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Farmer’s Tax Guide

For use in preparing **2023** Returns

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Volume 3 of 10

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Labor Hired

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 before withholding. See chapter 13 for more information on Employment Taxes. Also, deduct the employer's share of the social security and Medicare taxes you must pay on your employees' wages as a farm business expense on Schedule F, line 29. See *Taxes*, later.

Property for services. If you transfer property to an employee in payment for services, you can deduct as wages paid the fair market value of the property on the date of transfer. If the employee pays you anything for the property, deduct as wages the fair market value of the property minus the payment by the employee for the property.

Treat the wages deducted as an amount received for the property. You may have a gain or loss to report if the property's adjusted basis on the date of transfer is different from its fair market value. Any gain or loss has the same character the exchanged property had in your hands. For more information, see chapter 8.

Child as an employee. 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. Wages paid to minor children become subject to social security and Medicare taxes in the month the dependent child turns 18 years of age. For more information, see *Family Employees* in chapter 13.

TIP *A Form W2 should be issued to the child employee.*

The fact that your child spends the wages to buy clothes or other necessities you normally furnish doesn't prevent you from deducting your child's wages as a farm expense.

CAUTION *The amount of wages paid to the child could cause a loss of the dependency exemption depending on how the child uses the money.*

Spouse as an employee. 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. For more information, see *Family Employees* in chapter 13.

Nondeductible Pay

You can't deduct wages paid for certain household work, construction work, and maintenance of your home. However, those wages may be subject to the employment taxes discussed in chapter 13.

Household workers. Do not deduct amounts paid to persons engaged in household work, except to the extent their services are used in boarding or otherwise caring for farm laborers.

Construction labor. Do not deduct wages paid to hired help for the construction of new buildings or other improvements. These wages are part of the cost of the building or other improvement. You must capitalize them.

Maintaining your home. If your farm employee spends time maintaining or repairing your home, the wages and employment taxes you pay for that work are nondeductible personal expenses. For example, assume you have a farm employee for the entire tax year and the employee spends 5% of the time maintaining your home. The employee devotes the remaining time to work on your farm. You can't deduct 5% of the wages and employment taxes you pay for that employee.

Employment Credits

Reduce your deduction for wages by the amount of any employment credits you claim such as the work opportunity credit (Form 5884).

Repairs and Maintenance

You can deduct most expenses for the repair and maintenance of your farm property. Common items of repair and maintenance are repainting, sealing cracks or replacing broken windows on a farm building, and routine maintenance of trucks, tractors, and other farm machinery. However, expenses for improvements to depreciable property are generally capital expenditures. Amounts are paid for improvements if they are for the betterment of your property, are for a restoration of your property, such as the replacement of major components and substantial structural parts, or if your expenditures adapt your property to a new or different use. For example, if you replace a few shingles on the barn roof, these expenses are generally deductible as repairs and maintenance. If you replace (not repair) the entire barn roof with a new roof, then this expense is generally a capital expenditure.

For more information, see *Capital Expenses*, later.

Under certain conditions, you can elect to capitalize amounts paid for repair and maintenance. See Regulations section 1.263(a)3(n) for more information.

Interest

There may be a limit on the amount you can deduct as farming business interest paid or accrued during the tax year related to your farming business, such as for farm mortgages and other farm obligations. However, a small business taxpayer is not subject to the business interest expense limitation and is not required to file Form 8990. A small business taxpayer is a taxpayer that is not a tax shelter (as defined in section 448(d)(3)) and has average annual gross receipts of $29 million or less for the 3 prior tax years under the gross receipts test of section 448(c). Gross receipts include the aggregate gross receipts from all persons treated as a single employer, such as a controlled group of corporations, commonly controlled partnerships or proprietorships, and affiliated service groups.

The gross receipts test of section 448(c) applies only to corporations and partnerships, but for purposes of the business interest limitation the gross receipts test applies to individuals as if they were corporations or partnerships. Thus, any individual with a farming trade or business operating as a sole proprietorship is subject to the gross receipts test.

Certain businesses subject to the business interest expense limitation may elect out of the limitation. Certain farming businesses and specified agricultural or horticultural cooperatives (as defined in section 199A(g)(4)) qualify to make an election not to limit business interest expenses. This is an irrevocable election. If you make this election, you are required to use the alternative depreciation system (ADS), discussed later in chapter 7, to depreciate any farming property with a recovery period of 10 years or more. Also, you are not entitled to the special depreciation allowance for that property. For an individual with more than one qualifying business, the election is made with respect to each business. If you are required to limit your business interest expense, the amount you cannot deduct for the tax year is generally carried forward to the next tax year. However, there are special rules for partnership treatment of disallowed business interest. See the Instructions for Form 8990 for more information.

Subject to the preceding rules, and assuming other limitations do not apply, you can deduct as a farm business expense interest paid or accrued during the tax year related to your farming business, such as for farm mortgages and other farm obligations.

Cash method. If you use the cash method of accounting, you can generally deduct interest paid during the tax year. You can't deduct interest paid with funds received from the original lender through another loan, advance, or other arrangement similar to a loan. You can, however, deduct the interest when you start making payments on the new loan. For more information, see *Cash Method* in chapter 2.

Prepaid interest. Under the cash method, you generally can't deduct any interest paid before the year it is due. Interest paid in advance may be deducted only in the tax year in which it is due.

Accrual method. If you use an accrual method of accounting, you can deduct only interest that has accrued during the tax year. However, you can't deduct interest owed to a related person who uses the cash method until payment is made and the interest is includible in the gross income of that person.

For more information, see *Accrual Method* in chapter 2.

Allocation of interest. If you use the proceeds of a loan for more than one purpose, you must allocate the interest on that loan to each use. Allocate the interest to the following categories.

- Trade or business interest.
- Passive activity interest.
- Investment interest.
- Portfolio interest.
- Personal interest.

You generally allocate interest on a loan the same way you allocate the loan proceeds. You allocate loan proceeds by tracing disbursements to specific uses.

TIP *The easiest way to trace disbursements to specific uses is to* *keep the proceeds of a particular loan separate from any other funds.*

Secured loan. The allocation of loan proceeds and the related interest is generally not affected by the use of property that secures the loan.

Example. You secure a loan with property used in your farming business. You use the loan proceeds to buy a car for personal use. You must allocate interest expense on the loan to personal use (purchase of the car) even though the loan is secured by farm business property.

Allocation period. The period for which a loan is allocated to a particular use begins on the date the proceeds are used and ends on the earlier of the following dates.

- The date the loan is repaid.
- The date the loan is reallocated to another use.

More information. For more information on interest, see chapter 8 of Pub. 334.

