Return to TOC

CHAPTER 4

FARM DEDUCTIONS

SYNPOSIS (click on section title to go directly there)

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Return to TOC

Introduction

Some income tax deductions, although available to all business taxpayers, have special rules for farmers. Other deductions, such as soil and water conservation expenses, are available only to farmers and ranchers. This discussion is intended to help operators of farms and ranches optimize deductions to reduce their tax liability.

Some deductions discussed in this chapter are not claimed on Schedule F (Form 1040), Profit or Loss from Farming. However, farmers need to be familiar with these possible deductions, such as the Domestic Production Activities Deduction (DPAD).

Ordinary and Necessary Business Expenses

The Internal Revenue Code allows taxpayers to deduct "ordinary and necessary expenses paid . . . in carrying on any trade or business." These ordinary and necessary expenses include fertilizer, pesticides, lime, seeds, repairs to equipment, and other costs of operating a farm business. This chapter explains how you determine whether an expense is "ordinary and necessary" and therefore deductible from gross farm income.

The portion of Schedule F (Form 1040) shown in Figure 4.1 itemizes most of the deductible expenses that are likely to be incurred in a farming business. Farmers can use line 34, "Other expenses," to claim deductions that are not listed on lines 12 through 33.

Figure 4.1: Part II of Schedule F (Form 1040)

Part II **Farm Expenses—Cash and Accrual Method.**
Do not include personal or living expenses such as taxes, insurance, or repairs on your home.

12	Car and truck expenses (see instructions). Also attach **Form 4562**	12		25	Pension and profit-sharing plans	25	
13	Chemicals	13		26	Rent or lease (see instructions):		
14	Conservation expenses (see instructions)	14		a	Vehicles, machinery, and equipment	26a	
15	Custom hire (machine work) .	15		b	Other (land, animals, etc.) . .	26b	
16	Depreciation and section 179 expense deduction not claimed elsewhere (see instructions) .	16		27	Repairs and maintenance . .	27	
				28	Seeds and plants	28	
				29	Storage and warehousing . .	29	
17	Employee benefit programs other than on line 25	17		30	Supplies	30	
				31	Taxes	31	
18	Feed	18		32	Utilities	32	
19	Fertilizers and lime . . .	19		33	Veterinary, breeding, and medicine	33	
20	Freight and trucking . . .	20		34	Other expenses (specify):		
21	Gasoline, fuel, and oil . . .	21		a		34a	
22	Insurance (other than health)	22		b		34b	
23	Interest:			c		34c	
a	Mortgage (paid to banks, etc.)	23a		d		34d	
b	Other	23b		e		34e	
24	Labor hired (less employment credits)	24		f		34f	

Reporting all farm income and expenses on the proper lines allows you to compare line entries from one year to the next to ensure that you have not missed a deduction and to make management decisions about optimizing your expenses.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Some farm expenses, such as interest paid, are reported in subcategories on Schedule F (Form 1040). The mortgage interest that banks, farm credit associations, and other financial institutions report to you and the IRS on Form 1098, Mortgage Interest Statement, is entered on line 23a so that the IRS can match the Form 1098 amount with the amount you report on your tax return. Line 23b records other interest paid in your farming business that is not reported on a Form 1098, such as interest paid on a note held by the financing arm of your local implement dealer.

Rent expenses are split between machinery and equipment leases reported on line 26a and land rents reported on line 26b. Labor expenses are reported on line 24, and employee benefits and pension and profit-sharing expenses are reported on lines 17 and 25, respectively.

Repairs and Maintenance

Equipment maintenance expenses are deductible in the year they are paid if they are repairs but they must be capitalized and depreciated (as discussed later in this chapter) if they are improvements. This determination can be challenging.

Deductible repairs are expenditures that keep the property in efficient operating condition, restoring it to its previous operating condition. On the other hand, capital expenditures do one or more of the following:

1. Add to the property's value
2. Substantially prolong its useful life
3. Adapt the property to a new or different use

Example 4.1 Fence Expenses

Rusty Nail paid Juan Mendes $500 to tighten the wire and replace five of the forty fence posts on the east side of his pasture. Rusty also paid Juan $2,000 to build a new fence on the south side of his pasture.

Rusty can deduct as an ordinary business expense the $500 he paid to repair the fence on the east side of the pasture. The $2,000 he paid for the fence on the south side of the pasture is a capital expenditure, which is depreciable rather than currently deductible.

Separating Business and Personal Expenses

Some expenses, such as property insurance, utilities, and real estate taxes, may be incurred for both business and personal reasons. If you receive a single bill for this type of expense, you must allocate the expense between your business use and your personal use.

Example 4.2 Business and Personal Expenses

The $4,000 premium for your property casualty insurance covers all of the buildings on your farm property, including your house. The cost of casualty insurance for your home is $800. You can deduct $3,200 ($4,000 – $800) as a business insurance expense. None of the $800 is deductible unless you qualify to deduct part of the cost of the home as a business expense, as discussed in the next section of this chapter.

