Penn State **Extension**

AGRICULTURAL ALTERNATIVES

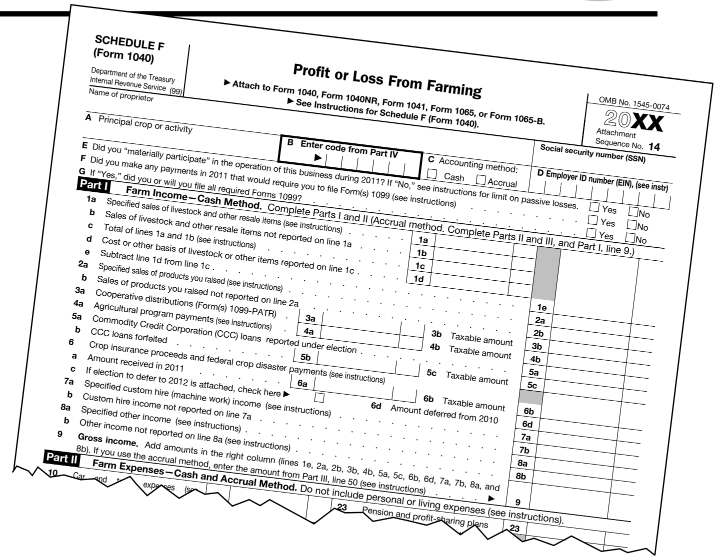
Understanding Your Federal Farm Income Taxes

Note: This fact sheet is intended for general education educational purposes. Farmers and other small business owners should seek advice from competent tax advisers for specific questions and/or circumstances.

Farmers, like many small business owners, often don't prepare their own federal tax forms, but they do need to know the record-keeping requirements for reporting and they must consider the impact business decisions have on their tax liability. Understanding the basic concepts and applications of federal income tax law are crucial because the amount of taxes owed often affects the economic benefit of the choice selected.

What's included in farm income and what expenses are deductible from that income? Can a tractor purchase be justified when you take into account depreciation? What will you owe in taxes if you sell some of your cows? How will hiring your spouse change the amount of taxes you pay?

As a farmer it is important for you to have at least a basic understanding on how federal income taxes affect your business. It's imperative to keep appropriate and sufficient records and estimate the taxes due to the IRS. Consulting with an accountant, bookkeeper, or other tax/finance professional will help you understand and appropriately assess impacts of a decision on your income tax liability. These professionals are part of the management team of a well-run business and their advice should be sought when needed.


SCHEDULE F
(Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Farming
► Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B.
► See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074
20XX
Attachment Sequence No. 14

Name of proprietor | Social security number (SSN)

A Principal crop or activity
B Enter code from Part IV ►
C Accounting method: ☐ Cash ☐ Accrual
D Employer ID number (EIN), (see instr)

E Did you "materially participate" in the operation of this business during 2011? If "No," see instructions for limit on passive losses. ☐ Yes ☐ No
F Did you make any payments in 2011 that would require you to file Form(s) 1099 (see instructions) ☐ Yes ☐ No
G If "Yes," did you or will you file all required Forms 1099? ☐ Yes ☐ No

Part I **Farm Income—Cash Method.** Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 9.)

1a Specified sales of livestock and other resale items (see instructions) 1a
b Sales of livestock and other resale items not reported on line 1a 1b
c Total of lines 1a and 1b (see instructions) 1c
d Cost or other basis of livestock or other items reported on line 1c 1d
e Subtract line 1d from line 1c 1e
2a Specified sales of products you raised (see instructions) 2a
b Sales of products you raised not reported on line 2a 2b
3a Cooperative distributions (Form(s) 1099-PATR) 3a | 3b Taxable amount 3b
4a Agricultural program payments (see instructions) 4a | 4b Taxable amount 4b
5a Commodity Credit Corporation (CCC) loans reported under election 5a
b CCC loans forfeited 5b | 5c Taxable amount 5c
6 Crop insurance proceeds and federal crop disaster payments (see instructions)
a Amount received in 2011 6a | 6b Taxable amount 6b
c If election to defer to 2012 is attached, check here ► ☐ | 6d Amount deferred from 2010 6d
7a Specified custom hire (machine work) income (see instructions) 7a
b Custom hire income not reported on line 7a 7b
8a Specified other income (see instructions) 8a
b Other income not reported on line 8a (see instructions) 8b
9 **Gross income.** Add amounts in the right column (lines 1e, 2a, 2b, 3b, 4b, 5a, 5c, 6b, 6d, 7a, 7b, 8a, and 8b). If you use the accrual method, enter the amount from Part III, line 50 (see instructions) ► 9

