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Farm Prepaids: Are you doing it correct?

Sometimes prepaying farm expenses for a tax deduction isn't quite as simple and straight forward as it may seem. Farmers and ranchers are allowed to prepay items such as: feed, supplies, fertilizer, chemicals, seed, etc. The ability to go out and prepay farm expenses is granted to a farmer/rancher that is using the cash method of accounting.

Prepaid Tests

The prepaid items that a farmer/rancher might prepay (i.e. chemicals, fertilizer, seed, etc.) are going to be for items that are used in the farming/ranching business, paid for in the current year but not used or consumed until the following year of purchase.

When looking at the expense of a "true" prepay, there are three tests that need to be met before it is an allowable prepaid expense for a Schedule F deduction:

1. Must be for a specified purchase. Not a DEPOSIT! When making a prepaid decision, you need to be writing a check for a specified quantity, at a specified price. There should also be an invoice for that purchase showing a binding commitment with no entitlement to a refund or repurchase.
2. Must have a business purpose. You are not to make a prepay purchase unless it will benefit the business. Examples of business benefits would be the following: prepaying for the next year's seed in order to receive the discounted price or prepaying to assure you receive a specific quantity.
3. The deduction must not materially distort income. Things to keep in mind when choosing what you are going to prepay and at what level are: a. Is the amount of expense relative to the business's income and expenses? b. Is the time of year the prepaid is made relevant? c. Are the prepaid expenses "necessary" to the business?

50% Prepay Expense Limit

Writing numerous checks the end of December might seem like a good plan, but don't get caught by a sometimes forgotten prepaid expense limit. In order for the prepaid expenses to be an allowable Schedule F deduction, the amount you can spend in prepaid expenses is limited to 50% of the total deductible Schedule F expense from a "normal" year plus depreciation and/or amortization. For example, if you had "normal" year Schedule F expenses totaling $600,000 and another $60,000 in depreciation, you would have the ability to prepay $330,000 of Schedule F expenses and have them deducted as long as all other rules are followed. If you were to exceed the 50% limit, the amount that is over the limit you have to carryover into the next tax year and deduct then. For example, if you were allowed to make $330,000 of prepaid purchases in 2014

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but actually made $375,000, the $45,000 ($375,000-$330,000=$45,000) that you went over would be deductible in 2015.

Conclusion

Qualified farmers and ranchers have the ability to deduct next year's expenses that they pay for in the current year, as long as they use the cash method of accounting. They should be certain that they don't exceed the 50% Schedule F expense limit and that any prepay expense they are looking at making is an allowable Schedule F expense in the current year.