

## Beginning, Small, Young Farmer Case Study: Going Home to Begin a Farm Business

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### Introduction

Young or beginning farmers typically start their farm businesses on a small scale. There are as many ways to begin farming as there are farmers. Some decide to pursue the noble endeavor of farming on a part-time basis by keeping their “day job” while renting acreage and borrowing, leasing, or buying a tractor and tillage equipment to operate the farm. They can grow the business over time. The goal of some is to eventually farm full-time. Another strategy is for children to return to the family farm and begin with Mom’s and Dad’s help.

Children of full-time farmers frequently desire to carry on the family tradition of farming. These children often receive parental help in starting their farming business. Upon completion of high school, technical trade school, community college, or four-year university, young people “return home” and begin farming in one of several different ways. They may join their parents’ farming operation on a full- or part-time basis as an employee or as a partner. Some may start their own farming business on a full- or part-time basis while working for their parents or for another employer.

Beginning farmers make important income tax decisions on the first business year’s tax return that affect them for their entire farming career. The following discussion of a case farm illustrates the effect of various choices. The case farm is based on the author’s experience from working with several students at a land grant university who returned to the family farm and began their own farming career.

Readers of this illustrative case-farm and the companion 2011 Federal Income Tax return (IRS Form 1040 and supporting forms and schedules) may have additional questions regarding income tax treatment of transactions or issues. Fact sheets and a *Tax Guide for Owner and Operators of Small and Medium Sized Farms*, which can be found at [www.ruraltax.org](http://www.ruraltax.org), may help answer those questions.



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## Background and Case Study for Mary Gold, a Young Beginning Farmer

Before Mary Gold completed her associate's degree in farm business management at the local community college in early May, she began farming on a part-time basis in the community where her parents, True and Pure Gold, live and have a traditional commodity-based farming business. Because True's long-term goal is to turn management of the farm over to a successor such as Mary, he made arrangements for Mary to lease a 150 acre farm he rented for many years. Over the March spring break, Mary helped True prepare fields for spring planting. She applied fertilizer on "her" farm, on which she will plant 75 acres of corn and 75 acres of soybeans. Returning home again over the Easter school holiday, Mary helped with corn planting. She and True planted soybeans in a timely manner on both her 75 acres and True's farm.

To help Mary get started in farming, True agreed to loan her the money she needed to pay for inputs (the "Pa Bank" as is common in many families). However, this arrangement is for the first year only. In subsequent years Mary will make her own financing arrangements with the local bank for her farm business. Further, True leased his tractors and other equipment to Mary for 75% of equipment rental rates. Mary recorded all use of True's equipment and calculated the resulting lease payments. True harvested Mary's corn and soybeans for a flat rate of \$65 per acre. Mary paid True his cost for all other inputs used on Mary's farm (thus Mary received the benefit of potential volume discounts). Mary and True "settled up" at harvest time for all the expenses she incurred in the raising and harvesting of her corn and soybeans. Mary paid the land owner \$125 cash rent per acre after harvest. With this arrangement, Mary received direct and indirect subsidies from her father and the land owner during the first year of her business.

For her work on his farm, True paid Mary \$200 per week, provided housing plus utilities in one of the farm homes that he owns, and health insurance. Mary's total annual compensation as a farm employee is \$18,860 when all the parts are added together: \$10,400 wages, \$4,800 annual house rent [which is at fair market value (FMV)], \$960 utilities, and \$2,700 health insurance.

As an initial investment in her farm business, Mary purchased a used  $\frac{3}{4}$  ton pickup in June 2011. She paid \$20,000 for the pickup and used it exclusively for farm business purposes. Mary paid \$5,000 down for the pickup and borrowed the remaining \$15,000 at 4% interest. Her 6 semi-annual payments are \$2,678 each, and the first payment, paid in December 2011, included \$300 of interest. Mary kept the car she owned and used during her high school and community college days for personal non-farm transportation.

### Mary's non-farm income for 2011, her first year in farming

Wages; \$200 per week, June through December	\$6,000
Interest earnings on savings and checking accounts	100

The FMV house rent, utilities and health insurance are *bona fide* employee benefits are not subject to income tax.



