Contemporary Tax Issues Related to Farmers and Ranchers

Kirsten M. Rosacker
Minnesota State University, Mankato

Paul Brennan
Minnesota State University, Mankato

In the United States, farmers and ranchers account for one percent of GDP and utilize 40 percent of the land in the 48 contiguous states. Tax statutes can appear within any law passed by Congress. Recent tax legislation provides tax benefits for farmers and ranchers. This paper will discuss the substantive tax provisions impacting or directed at these economic enterprises that appear in four recently passed legislative acts: (1) Tax Cut and Jobs Act of 2017; (2) Agriculture Improvement Act of 2018; (3) Families First Coronavirus Response Act; and (4) Coronavirus Aid, Relief, and Economic Security *Act of 2020.*

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INTRODUCTION

The Internal Revenue Code of 1986 (as amended) (IRC) defines farm entities in several code sections with nearly identical wording. For example, "The term 'farm' includes stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands" (Internal Revenue Code (IRC) Sec. 2032A). These entities come in many forms and sizes, ranging from sole proprietors to partnerships to corporate enterprises.

The United States (US) has 2.05 million operating farms and ranches, which generated approximately one percent of the United States Gross Domestic Product (GDP) in 2017. Additionally, farmers employed roughly 1.3 percent of the working population and utilize approximately 40 percent of the land in the 48 contiguous states (USDA, 2020). Americans spend approximately 13 percent of their household budgets on food products. Agriculture has a significant impact on the American population and the economy.

Farm and ranch entities are eligible for special tax methods due to the unique nature of their business and the respective income/expenses incurred in their businesses. These tax methods likely encourage increased investments in productive farm capacity while concurrently reducing the paperwork burden on such enterprises. Sole proprietors report their farm income (or loss) on Internal Revenue Service (IRS) Form 1040 Schedule F, which is entitled "Profit or Loss from Farming." This form is distinctive from Schedule C as both income and expense categories for farmers and ranchers are at significant variance with general business enterprises. The net farm income (or loss) carries to the taxpayer's Form 1040 to be included with income (losses) from other sources. Partnerships and limited liability corporations that have elected to be taxed as partnerships, report their income using a Schedule F with income flowing to the

partners (members) in the normal partnership income-sharing arrangement (K-1s) that produces Form 1065's final results. Farms and ranches that are organized as S Corporations prepare a Schedule F to be included with their Form 1102S for distribution to each stockholder (K-1s) in the normal income-sharing arrangement. Finally, regular Corporations prepare a Schedule F to include with their respective income reporting for preparation of the Form 1120. The United States Department of Agriculture (USDA) reports that in 2016, ninety-eight (98) percent of family farms were organized as pass-through entities (USDA, 2020), including partnerships, limited liability companies, and S corporations. However, one should be mindful that many farms and ranch enterprises may include several of these entities depending upon the legal and ownership barriers employed to protect, for example, the farm property from farm operations.

This paper describes the impacts associated with recent legislation on farmers and ranchers with respect to income taxation. In particular, this paper will describe the provisions included in the Tax Cut and Jobs Act of 2017 (PL 115-97, December 22, 2017); Agriculture Improvement Act of 2018 (PL 115-334 December 20, 2018); Families First Coronavirus Response Act (PL 116-127, March 18, 2020); and the Coronavirus Aid, Relief, and Economic Security Act of 2020 (PL 116-136 March 29, 2020) that may have direct impacts on these enterprises regardless of the type of business form utilized in their operations.

TAX CUT AND JOBS ACT (TCJA) OF 2017

The TCJA of 2017 made substantive and significant changes to the Federal income tax system impacting nearly all tax filers. This paper will focus on the changes directed explicitly at influencing farmers and ranchers. However, it is essential to note that the TCJA of 2017 significantly changed the calculation of taxable income while reducing tax rates for all taxpayers. Corporate rates were lowered and combined into a flat rate of 21 percent on all income (decreasing form a top rate of 35 percent). In contrast, the top rate for individuals, and therefore flow-through entities, was reduced to 37 percent for 2018 and 2019 from 39.60 percent in 2017.

