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# Sample Tax Return for a Beginning Small Farm with a Value-Added Business

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## Introduction

This 2011 sample income tax return for I.M. and Sheeza Hopefull is a compilation of several small farming enterprises that focus on high-value or retained value production. It illustrates the first year's federal income tax return of a beginning small farm business.

Generally beginning farmers start with one or two enterprises or products on a modest scale. However, this sample return includes four enterprises in a fictitious family farm to illustrate several federal income and self-employment tax considerations that beginning farmers must address. The author has worked with several small beginning farms that have incorporated one or more of these enterprises in their farming business. As for many beginning farmers, the Hopefull's intent is to pursue a profitable farm business.

The website, www.RuralTax.org, has additional fact sheets and a *Tax Guide for Owners and Operators of Small and Medium Sized Farms* that provide more information about farm income tax issues.

## Background and Fact Pattern for the Sample Return

I.M. and Sheeza Hopefull are married and have one child, Mia, who is 5 years old. Sheeza's uncle, I.M. Worn died recently and left her a $100,000 inheritance. This windfall allowed the Hopefull's to realize a long-held family goal of operating a small farm. Using the inheritance as a down payment, the Hopefulls borrowed another $150,000 to buy a 20-acre property that has a rustic three bedroom home and two outbuildings that are suitable for the farming activities they want to pursue. The Hopefulls have $20,000 of savings that is available to make improvements and to establish the enterprises in their new farm business, which will be organized as I.M.'s sole

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proprietorship called "Nature's Way Farm."[1] They closed the real estate transaction in mid-February and moved into their new home the following weekend

I.M., who worked as a truck driver prior to quitting, now devotes all his time and energy to beginning this new farm business. Sheeza, who is trained as a nurse, continues to work weekend shifts at the local hospital's emergency department, which provides shift differentials for weekend work. However, because she works less than the required hours for benefits, she is ineligible for health care coverage, and the Hopefulls therefore begin a Health Savings Account (HSA) to pay for out-of-pocket medical expenses not covered by their high-deductible major medical policy, for which they pay a $650 monthly premium.

The initial farm enterprises are: community supported agriculture (CSA) vegetable production by subscription; cut flowers; stocker steers supplying a grass-fed cut-meat business; and a one acre table-grape vineyard. Nature's Way Farm supplies weekly baskets full of fresh vegetables to 35 subscribers of the CSA, participates in several farmers' markets, and has a roadside stand located on their farm property. The Hopefulls planted the grape vineyard in 2011 and expect to harvest grapes for market in 2014. They planted both perennial and annual flower cultivars that produced flowers for harvest in 2011.

## Basis Allocation of Farm Purchase

The Hopefulls used the appraisal for the loan to allocate the $250,000 purchase price among the assets as shown in Figure 1.

Figure 1: Allocation of Purchase Price

| | |
|---|---|
| House | $100,000 |
| One acre of land on which house sits | 10,000 |
| 19 acres of farmland | 120,000 |
| Farm buildings ($10,000 each) | 20,000 |
| Total | $250,000 |

This allocation is important for two tax reasons and should be kept with their permanent business records.

First, the allocation establishes the beginning income tax basis in each asset. Income tax basis is used to calculate gain or loss on sale of assets and to calculate depreciation on depreciable assets such as the farm buildings (discussed later).

Second, the Hopefulls use the purchase price allocation to allocate the interest on the $150,000 loan between the personal residence and the farm property. They deduct the interest on the portion of the loan used to purchase the personal residence as an itemized deduction on Schedule

[1] Nature's Way Farm is an example and has no connection to any farm that may exist in any location by the same name.

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A (Form 1040), Itemized Deductions, and they deduct the rest of the interest on the loan on Schedule F (Form 1040), Profit or Loss From Farming.

Initially, 44% [($110,000 ÷ $250,000) × $150,000 = $66,000] of the loan is a personal residence loan for which interest can be deducted on Schedule A (Form 1040) and 56% [($150,000 ÷ $250,000) × $150,000 = $184,000] is a business loan for which interest can be deducted on Schedule F (Form 1040). However, all principal payments are allocated to the personal residence debt until it is reduced to zero. Therefore, after the first principal payment, the percentage of interest allocated to the personal residence loan and to the business loan will change.

In this example, the Hopefulls made one $8,000 loan payment in August 2011 of which $6,875 was interest and $1,125 was principal. Therefore, they allocate $3,025 (44% of $6,875) of the interest to their personal residence and the remaining $3,850 (56% of $6,875) to their farm business. Because all of the $1,125 principal payment is allocated to the $66,000 personal residence debt, it is reduced to $64,875. Therefore, 43.58% [$64,875 ÷ ($64,875 + $84,000)] of the next interest payment will be allocated to the personal residence debt and 56.42% will be allocated to the business debt.

## Line by Line Explanation of the Hopefull's 2011 Federal Income Tax Return

Because I.M. and Sheeza filed Schedule C (Form 1040), Profit or Loss From Business, Schedule F (Form 1040), Profit or Loss From Farming, Schedule SE (Form 1040), Self-Employment Tax, and Form 4562, Depreciation and Amortization, they must file the long Form 1040, U.S. Individual Income Tax Return.

The following discussion explains the federal income tax forms in their attachment sequence order, which is indicated by the number found at the upper right hand corner of the form under the year designation (2011 in this example). The discussion includes an explanation of each number that is entered or box that is checked. Numbers are rounded up or down to the nearest whole dollar value. Where several numbers are totaled on a line; the total number is rounded, not each individual component number.

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