Deducting Residual Fertility

USDA WEBINAR
JULY 10, 2025

CONTACT INFORMATION

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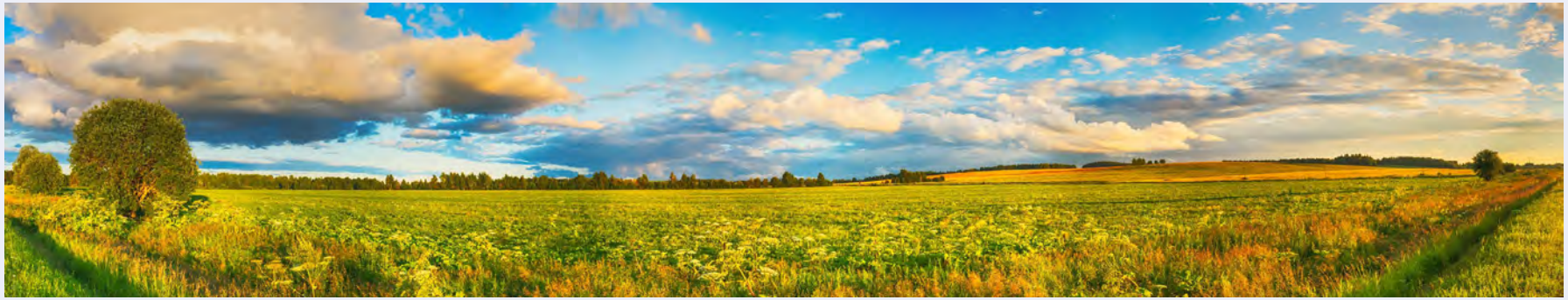
WHY THE WEBINAR

- In recent months, we have received many questions from farmers and their advisors about the so-called “residual fertility” deduction. Although farmers have been taking a limited deduction for the residual fertilizer purchased along with their farmland for many years, a push to extend and expand this practice beyond the traditional approach has been growing.

EXAMPLE

- John buys a farm for $10,000/acre. A company tells him there is a lucrative deduction he can take for the nutrients he purchased along with the soil.
- He agrees to enlist the services of the company and receives a spreadsheet valuing the nutrients at $5,000/acre.
- The information states that John must consult with his CPA to determine how to proceed on the tax return.



QUESTION

- What can John do?
  - A. Find a tax professional who will take the $5,000/acre deduction on the schedule F.
  - B. Work with a tax professional who will consider the data provided and determine whether a deduction is supported by the law.

QUESTION

- What can John do?
  - A. Find a tax professional who will take the $5,000/acre deduction on the schedule F.
  - **B. Work with a tax professional who will consider the data provided and determine whether a deduction is supported by the law.**

GOALS FOR TODAY

- Review the law
  - When are we entitled to tax deductions, generally?
  - When is fertilizer deductible?
  - What is Section 180?
  - What about residual fertilizer supply?
    - IRS Guidance
    - Court Cases
  - What about the seller?
  - Review Situations

DEDUCTIONS FROM TAXABLE INCOME

- Deductions from income are available only through legislative grace. This means an expenditure is only deductible if a deduction is specifically allowed by the Tax Code.
  - *White v. U.S.*, 305 U. S. 292 (1938) (holding taxpayers seeking a deduction **must be able to point to an applicable statute and show that they come within its terms**);
  - *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) (stating that whether and to what extent deductions shall be allowed depends upon legislative grace, and **only as there is clear provision can any particular deduction be allowed**).

BURDEN IS ON THE TAXPAYER

- It's impossible for the Code to anticipate and specify every item which is deductible within the intent of the Code. Consequently, IRS's regulations and rulings and court opinions must be searched to find authority for a particular deduction.

- ***The burden of clearly showing the right to a claimed deduction is on the taxpayer. INDOPCO, Inc. v. Commissioner,* 503 U.S. 79 (1992).**

TAX PENALTY

- A taxpayer must generally have *substantial authority* for a tax position taken (where the IRS disagrees) or must pay a penalty. I.R.C. § 6662 (20 percent penalty).