Business Use of the Home

Generally, expenses incurred to purchase or maintain a home are not tax-deductible because they are personal expenses. However, if you use part of your home for business (such as for office space), you may be able to deduct some of the costs. To prevent abuse, the tax rules for a business use of home

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

deduction are complicated. Therefore, you should compare the tax benefits with the administrative and other costs before claiming part of your home expenses as a business deduction.

Exclusive and Regular Use

To qualify for a business-use deduction, part of the home must be used **exclusively** and **regularly** for business purposes. The portion of the home used for business does not have to be a separate room; an area of a room qualifies if it meets the exclusive and regular use requirements. However, any personal use, such as for personal recordkeeping or using the computer to access the Internet for nonbusiness reasons or play games, disqualifies the area as being used exclusively for business.

Planning Pointer

Duplicated Costs

Home office expenses may include the cost of a separate computer, printer, desk, filing cabinet, and other office equipment just for business use. Taxpayers who forgo the business deduction can use the same equipment for both business and personal purposes.

Deduction Limit

The deduction for business use of a home is limited to net income from the business before that deduction. Otherwise deductible expenses in excess of the income limit are carried forward to future tax years and can be deducted subject to the net income limit in each succeeding year. If the carryforward has not been used up by the time the business is terminated, the remaining amount can never be deducted.

Example 4.3 Deduction Limit

Apple Blossom had a loss from her farm business this year before deducting her $2,400 of home business office expenses. She cannot increase her farm loss by deducting the $2,400, but she can carry the $2,400 forward and deduct it in a future profitable year.

Depreciation of Home

You can deduct depreciation for the portion of your home that is used for a business purpose. However, when you sell your home, gain equal to the total amount of depreciation that was allowable after May 6, 1997, does not qualify for the rule that allows you to exclude from income your gain from the sale of a principal residence.

Example 4.4 Depreciation of a Home

Beginning in 2000, Apple Blossom used a portion of her home as a business office. She deducted a total of $15,000 of depreciation before she sold her home for a gain. Apple must report $15,000 of that gain as capital gain that is taxed at a rate equal to the lesser of 25% or her marginal ordinary income tax rate. The remainder of her gain is excluded from her income because she met the rules for excluding gain from the sale of a home.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Return to TOC

Planning Pointer

Forgoing the Depreciation Deduction

Forgoing allowable depreciation to avoid reporting part of the gain on sale of the home is not good planning for two reasons.

First, gain equal to the amount of depreciation that could have been deducted is not eligible for the exclusion whether the depreciation was deducted or not. Therefore, not deducting the depreciation does not increase the amount of gain that can be excluded from income.

Second, the tax advantage of the depreciation deduction is greater than the tax cost of not excluding the gain in most cases. The deduction reduces farm income that is subject to both income tax at the ordinary income tax rates and self-employment tax. The gain that is not excluded is subject to a maximum 25% tax rate and is not subject to self-employment tax. The gain is also taxed in a later year.

Truck and Car Expenses

Farmers often use trucks and cars for both business and personal reasons. The business use costs can be deducted from taxable income if adequate records of that use are kept. To reduce the record-keeping burden, taxpayers can use a standard mileage rate for the business miles driven in a car, van, pickup, or panel truck. Alternatively, they can deduct the actual costs of the business use, such as gas, oil, repairs, insurance, and depreciation expenses.

Standard Mileage Rate

The standard mileage rate (SMR) is adjusted at least annually for changes in most of the fixed and variable costs of operating a vehicle. Self-employed taxpayers who use the standard mileage rate can also deduct the costs of parking, tolls, state and local taxes on the vehicle, and interest on loans to buy the vehicle because those costs are not included in the standard mileage rate.

For 2011, the SMR is 51¢ per mile for miles driven in January–June and 55.5¢ per mile for miles driven in July–December.

Although the SMR reduces the record-keeping burden, it results in a lower income tax deduction if the actual costs of operating a vehicle are greater than the SMR.

Example 4.5 SMR vs. Actual Costs

In 2011, Red Durham drove his pickup truck 10,000 miles for his farming business (4,000 miles before July and 6,000 miles after June) and 5,000 miles for personal use. If he kept adequate records of his business miles, he can deduct $5,371 [(4,000 × 51¢) + (6,000 × 55.5¢)] for vehicle expense on his 2011 Schedule F (Form 1040).

If Red kept adequate records of all of the costs of driving his pickup and the total cost for 2011 is $9,000, he can deduct $6,000 [$9,000 × (10,000 business miles ÷ 15,000 total miles)] of vehicle expense.

The ability to switch annually between deducting the SMR and actual expenses is restricted. If you claim actual expenses the first year a vehicle is used for business, you cannot use the SMR for that vehicle in later years. If you deduct the SMR for the first year you use a vehicle for business, you can deduct actual expenses in later years, but you are limited to using straight-line depreciation for the vehicle. Electing the SMR in the first year can allow you to deduct actual expenses for later years in which you have high repair bills and use the SMR in other years.

If you use more than four cars and trucks at the same time in your farming business, you cannot use the SMR; your only option is to deduct actual expenses. You are not using five or more cars or trucks for business at the same time if you alternate using them for business (that is, use them at different times).