Income Averaging

Farmers and ranchers have been able to use income averaging for many years via Form 1040, Schedule J, "Income Averaging for Farmers and Fishermen." Farm and ranch incomes are subject to many environmental uncertainties and economic fluctuations that can cause the bottom line to change significantly from year to year. Many farm programs are deployed by the federal government to assist in dampening such concerns and thereby encouraging farmers and ranchers to stay in business for the long-term in such a fluid environment. At the same time, proper tax planning is often used by professional accountants serving this sector to manage these variations to some degree across years; however, sometimes such efforts are simply insufficient, and reported income/losses can be wildly at variance over a series of tax years. To be fair, Congress has enacted income averaging as a mechanism to allow farmers and ranchers to achieve an "average" rate across several years. Since rates have been lowered, by employing this tax provision, farms and ranches may be able to lower their current federal income tax obligation if their farm income reported under the TCJA is higher, and their taxable income from one or more of the base years was lower.

Depreciation

Cost Recovery Period

Machinery and equipment are generally a significant investment in any farming operation. The definition of machinery and equipment for general businesses must be modified and broadened to fit the operative definition for farms and ranches. For example, purchased milking cows are classified similarly to machinery and equipment subject to depreciation. In contrast, raised milking cows are not depreciable as the expenses for developing heifers to maturity are deducted as incurred. Under the TCJA of 2017, machinery and equipment have a recovery period of five years rather than the previous seven-year

timeframe. A similar but not identical, change would impact farmers and ranchers engaged in the raising of other farm animals (e.g., hogs, turkeys, chickens, horses, etc.).

Bonus Depreciation

The bonus depreciation percentage raised from 50 to 100 percent (IRC Sec. 168(k)) for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. Property acquired before September 27, 2017, remains subject to the prior rules. The TCJA of 2017 expands the property eligible for bonus depreciation to include used qualified property acquired and placed in service after September 27, 2017. Bonus deprecation has no maximum amounts and is not limited to taxable income. For tax planning purposes, this presents a significant opportunity to generate and benefit from a net operating loss should this be desired.

IRC Sec. 179

Before the enactment of the TCJA, IRC Sec. 179 deduction limit was $500,000 per tax year. The classification of IRC Sec. 179 property now includes qualified improvements made to a building's interior. The maximum amount a business can elect to deduct for most IRC Sec. 179 property placed in service after December 31, 2017, is $1,000,000 for 2018 and $1,020,000 for 2019. This limit decreases by the amount by which the cost of the property placed in service during the 2018 tax year exceeds $2,500,000, and the 2019 tax year exceeds $2,550,000. The maximum amount of IRC Sec. 179 deduction is limited to the taxpayer's taxable income before considering the IRC Sec. 179 deduction. In other words, no opportunity to generate and benefit from a net operating loss. Any unused amounts as a result of this limitation are carried over for an indefinite period.

Like-Kind Exchanges

IRC Sec. 1031 enables a taxpayer to exchange business-use property for property of "like-kind" without recognizing gain/loss on the transaction as the taxpayer is merely exchanging one productive asset for another. By making these types of transactions non-taxable, the taw law allows the business taxpayer to remain whole while only exchanging one operating asset for another. Following the TCJA 2017, IRC Sec. 1031 property includes only reality exchanges where one or more pieces of farm or ranch land exchange for another real estate property (farm/ranch land or unimproved realty). In the instances where machinery or certain farm animals exchange under these provisions after December 31, 2017, the special non-recognition provisions of IRC Sec. 1031 no longer apply. A transition period from the date of the act through December 31, 2017, provided a safe harbor for such transactions.

The arguments for disallowing these later types of transactions appear to be related to the recent movement towards allowing full expensing of non-realty. In general, most farmers and ranchers are taking full advantage of the bonus and enhanced depreciation deductions afforded under the law. This leads to a basis of zero in most personality – a fully depreciated status. For example, consider when a farmer or rancher trades in an old, fully depreciated tractor for a new tractor. Assume a trade-in value given by the dealer resulting in a decreased cash price. Under the new law, the farmer or rancher would recognize ordinary income equal to the trade-in value (in general under the provisions of Sec. 1245) and then take a full depreciation deduction for the total purchase price of the new tractor, inclusive of the trade-in valuation. Essentially, two events have occurred – a sale of the old tractor causing recognition of an ordinary gain and a full depreciation deduction for a newly purchased asset. The net effect would be offsetting items in the calculation of taxable income. However, reporting this event in two stages, rather than the previous one-stage 1031 deferral, may have an impact on the determination of self-employment income, leading to a reduction of this tax in some instances. Further, if the personal property exchange included a raised animal as a trade-in, the result could be a lower-taxed capital gain. For certain farmers and ranchers, these changes may be significant, leading to many tax differences associated with the complexity of the underlying transactions (e.g., high production cow/calf combination swaps).

