, such as interest paid on a note held by the financing arm of your local implement dealer.

Rent expenses are split between machinery and equipment leases reported on line 24a and land rents reported on line 24b. Labor expenses are reported on line 22, and employee benefits and pension and profit-sharing expenses are reported on lines 15 and 23, respectively.

Repairs and Maintenance

Equipment maintenance expenses are deductible in the year they are paid if they are repairs, but they must be capitalized and depreciated (as discussed later in this chapter) if they are improvements. This determination can be challenging.

Deductible repairs are expenditures that keep the property in efficient operating condition, restoring it to its previous operating condition. Capital expenditures, on the other hand, do one or more of the following:

1. Add to the property's value
2. Substantially prolong its useful life
3. Adapt the property to a new or different use

Example 4.1: Fence Expenses

Rusty Nail paid Juan Mendes $500 to tighten the wire and replace five of the forty fence posts on the east side of his pasture. Rusty also paid Juan $8,000 to build a new fence on the south side of his pasture.

Rusty can deduct as an ordinary business expense the $500 he paid to repair the fence on the east side of the pasture. The $8,000 he paid for the fence on the south side of the pasture is a capital expenditure, which is depreciable rather than currently deductible.

§263(A) Exceptions

The uniform capitalization (UNICAP) rules of 263(A) require some deductible expenses to be capitalized and depreciated over a longer time period. There are several exceptions which currently exist for farmers. A safe harbor allows up to $2,500 to be deducted without regard to UNICAP. Additionally, a cash basis farm taxpayer with less than $26 million in gross receipts is exempt from the UNICAP rules. If a farmer is subject to UNICAP they may also elect out with some considerations. For more information on the UNICAP rules visit IRS Publication 225, *Farmer's Tax Guide*, Chapter 6.

Example 4.2: Fence Expenses

Using Example 4.1, Rusty would be able to deduct as an ordinary business expense the new fencing in the current year if the expense was $2,500 or less as that would put him under the safe harbor for UNICAP. Rusty would need to correctly make the election in the current year and have an accounting policy stating how they will treat such items.

Separating Business and Personal Expenses

Some expenses, such as property insurance, utilities, and real estate taxes, may be incurred for both business and personal reasons. If you receive a single bill for this type of expense, you must allocate the expense between your business use and your personal use.

Example 4.3: Business and Personal Expenses

The $4,000 premium for your property casualty insurance covers all the buildings on your farm property, including your house. The cost of casualty insurance for your home is $800. You can deduct $3,200 ($4,000 – $800) as a business insurance expense. None of the $800 is deductible unless you qualify to deduct part of the cost of the home as a business expense, as discussed in the next section of this chapter.

Business Use of the Home

Generally, expenses incurred to purchase or maintain a home are not tax-deductible because they are personal expenses. However, if you use part of your home for business (such as for office space), you may be able to deduct some of the costs. To prevent abuse, the tax rules for a business use of home deduction are complicated. Therefore, you should compare the tax benefits with the administrative and other costs before claiming part of your home expenses as a business deduction.

Exclusive and Regular Use

To qualify for a business-use deduction, part of the home must be used exclusively and regularly for business purposes. The portion of the home used for business does not have to be a separate room; an area of a room qualifies if it meets the exclusive and regular use requirements. However, any personal use, such as for personal recordkeeping or using the computer to access the Internet for nonbusiness reasons or play games, disqualifies the area as being used exclusively for business.

In order to qualify, you must also show that you use your home as your principal place of business. Business can be conducted at several locations, but you must consider the importance and time spent with each activity and location. You must not have another fixed location where you conduct substantial administrative or management activities of the trade or business.

There are two methods for calculating the deduction: (1) the actual expenses or (2) the simplified method. Schedule F filers can use worksheets from IRS publication 587, Business Use of Your Home, for either method to calculate the deduction.

- With actual expenses, the taxpayer is allowed to deduct certain direct expenses such as painting or repairs to the space used as an office. Other indirect expenses such as insurance, taxes, depreciation, and utilities are deducted based on business use percentage. Once the applicable expenses are totaled, you apply the business use percent to calculate the deduction. You can use any reasonable method to determine business percentage. One common method is to divide the area used for business by the total area of your home. 300 sq. ft (business use) / 3,000 sq. ft (total home) = 10 % business use. The taxpayer would get to deduct 10% of the indirect expenses of their home office in addition to the qualified direct expenses.

- The simplified method does not require you to keep track of costs during the year but allows you to multiply the prescribed rate, $5 at time of publication, by the area of the home used for a qualified business use. You are limited by this method to 300 sq. ft, so the maximum deduction would be 300 sq. ft x $5 = $1,500. Consequently, the actual expense method may provide a larger deduction but also requires greater recordkeeping requirements.

Deduction Limit

The deduction for business use of a home is limited to the net income from the business before the deduction. Deductible expenses in excess of the income limit are carried forward to future tax years and can be deducted subject to the net income limit in each succeeding year. If the carryforward has not been used up by the time the business is terminated, the remaining amount can never be deducted.

Example 4.4: Deduction Limit

Apple Blossom had a loss from her farm business this year before deducting her $2,400 of home business office expenses. She cannot increase her farm loss by deducting the $2,400, but she can carry the $2,400 forward and deduct it in a future profitable year.

Depreciation of Home

If the actual expense method is used, you can deduct depreciation for the portion of your home that is used for a business purpose. However, when you sell your home, any gain equal to the total amount of depreciation that was allowable after May 6, 1997, does not qualify for the rule that allows you to exclude from income your gain from the sale of a principal residence.

Example 4.5: Deduction Limit

Beginning in 2018, Apple Blossom used a portion of her home as a business office. She deducted a total of $15,000 of depreciation before she sold her home for a gain. Apple must report $15,000 of that gain as capital gain that is taxed at a rate equal to the lesser of 25% or her marginal ordinary income tax rate. The remainder of her gain is excluded from her income because she met the rules for excluding gain from the sale of a home.

Planning Pointer

Forgoing the Depreciation Deduction

Forgoing allowable depreciation to avoid reporting part of the gain on sale of the home is not good planning for two reasons.

First, gain equal to the amount of depreciation that could have been deducted is not eligible for the exclusion whether the depreciation was deducted or not. Therefore, not deducting the depreciation does not increase the amount of gain that can be excluded from income.

Second, the tax advantage of the depreciation deduction is greater than the tax cost of not excluding the gain in most cases. The deduction reduces farm income that is subject to both income tax at the ordinary income tax rates and self-employment tax. The gain that is not excluded is subject to a maximum 25% tax rate and is not subject to self-employment tax. The gain is also taxed in a later year.

Truck and Car Expenses

Farmers often use trucks and cars for both business and personal reasons. The business use costs can be deducted from taxable income if adequate records of that use are kept. To reduce the record-keeping burden, taxpayers can use a standard mileage rate for the business miles driven in a car, van, pickup, or panel truck. Alternatively, they can deduct the actual costs of the business use, such as gas, oil, repairs, insurance, and depreciation expenses.

Standard Mileage Rate

The standard mileage rate (SMR) is adjusted at least annually for changes in most of the fixed and variable costs of operating a vehicle. Self-employed taxpayers who use the standard mileage rate can also deduct the costs of parking, tolls, state and local taxes on the vehicle, and interest on loans to buy the vehicle because those costs are not included in the standard mileage rate.

For 2022, the SMR is 58.5¢ per mile for miles driven in January through June, and 62.5¢ per mile for miles driven in July through December.

Although the SMR reduces the record-keeping burden, it results in a lower income tax deduction if the actual costs of operating a vehicle are greater than the SMR.

Example 4.6: SMR vs. Actual Costs

In 2022, Red Durham drove his pickup truck 10,000 miles for his farming business (4,000 miles before July and 6,000 miles after June) and 5,000 miles for personal use. If he kept adequate records of his business miles, he can deduct $6,090 [(4,000 × 58.5¢) + (6,000 × 62.5¢)] for vehicle expense on his 2022 Schedule F (Form 1040).

If Red kept adequate records of all of the costs of driving his pickup and the total cost for 2022 is $9,000, he can deduct $6,000 [$9,000 × (10,000 business miles ÷ 15,000 total miles)] of vehicle expense.

The ability to switch annually between deducting the SMR and actual expenses is restricted. If you claim actual expenses the first year a vehicle is used for business (including I.R.C. §179 or other depreciation), you cannot use the SMR for that vehicle in later years. If you deduct the SMR for the first year you use a vehicle for business, you can deduct actual expenses in later years, but you are limited to using straight-line depreciation for the vehicle. Electing the SMR in the first year can allow you to deduct actual expenses for later years in which you have high repair bills and use the SMR in other years.

If you use more than four cars and trucks at the same time in your farming business, you cannot use the SMR; your only option is to deduct actual expenses. You are not using five or more cars or trucks for business at the same time if you alternate using them for business (that is, use them at different times).

Vehicle Depreciation and I.R.C. §179 Expensing Limits

Cars and trucks that have a gross vehicle weight of 6,000 pounds or less are subject to annual ceilings on the amount of allowable depreciation and I.R.C. §179 expensing deductions. The so-called 'luxury car limits' are imposed to prevent taxpayers from deducting large amounts of these expenses from taxable income. These limits affect the choice of using the SMR or actual expenses because they restrict the depreciation and I.R.C. §179 expensing that can be included in actual costs.

The ceiling varies depending on the type of vehicle, the year it is placed in service, whether additional first-year depreciation (AFYD) is deducted, and the number of years the vehicle has been in use. The ceiling must be prorated if business use of the vehicle is less than 100%. Figure 4.2 shows the limits for vehicles first placed in service in 2022. The limits do not apply to vehicles with a gross weight exceeding 6,000 pounds.

Figure 4.2. Depreciation and I.R.C. § 179 Expense Limits for Vehicles Placed in Service in 2022

Tax Year	Cars		Trucks and Vans	
	No AFYD	AFYD	No AFYD	AFYD
2022	$11,200	$19,200	$11,200	$19,200
2023	18,000	18,000	18,000	18,000
2024	10,800	10,800	10,800	10,800
After 2024	6,460	6,460	6,460	6,460

Cross-Reference

Cost-recovery rules, including depreciation, I.R.C. §179 expensing, and AFYD, are discussed later in this chapter and in Chapter 5 of this guide.

Example 4.7: Comparison of Vehicle Deduction Options

In 2022, Olga Petrov paid $62,000 for a new Cadillac. Her actual operating costs for the car were $5,000, and she drove it 15,000 miles for her farming business (7,000 miles before July and 8,000 miles after June) and 5,000 miles for personal use.

Olga can deduct $18,150 of actual expenses or the $9,095 standard mileage deduction, as shown in Figure 4.3.

Figure 4.3: Olga Petrov's 2022 Car Deduction Options

Actual Expenses		
Costs other than depreciation		$ 5,000
AFYD limit for cars		19,200
Total costs		$24,200
Business use percentage (15,000 ÷ 20,000)		× .75
Business deduction		$18,150
Standard Mileage Rate		
Miles before July	7,000	
SMR for January–June	58.5¢	
Standard mileage deduction		$ 4,095
Miles after June	8,000	
SMR for July–December	× 62.5¢	
Standard mileage deduction		5,000
Total standard mileage deduction		$ 9,095

If Olga deducts the $18,150 of actual expenses for 2022, she cannot use the SMR for later years. As shown in Figure 4.4, Olga's actual cost deduction in 2023 will be $17,250 and her 2023 standard mileage deduction will be $9,375, assuming the same costs and usage as in 2022 and a 62.5¢ SMR for 2023.

Figure 4.4: Olga Petrov's 2023 Car Deduction Options

Actual Expenses	
Costs other than depreciation	$ 5,000
AFYD limit for cars	18,000
Total costs	$ 23,000
Business use percentage (15,000 ÷ 20,000)	× .75
Business deduction	$ 17,250
Standard Mileage Rate	
Business miles	15,000
SMR (assumed)	× 62.5¢
Standard mileage deduction	$ 9,375

Before choosing a method for deducting vehicle expense, you should consider the discounted value of the deductions you can claim over the life of the car under each method.

Example 4.8: Comparison Over the Life of Vehicle

Olga, from Example 4.7, plans to keep the Cadillac she purchased in 2022 for 5 years. To compare the discounted value of the tax deductions over that period, assume that her costs, business use, personal use, and the SMR are the same in 2023 through 2025 as they were in 2022. Also assume that her marginal tax rate is 35% and that the appropriate discount rate is 5%. The present value of the tax savings from deducting actual costs is $19,941, and the present value from deducting the SMR is $14,113. Therefore, based on the assumptions used to make these calculations, Olga should choose the actual costs in 2022 rather than deducting her standard mileage.

Relief from Recordkeeping

A special rule for farmers allows them to deduct 75% of the cost of operating a vehicle without business mileage records, if the vehicle is used during most of the normal business day directly in connection with the business of farming. Farmers must choose this method of substantiating expenses for a vehicle in the first year it is placed in service. If this method is chosen, the farmer cannot use another substantiation method for that vehicle in late years. Either the actual expenses or the SMR can be used with the 75% method. The method eases recordkeeping requirements, but a taxpayer may be forgoing some additional deductions if their business use is greater than 75%.

Lease vs. Purchase of Equipment

Leasing is an alternative method of financing the acquisition of equipment. Instead of paying principal and interest on a loan to purchase the equipment, farmers can make lease payments for the right to use the equipment for a stated term. Both tax and non-tax factors affect the decision to lease or buy. The non-tax issue is whether the total cost of the lease payments is greater or less than the total cost of ownership, including interest on the loan and the decrease in value of the equipment. The tax issue is whether deductions for lease payments or deductions for interest and depreciation provide a greater tax advantage. Leasing may provide a tax advantage by increasing tax deductions in the early years of the lease.

The tax issue is further complicated by rules that may treat a lease as a disguised installment purchase for income tax purposes. These rules kick in if the terms of the contract look more like an installment purchase arrangement than a lease. If the lease contract is treated as a disguised sale, the farmer cannot deduct the required payments as rent. Instead, the payments are treated as payments on a loan. The farmer can deduct the deemed interest portion of the payments and depreciate the deemed purchase price.

After-Tax Comparison of Leasing and Purchasing

Example 4.9: Lease vs. Purchase of Tractor

Mary Farmer is considering acquiring a tractor for $100,000. She can purchase the tractor for a $30,000 down payment and a $70,000 loan amortized over 5 years at a 7% rate of interest, taking a tax deduction for the interest paid on the loan and for depreciation. Alternatively, Mary can lease the tractor for 5 years by paying $19,353 at the time of signing and making four additional $19,353 lease payments, taking a tax deduction for each lease payment. If Mary wishes, she can acquire the tractor at the end of the 5-year lease for $20,000 (its fair market value) and depreciate that $20,000 cost using MACRS depreciation over a 7-year recovery period.

The remainder of this example analyzes Mary's after-tax cost of a purchase or a lease. In both situations, Mary's total tax rate is 31.07%, including a 3% state income tax, 15% federal income tax, and net 13.07% self-employment tax (considering the income tax savings from deducting half of the self- employment tax, which is explained in Chapter 6 of this guide). This tax rate is assumed to be constant over the 10-year period of analysis. In both cases, it is also assumed that the tractor is sold at the end of the 10-year period for $15,000. Mary's after-tax discount rate for both the lease and purchase is 8%.

Purchase of Tractor:

Figure 4.5 shows the calculation of the present value of the after-tax cost of purchasing the $100,000 tractor. The second column shows Mary's $30,000 down payment when she purchased the tractor (year 0) and her $17,072 loan payments in years 1 through 5. Mary deducts the interest portion of the loan payments listed in column 3 and the allowable depreciation listed in column 4. The adjustments for taxes (tax savings) presented in column 5 are computed using Mary's 31.07% tax rate. The sale of the fully depreciated tractor in year 10 for $15,000 results in depreciation recapture that is taxed as ordinary income but is not subject to self-employment tax, and it yields $12,300 of after-tax income.

Finally, the net after-tax inflows (positive numbers) and outflows (negative numbers) from column 6 are discounted in column 8 using Mary's after-tax discount rate of 8% (column 7) and summed over the 10-year planning period. **The after-tax net present value of the cost of acquiring the $100,000 tractor by purchase is $65,556.**

(continued)

Example 4.9: Lease vs. Purchase of Tractor (*continued*)

Figure 4.5: Purchase of $100,000 Tractor

5-Year Fully Amortized Loan with 30% Down and 7% Interest; Sale in Year 10 for $15,000

Year (1)	Payments (2)	Interest Expense (3)	150% DB Depreciation (4)	Adjustment for Taxes (5)	Net After-Tax Cash Flow (6)	After-Tax Discount Factor (7)	Present Value Net Cash Flow (8)
0	– 30,000				– 30,000	1.0000	– 30,000
1	– 17,072	4,900	10,714	4,851	– 12,221	0.9259	– 11,316
2	– 17,072	4,048	19,133	7,202	– 9,870	0.8573	– 8,462
3	– 17,072	3,136	15,033	5,645	– 11,427	0.7938	– 9,071
4	– 17,072	2,161	12,249	4,477	– 12,595	0.7350	– 9,258
5	– 17,072	1,117	12,249	4,153	– 12,919	0.6806	– 8,793
6			12,249	3,806	3,806	0.6302	2,398
7			12,249	3,806	3,806	0.5835	2,221
8			6,124	1,903	1,903	0.5403	1,028
9						0.5002	
10					12,300*	0.4632	5,697
			100,000				– 65,556

*After-tax proceeds from sale of tractor $15,000 – ($15,000 x 0.18) = $12,300

Mary Farmer is considering acquiring a tractor for $100,000. She can purchase the tractor for a $30,000 down payment and a $70,000 loan amortized over 5 years at a 7% rate of interest, taking a tax deduction for the interest paid on the loan and for depreciation. Alternatively, Mary can lease the tractor for 5 years by paying $19,353 at the time of signing and making four additional $19,353 lease payments, taking a tax deduction for each lease payment. If Mary wishes, she can acquire the tractor at the end of the 5-year lease for $20,000 (its fair market value) and depreciate that $20,000 cost using MACRS depreciation over a 7-year recovery period.

Lease of Tractor:

Figure 4.6 presents similar information for leasing the $100,000 tractor. Mary made the initial $19,353 lease payment at the time of signing (year 0) and four more $19,353 tax-deductible payments at the end of years 1 through 4. She purchased the tractor at the end of year 5 and depreciated the $20,000 purchase price using 7-year MACRS (as newly bought used machinery). As in the outright purchase alternative, she sold the tractor for $15,000 in year 10. This results in an $8,281 net after-tax gain that is reported as ordinary income not subject to self-employment tax because of the I.R.C. § 1245 recapture rule. **The after-tax net present value of the cost of acquiring the tractor by lease is $64,583.** In this example, Mary would save $973 by leasing rather than making an outright initial purchase of the tractor.

(continued)

Example 4.9: Lease vs. Purchase of Tractor (*continued*)

Figure 4.6: Lease of $100,000 Tractor
Purchase for $20,000 in Year 5 and Sale for $15,000 in Year 10

Year (1)	Lease Payment (2)	Purchase/Sale (3)	150% DB Depreciation (4)	Adjustment for Taxes (5)	Net After-Tax Cash Flow (6)	After-Tax Discount Factor (7)	Present Value Net Cash Flow (8)
0	– 19,353			6,013	– 13,340	1.000	– 13,340
1	– 19,353			6,013	– 13,340	0.9259	– 12,352
2	– 19,353			6,013	– 13,340	0.8573	– 11,436
3	– 19,353			6,013	– 13,340	0.7938	– 10,589
4	– 19,353			6,013	– 13,346	0.7350	– 9,805
5		– 20,000	2,142	666	– 19,334	0.6806	– 13,159
6			3,826	1,189	1,189	0.6302	749
7			3,006	934	934	0.5835	545
8			2,450	761	761	0.5403	411
9			2,450	761	761	0.5002	381
10		8,281*	1,225	381	8,662	0.4632	4,012
			15,099		I		– 64,583-

*After-tax value of sale for $15,000 in year 10
$20,000 purchase price - $15,099 depreciation = $4,901 adjusted basis
$15,000 sales price - $4,901 = $10,099 depreciation recapture
$10,099 x (1 - 0.18) = $8,281 net after-tax sale proceeds

Planning Pointer

Rapid Cost-Recovery Rules

In 2022, leasing may not provide a tax advantage because the additional first-year depreciation and I.R.C. §179 expensing rules in effect will allow farmers to deduct most or all of the cost of equipment they purchase and place in service.

Ultimately, the lease vs. buy decision is influenced by a number of factors which cannot be analyzed with manual calculations. The University of Illinois farmdoc website contains excellent software for analyzing lease vs. purchase and other business decisions. See www.farmdoc.illinois.edu and look under FAST tools to find the program.

Disguised Sale Rules

A multiyear lease of equipment is more likely to be treated as a disguised sale than a short-term rental arrangement. IRS Publication 225, *Farmer's Tax Guide (for 2022 returns)*, lists the following factors as indications that the arrangement is a conditional sales contract:

- The agreement applies part of each payment toward an equity interest you will receive.
- You get title to the property after you make a stated amount of required payments.
- The amount you must pay to use the property for a short time is a large part of the amount you would pay to get title to the property.
- You pay much more than the current fair rental value of the property.
- You have an option to buy the property at a nominal price compared to the value of the property when you exercise the option. (This value is determined when you make the agreement.)
- You have an option to buy the property at a nominal price compared to the total amount you have to pay under the agreement.
- The agreement designates part of the payments as interest, or part of the payments can be easily recognized as interest.

Planning Pointer

Aggressive Leasing Arrangements

An aggressive leasing arrangement that requires large lease payments in the earlier years so that the farmer can accelerate the income tax deductions is more likely to be treated as a conditional sale. This is true because the lease payment is both more likely to exceed the current fair rental value and more likely to be a large part of the amount you would pay to get title to the property.

Most short-term leases of equipment are not disguised sales because the farmer does not have the right to buy the equipment at the end of the lease. The lease payments can be deducted because they are ordinary and necessary business expense as discussed earlier in this chapter.

Example 4.10: Short-Term Lease

Dusty Trail operates a cattle ranch and rents a hay baler on a per bale basis. At the end of the haying season, Dusty returns the hay baler to the rental company and pays his rental costs. Rusty can deduct the rent payment on his income tax return.

Example 4.11: Conditional Sales Contract

Bird O'Paradise leased a walk-in cooler to store freshly harvested flowers for her cut-flower farm business. The agreement requires Bird to pay $11,500 annually for 2 years—$10,000 as a lease payment and $1,500 as a capital charge (interest). At the end of the 2 years, the agreement allows Bird to purchase the cooler for $500.

For tax purposes, the agreement is a sale and not a lease. Bird cannot deduct the $11,500 annual payments as rent. She can deduct $1,500 each year as interest and begin depreciating the $20,000 cost of the cooler. If she pays the additional $500 at the end of the lease, it adds to her basis for depreciation.

Taxes

Generally, farmers may deduct several types of taxes as a farm business expense:

a) Real estate and personal property taxes on farm business assets such as equipment, animals, farmland, and farm buildings
b) Social security and Medicare taxes paid on behalf of employees
c) Federal unemployment on behalf of employees
d) Highway use tax on trucks or tractors used in the farm business

You are **not** allowed to deduct the following taxes as farm business expense on Schedule F:
a) Self-employment tax you pay as a farm business owner (can be taken on Schedule 1 of 1040)
b) State and local sales taxes on purchase of capital assets, which are capitalized and depreciated over the life of the asset

Seeds and Plants

Farmers may deduct the cost of seeds and plants used to produce a crop for sale. This rule does not apply to plants with a pre-productive period of more than two years (i.e. trees and vines). Costs for these types of plants must generally be capitalized (costs taken over time) and not expensed in the year of purchase as an ordinary business expense. However, as discussed earlier, under the TCJA, farmers with gross incomes of $26,000,000 or less are not subject to the UNICAP rules and may generally deduct new plantings in the year of purchase.

Items Purchased for Resale

Costs of animals and plants bought for resale are generally deducted in the year they are sold. The costs are netted against total sale receipts to determine taxable income before deductions. Some exceptions exist which allow the costs to be deducted in the year of purchase. This includes:
a) Baby chicks and pullets for raising and resale
b) Hens bought for commercial egg production
c) Seeds and young plants bought for further development and cultivation before sale

Travel Expenses

Ordinary and necessary business expenses include the costs of traveling for business. However, if the travel is for both personal and business purposes, only the cost of the business portion of the trip is deductible. To maximize the tax benefits of travel deductions, keep the following rules in mind when planning a business trip that includes some personal objectives.

Meals and Lodging

Meal and lodging costs must be allocated between the business and personal portions of a trip when it includes days that are spent primarily on personal activities.

Example 4.12: Allocation of Meal and Lodging Expenses

Paige Turner left home Wednesday afternoon for a business meeting in San Antonio. The business meeting ended Saturday morning, so Paige could have returned home before her evening meal on Saturday. Instead, she stayed over Saturday night to do some sightseeing and returned home on Sunday.

Paige can deduct her lodging costs for Wednesday through Friday nights and her meals through Saturday at noon. She cannot deduct the cost of her lodging Saturday night or the meals after her noon meal on Saturday.

Two rules may further limit the deduction for meal expenses incurred while traveling.

1. Only 50% of the cost of the meal can be deducted. The expense of a meal includes amounts you spend for your food, beverages, taxes, and tips relating to the meal. You can deduct either 50% of the actual cost or 50% of a standard meal allowance that covers your daily meal and incidental expenses. The standard meal allowance can be found at www.gsa.gov; selecting your location will bring up the applicable allowance.
2. A travel meal expense is not deductible unless the traveler must stop for substantial sleep or rest to properly perform his or her business duties.

Example 4.13: Sleep Required

Redd Angus attended a breeding cattle sale in a neighboring county. He left after breakfast, bought his noon meal at the sale, and returned home in time for his evening meal. Redd can deduct his transportation expenses because the purpose of the trip was business. He cannot deduct the cost of his noon meal because the trip did not require substantial sleep or rest.

Temporary Increased Deduction

The Taxpayer Certainty and Disaster Tax Relief Act allowed 100% business meal deduction for tax years 2021 and 2022 if provided by a restaurant (including carry-out or delivery).

Business-Related Entertainment

The 2017 Tax Cuts and Jobs Act eliminated deductions for any expense related to activities generally considered entertainment, amusement, or recreation.

Transportation

The cost of transportation for travel within the United States is subject to an all-or-nothing rule. If the primary purpose of your trip is business, you can deduct all of your transportation expense. If the primary purpose of your trip is personal, you cannot deduct any of your transportation expense.

Example 4.14: Transportation Costs

Paige Turner, from Example 4.12, returned from San Antonio on Sunday after her business meeting ended on Saturday. Because she spent 3 days at her business meeting and 1 day sightseeing, she can deduct all of her transportation expense.

Companion's Expenses

The travel expenses of a companion who joins you on a business trip are deductible only if there is a business purpose for your companion's travel. If there is no business purpose for your companion's travel, the extra costs for your companion's travel are personal expenses that cannot be deducted. This includes your companion's meal expenses and bus, train, or air fare. If there is a difference in lodging rates for more than one person staying in a room, the deductible lodging expense is the single rate. Rental car expenses incurred with a companion are fully deductible if there is no difference in the rental rate for one or two persons in the car.

Summary

Combining personal travel with business trips may allow you to deduct part of those costs as a business expense.

Soil and Water Conservation Expenses

Taxpayers engaged in the business of farming may elect to deduct the cost of certain improvements to land that otherwise must be added to the land's basis. Deductible conservation expenses are generally those that are paid to conserve soil and water for land used in farming, to prevent erosion of land used for farming, or for endangered species recovery.

The election to deduct the cost of certain improvements may have a significant tax advantage, because land cannot be depreciated and costs that are added to the basis of land provide a tax benefit only when the land is transferred in a taxable transaction. At that time, the basis reduces the gain or increases the loss from the transfer. In most cases, gain from the transfer of land is treated as capital gain rather than as ordinary income.

The election to deduct the cost of qualifying improvements not only allows farmers to obtain a tax benefit in the year of the improvements are purchased, rather than in the year the land is sold, but it also allows the expenses to reduce ordinary income and self-employment income rather than income that is taxed at the lower rate for capital gains.

Cross-Reference

Chapter 5 of IRS Publication 225, *Farmer's Tax Guide (for 2022)*, explains the special rules for deducting soil and water conservation expenses.

To be deductible, the conservation expenses must be consistent with a plan approved by the USDA Natural Resources Conservation Service or a soil conservation plan approved by a comparable state entity. The land must be land that the landowner or the landowner's tenant is using for farming or has used in the past for farming. **Expenditures on land that has not been used in farming are not deductible under I.R.C. §175.**

Eligible Expenses

Deductible conservation expenses include (but are not limited to) the following items:

1. Treatment or movement of earth, such as leveling, conditioning, grading, terracing, contour furrowing, or restoration of soil fertility
2. Construction, control, and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds
3. Eradication of brush
4. Planting of windbreaks

Expenses for improvements that can be depreciated cannot be claimed as a deduction under this special rule.

