

# Chapter 4 \*

## FARM DEDUCTIONS

### Introduction

In preparing their federal income tax returns, farmers are allowed to deduct certain expenses incurred when carrying on a trade or business. 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 Qualified Business Income Deduction (QBI). Alternatively, not all deductions available on Schedule F are examined in this chapter.

#### Planning Pointer

##### *Deductions*

The deductions discussed in this chapter pertain to a sole proprietorship form of ownership. The deductibility and/or reporting of specific expenses may vary depending on the form of ownership (sole proprietorship, limited liability company, partnership, trust, etc.)

### 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 Part II (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 32, “Other expenses,” to claim deductions that are not listed on lines 10 through 32.

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**Figure 4.1. Part II of Schedule F (Form 1040)**

<b>Part II Farm Expenses—Cash and Accrual Method.</b> Do not include personal or living expenses. See instructions.			
<b>10</b>	Car and truck expenses (see instructions). Also attach <b>Form 4562</b>	<b>10</b>	
<b>11</b>	Chemicals . . . . .	<b>11</b>	
<b>12</b>	Conservation expenses (see instructions)	<b>12</b>	
<b>13</b>	Custom hire (machine work) . . . . .	<b>13</b>	
<b>14</b>	Depreciation and section 179 expense (see instructions) . . . . .	<b>14</b>	
<b>15</b>	Employee benefit programs other than on line 23 . . . . .	<b>15</b>	
<b>16</b>	Feed . . . . .	<b>16</b>	
<b>17</b>	Fertilizers and lime . . . . .	<b>17</b>	
<b>18</b>	Freight and trucking . . . . .	<b>18</b>	
<b>19</b>	Gasoline, fuel, and oil . . . . .	<b>19</b>	
<b>20</b>	Insurance (other than health) . . . . .	<b>20</b>	
<b>21</b>	Interest (see instructions):		
<b>a</b>	Mortgage (paid to banks, etc.) . . . . .	<b>21a</b>	
<b>b</b>	Other . . . . .	<b>21b</b>	
<b>22</b>	Labor hired (less employment credits)	<b>22</b>	
<b>23</b>	Pension and profit-sharing plans . . . . .	<b>23</b>	
<b>24</b>	Rent or lease (see instructions):		
<b>a</b>	Vehicles, machinery, equipment . . . . .	<b>24a</b>	
<b>b</b>	Other (land, animals, etc.) . . . . .	<b>24b</b>	
<b>25</b>	Repairs and maintenance . . . . .	<b>25</b>	
<b>26</b>	Seeds and plants . . . . .	<b>26</b>	
<b>27</b>	Storage and warehousing . . . . .	<b>27</b>	
<b>28</b>	Supplies . . . . .	<b>28</b>	
<b>29</b>	Taxes . . . . .	<b>29</b>	
<b>30</b>	Utilities . . . . .	<b>30</b>	
<b>31</b>	Veterinary, breeding, and medicine . . . . .	<b>31</b>	
<b>32</b>	Other expenses (specify):		
<b>a</b>	-----	<b>32a</b>	
<b>b</b>	-----	<b>32b</b>	
<b>c</b>	-----	<b>32c</b>	
<b>d</b>	-----	<b>32d</b>	
<b>e</b>	-----	<b>32e</b>	
<b>f</b>	-----	<b>32f</b>	

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. The farm accounting records can be set up in such a way to match the lines of Schedule F to make it easy to transfer and compare the book records to the tax records. There will be some differences and additional detail with the book records, but doing this can reduce the administrative time spent on the tax return.

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 21a so that the IRS can match the Form 1098 amount with the amount you report on your tax return. Line 21b 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 24a and land rents reported on line 24b. Labor expenses are reported on line 22, and employee benefits and pension and profit-sharing expenses are reported on lines 15 and 23, 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. Capital expenditures, on the other hand, 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 \$8,000 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 \$8,000 he paid for the fence on the south side of the pasture is a capital expenditure, which is depreciable rather than currently deductible.