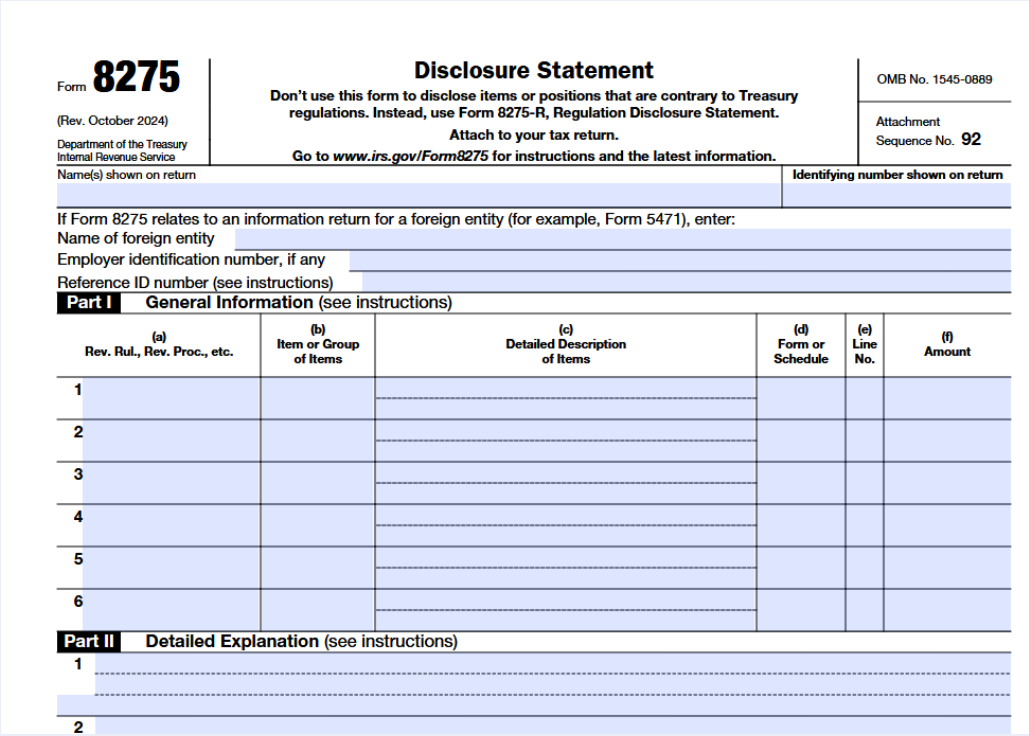
- **A substantial understatement of tax occurs if the amount of the understatement exceeds the greater of—**
  - 10 percent of the tax required to be shown on the return for the taxable year, or
  - $5,000.
- **Negligence or disregard of rules and regulations**

WHAT IS SUBSTANTIAL AUTHORITY?

- Weight of authorities for a position is **substantial** in relation to weight of authorities supporting contrary position (40 percent chance of success?)
  - Statutes, regulations, revenue rulings, relevant court cases, etc.

REASONABLE BASIS

- Another way to avoid the penalty is if the position had a reasonable basis and the taxpayer disclosed the position by submitting a Form 8275.
  - This is more than a colorable claim (at least a 20 percent chance of success?)



Form **8275**

(Rev. October 2024)

Department of the Treasury
Internal Revenue Service

Disclosure Statement

Don't use this form to disclose items or positions that are contrary to Treasury regulations. Instead, use Form 8275-R, Regulation Disclosure Statement.

Attach to your tax return.

Go to *www.irs.gov/Form8275* for instructions and the latest information.

OMB No. 1545-0889

Attachment Sequence No. **92**

Name(s) shown on return

Identifying number shown on return

If Form 8275 relates to an information return for a foreign entity (for example, Form 5471), enter:

Name of foreign entity

Employer identification number, if any

Reference ID number (see instructions)

Part I **General Information** (see instructions)

	(a) Rev. Rul., Rev. Proc., etc.	(b) Item or Group of Items	(c) Detailed Description of Items	(d) Form or Schedule	(e) Line No.	(f) Amount
1						
2						
3						
4						
5						
6						

Part II **Detailed Explanation** (see instructions)

1

2

LET'S START WITH FERTILIZER

SCHEDULE F DEDUCTION (SECTION 180 EXPENSE)

accrual method, enter the amount from Part III, line 50. See instructions 9

Part II **Farm Expenses—Cash and Accrual Method.** Do not include personal or living expenses. See instructions.