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Return to TOC

Depreciation and I.R.C. § 179 Expensing Limits

Cars and trucks that have a gross vehicle weight of 6,000 pounds or less are subject to annual ceilings on the amount of allowable depreciation and I.R.C. § 179 expensing deductions. The so-called *luxury car limits* are imposed to prevent taxpayers from deducting large amounts of these expenses from taxable income. These limits affects the choice of using the SMR or actual expenses because they restrict the depreciation and I.R.C. § 179 expensing that can be included in actual costs.

The ceiling varies depending on the type of vehicle, the year it is placed in service, whether additional first-year depreciation (AFYD) is deducted, and the number of years the vehicle has been in use. The ceiling must be prorated if business use of the vehicle is less than 100%. Figure 4.2 shows the limits for vehicles first placed in service in 2011. The limits do not apply to vehicles with a gross weight exceeding 6,000 pounds.

Figure 4.2: Depreciation and I.R.C. § 179 Expense Limits for Vehicles Placed in Service in 2011

Tax Year	Cars		Trucks and Vans	
	No AFYD	AFYD	No AFYD	AFYD
2011	$3,060	$11,060	$3,260	$11,260
2012	4,900	4,900	5,200	5,200
2013	2,950	2,950	3,150	3,150
After 2013	1,775	1,775	1,875	1,875

Cross Reference

Cost-recovery rules, including depreciation, I.R.C. § 179 expensing, and AFYD, are discussed later in this chapter and in Chapter 5 of this guide.

Example 4.6 Comparison of Vehicle Deduction Options

In 2011, Olga Petrov paid $62,000 for a new Cadillac. Her actual operating costs for the car were $5,000, and she drove it 15,000 miles for her farming business (7,000 miles before July and 8,000 miles after June) and 5,000 miles for personal use.

Olga can deduct $12,045 of actual expenses or the $8,010 standard mileage deduction, as shown in Figure 4.3.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Figure 4.3: Olga Petrov's 2011 Car Deduction Options

Actual Expenses		
Costs other than depreciation		$ 5,000
AFYD limit for cars		11,060
Total costs		$16,060
Business use percentage (15,000 ÷ 20,000)		× .75
Business deduction		$12,045
Standard Mileage Rate		
Miles before July	7,000	
SMR for January–June	51¢	
Standard mileage deduction		$ 3,570
Miles after June	8,000	
SMR for July–December	× 55.5¢	
Standard mileage deduction		4,440
Total standard mileage deduction		$ 8,010

If Olga deducts the $12,045 of actual expenses for 2011, she cannot use the SMR for later years. As shown in Figure 4.4, Olga's actual cost deduction in 2012 will be $7,425 and her 2012 standard mileage deduction will be $8,325, assuming the same costs and usage as in 2011 and a 55.5¢ SMR for 2012.

Figure 4.4: Olga Petrov's 2012 Car Deduction Options

Actual Expenses	
Costs other than depreciation	$ 5,000
AFYD limit for cars	4,900
Total costs	$ 9,900
Business use percentage (15,000 ÷ 20,000)	× .75
Business deduction	$ 7,425
Standard Mileage Rate	
Business miles	15,000
SMR (assumed)	× 55.5¢
Standard mileage deduction	$ 8,325

Before choosing a method for deducting vehicle expense, you should consider the discounted value of the deductions you can claim over the life of the car under each method.

Example 4.7 Comparison over the Life of Vehicle

Olga, from Example 4.6, plans to keep the Cadillac she purchased in 2011 for 5 years. To compare the discounted value of the tax deductions over that period, assume that her costs, business use, personal use, and the SMR are the same in 2012 through 2015 as they were in 2011. Also assume that her marginal tax rate is 35% and that the appropriate discount rate is 5%. The present value of the tax savings from deducting actual costs is $11,541, and the present value from deducting the SMR is $13,073. Therefore, based on the assumptions used to make these calculations, Olga should choose the SMR in 2011 rather than deducting her actual costs.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Relief from Recordkeeping

A special rule for farmers allows them to deduct 75% of the cost of operating a vehicle without business mileage records if the vehicle is used during most of the normal business day directly in connection with the business of farming. Farmers must choose this method of substantiating expenses for a vehicle in the first year it is placed in service. If this method is chosen, the farmer cannot use another substantiation method for that vehicle in late years.

Lease vs. Purchase of Equipment

Leasing is an alternative method of financing the acquisition of equipment. Instead of paying principal and interest on a loan to purchase the equipment, farmers can make lease payments for the right to use the equipment for a stated term. Both tax and nontax factors affect the decision to lease or buy. The nontax issue is whether the total cost of the lease payments is greater or less than the total cost of ownership, including interest on the loan and the decrease in value of the equipment. The tax issue is whether deductions for lease payments or deductions for interest and depreciation provide a greater tax advantage. Leasing may provide a tax advantage by increasing tax deductions in the early years of the lease.

The tax issue is further complicated by rules that may treat a lease as a disguised installment purchase for income tax purposes. These rules kick in if the terms of a contract look more like an installment purchase arrangement than a lease. If the lease contract is treated as a disguised sale, the farmer cannot deduct the required payments as rent. Instead, the payments are treated as payments on a loan. The farmer can deduct the deemed interest portion of the payments and depreciate the deemed purchase price.

