Taxes for Agricultural Enterprises

RightRisk

Section 1: Definition of a Farm

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- Farm
- Hobby Farm
- Qualified Farmer
- Material Participation in Farming

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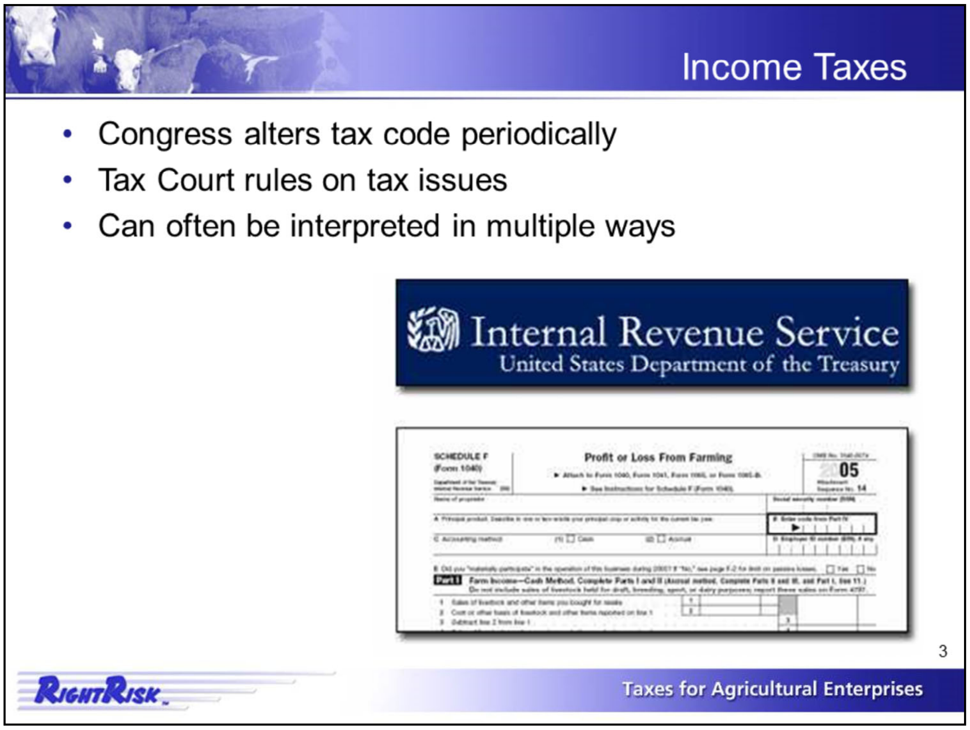
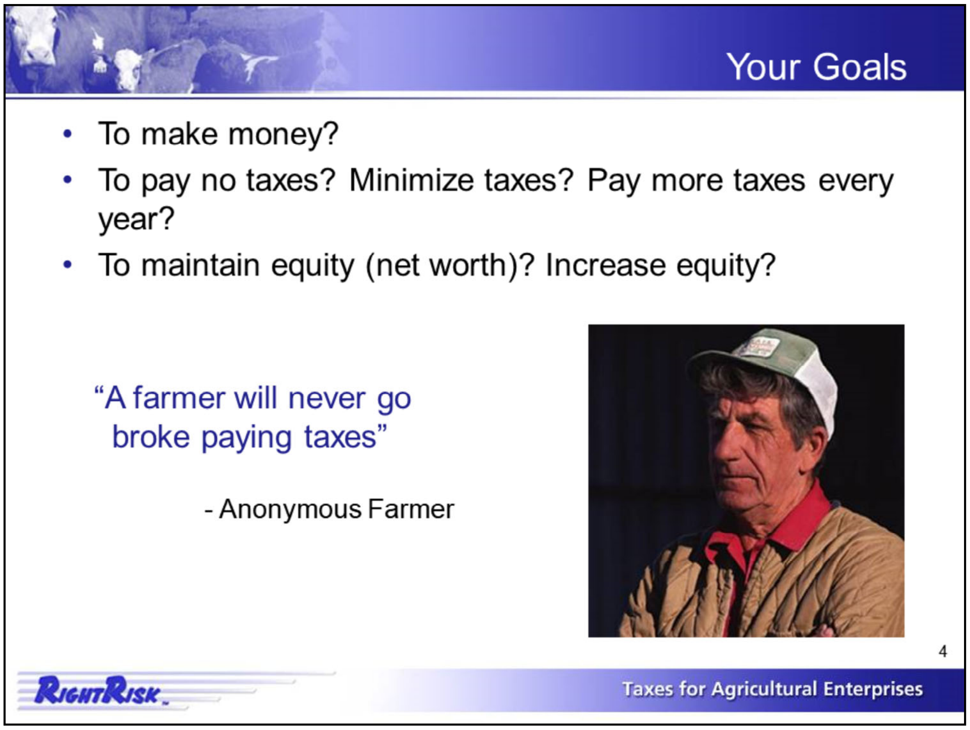
Taxes for Agricultural Enterprises