Business Interest Deduction

Farm and ranch enterprises often require operating loans to finance the acquisition of input costs such as fertilizer, seeds, and feed. Furthermore, most farmers and ranchers employ long-term debt for capital investments in machinery, equipment, animals, buildings, and land. The TCJA of 2017 limits the business interest deduction to total business interest income the plus 30 percent of adjusted taxable income (IRC Sec 163(j)). This rule includes two relevant exceptions. First, an enterprise with less than $25 million of gross receipts is exempt; and second, farmers and ranchers are not subject to the gross receipts limit test if they use the alternative depreciation system (ADS) for assets with a class life of 10 years or more. This provision will likely have minimal impact on farmers and ranchers.

Qualified Business Income

Under the TCJA of 2017, a 20 percent deduction is available for qualified business income. This provision includes most farm and ranch income and related farm and ranch rental income (IRC Sec 199A). This deduction intends to bring the maximum tax rate paid by individual taxpayers in line with the 21% flat rate paid by C-Corporation taxpayers. The deduction is available regardless of the form of the enterprise that generates the pass-through business income. If the taxpayer engages in a farm rental activity instead of the active conduct of a farming business, the availability of the Qualified Business Income deduction, while less likely, still may be available if the taxpayer's efforts comply with the safe harbor provisions of IRS Notice 2019-7. These provisions specify a minimum number of working hours and record-keeping requirements to qualify for the deduction but deny the deduction for triple net leases where the lessee pays for the normal costs of ownership (taxes, fees, insurance, etc.).

Net Operating Loss Deduction

The TCJA of 2017 has altered the Net Operating Loss (NOL) deduction. Historically, a business was able to carryback NOL for five years, with remaining balances being available for carryforward for up to 20 years until utilized. This law eliminates the carryback provisions for almost all businesses with a notable exception for farmers and ranchers. An NOL related to a farming operation is reduced to 80 percent and can be carried back two years. Additionally, a farmer can make an election to forego the carryback period and carryover the loss indefinitely to future years until consumed. The importance of this exception for farmers and ranchers is heightened by any tax law changes that may lead to a tax loss situation for a given year (e.g., see depreciation changes discussed above).

Estate Tax Exemption

A decedent's appreciated assets receive a stepped-up basis at death, making the beneficiaries carryforward basis to the fair market value at the date of death or alternate valuation date. Most family farms, regardless of tax entity selection, engage in succession planning to ensure the minimization of estate and inheritance taxes at the date of the owner's death. Much of the wealth of individual farmers and ranchers are in the land. Alternative use valuation methods are typically employed at death transfer to minimize the valuation of the land and ensure that it is not necessary to sell the farm to settle tax obligations (IRC Sec. 2032A). Delayed methods of paying estate taxes are provided in the tax law to further mitigate against such an undesirable outcome (IRC Sec. 6166). It is the stated public policy goal that farmers and ranchers be able to pass property to their children so that family farms remain a fixture in the US. However, farmland values have increased significantly across recent decades (USDA, 2019). This increase in value can be significant for many underfunded farmers and ranchers, providing access to financing that otherwise would not be available. But for many, this increase is simply a valuation issue as there is no need for borrowing nor any intent or desire to sell the farm or ranch land. This increased land valuation becomes a significant issue when it comes to death and land transfers within the family at that time. It would be productive if family transfers at death directed at maintaining family farms and ranches were wholly exempt from estate and inheritance taxes – a substantive step towards ensuring the stated public policy goal of encouraging family farms and ranches into the future. But this is not the case, and thus the issue becomes of significant importance in succession planning. The only protection provided is

a substantial exemption in estate tax law that operates to shield most, if not all, of the land valuation from estate taxation. In this regard, the Federal individual estate exemption has increased from 5.49 million dollars in 2017 to 11.18 million dollars in 2018 and 11.4 million dollars in 2019, a doubling of the exemption for each person. For a husband and wife, the exclusion would again double with proper planning. Many family enterprises operating in this arena will find this enhanced exemption a necessary and useful planning tool.

