AGRICULTURAL TAX PLANNING

Prepaid Farm Expenses – The Basics

By Thomas J. Bryant, CPA and Ryan Beasley, CPA

Last month we covered the Agro-Jal Tax Court case which may have re-defined the "Prepaid Farm Expense Deduction" that allows cash basis farmers and other agricultural businesses a federal income tax deduction for prepaid expenses. We discussed the case at length and some of the changes in the application of this deduction that this case may bring about. In this article we will review the basics of the prepaid expense deduction.

The Rules

The rules governing the prepaid expense deduction basically come from two sources; (1) case law and IRS Revenue Rulings, and (2) IRC Section 464 and the corresponding regulation. The rules focus on the words "feed, seed, fertilizer, or other similar farm supplies" as items qualifying for the prepaid deduction, **but the rules are considered to apply to any prepaid farm material or supply such as pesticides or fuels** except inventoried or capital items.

Rev. Rul. 79-229 provides the general guidelines for deducting prepaid farm expenses in the form of three tests that must be met.

Test 1 – There must be an actual purchase; a mere deposit to buy in the future does not qualify as a prepayment. In distinguishing between a prepayment and a deposit, four factors are stated in the ruling that indicate a **deposit** rather than a purchase;

- Absence of a **specific quantity** of items purchased,
- A **right to a refund** of any credit that remains,
- A right to **substitute other goods or services** for those specified in the purchase contract, and
- Treatment of the expenditure as a **deposit** on the seller's books.

Many tax professionals however, are of the opinion that the treatment on the seller's books of the transaction as a deposit should have no bearing as to whether the expenditure is a deposit or a prepayment. The farmer has no control over the seller's accounting methods. The seller's treatment as a deposit may be allowed under Reg.1.451-5(c), and the farmer's deduction should not depend on the seller following correct accounting methods.

Also, committing to a minimum quantity as opposed to a specific quantity should suffice, as long as the amount paid is not in excess of the minimum quantity specified. It is **important** that a cash method farmer or rancher secure a detailed invoice that clearly specifies a definite quantity, grade of goods, unit price, and a total expenditure amount, with no right to a refund or repurchase stated on the invoice. However, the payment accompanying the invoice need not be for the total amount.

Test 2 – The prepaid expense must be made for a **legitimate business purpose** and not to merely avoid taxes. Generally, farmers and ranchers can establish their prepaid purchases as legitimate business expenses. Examples of a business purpose include securing an assured feed supply, obtaining significant discounts for early purchases, expectations of rising costs, and anticipation of a feed shortage.

Test 3 – The expenditure must not result in a **material distortion of income**. The following factors are stated in the ruling as determining whether the deduction results in a material distortion of income.

- The relationship between the quantity purchased and the projected quantity to be used in the following year.
- The materiality of the prepaid purchase in relation to the total income of the farmer for the year.
- The business purpose for paying in advance and the customary business practices of the taxpayer in buying supplies.
- The relationship between the expenditure and past purchases.
- The time of year when the prepaid purchase was made, and
- How deductions of prepaid expenditures have affected taxes paid by the farmer or rancher in previous years.

This test should not be a problem for the farmer if the prepaid expense does not produce a benefit extending beyond 12 months or the end of the next tax year.

IRC Section 464, The 50% Prepaid Expense Limit – To the extent prepaid farm supplies of a farmer using the cash method of accounting **exceed 50%** of the deductible non prepaid farm expenses for the taxable year; the prepaid expenses **are only deductible as the purchased items are consumed**. For this limit, non prepaid expenses include ordinary and necessary operating expenses, interest, taxes, and depreciation. Inventoried or capitalized expenses are not included in the 50% test.

There are two **exceptions** to the 50% test.

- An eligible farmer, who fails the 50% test due to a change in business operations directly attributable to extraordinary circumstances, including government crop diversion programs, may ignore the test.
- An eligible farmer who satisfied the 50% test on the basis of the three preceding taxable years is also exempt.

In the case of any "**farming syndicate**", deductions for feed, seed, fertilizer or similar farm supplies are only allowed for the tax year in which the supplies are actually used or consumed. The farm syndicate limitations on prepaid expenses are generally targeted at investors in limited partnership tax shelters involved in farm feedlots. The various "active participant" exclusions will usually remove active, resident farmers from these restrictions.

Prepaid rent – Generally, taxpayers may not prepay rent expense; however, in 2004 the IRS issued final regulations related to capitalization of certain costs which have application to many prepaid expenses including prepaid rent. These rules made it clear that a **cash basis** taxpayer prepaying rent that does not extend beyond 12 months would be allowed to currently deduct that prepayment. Accrual basis taxpayers may not take advantage of the prepaid rent rule because of the economic performance rules.