This section provides information which helps in defining a farm and hobby farm, help determining if a person is a “qualified farmer”, and establishing material participation in farming – according to the Internal Revenue Code.



This is an educational course pertaining to income taxes issues. The primary focus of the following information is for those people currently operating or considering an agricultural business.

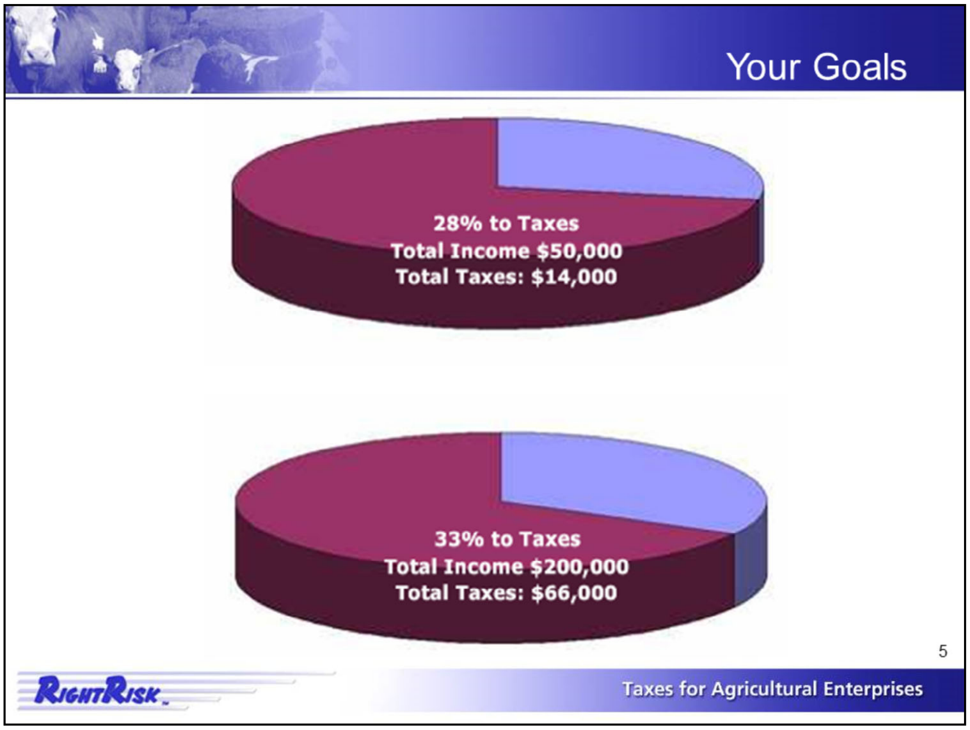
In the US, the Congress passes tax laws and requires taxpayers to comply. Income taxes in the US go back to the Civil War. Today, Congress periodically alters the revenue code and the Tax Court clarifies various issues pertaining to application of the tax laws to individual taxpayers and businesses. Often times taxcodes can be interpreted in multiple ways or have different applications to different situations.



