While the traditional family farm and traditional commodities remain the backbone of U.S. agriculture, we are witnessing substantial changes within the industry. These changes seem to be influencing traditional agricultural producers to become more specialized and smaller producers to become more diversified (bi-polar). Additionally, the interest in non-traditional agricultural enterprises is gaining popularity. For issues related to taxation, the definitions of “what is a farm” and “what is considered farm income” are becoming more complex. The IRS Code contains several provisions which are unique to farming, such as: 1) a deduction for soil & water conservation expenses; 2) an exception to the penalty for underpayment of estimated taxes; 3) the exclusion of non-cash wages from FICA taxes; and 4) an exception to the general income recognition rule for the discharge of farm indebtedness. These and many other tax provisions hinge on the amount of reported "gross farm income" compared to other income. While you might initially think the issue of whether income is farm income or not would be rather simple and straightforward, the numerous tax court cases dealing with this issue will attest that it is not.

The IRS considers gross income from farming to be income you derive in the business of farming from the production (raising and harvesting) of crops, fish, fruits, other agricultural products or livestock. Additionally, gains from the sales of livestock held for draft, breeding, dairy, or sport are included. However, gross farm income does not include any gains from the sales of assets such as farm machinery or land (income averaging is an exception to this rule).
As non-traditional agricultural enterprises gain popularity and more and more farmers look at direct marketing, options marketing, and further processing of their farm products, the issue of what is income from farming will become more complex. For example, is a school teacher who custom harvests wheat during the summer months from Texas to the Canadian border also in the business of farming? Is a person who raises wild flowers and herbs for sale in the business of farming? Several important taxation issues and filing requirements will hinge on the answer. Further, with today's interest in vertical integration, where does the business of farming end and the business of processing or manufacturing begin? For example, the income from grapes raised and sold to a processor or at a farmers market is considered farm income. However, if the grapes are processed into juice and/or wine by the farmer, the "added-value" should be reported on Schedule C as non-farm income, since the grapes are processed beyond the normal amount for preparing grapes for sale from the farm.

As the business of farming becomes more complex, so does the interpretation of the taxation regulations. Advance planning, good records, and communication with your tax advisor throughout your tax year can go a long way toward minimizing those March 1 or April 15 tax surprises.