10	Car and truck expenses (see instructions). Also attach **Form 4562**	10		23	Pension and profit-sharing plans	23	
11	Chemicals	11		24	Rent or lease (see instructions):		
12	Conservation expenses (see instructions)	12		a	Vehicles, machinery, equipment	24a	
13	Custom hire (machine work)	13		b	Other (land, animals, etc.)	24b	
14	Depreciation and section 179 expense (see instructions)	14		25	Repairs and maintenance	25	
15	Employee benefit programs other than on line 23	15		26	Seeds and plants	26	
16	Feed	16		27	Storage and warehousing	27	
17	Fertilizers and lime	17		28	Supplies	28	
18	Freight and trucking	18		29	Taxes	29	
19	Gasoline, fuel, and oil	19		30	Utilities	30	
20	Insurance (other than health)	20		31	Veterinary, breeding, and medicine	31	
21	Interest (see instructions):			32	Other expenses (specify):		
a	Mortgage (paid to banks, etc.)	21a		a		32a	
b	Other	21b		b		32b	
22	Labor hired (less employment credits)	22		c		32c	
				d		32d	
				e		32e	
				f		32f	

33 **Total expenses.** Add lines 10 through 32f. If line 32f is negative, see instructions 33

34 **Net farm profit or (loss).** Subtract line 33 from line 9 34

If a profit, stop here and see instructions for where to report. If a loss, complete line 36.

35 Reserved for future use.

36 Check the box that describes your investment in this activity and see instructions for where to report your loss:

a ☐ All investment is at risk. b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11346H **Schedule F (Form 1040) 2024**

FERTILIZER IS A BIT UNIQUE

- A business expense can generally be deducted under 162 only if you use it up in one year (seed, feed, etc.)

- In 1947, the IRS ruled that the cost of lime spread on farmland was an exhaustible capital expenditure that should be **amortized over the period of its effectiveness** if the benefit of the liming *extends substantially beyond one year.*
- The 1947 guidance likened this treatment of fertilizer expenditures to amortizing the cost of a pre-paid multi-year insurance premium on a pro rata basis over the years to which the premium applies

SECTION 180

- In 1960, Congress determined that capitalizing the cost of fertilizer was "contrary to the long-accepted and widespread practice [by farmers] of deducting fertilizer and lime expenditures in the year they were paid or incurred."
- In response Congress passed I.R.C. § 180, which applied to taxable years beginning after December 31, 1959.
- Today, § 180 continues to allow farmers to elect to presently deduct (and not capitalize) expenses paid or incurred during the taxable year for the ***"purchase or acquisition" or the application of "fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition" "land used in farming."***

SECTION 180

Specifically, this yearly election is available only where:

1. Taxpayer is “engaged in the business of farming”
2. Land is used in farming
   - Land used (before or simultaneously with the expenditures) by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.
     - It is not available for the cost of fertilizer used to first prepare land for farming.

SECTION 180

Taxpayers are **engaged in the business of farming** if they:

- Cultivate, operate, or manage a farm for gain or profit, either as owner or tenant.
- Are a crop share landlord
- Are a cash rent landlord who materially participates in the farm business (unusual)

SECTION 180

Make election by deducting fertilizer expense on return. Otherwise, taxpayer may capitalize

accrual method, enter the amount from Part III, line 50. See instructions 9

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CAN PURCHASE PRICE BE ALLOCATED TO "RESIDUAL FERTILIZER SUPPLY"?

- When farmers purchase farmland, they may allocate a portion of the purchase price to the fence or the drainage tile or the single purpose buildings on that land.
- The farmer may then expense the assets under I.R.C. § 179, take additional first year depreciation, and/or depreciate the cost of the asset over its useful life.

WHAT ABOUT "RESIDUAL FERTILIZER SUPPLY"?

- Is there a similar cost recovery option for residual fertilizer supply purchased with the land?
- **In other words, can a purchaser of farmland allocate a portion of the purchase price to the value of excess fertility on the land?**

IRS 1991 "GUIDANCE"

- In 1991, the IRS issued a technical advice memorandum (TAM) suggesting there **may be a deduction available for the value of residual fertilizer purchased with farmland**.
- In the TAM, the IRS denied the deduction to the taxpayer, but the agency took time to set forth the facts a taxpayer must establish to support such a deduction.

