

# Farmland Lease Income – Proper Tax Reporting

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## Overview

Yesterday's article focused on the legal aspects of farmer/landowner relationships – tenant, cropper or farm manager. Another aspect of leasing farmland involves the tax issues. What is the proper way to report farm rental income? Is the rental income subject to self-employment tax? What about estate planning implications?

The tax implications of farmland rental income – it's the topic of today's article.

## Reporting Farmland Lease Income

Farmland lease income may be reported on one of three possible IRS Forms: (1) Schedule F (Farm Income and Expenses); Form 4835 (Farm Rental Income and Expenses); and Schedule E. The appropriate Form depends upon whether the landlord is "materially participating" in the farming operation. Generally, a landlord receiving cash rent should file Schedule E to report the rental income. The income is not from a farming operation, but from a rental. Reporting the rental income on Schedule E also does not trigger the application of self-employment tax. By statute, "rents from real estate and personal property leased with real estate" are not "trade or business income." [I.R.C. §1402\(a\)](#).

If the lease is a crop or livestock share-rent arrangement, a materially participating landlord should report the income on Schedule F. If a share-rent landlord is *not* materially participating, the landlord should report the income on Form 4835. For lease income that is reported on Schedule F, self-employment tax will apply, except for any portion of the rental income that relates to the rental of real estate improvements (e.g., a farm building or grain bin). The amount apportioned to real estate improvements should be reported on Schedule E.

## What Is Material Participation?

Material participation is a key concept in the proper reporting of crop/livestock share lease income. If the landlord materially participates under the lease, the landlord's rental income is subject to self-employment tax.

For purposes of self-employment tax being imposed under [I.R.C. §1402](#), a landlord materially participates if *all three* of the following conditions are satisfied.

- There is an arrangement between the owner (landlord) of the property and another person, that provides that the other person is to produce agricultural or horticultural commodities on that land;
- Under the "arrangement", the landlord is to materially participate in the production or the management of the production of the commodities; and
- The landlord does actually materially participate. *R.C. §1402(a)(1)*.



A landlord also materially participates if the landlord satisfies *any one* of the four following tests:

**Test 1:** The landlord does any **three** of the following:

- Advance, pay, or stand good for at least half the direct cost of producing the crop;
- Furnish at least half the tools, equipment, and livestock used in producing the crop;
- Consult with your tenant; or
- Inspect the production activities periodically.

**Test 2:** The landlord 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:** The landlord works 100 hours or more spread over a period of five weeks or more in activities connected with crop production.

**Test 4:** The landlord does things that, *considered in their total effect*, show that the landlord is materially and significantly involved in the production of the farm commodities.

In situations where a farmer either owns land outright or in in entity and cash leases the land to a farming entity in which the farmer materially participates, the rental income can be subject to self-employment tax unless the lease rate is set at fair market value and there is no connection between the lease and the farmer's employment agreement with the farming entity . *Martin v. Comr.*, 149 T.C. 293 (2017). To bolster those points, the lease should be in writing and the labor provided to the farming entity should be under a written employment agreement calling for reasonable compensation.

While many farm landlords have only a verbal agreement with the tenant, clearly a written lease makes establishing the presence of material participation easier. While the presence of material participation causes the rental income to be subjected to self-employment tax, it also can be beneficial for other tax and non-tax reasons – including post-death estate planning purposes.

### Cash Rent Income – Potential Drawbacks

While cash rental income is not subject to self-employment tax, other tax implications should be considered, such as the following:

- The rental income is not treated as gross farm income for the exception to the estimated tax penalty. *R.C. §6654(i)*.
- The income does *not* count for the special treatment of soil and water conservation expenditures under [I.R.C. 175](#).
- The income *will* count for the exclusion of cost-sharing payments under [I.R.C. 126](#).
- The income is also potentially subject to the passive loss limitations of [I.R.C. 469](#).
- The income *won't* count for purposes of expense method depreciation under [I.R.C. 179](#).
- With a very minor exception, farmland subject to an election under [I.R.C. 2032A](#) cannot be cash rented during the ten-year period following the date of the decedent's death.
- For a retired farm landlord under age 65 receiving Social Security benefits, cash rental income won't diminish the payments.



## Conclusion

The proper structuring of a farm lease arrangement is important for numerous tax reasons. Some are more obvious than others, but all are important. Proper tax planning is the key to obtaining the best result and avoid unintended consequences.

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