Prepayment of feed, fertilizer, fuel, chemicals, seed, etc. has traditionally been a method of adjusting taxable income for cash-basis farmers with a higher than desired levels of income in the current tax year. Tax law changes a few years ago and coverage by the popular press have resulted in some continuing confusion and misinformation concerning the deductibility of prepaid farm supplies.

The IRS has more clearly defined what qualifies for a deduction of prepaid farm supplies and the upper limit on the deduction allowed in the year of payment. However, the main focus of the changes in prepayment regulations was directed toward tax shelters. The types of expenditure covered by the prepaid regulations are feed, seed, fertilizer, chemicals, and similar farm supplies that will not be used or consumed until the next tax year. No prepayment deduction is allowed for the advance payment of interest or insurance.

Under the current regulations the IRS allows, in the year of payment, a deduction for prepaid farm supplies that does not exceed 50% of the other deductible farm expenses. The deduction for any excess prepaid farm supplies is allowed as a deduction in the tax year in which the supplies are actually used or consumed. For purposes of the 50% test, farm expense includes depreciation, but not the amount of the prepaid expense. Thus, if a cash-basis farmer has $120,000 of ordinary and necessary farm expenses and depreciation, the farmer would be allowed under the 50% limitation test to deduct $60,000 of prepaid farm supplies.

As with most rules, there are exceptions and there is an exception to the 50% test rule. This exception
provides that the limit on the deduction of excess prepaid farm supplies does not apply if the taxpayer is a farm-related taxpayer and either: 1) exceeds the 50% rule because of a change in business operations directly attributable to extraordinary circumstances, or 2) the total prepaid farm supplies for the preceding three years are less than 50% of the other farm expenses for the same preceding three years. For this exception, a taxpayer is considered a farm-related taxpayer if they or a member of their family has their main home on a farm or their principal business is farming.

In addition to the above rules, if the prepayment is for feed, all three of the following tests must be met for the expenditure to be deductible in the year of payment.

1. The expense must be a payment for the purchase of feed, not a deposit.
2. The prepayment must be made for a business purpose and not merely for tax avoidance.
3. The deduction of these costs must not result in a material distortion of income.

In summary, the IRS has more clearly defined when deductions will be allowed for the prepayment of farm supplies. It is important that cash-basis farmers realize that the use of prepaid farm supplies remains a "legal and effective" tax strategy for adjusting farm net income. While the IRS Code has established defined limits, very few farmers should ever encounter a situation where their prepayments are limited in the year of payment.