Breeding Fees

You can generally deduct breeding fees as a farm business expense. However, if the breeder guarantees live offspring as a result of the breeding or other veterinary procedure, you must capitalize these costs as the cost basis of the offspring. Also, if you use an accrual method of accounting, you must capitalize breeding fees and allocate them to the cost basis of the calf, foal, etc. For more information on who must use an accrual method of accounting, see *Accrual Method Required* under *Accounting Methods* in chapter 2.

Fertilizer and Lime

You can deduct in the year paid or incurred the cost of fertilizer, lime, and other materials applied to farmland to enrich, neutralize, or condition it if the benefits last a year or less.

You can also deduct the cost of applying these materials in the year you pay or incur it. However, see *Prepaid Farm Supplies*, earlier, for a rule that may limit your deduction for these materials.

If the benefits of the fertilizer, lime, or other materials last substantially more than 1 year, you generally capitalize their cost and deduct a part each year the benefits last. However, you can choose to deduct these expenses in the year paid or incurred. If you make this choice, you will need IRS approval if you later decide to capitalize the cost of previously deducted items. If you sell farmland on which fertilizer or lime has been applied and if the selling price of the land includes part or all of the cost of the fertilizer or lime, you report the sale amount attributable to the fertilizer or lime as ordinary income. See section 180 for more information.

Farmland, for these purposes, is land used for producing crops, fruits, or other agricultural products or for sustaining livestock. It doesn't include land you have never used previously for producing crops or sustaining livestock. You can't deduct initial land preparation costs. (See *Capital Expenses*, later.)

Include government payments you receive for lime or fertilizer in income. See *Fertilizer and Lime* under *Agricultural Program Payments* in chapter 3.

Taxes

You can deduct as a farm business expense the real estate and personal property taxes on farm business assets, such as farm equipment, animals, farmland, and farm buildings. You can also deduct the social security and Medicare taxes you pay to match the amount withheld from the wages of farm employees and any federal unemployment tax you pay. For information on employment taxes, see chapter 13.

Allocation of taxes. The taxes on the part of your farm you use as your home (including the furnishings and surrounding land not used for farming) are nonbusiness taxes. You may be able to deduct these nonbusiness taxes as itemized deductions on Schedule A (Form 1040). To determine the nonbusiness part, allocate the taxes between the farm assets and nonbusiness assets. The allocation can be done from the assessed valuations. If your tax statement doesn't show the assessed valuations, you can usually get them from the tax assessor.

State and local general sales taxes. State and local general sales taxes on nondepreciable farm business expense items are deductible as part of the cost of those items. Include state and local general sales taxes imposed on the purchase of assets for use in your farm business as part of the cost you depreciate. Also treat the taxes as part of your cost if they are imposed on the seller and passed on to you.

State and federal income taxes. Individuals can't deduct state and federal income taxes as farm business expenses. Individuals can deduct state and local income taxes only as an itemized deduction on Schedule A (Form 1040). For tax years after 2017 and before 2026, the Schedule A (Form 1040) deduction for combined state and local income and property taxes is limited to $10,000 ($5,000 if married filing separately). However, you can't deduct federal income tax.

Highway use tax. You can deduct the federal use tax on highway motor vehicles paid on a truck or truck tractor used in your farm business. For information on the tax itself, including information on vehicles subject to the tax, see the Instructions for Form 2290.

Self-employment tax. You cannot deduct the self-employment tax you pay as a farm business expense. However, you can deduct as an adjustment to income on Schedule 1 (Form 1040), line 15, one-half of your self-employment tax in figuring your adjusted gross income. For more information, see chapter 12.

Insurance

You can generally deduct the ordinary and necessary cost of insurance for your farm business as a business expense. This includes premiums you pay for the following types of insurance.

- Fire, storm, crop, theft, liability, and other insurance on farm business assets.
- Health and accident insurance on your farm employees.
- Workers' compensation insurance set by state law that covers any claims for job-related bodily injuries or diseases suffered

by employees on your farm, regardless of fault.

- Business interruption insurance.
- State unemployment insurance on your farm employees (deductible as taxes if they are considered taxes under state law).

Insurance to secure a loan. If you take out a policy on your life or on the life of another person with a financial interest in your farm business to get or protect a business loan, you can't deduct the premiums as a business expense. In the event of death, the proceeds of the policy aren't taxed as income even if they are used to liquidate the debt.

Advance premiums. Deduct advance payments of insurance premiums only in the year to which they apply, regardless of your accounting method.

Example. On June 29, 2023, you paid a premium of $3,000 for fire insurance on your barn. The policy will cover a period of 3 years beginning on July 1, 2023. Only the cost for the 6 months in 2023 is deductible as an insurance expense on your 2023 calendar year tax return. Deduct $500, which is the premium for 6 months of the 36-month premium period, or 6/36 of $3,000. In both 2024 and 2025, deduct $1,000 (12/36 of $3,000). Deduct the remaining $500 in 2026. Had the policy been effective on January 1, 2023, the deductible expense would have been $1,000 for each of the years 2023, 2024, and 2025, based on one-third of the premium used each year.

Business interruption insurance. Use and occupancy and business interruption insurance premiums are deductible as a business expense. This insurance pays for lost profits if your business is shut down due to a fire or other cause. Report any proceeds in full on Schedule F, Part I.

Self-employed health insurance deduction. If you are self-employed, you can deduct as an adjustment to income on Schedule 1 (Form 1040) your payments for medical, dental, and qualified long-term care insurance coverage for yourself (including Medicare premiums), your spouse, and your dependents when figuring your adjusted gross income on your Schedule 1 (Form 1040). The insurance can also cover any child of yours under age 27 at the end of 2023, even if the child was not your dependent. Generally, this deduction can't be more than the net profit from the business under which the plan was established.

If you or your spouse is also an employee of another person, you can't take the deduction for any month in which you are eligible to participate in a subsidized health plan maintained by your employer or your spouse's employer.

Generally, use the *Self-Employed Health Insurance Deduction Worksheet* in the Instructions for Schedule 1 (Form 1040) to figure your deduction. Include the remaining part of the insurance payment in your medical expenses on Schedule A (Form 1040) if you itemize your deductions.

For more information, see *Deductible Premiums* in chapter 8 of Pub. 334.

Rent and Leasing

If you lease property for use in your farm business, you can generally deduct the rent you pay on Schedule F. However, you can't deduct rent you pay in crop shares if you deduct the cost of raising the crops as farm expenses.

Advance payments. Deduct advance payments of rent only in the year to which they apply, regardless of your accounting method.