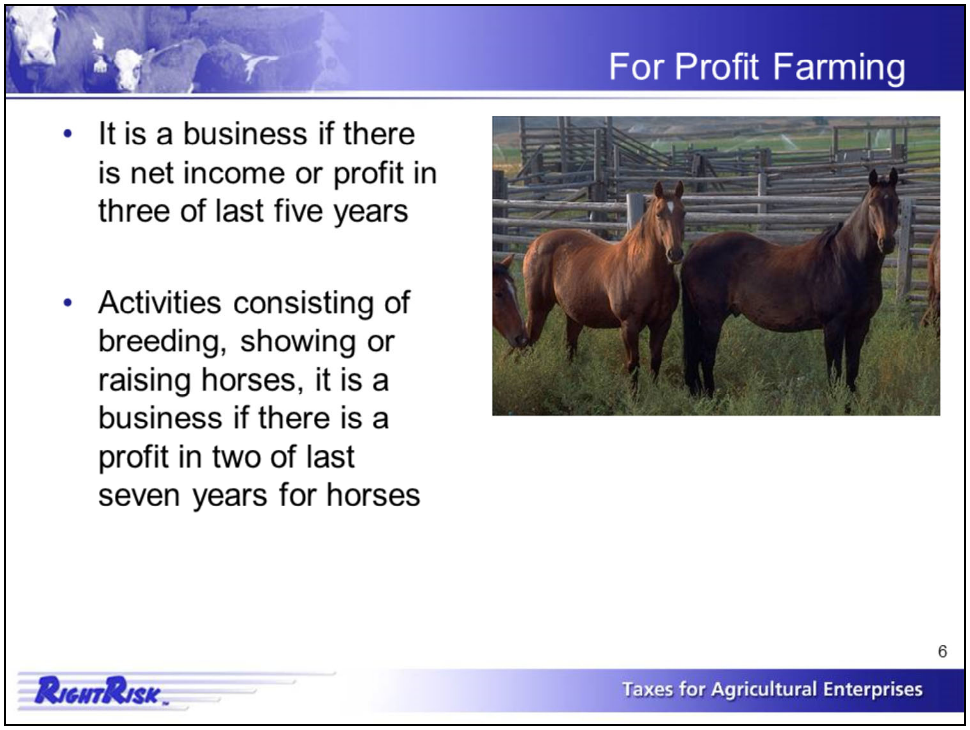
The first step people should take in financial management is to determine their financial goals for the agricultural business.

Do you want to make money? Over a short period of time such as a year or two? Or over a longer period of time?

What are your goals pertaining to paying income taxes? To pay no taxes? To minimize taxes? Paying more taxes each year indicates growth in the business.

