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## **Tax Accounting Rules for Farmers and Ranchers**

by

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# TAX ACCOUNTING RULES FOR FARMERS AND RANCHERS

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Farmers and ranchers historically have been given preferential tax treatment by Congress. One of the most significant aspects of this preferential treatment is the tax accounting methods that farmers and ranchers are entitled to use in reporting their income, particularly the "cash receipts and disbursements" form of accounting. These preferential tax accounting methods have spawned numerous cases centering around whether or not a taxpayer is a farmer entitled to use the advantageous tax accounting methods and, if so, whether or not the taxpayer's use of a particular accounting method is proper.

## DEFINITION OF FARMER

The initial hurdle a taxpayer must overcome in order to take advantage of the accounting methods accorded to farmers is to fit within the definition of a "farmer." Treasury Regulation section 1.61-4(d) provides the definition of a "farm" for purposes of the Internal Revenue Code (IRC) section 61 as follows:

As used in this section, the term "farm" embraces the farm in the ordinary accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. . . .

The quoted regulation refers to Treasury Regulation section 1.175-3 for more detailed rules with respect to the determination of whether or not an individual is engaged in the business of farming.

A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. For the purpose of section 175, a taxpayer who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the business of farming. However, a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm. A taxpayer engaged in forestry or the growing of

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timber is not thereby engaged in the business of farming. A person cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the business of farming. For the purpose of this section, the term "farm" is used in its ordinary, accepted sense and includes stock, dairy, poultry, fish, fruit, and truck farms, and also plantations, ranches, ranges, and orchards. A fish farm is an area where fish are grown or raised, as opposed to merely caught or harvested; that is, an area where they are artificially fed, protected, cared for, etc. A taxpayer is engaged in the "business of farming" if he is a member of a partnership engaged in the business of farming.<sup>1</sup>

A two-fold test has evolved in applying the regulations to a taxpayer to determine if he or she is a farmer: (1) The person must participate to a material extent in the operation or management of the farm, and (2) the person must assume a substantial risk of loss from the operation of the farm.<sup>2</sup>

"Participating to a material extent" is not defined by the regulations of section 175, and no specific test has been applied by the cited authorities. Material participation, however, has long been required for rental income received from leased farmland to be treated as earned income from self-employment for social security tax purposes.<sup>3</sup> The Regulations under section 1402 set forth a four part test which can be satisfied by passing any one of the four parts.<sup>4</sup> These tests would be very helpful in determining if a person is a farmer for accounting purposes.

In its tax shelter examination guidelines, the IRS has set forth policy guidelines for tax shelters including cattle breeding herds which attempt to have the investors treated as farmers. Investors in syndications of cattle breeding herds may not have acquired the burdens of ownership (and thus would not be classified as farmers) where the syndication has guaranteed such items as herd replacement and number of progeny. Agents are instructed to look for such guarantees in prospectuses and agreements and that "contingency reserves created to defer income of the syndicator are an indication that unstated guarantees exist."<sup>5</sup>

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1. I.R.C. § 175 (1976) sets forth conditions for expensing soil and water conservation expenditures which would otherwise have to be capitalized. The method described in § 175 is available only to a taxpayer engaged in the "business of farming."

2. See Treas. Reg. § 1.702-1 (1986). See also Treas. Reg. §§ 1.75-3, 1.182-2 (1986); Duggar v. Commissioner, 71 T.C. 147 (1978); Maple Leaf Farms, Inc. v. Commissioner, 64 T.C. 438 (1975); Rev. Rul. 69-606, 1969-2 CB 33.

3. I.R.C. § 1402(a) (1976). See also Rev. Rul. 75-365, 1975-2 C.B. 471 and Rev. Rul. 75-336, 1975-2 C.B. 472 dealing with the required material participation for eligibility for deferring estate tax payments under I.R.C. § 6166 (1976).

