

8. When You Retire From Farming/Ranching and Transition From Operator to Landlord, Are You Still a Farmer/Rancher For Income And Estate Tax Purposes?

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Abstract/Summary

Production agriculture like any business has a life cycle where the owner/operator decreases their active involvement in the farming/ranching operation. Besides the daily work routine, other issues could and will change business decisions depending on how the remaining farming/ranching assets are conducted. Most of these issues will pertain to land ownership, but other issues would involve the type of business entity, crop share lease vs. cash lease, material vs. nonmaterial participation in the remaining assets, family or nonfamily if farmland is rented out and etc. The outcomes of these changes could be minor in nature or it can be major in the overall decision objective. Overall changes will affect Income Tax regulations (timing of deductions and losses) along with Estate Tax laws (tax basis and special use value) and timing of receiving Social Security Benefits and Retirement Income Distributions. This presentation will highlight some of the topics for general knowledge overview.

WHEN YOU RETIRE FROM FARMING/RANCHING:

ARE YOU STILL A FARMER/RANCHER FOR INCOME AND ESTATE TAX PURPOSES?

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DISCLAIMER:

- These materials are designed solely to raise issues and serve as a guideline for the reader's research. These materials are presented for the purpose of education. Every taxpayer has a distinct set of facts and circumstances that makes it impossible to give solutions other than a general guideline approach.
- If legal advice, tax advice, accounting assistance or other expert assistance is required, the services of a competent professional person should be retained.

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- Production agriculture like any business has a life cycle where the owner/operator decreases their active involvement in the farming/ranching operation. Besides the daily work routine, other issues could and will change business decisions depending on how the remaining/ranching assets are conducted. Most of these issues will pertain to land ownership, but other issues would involve the type of business entity, crop share lease vs. cash lease, material vs. nonmaterial participation in the remaining assets, family or nonfamily if farmland is rented and etc.

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ARE YOU A FARMER/RANCHER?

- Perhaps you are. Perhaps you are not. As they say, it “depends”. “It depends” on the particular Internal Revenue Code section that is involved. There are many unique definitional provisions. It’s important to have an understanding of the various definitions because special tax benefits often apply to a taxpayer that is a “farmer/rancher”.

- However, not all agricultural producers meet these qualifications even if they are producing agricultural products, which is why it is important for operators and owners of farms and their tax professionals to understand the IRS tax definitions of farm, farming and farmer.

- Operators of farming business may associate the term farmer as an adjective when describing themselves. Most people will understand what being a farmer means as a description of the rural occupation.
- For income tax purposes, however, taxpayers and their tax advisors need to be certain of the facts and circumstances in the context of the tax issues at hand. In some instances, an individual can be classified as a farmer for one income tax purpose but not for another. Also, someone who is not classified as a farmer may still be engaging in farming activities and have farm income.

- In general, the Internal Revenue Code Section 61 definition of a farmer for purposes of determining gross income is a person engaged in agriculture. “Farming” includes cultivating, operating or managing a farm for profit, either as a owner or tenant. A “farm” includes a stock, dairy, poultry, fish, fruit or truck farm. It also includes a ranch or orchard.
- The description above is not all inclusive, taxpayers and tax preparers can find many other references that define farm for tax purposes.

- The definition of a farm describes farming activities. These activities produce farm income which is recorded on:
 - FORM 1040, Schedule F: Profit or Loss From Farming
 - FORM 1040, Form 4797: Sales of Business Property
 - FORM 1040, Form 4835: Farm Rental Income and Expenses
(crop & livestock shares but NOT cash received by Landowner)
(income not subject to self-employment tax)

- However, if a person's main source of income is from providing agricultural services such as soil preparation, veterinary farm labor, horticultural or management on a fee or contract basis, the person is not a farmer for tax purposes and would report their business income on Schedule C (nonfarm business) rather than Schedule F.
- If a person owns farmland and cash rents it to a tenant to conduct farming activities, the owner is engaged in a rental activity rather than a farming activity.

- This is important point for numerous provisions of the Internal Revenue Code, not the least of which are the passive loss rules of I.R.C. section 469 and the Net Investment Income Tax of I.R.C. section 1411. Cash rent often results in a less favorable tax result for a taxpayer than if the same taxpayer were an active participating landlord.

- A landlord who is not materially participating under a crop share lease receives the income from the lease not subject to self-employment tax. The income and expenses are to be reported on IRS Form 4835 rather than the Schedule F.
- Income under a cash rent lease is income from a passive rental arrangement and is not subject to self-employment tax. Income from the cash rent lease is to be reported on the Schedule E – Rental Income.

- As for depreciation expense method (Section 179), the landlord must be “meaningfully participating” in the management or operations of the trade or business, and avoid the “noncorporate lessor” rules. Thus, “cash rent” landlords are not allowed to utilize Section 179 depreciation. “Crop share” landlords are most likely not allowed to utilize Section 179 because of special conditions that must be met.
- However, the 50% “bonus depreciation” is allowed for “cash rent and crop share landlords. The noncorporate lessor rules are not a factor for utilizing bonus depreciation.