NOT THE BEST GUIDANCE

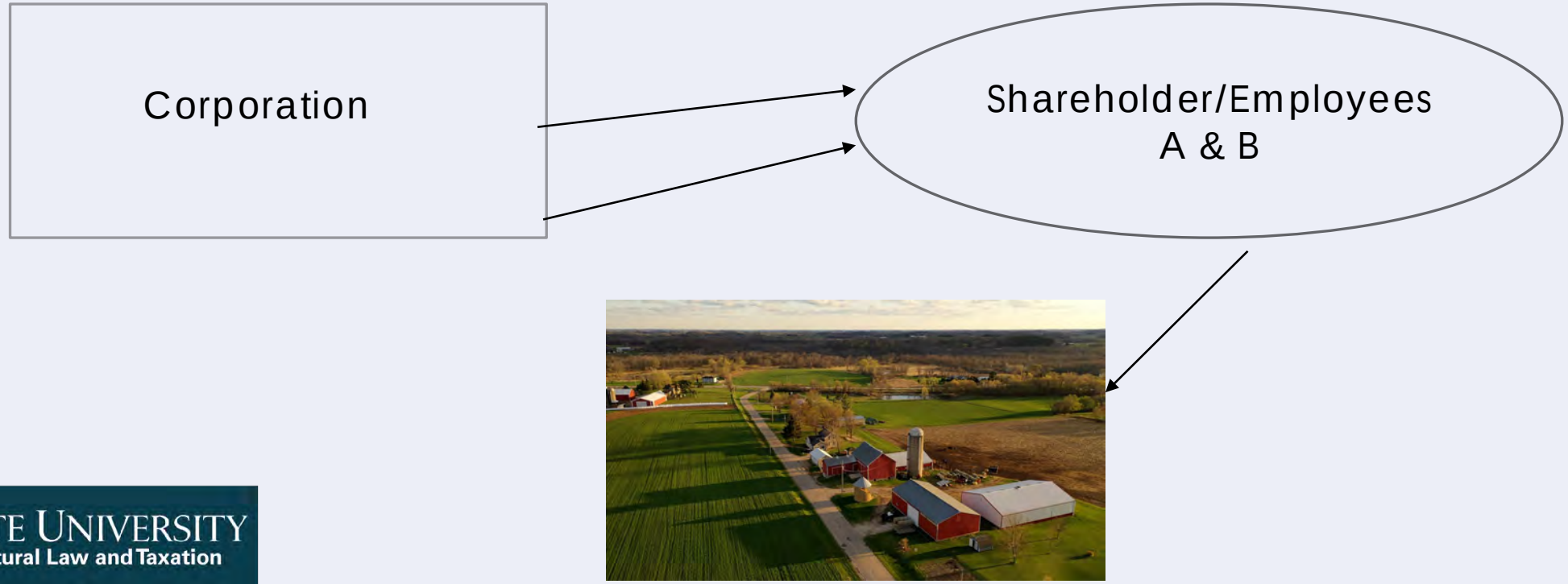
- While a TAM issued after October 31, 1976, can constitute substantial authority for a position taken on a tax return, it cannot be cited as precedent.
- In other words, a TAM is not sufficient to uphold a position, but it may help a taxpayer avoid accuracy related penalties.
  - Here it should be noted that the persuasiveness of the 1991 TAM—as it applies to authorizing a deduction for residual fertilizer supply—is limited because the **IRS denied the deduction to the taxpayer for multiple reasons.**

ANYTHING ELSE?

- In 1995, the IRS issued a Market Segment Specialization Program guide to auditing the income tax return of grain farmers. In this internal document, which has long been out of publication, the IRS basically summarized TAM guidance and suggested that a deduction may be possible for residual fertilizer supply.
- This is out of print and cannot be used as substantial authority.

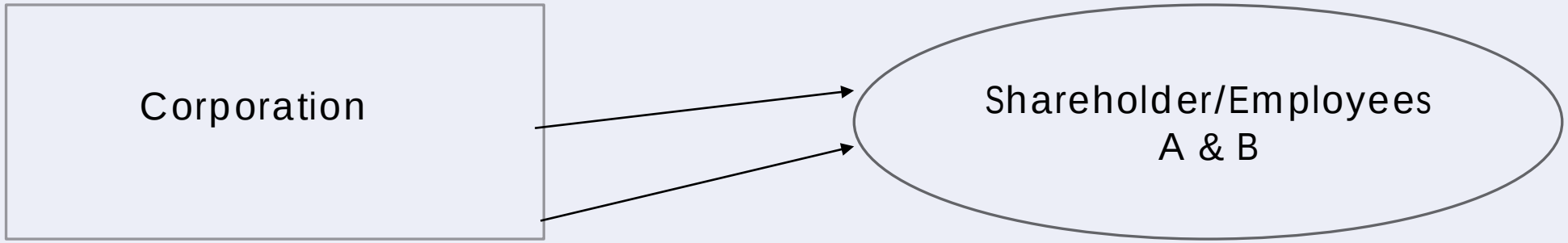
WHAT WERE THE FACTS OF THE TAM?

