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What Are Deductible Business Expenses?*

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Introduction

Farmers (and all business owners) pay income taxes based on profit. So, it is important to claim ALL legitimate business expenses to not overstate profits. On the other hand, it is illegal to deduct expenses that are not legitimate business expenses.

Ordinary and Necessary

IRS allows business owners to deduct business expenses that are ordinary and necessary. 'Ordinary' means that other people in the same type of business have similar types of expenses. 'Necessary' means that the expense is related to a 'profit motivated' business purpose (not personal expenses, family living expenses, or hobby expenses). Another phrase that IRS uses to describe business expenses is that they are costs of 'carrying on a trade or business.' Remember that receipts are needed to prove an expense. A credit card 'bill' is not sufficient because it does not usually list the specific items that were purchased. However, a credit card statement that specifically states the item purchased, or a receipt that lists the item in question is sufficient.

Capital Expenses

There are some costs that businesses have that are not deductible business expenses. Most of these non-deductible expenses are capital expenses. These are the cost of buying business assets, the cost of improvements, and start-up expenses. For example, items such as machinery, equipment, livestock, and buildings are capital expenses. These expenses are amortized or 'spread over' a number of years, usually by depreciating the asset or improvement. The depreciation length and the amount taken each month or year depend on the item, the procedure

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taken, and the tax and income situation that exists. (For example: A tractor has an IRS defined depreciation life of 7 – 10 years, a dairy cow has an IRS defined life of 5 – 7 years, and a building may be as little as 10 years or as long as 20 - 25 years). (There are other articles on RuralTax.org that focus on depreciation, and on start-up expenses.)

Mixed Business and Personal Use Expenses

Farmers pay a number of expenses that are both business and personal expenses. Part of this is because quite often the home is on the farm. Frequently bills like electricity, property tax, insurance, and telephone (and sometimes others) must be split between business use and personal use.

- Usually, by talking with the person or company that sends the bill, the farmer can figure out how to 'reasonably allocate' the bill between business and personal use.
- Here in Vermont, more and more dairy farms are having a second electric meter installed, one for the home and one for the farm, so allocation of this bill is not so much of an issue.
- Property taxes paid on the family home is not a business expense; taxes on the house have to be removed from farm property taxes.
- Usually an insurance agent can quickly separate out the insurance on the home (and personal vehicles) from the business insurance costs.
- The basic fee for phone service is not deductible. However, now many farmers have a landline for the home and a cell phone for the business use. In this case, the cell phone is generally deductible.

Some farms claim a 'business use of home.' This is a very specific designation, where part of the home is exclusively used by the business. So, a proportion of the costs can be deducted. See *IRS Publication 587, Business Use of Your Home* or RuralTax.org for more information.

Some assets are used partly in the business and partly for family use. The most common are cars, pickup trucks, and computers. These things are called 'Listed Property' and have special depreciation rules, based on the proportion of business use. For more information on this topic, see RuralTax.org factsheet RTE/2010-18 *Depreciation: Special Rules on Pickups, SUVs, Other Autos and Listed Property*.

Non-Deductible Expenses

Quite often we think that most expenses on the farm are deductible but there are many that are non-deductible. Below are a few for you to think about.

- No personal expenses are deductible: groceries, clothing, home repairs, pet food, etc. But expenses for employee uniforms, employee housing repairs, etc. <u>are</u> deductible.
- Principal paid back on a loan is not deductible. The interest paid on a business loan is deductible, but not the principal.
- If you expense the cost of raising livestock on the farm, when an animal dies, you cannot claim the loss as a business expense. You have already deducted the costs of raising the

animal. (In fact, if you receive an insurance payment for the unforeseen, sudden death of an animal, you may have a gain to report.)

- If the farm suffers a loss of crops, the loss cannot be deducted, since the costs of raising the crops will be deducted as a business expense. (But, if you receive a crop insurance payment your farm may show a profit- if the insurance payment income is greater than your farm expenses.)

Deductible Expenses

IRS form 1040 Schedule F, Farm Profit and Loss, lists the typical farm expenses in Part II (in alphabetical order!): Car and Truck, Chemicals, Conservation Expenses, Custom Hire, Depreciation, Employee Benefit Programs, Feed, Fertilizer and Lime, Freight and Trucking, Gasoline and Fuel, Insurance, Interest, Labor, Pension, Rent, Repairs, Seeds and Plants, Storage, Supplies, Taxes, Utilities, Veterinary Breeding and Medicine, and Other.

A good portion of Chapter 4, Farm Business Expenses in IRS Publication 225 (Farmer's Tax Guide) is devoted to explaining what types of expenses get included into each line. 'Other' is the catch-all: typical inclusions are accounting and tax preparation expenses, dues and fees, office expenses, subscriptions, registrations, and promotion fees. The fee you pay for tax preparation must be 'allocated' between the farm and a personal expense, not all of it is for the farm.

If you use a computer for farm accounting, it can be very helpful to have your Chart of Accounts set up like this list of expenses as outlined by IRS. It makes things very convenient come tax time. If you don't have it set up this way, someone will have to convert your expense categories into the IRS expense list (and you may have to pay them each year to do it). In addition, farm advisors, lenders, and others tend to think of these expenses in this order.

Truck and car expenses for business are deductible. Keeping a calendar-type record book (with a pen/pencil) in the vehicle to record miles driven for both personal and business is a good idea. This way you can claim at least the standard mileage rate, or maybe more.

Not-For-Profit-Farming

If you are not farming with the intent of making a profit, only some of your expenses are deductible. There is a sorting process that must be used on the expenses, so that some can be claimed on the personal Itemized Deduction Form. These are called hobby losses. There are nine factors that may be used to determine whether you are carrying on your farming activity for profit; no one factor alone is decisive. All the facts are taken into account.

For additional information, see at these two IRS Publications: Publication 225, 'Farmer's Tax Guide,' Chapter 4- Farm Business Expenses Not-for-Profit Farming; and Publication 535, 'Business Expenses.'

IRS Publications

IRS publication 225 Farmers Tax Guide is very helpful for farmers who are trying to determine if certain expenses are deductible.

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.
