Farm Income and Taxes

Get a few tips for preparing your farm taxes. Learn about hobby farm “losses” and the farm tax, as well as the advantages—and pitfalls—of being your own boss.

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Farms, like other businesses, make money or income (sometimes), and then farmers pay taxes on the income.

In 1996, the federal government estimated farm households paid $19 billion in federal income taxes and $10.2 billion in social security and self-employment taxes.

Farm Taxes: The Basics
Taxpayers generally use the Internal Revenue Service’s form 1040, 1040a or 1040EZ to report their income.

In this article ...

Farmers report their farm income on a form known as Schedule 1040F (or simply Schedule F). As the IRS uses the term, a Schedule refers to a sheet of paper that gets attached to the main piece of paper to explain it. In this case, Schedule F, which may only be used for income that comes from farming, gets attached to the taxpayer’s form 1040 to explain how the farm taxpayer earned his or her farm income.

Schedule C is the IRS form taxpayers use to report profit and losses from businesses which are related to farming but do not qualify for Schedule F, such as landlords who only have income from renting farmland. (If landlords “materially participate” in the running of the farm they may file Schedule F; however, this requires a lengthy tax analysis to determine whether they qualify.) Others that would qualify for Schedule C are: soil preparation consultants, veterinarians, farm laborers, horticultural workers, farm managers, and people who breed, raise and care for dogs, cats or other pet animals.

The first part of Schedule F requires farm taxpayers to supply the details of their farm income. These questions involve how much livestock was bought for resale, as well as questions about crops that were raised and sold. Some miscellaneous sources of farm income also get reported such as co-op distributions and payments from farm programs such as Commodity Credit Corporation loans. Money paid for custom machine work and fuel tax refunds should also be included.

Schedule F and Gross Income
The second part of Schedule F asks about gross income (the big pot of money earned all year from all sources) and how that money was distributed for expenses on the farm. Total expenses are then deducted from income to show the net profit or loss of the activity.

For example, here are some of things the IRS says should be included in your gross income: Compensation received for services rendered Business income/farm income Gains from selling property Interest income you receive Rents Royalties Dividends Alimony Annuities life insurance income Pensions Income from having debts paid off Partnership income Income from deceased Income from estates and trusts

Deductible Expenses for Farmers
Of course, you always have expenses when running a business. Imagine you’ve collected in a pot all the money you made from farming, and now you have to deduct all the expenses you incurred running the farm. After these deductions you have a net income, which may be positive or negative. (A deduction is an expense that the taxpayer can lawfully subtract from his or her gross income to arrive at his or her net income.)

Income tax is a progressive tax, which means the more the taxpayer earns, the more they pay; and those earning lower incomes pay less tax to the IRS. Deductible expenses for farm taxpayers include: Advertising Bad debts Car and truck expenses Chemicals Conservation Money paid for machine work Depreciation Employee benefits Feed Fertilizer Freight Fuel Interest Insurance Legal and professional fees Office supplies Rent for land vehicles and animals used in farming Repairs and maintenance Seeds Taxes Travel and entertainment (up to 50 percent) Utilities Vet bills

There are several miscellaneous expenses that can also be deducted from farm income such as certain amortization deductions. Amortization allows you to spread the cost of certain things over several years for tax purposes. If you think you might qualify based on your farming activities, the IRS has a pamphlet (publication 535) at http://www.irs.gov/ that can tell you more about what is available.

Hobby Farm Loss Rule
Generally speaking, the tax code provides a lot of benefits to farmers and other people who own their own businesses. Many expenses such as mileage related to earning a living are deductible for small business owners but not for employees.

One of the biggest tax advantages for the self-employed is that they can deduct all their losses from a business that is engaged in trying to make a profit. But if the business does not make a profit or if the IRS determines that the owners are not really trying to make it profitable, they may conclude it is an “activity not engaged in for profit.”