Eligible Taxpayers

Taxpayers must be engaged in the business of farming to elect to deduct conservation expenses. Taxpayers are engaged in the business of farming if they cultivate, operate, or manage a farm for gain or profit, either as an owner or as a tenant.

- A person engaged only in forestry or the growing of timber is not engaged in the business of farming.
- Landowners who rent their land and receive farm rental payments based on farm production, either in shares or in cash, are in the business of farming for this purpose.
- Landowners who receive a fixed cash rent are in the business of farming only if they materially participate in the farming business.

Cross-Reference

See the discussion of material participation for landlords on page 78 of IRS Publication 225, *Farmer's Tax Guide (for 2022).*

Planning Pointer

Shift to a Share Lease

A cash-rent landowner could shift to a share lease for a year in which conservation expenditures will be incurred. This makes the landowner a farmer for the election to deduct soil and water conservation expenses, without regard to material participation.

Gross Farm Income Limit

The deduction for soil and water conservation expenses is limited to 25% of the taxpayer's gross income from farming. Qualifying expenses in excess of this limit can be carried forward to future tax years and deducted to the extent of 25% of gross farming income for each year. If the taxpayer ceases to farm before the carryforward is used up, the excess can never be deducted and cannot be added to the basis of the land.

The election to deduct soil and water conservation expenses applies to all tax years after the year you make the election unless you receive permission from the IRS to change your election. When the affected land is sold, any unused carryforward cannot be added to its basis. However, if the taxpayer continues in a farming business after selling the land, the carryover can still be deducted to the extent of 25% of gross farm income.

To avoid losing the tax benefits from deducting soil and water conservation expenses, you should plan to use them up before you quit farming. As you near the end of your farming career, you may want to seek permission from the IRS to change your election so that you can add newly incurred soil and water conservation costs to the basis of your land rather than increase a carryover that you cannot deduct because of the gross farm income limit.

An alternative for a farmer who plans to retire is to postpone planned soil and water conservation improvements until after the farmer quits farming. If you then lease the land on a cash lease without material participation, you will not be eligible to deduct new soil and water conservation expenses and must add them to the basis of your land.

Recapture

If you deduct soil and water conservation expenses and later sell the affected land, you may have to treat part of the gain realized on the sale as ordinary income rather than as capital gain. If you held the land for 5 years or less, all of the gain is treated as ordinary income up to the amount previously deducted for soil and water conservation expenses. If you held the land for more than 5 years but less than 10 years, the ordinary income recapture amount is reduced by 20% for each year you held the land beyond 5 years.

In most cases, the tax benefit of the soil and water conservation expense deduction exceeds the tax cost of the recapture because the deduction reduces both ordinary income and self-employment income and the recapture adds only to ordinary income. The deduction also reduces tax liability in an earlier tax year than the recapture adds to tax liability. However, if the deduction falls in a year with little or no farm income, and the recapture falls in a year of high income, the tax cost of the recapture may exceed the tax benefit of the deduction.

Fertilizer and Lime

Because fertilizer and lime often benefit the land for longer than a year, their cost must generally be capitalized and deducted over the period their benefits last. However, farmers can elect to deduct expenses for fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming in the year the expenses are paid. This includes both the cost of the materials and the cost of applying them to the land.

Cross-Reference

See the discussion of fertilizer and lime on page 23 of IRS Publication 225, *Farmer's Tax Guide (for 2022)*, for further information about deducting or capitalizing the cost of fertilizer and lime.

Most farmers elect to deduct these expenses in full in the year they are paid. However, you may want to spread the deduction over the years the fertilizer, lime, or other materials benefit the soil if you expect to be in a higher tax bracket in those later years.

Depreciation and I.R.C. § 179

The cost of assets (such as buildings, equipment, and breeding livestock) that farmers use to produce income generally cannot be deducted as an expense in the year the asset is purchased. Instead, the cost is deducted over the useful life of the asset. The cost-recovery rules give taxpayers several options for deducting the basis of assets.

The depreciation rules establish a recovery period for each type of asset. For example, the recovery period for breeding hogs is 3 years; for cars and trucks, it is 5 years; for new farm machinery and equipment, it is 5 years; newly bought used machinery and equipment is 7 years; and for farm buildings, it is 20 years. Farmers can choose a longer recovery period and a slower method of depreciation for assets if they want to save more of the total depreciation deduction for later years. See Chapter 5 for comparison of depreciation methods.

Farming businesses that elect out of the interest deduction limit must use the alternative depreciation system (i.e. straight line depreciation) to depreciate any property with a recovery period of 10 years or more, such as single purpose agricultural or horticultural structures, trees or vines bearing fruit or nuts, farm buildings and certain land improvements.

Property used in a farming business and placed in service after Dec. 31, 2017, is not required to use the 150 percent declining balance method. A 200 percent declining balance may provide greater deduction in earlier years. However, if the property is 15-year or 20-year property, the taxpayer should continue to use the 150 percent declining balance method.

I.R.C. §179 expensing allows taxpayers to elect to deduct part or all of the cost of qualifying assets in the year the assets are placed in service. The deduction is limited to the taxpayer's income from all businesses and is also limited to a set dollar amount that varies by tax year. Under current law, the dollar limit is $1,040,000 for tax years beginning in 2020, $1,050,000 for tax years beginning in 2021, and $1,080,000 for tax years beginning after 2022.

The additional first-year depreciation (AFYD) rules allow taxpayers to deduct 100% of the cost of qualifying assets that they place in service between Sept. 27, 2017, and before Jan 1, 2023; 80% for property placed in service during calendar year 2023; 60% for property placed in service during calendar year 2024; 40% for property placed in service during calendar year 2025; and 20% for property placed in service during calendar year 2026. At the time of publication, no bonus depreciation is available for qualified property that is placed in service after Dec. 31, 2026, except for certain long-production period property and aircraft which extends to 2027.

Cross-Reference

See Chapter 7 of IRS Publication 225, *Farmer's Tax Guide (for 2022)*, for further information about the cost-recovery rules.

The cost-recovery rules result in a dizzying array of options for deducting the cost of the assets purchased to use in a farming business. Because some assets qualify for only some of the options, the farmer must carefully choose the cost-recovery method to use for each asset. Managing your cost-recovery options to minimize your income tax liability is discussed in Chapter 5 of this guide.

Section 199A Qualified Business Income Deduction (QBI)

I.R.C. §199A was enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA). §199A(a) establishes the qualified business income (QBI) deduction for individuals, estates, and trusts. This deduction is determined after computing a taxpayer's 'qualified business income'. Eligible taxpayers can deduct up to 20% of their QBI from sole proprietorships and pass-through entities for tax years 2018 through 2025.

An individual farmer who is a patron of a specified cooperative may be entitled to two deductions under §199A. A farmer can have a qualified trade or business that generates a §199A(a) QBI deduction, and the farmer may also receive a §199A(g) deduction passed through from the specified cooperative. The latter is based on the former domestic production activities deduction (DPAD). A patronage from an agricultural cooperative can be treated differently depending on the nature of the cooperative.

QBI is the net amount of qualified items of income, gain, deduction, and loss from any qualified trade or business, including income from partnerships, S corporations, sole proprietorships, and certain trusts. Generally, this includes, but is not limited to, the deductible part of self-employment tax, self-employed health insurance, and deductions for contributions to qualified retirement plans (e.g., SEP, SIMPLE and qualified plan deductions).

http://www.IRS.gov/ has information on the QBI deduction including IRS Forms 8995 and 8995-A.

Labor

Hired Labor

You can deduct reasonable wages paid for regular farm labor, piecework, contract labor, and other forms of labor hired to perform your farming operations. You can pay wages in cash or in noncash items such as inventory, capital assets, or assets used in your business. The cost of boarding farm labor is a deductible labor cost. Other deductible costs you incur for farm labor include health insurance, workers' compensation insurance, and other benefits. If you must withhold social security, Medicare, and income taxes from your employees' cash wages, you can still deduct the full amount of wages and the employer's share of the Social Security and Medicare taxes you must pay.

Children

You can deduct reasonable wages or other compensation you pay to your child for doing farmwork if a true employer-employee relationship exists between you and your child. Include these wages in the child's income. The child may have to file an income tax return. These wages may also be subject to Social Security and Medicare taxes if your child is age 18 or older. The amount of wages paid to the child could cause a loss of the dependency exemption, depending on how the child uses the money.

Spouses

You can deduct reasonable wages or other compensation you pay to your spouse if a true employer-employee relationship exists between you and your spouse. Wages you pay to your spouse are subject to Social Security and Medicare taxes.

Hobby Farms

If you operate a farm for profit, you can deduct all the ordinary and necessary expenses of carrying on the business of farming on Schedule F. However, if you do not carry on your farming activity to make a profit, it is considered a hobby and you report the income from the activity on Schedule 1 (Form 1040).

Additionally, if the activity is considered a hobby activity you are not allowed to deduct expenses, even if you itemize your deductions on Schedule A.

Cross-Reference

See page 28 of IRS Publication 225, *Farmer's Tax Guide (for 2022)*, for further information about the not- for-profit activity rules.

Presumption of Profit Motive

An activity is presumed to be *engaged in for profit* if it produces a profit (gross income exceeding deductions) in 3 of 5 consecutive tax years. Horse breeding, training, showing, or racing activities meet the presumption if they show a profit in 2 of 7 consecutive tax years. If the taxpayer meets the threshold for the presumption, the IRS has the burden of proving the lack of a profit motive.

Factors in Determining Profit Motive

If a taxpayer does not meet the 3- of 5-year (or 2- of 7-year) profit test, the burden of showing that a profit motive exists is borne by the taxpayer. The following nine factors help determine whether a taxpayer is engaged in an activity for profit:

1. The manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or the taxpayer's advisers
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that assets used in the activity will appreciate in value
5. The taxpayer's success in carrying on other similar (or dissimilar) activities

Farm Deductions

1. The taxpayer's history of income or losses with respect to the activity
2. The amount of occasional profits that are earned
3. The taxpayer's financial status
4. The elements of personal pleasure or recreation

Other facts and circumstance may also be considered, and no one factor is conclusive of a profit objective. A simple comparison of the number of factors indicating a profit motive with the number of factors indicating there is not a profit motive is **not** decisive.

Satisfying the For-Profit Requirement

The IRS does not impose the not-for-profit limit on farmers whose only source of income is their farming business, because it is clear that the farmer is engaged in the farming activity with a profit motive.

Example 4.15: Full-Time Farmer

Juan de Herrera began raising pistachios in 2019. Juan works 60 hours a week in his farming business and has no other income. His bank gave him a line a credit that allows him to pay his business and personal living expenses until his pistachio orchard is productive enough to make a profit.

The IRS will not limit Juan's expense deduction to his pistachio income even if he does not make a profit in 3 of 5 years because he is not raising pistachios for personal pleasure or recreation. Therefore, Juan does not need to postpone deductions or accelerate income in an attempt to show a profit in 3 of 5 years.

If you have substantial off-farm income and do not work full time in your farming activity, you may want to avoid more than 2 consecutive years (5 consecutive years for the specified horse activities) of losses so that you satisfy the 3- of 5-year (or 2- of 7-year) profit test each year and thus shift the burden of proving the lack of a profit motive to the IRS.

Postponing the For-Profit Test

You can postpone IRS's application of the for-profit test by filing Form 5213, Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit.

Filing this form prevents the IRS from imposing the not-for-profit limit on your deductions until the close of the sixth tax year after you start a horse activity and the close of the fourth tax year after you start any other activity. However, filing the form also keeps all of those tax years open so that the IRS can limit your deductions for those years if it finds that you did not have a profit motive.

If you do not file Form 5213, the IRS generally has only 3 years after you file a return to challenge your deductions on that return. Therefore, you should not file Form 5213 unless the IRS applies the not-for-profit limit to your deductions. If the IRS applies the limit, you can then file Form 5213 to postpone the application until the fifth year (seventh year for horse activities) of the activity.

Table of Contents: Chapter 5

CHAPTER 5

MANAGING THE TIMING OF INCOME AND DEDUCTIONS

Introduction

Uncertainty is a significant component of an agricultural operation. These businesses, like non-farm businesses, are subject to general economic market factors that impact availability of inputs such as labor and supplies. In addition, agricultural operations also see fluctuations in input and output prices, and production risk due to weather, disease, and other natural phenomena. Together, these factors often result in annual variations in farm business income, requiring operators to plan ahead in order to manage taxable income and the amount of income tax paid.

Because marginal tax rates increase as income increases, significant fluctuations in taxable income from year-to-year may result in a higher amount of tax paid over a period of time compared to consistent farm income year-to-year. Fortunately, most agricultural operations use cash basis of accounting to calculate taxable income, which allows great flexibility in managing the ups and downs of farm income. A primary goal of tax management is to avoid wide fluctuations in annual income to avoid swings in marginal tax rates.

Marginal Federal Income Tax Rate

A taxpayer's *marginal federal income tax rate* is the rate that applies to the taxpayer's last dollar of taxable income. Each year the IRS publishes rate schedules for each filing status, adjusting the taxable income brackets for inflation. Figure 5.1 shows the 2022 tax rate brackets for a married taxpayer filing a joint return. It is important to recognize that marginal tax brackets are just that—marginal. The marginal tax bracket applies only to each incremental dollar of income.

Figure 5.1. 2022 Federal Income Tax Rates Joint Returns

Married filing jointly or Qualifying widow(er)			
If taxable income is over	but not over	the tax is	of the amount over
$0	$20,550	10%	$0
20,550	83,550	$2,055.00 + 12%	20,550
83,550	178,150	9,615.00 + 22%	83,550
178,150	340,100	30,427.00 + 24%	178,150
340,100	431,900	69,295.50 + 32%	340,100
431,900	647,850	98,671.00 + 35%	431,900
647,850	----------	174,253.50 + 37%	647,850

Example 5.1: Marginal Federal Income Tax Rate

Bob is a married farmer who has $44,238 of taxable income in 2022. Applying the 2022 tax rate schedule in Figure 5.1, the first $20,550 of income is taxed at a 10% rate. The remaining $23,688 ($44,238 –$20,550) is taxed at a 12% rate. Bob's marginal federal income tax rate is 12%.

Because the federal income tax rate brackets are indexed for inflation, a taxpayer with the same amount of income for two consecutive years might find that a higher portion of their income is taxed at lower rates in the second year.

Example 5.2: Application of Marginal Tax Rate

If Bob (in Example 5.1) increases his taxable income above $83,550, he will move into a 22% marginal federal income tax bracket (see Figure 5.1). Therefore, if Bob's income rises from $83,550 to $83,551, the federal income tax is 22¢ of that last dollar, **but only of the last dollar**. Moving into a 22% marginal bracket does not mean that he will be taxed at a 22% rate on **every** dollar. All of the income up to $83,550 is still taxed in the lower brackets.

After-Tax Income

Although there may be many motives to operate a business, for most agricultural operations, profit is the primary motive. In the long-term, profit is necessary to pay for non-deductible expenses such as income tax, family living expenses, land purchases, or loan principal payments. If profit is a goal of agricultural business managers, incorporating after-tax income into a tax management decision should be part of farm income tax management decisions.

When a manager of an agricultural operation considers *after-tax income*, they are considering not only their marginal tax rate, but also any potential self-employed deductions, other non-business deductions, and tax credits available. Certain deductions and credits are not available if the taxpayer's adjusted gross income or taxable income exceeds a certain amount. If a manager of an agricultural operation looks at the portion of total income that is retained as after-tax dollars (after-tax dollars divided by total income), they can maximize or optimize the dollars they keep in their pocket.

After-tax dollars can be defined as total income reported on the income tax return, less out-of-pocket expenses reported on the return. Caution must be used when calculating after-tax income as some items deducted on Form 1040 are only reported on the return and require no cash payment. Things like the deduction for one-half of self-employment tax, the standard deduction, or the qualified business income deduction reduce taxable income on the income tax return, but do not require a payment by the taxpayer. Conversely, deductions for contributions to self-employed retirement plans or traditional individual retirement accounts (IRAs) require a cash payment and reduce taxable income. However, these contributions are a deferral of income and still belong to the taxpayer so, at least in the short-term, they could be considered after-tax income retained.

Example 5.3: After-Tax Dollars

Jerry is a married taxpayer who files a joint income tax return with his spouse. Jerry is working with his income tax preparer at the end of 2022 and they are projecting his net farm income will be $65,000. Jerry and his spouse do not have any other sources of income. Their taxable income is $27,606 which means their marginal tax rate is 12%. Jerry's total tax liability is $12,086 ($2,902 of income tax + $9,184 of self-employment tax). Their after-tax income would be $52,914 ($65,000 total income minus $12,086 of income tax owed). Their portion of income retained as after-tax dollars is 81.41% ($52,914 ÷ $65,000).

Figure 5.2. Jerry's Effective Tax Rate

Net farm income	$ 65,000
Deduction for one-half of self-employment tax	– 4,592
Adjusted gross income	60,408
Standard deduction	– 25,900
§199A deduction	– 6,902
Taxable Income	$ 27,606
Income tax	2,902
Self-employment tax	9,184
Total federal tax liability	$ 12,086

Example 5.4: Impact of Income Changes on After-Tax Income

Consider Jerry from Example 5.3. If he is able to increase deductible farm expenses enough to decrease farm income to $55,000, his taxable income would be $20,171 and his after-tax dollars would decrease to $45,212 ($55,000 – $9,788). However, the percentage of his total income retained as after-tax dollars would increase to 82.20%.

Figure 5.3. Jerry's Effective Tax Rate

Net farm income	$ 55,000
Deduction for one-half of self-employment tax	– 3,886
Adjusted gross income	51,114
Standard deduction	– 25,900
§199A deduction	– 5,043
Taxable Income	$ 20,171
Income tax	2,017
Self-employment tax	7,771
Total federal tax liability	$ 9,788

Observation

Tax Rate Change

It is important to remember that tax rates have changed over the years and could change again at any time. It is important to factor these changes into to farm management decisions.

Tax-planning strategies for a cash basis taxpayer often involve delaying income or prepaying expenses to move income from a higher effective marginal tax rate to a lower one. A farmer may receive a tax benefit by prepaying supplies, but even though the farmer will ultimately use the supplies, the additional cost of pre-purchasing must be recognized. This cost typically includes the time value of money—interest expense on money borrowed or lost interest income on money taken from savings to make the prepayments. Therefore, a taxpayer gains the most by prepaying expenses that will be used early in the next year. A taxpayer must consider whether his or her marginal bracket is high enough that the tax savings justify taking on a current cost that could have been delayed.

When deciding to prepay expenses, it is important to consider if the expense is necessary as a business expense, and not just an income tax management decision. Spending money on something that would not have been purchased otherwise, simply to save tax, does not make financial or economic sense.

Managing the Timing of Income and Expenses

When it comes to income tax management, a cash-basis agricultural operator has numerous tools at their disposal that can impact the timing of reporting income. Most often, taxpayers focus on methods to decrease taxable income in the current year. However, it might be reasonable for a producer to look for methods to increase taxable income, depending on their situation. If a manager has experienced a poor production year, it may make sense to increase income to maximize the amount of an available income tax credit, to fill up an income tax bracket, to optimize after-tax income, or to plan for a future year where they know they will have a higher level of income. On the other hand, an agricultural operator may have exceptional crops this year and is interested in a way to delay reporting income, allowing them to reduce their current income tax liability.

Shifting income *into* the current year can be accomplished by:

1. Delaying the deduction of expenses to a later year, or
2. Accelerating recognition of income to an earlier year.

Delaying the deduction of expenses can be as simple as not paying inputs or expenses until the following year. It is common for crop producers to prepay for inputs such as seed and fertilizer that will be used in the following year at the end of their tax year to receive discounts or to insure delivery. By delaying payment until after the end of the tax year, a producer may be able to increase taxable income in the current year. However, the decision to delay payment requires accurate year-to-date accounting with careful income tax planning at year end.

If there is not an opportunity for year-end income tax planning, several after-the-fact options are available to delay deduction of expenses. A taxpayer can choose to utilize alternative depreciation methods that reduce the amount of first year depreciation taken on capital asset purchases, thus increasing taxable income. See Managing Depreciation Expense on page 5.11 for more information related to depreciation elections available. In addition, agricultural producers may elect to treat certain repair and maintenance expenses as a capital improvement which would be capitalized (depreciated) rather than immediately deducted. A second option applies to fertilizer that has a beneficial life beyond the current year. In this case the cost of the fertilizer can be capitalized and deducted over its beneficial life.

The most effective method to accelerate recognition of income is to sell inventory. However, this may not be feasible if you either don't have additional inventory to sell or don't have enough time to deliver your inventory before year end. In addition, it may not be practical if the current commodity price is low and there is an expectation for higher prices in the future. Again, deciding how much inventory to sell requires up-to-date accounting records and careful planning.

An agricultural producer that has year-end inventory of a commodity that is eligible for a CCC Commodity Loan may be able to elect to report the loan proceeds as income rather than treating the proceeds as a loan. While there may be additional paperwork associated with a CCC loan, the added income tax flexibility may be worth the effort. As an added benefit, the election to treat the proceeds as income can be made at the time the tax return is filed, giving a taxpayer options after-the-fact.

An additional option available to agricultural producers is to elect out of installment treatment of a deferred sales contract. A valid deferred sales contract allows a producer to sell inventory, but delay receiving the payment until a later date, usually in the tax year following the current tax year. Typically, these contracts are treated as installment sales where income is reported on the tax return when the proceeds are received rather than when the commodity is sold. However, an election is available to recognize income at the time of sale, even though proceeds were received in a different tax year. Because this election is made on a contract-by-contract basis, it is recommended that commodities are sold using multiple, smaller, deferred sales contracts to be most effective. The election out of installment reporting offers considerable flexibility in that it can be made at the time of the tax return filing. A decision to sell inventory through a deferred sales contract must be made before the end of the tax year.

Cross-Reference

Constructive Receipt of Income

See page 6 and 7 of the 2022 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of when income has to be reported because it is available to you.

If none of the above options are available, it may be reasonable to rollover all, or a portion of, a traditional IRA to a Roth IRA. Because a rollover like this is taxable, additional income may be added to the current tax year. Although the decision to rollover must be made before the end of the tax year, this option offers flexibility because a taxpayer can choose, with careful planning, the amount to rollover.

More often, the goal of year-end tax planning is to delay reporting taxable income. However, this is only an effective tool when the delayed income will be taxed at the same or a lower marginal tax bracket when it is reported in a later year.

Deferring taxable income can be accomplished in one or both of two ways:

1. Delaying the receipt of income to a later year, or
2. Accelerating tax deductions to an earlier year.

A deduction taken this year is not available for a later year. Similarly, if income is not reported this year, it must be reported in a later year. **Therefore, deferral does not affect the total amount of income reported over a period of years.**

If deferral does not ultimately change the amount of taxable income reported, what does it accomplish? Potentially, it should accomplish two things. First, it can defer the payment of tax for a period of time, as Example 5.5 illustrates.

Example 5.5: Income Deferral

Jane has a choice of selling $10,000 of crops on December 31, 2022, or waiting until January 1, 2023. Jane is in a 24% marginal tax bracket each year, so $2,400 of income tax (plus SE tax on the additional income) will be due in either event. If Jane takes the $10,000 on December 31, 2022, she will pay the additional income tax of $2,400 on March 1, 2023. If she waits until January 1, 2023, she will not have to pay the additional income tax until March 1, 2024—a full year later. Jane should analyze this deferral by deciding whether the loss of the use of $10,000 for one day (December 31, 2022, to January 1, 2023) is more than made up by gaining the use of $2,400 for one year (March 1, 2023, to March 1, 2024).

The second benefit that deferral can sometimes accomplish is taxing the deferred income at a lower marginal tax bracket when it is reported. If this happens, the taxpayer not only delays the payment of tax but pays less tax as well.

Example 5.6: Income Deferral and Tax Reduction

Suppose Jane (from Example 5.5) is in a 32% marginal bracket in 2022 and will be in a 24% effective marginal bracket in 2023. Pushing $10,000 of crop sales from 2022 to 2023 not only delays the payment of tax by one year, but it also reduces Jane's income tax on this $10,000 from $3,200 to $2,400. Jane would save $800 due to the lower 2023 tax rate.

There are two strong cautions to consider when deciding to use the deferral concept. The first is that marginal tax brackets can cut both ways. In the above example, Jane saved $800 due to the lower 2023 marginal tax rate. However, suppose Jane focuses only on delaying the tax and finds that her marginal tax rate goes up in 2023.

Example 5.7: Income Deferral and Tax Increase

Jane (from Example 5.5) pushed $10,000 of sales from 2022 to 2023. She is in a 24% marginal bracket in 2022, and is in a 32% marginal bracket in 2023. Jane has delayed paying $2,400 of tax from March 1, 2023, to March 1, 2024. However, on March 1, 2024, she owes $3,200, not $2,400, which is $800 more. Unless Jane can earn $800 on $2,400 between March 1, 2023, and March 1, 2024 (a 33% rate of return), her tax planning was a mistake.

The second caution in using the deferral concept is that it may entail risks beyond taxes. For instance, delaying sales to defer income may subject the taxpayer to price fluctuations.

Example 5.8: Income Deferral and Loss of Income

Suppose Jane (from Example 5.5) delayed $10,000 of sales from 2022 to 2023. Further assume that Jane is in a 32% marginal bracket in 2022 and a 24% marginal bracket in 2023. However, suppose that after delaying her sale into 2023, Jane received only $7,000 instead of the $10,000 she would have received in 2022. Figure 5.3 shows a comparison of Jane’s after-tax positions.

Figure 5.3 After-Tax Effect of Delayed Sale

	2022 Sale	2023 Sale
Cash received	$10,000	$ 7,000
Tax paid	– 3,200	– 1,680
Net cash	$ 6,800	$ 5,320

Taxes were deferred, as well as reduced. However, Jane ended up with less after-tax income because of the lower sales price.

Installment Sale Reporting

If a sale qualifies for installment reporting, the gain is included in gross income in future years as payments are received from the buyer. Such a sale avoids the risk of price changes discussed earlier under deferring income, but it does not eliminate the risk that the buyer might default on payment. The seller eliminates market risk but takes on the risks of being the creditor.

Cross-Reference

Installment Sale Tax Rules

See Chapter 10 of the 2022 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the installment sale reporting rules.

Installment reporting may be especially useful when a significant dollar amount of farm assets is being liquidated (including sales to family members) because it can spread the income over future years in which the seller's effective marginal tax rate may be lower.

All three of the following requirements must be met for a sale to qualify for installment reporting.

1. There is a gain on the sale. (Losses are reported in full in the year of sale.)
2. At least one payment is received in a tax year after the tax year of sale.
3. The gain is not ordinary income from depreciation recapture arising from the sale of depreciable property, such as purchased breeding livestock, equipment, and certain farm buildings.

Agricultural producers who report on a cash basis and who are not required to account for inventory on their tax returns can report the sale of crops and market livestock on the installment method. (Accrual-basis taxpayers and those required to account for inventory on their tax returns cannot report the sale of their products on the installment method, although they can use it for qualifying asset sales.)

If the installment sale contract does not include an interest charge, or if it includes an interest charge that is lower than a required rate, the IRS will treat part of the sales price as interest that is taxed as ordinary income. The minimum rate of interest that must be charged to avoid the adjustment is called the Applicable Federal Rate (AFR). The AFRs are published monthly by the IRS and the appropriate rate will depend on the term of the contract. There are two notable exceptions to the requirement that the AFR be charged:

1. The total sales price is $3,000 or less.
2. All payments under the contract are to be made within 1 year of the sale date.

In addition, no interest needs to be charged on any payment made within 6 months of the sale date, regardless of the total length of the contract.

Note

Related-Party Farmland Rate

A special rule allows sellers to charge the lesser of the AFR or a 6% rate compounded semi-annually for the sale of farmland (not buildings) between family members. This rule applies only to a total of $500,000 of land sales in any given tax year. (With the currently low AFRs, this provision is irrelevant but it has been useful with historically higher AFRs.)

Example 5.9: Installment Sale of Crops

Samantha is normally in the 12% bracket, but this year expects to be in the 24% tax bracket due to an exceptionally good apple crop. Sam is concerned that the market price may drop, so she is reluctant to store her crop and sell it next year. She trusts the creditworthiness of the company that has been buying her apples for the last 12 years. Therefore, Sam entered into an installment sale with the buyer. She sold $50,000 of apples in November (based on the current market price at that time) and agreed to take payment the following January. Even though the AFR rules do not apply (because all contract payments will be made in less than 1 year), Sam convinced the buyer to pay 4.45% interest on the unpaid balance.

Sam reports the $50,000 of apple income next year as ordinary income from the sale of her crop when she receives the payment. She also reports the interest income that accrues through the date of payment.

The sale of farmland can be reported in much the same way. The computations are somewhat more complex because gain must be calculated by subtracting the taxpayer's cost basis and any expenses of sale from the sales price. This gain is then prorated and reported by the seller as payments are received.

Generally, the terms of payment for the sale of farmland extend beyond 1 year, and an amortization schedule is required to determine the amount of principal and interest included in each payment received.

