Bulletin 855

Basic Concepts of Farm Income Taxation

The Ohio State University Extension

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For sale publication

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Keith L. Smith, Director, Ohio State University Extension.

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Introduction

This publication is an introduction and review of basic ground rules of farm income taxation for the cash basis taxpayer. We do not cover all aspects of these basic rules or how all the federal tax laws apply to farming. Consult tax professionals and annual Internal Revenue Service (IRS) publications, such as the *Farmer's Tax Guide,* for a more thorough discussion of these and other topics.

Because income tax laws and regulations change frequently and publications soon become out-of-date, we limit our discussion to those aspects of taxation that tend to remain constant. These constants serve as a foundation for understanding what you will encounter in later study and discussion.

The material in this publication is for informational purposes only. It does not carry the weight of law.

Why Bother?

"I'll have someone else fill out my income tax return. Taxes are bad anyhow, aren't they? I dislike even *thinking* about income taxes. My main goal is to fork over as little as possible to the government." Have you ever heard statements such as these, or maybe even said them yourself? Looking at the task of filing income taxes as an event over which you have some control, however, may give you a fresh perspective and help you feel better.

Income tax can be a sizable cash outlay, particularly if you are having a "good year." Taxes fund our government. Each of us is required to pay our share. We should manage our income, however, to avoid paying more than necessary. This practice is called **tax management.** Good tax management can help you maximize income after taxes over time. Tax management strategies are particularly important when one year's income levels are substantially higher or lower than the previous year.

A good understanding of income tax provisions can help you recognize opportunities before transactions are complete. Understanding tax law enables you to avoid costly mistakes. You can help your tax preparer by providing all the necessary information he or she needs to complete an accurate return. Establish a goal of maximizing after-tax income over time, rather than simply trying to reduce taxes each year. You should always plan to have enough income in each year to use all personal exemptions and deductions. You cannot carry these unused amounts forward to future years.

Definitions of "Farming" and "Farmers"

According to the IRS, you are in the **business of farming** if you cultivate, operate, or manage a farm for profit, either as an owner or tenant. The definition of a **farm** encompasses stock, dairy, poultry, fish and other marine animals, fruit, and truck farms. It also encompasses 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. A fish farm does not include an area where fish are merely caught or harvested. A plant nursery is considered a farm for purposes of deducting soil and water conservation expenses.

Forestry or timber-growing enterprises do not qualify as farming if they are the only enterprises on your land. Cultivating or operating a farm for recreation or pleasure, rather than for profit, also does not qualify as farming.

Farmers and Estimated Tax

At one time, the United States (U.S.) income tax was a yearly tax. Tax laws now require payment of income taxes as we receive income during the year. Payment can be made in two ways: (1) tax withholding and (2) estimated tax. **Employees** have income tax withheld from their payroll checks. *Self-employed* persons and *businesses* estimate their income for the year and pay an **estimated tax** quarterly. For *farmers,* however, the rules are different. When you must pay your estimated tax and file your return depends on whether or not you qualify as a farmer.

Not everyone who farms is considered a farmer for tax purposes. You qualify as a farmer for estimated tax purposes if you meet the following test: for the current or previous taxable year, at least two-thirds of the gross income from *all* sources shown on your income tax return must be gross income from farming. If you qualify as a farmer, there is only one required installment of estimated tax for the year (rather than four). If you file a joint tax return with your spouse, include your spouse's income in the two-thirds test. Land and machinery sales are part of gross income, but are not considered gross income from farming in this test.

Farm Landlords

Owners of farmland may or may not be treated in the same way as farm operators in tax matters. First, three different forms may be used to report farm rental income: (1) Schedule F, (2) Form 4835, and (3) Schedule E. Which one(s) you should use depends whether or not the landlord is **"materially participating"** in the farm operation—in other words, the extent to which the landlord is involved in the management and operation of the farm(s). The tests for material participation are in the *Farmer's Tax Guide.* A landlord receiving cash rent should file **Schedule E.** A share rent landlord who meets the tests for material participation should file **Schedule F.** If the share rent landlord is not materially participating, he or she should file Form 4835.

If you file Schedule F, you must pay **self-employment tax**. The decision of which form to file depends on the type of rental agreement and the material participation test—not whether or not you wish to pay self-employment tax!

Several other tax provisions available to farmers may not be available to landlords who file Form 4835 or Schedule E. Check with a tax preparer before making major decisions if possible tax savings could sway your decision. For example, you might save using the **Section 179** expensing election, using the current 25-percent deduction for soil and water conservation expenses, or meeting the criterion for passive activity, which would currently enable you to deduct up to $25,000 in losses from certain rental activities.

Diversification in Farm Businesses

Many people produce and market agricultural and horticultural products part-time or by operating a small farm. For example, a person who prefers to live in the country and operate a small farm may also commute to a job elsewhere each day. Many retirees also move to farms for a second career or to pursue farming as a hobby (Campbell).

On the other hand, many full-time farmers and their family members engage in nonfarm business activities, such as selling seed corn, machinery, or greenhouse plants, or operating a roadside market, bed and breakfast, or tourist farm. This combination of farm and nonfarm businesses brings about questions on federal, state, and local taxes. Remember—tax laws written for farming activities are often different from those that apply to nonfarm businesses.

Farming as a "Business" versus Farming as a "Hobby"

The IRS considers you to be **self-employed** if you operate a business and are not an employee. You do not have to conduct full-time business activities to be self-employed. Part-time work, including work you do in addition to your regular job, may also be considered self-employment. Self-employed individuals are usually either sole proprietors, **independent contractors,** or members of a partnership (see IRS publication 334). If you own and operate a business for yourself, realize the full profit from the business, and are responsible for all debts, risk and liabilities, you are a **sole proprietor.**

A business is typically an activity conducted for a livelihood or in good faith to make a **profit**. For income tax purposes, you make a profit when gross income from an activity is more than deductions attributable to it. The IRS assumes you are conducting your farming or other activity for profit if it produced a profit in at least three out of the last five tax years, including the current year. For breeding, training, showing, or racing horses, the requirement is two out of the last seven tax years.

If you fail the years-of-profit test, the IRS may still consider you to be operating your farm for profit. The IRS considers several other factors in making this determination, and no one factor or group of factors is decisive. If the IRS determines that you do not conduct your activity for profit, you are limited in the deductions you can take. You cannot offset other income with a loss from farming activities if the IRS determines it to be a hobby rather than a business.

Farm Business, Nonfarm Business, or Both?