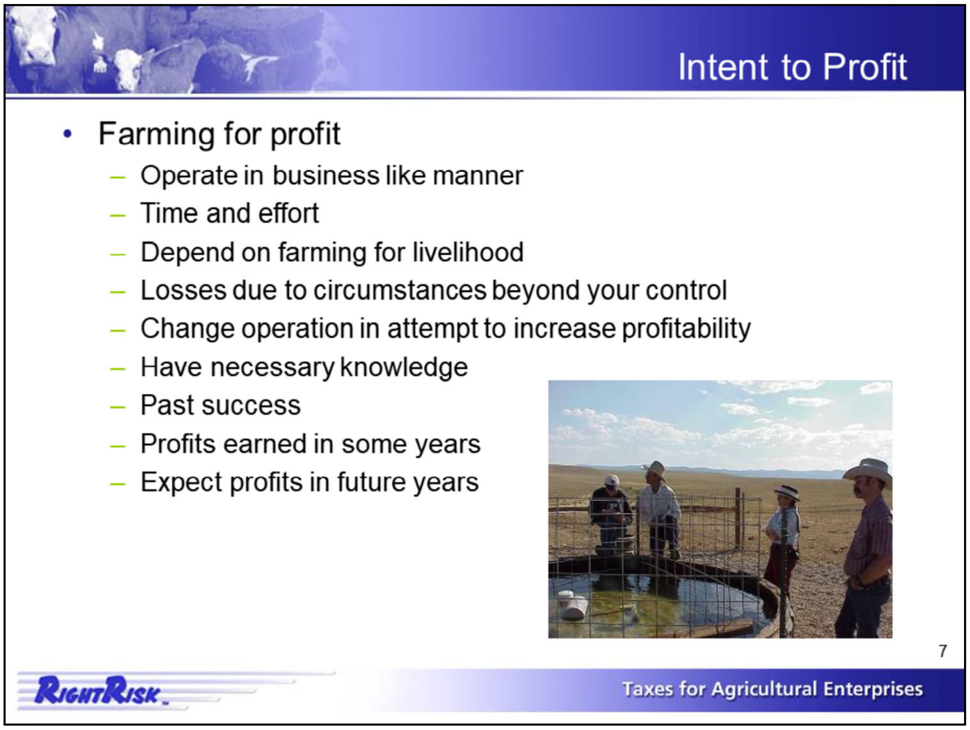


Discuss pie graphs – illustration to last slide.



An activity is presumed to be a business if there is net income or profit for 3 or more of the last 5 years for most farm or ranch businesses. For activities consisting of breeding, showing or raising horses, the presumption arises if there is a profit in any 2 of the last 7 years.

The IRS can rebut the presumption by carrying the burden of proof and establishing a lack of profit motive.



If the business fails to meet the profit test, certain factors may be considered to determine an "intention to be profitable". The taxpayer does not have to qualify on each of these factors – the cumulative picture will provide the basis for the determination.

These factors include:

The farm is operated in a business-like manner.

The time and effort spent on farming indicates an intention to make it profitable.

The taxpayer depends on farm income for his livelihood.

Losses are due to circumstances beyond the manager's control or are normal in the start-up phase of farming.

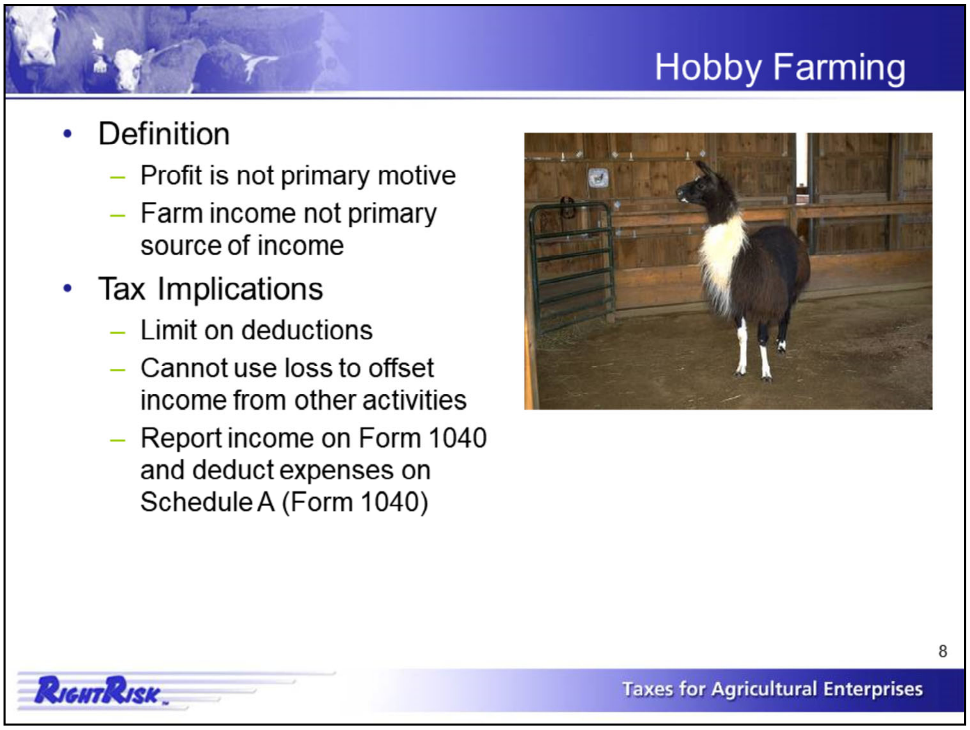
Methods of operation are changed in an attempt to improve profitability.

