Tax Tidbits: Farm Leases – Time To Review: Part Two

Farmland rental arrangements are either fixed-cash rent, flexible-cash rent, or some variation of a crop-share lease. Crop production, expense sharing, and risk tolerance are important factors to consider in selecting the most appropriate leasing arrangement. Additionally, there are substantial tax differences associated with the various types of leases which should also be factored into the decision of which type of lease is best for you.

Following are some of the income tax and social security issues that vary depending on the type of rental arrangement. Landlords will serve themselves well by gaining an understanding of these differences.

1. Will the rental income be subject to self-employment tax and impact your social security retirement and disabilities benefits?
2. Are Conservation Reserve Program (CRP) payments subject to self-employment tax?
3. Will the landowner qualify for deduction of soil and water conservation expenses or will the cost have to be added to the cost basis of the land?
4. Will the landowner qualify for the income exclusion provisions relative to various government cost sharing payments?
5. Will the landowner qualify for the Code Section 179 deduction that provides for the current year expensing of certain capital expenditures?
6. Will the charitable donation of commodities trigger the recognition of income?

The answer to each of these questions depends on whether the rental arrangement is a cash lease, landlord non-material participating share lease, or a landlord material participating share lease.

Additionally, although not of immediate consequence, the rental arrangement selected can have substantial tax implications in the settlement of the landowner’s estate. For example, rental arrangements can have an impact on whether or not an estate is able to utilize:

1. The “special-use valuation” provision for real property devoted to farming or other business use; or
2. The 14-year installment payment option for qualified federal estate taxes. Additionally, the type of rental arrangement determines whether the lease income or farm production accrued or on hand at the date of death is considered “income in respect of decedent”. Income in respect of decedent does not receive a step-up in basis and thus results in the item being subject to income tax by the estate or heirs who receive the income or inventory.

As with most choices in life, there are pros and cons to each type of lease. Further, the type of lease that is most appropriate for you at one point in your life will not necessarily remain appropriate throughout your lifetime. Additionally, what is best for your friend at the coffee shop or bridge club may not necessarily be best for you!

(Author: Parman Green, Ag. Business Management Specialist)