General Topics

Tax Management

AUTHORS & INSTITUTIONS

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SECTIONS

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INTRODUCTION

Taxes are a critical part of farm financial management. Understanding how they apply to your operation can help you make informed decisions and avoid costly mistakes. This document is designed to guide farmers through key tax considerations, from determining whether your operation qualifies as a farm business to managing records, filing returns, and planning for year-end.

The first step is to define your farm business. The IRS requires that an operation produces agricultural or horticultural products and be managed with a profit motive to qualify as a business. This distinction determines whether you can deduct expenses and file Schedule F. Next, accurate recordkeeping is essential for compliance and audit protection. Most farms use the cash method of accounting, and maintaining organized records of income, expenses, and assets simplifies tax preparation.

Understanding farm tax returns is equally important. Schedule F reports farm income and expenses, while other forms address depreciation, asset sales, and self-employment tax. Some aspects of your tax return will depend on the structure of your business. Finally, proactive tax planning can reduce long-term tax liability. This resource provides practical steps, examples, and FAQs to help you navigate farm tax rules and work effectively with your tax preparer.

SECTION 1

Defining a Farm Business

Primary Considerations

- An operation is considered a farm if it produces agricultural or horticultural products.
- To be defined as a farm business, the farm must operate with the intent to make a profit.
- The IRS has defined nine criteria upon which it evaluates whether a farm is a farm business.

Process for Getting Started

The Internal Revenue service defines a farm as an operation that produces an agricultural or horticultural product. “A farm includes livestock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.” (IRS, Pub 225)

In order to deduct any expenses, the farm must qualify as a farm business. The key feature that distinguishes farm businesses from hobby farms is the intent to make a profit. For hobby farms, the operator must report their farm income but cannot deduct farm expenses.

The IRS uses multiple criteria to determine whether the farm is operated with a profit motive. If the farm is profitable for three of the last five years, the IRS will presume a profit motive. Some horse farms can achieve this presumption with two of the last seven years. However, a farm does not need to be profitable for the IRS to determine that the operator is farming with the intent to make a profit.

The IRS uses nine criteria to evaluate the profit motive:

1. Whether the farm is operated in a businesslike manner
2. The time and effort spent on farming
3. Whether the operator depends on the farming for their livelihood
4. If losses are due to circumstances beyond the owners' control and/or are normal for a start-up farm
5. Methods evolve in an attempt to make a profit
6. If the operator and/or their advisors have sufficient knowledge to carry out farm operations
7. If the operator has made a profit on similar activities in the past
8. If (and how much) profit has been made on the farm
9. If future profits are expected from the appreciation of assets used in farming

These criteria are evaluated together, not by any individual factor alone. If the farm is judged to be a business, it is eligible to file a farm tax return (Schedule F) and associated forms, reporting income, expenses, and asset transactions. Hobby and investment farms are not eligible to deduct expenses associated with farming activities.

Disclaimer. For a specific list of resources in the above description, view the Necessary Resources area of this section.

SECTION 1

COMMON QUESTIONS

01 Does my operation qualify as a farm business?

To qualify as a farm business, your farm must qualify as a farm and as a business. The IRS defines a farm as an operation that produces an agricultural or horticultural product. To qualify as a business, the farm must be operated with the intent to make a profit. The IRS uses the nine criteria listed above to determine if the farm is operated with a profit motive. These criteria are listed above and considered as a whole, not individually.

02 Does my farm have to earn a profit to be considered a farm business?

No, but the operator must be farming with the intent of making a profit. The nine criteria listed above are used by the IRS to evaluate that intent, even if not currently making a profit. If the farm has made a profit in three of the past five years (or two of seven for certain horse farms), it will be presumed to have a profit motive.

03 When is my operation first considered a farm business?

A farm is defined as producing an agricultural or horticultural product. Thus, the operation is first considered a farm when productive activities have started. Examples include planting one's first crop or starting to raise market cattle. Start-up expenses cannot be deducted until the business starts productive operations. A farm qualifies as a business when its operations have a profit motive.