Example 5.10: Installment Sale of Land

Maurice sold bare farmland for $1,000,000. He had acquired the land 30 years ago for $200,000. He paid his real estate agent, attorney, appraiser, and surveyor $75,000 in closing costs. Maurice agreed to accept a $100,000 cash down payment plus $100,000 each year for 9 years, with interest of 6% on the unpaid balance. Maurice's gain on the sale is calculated as follows:

Sale price	$1,000,000
Less: basis	– 200,000
Less: cost	– 75,000
Gain	$ 725,000

Maurice's gross profit percentage is 72.5% ($725,000 gain ÷ $1,000,000 sale price), so 72.5¢ of each dollar of principal received on the sale is taxable. In the year of sale Maurice must pay tax on $72,500 (72.5% × the $100,000 down payment). Taxation of the balance of the gain is deferred until Maurice receives each payment during the next 9 years.

Caution

Property Sold Subject to Debt

The property sold may be subject to debt that is assumed by the buyer. Such sales require complex calculations and may trigger unexpected tax results for the seller. Taxpayers should seek competent tax advice in such situations.

As stated previously, depreciation recapture from the sale of purchased breeding livestock, equipment, and certain buildings cannot be reported on the installment method. This may result in a surprise to the taxpayer who sells on a deferred-payment basis and expects to pay no tax until the cash is actually received.

Example 5.11: Sale of Equipment

Amiyah sold some equipment for $100,000. The equipment originally cost her $125,000 but she had deducted a total of $80,000 of depreciation by the time of the sale. Therefore, her adjusted basis in the equipment is $45,000 ($125,000 – $80,000). Amiyah incurred no expenses on the sale, so her gain is calculated as:

Sale price	$100,000
Less: basis	– 45,000
Gain	$ 55,000

Amiyah agreed to allow the buyer pay $20,000 down and $20,000 annually for the next 4 years, plus interest of 6% on the unpaid balance. Amiyah's gain is 55% ($55,000 ÷ $100,000) of her sale price so she expects to pay tax in the year of sale on $11,000 (55% × $20,000 down payment). However, all the gain arose from depreciation recapture, which results in the full $55,000 being taxable to Amiyah in the year of sale. The income tax impact to Amiyah in the year of sale would be the same even if no cash payment was received in the year of sale.

As discussed earlier, it is possible to elect out of installment reporting and report all of the taxable gain in the year of sale. More often this is utilized for income tax management using an installment sale of an inventory item, such as grain, but is possible with most any sort of installment agreement.

Accelerating Expenses

In tax planning and tax management, it is important to consider the difference between a tax deduction and a tax credit. One dollar of *tax deduction* has the potential to reduce taxable income by one dollar, which will decrease tax liability by the marginal tax rate. In contrast, one dollar of a *tax credit* has the potential to reduce tax liability by one dollar.

Because a taxpayer incurs a personal out-of-pocket cost for a portion of each dollar spent, it is unwise to spend money just for a tax deduction. The taxpayer must gain something of value, in addition to tax savings, to justify additional expenses. This may seem obvious, but there are many taxpayers who want to spend money just to avoid tax, when there may not have been a reasonable business purpose to make the purchase otherwise.

In addition to deferring income, taxpayers may reduce taxable income in the current year by accelerating expenses. Cash-basis taxpayers can accelerate the deduction of expenses by prepaying farm expenses for the coming year. Three rules must be met in order to deduct such prepaid expenses.

1. The expenditure must be a payment and not merely a deposit.
2. The payment must be made for a legitimate business purpose, such as securing a lower price, receiving a discount, or guaranteeing availability.
3. The deduction must not materially distort income.

Taxpayers who are not farmers (and, in some rare cases, those who are farmers) can deduct prepaid expenses only to the extent that the expenses do not exceed 50% of the total of non-prepaid expenses.

Cross-Reference

Prepaid Expenses

See pages 19–20 of the 2022 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the prepaid expense rules.

The deduction of certain expenses cannot be accelerated even if they are prepaid. These generally include interest, rent, insurance, and real estate taxes. Taxpayers may pay and deduct the interest accrued on loans up to year end, but they cannot deduct advance payments of next year's interest until next year. Payments for rent and insurance cannot be currently deducted to the extent that the rental or insurance coverage period exceeds 12 months. If the payment provides a benefit for more than 12 months, the taxpayer must prorate the payment and deduct only the portion with current year benefit.

Example 5.12: Prepaid Rent

Guadalupe rented land from her neighbor for $12,000 under a 12-month lease agreement. The term of the lease runs from December 1 to November 30. When Guadalupe makes her $12,000 lease payment in November, she is able to deduct the full amount in the year of payment.

However, if Guadalupe's lease is for a 24-month term ($24,000) and Guadalupe paid the full lease amount at signing in November, her deduction in the year she made the payment is limited to only $1,000 ($24,000 ÷ 24 months). She can deduct $12,000 in the next tax year and the remaining $11,000 in the year after that year. If she paid only $12,000 at signing, she could deduct the full $12,000 in the year she made the payment because the benefit of the payment does not exceed 12 months.

A common year-end tax-savings tactic for cash-basis taxpayers is to pay off open accounts, because these taxpayers can claim expense deductions only when the amount is actually paid. Before making advance payments on other items, farmers should consider clearing their open accounts.

Another tactic to accelerate expenses is to move needed repairs and maintenance up to the current year. For instance, painting a barn or repairing machinery could be moved from the following spring to the current year.

Managing Depreciation Expense

Deductions can also be accelerated by maximizing the expense deductions available for depreciable property. (See Chapter 4 for more information about depreciation.) Taxpayers can manage the tax effect of depreciation by choosing the depreciation method and the timing of acquisitions. As noted in Chapter 4, taxpayers can deduct 100% of the cost using a special depreciation allowance, often called bonus depreciation, for the cost of farm equipment, dairy or breeding livestock, and buildings (with a recovery period of 20 years or less) purchased and placed in service in 2022. In addition, there is the direct expense election under Internal Revenue Code Section 179 (referred to as §179). The §179 deduction applies to farm equipment, dairy or breeding livestock, and single purpose agricultural structures but does not apply to other farm buildings. Even for the cash-basis taxpayer, equipment is depreciable when it is placed in service. This can generate a deduction with little cash outlay if equipment is purchased using financing or a deferred payment plan.

Although it might initially seem to be beneficial, the special depreciation allowance can sometimes be difficult to incorporate when targeting a certain level of income. Bonus depreciation, or 100% deduction of the capital asset cost, happens by default. A taxpayer must elect to not take the special depreciation allowance, and when this election is made, it applies to all property within the same class (e.g., 5-year recovery period assets). In contrast, a taxpayer can choose to take §179 deduction on an asset-by-asset basis, and can select the amount of §179 deduction for each asset, up to certain limits.

The timing of acquisitions can also affect the amount of depreciation that is allowed. For example, taxpayers must use a mid-quarter convention rather than the half-year convention if the depreciable basis of property purchased in the last quarter of the tax year is more than 40% of the depreciable basis of all property purchased during the year. Many farmers want to move a planned purchase from the following year to the current year to gain depreciation deductions on the new item. However, accelerating the purchase may trigger the mid-quarter convention, which can result in not only little depreciation gained on the accelerated purchase, but also a reduced total of depreciation deductions for the year.

Without electing an alternative method, most farm machinery and equipment is depreciated using the general depreciation system (GDS) 200% declining balance method. If a taxpayer is interested in reducing depreciation in the year of purchase, elections are available to depreciate using the GDS 150% declining balance, GDS straight-line, or ADS straight-line. These elections do not change the total amount of depreciation taken over time, rather it changes the timing of the depreciation. In some cases, the election to depreciate using ADS straight-line increases the recovery period, spreading total depreciation expense over a longer period. It is important to note that an election to depreciate under a different method applies to all assets within that property class. The election cannot be made on an asset-by-asset basis. Figure 5.4 illustrates the difference in the amount of depreciation in the first year of an asset purchase using various depreciation methods.

Figure 5.4. First-Year Depreciation for a $100,000 Purchase

	Recovery Period (Half-Year Convention)			
	3-Year GDS/ 4-Year ADS	5-Year GDS/ 7-Year ADS	7-Year GDS/ 10-year ADS	10-Year GDS/ 15-Year ADS
GDS 200% DB	33,330	20,000	14,290	10,000
GDS 150% DB	25,000	15,000	10,710	7,500
GDS SL	16,670	10,000	7,140	5,000
ADS SL	12,500	7,140	5,000	3,330

Example 5.13: Less Depreciation

Don's only equipment purchases were $40,000 in September. The equipment is 7-year MACRS property, and Don elects not to utilize special depreciation allowance. With the half-year convention, Don could deduct $5,716 of depreciation with the default 200% declining balance method.

In a tax-planning attempt, Don moved $27,000 of equipment purchases (also 7-year MACRS property) scheduled for next year up to December. This triggers the mid-quarter convention ($27,000 ÷ $67,000 = 40.3%). Don's total allowable depreciation on the entire $67,000 of equipment is reduced to $5,248 ($4,284 + $964). Don tax-planned himself into less depreciation by triggering the mid-quarter convention.

This example demonstrates that you must be very cautious in the timing of depreciable asset purchases as a tax-planning move. As illustrated, the mid-quarter convention may reduce first-year depreciation. In contrast, triggering mid-quarter convention may increase the overall depreciation deduction if the original purchases were made early in the year.

Example 5.14: More Depreciation

Suppose Don (from Example 5.13) purchased $40,000 of equipment in March and $27,000 in December. The mid-quarter convention is triggered and his total depreciation on the purchases is $10,964. If the timing of his purchases had not triggered the mid-quarter convention, his allowable depreciation on the $67,000 under the half-year convention would be $9,574.

The special depreciation allowance and the §179 deduction were ignored in Examples 5.13 and 5.14, but they can be significant tax planning tools when available. There are some additional considerations regarding special depreciation allowance and §179.

1. The full deduction is allowed even if property is purchased on the last day of the year.
2. To maximize the acceleration of deductions, §179 should be taken on property in the class with the longest life. This will increase the deductions in the earlier years of the properties' useful lives.
3. A taxpayer may benefit from delaying purchases into later years to take greater advantage of §179 each year.

Example 5.15: Maximizing §179

Jazlyn purchased $1,150,000 of used farm equipment in October 2021 and made no purchases in 2022. In 2021, she expensed $1,050,000 under §179 (the 2021 limit) and depreciated the remaining $100,000 of her cost using MACRS 200% declining balance depreciation and the mid-quarter convention. She can deduct $1,053,570 of depreciation and §179 expenses in 2021 and $27,550 of depreciation in 2022. The remaining $68,880 of her cost would be depreciated from 2023-2027.

If Jazlyn delayed $100,000 of her purchases until 2022, she could claim a $1,050,000 §179 deduction in 2021 and a $100,000 §179 deduction in 2022. She would not have any regular depreciation because her entire purchase price would be recovered through §179 deductions.

Lease vs Purchase of Equipment

Leasing is often considered to be a way of reducing taxable income because deductible lease payments can be greater than deductible depreciation and interest. However, taxpayers need to carefully analyze the after-tax cost of a lease versus purchase. If the total cost of leasing is greater than the total cost of owning, the tax savings must exceed that difference to make leasing the better after-tax alternative.

If leasing is the better option, taxpayers must be sure the transaction will be treated as a true lease rather than as an installment purchase contract. Over the years, IRS rulings and court decisions have indicated that the following factors result in a transaction being treated as a purchase rather than a lease.

1. The agreement applies part of each payment toward an equity ownership interest.
2. The lessee receives title to the property upon payment of a stated amount under the contract, in contrast to an option to purchase at reasonable market value.
3. The amount the lessee pays for a short period of time is nearly the amount that would be paid to buy the property.
4. The lessee pays much more than the current fair rental value of the property.
5. The lessee can purchase the property at a nominal price compared to the value of the property at the time of purchase (for example, $1).
6. The lessee has the option to buy the property at a nominal price compared to the total amount the lessee has to pay under the lease.
7. The lease designates part of the payments as interest, or a part of the payments is easy to recognize as interest.
8. The lessee has an equity interest in the leased item during the lease period.

Trade-ins and Leasing

Trade-ins on leased items can create tax problems. If the lessee has an equity interest in the equipment as a result of the trade-in, the transaction does not qualify as a lease. To preserve lease treatment, the transaction must be structured as a sale of the old equipment. This is a taxable sale for which the gain is generally reportable on IRS Form 4797, Sale of Business Property, as ordinary income that is not subject to self-employment (SE) tax.

Example 5.16: Trade-In Resulting in Installment Purchase

Brenda traded her old tractor for what she thought was a lease of a new tractor. However, the dealer applied the $25,000 trade-in value of the old tractor to the purchase price of the new tractor and figured the subsequent payments on the balance of the purchase price.

Because Brenda has an equity interest in the new tractor, she is treated as making an installment purchase of the new tractor. Her "lease" payments are treated as installment payments. She cannot deduct the payments as lease payments, but she can deduct the new tractor's cost through special depreciation allowance, §179 expense deduction, or depreciation. She can also deduct the interest portion of her installment payments.

Observation

Constructive Receipt of Income

As discussed earlier in this chapter (see Example 5.12) prepaid lease payments can be deducted in full only if the benefit does not exceed 12 months. If a trade-in credit covers lease payments that extend beyond 12 months, only the portion attributed to months in the current tax year can be deducted currently.

Example 5.17: Trade-In Treated as a Sale

If Brenda from Example 5.16 sold her old tractor to the dealer for $25,000, she must report her gain from that sale on Form 4797 as ordinary income that is not subject to SE tax. If her adjusted basis in the old tractor after depreciation is zero, she has a $25,000 gain to report.

If the dealer applies the $25,000 sale price to true lease payments, the $25,000 can be deducted as a lease payment subject to the 12-month rule discussed earlier in this chapter. If the annual lease payments are $25,000 or more, Brenda can deduct the $25,000 credit as a lease expense in the year she entered into the lease. However, if the annual lease payment is less than $25,000, she can deduct currently only the portion of the credit that is prorated to the tax year of the transaction.

Depreciation vs Lease Expense

If the transaction qualifies as a lease for tax purposes, the next step is to consider whether a lease payment deduction is more beneficial than a depreciation deduction. If the asset qualifies for the §179 deduction, the taxpayer can get a bigger first-year deduction by purchasing rather than leasing the asset. (The details of qualifying property and other considerations are discussed in Chapter 4.) Leasing may provide a larger first-year deduction for assets that do not qualify for the §179 deduction, such as general-purpose farm buildings.

Furthermore, leasing may also be a useful tool for the taxpayer whose purchases are great enough to cause the phase-out of the §179 deduction. (In 2022, the deduction is reduced dollar for dollar for total qualifying purchases over $2,700,000.)

Example 5.18: Leasing to Maximize §179 Deduction

George plans to purchase $2,900,000 of equipment in 2022. Because this exceeds the $2,700,000 limit on qualifying property by $200,000, his §179 deduction is reduced by $200,000 from $2,080,000 to $1,880,000. If he leases the $200,000 of excess equipment, he could claim the full $2,080,000 §179 expense deduction. The leasing company told George that his first-year lease payment would be $40,000.

The total deductions available to George for the two alternatives are shown in Figure 5.5 below.

Figure 5.5. Deduction Alternatives

	Purchase Only	Purchase and Lease
§179 deduction	$1,880,000	$2,080,000
Lease payment	0	40,000
First-year depreciation*	21,420	
Total first-year deductions	$1,901,420	$2,120,000

*10.71% of cost of purchases reduced by §179 deduction

George can increase his first-year deduction by $218,580 if he leases the excess equipment that would reduce his maximum §179 deduction.

Non-Tax and Other Considerations

Example 5.18 illustrates that using a lease may generate significant first-year tax deductions. Note that the lease payment in the example is $40,000, whereas the depreciation expense on $200,000 of equipment would be only $21,420. However, the producer needs to consider the total cost of leasing versus purchase over the life of the asset. A lease may include a different interest component than the financing available for purchase. The purchase option amount must be factored in. The lease term may also be shorter than the loan term, making it necessary to consider the time value of money. In making the decision, the farm producer should consider a cash-flow analysis that takes into account all of these factors.

State income taxes, such as incentives for capital purchases, also influence the decision, and there may be non-tax considerations favoring the lease such as:

1. The lease obligation not being included as a financial statement liability,
2. No lost capital on the financial statement for the leased item, and
3. The ease of replacing leased equipment if it becomes obsolete or is no longer needed.

Summary

Because the federal income tax rates are graduated (a higher tax rate applies to income in the higher brackets than in the lower brackets) farmers who use cash-basis accounting can manage their tax liability by shifting income away from the high-income years and deductions away from low-income years. However, the tax rules impose some limits on making these shifts and there are some non-tax factors to include in the analysis of the costs and benefits of the shifts.

Table of Contents: Chapter 6

CHAPTER 6
MANAGING THE CHARACTER OF INCOME AND DEDUCTIONS

Introduction

Taxable income from farming falls into three categories:

1. Ordinary income subject to self-employment (SE) tax
2. Ordinary income not subject to SE tax
3. Gain on disposition that is taxed as long-term capital gain

A farmer's effective tax rate is highest for ordinary income that is subject to SE tax and is the lowest for long-term capital gain. By knowing the rules, taxpayers may have opportunities to shift income to a lower tax category.

Self-Employment Income

Generally, any income generated by an individual's own work is self-employment income. An exception is wages reported on Form W-2, Wage and Tax Statement, which are subject to a Federal Insurance Contributions Act (FICA) tax of 7.65% on the employer and 7.65% on the employee for a total of 15.3%.

Self-employment income is subject to ordinary income tax rates ranging from 10% to 37% and is also subject to a 15.3% SE tax. Therefore, ordinary farm income reported on Schedule F (Form 1040), Profit or Loss from Farming, as well as director's fees, are ordinary income subject to SE tax.

Net rental income from land used in farming **is subject** to SE tax if the landowner materially participates in the farming activity. Net rental income from buildings **is not subject** to SE tax. Net rental income from machinery and equipment **is subject** to SE tax unless it is rented with farmland and the landowner does not materially participate in the farming activity or it is rented with land that is not used in farming or with buildings.

Cross-Reference

For more information on self-employment tax, see Chapter 12 of IRS Publication 225, *Farmer's Tax Guide,* for an explanation of the SE tax rules.

Some income from farm operations is not subject to SE tax. The most notable exclusion is gain from the sale of assets used in a farming business to produce other products. Such assets include land, buildings, machinery, and draft, breeding, dairy, and sporting livestock. Reporting the sale of cull cows, ewes, sows, and mares on Schedule F (Form 1040) is a costly error because it erroneously includes gain from those sales in the self-employment income that is reported on Schedule SE (Form 1040), Self- Employment Tax.

Example 6.1: Livestock Sales

Carlos operates a hog operation. His principal income is from the sale of market hogs. Carlos reports his hog sales on Schedule F (Form 1040). The net income from these market hogs is ordinary income subject to SE tax. Carlos retains some of the female hogs born on his farm to utilize as breeding stock. When these sows are no longer fit to produce litters of pigs, he sells them. The income from the sale of these sows is reported on Form 4797, Sales of Business Property, and is not subject to SE tax.

Timber sales can also be exempt from SE tax and therefore are reported on Form 4797. To qualify for Form 4797 reporting, the taxpayer must sell standing timber rather than participate in the harvest or any further processing. Christmas trees are treated as timber if they are more than 6 years old when they are severed from their roots.

Cross-Reference

For more information on timber tax rules, see IRS Publication 225, *Farmer's Tax Guide,* for an explanation of the tax rules for timber.

Material Participation and Rental Income

Rent received for the use of real estate is generally not subject to SE tax. Therefore, income and expenses from the rental of farm real estate are generally not reported on Schedule F (Form 1040). However, rent received for land used in agricultural production is subject to SE tax **if** the owner materially participates in the farming operation. A materially participating farm owner must report the rental proceeds (whether received as cash or as a share of the crop) and related deductions on Schedule F (Form 1040). The net Schedule F (Form 1040) profit is subject to SE tax.

The material participation tests for including net rental income as self-employment income apply only to *land* used in agricultural production. The net rent from *buildings* used in agricultural production and from any real estate that is not used in agricultural production is generally **not subject** to SE tax even if the owner materially participates in the activity. However, if the owner or the owner's employees provide additional services (such as in the rental of hotel or motel rooms) or the rent is received by a real estate dealer in the course of his or her real estate business, the net rent **is subject** to SE tax.

Material participation is not an issue for rental income and expenses from property other than land and buildings (e.g., farm equipment). Net rent from that property **is subject** to SE tax unless renting it is a one-time event. The rental income and expenses must be reported on Schedule C (Form 1040), Profit or Loss from Business.

A landowner materially participates in a farming activity if he or she meets any one of the following four tests:

Test #1: The landowner performs any three of the following activities:

a) pays, using cash or financing, for at least half the direct costs of producing the commodities;
b) furnishes at least half the tools, equipment, and livestock used in producing the commodities;
c) advises and consults with the tenant periodically; and
d) inspects the production activities periodically.

Test #2: The landowner regularly and frequently makes, or takes an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.

Test #3: The landowner works 100 hours or more over a period of 5 weeks or more in activities connected with producing the farm commodities.

Test #4: The landowner takes actions that, considered in their total effect, show that he or she is materially and significantly involved in the production of the farm commodities.

If the landowner does not materially participate in the farming activity, then the tax reporting depends on the form in which rental payments are received.

- For a *cash rental arrangement*, the income and expenses are reported on Schedule E (Form 1040), Supplemental Income and Loss, which is used to report most rentals.

- For a *crop share rental arrangement*, the income and expenses are reported on Form 4835, Farm Rental Income and Expense.

In either case, the income is ordinary income, but it is not subject to SE tax because the landowner does not materially participate.

This provision of the tax law provides a tax planning opportunity in certain situations. If the taxpayer operates the farm, but the taxpayer's spouse owns the real estate (and does not materially participate in the farming operation), the farm operator can pay rent to the landowner and reduce the couple's overall tax liability. The farm operator and landowner should enter into a bona fide lease arrangement (preferably in writing), with rent set at the prevailing market rate. However, an arrangement like this may reduce the qualified business income deduction (QBID), negating a portion of the potential SE tax savings.

Example 6.2: Rent to Spouse

Mary operates a corn and soybean farm on land owned by her husband, Joe. On average over the last 5 years, the farm generated a $75,000 profit. When non-farm income and their deductions are factored in, their usual taxable income is $65,000. In their area, the fair rental value of the land is $20,000 per year. The property taxes are $8,000. As shown below, Mary and Joe could reduce their overall joint tax liability by $1,568 each year if Mary paid $20,000 of rent to Joe.

2022 Tax Comparison With and Without Rent Payments

	Without Rent Payments	With Rent Payments
Non-farm income	$35,139	$35,139
Net farm income	75,000	63,000*
Net rental income		12,000
Deduction for ½ SE tax	– 5,299	– 4,451
Standard deduction	– 25,900	– 25,900
QBI deduction	– 13,940	– 11,710
Taxable income	65,000	68,078**
Income tax	7,389	7,758
SE tax	10,597	8,902
Total Tax	***17,986***	***16,660***

*Mary's net farm income is reduced by $20,000 because of the additional rent expense to Joe and increased by $8,000 because property tax is now reported by Joe as a rental expense.
**Even though total income did not change, net taxable income increased because both the QBI deduction and deduction for ½ of the SE tax paid were reduced.

Other Tools for Reducing Self-Employment Income

Wages paid to the children of a farm operator are exempt from FICA taxes until the child reaches age 18. Thus, the family can reduce their contribution to the social security and Medicare systems by employing their children. The farmer must abide by all applicable labor laws and enter into a bona fide employer-employee relationship, preferably in writing. The child must have specific job responsibilities and be paid a wage commensurate with those duties.

Wages paid to a spouse are subject to FICA taxes, so hiring a spouse does not provide the same tax savings as hiring the farmer's children. However, as an employee, a spouse is eligible for fringe benefits that are tax deductible by the farmer and tax-free to the spouse. Such fringe benefits include group term life insurance with a benefit of up to $50,000, qualifying meals and lodging, and participation in the farm's retirement program. The farmer could also provide health insurance or reimbursement for out-of-pocket medical expenses for his or her spouse who is a bona fide employee. This may allow the farmer to deduct the premium as a farm expense, thereby reducing SE tax. The health insurance policy may provide family coverage, thus indirectly insuring the farmer. Without this strategy, the farm operator may qualify to deduct the health insurance premium as an adjustment to gross income, which still reduces taxable income but does not reduce self-employment income. See Health Plans in Chapter 7 for more information.

Maximizing Capital Gain Treatment

As mentioned previously in this chapter, not all sales from farm operations are reportable on Schedule F (Form 1040) as ordinary farm income subject to SE tax. Most notably, the sale of livestock held for dairy, breeding, sport, and draft purposes is reported on Form 4797. This same reporting rule applies to the sale of standing timber.

Cross-Reference

For more information on the sale of assets used in a farming business, see Chapter 9 of IRS Publication 225, *Farmer's Tax Guide,* for an explanation of the tax treatment of gains and losses from the sale of assets used in a farming business.

Draft, breeding, dairy, or sporting livestock must be held for a minimum period of time called the *required holding period* before gain on their sale is eligible for more favorable, long-term capital gain treatment. The required holding period is more than 1 year for assets other than livestock. It is 24 months or longer for cattle and horses, and 12 months or longer for other livestock, such as hogs, sheep, goats, and alpacas.

For a taxpayer filing jointly with their spouse, if taxable income is below $83,350 (MFJ for 2022), capital gain is taxed at a 0% rate. When taxable income is between $83,350 and $517,200 (MFJ for 2022), the maximum tax rate on capital gain is 15%, although some may still be taxed at the lower 0% rate, depending on total taxable income and the amount of capital gain income. Above $517,200 (MFJ for 2022), the maximum capital gain rate is 20%.

Example 6.3: Maximizing the Capital Gain Advantage

George sold $40,000 of heifers. He raised these animals to add to his dairy herd but decided against putting them in the herd due to a change in economic conditions. George is married and files jointly with his spouse. Their total taxable income is $80,000, which is in the 12% ordinary income tax bracket. Because he sold the heifers when they were 23 months old, his tax on the sale is $4,800 ($40,000 × 12%). Because the heifers were held for dairy purposes, the sale is reported on Form 4797 as ordinary income and George is not subject to SE tax on the gain.

If George held the heifers one more month, the gain would qualify for long-term capital gain treatment and George would pay no tax (a 0% capital gain rate) on the sale. George incurred a $4,800 tax cost by selling one month too soon.

Observation

Purchased Livestock

Gain from the sale of *purchased* dairy, breeding, sport, and draft livestock is eligible for long-term capital gain treatment only if the livestock is held for the required holding period **and** only to the extent the animals are sold for more than their original cost. Any gain due to depreciation of the original cost basis is ordinary gain from the recapture of depreciation, as discussed in Chapter 5 for equipment sales.

Effect of Losses from the Sale of Business Assets

Taxpayers may deduct losses from the sale of business assets from ordinary income whether or not they are held for the required holding period. However, losses incurred during the tax year on the sale of assets that were held for the required holding period must first be netted against gains during the tax year from the sale of assets held for the required holding period. Ordinary income is reduced only if this netting of gains and losses results in a net loss for the tax year.

Observation

Gains and Losses in the Same Year

Having both gains and losses in the same year from business assets held for the required holding period reduces the benefit of long-term capital gain treatment.

Example 6.4: Sale of Gain and Loss Assets

In 2022, Camille plans to sell land that will generate a $40,000 gain, and equipment that will generate a $10,000 loss. Both assets have been held for the required holding period. Camille is married and filing jointly with her spouse. Their taxable income is $140,000.

If Camille sells both the land and the equipment in the same year, she will have a $30,000 net gain ($40,000 gain on land minus $10,000 loss on equipment) eligible for long-term capital gain treatment. The preferential 15% capital gain rate applies because Camille's taxable income is between $83,350 and $517,200. Camille owes $4,500 of tax.

If Camille sells only the land this year, her tax on the gain will be $6,000 ($40,000 gain × 15%). She could then sell her equipment next year at a $10,000 loss. Even though the equipment has been held for the required holding period, the loss becomes a fully deductible ordinary loss because she has no assets sold that year at a gain. If her taxable income is similar in 2023, the loss reduces Camille's tax liability next year by $2,400 ($10,000 × 24%). Over the 2-year period, Camille has paid $3,600 under this plan – saving $900 over the initial plan to sell both assets in the same year.

Planning Pointer

"Look Back" Rule

It appears that Camille would be better off by selling the loss asset in the first year to accelerate the deduction and then selling the land the following year to delay the income. However, Congress decided to disallow this by enacting what is called "1231 loss recapture." This provision requires taxpayers who generate a gain eligible for capital gains treatment on the sale of a business asset, to "look back" at the last 5 years. To the extent there is a net loss from that period, the current year's gain is taxed as ordinary income.

