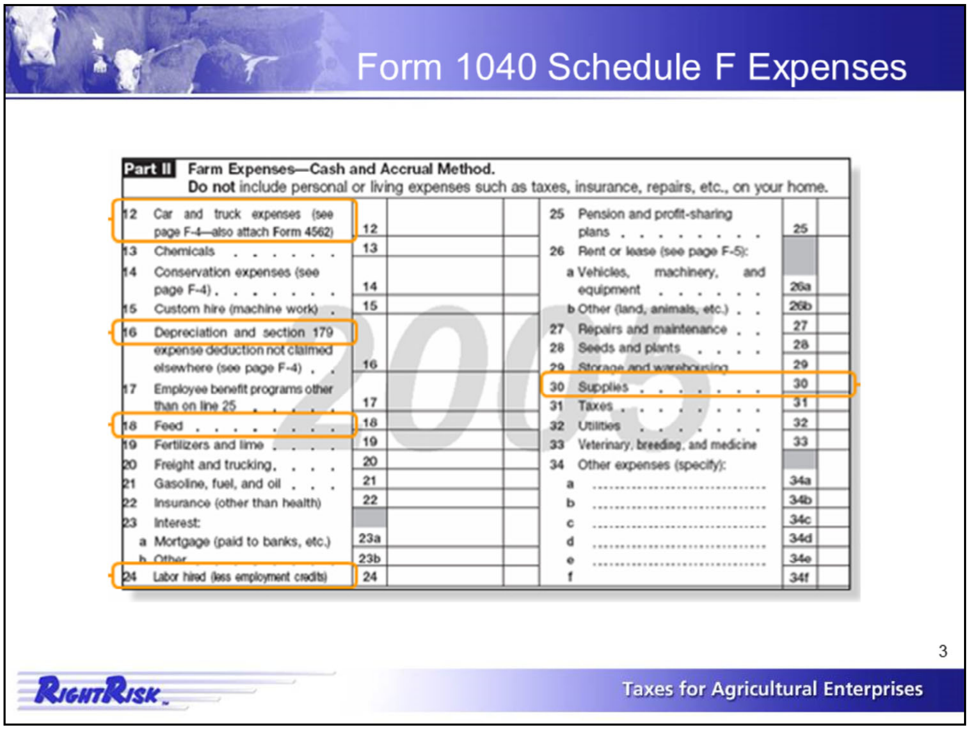
Taxes for Agricultural Enterprises

RightRisk™

Section 4: Farm Expenses

This section provides information explaining expenses that can and should be reported on the From 1040 Schedule F including car and light truck expenses, conservation expenses, prepaid livestock feed and labor. This section also discusses business use of a home, depreciation and other concerns surrounding the reporting of farm expenses.

Not all expenses are detailed in this section. Taxpayers are encouraged to view other resources and consult with their tax preparers with questions.



Farm expenses are the “ordinary and necessary costs of operating a farm or agricultural enterprise”.

Here is the farm expenses part of From 1040 Schedule F for the 2005 tax year.

Depreciation, while not a cash expense, is included as a farm expense. However, any depreciation taken in a particular year reduces the basis of appropriate assets.

Money spent on capital improvements are not considered farm expenses. Rather, such outflows of money increase the basis of applicable assets.

The business portion of the actual costs of operating a car or light truck in the farm business can be deducted. The taxpayer can claim 75% of the use of a car or light truck as business use without records if the vehicle is used during most of the normal business day directly in connection with the business of farming. This election is made the first year the vehicle is placed in service, and it cannot be changed to another method at a later time. More than 75% of such expenses can be deducted if records are kept and they show that business use was more than 75%.