04 What if I have agritourism, processing, or some other non-farm activity as part of my business?

A taxpayer is considered a farmer if at least two-thirds of their gross income comes from farming. A farmer qualifies for some unique provisions. If the business contains multiple activities, the taxpayer should work with their tax preparer to properly separate farm and non-farm activities.

05 What if my farm is not considered a business?

Only farm businesses are allowed to deduct expenses incurred from farming. Farms not operated with the intent to make a profit, such as hobby farms, must report farm income but are not allowed to deduct farming expenses.

SECTION 1

RESOURCES & PARTNERS

Necessary Resources

- **IRS:** Farmers Tax Guide (Publication 225)
- **Ag FTAP**: Farm Management Resources for Farmers
- **USDA**: Taxes for Farmers and Ranchers
- **USDA**: Taxes Training Videos
- **Rural Tax Education:** New Farmer Tax Information
- **Rural Tax Education:** Small Farmer Tax Guide

SECTION 2

Farm Recordkeeping for Income Taxes

Primary Considerations

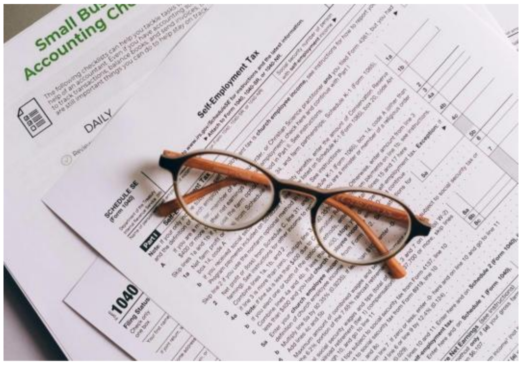
- The goal of keeping farm tax records is to provide accurate, complete summaries of financial transactions so your tax preparer can prepare returns correctly.
- The cash method of accounting is most common. This method records income when received and expenses when paid without the need for accounts payable or receivable systems.
- Keep tax returns, payroll records, 1099s, invoices, receipts, and loan/asset documents organized by transaction type; records should show amount, purpose, and proof of payment.
- Maintain records for at least 5–7 years (minimum 3 years by law) to support audits and verify that all income and deductions are legitimate.

Process for Getting Started

Many people worry that keeping financial records for taxes may be complicated and even intimidating. Tax returns for farmers require accurate complete financial information, but these records are manageable for most farms. Keep in mind that the goal is to provide an accurate and complete summary of your financial records to the tax preparer so that they have the information they need to prepare your tax return.

Most farm financial recordkeeping systems are allowed to utilize the cash method of accounting. This means that income is recorded when it is available, and expenses are recorded when they are paid. No system of accounts payable and receivable is required in your accounting records.

Your financial records should include the federal and state tax records themselves, including your tax returns, payroll records, and any 1099s filed. It should also include documentation, like invoices and receipts, that support the purchases, sales, and payroll represented on your tax return. Your records should categorize income and expenses and show what, why, and how it is related to the farm. Your tax return will summarize all the transactions of the farm.



Thus, your supporting documentation should include both a summary of the transactions represented on your tax return as well as the records for each transaction. These transactions include income, expenses, loan, and asset transactions.

Documentation of these transactions might include receipts, bills, asset purchase documents, and loan agreements. These documents should show the amount of the transaction, what the transaction was for, and that it was paid. These documents can be retained as hard copies, or they may be stored in an electronic form that can legibly reproduce the documents. Your files of tax documents should be sorted by the type of transaction.

All documents should remain in your tax file for at least 5 to 7 years. The law requires you to keep your tax documents for at least three years. Audits can be conducted on returns up to 3 years after filing, but they may request documents filed prior to that date.

In an audit, you may need bank statements and transaction records, all matched up. The IRS goal is to make sure all income is reported, and all deducted expenses are business-related, so complete and consistent records are essential.

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SECTION 2

COMMON QUESTIONS

01 What financial records do I need to keep for my farm taxes?

All farmers should have an accounting system that records all transactions and their purpose. Receipts and invoices for all income, expenses, loans, and asset purchases are essential. Payroll records and associated tax returns should be maintained. Farmers should also keep tax records, like tax returns and 1099s, in their files.

