

What is Farming? Does Reporting Matter?*

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Introduction

Many rural families combine a number of economic activities to generate additional family income. Farm production activities may be combined with full-time employment in farming or in the non-farm sector. Part-time employment may involve several seasonal jobs during the year or a part-time job throughout the year.

Generally, an employed individual will receive a Form W-2 reporting the wages received and taxes withheld. In other situations, the individual may be contracted to perform a specified task or provide a service and properly receive a Form 1099-MISC. The individual generally has responsibility for paying the self-employment tax as well as the income tax. Payment for agricultural work may be made in commodities to avoid the social security taxes¹, but such payments are taxable for income tax purposes. The instructions and documentation received facilitates the proper reporting of these items of income.

Agricultural producers may also be involved in a variety of activities involving farming and direct marketing, such as farmers' markets or community-supported agriculture. Farm income and expenses are reported on Schedule F, Profit or Loss from Farming. Other businesses report income and expenses on Schedule C, Profit or Loss from Business. The profit or loss from business activities is carried to the income section of the Form 1040. But where do farming

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¹ For a more in-depth discussion of commodity wages, see the IRS Publication 225, Farmer's Tax Guide, Chapter 6, Managing Character of Income and Deductions

activities end and non-farm activities begin? Does it matter how income and expenses are reported?

Farm v. Non-Farm Activities

Farming generally includes activities normally incident to the growing, raising or harvesting of any agricultural or horticultural product. Raising, feeding, caring for, training and management of animals on a farm are also farming activities. Participation is the process of producing an agricultural or horticultural product and bearing substantial risk. These are factors in determining if an individual is a farmer. In addition, farming activities include: handling, packing, grading, or storage on a farm of any agricultural or horticultural commodity in its unmanufactured state; but only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity.

Processing that is incidental to growing and harvesting is considered as a farming activity and associated costs are reported on Schedule F (Form 1040). In contrast, processing of a commodity beyond the minimum to prepare it for initial sale is not a farming activity and should be reported on Schedule C (Form 1040).

Table 1. On-Farm Processing Activities that Qualify as Farming Activities

Commodity	Processing Activities
Fresh fruits and vegetables	Washing, grading, packing, cooling and storage
Cotton	Ginning and baling
Grains (corn, wheat, rice, etc.)	Drying and storage
Honey	Processing for sale
Maple sap	Harvest of sap is farming Processing of sap into syrup or sugar is NOT farming
Mint oil	Extraction of oil from plant
Tobacco	Drying and stripping in accordance with type of tobacco
Wool	Shearing

Farmers' Markets and Community-Supported Agriculture

Over 7,175 farmers' markets operated throughout the US in 2011, allowing more producers to sell an increasing variety of products directly to consumers. Community-supported agriculture (CSA) arrangements provide producers with opportunities to add value to some or all of their production. Typically, a farmer or group of farmers sells shares (also referred to as memberships or subscriptions) of production to nonfarm consumers. These consumers then share in the farm's production of fresh fruits and vegetables throughout the growing season. A good year results in a well-filled weekly box, bag, or basket of the seasonal produce. A small harvest -- due to unfavorable weather, plant diseases, insects and other factors -- results in a smaller weekly

distribution. Although the consumers bear some risk, they are not involved in production and are not farmers. A farming business does not include the processing of commodities beyond the activities necessary to prepare a commodity for initial sale.

Direct Marketing

Participation in farmers' markets and CSAs are alternative ways of marketing a farm's production. For example, a farmer may sell vegetables, fruits, potted plants, cut flowers, dried floral arrangements, honey, jellies, cheese, and meat. All of the products were raised on the farm.

The receipts from sales of the vegetables, fruits, potted plants and cut flowers would be reported on Schedule F. Associated expenses include costs of producing and selling in the farmers' market and/or delivering the weekly distribution of seasonal produce would also be reported on Schedule F. As discussed above, the honey could be processed for sale and the entire amount would be reported on Schedule F with any associated expenses being deducted on Schedule F.

The dried floral arrangements, jellies, cheese, and meats involve processing beyond the minimum of what is needed to prepare the commodities for sale. The value of the commodities, before processing, would be treated as a sale on Schedule F (Form 1040) and a purchase on Schedule C (Form 1040). Expenses would be allocated between Schedule F (production) and Schedule C (processing). Expenses of selling and delivery could be allocated between Schedules C and F (Form 1040) based on sales of the commodities. Depending on the produce being sold and state law, the producer may need to collect and submit sales tax on some of the Schedule C and Schedule F sales. For an illustration of a farmer's tax return with value-added product sales, see the sample income tax return for the Hopefull Family case study as found on www.RuralTax.org.

Producers involved in direct marketing may not be producing all of the commodities in the quantities they would like to be able to offer to customers. Purchases for resale may be common. When an item is sold, the entire sales price is reported in Part I of Schedule F (Form 1040) and the original cost of the item is deducted to arrive at gross income, which is included in gross farm income.

Does Reporting Matter?

Considerable emphasis has been given to separating and properly reporting Schedule C and Schedule F (Form 1040) activities. For many individual situations, the relative size of the enterprise helps determine reporting procedures. IRS Publication 225, *The Farmer's Tax Guide*, indicates that some custom work can be done and reported on Schedule F.

Agricultural producers have a number of favorable tax provisions, and gross farm income often is a key part of the eligibility requirements. Some of the provisions in which farm income affects tax treatment of income and expenses include:

- Farm income averaging

Estimated tax requirements and filing dates
Limit on deduction for soil and water deduction
150% declining balance limit on depreciation of assets used in a farming business
Deferral of reporting crop insurance indemnities
Deferral of reporting sale of excess animals to be replaced

Summary

Individuals involved in farming are often involved in a variety of other activities. W-2 and Form 1099-MISC provide guidelines for reporting income and expenses. Reporting all business income and expenses on Schedule F (Form 1040) often incorrectly reports income and expenses. Expenses related to getting a commodity prepared for its initial sale are farm expenses. The sales prices represent gross farm income. However, farmers who broaden their economic activities to increase returns to their business also need to be aware of potential income tax consequences that may require different treatment from the IRS. Health insurance, liability insurance, and worker compensation are only some of the other areas that need to be reviewed when making business changes. Working with a tax professional may help minimize business problems over time.

IRS Publications

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Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.

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