Part II **Farm Expenses—Cash and Accrual Method.** Do not include personal or living expenses (see instructions).
10 Car and truck expenses ... 23 Pension and profit-sharing plans 23

What's a Farm? Who's a Farmer?

Under tax law, a farmer is defined as someone who operates a farming business with the intent of making a profit. However, there are special provisions in the tax code that further restrict who qualifies as a farmer in order for the individual to take advantage of the benefits provided under the provision.

A farm is described by the Internal Revenue Service (IRS) as a business that undertakes farming activities and produces income reportable on *Schedule F (Form 1040), Profit or Loss from Farming*.

Several references in the IRS tax code describe farming activities, with minor variations among them. These

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references often refer to cultivating land and the raising or harvesting of agricultural or horticultural commodities. Perhaps one of the more direct references can be found on the front cover of the *Farmer's Tax Guide, IRS Publication 225*: "You are in the business of farming if you cultivate, operate, or manage a farm for profit, either as owner or tenant. A farm includes livestock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges and orchards."

Special estimated tax rules apply for qualified farmers. If more than two-thirds of an individual's gross income is from farming in the current or prior year, then the qualifying farmer is allowed to make a single estimated tax payment by the fifteenth of the month following the close of the tax year, or pay the full income tax liability by the first of the third month following the close of the tax year. Nonqualifying farmers, like other nonfarm businesses, must pay estimated tax payments on a quarterly basis throughout the tax year.

Note that farming doesn't include service providers such as veterinarians or custom harvesters, nor does it include landscaping operations or pet kennels. Processing is considered part of farming only to the extent that it's normally incidental to the growing, raising, or harvesting of commodities. Cleaning, grading, and packaging fruit prior to sale is considered part of the farming activity of an orchard. A winery, however, is separate from growing grapes and would not be considered a farm. In the latter case, operations that grow grapes and produce wine would have two separate businesses, apportioning receipts and expenses accordingly.

Hobby (Not-for-Profit Farming)

An activity is a hobby if it's primarily for fun, recreation, or sport without any intention of making a profit. Any income from a hobby farm is reported on the first page of *Form 1040, U.S. Individual Income Tax Return* under "Other income," not on *Schedule F (Form 1040)*. Expenses of a hobby can only be deducted on *Schedule A (Form 1040), Itemized Deductions*. Furthermore, the IRS prescribes the order and method for taking hobby-related deductions and limits the amounts that can be taken. Ultimately, hobby losses can't be used to offset unrelated income.

The IRS will presume a farming activity is being conducted for profit if it produced a profit in at least three of the past five tax years, including the current year. (For equine operations, the presumption is two of seven years.) If the years-of-profit test isn't met, it doesn't automatically mean the activity is a hobby. Instead, IRS will consider other criteria in its determination, including the following:

- Extent to which the activity is conducted in a businesslike manner
- Time and effort spent on the activity
- Taxpayer's dependence on income derived from the activity
- Whether activity losses are due to uncontrollable circumstances or are typical for similar startups
- A farmer's or their adviser's expertise and knowledge related to the activity
- Expectation that assets used in the activity will appreciate in value
- Taxpayer's success in carrying on similar activities in the past
- Efforts to change methods of operation to improve profitability
- Amounts of occasional profits from the activity, if any

No single factor indicates whether an activity is carried on for profit or not; all facts are considered.

Record-Keeping

The most common reason cited for keeping business records is to fulfill tax-reporting requirements. For the most part, a farmer can choose any suitable record-keeping system that clearly identifies sources of income, deductible expenses, and other items reported on tax returns. Before selecting a particular record-keeping system, keep in mind that business records are also important in obtaining and attracting capital, measuring progress, and preparing projections.