## §263(A) Exceptions

The uniform capitalization (UNICAP) rules of 263(A) require some deductible expenses to be capitalized and depreciated over a longer time period. There are several exceptions which currently exist for farmers. A safe harbor allows up to \$2,500 to be deducted without regard to UNICAP. Additionally, a cash basis farm taxpayer with less than \$26 million in gross receipts is exempt from the UNICAP rules. If a farmer is subject to UNICAP they may also elect out with some considerations. For more information on the UNICAP rules visit IRS Publication 225, *Farmer's Tax Guide*, Chapter 6.

**Example 4.2: Fence Expenses**

Using Example 4.1, Rusty would be able to deduct as an ordinary business expense the new fencing in the current year if the expense was \$2,500 or less as that would put him under the safe harbor for UNICAP. Rusty would need to correctly make the election in the current year and have an accounting policy stating how they will treat such items.

## 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 4.3: Business and Personal Expenses**

The \$4,000 premium for your property casualty insurance covers all 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 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.

In order to qualify, you must also show that you use your home as your principal place of business. Business can be conducted at several locations, but you must consider the importance and time spent with each activity and location. You must not have another fixed location where you conduct substantial administrative or management activities of the trade or business.

There are two methods for calculating the deduction: (1) the actual expenses or (2) the simplified method. Schedule F filers can use worksheets from IRS publication 587, *Business Use of Your Home*, for either method to calculate the deduction.

- With actual expenses, the taxpayer is allowed to deduct certain direct expenses such as painting or repairs to the space used as an office. Other indirect expenses such as insurance, taxes, depreciation, and utilities are deducted based on business use percentage. Once the applicable expenses are totaled, you apply the business use percent to calculate the deduction. You can use any reasonable method to determine business percentage. One common method is to divide the area used for business by the total area of your home.  $300 \text{ sq. ft (business use)} / 3,000 \text{ sq. ft (total home)} = 10\% \text{ business use}$ . The taxpayer would get to deduct 10% of the indirect expenses of their home office in addition to the qualified direct expenses.
- The simplified method does not require you to keep track of costs during the year but allows you to multiply the prescribed rate, \$5 at time of publication, by the area of the home used for a qualified business use. You are limited by this method to 300 sq. ft, so the maximum deduction would be  $300 \text{ sq. ft} \times \$5 = \$1,500$ . Consequently, the actual expense method may provide a larger deduction but also requires greater recordkeeping requirements.

### Deduction Limit

The deduction for business use of a home is limited to the net income from the business before the deduction. 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 4.4: 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

If the actual expense method is used, you can deduct depreciation for the portion of your home that is used for a business purpose. However, when you sell your home, any 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 4.5: Deduction Limit**

Beginning in 2018, 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.

**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 2022, the SMR is 58.5¢ per mile for miles driven in January through June, and 62.5¢ per mile for miles driven in July through 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 4.6: SMR vs. Actual Costs

In 2022, 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 \$6,090  $[(4,000 \times 58.5¢) + (6,000 \times 62.5¢)]$  for vehicle expense on his 2022 Schedule F (Form 1040).

If Red kept adequate records of all of the costs of driving his pickup and the total cost for 2022 is \$9,000, he can deduct \$6,000  $[\$9,000 \times (10,000 \text{ business miles} \div 15,000 \text{ total miles})]$  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 (including I.R.C. §179 or other depreciation), 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).

## Vehicle 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 affect 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 2022. 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 2022**

Tax Year	Cars		Trucks and Vans	
	No AFYD	AFYD	No AFYD	AFYD
2022	\$11,200	\$19,200	\$11,200	\$19,200
2023	<u>18,000</u>	<u>18,000</u>	<u>18,000</u>	<u>18,000</u>
2024	<u>10,800</u>	<u>10,800</u>	<u>10,800</u>	<u>10,800</u>
After 2024	6,460	6,460	6,460	6,460

**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 4.7: Comparison of Vehicle Deduction Options**

In 2022, 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 \$18,150 of actual expenses or the \$9,095 standard mileage deduction, as shown in Figure 4.3.