There is profit from farming in some years and the amount of that profit.

The operator or his advisors have the knowledge needed to carry on the farming activity as a successful business.

The operator made a profit in similar activities in the past.

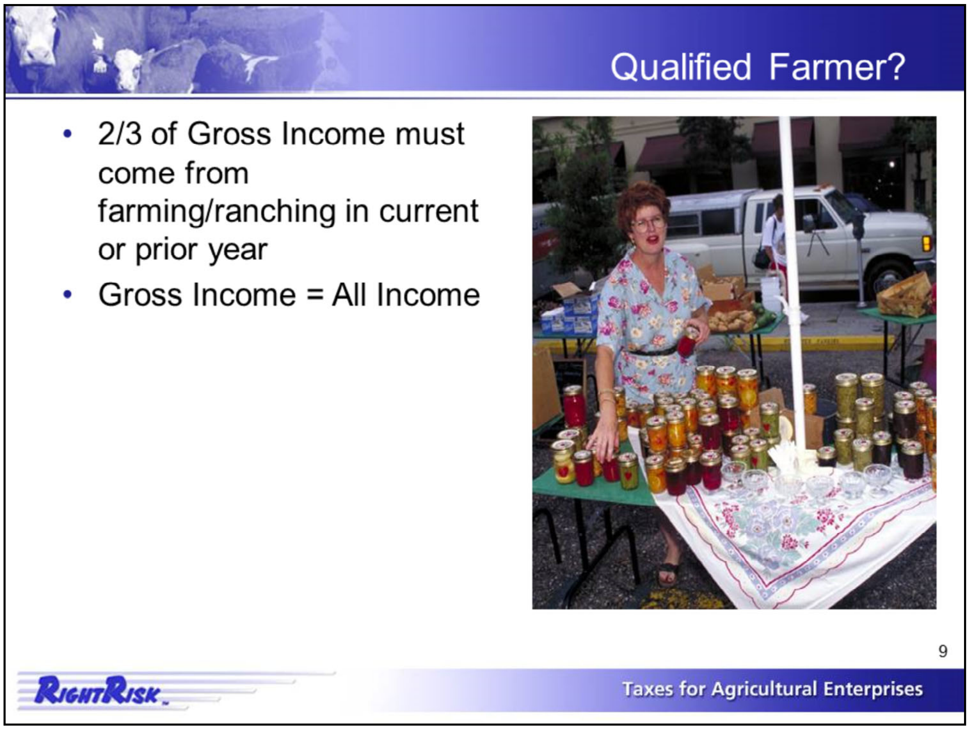
The farm or ranch is not operated for personal pleasure or recreation.



Hobby farmers are, generally, those people operating an agricultural enterprise where profit or farm income is not the primary motive for the taxpayer.