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**Mary's farm income and expenses for 2011, her first year in farming**

<b>Income</b>		
Corn	145 bu/A @ \$6.05 per bushel * 75 acres	\$65,794
Soybeans	51 bu/A @ \$11.50 per bushel * 75 acres	43,988
FSA payments	\$15/A * 150 acres	<u>2,250</u>
Total Income		\$112,032
<b>Reimbursement to True Gold</b>		
Corn seed (25 bags @ \$110 / bag)	\$2,750	
Soybean seed (113 bags @ \$36 / bag)	4,068	
Corn fertilizer (75 A @ \$140 / A)	10,500	
Soybean fertilizer (75A @ \$62 per A)	4,650	
Pesticides (weed/insect) (150A @ \$37 / A)	5,550	
Pesticide application (150 A @ 3 × \$4.50 / A)	2,025	
Equipment rental (\$40 * 150A * 0.75)	4,500	
Harvest (150 A @\$65 / A)	9,750	
Drying of crops (14,700 Bu @ \$0.204/Bu)	<u>3,000</u>	
Total owed to True		(46,793)
<b>Land rent</b>		
Cash rent (150A @ \$125 / A)		(18,750)
<b>Pickup truck operating expenses</b>		
Fuel	3,485	
Oil	100	
Repairs	100	
Insurance	450	
Interest on loan	300	
Registration and license	<u>150</u>	
Total pickup truck operating expenses		(4,585)
<b>Earnings before interest, taxes, depreciation and amortization (EBITDA)</b>		\$41,904

Mary must file IRS Form 1099 MISC to report the \$18,750 rental payment to the land owner, the \$4,500 rental payment to True as “Rents” in box 1, and the \$14,475 she paid for the pesticide application (\$2,025), harvest (\$9,750), and drying crops (\$3,000) as “Non-employee



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compensation” in box 7. She does not have to file a Form 1099 for the seed, fertilizer and pesticides she purchased from True.

**Note:** Mary’s payments to True for equipment rental and for pesticide application, harvest, and drying crops are subject to self-employment tax. The rent for the land is not subject to self-employment tax because the land owner did not materially participate in the agricultural production on the land.

## **Line by Line Explanation of Mary Gold’s 2011 Federal Income Tax Return**

Because Mary has farm income and expenses to report on IRS Schedule F (Form 1040), Profit or Loss From Farming; IRS Schedule SE (Form 1040), Self-Employment Tax; and IRS Form 4562, Depreciation and Amortization, she must file IRS Form 1040, U.S. Individual Income Tax Return rather than IRS Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents, or IRS Form 1040A, U.S. Individual Income Tax Return.

The following discussion explains the federal income tax forms in their attachment sequence order, which is indicated by the number found in the upper right-hand corner of the form under the year (2011 in this example). The discussion includes an explanation of each number that is entered or box that is checked.

## **2011 IRS Form 1040, U.S. Individual Income Tax Return**

Mary Gold entered her current mailing address and social security number (SSN) in the upper part of Form 1040. Taxpayers can elect to contribute \$3 to the presidential election campaign by checking a box, but Mary did not make that election.

- Line 1: Mary marked her filing status as “Single” because she is not married and has no children.
- Line 6a: Mary checked the box, “Yourself” for her personal exemption because her parents cannot claim her as a dependent on their tax return. She is over age 18 and is no longer a student. Mary entered the number 1 on the correct line on the right hand of the page.
- Line 6d: Mary reported her one exemption as an individual, single taxpayer.

### **Income**

- Line 7: Mary reported the \$6,000 of wages True paid for her labor. True reported the \$6,000 to Mary on IRS Form W-2, Wage and Tax Statement by January 31, 2012 (for the 2011 tax year).



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Line 8a: Mary reported \$100 of interest income she earned on her savings and interest bearing checking accounts. Her financial institution sent Mary IRS Form 1099-INT, Interest Income, because the amount was above \$10.

Line 18: Mary reported her \$21,904 net farm income and attached IRS Schedule F, (Form 1040), Profit or Loss From Farming, which shows how she calculated the net amount. Schedule F (Form 1040) is discussed below.