- The taxpayer was a corporate farm owned by two shareholders who were also employees of the corporation.
- In 1988, the shareholders purchased farm property, which included land and a dwelling.



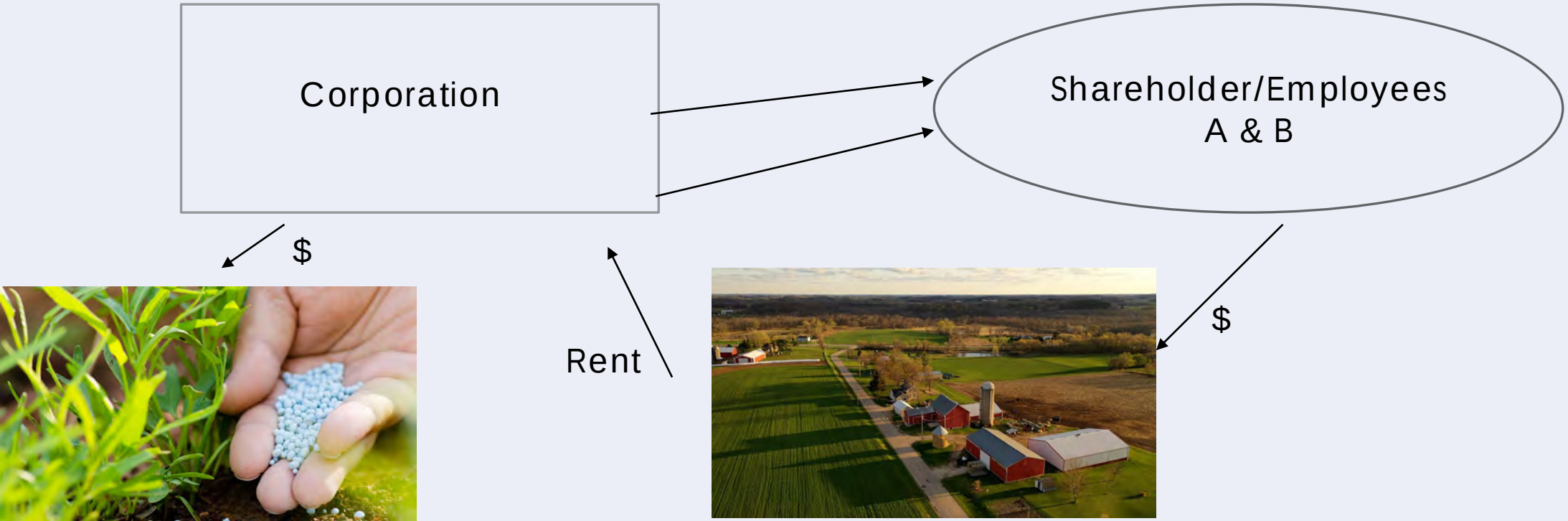
WHAT WERE THE FACTS OF THE TAM?

- The corporation purchased the “residual fertilizer supply.”
  - This existed because the seller, who had owned the land for 14 years, applied a “**semi-truck load**” of fertilizer to the land each year.



WHAT WERE THE FACTS OF THE TAM?

- The shareholders rented the land to the corporation to grow crops, and the corporation **sought to amortize the cost of the so-called residual fertility supply over 7 years**.



WHAT DID THE IRS SAY?

- Although stating that "**capitalized farm fertilization costs may be amortized**," the IRS first found that a taxpayer must be the **beneficial owner of the fertilizer** to take an amortization deduction.
- Here, the IRS reasoned, the alleged residual fertilizer supply was incorporated into the land and for all practicable purposes was inseparable from the land.
  - Although the corporation supposedly purchased the residual fertilizer supply from the shareholders, the IRS noted that it **could only realize a benefit from that fertilizer by entering a lease with the shareholders, who owned the property**.
- As such, the IRS found that **the *shareholders and not the corporation were the beneficial owners of any residual fertilizer supply***.