AGRICULTURE IMPROVEMENT ACT OF 2018

Before the passage of the Agriculture Improvement Act of 2018, commonly referred to as the 2018 Farm Bill, hemp was a Schedule I drug by the Drug Enforcement Agency (DEA). While hemp was restricted, but the legal crop in many states before the passage of the 2018 Farm Bill, it was considered illegal by the Federal Government. As a result of the plant's illegal status at the Federal level, any costs and expenses related to growing and handling cannabis were not tax-deductible (IRC Sec. 280E). Hemp farmers were considered drug dealers and were required to report 100 percent of their gross revenue without any ability to deduct any of the input costs associated with producing the product for the market. This situation is similar to that first enacted by President Nixon, where drug dealers were not allowed to deduct any associated business expense. That was subsequently changed to permit drug dealers to deduct their cost of goods sold, but no such exemption exists for the cost of goods manufactured (grown).

The 2018 Farm Bill defines hemp as "(t)he plant Cannabis sativa L. and any part of the plant … whether growing or not, with delta-9 Tetrahydrocannabinol concentration of not more than 0.3 percent on a dry weight basis." Further, hemp, which contains 0.3 percent or less of Tetrahydrocannabinol (THC), is no longer a Schedule I controlled substance under the Controlled Substance Act. Therefore, a farmer or rancher is permitted to deduct costs and expenses related to growing or producing this plant. While this crop remains highly regulated by both State and Federal governments, it has seen broader acceptance across society and evolving forms of retail delivery, thus providing a new product for farmers and ranchers to consider.

FAMILIES FIRST CORONAVIRUS RESPONSE ACT

The Families First Coronavirus Response Act (PL 116-127), signed by President Trump on March 18, 2020, provides small and midsize employers refundable tax credits that reimburse them, dollar-for-dollar, for the cost of providing paid sick and family leave wages to their employees for leave related to the coronavirus pandemic. Specific self-employed individuals are also eligible for protection under these provisions.

Qualified Paid Sick Leave and Family Leave Credits

Small and medium-sized businesses are eligible for refundable credits related to the expenses associated with employees who take sick and family leave due to the coronavirus pandemic. Employees taking care of themselves or family members represent the targeted classes. If the employer pays the employee during this timeframe, the employer is eligible for a refundable tax credit up to 100 percent of qualified sick and family leave salary paid by the employer. The employee is eligible for up to 80 hours of paid sick leave for his/her personal care or the care of a family member. Also, the employee is eligible for up to 10 weeks of paid family leave for the care of a child should his/her school be closed for coronavirus precautions.

Qualifying employers will access funds to support these payments in one of two ways: (1) through their Form 941 quarterly employment tax filings or (2) by asking the Department of the Treasury for advance payments against their expected refundable credits. For employers with many employees, this means that the employer can use withholding amounts from other workers to fund the employee who is out on sick or family leave. For employers with few employees, the preferred method would be to seek an advance payment from the Department of the Treasury. For farmers and ranchers, this process may be

quite different as they generally use Form 943 once a year to report both withholding taxes and FICA taxes. They may need further guidance from professional accountants who service this area to determine the appropriate process for agricultural concerns.

CORONAVIRUS, AID, RELIEF, AND ECONOMIC SECURITY ACT

On March 27, 2020, President Trump signed into law the Coronavirus, Aid, Relief, and Economic Security (CARES) Act (PL 116-136). This represents the third bill targeted at addressing the economic issues associated with fighting the coronavirus pandemic through social distancing measures. It is touted as the most significant relief effort in the history of the US. While most of the lengthy legislative act is directed at providing direct financing to individuals and businesses, a portion of the bill addresses tax incentives intended to provide indirect financing to business. Many of these initiatives will have direct impacts on farm and ranch enterprises that meet the specific criteria for relief.