Farm home. If you rent a farm, don't deduct the part of the rental expense that represents the fair rental value of the farm home in which you live.

Lease or Purchase

If you lease a farm building or equipment, you must determine whether or not the agreement must be treated as a conditional sales contract rather than a lease. If the agreement is treated as a conditional sales contract, the payments under the agreement (so far as they don't represent interest or other charges) are payments for the purchase of the property. Do not deduct these payments as rent, but capitalize the cost of the property and recover this cost through depreciation.

Conditional sales contract. Whether an agreement is a conditional sales contract depends on the **intent** of the parties. Determine intent based on the provisions of the agreement and the facts and circumstances that exist when you make the agreement. No single test, or special combination of tests, always applies. However, in general, an agreement may be considered a conditional sales contract rather than a lease if any of the following is true.

- 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 may exercise the option. Determine this value 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.

Example. You lease new farm equipment from a dealer who both sells and leases. The agreement includes an option to purchase the equipment for a specified price. The lease payments and the specified option price equal the sales price of the equipment plus interest. Under the agreement, you are responsible for maintenance, repairs, and the risk of loss. For federal income tax purposes, the agreement is a conditional sales contract. You can't deduct any of the lease payments as rent. You can deduct interest, repairs, insurance, depreciation, and other expenses related to the equipment.

Motor vehicle leases. Special rules apply to lease agreements that have a terminal rental adjustment clause. In general, this is a clause that provides for a rental price adjustment based on the amount the lessor is able to sell the vehicle for at the end of the lease. If your rental agreement contains a terminal rental adjustment clause, treat the agreement as a lease if the agreement otherwise qualifies as a lease. For more information, see section 7701(h).

Leveraged leases. Special rules apply to leveraged leases of equipment (arrangements in which the equipment is financed by a nonrecourse loan from a third party). For more information, see Revenue Procedure 200128, which begins on page 1156 of

Internal Revenue Bulletin 200119 at *IRS.gov/pub/irs-irbs/irb0119.pdf*.

Depreciation

If property you acquire to use in your farm business is expected to last more than 1 year, you generally can't deduct the entire cost in the year you acquire it. You must recover the cost over more than 1 year and deduct part of it each year on Schedule F as depreciation or amortization. However, you can choose to deduct part or all of the cost of certain qualifying property, up to a limit, as a section 179 deduction or special depreciation in the year you place it in service.

Depreciation, amortization, and the section 179 deduction are discussed in chapter 7.

Business Use of Your Home

You can deduct expenses for the business use of your home if you use part of your home exclusively and regularly:

- As the principal place of business for any trade or business in which you engage;
- As a place to meet or deal with patients, clients, or customers in the normal course of your trade or business; or
- In connection with your trade or business, if you are using a separate structure that isn't attached to your home.

Your home office will qualify as your principal place of business for deducting expenses for its use if you meet both of the following requirements.

- You use it exclusively and regularly for the administrative or management activities of your trade or business.
- You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

If you use part of your home for business, you must divide the expenses of operating your home between personal and business use.

The IRS now provides a simplified method to determine your expenses for business use of your home. For more information, see Pub. 587.

Deduction limit. If your gross income from farming equals or exceeds your total farm expenses (including expenses for the business use of your home), you can deduct all your farm expenses. But if your gross income from farming is less than your total farm expenses, your deduction for certain expenses for the use of your home in your farming business is limited.

Your deduction for otherwise nondeductible expenses, such as utilities, insurance, and depreciation (with depreciation taken last), can't be more than the gross income from farming minus the following expenses.

- The business part of expenses you could deduct even if you didn't use your home for business (such as deductible mortgage interest, real estate taxes, and casualty and theft losses).
- Farm expenses other than expenses that relate to the use of your home. If you are self-employed, don't include your deduction for half of your self-employment tax.

Deductions over the current year's limit can be carried over to your next tax year. They are subject to the deduction limit for the next tax year.

More information. See Pub. 587 for more information on deducting expenses for the business use of your home.

Telephone expense. You can't deduct the cost of basic local telephone service (including any taxes) for the first telephone line you have in your home, even if you have an office in your home. However, charges for business long-distance phone calls on that line, as well as the cost of a second line into your home used exclusively for your farm business, are deductible business expenses. Cell phone charges for calls relating to your farm business are deductible. If the cell phone you use for your farm business is part of a family cell phone plan, you must allocate and deduct only the portion of the charges attributable to farm business calls.

Truck and Car Expenses

You can deduct the actual cost of operating a truck or car in your farm business. Only expenses for business use are deductible. These include such items as gasoline, oil, repairs, license tags, insurance, and depreciation (subject to certain limits).

Standard mileage rate. Instead of using actual costs, under certain conditions you can use the standard mileage rate. The standard mileage rate for 2023 is 65.5 cents per mile. You can use the standard mileage rate for a car or a light truck, such as a van, pickup, or SUV, you own or lease.

You can't use the standard mileage rate if you operate five or more cars or light trucks at the same time. You aren't using five or more vehicles at the same time if you alternate using the vehicles (you use them at different times) for business.

Example. You own a car and four pickup trucks that are used in your farm business. Your farm employees use the trucks and you use the car for business. You can't use the standard mileage rate for the car or the trucks. This is because all five vehicles are used in your farm business at the same time. You must use actual expenses for all vehicles.

Business use percentage. You can claim 75% of the use of a car or light truck as business use without any allocation records if you used the vehicle during most of the normal business day directly in connection with the business of farming. You choose this method of substantiating business use the first year the vehicle is placed in service. Once you make this choice, you may not change to another method later. The following are uses directly connected with the business of farming.

- Cultivating land.
- Raising or harvesting any agricultural or horticultural commodity.
- Raising, shearing, feeding, caring for, training, and managing animals.
- Driving to the feed or supply store.

If you keep records and they show that your business use was more than 75%, you may be able to claim more. See *Recordkeeping requirements* under *Travel Expenses*, later.

More information. For more information on deductible truck and car expenses and disposition of truck or car in reference, see chapter 4 of Pub. 463. If you pay your employees for the use of their truck or car in your farm business, see *Reimbursements to employees* under *Travel Expenses* next.

Travel Expenses

You can deduct ordinary and necessary expenses you incur while traveling away from home for your farm business. You can't deduct lavish or extravagant expenses. Usually, the location of your farm business is considered your home for tax purposes. You are traveling away from home if:

- Your duties require you to be absent from your farm substantially longer than an ordinary workday, and
- You need to get sleep or rest to meet the demands of your work while away from home.

If you meet these requirements and can prove the time, place, and business purpose of your travel, you can deduct your ordinary and necessary travel expenses.