**Figure 4.3: Olga Petrov’s 2022 Car Deduction Options**

<b>Actual Expenses</b>	
Costs other than depreciation	\$ 5,000
AFYD limit for cars	<u>19,200</u>
Total costs	<u>\$24,200</u>
Business use percentage (15,000 ÷ 20,000)	× .75
Business deduction	<u>\$18,150</u>
<b>Standard Mileage Rate</b>	
Miles before July	<u>7,000</u>
SMR for January–June	<u>58.5¢</u>
Standard mileage deduction	<u>\$ 4,095</u>
Miles after June	<u>8,000</u>
SMR for July–December	× <u>62.5¢</u>
Standard mileage deduction	<u>5,000</u>
Total standard mileage deduction	<u>\$ 9,095</u>

*(continued)*

**Example 4.7: Comparison of Vehicle Deduction Options (continued)**

If Olga deducts the \$18,150 of actual expenses for 2022, she cannot use the SMR for later years. As shown in Figure 4.4, Olga's actual cost deduction in 2023 will be \$17,250 and her 2023 standard mileage deduction will be \$9,375, assuming the same costs and usage as in 2022 and a 62.5¢ SMR for 2023.

***Figure 4.4: Olga Petrov's 2023 Car Deduction Options***

<b>Actual Expenses</b>	
Costs other than depreciation	\$ 5,000
AFYD limit for cars	<u>18,000</u>
Total costs	<u>\$ 23,000</u>
Business use percentage (15,000 ÷ 20,000)	<u>× .75</u>
Business deduction	<u>\$ 17,250</u>
<b>Standard Mileage Rate</b>	
Business miles	<u>15,000</u>
SMR (assumed)	<u>× 62.5¢</u>
Standard mileage deduction	<u>\$ 9,375</u>

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 4.8: Comparison Over the Life of Vehicle**

Olga, from Example 4.7, plans to keep the Cadillac she purchased in 2022 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 2023 through 2025 as they were in 2022. 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 \$19,941, and the present value from deducting the SMR is \$14,113. Therefore, based on the assumptions used to make these calculations, Olga should choose the actual costs in 2022 rather than deducting her standard mileage.

## 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 later years. Either the actual expenses or the SMR can be used with the 75% method. The method eases recordkeeping requirements, but a taxpayer may be forgoing some additional deductions if their business use is greater than 75%.



## 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 non-tax factors affect the decision to lease or buy. The non-tax 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 the 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 4.9: 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 (its fair market value) 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.

*(continued)*

**Example 4.9: Lease vs. Purchase of Tractor (continued)**

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

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 (its fair market value) and depreciate that \$20,000 cost using MACRS depreciation over a 7-year recovery period.

**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 newly bought used machinery). 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. **(continued)**

**Example 4.9: Lease vs. Purchase of Tractor (continued)**

**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
			<u>15,099</u>				<u>- 64,583-</u>

\*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 2022, leasing may not provide a tax advantage because the additional first-year depreciation and I.R.C. §179 expensing rules in effect will allow farmers to deduct most or all of the cost of equipment they purchase and place in service.

Ultimately, the lease vs. buy decision is influenced by a number of factors which cannot be analyzed with manual calculations. The University of Illinois farmdoc website contains excellent software for analyzing lease vs. purchase and other business decisions. See [www.farmdoc.illinois.edu](http://www.farmdoc.illinois.edu) and look under FAST tools to find the program.

**Disguised Sale Rules**

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 2022 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.
- 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 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.

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 4.10: 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.