- Farmers are eligible for the cash method of accounting. Cash-basis farmers are permitted to report income from the sale of farm products when the product is sold. They are not required to maintain inventories. In addition grain, livestock and real estate can be sold on the installment method.
- Any contract for the sale of goods is an installment sale and taxable on the installment method if any part of the payment is to be received in a subsequent year. Crops and livestock as inventory-type property are eligible for installment reporting by cash method farmers and ranchers.

- With respect to livestock pasturing, if an individual pastures someone else's livestock and takes care of the livestock for a fee, the individual is a farmer and the income belongs on a Schedule F. However, if the individual simply rents pasture for a flat cash amount without providing services the individual is not a farmer and must report the rent on Schedule E. In this situation, the individual is engaged in a rental activity and not a farming activity.
- That passive status will also have other tax and possible estate planning implications.

- A shareholder of an S-Corporation engaged in farming can treat compensation received from the corporation as farming income if the compensation is paid by the corporation in the conduct of farming. Also amounts passed through to the shareholder, is treated as if it were realized directly. (IRS Revenue ruling 87-121).

- “Farmers” in the farming business can exclude from income a cancelled debt that is a qualified farm debt owed to a qualified person, Also, a person that meets an income test and an aggregate debt test can file Chapter 12 bankruptcy and be eligible to have tax debts changed from priority to nonpriority status. (11 U.S.C. Section 1222(a)(2)(A))

- For purposes of special use valuation, a surviving spouse of a farmer can be considered to be a farmer by providing active management in the farming operation. (I.R.C. Section 2032A(b)(5))

- To be a farmer eligible potentially eligible for federal farm programs, a farmer must be “actively engaged” in farming to be eligible for certain farm programs. The term applies to either individuals or entities. As an individual/entity they must make a significant contribution to the farming operation of capital, equipment or land and a significant contribution of personal labor or active management.
- Additionally, the individual/entity must share the profits/losses from the operation as well as the contributions would have to be deemed at risk.

- Farmers are allowed to deduct expenses for fertilizer and lime in the current year even though the fertilizer and lime provide more than one year’s economic benefit to soil fertility. The farmer, therefore, does not capitalize this expense to match the economic life of this production input. This is available for all farming income.

- Individual taxpayers who qualify as being a farmer under I.R.C. Section 1301 may average their farm income. This provides for the opportunity to level income tax liabilities over a period of years. The usefulness of this provision is based upon the individual circumstances of a particular taxpayer's situation.
- For this purpose, the term "individual" does not apply to an estate or trust, corporations, partnerships or S-Corporations.

- Cash rent landlords are not considered to be in the business of farming for the tax purposes. Cash rent landlords, for example, do not qualify for farm income averaging.
- Crop share landlords whether or not they materially participate under the lease, may be eligible for Farm Income Averaging.

- Nonmaterially participating crop share landlords are generally subject to the passive loss rules in the same manner as cash rent landlords.
- Their income may also be subject to the net income tax.

- Generally, passive losses may be used to offset only passive income. Passive losses may, however, be applied against ordinary income in an amount up to \$25,000 if the landlord “actively participated” in the rental activity. This special allowance begins to phase out when adjusted gross income is greater than \$100,000. It should also be noted that IRS regulations recharacterize rental income from land where less than 30% of the adjusted basis of the property is depreciable as non-passive income. This means that passive losses from other activities cannot be offset by rental income. Any loss from the farm rental activity however remains passive.

(Treas. Reg 1.469-2T(f)(3).

CHARITABLE CONTRIBUTIONS OF COMMODITIES

- For some farmers, making a charitable contribution in kind, rather than cash increase the tax benefit of the gift. The tax consequences of the gift differs depending on whether the donor is an active farmer or a landlord.

Basic Rules

- For gifts by farm operators and materially participating landlords, the gifts of crops, livestock and other items of inventory do not trigger gain on contribution to a charity. Instead, the contribution is limited to the donor's income tax basis of the grain and other "ordinary income property." For charitable gifts of grain or raised livestock, the costs of production are deductible as trade or business expenses under IRC Section 162. That is the result regardless of whether the contribution occurs in the past year of production or a later year.

- In Rev. Rul. 75-11, 1975-1 C.B. 27. a “crop share landlord” donated crop shares received by him as rent to a charity. The IRS noted that the crop share landlord had made a gift of realized income.
- The crop share landlord receives commodities as the equivalent of rental income: the commodities do not have an inventory-asset status in the hands of the landlord.
- A gift by a landlord of a commodity received in a crop share arrangement is treated as an “assignment of income” disposition.

- The landlord had to recognize rental income in an amount equal to the FMV of the crop shares as of the time of contribution to the charity.
- The IRS also ruled that the landlord would be treated as having made simultaneously a charitable contribution in the same amount.

Gifts of Commodities to NonCharities

- There is no income recognition by a donor upon a gift of unsold inventory (Rev. Rul. 55-138; Rev. Rul. 55-531).
- The IRS have held that a gift of unsold raised farm commodities represents a transfer of an asset (i.e. inventory) rather than an assignment of income.
- The farmer/donor sidesteps the income tax on commodities that are transferred by the gift to another taxpayer. Further, the self-employment tax is also eliminated on the commodities, as excludable gross income is not considered in determining self-employment income.