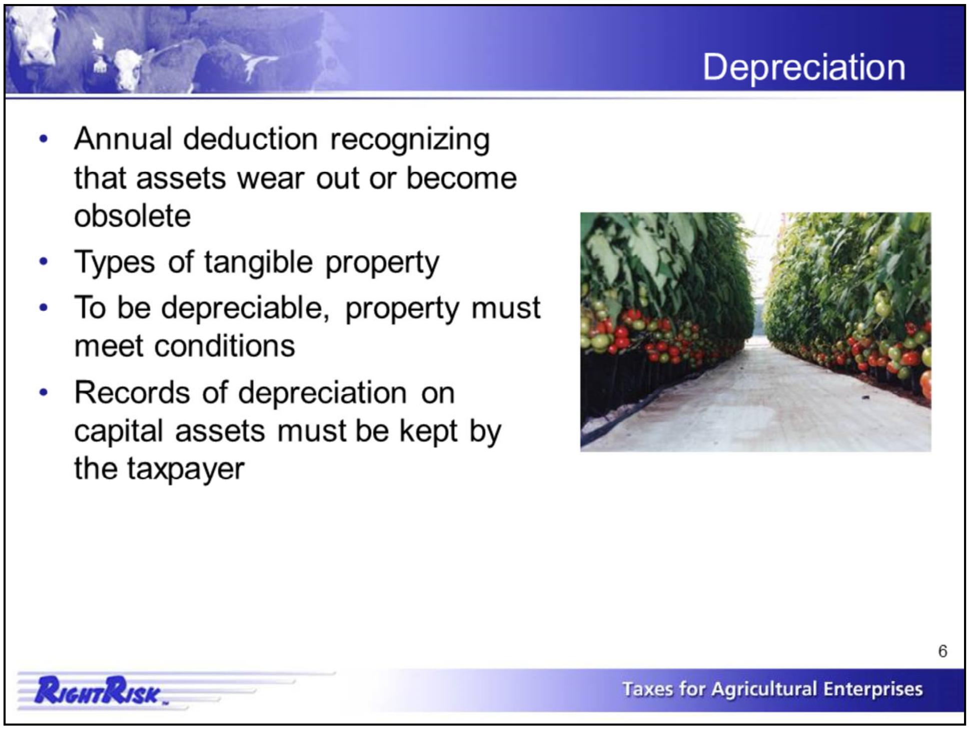
Proof can be in the form of an account book showing the dates, beginning and ending odometer readings, and purpose of the trips or a list of all direct expenses associated with operating the vehicle.

Instead of using actual costs for fuel, repairs, insurance, license tags, and depreciation, taxpayers can use the standard mileage rate.

The standard mileage rate for the cost of operating your car, van, pickup, or panel truck is 2005 is 40.5 cents a mile for all business miles driven between January 1, 2005 and September 1, 2005. The rate is 48.5 cents a mile for business miles driven after August 31, 2005.

The standard mileage rates cannot be used for a vehicle being depreciated or for which section 179 depreciation was deducted, a vehicle for hire, or when the taxpayer operates five or more cars or light trucks at the same time.

Commuting miles, those miles traveled between home and place or work, are not deductible. There are rules regarding the definition of “place of work”.



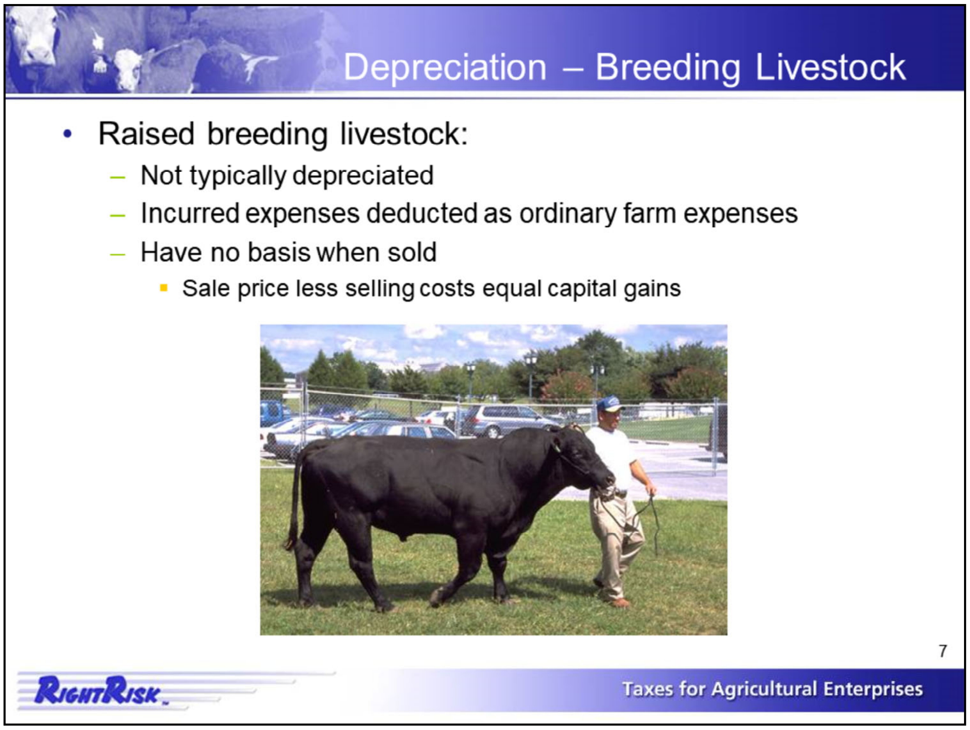
Depreciation is an annual allowance recognizing that assets wear out or become obsolete over time. Depreciation can be taken for most types of tangible property such as buildings, machinery and equipment, vehicles, livestock, and fences. There is no depreciation allowance for land.

Depreciation is a non-cash business cost. It is deductible on Form 1040 Schedule F for farm business property.

To be depreciable, property must meet these 4 conditions:

1. Be owned by the taxpayer
2. Be used in the business or income producing activity
3. Have a determinable useful life
4. Be expected to last more than one year.