The following are some types of deductible travel expenses.

- Air, rail, bus, and car transportation.
- Meals and lodging.
- Dry cleaning and laundry.
- Telephone and fax.
- Transportation between your hotel and your temporary work or business meeting location.
- Tips for any of the above expenses.

Meals. You can deduct only 50% of your nonentertainment business-related meal expenses. You can deduct the cost of your meals while traveling on business only if your business trip is overnight or long enough to require you to stop for sleep or rest to properly perform your duties. You can't deduct any of the cost of meals if it isn't necessary for you to rest. For information on entertainment expenses, see chapter 2 of Pub. 463.

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.

Note. No deduction is allowed for certain entertainment expenses, membership dues, and facilities used in connection with these activities for amounts paid or incurred after December 31, 2017. See section 274, as amended by the Tax Cuts and Jobs Act, section 13304.

Recordkeeping requirements. You must be able to prove your deductions for travel by adequate records or other evidence that will support your own statement. Estimates or approximations don't qualify as proof of an expense.

You should keep an account book or similar record, supported by adequate documentary evidence, such as receipts, that together support each element of an expense. Generally, it is best to record the expense and get documentation of it at the time you pay it.

If you choose to deduct a standard meal allowance rather than the actual expense, you don't have to keep records to prove amounts spent for meals and incidental items. However, you must still keep records to prove the actual amount of other travel expenses, and the time, place, and business purpose of your travel.

More information. For detailed information on travel, recordkeeping, and the standard meal allowance, see Pub. 463.

Reimbursements to employees. You can generally deduct reimbursements you pay to your employees for travel and transportation expenses they incur in the conduct of your business. Employees may be reimbursed under an accountable or nonaccountable plan. Under an accountable plan, the employee must provide evidence of expenses. Under a nonaccountable plan, no evidence of expenses is required. If you reimburse expenses under an accountable plan, deduct them as travel and transportation expenses. If you reimburse expenses under a nonaccountable plan, you must report the reimbursements as wages on Form W-2 and deduct them as wages. For more information, see chapter 8 of Pub. 334.

Marketing Quota Penalties

You can deduct as *Other expenses* on Schedule F penalties you pay for marketing crops in excess of farm marketing quotas. However, if you don't pay the penalty, but instead the purchaser of your crop deducts it from the payment to you, include in gross income only the amount you received. Do not take a separate deduction for the penalty.

Tenant House Expenses

You can deduct the costs of maintaining houses and their furnishings for tenants or hired help as farm business expenses. These costs include repairs, utilities, insurance, and depreciation.

The value of a dwelling you furnish to a tenant under the usual tenant-farmer arrangement isn't taxable income to the tenant.

Items Purchased for Resale

If you use the cash method of accounting, you ordinarily deduct the cost of livestock and other items purchased for resale only in the year of sale. You deduct this cost, including freight charges for transporting the livestock to the farm, on Schedule F, Part I. However, see *Chickens, seeds, and young plants* below.

Example. You use the cash method of accounting. In 2023, you buy 50 steers you will sell in 2024. You can't deduct the cost of the steers on your 2023 tax return. You deduct their cost on your 2024 Schedule F, Part I.

Chickens, seeds, and young plants. If you are a cash method farmer, you can deduct the cost of hens and baby chicks bought for commercial egg production, or for raising and resale, as an expense on Schedule F, Part I, in the year paid if you do it consistently and it doesn't distort income. You can also deduct the cost of seeds and young plants bought for further development and cultivation before sale as an expense on Schedule F, Part I, when paid if you do this consistently and you don't figure your income on the crop method. However, see *Pre-paid Farm Supplies*, earlier, for a rule that may limit your deduction for these items.

If you deduct the cost of chickens, seeds, and young plants as an expense, report their entire selling price as income. You also can't deduct the cost from the selling price.

You can't deduct the cost of seeds and young plants for Christmas trees and timber as an expense. Capitalize the cost of these seeds and plants, and later deduct, through depletion. For more information, see *Depletion* in chapter 7.

The cost of chickens and plants used as food for your family is never deductible.

Capitalize the cost of plants with a preproductive period of more than 2 years, unless you can elect out of the uniform capitalization rules. These rules are discussed in chapter 6.

Example. You use the cash method of accounting. In 2023, you buy 500 baby chicks to raise for resale in 2024. You also buy 50 bushels of winter wheat seed in 2023 that you sow in the fall. Unless you previously adopted the method of deducting these costs in the year you sell the chickens or the harvested crops, you can deduct the cost of both the baby chicks and the seed wheat in 2023.

Election to use crop method. If you use the crop method, you can delay deducting the cost of seeds and young plants until you sell them. You must get IRS approval to use the crop method. If you follow this method, deduct the cost from the selling price to determine your profit on Schedule F, Part I.

For more information, see *Crop method* under *Special Methods of Accounting* in chapter 2.

Choosing a method. You can adopt either the crop method or the cash method for deducting the cost in the first year you buy egg-laying hens, pullets, chicks, or seeds and young plants.

Although you must use the same method for egg-laying hens, pullets, and chicks, you can use a different method for seeds and young plants. Once you use a particular method for any of these items, use it for those items until you get IRS approval to change your method. For more information, see *Change in Accounting Method* in chapter 2.

Other Expenses

The following list, while not all-inclusive, shows some expenses you can deduct as other farm expenses on Schedule F, Part II. These expenses must be for business purposes and paid, if you use the cash method of accounting; or (2) incurred, if you use an accrual method of accounting.

- Accounting fees.
- Advertising.
- Business travel and meals.
- Commissions.
- Consultant fees.
- Crop scouting expenses.
- Dues to cooperatives.
- Educational expenses (to maintain and improve farming skills).
- Farm-related attorney fees.
- Farm magazines.
- Ginning.
- Insect sprays and dusts.
- Litter and bedding.
- Livestock fees.

- Marketing fees.
- Milk assessment.
- Recordkeeping expenses.
- Service charges.
- Small tools expected to last 1 year or less.
- Stamps and stationery.
- Subscriptions to professional, technical, and trade journals that deal with farming.
- Tying material and containers.
- Utilities and Internet

De minimis safe harbor for tangible property. If you elected to use the de minimis safe harbor for tangible property for the tax year, you can deduct as a farm business expense on Schedule F amounts paid for tangible property qualifying under the de minimis safe harbor. For more information, see *Capital Expenses*, later.

Loan expenses. You prorate and deduct loan expenses, such as legal fees and commissions, you pay to get a farm loan over the term of the loan.

Tax preparation fees. You can deduct as a farm business expense on Schedule F the cost of preparing that part of your tax return relating to your farm business.