IRS 1991 "GUIDANCE"

- Even so, the IRS continued to say what would have to be proved if a taxpayer could take such a deduction.
  1. **The taxpayer must establish the presence and the extent of the *fertilizer* in the ground.** The IRS found the taxpayer in this case did not prove this.
     - The taxpayer *had the soil tested*, but the taxpayer did not provide data to indicate the level of soil fertility attributable to fertilizer applied to the land by the previous owner.
       - The data the taxpayer provided about the level of fertility for similar parcels of land in the area was useless. This is a land-specific question.

SUMMARY OF LIMITED GUIDANCE

2. **The residual fertilizer supply must be attributable to fertilizer applied by the prior owner that has not yet been depleted by crop production.** This link *cannot be presumed*. It must be proven through soil testing and other data (perhaps fertilization records of the seller?).
3. **The taxpayer must show that the residual fertilizer supply is declining.** A deduction cannot be taken merely because a purchased farm has higher fertility levels than neighboring farms.
4. **The taxpayer must be the beneficial owner of the residual fertility supply**, meaning they must own the land from which the fertility supply is inseparable.

IF THIS IS PROVED, COULD SECTION 180 WORK?

- If the cost is eligible for amortization, it may be eligible for expensing if the other requirements of I.R.C.§ 180 are met:
  - The taxpayer **pays money or incurs expenses** for the "purchase" or "acquisition" of "fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming"
  - The taxpayer is in the "**business of farming**," which includes crop share, but not cash rent, landlords (unless they materially participate)
  - The land is "**used in farming**," meaning that it is used for the production of crops or the sustenance of livestock. This deduction is not allowed for fertilizer used to first prepare land for farming.

WHAT KIND OF DEDUCTION DOES THAT GET YOU?

WHAT DEDUCTION MAY BE ALLOWED?

- The very limited authority suggests that a ***modest deduction*** may be allowed for the value of the ***residual fertilizer*** supply purchased with farmland.
- The deduction amount under this approach would generally correspond to the reasonable value of unexhausted fertilizer that has been applied to the land.
- **It appears that a farmer's ability to deduct the cost of residual fertilizer flows from the farmer's right to deduct the cost of fertilizer in the first place.**
  - The farmer is purchasing a valuable crop input that is now integrated into the soil, but still available for use.

WHAT ABOUT THE SELLER?

- Buyers of farmland must complete a purchase price allocation to determine which portion of the sales price is allocable to assets that can be expensed, depreciated, or amortized.
- Conversely, the seller must determine which portion of the sales price is allocable to the land and which portion is allocable to assets that have been depreciated, expensed or amortized.
- Gain from the sale of land is generally subject to long-term capital gain treatment, whereas gain from the sale of other assets is often subject to ordinary income tax rates.
- Thus, in completing this allocation, the buyer and the seller have different incentives.

WHAT ABOUT THE SELLER?

- If the seller is disposing of a trade or business, the law requires both the buyer and the seller to file Form 8594 listing the allocation of the purchase price for each asset. In this case, the allocations must line up.
- Outside of the sale of a business, it is not legally required that the allocation of the seller matches the allocation of the buyer.
- No Form 8594 is required. On audit, however, the IRS can examine the returns of both parties to determine whether the reported allocations were reasonable.

WHAT ABOUT THE SELLER?

- In the case of a deduction for residual fertilizer supply, **it seems best practice to work with the seller to establish the value of the residual fertility and document that in the sales contract.**
- On audit, this documentation would be strong evidence supporting the reasonableness of the deduction.
- It appears that the seller of the residual fertility must pay **ordinary income tax** on the portion of the sales price allocable to the residual fertility supply.
- What would be IRS response if seller didn't know they were "selling residual fertilizer?" The transaction does not balance.

IS THERE A BETTER WAY?

- Some have suggested that if Section 180 does not get the desired result, try:
  - Depreciation (IRC § 167)
  - Depletion (IRC § 611)

WHAT ABOUT *DEPRECIATING* SOIL NUTRIENTS?