Records of depreciation on capital assets must be kept by the taxpayer.



Raised breeding livestock is not typically depreciated. The expenses incurred to raise the animals are usually deducted as ordinary farm expenses in the year incurred.

Since raised breeding livestock are not usually depreciated, they have no basis when sold. This means the taxpayer pays capital gains tax on the sale price less any costs associated with selling the animals.

Depreciation Limits

- Limits
  - Passenger automobiles of < 6,000 lbs (GVW)
  - Entertainment and recreational property
  - Computers
  - Cellular telephones
  - Generally, most assets that lend themselves to personal use

8

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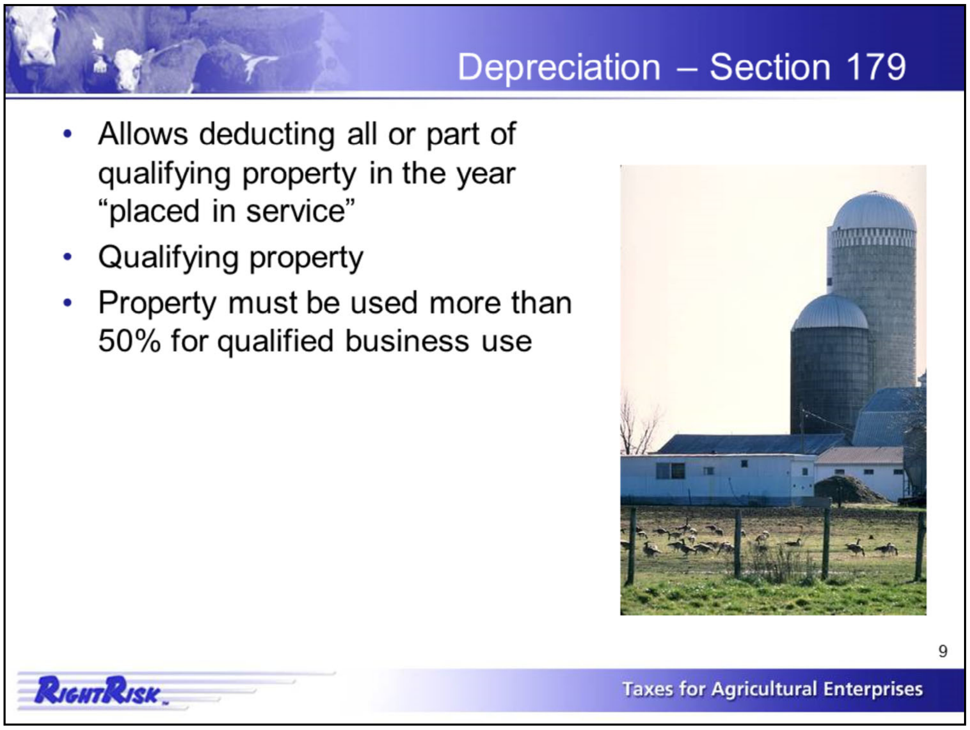
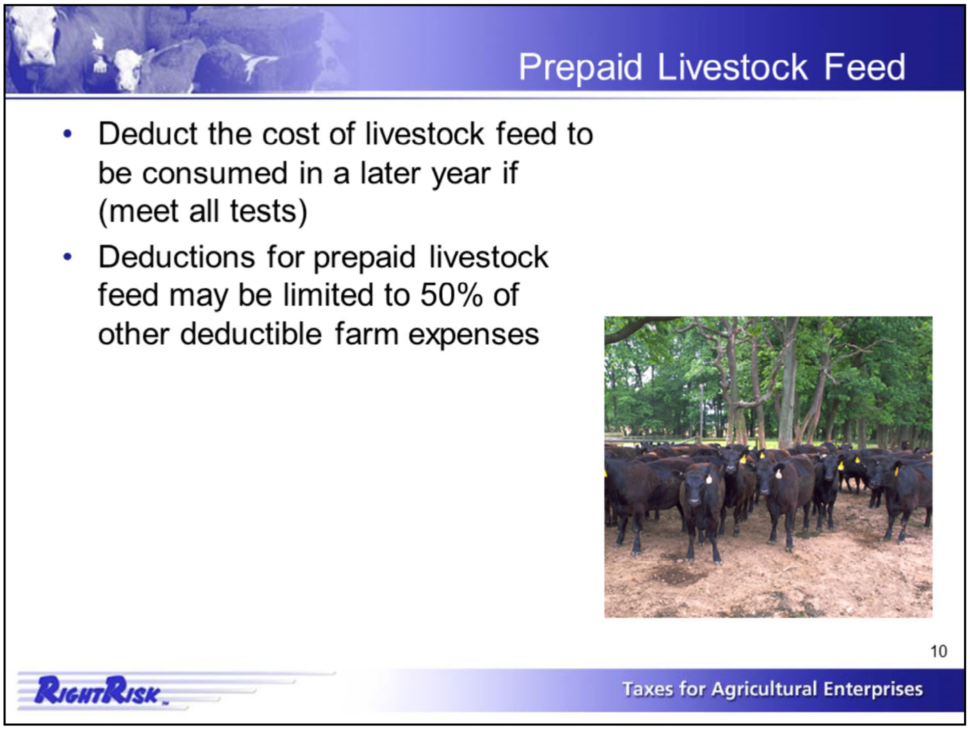
There are limits to the amount of depreciation that can be taken on certain property. Generally, such assets lend themselves to personal use. Examples include: cars and light trucks (passenger automobiles having a gross vehicle weight of less than or equal to 6,000 pounds, entertainment and recreational property, computers, and cellular telephones.