After-Tax Comparison of Leasing and Purchasing

Example 4.8 Lease vs. Purchase of Tractor

Mary Farmer is considering acquiring a tractor for $100,000. She can purchase the tractor for a $30,000 down payment and a $70,000 loan amortized over 5 years at a 7% rate of interest, taking a tax deduction for the interest paid on the loan and for depreciation. Alternatively, Mary can lease the tractor for 5 years by paying $19,353 at the time of signing and making four additional $19,353 lease payments, taking a tax deduction for each lease payment. If Mary wishes, she can acquire the tractor at the end of the 5-year lease for $20,000 and depreciate that $20,000 cost using MACRS depreciation over a 7-year recovery period.

The remainder of this example analyzes Mary's after-tax cost of a purchase or a lease. In both situations, Mary's total tax rate is 31.07%, including a 3% state income tax, 15% federal income tax, and net 13.07% self-employment tax (considering the income tax savings from deducting half of the self-employment tax, which is explained in Chapter 6 of this guide). This tax rate is assumed to be constant over the 10-year period of analysis. In both cases, it is also assumed that the tractor is sold at the end of the 10-year period for $15,000. Mary's after-tax discount rate for both the lease and purchase is 8%.

Purchase of Tractor

Figure 4.5 shows the calculation of the present value of the after-tax cost of purchasing the $100,000 tractor. The second column shows Mary's $30,000 down payment when she purchased the tractor (year 0) and her $17,072 loan payments in years 1 through 5. Mary deducts the interest portion of the loan payments listed in column 3 and the allowable depreciation listed in column 4. The adjustments for taxes (tax savings) presented in column 5 are computed using Mary's 31.07% tax rate. The sale of the fully depreciated tractor in year 10 for $15,000 results in depreciation recapture that is taxed as ordinary income but is not subject to self-employment tax, and it yields $12,300 of after-tax income. Finally, the net after-tax inflows (positive numbers) and outflows (negative numbers) from column 6 are discounted in column 8 using Mary's after-tax discount rate of 8% (column 7) and summed over the 10-year planning period. **The after-tax net present value of the cost of acquiring the $100,000 tractor by purchase is $65,556.**

FIGURE 4.5: PURCHASE OF $100,000 TRACTOR
5-Year Fully Amortized Loan with 30% Down and 7% Interest; Sale in Year 10 for $15,000

Year (1)	Payments (2)	Interest Expense (3)	150% DB Depreciation (4)	Adjustment for Taxes (5)	Net After-Tax Cash Flow (6)	After-Tax Discount Factor (7)	Present Value Net Cash Flow (8)
0	– 30,000				– 30,000	1.0000	– 30,000
1	– 17,072	4,900	10,714	4,851	– 12,221	0.9259	– 11,316
2	– 17,072	4,048	19,133	7,202	– 9,870	0.8573	– 8,462
3	– 17,072	3,136	15,033	5,645	– 11,427	0.7938	– 9,071
4	– 17,072	2,161	12,249	4,477	– 12,595	0.7350	– 9,258
5	– 17,072	1,117	12,249	4,153	– 12,919	0.6806	– 8,793
6			12,249	3,806	3,806	0.6302	2,398
7			12,249	3,806	3,806	0.5835	2,221
8			6,124	1,903	1,903	0.5403	1,028
9						0.5002	
10					12,300*	0.4632	5,697
			100,000				– 65,556

*After-tax proceeds from sale of tractor $15,000 – ($15,000 x 0.18) = $12,300

Lease of Tractor

Figure 4.6 presents similar information for leasing the $100,000 tractor. Mary made the initial $19,353 lease payment at the time of signing (year 0) and four more $19,353 tax-deductible payments at the end of years 1 through 4. She purchased the tractor at the end of year 5 and depreciated the $20,000 purchase price using 7-year MACRS. As in the outright purchase alternative, she sold the tractor for $15,000 in year 10. This results in an $8,281 net after-tax gain that is reported as ordinary income not subject to self-employment tax because of the I.R.C. § 1245 recapture rule. **The after-tax net present value of the cost of acquiring the tractor by lease is $64,583.** In this example, Mary would save $973 by leasing rather than making an outright initial purchase of the tractor.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Return to TOC

FIGURE 4.6: LEASE OF $100,000 TRACTOR
Purchase for $20,000 in Year 5 and Sale for $15,000 in Year 10

Year (1)	Lease Payment (2)	Purchase/Sale (3)	150% DB Depreciation (4)	Adjustment for Taxes (5)	Net After-Tax Cash Flow (6)	After-Tax Discount Factor (7)	Present Value Net Cash Flow (8)
0	– 19,353			6,013	– 13,340	1.000	– 13,340
1	– 19,353			6,013	– 13,340	0.9259	– 12,352
2	– 19,353			6,013	– 13,340	0.8573	– 11,436
3	– 19,353			6,013	– 13,340	0.7938	– 10,589
4	– 19,353			6,013	– 13,346	0.7350	– 9,805
5		– 20,000	2,142	666	– 19,334	0.6806	– 13,159
6			3,826	1,189	1,189	0.6302	749
7			3,006	934	934	0.5835	545
8			2,450	761	761	0.5403	411
9			2,450	761	761	0.5002	381
10		8,281*	1,225	381	8,662	0.4632	4,012
			15,099				– 64,583-