You can also deduct on Schedule F the amount you pay or incur in resolving tax issues relating to your farm business.

Capital Expenses

A capital expense is payment, or debt incurred, for the acquisition, production, or improvement of a unit of property. You include the expense in the basis of the asset. Uniform capitalization rules also require you to capitalize or include in inventory certain other expenses. See chapters 2 and 6 for more information.

Capital expenses are generally not deductible, but they may be depreciable. However, you can elect to deduct certain capital expenses, such as the following.

- The cost of fertilizer, lime, etc. (See *Fertilizer and Lime* under *Deductible Expenses*, earlier.)
- Soil and water conservation expenses. (See chapter 5.)
- The cost of property that qualifies for a deduction under section 179. (See chapter 7.)
- Business start-up costs. (See *Business start-up and organizational costs*, later.)
- Forestation and reforestation costs. (See *Forestation and reforestation costs*, later.)

Generally, the costs of the following items, including the costs of material, hired labor, and installation, are capital expenses.

1. Land and buildings.

2. Additions, alterations, and improvements to buildings, etc.

3. Cars and trucks.

4. Equipment and machinery.

5. Fences.

6. Draft, breeding, sport, and dairy livestock.

7. Repairs to machinery, equipment, trucks, and cars that prolong their useful life, increase their value, or adapt them to different use.

8. Water wells, including drilling and equipping costs.

9. Land preparation costs, such as:

    a. Clearing land for farming;

    b. Leveling and conditioning land;

    c. Purchasing and planting trees;

d. Building irrigation canals and ditches;

e. Laying irrigation pipes;

f. Installing drain tile;

g. Modifying channels or streams;

h. Constructing earthen, masonry, or concrete tanks, reservoirs, or dams; and

i. Building roads.

Business start-up and organizational costs. You can elect to deduct up to $5,000 of business start-up costs and $5,000 of organizational costs paid or incurred after October 22, 2004. The $5,000 deduction is reduced by the amount your total start-up or organizational costs exceed $50,000. Any remaining costs must be amortized. See chapter 7 for more information.

You elect to deduct start-up or organizational costs by claiming the deduction on the income tax return filed by the due date (including extensions) for the tax year in which the active trade or business begins. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Clearly indicate the election on your amended return and write “Filed pursuant to section 301.9100-2” at the top of the amended return. File the amended return at the same address you filed the original return. The election applies when figuring taxable income for the current tax year and all subsequent years.

You can choose to forgo the election by clearly electing to capitalize your start-up or organizational costs on an income tax return filed by the due date (including extensions) for the tax year in which the active trade or business begins. For more information about start-up and organizational costs, see chapter 7.

Exception for tangible real and personal property under the de minimis safe harbor. If you elect the de minimis safe harbor for your farming business for the tax year, you’re not required to capitalize the de minimis costs of acquiring or producing certain real and tangible personal property and may deduct these amounts as farm expenses on Schedule F. For more information on electing and using the de minimis safe harbor, see chapter 8 of Pub. 334.

Crop production expenses. The uniform capitalization rules generally require you to capitalize expenses incurred in producing plants. However, except for certain taxpayers required to use an accrual method of accounting, the capitalization rules don't apply to plants with a preproductive period of

2 years or less. For more information, see *Uniform Capitalization Rules* in chapter 6.

Timber. Capitalize the cost of acquiring timber. Do not include the cost of land in the cost of the timber. You must generally capitalize direct costs incurred in reforestation. However, you can elect to deduct some forestation and reforestation costs. See *Forestation and reforestation costs* next. Reforestation costs include the following.

1. Site preparation costs, such as:
   a. Girdling,
   b. Applying herbicide,
   c. Baiting rodents, and
   d. Clearing and controlling brush.
2. The cost of seed or seedlings.
3. Labor and tool expenses.

4. Depreciation on equipment used in planting or seeding.

5. Costs incurred in replanting to replace lost seedlings.

You can choose to capitalize certain indirect reforestation costs.

These capitalized amounts are your basis for the timber. Recover your basis when you sell the timber or take depletion allowances when you cut the timber. See *Depletion* in chapter 7.

Forestation and reforestation costs. You can elect to deduct up to $10,000 ($5,000 if married filing separately; $0 for a trust) of qualifying reforestation costs paid or incurred after October 22, 2004, for each qualified timber property. Any remaining costs can be amortized over an 84-month period. See chapter 7. If you make an election to deduct or amortize qualifying reforestation costs, you should create and maintain separate timber accounts for each qualified timber property. The accounts should include all reforestation treatments and the dates they were applied. Any qualified timber property that is subject to the deduction or amortization election can't be included in any other timber account for which depletion is allowed. The timber account should be maintained until the timber is disposed of. For more information, see Notice 2006-47, 2006-20 I.R.B. 892, available at *IRS.gov/irb/2006-20_IRB/ar11.html*.

You elect to deduct forestation and reforestation costs by claiming the deduction on the income tax return filed by the due date (including extensions) for the tax year in which the expenses were paid or incurred. If you are filing Form T (Timber), Forest Activities Schedule, also complete Form T (Timber), Part IV. If you aren't filing Form T (Timber), attach a statement to your return with the following information.

- The unique stand identification numbers.

- The total number of acres reforested during the tax year.
- The nature of the reforestation treatments.
- The total amounts of the qualified reforestation expenditures eligible to be amortized or deducted.

However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Clearly indicate the election on your amended return and write “Filed pursuant to section 301.9100-2” at the top of the amended return. File the amended return at the same address you filed the original return.

For more information about forestation and reforestation costs, see chapter 7.

For more information about timber, the Agriculture Handbook Number 731, *Form T (Timber)*, and the *Hardwood Industry Audit Technique Guide*.

Christmas tree cultivation. If you are in the business of planting and cultivating Christmas trees to sell when they are more than 6 years old, capitalize expenses incurred for planting and stump culture and add them to the basis of the standing trees. Recover these expenses as part of your adjusted basis when you sell the standing trees or as depletion allowances when you cut the trees. For more information, see *Timber Depletion* under *Depletion* in chapter 7.

You can deduct as business expenses the costs incurred for shearing and basal pruning of these trees. Expenses incurred for silviculture practices, such as weeding or cleaning, and noncommercial thinning are also deductible as business expenses.

Capitalize the cost of land improvements, such as road grading, ditching, and fire breaks, that have a useful life beyond the tax year. If the improvements don't have a determinable useful life, add their cost to the basis of the land. The cost is recovered when you sell or otherwise dispose of it. If the improvements have a determinable useful life, recover their cost through depreciation. Capitalize the cost of equipment and other depreciable assets, such as culverts and fences, to the extent you don't use them in planting Christmas trees. Recover these costs through depreciation.