02 What documentation is required for each transaction?

Each record should show the amount, purpose, and proof of payment for income, expenses, loans, and asset purchases.

03 How long should I keep my farm tax records?

At least 3 years by law, but 5–7 years is recommended to cover audits and verify deductions.

04 Do I need to use accrual accounting for my farm records?

Most farms can use the cash method, meaning income is recorded when received and expenses when paid.

05 Can I store my records electronically?

Yes, as long as electronic copies are legible and can reproduce original documents if needed.

SECTION 2

RESOURCES & PARTNERS

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- **Rural Tax Education:** Small Farmer Tax Guide
- **MSU Extension:** Farm Records Book for Management

SECTION 3

Farm Income Tax Returns

Primary Considerations

- The Schedule F tax form reflects farm income and expenses. Farm income from sales of agricultural or horticultural products is reported on Schedule F. Farming expenses are deducted on Schedule F, including input costs and depreciation expense.
- Farmers are required to pay self-employment tax as well as ordinary income tax on net farm income.
- Gains on the sales of assets are taxable at ordinary or capital gains rates, but they are not subject to self-employment tax. The gain is defined as the difference between the sale price and the item's basis.
- Farmers are exempt from estimated taxes under some conditions. See your tax preparer to determine your eligibility for exemption.

Process for Getting Started

The main farm tax return is Schedule F for income and expenses, but there are a number of other tax forms needed for farms. Be sure to work with your tax preparer to provide the information that they need to prepare your taxes.

Schedule F contains information from your income and expenses. All income from sales of your agricultural or horticultural products needs to be reported on Schedule F. For purchased and resale products, the cost of purchase will be deducted, but this does not happen until the purchased or resale product is sold. Other important sources of farm income include:

- Patronage dividends from cooperatives
- Government payments
- Crop insurance proceeds
- Custom work income
- Other sources of income

For most of these sources of income, you will receive a 1099 of the type related to the payments. Examples include a 1099-G for government payments and a 1099-PATR for patronage dividends. However, it is the taxpayer's responsibility to report all income, with or without a 1099.

Expenses incurred in farming activities are deductible on Schedule F. There are approximately 20 lines of input products and services on Schedule F. Your financial records should correspond to the lines of Schedule F to facilitate taxes prepared for your farm.

Notes on certain lines of the Schedule F:

- Depreciation expense is also deducted on Schedule F. This line ties to other forms on the tax return. Your tax preparer will keep a depreciation schedule of your assets to calculate depreciation expense. Usually, depreciation takes place over a period of years, as defined by the IRS. However, Section 179 rules allow depreciation on some assets to be taken in the first year, with remaining amounts depreciated over time.
- Car and auto expenses can be calculated through mileage, but vehicles used by the farm can have their actual expenses deducted under certain conditions. Seventy-five percent of actual expenses can be deducted for any vehicle used normally during the business day for farming activities.
- Interest must be separated out of your debt payments because debt principal is not deductible for tax purposes. The underlying asset (except land) is typically depreciated over time and deducted through depreciation expense.

- Insurance that can be deducted on Schedule F is typically only crop and property & casualty insurance. Life insurance is deductible in some circumstances, and health insurance for a sole proprietor, partner, and most LLC members is deductible only on the individual tax return (Form 1040).
- Equipment leases may or may not be deductible on Schedule F. Operating leases that only reflect use of assets are deductible, but capital leases that culminate in ownership of the equipment are not always deductible. See your tax preparer to determine any specific situation.

The Net Farm Income from Schedule F, calculated as farm income less farm expenses, flows through to the individual tax return as self-employment income. In addition to the ordinary income tax that is paid on this income, the proprietor, partner, or LLC member must pay self-employment tax of 15.3% of the net farm income.