Every business must file an annual income tax return. Businesses have to follow a multitude of laws and regulations in addition to tax laws. The nature of your business activity (farm or nonfarm business) and how you organize your business determines which return forms and regulations apply. If you have both a farm business and a nonfarm business, then you need to file a separate Schedule F (farming) or **Schedule C** for each business.

Let's suppose you are a farmer raising or harvesting agricultural products on a farm. You haul your grain, farm supplies, and merchandise with your grain truck, *and* you haul grain for other farmers from time to time. Because hauling grain for others is a nonfarm business activity, you are subject to some regulations that farmers normally do not have to deal with (e.g., commercial driver's license).

If your income from trucking is small compared with your income from farming, then you would report your income and expense on Schedule F with your other farm business activities. If you run a fleet of five grain trucks for hauling other farmers' grain or merchandise, then you need to file a separate Schedule C for the trucking business and a Schedule F for your farm business.

Let's look at another example. Suppose you farm on the side, in addition to your off-farm job, or maybe you have retired to a "few acres" in the country. You raise and harvest agricultural and horticultural products. This activity is more than just a hobby. You are a bona fide part-time farmer. You also have a roadside market where you sell your produce, along with homemade pies, wood crafts, dolls, wreaths, and various other nonfarm products. If most of your roadside market income is from farming activities then you would file a Schedule F. However, if most of the income from these activities is from the sale of nonfarm products, then file a separate Schedule C in addition to your Schedule F.

As your business expands, or if you engage in a business other than the activity now serving as your main source of income, be sure to consult with your accountant, tax preparer, attorney, or Extension agent. You will need to deal with many other tax issues, whether your business is considered farm or nonfarm. These include: self-employment tax, employment taxes, excise taxes, sales and use tax, and corporate franchise tax.

Basis of Farm Property

Farms consist of many kinds of property or **assets.** At any one time, for example, crops may be held for sale or feed and market livestock fed for market. These are current assets, which you will convert to cash or use in production during one business year. Other kinds of property support production and have an expected, useful life of one or more years. Examples include animals raised or purchased for producing offspring or livestock products (breeding and dairy livestock), farm machinery, farmland, buildings and improvements, and your personal farm residence. Basis measures your investment in these kinds of property for tax purposes.

Basis Defined

Basis is the amount of your investment in property for tax purposes. You figure your original basis when you acquire an asset. You may acquire assets in various ways, by purchase, trade, gift, or inheritance. The basis generally equals cost, or the amount you pay in cash, notes, other property, or services to purchase property. If property is received in a trade, inherited, or received as a gift, however, a basis other than cost is used. You adjust your original basis according to events that occur after you acquire the asset, such as adding improvements or subtracting depreciation.

Some assets will have no tax basis. For example, raised crops and livestock always have a zero basis. Does this mean there was no production cost? No. It simply means all costs at-

TABLE 1. BASIS OF TYPICAL FARM ASSETS

Asset	Basis
Crops held for sale or feed	Zero
Crops under government loan	Depends how loan proceeds treated
Raised market livestock	Zero
Purchased market livestock	Cost when purchased
Raised breeding livestock	Zero
Purchased breeding livestock	Cost less amounts expensed and depreciated
Farm machinery and equipment	Cost plus improvements less amounts expensed and depreciated
Farmland	Cost plus improvements (land is not depreciated)
Farm buildings, fence, tile	Cost plus improvements less amounts expensed and depreciated
Personal residence	Cost plus improvements

tributable to production of an animal or crop have already been deducted on the **farm income** tax form. A completely depreciated asset also has no tax basis. Table 1 shows the basis of typical farm assets.

WHY BE CONCERNED ABOUT BASIS?

Understanding basis is an important first step in understanding how tax laws apply to farming. As you obtain or dispose of property in your farming business, you may encounter situations where you can save tax dollars. The basis of property is used to determine the gain or loss on the sale, exchange, or other disposition of property. If you cannot prove the amount of remaining basis, you will pay more in taxes. Following are several common farm situations where basis is important.

ESTABLISHING BASIS OF FARM ASSETS

Let's suppose you buy a farm consisting of your residence, land, buildings, machinery, and livestock. You must allocate the total purchase price to the various types of assets. Your records should show the original basis for each of these assets at the time the farm was acquired, as well as the up-to-date basis (including improvements and depreciation) of each of these assets. If an asset is disposed of, you must know the basis to determine gain or loss.

You may have little difficultly in determining the original basis of assets recently purchased or acquired. If the farm was passed down as a gift through several generations, however, you may have to do a lot of searching to find the original cost.

Allocating the Basis

Remember, if you buy property for a lump sum, you must allocate the cost among the items purchased. This includes land, depreciable property, personal residence, and other items (cows pregnant with embryo transplants, tobacco, and milk quotas). You also need to do this when you sell property. This allocation is necessary because assets vary in how they are treated for depreciation. For example, land cannot be depreciated. Because assets such as machinery are depreciated for different lives than buildings or breeding livestock, separate basis figures are necessary to figure gain or loss on a later sale or disposition. See the sections of this publication on buying and selling farms for examples of basis allocation.

Gifts and Inheritances

If you receive property as a gift, you typically receive the donor's basis in that property. There are exceptions to this rule, however, when a gift tax is involved or the property is later sold at a loss.

The basis of inherited property is usually its **fair market value (FMV)** at the date of the decedent's death. When property passes through an estate, it receives a "stepped up" basis equal to its appraised FMV in the estate.

Construction Costs

If you build a home, or a business or nonbusiness property, your construction expenses are part of your basis. If you use your employees, farm materials, or equipment to construct an asset, you may not deduct these expenses as current business expenses. The supplies and materials you use in construction and the employee compensation for construction are expenses that become a part of your cost basis in the asset. Payments to contractors are also included in basis. *However, the value of your own labor is not part of the basis.*

Adjusting Basis

Before you can figure gain or loss on a sale, exchange of property, or allowable depreciation, you must determine the adjusted cost basis. Alterations and improvements increase the basis of an asset. For example, you might build a new fence, replace a barn roof, or replace an old tractor engine with a new one. Because these capital expenditures extend the life of the asset or increase the value of an asset, add your costs to the basis of the property. However, do not add repairs to the basis if they are deductible. Repairs keep property in good working order. Examples of repairs include putting a new tire on a vehicle, spot replacing drain tile, and repairing fences.

You decrease basis by depreciation, Section 179 expensing, depletion, amortization, and losses. Table 2 shows three examples of how to adjust basis.