##### **Example 4.11: 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.

## Taxes

Generally, farmers may deduct several types of taxes as a farm business expense:

- a) Real estate and personal property taxes on farm business assets such as equipment, animals, farmland, and farm buildings
- b) Social security and Medicare taxes paid on behalf of employees
- c) Federal unemployment on behalf of employees
- d) Highway use tax on trucks or tractors used in the farm business

You are **not** allowed to deduct the following taxes as farm business expense on Schedule F:

- a) Self-employment tax you pay as a farm business owner (can be taken on Schedule 1 of 1040)
- b) State and local sales taxes on purchase of capital assets, which are capitalized and depreciated over the life of the asset

## Seeds and Plants

Farmers may deduct the cost of seeds and plants used to produce a crop for sale. This rule does not apply to plants with a pre-productive period of more than two years (i.e. trees and vines). Costs for these types of plants must generally be capitalized (costs taken over time) and not expensed in the year of purchase as an ordinary business expense. However, as discussed earlier, under the TCJA, farmers with gross incomes of \$26,000,000 or less are not subject to the UNICAP rules and may generally deduct new plantings in the year of purchase.

## Items Purchased for Resale

Costs of animals and plants bought for resale are generally deducted in the year they are sold. The costs are netted against total sale receipts to determine taxable income before deductions. Some exceptions exist which allow the costs to be deducted in the year of purchase. This includes:

- a) Baby chicks and pullets for raising and resale
- b) Hens bought for commercial egg production
- c) Seeds and young plants bought for further development and cultivation before sale

## 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 4.12: 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 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 at 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.

1. Only 50% of the cost of the meal can be deducted. The expense of a meal includes amounts you spend for your food, beverages, taxes, and tips relating to the meal. You can deduct either 50% of the actual cost or 50% of a standard meal allowance that covers your daily meal and incidental expenses. The standard meal allowance can be found at [www.gsa.gov](http://www.gsa.gov); selecting your location will bring up the applicable allowance.
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.

**Example 4.13: Sleep 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.

**Temporary Increased Deduction**

The Taxpayer Certainty and Disaster Tax Relief Act allowed 100% business meal deduction for tax years 2021 and 2022 if provided by a restaurant (including carry-out or delivery).

**Business-Related Entertainment**

The 2017 Tax Cuts and Jobs Act eliminated deductions for any expense related to activities generally considered entertainment, amusement, or recreation.

**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 4.14: Transportation Costs**

Paige Turner, from Example 4.12, 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. Deductible conservation expenses are generally those that are paid to conserve soil and water for land used in farming, to prevent erosion of land used for farming, or for endangered species recovery.

The election to deduct the cost of certain improvements may have 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.

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 2022)*, 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 USDA 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

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 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 78 of IRS Publication 225, *Farmer's Tax Guide (for 2022)*.

### 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 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.

#### Cross-Reference

See the discussion of fertilizer and lime on page 23 of IRS Publication 225, *Farmer's Tax Guide (for 2022)*, 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

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.

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 new farm machinery and equipment, it is 5 years; newly bought used machinery and equipment 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. See Chapter 5 for comparison of depreciation methods.

Farming businesses that elect out of the interest deduction limit must use the alternative depreciation system (i.e. straight line depreciation) to depreciate any property with a recovery period of 10 years or more, such as single purpose agricultural or horticultural structures, trees or vines bearing fruit or nuts, farm buildings and certain land improvements.

Property used in a farming business and placed in service after Dec. 31, 2017, is not required to use the 150 percent declining balance method. A 200 percent declining balance may provide greater deduction in earlier years. However, if the property is 15-year or 20-year property, the taxpayer should continue to use the 150 percent declining balance method.

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 \$1,040,000 for tax years beginning in 2020, \$1,050,000 for tax years beginning in 2021, and \$1,080,000 for tax years beginning after 2022.

