CHAPTER 6

MANAGING THE CHARACTER OF INCOME AND DEDUCTIONS

SYNPOSIS (click on section title to go directly there)

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

Self-employment income is subject to ordinary income tax rates ranging from 10% to 35% (in 2011) and is also subject to a 13.3% (in 2011) SE tax. (The SE tax rate is effectively 11.36% for taxpayers in the 15% federal income tax bracket, as discussed in Chapter 5).

Generally, any income generated by an individual's own work is self-employment income, except for wages reported on a Form W-2, Wage and Tax Statement. (These wages 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%. For wages earned in 2011, employees pay only 5.65% in FICA taxes.) 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 land owner 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 farm land and the land

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owner 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

Self-Employment Tax

See Chapter 12 of the 2010 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 raises some of the female hogs born on the farm to become part of his breeding stock. When these sows are no longer fit for producing more 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 is they are more than 6 years old when they are severed from their roots.

Cross-Reference

Timber Tax Rules

See pages 53 and 54 of the 2010 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 land owner materially participates in a farming activity if he or she meets any one of the following four tests.

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

(a) advances, pays, or stands good 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 land owner 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 land owner works 100 hours or more over a period of 5 weeks or more in activities connected with producing the farm commodities.

Test #4: The land owner 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 land owner 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 land owner does not materially participate.

This provision of the tax law provides a tax planning opportunity. 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 land owner 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.

Example 6.2 Rent to Spouse

Mary operates a tobacco 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 $62,000. Based on the prevailing tobacco land rental rates in their area, the fair rental value of the land is $20,000 per year. The property taxes are $8,000. As shown in Figure 6.1, Mary and Joe could reduce their overall joint tax liability by $1,568 each year if Mary paid $20,000 of rent to Joe.

Return to TOC

FIGURE 6.1 Tax Comparison With and Without Rent Payments

	Without Rent Payments	With Rent Payments
Farm income	$75,000	$63,000[*]
Deduction for ½ S/E tax	– 5,299	– 4,451
Net rental income		12,000
Other non-farm net income	– 7,701	– 7,701
Taxable income	$62,000	$62,848[**]
Income tax	8,462	8,590
SE tax	10,598	8,902
Total tax	$19,060	$ 17,492

[*] Reduced by $20,000 rent expense but increased by $8,000 property tax which becomes Joe's expense.

[*] Net taxable income is unchanged except for the reduced deduction for ½ of the SE tax paid.

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 that 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 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 to his or her spouse who is a bona fide employee. This allows the farmer to deduct the premium as a farm expense, thereby reducing SE tax while not increasing FICA 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.

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

Sale of Assets Used in a Farming Business

See Chapter 9 of the 2010 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 long-term capital gain treatment. Such treatment currently means a 0% rate of tax to the extent the taxpayer's taxable income does not exceed the 15% federal income tax bracket for ordinary income. The income tax rate is 15% on long-term capital gain that, when added to ordinary taxable income, exceeds the top end of the 15% federal income tax bracket. 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.

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's total taxable income is in the 15% federal income tax bracket. Because he sold the heifers when they were 23 months old, his tax on the sale is $6,000 ($40,000 × 15%). 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 $6,000 tax cost for 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 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 the result of netting the gains and losses is 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

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's taxable income is in the 25% tax bracket.

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 in the 25% federal income tax bracket. Camille owes $4,500 of tax.

If Camille sells only the land this year, her tax will increase by $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. Therefore, the loss reduces Camille's tax liability next year by $2,500 ($10,000 × 25%). Over the 2-year period, Camille has paid $3,500 under this plan – saving $1,000 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 $2,500. If she then sells the land in the second year, $10,000 of the gain is taxed at her 25% ordinary income rate and the remaining $30,000 is taxed at the 15% capital gain rate. Therefore her total tax increase in the second year is $7,000 [($10,000 × 25%) + ($30,000 × 15%)]. The net tax increase for the 2 years is $4,500 ($7,000 – $2,500), 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 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's taxable income is in the 25% federal income tax bracket and he plans to sell 50 acres of cropland. The growing crop 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 incur an $8,580 tax on his $24,000 net income from the crop, as shown in Figure 6.2.

FIGURE 6.2 Tax on Harvested Crop

Net income from crop sale	$ 24,000
Less: 1/2 SE tax	– 1,474
Net ordinary income	$ 22,526
Income tax	$ 5,632
SE tax*	2,948
Total tax	$ 8,580

* In 2011, the SE tax rate is 13.3% of the net earnings from self-employment, which is 92.35% of the self-employment income ($24,000 × 92.35% × 13.3% = $2,948).

If the unharvested crop is sold with the land, the net income from the crop qualifies for long-term capital gain treatment and results in a \$3,600 (\$24,000 × 15%) federal income tax. There is no SE tax and Billy Bob therefore saves \$4,980 (\$8,580 – \$3,600) of taxes.

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.