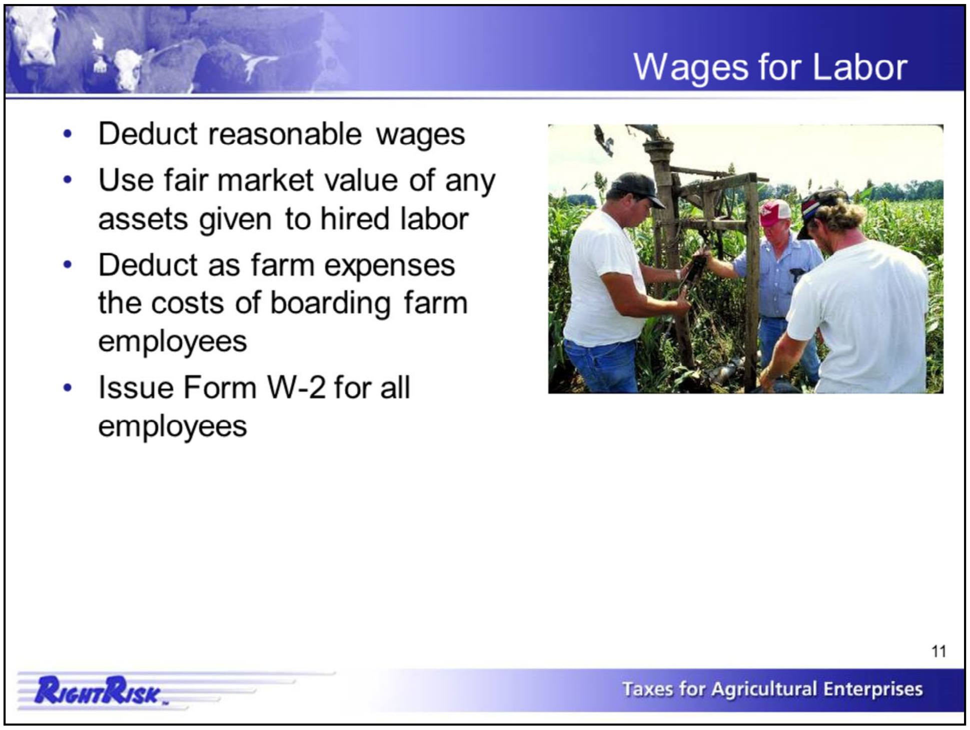
The section 179 deduction allows the recovery of all or part of the basis of certain qualifying property, up to a limit, by deducting the basis in the year in which the property is placed in service. The taxpayer can elect either the section 179 deduction or to recover the property's costs by taking ordinary depreciation deductions.

To qualify for the section 179 deduction, the property must be eligible property, must be acquired for business use (at least 50% for business), and it must have been acquired by purchase.



Livestock feed is normally considered a farm expense in the year it was purchased.

Sometimes a livestock producer will prepay for livestock feed. Expenditures for prepaid livestock feed can be deducted in the year of purchase if the farmer uses the cash method of accounting and 1) the payment is for the purchase of feed rather than a deposit, 2) the prepayment has a business purpose and not merely for tax avoidance, and 3) deducting the prepayment does not materially distort income. Furthermore, deductions for prepaid livestock feed may be limited to 50% of other deductible farm expenses. This limit is similar to that for prepaid supplies expense.



