

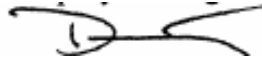
DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
Washington, DC 20224

SMALL BUSINESS / SELF-EMPLOYED DIVISION

February 27, 2017

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MEMORANDUM FOR DIRECTOR, EXAMINATION - CAMPUS

FROM: Michael Damasiewicz   
Director, SB/SE Examination Field and Campus Policy

SUBJECT: Pilot Program Auditing Schedule F Expenses

The purpose of this memorandum is to issue guidance on a pilot program for Schedule F Expenses for SB/SE Correspondence Examination. Although this pilot will only be worked in the Brookhaven Campus, phone calls may be received in all SB/SE Campuses. Please distribute this information to all affected employees within your organization.

The pilot is expected to begin April 1, 2017 and conclude April 1, 2018.

The attached document contains additional details. If you have questions you may contact me or Program Manager Miriam Gottlieb at 402-233-7329.

Attachments

## Attachment 1

**Purpose:** This interim guidance communicates temporary procedures for a pilot program auditing Schedule F Expenses. The pilot will focus on verifying certain Schedule F expenses.

**Background/Source(s) of Authority:** There has been limited coverage of Schedule F in recent years in Correspondence Exam (Corr Exam). We believe there may be compliance issues such as deducting expenses on the wrong form, deducting expenses actually belonging to another taxpayer, or related to Internal Revenue Code (IRC) § 183. We will use the same filtering process as is currently used for Schedule C examinations.

Taxpayers are being asked to provide documentation to show they qualify for the questioned expenses. In general, a taxpayer may deduct reasonable, ordinary, necessary and business-related expenses on Schedule F.

Occasionally, the items being verified appear to be legitimate and verifiable deductions but they should not be on a Schedule F. They are not deductible on the Schedule F if they are related to the taxpayer's W-2 job, the Schedule A, or a Corporate Return. These cases may also have start-up costs or a hobby loss where enjoyment is the main focus of the activity.

Leads will be generated from a series of compliance Data Environment (CDE) filters run through Campus Workload Delivery (CWD) elimination filters. The filter is designed to identify those taxpayers who have W-2s with large income who file a Schedule F and may not have the time to run a farm.

This pilot consists of 50 TY 2015 cases. Project Code 0199 will be used to monitor pilot cases.

**Procedural Change:** A section has been drafted in IRM 4.19.15 as Interim Guidance (IG) procedures, specifically IRM 4.19.15.32, *Schedule F Expenses*, to provide guidance for working the pilot program.

**Effect on Other Documents:** Pending the outcome of this pilot, this guidance may be incorporated into IRM 4.19.15.32, *Schedule F Expenses*, at the conclusion of the pilot.

**Effective Date:** April 1, 2017

**Contact:** [Nancy Higgs](#), SBSE Campus Exam Program Analyst, 801-612-4409, by email, OC or phone

**Attachments:** Interim procedures

Distribution:  
[IRS.gov \(http://www.irs.gov\)](http://www.irs.gov)

### 4.19.15.32 (MM-DD-YYYY) Schedule F Expenses

(1) The form 1040, *Schedule F, Profit or Loss From Farming*, is used to report farm income and expenses. A farm includes grain livestock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards and groves. See Pub 225 for more information.

(2) A taxpayer is a farm-related taxpayer if any of the following tests apply:

- 1) Main home is on a farm.
- 2) Principal business is farming.
- 3) A member of the family meets tests (1) or (2).

**Note:** For this purpose, family includes your brothers and sisters, half-brothers and half-sisters, spouse, parents, grandparents, children, grandchildren, aunts, uncles and their children.

(3) [REDACTED]

- a) [REDACTED]
- b) [REDACTED]
- c) [REDACTED]
- d) [REDACTED]
- e) [REDACTED]

[REDACTED]

(4) Schedule F cases will be started in Program Code 0199 and worked only in the Brookhaven Service Center Campus.

(5) When inspecting returns always look for costs being deducted that appear to be excessive for the income reported. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the trade or business. A necessary expense is one that is helpful and appropriate for the trade or business.

It is important to separate deductible business expenses from the following expenses:

- **Capital Expenses**, (payment or debt incurred for the acquisition, improvement, or restoration of an asset having a useful life of more than one year.) See Publication 225, *Capital Expenses*, for certain expenses that may be deducted.

- **Personal Expenses**, including gasoline, oil, fuel, repairs, maintenance or mortgage interest. It is not always easy to determine the business and non-business parts of an expense. Any reasonable allocation is acceptable. What is reasonable depends on the circumstances in each case.

(6) IRC § 162 and Treas. Reg. § 1.162-12 provides for the deduction of ordinary and necessary expenses, paid or incurred in connection with the operation and maintenance of a farm. Most farmers use the cash method of accounting to record their expenses. When using the accrual method of accounting, farm business expenses are not deductible until economic performance occurs. Economic performance generally occurs as the property or services are furnished to the farmer and the liability is incurred. See **Farmers ATG - Expenses** at <https://www.irs.gov/businesses/small-businesses-self-employed/farmers-atg>, for detailed information.

