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Farmer's Tax Guide

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For use in preparing

2001 Returns

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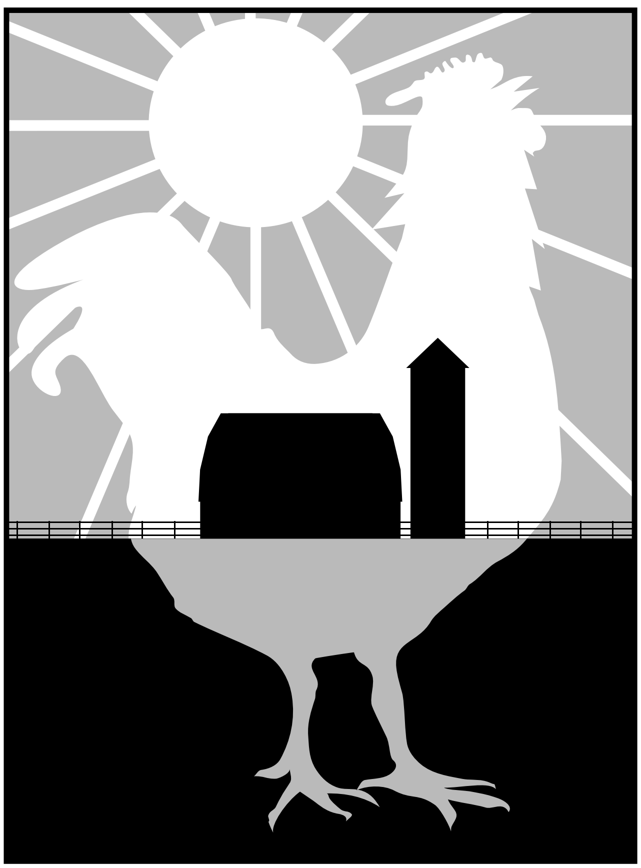

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Introduction

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 stock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.

operations on the land, the rent is farm income. See *Landlord Participation in Farming* in chapter 15.

Pasture income and rental. If you pasture someone else's cattle and take care of the livestock for a fee, the income is from your farming business. You must enter it as *Other income* on Schedule F. If you simply rent your pasture for a flat cash amount without providing services, report the income as rent in Part I of Schedule E (Form 1040).

Crop Shares

You must include rent you receive in the form of crop shares in income in the year you convert the shares to money or the equivalent of money. It does not matter whether you use the cash method of accounting or an accrual method of accounting.

If you materially participate in operating a farm from which you receive rent in the form of crop shares or livestock, the rental income is included in self-employment income. (See *Landlord Participation in Farming* in chapter 15.) Report the rental income on Schedule F.

If you do not materially participate in operating the farm, report this income on Form 4835 and carry the net income or loss to Schedule E (Form 1040). The income is not included in self-employment income.

Crop shares you use to feed livestock. Crop shares you receive as a landlord and feed to your livestock are considered converted to money when fed to the livestock. You must include the fair market value of the crop shares in income at that time. You are entitled to a business expense deduction for the livestock feed in the same amount and at the same time you include the fair market value of the crop share as rental income. Although these two transactions cancel each other for figuring adjusted gross income on Form 1040, they may be necessary to figure your self-employment tax. See chapter 15.

Crop shares you give to others (gift). Crop shares you receive as a landlord and give to others are considered converted to money when you make the gift. You must report the fair market value of the crop share as income, even though someone else receives payment for the crop share.

Example. A tenant farmed part of your land under a crop-share arrangement. The tenant harvested and delivered the crop in your name to an elevator company. Before selling any of the crop, you instructed the elevator company to cancel your warehouse receipt and make out new warehouse receipts in equal amounts of the crop in the names of your children. They sell their crop shares in the following year and the elevator company makes payments directly to your children.

In this situation, you are considered to have received rental income and then made a gift of that income. You must include the fair market value of the crop shares in your income for the tax year you gave the crop shares to your children.

