

AGRICULTURAL TAX PLANNING

Agro-Jal Tax Court Case

Prepaid Farm Expenses

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The “Prepaid Farm Expense Deduction” is one of several federal income tax benefits made available to agricultural businesses, but not others. **Cash basis farmers**, which include ranchers, may deduct prepaid expenses if they meet certain criteria. **The recent Agro-Jal Farming Enterprises, Inc. Tax Court case may have expanded this benefit.**

The Case

Agro-Jal, a farming corporation, deducted the cost of various field-packing materials for the year in which it **bought them**. The years at issue are 2006 through 2008. Although 2005 was not at issue, it was included because field-packing materials bought in 2005 were used in 2006. The IRS contended that under IRC section 464 (section 464) and section 1.162-3, Income Tax Regulations (section 1.162-3) Agro-Jal may deduct the cost of those materials **only for the year in which they used them**.

The Tax Court **held** that the class of items described under section 464 as “feed, seed, fertilizer, or other similar farm supplies” does not include packing materials as “similar farm supplies.”

The Tax Court held further, that the “provided that” clause of section 1.162-3 for the years at issue means that the cost of materials and supplies must be deducted as the items are used or consumed, **on the condition that** they haven’t been deducted for any prior year. Thus Agro-Jal may deduct the cost of field-packing materials for the year of purchase.

Opinion and Background

Agro-Jal is a farming corporation located in California that grows strawberries and vegetables. The company uses the cash method of accounting for tax purposes and the accrual method for financial statements using GAAP. When Agro-Jal harvests these crops it uses field-packing materials, plastic clamshell containers for the strawberries and cardboard trays and cartons for the other produce. Agro-Jal has always used the cash method of accounting for these materials for tax purposes which means they deducted the full purchase price in the year purchased instead of deducting them bit-by-bit when used. The IRS insisted that Agro-Jal may deduct the cost of only those field-packing materials that it actually uses each tax year, and that it must defer deduction of the rest. Agro-Jal disagreed. Who is right depends on the Tax Court’s interpretation of section 464 of the Code and section 1.162-3 of the regulations in effect in the years at issue. This issue has apparently never been addressed by the court.

Agro-Jal’s Business – Agro-Jal was incorporated in 1996, but in many ways is run as the Maldonado family farm. The business has grown greatly over the years and most of its income comes from efficient production of a few crops, strawberries, broccoli, cauliflower, iceberg and romaine lettuce, and celery. It is a year-round business but somewhat unpredictable due to weather and market demand. The crops are planted and harvested at various times during the year. The company must harvest quickly when the crops fully mature and get them to market. Crops are shipped and marketed fresh and frozen. The crops are picked, trimmed, inspected, graded and packed in the field. Thus

labeled packaging must be available when needed. Strawberries for example, are packed in pre-labeled plastic clamshells in various sizes and then the packed clamshells are placed in pre-assembled cardboard trays. The plastic clamshells are not exotic and are identical to those found in the grocery store when buying strawberries. Packaging in the field drastically reduces processing time, lets cool air move through the packages and chill the product before shipping, and allows ethylene gas to escape (ethylene gas speeds ripening).

Regulations lengthen the lead time for getting field-packing materials out to the field. Labels must identify the product, its origin, brand name, weight, the UPC and other required information. This customized packaging requires a lead time of two to four months. Agro-Jal therefore buys in bulk and regularly prepays for large quantities to insure crops don't spoil for want of packaging.

Agro-Jal's year-end records enabled the parties to stipulate the total amount paid for field-packing materials each year, the portion of the costs of those materials purchased and used during the year, the portion paid for and received but not used during the year, and the portion paid for but not yet received. Both Agro-Jal and the IRS agreed that any field-packing materials paid for but not yet received by year end were used by the end of the next year.

Discussion

The Tax Court first looked at the right of farmers to use the cash method of accounting and the ability to deduct prepaid expenses and quickly determined this was not an issue. Next, the Tax Court looked at section 464 which in very general terms limits the use of the cash method of accounting for "farming syndicates" and their ability to deduct prepaid farm expenses. Both parties agreed that this section did not apply directly to the Agro-Jal case but did agree that the section helped in determining the meaning of the regulation that does.

That regulation is section 1.162-3. The new Tangible Property Regulations substantially changes the language of this section, but the following analysis is based on the regulation as it read in years 2006 through 2008. The court cited the first sentence of the regulation four times in its discussion, focusing on a different section of the wording in each case.

The first sentence reads:

Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year.

The second sentence of the regulation refers to the exception that permits the deduction for incidental materials or supplies on hand for which no record of consumption is kept or of which physical inventories are not taken at the beginning or end of the year. Agro-Jal clearly fails this exception as it takes year-end inventories of its field-packing materials for financial statement presentation. All parties also stipulated that Agro-Jal always uses its prepaid packing materials by the end of the following tax year because they begin to deteriorate six to eight months after they are delivered. Thus the "one year rule" does not come into play in this case.

