

Greener Pastures

Tax Benefits for Farmers

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People purchase rural land for a variety of reasons. Many want the serenity of living on a few acres in a rural area. Others just like the idea of purchasing and holding on to it, waiting for the metropolis to come to them.

Investors generally want two things: return of their money (initial investment) and an economic return on the money invested. Investing in rural land has traditionally been thought an effective way to accomplish these twin goals. Given sufficient time, an economic return in rural land can almost certainly result from appreciation in land value. Many investors purchase land to hold long term, waiting for the marketplace to create the favorable profit.

One idea for investors to consider while holding rural land and waiting for it to turn a profit is to operate a farm on the land. That may not be the first idea that comes to most people's minds, but farms and farmers enjoy significantly favorable tax treatment. In fact, there is a strong pro-farm current throughout many U.S. laws (and not only tax laws). The most prominent federal law oriented toward farming is the periodic subsidy bills that

Takeaway

Investors purchase rural land for a host of reasons, including the hope of making money when land values appreciate. Powerful tax provisions favoring farms are another reason rural land is an attractive investment option.

congress enacts about every five years or so. The average person might be surprised at the degree to which the federal government subsidizes U.S. farms.

Harvesting Tax Savings

In Texas, one of the most sought-after property tax benefits is the agriculture use valuation, commonly referred to as an "ag exemption." This treatment represents a tremendous cost savings. However, it's not an exemption, but rather a special method of valuing the real estate. In 1978, the Texas Constitution was amended to allow open-space land to be appraised based on its productivity value. In 1995, it was amended again to permit agriculture appraisal for land used to manage wildlife.

Property tax valuation is generally based on the best use of the land, but agriculture landowners are entitled to have their property taxes computed based on the productive agriculture value. Obtaining the agriculture exemption can yield significant cost savings, so anyone acquiring rural land should pay attention to the requirements for an agriculture exemption.

Generally, about ten acres of qualified agricultural land is required for the special agricultural valuation. The land must have been primarily used for agricultural purposes for five out of the seven preceding years. The landowner applies for the special agriculture valuation with the local appraisal district.

In addition to property taxes, farmers also enjoy relief from sales and use and various fuel taxes when purchasing certain items used exclusively to produce agricultural products. To claim the tax exemption, the landowner must apply to the Comptroller of Public Accounts for an agriculture registration number, which is then used when purchasing qualifying items. The cost savings from an agriculture tax exemption from sales and fuel taxes can be significant.

What is Agriculture Use?

The definition of “agriculture use” is broad. As a principal guideline, the comptroller publishes a *Manual for the Appraisal of Agricultural Land* (<https://comptroller.texas.gov/taxes/property-tax/docs/96-300.pdf>), which says agricultural use is cultivating the soil; producing crops; raising or keeping livestock, poultry, or fish; or planting cover crops. The land can be used to raise exotic animals or birds (or even bees), harvest timber, or for wildlife management. Local appraisal districts also publish guidelines concerning the degree of intensity of agricultural use generally accepted in the county.

For federal tax purposes, IRS guidelines indicate farming could include:

- operating a nursery or sod farm;
- raising or harvesting trees bearing fruits, nuts, or other crops;
- raising ornamental trees (but not evergreen trees that are more than six years old when severed from the roots);
- raising, shearing, feeding, caring for, training, and managing animals; and
- leasing land to a tenant engaged in a farming business, but only if the lease payments are based on a share of the tenant’s production (not a fixed

amount) and determined under a written agreement entered into before the tenant begins significant activities on the land.

But the IRS cautions that farming does not include:

- contract harvesting of an agricultural or horticultural commodity grown or raised by someone else, or
- merely buying or reselling plants or animals grown or raised by someone else.

Hobby Losses

Another important tax benefit of owning and operating a farm is using economic losses from the farm to offset other ordinary income. The weekly release of current tax developments routinely includes at least one Tax Court case involving someone attempting to sustain tax losses from rural property that is said to be a farm (or ranch), and the IRS arguing that the taxpayers are merely engaging in a hobby.