- Commodities that are subject of a gift should have been raised or produced in a “prior tax year”, to avoid any expense adjustments for the donor.
- If current crop is given, current year costs applicable to the commodity are not deductible by the donor.
- The IRS notes that costs that apply to gifts of agricultural products may not be deducted as a farm business expense in the year of the gift or any later year (but by implication, costs deducted in a prior year to the gift will remain allowable) [IRS Publication 225, chapter 4].

Crop Share Landlords

- A crop share landlord receives commodities as the equivalent of rental income.
- A gift or transfer by a landlord of a commodity received in a crop share arrangement is treated as an “assignment of income” disposition, causing full taxation to the donor/landlord at disposition.
- The crop share landlord must recognize the crop share as income at the time of the gift or transfer.

- An individual is a farmer for purposes of estimated payment rules if:
 - Gross income from farming is at least 66.67% of total gross income from all sources of the tax year (I.R.C. Section 6654(i)(2)(A):
 - or
 - Gross income from farming shown on the preceding tax year is at least 66.67% of the total gross income from all sources shown on the tax return. (I.R.C. Section 6654(i)(2)(B)

- If a taxpayer qualifies as a farmer by having more than two-thirds of his/her gross income being derived from farming;
 - they make a single estimated tax payment by the 15th of the month that follows the close of their tax year or make payment in full of their income tax liability by the first of the third month following the close of their tax year. (Calendar taxpayers: 15th of January or 1st of March).

- If a farmer does not make any estimated payments and cannot file the final tax return by the March 1 deadline, a six month extension will not prevent the taxpayer from being assessed an estimated payment penalty.
- The estimated income tax payment should be the smaller of:
 - 66.67% of the tax you expect to owe for the current year or
 - 100% of the tax owed the prior year.

QUALIFIED FARMER DETERMINATION - INTERNAL REVENUE SECTION 6654(I)

- (FOR FORM 2210F ESTIMATED TAX EXCEPTION)
(FARMERS TAX GUIDE – PUBLICATION 225)

DETERMINATION OF TOTAL GROSS INCOME:

| | | |
|--|------------|----------|
| • Form 1040 – All wages | - Line 7 | \$ _____ |
| • Form 1040 – Taxable interest Income | - Line 8a | \$ _____ |
| • Form 1040 - Ordinary dividend income | - Line 9a | \$ _____ |
| • Form 1040 – Taxable state tax refund | - Line 10 | \$ _____ |
| • Form 1040 - Alimony received | - Line 11 | \$ _____ |
| • Form 1040 – Ordinary gain and losses | - Line 14 | \$ _____ |
| • Form 1040 - Taxable IRAs | - Line 15b | \$ _____ |
| • Form 1040 - Taxable pensions/annuities | - Line 16b | \$ _____ |
| • Form 1040 - Taxable unemployment comp. | - Line 19 | \$ _____ |

- Form 1040 – Taxable social security benefits - Line 20b \$ _____
 - From 1040 - Other Income - Line 21 \$ _____
 - Schedule C – Gross income - Line 7 \$ _____
 - Schedule D - Capital gains (See Note 2) \$ _____
 - Schedule E - Gross rental income - Line 4 \$ _____
 - Schedule E - Gross royalties - Line 4 \$ _____
 - Schedule E - Share of p’ship & S corp. income – Line 32 \$ _____
- (See Note 1)

- Schedule E – Estates and trusts (See note 1) - Line 37 \$ _____
 - Schedule F - Gross farm income - Line 9/50 \$ _____
 - Form 4835 – Gross farm rental income - Line 7 \$ _____
- TOTAL GROSS INCOME \$ _____

Determination of Gross Farm Income:

- Schedule E Included gross farm income from pass-thru entities (Part II & III) and crop-share arrangements (via Form 4835).

It does not include cash rent received on farmland.

- Line 41 \$ _____

- Schedule F Gross farm income

- Line 9/50 \$ _____

- From 4797 Portion of gains attributed to the sale of draft, dairy or breeding stock (see Note 3)

- Various \$ _____

TOTAL GROSS FARM INCOME

\$ _____

- Determination of Gross Income Ratio: Percentage of gross income attributable to farming = (total gross farm income/total gross income)

Must be at least two-thirds (66.67%) to qualify for special estimated tax exclusion rules for farmers.

• NOTES:

(1) See Schedule K-1 for pass-through entity owner's share of total gross farm income.

(2) IRS Pub. 225 specifies only capital gains are to be considered. Capital losses cannot be netted against capital gains. Capital gain distributions from Schedule d, line 13 are also included.

(3) Farm income does not include gains or losses from the sale of farmland and depreciable farm equipment; income of custom farm operators; or wages earned as a farm employee.

- The definition of a farmer is different for different provisions in the IRS Code. It also matters for purposes of federal farm programs and other areas of the law. There's even more detail on additional provisions than are mentioned here.
- As can be seen in this presentation, this is a general overview of "who qualifies as a farmer".