Crop share loss. If you are involved in a rental or crop-share lease arrangement, any loss from these activities may be subject to the limits under the passive loss rules. See Publication 925 for information on these rules.

Agricultural Program Payments

You must include in income most government payments, such as those for approved conservation practices and production flexibility contracts, whether you receive them in cash, materials, services, or commodity certificates. However, you can exclude some payments you receive under certain cost-sharing conservation programs. See *Cost-Sharing Exclusion (Improvements),* later.

Report the agricultural program payment on the appropriate line of Part I of Schedule F. Report the full amount even if you return a government check for cancellation, refund any of the payment you receive, or the government collects all or part of the payment from you by reducing the amount of some other payment or Commodity Credit Corporation loan. However, you can deduct the amount you refund or return or that reduces some other payment or loan to you. Claim the deduction on Schedule F for the year of repayment or reduction.

Commodity Credit Corporation (CCC) Loans

Normally, you do not report loans you receive as income, and you report income from a crop for the year you sell it. However, if you pledge part or all of your production to secure a CCC loan, you can treat the loan as if it were a sale of the crop and report the loan proceeds as income for the year you receive them. You do not need approval from the IRS to adopt this method of reporting CCC loans, even though you may have reported those received in earlier years as taxable income for the year you sold the crop.

Once you report a CCC loan as income for the year received, you must report all CCC loans in that year and later years in the same way, unless you get approval from the IRS to change to a different method. See *Change in Accounting Method* in chapter 3.

TIP *You can request income tax withholding from CCC loan payments you receive. Use Form W–4V,* Voluntary Withholding Request. *See chapter 21 for information about ordering the form.*

To choose to report a CCC loan as income, include the loan as income on line 7a of Schedule F for the year you receive it. Attach a statement to your return showing the details of the loan.

You must file the statement and the return by the due date of the return, including extensions. If you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach the statement to the amended return and write "Filed pursuant to section 301.9100–2" at the top of the return. File the amended return at the same address you filed the original return. Once you have made the choice, you can change it only with the approval of the IRS.

When you make this choice, the amount you report as income becomes your basis in the commodity. See chapter 7 for information on the basis of assets. If you later repay the loan, redeem the pledged commodity, and sell it, you report as income at the time of sale the sale proceeds ***minus*** your basis in the commodity. If the sale proceeds are less than your basis in the commodity, you can report the difference as a loss on Schedule F.

If you forfeit the pledged crops to the CCC in full payment of the loan, the forfeiture is treated for tax purposes as a sale of the crops. If you did not report the loan proceeds as income for the year you received them you must include them in your income for the year of the forfeiture. If you reported the loan proceeds as income for the year you received them and the amount of the forfeited loan is less than your basis in the commodity, you can report the difference as a loss on Schedule F.

Market Gain

Under the CCC nonrecourse marketing assistance loan program, your repayment amount for a loan secured by your pledge of an eligible commodity is generally based on the lower of the loan rate or the prevailing world market price for the commodity on the date of repayment. If you repay the loan when the world price is lower, the difference between that repayment amount and the repayment amount based on the loan rate is market gain. You will receive a Form CCC–1099–G showing the market gain you realized. If you chose to include the CCC loan in income in the year you received it, do not include the amount shown on Form CCC–1099–G in income. The following examples show how to report market gain.

Example 1. Mike Green is a cotton farmer. He uses the cash method of accounting and files his tax return on a calendar year basis. He has deducted all expenses incurred in producing the cotton and has a zero basis in the commodity. In 2000, Mike pledged 1,000 pounds of cotton as collateral for a CCC price support loan of $500 (a loan rate of $.50 per pound). In 2001, he repaid the loan and redeemed the cotton for $420 when the world price was $.42 per pound. Later in 2001, he sold the cotton for $600.