Example 6.5: Sale of Loss Asset in First Year

If Camille sells only the equipment the first year, the $10,000 loss reduces her income tax by $2,400. If she then sells the land in the second year, $10,000 of the gain is taxed at her 24% ordinary income rate because of the look-back rule and the remaining $30,000 is taxed at the 15% capital gain rate. Therefore, her total tax in the second year is $6,900 [($10,000 × 24%) + ($30,000 × 15%)]. The net tax on the gain for the 2 years is $4,500 ($6,900 – $2,400), which is the same amount as if she had sold the two assets in the same year.

Unharvested Crop Sales

Crop sales are generally subject to both ordinary and SE tax and are reported on Schedule F (Form 1040). However, if unharvested crops are sold with land to the same buyer, the crop value can be reported as part of the land sale. If the land was held for the required holding period (more than 1 year), the entire gain on the sale qualifies for long-term capital gain treatment. When the crop is sold with the land, the costs of raising the crop cannot be deducted as farm expenses, but they are added to the basis of the crop to determine the gain or loss from the sale.

Example 6.6: Sale of Unharvested Crops

Billy Bob and his wife Charlene are planning to file a joint tax return in 2022. They project that Charlene's wages will be $40,000, Schedule F will be $100,000, and gain from the sale of 50 acres will be $100,000. The 50 acres to be sold includes a growing crop that has a $34,000 fair market value. The cost of raising and harvesting the crop is $10,000. If Billy Bob harvests and sells the crop, he will pay $4,334 of additional tax versus selling the growing crop with the land.

Tax on Harvested Crop

	Sell Harvested Crop	Sell Land with Growing Crop
Non-farm income	$40,000	$40,000
Farm income	100,000	76,000*
Capital Gain	100,000	124,000
Deduction for ½ S/E tax	– 7,065	– 5,369
Standard deduction	– 25,900	– 25,900
QBI deduction	– 18,587	– 14,126
Taxable income	188,448	194,605**
Income tax	25,693	24,750
SE tax	14,130	10,738
Total Tax	***39,822***	***35,488***

* Billy Bob sells $34,000 less grain but deducts $10,000 less in farm expense if the growing crop is sold with the land.
** Even though total income did not change, net taxable income increased because both the QBI deduction and deduction for ½ of the SE tax paid were reduced.

Cross-Reference

See Chapter 12 for a discussion of maximizing the capital gain advantage when selling a farm.

Summary

The tax rate for a farmer's income varies by the type of income. Some income is subject to both ordinary income tax rates and self-employment taxes; some is subject only to ordinary income tax rates; and some is subject only to capital gains rates. Farmers can use a few planning opportunities to move income to the most favorable tax rates.

Table of Contents: Chapter 7

CHAPTER 7

OTHER TOOLS TO MANAGE TAX LIABILITY

Introduction

Chapter 5 presented timing techniques that can be useful in leveling out the peaks and valleys of farm income to avoid higher tax brackets. Chapter 6 explained the ways that various types of income are taxed and strategies for maximizing the income that is taxed at the lowest rates. This chapter describes additional tax law provisions that help farm producers manage or reduce their overall tax liability.

Fluctuations in farm income may be caused by either market or growing conditions. Legal restrictions may cap a deduction for expenses that are prepaid. Market considerations may promote either making such pre-purchases or delaying the sale of products. In such cases, farm producers may need to rely on additional tools provided in the tax law.

Farm Income Averaging

Individual taxpayers engaged in a farming business may be able to average some or all of their farm income to calculate tax on the current year's income. This may result in higher-than-usual income being taxed at lower marginal tax rate brackets. C corporations, estates, and trusts cannot use the election. The IRS reports that this tax-saving method of calculating tax is being underutilized by taxpayers.

The taxpayer chooses an amount of farm income (elected farm income) from the current year that will be included in the income averaging calculation. The elected farm income is added to the taxable income in the 3 prior years (base years). Total Federal income tax over the four tax years (current year plus three base years) is compared before and after averaging. If the total is lower when income is averaged, the current year income tax liability is reduced by the difference, resulting in in a lower Federal tax liability in the current year.

Farm income averaging does not affect self-employment (SE) tax or state income taxes for either the election year or the base years. It also does not increase the alternative minimum tax.

Taxpayers report their income-averaging election and compute their income-averaging tax on Schedule J (Form 1040), Income Averaging for Farmers and Fishermen. The relevant lower tax rates for capital gains apply in the election year as well as in the base-year calculations.

Elected Farm Income (EFI)

Elected Farm Income (EFI) is limited to the lesser of 1) the taxpayer's total taxable income [after subtracting any net operating loss (NOL) deductions] or 2) the taxable income attributed to any farming business (called e*lectible farm income*).

Electible farm income includes net farm profits from Schedule F (Form 1040) and the owner's share of net farm income from an S corporation (including wages), partnership, or LLC. It does not include wages from a C corporation. Gains from the sale of farm business property (excluding land and timber) regularly used in farming for a substantial period are also included in electible farm income.

A farming business includes nursery production, sod farming, and the production of ornamental trees and plants, as well as the production of livestock, fruit, nuts, vegetables, horticultural products, and field crops. However, gain from the sale of trees that are more than 6 years old when cut is not electible farm income, because these trees are no longer classified as ornamental trees. The income, gain, or loss from the sale of grazing and development rights or other similar rights classified as attributable to a farming business is not electible farm income.

The terms *regularly used* and *substantial period* are not defined in the Internal Revenue Code or congressional committee reports. However, Treasury regulations state that if a taxpayer ceases farming and later sells farm business property (other than land) within a reasonable time after the cessation of farming, gains or losses from the sale are farm income. A sale within 1 year is deemed to be within a reasonable time. Taxpayers must consider all of the facts and circumstances of sales beyond 1 year from the cessation of the farm business to determine if the asset was still regularly used in the farm business.

Income-Averaging Tax

To calculate the income-averaging tax for the election year, taxpayers subtract EFI from the current year's taxable income and calculate the tax on the remaining income using the current-year income tax rates. The tax on the EFI is calculated by

1. adding one-third of the EFI to the taxable income of each base year,
2. computing the tax on the total from step 1 for each base year using the tax rates for each base year, and
3. subtracting the tax paid for each base year from the tax computed in step 2 for each base year.

The total tax for the election year is the sum of the tax on the election year income reduced by the EFI and the amount from step 3 for each of the base year calculations.

Example 7.1: Income Averaging

Fruit growers Mr. and Mrs. B & B Goodyear had a substantial increase in farm income in 2022. Receipts were up and costs were down. Mrs. Goodyear works off-farm. Their $58,000 Schedule F (Form 1040) profits, combined with their nonfarm income and deductions, result in a $110,550 taxable income. They file a joint return. Their taxable incomes for 2022 and the previous 3 years are shown in Figure 7.1, below.

Figure 7.1. Goodyears' Taxable Income

Year	Taxable Income
2022	$110, 550
2021	30,900
2020	71,600
2019	28,200

The Goodyears elected to income average in 2022. Their maximum EFI is $58,000 (the amount of taxable income attributed to farming). Their optimum EFI may be the taxable income that exceeds their 12% tax bracket or $27,000 ($110,550 – 83,550). They decided to designate $27,000 of their Schedule F (Form 1040) profit as EFI and tax $9,000 per year at the tax rates borrowed from each of the 3 base years.

Question 1. Will all of the EFI be taxed at 12%?

Answer 1. In 2020 their 12% tax bracket ended at $80,250, and their taxable income was $71,600, leaving $7,350 of the 12% rate bracket available for EFI from the election year. This $8,650 is taxed at the 12% tax rate. However, the remaining $350 ($9,000 – $8,650) added to the 2020 base-year income is taxed at the 22% rate from the 2020 tax brackets. For 2019 and 2021, all $9,000 will be taxed at the lower 12% rate.

Question 2. Should the Goodyears reduce EFI to avoid the 22% tax bracket from 2019?

Answer 2. For each $1 of EFI subject to the 22% tax rate from 2020, $2 is taxed at the 12% rate from the other 2 base years. Therefore, the marginal tax rate for the Goodyear's EFI is 15.33% [(12 + 12 + 22) ÷ 3]. If they put less than $27,000 in their EFI for 2022, their income taxed at their 2022 tax rates will exceed $83,550, and their marginal tax rate on the income taken out of the EFI will be 22%.

Question 3. How much income tax will the Goodyears save by income averaging in 2022?

Answer 3. They will save $2,665. They would have paid $5,940 ($27,000 x 22%) without income averaging. Instead, they paid $3,275 ($9,000 in 2019 @ 12% +$8,650 in 2020 @ 12% + $350 in 2020 @ .22% + $9,000 in 2021 @ 12%).

Base Year Losses

The IRS allows the use of negative taxable incomes in base years when performing the income-averaging calculation. This, in effect, allows such taxpayers to apply 0% tax rates from the base years with eligible losses. However, there can be no double benefit from the negative taxable incomes already reflected in any net operating loss (NOL) arising from that year (see Chapter 10).

Example 7.2: Income Averaging and Net Operating Losses

Abdul had a $45,000 Schedule F (Form 1040) loss in 2020. He and his wife filed a joint return and claimed five personal and dependent exemption deductions (including three children). Their taxable income is a negative $74,650, as shown in Figure 7.2, below.

Figure 7.2. 2020 Taxable Income

Schedule F	$ – 45,000
Standard deduction	– 11,400
Exemptions	– 18,250
Taxable income	$ – 74,650

Abdul's NOL for 2020 is $45,000. This NOL must be removed from taxable income, leaving a negative $29,650 to be used as base-year income for 2020 on Abdul's Schedule J (Form 1040), Income Averaging for Farmers and Fishermen, when he files his 2022 tax return.

Questions and Answers

Question 1. Which taxpayers qualify for farm income tax averaging?

Answer 1. The Internal Revenue Code says that "individuals engaged in a farming business" qualify, but it specifically excludes estates and trusts. The IRS instructions indicate that individual owners of partnerships, LLCs, and S corporations qualify (farm income flows through the business and retains its character in the hands of the individual owner taxpayer). C corporations do not qualify for farm income averaging. Wages and dividends from a C corporation are not qualified farm income.

Question 2. Does the EFI retain its character as unused brackets are carried forward, and may the taxpayer select the type of income to include in EFI?

Answer 2. Taxpayers are allowed to carry forward the unused lower brackets as ordinary farm income and keep capital gains in current-year taxable income, or select the best combination of ordinary farm income and qualified capital gains to meet their tax management objectives. When a combination of ordinary farm income and capital gains is included in EFI, the IRS indicates that an equal portion of each type of income must be taxed at each base-year rate. The taxpayer cannot tax all of the capital gains at just one prior-year's rate.

Any capital gain that is taxed at a base-year rate is taxed at the capital gains tax rate in effect for that prior year. Therefore, farm business capital gains of a taxpayer taxed at 15% in 2022 could be eligible for a 0% rate for capital gains if the taxpayer has a base year with taxable income below the 0% capital gain maximum and those gains are included in EFI.

Question 3. Do farm owners who rent their farm or land for agricultural production qualify?

Answer 3. If the farm owner materially participates in the farming activity and properly reports the income on Schedule F (Form 1040), this income qualifies for income averaging. Final regulations allow farm owners who do not materially participate but who receive crop-share rental income (properly reported on Form 4835, Farm Rental Income and Expenses) to also use the farm income-averaging rules. For crop-share rents, the lessor must have a written crop-share lease agreement. Cash rental income reported on Schedule E (Form 1040), Supplemental Income and Loss, is not income attributable to a farming business.

Question 4. How much farm use is required to meet the "regularly used in farming" rule that applies to gains from the sale of farm business property?

Answer 4. All sales reported on Schedule F (Form 1040) are qualified. Sales of raised dairy and breeding livestock reported on Form 4797, Sales of Business Property, qualify. Sales of farm property for which depreciation and I.R.C. § 179 deductions were claimed also qualify. Therefore, it appears as if all sales of farm machinery, buildings, and livestock qualify as being "regularly used."

Question 5. Can taxpayers make the election to income average on an amended return?

Answer 5. Yes.

Question 6. If an NOL was carried to a base year, does the income-averaging election affect how much of that NOL is used in the base year?

Answer 6. No, the amount of the NOL used in the base year is not refigured as a result of taxing one-third of the EFI at that base year's rate. Similarly, the base-year's income, deductions, and credits are not affected by the additional income taxed at that year's rates (for example, the taxable portion of social security benefits and the allowable deductions on Schedule A (Form 1040), Itemized Deductions, are not recalculated). The income-averaging computation on Schedule J (Form 1040) simply uses the tax brackets of the base years without altering the tax returns originally filed for those base years.

Question 7. Must a taxpayer use the same filing status in each year?

Answer 7. No, the tax is computed based on the filing status in effect for each base year and the election year.

Question 8. Can a taxpayer use income averaging even though it provides no current-year tax savings?

Answer 8. Yes, this technique may be used to shift income to the oldest base-period year, which drops out of the calculations for the following year. This may also allow the base-period incomes (and marginal tax rates) to be leveled out in anticipation of income averaging in future years.

Planning Guidelines

Generally, it is better to implement economically sound income tax management practices throughout the year rather than use income averaging as the only tax management strategy. Use tax management practices that reduce taxable income and then elect income averaging as needed. Income averaging provides an opportunity for reducing only the regular income tax rates applied to the current year taxable income. Farm income averaging does nothing to reduce gross income or its impact on the many phase-outs of deductions and credits that are triggered by higher gross income.

An often-cited exception to this general rule is to use income averaging to reduce Self-Employment (SE) contributions until every fourth year. Net earnings are held low with income averaging for three years, reducing SE tax as low as possible. Then net earnings from self-employment are allowed to spike in the fourth year, exceeding the maximum amount subject to the social security component of SE tax ($147,000 for 2022) and saving on SE tax for the four-year period. This practice should be evaluated in light of the time value of money.

Income averaging should be used to transfer as much high-bracket income as possible from the election year to low tax brackets in the base years. There will be cases in which the EFI used in a base year is not taxed in the lowest bracket, but income averaging still saves taxes. A farm taxpayer needs the following information to determine whether, and (if so) how much, 2022 farm income should be averaged:

- Taxable income for 2022, as well as ordinary income and capital gain attributed to farming
- Taxable income from 2019, 2020, and 2021 tax returns, including any Schedule D worksheets used to calculate income tax due
- If a taxpayer elected to use income averaging in any of the 3 prior years, Schedule J (Form 1040) will be needed, as well as associated worksheets for each year
- Income tax brackets for 2022 and the 3 prior years

Priority of Goals

1. Elect farm income until the marginal rate of the election year is not greater than the average of the marginal rates that are borrowed from the base years. Be sure to consider the effective rate if there are capital gains in the base year or in EFI.
2. Load the oldest base year followed by an equal amount in the other base years to the extent

this can be done without increasing tax.

3. Attempt to level the income of the current and prior 2 base years by electing additional income to prepare these years to be base years for next year's income averaging (again, only to the extent that this can be done without increasing tax).

Farm Income Averaging After the Cessation of Farming

Treasury regulations state that if a taxpayer ceases farming and sells farm business property (other than land) within a reasonable time after the cessation of farming, gains or losses from the sale are farm income. A sale within one year is deemed to be within a reasonable time. Taxpayers must consider all of the facts and circumstances of sales beyond one year from the cessation of the farm business to determine if the asset was still regularly used in the farm business.

Example 7.3: Facts and Circumstances of Reasonable Time After the Cessation of Farming

Joseph quit farming in 2019 and sold most of his farm equipment. He did not sell his pickup truck at that time because he used it in a new construction business. He did not find a buyer for his baler until June 2021. He also sold his pickup in 2021.

Gain on the baler is electible farm income because Joseph's only reason for holding it was to find a buyer after terminating the farm business. Gain on the pickup is not electible farm income because it was realized more than a year after Joseph terminated his farm business and he kept the pickup to use in a non-farm business.

CCC Commodity Loans and Loan Deficiency Payments

When the market price of a commodity falls below the marketing assistance loan rate offered by the Commodity Credit Corporation (CCC), producers may realize more income by taking advantage of one or more of the government program options. Those options and the income tax consequences of each option are discussed in this section. This allows the farm producer to maximize the use of lower tax brackets while selling the crop at the most favorable market price and avoiding the accumulation of income that might be pushed into higher marginal tax rates.

CCC Nonrecourse Marketing Assistance Loan

Instead of selling a commodity, producers can use the commodity as collateral for a nonrecourse loan from the CCC. This alternative puts cash in the producer's pocket at the time of harvest and lets the producer wait to see whether market prices improve.

The Internal Revenue Code allows taxpayers to elect to treat these loans as income in the year received. They make the election on Schedule F (Form 1040), Profit or Loss from Farming. If the producer has not made this election, the CCC loan is treated the same way as any other loan. The IRS provides procedures for an automatic change in accounting method in the event that a taxpayer wants to stop reporting loans as income.

Example 7.4: Using CCC Commodity Loans under Election to Manage Taxable Income

Isabella is a crop farmer who files a joint tax return with her husband, and they are normally able to keep their taxable income near the top of the 12% federal income tax bracket and out of the 22% federal income tax bracket. It was a great crop year and Isabella expects her commodity to ultimately sell for $170,000. However, it is currently selling for 75% of the amount Isabella expects the market price to be next spring. She would like to wait until then to sell her crop, but her taxable income is currently projected to be only $20,000 without any additional sales. If Isabella is unable to increase her current-year income, they will waste much of their 12% tax bracket this year and will potentially push $63,550 of income into the 22% tax bracket next year. Farm income averaging could be used to obtain tax savings on some but not all of this income.

Because Isabella does not want to sell her commodity at the current market price, she should consider obtaining a CCC commodity loan and electing to treat the loan as current year income. If the loan is less than $63,550, all of it will be taxed at a 12% tax rate.

If market prices subsequently rise above the loan rate, producers can repay the loan, with interest, and then sell the commodity for more than the loan amount.

The income tax consequences of the sale depend upon whether or not the taxpayer made the election to treat the loan as income. In any event, the interest expense is deductible on Schedule F (Form 1040).

- If a producer did not make the election to treat the loan as income, they have no basis in the commodity. Therefore, the full sale price is reported as Schedule F (Form 1040) income.
- If the producer made the election to report the loan as income, they have basis in the commodity equal to the amount of the loan. That basis is subtracted from the sale price to determine the gain on the sale, which is reported in the resale section of Schedule F (Form 1040). (This treatment is the same as if the farm producer had purchased the crop for resale. Such resale crops have a basis equal to their original cost because that amount is not deductible at the time of purchase. Therefore, only the amount of sale price in excess of that original cost is taxable at the time of sale.)

Example 7.5: Subsequent Sale of Commodity with Loan Under Election

Isabella, from Example 7.4, was able to borrow $63,000 from CCC using her crop as collateral, which she elected to report as income on her income tax return. The following year, she sold her carryover commodity for $165,000. Because the crop was collateral for a CCC loan and Isabella had elected to report the loan as income, she recognizes only $102,000 of income from the sale ($165,000 sale proceeds minus $63,000 of basis from the CCC loan under election). This increase in income may be much easier to tax-manage through the tax-planning techniques discussed in Chapter 5. In addition, Isabella and her husband were able to take advantage of the 12% bracket in the previous year by including the $63,000 loan in their income.

Figure 7.4 Reporting Subsequent Sale of Commodity with Loan Under Election

Part I	**Farm Income—Cash Method.** Complete Parts I and II. (Accrual method. Complete Parts II and III, and Part I, line 9.)				
1a	Sales of purchased livestock and other resale items (see instructions)	**1a**	165,000		
b	Cost or other basis of purchased livestock or other items reported on line 1a	**1b**	63,000		
c	Subtract line 1b from line 1a			**1c**	102,000

If market prices do not rise above the loan rate, producers should choose to redeem the commodity by paying the posted county price (PCP) to the CCC. By making that payment, the producer is no longer obligated on the loan and can keep the difference between the original loan rate and the PCP. This replaces the previous option of forfeiting the grain to the CCC.

A producer who redeems the commodity by paying the PCP will receive a Form CCC-1099-G from the CCC for the difference between the loan rate and the PCP (market gain). That amount must generally be reported as an agricultural program payment on Schedule F (Form 1040).

However, if the producer elected to treat the loan as income, the difference between the loan rate and the PCP is not reported as taxable income because the full loan amount was already reported in taxable income in the year it was received. Instead, the difference is subtracted from the producer's basis in the commodity so that the producer now has basis in the commodity equal to the PCP. The producer should still report the market gain on Line 6a (Agricultural Program Payments) on Schedule F (Form 1040) but not include it as taxable on Line 6b.

Loan Deficiency Payment

If the market price of a commodity is below the loan rate, producers can choose not to borrow from the CCC but to instead claim a loan deficiency payment (LDP) for the crop. This presents another opportunity to increase taxable income when market prices are down at year end. The loan deficiency payment is equal to the difference between the loan rate and the PCP on the date the LDP is claimed. Producers obtain the same result as if they had taken the loan and paid the PCP rate on the date they claimed the LDP. The LDP is reported as an agricultural program payment on Lines 6a and 6b of Schedule F (Form 1040).

Observation

Note that reconciling taxpayer records to the amounts reported on Form CCC-1099-G can be challenging:

- CCC loan activity is not reported on the Form 1099. Borrowings and program payments may be commingled in taxpayer records.
- Often, advance government payments are made. If market conditions later are better than expected, these advances must be repaid. Sometimes these payments are simply netted from subsequent government payments; at other times they are paid by taxpayer check and can be confused with PCP "purchase" payments or repayments of CCC loans.
- Program payments are typically direct-deposited to the producer's bank account. Sometimes these payments are applied directly to CCC loan balances. These directly applied payments may distort taxable income when a commodity is sold, so accurate accounting is important.
- Interest paid to the CCC on loans is not reported to the taxpayer on a Form 1099.

Like-Kind Exchanges

A cardinal rule of taxation is that all income, from whatever source derived, whether received in cash or property, is taxable unless specifically excluded by law. Therefore, if a farm operator works a neighbor's field and receives a steer in exchange, the farm operator must report custom work income equal to the market value of the steer. If a farmer trades five steers for used equipment, the farmer must report steer sales on Schedule F (Form 1040) equal to the value of the equipment received.

The Internal Revenue Code (I.R.C.) provides an exception to this general rule for like-kind exchanges. These exchanges are often referred to as §1031 exchanges after the I.R.C. section that describes them. I.R.C. §1031 allows the gain in such exchanges to be deferred rather than recognized at the time of the exchange. Ordinarily, when a taxpayer disposes of property, gain is realized to the extent that the value of whatever is received exceeds the total of the taxpayer's income tax basis in the property given up and any expenses of sale. Under the like-kind exchange rules, the realized gain is recognized (or reported as taxable on the taxpayer's tax return) only to the extent of cash and other unlike property received. The difference between the realized gain and the recognized gain is deferred. This deferral is accomplished by reducing the basis of the like-kind property received by the amount of the deferred gain.

Rules and Requirements

A §1031 transaction must actually be an exchange of qualifying property. A sale of property, followed by a purchase of like-kind property, does not qualify for non-recognition of gain as a like-kind exchange unless the sales proceeds are held by a qualified intermediary and stringent timeframes regarding the replacement property are met. Gain or loss is recognized if the taxpayer actually or constructively receives money or non-like-kind property before the taxpayer actually receives the like-kind replacement property. Both the relinquished property and the acquired property must be used in a trade or business or held for investment.

- For real property, *like-kind* is interpreted very broadly. Any real estate can be exchanged for any other real estate, as long as the relinquished property was, and the acquired property is, used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate, and improved real estate can be exchanged for unimproved real estate. However, care must be exercised to ensure that any property subject to recapture rules (such as the depreciation recapture rules) that is included as part of the real estate given up is replaced with an equal amount of such recapture property in the replacement real estate received. The depreciation recapture rules apply to single-purpose livestock and horticultural facilities, silos, grain bins, and drainage tile. If this requirement is not met, the taxpayer must recognize ordinary income.

- The Tax Cuts and Jobs Act (TCJA) eliminated tax-deferred, like-kind exchanges for personal property after 2017. Personal property used on the farm includes machinery and equipment, autos and trucks, office equipment, and livestock.

Farmers and ranchers who trade-in personal property, like trucks and tractors, on another piece generally now have two reportable tax events. The trade-in value of the item traded is a taxable sale and is reported in the same way as a cash sale on Form 4797 Sales of Business Property. Any depreciation recapture or capital gains will be recognized as income. See Chapter 3 on Disposition of Property Used in Farming. The sales price (generally the trade allowance of the old property plus trade difference) of the item acquired in the trade will become basis for depreciation. See Chapter 4 on Depreciation and I.R.C. §179 Expensing.

Example 7.6: Equipment Trade-In

Christy had a planter with a $60,000 depreciated basis. On March 15, 2022, she acquired a newer planter that the dealer had listed for $120,000. Christy traded in her old planter and paid the dealer $40,000 in cash.

The trade-in value Christy received for her planter was $80,000 ($120,000 cost of the new planter - $40,000 cash paid). She reports the sale of the old planter on Form 4797 with a $80,000 sale price and $60,000 remaining basis. The basis in the newer planter Christy acquired is $120,000. She may use any applicable method including Bonus Depreciation and §179 to expense the planter.

Other Rules and Reporting Requirements for Like-Kind Exchanges

Taxpayers must use IRS Form 8824, Like-Kind-Exchanges, as a supporting statement for like-kind exchanges that either generate no taxable gain or gain that is reported on other forms [including Form 4797, Sales of Business Property, and Schedule D (Form 1040), Capital Gains and Losses]. A separate Form 8824 should be attached to Form 1040, U.S. Individual Income Tax Return, for *each* exchange. Form 8824 should be filed for the tax year in which the seller (exchanger) transferred property to the other party in the exchange.

If the relinquished property is subject to depreciation recapture or other recapture rules, part or all of the recapture must be recognized in the year of the like-kind exchange if the like-kind property received is not also property subject to the same recapture rules. Furthermore, any recapture potential not recognized in the year of the exchange carries over as an attribute of the asset received in the exchange, and it may trigger ordinary income recapture upon any subsequent sale of the property received.

Observation

Related Parties

Like-kind exchanges between related parties can result in recognition of gain if either party disposes of the received property within 2 years after the exchange.

Tax Planning Opportunities with the Like-Kind Exchange Rules

In many cases, a taxpayer benefits from deferring gain on an asset that is sold by using the like-kind exchange rules to roll the gain into a replacement asset. In some situations, however, it is better to recognize the gain at the time the asset is sold. The key to a successful tax plan is to analyze whether the cost of recognizing gain at the time the asset is sold is offset by the benefit of having additional basis in the property later. This question brings together many of the tax-planning issues discussed in Chapters 5 and 6.

- If gain is recognized, will it be ordinary income or income eligible for the reduced rate for capital gains?
- Will the property received in the exchange be depreciable? If so, how quickly?
- What is the income tax rate for the year of the exchange compared to years when depreciation will be claimed or the property received in the exchange might be sold?
- What impact does the self-employment tax have on the choice?
- Are there any state tax considerations that may favor recognizing gain and therefore having a higher basis in the property received?

The gain deferral under §1031 is mandatory for all qualifying transactions. Therefore, a taxpayer who wants to recognize gain must carefully plan the transaction so that it is not a like-kind exchange.

Shifting Income to Another Taxpayer

Chapter 5 discussed reducing self-employment tax by paying wages to the taxpayer's children under the age of 18. There are additional tax benefits to having other family members as bona fide employees, paying them for the use of farm assets they may own, or giving assets to them for them to sell.

Each taxpayer is entitled to his or her own standard deduction. Each taxpayer also has his or her own tax rate brackets to fill (unless subject to the so-called *kiddie tax*). These provisions of the tax law provide tax-planning possibilities for the farm family.

Example 7.7: Employing Family Members

Sven is in the 24% tax bracket and on average has a $100,000 Schedule F (Form 1040) profit. His 20- year-old daughter, Mary, is in college but spends many weekends, most school breaks, and summers working on the farm. She and Sven determine that $17,000 is reasonable compensation for the work she does on the farm. Mary still qualifies as Sven's dependent.

Because Mary is not under age 18, she and Sven must pay FICA tax on her $17,000 wage. Therefore, there will be no significant net savings from the reduction in Sven's self-employment tax. Because Mary is filing as Single, she is eligible for a standard deduction ($12,950 in 2022). Mary has no other income, so her taxable income is $4,050 ($17,000 wages minus $12,950 standard deduction). This leaves Mary in the 10% tax bracket, so she pays $405 of income tax.

Sven reduces his taxable income by $17,000 which saves $4,080 of income taxes. The net federal income tax savings to the family is $3,675 ($4,080 – $405) and the cash stays in the family.

This approach could also be considered in paying wages to parents who have retired from the farm and find themselves in a lower tax bracket than the family members currently operating the farm.

Observation

There may be non-tax considerations that enter into payments to others. College financial aid may be impacted by the student having increased earnings. Social security benefits may be reduced for a retired parent who has not yet reached full retirement age. In addition, increased earnings for those collecting social security benefits could result in more of those benefits being subject to income tax.

