9-2012

Prepaid Farm Expenses

Jeffrey E. Tranel

Colorado State University

RURAL TAX EDUCATION www.RuralTax.org

September 2012 RTE/2012-42

Prepaid Farm Expenses*

Jeffrey E. Tranel, *Agricultural and Business Management Economist*
Colorado State University Extension

Introduction

Farmers and ranchers often pay for feed, supplies, fertilizer, and other inputs in one year and use those items in the following year. They may do so to pay lower prices, guarantee availability, for planning purposes, and/or other reasons.

The Internal Revenue Code allows qualified farmers and ranchers (farm-related taxpayers) to deduct the costs of such purchases in the year that the purchases are made rather than the year in which such items are used. Generally, the deduction for pre-paid farm supplies is limited to 50% of other deductible farm expenses (all schedule F deductions except supplies) for the year.

Farm-Related Taxpayers

"Farm-related taxpayers" may deduct up to fifty percent (50%) of the costs of prepaid supplies and feed in the year of purchase rather than the year of use or consumption. A farm-related taxpayer is someone whose:

1. Main home is on the farm,
2. Principal business is farming, or
3. A family member of someone who meets tests 1 and 2. For this purpose, a family member includes the person's brothers and sisters, half-brothers and half-sisters, spouse, parents, grandparents, children, grandchildren, and aunts and uncles and their children.

Additionally, farm-related taxpayers wanting to deduct the costs of prepaid farm supplies and livestock feed must use the cash method of accounting.

* **In cooperation with the participating land-grant universities, this project is funded in part by USDA-Agricultural Research Service under a cooperative agreement, with technical support from the USDA Small Farms and Beginning Farmers and Ranchers Group at the Office of Advocacy and Outreach. The information reflects the views of the author(s) and not USDA-ARS. For a list of participating land-grant universities, see RuralTax.org.**

A farm-related taxpayer may deduct more than 50% of prepaid supplies and feed if: (1) the prepaid farm supplies expense is more than 50% of the deductible farm expenses because of a change in business operations due to extraordinary circumstances, or (2) total expenses for prepaid farm supplies for the three preceding years is less than 50% of all other deductible farm expenses in those three years.

Prepaid Farm Supplies

Prepaid farm supplies are amounts paid during the tax year for seed, fertilizer, and other farm supplies not used or consumed during that year. They also include the costs of purchasing poultry bought for use in the farm business that would be deductible in the following year. The cost of poultry purchased for resale, but not sold during the year, may be deducted as prepaid expenses.

There are three tests that must be met in order to deduct the cost of a supply purchased in the current taxable year but used in the next tax year.

1. The expense must be a payment for the purchase of supplies, not a deposit. It is considered a payment if there is a binding commitment to accept delivery of a specific quantity at a fixed price, and there is no entitlement to a refund or repurchase. Deposits are not considered prepaid farm expenses.
2. The prepayment has a specific business purpose and is not merely to avoid taxes. Examples of business benefits include fixing maximum prices, securing an assured supply, and securing preferential treatment in anticipation of shortages.
3. The deduction does not materially distort income. Some factors to consider in determining whether there is a material distortion of income are:
    a. The farmer’s customary business practices in conducting the farming operation.

Example 1: Maria uses the cash method of accounting. In December 20X1, she paid $20,000 to the Co-Op for fertilizer to be applied in the spring of 20X2 on her corn crop. Maria’s deductible expenses for 20X1, other than this purchase of fertilizer, were $100,000. She purchased the fertilizer in December for two reasons. First, she was offered a discount for purchasing in December rather than the following spring. Second, she was concerned that fertilizer may be difficult to buy at any price the following spring.

Maria is allowed to deduct the $20,000 she paid for the fertilizer on her 20X1 income tax return. She meets all three tests required to deduct the costs of prepaid farm supplies. Further, the deduction is not limited because (1) she is a “qualified farm related taxpayer” and (2) she has not exceeded the 50% limit.

    b. The amount of the expense relative to income for the year.
    c. The time of the year the purchase is made.
    d. The amount of the expenditure in relation to past purchases.

Limits on Deductions for Prepaid Farm Supplies

The allowable deduction of prepaid farm supplies may be limited if the expenses exceed fifty percent (50%) of the total deductible farm expenses (excluding prepaid feed and supplies) for the tax year. If the prepaid farm feed and supplies are actually used or consumed during the year they are purchased, the amount is fully deductible.

It is important to remember that the limit on the deduction for prepaid farm supplies does not apply to a farm-related taxpayer if (1) the prepaid farm supplies expense is more than 50% of the deductible farm expenses because of a change in business operations due to extraordinary circumstances or (2) total expenses for prepaid farm supplies for the three preceding years is less than 50% of all other deductible farm expenses in those three years.

Prepaid Feed

A qualified farmer or rancher, reporting income and expenses under the cash method of accounting, may deduct (in the year paid) the cost of livestock feed to be consumed in a future year if the following tests are met.