Summary

Remember, the rules for determining basis vary depending on how you obtain the property. For most farm property, basis will change over time. Your tax or farm advisor and the *Farmer's Tax Guide,* available from the IRS, are good sources of information about this topic.

Table 2. Adjusted basis examples

Bred gilt purchased for $350; $87.50 depreciation taken; adjusted basis is:

Original Basis	$350.00
+Increases	0.00
- Decreases	-87.50
Adjusted Basis	262.50

Cost of new fencing $10,000; $2,984 (2 years worth) depreciation taken; adjusted basis is:

Original Basis	$10,000.00
+Increases	0.00
- Decreases	-2,984.00
Adjusted Basis	7,016.00

Purchase farm and allocate $5,000 of purchase price to fence; immediately added $10,000 worth of new fence and depreciation (2 years worth) taken on $15,000.

Original Basis	$ 5,000.00	
+Increases	10,000.00	
- Decreases	-4,476.00	(fence depreciation)
Adjusted Basis	10,524.00	

Depreciation

Many, but not all, farm costs occur each year. Farmers usually purchase and pay for seed, fertilizer, chemicals, fuel, feed, and utilities each year. They pay interest, at least annually, on borrowed money. Some farmers pay for either full-time or part-time hired labor. Farmers subtract these cash costs from gross farm income when they determine net farm profit (or loss) on their farm tax returns.

Other costs do not occur each year and often involve items which are used in the business for several years, such as farm machinery, breeding livestock, or a new farm building. Charging the full cost against the farm business in the year of purchase "would distort the cost structure of the farm for the first year and for the next (5–20) years. Profits would appear too low in the first year and too high in later years" (Doll and Orazem).

Spreading the cost of an item over several years remedies this situation. The farmer charges only a portion, called **depreciation,** of the total cost of the item against the business each year. The farm business then pays for the item a little bit at a time rather than all at once. This is proper business procedure, even though the farmer may have borrowed money or withdrawn money from savings for the total cost at the time of purchase.

Federal income tax regulations provide for charging the cost of long-term assets, such as farm machinery or buildings, over a period of years as a depreciation allowance. You normally cannot deduct in the year of purchase the cost of an asset that has a useful life of more than one year. An exception to this would be if the cost of qualifying property is less than the Section 179 election. Section 179 is a provision that may allow a deduction of up to $17,500 (current law) in the year of purchase for certain depreciable items. Otherwise, you must spread the cost over more than one year and deduct part each year as depreciation.

Depreciable Property

You depreciate items purchased (new or used) for the business that have a useful life that can be determined and is longer than one year. The item must be something that wears out, decays, is used up, becomes obsolete, or loses value from natural causes. For example, you normally do not deduct depreciation on your home or furniture because they are personal (rather than business) items.

You would depreciate an animal purchased as an addition or replacement to your own breeding herd because that animal has an expected useful life of more than one year. A steer feeder calf bought for resale as a market animal is not depreciable because it is inventory. The feeder calf is property held primarily for sale to customers in the ordinary course of business. However, you do not deduct the cost of the animal until the year of sale. Land is never depreciable because it doesn't wear out. However, fence, tile, and buildings do wear out and are depreciable.

When Does Depreciation Begin?

Depreciation begins the year the item goes into service or is available for service, whichever is earlier. A corn planter purchased, set up, and delivered to the farm in December is eligible for depreciation that year. Although you may not use it for planting corn until the following spring, it is available for service in December. You begin depreciating a purchased dairy heifer when she begins producing milk. You depreciate a purchased beef bull when he can be used for breeding.

For farm property, you can take a half-year's depreciation in the year property goes into service. A half-year's depreciation also can be claimed in the year of disposition if the item is not fully depreciated. Different rules apply if more than 40 percent of the total **adjusted basis** of assets purchased during the year are placed in service during the fourth quarter of the tax year. If you are eligible to take the deprecation deduction on an item, you must take it. If you do not, you lose that opportunity unless you file an amended income tax return within the time limit. When you sell depreciable property, you must adjust the basis of the item for depreciation even if it was not taken.

Classes of Depreciation

A tractor normally lasts much longer than a cow, and a farm building usually lasts much longer than a tractor. Therefore, rather than depreciating all farm property for the same length of time, the depreciation rules provide for classes of depreciable property. The following classes were in effect as of January 1996. Breeding swine are in the 3-year class. Pickup trucks, breeding cattle, and sheep are in the 5-year class. Most farm machinery and equipment fall into the 7-year class. Ten-year property includes confined beef or hog setups or milking parlors that qualify as single-purpose agricultural structures. Paved lots and drainage tile are 15-year property, and a general purpose barn or machine shed is in the 20-year property class. Residential rental property and nonresidential property are 27.5- and 39-year property, respectively.

Once you purchase an item of depreciable property, you first determine the appropriate property class (3-, 5-, 7-, 10-, 15-, 20-, 27.5-, or 39-year property). Then, for each property class, select the regular **Modified Accelerated Cost Recovery System (MACRS)** or alternate MACRS years of life and a depreciation method (declining balance or straight line). Four choices now exist for newly acquired property.

The first two choices, regular MACRS and regular MACRS straight line, provide a quick cost recovery. The other two choices, alternate MACRS and alternate MACRS straight line, generally provide a slower cost recovery.

Managing Depreciation

How fast should you write off or recover your cost of a depreciable asset? There is no clear answer. Instead, the question requires consideration of several factors.

Let's suppose you are making very little money in your farming business. Income taxes are not a problem for you. This low income situation could be a result of low productivity, which in turn could be a result of weather, management, or quality of resources. Prices may also be a contributing factor. Maybe none of these factors apply, and instead you are a young farm family just starting to farm. The business is not yet in high gear, interest expenses are high, and—although you're confident of the future—you are struggling right now.

If this is your situation, choose a depreciation method with a longer recovery period and straight-line depreciation. This allows you to save depreciation for future years when you're making money. Now would not be a good time to use the Section 179 expensing election either, because you do not need that immediate deduction.

Let's suppose you *are* making money and paying large amounts of tax. Production is up, prices are good, and with your management and marketing skills, the business is doing great. This may be a good time to replace farm machinery. You may also want to choose a shorter recovery period and accelerated depreciation. In this situation, the Section 179 expensing alternative is attractive. Here, you may immediately deduct or expense up to a certain amount for qualifying newly acquired property. This creates a significant deduction or expense on your tax return, often amounting to several thousand dollars. For example, in 1995 a taxpayer could expense as much as $17,500 on a newly purchased piece of farm machinery. The machine's depreciable basis would, however, be reduced by the amount expensed.