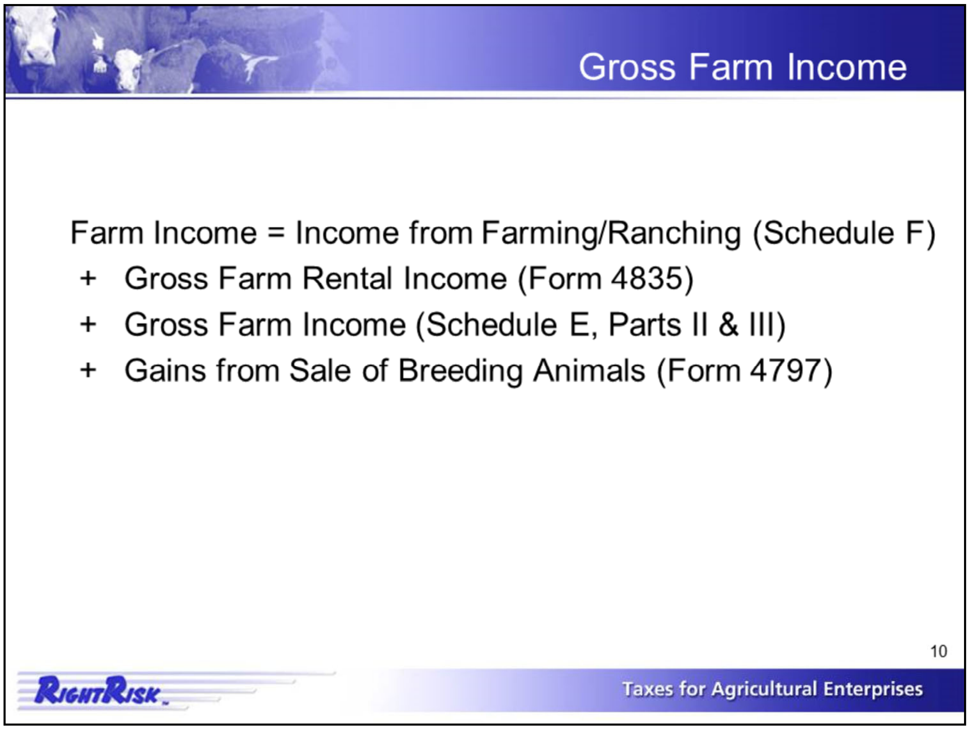
Hobby losses are generally deductible only to the extent of income produced by the activity. Losses from one hobby cannot be used to offset income from other activities.

Hobby farmers report the income from the activity on Form 1040 and deduct expenses of carrying on the activity on Schedule A (Form 1040).



An individual is a “qualified farmer” if at least two-thirds of his or her gross income from all sources in either the current or prior years was for farming.

Gross income is all income received in the form of money, goods, property, and services that is not exempt from tax. On a joint return, the gross income for both spouses is included.



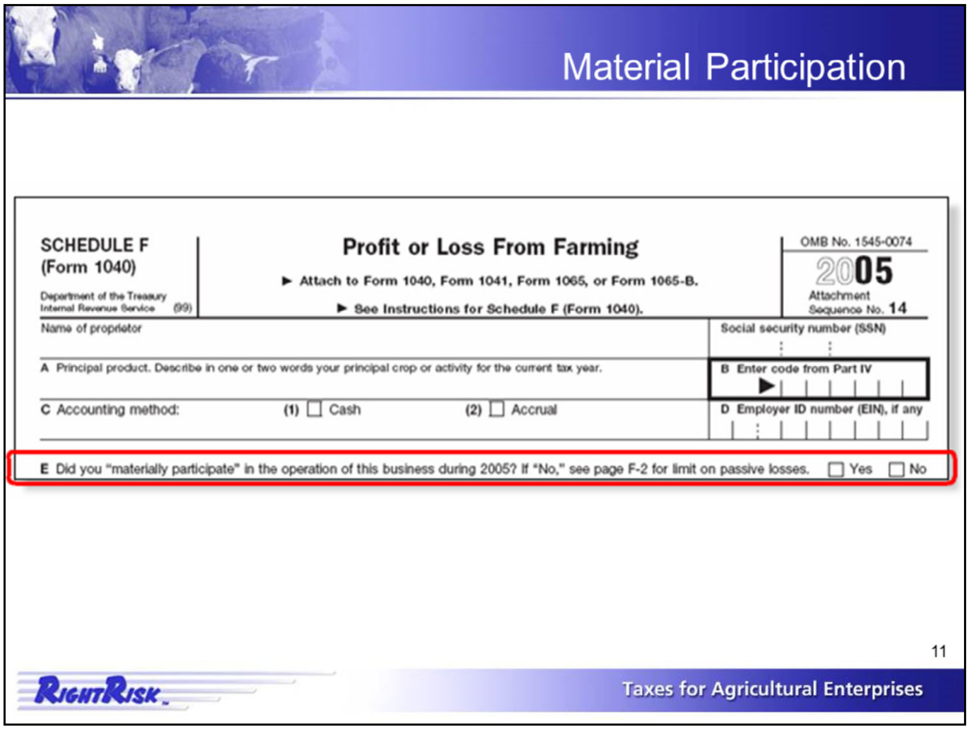
Gross farm income includes:

