Prepaid Expenses

Abstract:
While the rules for deducting prepaid farm expenses have not changed, the IRS is taking a closer look at the deduction in recent audits. This material discusses the general rules that make the expenses eligible for a current deduction.

ISSUE 5: PREPAID EXPENSES: CHANGE OF PLANS

GENERAL RULES FOR PREPAID EXPENSES
Farm producers who use the cash method of accounting are allowed to deduct the cost of supplies purchased during the year even if the supplies will not be used until the following year if they meet the requirements of two sets of rules.

One set of rules comes from case law and IRS rulings. The general rule is stated in Grynberg v. Commissioner, 83 T.C. 255 (1984), and is applied to feed expenses in Rev. Rul. 79-229 1979-2 C.B. 210. This rule requires the producer to meet the following three conditions to claim a deduction in the year of the expenditure:

1. The expenditure must be a payment for the supply rather than a deposit.
2. The prepayment must be made for a business purpose and not merely for tax avoidance.
3. The deduction must not result in a material distortion of income.

The other set of rules is set out in I.R.C. §464(f). Those rules limit a taxpayer’s deduction for prepaid expenses to 50% of deductible expenses other than the prepaid expenses unless the taxpayer is a “qualified farm related taxpayer.” A “farm related taxpayer” is any taxpayer:

1. Whose principal residence is on a farm
2. Whose principal occupation is farming, or
3. Who is a member of the family of a taxpayer who meets the requirements of 1 or 2 above

To be “qualified,” the farm related taxpayer must meet one of the following two requirements:
1. Aggregate prepaid farm supplies for the prior three years must be less than 50% of the aggregate deductible farming expenses other than prepaid expenses, or

2. Extraordinary circumstances (such as a flood or a drought) caused prepaid expenses to exceed 50% of farming expenses other than prepaid expenses in the current year.

Example 1. Patty Producer uses the cash method of accounting. In December 2000, she paid $20,000 to Supply Cooperative for fertilizer to be applied in the spring of 2001 on her corn crop. Patty’s deductible expenses for 2000 other than this purchase of fertilizer was $100,000. She purchased the fertilizer in December for two reasons. First, she was offered a discount for purchasing in December rather than the following spring. Second, she was concerned that fertilizer may be difficult to buy at any price the following spring. Patty is allowed to deduct the $20,000 she paid for the fertilizer on her 2000 income tax return. She meets the three requirements of the general rule. I.R.C. §464(f) does not limit her deduction for two reasons. First, she is a qualified farm related taxpayer, so the 50% limit does not apply to her. Second, she has not exceeded the 50% limit.

EFFECT OF CHANGE IN PLANS

After purchasing supplies for the following year, a producer’s plans may change. He or she may decide not to produce the crop or raise the livestock for which the supply was purchased. Such producers must address the tax consequences of that change in plans.

Example 2. Assume the same facts as in Example 1, except that the price of corn dropped dramatically before Patty planted her crop and the cost of fertilizer increased significantly. Consequently, Patty decided to sell the fertilizer she had purchased and plant an alternative crop that does not require fertilizer. She found a buyer that paid her $25,000 for the fertilizer.

What are the income tax consequences of Patty’s change in plans?

Law and Analysis

Deduction on 2000 Tax Return. A potential consequence of Patty’s change in plans is a denial of the $20,000 deduction on her 2000 income tax return.

In Rev. Rul. 82-208, 1982-2 C.B. 58, the prepayment rules were applied to a payment of estimated state income taxes on December 31, 1981. The IRS noted that estimated state income taxes are deductible in the year they are paid if the amount of the payment is reasonably determined in good faith at the time of the payment. In that ruling, the IRS held that the taxpayer had no reasonable basis to
believe that he owed any additional state income taxes and did not allow the estimated payment to be deducted on the 1981 income tax return.

Applying the principle of Rev. Rul. 82-208 to the facts in Example 2, the IRS is not likely to challenge Patty’s deduction of the $20,000 on her 2000 income tax return. At the time she made the payment, she in good faith thought that she would use the fertilizer on her 2001 corn crop.

**Income on 2001 Tax Return.** The sale of the fertilizer in 2001 results in taxable income for 2001. Since Patty deducted the cost on the fertilizer on her 2000 income tax return, she has a zero basis in the fertilizer. Therefore, Patty must report the full $25,000 that she received for the fertilizer on her 2001 income tax return. The other income line of Schedule F (line 10 on the 2001 Schedule F) is the logical place to report this income since it was neither purchased for resale (Schedule F, line 1) nor raised (Schedule F, line 4).

**Other Supplies**

The same tax consequences are likely to follow from the purchase and sale of other farm supplies so long as there is a good faith expectation the supply will be used in the farm business when it is purchased and there is a genuine change in plans that results in a sale of the supply. The following supplies are likely to qualify for the above tax consequences for the reasons listed with each supply.

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<thead>
<tr>
<th>Supply</th>
<th>Reason for Sale</th>
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<tbody>
<tr>
<td>Feed</td>
<td>Drought forced sale of livestock</td>
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<tr>
<td>Seed</td>
<td>Weather conditions or market caused producer to not plant the crop</td>
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<tr>
<td>Pesticides</td>
<td>Weather conditions or market caused producer to not plant the crop</td>
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<tr>
<td>Fuel</td>
<td>Weather conditions or market caused producer to not plant the crop</td>
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**Return of Supplies to Seller for a Credit**

If the supplies are returned to the seller for a credit, the taxpayer must be careful to not trigger the deposit rule. If the supply is returned to the seller for a credit equal to the original amount paid, the original transaction could appear to be a deposit rather than a purchase. The taxpayer should document the negotiations that result in a credit for the taxpayer.

**Example 3.** Assume the same facts as in Example 2, and in addition assume that Patty sells the fertilizer back to Supply Cooperative and receives cash for the sale. These facts do not jeopardize Patty’s argument that the original purchase was a purchase and not a deposit.

If Patty received a credit from Supply Cooperative that could only be used to purchase other supplies from the cooperative, the IRS could argue that her original payment was a deposit and not a purchase. However, since Patty
negotiated a different price for the fertilizer, she can show that she faced the risk of a price change. Therefore, she is likely to prevail on her argument that the original payment was a purchase.

If Patty received a credit from Supply Cooperative that is exactly equal to her original purchase price, it is more difficult for her to show that her original payment was not a deposit. She should document her negotiations with Supply Cooperative so that she can prove that she faced the risk of a price change and that the credit was the same as the original purchase price only because the value of the fertilizer when she returned it was the same as the cost of the fertilizer when she purchased it.