This rule is commonly known as the “hobby loss rule.” Here are three examples of how the rule might apply:Farmer Sue only farms—she has no other job. She starts growing ornamental flowers on her 20-acre farm. The first year she earns $2,000, and has expenses of $3,000; her net loss is $1,000. Since she has no income to tax, her losses should be fully deductible.
Farmer John grows the same crop with same results. But he has a job in town that earned him an additional $1,000. When he adds his $1,000 earnings to his $1,000 loss, he has zero income for the year, so he should get a refund.
Farmer Anne grows the same crop and gets the same result as Farmer Sue. However, the IRS examines her return and concludes she is not really trying to make a profit and the hobby loss rule applies to her. Even though she had expenses of $3,000, the IRS only allows her to deduct $2,000 because this is the amount of her profits. She had a job in town that paid $1,000 as well. But, she cannot offset all of that income with her full loss, so she has to pay income taxes on her in-town earnings.

Section 183 of the tax code governs “hobby losses.” This section of the tax code was passed so Congress could close down what it perceived as inappropriate farm and horse shelters. The law sets up a presumption that if an activity shows a profit in three out of five tax years, then the taxpayer is engaged in it to make a profit. In the case of horse operations, the business must show a profit in two out of seven tax years. Here are the factors the IRS uses to determine hobby farm losses:The manner in which the taxpayer carries on the activity. The expertise of the taxpayer or his or her advisors. The time and effort expended by the taxpayer in carrying on the activity. The expectations that the assets used in the activity may appreciate in value. The success of the taxpayer in carrying on other similar or dissimilar activities. The taxpayer’s history of income or losses with respect to the activity. The amount of occasional profits, if any, which are earned. The financial status of the taxpayer. The elements of personal pleasure or recreation.

Audit-proof Your Tax Return
As you structure your farm activities you can take some steps to audit-proof your return. First, ask yourself the following questions, which the IRS uses to evaluate farm and horse operations. By doing some planning you can take practical steps to save yourself some money. Does the taxpayer carry on the activity like a business?
First and foremost you must be able to show the IRS that you carry on your activities in a business-like manner to make money. For example, if you have purchased advertising to promote your business you should be prepared to show it to the IRS.

Further, your accounting should be clear and adequate; expect to supply photocopies. Also, you should maintain separate checking accounts for personal and business expenses. If you belong to a breed association, keep accurate and timely records.

The next thing you should do is to have a written, documented business plan that is realistic. (You may only be asked about whether you have a business plan at the first initial interview, but you should be prepared to produce it at any time.)

You can expect the IRS to compare your farm’s numbers against other similar farms. The IRS can readily obtain these estimates through extension offices and other sources for industry numbers on farming operations. Next, make sure that if all went well, your business plan would show a profit.

Also, be prepared to show that on a day-to-day basis you are running the operation like a business. This means daily activity records, but it's also a matter of showing that you're looking for ways to increase your efficiency.How much expertise do the taxpayer and his or her advisors have?
Businesses that want to make money seek out expert advice. If you have sought the help of extension personnel or other knowledgeable sources, you need to be able to show that. You also need to document, based on expert advice, that you implemented changes that made your business more profitable. If you didn't follow through on expert advice, the IRS may want to know why you ignored it.
How much time and effort is the taxpayer putting into the activity?
In addition to being prepared to answer how much time you've put into the operation, you should be able to describe what you did. For example, time spent reading and going to seminars will count, but time actually doing the farming or horse work will count more. You should provide examples of time spent reading journals and magazines, time at seminars and time spent doing work repairs and day-to-day operations.
Does the taxpayer expect that the assets used in the activity will go up in value?
This factor is your expectation that the assets you used in the endeavor may appreciate in value. The largest asset in most farming operations is usually the land itself, and being able to show that the land is being used for farming; demonstrating that it is appreciating is a big factor. There is a danger factor here, which you should know about: If you plan on retiring on the property, then this factor will not go in your favor. A decision to retire on the farm could show that your motivation was to have an enjoyable retirement spot and not a profitable farming venture. If you think the farm is appreciating in value then you should be prepared to show it with appraisals.
What success has the taxpayer had in similar or different activities?
This factor looks at how much business success or failure you have had in different ventures, not including your "day job." For example, a medical doctor who is also a restaurateur would be evaluated against his or her past business success in running restaurants—not the main career of practicing medicine.
What history of income or loss has the taxpayer had with respect to the activity?
At first glance this would seem to be the essential question. And yet, if the taxpayer has done his or her homework he or she may be able to prevail and show a profit motive in spite of a history of losses.