A record-keeping system should organize business transactions normally initially entered in journals, then recorded and summarized in ledgers. For many small farms, a business checkbook often serves as the primary source for a list of transactions.

Supporting documents associated with sales, purchases, payroll, and other transactions need to be filed in a safe place. In general, these documents should be kept for at least three years from when the tax return was due or filed or two years from the date the tax was paid, whichever is later. (You may want to consider keeping tax information for a minimum of five years since those with a current-year net operating loss may carry back the loss to offset a portion of taxable income reported five years earlier.) Documents associated with employment taxes and those relating to farm property (i.e., machinery, buildings, and land) must be kept longer.

The two basic methods of accounting are cash and accrual. IRS allows a farm business to use either accounting method while imposing special treatment to certain income and expense items. You choose the method of accounting when you file your first tax return for the farm business. Any subsequent change in an accounting method for tax reporting requires prior IRS approval.

Under the cash method of accounting, income is reported in the tax year actually or constructively received. A constructive receipt is one credited to the business account or made available to the business without restriction. Expenses under the cash method are deducted in the tax year the expense is paid. Many farmers use the cash method when reporting income and expenses to the IRS because they find it easier and are able to better match farm cash flows with the taxes due.

With the accrual method, income is reported in the tax year it was earned or due to the business or when payment was made or title was passed, whichever is earliest. Accrual expenses are deducted in the tax year the expenses were incurred (i.e., an identifiable expense exists and the business used the expense item to provide services or goods). The accrual method matches income to the expenses for a given year, providing a more accurate assessment of profit earned, but accrual accounting requires more information and may result in the farmer paying taxes on anticipated revenue.

Farm Income

Income from normal farm business operations is reported on the *Schedule F (Form 1040)*. Part I is for farms using the cash method of accounting; Part III is for farms using the accrual method (Part II is used to report expenses and will be discussed in the next section).

Farm income includes the sales of both raised and grown farm products, sales of farm products purchased for resale, income received from custom work and farm-related services, distributions from cooperatives, barter income (at fair market value), refunds, and reimbursements.

Most agricultural program payments, reported to recipients and the IRS on *Schedule 1099-G, Certain Government Payments*, are taxable and need to be added to income on *Schedule F (Form 1040)*. Expenses associated with the agricultural practice or project supported by these payments usually offset the money received.

As a rule, farm loans aren't reported as income. However, a farmer who pledges all or part of production to secure a Commodity Credit Corporation (CCC) loan can treat the CCC loan as the crop sale and report loan proceeds as income in the year received.

If a farmer chooses to report the CCC loan as income, then the amount reported becomes the basis in the commodity. Any subsequent sale of crop above the basis is additional income; a sale below the basis is a loss. If the crop is fed to livestock, then the basis can be deducted as a farm expense.

Rent received for the use of farm land is generally not included in farm income, but rather is reported as rental income on *Form 4835, Farm Rental Income and Expenses* and/or *Schedule E (Form 1040), Supplemental Income and Loss*. However, if you materially participate in operating a farm from which you receive rent in the form of crop shares or livestock, then the rental income is reported on *Schedule F (Form 1040)*.

Money received from the sale of farm assets used in ongoing business operations (such as farm machinery and equipment, breeding and working livestock, buildings and land) is not reported on *Schedule F (Form 1040)*. The gain or loss resulting from the sale of these assets appears on *Form 4797, Sales of Business Property*. Sales of farm assets are discussed in more detail later in this publication.

Farm Expenses

Ordinary and necessary expenses associated with producing farm products and providing services are reported on Part II of *Schedule F (Form 1040)*, which lists more than twenty deductible items, including chemicals, seeds and plants, fertilizers and lime, feed, gasoline and fuel, repairs and maintenance, labor hired, insurance, interest, rent, depreciation, utilities, veterinary and breeding, and supplies.

The costs of items purchased for resale, including livestock, aren't shown on Part II of *Schedule F (Form 1040)*. Instead, the costs of items to be resold are subtracted from gross sales in the year of sale on Part I of *Schedule F*. This procedure is followed for reporting costs of items resold even if a farmer has adopted the cash method of accounting.