Payroll Tax Payments Delayed

The CARES Act allows an employer to elect to delay the payment of 50 percent of their 2020 employer FICA (not including Medicare) payroll taxes until December 31, 2021, with the other 50 percent coming due on December 31, 2022. This provision also applies to self-employment taxes. The effect of this is to provide cash flow to employers and the self-employed by delaying these payments for one to two years. Concurrently, cash basis employers, and self-employed individuals would not be able to deduct these expenses until the date paid. Therefore, if a business adopts this deferral, there are implications for their tax planning for 2020, 2021, and 2022 tax years.

Access to Defined Contribution Retirement Funds

Taxpayers can withdraw up to $100,000 from their retirement accounts without the standard 10 percent early withdrawal penalty. To avoid the usual penalty, a taxpayer's withdrawal must be due to a financial need generated by the coronavirus and made between January 1, 2020, and December 31, 2020. Furthermore, the taxpayer may elect to include the distribution in their income ratably over three years rather than as a lump sum in a single year. Finally, the taxpayer can avoid paying tax entirely on the distribution by paying it back to the retirement fund within three years from the date of the original distribution. As farmers and ranchers are primarily responsible for funding their retirement (as are most self-employed individuals), it is reasonable to assume they will have significant funds set aside for this purpose. This provision provides them with a means for generating funds should the coronavirus negatively impact their operations.

Qualified Improvement Property

The CARES Act corrects a technical error in the TCJA of 2017 by recategorizing qualified improvement property (improvements to the interiors of non-residential buildings) to 15-year life property rather than 39-year life. This change allows qualified improvement property to be eligible for bonus depreciation. This provision is retroactive to January 1, 2018. Farmers and ranchers who are impacted by this change will have an opportunity to file amended tax returns as necessary to correct for this change and will receive tax refunds as a result.

Net Operating Losses

The bill temporarily repeals the 80 percent income limitation for all taxpayers for net operating loss deductions for years beginning before 2021. For losses arising in 2018, 2019, and 2020, a five-year carryback is allowed (taxpayers can elect to forgo the carryback). This enhances the NOL provisions discussed above under the TCJA of 2017. Any farm or ranch enterprises that previously filed amended, NOL carryback returns under the TCJA of 2017 provisions will need to reassess those filings and determine the newly amended returns that may be required to conform to benefit from this tax change.

Individual Taxpayer Rebates

Resident individual taxpayers with an adjusted gross income of $75,000 or less (single filer) are eligible for a $1,200 refundable tax rebate. The limitations and refundable amounts double for joint filers. A phase-out of the refundable amount occurs at higher income levels. Furthermore, an additional $500 is available for each child of the taxpayer. Many farmers and ranchers will qualify for these refundable tax credits. Electronic and paper checks will be automatically provided to those eligible taxpayers with a more complex refundable tax credit process being utilized to finalize these disbursements in the 2020 tax year. In other words, eligibility for these rebates will ultimately be determined by the 2020 tax filing, meaning that some people who receive the rebates may have to repay them at that time. Conversely, farmers, and ranchers who do not immediately qualify may obtain this position in the future. As stated above, farm and ranch income can vary across the years, so it may be advisable to assess each person's situation relative to these transfers to mitigate unwelcome surprises in the future.

CLOSING

Many significant changes have been enacted over the past three years affecting the tax returns of all entities. Some of these provisions have a direct impact on farm and ranch entities, providing opportunities for tax planning for future years and refunds of previously paid income taxes associated with past tax filings. This paper has addressed significant changes and provided a discussion of the impact of these changes to guide tax professionals operating in this arena.

REFERENCES

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IRC Sec. 11 - Tax imposed
IRC Sec. 167 - Depreciation
IRC Sec. 163(j) - Limitation on business interest
IRC Sec. 168(k) - Accelerated cost recovery system
IRC Sec. 179 - Election to expense certain depreciable business assets
IRC Sec. 199A - Qualified business income
IRC Sec. 280E - Expenditures in connection with the illegal sale of drugs
IRC Sec. 1031 - Exchange of real property held for productive use or investment
IRC Sec. 2032A - Valuation of certain farm, etc., real property
IRC Sec. 6166 - Extension of time for payment of estate tax where estate consists largely of interest in closely held business
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