Of Accounting Methods, Farmland Leases and Farm Program Benefits

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
September 2023
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/
Used with permission from the Law Professor Blog Network

Overview

An accounting method is the manner in which a taxpayer reports income and deducts business-related expenses. Under the cash method, income is reported in the year it is received, and expenses are deducted in the year they are paid. *I.R.C. §461(a).* Conversely, taxpayers on the accrual method keep a closing and opening inventory and take into account income when it is earned (when it accrues) rather than when sold, and expenses when incurred rather than when paid. For accrual basis taxpayers, income is reported when it shows up in the closing inventory. Accrual basis taxpayers may have a more even income stream, but there are some very significant tax negatives associated with accrual accounting such as its relative complexity as compared with cash accounting.

Note: Farm taxpayers that utilize cash accounting taxpayers practically always hold inventory that has not been reported as income. At death, the potential gain is eliminated as property takes on a new basis at death equal to fair market value (except for items categorized as "income in respect of decedent"). Consequently, it is usually advantageous for a farmer or rancher to use the cash method of accounting.

Farming businesses, in general, can use the cash method of accounting, and most do. A taxpayer generally may adopt any permissible method. *Treas. Reg. Sec. 1.446-1(e)(1).*

But, certain rules apply when a taxpayer changes from one method of accounting to another. Those rules came up in a case involving an Arkansas farming corporation involving the corporation's tax treatment of income and deductions associated with its leasing of farmland.

Change in accounting method rules – it's the topic of today's post.

Computation of Taxable Income

A taxpayer computes taxable income "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." *I.R.C. §446(a).* By definition, an accounting method consists of both the overall plan of accounting for gross income or deductions and the treatment of any material item used in that overall plan. *Treas. Reg. Sec. 1.446-1(e)(2)(ii).* Once an accounting method has been adopted, the general rule is that it cannot be changed without IRS consent. *I.R.C. §446(e).* A change in the treatment of an asset from non-

depreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in the taxpayer's method of accounting. *Treas. Reg. §1.446-1(e)(2)(ii)(d)(2).* In addition, such a change in treatment results in an adjustment under I.R.C. §481to prevent the duplication or omission of income or deductions and to reflect the cumulative difference between the old and new methods. *Treas. Reg. §446-1(e)(2)(ii)(d)(5)(ii).*

Note: A change in the method of accounting does *not* include a change in treatment resulting from a change in the underlying facts. *Treas. Reg. §1.446-1(e)(2)(ii)(b).*

Accounting Methods and Farming

Many farmers participate in the federal government's farm programs and receive farm program payments. The amount of payments a farm is eligible to receive is tied to the farm "base acres." In other words, base acres is farmland that establishes a "base" for the right to receive farm subsidies for the production of certain commodities. Base acres are a farm's crop specific acreage of wheat, feed grains, rice, oilseeds, pulse crops, or peanuts that are eligible to be used for Farm Service Agency (FSA) program purposes. Base acres do not necessarily align with current plantings. For instance, upland cotton base acres on the farm are renamed "generic" base acres.

Note: A farmer's base acreage is reduced by the portion of cropland placed in the Conservation Reserve Program (CRP) but is increased by CRP base acreage leaving the CRP.

Government allotments or quotas. Historically, farmers have been required to participate in acreage allotments. An acreage allotment is a particular farm's share, based on its historic production, of the national acreage needed to produce sufficient supplies of a particular crop. In essence, an allotment represents the federal government's attempt to micro-manage production of certain types of crops. These allotments have been held to not be depreciable due to a lack of a determinable useful life. For example, in *Wenzel v. Comr., T.C. Memo. 1991-166,* the Tax Court addressed the peanut base acreage allotment as part of the federal farm programs was depreciable. The Tax Court noted that while the program had been controversial for some time, it continued to be reauthorized by subsequent farm bills. Thus, the Tax Court determined that the peanut program was a stable program that would continue unless the Congress took action to terminate it. Because the actions of Congress were completely unpredictable, the Tax Court held that the peanut program base acreage allotment was indeterminant and the associated cost to the taxpayer was not depreciable.

Later, in *C.C.A. 200429001 (Jul. 16, 2004)*, the IRS noted that three additional Farm Bills had become law since the Tax Court's ruling in *Wenzel* and the peanut program continued. That lead the IRS to conclude that the duration of the peanut program could not be determined with reasonable certainty or accuracy. Consequently, the IRS determined, the peanut base acreage allotment did not have a determinable useful life and could not be depreciated. But a transferable right to receive a premium price for a fixed quantity of milk in accordance with a regional milk marketing order has been held to be amortizable (e.g., the cost could be spread over the useful life – 15

years) when it has a statutory expiration date and is not expected to be renewed. For example, in *Van de Steeg v. Comr., 60 T.C. 17 (1973), aff'd., 510 F2d 961 (9th Cir. 1975),* the taxpayers were dairy farmers who marketed their milk production subject to a Federal Milk Marketing Order. On several occasions they purchased an intangible asset (referred to as a "class I milk base") which they used in their dairy business. They claimed depreciation for the milk base and IRS disallowed the deduction on the basis that the asset had an indeterminable useful life – it depended on the will of the Congress whether to extend the program. The Tax Court (affirmed by the Ninth Circuit) held that the program that created the class I milk base always contained an express termination date and the existence of two extensions did not change the fact that a termination date always existed, even though the date had changed.