Machinery and building repairs and maintenance are deducted in the year paid; the purpose of repairs is to keep the property in operating condition. Improvements to machinery and buildings must be capitalized and depreciated. Improvements add to a property's value, prolong its useful life, and/or adapt it to a different or new use.

Payments for some expenses such as utilities, property taxes, interest, and insurance may be partly personal and partly business. The personal portion isn't deductible, but the business portion should be added to expenses on *Schedule F (Form 1040)*. Although there is no official allocation method, a reasonable approach must be used to allocate the expense between personal and business use when there is a single payment.

Famers can deduct the costs of using an automobile or light truck in their business using the standard mileage rate method or actual expense method. The standard mileage rate is set by the IRS and adjusted periodically to reflect changes in vehicle operating and ownership costs. Current standard mileage rates can be found on the IRS website (**irs.gov**) by searching for "standard mileage rates." In general, the number of business miles driven must be substantiated with records, like a logbook; but, farmers are allowed to claim 75 percent of a car or light truck use as business related without keeping records if the vehicle is used most of the normal business day in connection with farm operations.

A farmer who uses the cash method of accounting is allowed to deduct prepaid farm supplies in the year purchased. This deduction is limited to 50 percent of all other farm expenses for that year. This limit doesn't apply to "farm-related" taxpayers under either of two exceptions.

A farm-related taxpayer is one whose main home is on a farm or whose principal business is farming or a taxpayer who is related to someone meeting either of these criteria. One exception is if there was a change in business operations as result of unusual circumstances. The second exception is if the total prepaid supplies expense for the preceding three tax years is less than 50 percent of other total deductible farm expenses for those three tax years.

In the case of prepaid livestock feed, further conditions must be met for the prepaid expense to be deductible in the year purchased. The prepayment must be for the purchase of feed, not just a deposit. The prepayment must be for a business purpose, not just to reduce tax liability. The deduction resulting from the prepayment must not materially distort income.

Rent or lease payments for equipment and buildings are deductible farm expenses. If a lease agreement is set up in a similar manner to an installment sales contract, then the rental amount will be treated as loan payments by the IRS. The farmer will be allowed to only deduct the portion of the rent deemed interest and deduct depreciation for the asset purchased, if applicable.

Most short-term leases are clearly deductible because the farmer has neither the right to buy the property nor any equity interest in the property at the end of the lease term. Longer, multiyear lease agreements will likely receive more scrutiny from the IRS in determining both the lessor's and lessee's intent.

Farmers can also choose to deduct costs incurred for certain soil and water conservation expenses on farmland rather than add those costs to the basis of the land. Eligible deductible conservation expenses include leveling, grading, terracing, contour furrowing, and fertility restoration of land; constructing diversion channels, drainage ditches, irrigation ditches, earthen dams and ponds; and eradicating brush and planting windbreaks.

The deduction for soil and water conservation expense is limited to 25 percent of gross income from farming, with excess qualifying expenses carried forward to future tax years. Expenses normally depreciated aren't eligible for the deduction. The election to deduct soil and water conservation expenses applies to similar expenses incurred in subsequent tax years. A taxpayer must receive permission from the IRS to change this election.

The interest charged on a loan is a cost associated with borrowing and is a deductible expense if the loan was related to farm operations. For a loan used to acquire both personal and business assets, a farmer needs to determine the portion of interest charges applicable to the farm business.

Sole proprietors may not deduct any charge for their labor associated with operating the farm. Net farm profit on *Schedule F (Form 1040)* is considered the sole proprietor's income and is reported as such on his/her personal tax return. This is also true for other "pass through" entities—namely, partnerships and limited liability companies not taxed as corporations. Even though they may file forms different from the sole proprietor, business profits pass through the business to the owners' personal tax forms.

Depreciation

Depreciation is a means of recovering the investment in certain business property. Business property is depreciable if it has a useful economic life exceeding one year and wears out with use and/or becomes obsolete over time.