Example 7.8: Gift of Farm Asset

Gail, a dairy farmer, would like to give her daughter Beth $10,000 in 2022. Because this is Gail's only gift to Beth this year and it is under the $16,000 annual gift tax exclusion for 2022, she can make the gift without any gift tax consequences. However, Gail is in the 24% income tax bracket and Beth is in the 10% bracket. Gail normally sells $10,000 of raised cows each year that qualify for capital gain treatment. Instead of gifting cash to Beth, she could gift $10,000 of cows that Beth could then sell. If Gail sells the cows, the gain will be taxed at a 15% tax rate on capital gains. Beth is in the 0% tax bracket for capital gains, so the family can save $1,500 in income tax.

Non-Farm Tax Planning

The majority of annual tax planning is likely to be driven by the income and expenses of the farm operation and how these items are managed using the techniques presented in this chapter as well as in Chapters 5 and 6. However, farmers and non-farmers alike may benefit from the following tax-planning considerations.

"Bunching" Itemized Deductions

Taxpayers often find that their itemized deductions fall just short of the amount of their standard deduction, and therefore they claim the standard deduction each year. The "bunching" strategy involves shifting itemized deductions into alternate years, so that the taxpayer is eligible for itemizing in those years. In the intervening years, the taxpayer claims the standard deduction.

Example 7.9: Managing Itemized Deductions

Barney and Betty normally have about $20,000 of itemized deductions. Therefore, they plan to claim the $25,900 standard deduction for 2022 instead of itemizing deductions. Assuming the standard deduction is also $25,900 for 2023, they will deduct $51,800 over the 2-year period.

If Barney and Betty accelerate $10,000 of itemized deductions from 2023 to 2022, they can deduct $30,000 in itemized deductions in 2022. In 2023, they will have only $10,000 of itemized deductions, so they will use the $25,900 standard deduction. They now claim $55,900 ($30,000 + $25,900) of tax deductions over the 2-year period and gain $4,100 ($55,900 – $51,800) in deductions.

Itemized deductions can be bunched by techniques such as

- Making all planned charitable contributions in one year;
- Grouping planned medical expenses (Junior's braces, wisdom teeth, etc.);
- Making an estimated state income tax payment by December 31 to cover the full amount of state tax that will be due at the time of filing. Total deduction of state and local income, sales, and property taxes is limited to a combined total deduction of $10,000.

Retirement Accounts

Contributions to retirement accounts also provide a tax-deferral opportunity. Such contributions can reduce the taxpayer's overall tax if the taxpayers are in a lower tax bracket in the years when they withdraw funds than in the years when they contribute the funds. Traditional Individual Retirement Arrangements (IRAs) are a common vehicle for both farm and non-farm taxpayers. Not only are the contributions tax deductible, but the earnings are also tax deferred.

Example 7.10: Traditional Individual Retirement Account

Jose is in the 24% tax bracket and has a $75,000 farm profit. He expects to be in the 12% tax bracket when he withdraws the funds in retirement 10 years from now. He contributes and deducts $5,000 this year, which saves him $1,200 ($5,000 × 24%) of taxes. When he withdraws this $5,000 in retirement, his tax will be only $500 ($5,000 × 10%). Hose not only reduced his total tax by $700 but also delayed the tax by 10 years. In addition, the account generates earnings that are not taxed until Jose withdraws them.

Retirement accounts should be considered when taxpayers encounter a low-income year. Contributions to Roth IRAs may be a good option for those years. The disadvantage of Roth contributions compared to a traditional IRA is that the Roth contributions are not deductible, but that disadvantage is relatively small for a year in which the taxpayer is in a low tax bracket. The advantage of Roth IRAs is that the earnings are not simply tax deferred, as with traditional IRAs; qualified withdrawals from Roth IRAs are not subject to tax. This means that the earnings are **not taxed at all**. Taxpayers who expect to be in a higher tax bracket when they retire should consider a Roth IRA. For some taxpayers with a balance in a traditional IRA, it may be appropriate to convert the account to a Roth IRA. A conversion triggers taxable income currently but the taxpayer may take advantage of operating losses (see Chapter 10) or simply a lower than usual tax bracket.

Retirement accounts may also be used to maximize the benefits of having the taxpayer's children on the farm payroll, as discussed earlier in this chapter. Because IRA contributions are limited in amount (generally $6,000 in 2022) and are limited to earned income (wages and net earnings from self-employment), the family can increase tax-deductible and tax-deferred contributions by paying wages to children.

Example 7.11: IRAs for Taxpayer's Children Working on the Farm

Fred and Wilma file a tax return showing a $30,000 farm profit. They each contribute $6,000 to their IRAs. They could hire their son Dale for $6,000. Dale would then also be able to make a $6,000 contribution to his IRA. In addition, Fred and Wilma will receive the tax benefits discussed previously from hiring their son.

Health Plans

Health and accident insurance provided to employees can be claimed as a deduction by the employer on Schedule F (Form 1040) and does not have to be included in the employee's income.

Example 7.12: Health Insurance

Ariana Land owns and operates a farm. Ariana has a health plan that provides health insurance for employees. In 2022, Ariana paid $15,000 for health insurance premiums under the plan. Ariana can deduct $15,000 on her Schedule F (Form 1040), and her employees do not have to include that $15,000 in their income. If the employees' marginal tax rate (including income and employment taxes) is 22%, providing health insurance rather than paying $15,000 more in wages reduces the employees' taxes by $3,300 (22% × $15,000).

When structured correctly, a health reimbursement arrangement (HRA) can reimburse employees for the cost of health insurance and for health care costs that are not covered by health insurance. These plans fall under I.R.C. §105 and must be properly structured and correctly documented, so it is suggested that a third-party administrator be utilized to ensure compliance. Several private companies provide third-party administration services for a fee.

Example 7.13: Reimbursement of Health Care Costs

The insurance that Ariana (from Example 7.12) provides for her employees requires the employees to pay 100% of the first $1,000 of health care costs and 20% of the next $5,000 of health care costs. In 2022, Ariana's employee John Tiller paid $1,200 for health care that was not covered by the health insurance.

In addition to providing her employees with health insurance, Ariana provides a health reimbursement arrangement that reimburses employees for their out-of-pocket costs, up to $2,000. Ariana can deduct her reimbursement of John's $1,200 expense. John does not have to include the $1,200 in income. If John's marginal tax rate is 22%, reimbursing his health care costs instead of paying him another $1,200 in wages reduces his taxes by $264 (22% x $1,200).

Similarly, if Ariana's health reimbursement arrangement provided reimbursements for the cost of health insurance rather than providing health insurance, Ariana could deduct those reimbursements and her employees would not have to include them in income.

Family Members

A health reimbursement arrangement can include health insurance for family members of employees and reimbursement of health care costs for family members of employees. If the business owner employs his or her spouse, the business owner can be included in the HRA as a member of the employee's family.

Example 7.14: Husband is an Employee

If Ariana's HRA (from Examples 7.12 and 7.13) includes members of employee's families, and her husband, Levi, is an employee of her business, then Ariana's business can pay for health insurance that includes coverage for both Levi and Ariana and her business can reimburse Levi for out-of-pocket health care costs for both himself and Ariana.

Self-employed individuals who are not eligible to participate in an employer-subsidized health plan can deduct the cost of health insurance for themselves and members of their family from income subject to federal income tax, but that deduction does not provide the same tax benefit as an HRA that includes the self-employed individual's spouse as an employee. Partners in a partnership, members of an LLC that is taxed as a partnership, and shareholders of S corporations can also claim the self-employed health insurance deduction. The advantages of an HRA, as compared to the self-employed health insurance deduction, are:

1. It allows the cost of health insurance to be deducted from income subject to the self-employment tax, as well as from income subject to federal income tax.
2. It allows reimbursements for out-of-pocket health care costs to be deducted, as well as the cost of health insurance.

Example 7.15: Husband is Not an Employee

If Levi (from Example 7.14) is not an employee of Ariana's business, Ariana's cost of health insurance for her family can be deducted from income subject to federal income tax, but the out-of-pocket health care costs can be deducted only as itemized deductions, and none of the costs can be deducted from Ariana's self-employment income.

To illustrate, assume that the cost of health insurance for Levi and Ariana is $8,000 per year and their out-of-pocket expenses for health care are $3,000. Also assume that Levi and Ariana's taxable income is in the 12% federal income tax bracket.

If Levi is not Ariana's employee, Ariana can deduct the $8,000 cost of their health insurance from their joint income subject to income tax, which reduces their federal income tax by $960 (12%×$8,000).

If Levi is Ariana's employee and is included in her HRA for employees, Ariana can deduct both the $8,000 cost of the health insurance and the $3,000 reimbursement from her business income. That reduces her self-employment tax by $1,554 ($11,000 × 0.9235 ×15.3%) and their joint income tax by $1,227 [$11,000 – (50% × $1,554) × 12%]. The $2,781 ($1,554 + $1,227) total savings from the HRA is $1,821 ($2,781 – $960) greater than the tax savings without the health reimbursement arrangement.

Ariana must file all tax forms applicable to her employment of Levi. Therefore, she must file Forms W–2, W–3, and 943, but she should not include the cost of Levi's health insurance as taxable compensation because it is not subject to income tax or FICA tax.

Nondiscrimination

For 2022 and later years, most employers who provide either group health or accident insurance or a health reimbursement arrangement are subject to certain nondiscrimination rules. A plan generally may not discriminate in favor of highly compensated individuals in either eligibility or benefits. A highly compensated employee is any of the following individuals:

1. one of the five highest paid officers,
2. an employee who owns (directly or indirectly) more than 10% in value of the business, and
3. an employee who is among the highest paid 25% of all employees (other than those who can be excluded from the plan).

When properly structured, an HRA may be offered only to a class of employees as long as the class of employees is reasonable and does not discriminate. Employee classes could be based on the following criteria:

1. Full-time or part-time
2. Hourly or salaried
3. Seasonal or non-seasonal
4. Temporary or permanent

In addition, the following employees may be excluded from the plan:

1. employees who have not completed 3 years of service,
2. employees who have not attained age 25,
3. part-time or seasonal employees,
4. employees represented by a collective bargaining agreement in which health benefits were the subject of good faith bargaining, and
5. employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from a source within the United States.

Part-time is defined as under 25 hours per week, but if other employees with similar work have substantially more hours, then a part-time employee may work up to (but not including) 35 hours per week. *Seasonal* is defined as under 7 months per year, but if other employees with similar work have substantially more months, then a seasonal employee may work up to (but not including) 9 months per year.

If a plan favors highly compensated individuals, you must include all or part of the health benefits you provide to these employees in their wages subject to federal income tax withholding. However, you can exclude these amounts from the employee's wages subject to social security, Medicare, and FUTA taxes. The benefits provided to employees who are not highly compensated individuals are still tax-free.

The term *officer* generally means an executive with administrative authority in the business. Unincorporated entities such as sole proprietorships and partnerships may have officers for this purpose. The indirect (constructive) ownership rules deem an employee to hold the ownership interest of his or her spouse, parents, children, and grandchildren. Therefore, a plan must be nondiscriminatory before an employee-spouse can receive fully excludable benefits.

Summary

In addition to managing the timing of deductions and income, farmers can use income averaging, special tax rules for CCC commodity loans and loan deficiency payments, like-kind exchanges, shifting income to another taxpayer, bunching itemized deductions, retirement accounts, and health plans to manage their income tax liability to keep it as low as possible.

Table of Contents: Chapter 8

CHAPTER 8

DAMAGED, DESTROYED OR STOLEN PROPERTY

Introduction

After their property is damaged, destroyed, or stolen, many taxpayers are surprised to learn that their economic loss is not a tax-deductible loss. This occurs in any of the following circumstances:

- The taxpayer does not have an income tax basis in the property,
- The Tax Cuts and Jobs Act of 2017 rules for personal property losses modified the rules for itemized deductions resulting in a non-deductible loss, or
- The taxpayer is reimbursed for the loss (by insurance or other compensation) in an amount that is equal to or greater than the taxpayer's income tax basis in the property.

If a reimbursement exceeds the property's income tax basis, the taxpayer has a gain that must be reported on the income tax return.

The deductibility of the loss also depends upon the type of property. Business use property is treated differently than personal use property for tax purposes.

The tax rules for these gains and losses are explained thoroughly in the publications listed in the following cross-reference. This chapter explains some of the basic rules and some planning opportunities for taxpayers whose property is damaged, destroyed, or stolen, but it does not provide a detailed explanation of these complex rules.

Cross-Reference

IRS publications that explain the tax rules for damaged, destroyed, and stolen property are:

- IRS Publication 547, Casualties, Disasters, and Thefts
- IRS Publication 584, Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
- IRS Publication 584-B, Business Casualty, Disaster, and Theft Loss Workbook
- IRS Publication 225, Farmer's Tax Guide (Chapter 11 in the 2022 edition)

IRS Form 4684, Casualties and Thefts, and its instructions, are also very helpful in calculating the tax consequences for damaged, destroyed, and stolen property.

General Rules

When property is damaged, destroyed, or stolen, the owner suffers an economic loss unless the loss is fully reimbursed by insurance or other compensation. The damage, destruction, or theft may result in a tax loss or a tax gain, depending on whether the compensation is less than or greater than the property owner's income tax basis in the property.

Example 8.1: Casualty Gain or Loss

Rose Petal's cow was struck by lightning and killed. The cow was worth $1,200, and Rose's insurance company compensated her for $1,000 of the loss. Therefore, Rose's economic loss is $200 ($1,200 – $1,000). However, Rose had deducted all the costs of raising the cow, so she had a zero income tax basis in it. Consequently, Rose had a $1,000 ($1,000 – $0) tax gain.

Casualty and Theft Losses

The Internal Revenue Code gives taxpayers more favorable treatment of casualty and theft losses than of other losses. The code also provides even more favorable tax treatment for business-use property than for personal-use property. The Tax Cuts and Jobs Act of 2017 made significant changes to the treatment of losses impacting personal-use property, which limited the ability to deduct a personal-use property loss as an itemized deduction, unless the area where the loss occurs receives a presidential disaster declaration.

Personal-Use Property

If the property's use is for **personal purposes** and the loss occurs in a presidentially declared disaster area, favorable treatment is given to allow part of the loss to be included as an itemized deduction on Schedule A (Form 1040), Itemized Deductions. By contrast, losses of personal-use property that are not due to a casualty or theft are not deductible. Two reductions apply to allowable personal casualty or theft losses—$100 per loss event and a 10% of adjusted gross income (AGI) subtraction from the total of all such losses.

Example 8.2: Loss on Personal-Use Property

Pedro Gonzales' exotic pet bird was killed in a wildfire. Due to the scope of the fire, the area received a federal disaster area declaration. The bird was worth $10,000 and Pedro's insurance company compensated him for $7,000 of the loss. Pedro paid $12,000 when he purchased the bird and therefore realized a $5,000 ($12,000 – $7,000) loss for income tax purposes. Because the bird's death was a casualty (it was sudden and unexpected), the loss may be included as an itemized deduction on Pedro's income tax return after subtracting $100 and 10% of his AGI from the $5,000. If the bird had died from a fire caused by an electrical fault, Pedro could not deduct any of his loss as there was not a federal disaster.

The acceleration of a disaster-area casualty loss deduction that is explained in the next section also applies to disaster losses incurred on personal-use property in federally declared disaster areas.

Business-Use Property

If the property's use is for **business purposes** and the loss occurred in a federally declared disaster area, the taxpayer may elect to deduct the loss in the tax year preceding the disaster. By contrast, losses that are not due to a federally declared disaster must be deducted in the year the loss occurred unless there is a reasonable likelihood the loss will be reimbursed. If there is a reasonable likelihood that part or all of the loss will be reimbursed, the deduction is deferred (to the extent of the likely reimbursement) until the tax year it becomes reasonably unlikely that it will be reimbursed.

The $100 and 10% of AGI reductions do not apply to business property losses.

Casualty

For federal income tax purposes, a **casualty** is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. For example, damage to shingles caused by a hailstorm is a casualty loss, but gradual damage to shingles by the sun over several years is not a casualty.

Loss of property due to progressive deterioration is not deductible as a casualty loss because the damage results from a steadily operating cause or normal process, rather than from a sudden event. The following are examples of damage due to progressive deterioration rather than from a sudden, unexpected, or unusual event:

- Gradual weakening of a building due to normal wind and weather conditions.
- Deterioration and damage to a water heater that has burst. However, rust and water damage to rugs and drapes caused by the bursting of a water heater does qualify as a casualty.
- Most losses of property caused by a drought. To be deductible, a drought-related loss must be incurred in a trade or business, or in a transaction entered into for profit.
- Damage or destruction of trees, shrubs, or other plants by fungus, disease, insects, worms, or similar pests. However, a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss.

Theft

A **theft** is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the law of the state where it occurred, and it must have been done with criminal intent.

Theft losses are calculated in the same manner as casualty losses, but the loss is reported in the year that the taxpayer discovers the theft.

Example 8.3: Theft Loss

Thieves removed irrigation pipe from Lemon Lime's orchard. The fair market value of the missing pipe was $5,000 and Lemon's income tax basis in the missing pipe was $3,000. Lemon did not have any insurance coverage.

Lemon's casualty loss for tax purposes is limited to the $3,000 income tax basis in the asset.

Casualty and Theft Gains

The tax law also treats gains that result from a casualty or theft favorably by treating them as resulting from an involuntary conversion of the property. This allows the taxpayer to avoid recognizing the gain if he or she reinvests the insurance proceeds or other compensation in replacement property. The unrecognized gain is deferred by reducing the taxpayer's basis in the replacement property. Therefore, a subsequent taxable transfer of the property causes the taxpayer to recognize the gain.

Cross-Reference

See the discussion of postponing gain in Chapter 11 of IRS Publication 225, *Farmer's Tax Guide (2022)*, for more information on involuntary conversions.

Example 8.4: Deferring Casualty Gain

Rose Petal, from Example 8.1, may elect to defer the $1,000 gain from her cow that was killed by lightning if she buys a replacement cow that costs $1,000 or more by the end of the second tax year following the year the cow was killed. The entire insurance payment must be reinvested to postpone all of the gain.

Tax Management of Damaged, Destroyed, or Stolen Property

Although the tax benefits are often less than a taxpayer anticipates, there are tax-planning opportunities when property is damaged, destroyed, or stolen.

Deferring Recognition of Gain

As noted in the previous section, property that is damaged, destroyed, or stolen is eligible for the involuntary conversion rules. An involuntary conversion does not have to result from a casualty. If the taxpayer receives compensation for the damaged or destroyed property that results in a gain, the taxpayer may elect to defer recognition of the gain if he or she reinvests the compensation in similar property by the end of the second tax year after the damage, destruction or theft.

Observation

Rules Less Restrictive than Like-Kind Exchange Rules

Although the involuntary conversion rules are similar to the like-kind exchange rules, some differences make the involuntary conversion rules more taxpayer-friendly. A broader range of property often qualifies as replacement property in an involuntary conversion than under the like-kind exchange rules which only applies to real property. A second difference is that a taxpayer may take possession of the compensation for the converted property under the involuntary conversion rules before acquiring the replacement property. By contrast, a taxpayer can defer gain under the like-kind exchange rules only if the proceeds from the relinquished property are held by a qualified intermediary until they are used to acquire the replacement property.

Example 8.5: Deferred Gain

Amanda Reckonwith owns farmland by a river that floods regularly. Amanda paid $1,000 per acre for the land in 1975. In 2023, a flood washed out a levee, and 10 acres of her land are now under water. Instead of rebuilding the levee, the government bought the 10 acres from Amanda for $3,000 per acre.

Amanda has realized a $2,000 ($3,000 – $1,000) per acre gain from this involuntary conversion of her land. If she does not replace the land, she must recognize $20,000 ($2,000 × 10 acres) of long-term capital gain in 2023. The federal income tax rate on her long-term capital gain is 15%, and her state income tax marginal rate on her long-term capital gain is 5%. Therefore, Amanda must pay $4,000 ($20,000 × 20%) income tax on the gain if she does not acquire replacement property timely.

If Amanda pays at least $30,000 for replacement land, regardless of total acreage, she can defer recognition of the gain by rolling it into the replacement land. For example, she can defer the gain if she buys 25 acres of land for $50,000 ($2,000 per acre). Her basis in the replacement 25 acres will be her $10,000 ($1,000 × 10 acres) basis in the flooded land, plus the $20,000 excess she paid for the replacement land over the $30,000 she received for the flooded land. Therefore, her basis in the replacement land is $30,000 ($10,000 + $20,000). If she later sells the replacement land for $50,000, she will then recognize the $20,000 gain that was deferred from the 10 acres the government bought from her.

Cross-Reference

See the discussion of self-employment tax in Chapter 6 of this guide.

Depreciable Replacement Property

If replacement property is depreciable, it is often more advantageous to not defer gain from involuntarily converted property. By not deferring the gain, the taxpayer acquires a higher income tax basis in the replacement property. The depreciation or I.R.C. §179 deduction for that higher basis reduces not only ordinary income, but also self-employment income. By contrast, the gain that is recognized increases only ordinary income or capital gains and does not increase self-employment income.

Example 8.6: Depreciable Replacement Property

Allen Rentch's tractor caught on fire in 2023 and was damaged beyond repair. The loss was insured, and his insurance company paid him the tractor's $5,000 fair market value. Allen had depreciated his original $12,000 basis of the tractor down to zero, so he realized a $5,000 tax gain from the tractor's loss.

- If Allen does not elect to defer the gain he must report $5,000 of ordinary income (depreciation recapture) on his 2023 income tax return. Allen is in the 12% federal marginal income tax bracket and a 5% state marginal income tax bracket. Therefore, recognizing the gain adds $850 ($5,000 × 17%) to his 2023 income tax liability.
- If Allen pays $5,000 for a used replacement tractor and elects to defer the gain on the destroyed tractor, he has no gain to report in 2023 and has a zero basis in the replacement tractor. If he sells the replacement tractor in 2027 for $5,000, he must report $5,000 of ordinary income in 2027. If his marginal tax rates are the same as in 2023, he will pay an additional $850 of income tax for 2027 due to the sale of the tractor. Therefore, his tax liability is the same, but he has postponed paying the $850 of taxes for 5 years.
- If Allen pays $5,000 for a used replacement tractor and **does not** elect out of the special depreciation allowance for the gain on the destroyed tractor, he must report the $5,000 gain in 2023. If he does not elect out of the special depreciation allowance (often referred to as bonus depreciation) for 2023, he can deduct 80% of the $5,000 cost of the replacement tractor in 2023. The special depreciation allowance percentage for 2023 is 80% and will be reduced to 60% for 2024. That deduction offsets $4,000 ($5,000 × 80%) of the gain in 2023 and the remaining $1,000 is depreciable over 8 tax years (7-year property with a half-year convention) from the destroyed tractor. It also reduces his self-employment income for the 8 years, which saves him $706 ($5,000 × 92.35% × 15.3%) of self-employment tax. The self-employment tax savings reduces his self-employment tax deduction from ordinary income by $353 ($706 × 50%), which adds $60 ($353 × 15.3%) to his income taxes. Therefore, the net tax savings is $646 ($706 – $60).
- Again, if Allen pays $5,000 for a used replacement tractor and **does not** elect to defer the gain on the destroyed tractor, he must report the $5,000 of gain in 2023. However, if he elects out of the special depreciation allowance, he can elect to use the I.R.C. §179 deduction, and as long as he has not used up his $1,160,000 I.R.C. §179 deduction for 2023 on other property, he can elect to deduct the entire $5,000 cost of the replacement tractor in 2023. As shown in the previous paragraph, that deduction offsets his entire $5,000 gain from the destroyed tractor. It also reduces his self-employment income for 2023, which saves him $706 ($5,000 × 92.35% × 15.3%) of self-employment tax. The self-employment tax savings reduces his self-employment tax deduction from ordinary income by $353 ($706 × 50%), which adds $60 ($353 × 17%) to his income taxes. Therefore, the net tax savings is $646 ($706 – $60) in the current year.
- If Allen has used his I.R.C. §179 deduction on other property or elected out of the special depreciation allowance, he can depreciate the $5,000 he paid for the used replacement tractor over 8 tax years (7-year property with a half-year convention). The depreciation deductions will reduce his ordinary income and self-employment income by a total of $5,000 over the 8 years. Therefore, by not electing to defer the gain on his destroyed tractor, Allen has accelerated $1,000 of taxes into 2023 but will save $1,556 of taxes over the 8 years. Using a 6% discount rate, the present value of the $1,556 of tax savings over the 8 years is $1,291. Therefore, the net value of Allen's tax savings over the 8 years is $291 ($1,291 – $1,000) and, even without the I.R.C. §179 deduction or the special depreciation allowance, Allen is better off **not** electing to defer the gain from the destroyed tractor.

Planning Pointer

Capital Gain on Converted Property

If the gain on the converted property is capital gain and the replacement property can be depreciated, it is even more advantageous to include the gain in income rather than deferring it. For example, if in Example 8.6, Allen lost five raised cows held for more than 24 months and realized the same $5,000 gain, the gain would be long-term capital gain, and the federal income tax rate on that gain is zero in 2023. Assuming a 5% state income tax rate on long-term capital gain, Allen would owe only $250 ($5,000 × 5%) of income tax on the realized gain, if he did not defer that gain. His $5,000 basis in replacement cows would reduce his income and self-employment taxes by the same $1,556 as in Example 8.6.

Effect on Netting of Gains and Losses

The tax rules allow taxpayers to deduct a net loss from certain property they use in a trade or business from ordinary income, but to treat a net gain from that property as a capital gain. For example, if a farmer has a $10,000 gain from selling cull cows and a $12,000 loss from selling machinery in 2023, the net $2,000 loss is deducted from ordinary income. If the loss on the machinery is only $7,000, the $3,000 net gain is taxed as capital gain.

If a taxpayer has a net gain from damaged, destroyed, or stolen property during a tax year, that net gain is included in the netting of gains and losses from property used in a trade or business. However, if a taxpayer has a net loss from damaged, destroyed, or stolen property, that net loss is deducted from ordinary income, without netting it with the gains and losses from property used in a trade or business. The effect of these rules is the following. If a taxpayer has a net gain from damaged, destroyed, and stolen property, and also has a net gain from assets used in the trade or business, the losses from damaged, destroyed, or stolen property just reduce gain that is taxed as capital gain. By contrast, if a taxpayer has a net loss from damaged, destroyed, or stolen property, that net loss reduces ordinary income.

Electing to defer gain from damaged, destroyed, or stolen property preserves the benefits of deducting a loss from other property in the same tax year.

Example 8.7: Preserving Ordinary Deduction

A tornado completely destroyed Braxton Bovine's barn on August 29, 2023, killing the 20 dairy cows that were in the barn. Figure 8.1 shows information from Braxton's records regarding the barn and the cows.

Figure 8.1. Braxton Bovine's Records

Item	Barn	20 Dairy Cows
Purchase Date	May 15, 2022	August 20, 2019
Cost	$35,000	$20,000
Depreciation claimed	-35,000[1]	-13,336[2]
Adjusted basis	$0	$6,664
FMV before casualty	$ 35,000	$ 17,000
Insurance payment	$ 30,000	0
Gain or loss	$ 30,000	- $6,664

[1] *150% declining balance for 20-year property*
[2] *150% declining balance for 5-year property, half-year convention*

If Braxton does not elect to roll the gain from the barn into a replacement barn, the $6,664 loss from the cows reduces the $30,000 gain from the barn, so that Braxton reports only the $23,336 ($30,000 – $6,664) remaining gain as long-term capital gain. His other ordinary income is not reduced by the loss.

If Braxton elects to roll the gain from the barn into a replacement barn, the $6,664 loss from the cows offsets ordinary income in 2023, rather than capital gain on the barn.

Accelerating a Loss Deduction

If a disaster caused your area to be eligible for federal assistance, you can elect to deduct the loss on your original or amended return for the tax year immediately preceding the tax year in which the disaster occurred. There are two potential advantages of making this election:

1. Accelerating the deduction may allow you to realize the tax savings earlier.
2. Accelerating the deduction may offset income in a higher tax bracket.

Example 8.8: Earlier Tax Savings

The roof on Paige Turner's barn collapsed under the weight of ice from a January 2023 ice storm that caused her county to be declared a federal disaster area. Paige files her income tax return on a calendar- year basis. Because she qualifies as a farmer, she avoids the penalty for not making estimated tax payments by filing her return and paying her taxes before March 1 each year. The barn was not insured, and her income tax basis in it was $10,000. Therefore, Paige realized a $10,000 loss that she can deduct on her 2023 income tax return.

Paige can elect to accelerate the deduction by claiming the $10,000 loss on her 2022 tax return. If she is in the same income tax brackets in 2022 and 2023, she will realize the same tax benefit on either income tax return. However, by claiming the deduction on her 2022 income tax return, Paige will realize the tax savings when she files the 2022 income tax return and pays her taxes in February 2023, rather than when she files her 2023 income tax return and pays her taxes in February 2024.

In many cases, the disaster that caused the tax loss also reduces income for the tax year. Consequently, taxable income in the year preceding the loss year may be in a higher tax bracket than in the year of the disaster. If that is the case, accelerating the tax deduction results in a larger tax savings from the deduction.

