



Tax Implications of a Farmland Lease

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Overview

The decision to lease farm ground comes with many choices: cash rent, crop share, or some combination thereof. Parties to a lease must understand that each option has distinct income tax implications. This fact sheet provides a brief overview of several key tax considerations associated with farmland leases, as they apply to individual landowners.¹

Cash Rent Lease

Under a cash rent lease, the farm tenant generally pays a cash sum (usually on a per acre basis) to the landlord for the privilege of renting the farm ground. Rent received by a landlord under a typical cash rent lease is rental income, not subject to self-employment tax.² This means also that the income will not be credited as net earnings from self-employment tax.² This means also that the income will not be credited as net earnings from self-employment tax.² This means also that the income will not be credited as net earnings from self-employment for social security eligibility purposes. Individual cash rent landlords report their rental income on Schedule E, IRS Form 1040.

Cash rent landlords are generally not considered to be in the business of farming for tax purposes. Consequently, they face limitations with respect to expenses and

losses they can offset against their income. Cash rent landlords, for example, do not qualify for the following tax breaks:

- IRC § 179 Expense Deduction
- IRC § 175 Deduction for Soil and Water Conservation Expenses
- IRC § 1301 Farm Income Averaging
- IRC § 6654 Special Rule for Estimated Tax Payments

This means, for example that cash rent landlords cannot use Section 179 to immediately expense the cost of field tile. They are, however, allowed to depreciate the cost of the tile over a 15-year period.

Likewise, cash rent landlords are not eligible to presently deduct the cost of soil and water conservation improvements, such as terracing. They must instead capitalize those expenses (add the cost of the improvement to the basis of the land).

Cash rent landlords may generally deduct the cost of ordinary and necessary expenses relating to the production of the rental income. These expenses might include taxes, interest, repairs, insurance, management fees, agents' commissions, and depreciation. Because rental income, however, is passive income, cash rent landlords are subject to special passive loss rules.³ This also means that cash rent income is net investment

income, subject to the 3.8% net investment income tax for higher income earners.

Crop Share Lease

A crop share lease is generally an arrangement under which the landlord agrees to rent the farm ground to the tenant in exchange for a share of the crop. The tax treatment of income earned by a landlord under a crop share lease is largely dependent upon the landlord's level of participation in the farming activities governed by the lease. If the landlord materially participates under the lease, any income from the lease is subject to self-employment tax.⁴ The landlord will report the income and expenses on Schedule F, IRS Form 1040. If the landlord does not materially participate, the income is not subject to self-employment tax, and the landlord will report the income and expenses on IRS Form 4835. Any net income or loss will be carried to Schedule E, IRS Form 1040.

A landlord materially participates in a lease if (A) the landlord has an arrangement with the tenant requiring the landlord to materially participate in the production of the management of the production of the commodities AND (B) the landlord meets one or more of the following four tests:

Test 1: The landlord does at least three of the following

- Pays, using cash or credit, at least half the direct costs of producing the crop.
- Furnishes at least half the tools and equipment used in the production activities.
- Advises or consults with the tenant.
- Inspects the production activities periodically.

Test 2: Regularly and frequently makes, or takes an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.

Test 3: Works 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production.

Test 4: Does things that, considered in their totality, show that the landlord is materially and significantly involved in the production of the farm commodities.

Unlike cash rent landlords, crop share landlords, whether or not they materially participate under the lease, may be eligible for the following tax breaks:

- IRC § 179 Expense Deduction (watch for noncorporate lessor rule)
- IRC § 175 Deduction for Soil and Water Conservation Expenses
- IRC § 1301 Farm Income Averaging
- IRC § 6654 Special Rule for Estimated Tax Payments

Non-materially participating crop share landlords are generally subject to the passive loss rules in the same manner as cash rent landlords. Their income may also be subject to the net investment income tax.

Section 199A Deduction

In 2018, the Tax Cuts & Jobs Act introduced a 20 percent deduction for “qualified business income” arising from a “qualified trade or business.” Determining whether rental income qualifies for the deduction must be determined on a case-by-case basis, depending upon the facts.

In general, IRS regulations state that a landlord must meet two definitional

requirements for an activity to rise to the level of a trade or business:

- Good faith intention to make a profit
- Considerable, regular, and continuous activity

Relevant factors include, but are not limited to, (i) the type of rented property (commercial real property vs. residential property), (ii) the number of properties rented, (iii) the owner's agent's day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (net lease v. traditional, short-term v. long-term).

In general, a cash rent lease under which the landlord merely collects a check will not qualify as a trade or business so as to qualify the income for the deduction. Many crop share leases, however, will. Landlords with questions should consult with a tax professional.

1 This fact sheet is for educational purposes only. Landowners are encouraged to discuss specific rental arrangements with a trusted tax advisor. For more detailed information on this and other topics, please visit www.calt.iastate.edu. The tax implications of farm lease arrangements involving business entities is beyond the scope of this fact sheet, as is the impact of leasing arrangements on valuation of property at death.

2 It is possible for a landlord and tenant to enter into a cash lease under which the landlord is to "materially participate."

These types of leases are very rare, but would require the landlord to pay self-employment tax on the rental income. 3 Generally, passive losses may be used to offset only passive income. Passive losses, may, however, be applied against ordinary income in an amount up to \$25,000 if the landlord "actively participated" in the rental activity. This special allowance begins to phase

out when adjusted gross income is greater than \$100,000. It should also be noted that IRS regulations recharacterize rental income from land where less than 30 percent of the unadjusted basis of the property is depreciable as non-passive income. This means that passive losses from other activities cannot be offset by farm rental income. Any loss from the farm rental activity, however, remains passive. Treas. Reg. 1.469-2T(f)(3).

4 "Net earnings from self-employment" is defined by Treas. Reg. § 1.1402(a)-1 as "gross income derived by an individual from any trade or business carried on by such individual, less the deductions ...attributable to such trade or business."