Line 22: Mary's reported her \$28,004 total of lines 7, 8a, and 18.

### **Adjusted Gross Income**

Line 27: Mary can deduct \$1,547 of the self-employment tax (social security and Medicare taxes) that she paid on her net farm income. She calculated the self-employment tax and the \$1,547 deduction on IRS Schedule SE (Form 1040), Self-Employment Tax, which is discussed later.

Line 28: Mary chose to set aside funds for her future retirement using a simplified employee pension (SEP) plan. The SEP contribution is calculated as a percentage of her net farm income. Based on this year's net income, the maximum Mary can contribute is \$4,071. She chose to contribute \$4,000.

Line 32: Mary wants to aggressively save for future retirement. She is eligible for a \$5,000 IRA contribution in addition to her SEP contribution and she made that contribution.

Line 36: Mary reported the \$10,547 sum of lines 27, 28, and 32.

Line 37: Mary calculated her \$17,457 adjusted gross income (AGI) by subtracting the \$10,547 on line 36 from the \$28,004 on line 22.

### **Tax and Credits**

Line 38: To begin the calculations on page 2 of IRS Form 1040, Mary carried the \$17,457 AGI from line 37 to line 38.

Line 40: Mary claimed the standard deduction for a single taxpayer because she did not have itemized deductions sufficiently larger than \$5,800.

Line 41: Mary subtracted her \$5,800 standard deduction from her \$17,457 AGI and entered the \$11,657 result.

Line 42: Mary, as a single taxpayer, is allowed one \$3,700 exemption deduction (line 6d times \$3,700)

- Line 43: Mary subtracted her \$3,700 personal exemption deduction from the \$11,657 reported on line 41 and entered the \$7,957 result.
- Line 44: Mary's taxable income is all in the 10% income tax bracket, but she must use the tax tables to calculate her taxes. The tax table amount for \$7,957 of taxable income for a single taxpayer is \$798.
- Line 45: Mary is not subject to the alternative minimum tax (AMT).
- Line 46: Mary entered the \$798 total of lines 44 and 45.
- Line 49: Mary entered her \$798 American Opportunities Credit for her last semester at the local community college as calculated on IRS Form 8863, Education Credits (American Opportunity and Lifetime Learning Credits) discussed later.
- Line 54: Mary's only credit is her \$798 American Opportunity Credit.
- Line 55: Mary's federal income tax is \$0 after subtracting her \$798 of credits.
- Line 56: Mary entered her \$2,690 of self-employment tax as calculated on IRS Schedule SE (Form 1040) discussed later.
- Line 61: Mary's \$2,690 total tax is the sum of lines 55 and 56.
- Line 62: Mary entered the \$180 federal income tax withholding from her wages as reported on her Form W-2, Income and Tax Statement.
- Line 66: Mary entered the \$800 refundable portion of the American Opportunity Credit as calculated on IRS Form 8863.
- Line 72: Mary entered the \$980 total of lines 62 through 71.
- Line 76: Mary subtracted her \$980 of withholding and tax credits from her \$2,690 tax liability and entered the \$1,710 result.
- Line 77: Although Mary owed \$1,710 in taxes, she was not subject to a penalty for underpayment of estimated taxes because she filed her return and paid the \$1,710 of taxes due by March 1, 2012.

Below Line 77 is the signature block where Mary signed and dated the return. If Mary hired a paid preparer to prepare her income tax returns; that person would sign and provide information in the appropriate boxes.



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## 2011 IRS Schedule F, (Form 1040), Profit or Loss From Farming

As the proprietor of a farming operation, Mary entered her name and her social security number (SSN) at the top of Schedule F (Form 1040).