Summary

This has been a brief introduction to depreciation—a concept relevant both to income tax management *and* the overall financial management of the farm business. When looking at future investments, it may be inappropriate to use annual amounts of tax depreciation for analysis. If you have used rapid methods of depreciation, or use equipment beyond it's tax life, the amount of depreciation shown on current tax returns may underestimate the annual cost of replacing these farm assets. In making new investments, **"economic depreciation"** (the average annual cost over the expected life of the investment) may better help you analyze the financial feasibility of major investments.

In this chapter we have outlined some of the federal income tax regulations for depreciation as they apply to a cash basis taxpayer. Understanding the basics will help you as you work with your tax preparer and manage your farm. The regulations are complex, however, and require further study for a fuller understanding of tax laws.

Trading Farm Property

Farmers often acquire property by trading one business asset for another, such as an old tractor for a new tractor. This is a **nontaxable exchange,** an exchange for **"like-kind" property.** (Trading a tractor for cropland acreage would not be an exchange for property of like-kind.) In a nontaxable exchange you are not taxed on any gain; however, you cannot deduct any loss either. At a later date, any realized gain or loss will be reported on a tax return when you sell or dispose of the property you receive.

Both real estate and **personal property** qualify for nontaxable exchange. Examples include farmland, buildings, livestock, and farm machinery and equipment.

The major nontaxable exchanges occurring on farms are trades of farm machinery. Usually, property received in a nontaxable exchange has the same basis for income tax purposes as property traded, plus any **"boot"** given. The following example illustrates the application of this rule.

Example

Don traded in his 1988 model corn planter for a new one. He had paid $7,000 for the older planter. Because the allowable depreciation he had taken on his planter was $4,813, his remaining tax basis in the planter was $2,187. The seller gave Don a $3,000 credit for his old planter, and Don paid an additional $10,000 cash for the new corn planter. The FMV of his new planter is $13,000. The basis of the new planter for income tax purposes, however, is $12,187 ($10,000 + $2,187).

In this example, the difference between FMV and basis is $813 ($13,000 - $12,187). Don has realized a gain (income) of $813 in this transaction. However, because this is a like-kind exchange, he does not have to recognize this gain and pay income tax on it now. He can delay recognition of the $813 gain until he makes an outright sale of the planter. If he never sells this planter, but continues trading planters, he can continue deferring any gain realized on such transactions, assuming the tax laws do not change.

Conditions

Exchanges must meet several conditions to qualify as nontaxable.

- Both the property given up and the property acquired must be used for business or investment purposes. A farm truck traded for a family car used entirely for personal purposes is not a tax-free exchange.

- The property must be like-kind property. Examples include a trade of one tractor for another tractor, a corn chopper for a combine, or a farm truck for another farm truck (with the exception of "listed property"). However, the exchange of farm machinery for a grain bin is not a like-kind exchange. You may trade dairy cows for dairy cows, but not livestock of one sex for livestock of the opposite sex.

  In general, it is easier to have qualifying exchanges with **real property**—land and buildings—than with property such as machinery and livestock. You may exchange a farm for a farm, timberland for crop acreage, or farm real estate for city real estate, such as an apartment.

- Deferred like-kind exchanges. Although as a farmer you may have an opportunity to sell your farm, realize that a large tax bill may result unless a deferred exchange, in which you transfer property and later receive similar business or investment property, is used. The rules are complex and must be followed exactly, or tax will be due. For example, the property may be either tangible or intangible, and must not be property held for sale. The property you receive must meet certain identification requirements, and the trade must meet the completed transaction requirements.

- Special rules apply if the exchange is with a related party. For example, disposal of the like-kind property within two years after the exchange by either of the related parties disqualifies the exchange from like-kind treatment.

Importance to Farmers

If you realize a gain on a nontaxable exchange, you are receiving income, even though it is not cash. However, this income is not taxed at the time of the exchange (in other words, the gain is not recognized) if the transaction meets the required regulations. Income taxes can be a sizable cash expenditure on a farm. If you have an improved cash flow because of a "good year," then consider trading farm machinery. The tax advantage of nontaxable exchanges complements this financial situation.

With no loss recognition in a like-kind exchange, new property has a higher basis, advantageously increasing depreciation. Not realizing a tax savings from the immediate recognition of the loss, however, is a disadvantage (Stara). In certain instances, your total tax (income and self-employment) savings may be greater if you sell the old machine outright rather than trade it (Patrick). Check with your tax preparer in these situations before closing the deal.

Summary

In certain situations, federal income tax regulations allow farmers to delay recognition of gain (income) and payment of tax on that gain. The most common example of this provision is in trading old farm equipment for new machinery. You must meet specific regulations—for example, the items traded must be for business use only and the newly acquired asset must continue in the same form. Please check your current *Farmer's Tax Guide* (Publication 225) or your tax advisor for detailed information about this topic.

Sale of Capital and Noncapital Assets

Everything you own is, for income tax purposes, a **capital asset.** However, tax rules allow certain assets to be excluded from the definition of capital assets. These assets are called **noncapital assets.**

Think for a moment about your property: your car, the home you own and live in, household furnishings, stocks and bonds, grain, machinery, and farmland. Capital assets include items you use for personal purposes or pleasure, such as your car, personal residence, and furnishings. They also include items held as investments, such as stocks and bonds or 20 acres of timberland. On a farm, capital assets also include commodity futures contracts held for speculative purposes and milk or tobacco quotas/allotments.

Assets produced from, or used in, the business of farming—such as market hogs, corn, dairy cows, tractors, and farmland—are considered noncapital assets. If you use an asset, such as your automobile, for both personal and business use then it's partly a capital asset and partly a noncapital asset.

The tax treatment of capital assets held for personal use is different than the treatment of capital assets held for investment. Sale of assets held for investment leads to **capital gains** or losses, which are reported on Schedule D. Net gains add to other sources of income for the year. However, no more than $3,000 of net capital loss can be deducted against other income in any year. Additional losses must be carried to a later year or years. Capital assets held for personal use or pleasure are treated differently. Although any gain on disposition is reported as taxable income, you can never deduct a loss on such assets.

What exceptions lead to noncapital assets? Four primary ones affect farming.

1. Property included in inventory, and
2. Property held for sale to customers.
   In a farm business, these exceptions include such items as grain, milk, and market livestock. All of these items are reported as income on Schedule F. Some items may have been purchased for resale, such as feeder cattle or feeder pigs. Schedule F can show a profit (or a loss), and the net profit (or loss) is treated as ordinary gain and added to other sources of income to determine total income. In addition, net profit on Schedule F is subject to Social Security tax.