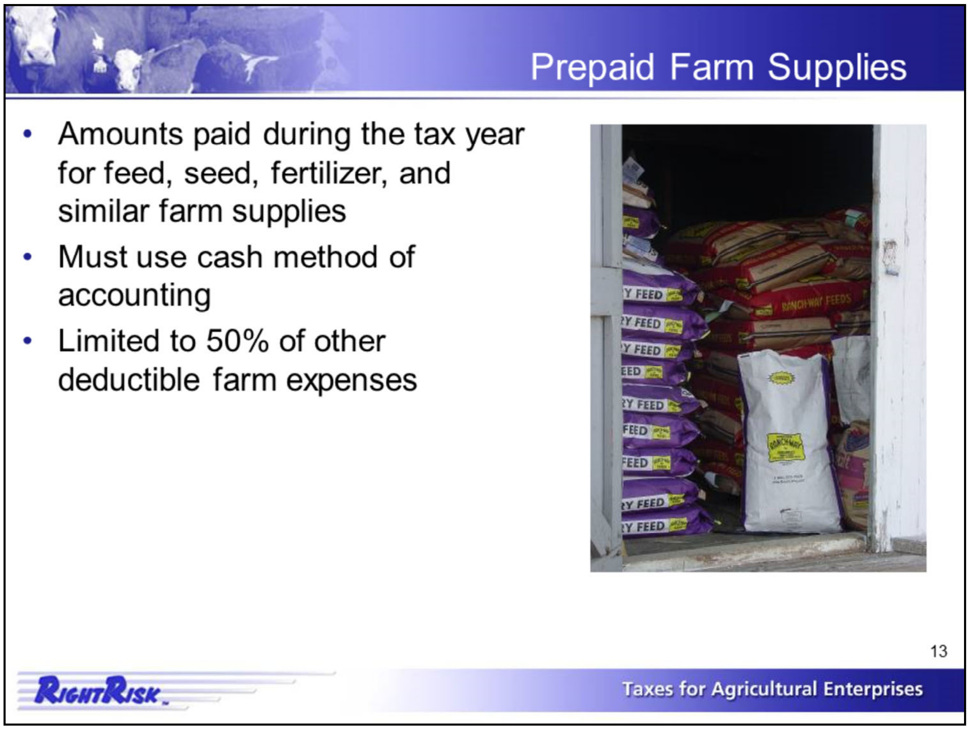
Reasonable wages for regular farm labor, piecework, contract labor, and other forms of labor hired to perform farming operations can be deducted.

Wages can be paid in cash or non-cash items such as inventory, capital assets, or assets used in the business. If property is transferred to an employee in payment of services, the fair market value of the property on the date of transfer can be deducted as wages. The cost of boarding farm labor is a deductible labor expense.

A Form W-2 must be issued to each employee receiving wages.

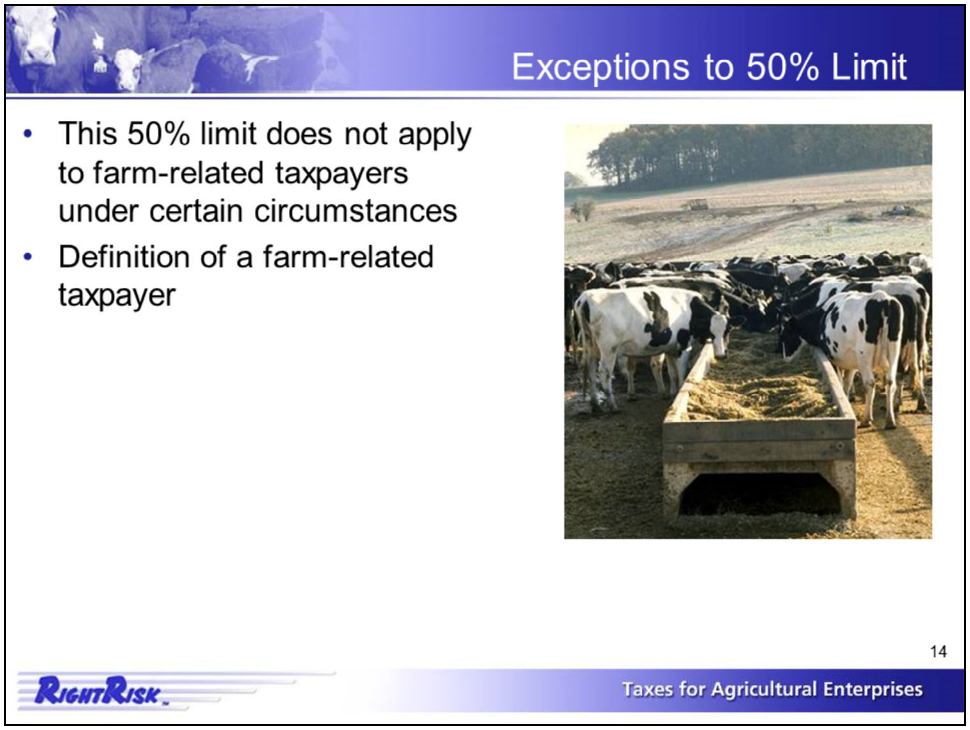
There are specific differences between contract labor expenses and employee wages. The costs of custom work, machine hire, and independent contractors should be entered as "custom hire" on Schedule F. Such expenses are not subject to social security and Medicare taxes. Furthermore, a 1099-MISC should be filed for each individual receiving compensation for $600 or more for custom work and machine hire or working as an independent contractor.

