

Farm, Farming and Who's a Farmer for Tax Purposes*

*Guido van der Hoeven, Emeritus Extension Specialist/Senior Lecturer
Department of Agricultural and Resource Economics, NC State University*

*Revision by Mark Dikeman, Executive Director
Kansas Farm Management Association
Department of Agricultural Economics, Kansas State University*

Introduction

Meeting the qualifications of farming and being a farmer under the Internal Revenue Code (IRC) allows for special benefits; however, not all agricultural producers meet these qualifications even if they are producing agricultural products, which is why it is vitally important for operators of farms and their tax professionals to understand the IRS tax definitions of farm, farming, and farmer. For example, one of the benefits of being classified as a farmer is the exclusion of certain receipts from income as in the case of conservation payments as allowed under IRC Section 126.

Operators of farming businesses may associate the term farmer as an adjective when describing themselves. Used in the colloquial context most people will understand what being a farmer means as a description of the noble rural occupation. For income tax purposes, however, taxpayers and their advisers need to be certain of the facts and circumstances in the context of the tax issue at hand. In some instances, an individual can be classified as a farmer for one income tax purpose but not for another. Also, someone who is not classified as a farmer may still be engaging in farming activities and have farm income.

*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.

Brief examples of farmers/ranchers are:

- Bob raises wheat and sells his wheat to the local elevator.
- Rosa has a flock of milking goats and sells the milk to a local organic foods co-op.
- Amal grows cut flowers which she sells weekly at the local farmer's market.
- Ricardo raises lettuce and cabbage which he sells to a salad processing company.
- Louisa operates a cattle ranch; she sells weaned calves to a feedlot investor.

These examples show a producer raising or growing a product and selling that product. They have not further processed or modified the product. These are farming activities and hence would all qualify as farm income.

The following discussion looks at the definition of a farmer from an income tax perspective, including the definitions of farm, farming and farmers as found in the Internal Revenue Code (IRC) and Treasury Regulations.

Defining “Farm”

Farm is commonly defined in the tax code in numerous places with nearly the same words. One such definition is found in IRC Section 2032A(e)(4) relative to estate tax valuation; 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.*

Examples of other locations in the Internal Revenue Code (IRC) and Treasury Regulations (TR) where this language with minor variation is used to define farm are:

- TR Section 1.61-4(d) (gross income of farmers)
- TR Section 1.175-3 (soil and water conservation expenses)
- TR Section 1.6073-1(b)(2) (estimated taxes)
- IRC Section 6420(c)(2) (excise tax on gasoline)
- TR Section 48.6420-4(c) (meaning of terms; excise tax on gasoline)

The list above is not all inclusive, taxpayers and tax preparers can find many other references that define farm for tax purposes.

In the definition above the word orchard is included, however, vineyard or grove is not. Yet, operators of a grape vineyard will fall under the definition of farm when using the inclusive wording *“agricultural and horticultural commodities”*. Grapes are the product of the vineyard and an agricultural commodity; therefore, the vineyard is a farm. Other rural operations producing products which can be defined as agricultural or horticultural, for example, a rural business producing goat's milk will be defined for income tax purposes as a farm. A vineyard selling grapes is a farm. A winery

that produces and sells wine would not be a farm. For operations with a combination, they would need to work with their tax preparer to separate the farming activities from non-farm business activity.

The definition of a farm describes farming activities. These activities produce farm income which is recorded on a *Schedule F (Form 1040), Profit or Loss From Farming*. Someone may have a farm and produce farm income, but not qualify as a farmer under a specific tax provision.

Defining “Farmer”

A farmer is an individual who is engaged in farming per the definition found above (IRS Publication 225, page 1, “You are in the business of farming if you cultivate, operate, or manage a farm for profit, either as an owner or tenant”). Generally, the farmer has a profit motive when operating a farming business. IRS uses nine factors found in IRC Section 183 to determine a business’ profit motive, commonly known as the hobby loss rules. See the “Further Information” section at the end of this fact sheet to get more information rules for activities not engaged for a profit (hobby losses).

Below are some of the tax benefits of being a farmer. Each has some special provisions, so taxpayers may qualify as a farmer for one test or rule, but not for another test.

Underpayment of Estimated Tax Penalties [IRC § 6654(i)(2)]

If a taxpayer qualifies as a farmer by having more than two-thirds of his/her gross income being derived from farming; they may be exempt from penalties for underpayment of estimated tax if they either make a single estimated tax payment by January 15, or make payment in full of their income tax liability (and file their income tax return) by March 1.

Example 1: Jose raises sheep full-time in the alpine meadows of Colorado. Jose sells market lambs and wool shorn from the flock. This is Jose’s primary source of income with over two-thirds of his income coming from this. He has a profit motive relative to his business activities. Jose is a farmer for income tax purposes and would qualify for the estimated tax payments provisions.

Example 2: Susie grows herbs for sale at her local farmer's market on the weekends. Susie's main source of income is her work as a computer engineer for a software company. Her herb sales are a small part of her total income.

