# 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.

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This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

**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

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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.

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