

# Special Tax Considerations for Small Farmers Value-Added Products and Permanent Crops

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## Tax Definition of Farming Activity

Farming activity includes all activity necessary to bring agricultural products to the state in which they are *generally* marketed. Tomatoes are generally marketed as harvested unprocessed tomatoes. When you start making tomato sauce, you have ceased farming activities and begun manufacturing activities.

*Now we know that in real life whole tomatoes are not always marketable, and you may need to make some tomato sauce if you don't want some of your crop to rot before you can sell it. The IRS is not going to accept this argument though, so there is no reason to waste time arguing with them.*

If you visit a vineyard and winery, you may think of it as one business. If you saw their tax returns though, you would see that they report the farming activity associated with growing the wine grapes on the schedule F, and the manufacturing and marketing activity associated with making and selling the wine on a regular schedule C. The vineyard is deemed to have sold its grapes to the winery at the prevailing price for grapes of that quality in that region. Actual money may or may not be involved. The winery is deemed to have purchased grapes from the farming operation at the prevailing fair market price.

Should you set up a separate business because you sometimes sell some tomato sauce at the farmer's market? There are general de minimus exceptions to many tax laws, allowing for activities which are around 2% of your total activities to slide. If you start getting much above that, you need to start thinking about how it would affect you to come into compliance with the rules, and the possible consequences of remaining out of compliance.

## Tax Requirements for Cost Capitalization

### I. Manufacturing

Manufacturing is adding value to raw materials and creating an inventory of goods available for sale. In a simple situation you buy stuff and make it into other stuff and sell it. You report total sales as total income, and you report all of your expenses as deductions, and you pay taxes on the difference.

In a more realistic example, you buy stuff and make it into other stuff and then you sell some of it. What you would like to do is show total sales as total income, all your costs as deductions, and the difference as your taxable income or loss. The only problem that the IRS has with this is that you are still sitting on valuable inventory. You can not deduct all the costs associated with the inventory that you did not sell.

*Back when you were in the T-shirt business, things were pretty simple. T-shirts cost a dollar each, and when you got back from the party on New Year's Eve you had 100 T-shirts left. You remember that you bought \$100 worth of dye in the spring. You look*

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*out in the garage, and only about a quarter is left. You have inventory of \$125. You add up all of your expenses, subtract \$125, and you have your manufacturing cost for the year.*

*Life got a bit more complicated when you bought the goats and started making eight different kinds of herbed cheeses with aging periods from a month to a year.*

**A simple inventory system will track the following:**

### **Quantities manufactured, “Work in Process or WIP”**

Be careful to track conversions and changes in units of measurement.  
*For Example: 20 gallons of milk and 180 pounds of cheese.*

### **Costs at each stage of the process**

Each time you convert quantities, you apply costs. *For Example: You go from pounds of bulk cheese to ounces of packaged cheese and you apply the costs of labor and packaging. Packaged cheese costs more than bulk cheese.*

### **Quantities Available for Sale (and where they are if you sell on commission) and Quantities Sold.**

It would be great if Inventory Available for Sale less Sales equaled Ending Inventory, but it won't because some will be given away and eaten and some will get spilled or spoiled.

### **Year – End Actual Inventory**

The more you have in inventory at the end of the year, the less you can deduct on your tax return. If you subtract what you know you sold from what you know you made, and call that ending inventory, you will not account for the **deductible** costs of inventory that was given away for promotional purposes, or that was lost to spillage or spoilage.

*If you have a perishable product, you need to track inventory in batches rather than on a calendar year, so that you will know spoilage rates on each batch.*

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*Here is an example of The Really Simple Goat Cheese Farm's inventory calculation:*