- IRC § 167 says that there shall be allowed as a depreciation deduction a *reasonable allowance* for the *exhaustion, wear and tear* (including a reasonable allowance for obsolescence)—
  - (1) of property used in the trade or business, or
  - (2) of property held for the production of income.

Can I apply this to the soil nutrients that exist in the land that I purchase?

Test for all nutrients and depreciate them over their useful life?

WHAT ABOUT *DEPRECIATING* SOIL NUTRIENTS?

- It is well established that farmers cannot depreciate the cost of their land.
  - Treas. Reg. § 1.167a-6(b), for example, states that farmers may claim a reasonable allowance for depreciation on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property, but **this does not include land** (emphasis added).
- The tax court has explained that this means "**owners of farmland are specifically denied a deduction for exhaustion and wear and tear due to erosion, wind, or privation of soil nutrients.**"

- We have that nagging comment from the IRS that that the alleged residual fertilizer supply was incorporated into the land and for all practicable purposes was inseparable from the land.

WHAT ABOUT *DEPRECIATING* SOIL NUTRIENTS?

- In 1977, the Fifth Circuit Court of Appeals addressed a farm taxpayer's claimed depreciation of peat soil.
- In A. **Duda & Sons, Inc. v. U.S.**, the topsoil of the farmer's land consisted of peat and muck soil composed of partially decomposed plant deposits. The soil was uniquely rich and had a value greater than other soils.
- To cultivate vegetables on the land, the farmer had to drain and compact the soil and apply various chemicals. This caused his heavily carbonized soil to oxidize and subside at a rate of 15 inches in the first year and 1.1. inches thereafter. The farmer sought to take depreciation and depletion deductions for the vanishing peat soil, which the IRS denied.

WHAT ABOUT *DEPRECIATING* SOIL NUTRIENTS?

- On appeal, acknowledging that land is not a depreciable asset for tax purposes, the taxpayer argued that the peat soil was an exhaustible capital asset separate from the underlying land.
- With respect to this claim for depreciation, the court stated, "**all topsoil is subject to the oxidation of its organic constituents, to water and wind erosion, and other kinds of 'wear and tear.' [Here] the taxpayer makes no additions to or improvements on the land but seeks to depreciate the land itself.**"
- The court thus ruled that the taxpayer was not entitled to depreciation deductions for the subsidence of the peat soil.
  - ***It appears that any deduction for unexhausted fertilizer supply must flow from the past application of fertilizer, which is an addition to the land.***

WHAT ABOUT *DEPRECIATING* SOIL NUTRIENTS?

- **Another Question**: Depreciation that is allowed or allowable must be considered at the time of sale. If this depreciation approach were adopted would everyone need to test their soil nutrients to see what depreciation is *allowable*?

DEPLETION UNDER IRC § 611

- In the case of mines, oil and gas wells, other *natural deposits*, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements.

- Do soil nutrients qualify as natural deposits eligible for depletion?

TAX COURT CASE SUGGESTS NO

- In Duda, the Fifth Circuit also found that the taxpayer was not entitled to a depletion deduction for the wasting of peat soil.
- The court first explained that the *depletion deduction is totally dependent upon statute* and has no independent significance in tax law as a legal or equitable principle.
- After lengthy consideration of the statute and its history, the court suggested that the kinds of depletion deductions encompassed by IRC § 611 **do not include the situation in which a natural asset wastes in place**.
- The court stated that the depletion deduction appears limited to cases in which the asset is recovered or extracted and that "*extraction or severance* is bound up with the depletion deduction."

COURT DECLINED TO EXTEND THE DEPLETION DEDUCTION

- The court noted that if the farmer were "allowed a deduction for the peat soil, another farmer should be allowed a depletion deduction for the exhaustion of the nutrients in his soil attributable to, say, cotton farming."
- After noting that this would present a new set of difficulties for administering the depletion deduction, the court declined to extend the general depletion provisions to the situation where an asset is wasting in place, as opposed to extracted and sold.
- "***It may be that Congress intends to grant deductions in these cases. If so, we must insist that it address itself specifically to the case of a natural asset wasting in place."***

OTHER COURT DISCUSSION

- Prior courts had explained that farmers cannot take a depletion deduction to recover the cost for the exhaustion of soil nutrients.
- In 1963, the tax court denied a depletion deduction to a producer of sod on the basis that the taxpayer failed to establish the amounts of depletion he claimed.
- However, in recognizing that it may be possible to take a depletion deduction for the cost of sod, the court distinguished the production of sod from ordinary farm activities, "***In this it differs from other farming activities where that which is taken from the soil is its nutrients. In the ordinary farming operation, the soil can be reconditioned by fertilizers designed to replace the plant food consumed in the farming operation***."