•Gross farm income from Schedule F, line 11, plus

•Gross farm rental income from Form 4835, line 7, plus

•Gross farm income from Schedule E, parts II and III, plus

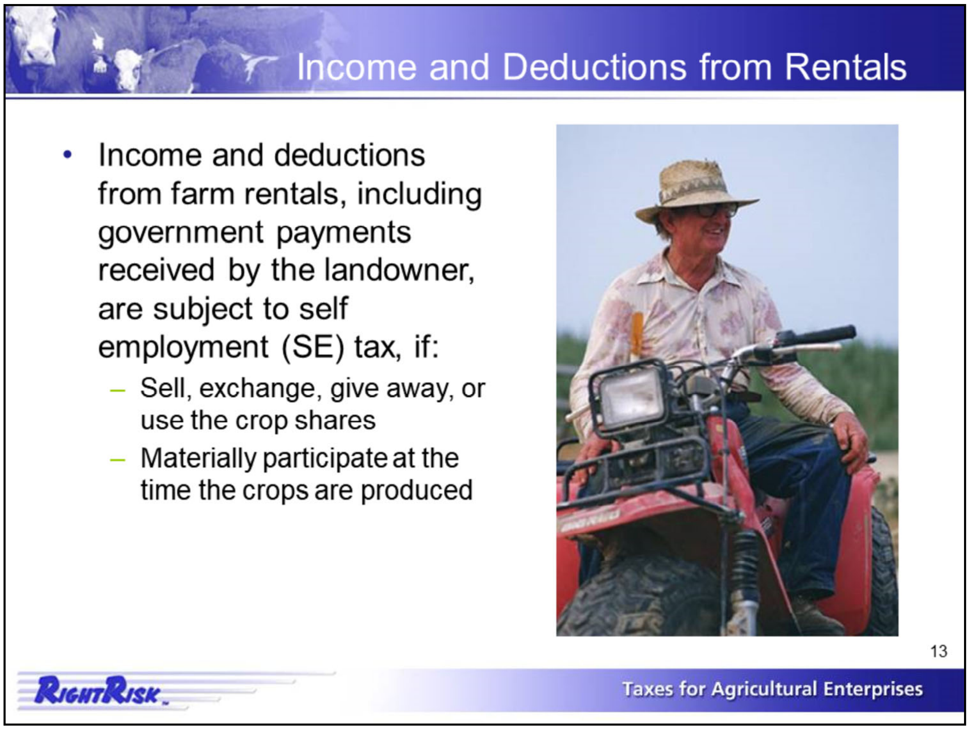
•Gains from the sale of livestock used for breeding, draft, sport, or dairy reported on Form 4797.



Some taxpayers may own agricultural land which is leased to farmers. As a general rule, income and deductions from rentals and from personal property leased with real estate are not included in determining earnings subject to self employment tax. However, income and deductions from farm rentals, including government commodity program payments received by a landowner who rents land, are included if the rental arrangement provides that the landlord will, and does, materially participate in the production of management of production of the farm products on the land.