1. The payment is for the purchase of feed rather than a deposit.
2. The prepayment has a business purpose and is not merely for tax avoidance. There must be a reasonable expectation of receiving some business benefit from prepaying the cost of livestock feed. For example, fixing maximum prices, securing an assured feed supply, and/or securing preferential treatment in anticipation of a feed shortage.
3. Deducting the prepayment does not materially distort income. Some factors considered in determining whether deducting prepaid livestock feed materially distorts income include (a) it is the taxpayer's customary business practice in conducting his livestock operations, (b) the expense is similar to past purchases, (c) the time of year the purchases are made, and (d) the expense in relation to income for the year.

If the taxpayer fails any of the tests, the cost of prepaid feed can be deducted only in the year it is consumed. Even if the tests listed above are met, the amount of prepaid feed is subject to the same "50% of deductible expenses" limit as described for prepaid farm supplies. This rule does not apply to the purchase of commodity futures contracts.

Whether a payment is for the purchase of feed or a deposit depends on the facts and circumstances in each case. Feed is considered purchased if it can be shown that the payment was made under a binding commitment to accept delivery of a specific quantity of feed at a fixed price and there is no entitlement, by contract or business custom, to a refund or repurchase. The following are some factors that show a payment is a deposit rather than for the purchase of feed.

- The absence of specific quantity terms.
- The right to a refund of any unapplied payment credit at the end of the contract.
- The seller's treatment of the payment as a deposit.
- The right to substitute other goods or products for those specified in the contract. However, provisions to substitute feed ration ingredients to meet an animal's changing

diet requirements do not suggest a deposit. Also, a price adjustment to reflect market value at the date of delivery is not, by itself, proof of a deposit.

Example 2: Conrad typically purchases hay in July so as to have sufficient feed for his animals during the winter of the next year. Since Conrad uses the cash method of accounting, he deducted the cost of the hay ($25,000) in the year it was purchased.

Conrad fed some of the hay ($5,000) in January and February, before a drought forced him to sell his animals. Another producer had kept her animals and was in need of hay, so Mr. Cattleman sold her the remaining hay. Consequently, Conrad reported the hay sales ($20,000) in the year it would have been normally consumed by his animals.

If he had not deducted the cost of the hay in the year it was purchased (not deducted as prepaid feed), Conrad would have reported the hay sales less the cost of the hay in the income section of Schedule F -- $20,000 less $25,000. The resulting negative number would account for the $5,000 of hay he fed to his own animals.

Effect of Change in Plans

After purchasing supplies or feed for the following year, a producer's plans may change. The producer may decide not to produce the crop or raise the livestock for which the items were purchased. For example:

- Drought forced the sale of livestock, so the feed was not needed.
- Weather or market conditions caused the producer to plant a crop for which the supply was not needed or the quantity of supply was significantly less than needed for the alternative crop.

One potential consequence of the change in plans is that the IRS may deny the producer's deduction of prepaid farm supplies or feed. This denial is not likely if the amount of the payment is reasonably determined in good faith at the time of the payment.

Another consequence arises if the prepaid supplies or feed are sold in the year such items would have normally been used or sold. In such cases, the income from the sale of those items would be considered taxable income. Since the cost of the prepaid supplies was deducted in the preceding year, there would be no off-setting expense, i.e. the supplies or feed would have a zero basis.

There may be times when a producer purchases prepaid feed or supplies in one year, has a change in production plans, and sells the prepaid items back to the seller in the following year. If the prepaid supplies are returned to the seller for a credit, the taxpayer must be careful to avoid the original transaction being considered a deposit rather than a purchase. The taxpayer should document the negotiations in order to prove that the value of the supply was exactly equal to the original purchase price. In such cases, it is the producer who faced the risk of a change in price.

However, if the negotiated sales price is different than the purchase price, the producer must show that he or she faced the risk of a price change.

Conclusion

Qualified farmers and ranchers, using the cash method of accounting, may deduct the costs of prepaid supplies and feed in the year of purchase rather than the year of use or consumption. Such purchases must be for business purposes – to fix maximum prices, secure sufficient supplies, etc. – and may not distort income from one year to the next. Further, prepayments must be for a specific quantity at a fixed price rather than a deposit. There are various tests that must be met and limitations to the deductibility of prepaid expenses.

Farmers and ranchers have unique business, financial, and tax liability circumstances. They should consult with their tax preparers before prepaying for farm supplies and feed.

IRS Publications

IRS Publication 225 (Farmer's Tax Guide) can serve as a good reference for producers wanting more information about prepaid supplies and feed. Numerous parts of the Internal Revenue Code and Revenue Rulings were referenced when writing this fact sheet. They include: Rev. Rul. 82-208, 1982-2 C.B. 58; Rev. Rul. 79-229, 1979-2 C.B. 210; IRC § 464; IRC § 469; and *Grynberg v. Commissioner,* 83 T.C. 255 (1984).

To access IRS forms and publications, go to www.irs.gov and click on "Forms and Publications". Then click on "Publication number" under "Download forms and publications by:" Type the publication number in the find box to search for the publication. Publications may be viewed online or downloaded by double clicking on the publication.

Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.