The market gain on the redemption was $.08 ($.50 – $.42) per pound. Mike received a Form CCC–1099–G from the CCC showing market gain of $80 ($.08 x 1,000 pounds). How he reports this market gain and figures his gain or loss from the sale of the cotton depends on whether he included CCC loans in income in 2000.

Including CCC loan. Because Mike reported the $500 CCC loan as income for 2000, he is treated as if he sold the cotton for $500 when he pledged it and repurchased the cotton for $420 when he redeemed it. The $80 market gain is not recognized on the redemption. He reports it for 2001 as an "Agricultural program payment" on line 6a of Schedule F, but does not include it as a taxable amount on line 6b.

Mike's basis in the cotton after he redeemed it was $420, which is the redemption (repurchase) price paid for the cotton. His gain from

5.

Farm Business Expenses

Important Changes for 2001

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2001 is $34\frac{1}{2}$ cents a mile for all business miles driven. See *Truck and Car Expenses.*

Introduction

You can generally deduct the current costs of operating your farm. Current costs are expenses you do not have to capitalize or include in inventory costs. However, your deduction for the cost of livestock feed and certain other supplies may be limited. If you have an operating loss, you may not be able to deduct all of it.

Topics

This chapter discusses:

- Deductible expenses
- Capital expenses
- Nondeductible expenses
- Farm operating losses
- Net operating losses
- Not-for-profit farming

Useful Items

You may want to see:

Publication

- ❏ **463** Travel, Entertainment, Gift, and Car Expenses
- ❏ **535** Business Expenses
- ❏ **536** Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- ❏ **587** Business Use of Your Home
- ❏ **925** Passive Activity and At-Risk Rules
- ❏ **936** Home Mortgage Interest Deduction

Form (and Instructions)

- ❏ **Sch A (Form 1040)** Itemized Deductions
- ❏ **Sch F (Form 1040)** Profit or Loss From Farming
- ❏ **1045** Application for Tentative Refund
- ❏ **5213** Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit

See chapter 21 for information about getting publications and forms.

Deductible Expenses

The ordinary and necessary costs of operating a farm for profit are deductible business expenses. Part II of Schedule F lists expenses common to farming operations. This chapter discusses many of these expenses, as well as others not listed on Schedule F.

Reimbursed expenses. If an expense is reimbursed, either reduce the expense or report the reimbursement as income when received. See *Refund or reimbursement* under *Income From Other Sources* in chapter 4.

Personal and business expenses. Some expenses you pay during the tax year may be partly personal and partly business. These may include expenses for gasoline, oil, fuel, water, rent, electricity, telephone, automobile upkeep, repairs, insurance, interest, and taxes.

You must allocate these mixed expenses between their business and personal parts. The personal part of these expenses is not deductible.

Example. You paid $1,500 for electricity during the tax year. You used one-third of the electricity for personal purposes and two-thirds for farming. Under these circumstances, you can deduct two-thirds of your electricity expense ($1,000) as a farm business expense.

Reasonable allocation. It is not always easy to determine the business and nonbusiness parts of an expense. There is no method of allocation that applies to all mixed expenses. Any reasonable allocation is acceptable. What is reasonable depends on the circumstances in each case.

Prepaid Farm Supplies

Prepaid farm supplies are amounts paid during the tax year for the following items.

- Feed, seed, fertilizer, and similar farm supplies not used or consumed during the year. However, do not include amounts paid for farm supplies that you would have consumed if not for a fire, storm, flood, other casualty, disease, or drought.
- Poultry (including egg-laying hens and baby chicks) bought for use (or for both use and resale) in your farm business. However, include only the amount that would be deductible in the following year if you had capitalized the cost and deducted it ratably over the lesser of 12 months or the useful life of the poultry.
- Poultry bought for resale and not resold during the year.

Deduction limit. If you use the cash method of accounting to report your income and expenses, your deduction for prepaid farm supplies in the year you pay for them may be limited to 50% of your other deductible farm expenses for the year (all Schedule F deductions except prepaid farm supplies). This limit does not apply if you meet one of the exceptions described later.