Nondeductible Expenses

You can't deduct personal expenses and certain other items on your tax return even if they relate to your farm.

Personal, Living, and Family Expenses

You can't deduct certain personal, living, and family expenses as business expenses. These include rent and insurance premiums paid on property used as your home; life insurance premiums on yourself or your family; the cost of maintaining cars, trucks, or horses for personal use; allowances to minor children; attorneys' fees and legal expenses incurred in personal matters; and household expenses. Likewise, the cost of purchasing or raising produce or livestock consumed by you or your family isn't deductible.

Other Nondeductible Items

You can't deduct the following items on your tax return.

Loss of growing plants, produce, and crops. Losses of plants, produce, and crops raised for sale are generally not deductible.

However, you may have a deductible loss on plants with a preproductive period of more than 2 years. See chapter 11 for more information.

Repayment of loans. You can't deduct the repayment of a loan. However, if you use the proceeds of a loan for farm business expenses, you can deduct the interest on the loan. See *Interest*, earlier.

Estate, inheritance, legacy, succession, and gift taxes. You can't deduct estate, inheritance, legacy, succession, and gift taxes.

Loss of livestock. You can't deduct as a loss the value of raised livestock that die if you deducted the cost of raising them as an expense.

Losses from sales or exchanges between related persons. You can't deduct losses from sales or exchanges of property between you and certain related persons, including your spouse, brother, sister, ancestor, or lineal descendant. For more information, see chapter 2 of Pub. 544.

Cost of raising unharvested crops. You can't deduct the cost of raising unharvested crops sold with land owned more than 1 year if you sell both at the same time and to the same person. Add these costs to the basis of the land to determine the gain or loss on the sale. For more information, see *Section 1231 Gains and Losses* in chapter 9.

Cost of unharvested crops bought with land. Capitalize the purchase price of land, including the cost allocable to unharvested crops. You can't deduct the cost of the crops at the time of purchase. However, you can deduct this cost in figuring net profit or loss in the tax year you sell the crops.

Cost related to gifts. You can't deduct costs related to your gifts of agricultural products or property held for sale in the ordinary course of your business. The costs aren't deductible in the year of the gift or any later year. For example, you can't deduct the cost of raising cattle or the cost of planting and raising unharvested wheat on parcels of land given as a gift to your children.

Club dues and membership fees. Generally, you can't deduct amounts you pay or incur for membership in any club organized for business, pleasure, recreation, or any other social purpose. This includes country clubs, golf and athletic clubs, hotel clubs, sporting clubs, airline clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

Exception. The following organizations won't be treated as a club organized for business, pleasure, recreation, or other social purposes, unless one of its main purposes is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities.

- Boards of trade.
- Business leagues.
- Chambers of commerce.
- Civic or public service organizations.
- Professional associations.
- Trade associations.
- Real estate boards.

Fines and penalties. Generally, no deduction is allowed for fines and penalties paid to a government or specified nongovernmental entity for the violation of any law except:

- Amounts that constitute restitution,
- Amount paid to come into compliance with the law,
- Amounts paid or incurred as the result of certain court orders in which no

government or specified non-governmental agency is a party, and

- Amounts paid or incurred for taxes due.

On or after December 22, 2017, no deduction is allowed for the restitution amount or amount paid to come into compliance with the law unless the amounts are specifically identified in the settlement agreement or court order. Also, any amount paid or incurred as reimbursement to the government for the costs of any investigation or litigation are not eligible for the exceptions and are nondeductible.

See section 162(f), as amended by the Tax Cuts and Jobs Act, section 13306.

For the deductibility of penalites for exceeding marketing quotas, see *Marketing Quota Penalties*, discussed earlier.

Losses From Operating a Farm

If your deductible farm expenses are more than your farm income, you have a loss from the operation of your farm. The amount of the loss you can deduct when figuring your taxable income may be limited. To figure your deductible loss, you must apply the following limits.

- The at-risk limits.
- The passive activity limits.

The following discussions explain these limits.

If your deductible loss after applying these limits is more than your other income for the year, you may have a net operating loss. See Pub. 536.

If you don't carry on your farming activity to make a profit, your loss deduction may be limited by the not-for-profit rules. See Not-for-Profit Farming*, later.*

At-Risk Limits

The at-risk rules limit your deduction for losses from most business or income-producing activities, including farming. These rules limit the losses you can deduct when figuring your taxable income. The deductible loss from an activity is limited to the amount you have at risk in the activity.

You are at risk in any activity for:

1. The money and adjusted basis of property you contribute to the activity; and
2. Amounts you borrow for use in the activity if:
    a. You are personally liable for repayment, or
    b. You pledge property (other than property used in the activity) as security for the loan.

You aren't at risk, however, for amounts you borrow for use in a farming activity from a person who has an interest in the activity (other than as a creditor) or a person related to someone (other than you) having such an interest.

For more information, see Pub. 925.

Passive Activity Limits

A passive activity is generally any activity involving the conduct of any trade or business in which you don't materially participate. Generally, a rental activity is a passive activity.

If you have a passive activity, special rules limit the loss you can deduct in the tax year. You can generally deduct losses from passive activities only up to income from passive activities. Credits are similarly limited.

For more information, see Pub. 925.

Excess Business Loss Limitation

Noncorporate taxpayers may be subject to excess business loss limitations. The at-risk limits and the passive activity limits are applied before calculating the amount of any excess business loss. An excess business loss is the amount by which the total deductions attributable to all of your trades or businesses exceed your total gross income and gains attributable to those trades or businesses plus $289,000 (or $578,000 in the case of a joint return). Business gains and losses reported on Form 4797 and Form 8949 are included in the excess business loss calculation. This includes farming losses from casualty losses or losses by reason of disease or drought. Excess business losses that are disallowed are treated as a net operating loss carryover to the following tax year. See Form 461 and its instructions for details.

Taxpayers with losses from a farming business must apply the excess business loss limitation before carrying any net operating losses back 2 years. See the Instructions for Form 1045, Application for Tentative Refund.

If you incur both farming and nonfarming business losses that are more than the threshold amount you must allocate the threshold amount first to the farming losses to the extent you have a net operating loss.

Excess farm losses that are disallowed can be carried forward to the next tax year and treated as a net operating loss deduction from that year.

Net Operating Loss Limitation

If you have a 2023 net operating loss attributable to farming, you must carry it back two years, unless you elect to forgo the carryback. Farming businesses can elect to forgo the carryback and carry forward the farm net operating loss to a later year. See the Instructions for Form 1045 or Form 1138 for more information.