Machinery, equipment, purchased breeding animals, livestock facilities, barns, fencing, greenhouses, and storage structures are common examples of depreciable property found on farms. Farmland isn't depreciable since it doesn't have a definite life, nor is a home because it is personal property.

The Modified Accelerated Cost Recovery System (MACRS) is used to calculate the correct depreciation deductions for federal income tax purposes. To determine the depreciation allowed, you need to know the "basis" of your property, when the property was placed in service, and the property's class. Basis is the owner's investment in property. A property's initial basis depends on how the property was acquired. The basis of purchased property is generally the property's cost. For property acquired as a gift, the donor's basis commonly becomes the recipient's basis in the property.

The basis of inherited property, property constructed by an owner, property received in a tax-free exchange, and personal property converted to business use are all figured differently. A depreciable property's basis is the amount available for depreciation deductions under MACRS.

Depreciation begins when a property is placed in service. A property is placed in service when it is ready and available for its specific use in farm operations. A hay baler delivered to a farm in December begins depreciation the year delivered, even though it probably won't be first used until the following spring. The depreciation of fruit trees and grapevines begins when the plants first produce fruit for commercial sales even though they were likely purchased several years earlier. Depreciation of immature, purchased breeding livestock begins when they are first bred.

MACRS designates the classes and methods of depreciation for all business property. MACRS property classes prescribe the number of years over which the investment in depreciable properties may be recovered. Nine different property classes are defined under the MACRS General Depreciation System (GDS). In many situations, a farmer may elect to use the MACRS Alternative Depreciation System (ADS) for property in a given class purchased in the same year. Figuring depreciation under the ADS method essentially slows annual depreciation, preserving greater deductions for later years.

Identifying property class is critical to understanding depreciation choices under MACRS. Tractors used over the road and breeding hogs are "three-year property." Dairy and breeding cattle, breeding goats and sheep, grain bins, and trucks are "five-year property." Fences and most farm machinery and equipment are "seven-year property." Fruit trees and single purpose agricultural structures are "ten-year property." Water wells, drainage facilities, and paved lots are "fifteen-year property." General, multiple-use farm buildings are "twenty-year property."

MACRS allows for three depreciation choices under GDS and one choice under ADS. The GDS choices are 200 percent declining balance, 150 percent declining balance, or straight-line over the GDS recovery period. Straight-line is the only choice over the ADS recovery period. It's important to note that farm property can't be depreciated using the 200 percent declining balance method, eliminating one of three GDS options for farmers.

Under Section 179 of the *Internal Revenue Code*, farmers and other business owners may elect to deduct all or part of the cost of qualifying depreciable assets in the year the assets are placed in service. Section 179 expense deductions are limited to the taxpayer's income from all businesses and a total dollar amount that varies by tax year. Qualifying property is tangible personal property used over 50 percent in the business and acquired by purchase. Any amount of a property's cost deducted using Section 179 must be subtracted from the property's basis before depreciation deductions are calculated.

Other facets associated with determining tax depreciation for business property are conventions for when the recovery period begins and ends, special rules regarding passenger automobile and computers, and additional first year deductions. A review of available IRS publications will provide more detail on depreciation as well as other tax provisions described in this fact sheet.

Employees

Wages paid to hired labor, as well as the employer's share of employment taxes and employee benefit costs, are deductible farm expenses reported on *Schedule F (Form 1040)*. As noted earlier, owners of sole proprietorships and other pass-through entities can't deduct a cost for their personal labor; however, a farmer may deduct the wages paid to a spouse and/or child if a true employer-employee relationship exists.

Generally, an employee performs services for the business under the direction and control of the employer, receives wages and benefits commensurate with the services performed, and anticipates a "long-term" continuing relationship with the business rather than one based on a specific project or for a short-term period.

An independent contractor, unlike an employee, is self-employed and offers services to the general public. A business owner doesn't have the legal right to control the details of how the services are performed by an independent contractor. Veterinarians, crop/feed consultants, and accountants are independent contractors commonly hired by farmers.

Farmers with employees are required to have an Employer Identification Number (EIN). Application for an EIN can be done online, by telephone, or by faxing or mailing a completed *Form SS-4, Application for Employer Identification Number*.