Example 8.9: Greater Tax Savings

The ice storm in Example 8.8 also suffocated most of Paige's alfalfa crop, which reduced her 2023 income substantially. As a result, her taxable income for 2023 is in the 12% federal income tax bracket. In 2022, her taxable income was in the 22% federal income tax bracket.

By electing to deduct the $10,000 loss on her 2022 income tax return, Paige increased the income tax savings from the deduction from $1,200 (12% of $10,000) to $2,200 (22% of $10,000).

Summary

Many taxpayers are surprised to learn that losing property in casualties, thefts, or disasters often does not result in the deductible income tax loss they expected. However, special income tax provisions provide some tax advantages. These provisions may allow taxpayers to postpone reporting taxable gain or to accelerate reporting tax losses. Making optimal use of these special provisions can take some of the economic sting out the unexpected loss of property.

Table of Contents: Chapter 9

CHAPTER 9

ALTERNATIVE MINIMUM TAX

Introduction

Congress imposed the alternative minimum tax (AMT) to prevent taxpayers with significant income from combining specified tax exclusions, deductions, and credits to pay very little or no federal income tax. When it was first enacted in 1969, the AMT affected only a few very high-income taxpayers. But since it was first imposed, changes to the regular tax rules have caused many more taxpayers to pay the AMT. Following the passage of the Tax Cuts and Jobs Act (TCJA), increased AMT phaseouts and exemption amounts have significantly reduced the number of taxpayers required to calculate and pay AMT. If no other legislation is enacted, these provisions will expire at the end of 2025, and significantly more taxpayers will be affected.

Cross-Reference

More Detailed Information

For more detailed information about the AMT for individual taxpayers, see the 2-page Form 6251, Alternative Minimum Tax--Individuals, and the 12 pages of instructions for it. Form 6251 and its instructions can be accessed at www.irs.gov.

This chapter gives a basic explanation of the AMT, some examples of situations that cause taxpayers to pay it, and some planning techniques to minimize the AMT's impact.

The terminology of the AMT tax is a little confusing because the tax is technically an add-on tax (added on to the regular tax liability), rather than an alternative to the regular income tax. Therefore, taxpayers report their regular income tax on their income tax return and then add on the AMT to find their total income tax liability.

While the AMT is technically an add-on tax, it has the effect of an alternative tax because taxpayers calculate their AMT by subtracting regular tax liability from a *tentative minimum tax*. If the taxpayer's tentative minimum tax is less than the regular tax, there is no AMT. If the tentative minimum tax is greater than the regular tax, the AMT is the difference between the tentative minimum tax and the regular tax. The effect of these rules is that taxpayers must pay the higher of the regular tax or the tentative minimum tax.

This chapter focuses on the AMT imposed on individual taxpayers. The AMT imposed on C corporations (CAMT) is discussed briefly at the end of the fact sheet.

Basic AMT Calculation

To determine if you should compute AMT, you can refer to the instructions for Form 1040 which includes a worksheet and information regarding Form 6251, AMT – Individuals. Some of the common reasons for filing Form 6251 include: accelerated depreciation, investment interest expense, NOL deduction, foreign tax credits and electric vehicle tax credits. Just because the form must be completed does not mean you will owe AMT.

Taxpayers compute their tentative minimum tax by first computing their alternative minimum taxable income (AMTI), which is their taxable income for regular tax purposes adjusted by the difference between deductions that are allowed for the regular tax and those that are allowed for the AMT. The AMTI is then reduced by an exemption amount. The resulting income is multiplied by 26% for the first $206,100 ($103,050 for married filing separately) and 28% for the amount over $206,100 ($103,050).

AMT Adjustments

To calculate AMTI, taxpayers start with their taxable income and then add back in some of the deductions they claimed to compute their taxable income. They also make some adjustments that reduce their taxable income. These adjustments account for the differences between the deductions that are allowed for the regular income tax and those that are allowed for the AMT.

Example 9.1: AMT Adjustments

Andy and Mary Thompson are married and have four children. In calculating their $315,000 taxable income for 2022, they included the following deductions that affect AMTI:

1. $80,000 depreciation on new farm equipment (bought in 2022 for $400,000; depreciated over 5 years using the 200% declining balance method, half-year convention)
2. $25,900 standard deduction

The AMT rules require Andy and Mary to add the following amounts to their taxable income to compute their AMTI:

1. $20,000 of the farm equipment depreciation (this is the excess over the $60,000 of depreciation that could be claimed using the 150% declining balance method over 5 years assuming half-year convention)
2. $25,900 standard deduction

Adding the $45,900 total of these adjustments to their $315,000 taxable income results in $360,900 AMTI.

AMT Exemption Amounts

Figure 9.1 shows the maximum AMT exemption amounts provided in the Internal Revenue Code (I.R.C.) for any year that the Congress does not temporarily increase them. However, each year beginning in 2001, Congress has temporarily increased these exemption amounts for individual returns, and it is likely to continue to increase them or otherwise change the AMT rules to reduce the impact of the AMT. Figure 9.1 also shows the temporary increase in the exemption amounts for 2022 and 2023. The examples in this chapter use the amounts shown in Figure 9.1 for 2022.

Figure 9.1. AMT Exemption Amounts

Filing Status	I.R.C. Exemption Amount	2022 Exemption Amount	2023 Exemption Amount
Married individuals filing jointly	$45,000	$118,100	$126,500
Surviving spouses	45,000	118,100	126,500
Head of household	33,750	75,900	81,300
Single individuals	33,750	75,900	81,300
Married individuals filing separately	22,500	59,050	63,250
Estates and trusts	22,500	26,500	28,400

Example 9.2: Basic AMT Calculation

Andy and Mary Thompson from Example 9.1 compute their AMT as shown in Figure 9.2.

Figure 9.2. AMT Calculation

AMTI	$360,900
Exemption	– 118,100
AMT tax base	$ 242,800
AMT tax rate on first $206,100 of AMTI AMT tax rate on remaining $36,700	× 0.26 x 0.28
Tentative minimum tax	$ 63,862
Regular tax on $315,000	– 63,271
AMT	$ 591

Note that Andy and Mary pay the $63,271 regular tax plus the $591 AMT for a total tax of $63,862, which is equal to the tentative minimum tax. Therefore, the effect of the AMT is to make taxpayers pay the higher of their regular tax liability or their tentative minimum tax.

AMT Credit

The AMT caused by some adjustments can create a credit that reduces regular income tax liability in subsequent tax years. In effect, these adjustments do not increase a taxpayer's total tax liability; they simply accelerate income tax liability by imposing the AMT in one year and reducing income taxes in a later year. Because taxpayers must pay the higher of their regular tax or their tentative minimum tax each year, a subsequent-year reduction of AMTI does not in itself produce the offsetting benefit that the credit provides.

Adjustments that Create an AMT Credit

The adjustments that can create an AMT credit are those that defer deductions rather than permanently prohibit them. For example, some assets can be depreciated at a faster rate for regular tax purposes than for AMT purposes. In the early years of depreciating those assets, the regular tax depreciation exceeds the AMT depreciation, and the excess is an addition to AMTI that can cause an AMT liability. In the later years of depreciating those assets, the regular tax depreciation is less than the AMT depreciation, and the deficit is subtracted in calculating AMTI. By the end of the assets' recovery period, the total regular tax depreciation and the AMT depreciation are the same. Therefore, the AMT rules simply deferred the depreciation deduction—they did not reduce the total depreciation deduction.

AMT adjustments that cause a permanent difference in regular taxable income and AMTI do not create an AMT credit. These adjustments include:

- itemized deductions, including any investment interest expense reported on Schedule E,
- the standard deduction

Example 9.3: AMT Credit

In Example 9.2, Andy and Mary Thompson's AMT for 2022 was $591. One of their two AMT adjustments—the $25,900 standard deduction—**is not a** deferral adjustment. The AMT caused by that permanent adjustment does not create an AMT credit.

However, their $20,000 depreciation adjustment is a deferral adjustment that creates a $591 AMT credit. (Without the $20,000 depreciation adjustment, their 2022 AMT would be zero). The credit can be subtracted from their regular tax liability in 2023, but a limit applies; it can reduce their regular tax liability only to their tentative minimum tax for 2023. Any excess is carried forward to reduce regular income taxes in future years, subject to each year's tentative minimum tax limit.

Observation

AMT on Deferral Items Only Accelerates Tax Liability

Because Andy and Mary receive a $591 credit in 2023 for the $591 AMT they paid in 2022, the AMT did not permanently increase their income tax. The AMT only accelerated the $591 liability from 2023 to 2022.

AMT Management and Planning Issues

The examples in this section show how the AMT affects taxpayers with large capital gains or itemized deductions that are limited for the AMT calculation.

Taxpayers with Large Capital Gains

The same capital gains tax rates that are used for regular tax liability apply in calculating the AMT. Although these rates do not trigger the AMT, taxpayers with large capital gains nevertheless may be subject to the AMT as a result of a reduction of the AMT exemption. The AMT exemption amounts shown in Figure 9.1 are maximums; the exemption is phased out for higher income taxpayers. (The phase-out begins when AMTI exceeds $539,900 for taxpayers filing as single or head of household, $1,079,800 for joint returns and surviving spouses, and $539,900 for married taxpayers filing separate returns.) Thus, while the tax rate on capital gains is still capped at 20%, the tentative minimum tax increases because the reduced AMT exemption increases the total income that is subject to the AMT rates.

Example 9.4: Taxpayer with Large Capital Gains

Tommy Hawk is single with no dependents. In 2022, Tommy decided to get out of farming, so he sold his 150 acres of farmland, but kept the home, outbuildings, and machinery. He had $55,000 of farm income for 2022 and $50,000 of wages from a new job. He sold the 150 acres of farmland for $710,000. His income tax basis in the land was $10,000, so he had a $700,000 capital gain from the sale of the land.

Tommy claims the $12,950 standard deduction. If Tommy had not sold the land, he would not owe any AMT. His AMTI would be $101,114 ($55,000 farm income – $3,886 SE tax deduction + $50,000 wages). His income subject to the AMT after subtracting his $75,900 AMT exemption would be $25,214, and he would have a $6,556 tentative minimum tax ($25,921 × 26% = $6,556), which is less than the $15,013 regular tax on his $88,164 taxable income.

However, the capital gain from the farmland sale increases his taxable income to $788,164 and his regular tax to $136,433. The capital gain is still taxed at the 15% and 20% rate, but its inclusion in his $801,114 AMTI reduces his $75,900 AMT exemption to $10,594 causing his AMT to increase to $144,955. Therefore, Tommy owes an additional $8,522 after triggering the AMT.

Planning Pointer

Spread Capital Gains to More Than One Year

If large capital gains would cause the AMT, spreading them over more than one year can reduce or eliminate the additional liability. Spreading the gains can keep AMTI below the threshold for reducing the AMT exemption amount.

Capital gains can be spread out by making an installment sale or by selling part of the assets in each of two or more years. Be sure to compare the tax savings with the risk of not being paid on an installment contract or the risk of a price decrease if you delay selling part of the assets.

Example 9.5: Spreading Capital Gains

Tommy Hawk from Example 9.4 sold his farmland for $710,000, but he entered into an installment contract that required the buyer to pay $355,000 in 2022 and $355,000 in 2023. After subtracting $5,000 of basis from each of those payments, Tommy has $350,000 of long-term capital gain to report in each year. He has $101,821 of ordinary income and claims the standard deduction for 2022. Tommy's AMT for 2022 is zero.

If his income is similar in 2023, and the AMT exemption amounts, tax rates, standard deduction, and personal exemption deduction are the same for 2023 as they are for 2022, Tommy also will owe no AMT for 2023.

Itemized Deduction Limitations

The AMT calculation eliminates or limits several of the Schedule A (Form 1040) itemized deductions. They include the following common itemized deductions.

1. State and local taxes (including property taxes, income taxes, and sales taxes) are not deductible at all in calculating AMT. Taxpayers with high state and local taxes are more likely to have an AMT liability. This deduction however is capped at $10,000, following the

passage of TCJA.

2. Home mortgage interest on indebtedness that is not used to acquire, construct, or substantially improve the taxpayer's main home or second home is not deductible for AMT.
3. Medical and dental expense deductions are limited to a 10%-of-AGI floor instead of the 7.5%-of-AGI floor that applies to the regular tax liability calculation.

Planning Pointer

Prepayment of Taxes

Taxpayers who prepay property taxes or state income taxes for the following year (doubling the current-year deduction) to maximize the use of the standard deduction the following year may find themselves with an AMT liability that reduces or eliminates the intended tax benefit.

AMT for Corporations

The Tax Cuts and Jobs Act repealed the Corporate AMT; however, the Inflation Reduction Act of 2022 reinstituted the corporate AMT for tax years 2023 and beyond. This rule does not apply to S-corporations, REITs, investment companies and private equity funds.

Corporations with average annual book income exceeding $1 billion for three consecutive years are subject to CAMT. CAMT will be 15% of corporate income. Corporations that are subject to CAMT will calculate their taxes under regular corporate tax rules and the CAMT, and be responsible for paying the higher amount.

It is important to note that the calculation is based on the book income, and not taxable income, of the corporation. This is referred to as adjusted financial statement income, AFSI. This was seen as a way to avoid corporate tax incentives that reduce taxable income, resulting in no or low tax liability.

The Future of the AMT

AMT was becoming a concern for a growing number of taxpayers. AMT rates were temporarily increased, but not indexed for inflation like regular income tax rates. Following the passage of the Tax Cuts and Jobs Act, increased AMT phaseouts and exemption amounts have significantly reduced the number of taxpayers required to calculate and pay AMT. If no other legislation is enacted, these provisions will expire at the end of 2025, causing a significant number of taxpayers to once again be subject to AMT starting in 2026.

Table of Contents: Chapter 10

CHAPTER 10

NET OPERATING LOSSES

Introduction

Weather, disease, and variable prices for inputs and commodities often cause farmers' income to fluctuate from one year to the next. As discussed in Chapter 5, "Managing Timing of Income and Deductions", farmers can minimize their income tax liability by timing income and deductions to keep their taxable income level. Sometimes, leveling techniques are not enough to avoid a spike or a dip in taxable income. The tax effect of spikes can be minimized with the income-averaging rules discussed in Chapter 7, "Other Tools to Manage Income Tax Liability". If taxable income dips below zero, the tax effect can be managed with the net operating loss (NOL) rules discussed in this chapter.

The concept of the NOL rules is quite simple: Taxpayers can carry business losses from the loss year to offset taxable income in other tax years. A farming loss can be carried back and/or forward.

Planning Pointer

NOL Rules Are Last Planning Resort

The NOL rules **do not** make the best use of business deductions. Therefore, farmers should first try to smooth their taxable income with the leveling techniques discussed in Chapter 5 of this guide. When those techniques do not fully succeed in avoiding negative taxable income, the NOL rules make the best of an unfortunate situation.

Most NOLs cannot be carried back, but a farm NOL may be carried back two years unless the taxpayer elects to forgo the carryback. If the NOL is not fully absorbed (used up) in the second tax year that precedes the loss year, the excess is carried to the prior year. If all or part of the NOL is unused after it has been carried to the first year before the loss year, the balance is carried forward to the year after the loss year and then to subsequent years until it is fully absorbed. An NOL can be carried forward indefinitely.

Caution

Income Absorbing the NOL

As discussed later in this chapter, if the NOL exceeds taxable income in a carryback or carryforward year, the amount of the NOL that is absorbed will be more than the taxable income for the carryback or carryforward year.

Example 10.1: Absorption of NOL Carryover

Pete Moss started his horticulture farm in 2011 as a sole proprietor. His business blossomed in several good years before 2021. In 2021, a late frost followed by a June hailstorm and an August drought caused an $80,000 farm loss. Pete had no other income or losses that year, and he carried his $80,000 farm NOL back to 2019, which absorbed $17,000 of it. The remaining $63,000 was carried to 2020 and subsequent years as shown in Figure 10.1.

The $20,000 NOL carryforward remaining after 2022 can be carried forward indefinitely until it is used.

Figure 10.1. Absorption of Pete Moss's 2021 NOL

Carryback or Carryforward Year	Year	NOL Carryback or Carryforward	NOL Absorbed	NOL Remaining
Second year before loss year	2019	80,000	17,000	63,000
First-year before loss year	2020	63,000	27,000	36,000
First-year after loss year	2022	36,000	16,000	20,000

Although the principle of NOLs is simple, the actual computation of NOL deductions can be complex. Complexity arises because the NOL is limited to business losses not carried to other years under other tax rules, such as the capital loss carryover rules. These limitations require taxpayers to add back some expenses and losses deducted to compute taxable income. Required modifications further complicate the calculations to taxable income in the years to which the NOL is carried.

Cross-Reference

For more information on NOLs, see IRS Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts. It can be accessed from the IRS website, www.irs.gov.

Computing the NOL

One way to compute an NOL is to start with the year's negative taxable income and add back the deductions that are not allowed to be included in the NOL.

Observation

Taxable Income Must be Negative to Have an NOL

If you have positive taxable income for a tax year, you do not have an NOL for that year even if your business has a net loss. Positive taxable income indicates that you have income from other sources (such as wages, nonbusiness income, or income from other businesses) that offsets the business loss, so there is no net loss left to carry to another tax year.

Items Not Included in NOL

Several deductions in the calculation of taxable income are not included in NOL calculations. These usually are excluded from the NOL computation for one of the following two reasons:

1. Generally, only business losses can be carried to another year; therefore, with a few exceptions, nonbusiness deductions in excess of business income are not included in the NOL.
2. Items that carry to another tax year under another carryover rule—such as capital loss carryovers—are excluded from the NOL calculation to avoid duplication.

The following items are examples of deductions that are removed from the NOL by adding them back into the taxpayer's negative taxable income:

1. Dependent and personal exemptions deduction (currently zero until 2026).
2. Nonbusiness deductions (such as itemized deductions, the standard deduction, alimony paid, health savings and Archer medical savings account, charitable contributions if you take the standard deduction, and the deductions for contributions to retirement plans) in excess of nonbusiness income (such as interest, dividends, taxable IRA distributions, pension benefits, and taxable social security benefits)
3. Capital losses in excess of capital gains
4. An NOL deduction carried from another year

Computation Note

Schedule A (Form 1045) Calculation

Instead of beginning with negative taxable income and then adding back the personal and dependent exemptions deduction, Schedule A (Form 1045), Application for Tentative Refund, begins with the taxpayer’s income before the personal and dependent exemptions deduction is subtracted. Consequently, if you use Schedule A (Form 1041) to compute your NOL, you do not add back your personal and dependent exemptions deduction to compute your NOL.

Example 10.2: Adding Back Nonbusiness Deductions

Paige Turner's taxable income for 2021, before deducting personal and dependent exemptions, is a negative $10,000 that results from both business losses and nonbusiness deductions. Her nonbusiness deductions exceed her nonbusiness income by $6,000, so she must add that $6,000 back to her negative $10,000 taxable income, which reduces her NOL to $4,000.

If Paige's nonbusiness deductions exceeded her nonbusiness income by more than her $10,000 negative taxable income, she would not have an NOL.

Business Income and Deductions

Business income and deductions are defined broadly for purposes of the NOL calculation. They include not only the ordinary income and deductions from a trade or business but also gain or loss from the disposition of both real property used in a trade or business and depreciable property used in a trade or business. Being employed is treated as a trade or business, which means wages are business income and deductible employee expenses are business deductions (deductible employee business expenses are probably zero until 2026).

An exception to the business-connection requirement is that deductions attributable to casualty and theft losses from property held for personal use or investment are treated as business losses for the NOL calculation even though they are not connected with a trade or business.

Observation

Effect of Business or Nonbusiness Classification

Classifying **ordinary income and capital gain as nonbusiness income** is advantageous to a taxpayer because it reduces the amount of nonbusiness deductions that must be added back to compute an NOL. Similarly, classifying **deductions and capital losses as business deductions** is advantageous to the taxpayer.

Example 10.3: Business and Nonbusiness Income and Deductions

Neil Down, who is unmarried and does not itemize deductions, realized a $10,000 loss from his sole-proprietor farming business in 2021. After considering his other income and deductions (as shown in Figure 10.2), his taxable income for 2021 is a negative $16,050.

Figure 10.2. Neil Down's 2021 Taxable Income

Income or Deduction	Amount
Business loss	–$10,000
Wage income	6,000
Investment income	500
Adjusted gross income	–$3,500
Personal exemption deduction	0
Standard deduction	–12,550
Taxable income	–$16,050

Observation

Other Ways to Look at the NOL

Note that in Example 10.3, the $4,000 NOL equals the sum of Neil's negative $3,500 AGI and the $500 portion of his standard deduction that is allowed by his $500 investment income. His NOL could also be viewed as his $10,000 business loss reduced by his $6,000 of wage income.

Carrying the NOL Back or Forward

Most NOLs are carried forward indefinitely. NOLs from a farming business are carried back two years. Farmers can elect to forgo the carryback and carry the NOLs forward only.

Farming Loss (2 Years)

Taxpayers who have an NOL from a farming business can carry that NOL back two years and then forward indefinitely. A farming business involves cultivation of land, raising or harvesting any agricultural or horticultural commodity, operating a nursery or sod farm, and raising or harvesting trees bearing fruit, nuts, other crops, or ornamental trees. Raising, shearing, feeding, caring for, training, and management of animals are also farming businesses. A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by someone else, or a business in which the taxpayer merely buys or sells plants or animals grown or raised by someone else.

Election to Forgo Any Carryback

Taxpayers with a farming NOL who decide to forgo the carryback period must include a statement with the original return filed for the loss year declaring that they are waiving the carryback period. The original return must be filed by its due date (including extensions). Suppose the original return is filed by its unextended due date without the election. In that case, the taxpayer can make the election on an amended return filed within six months of the unextended due date.

Absorbing the NOL

The amount of an NOL that is absorbed (used up) by the year it is carried is equal to that year's *modified taxable income*. Modified taxable income is taxable income increased by some of the deductions in calculating taxable income.

The NOL amount that is carried to the second eligible carryback or carryforward year is the beginning NOL minus the first eligible year's modified taxable income. The NOL carried to the third eligible year is the amount carried to the second year minus the second year's modified taxable income. This process is repeated until the NOL is fully absorbed or until it is carried to the last eligible year.

Because the modified taxable income is always greater than taxable income, more of an NOL is absorbed each year than the amount of income offset by the NOL. Therefore, some of the NOL deduction is wasted by each intervening year to which the NOL is carried, if the NOL is greater than the taxable income for that intervening year.

Planning Pointer

Avoiding Lost Deductions

Two planning techniques can reduce or eliminate the lost deductions:

1. Choose the carryback or carryforward year so that the NOL is absorbed in as few intervening years as possible.
2. Avoid the NOL by spreading income evenly over several tax years.

80%-of-Taxable Income Limit

Only NOLs arising after 2017 and carried forward to a year after 2020 are subject to the 80%-of-taxable income limit. The total amount of any NOL deduction for 2021 or thereafter that is attributable to NOLS from tax years after 2017 can't exceed 80% of taxable income without regard to the NOL deduction, section 199A (Qualified Business Income Deduction), or section 250 (Foreign Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)).

Calculating Taxes in Carryback and Carryforward Years

If an NOL is carried back, it is claimed as a deduction that reduces taxable income and tax for the carryback year. The recalculation of tax in a carryback year is complicated because the NOL deduction reduces AGI, and that reduction in AGI may affect itemized deductions or other deductions. Consequently, the affected deductions must be recalculated.

Taxpayers can claim a quick refund of taxes paid in prior years by filing Form 1045, Application for Tentative Refund, on or after the date you file your tax return for the NOL year, but no later than the end of the tax year following the year the NOL occurred. For example, a farmer with an NOL in 2021 has until December 31, 2022, to file a Form 1045 claiming a refund from carrying the NOL back to 2019 and any other carryback year affected.

Taxpayers can also claim a refund from carrying an NOL back by filing a Form 1040X, Amended U.S. Individual Income Tax Return for each of the carryback years. Form 1040X must be filed within three years of the due date (including extensions) for the loss year's tax return. For example, a farmer with an NOL carryback from 2019 generally has until April 15, 2023 (3 years after April 15, 2020, the due date of the 2019 return), to file amended returns for 2019. If the farmer received a 6-month extension of time to file that extended the due date of the 2019 return to October 15, 2020, they have until October 15, 2023, to amend the 2019 tax return.

Note

Election to Forgo the Farming NOL Carryback

As noted earlier in this chapter, the election to forgo the farming NOL carryback must be made on the tax return for the year the NOL occurred or on an amended return for that year filed within 6 months (excluding extensions) of the due date for the original return. A calendar year taxpayer has until October 15, 2022, to elect on an amended return to forgo the carryback of a 2021 NOL. If this deadline is not met, the taxpayer cannot forgo the carryback.

NOL Carried Between Joint and Separate Returns

If the taxpayer's filing status is not the same in the loss year and all of the carryback or carryforward years, allocations may be required. If you and your spouse were married and filed a joint return for each year involved in figuring NOL carrybacks and carryovers, figure the NOL deduction on a joint return as you would for an individual. However, treat the NOL deduction as a joint NOL. If you and your spouse were married and filed separate returns for each year involved in figuring NOL carrybacks and carryovers, the spouse who sustained the loss may take the NOL deduction on a separate return.

Taxpayers who file a joint return for at least one of the years involved in an NOL calculation and its carryback or carryforward period and file a separate return or file a return as a person who is not married for at least one of those years may need to allocate the NOL, income, and deductions, or the modified taxable income between the spouses.

Separate Returns May Reduce Tax Liability

If one spouse has an NOL and their joint income without the loss is lower than their average annual income, it may be advantageous to file separate returns in the NOL year. By filing separate returns, the NOL can be carried to another tax year to reduce income in a tax bracket higher than the joint income bracket of the NOL year.

Example 10.4: Separate Returns

Tom and Mary Katt have no children, do not itemize deductions, and are both under age 65. Figure 10.3 shows their AGI for 2021 (the loss year) and 2019 (the first carryback year for their farm NOL). Mary's income is from wages.

Figure 10.3. Tom and Mary Katt's AGI

	2021	2019
Tom	–$20,000	$30,000
Mary	21,500	40,000
Total	$ 1,500	$70,000

If Tom files a separate 2021 return, his NOL is $20,000.

If Tom and Mary file a joint return for 2021, their income tax is zero after taking the standard deduction, but there is no NOL to carry back. Therefore, their AGI for 2019 (the carryback year) is still $70,000.

If Tom and Mary file separate returns for the loss year (2021), Mary has some federal income tax, and Tom has a $20,000 NOL to carry back. The NOL deduction reduces their 2019 joint AGI to $50,000.

Making Optimal Use of an NOL Deduction

The tax benefit of an NOL can be squandered if other tax benefits are used in the loss year or in a year the NOL deduction is claimed. Other tax benefits may waste NOLs in two ways.

1. They may reduce an NOL in a loss year, even though they do not reduce taxable income in that or any other year.
2. In the years that an NOL deduction is claimed (the carryback and carryforward years), other tax benefits may reduce the NOL to be carried to subsequent years even though they do not reduce taxable income in that year or any other year.

Because some of those tax benefits could be shifted to another tax year, it is useful to know which waste NOLs.

Excess Nonbusiness Deductions and Losses

If nonbusiness deductions exceed the total of nonbusiness ordinary income plus excess nonbusiness capital gains in an NOL year, **the excess nonbusiness deductions will never provide a tax benefit**.

Shifting Nonbusiness Deductions Away from Loss Year

One way to benefit from the excess nonbusiness deductions is to shift them to another tax year. If those deductions are shifted to a year with no NOL, they will offset taxable income in that year. If they are shifted to a year when there is an NOL, but nonbusiness ordinary income plus net nonbusiness capital gains exceed nonbusiness deductions, they will increase the NOL.

Shifting excess nonbusiness deductions involves the same kind of tax planning as bunching itemized deductions every other year and claiming the standard deduction in the alternate years. Therefore, deductions you may be able to shift away from the NOL year include medical expenses, taxes, interest expenses, and charitable contributions. Shifting other non-business deductions such as alimony payments (if deductible) away from the NOL year can also help reduce nonbusiness deductions down to nonbusiness income. If you are making less than the maximum retirement plan contributions each year, contributions could be bunched in the years where they would offset taxable income or add to the NOL.

Example 10.5: Shifting Nonbusiness Deductions

Guy and Barb Wire's tax adviser projects that they will have a $20,000 NOL for 2021. They have $16,000 of itemized deductions, including $3,500 in real estate taxes that can be paid in 2021 or postponed until 2022. Their only nonbusiness income is $2,000 of interest income.

The $14,000 of itemized deductions in excess of their $2,000 interest income provides no tax benefit—they do not increase the Wires' 2021 NOL and do not reduce taxable income in 2021. If Guy and Barb postpone paying the $3,500 of real estate taxes until 2022 and have $3,500 or more taxable income in 2022, they can preserve the tax benefit by deducting the taxes. Shifting the $3,500 payment to 2022 does not affect their 2021 NOL (it is still $20,000) but allows them to deduct the $3,500 from their 2022 taxable income. If they are in the 10% federal income tax bracket in 2022, the deduction will save them $350 ($3,500 × 10%) of federal income taxes.