Not-for-Profit Farming

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 don't carry on your farming activity, or other activity you engage or invest in, to make a profit, you report the income from the activity on Schedule 1 (Form 1040), line 8i. You can no longer deduct expenses of carrying on the activity, even if you itemize your deductions on Schedule A (Form 1040).

Expenses for activities you do as a hobby, or mainly for sport or recreation can not be deducted. This also applies to an investment activity intended only to produce tax losses for the investors.

The deductibility of not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It doesn't apply to corporations other than S corporations.

In determining whether you are carrying on your farming activity for profit, all the facts are taken into account. No one factor alone is decisive. Among the factors to consider are whether:

- You operate your farm in a businesslike manner;
- The time and effort you spend on farming indicate you intend to make it profitable;
- You depend on income from farming for your livelihood;
- Your losses are due to circumstances beyond your control or are normal in the startup phase of farming;
- You change your methods of operation in an attempt to improve profitability;
- You, or your advisors, have the knowledge needed to carry on the farming activity as a successful business;

- You were successful in making a profit in similar activities in the past;
- You make a profit from farming in some years and the amount of profit you make; and
- You can expect to make a future profit from the appreciation of the assets used in the farming activity.

Presumption of profit. Your farming or other activity is presumed carried on for profit if it produced a profit in at least 3 of the last 5 tax years, including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are presumed carried on for profit if they produced a profit in at least 2 of the last 7 tax years, including the current year. The activity must be substantially the same for each year within this period. You have a profit when the gross income from an activity is more than the deductions for it.

If a taxpayer dies before the end of the 5-year (or 7-year) period, the period ends on the date of the taxpayer's death.

If your business or investment activity passes this 3(or 2-) years-of-profit test, presume it is carried on for profit. This means the limits discussed here don't apply. You can take all your business deductions from the activity on Schedule F, even for the years that you have a loss. You can rely on this presumption in every case, unless the IRS shows it isn't valid.

If you fail the 3(or 2-) years-of-profit test, you may still be considered to operate your farm for profit by considering the factors listed earlier.

Using the presumption later. If you are starting out in farming and don't have 3 (or 2) years showing a profit, you may want to take advantage of this presumption later, after you have had the 5 (or 7) years of experience allowed by the test.

You can choose to do this by filing Form 5213. Filing this form postpones any determination that your farming activity isn't carried on for profit until 5 (or 7) years have passed since you first started farming. You must file Form 5213 within 3 years after the due date of your return for the year in which you first carried on the activity, or, if earlier, within 60 days after receiving a written notice from the IRS proposing to disallow deductions attributable to the activity.

The benefit gained by making this choice is that the IRS won't immediately question whether your farming activity is engaged in for profit. Accordingly, it won't limit your deductions. Rather, you will gain time to earn a profit in 3 (or 2) out of the first 5 (or 7) years you carry on the farming activity. If you show 3 (or 2) years of profit at the end of this period, your deductions aren't limited under these rules. If you don't have 3 (or 2) years of profit (and can't otherwise show that you operated your farm for profit), the limit applies retroactively to any year in the 5-year (or 7-year) period with a loss.

Filing Form 5213 automatically extends the period of limitations on any year in the 5-year (or 7-year) period to 2 years after the due date of the return for the last year of the period. The period is extended only for deductions of the activity and any related deductions that might be affected.

Limit on deductions and losses. If your activity isn't carried on for profit, take deductions only in the following order, only to the extent stated in the three categories.

Category 1. Deductions you can take for personal as well as for business activities are allowed in full. For individuals, all nonbusiness deductions, such as those for home mortgage interest, taxes, and casualty losses (attributable to a federally declared disaster), belong in this category. See chapter 11 for more information. For the limits that apply to mortgage interest, see Pub. 936.

Category 2. Deductions that don't result in an adjustment to the basis of property are allowed next, but only to the extent your gross income from the activity is more than the deductions you take (or could take) under the first category. Most business deductions, such as those for fertilizer, feed, insurance premiums, utilities, wages, etc., belong in this category.

Category 3. Business deductions that decrease the basis of property are allowed last, but only to the extent the gross income from the activity is more than deductions you take (or could take) under the first two categories. The deductions for depreciation, amortization, and the part of a casualty loss an individual could not deduct in category 1 belong in this category. Where more than one asset is involved, divide depreciation and these other deductions proportionally among those assets.

Partnerships and S corporations. If a partnership or S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reflected in the individual shareholder's or partner's distributive shares.

More information. For more information on not-for-profit activities, see *Not-for-Profit Activities* in chapter 9 of Pub. 334.

5.

Soil and Water Conservation Expenses

Introduction

If you are in the business of farming, you can choose to deduct certain expenses for:

- Soil or water conservation,
- Prevention of erosion of land used in farming, or
- Endangered species recovery.

Otherwise, these are capital expenses that must be added to the basis of the land. (See chapter 6 for information on determining basis.)

The deduction for conservation expenses cannot be more than 25% of your gross income from farming. See *25% Limit on Deduction*, later.

Conservation expenses for land in a foreign country do not qualify for this special treatment.

Although some expenses are not deductible as soil and water conservation expenses, they may be deductible as ordinary and necessary farm expenses. These include interest and taxes, the cost of periodically clearing brush from productive land, the regular removal of sediment from a drainage ditch, and expenses paid or incurred primarily to produce an agricultural crop that may also conserve soil.

You must include in income most government payments for approved conservation practices. However, you can exclude some payments you receive under certain cost-sharing conservation programs. For more information, see *Agricultural Program Payments* in chapter 3.

To get the full deduction to which you are entitled, you should maintain your records to clearly distinguish between *your ordinary and necessary farm business expenses and your soil and water conservation expenses.*

Topics. This chapter discusses the following.

- Business of farming,
- Plan certification,
- Conservation expenses,
- Assessment by conservation district,
- 25% limit on deduction,
- When to deduct or capitalize, and
- Sale of a farm.

Business of Farming

For purposes of soil and water conservation expenses, you are in the business of farming if you cultivate, operate, or manage a farm for profit, either as an owner or a tenant. You are not in the business of farming if you cultivate or operate a farm for recreation or pleasure, rather than for profit. You are not farming if you are engaged only in forestry or the growing of timber.

Farm defined. A farm includes livestock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards. A fish farm is an area where fish and other marine animals are grown or raised and artificially fed, protected, etc. It doesn't include an area where they are merely caught or harvested. A plant nursery is a farm for purposes of deducting soil and water conservation expenses.

Farm rental. If you own a farm and receive farm rental payments based on farm production, either in cash or crop shares, you are in the business of farming.