If the limit applies, you can deduct the excess cost of farm supplies other than poultry in the year you use or consume the supplies. The excess cost of poultry bought for use (or for both use and resale) in your farm business is deductible in the year following the year you pay for it. The excess cost of poultry bought for resale is deductible in the year you sell or otherwise dispose of that poultry.

Example. During 2001, you bought fertilizer ($4,000), feed ($1,000), and seed ($500) for use on your farm in the following year. Your total prepaid farm supplies expense for 2001 is $5,500. Your other deductible farm expenses totaled $10,000 for 2001. Therefore, your deduction for prepaid farm supplies may not exceed $5,000 (50% of $10,000) for 2001. The excess prepaid farm supplies expense of $500 ($5,500 − $5,000) is deductible in the later tax year you use or consume the supplies.

Exceptions. This limit on the deduction for prepaid farm supplies expense does not apply if you are a farm-related taxpayer and either of the following apply.

1) Your prepaid farm supplies expense is more than 50% of your other deductible farm expenses because of a change in business operations caused by unusual circumstances.
2) Your total prepaid farm supplies expense for the preceding 3 tax years is less than 50% of your total other deductible farm expenses for those 3 tax years.

You are a farm-related taxpayer if any of the following tests apply.

1) Your main home is on a farm.
2) Your principal business is farming.
3) A member of your family meets (1) or (2).

For this purpose, your family includes your brothers and sisters, half-brothers and half-sisters, spouse, parents, grandparents, children, grandchildren, and aunts and uncles and their children.

CAUTION *Whether or not the deduction limit for prepaid farm supplies applies, your expenses for prepaid livestock feed may be subject to the rules for advance payment of livestock feed, discussed next.*

Prepaid Livestock Feed

If you report your income and expenses under the cash method of accounting, you cannot deduct in the year paid the cost of feed your livestock will consume in a later year unless you meet ***all*** of the following tests.

1) The payment is for the purchase of feed rather than a deposit.
2) The prepayment has a business purpose and is not merely for tax avoidance.

If your business or investment activity passes this 3- (or 2-) years-of-profit test, it is presumed to be carried on for profit. This means the limits discussed here do not apply. You can take all your business deductions from the activity on Schedule F, even for the years that you have a loss. You can rely on this presumption unless the IRS shows it is not valid.

If you fail the 3- (or 2-) years-of-profit test, you may still be considered to operate your farm for profit by considering the factors listed earlier.

Using the presumption later. If you are starting out in farming and do not have 3 (or 2) years showing a profit, you may want to take advantage of this presumption later, after you have had the 5 (or 7) years of experience allowed by the test.

You can choose to do this by filing ***Form 5213.*** Filing this form postpones any determination that your farming activity is not carried on for profit until 5 (or 7) years have passed since you first started farming. Form 5213 must be filed within 3 years after the due date of your return for the year you first started farming. However, if you receive a notice from the IRS proposing to disallow your farm loss, file this form within 60 days after receiving the notice.

The benefit gained by making this choice is that the IRS will not immediately question whether your farming activity is engaged in for profit. Accordingly, it will not limit your deductions. Rather, you will gain time to earn a profit in 3 (or 2) out of the first 5 (or 7) years you carry on the farming activity. If you show 3 (or 2) years of profit at the end of this period, your deductions are not limited under these rules. If you do not have 3 (or 2) years of profit (and cannot otherwise show that you operated your farm for profit), the limit applies retroactively to any year in the 5- (or 7-) year period with a loss.

Filing Form 5213 automatically extends the period of limitations on any year in the 5- (or 7-) year period to 2 years after the due date of the return for the last year of the period. The period is extended only for deductions of the activity and any related deductions that might be affected.

Limit on deductions and losses. If your activity is not carried on for profit, take deductions only in the following order, only to the extent stated in the three categories, and, if you are an individual, only if you itemize them on Schedule A (Form 1040).