Barb and Guy could further reduce their 2022 taxable income without decreasing their 2021 NOL by shifting to $11,500 of other nonbusiness deductions to 2022.

Shifting Nonbusiness Income to Loss Year

The problem of losing the benefits of a deduction because nonbusiness deductions exceed non-business income and net nonbusiness capital gains can also be alleviated by increasing the total amount of nonbusiness ordinary income and nonbusiness capital gains in the loss year. Such an increase will be effectively tax-free until the sum of nonbusiness ordinary income and excess nonbusiness capital gains equals nonbusiness deductions.

If nonbusiness ordinary income or nonbusiness capital gains are shifted from a year without an NOL to an NOL year in which nonbusiness deductions exceed the total of nonbusiness ordinary income and net nonbusiness capital gains, the shifted income is tax-free. The same result occurs if nonbusiness ordinary income is shifted from an NOL year with an excess of nonbusiness ordinary income and net nonbusiness capital gains over nonbusiness deductions.

Example 10.6: Shifting Nonbusiness Capital Gain

Guy and Barb Wire from Example 10.5 have 100 shares of XYZ stock with a $45,000 income tax basis and is currently worth $50,000. If they sell that stock in 2021, the $5,000 capital gain ($50,000 – $45,000) does not increase their income taxes for 2021 and does not reduce their 2021 NOL. Therefore, the $5,000 gain is effectively tax-free.

Guy and Barb could repurchase $50,000 of XYZ stock or make another investment. In either case, they would have a $50,000 income tax basis in the new investment. If they later sell the new investment for $50,000 or more, their gain is $5,000 less than it would have been if they kept the original XYZ stock with a $45,000 income tax basis and subsequently sold it for the same amount as the new investment.

Shifting Nonbusiness Capital Losses

Nonbusiness capital losses in excess of nonbusiness capital gains provide no tax benefit in an NOL year because they are not allowed as part of the NOL computation. If those capital losses are shifted to a year when there is no NOL, or to an NOL year with excess nonbusiness capital gains, the losses will provide a tax benefit.

Example 10.7: Shifting Nonbusiness Capital Losses

The projected $20,000 NOL for Guy and Barb Wire in Example 10.5 includes a planned sale of RST stock for a $900 capital loss. Guy and Barb will get no tax benefit from that capital loss in 2021. It does not increase their 2021 NOL and is not carried over as a capital loss carryover because Guy and Barb have business capital gains in 2021 that give them a net capital gain for 2021. Because they have the NOL, it does not reduce taxable income in 2021.

If Guy and Barb postpone the sale of the RST stock until 2022, they still have a $20,000 NOL for 2021, and the $900 capital loss in 2022 will reduce their taxable income.

Waiving Carryback May Reduce Tax Liability

In some cases, an NOL deduction is more useful to the taxpayer following the NOL year than in the carryback years because of the higher tax rates imposed in higher income years. If the carryback years have low income compared to the income expected in the carryforward years, forgoing the carryback is advantageous.

Capital losses in the carryback or carryforward years may keep a taxpayer from realizing the full benefit of the NOL deduction in those years. Similarly, the NOL deduction may cause the loss of a tax credit that cannot be carried beyond its carryback or carryforward year. In these cases, the election can minimize the loss of the NOL deduction or credit.

Sometimes, the taxpayer may not expect to realize enough taxable income in the carryforward years to absorb the NOL. In those cases, the NOL should be carried back to the low-income years to reduce low-bracket income rather than be completely wasted.

Because the timing of the tax savings differs between carrying an NOL back and carrying it forward, the present value of the tax savings should be computed to compare the options. If the NOL is carried back, the tax savings will be received shortly after filing the refund claim. If the NOL is carried forward, the tax savings are realized when taxes would otherwise be paid in the carryforward years. The NOL deduction can be used to reduce quarterly estimated tax payments, or it can be used to reduce the tax paid or increase the refund received when the carryforward year return is filed. In either case, the present value is less than the face amount of the tax savings.

To compare the value of future tax savings with the value of refunds from previous years, you or your tax adviser should calculate the present value of future tax savings as of April 15 of the year following the NOL year.

Control Timing of NOL

If you have some choice in determining the tax year that an NOL is realized, it should occur in the year that results in deductions that will generate the greatest tax benefit. The years in which an NOL deduction generates the greatest benefit are those with the highest taxable income (and therefore in the highest marginal bracket) and those with little long-term capital gain or tax credits that will waste the NOL. For example, if a farmer's marginal tax rate was higher in 2020 than in 2021, accelerating an NOL into 2022 instead of delaying it to 2023 will cause the loss to offset the higher bracket 2020 income instead of the lower bracket 2021 income.

Farm Corporations and NOLs

A farm corporation generally figures and deducts an NOL like an individual, estate, or trust does. The two-year carryback and indefinite carryforward periods apply, and the same sequence applies when the corporation carries two or more NOLs to the same year.

A corporation's NOL differs from an individual, estate, and trust NOLs in the following ways:

1. A corporation can take different deductions when figuring an NOL.
2. A corporation must modify its taxable income in the carryback or carryforward year when figuring how much of the NOL is used and how much is carried over to the next year.
3. A corporation uses different forms when claiming an NOL deduction.
4. A corporation is not subject to section 461, which limits the amount of losses from the trades or businesses of noncorporate taxpayers.

Figuring the NOL

A corporation figures an NOL like it figures taxable income, starting with its gross income and subtracting its deductions. If its deductions exceed its gross income, the corporation has an NOL. However, the following rules for figuring the NOL apply:

1. A corporation cannot increase its current year NOL by carrybacks or carryovers from other years.
2. A corporation can take the deduction for dividends received, explained later, without regard to the aggregate limits based on taxable income that generally apply to this deduction.
3. A public utility corporation can figure its deduction for dividends paid on certain preferred stock without limiting it to its taxable income for the year.

Dividends-Received Deduction

A corporation's deduction for dividends received from domestic corporations is generally subject to an aggregate limit of either 50% or 65% of taxable income. However, if a corporation has an NOL for a tax year, the limit based on taxable income does not apply. In determining if a corporation has an NOL, the corporation figures the dividends-received deduction without regard to the applicable taxable income limit.

Claiming the NOL Deduction

If a corporation carries an NOL back, it can file Form 1139, Corporation Application for Tentative Refund, or Form 1120X, Amended U.S. Corporation Income Tax Return. Suppose a corporation expects to have an NOL in its current year. In that case, it can automatically extend the time for paying all or part of its income tax for the immediately preceding year. It does this by filing Form 1138, Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback.

Figuring the NOL Carryover

If an NOL available for a carryback or carryforward year is greater than the taxable income for that year, the corporation must modify its taxable income to figure how much of the NOL it will use up in that year and how much it can carry over to the next tax year. Its carryover is the excess of the available NOL over its modified taxable income for the carryback or carryforward year.

Modified Taxable Income

A corporation figures its modified taxable income the same way it calculates its taxable income, with the following exceptions:

1. It can deduct NOLs only from years before the NOL year whose carryover is being figured.
2. The corporation figures its deduction for charitable contributions without considering any NOL carrybacks.

Modified taxable income for any year cannot be less than zero. Modified taxable income is used only to figure how much of an NOL the corporation uses up in the carryback or carryforward year and how much it carries to the following year. It is not used to fill out the corporation's tax return or figure its tax.

Ownership Change

A loss corporation (one with cumulative losses) that has an ownership change is limited on the taxable income it can offset by NOL carryforwards arising before the date of the ownership change. This limit applies to any year ending after the change of ownership.

Summary

Planning the timing of income, deductions, gains, and losses can maximize the benefit of the NOL rules.

Certain tax benefits are removed to determine the NOL that is carried to the first eligible year and the NOL carried to each subsequent year. Whether the NOL is expressed as a positive number (i.e., as a deduction) or a negative number (i.e., as the taxable loss), the removal of the other tax benefits decreases the NOL.

The NOL deduction claimed in any carryback or carryforward year is not necessarily the amount of the NOL that is absorbed that year. A year to which the NOL is carried can use more of the NOL than that year's taxable income before modifications.

Table of Contents: Chapter 11

CHAPTER 11

INCOME TAX CONSEQUENCES OF FARM FINANCIAL DISTRESS

Introduction

Farmers often face significant income tax consequences from financial distress transactions. The two most common income tax consequences from these transactions are:

1. the recognition of gain or loss from transfer of assets, and
2. discharge of indebtedness income.

Recognition of Gain or Loss from Transfer of Assets

The rules that require the recognition of gain or loss as a result of transferring assets in financial distress are the same as those that apply to transfers outside of financial distress.

Example 11.1: Transfer of Assets

Danica Distress previously weathered financial setbacks by tapping her secured line of credit with her local bank. However, she has reached the limit of that credit and now wants to know the income tax consequences of selling her assets to pay her debts. She has $500,000 of secured debt. Her assets are shown below.

Danica's Assets

Asset	Fair Market Value	Basis
Stored grain	$20,000	$0
Raised herd	90,000	0
Machinery	75,000	20,000
Land	300,000	80,000
Total	$485,000	$100,000

Danica is married and files a joint federal income tax return with her husband Dillon, who earns $30,000 a year from an off-farm job. He has enough federal income tax withheld from his paycheck to pay the federal income tax on all of their income, the FICA taxes on his wages, and the self-employment tax on Danica's $10,000 of farm income. They have two children.

If Danica sells all of her assets for their $485,000 fair market value, she and Dillon will owe an additional $75,174 of federal taxes on the $385,000 ($485,000 – $100,000 basis) gain (tax calculations approximate). However, all $485,000 of the sales proceeds will go to her secured creditors to reduce the debt owed to them from $500,000 to $15,000. After paying $485,000 of debt with the sale proceeds, Danica will still owe $90,174 ($75,174 + $15,000) in taxes and lender debt.

Tax Planning for Gain on Transfer of Assets

Tax planning for the gain on the sale of assets because of financial distress is the same as planning for the sale of assets outside of financial distress. Two particularly useful strategies are income averaging and timing of income.

Income Averaging

The income-averaging rules allow farmers to use tax brackets from the 3 prior years to compute taxes on some or all of the current-year electable farm income. Therefore, income in the high brackets of the current year can be taxed at lower rates.

Cross-Reference

See Chapter 7 of this book for an explanation of the income-averaging rules.

Timing of Income

If farmers can control the timing of asset sales, they may delay selling some assets until the following tax year to save both income taxes and self-employment (SE) taxes.

Bunching up SE income in one year can push some of that income above the social security wage base, which is $160,200 for 2023. Earned income above the wage base is subject to a 2.9% SE tax rate instead of the 15.3% tax rate that applies to earned income up to $160,200. The income-averaging rules can then be used to reduce the income tax rate on the income that is pushed into a higher tax bracket by the bunching of income.

Example 11.2: Bunching Self-Employment Income

Sven Olssen has potentially $160,200 of net earnings from self-employment in Year 1, and $100,000 of net earnings from self-employment in Year 2. He had no investment income. If the tax rate is 15.3% in both years, his SE tax would be $24,511 ($160,200 × 15.3%) in Year 1 and $15,300 ($100,000 × 15.3%) in Year 2, for a total of $39,811.

If he can bunch the net earnings from self-employment into one tax year, his SE tax would be $27,411 ($24,511 on the first $160,200, plus $2,900 on the remaining $100,000). That is a $12,400 ($39,811 – $27,411) reduction in his SE tax.

Bunching up ordinary income has the added advantage of emptying the 12% regular income tax bracket for the following year so that long-term capital gains in the following year qualify for the lower tax rate for capital gains, which is 0% in 2022 and 2023.

The federal income tax rate on long-term capital gains and qualified dividends is the lesser of the ordinary income tax rate or the tax rate for long-term capital gain. For 2022, the tax rate for most long-term capital gains is 0% for eligible gains and dividends included in total taxable income that does not exceed the $83,350 for Married Filing Jointly (MFJ) filed returns or $41,675 for single individuals. It is 15% for eligible long-term capital gains and dividends included in income that would be above $83,350 for MFJ filed returns or above $41,675 for single filers.

Figure 11.1. 2022 Long Term Capital Gain Rates

2022 Long Term Capital Gains Rates						
	Single/Individual		Married Filing Jointly		Head of Household	
	Above	Top	Above	Top	Above	Top
0%	$ -	$ 41,675.00	$ -	$ 83,350.00	$ -	$ 55,800.00
15%	$ 41,676.00	$459,750.00	$ 83,351.00	$ 517,200.00	$ 55,801.00	$ 488,500.00
20%	$459,751.00	And Up	$517,201.00	And Up	$ 488,501.00	And Up

*There are higher capital gain rates for collectibles. Long-term capital gains for C-corporations are treated at the same tax rate as ordinary income.

Example 11.3: Tax Rate on Capital Gain

In 2022, Carlos and Virginia Little Otter have $25,000 of long-term capital gains, in addition to $80,000 of ordinary income. The top of the 0% tax rate for long-term capital gain is $83,350 (total of ordinary income and capital gain income) for married filing jointly; any gain that falls above that amount will be treated at a 15% tax rate until $517,200 of total income, where a 20% tax rate will be applied.

The Little Otters' have $80,000 of ordinary income and $25,000 of long-term capital gain income. Since the $80,000 of ordinary income is below the $83,350 (see below) there is $3,350 of the long-term capital gain income that will be taxed at a 0% tax rate and the remaining long-term capital gain income will be taxed at a 15% tax rate since it is below the $517,200.

Ordinary Income ($80,000)		
Tax on Ordinary Income		
$20,550 at 10% (of the $80,000)	$2,055.00	
$59,450 at 12% ($80,000 - $20,550)	$7,134.00	
Total Tax Owed on Ordinary Income	$9,189.00	$9,189.00
Long-Term Capital Gain (LTCG) ($25,000)		
$3,350 of capital gain ($83,350 – $80,000) = ($3,350 * 0%)	$0.00	
$21,650 ($25,000 - $3,350) * 15%	$3,247.50	
Total Tax Owed on Long-Term Capital Gain	$3,247.50	$3,247.50
Total of all Taxes Owed ($3,247.50 LTCG + $9,189 Ordinary Inc):		$12,436.50

Bunching up ordinary income may create a situation where you owe additional taxes. If you have net investment income you may owe the 3.8% Net Investment Income Tax (NIIT) on the lesser of your net investment income or the amount your Modified Adjusted Gross Income (MAGI) exceeds the annual threshold. The 2022 threshold is $250,000 for married filing jointly and $200,000 for single.

Net investment income includes gross income from interest, dividends, capital gains, rental and royalty income, nonqualified annuities, and income from passive activities minus allowable expenses.

Discharge of Indebtedness Income

Creditors sometimes forgive or discharge some or all of a financially distressed taxpayer's debt because the taxpayer is unable to pay or because the cost of collecting the debt is more than the debt. For income tax purposes, if a creditor forgives debt for any reason other than for the purpose of making a gift to the debtor, the discharged debt is potentially included in taxable income as cancellation of debt income (CODI). Cancellation of debt may also occur because of foreclosure, repossession, abandonment, or voluntary transfer of the property to the lender.

When debt is canceled the creditor may send you a Form 1099-C, Cancellation of Debt, showing the amount and date of debt cancelled. Whether or not you receive a correct Form 1099-C, you are responsible for reporting the taxable amount of canceled debt as income on your tax return for the year the cancellation occurs.

If your debt was secured by property, and the creditor takes that property in full or partial satisfaction of your debt, you are treated as having sold that property to the creditor. The tax treatment depends on whether you were personally liable for the debt (recourse debt) or not personally liable for the debt (nonrecourse debt).

For a recourse debt, the amount realized is the fair market value (FMV) of the property. You must include this cancellation of debt in your income unless an exception or exclusion applies (see below). Ordinary income from the cancellation of the debt is the amount of the debt in excess of the FMV of the property the lender repossessed. Gain or loss on the disposition of the property is the difference between the FMV and adjusted basis (usually your cost).

Example 11.4: Repossession of Assets

Paige Turner borrowed $100,000 from her bank to buy a $120,000 tractor in 2017. In 2021, she was unable to make the payments on the loan and the bank repossessed the tractor. At the time of repossession, the remaining debt was $75,000 and the tractor's fair market value (FMV) was $50,000. The bank decided to not pursue a claim for payment of the rest of the debt because Paige was insolvent.

For income tax purposes, Paige is treated as selling the tractor to the bank for its $50,000 FMV and then using the $50,000 to pay that much of her $75,000 debt. The remaining $25,000 of debt is potentially CODI.

Paige had claimed $68,544 of depreciation on the tractor before 2021, and she can claim $7,350 of depreciation for 2021 (half-year convention and the fifth year of 7-year property). Her adjusted basis in the tractor then is $44,106 ($120,000 –$68,544 – $7,350), and she has a $5,894 ($50,000 – $44,106) gain on the deemed sale. The depreciation recapture rules treat all of that gain as ordinary income.

For a nonrecourse debt, the amount realized is the entire amount of the nonrecourse debt plus the amount of cash and the FMV of any property you received. You will not have ordinary income resulting from debt cancellation.

Exceptions to Recognition of CODI

If any of the following exceptions apply, the debtor does not have to include CODI in income.

1. A deduction for the amount paid would be allowable if the taxpayer paid the debt that was discharged. Examples include feed or other farm inputs purchased on credit from the seller and interest on a loan.
2. The debt was discharged in bankruptcy.
3. The debtor was insolvent at the time the debt was discharged.
4. The seller of property under an installment contract discharged the debt, and the original purchaser under the contract owed the debt that was discharged.
5. The debt discharged is *qualified farm indebtedness*.
6. The debtor is not a C corporation, and the debt discharged is *qualified real property business indebtedness*.

If discharged debt qualifies for more than one of these exceptions, the first applicable exception in the list is applied to the discharged debt.

> **Example 11.5: Qualified Farm Debt**
>
> Because the $25,000 of debt that was discharged in Example 11.4 was discharged while Paige was insolvent, Paige does not have to include the $25,000 CODI in her gross income, although she must record it on her federal income tax return.

Paying the Price

In most cases, the taxpayer must pay a price for not recognizing CODI. The price is a reduction of the taxpayer's following tax attributes:

1. Net operating loss (NOL): Any NOL for the tax year of the discharge, and any NOL carryover to such year.
2. General business credit: Any carryover to or from the tax year of debt discharge of an amount includable in determining the amount allowable as a general business credit.
3. Minimum tax credit: The amount of the minimum tax credit available at the beginning of the tax year immediately following the tax year of the discharge.
4. Capital loss carryovers: Any net capital loss for the tax year of the discharge, and any capital loss carryover to such year.
5. Basis reduction: The basis of the taxpayer's property.
6. Passive activity loss and credit carryovers: Any passive activity loss or credit carryover of the taxpayer from the tax year of the discharge.
7. Foreign tax credit carryovers: Any carryover to or from the tax year of the discharge for determining the amount allowable as a foreign tax credit.

Credits are reduced $1 for every $3 of CODI that is excluded from income. The other tax attributes are reduced $1 for every $1 of CODI that is excluded from income. The CODI exclusion and tax attribute reductions are reported on IRS Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness.

Order of Reduction

The general rule is that the tax attributes are reduced in the order listed. However, a taxpayer can elect to reduce the basis in depreciable property first.

> **Example 11.6: Attribute Reduction**
>
> Paige (from Example 11.4) must reduce her tax attributes to pay the price for not including the $25,000 discharged debt in her gross income. If she has no NOL, general business credit, minimum tax credit, or capital loss carryovers, she must reduce the basis in her farm assets by $25,000.

Limit on Basis Reduction

If the debt discharge is excluded from income under the bankruptcy or insolvency exceptions, a limit applies to the reduction of basis in assets. The aggregate basis in the taxpayer's assets is reduced only down to the remaining debt after the discharge, so that the taxpayer's assets may equal his or her remaining liabilities.

Timing

The attribute reduction occurs after taxes are computed for the year of the debt discharge. Therefore, the attributes are used on the tax return before they are subject to reduction under the CODI rules.

Example 11.7: Timing of Attribute Reduction

Paige (from Example 11.4) must reduce the basis in her assets after she has claimed depreciation for 2021 and calculated gain on sale of assets in 2021. Assume that she had only one asset after the tractor was repossessed: land with a $60,000 basis and a $100,000 FMV.

If Paige sells the land in 2021 (the same year the tractor was repossessed), she must recognize $40,000 ($100,000 – $60,000) of gain on the land. She then has no basis in assets to reduce and therefore does not have to pay a price for not recognizing the $25,000 of CODI.

If she waits until 2022 to sell the land, she must reduce its basis by $25,000 at the end of 2021 (to pay the price of excluding the CODI from her taxable income). She will then have a $65,000 ($100,000 – $35,000 reduced basis) gain to report on her 2022 income tax return.

Summary

Farmers in financial distress face income tax consequences from transferring their assets as well as from cancellation of debt. Those taxes can be minimized by planning the timing of the transfers and the cancellation of debt, as well as by electing income tax options that reduce taxes. To make the best use of the tax-planning opportunities, it is important for farmers to consult their tax advisers before they enter into transactions to restructure their debt.

Table of Contents: Chapter 12

CHAPTER 12

BUYING AND SELLING A FARM

Introduction

The purchase and/or sale of a farm are major economic events for most producers and have significant tax consequences for both the buyer and seller. This chapter provides an introduction to the issues buyers and sellers face when they buy or sell a farm.

Allocation of Purchase Price

The buyer and the seller of a group of farm assets must each allocate the purchase price among the assets involved. The seller must know the sales price of the individual assets to separately calculate the gain or loss on each asset. The buyer must know the purchase price of each asset to determine its basis.

If the buyer and the seller are unrelated parties, they generally have divergent economic interests. The seller would like to allocate as much of the sales price as possible to assets from which gains are taxed as long-term capital gains, such as certain agricultural buildings that have been fully depreciated and land. In contrast, the purchaser would like to allocate as much of the purchase price as possible to assets for which cost-recovery deductions can be claimed as quickly as possible, such as machinery and equipment.

Generally, the buyer and seller can use any reasonable method of allocating the price. Ideally, they will agree on an allocation at the time of the sale and include that allocation in the sales agreement. If they agree in writing to an allocation, both parties must use that allocation for income tax purposes unless the IRS successfully challenges the allocation or one of the parties can show a mistake, undue influence, fraud, or duress.

However, the parties often do not discuss allocation of the overall price at the time of the sale. They then must allocate it when they report the sale or purchase on their income tax returns. The tax rules do not explicitly require the seller and the buyer to use the same allocation, but the IRS can compare the two parties' allocations and use a disparity to challenge either or both of the allocations.

Installment Sales

The seller may finance the buyer's purchase by entering into a contract that requires the buyer to make a down payment and periodic payments of principal and interest. When the buyer has made most, or all, of the payments, the seller gives the buyer a deed for the farm. Alternatively, seller financing can be documented with a deed from the seller to the buyer at the time of the sale and a promissory note from the buyer to the seller to pay the balance due with interest. The buyer also gives the seller a mortgage to secure the buyer's obligation to pay the promissory note.

The income tax treatment of a land contract and a deed with a promissory note and mortgage are identical. For income tax purposes, these sales are treated as *installment sales* if one or more payments are due in tax years following the year of the sale.

Cross-Reference

See Chapter 10 of IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the installment sale rules. Chapter 5 of this book also discusses installment sales.

Tax Consequences for Seller

Generally, a seller reports gain as principal payments are received. However, the gain from the sale of assets that have been depreciated, that is treated as ordinary income under the depreciation recapture rules, must be reported in the year of the sale. Fences, grain bins, land improvements, and single purpose agricultural or horticultural structures are often sold in conjunction with farmland, requiring depreciation recapture in the year of sale, regardless of the amount of proceeds the seller received.

A seller can elect out of installment reporting by reporting all gain from the sale on the return for the year of the sale. Sellers who report all gain in the year of the sale have no gain to report as they receive each principal payment, but they must report interest as income when it is received.

Cross-Reference

See Chapter 9 of IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the depreciation recapture rules.

Example 12.1: Installment Sale

Gabriella Muccio sold 180 acres of land to Liam Syed for $900,000 in 2022. Gabriella and Liam agreed to allocate $15,000 of the purchase price to fences that were included in the sale. Gabriella paid $30,000 for the fences and had fully depreciated that cost. Gabriella's income tax basis in the land was $200,000.

If Liam gets financing from a bank and pays Gabriella the full $900,000 purchase price, Gabriella must report $685,000 ($885,000 – $200,000) capital gain from sale of the land and $15,000 ordinary income (depreciation recapture) from sale of the fences on her income tax return for 2022. If Gabriella is single, and has $25,000 of other non-capital gain income, she would have a federal taxable income of $712,050 ($25,000 + $15,000 + $685,000 – $12,950 standard deduction).

Of her taxable income, she would have $685,000 of capital gain and $27,050 of ordinary income. Once taxable income is known, capital gain is considered first when determining how much income is taxed ordinary or capital rates. If total capital gain is less than taxable income, the difference between total taxable income and capital gain is taxed at ordinary rates. If capital gain is greater than taxable income, all income is taxed at capital gain rates. In this example, capital gain is less than taxable income, so the difference of $27,050 ($712,050 – $685,000) is ordinary income. Gabriella would have a total federal income tax liability of $108,376 from the sale. Review Figure 12.1 for her federal income tax liability calculation.

Figure 12.1. Gabriella's Federal Income Tax Calculation from an Outright Sale of Land

Ordinary income from	To	Is taxed at	Ordinary Income in this bracket	Tax on ordinary income
0	10,275	10%	2,050	205
10,275	41,775	12%	-	-
41,775	89,075	22%	-	-
89,075	170,050	24%	-	-
170,050	215,950	32%	-	-
215,950	539,900	35%	-	-
539,900	+	37%	-	-
Total Ordinary			**2,050**	**205**
Capital gain income from	To	Is taxed at	Capital gain in this bracket	Tax on capital gain
0	41,675	0%	39,625	-
41,675	459,750	15%	418,075	62,711
459,750	+	20%	227,300	45,460
Total Capital Gain			**685,000**	**108,171**
Total			***687,050***	***108,376***

(continued)

Example 12.1: Installment Sale (*continued*)

If Gabriella financed Liam's purchase of the farm, she could spread her gain from the sale of the land over the years she receives payments. (The gain from the sale of the fences must all be reported in the year of sale, even if Liam pays for them over several years.) That may allow her to take advantage of a lower tax rate on the capital gain.

For example, if she spread the capital gain over several years, she may be able to keep some of her capital gain in the zero percent bracket and limit the amount of capital gain taxed at the 15% rate. As mentioned earlier in this chapter, to determine the capital gains tax rate, you begin with all non-capital gain income. You then stack the capital gains on top of all other income on the tax return and apply the capital gains rates based upon where the capital gains fall in the brackets.

Figure 12.2. 2022 Capital Gains Rates

Capital Gains Tax Rate	Taxable Income (Single)	Taxable Income (Married Filing Joint or Qualifying Widower)	Head of Household	Married Filing Single
0%	≤$41,675	≤$83,350	≤$55,800	≤$41,675
15%	≤$459,750	≤$517,200	≤$488,500	≤$258,600
20%	> $459,750	>$517,200	>$488,500	>$258,600

If Gabriella and Liam set up a ten-year installment sale for the purchase of the farm, Gabriella will recapture depreciation on the fence (ordinary income) in year one because the fence was depreciable property. In an installment sale, a gross profit percentage is calculated by dividing the gross profit by the total contract price. Gross profit is the contract price minus any remaining basis in the assets sold minus any depreciation recapture recognized in the year of sale. For Gabriella, gross profit is $685,000 ($900,000 - $200,000 land basis - $15,000 depreciation recapture) and her gross profit percentage is 76.11% ($685,000 divided by $900,000). Any principal payment received in an installment sale is multiplied by the gross profit percentage to determine the amount of capital gain in the payment. The remaining portion of the payment is not taxable.

Assume the same facts as earlier (Gabriella is a single taxpayer and has $25,000 of non-capital gain income), except Gabriella sells the land to Liam over 10 years, with a principal payment of $90,000 plus interest due to her each year. In the year of sale, her taxable income would be $92,549 ($25,000 + $15,000 + $68,499 ($90,000 X 76.11%)). Gabriella's federal income tax liability in 2022 would be $10,312. Review Figure 12.3 for her federal income tax liability calculation.

(continued)

Example 12.1: Installment Sale (*continued*)

Figure 12.3. Gabriella's Federal Income Tax Calculation with an Installment Sale of Land

Ordinary income from	To	Is taxed at	Ordinary Income in this bracket	Tax on ordinary income
0	10,275	10%	10,275	1,028
10,275	41,775	12%	13,775	1,653
41,775	89,075	22%	-	-
89,075	170,050	24%	-	-
170,050	215,950	32%	-	-
215,950	539,900	35%	-	-
539,900	+	37%	-	-
Total Ordinary			**24,050**	**2,681**

Capital gain income from	To	Is taxed at	Capital gain in this bracket	Tax on capital gain
0	41,675	0%	17,625	-
41,675	459,750	15%	50,874	7,631
459,750	+	20%	-	-
Total Capital Gain			**68,499**	**7,631**
Total			***92,549***	***10,312***

Caution

By financing the buyer's purchase, you run the risk of the buyer defaulting on the payments.