(7) Farmers often write a substantial number of checks during the last few days of the tax year to pay expenses. Large disbursements should always be part of your examination. You must then determine if the disbursement is a payment or a deposit. Whether an expenditure is a payment or a deposit depends on the facts and circumstances of each case.

A deposit to be applied against a future expense is not deductible; unless the expense is for **future supplies** (Addressed in Supplies below). Although a check is written, no deduction is allowable until the expense is actually incurred. The following factors, although not all inclusive, are indicative of a deposit rather than a payment.

- a) The absence of specific quantity terms.
- b) The right to a refund of any unapplied payment credit of the contract.
- c) The treatment of the expenditure as a deposit by the seller.
- d) The right to substitute other goods or products as specified in the contract.

These Factors apply to all farm expenses for which a payment is made prior to delivery.

#### 4.19.15.32.1 (MM-DD-YYYY)

##### Custom Hire

(1) Farmers hire individuals or business who own equipment, the farmer does not own, to perform specific activities on their farms such as no till planters, combines, etc. These amounts are fully deductible as an expense on line 13 of Schedule F.

**Note:** Do not include amounts paid for rental or lease of equipment operated by the taxpayer; these should be listed on line 24A, *Rent or lease*.

**Note:** Do not include amounts paid to employees as wages. If a pilot case is claiming wages under Custom Hire on line 13 of their Schedule F, send an e-mail containing the SSN, and details pertaining to the issue to: [nancy.b.higgs@irs.gov](mailto:nancy.b.higgs@irs.gov).

(2) Acceptable documentation may included receipts or contracts from the provider and canceled checks or bank statements showing payment for services.

#### 4.19.15.32.2 (MM-DD-YYYY)

##### Gasoline, Fuel, and Oil

(1) Fuel expenses **on the farm** may include gas, diesel, or oil. All fuel expenses must be for conducting business on the farm. The following questions must be asked:

- a) Do you have a storage tank on the farm?
- b) How do you account for personal use from the storage tanks?
- c) If fuel was purchased from a gas station, request an explanation why, to ensure it was not for personal use.

(2) Acceptable documentation may include receipts for purchase and canceled checks or bank statements showing payment for the purchase. Reasonable documentation explaining business verses personal use of fuel.

#### 4.19.15.32.3 (MM-DD-YYYY)

##### Mortgage Interest

(1) Mortgage Interest on real property used in the taxpayers farming business (other than their main home), will be claimed on line 21a, if paid to a bank or other financial institution for which the taxpayer received a Form 1098 (or similar statement).

**Note:** If purchased from a bank the loan may include their personal residence. You will need to separate personal use and farm use of the loan and any interest claimed.

(2) Farms generally have one of two types of purchase agreements for farms, purchased from a family member or purchased from a bank.

(3) If purchased from a family member the taxpayer may have an amortization schedule with a purchase agreement. A form 1098 will not be issued. This interest amount will be claimed on Line 21b and will not be included in the audit.

(4) If the mortgage loan combines farm and personal assets, the taxpayer must provide a breakdown showing the amount of interest applied to farm and personal.

#### 4.19.15.32.4 (MM-DD-YYYY)

##### Repairs & Maintenance

(1) Repairs and maintenance of farm buildings, machinery, and equipment that do not add tot he property's value or appreciably prolong its life.

**Note:** Do not allow deductions for repairs or maintenance on personal residence.

#### 4.19.15.32.5 (MM-DD-YYYY)

##### Supplies

(1) Farmers can pre pay for supplies used in the upcoming year. IRC § 464 limits the allowable deduction for prepaid supplies if they exceed 50% of the total deductible farm expenses for the taxable year. If the prepaid farm supplies have actually been used or consumed, the amount is fully deductible.

(2)

1) The expense must be a payment for the purchase of supplies, not a deposit. The amount is considered a payment if it was made under a binding commitment to accept delivery of a specific quantity at a fixed price, and the farmer is not entitled to a refund or repurchase.

2) The prepayment is not merely for tax avoidance, but has a specific business purpose. Examples of business benefits are:

a- Fixing maximum prices.

b- Securing an assured feed supply.

c- Securing preferential treatment in anticipation of shortages.

3) The deduction does not result in a material distortion of income. Some factors to consider in determining whether there is a material distortion of income are:  
The farmer's customary business practices in conducting the farming operation.  
The materiality of the expenditure in relation to the taxpayer's income for the year.  
The time of the year the purchase is made.  
The amount of the expenditure in relation to past purchases.

(3) Acceptable documentation may include receipts, or contracts and copies of checks or bank statements showing payment. The taxpayer must include a reasonable explanation for prepaying the supplies.