- Line A: Mary's principal crops are corn and soybeans.
- Line B: The principal activity code for crop farming is 111100. It is used for statistical analysis by the United States Departments of Agriculture, Commerce and Treasury and other federal agencies in aggregate data studies without any personal or individual identifiers.
- Line C: Mary chose to use the cash method of accounting, which is by far the most common accounting method used by farmers. This choice remains in effect until she elects to change to the accrual method of accounting. However, very few farmers elect to change to accrual accounting.
- Line E: Mary answered yes to the question of material participation because she makes all decisions regarding production and marketing and she is physically involved in the tillage and harvesting of her corn and soybeans.
- Line F: As discussed earlier, Mary made payments to the owner of the land she rented and to True that require her to file Forms 1099-MISC. Therefore she checked the yes box. Generally, farmers must file IRS Forms 1099 for any cumulative payments of \$600 or more to an individual or unincorporated business for rents, machine hire, or contract work paid in the ordinary course of the farming business.
- Line G: Mary filed IRS Forms 1099-MISC for rent paid to her lessor and for rent and fees for services paid to True as discussed earlier. Therefore, she checked the "Yes" box.

### Part I Farm Income – Cash Method

- Line 2b: Mary reported her \$109,782 of her raised crop sales.
- Line 4a: Mary reported her \$2,250 of Direct Payments as part of the USDA Farm Program. The Farm Service Agency (FSA) issued Mary an IRS Form 1099-G, Government Payments, for this amount.
- Line 4b: Because all of her \$2,250 government program payments are taxable, she reports the full \$2,250.
- Line 9: Mary entered the \$112,032 sum of lines 2b and 4b.

## Part II Expenses

- Line 10: Because Mary elected to deduct the \$20,000 cost of her pickup truck under I.R.C. § 179 (discussed later), she cannot claim the standard mileage rate deduction for her pickup. Therefore, she deducted the \$4,585 itemized expenses for her pickup truck (listed earlier in the facts for this case study).
- Line 11: Mary entered the \$5,550 she paid True for pesticides.
- Line 13: Mary entered the \$11,775 she paid True for the pesticide application and harvesting of her crops.
- Line 14: Mary reported the \$20,000 I.R.C. § 179 expense deduction from IRS Form 4562, Depreciation and Amortization, which is discussed later.
- Line 17: Mary entered the \$15,150 she paid True for fertilizer.
- Line 24a: Mary entered the \$4,500 she paid True for equipment rental.
- Line 24b: Mary entered the \$18,750 she paid for land rent.
- Line 26: Mary entered the \$6,818 she paid True for corn and soybean seed.
- Line 32a: Mary reported the \$3,000 she paid True to dry her corn and soybeans.
- Line 33: Mary entered the \$90,128 sum of lines 10 through 32a.
- Line 34: Mary entered her \$21,904 net farm profit.
- Line 35: Mary answered “Yes” to the question regarding receipt of subsidy payments in 2011, which are reported on lines 4a and 4b as discussed earlier.

Because Mary chose to use the cash method of accounting, she did not need to complete or file page 2 of IRS Schedule F (Form 1040). Farmers who use the accrual method of accounting must complete and file page 2 of IRS Schedule F.

Note: Beginning farmers may have a net loss on their Schedule F (Form 1040) in their first year or two of farming because of the cost of getting started. If they have a net operating loss (NOL) as a result of their farm loss, they can carry the NOL to another tax year to offset taxable income. By default, a farm NOL is carried back 5 years, but farmers can elect to carry the NOL back 2 years or to forego the carryback and carry it forward only. There is a more detailed discussion of NOLs in a fact sheet and in the *Tax Guide for Owners and Operators of Small and Medium Sized Farms* at [www.RuralTax.org](http://www.RuralTax.org).



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## **2011 IRS Form 1040 Schedule SE (Form 1040), Self-Employment Tax**

Mary completed the top line of Schedule SE (Form 1040) with her name and social security number.

- Line 1a: Mary entered the \$21,904 net farm profit from line 34 as of Schedule F (Form 1040). Because she did not have anything to report on lines 1b or 2 she also enters \$21,904 on line 3.
- Line 4: Mary calculated her \$20,228 of net earnings from self-employment by multiplying her \$21,904 net farm profit by 92.35%.
- Line 5: Mary calculated her \$2,690 self-employment tax by multiplying her \$20,228 of net earnings from self-employment by 13.3% and entered it here and on line 56 of IRS Form 1040 as discussed earlier.
- Line 6: Mary calculated her \$1,547 deductible portion of her self-employment tax by multiplying her \$2,690 self-employment tax by 57.51% and reported it here and on line 27 of IRS Form 1040 as discussed earlier.