Note: While the IRS disagrees with the *Van de Steeg* opinion, it did announce that it would follow it. *Rev. Rul. 75-466, 1975-2 C.B. 74.*

Changing Tax Treatment of "Base" Acres

Conmac Investments, Inc. v. Comr., T.C. Memo. 2023-40

In this case, the petitioner was a corporation that owned and leased farmland to tenant farmers under oral leases. The petitioner did not personally farm any of the land, but was a mere investor. The petitioner's line of business involved the retail sale of new and used automobiles. The farmland contained "base acres" –such as wheat, corn, soybeans, cotton, rice, etc., from the USDA. The farm program payments (paid pursuant to the 2008 and 2014 Farm Bills) were paid to the tenants. Under the oral leases, the tenants received all of the payments attributable to the base acres and the annual rent payment was generally 25 percent of the gross income from the farmland, with "gross income from the farmland" including any farm subsidy payments received on account of the base acres.

Before 2009, the petitioner did not claim any deductions for amortization or depreciation of the base acres. But, starting in 2009, the petitioner began claiming an amortization or depreciation deduction for base acres acquired and placed in service in 2004 through 2013 (i.e., asserting an ownership interest in an intangible asset). Changing the treatment of an asset from non-depreciable to depreciable or non-amortizable to amortizable (or vice-versa) is a change of accounting that results in an I.R.C. §481 adjustment.

Note: Why the petitioner decided to claim deductions against, essentially, cash rent, is not known. It was the tenants that were assuming the risk of production under the leases, not the petitioner. In essence, the petitioners started claiming deductions against guaranteed rental income without assuming any of the risk of the expenses under the leases.

However, the petitioner did not attach Form 3115 (application for change in accounting method) to its Form 1120 (corporate tax return) or otherwise seek IRS consent to change its accounting method. The petitioner also did not file amended returns with an explanatory statement for all

open years reclassifying the base acres as amortizable under I.R.C. §197. The petitioner also did not adopt the same accounting treatment for all bases acres that it owned.

The IRS determined that the petitioner had adopted an impermissible method of accounting and asserted deficiencies of approximately $116,000 for 2013 and $114,000 for 2014, and that an I.R.C. §481 adjustment of $141,614 for 2009-2012 was required. The petitioner claimed that it had not changed its accounting method because of a change in underlying facts impacting its business. In addition, the petitioner claimed that even if there weren't a change in the underlying facts that supported an accounting method change, the lack of IRS consent didn't matter because the relevant tax years had closed. The petitioner also claimed that an I.R.C. §481 adjustment wasn't necessary because it should have been made for the "year of change" (e.g., 2009) and that IRS could no longer require the adjustment because 2009 was a closed tax year.

The Tax Court (opinion by Judge Paris) agreed with the IRS noting that the petitioner had changed an accounting method in violation of I.R.C. §446(e) which requires IRS consent for such a change, and that an I.R.C. §481 adjustment was proper. The facts did not involve the application of an existing accounting method to a change in business practices. Indeed, there was no change in business practices - the petitioner continued to serve as landlord to the tenant farmers and didn't change the terms of the leases. Instead, the only economic consequence was the tax benefit that the petitioner received on account of the change – there was no change in existing legal or economic relationships. In addition, the petitioner continued to treat base acres acquired and placed in service in other years as nonamortizable or non-depreciable. The Tax Court determined that the petitioner has simply made a business decision in 2009 to start claiming amortization deductions on farmland what it had acquired and placed in service beginning in 2004. The corporation, the Tax Court pointed out, failed to identify the facts that had changed that caused it to change its tax treatment of the rented farmland.

Note: Judge Paris brought up on her own the case of *Comr. v. Brookshire Bros. Holding, Inc., 320 F.3d 507 (5th Cir. 2003), aff'g., T.C. Memo. 2001-150.* In that case, the appellate court, affirming the Tax Court, held that an IRS challenge to a method change for which consent was not given must be for the year of the improper change, and that failure to obtain prior consent did not serve as a basis to challenge the change for a closed year. Judge Paris distinguished *Brookshire* on the basis that the corporation in the present case did not file amended returns with an explanatory statement for all open years reclassifying the base acres. In addition, based on the corporation's inconsistent treatment of the base acres depending on the year the farmland was placed in service, the Tax Court determined that finding an unauthorized change in accounting would promote consistency and wouldn't offend basic fairness.

The Tax Court also sustained the I.R.C. §481 adjustment. The Tax Court rejected the petitioner's argument that the I.R.C. §481 adjustment was barred by the statute of limitations after finding that the "year of the change" was the oldest open tax year. The Tax Court explained that the only limitation on an I.R.C. §481(a) adjustment is that no pre-1954 adjustments may be made. So long

as a change in an accounting method has occurred, the IRS may adjust a taxpayer's income in an open year to reflect amounts attributable to years for which the applicable statute of limitations has expired (i.e., time-barred years). *Huffman v. Comr., 518 F.3d 357 (6th Cir. 2008), aff'g., 126 T.C. 322 (2006).*

Conclusion

The bottom line in *Conmac* was that the petitioner's failure to get IRS permission under I.R.C. §446(e) prevented the corporation from implementing an accounting method change with respect to the base acres rented to tenants for tax years 2009-2014. As a result, the petitioner had tax deficiencies to pay and had to include in income for 2013 a positive I.R.C. §481 adjustment for I.R.C. §197 amortization deductions claimed for the base acres for 2009-2012.

Not understanding the tax nuances of agricultural leases and the tax treatment of ag-related intangibles, as well as the procedures for changing accounting methods ending up costing the petitioner a large sum in tax deficiencies (about $100,000) an I.R.C. §481 adjustment of about $141,000 plus attorney fees.

Copyright 2023: AgManager.info and K-State Department of Agricultural Economics