*After-tax value of sale for $15,000 in year 10
$20,000 purchase price - $15,099 depreciation = $4,901 adjusted basis
$15,000 sales price - $4,901 = $10,099 depreciation recapture
$10,099 x (1 - 0.18) = $8,281 net after-tax sale proceeds

Planning Pointer

Rapid Cost-Recovery Rules

In 2011 and 2012, leasing may not provide a tax advantage because the additional first-year depreciation and I.R.C. § 179 expensing rules in effect for both years will allow farmers to deduct most or all of the cost of equipment they purchase and place in service in those years.

Disguised Sale Rules

Most short-term leases of equipment are not disguised sales because the farmer does not have the right to buy the equipment at the end of the lease. The lease payments can be deducted because they are ordinary and necessary business expense as discussed earlier in this chapter.

Example 4.9 Short-term Lease

Dusty Trail operates a cattle ranch and rents a hay baler on a per bale basis. At the end of the haying season, Dusty returns the hay baler to the rental company and pays his rental costs. Rusty can deduct the rent payment on his income tax return.

A multiyear lease of equipment is more likely to be treated as a disguised sale than a short-term rental arrangement. IRS Publication 225, *Farmer's Tax Guide (for 2010 returns),* lists the following factors as indications that the arrangement is a conditional sales contract:

- The agreement applies part of each payment toward an equity interest you will receive.
- You get title to the property after you make a stated amount of required payments.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

- The amount you must pay to use the property for a short time is a large part of the amount you would pay to get title to the property.
- You pay much more than the current fair rental value of the property.
- You have an option to buy the property at a nominal price compared to the value of the property when you may exercise the option. (This value is determined when you make the agreement.)
- You have an option to buy the property at a nominal price compared to the total amount you have to pay under the agreement.
- The agreement designates part of the payments as interest, or part of the payments can be easily recognized as interest.

Planning Pointer

Aggressive Leasing Arrangements

An aggressive leasing arrangement that requires large lease payments in the earlier years so that the farmer can accelerate the income tax deductions is more likely to be treated as a conditional sale. This is true because the lease payment is both more likely to exceed the current fair rental value and more likely to be a large part of the amount you would pay to get title to the property.

Example 4.10 Conditional Sales Contract

Bird O'Paradise leased a walk-in cooler to store freshly harvested flowers for her cut-flower farm business. The agreement requires Bird to pay $11,500 annually for 2 years—$10,000 as a lease payment and $1,500 as a capital charge (interest). At the end of the 2 years, the agreement allows Bird to purchase the cooler for $500.

For tax purposes, the agreement is a sale and not a lease. Bird cannot deduct the $11,500 annual payments as rent. She can deduct $1,500 each year as interest and begin depreciating the $20,000 cost of the cooler. If she pays the additional $500 at the end of the lease, it adds to her basis for depreciation.

Travel Expenses

Ordinary and necessary business expenses include the costs of traveling for business. However, if the travel is for both personal and business purposes, only the cost of the business portion of the trip is deductible. To maximize the tax benefits of travel deductions, keep the following rules in mind when planning a business trip that includes some personal objectives.

Meals and Lodging

Meal and lodging costs must be allocated between the business and personal portions of a trip when it includes days that are spent primarily on personal activities.

Example 4.11 Allocation of Meal and Lodging Expenses

Paige Turner left home Wednesday afternoon for a business meeting in San Antonio. The business meeting ended Saturday morning, so that Paige could have returned home before her evening meal on Saturday. Instead, she stayed over Saturday night to do some sightseeing and returned home on Sunday.

Paige can deduct her lodging costs for Wednesday through Friday nights and her meals through Saturday noon. She cannot deduct the cost of her lodging Saturday night or the meals after her noon meal on Saturday.

Two rules may further limit the deduction for meal expenses incurred while traveling.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

1. Only 50% of the cost of the meal can be deducted.
2. A travel meal expense is not deductible unless the traveler must stop for substantial sleep or rest to properly perform his or her business duties.

> ✔ **Note**
> Business-Related Entertainment
> If a meal is business-related entertainment (such as taking a client or customer to dinner), the cost of the meal is deductible, subject to the 50% limit, even though there is no need for substantial sleep or rest.

Example 4.12 Sleep Not Required

Redd Angus attended a breeding cattle sale in a neighboring county. He left after breakfast, bought his noon meal at the sale, and returned home in time for his evening meal. Redd can deduct his transportation expenses because the purpose of the trip was business. He cannot deduct the cost of his noon meal because the trip did not require substantial sleep or rest.

Transportation

The cost of transportation for travel within the United States is subject to an all-or-nothing rule. If the primary purpose of your trip is business, you can deduct all of your transportation expense. If the primary purpose of your trip is personal, you cannot deduct any of your transportation expense.