Even though she has a horticultural activity, less than 2/3s of her income is from farming. So, she would not qualify for the special benefits for estimated tax payments.

If Susie can show she has a profit motive, her herb production would qualify as a farm activity and any income and expenses would be recorded on an IRS Form 1040 Schedule F.

Installment Sale of Farm Products (IRC § 453)

Cash-basis farmers are required to report income from the sale of farm products when the product is sold. They are not required to maintain inventories. If the farmer enters a forward sales contract to deliver the farm product in a subsequent year after production the income is reported in the year of payment not production. The contract must specify that the farmer can only receive the payment in the subsequent year to production, even if the delivery of the production occurred in the year of production. This is available for all farming income. The activities must fall within the definition of a farm in the previous section.

Current Year Deduction of Fertilizer and Lime [IRC § 180]

Farmers are allowed to make the annual election to deduct expenses for fertilizer and lime in the current year even though the fertilizer and lime provide more than one year's economic benefit to soil fertility. The farmer, therefore, does not capitalize this expense to match the economic life of this production input. The activities must fall within the definition of a farm in the previous section. Most farmers and tax professionals deduct the current year's fertilizer costs by making the election which is executed by reporting and deducting this expense on Schedule F. For planning purposes, if more income is needed in a year, amortizing the fertilizer cost thus decreasing a current deduction and increasing farm income.

Business Use of a Farm Vehicle -- a Safe Harbor [Treas. Reg. § 1.274-6T(b)]

Farmers may deduct up to 75 percent of their farm vehicle expenses as qualified business expenses without the business record substantiation (a mileage log). This safe harbor is helpful to beginning farmers and ranchers. This is available for all farming income. The activities must fall within the definition of a farm in the previous section.

Farm Income Averaging

Individual taxpayers who qualify as being a farmer under IRC Section 1301 may average their farm

income. This provides for the opportunity to “level” income tax liabilities over a period of years. The usefulness of this provision is based upon the individual circumstances of a particular taxpayer’s situation.

The above list is taken from Philip E. Harris’ *Agricultural Tax Issues*, Fall 2007.

Defining Agritourism as a Contrast to Farming

Determining whether or not a business is a farming business is a confusing issue for operators of agritourism businesses using farmland and farm production as part of that business model which may be educational in nature or focuses on the sale of value-added products (Isn’t it really the “farming of people”?). In recent years agritourism businesses have a goal of connecting the non-farming population with production agriculture through experiences in a rural and farm setting.

Agritourism is defined by Merriam-Webster as, “*the practice of touring agricultural areas to see farms and often to participate in farm activities*”. Merriam-Webster also indicates that the word agritourism entered the English language as a new word in 1979. [Merriam-Webster Online Dictionary ©2009. Accessed June 8, 2009, www.merriam-webster.com/dictionary/agritourism] Agritourism is also defined in other sources to include cooking cleaning and handicrafts or in contrast only when staying at the farm¹.

¹ The unabridged Dictionary.com (based on Random House Dictionary © 2009) defines agritourism as a noun with the following meaning: *Tourism in which tourists take part in farm or village activities, as animal and crop care, cooking and cleaning, handicrafts, and entertainments.* Agritourism is also defined by The American Heritage® Dictionary of the English Language, Fourth Edition © 2009 by Houghton Mifflin Company, with the following meaning: *Tourism in which tourists board at farms or in rural villages and experience farming at close hand.*

Example 3: Friendly Farmer uses the six-bedroom antebellum farm house as a Bed & Breakfast. He has developed walking and horseback riding trails over the 600 acre farm that has been in his family for six generations. He is quite successful as a spinner of tall tales and is a gregarious host, so much so, that he now generates 70 percent of his gross income from guest services. Friendly is in the agritourism business even though he uses the family farm as the venue for these activities, he is more of an entertainer than farmer. While the income from the farm part of the operation would still be considered Farm Income and reported on Schedule F (Form 1040), since less than two-thirds of his income is from farming, he would not be eligible for the estimated tax payments provisions.

Agritourism is not defined in the Internal Revenue Code or Treasury Regulations for income tax purposes. Definitions from dictionaries provide similarities within the meaning of agritourism ranging from simply touring agricultural areas to see farms to boarding on those farms and engaging in various activities for education or entertainment. When the definition of farming is contrasted with these definitions of agritourism it becomes clear that farming taxpayers who expand into

agritourism activities and their practitioners should be diligent in determining extent of the non-farming business.

IRS Publications

To access IRS forms, schedules, and publications, go to www.irs.gov and type the publication, form or schedule number or title in the search box.

- **IRS Publication 225, Farmer's Tax Guide.** This publication covers a wide variety of farm related income tax issues.

Additional Topics

This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.

The following fact sheets are either referenced in this paper or might be of particular interest.

- Farm Losses versus Hobby Losses: Farmers Must Plan Ahead to Avoid Adverse Tax Consequences
- Filing Dates and Estimated Tax Payments

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. Pursuant to Treasury Department (IRS) Circular 230 Regulations, any federal tax

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