## **2011 IRS Form 8863, Education Credits**

Mary completed the top line of IRS Form 8863 with her name and social security number. She is entitled to claim an education credit because she was a full-time student for the spring semester at the community college and her parents could not claim her as a dependent.

### **Part I American Opportunity Credit**

- Lines 1a&b: Mary entered her name and social security number
- Line 1c: Mary entered the \$2,000 she paid for tuition (\$1,500) and educational material (\$500) and carried that amount to lines 1f and 2.

### **Part III Refundable American Opportunity Credit**

- Line 7: Mary entered the \$2,000 from line 2 on page one.
- Line 8: Mary entered \$90,000 because she is a single taxpayer.
- Line 9: Mary entered her \$17,457 from line 38 of her IRS Form 1040.
- Line 10: Mary subtracted \$17,457 from \$90,000 and entered the \$72,543 result.
- Line 11: Mary entered \$10,000 because she is a single taxpayer.



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Line 12: Mary entered 1.000 because the \$72,543 entered on line 10 is greater than the \$10,000 entered on line 11.

Line 13: Mary multiplied the \$2,000 on line 7 by the 1.000 on line 12 and entered the \$2,000 result.

Line 14: Mary multiplied the \$2,000 on line 13 by 40% and entered the \$800 result here and on line 66 of IRS Form 1040 as discussed earlier.

#### **Part IV Nonrefundable Education Credits**

Line 15: Mary subtracted the \$800 on line 14 from the \$2,000 on line 13 and entered the \$1,200 result.

Line 23: Mary's nonrefundable credit is limited to her \$798 tax liability on line 54 of Form 1040. The remaining \$402 (\$1,200 - \$798) cannot be carried forward to a future year and is therefore lost.

#### **2011 IRS Form 4562, Depreciation and Amortization**

Mary completed the top line of IRS Form 4562 by entering her name, the business activity to which this form applies [her farming business as reported on IRS Schedule F (Form 1040)], and her social security number.

#### **Part I Election to Expense Certain Property Under Section 179**

Line 1: Mary entered the \$500,000 maximum statutory limit for IRC § 179 expensing in 2011.

Line 2: Mary entered the \$20,000 she paid for her ¾ ton pickup. The pickup was the only property Mary purchased in 2011 that is eligible for I.R.C. § 179 expensing.

Line 3: Mary entered the \$2,000,000 statutory investment limit before the expense election is reduced dollar for dollar for investment amounts above the limit.

Line 4: Mary entered \$0 because she did not invest more than \$2,000,000 in property that qualifies for the I.R.C. § 179 deduction in 2011.

Line 5: Mary entered the \$500,000 result of subtracting \$0 from \$500,000.



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- Line 6: Mary described her  $\frac{3}{4}$  ton pickup in column (a), entered the \$20,000 cost in column (b), and her \$20,000 election in column (c).
- Line 8: Mary entered the \$20,000 total for all elected property.
- Line 9: Mary entered the smaller of the \$20,000 on line 8 and \$500,000 deduction limit on line 5.
- Line 11: Mary entered her \$41,904 farm profit before the expense deduction plus \$6,000 of wages, which is treated as business income for this purpose.
- Line 12: Mary entered the \$20,000 I.R.C. § 179 expense deduction.
- Line 22: Mary entered the \$20,000 sum of her I.R.C. § 179 deduction and depreciation here and on line 14 of Schedule F (Form 1040) as discussed earlier. Because Mary elected to fully expense her pickup, she will not have any depreciation for the pickup in subsequent years.

### **2011 IRS Form 1040-V Payment Voucher**

Mary owed \$1,710 of income and self-employment tax liability as calculated on line 76 of IRS Form 1040. She filed Form 1040-V, Payment Voucher, with her 2011 income tax return and her payment. If Mary had filed electronically, she would have filed Form 1040-V with her payment to ensure correct crediting of her tax payment.