3. Assets used in a trade or business subject to depreciation, or
4. Real property used in a trade or business.
   Breeding livestock, machinery, equipment, and buildings are assets subject to depreciation and are excluded if they are used in the business of farming. Likewise, any farmland used in the business becomes a noncapital asset because it is real property, but it cannot be depreciated. These two exclusions are called **Section 1231** property. Their tax treatment is similar to that for investment property. Gain or loss on the sale of these assets is reported on **Form 4797** and Schedule D. The full amount of net Section 1231 losses is deductible in a year, but there are other limitations. Income from Form 4797 and Schedule D is not subject to Social Security tax.

Sound confusing? Well, give yourself some time and try to concentrate on the following examples. Listing property that does *not* constitute a capital asset and checking the list with your tax advisor should help. There are tax benefits to identifying and reporting noncapital assets used in a farming trade or business.

The sale of capital and certain noncapital assets (Section 1231 property) usually results in either a capital gain or loss. Let's suppose you sell a small farm tractor (Section 1231 property) that you have used in your farm business for several years (Miller). The tractor is depreciable property used in your trade or business—a noncapital asset. Holding the tractor more than one year means any gain or loss resulting from the sale will be long-term. Had you held the tractor one year or less, the resulting gain or loss would be short-term.[1]

The original cost of the tractor was $3,900. Assume you have claimed $1,000 of depreciation and the adjusted cost basis of the tractor is now $2,900 ($3,900 - $1,000 = $2,900). Your

TABLE 3. DETERMINING ADJUSTED COST BASIS AND GAIN OR LOSS ON SALE OF TRACTOR

Original Cost	$3,900	Selling Price	$5,000
+Improvements	0	-Adjusted Cost Basis	2,900
-Depreciation Claimed	1,000	-Expense of Sale	100
Adjusted Cost Basis	$2,900	Total Gain	$2,000

TABLE 4. DETERMINING ORDINARY AND CAPITAL GAIN

Total Gain	$2,000
Depreciation (Ordinary Gain)	-1,000
Capital Gain	$1,000

[1] Property is treated differently depending on the length of time it has been owned prior to its sale. The general rule is as follows: property held more than 12 months from the date of purchase is considered long-term. Special rules apply to livestock. Horses and cattle held for draft, dairy, breeding, or sporting must be held at least 24 months, while hogs, sheep, and other livestock must be held at least 12 months to qualify as long-term.

neighbor pays you $5,000 for the tractor and you incur sale expenses of $100. Your total gain on the sale is $2,000 ($5,000 - $2,900 - $100 = $2,000), as shown in Table 3.

At this point let's introduce the term **depreciation recapture.** Depreciation recapture rules are not the same for all types of farm property. We'll use our tractor example to explain the concept, but remember different rules would apply, for example, in the sale of a farm building.

The total gain of $2,000 on the sale of the tractor is not all long-term capital gain (see Table 4). The amount of gain up to the amount of depreciation allowed or allowable ($1,000 in this case) is called depreciation recapture and is treated as ordinary gain. Any gain in excess of the depreciation amount is long-term capital gain.

Because current tax law does not allow a capital gains deduction, income reported includes both ordinary gain and capital gain. But federal tax rates on ordinary gain income may be as high as 39.6 percent; on capital gain income, the maximum rate is 28 percent. Also, because these items are reported on Form 4797, not Schedule F, they are not subject to the 15.3 percent self-employment tax. Proper tax reporting requires separating the two types of gain. In some cases, such as an **installment sale,** all depreciation recaptured (ordinary gain) must be reported in the year of sale. Report the capital gain in years when you receive installment payments.

Casualty and Theft Losses

If any of your property is destroyed, damaged, or stolen, you may have a deductible tax loss. Because the property was not sold, it cannot be reported as income. However, if you receive an insurance payment or other reimbursement, this can be considered income. If the reimbursement is more than the adjusted basis of the destroyed, damaged, or stolen property, you may have a gain.

How do you determine the amount of loss? The mere failure to receive the potential value of the property does not allow you to claim a loss. The loss will be limited to your loss for tax purposes. The following information is taken directly from the *Farmer's Tax Guide* and explains some losses you can deduct and some that you may not in operating your farm business.

Livestock or Produce Purchased for Sale

Losses of livestock or produce purchased for sale are deductible if you report your income on the cash method. The loss is limited to the adjusted basis of the animal or produce.

If you report on an accrual method, take casualty and theft losses of property raised or bought for sale by omitting the item from the closing inventory for the year of the loss. You cannot take a separate deduction.

Livestock, Produce, and Crops Raised for Sale

Losses of livestock, produce, and crops raised for sale are not deductible if you report on the cash method. You have already deducted the cost of producing these items as **farm expenses.** Likewise, you will not receive, nor report, any income from sale of products.

If you report on an accrual method, a casualty or theft loss is deductible only if you included the items in your inventory at the beginning of your tax year. You get the deduction by omitting the item from your inventory at the close of your tax year. Do not take a separate deduction.

Damage to Crops

Damage to crops, whether or not covered by insurance, are not deductible losses. These damages are losses of expected income. The costs of raising the damaged crops are deductible as business expenses.

Property Used in Farming

Casualty and theft losses of property used in the farm business usually result in deductible losses. If a fire or storm destroyed your barn, or you lose by casualty or theft an animal you bought for draft, breeding, dairy, or sport, you may have a deductible loss. But your loss will be the lesser of the adjusted basis of the asset at the time of loss or the decrease in the FMV as a result of the casualty or theft. Generally, the adjusted basis will be the amount of deductible loss.

Raised Draft, Breeding, Dairy, or Sporting Animals

Losses of raised draft, breeding, dairy, or sporting animals do not result in deductible casualty or theft losses, unless you use inventories to determine your income and you included the animals in your inventory. If you do not use inventories and you deducted the cost of raising the livestock, the livestock has no cost or other basis for income tax purposes. However, if you did not elect out of the capitalization rules, you may still have a tax basis in the livestock.

When you include livestock in inventory, its last inventory value is its basis. This is true of both raised and purchased inventoried animals. When you lose an inventoried animal held for draft, breeding, dairy, or sport by casualty or theft during the year, decrease your inventory at the beginning of the year by the value at which you included the animal in inventory. Use this inventory value as the basis of the animal to determine the amount of your gain or loss.