Example 4.13 Transportation Costs

Paige Turner, from Example 4.11, returned from San Antonio on Sunday after her business meeting ended on Saturday. Because she spent 3 days at her business meeting and 1 day sightseeing, she can deduct all of her transportation expense.

Companion's Expenses

The travel expenses of a companion who joins you on a business trip are deductible only if there is a business purpose for your companion's travel. If there is no business purpose for your companion's travel, the extra costs for your companion's travel are personal expenses that cannot be deducted. This includes your companion's meal expenses and bus, train, or air fare. If there is a difference in lodging rates for more than one person staying in a room, the deductible lodging expense is the single rate. Rental car expenses incurred with a companion are fully deductible if there is no difference in the rental rate for one or two persons in the car.

Summary

Combining personal travel with business trips may allow you to deduct part of those costs as a business expense.

Soil and Water Conservation Expenses

Taxpayers engaged in the business of farming may elect to deduct the cost of certain improvements to land that otherwise must be added to the land's basis. This election is a significant tax advantage because land cannot be depreciated and costs that are added to the basis of land provide a tax benefit only when the land is transferred in a taxable transaction. At that time, the basis reduces the gain or increases the loss from the transfer. In most cases, gain from the transfer of land is treated as capital gain rather than as ordinary income.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

The election to deduct the cost of qualifying improvements not only allows farmers to obtain a tax benefit in the year of the improvements are purchased, rather than in the year the land is sold, but it also allows the expenses to reduce ordinary income and self-employment income rather than income that is taxed at the lower rate for capital gains.

Cross Reference
Chapter 5 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* explains the special rules for deducting soil and water conservation expenses.

To be deductible, the conservation expenses must be consistent with a plan approved by the Natural Resources Conservation Service or a soil conservation plan approved by a comparable state entity. The land must be land that the landowner or the landowner's tenant is using for farming or has used in the past for farming. **Expenditures on land that has not been used in farming are not deductible under I.R.C. § 175.**

Eligible Expenses

Deductible conservation expenses include (but are not limited to) the following items:

1. Treatment or movement of earth, such as leveling, conditioning, grading, terracing, contour furrowing, or restoration of soil fertility
2. Construction, control, and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds
3. Eradication of brush
4. Planting of windbreaks
5. Expenses such as cleaning ditches and periodic brush removal

Expenses for improvements that can be depreciated cannot be claimed as a deduction under this special rule.

Eligible Taxpayers

Taxpayers must be engaged in the business of farming to elect to deduct soil and water conservation expenses. Taxpayers are engaged in the business of farming if they cultivate, operate, or manage a farm for gain or profit, either as an owner or as a tenant.

- A person engaged only in forestry or the growing of timber is not engaged in the business of farming.
- Landowners who rent their land and receive farm rental payments based on farm production, either in shares or in cash, are in the business of farming for this purpose.
- Landowners who receive a fixed cash rent are in the business of farming only if they materially participate in the farming business.

Cross Reference
See the discussion of material participation for landlords on page 74 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for a definition of *material participation*.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Planning Pointer

Shift to a Share Lease

A cash-rent landowner could shift to a share lease for a year in which conservation expenditures will be incurred. This makes the landowner a farmer for the election to deduct soil and water conservation expenses, without regard to material participation.

Gross Farm Income Limit

The deduction for soil and water conservation expenses is limited to 25% of the taxpayer's gross income from farming. Qualifying expenses in excess of this limit can be carried forward to future tax years and deducted to the extent of 25% of gross farming income for each year. If the taxpayer ceases to farm before the carryforward is used up, the excess can never be deducted and it cannot be added to the basis of the land.

The election to deduct soil and water conservation expenses applies to all tax years after the year you make the election unless you receive permission from the IRS to change your election. When the affected land is sold, any unused carryforward cannot be added to its basis. However, if the taxpayer continues in a farming business after selling the land, the carryover can still be deducted to the extent of 25% of gross farm income.

To avoid losing the tax benefits from deducting soil and water conservation expenses, you should plan to use them up before you quit farming. As you near the end of your farming career, you may want to seek permission from the IRS to change your election so that you can add newly incurred soil and water conservation costs to the basis of your land rather than increase a carryover that you cannot deduct because of the gross farm income limit.

An alternative for a farmer who plans to retire is to postpone planned soil and water conservation improvements until after the farmer quits farming. If you then lease the land on a cash lease without material participation, you will not be eligible to deduct new soil and water conservation expenses and must add them to the basis of your land.

Recapture

If you deduct soil and water conservation expenses and later sell the affected land, you may have to treat part of the gain realized on the sale as ordinary income rather than as capital gain. If you held the land for 5 years or less, all of the gain is treated as ordinary income up to the amount previously deducted for soil and water conservation expenses. If you held the land for more than 5 years but less than 10 years, the ordinary income recapture amount is reduced by 20% for each year you held the land beyond 5 years.