Also, the application of IRS Code Section 467 may prevent some taxpayers from deducting prepaid rent and thus it may have limited application to farmers.

Prepayment by Delivery or Mailing of a Check

- Taxpayers are permitted to claim a deduction for payment by check when that check is delivered to the payee or when placed in the mail to that payee.

- Payments may be made from borrowed funds, but not borrowed funds from the vender or payee of the same transaction.
- Credit card purchases are considered a payment when the charge occurs, not when the credit card bill is paid.
- A check issued at year-end that exceeds funds in the taxpayer's bank account is acceptable, providing the check is promptly covered by the bank as a result of subsequent deposits. However, if a payee is instructed to hold a check, the expense is not deductible until the check is cashed.

The New Tangible Property Regulations

The new Tangible Property Regulations, although not directly addressing the prepaid farm expense deduction, do bring some new rules to the table.

The De minimis Safe Harbor Provision - This new provision permits taxpayers to currently expense amounts paid to produce or purchase items under a certain dollar limit. For most small farmers, the safe harbor limit is $500. This is an annual election and certain requirements must be met. This new provision may be helpful to farmers and ranchers in specific situations where large quantities of items costing less than their safe harbor limit are purchased at the end of the year. The items may be currently deducted without any concern of meeting the prepaid expense deduction rules. Caution - Amounts otherwise deductible under the de minimis safe harbor rules may be subject to the IRC Sec.163A capitalization requirements that require capitalization of direct or indirect costs allocable to property produced or acquired by the taxpayer for resale.

Materials and Supplies - Materials and supplies (M & S) under the new regulations are classified as either incidental or non-incidental. Incidental M & S are those for which no record of consumption is kept or of which no year end physical inventories are taken. These may be deducted as purchased. Non-incidental M & S are deductible in the first tax year used or consumed. These are generally major repair items. The regulations define M & S as tangible property used or consumed in the taxpayer's business **that is not inventory (cost of goods sold).** This appears to be in conflict with IRC Sec. 464 which permits the prepaid deduction of feed, seed, etc. if the requirements of the section are met.

In addition, the decision in the Agro-Jal Tax Court case permitted a current deduction of prepaid non-incidental materials and supplies. The prepaid items were clearly inventoried for book purposes. Agro-Jal used the cash basis for tax reporting. Do the new Tangible Property Regulations trump IRC Sec. 464 and the Agro -Jal decision?

Summary and Conclusion

Proper support and documentation of your prepaid expense deduction is important for several reasons. Your plans may change in the following year and you may not produce the crop or raise the livestock for which the items were purchased. This could be caused by drought or other weather conditions. Market conditions could change and your production could be drastically cut or you may be forced to produce an alternate crop. Upon audit, the IRS may attempt to disallow your prepaid expense deduction. Be sure your payment is reasonably determined and in good faith at the time of the payment and that you have the proper documentation to support it.

Also be sure you can adequately support the tests of Rev. Rul. 79-229. The U. S. Court of Appeals, Eighth Circuit affirmed a hard stance taken by a District Court in a case that

disallowed a prepaid expense deduction apparently due to a lack of "business purpose". The taxpayer's year-end prepayment represented only 17% of the annual feed expenditure and the discounts involved were very nominal. This case shows the importance of the need to justify the business purpose of every prepaid deduction.
As stated above the new Tangible Property Regulations raise some new questions regarding the prepaid expense deduction, and we will have to see how the IRS or the courts rule on these issues.
The prepaid expense deduction is a tool that farmers and ranchers can use to avoid spikes in income from year to year. Farmers, ranchers and those in the agricultural business have unique tax, business, and financial circumstances and should consult their tax professionals before making prepayments for farm supplies. This is especially important if the taxpayer has not used this deduction in the past.

For information on this topic or other tax planning for ranching and farming, please contact me at (863) 640-2008 or tom@beasleybryantcpa.com and /or Ryan Beasley at (863) 646-1373 or ryan@beasleybryantcpa.com.
For information on other relevant topics visit our website at www.beasleybryantcpa.com.
We at Beasley, Bryant & Company, CPA's, P. A. are experienced in agricultural business problems, tax issues or concerns, and are here to help you.
Thomas J. Bryant, CPA is Senior Tax Partner, and Ryan Beasley, CPA is Tax & Business Management Partner; Beasley, Bryant & Company, CPA's, P. A., Lakeland, Florida (863) 646-1373.

November 2015 FL Cattleman Journal Article