ANOTHER CASE

- In 1976, in the Meyers case, the tax court held that topsoil sold by a taxpayer was a "natural deposit" subject to the depletion allowance under IRC § 611.
- Fundamental to its determination was “the **ultimate exhaustibility** of the natural resource on which depletion is claimed.”
  - Here, the taxpayer established that his topsoil, removed with the extraction of sod for sale, would be exhausted in 16 cuttings. The court explained, “Since sod is by definition a combination of soil and plant life, the loss of topsoil suffered in a sale of sod cannot be considered minimal…In each case some topsoil is being physically removed, so that after 16 cuttings the layer of topsoil on petitioner's land would be totally exhausted. Hence, there is an actual loss of soil which results in eventual exhaustion of petitioner's capital investment in a natural resource, precisely the circumstances in which a depletion allowance was intended.”

NO DEPLETION FOR ORDINARY FARMING ACTIVITIES

- The IRS argued that the taxpayer's activities were farming activities and that, as such, depletion was not allowed. The taxpayer could instead restore the productivity of the land and deduct the cost as a business expense.
- The court rejected that argument, explaining that it would be an "**unnecessary overgeneralization to treat the cultivation and sale of sod as we would a purely farming activity**."
- There is, the court stated, "**a difference between the physical removal of topsoil with sod and the diminution in land value resulting from the exhaustion of soil nutrients with the planting of crops**."
- The latter can be replenished with fertilizer, the former cannot.

WHAT ABOUT DEPLETION?

- ***Depletion does not appear to apply to soil nutrients that are exhausted over time. Crop production is a purely farming activity for which no depletion deduction has been authorized. The nutrients can be restored through fertilization, which is deductible.***

WHERE DOES THIS LEAVE US?

- Deduction likely allowed for the value of **unexhausted fertilizer** in ground where:
  - The taxpayer establishes the presence and the extent of the fertilizer in the ground.
  - The residual fertilizer supply is proven to be attributable to fertilizer applied by the prior owner that has not yet been depleted by crop production.
  - The taxpayer shows that the residual fertilizer supply is declining.
- Section 180 can likely be used if taxpayer is a farmer or crop share landlord or materially participating cash rent landlord and land is used in farming.

- In my opinion, there is not substantial authority for taking a depreciation or depletion deduction for soil nutrients.

CAN VALUE OF DEDUCTION EXCEED VALUE OF PAST FERTILIZATIONS?

HIGH VALUE DEDUCTIONS

- Taking large deductions unrelated to the value of past fertilizer applications ignores guidance specifying that residual fertilizer supply must be attributable to past fertilizer applications.
- It also appears that a deduction is only available if the nutrients from fertilizer are being exhausted over a predictable number of years.

CAN I TAKE A DEDUCTION FOR NON-FERTILIZED PASTURE GROUND?

PASTURE

- As we discussed, IRS has required proof that the residual fertility supply arose from the past application of fertilizer.
  - Can you prove the quantity and the value of the manure that was deposited by the prior owner's livestock?
  - Can you prove that the fertilizer is being exhausted and at what rate is it being exhausted?

CAN I TAKE A DEDUCTION FOR LAND PURCHASED YEARS AGO?

PAST PURCHASE

- If you can't use depreciation, it's difficult to see how this is possible.
  - It appears that a residual fertilizer deduction requires proof of the extent of the residual fertilizer supply, evidence that the supply is linked to past fertilizer applications, and data showing the rate at which the supply is being exhausted.
  - It is difficult to see how this data could be collected years after the purchase.

FINAL CONSIDERATIONS

- This remains an area ripe for statutory, regulatory, or judicial guidance.
- Any tax position taken without clear guidance comes with risk.
- Until authoritative guidance is issued, taxpayers and their advisors must consider the level of risk associated with various deductions for residual fertility.
- They should also recognize that if the IRS disagrees with their position on audit, they could be liable for penalties if the position is found to be unreasonable.

- This article provides additional information: https://www.calt.iastate.edu/blogpost/considering-residual-fertility-deduction


Have
questions?
Ask.