If you receive a fixed rental payment that is not based on farm production, you are in the business of farming only if you materially participate in operating or managing the farm.

If you get cash rental for a farm you own that is not used in farm production, you can't deduct soil and water conservation expenses for that farm.

Example. You own a farm in Iowa. You rent out the farm for $250 in cash per acre and don't materially participate in producing or managing production of the crops grown on the farm. You can't deduct your soil conservation expenses for this farm. You must capitalize the expenses and add them to the basis of the land.

For more information, see *Material participation for landlords* under *Landlord Participation in Farming* in chapter 12.

Plan Certification

You can deduct soil and water conservation expenses only if they are consistent with a plan approved by the Natural Resources Conservation Service (NRCS) of the Department of Agriculture. If no such plan exists, the expenses must be consistent with a soil conservation plan of a comparable state agency. Keep a copy of the plan with your books and records to support your deductions.

Conservation plan. A conservation plan includes the farming conservation practices approved for the area where your farmland is located. There are three types of approved plans.

- NRCS individual site plans. These plans are issued individually to farmers who request assistance from NRCS to develop a conservation plan designed specifically for their farmland.
- NRCS county plans. These plans include a listing of farm conservation practices approved for the county where the farmland is located. You can deduct expenses for conservation practices not included on the NRCS county plans only if

the practice is a part of an individual site plan.

- Comparable state agency plans. These plans are approved by state agencies and can be approved individual site plans or county plans.

A list of NRCS conservation programs is available at [*NRCS.USDA.gov/programs-initiatives*](NRCS.USDA.gov/programs-initiatives). Individual site plans can be obtained from NRCS offices and the comparable state agencies.

Conservation Expenses

You can deduct conservation expenses only for land you or your tenant are using, or have used in the past, for farming. These expenses include, but are not limited to, the following.

1. The treatment or movement of earth, such as:

    a. Leveling,

    b. Conditioning,

c. Grading,

d. Terracing,

e. Contour furrowing, and

f. Restoration of soil fertility.

2. The construction, control, and protection of:

    a. Diversion channels;

    b. Drainage ditches;

    c. Irrigation ditches;

    d. Earthen dams; and

    e. Watercourses, outlets, and ponds.

3. The eradication of brush.

4. The planting of windbreaks.

You can't deduct expenses to drain or fill wetlands, or to prepare land for center pivot irrigation systems, as soil and water conservation expenses. These expenses are added to the basis of the land.

If you choose to deduct soil and water conservation expenses, you must include as gross income any cost-sharing payments you receive for those expenses. See chapter 3 for information about payments eligible for the cost-sharing exclusion.

New farm or farmland. If you acquire a new farm or new farmland from someone who was using it in farming immediately before you acquired the land, soil and water conservation expenses you incur on it will be treated as made on land used in farming at the time the expenses were paid or incurred. You can deduct soil and water conservation expenses for this land if your use of it is substantially a continuation of its use in farming. The new farming activity doesn't have to be the same as the old farming activity. For example, if you buy land that was used for grazing cattle and then prepare it for use as an apple orchard, you can deduct your conservation expenses.

Land not used for farming. If your conservation expenses benefit both land that doesn’t qualify as land used for farming and land that does qualify, you must allocate the expenses between the two types of land. For example, if the expenses benefit 200 acres of your land, but only 120 acres of this land are used for farming, then you can deduct 60% (120 ÷ 200) of the expenses. You can use another method to allocate these expenses if you can clearly show that your method is more reasonable.

Depreciable conservation assets. You generally can't deduct your expenses for depreciable conservation assets. However, you can deduct certain amounts you pay or incur for an assessment for depreciable property that a soil and water conservation or drainage district levies against your farm. See *Assessment for Depreciable Property*, later.

You must capitalize expenses to buy, build, install, or improve depreciable structures or facilities. These expenses include those for materials, tile (including drainage tile), pipe, pumps (and other equipment), supplies, wages, fuel, hauling, and moving dirt when making or installing structures such as tanks, reservoirs, culverts, canals, dams, drainage systems, waste management systems or wells composed of masonry, concrete, tile (including drainage tile), metal, or wood. You recover your capital investment through annual allowances for depreciation.

You can deduct soil and water conservation expenses for nondepreciable earthen items. Nondepreciable earthen items include certain dams, ponds, and terraces described under *Property Having a Determinable Useful Life* in chapter 7.

Water well. You can't deduct the cost of drilling a water well for irrigation and other agricultural purposes as a soil and water conservation expense. It is a capital expense. You recover your cost through depreciation. You must also capitalize your cost for drilling a test hole. If the test hole produces no water and you continue drilling, the cost of the test hole is added to the cost of the producing well. You can recover the total cost through depreciation deductions.

If a test hole, dry hole, or dried-up well (resulting from prolonged lack of rain, for instance) is abandoned, you can deduct your unrecovered cost in the year of abandonment. Abandonment means that all economic benefits from the well are terminated. For example, filling or sealing a well excavation or casing so that all economic benefits from the well are terminated constitutes an abandonment.

Endangered species recovery expenses. If you are in the business of farming and meet other specific requirements, you can choose to deduct the conservation expenses discussed earlier as endangered species recovery expenses. Otherwise, these are capital expenses that must be added to the basis of the land.

The expenses must be paid or incurred for the purpose of achieving site-specific management actions recommended in a recovery plan approved under section 4(f) of the Endangered Species Act of 1973. See section 175 for more information.

Assessment by Conservation District

In some localities, a soil or water conservation or drainage district incurs expenses for soil or water conservation and levies an assessment against the farmers who benefit from the expenses. You can deduct as a conservation expense amounts you pay or incur for the part of an assessment that:

- Covers expenses you could deduct if you had paid them directly, or
- Covers expenses for depreciable property used in the district's business.

A water or drainage district assessment for repairs or maintenance of district property or for interest paid by the district for a loan to buy property may qualify as a business deduction. See Regulations section 1.1644(b)(1).

Assessment for Depreciable Property

You can generally deduct as a conservation expense amounts you pay or incur for the part of a conservation or drainage district assessment that covers expenses for depreciable property. This includes items such as pumps, locks, concrete structures (including dams and weir gates), draglines, and similar equipment. The depreciable property must be used in the district's soil and water conservation activities. However, the following limits apply to these assessments.

- The total assessment limit.
- The yearly assessment limit.

After you apply these limits, the amount you can deduct is added to your other conservation expenses for the year. The total for these expenses is then subject to the 25% of gross income from farming limit on the deduction, discussed later. See Table 5-1 for a brief summary of these limits.