Asset sales are subject to income tax, albeit differently than net farm income. Asset sales are not subject to self-employment tax. The only portion of the asset sale that is taxable is the gain, which results from the sale price less the item's basis. Your tax preparer should maintain records of the basis of your assets on the depreciation schedule or other records. Gains on the sale of assets held for less than one year are short-term capital gains and subject to ordinary income tax rates. Gains on the sale of assets held more than one year are subject to long-term capital gains tax, which is lower than ordinary income tax rates. The sale of some depreciated assets, like farm equipment, may yield depreciation recapture, in which the asset's previous depreciation expense is "recaptured" as part of the gain on the sale.

A few farm-related expenses are deductible on the individual tax return (Form 1040). Health insurance premiums may be deductible here, as may health savings account and IRA contributions. One-half of self-employment tax is also deductible here. See your tax preparer to see how this impacts your tax return.

Farmers that have a tax liability to pay must file by March 1. Farmers that do not owe a tax liability must file by April 15. Business owners are generally required to submit estimated taxes each quarter to minimize their tax liability at tax filing. If you do not receive salaries and wages from which you have tax withholdings withheld, you may need to file estimated taxes. Farmers are exempt from these requirements under some conditions. See your tax preparer to determine the proper approach for your estimated taxes and your associated tax filing deadline.

Selecting a good tax preparer is an important part of filing your taxes. Not only do you rely on them to properly complete your tax return, but they also maintain your depreciation schedule and may track your basis on other assets. It is important to choose a tax preparer with acceptable qualifications. An Enrolled Agent or CPA can assist you more thoroughly should the IRS question your return. You should also know their experience with farm tax returns and their fee structure. You should have access to tax planning services with a philosophy similar to your own, and they need to have a process you can meet.

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SECTION 3

COMMON QUESTIONS

01 When do I file my first farm tax return?

When productive operations begin with the intent of making a profit. Purchasing assets isn't enough – they must be held until productive operation begins. This could be planting your first crop or starting to raise cattle for sale. It has to be producing the product that will be sold. Growing heifers for dairy production is not productive operations, but growing heifers for sale is.

02 How do I find a good tax preparer?

Evaluate the qualifications of potential tax preparers. In particular, ask about their experience with farm tax returns. Consider using an Enrolled Agent or CPA that can assist you with IRS correspondence. Check that their philosophy on tax planning is consistent with your own. Finally, ensure that their process for managing tax filing matches your needs.

03 Is all my farm income subject to self-employment tax?

The net farm income from Schedule F is subject to self-employment tax. Asset sales, including equipment and raised adult cattle, generate taxable gains that are not subject to self-employment tax.

04 Do I have to pay estimated taxes?

If you do not have withholdings on wages, you may need to submit quarterly estimated tax. However, if two-thirds of your gross income is from farming and you file by March 1, you generally do not need to file estimated taxes. See your tax preparer to ensure you know your individual estimated tax responsibility.

05 How do nonfarm expenses or cash draws paid from the farm account impact my taxes?

Nonfarm expenses or cash draws from the farm account are not tax deductible. While they influence the cash flow of the business, they do not directly impact the farm's tax liabilities. Some personal expenses, like health insurance, are not deductible by the farm but can be deducted on the Form 1040 tax return.

SECTION 3

RESOURCES & PARTNERS

Necessary Resources

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- **Rural Tax Education:** Small Farmer Tax Guide
- **Rural Tax Education:** Tax Estimator
- **MSU TelFarm:** Farm Tax Practitioners

SECTION 4

Business Structure

Primary Considerations

- Business structure affects tax reporting. Different structures determine whether income is reported on an individual return or a separate business return. Some also impact how income is taxed.
- For sole proprietorships, farm income and expenses are reported on a Schedule F that is filed with the owner's personal tax return.
- Partnerships and S-corporations are pass-through entities. They file informational returns, but the farm income flows to owners' individual returns.
- C-corporations pay corporate tax. Owners report wages and dividends on their individual tax return, separate from the profits of the corporation.

Process for Getting Started

The choice of business structure has significant implications for how farm income is reported on the owners' tax return. Certain business structures, such as partnerships and corporations, may be required to file separate income tax forms from their owners.