Wages paid to hired help for the construction of new buildings or other improvements are not deductible in the year paid. Such wages are part of the cost of the building or other improvement. You must capitalize them.



Prepaid farm supplies are amounts paid during the tax year for seed, fertilizer, and similar farm supplies not used nor consumed during the year. It does not include amounts paid for farm supplies that would have been consumed if not for fire, storm, flood, other casualty, disease, or drought.

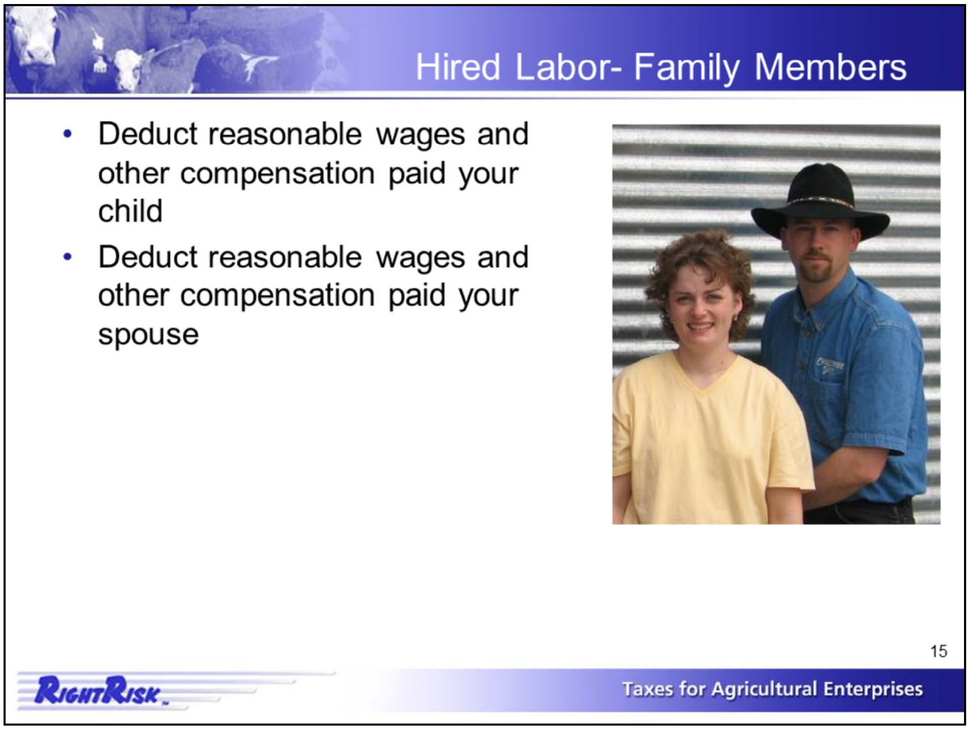
Under the cash method of accounting, deductions for prepaid farm supplies may be limited to 50% of other deductible farm expenses.



This 50% limit does not apply to farm-related taxpayers and if either:

- •Prepaid farm supplies expense is more than 50% of other deductible farm expenses because of a change in business operations caused by unusual circumstances or
- •Total prepaid farm supplies expense for the preceding three tax year is less than 50% of total other deductible farm expenses in those three years

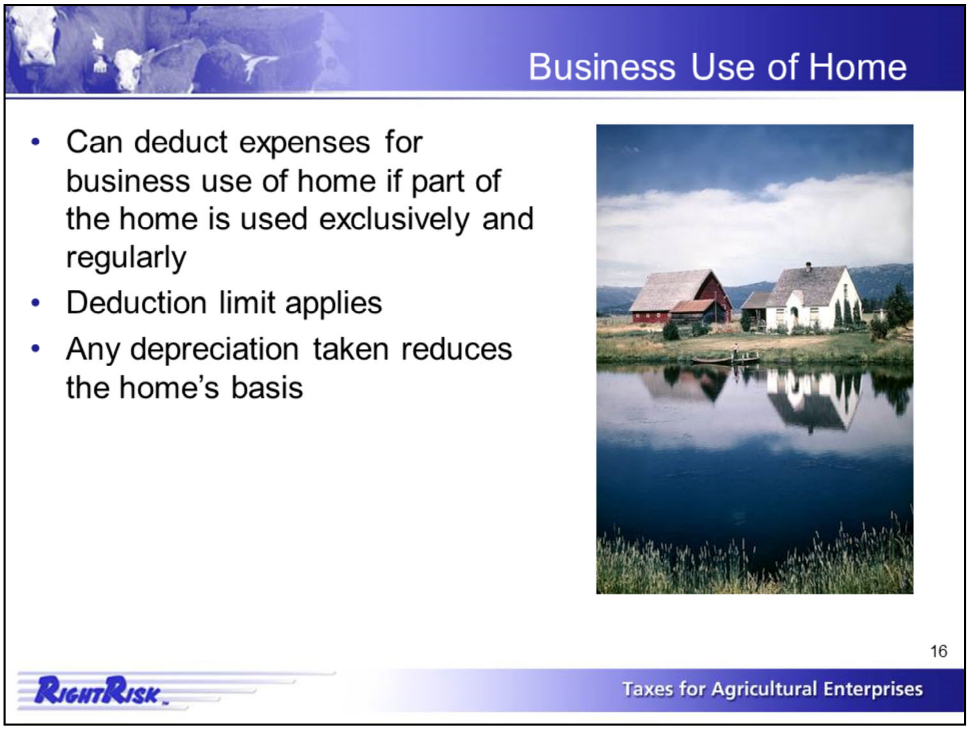
A farm-related taxpayer is a person whose main home is on the farm and whose principal business is farming, or who has a family member whose main home is one of the farm and whose principal business is farming