The IRS (Commissioner's) Argument – The IRS based its argument on the first clause of the first sentence of section 1.162-3 which sets up the general rule that every taxpayer must defer deductions for materials and supplies until the year he uses or consumes them. The IRS also argued that section 464 is the only exception to this general rule, and that it permits immediate deductions only for “feed, seed, fertilizer, or other similar farm supplies” when the amounts prepaid for these expenses don't account for more than 50% of all farming expenses during any three-year period. Agro-Jal doesn't spend that much on packing materials, but packing materials aren't “feed, seed, or fertilizer,” and the IRS argues that the phrase “other similar farm supplies” should be narrowly construed.

Agro-Jal's Argument – Agro-Jal used several arguments in justifying that its deduction of field-packing materials was permitted under section 464. It also cited the clause in section 1.162-3 “provided that the costs of such materials and supplies have not been deducted in any previous year.” Agro-Jal's position is that because it already legitimately deducted its materials and supplies in an earlier year, the year it bought them, it isn't required to defer its deduction until the year the supplies are used or consumed.

In general, the Tax Court sided with the IRS position that the “feed, seed, fertilizer, and other similar farm supplies” should be interpreted narrowly and that Agro-Jal's field-packing materials were a critical part of its overall operations, but not materials critical to the growing of crops or raising of livestock which makes them not similar enough to the class of items described by the phrase “feed, seed, fertilizer, and other similar farm supplies”.

This brings us to the critical section of applicable law cited in this case, the clause of the first sentence of section 1.162-3, “**provided that** the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year”. Agro-Jal contended that the phrase “provided that” is a synonym for “only if”. Using this interpretation, Agro-Jal has to defer its deduction until it uses or consumes the field-packing materials “**only if**” it didn't deduct them in any prior year. The IRS interpreted the wording differently and both parties provided lengthy arguments supporting their position. Time was also spent on defining the term “on hand”.

Tax Court Conclusion

“Agro-Jal can deduct its field-packing materials for the year it bought them. The materials that it buys that are not “on hand” are governed by the general rules of cash-method accounting, which allows current deduction. The materials that it buys that are “on hand” are governed by section 1.162-3, which we hold does not require a cash-method taxpayer to defer its deductions until the materials are used or consumed, if the taxpayer deducted their costs for a prior tax year. The “one-year rule”--the rule that a taxpayer has to use those supplies within an approximately one-year period--might limit deductibility in some other case. But not here.”

Summary and Future Implications

The wording used in Reg. 1.162-3 by the Tax Court in deciding the Agro-Jal case has been dropped from the new Tangible Property Regulations. However, there are several implications we can draw from the Tax Court's ruling that may prove helpful in expanding the prepaid expense deduction for farmers in the future.

The 50% limit Rule – The Tax Court concluded that the phrase “amounts paid for feed, seed, fertilizer, or other similar farm supplies” should be narrowly interpreted and therefore Agro-Jal's field-packing materials fell outside of the definition of “other similar

farm supplies”. The Tax Court concluded that the 50% limit applied to a class of items similar to feed, seed or fertilizer that is more closely related to the growing of crops or the raising of livestock. **This may have greatly expanded the universe of the prepaid expense deduction if the 50% test only applies to prepaid expenses that have direct application to the growing or raising of crops or livestock as the Tax Court implied in its decision.**

The New Reg. 1.162-3 – The version of this regulation in years 2006 through 2008 categorizes materials and supplies as incidental and non-incidental as it does today. In very general terms, the regulation states incidental materials and supplies are deducted in the year purchased, while non-incidental materials and supplies are deducted when used or consumed. In the Agro-Jal case the field-packing materials were classified as non-incidental because of its accrual basis financial statements and that the containers were inventoried at year-end. **But the Tax Court concluded that a cash method taxpayer could deduct these materials and supplies when paid even though they were classified by the taxpayer as non-incidental on their financial statements.** The Tax Court based much of its opinion on the old law and the IRS may take exception to this under the new Tangible Property Regulations. However, Agro-Jal clearly had non-incidental materials and supplies that the Tax Court concluded it could currently deduct as a cash method farmer. In addition, there is another section of the tax regulations that states a farmer operating a business for profit may deduct as necessary expenses all amounts actually expended in conducting the farm operation. The Tax Court did not refer to this regulation in its decision.

Setting aside the fact that the Tax Court’s decision was mostly based on old law it does provide some useful implications that cash basis farmers may find helpful as stated above. However, **a word of caution**, the unanswered questions are how the IRS will react in future examinations of similar issues and how the new Tangible Property Regulations will influence their thinking on the issue.

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.

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