For each person hired, an employer must verify the individual is legally eligible to work in the United States. Verification includes completing *Form I-9, Employment Eligibility Verification*. *Form I-9* is available online from U.S. Citizenship and Immigration Services. Identifying an employee as a farmworker will impact withholding rules for Social Security and Medicare taxes, participation in federal unemployment tax, and the application of other federal and state labor laws.

According to the IRS, agricultural employees do any of the following work:

- Raise or harvest agricultural or horticultural products on a farm
- Operate, manage, conserve, improve, or maintain a farm and its tools and equipment
- Perform services in salvaging timber or clearing farmland of brush and other debris left by a hurricane
- Handle, process, or package any agricultural commodity of which over 50 percent was produced by the farm employer
- Hatch poultry on a farm
- Perform work related to cotton ginning, turpentine production, or gum resin products
- Produce or harvest maple syrup
- Operate and maintain irrigation and water storage facilities for farming purposes (facilities must not be operated for profit)

Farm work doesn't include selling agricultural or horticultural products when a substantial amount of those products were not produced on the farm.

Social Security and Medicare (FICA) taxes are shared by the employer and employee. The employee's share of the tax is deducted from employee wages. Current FICA tax rates can be found on the Social Security website (**ssa.gov**) by searching "FICA tax rates."

All cash wages paid by a farmer-employer are subject to FICA taxes if the farmer paid (1) wages of $2,500 or more during the year to all employees or (2) an individual employee more than $150 in cash wages during the year. If the $2,500 group test isn't met, the $150 test for an employee still applies. Wages paid to a child who works for a parent and is under the age of eighteen aren't subject to FICA taxes if the business is a sole proprietorship or a partnership, provided each partner is a parent of the child.

Federal unemployment tax (FUTA) is paid only by the employer; no portion is deducted or collected from the employee's wages. Since 1983, the FUTA rate has been either 6.0 or 6.2 percent of the first $7,000 in wages paid to each employee. Credits paid for state unemployment taxes paid on behalf of an employee can be used to reduce the FUTA rate and liability.

A farmer-employee is subject to FUTA if during the current or preceding tax year the farmer (1) paid $20,000 or more in cash wages to farmworkers in any calendar quarter or (2) employed ten or more farmworkers for some part of at least one day during any twenty or more different calendar weeks. FUTA doesn't apply to the wages paid to a farmer's spouse, parents, or children under the age of twenty-one.

A farmer must withhold income taxes on agricultural employees who are subject to FICA taxes. The amount of federal income tax withheld from an employee's wages depends on his/her filing status and withholding allowances; these are identified on *Form W-4, Employee's Withholding Allowance Certificate*. Employers required to withhold taxes from an employee's wages should refer to tax-withholding tables found in IRS tax guides.

Withheld federal income taxes are combined with the employer and employee shares of FICA taxes when making payroll tax deposits. Federal tax deposits must be made by electronic funds transfer; deposits with coupons are no longer accepted. Electronic fund transfers are made online using the Electronic Federal Tax Payment System (EFTPS) or can be arranged through a trusted third party. The required frequency of deposits depends on the size of the employer's payroll tax liability.

Sale of Business Property

Sales of assets that support farm operations are reported on *Form 4797, Sales of Business Property*. Types of property sales reported on this form include machinery, equipment, breeding livestock, draft animals, buildings, and land. *Form 4797* helps determine if there is a gain or loss from the sale of business property and further identifies if the gain is eligible for preferential tax treatment as a long-term capital gain. Also, reporting property sales on *Form 4797* keeps any gains associated with these transactions from being exposed to self-employment taxes.

The sale of business property results in a gain if the selling price is greater than the property's adjusted tax basis plus any selling expenses. If the selling price is less than the adjusted tax basis plus selling expenses, then the result is a loss. The adjusted tax basis of business property equals its book value for tax purposes (i.e., the property's initial basis plus the cost of any improvements less depreciation allowed or allowable, including any depreciation taken as a Section 179 expense).