In the examples discussed above, you must compare any loss determined with any gain resulting from insurance or other reimbursement to see if the net result is a gain or a loss.

Property Held for Personal Use

Casualty and theft losses of property held for personal use are deductible on your federal income tax return. Examples of these losses are fire damage to your home, furniture, car, clothing, or other personal property, and storm damage to trees and shrubbery, including ornamental ones. You also can deduct losses from theft.

The rules that apply to casualty or theft losses of personal-use property differ from those applying to business property. Two rules, the $100 rule and 10-percent rule, limit the losses you are allowed to take on personal-use property.

Net versus Gross

Taxpayers sometimes record receipts from the sale of crops, livestock, and livestock products erroneously, showing net rather than gross amounts received. For example, if you file Schedule F and only report net receipts, both farm income and expenses are underreported. Making this error could keep you from meeting the two-thirds test for estimated tax purposes. The amount of gross income you receive from farming determines whether or not you can file as a farmer for estimated tax purposes. Suppose you are on the borderline of meeting the requirement of gross income from farming being at least two-thirds of your gross income from all sources. Showing net amounts *reduces* your chances of meeting the test.

Also, the IRS uses gross, rather than net, income to calculate the allowable soil and water conservation deduction you may take on your farm. There may also be a deduction coming out of a payment to you that is not allowable or fully allowable, such as family health insurance or supplies for personal use.

Finally, by always using net amounts you may not be fully aware of your true business expenses, such as costs for marketing, hauling, and supplies. This makes analyzing the performance of your farm business very difficult.

Livestock Sales

Sales of farm livestock fall into three classes for income tax reporting purposes. Properly reporting livestock sales may save you several dollars when you file your income tax return.

When you sell animals held primarily for sale, report the gross amount as **ordinary income** on Schedule F. These may be animals you have raised on the farm or purchased for resale, such as feeder cattle. Remember, in **cash accounting**, the costs of livestock and other items purchased for resale are not deductible until you sell them. This is especially important to consider when you purchase the cattle one year and sell them in a later year. On Schedule F, livestock purchased for resale are reported separately from raised livestock.

You should report the sale of animals held for draft, breeding, dairy, or sporting purposes on Form 4797 as sales of business property. In both situations, the sales are taxed the same except the income reported on Schedule F is subject to self-employment tax while the in-

Farm Income Tax Quiz

Should you report the following items of income on Schedule F (Form 4835 if you are in a nonmaterial participation share lease) of your federal farm income tax return? Please respond "yes" or "no" to each item. For "no" responses, indicate the form to use if the income is taxable.

	Yes	No	Proper form
❶ Feeder pigs/feeder lambs/feeder calves raised on your farm	○	○	________
❷ Dairy calves, three days old	○	○	________
❸ Market hogs, steers, or lambs (raised or bought for resale)	○	○	________
❹ Young animals (beef, sheep, dairy, or swine) raised on the farm and bred for sale to others for use as breeding livestock	○	○	________
❺ Poultry	○	○	________
❻ Young animals (beef, sheep, dairy, or swine) raised on the farm for additions or replacements to your own breeding herd (even if they have not actually produced offspring)	○	○	________
❼ Animals culled from your breeding herd (cattle, swine, sheep, goats)	○	○	________
❽ Horses culled after being raced at public tracks	○	○	________

come reported on Form 4797 is not. The sale of business property may result in ordinary gains or losses or in capital gains or losses, depending on the circumstances.

Why is this important to farmers? First, you can take advantage of capital gains tax treatment when you sell capital assets, which allows you to deduct all or part of certain losses not otherwise deductible. Second, you may reduce the amount of self-employment tax paid, taking advantage of the current tax savings.

At this point, take a few moments to complete the short quiz on page 24.

Let's see how you did. The correct answer for items 1 through 5 is "yes." Consider these animals as being held primarily for sale. Report the receipts as ordinary income on Schedule F of the income tax return. The correct answer for items 6, 7, and 8 is "no." These are examples of livestock used in your trade or business rather than held primarily for sale to customers. Income from these sales is reported on Form 4797 and not Schedule F.

Summary

Currently, no capital gain deduction is available when you sell and/or trade capital or business assets. Reporting these sales properly, however, enables you to take advantage of what tax savings are available. Farmers often mistakenly include sales of cull breeding livestock with sales of livestock held primarily for sale. For more information on this topic, consult with your tax advisor and refer to the *Farmer's Tax Guide.*

Information Returns

Information returns are issued and received by most taxpayers. Farmers are most concerned with filing the **1099-MISC** and **1099-INT** returns. The IRS requires you to report the name, address, and **taxpayer identification number (TIN)** of every person or business to whom you paid $600 or more for rent, royalties, or services rendered to your trade or business. A TIN is the Social Security or employer identification number of the individual or business.

Keep the following three points in mind when filing your returns:

1. Do not include payments for services for personal use.

2. Do not file a 1099-MISC for payments to corporations or employees (W-2's should be filed for employees).

3. Do not report payments for items such as feed, seed, fertilizer, freight charges, parts, fuel, or livestock.

It is impossible to list every type of expense that must be reported on a 1099-MISC return. In general, you should report payments for business expenses (services, not merchandise) totaling $600 or more for the year to individuals or nonincorporated businesses *who are not your employees.* Typical expenses that must be reported include cash rent, veterinary services, tiling, custom work, accounting or legal fees, and painting or remodeling farm buildings.

A 1099-INT must be filed if you paid $600 or more in interest, including interest paid on an installment sale contract, to an individual.

When to File

A 1099-MISC or 1099-INT is due to the recipient by January 31 and to IRS by February 28 in the year following the payment. When you file a 1099 you must also prepare **Form 1096,** Annual Summary and Transmittal of U.S. Information Returns. This summarizes the number of each type of form you are filing.

Why to File

The IRS uses information returns to determine income to be reported on tax returns in the same way that wages are reported on W-2's. At the same time, this reporting assures that business expenses are not deducted unless the amount is reported elsewhere as income. The IRS receives over one billion information returns each year. This data is then matched against the amounts listed on the payees' tax returns. Because compliance has been poor in the past, Congress added teeth to the tax laws to encourage more complete reporting. These teeth are generally of two types: penalties and backup withholding.

Information Returns Farmers May Receive

Farmers both receive and issue information returns. Some typically received returns include: **1099-PATR** for patronage refunds, 1099-MISC for cash rent or custom work income, **1099-G** for government payments, and 1099-INT for interest income. These all indicate income that should be reported on your tax return. The amount shown on the 1099-G, Government Payments, should be entered on your Schedule F. Be sure the amounts shown on the information returns are correct, since IRS expects this to be included on your tax return.