Sole Proprietorship

Many farm businesses owned by individuals are structured as a sole proprietorship, meaning that the individual farmer owns the farm assets and is responsible for the farm operations. Owners of sole proprietorships file **Schedule F** to report farm profit or loss, in addition to their individual income tax return.

Partnership

Jointly owned farms can operate as a partnership. All income and expenses are in the partnership's name which the partnership reports on its own Schedule F. Each partner's share of partnership profit or loss is reported on Form 1065 Schedule K-1. A partnership is considered a pass-through entity, meaning that even though a partnership is required to file an income tax return, the partnership does not typically pay income tax. Instead, the income tax is paid by each partner.

C-Corporations

C-corporations file their own corporate income tax return and are subject to corporate income tax rates. Shareholders employed by the business are taxed on their wages through their individual tax return but do not report a share of corporation income. However, shareholders may receive dividends (distributions of profit) from the corporation which are reported on their individual tax return.

S-Corporations

The S-corporation is more complicated and has more reporting requirements than a sole proprietor or partnership, but it also may have tax advantages over other business structures. An S-corporation combines the pass-through structure of a partnership with the liability protection of a C-corporation. Like a partnership, shareholders in a farming S-corporation report their wages and their share of the farm profit or loss on their individual tax return.

Limited Liability Company (LLC)

Limited Liability Companies (LLC) are often formed to reduce liability exposure to the farm owners from the farm operations while maintaining the pass-through status of a partnership. When an LLC is formed, a decision must be made to determine how it is treated for federal tax purposes. Single member LLCs can elect to be taxed like a sole proprietorship, S-corporation, or a C-corporation. Multi-member LLCs can elect to be treated as a partnership, S-corporation, or C-corporation.

SECTION 4

COMMON QUESTIONS

01 Which business structure is best for my farm?

While each business structure has different tax implications, the optimal choice for your business depends on multiple factors, like liability protection, tax flexibility, and management complexity. Sole proprietorships are simple, while LLCs and corporations offer liability protection but require more paperwork.

02 How does my business structure affect how I file my taxes?

Sole proprietors report farm income on Schedule F, which is filed with their personal return. Partnerships and S-corporations are pass-through entities, meaning the farm has its own tax return, but the net farm income flows through to owners' tax returns. C-corporations pay corporate tax separately, with owners taxed on their wages and dividends only.

03 Do I need a separate tax return for my farm business?

Sole proprietorships file Schedule F with the owner's return. Partnerships file a Form 1065 and issue K-1s to partners with their share of income and gains. Both S- and C-Corporations file their own returns, which report the related income to be recognized by the owner. S-Corporation owners may have wage and profit income, while C-Corporation owners may have wage and dividend income.

04 Do the business structures affect self-employment tax?

Yes. Sole proprietors and partners generally pay self-employment tax on net farm income. S-corporation owners may have wage income from the business but do not pay self-employment taxes on their share of the net farm income. C-Corporations are subject to corporate taxes; their owners do not pay self-employment taxes on profits.

05 Can I change my farm's business structure later?

Yes. Many farmers start as sole proprietors and later transition to an LLC or corporation as the business grows. Changing structures can have tax and legal implications, so consult a tax professional before making changes.

SECTION 4

RESOURCES & PARTNERS

Necessary Resources

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- **Rural Tax Education**: Small Farmer Tax Guide

SECTION 5

Income Tax Planning

Primary Considerations

- Tax planning is essential every year, not just in profitable years, because it helps maintain consistent taxable income and reduces long-term tax liability.
- Income and expense timing are primary tools for tax management. Deferring crop or livestock sales and prepaying expenses can help balance income and deductions across years.
- Depreciation strategies offer flexibility, but overusing accelerated depreciation can create future tax burdens alongside debt payments.
- Additional options exist after year-end to fine-tune tax liability, but the optimal strategy usually involves a combination of advanced planning and tax time decisions.

Process for Getting Started

One of the only certain things about farming is that the income tax deadline will come every year. Between federal and state income taxes and self-employment tax, prospects of a large tax bill can feel overwhelming. Year-end tax planning can address this concern and is an essential tool for farm financial management.