Gains or losses from the sales of business property that don't meet the holding-period requirement are treated as ordinary gains or losses, which are subject to the same tax treatment as ordinary income. The holding period for most business property is one year; notable exceptions are cattle and horses, both must be held for at least twenty-four months to meet the holding-period requirement.

Gains and losses from the sales of property held for the required time period are added together for each tax year. If the result is a net loss, then the net loss is subtracted from ordinary income. If the result is a net gain, then the gain is eligible for treatment as long-term capital gains and will be taxed at a rate lower than ordinary income, with one important exception relating to the amount of depreciation claimed. If any of the long-term gain represents recovery of depreciation under the recapture rules, then that part of the gain will be reported as ordinary income. The depreciation recapture rules for buildings specify that depreciation taken in excess of the amount allowed under the straight-line method will be treated as ordinary income. For this purpose, buildings include barns and machinery sheds, but not single purpose agricultural structures. For all other depreciable business property, the recapture rules require any gains attributable to prior depreciation claimed or allowed to be claimed, regardless of method used, to be treated as ordinary income.

Self-Employment Tax

Farmers pay self-employment tax on their business income. Self-employment tax (FICA) combines both Social Security and Medicare taxes. Social Security taxes are assessed on a maximum level of net earnings that changes annually. There is no earnings limit with respect to the Medicare portion of FICA taxes. Under the regular method of determining earnings subject to self-employment tax, net farm profit from *Schedule F (Form 1040)* is multiplied by 92.35 percent on *Schedule SE (Form 1040), Self-Employment Tax* before applying the FICA tax rate. Information on current FICA tax rates and income limits can be found on the Social Security Administration website (**ssa.gov**).

Farmers' payments of self-employment taxes contribute to their eligibility for Social Security benefits, including disability, retirement, and Medicare programs. To receive benefits, an individual must have the required number of credits or quarters of coverage at the time of application. Taxpayers can earn a maximum of four credits per year based on the amount of combined self-employment income and wages subject to FICA taxes. More information on credits needed and benefits available to taxpayers can be found on the Social Security Administration website (**ssa.gov**).

Optional methods of reporting net earnings subject to FICA taxes are available to certain business owners. Farmers with small net incomes or losses may report net earnings for FICA taxes as a portion of gross income or at a minimum amount. Using the optional method enables these farmers to earn credits for Social Security benefits and increase earned income eligible for child, dependent care, and/or earned income credits.

Tax Management

Key goals of tax management are to (1) preserve the benefits associated with deductions and exemptions and (2) minimize income tax paid over time, not just in the current year. Tax management starts with understanding the relationship of gross income to adjusted gross income and taxable income.

When determining your gross income, net farm profit from *Schedule F (Form 1040)* is added to wages, interest received, and other sources of income. Adjustments or "above-the-line" deductions are subtracted from gross income to arrive at your adjusted gross income. Adjusted gross income is reduced by personal and dependent exemptions and either the standard or itemized deduction to arrive at taxable income.

Above-the-line deductions include a portion of the self-employment tax paid, cost of self-employed health insurance, certain retirement plan contributions, student loan interest, higher education tuition costs and fees, moving expenses, and the domestic production activities deduction. These adjustments and others are listed on the bottom half of the first page on *Form 1040, U.S. Individual Income Tax Return*.

Itemized deductions are allowable personal expenses such as state and local taxes, home mortgage interest, gifts to charities, and dental and medical expenses that exceed 7.5 percent of adjusted gross income. *Schedule A (Form 1040), Itemized Deductions* is used to report these deductions. If you elect to not itemize deductions, then a standard deduction based on your filing status and age applies.

If you reduce net farm profit on *Schedule F (Form 1040)* to zero or near zero, this may result in "losing" the benefit of offsetting taxable income with your deductions and exemptions. This is especially true if you report little nonfarm or interest income.

Minimizing tax liability over several years is often the better approach to managing taxes compared to only focusing on your current year's obligation. Various techniques may be employed to either reduce or increase net farm profit reported to the IRS in a given year. Since some choices must be made before the close of the tax year, the initial step in managing income tax liability is to estimate your farm receipts, expenses, and net profit in November before transactions for the year are finalized.