Buying a Farm

If you buy property that includes land, depreciable property, a personal residence, and other items for a lump sum, allocate the cost among the items you buy. Base your allocation on the ratio of the FMV of each item at the time you buy it to the total FMV of all the property you buy. This allocation is necessary to figure the basis of the items for depreciation purposes. The allocation is also used to figure the gain or loss on a sale or disposition at a later date.

Group of Assets Acquired

If you buy multiple assets for a lump sum, you and the seller may agree to a specific allocation of the purchase price to each asset in the sales contract. If you base the allocation on the value of each asset, and you and the seller have adverse tax interests, the IRS will usually accept the allocation.

Example

You bought farm property on March 1 for the lump sum price of $275,000. You use the cash method of accounting. An inventory of the property at its FMV on the date of purchase is shown in Table 5 *(Farmer's Tax Guide)*.

The FMV of each asset, or group of assets, becomes its cost basis. Further allocation (based on FMV) is done on groups of assets. For example, allocate the $60,000 cost assigned to the depreciable assets used in the farming business among the individual assets. Each asset's share of the cost basis is its basis for figuring depreciation. The cost allocated to the wheat crop ($1,400) can be deducted on the income tax return for the year you sell the crop.

Selling a Farm

The sale of your farm usually will involve the sale of both nonbusiness property (your residence) and business property. Business property includes the land and buildings used

Table 5. Sample FMV on date of purchase

Type of Property	FMV
Growing wheat crop	$ 1,400
Timber	5,600
Minerals (such as gravel, coal, sand, etc.)	8,000
Farmland	170,000
Farm residence	30,000
Depreciable assets used in farming	60,000
Total purchase price	275,000

in the farm operation, machinery, and livestock. You must allocate the selling price to determine the amount received for each kind of property sold. The classification of each asset determines the tax treatment of gain or loss on the sale of the asset. If the sale of your farm includes your residence, land and buildings used in the farm operation, livestock, farm machinery, and harvested crops, you must determine the selling price of each asset.

Example

Assume you sell your farm for a lump sum of $625,000. Table 6 lists a sample allocation of the sales price to each asset *(Farmer's Tax Guide)*.

These allocated amounts and the adjusted cost basis for each asset are used to determine gain or loss on each item. If you have a gain from the sale of your personal residence, you may be allowed to postpone paying tax on it. You cannot, however, postpone paying tax on the gain of property used in the business of farming.

Example

You sell your farm, consisting only of bare farmland and a residence, which you have owned since December 1991. Table 7 lists your realization of gains in the sale *(Farmer's Tax Guide)*.

TABLE 6. SAMPLE ALLOCATION OF SALES PRICE

Growing Crops		$ 15,000
Farmland		300,000
Farm Residence		60,000
Farm Buildings		
Barns	45,000	
Silo	8,000	
Shed	10,000	
Grain Bin	10,000	
Shop	9,000	
Total		82,000
Farm Machinery		150,000
Fence		8,000
Tile Line		10,000
Grand Total		$625,000

TABLE 7. REALIZATION OF GAINS

	Farm with residence	Residence Only	Farm without Residence
Selling price	$182,000	$58,000	$124,000
Cost (or other basis)	40,000	10,000	30,000
Gain	$142,000	$48,000	$ 94,000

You may not postpone paying tax on the $94,000 gain from the sale of the property used in your farm business, even though you invest all of the selling price in another farm. You may have to report all or a part of that gain as ordinary income from the recapture of depreciation, or soil and water conservation expenses. Treat the balance as Section 1231 gain.

If you receive payments for your farm in installments, the IRS may permit you to pay the tax on your gain over the period of years that the payments are received.

Basis Wasn't Allocated When Farm Purchased

Suppose you paid a flat sum for the entire farm and no other facts are available for properly allocating a part of your original cost or other basis to the part sold. In this case, you may use assessed values for local property taxes for the year of purchase to allocate the costs to basis.

Sale of the Residence

In our example, the $48,000 gain from the sale of the residence is a capital gain. This gain is not taxable if you purchase or build another residence for at least $58,000 within the required time period.

Your personal residence is a capital asset and not property used in the trade or business of farming. If you sell a farm that includes a house you and your family occupy, you must determine the part of the selling price and the part of the cost or other basis that are allocable to the residence. Your residence includes the immediate surroundings and outbuildings relating to it. If you use a part of your residence for business, make the appropriate adjustment to the basis for depreciation allowed or allowable.

Gain on Sale of Residence

When you have a gain on the sale of your residence, you must postpone the tax on the gain if, within the period beginning two years before and ending two years after the sale, you buy and occupy another residence that you purchase at a cost equal to or more than the adjusted sale price of your previous residence.

Age 55 or Older Provision

If you are age 55 or older and sell your residence, you may not have to pay tax on the gain up to $125,000 ($62,500, if married and filing separately). This provision applies even if you do not invest in another home, provided all requirements are met.

Loss on the Sale

A loss on the sale of your business property to an unrelated party, can be deducted as an ordinary loss. However, losses other than casualty, theft, etc. from nonbusiness property are personal losses and are not deductible. You cannot deduct a loss on your personal residence from a voluntary sale, condemnation, or a sale under threat of condemnation.

Some Final Thoughts

In this bulletin, we have explained many of the basic aspects of farm income taxation—aspects that tend to remain constant from year to year. Hopefully, you now have a better understanding of income tax laws and a secure foundation on which to build further study and discussion.

Proper reporting of tax information and/or income and expenses is a necessary part of tax management, which is, in turn, an important aspect of farming. We have stressed this point at the outset and reinforced it with examples of sound tax management strategies. Remember, you can participate in tax management even though you leave the preparation of your income tax return to a tax professional.

Opportunities for learning more about farm income taxation are available through your local Extension office. In addition to publications such as this, Extension offers written materials and educational meetings for individuals, and workshops for tax preparers.

Income Tax Terms

The following definitions are meant to clarify concepts, not conform to the strict definitions of the IRS tax code.

Accounting method

A set of rules you follow to determine when and how income and expenses are reported. The cash and accrual methods are common examples.

Accrual accounting

Income is reported in the year earned regardless of when payment is received. Expenses, whether they are paid or not, are deducted when they are incurred.

Adjusted basis

The amount you have invested in property, including any alterations and improvements less allowable depreciation and other deductions.