Wages and other compensation paid to family members are normally deductible as farm expenses if a true employer-employee relationship exists.

Wages paid to children are not subject to social security and Medicare taxes if the child is less than 18 years of age. Although not subject to social security, Medicare or federal unemployment taxes (FUTA), the child's wages still may be subject to federal income tax withholding.

Wages paid to a spouse and children 18 and older are subject to social security and Medicare taxes, but not federal unemployment taxes (FUTA).



The costs associated with the business use of the taxpayer's home is deductible if part of the home is used exclusively and regularly as a principal place of business for the business and there is not other fixed location where you substantially administrate or manage your business.

A taxpayer's home may also be deductible if the home is used as a place to meet with patients, clients or customers in the normal course of business, or in connection with the business, if using a separate structure that is not attached to the home.

Any depreciation taken for the business use of the home reduces the home's basis. Consequently, when the home is sold, a portion of any gains may be subject to capital gains tax. There may be need to recapture some of the depreciation as well.

Business Use of Home - Telephones

- Cannot deduct cost of basic local telephone service for the first telephone line into the home
- Can deduct:
  - Business long-distance changes on the first line
  - Cost of second telephone line into the home if used exclusively for farm business

17

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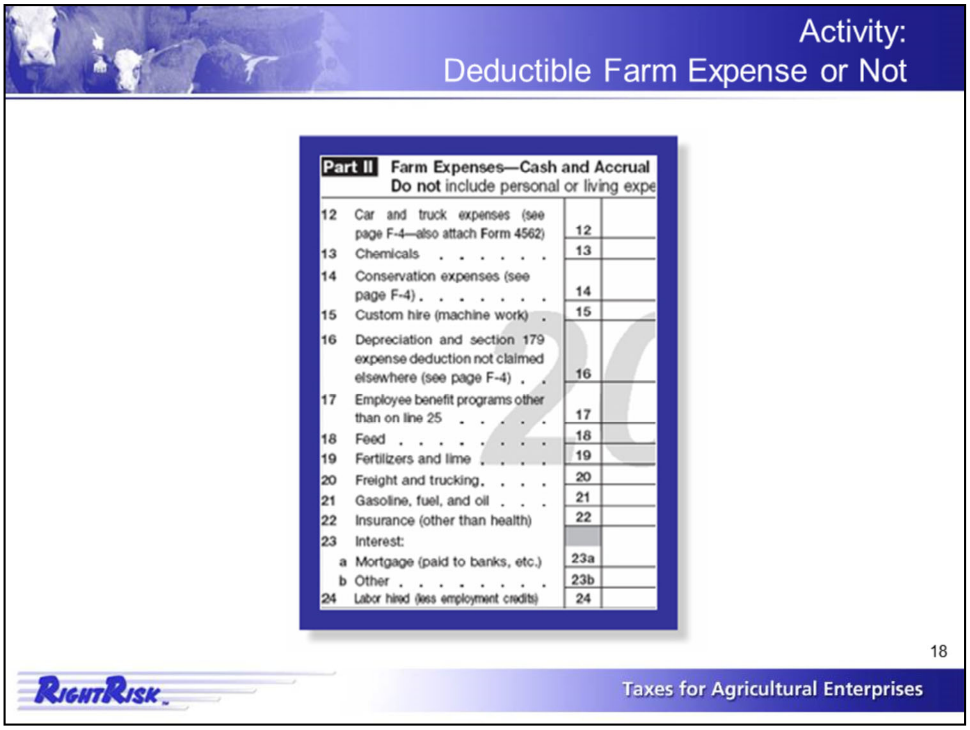
Taxes for Agricultural Enterprises