An anticipated high net farm profit may be reduced before year-end by either postponing sales or accelerating expenses. Delaying delivery of products until January or later would shift sales to the following year; however, a check you receive from a customer must be reported in the year it was received because it was made available on receipt and recognition can't be postponed.

Under the cash method of accounting, year-end purchases of feed, fertilizer, chemicals, and similar supplies are deductible if certain conditions are met as discussed earlier. Other tactics for accelerating expenses are paying outstanding balances on supplier accounts and making needed repairs in the current year. Certain expenses can't be accelerated even if they are prepaid; these include interest, rent, insurance, and real estate taxes.

If net farm profit is expected to be too low to take advantage of adjustments and exemptions, profit may be increased by accelerating sales and postponing expenses before the end of the year.

Other tactics for managing income taxes include choosing whether or not to use the Section 179 expense deduction, choosing the method of depreciating purchases, varying contributions to retirement plans, reporting certain sales under the installment method, electing to report farm income using farm income averaging, electing to postpone reporting the gain on sales livestock due to weather-related conditions, and shifting income by employing family members. Finally, when making decisions about changing taxable profit, it's important to keep in mind the marginal tax rates and any changes being proposed for the upcoming years.

Schedule F and the Income Statement

Schedule F (Form 1040) resembles a farm's income statement (also known as the profit and loss or earnings statement). Net farm profit on *Schedule F (Form 1040)* will equal accounting profit on an income statement provided the farmer reports to the IRS on an accrual basis and depreciation claimed approximates the actual decrease in depreciable asset values.

Accounting profit for a sole proprietor represents your return for your labor and management efforts and your equity in the business. For a partnership, accounting profit equals returns to the partner's labor and management and to the partner's equity. Accounting profit for a corporation equals returns to shareholder's equity since all labor and management costs have typically already been deducted.

If you report to the IRS on a cash basis, then adjustments to receipts and expenses may be needed in order to get a true picture of accounting profit. Cash receipts need to be adjusted for any change in end-of-the-year values compared to start-of-the-year values for product inventory and accounts receivable. Cash expenses will also need to be adjusted for changes in ending versus beginning values for supplies inventory, vendor accounts, and prepaid expenses. These changes can be determined by comparing values for current assets and current liabilities on the farm's beginning and ending balance sheets for the year.

Depreciation claimed on *Schedule F (Form 1040)* also needs to be reviewed. If an accelerated portion of the cost of machinery or other depreciable assets is deducted in the first or early years, then the tax depreciation claimed will overstate the decrease in the asset's value due to wear and tear. Accelerating depreciation may be a wise decision for tax management purposes, but accounting profit will be understated. Decreasing depreciation to a reasonable deduction on the income statement would provide a more realistic measure of actual profit.

When comparing your tax returns to an income statement, an additional item to consider is breeding livestock. Sales of breeding livestock and dairy animals are often considered part of receipts on an income statement. For taxes, these sales may be reported on *Form 4797*. Moreover, changes in raised breeding livestock inventory are commonly taken into account in determining net profit.

Keeping complete and accurate records will help you not only support the information you report to the IRS but assess business progress and make realistic plans. The reason for preparing a *Schedule F (Form 1040)* is to determine net farm profit for tax purposes, but a business income statement estimates returns to your labor, management, and equity. Understanding the difference is crucial.

For More Information

Publications

"Agricultural Employer's Tax Guide," IRS Pub. 51 (Washington, D.C.: Department of the Treasury, U.S. Government Printing Office).

"Farmer's Tax Guide," IRS Pub. 225 (Washington, D.C.: U.S. Department of the Treasury, Government Printing Office).

"Starting a Business and Keeping Records," IRS Pub. 583 (Washington, D.C.: U.S. Department of the Treasury, Government Printing Office).

"Tax Guide for Owners and Operators of Small and Medium Sized Farms" (Kelso, WA: Land Grant University Tax Education Foundation, 2011).

Recommended Websites

Internal Revenue Service: **irs.gov**
National Timber Tax Website: **timbertax.org**
Rural Tax Education: **ruraltax.org**
U.S. Social Security Administration: **ssa.gov**

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