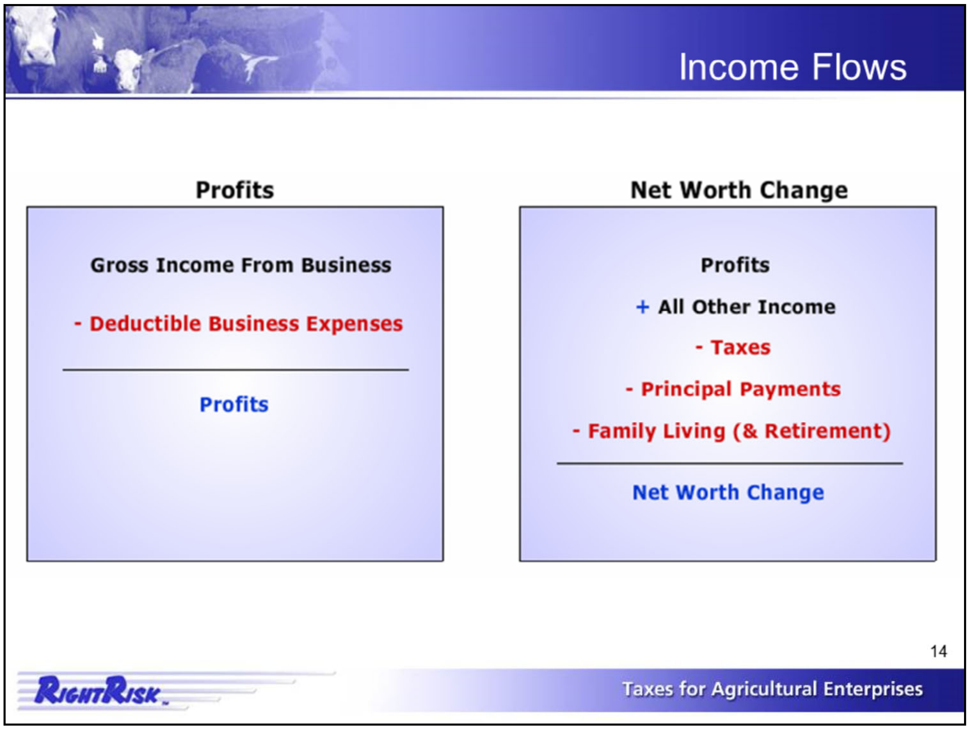
A landlord materially participates with the tenant if the landowner meets one of the following tests listed here:

- Regularly and frequently makes, or takes an important part in making, management decisions.
- Works 100 hours or more spread over a period of 5 weeks or more.
- Does things that, considered in their totality, show material and significant involvement.
- Does any three of the following:
    - Pays, using cash or credit, at least half the direct costs of producing the crop or livestock
    - Furnishes at least half the tools, equipment, and livestock used in the production activities
    - Advises or consults with the tenant
    - Inspects the production activities periodically



For those taxpayers NOT materially participating in farming, income and deductions from rentals and personal property leased with real estate are not subject to self-employment tax.

Income and deductions from farm rentals, including government payments received by the landowner, are subject to self-employment tax if the taxpayer 1) sells, exchanges, gives away, and/or uses any portion of crop shares received and 2) materially participates in the farming operation at the time the crops are produced.



The flow of money into and out of a farm or ranch business begins with gross income. From this amount business expenses are deducted equaling farm profits.

Farm profits plus all other income less taxes, principal payments, and family living equal changes in net worth. Depreciation, while deductible on the business return for tax purposes decreases net worth.

Summary:

•An activity is presumed to be a farm business if there is net income or profit for 3 or more of the last 5 years. For activities consisting of breeding, showing or raising horses, the presumption arises if there is a profit in any 2 out of the last 7 years

•If the business fails to meet the profit test, other factors may be considered when determining "intention to be profitable"

•An individual is a "qualified farmer" if at least 2/3 of his/her gross income from all sources in either the current or prior years was from farming or ranching