The basic rule of “hobby losses” is often quoted but perhaps not readily understood. The governing statutes from the tax code distinguish trades or business from activities other than those engaged in for profit—or those engaged in as a hobby. The Internal Revenue Code allows a taxpayer to deduct “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business” [IRC §162(a)]. However, if the activity giving rise to the expenses “is not engaged in for profit,” deduction of expenses incurred in the activity is permitted “only to the extent that the gross income derived from such activity (i.e., the not-for-profit activity) for the taxable year exceeds the deductions.”

Activities not engaged in for profit are usually referred to as “hobbies.” Hobby expenses may be deducted from hobby profits but not from any other income the taxpayer may have. Of course, this is exactly what a taxpayer hopes to achieve by owning rural property—to deduct large sums of money year after year against other income the taxpayer derives from other (and genuine) businesses or trusts or other conventional sources of income.

Hobby loss rules are based on a presumption. An activity is presumed to be engaged in for profit if the activity shows a profit for any of three out of five consecutive years ending with the year for which tax deductions are taken. For horse breeding, training, showing, or racing, the period is extended to two out of seven years. This presumption is not an absolute bar from using the losses against ordinary income. Rather, the hobby loss rule

is a presumption in favor of a hobby. This means the taxpayer can take deductions in excess of income over a longer period provided the taxpayer can overcome the presumption that the losses are engaged in for a hobby (i.e., not engaged in for profit).

An activity constitutes a “trade or business”—and it escapes the hobby loss limitations—if the taxpayer has an actual and honest objective to realize a profit. The courts look at all surrounding facts and circumstances.

In one of the more prominent cases, an Indianapolis restaurant owner and operator maintained a horse-training activity outside of the city. The Tax Court denied him the deductions on the grounds that he was engaged in a hobby, but the U.S. Court of Appeals (Seventh Circuit) upheld the deductions stating that the Tax Court misapplied the usual factors considered. The Circuit Court rejected the Tax Court’s explanation that a profit motive will not be found when a taxpayer combines horse-racing activities with social and recreational activities. The Circuit Court explained that a business owner’s enjoyment of his business doesn’t automatically make the activity a hobby.

Income Averaging for Farmers

Although income averaging is no longer generally available, farmers retain this helpful feature. They can average their incomes over three years.

Since farm income can vary widely from year to year, the ability to average becomes an important benefit. It provides a way to balance an income tax burden over several years, reducing the effects of both lean and bounty years. Tax brackets increase the more income one earns. Thus, for bounty years, taxes increase because the tax bracket increased. Averaging allows the taxpayer to reduce the harsh effect of the higher brackets in the bounty years.

Special Rules for Debt Relief

Special relief from cancellation of indebtedness income is an important tax provision for the farmer.

For most taxpayers, when debt is cancelled, the relieved debt is income. The principal exception is when the taxpayer is insolvent. If debt is cancelled when the taxpayer is insolvent, there is no income. Farmers do not have this requirement. They can avoid debt cancellation income

if the debt was incurred directly in connection with the farm’s business activity and the taxpayer’s predominate income (over 50 percent) for the past three years comes from farming. The lender or creditor of the debt in question must also be in the business of lending money.

Conservation Improvements and Restoration

Expenditures for conservation expenses is an important area of favorable tax rules for farmers.

These types of expenses are normally capitalized, but for farmers they are deductible. The tax code provision describes the pertinent conservation expenses as those for the purposes of soil and water conservation with respect to land used in farming, or for the prevention of erosion or farmland.

The farmer is required to have a conservation plan, which the U.S. Department of Agriculture must approve. If there is no plan, the improvements must be consistent with a soil conservation plan of another state agency concerned with farming.

Deductions for conservation expenses are limited to 25 percent of farm gross income, but a carryforward is permitted. The limitation being expressed as a percentage of gross farm income is an important feature, suggesting the potential for offsetting other nonfarm income.

Vehicle Expense

Farmers receive liberal treatment for their auto and vehicle expenses.

The normal requirement of documentation to support auto or truck expense is waived for farmers. Up to 75 percent of vehicle expenses are deductible even without documentation.

Nothing in this publication should be construed as legal or tax advice. For specific advice, consult an attorney and/or a tax professional. ➔

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