Tax Consequences for Buyer

For the buyer, an installment purchase is treated in the same way as a purchase that is financed by a third party. The buyer of business or investment property can begin depreciating assets in the year of the purchase and can deduct the interest paid to the seller as a business or investment expense.

Example 12.2: Installment Sale

Liam (from Example 12.1) can begin depreciating the $15,000 cost of the fence in 2022, whether the purchase is financed by Gabriella or by a third party such as a bank. He can deduct the interest he pays to Gabriella, if she finances the purchase, or to the bank, if it finances the purchase.

Sale of Farm with Principal Residence

A special provision in the Internal Revenue Code for the sale of principal residences allows taxpayers to exclude up to $250,000 ($500,000 joint returns) of gain on the sale or exchange of a principal residence. To qualify, the taxpayers must have owned the residence and used it as their main home for at least 2 of the 5 years before the sale. This exclusion from income increases the incentive for owners of farms to claim that land around the personal residence as a part of the residence, rather than being used in the farming operation. By claiming more of the land as part of the personal residence, more gain can be attributed to the personal residence and therefore excluded from income up to the $250,000 or $500,000 limit.

Cross-Reference

See IRS Publication 523, *Selling Your Home*, for an explanation of the exclusion of gain on the sale of a principal residence.

Growing Crops Sold with Land

If a growing crop is included in the sale of land, part of the purchase price must be allocated to the growing crop. That allocation must be reflected in the income tax reporting of both the buyer and the seller.

Tax Consequences for Seller

Taxpayers who sell a growing crop with the land on which it is growing can treat the gain on the growing crop as long-term capital gain if the land has been held for more than a year. The growing crop must be sold, exchanged, or involuntarily converted at the same time and to the same individual as the land.

In calculating the gain from sale of the growing crop, the seller must allocate part of the purchase price to the growing crop and treat the costs of raising the crop as its income tax basis. The costs allocated to the basis of the growing crop cannot be deducted as a business expense.

Example 12.3: Sale of Growing Crop with Land

In 2022, Red Durham sold 240 acres of land with a growing winter wheat crop to his neighbor, Buck Wheat, for $4,575 per acre. Based on the value of the winter wheat crop, Red and Buck agreed in writing to allocate $325 of the per acre price (a total of $78,000) to the growing wheat crop.

Red incurred $30,000 ($125 per acre) of direct costs (seed, fertilizer, chemicals, etc.) and indirect costs (e.g., depreciation) of growing the winter wheat in 2021, and he deducted that $30,000 on his 2021 Schedule F (Form 1040). Now that Red has sold the growing crop in a transaction that qualifies for long- term capital gain treatment, he must remove the $30,000 from his deductions by amending his 2021 tax return. The $30,000 is included in his income tax basis in the growing crop.

Red also paid $18,000 ($75 per acre) for fertilizer and fungicide in 2022 for the growing wheat crop. Because Red sold the growing crop, he cannot deduct that $18,000. Instead, he adds it to the basis of his growing crop, which gives him a $48,000 ($30,000 + $18,000) income tax basis in the crop.

Red calculates his $30,000 gain on the sale of the growing crop by subtracting his $48,000 income tax basis from the $78,000 purchase price allocated to the growing crop. He nets that gain with the gains and losses from other sales of property used in the farming business (including the gain from the sale of the land). A net gain is treated as long-term capital gain to the extent it exceeds losses reported from sales of property used in the farming business in the previous five years. A net loss is treated as an ordinary loss.

Tax Consequences for Buyer

The buyer of land with a growing crop has a basis in the growing crop equal to the portion of the purchase price that is allocated to the growing crop. If the buyer of the land sells the crop, the basis reduces the income he or she must report from that sale. If the buyer of the land feeds the crop to livestock, he or she can deduct the allocable cost as an expense of raising the livestock.

Example 12.4: Purchase of Growing Crop with Land

Buck Wheat (the buyer in Example 12.3) has a $78,000 basis (the price he and Red agreed to allocate to the growing crop) in the wheat. When Buck harvested the winter wheat, he sold it for $100,000. He must report the $100,000 sale price on line 1, his $78,000 basis on line 2, and the resulting $22,000 gain on line 3 of Schedule F (Form 1040).

If Buck fed the wheat to his livestock in 2022 (the same year he purchased the land and growing crop), he can deduct the $78,000 income tax basis in the wheat on his 2022 income tax return.

If Buck fed part, or all, of the wheat to his livestock in 2023 (the year after he purchased the land and the growing crop), it is not clear when he can claim the deduction. Buck could take the position that he can deduct the entire basis in 2022 (the year he purchased the crop with the intent to feed it to livestock), but the IRS may allow him to deduct the basis only in 2023 (the year he uses the wheat as feed).

Like-Kind Exchange of Real Property

Taxpayers who do not need or want immediate cash from the sale of a farm can delay recognizing the gain by rolling the sales price into *like-kind* property. The deferred gain is rolled over by carrying the basis of the relinquished property into the basis of the replacement property. If the taxpayer never disposes of the replacement property, the taxpayer's heirs can avoid recognizing the deferred gain through the tax law provision for a basis adjustment to date-of-death fair market value.

The tax rules that allow the gain to be rolled to replacement property have a variety of labels, including tax-free exchange, like-kind exchange, and 1031 exchange (after §1031 of the Internal Revenue Code). More complex 1031 exchanges are called deferred like-kind exchanges, Starker exchanges, or reverse deferred exchanges.

Cross-Reference

See Nontaxable Exchanges in IRS Publication 544, *Sales and Other Dispositions of Assets* (for 2021), for an explanation of the like-kind exchange rules. Also see Chapter 7 of this book.

For real property, the term *like-kind* is interpreted very broadly. Any real estate can be exchanged for any other real estate as long as both the relinquished property and the replacement property are used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate and improved real estate can be exchanged for unimproved real estate, although there may be some immediate tax impact when a property with certain depreciable improvements is exchanged for bare, or unimproved, land.

Example 12.5: Exchange of Real Property

Alva Babcock plans to sell bare farmland that has a $100,000 income tax basis and is worth $500,000. She wants to invest the proceeds in an apartment building. The farmland and apartment building are like-kind property. Therefore, if she exchanges the farmland for an apartment building that is worth $500,000, she does not have to recognize the $400,000 gain on her farmland. Her income tax basis in the apartment building is $100,000.

Requirements

A transaction does not qualify as a like-kind exchange to the extent the taxpayer receives cash or unlike property.

Example 12.6: Exchange of Real Property

Assume the same facts as example 12.5, except the apartment building is worth $450,000. After the exchange is complete, Alva receives $50,000 in cash. Her income tax basis in the apartment building is $100,000 (carryover basis from the land given up in the exchange). She will recognize gain of $50,000 (cash received) from the exchange.

To qualify as a deferred like-kind exchange, the taxpayer must carefully comply with detailed rules that require the services of a knowledgeable professional. In general, those rules require the taxpayer to identify the replacement property within 45 days and to acquire ownership of the replacement property within 180 days of selling the relinquished property.

Caution

Taxpayer Cannot Possess Sale Proceeds

It is imperative that the taxpayer use a qualified intermediary and never have possession of the sale proceeds prior to completion of the exchange. If a taxpayer sells a farm and receives the sales proceeds, rather than the qualified intermediary, he or she cannot defer gain recognition by using the proceeds to purchase replacement property. Therefore, taxpayers should seek the counsel of a qualified professional before entering into any agreement to sell a farm if they plan to roll the gain into replacement property under the like-kind exchange rules.

Summary

Income tax planning is as important in buying and selling a farm as it is in operating a farm. Sellers can **defer** recognizing their gain by making an installment sale, **avoid** recognizing their gain on the sale of their principal residence, or **roll** their gain on business or investment property into replacement property through a like-kind exchange.

Buyers can reduce their taxable income after the purchase by depreciating the portion of their purchase price that is properly allocated to the depreciable property included in the purchase.

Table of Contents: Chapter 13

CHAPTER 13
TAX REPORTING AND PAYMENT

Introduction

This chapter explains a farmer's income and self-employment tax reporting obligations, including estimated taxes, entity returns, and information returns.

Cross-Reference

For more information, see the sample income tax return at www.ruraltax.org.

Filing Requirements for Individual Income Tax Returns

Filing Threshold

Taxpayers are required to file federal income tax returns if their gross income is equal to or greater than a filing threshold. In general terms, a farmer's gross income is the total proceeds from the sale of commodities plus gain on the sale of breeding livestock, equipment, land, and buildings. Off-farm income should also be added to the farm income before looking at the filing threshold. If you meet the gross income requirement, you must file a federal income tax return even if your deductions reduce your income and self-employment taxes to zero.

Filing thresholds are equal to the standard deduction (except for taxpayers who are married and file separate returns) Therefore, they vary by filing status and are adjusted each year. Figure 13.1 shows filing thresholds for 2022 based on filing status.

Figure 13.1. Components of Filing Thresholds (2022)

Filing Status	Standard Deduction	Additional Standard Deduction	Total
Married individual, separate return	$ 12,950	$ 0	$ $ 12,950
Single individual	12,950	0	12,950
Single individual, 65 or older	12,950	1,750	14,700
Head of household	19,400	0	19,400
Head of household, 65 or older	19,400	1,750	21,150
Qualifying widow (er)	25,900	0	25,900
Qualifying widow (er), 65 or older	25,900	1,400	27,300
Married couple, joint return	25,900	0	25,900
Married couple, joint return, one spouse 65 or older	27,300	0	27,300
Married couple, joint return, both spouses 65 or older	28,700	0	28,700

Example 13.1: No Net Farm Income

Red Durum is a single taxpayer who has $70,000 of gross farm income and $70,000 of farm expenses in 2022. He has no other income. Even though he has no taxable income in 2022, he is required to file a federal income tax return because his gross income exceeds $12,950.

Even with gross income below the filing threshold, there are certain situations in which you must file a federal income tax return. The most common situation for farmers is having $400 or more of net earnings from self-employment.

Example 13.2: No Taxable Income

Assume that Red, from Example 13.1, had only $9,000 of gross farm income and $6,000 of farm expenses, for a $3,000 net farm income. Red's $12,950 standard deduction reduces his taxable income below zero. However, Red is still required to file a tax return because he has more than $400 of earnings from self-employment.

You should file a return even though you do not meet the filing requirements if you qualify for a tax refund due to tax withholding or a refundable credit, such as a refundable child tax credit, earned income credit, or refundable education credit.

Cross-Reference

For more information on filing requirements, see the instructions for Form 1040, U.S. Individual Income Tax Return, which are available at www.irs.gov.

Due Dates

Individual income tax returns are due on the fifteenth day of the fourth month after the end of the individual's tax year. The tax year for most individuals is the calendar year, which means that the tax return is due on April 15th of the following year. An exception applies if the taxpayer has filed bankruptcy and is filing two short tax years in the same calendar year.

Most farmers are aware of an option to file tax returns by March 1. This option exempts them from the penalty for not paying estimated taxes and is discussed later in this chapter.

Every individual taxpayer can receive an automatic extension of time to file a tax return by filing Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, by the original due date of the return. The total tax due still must be paid by the original due date, even though the exact amount due has not been calculated. Any underpayments are subject to interest and a penalty on the remaining balance that is paid when the Form 1040, U.S. Individual Income Tax Return, is filed. However, the penalty is not charged if at least 90% of the tax was paid by the due date and the remaining amount is paid when the return is filed by the extended due date.

The extension period is six months after the original due date. For individual taxpayers with a calendar tax year, the extended return must be filed by October 15th to avoid late filing penalties. The only requirement for receiving the extension is filing the application.

Penalties

There are penalties both for filing a return late and for paying a balance due late.

The late payment penalty is usually ½ of 1% of any tax (other than estimated tax) not paid by the regular due date of your return. It's charged for each month or part of a month the tax is unpaid. The maximum penalty is 25%. The late payment penalty won't be charged if you can show reasonable cause for not paying on time. Attach a statement to your return fully explaining the reason. Don't attach the statement to Form 4868. You're considered to have reasonable cause for the period covered by this automatic extension if both of the following requirements have been met.

1. At least 90% of the total tax on your 2022 return is paid on or before the regular due date of your return through withholding, estimated tax payments, or payments made with Form 4868.
2. The remaining balance is paid with your return.

A late filing penalty is usually charged if your return is filed after the due date (including extensions). The penalty is usually 5% of the amount due for each month or part of a month your return is late. The maximum penalty is 25%. If your return is more than 60 days late, the minimum penalty is $435 (adjusted for inflation) or the balance of the tax due on your return, whichever is smaller. You might not owe the penalty if you have a reasonable explanation for filing late.

Observation

No Late Penalty if No Tax Due

If there is no tax due with the return because the tax is covered by estimated payments, tax withholding from wages or other payments, or tax credits, there are no penalties for failure to file on time.

Example 13.3: Late Filing

Red Durum, a single farmer, filed his 2021 tax return on June 16, 2022. He had not filed an application for an automatic extension. Red had a $10,000 balance due on his 2021 return, which he paid on June 30, 2012. His late filing penalty is $1,500, which is 5% of the balance due for each month or fraction of a month his return was late (3 × 5% × $10,000). Red also has a $150 late payment penalty, which is one-half of 1% for each month or fraction of a month he was late (3 × 0.5% × $10,000). The late payment penalty partially offsets the late filing penalty, so Red's total penalty is $1,500.

Statute of Limitations

The statute of limitations for the IRS to assess additional taxes after an original return is filed is generally 3 years from the original or extended due date. A return filed before the due date is treated as filed on the due date.

There is no time limit for assessing additional tax if the return was fraudulent or false, no return was filed for the year, or there was a willful attempt to evade taxes.

If a taxpayer omits an amount in excess of 25% of gross income, the assessment statute of limitations is extended to 6 years.

Filing Requirements for Entity Returns

Several entities besides a sole proprietorship can be used to conduct a farm business. These include C corporations, S corporations, partnerships, trusts, and estates. Limited liability companies (LLCs) are another option but for federal income tax purposes, they are taxed as sole proprietorships, partnerships, S corporations, or C corporations. Each of these entities has its own filing requirements, return due dates, and penalties for late filing and late payment. However, the statutes of limitations for assessment are the same for entities as for individuals.

Filing Threshold

C corporations must file Form 1120, U.S. Corporation Income Tax Return, and S corporations must file Form 1120S, U.S. Income Tax Return for an S Corporation. Corporations must file tax returns even if they have no income or have no income tax due. Inactive corporations should attach a statement stating there was no activity for the tax period.

Partnerships must file Form 1065, U.S. Return of Partnership Income, regardless of the amount of partnership taxable income.

Estates with income must file Form 1041, U.S. Income Tax Return for Estates and Trusts, if they have $600 or more of gross income. Trusts must file if they have $600 or more of gross income or any amount of taxable income. Both estates and trusts must file tax returns if any beneficiary is a nonresident alien.

Bankruptcy estates must file Form 1041 if their gross income is equal to or greater than the sum of the exemption deduction and the basic standard deduction, which is $12,950 for 2022.

Due Dates

The due date for filing a corporation tax return is the fifteenth day of the third month after the close of the tax year. For corporations that use a calendar year, this due date is March 15th. Corporations often have fiscal years that are different from the calendar year. For example, the due date of the return for a corporation with a fiscal year that ends on February 28 is May 15th.

Both C and S corporations may obtain an automatic 6-month extension by filing Form 7004, Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns, by the return's original due date. As with individuals, the corporation must pay any tax due by the return's due date. Any remaining balance due calculated at the time the return is filed is subject to interest and penalty, but as with individuals, the penalty is not charged if the corporation has an extension of time to file its tax return, pays at least 90% of the tax due by the regular due date of the return, and pays the remaining tax by the extended due date of the return.

The due date for filing a partnership return is the 15th day of the third month following the close of the tax year. Most partnerships are on a calendar year, for which the due date of the partnership return is March 15th. Partnerships may receive an automatic 6-month extension of time to file by filing Form 7004 by the due date of the partnership return. Partnership returns are informational returns, with each partner paying taxes on his or her prorated share of income. This information is reported to each partner on Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc.

Trusts and estates with income must file Form 1041 by the 15th day of the fourth month following the close of the tax year. Estates and trusts may obtain an automatic 5½-month extension by filing Form 7004 by the due date.

Penalties

The late filing penalty for C corporations is 5% of the unpaid tax for each month, or fraction of a month, the return is filed after the due date (including any extension), up to a maximum of 25%. The minimum penalty for a return that is filed late is the smaller of the tax due or $435. The late payment penalty is one-half of 1% of the unpaid balance for each month, or fraction of a month, after the return due date, up to a maximum of 25%. If the return is filed late and the tax is paid late, the late payment penalty partially offsets the late filing penalty, so that the combined penalty is limited to 5% of the unpaid balance per month or part of a month.

The penalty for failing to file a partnership return by the due date, including extensions, or filing a return that fails to show all the information required, is $210 for each month, or part of a month, the failure continues times the number of partners, up to 12 months.

The penalty for filing an S corporation return late is $210 per month, or part of a month, times the number of shareholders, up to 12 months. If any S corporation taxes are due, the penalty is the amount stated above, plus 5% of the unpaid tax for each month or part of a month, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or $435 late payment. If any S corporation taxes are due, a late payment penalty of 0.5% of unpaid tax per month, or part of a month, applies up to a maximum of 25% of the unpaid tax.

Trusts and estates are subject to the same late filing and late payment penalties that apply to individuals and C corporations.

Where to Report Income and Expenses

Farmers generally report their income and expenses on Schedule F (Form 1040), Profit or Loss From Farming. However, there are several exceptions that are discussed in this section. Reporting income and expenses on the proper tax form is important because the tax rules differ for the various forms.

Schedule F (Form 1040), Profit or Loss From Farming

Farmers report the income received and the expenses incurred in the ordinary course of a farming business on Schedule F (Form 1040). The types of income reportable on Schedule F (Form 1040) include revenue from the sale of livestock and commodities that were raised to be sold in the ordinary course of the farming business, government payments, patronage dividends, and per-unit retains from cooperatives.

Farmers should **not** report the proceeds from selling assets used in the farming business on Schedule F (Form 1040). Those proceeds are reported on Form 4797, Sales of Business Property. Assets used in the farming business include breeding, dairy, and draft livestock; machinery; and real property (land and improvements on the land, such as buildings, fences, tile lines, and grain bins).

Expenses reportable on Schedule F (Form 1040) include the costs of raising the livestock and commodities that are raised to be sold in the ordinary course of the farming business and the costs of raising and maintaining draft, breeding, or dairy animals. Depreciation of buildings, machinery, and other assets used in the farming business is deducted on Schedule F (Form 1040), as is the cost of repairing those assets.

Schedule C (Form 1040), Profit or Loss From Business

If a farmer engages in a business activity that is not farming, the income and expenses for that activity are reported on Schedule C (Form 1040). Any processing of a commodity that was raised on the farm beyond the stage required to make it marketable as a commodity is a non-farming business. For example, if you raise grapes and use them to make wine, you should report the income and expenses from the grape production on Schedule F (Form 1040) and the income and expenses from making wine on Schedule C (Form 1040).

Form 4797, Sales of Business Property

The proceeds from selling assets used in the farming business — including breeding, dairy, and draft animals, machinery, and real property (land and improvements on the land such as buildings, fences, tile lines, and grain bins) — are reported on Form 4797. The gain or loss from each sale is computed by subtracting the basis of the asset from its sales proceeds.

Schedule SE (Form 1040), Self-Employment Tax

Some income from farming is subject to self-employment tax as well as income tax, and must be reported on Schedule SE (Form 1040). Self-employment income includes the net profit from farming from line 34 of Schedule F (Form 1040), a partner's share of farm income from a partnership, and a member's share of income from a limited liability company (LLC) that is taxed as a partnership.

Information Returns

Like all business operators, farmers must prepare information returns for some of the payments that they make, and they must send copies of the information return to the taxpayers they paid, as well as filing the returns with the IRS. The IRS matches the amounts on these returns with the amounts reported on the recipients' income tax returns to determine if the income was reported. Farmers who fail to file required information returns are subject to penalties.

Farmers must file Form 1099-MISC, Miscellaneous Income, or Form 1099-NEC, Nonemployee Compensation, to report several types of business expenses paid to other taxpayers. Lenders are required to file Form 1098, Mortgage Interest Statement, to report mortgage interest received in the conduct of a trade or business. Employers, including farmers who have employees, must file Form W-2, Wage and Tax Statement, to report wages paid to their employees.

The amounts reported on information returns reflect payments made during the calendar year, whether the payer reports income taxes on a fiscal year or on a calendar year.

Forms 1098 and 1099

Except for Form 1099-NEC, the information returns listed above are generally due to the IRS on February 28, for paper filers, and March 31, for electronic filers. The filing due date for Form 1099-NEC is January 31, for both paper and electronically filed returns.

Each type of Form 1099 must be grouped and filed with a separate Form 1096, Annual Summary and Transmittal of U.S. Information Returns, if paper returns are filed. For example, all Forms 1099-MISC, Miscellaneous Income, must be grouped together and filed with a Form 1096. All Forms 1099-INT, Interest Income, must be grouped together and filed with a separate Form 1096. A Form 1096 must also be filed for all 1099-NEC, Nonemployee compensation, issued by the business operator.

The recipient of the payments must provide the payer with a completed Form W-9, Request for Taxpayer Identification Number and Certification, to report his or her taxpayer identification number (TIN). If the recipient does not provide the TIN in the required manner, the payer must impose backup withholding at a 28% rate.

The 2022 penalties for failure to file correct information returns with the IRS are time-sensitive. If a return is correctly filed within 30 days of its due date, the penalty is $50 per information return. If the returns are filed more than 30 days late but before August 1, the penalty is $280 per information return. If the forms are not filed by August 1, the late filing penalty is $570 per information return.

Form 1099-MISC, Miscellaneous Income

Form 1099-MISC is used to report several types of payments of $600 or more made in the course of a trade or business. It is not filed when personal expenses are paid. Generally, it is issued only for payments made to noncorporate businesses, but there are exceptions for legal services furnished by incorporated law firms, and for medical and health care payments made to corporations by the farming business.

Form 1099-MISC is also used to report rents for real estate (including farmland, pasture, buildings, and grain storage) and equipment. Generally, payments reported as rent for real estate are not included as self-employment income by recipients.

Form 1099-NEC, Nonemployee Compensation

Form 1099-MISC is used by farmers to report non-employee compensation (payments for services made to independent contractors). Generally, these payments are for machine hire, but they also include amounts paid for professional services provided by attorneys, accountants, and crop consultants. Payments for non-employee compensation are almost always reported as self-employment income by the recipients.

Form 1099-INT, Interest Income

Form 1099-INT is filed to report interest payments of $600 or more made to individuals or noncorporate entities in the course of a trade or business. Taxpayers are not required to file Form 1099-INT for nonbusiness loans.

Form 1099-DIV, Dividends and Distributions

Corporations file Form 1099-DIV to report the dividends they pay to a shareholder. Dividends are commonly used to reduce capital in a closely held farming corporation and to make cash available to the shareholder.

Dividends paid by U.S. corporations are generally *qualified dividends*, if the recipient has held the stock for at least 61 days (91 days for preferred stock). Qualified dividends presently receive preferential tax treatment. Qualified dividends are ordinary dividends that qualify for the same 0%, 15%, or 20% maximum tax rate that applies to net capital gains.

Form 1098, Mortgage Interest Statement

Lenders use Form 1098 to report mortgage interest received in the course of a trade or business from an individual who has paid $600 or more of interest. Lenders do not have to file Form 1098 if they are not in the business of lending money. A mortgage is a loan secured by real property, including land and anything built on it.

Form 1098 is not required for interest received on loans made to a partnership, corporation, trust, or estate.

Form W-2, Wage and Tax Statement

An employer must file a Form W-2 for each employee, no matter how small the amount of wages that were paid during the calendar year. If paper Forms W-2, along with a Form W-3, Transmittal of Wage and Tax Statements, are submitted, they must be filed with the Social Security Administration by the following February 28. If the Forms W-2 are filed electronically, they must be filed by March 31.

Form W-2 must be provided to each employee by January 31, and employers must file a copy with the state tax agency as well.

Cross-Reference

For more information, see the instructions for Forms 1096, 1099-MISC, 1099-INT, 1099-DIV, W-2, and W-3, which are available at www.irs.gov.

Estimated Taxes

Most taxpayers who owe a tax of $1,000 or more after subtracting withholding and refundable credits are required to pay quarterly estimates of their taxes. Penalties apply to late payments of the estimates. Qualified farmers are not subject to the penalties if they meet certain requirements (see below).

Special Rules for Farmers

If a farmer files his or her tax return using a calendar year and pays the tax in full by March 1, the penalty for not paying estimated taxes does not apply.

A qualified farmer who wants to file on April 15th can avoid the penalty for underpayment of estimated taxes by making a single estimated payment by January 15th. This payment must equal or exceed the lesser of two-thirds of the tax due on April 15th for the current year, including self-employment tax, or 100% of the tax due for the previous year, including self-employment tax.

Example 13.4: Payment of January Estimate

For 2021, Red Durham paid $3,756 of federal income tax and $5,652 of self-employment tax, for a total of $9,408. He expects to owe $15,000 of federal income tax and self-employment tax for the 2022 tax year and will not be able to file by March 1. Because 100% of his 2021 tax is less than two-thirds of his $15,000 projected tax for 2022, $9,408 is the lowest amount Red can pay by January 15, 2023, to avoid the estimated tax penalty.

Qualified Farmer for Estimated Tax Purposes

To qualify as a farmer for estimated tax purposes, two-thirds of gross income must be received from farming for the current or previous year. The calculation is made in three steps.

First, the taxpayer must calculate gross income from all sources. The following income items are combined for this calculation:

- Wages
- Taxable interest

- Ordinary dividends
- Taxable refunds from state income tax
- Alimony received
- Gross income from business reported on Schedule C
- Capital gain income (before netting against losses)
- Gains on the sale of business property
- Taxable individual retirement account distributions, pension distributions, and social security benefits
- Gross rental and royalty income
- Taxable income from estates and trusts
- Gross farm income from Schedule F (Form 1040) and Form 4835
- Shares of gross income from partnerships, LLCs, and S corporations
- Unemployment compensation
- Other income

Next, the taxpayer must calculate gross farm income. The following income items are combined for this calculation:

- Gross income from Schedule F (Form 1040), Profit or Loss From Farming
- Gross income from Form 4835, Farm Rental Income and Expenses
- Gross farm income from partnerships, LLCs, S corporations, and trusts and estates engaged in farming
- Gains from the sale of livestock

Gains from the sale of farm equipment or land, wages received as a farm employee, and income from custom grain harvesting or hauling are not included in gross farm income.

The final step is dividing gross farm income by gross income. If this calculation results in a fraction of at least two-thirds, the taxpayer is considered a qualified farmer and is exempt from the penalty for not paying quarterly estimated taxes if he or she follows the special rules discussed in the previous section.

Example 13.5: Calculation of Qualified Farmer Status

Red Durum's gross income includes $40,000 of gross income from his Schedule F (Form 1040), and he reported $10,000 from sales of raised breeding stock on Form 4797, Sales of Business Property. In addition, he has $4,000 of interest on his savings accounts and $3,000 in wages. His gross farm income is $50,000 ($40,000 + $10,000) and his total gross income is $57,000 ($40,000 + $10,000 + $4,000 +3,000). Red is a qualified farmer for estimated tax purposes because his gross farm income is 88% ($50,000 ÷ $57,000) of his total gross income, which exceeds the two-thirds requirement.

Estimated Tax Penalty

Qualified farmers who do not make quarterly estimated tax payments but file and pay all taxes due by March 1st do not owe estimated tax penalties. Qualified farmers who do not file by March 1st, but who make a single estimated tax payment by January 15th, owe a penalty only if the payment is less than the lesser of two-thirds of the tax due for the current year or 100% of the tax for the previous year.

The penalty is calculated on Form 2210F, Underpayment of Estimated Tax by Farmers and Fishermen. It is equal to interest from January 15th to the date the balance due is paid, calculated using the amount by which the estimated payment, if any, was less than the amount required to be paid to avoid the penalty. This usually results in small penalties.

Example 13.6: Estimated Tax Penalty

Red Durum is a qualified farmer who paid $7,235 of federal income tax and self-employment tax on his 2021 income tax return. He made a $3,000 estimated federal tax payment for his 2022 taxes on January 15, 2023. On April 15, 2023, he filed his 2022 return and paid his remaining balance due of $6,008.

The lesser of the $7,235 of taxes Red paid for 2021 and two-thirds of his $9,008 taxes for 2022 is $6,005 (two-thirds of $9,008). Therefore, his underpayment was $3,005 ($6,005 – $3,000). Assuming a penalty rate of 3%, he owes an additional $22 ($3,005 × 3% × 90 days ÷ 365 days).

Cross-Reference

For more information see Chapter 15, “Estimated Tax,” of IRS Publication 225, *Farmer’s Tax Guide* (2022).