Category 1. Deductions you can take for personal as well as for business activities are allowed in full. For individuals, all nonbusiness deductions, such as those for home mortgage interest, taxes, and casualty losses (see chapter 13), belong in this category. For the limits that apply to mortgage interest, see Publication 936, *Home Mortgage Interest Deduction.*

Category 2. Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent your gross income from the activity is more than the deductions you take (or could take) under the first category. Most business deductions, such as those for fertilizer, feed, insurance premiums, utilities, wages, etc., belong in this category.

Category 3. Business deductions that decrease the basis of property are allowed last, but only to the extent the gross income from the activity is more than deductions you take (or could take) under the first two categories. The deductions for depreciation, amortization, and the part of a casualty loss an individual could not deduct in category (1) belong in this category. Where more than one asset is involved, divide depreciation and these other deductions proportionally among those assets.

TIP *Individuals must claim the amounts in categories (2) and (3) above as miscellaneous deductions on Schedule A (Form 1040). They are subject to the 2%-of-adjusted-gross-income limit. See Publication 529,* Miscellaneous Deductions*, for information on this limit.*

Partnerships and S corporations. If a partnership or S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reflected in the individual shareholder's or partner's distributive shares.

For more information on not-for-profit activities, see *Not-for-Profit Activities* in chapter 1 of Publication 535.

6. Soil and Water Conservation Expenses

Introduction

If you are in the business of farming, you can choose to deduct certain expenses for soil or water conservation or for the prevention of erosion of land used in farming. Otherwise, these are capital expenses that must be added to the basis of the land. (See chapter 7 for information on determining basis.) Conservation expenses for land in a foreign country do not qualify for this special treatment.

The deduction cannot be more than 25% of your gross income from farming. See *Limit on Deduction,* later.

Ordinary and necessary expenses that are otherwise deductible are not soil and water conservation expenses. These include interest and taxes, the cost of periodically clearing brush from productive land, the annual removal of sediment from a drainage ditch, and expenses paid or incurred primarily to produce an agricultural crop that may also conserve soil.

RECORDS To get the full deduction to which you are entitled, you should maintain your records in a way that will clearly distinguish between your ordinary and necessary farm business expenses and your soil and water conservation expenses.

Topics

This chapter discusses:

- Business of farming
- Plan certification
- Conservation expenses
- Assessment by conservation district
- Limit on deduction
- Choosing to deduct
- Sale of a farm

Business of Farming

For purposes of soil and water conservation expenses, you are in the business of farming if you cultivate, operate, or manage a farm for profit, either as owner or tenant. You are not farming if you cultivate or operate a farm for recreation or pleasure, rather than for profit. You are not farming if you are engaged only in forestry or the growing of timber.

Farm defined. A farm includes stock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards. A fish farm is an area where fish and other marine animals are grown or raised and artificially fed, protected, etc. It does not include an area where they are merely caught or harvested. A plant nursery is a farm for purposes of deducting soil and water conservation expenses.

Farm rental. If you own a farm and receive farm rental payments based on farm production, either in cash or crop shares, you are in the business of farming. If you receive a fixed rental payment not based on farm production, you are in the business of farming only if you materially participate in operating or managing the farm. See *Landlord Participation in Farming* in chapter 15.

If you get cash rental for a farm you own that is not used in farm production, you cannot deduct soil and water conservation expenses for that farm.

Example. You own a farm in Iowa and live in California. You rent the farm for $125 in cash per acre and do not materially participate in producing or managing production of the crops grown on the farm. You cannot deduct your soil conservation expenses for this farm. You must capitalize the expenses and add them to the basis of the land.

Plan Certification

You can deduct soil and water conservation expenses only if they are consistent with a plan approved by the Natural Resources Conservation Service (NRCS) of the Department of Agriculture. If no such plan exists, the expenses must be consistent with a soil conservation plan of a comparable state agency. Keep a copy of the plan with your books and records as part of the support for your deductions.