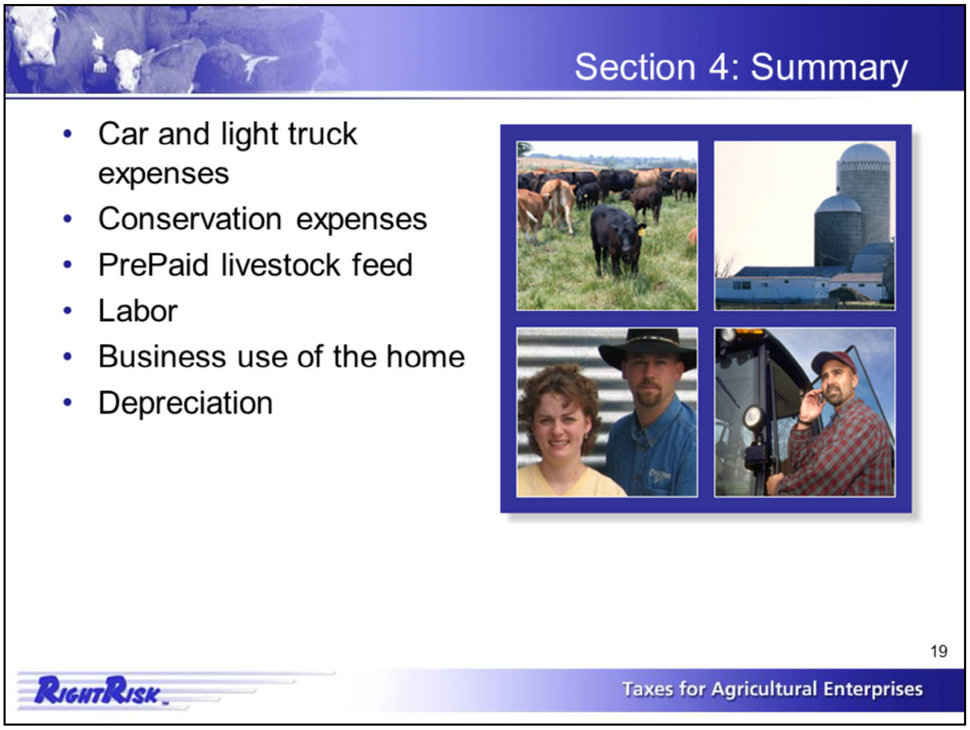
The cost of basic telephone service for the first telephone line into the home cannot be deducted. Business long-distance charges on the first line can be deducted.

The cost of a second telephone line into the house can be deducted if it is used exclusively for farm business. Also, any depreciation taken for a home office reduces the home's basis when sold.



Lets see if we can decide whether a scenario needs to be deducted as farm expenses. You need to decide whether each qualifies as a deductible farm expense or not.

1. 100% OF TOTAL USE OF LIGHT TRUCK WITHOUT RECORDS IF TRUCK IS USED DURING MOST OF BUSINESS DAY FOR FARMING OPERATION – NOT DEDUCTIBLE FARM EXPENSE (to deduct 100% of a light truck, you need records proving the truck was used for business purposes greater than 75% of the time. You do not need records to deduct 75% of less of light truck use.)
2. COMMUTING MILES FOR A LIGHT TRUCK – NOT DEDUCTIBLE FARM EXPENSE
3. PREPAID LIVESTOCK FEED IF IT MEETS CERTAIN CRITERIA - DEDUCTIBLE FARM EXPENSE
4. REASONABLE WAGES FOR REGULAR FARM LABOR - DEDUCTIBLE FARM EXPENSE
5. WAGES PAID TO HIRED HELP FOR CONSTRUCTION OF NEW BUILDINGS – NOT DEDUCTIBLE FARM EXPENSE (wages paid to hired help for the construction of new buildings or other improvements are not deductible in the year paid. Such wages are part of the cost of the building or other improvement. You must capitalize them)
6. REASONABLE WAGES AND OTHER COMPENSATION PAID TO YOUR SPOUSE - DEDUCTIBLE FARM EXPENSE
7. DEPRECIATION OF FARM MACHINERY - DEDUCTIBLE FARM EXPENSE
8. PRINCIPAL PAYMENTS ON LOANS – NOT DEDUCTIBLE FARM EXPENSE



Summary:

•The business portion of the actual costs of operating a car or light truck in the farm business can be deducted

•Conservation expenses are deductible if the land used for farming

•Depreciation can be taken for most types of tangible property such as buildings, machinery and equipment, vehicles, livestock, and fences. There is no depreciation allowance for land

•Livestock feed is normally considered a farm expense in the year it was purchased

•Reasonable wages for regular farm labor, piecework, contract labor, and other forms of labor hired to perform farming operations can be deducted

•Under the cash method of accounting, deduction for prepaid farm supplies may be limited to fifty percent (50%) of other deductible farm expenses

•The costs associated with the business use of the taxpayer’s home is deductible if part of the home is used exclusively and regularly as a principal place of business and there is no other fixed location where you substantially administrate or mange your business