1. 20 gallons of milk turns into 180 pounds of bulk cheese.
2. The 20 gallons of milk cost \$120 and the labor to turn it into bulk cheese was 10 hours at \$10 an hour or \$100.
3. 180 lbs of bulk cheese is WIP, valued at \$220, or \$1.23 per lb.
4. Add herbs, \$25 and four hours of labor, \$40
5. WIP is now \$285 or 1.59 per lb.
6. Packaging costs \$300 plus labor of 20 hours, \$500 total
7. Conversion from bulk pounds to packaged ounces is 16 ounces/lb LESS SPILLAGE. You package to 4 ounce containers and when you are done you have 684 of them. Your TRUE conversion rate includes spillage of approximately 5%. You need that number to manage production efficiency.
8. Inventory Available for Sale is now 684 four ounce packages at \$285 + \$500 = \$785 total value. Each 4 ounce package cost you \$785/684 or \$1.15.
9. You give away 200 containers of cheese for promotional marketing efforts.
10. You find a store to take 100 containers on commission.
11. You sell 50 at the farmer's market.
12. Calculated Inventory Available for Sale is now 684-350 or 334, still valued at \$1.15 each.
13. Actual Physical Count is 328. The store reports that they dropped 10, sold 50, and still have 40 available for sale.
14. Spoilage was 334-328+10=16
15. The value of your ending inventory is 328+40=368 x \$1.15=\$423.
16. **Deductible costs are total costs \$784 less ending inventory \$423 = \$361.**
17. **Alternative calculation:** *(difference is rounding)*

Cost of product sold	100+50+50=200 sold x \$1.15 =	230
Cost of promotional products	100 x \$1.15	= 115
Cost of spoilage	16 x \$1.15	= 18
<b>Deductible Costs</b>	<b>230+115+18</b>	<b>= 363</b>

### HINT:

**You may do just as well setting up a system using an Excel spread sheet as trying to get QuickBooks to do it correctly. There are plenty of expensive inventory systems out there that will scan and bar code everything for you. If you plan to market to stores, it is important to plan on purchasing a bar code inventory system as soon as possible.**

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### **II. Self Constructed Assets (Including Permanent Crops)**

If you purchase a building, you record it on your books at the purchase price, and you take a depreciation deduction each year for a fraction of the purchase price. If you buy an orchard you do the same thing, allocating the purchase price between land and trees and then taking a depreciation deduction each year for 10 (or 20) years for 1/10<sup>th</sup> (or 1/20<sup>th</sup>) of the value.

If you build a building or plant an orchard and you do your own bookkeeping, you probably do not make a special effort to separate the costs associated with the building materials and the labor from your other farming costs. At the end of the year your books probably don't show that you own a new building or a young orchard.

If you take your books to a tax preparer, they will tell you that **for tax purposes, you always need to separate construction or permanent crop development costs from normal operating costs.** You need to report a new asset on your tax return valued at the sum of the costs of all the labor and materials. You may then deduct the costs of the building or orchard through a fractional depreciation deduction each year.

#### **SPECIAL RULES FOR ADDITIONAL COST CAPITALIZATION**

**Actually, it is a little worse than that.** In the case of planting a permanent crop with a pre-productive period in excess of two years, there are special rules:

1. First, the IRS decides what constitutes a permanent crop with a pre-productive period in excess of two years. They are unimpressed if you can get a crop faster.
2. Second, the **general rule** is that you must capitalize all cultivation costs associated with the pre-productive crop from the time of planting until the time you get a harvestable crop (and for at least two years.)
3. Third, **almost everyone qualifies for the exception to this rule,**

***But***

**You must know how to make a valid election on your tax return in order for the exception to apply.**

As long as you are not planting Almonds or Citrus, and you are eligible to be a cash basis taxpayer, you are eligible for the exemption. I do not know what the IRS has against almonds and citrus fruit, but the cash basis taxpayer part is easy. It is not really possible to make enough money to **not** qualify for this exception and not already be paying big bucks to an accountant who should have already explained this to you.

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The election is made as follows:

- A. Deduct the cultivation cost of your pre-productive crop on your tax return.**
- B. Take special depreciation, under the Alternative Depreciation System, on any assets acquired for any business you own, during any year for which you want a valid election.**

**To summarize:**

You must **capitalize** (not deduct but may depreciate) all cost associated with building a building or planting a permanent crop.

If you plant **almonds or citrus**, you must also capitalize all of the pre-productive cultivation costs of the orchard or grove.

If you plant **other permanent crops**, you need to take a **special (reduced) depreciation** rate on any assets purchased between the time you plant and the time you get a marketable crop (at least two years from planting.)