4. If the landowner does any three of the following: (1)(a) advances, pays or stands good for at least half the direct costs of producing the crops; (b) furnishes at least the tools, equipment, and livestock used in producing the crops; (c) advises and consults with the tenant periodically; and (d) inspects the production activities periodically; (2) the landowner regularly and frequently takes an important part in making management decisions substantially contributing to or effecting the success of the enterprise; (3) the landowner works 100 hours or more, spread over a period of five weeks or more, in activities connected with producing the crop; or (4) the landowner does things which, considered as a whole, show that he or she is materially and significantly involved in the production of farm commodities. See Treas. Reg. 1.1402(a) (1974).

5. INTERNAL REVENUE MANUAL TRANSMITTAL 4236-1 (March 2, 1979).

Many of the cases dealing with the definition of a "farmer" involve suspicious fact situations where the taxpayer is engaged in non-farming businesses or is removed from traditional farming, such as actual tilling of the soil or raising of livestock. In *Hi-Plains Enterprises, Inc. v. Commissioner*,<sup>6</sup> for instance, the taxpayer was not a cattle producer, but in the course of its business purchased feeders for itself and for others, known as customers, who desired to utilize its services and feedlots for the purpose of fattening cattle. Over the period in question, the cattle on feed in the lots were owned on the average of approximately fifty percent by the taxpayer and fifty percent by the customers. The entire operation was conducted as one business, with the exclusive management in the taxpayer. All services necessary for conditioning of the cattle, regardless of ownership, were the same. The customer paid for the use of lots, feed and other necessary services according to an arrangement between the parties resulting in income to the taxpayer.

The Tax Court held that the essence of the Commissioner's argument was that in its activities as to the customer's cattle, the taxpayer was engaged in furnishing a service that was comparable to any other business which has farmers for customers, including one which sells cattle feed to farmers. The Tax Court held that the Regulations defining "farm" include livestock business, and the management of farms and that nowhere in the Regulations or decisions has there been any indication that a farmer's right under the Regulations is effected by the ownership of farm property which he operates. The Tax Court chastised the Commissioner for overlooking the fact that the taxpayer was engaged only in the business of feeding cattle, which the Commissioner had conceded to be that of a farmer within the meaning of the Regulations.

In *Maple Leaf Farms, Inc.*,<sup>7</sup> the taxpayer raised ducks on its property, and also slaughtered and processed the ducks. The ducks were raised by growers who contracted with the taxpayer. The contract required the taxpayer to provide "at a charge" to each grower, all feed, medications and vaccines needed in the growing process. The taxpayer selected all feed and medications it determined to be necessary and paid the supplier for these items. As the grower's supply of feed ran low, he would notify the feed mill and ordered the feed to be delivered directly to his premises. As medication was needed, each grower would notify the taxpayer, who would authorize delivery of such medication from the supplier to the grower. The taxpayer retained legal title to "all material delivered to the grower" pursuant to the contractual agreement, and the taxpayer carried and paid for insurance and paid all personal property taxes on the ducks and feed in possession of the growers. The taxpayer did not consider the growers as its employees and did not include them in its profit sharing or medical plans nor did it withhold

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6. 60 T.C. 158 (1973), *aff'd*, 496 F.2d 520 (10th Cir. 1974), applied in *In re Cameron*, 51 T.C.M. (P-H) 1081 (1982).

7. *Maple Leaf Farms, Inc.*, 64 T.C. 438 (1975). The Tax Court has held likewise in a case involving chickens. See *United States v. Chemell*, 243 F.2d 944 (5th Cir. 1957).

FICA and income taxes from payments to its growers. Employees of the taxpayer would visit each grower and would check the facilities to be sure the requirements of the contractual agreement were being met. On these trips, the employees of the taxpayer would often given criticism and make recommendations. At the end of the seven-week growing period, the ducks were delivered to the taxpayer's processing plant and slaughtered.

