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CHAPTER 3
FARM INCOME

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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 of 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 as a farmer 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 incident to 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.

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 3

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 incident to 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 22 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 11 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 in Figure 3.1, 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.

FIGURE 3.1: 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 2012 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 11 of Schedule F (Form 1040) is $50,000, and they have a $75,000 sale of timber, as shown in Figure 3.2. 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.

FIGURE 3.2: 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.

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 exception 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 supposed to be only $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)]