As a precautionary note you should keep an eye out for any expense related to your farm that is large, unusual or questionable that you intend to deduct. For example, is there something you spent money on that you have not before? Or were vet bills unusually high for some reason?

If you do supply information about your operation to show how you're trying to make a profit, make sure it's accurate. Even if the IRS examiner appears not to know much about farming, he or she will have resources at his/her disposal. It is a very bad idea to make things up. For example, one farmer submitted a video to the IRS showing his beef cattle operation. Unfortunately, all the cattle in the video were Holsteins—dairy cattle. If the IRS wants to tour your operation, get all your ducks in a row.

Surviving IRS Scrutiny
One of the easiest things you can do to be sure you survive this kind of scrutiny is to gather as much extension evidence as possible about your operation. Some IRS personnel will have great expertise and experience in agriculture. Others will only know what they have read. If you can show your operation is being run according to the best practices you can find, you should have a leg up on proving that you have the expertise to run a profitable operation. You should also be prepared to speak about general trends in the commodity you're raising.

One thing you should not do is report other income on the farm Schedule to make it look like you're making money. Do not give in to the temptation to report income from a non-farm activity under farm income to make it look like you are turning a profit. For example, say you have a farm with an orchard and an office you use for a holistic dental practice. These ventures are too different, so income from each should be reported separately. Penalties for willfully reporting false information to the IRS can be quite severe and could include fraud charges.Have there been occasional profits?
If the business has made even an occasional profit this needs to be emphasized. You also need to show you've learned from the years that showed profit and that you have integrated those lessons into your operation.
What is the financial status of the taxpayer?
People without money generally abandon activities that don't turn a profit because they run out of money and have no choice but to find other ways to support themselves. However, taxpayers with cash reserves can afford the losses until the business starts to make money. Also, you'll be in a better position to argue for deducting all of your losses if the business is the only activity you're doing to make a living.
How much of the activity is for the personal pleasure or recreation of the taxpayer?
Don't expect the IRS to necessarily buy your contention that running the business is all misery. The IRS will know that livestock operations in particular offer many rewards. You should know that a savvy IRS examiner wouldn't call your

operation a “hobby” to tip you off. Instead, he or she will call it an activity not engaged in for profit. If possible, you should impart to the examiner that you’re in it to make a dollar, and although there are many things that are pleasurable, it’s also a lot of work.

Election Options: Denying or Allowing Losses
There is another option taxpayers should be aware of. If it looks like the operation will make money—but not right away—the taxpayer can make a choice to put off determining whether or not the business is a for-profit venture. This means that the issue won’t be determined until the end of the fourth tax year for farm operations and not until the end of the fifth year for horse operations. If you have losses, but think it likely you’ll make money fairly soon, this could be an important option. You can still take deductions before year four and five.

Here is an example where losses would be denied:Bill buys a farm in the country with a lovely house that he intends to retire to someday. Many of the surrounding farms are now subdivisions and his farm is only an hour away from the large city Bill lives in. Bill grew up in the city and knows nothing about farming, but he likes llamas so he buys his own herd. The livestock pens at the farm are old and Bill leaves them as they are. He never had a plan for making money and never prepared a business plan. Bill thinks all the money is coming out of the same pot anyway so he only has one checkbook and writes all of his personal and business expenses out of that checkbook.

At an IRS examination, it would be hard for Bill to show that he meant to make a profit. He did not have financial records nor did he have a business plan or separate accounts. And, he never sought out help to make the operation show a profit.

Here is an example where losses would be allowed:Sarah inherits the 40-acre farm next to Bill’s. She grew up on the farm and helped her mother raise vegetables for market. She too moves back to the farm and begins transition into organic production. She regularly consults with local extension agents and other organic farmers, has a five-year business plan, is pursuing organic certification and has many contacts with local produce markets. She keeps extensive field journals on vegetable varieties and crop rotations so she can immediately tell which vegetables made money for her and which did not.

At an audit, it would be easy for Sarah to show her intention to make a profit. She kept separate books, sought expert advice and changed her operation in an effort to make money.

Note: This article does not constitute financial or accounting advice and does not form an attorney-client relationship.

About the Author: Rich Schell is a lawyer, writer and small farm owner. He is the author of a legal guide for Illinois farmers who want to sell food directly to consumers.

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