Asset

Any property that you own. Examples include your household furnishings, car, tractor, land, livestock, and corn crops. For income tax purposes, assets are either capital or noncapital.

Basis

The amount of your investment in property for tax purposes. This is usually your cost with some adjustments.

Boot

The amount of money you give in a trade over and above the value of the property traded.

Capital asset

Property you own and use for personal purposes, pleasure, or investment. All property is considered a capital asset unless it is excluded. Major exclusions for farm businesses are items held for sale, such as grain, land, and depreciable properties.

Capital gain

Gain from the sale of capital assets (such as land) or Section 1231 assets (such as breeding livestock) reported on Form 4797 and Schedule D. Capital gains are currently taxed at no more than 28 percent.

Cash accounting

A method of accounting in which income is reported in the year payment is received, and expenses are deducted in the year paid. (See also constructive receipt).

Casualty loss

Deductible tax losses resulting when property is damaged or destroyed by a sudden, unexpected, or unusual event. Casualty losses of business property are treated differently than losses for personal use property. Casualties may also result in a gain if insurance proceeds are greater than the tax loss.

Constructive receipt

Using the cash method of accounting, amounts credited to your account or made available to you must be counted as income in that tax year. For example, a check received on December 30, but deposited on January 2, must be counted as income for December.

Depreciation

An annual deduction representing a portion of the total cost of assets, such as buildings, farm machinery, and purchased breeding livestock. Such assets are used for several years in the business, with only a portion of the cost charged as a taxable expense each year.

Depreciation recapture

When depreciable assets are sold, the gain may be considered either ordinary or capital gain. Form 4797, Part III, is used to determine these amounts. Gain on sales of property, such as machinery, is ordinary gain (depreciation recapture) until the gain exceeds the depreciation taken on the property. Any gain above the depreciation recapture is capital gain.

Depreciation schedule

The record a taxpayer keeps showing the date individual depreciable items were placed in service, cost or other basis, method of depreciation, amount of depreciation taken, etc.

Employees

Workers are employees if they perform services subject to your will and control in exchange for an agreed wage. Wages paid to employees are subject to employment taxes, such as FICA and Medicare taxes, and Workers' Compensation.

Estimated tax

Businesses and self-employed persons must make quarterly estimates of their income and pay tax on that estimated income. However, farm operators do not have to make quarterly tax payments if they meet the IRS definition of a farmer.

Farm expenses

The ordinary and necessary costs of operating a farm for profit, which can be deducted as taxable business expenses. Examples include feed, seed, labor, depreciation, and Section 179 expenses. Allocate and deduct only the business portion of expense items, such as utilities or fuel.

Farm income

Farm income is reported on Schedule F or Form 4835. Farm income is primarily receipts from the sale of raised produce or livestock, as well as produce or livestock bought for resale. Other sources, such as government payments and custom work income, also constitute farm income. Income from the sale of breeding livestock, machinery, etc., however, are reported on Form 4797.

Farmer's Tax Guide (Publication 225)

A useful guide for farmers and tax preparers when they prepare annual farm income tax returns. The National Farm Income Tax Extension Committee helps the IRS develop this free publication.

Fair market value (FMV)

"The fair market value is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all necessary facts" *(Farmer's Tax Guide)*.

Form 4797

The IRS form used to report sales of business property, such as farm machinery and breeding livestock.

Form 4835

The IRS form used by a nonmaterially participating share rent landlord to report farm rental income and expense.

Independent contractor

A worker who has the right (rather than the employer) to direct and control the way he/she works both as to the final results and as to the details of when, where, and how the work is to be done. Wages paid to independent contractors are not subject to employment taxes, such as FICA, Medicare, and Workers' Compensation.

Information returns

These forms provide information to the IRS about certain types of payments made to others. Payments include interest, rent, services performed by nonemployees (such as veterinarians and consultants), and government payments. Required 1099 forms must be completed and mailed to the other party by January 31 and to the IRS by February 28 of the following year.

Installment sale

"An installment sale is a sale of property, except for inventory, where one or more payments are received after the close of the tax year" *(Farmer's Tax Guide)*.

Involuntary conversions

Casualties, thefts, and condemnations constitute involuntary conversions.

Like-kind property

"Like-kind" refers to the nature or character of the property, not to it's quality or grade. Trucks and tractors are considered like-kind, as are timberland and cropland. Tractors and cropland, however, are not like-kind, nor are bulls and cows.

MACRS

MACRS stands for Modified Accelerated Cost Recovery System, a system of depreciation used for property acquired after 1986.

Material participation

A tax term that refers to the extent to which a landlord is involved in the management and operation of the farm.

Noncapital asset

Items of property, such as inventory and depreciable property, used in a trade or business. Farm business examples include grain and feeder livestock held for sale, land, farm buildings, machinery, and breeding livestock.

Nontaxable exchange

Certain exchanges of like-kind business property may be nontaxable. This means that any gain is not taxed, and any loss cannot be deducted until you sell or dispose of the property you receive.

Ordinary income

All taxable income, including net income from operations, wages, rent, interest, and other sources. Income from assets treated as capital gain income is an exception to ordinary income.

Personal property

Personal property is movable property. Examples include farm implements (tangible) and life insurance policies (nontangible).

Prepaid expense

Annual deductions of prepaid interest, insurance, and rent are limited to the portion that applies to that tax year. In addition, there may be limits on the amount of deductible prepaid farm supplies (feed, seed, chemicals, etc.).

Real property

Real property is land and improvements attached to the land. Examples include land, trees, fence, tile, buildings, furnaces, and fixtures built into or attached to the real estate.

Schedule C

The tax form used to list income and deductions and to determine the net profit or loss from a *nonfarm* business.

Schedule F

The tax form used to list income and deductions and to determine the net profit or loss from a *farm* business.

Self-employment tax

This tax is part of a system that provides farmers and other self-employed individuals with Social Security and medical insurance (Medicare) coverage.

Section 179 deduction

A tax law provision that allows the taxpayer to deduct all or part of the cost of qualifying property as an expense in the year of purchase (rather than taking depreciation deductions on part or all of a capital expenditure).

Section 1231 property

Property used in the business, such as land, structures, machinery, and breeding livestock, that meets the appropriate holding period. Gain on sale may be either capital gain or ordinary income.

Taxable exchange

An exchange in which the gain is taxable, or the loss deductible. A taxable exchange occurs when you receive cash or property that is not similar or related in use to the property exchanged. An example would be a trade of a tractor for a tract of farmland.

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