The additional first-year depreciation (AFYD) rules allow taxpayers to deduct 100% of the cost of qualifying assets that they place in service between Sept. 27, 2017, and before Jan 1, 2023; 80% for

property placed in service during calendar year 2023; 60% for property placed in service during calendar year 2024; 40% for property placed in service during calendar year 2025; and 20% for property placed in service during calendar year 2026. At the time of publication, no bonus depreciation is available for qualified property that is placed in service after Dec. 31, 2026, except for certain long-production period property and aircraft which extends to 2027.

#### Cross-Reference

See Chapter 7 of IRS Publication 225, *Farmer's Tax Guide (for 2022)*, 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 purchased to use in a farming business. Because some assets qualify for only some of the options, the farmer must carefully choose the cost-recovery method to use for each asset. Managing your cost-recovery options to minimize your income tax liability is discussed in Chapter 5 of this guide.

## Section 199A Qualified Business Income Deduction (QBI)

I.R.C. §199A was enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA). §199A(a) establishes the qualified business income (QBI) deduction for individuals, estates, and trusts. This deduction is determined after computing a taxpayer's 'qualified business income'. Eligible taxpayers can deduct up to 20% of their QBI from sole proprietorships and pass-through entities for tax years 2018 through 2025.

An individual farmer who is a patron of a specified cooperative may be entitled to two deductions under §199A. A farmer can have a qualified trade or business that generates a §199A(a) QBI deduction, and the farmer may also receive a §199A(g) deduction passed through from the specified cooperative. The latter is based on the former domestic production activities deduction (DPAD). A patronage from an agricultural cooperative can be treated differently depending on the nature of the cooperative.

QBI is the net amount of qualified items of income, gain, deduction, and loss from any qualified trade or business, including income from partnerships, S corporations, sole proprietorships, and certain trusts. Generally, this includes, but is not limited to, the deductible part of self-employment tax, self-employed health insurance, and deductions for contributions to qualified retirement plans (e.g., SEP, SIMPLE and qualified plan deductions).

<http://www.IRS.gov/> has information on the QBI deduction including IRS Forms 8995 and 8995-A.

## Labor

### Hired Labor

You can deduct reasonable wages paid for regular farm labor, piecework, contract labor, and other forms of labor hired to perform your farming operations. You can pay wages in cash or in noncash items such as inventory, capital assets, or assets used in your business. The cost of boarding farm labor

is a deductible labor cost. Other deductible costs you incur for farm labor include health insurance, workers' compensation insurance, and other benefits. If you must withhold social security, Medicare, and income taxes from your employees' cash wages, you can still deduct the full amount of wages and the employer's share of the Social Security and Medicare taxes you must pay.

## Children

You can deduct reasonable wages or other compensation you pay to your child for doing farmwork if a true employer-employee relationship exists between you and your child. Include these wages in the child's income. The child may have to file an income tax return. These wages may also be subject to Social Security and Medicare taxes if your child is age 18 or older. The amount of wages paid to the child could cause a loss of the dependency exemption, depending on how the child uses the money.

## Spouses

You can deduct reasonable wages or other compensation you pay to your spouse if a true employer-employee relationship exists between you and your spouse. Wages you pay to your spouse are subject to Social Security and Medicare taxes.

## Hobby Farms

If you operate a farm for profit, you can deduct all the ordinary and necessary expenses of carrying on the business of farming on Schedule F. However, if you do not carry on your farming activity to make a profit, it is considered a hobby and you report the income from the activity on Schedule 1 (Form 1040).

Additionally, if the activity is considered a hobby activity you are not allowed to deduct expenses, even if you itemize your deductions on Schedule A.

### Cross-Reference

See page 28 of IRS Publication 225, *Farmer's Tax Guide (for 2022)*, 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

### Farm Deductions

1. The taxpayer's history of income or losses with respect to the activity
2. The amount of occasional profits that are earned
3. The taxpayer's financial status
4. 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 4.15: Full-Time Farmer

Juan de Herrera began raising pistachios in 2019. 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.