In most cases, the tax benefit of the soil and water conservation expense deduction exceeds the tax cost of the recapture because the deduction reduces both ordinary income and self-employment income and the recapture adds only to ordinary income. The deduction also reduces tax liability in an earlier tax year than the recapture adds to tax liability. However, if the deduction falls in a year with little or no farm income, and the recapture falls in a year of high income, the tax cost of the recapture may exceed the tax benefit of the deduction.

Fertilizer and Lime

Because fertilizer and lime often benefit the land for longer than a year, their cost must generally be capitalized and deducted over the period their benefits last. However, farmers can elect to deduct expenses for fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming in the year the expenses are paid. This includes both the cost of the materials and the cost of applying them to the land

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Cross Reference

See the discussion of fertilizer and lime on page 21 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for further information about deducting or capitalizing the cost of fertilizer and lime.

Most farmers elect to deduct these expenses in full in the year they are paid. However, you may want to spread the deduction over the years the fertilizer, lime, or other materials benefit the soil if you expect to be in a higher tax bracket in those later years.

Depreciation and I.R.C. § 179 Expensing

The cost of assets (such as buildings, equipment, and breeding livestock) that farmers use to produce income generally cannot be deducted as an expense in the year the asset is purchased. Instead, the cost is deducted over the useful life of the asset. The cost-recovery rules give taxpayers several options for deducting the basis of assets. Assets used in a farming business are eligible for one or more of the following cost-recovery methods:

1. I.R.C. § 179 expensing allows taxpayers to elect to deduct part or all of the cost of qualifying assets in the year the assets are placed in service. The deduction is limited to the taxpayer's income from all businesses and is also limited to a set dollar amount that varies by tax year. Under current law, the dollar limit is $500,000 for tax years beginning in 2011, $125,000 for tax years beginning in 2012, and $25,000 for tax years beginning after 2012.
2. The additional first-year depreciation (AFYD) rules allow taxpayers to deduct on their 2011 income tax returns 100% of the cost of qualifying assets that they purchase in 2011. In 2012, taxpayers can deduct 50% of the cost of qualifying assets purchased in 2012. Under current law, there is no AFYD provision for most assets purchased after 2012.
3. The depreciation rules establish a recovery period for each type of asset. For example, the recovery period for breeding hogs is 3 years; for cars and trucks, it is 5 years; for farm machinery and equipment, it is 7 years; and for farm buildings, it is 20 years. Farmers can choose a longer recovery period and a slower method of depreciation for assets if they want to save more of the total depreciation deduction for later years.

Cross Reference

See Chapter 7 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for further information about the cost-recovery rules.

The cost-recovery rules result in a dizzying array of options for deducting the cost of the assets you buy to use in your farming business. Because some of your assets qualify for only some of the options, you must carefully choose the cost-recovery method you use for each asset. Managing your cost-recovery options to minimize your income tax liability is discussed in Chapter 5 of this guide.

Domestic Production Activities Deduction (DPAD)

In 2004, Congress added the domestic production activities deduction (DPAD) to the Internal Revenue Code. The DPAD allows taxpayers to reduce their taxable income by up to 9% of their net income from most production activities in the United States, including production of commodities in a farming business. (Under a phase-in provision, the deduction rate was 3% in 2005 and 2006 and 6% in 2007, 2008, and 2009.)

For 2010 and later years, the DPAD is limited to the least of three amounts:

1. 9% of the net income from qualifying production,
2. 9% of modified adjusted gross income (9% of taxable income for a business entity), or

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

3. 50% of the qualifying wages paid by the taxpayer for qualifying production during the year.

Cross Reference

See page 24 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for further information on the DPAD.

50% of Wages Paid Limit

The DPAD limit of 50% of qualifying wages paid reduces your DPAD to zero if you have no paid labor, and it severely limits the DPAD if you have very little paid labor. Therefore, you may save taxes by paying wages to family members who are working on the farm.

Example 4.14 Wages for Spouse

Carlos and Virginia Little Otter operate a farming business as Carlos's sole proprietorship. Before 2011, they reported all of the farm income as Carlos's self-employment on Carlos's Schedule F (Form 1040), Profit or Loss From Farming. Virginia was not paid a wage, so Carlos had no deduction for wages paid. Because Carlos had no qualifying wages, his DPAD was limited to 50% of zero, even though his net income from production and his modified adjusted gross income both exceed $40,000.

Beginning in 2011, Carlos decided to pay Virginia $15,000 per year (a reasonable wage for her work in the farming business). The wages are subject to FICA tax, which increases their taxes by $1,682 but the wages reduce Carlos's self-employment tax which saves $1,704. Paying the wages also allows Carlos to claim a $7,500 DPAD, decreasing their tax by $1,125. Therefore, the net savings from paying wages to Virginia is $1,147.

Wages that are not subject to withholding are not qualifying wages for the DPAD limit. Consequently, the following farm wages are not included:

1. Wages paid in commodities
2. Wages paid for agricultural labor to a child under age 18
3. Compensation paid in nontaxable fringe benefits

Further, only wages that are paid for qualifying production count as part of the limit. For example, wages paid for custom-hire work do not count because custom hire is not a production activity that qualifies for the DPAD.

