



AGRICULTURAL LAW AND TAXATION BRIEFS

DEPARTMENT OF AGRICULTURAL AND CONSUMER ECONOMICS, UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

SOME FARM FAMILIES ARE UNDERPAYING THEIR SELF-EMPLOYMENT TAX

By Gary J. Hoff, E.A.*

Synopsis: If both husband and wife are receiving USDA farm program payments they may be underpaying their self-employment tax. Except for crop share landlords, a participant must actively participate in the farming operation to qualify for payments. This means each person also is liable for self-employment tax on the profits created by the farming operation.

While Congress wrestles with a new Farm Bill, the Internal Revenue Service reportedly is looking at large farming operations to see if the proper amount of self-employment tax is being paid on USDA farm program payments. Currently, rules administered by the Farm Service Agency (FSA) limit the program payments that can be received by large farming operations. These program payment “caps” are based on the number of “persons” involved in the operation.

FSA Rules: Husband & Wife as 2 Persons

The definition of a “person” is too involved for this article, but the basic rule is this: For payment limitation purposes, FSA considers husband and wife to constitute one person *unless* certain qualifications are met.

Below are two circumstances in which husband and wife can be treated as two persons for purposes of payment limitations:

1. *Separate farming operations before marriage:* “Both spouses were separately engaged in unrelated farming operations before their marriage and the farming operations of both spouses have been maintained separately and distinctly after their marriage.”¹

¹ FSA HANDBOOK – PAYMENT LIMITATIONS, Part 4, Section 1, Para. 253B (Husband and Wife – “Person” Rule), p. 4-4.

2. *Selected Joint Farming Operations.* If husband and wife are farming as a joint farming operation they may be separate persons if both of the following apply:

- *Neither* spouse has an interest in more than one entity, and
- *Each* spouse provides “qualifying contributions, including active personal labor or active personal management as applicable” sufficient for *each* to be considered “actively engaged in farming”.²

IRS Rules: 2 Persons “Actively Engaged in Farming” Means 2 SE Tax Liabilities

Under tax law, a husband and wife involved in a joint farming operation where each provides active personal labor or active personal management must *each* report income on a separate Schedule F, *Profit or Loss From Farming*. A separate Schedule F also means a separate Schedule SE, *Self-Employment Tax*.

Example: Assume Ted and Helen, husband and wife, have a large farming operation. They receive the maximum FSA payments for one person. Subsequently, they determine that Helen

² See FSA HANDBOOK – PAYMENT LIMITATIONS, Part 4, Section 1, Para. 253B (Husband and Wife – “Person” Rule), p. 4-4, and Para. 253E (Husband and Wife – “Actively Engaged in Farming” Rule), p. 4-7.



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is actively participating in the farming operation and, therefore, qualifies as a separate person for purposes of farm program payment limitations. Ted and Helen file the applicable papers with FSA and are recognized by the FSA as two separate persons.

The farm shows a profit of \$250,000 for the 2007 crop year. This would create a self-employment tax liability for Ted of \$18,785 if only one Schedule F and one Schedule SE were filed in Ted's name and social security number. However, Ted and Helen, as separate persons for purposes of farm program payments, **must each** file a separate Schedule F and Schedule SE because each is actively engaged in farming for purposes of SE tax liability. Their combined 2007 SE tax liability becomes \$30,876 – an additional \$12,091 over the liability if only Ted filed.

If Helen is actively participating in farming for purposes of FSA farm program payment limitations, she is actively participating for purposes of the SE tax.

Why Additional SE Tax Liability When Ted and Helen Each File SE Schedules?

The 15.3% SE Tax is made up of the "Retirement" portion (12.4%) and the "Medicare" portion (2.9%). There is a "cap" on the amount of earnings subject to the retirement portion of SE tax – \$97,500 in 2007. Therefore, if Ted reports 100% of the \$250,000 farm income on his Schedule F, his Net Earnings from Self Employment exceeding \$97,500 would escape the 12.4%

**Gary J. Hoff is an extension specialist in the Department of Agricultural and Consumer Economics. Agricultural Law and Taxation Briefs are available at www.farmdoc.uiuc.edu/legal/.*

retirement rate and only be taxed at the 2.9% Medicare rate. With the \$250,000 of farm profit divided between two separate SE schedules, both Ted and Helen now pay the SE tax and *each* reaches the \$97,500 cap.

Rules If Filing Form 4835 Not Relevant

Crop share landlords have a special exemption from the FSA government payment limitation rules. Under these special rules, crop share landlords who do not materially participate in management are still considered to be actively engaged in farming (and eligible for program payments) even though their rental income is not subject to SE tax. [See FSA HANDBOOK – PAYMENT LIMITATIONS, Part 2, Section 7, Para. 132A (Landowner Exemption – Rule), p. 2-177 and Tax Form 4835 (*Farm Rental Income & Expense – Share Rents not subject to self-employment tax*).

This typically does not help spouses involved in Joint Farming Operations, however. For farming operations conducted jointly by husband and wife, the income and expense is reported on Schedule F, not on Form 4835.

Conclusion

Until either the IRS or FSA changes the rules, the additional SE tax will continue to be a problem for spouses who qualify as "separate persons" for purposes of farm program payments. These spouses should work with their tax advisors to make sure they are properly reporting their self employment income and calculating the SE tax liability correctly.