We tend to think that tax planning is only necessary in good years. However, a better tax planning strategy is to maintain consistent taxable income across the years. This minimizes taxes owed over a longer span of years. Thus, farmers can benefit from tax planning in moderate and poor years too.

Maintaining a level taxable income is often a wise long term tax management strategy. Managing taxes in a high-income year can reduce your tax liability. Tax planning can also be advantageous in low-income years. Planning helps to maintain a stable taxable income over time and avoid tax losses that have limited long-term benefit. Your tax preparer can help you plan a target net farm income to maintain consistent total tax liability.

The primary tools in year-end tax planning are income timing, increasing or decreasing expenses, and managing depreciation. Crop and livestock sales may be most effective in managing an increase or decrease in income. Deferring income commonly refers to carrying over crops or livestock for sale to the next year and is a common method to reduce taxable income. Remember that income is recognized when funds are available to your farm, not when the check is cashed.

Managing expenses should first be done with cash options. Prepaying expenses during a production year can allow you to reach a target balance of income and expenses. Prepaying not only increases cash expenses in this year but may also allow discounts on next year's inputs. Managing the timing of common bills, such as insurance premiums, rent, or interest, can optimize the current year's expenses as needed. Remember that expenses can only be recognized when payment is extended to a vendor. Purchases made "on account" are not deductible.

Accelerated depreciation can provide flexibility, allowing assets to be purchased when they are most advantageous to your overall financial condition. Available depreciation options allow many asset purchases to be depreciated entirely or in large part for the current tax year. While accelerated depreciation can significantly reduce taxable farm income, relying too heavily on it can leave you with a large tax liability on top of debt payments in future years.

Even after year end, a few tools exist to further refine your tax liability. Contributions to personal IRAs and health savings accounts (HSAs) are not due until the April tax deadline. Depreciation decisions can also be made when preparing the tax return. In addition, farm income averaging is a tool that your tax preparer can use to reduce federal income tax. If negative or extremely low self-employment income is unavoidable, you or your spouse may still want to pay enough to gain credits for social security.

Although year-end tax planning takes some effort, it is an important tool to reduce your long-term tax liability. Work with your tax preparer to develop a plan that is right for your farm. More information about farm income taxes can be found at the IRS website.

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SECTION 5

COMMON QUESTIONS

01 What is the benefit of tax planning in years that did not have high profit?

Managing a level taxable income across years is often the best strategy to minimize tax liability over the long term. While some losses may be able to be carried over to future years, often some of the benefit will be lost with that strategy. Negative self-employment income cannot be carried over, so that potential tax savings is forfeited. In addition, the self-employed health insurance deduction requires positive net income for the business.

02 Can I prepay expenses for the next crop year to reduce my tax liability?

Prepaying expenses is a common tax management tool. Many farmers prepay for seed, fertilizer, or feed to manage taxable income. The IRS generally limits prepaid expenses to 50% of other deductible farm expenses. A business purpose beyond tax avoidance is required for all prepaid expenses.

03 Can I ask a buyer to delay their payment until after the first of the year in order to avoid recognizing that income?

Sales income can be deferred until the next tax year only if the contract states that the funds shall be paid in the next tax year and the funds are not made available in the current year. This must align with normal crop sales practices and not solely to avoid tax.

04 Are products I purchased "on account" with a vendor deductible as expenses in the current tax year?

Only products purchased in cash or through a third-party creditor are deductible in the current tax year. Purchases made "on account" with a vendor are not deductible until payment is made to the vendor.

05 Can I purchase a piece of equipment in order to increase depreciation in the current year and reduce my tax liability?

Equipment placed in service in the current tax year are depreciable to some extent in the current tax year. Standard MACRS depreciation allows partial depreciation based on the purchase date and type of equipment. Section 179 depreciation and bonus depreciation commonly allow accelerated depreciation in the year of purchase. Check with your tax professional for your specific situation.

SECTION 5

RESOURCES & PARTNERS

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