Example 4.15 Non-Qualifying Wages

If Carlos from Example 4.14 avoids FICA taxes by paying Virginia in commodities, her commodity wages will not qualify as wages for the DPAD limit. Similarly, if Carlos pays cash wages to their children under age 18 for their work in the farming business, the wages will not be qualifying wages for the DPAD limit.

Members of Cooperatives

Members of cooperatives can claim their share of the cooperative's DPAD if the cooperative elects to pass the DPAD through to its patrons. Marketing commodities through a cooperative that passes its DPAD through to its members results in a greater DPAD deduction for most farmers for one or both of two reasons:

1. The member's share of the cooperative's DPAD is often greater than the DPAD the member could claim if he or she sold the commodity to a buyer that is not a cooperative.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

2. The member's DPAD is not limited by his or her modified adjusted gross income or qualifying wages.

Example 4.16 DPAD from a Cooperative

In 2011, Maggie O'Malley sold $120,000 of corn to the local elevator (which is not a cooperative). Her total cost of producing the corn was $90,000, including $6,000 of wages. Her 2011 modified adjusted gross income was $40,000.

Maggie's DPAD is $2,700, which is the least of

1. $2,700 (9% of her $30,000 profit on the corn),
2. $3,600 (9% of her $40,000 modified adjusted gross income), or
3. $3,000 (50% of her $6,000 of qualifying wages).

If Maggie marketed her corn through a cooperative that elected to pass its DPAD through to its members and incurred expenses equal to 5% of its gross grain sales, Maggie's share of the cooperative's DPAD would be $10,260. Because Maggie's DPAD is not limited by her own table income qualifying wages, she can claim the entire $10,260 DPAD on her income tax return.

Hobby Farms

Taxpayers who engage in an activity (such as raising horses) without an intent to make a profit can deduct the expenses of the activity only to the extent of income from the activity. Furthermore, the expenses can be deducted only as an itemized deduction that is subject to a 2% of adjusted gross income reduction, which means many taxpayers do not get the full benefit of the deduction.

The purpose of this *hobby loss* rule is to prevent taxpayers from deducting the cost of their personal activities from their taxable income from other sources.

Cross Reference

See pages 6 and 27 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for further information about the not-for-profit activity rules.

Presumption of Profit Motive

An activity is presumed to be *engaged in for profit* if it produces a profit (gross income exceeding deductions) in 3 of 5 consecutive tax years. Horse breeding, training, showing, or racing activities meet the presumption if they show a profit in 2 of 7 consecutive tax years. If the taxpayer meets the threshold for the presumption, the IRS has the burden of proving the lack of a profit motive.

Factors in Determining Profit Motive

If a taxpayer does not meet the 3- of 5-year (or 2- of 7-year) profit test, the burden of showing that a profit motive exists is borne by the taxpayer. The following nine factors help determine whether a taxpayer is engaged in an activity for profit:

1. The manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or the taxpayer's advisers
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that assets used in the activity will appreciate in value
5. The taxpayer's success in carrying on other similar (or dissimilar) activities

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

6. The taxpayer's history of income or losses with respect to the activity
7. The amount of occasional profits that are earned
8. The taxpayer's financial status
9. The elements of personal pleasure or recreation

Other facts and circumstance may also be considered, and no one factor is conclusive of a profit objective. A simple comparison of the number of factors indicating a profit motive with the number of factors indicating there is not a profit motive is **not** decisive.

Satisfying the For-Profit Requirement

The IRS does not impose the not-for-profit limit on farmers whose only source of income is their farming business, because it is clear that the farmer is engaged in the farming activity with a profit motive.

Example 4.17 Full-time Farmer

Juan de Herrera began raising pistachios in 2011. Juan works 60 hours a week in his farming business and has no other income. His bank gave him a line a credit that allows him to pay his business and personal living expenses until his pistachio orchard is productive enough to make a profit.

The IRS will not limit Juan's expense deduction to his pistachio income even if he does not make a profit in 3 of 5 years because he is not raising pistachios for personal pleasure or recreation. Therefore, Juan does not need to postpone deductions or accelerate income in an attempt to show a profit in 3 of 5 years.

If you have substantial off-farm income and do not work full time in your farming activity, you may want to avoid more than 2 consecutive years (5 consecutive years for the specified horse activities) of losses so that you satisfy the 3- of 5-year (or 2- of 7-year) profit test each year and thus shift the burden of proving the lack of a profit motive to the IRS.

Postponing the For-Profit Test

You can postpone IRS's application of the for-profit test by filing Form 5213, Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit.

Filing this form prevents the IRS from imposing the not-for-profit limit on your deductions until the close of the sixth tax year after you start a horse activity and the close of the fourth tax year after you start any other activity. However, filing the form also keeps all of those tax years open so that the IRS can limit your deductions for those years if it finds that you did not have a profit motive.

If you do not file Form 5213, the IRS generally has only 3 years after you file a return to challenge your deductions on that return. Therefore, you should not file Form 5213 unless the IRS applies the not-for-profit limit to your deductions. If the IRS applies the limit, you can then file Form 5213 to postpone the application until the fifth year (seventh year for horse activities) of the activity.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.