The Tax Court applied a two-part test to determine if the taxpayer was a farmer: (1) Did it participate to a significant degree in the growing process, and (2) did it bear a substantial risk of loss from that process. Based on the facts of the case and the agreement between the taxpayer and growers, the Court held that both of these tests were met. The taxpayer's activities of selecting and purchasing the ducklings, determining all necessary feed and medication required by the growers satisfied the participation requirement. The substantial risk of loss test was met because, under the contract and in the manner the business was conducted, the taxpayer had to bear death loss and condemnation loss, as well as market uncertainties.

Farming has also been held to include nurseries,<sup>8</sup> growing mushrooms in a cave,<sup>9</sup> and breeding and raising various furbearing animals.<sup>10</sup>

#### ACCOUNTING METHODS

Farmers and ranchers have four basic methods they can use in reporting income, (1) the cash receipt and disbursements method, (2) the accrual method, (3) the crop method and (4) the so-called "hybrid" method which combines the cash and accrual methods, if such method clearly reflects income. Since the crop method is rarely used, and for brevity purposes, it will not be discussed.

##### *Cash receipt and disbursement method*

The Regulations permit farmers to use the cash receipts and disbursements method of income tax reporting.<sup>11</sup> A farmer may also make his return upon an inventory method instead of a cash receipt and disbursements method. It is optional with the taxpayer which of these methods of accounting is used, but having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of Regulation section 1.446-1.<sup>12</sup> The Reg-

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8. *Stokes v. Commissioner*, 22 T.C. 415 (1954) and Rev. Rul. 59-12, 1959-1 C.B. 59.

9. Rev. Rul. 59-41, 1957-1 C.B. 341.

10. Rev. Rul. 59-588, 1957-2 C.B. 305.

11. Treas. Reg. § 1.61-4(a) (1972).

12. A farmer using the cash receipt and disbursements method of accounting shall include in his gross income for the taxable year (1) the amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised; (2) the profits from the sale of any livestock or other items which were purchased; (3) all amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income; (4) all subsidy and conservation payments received which must be considered as income; and

ulations provide the general formula for how the cash receipt and disbursement method of accounting works. Generally, all disbursements made by the taxpayer in a taxable year in the operation of the farm, including the raising of crops and livestock, are deductible.

The cash method of accounting, in addition to its simplicity, has many advantages over other accounting methods for farmers. These advantages include:<sup>13</sup>

1. Elimination of the necessity of keeping inventories. Most farmers have substantial inventories of livestock and crops but they do not have the expertise or personnel to engage in the tedious task of taking inventories that retail and manufacturing entities engage in.
2. Farmers may claim all the immediate deductions allowed cash method taxpayers, which allows farmers to easily keep track of their deductions; this, in turn allows farmers to easily control the amount of income tax for which they may be liable. Most farmers who report their income on the cash receipt and disbursement method can prepare their income tax returns directly from their bank statements.
3. Since income is not actually recognized until cash is received, farmers have cash available to pay income taxes.
4. The farmer may control the year in which income is reported by manipulating the rules concerning when cash is actually received. The doctrine of constructive receipt, however, as discussed below, has been applied to limit the lengths to which farmers can go in manipulating the timing of cash receipts.

Cash basis taxpayers have used many imaginative techniques to defer reporting income which have resulted in a substantial volume to case law. Technically, if a taxpayer's control of the receipt of money is subject to limitations or restrictions, the income is not constructively received.

The cash method of accounting requires a farmer to include in gross income the amount of cash and the fair market value of other property received during the taxable year. This includes checks or other cash equivalents. Payments received subject to the contingency that a refund might have to be made are includible income when received.<sup>14</sup>

A fine line exists between when cash is actually received and when it is not received for purposes of the cash receipts and disbursements method. Under Treasury Regulation section 1.451-2(a), income is constructively received when it is:

1. Credited to the taxpayer's account;
2. Set apart for the taxpayer;

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(5) gross income from all other sources. Treas. Reg. § 1.471-6 (1960); see also I.R.S. PUB. NO. 225, FARMERS TAX GUIDE 6 (Rev. October 1985).

13. N. HARL, 4 AGRICULTURAL LAW § 25.03[9] (1985), contains comprehensive discussions of the cash method and points out several disadvantages of the cash method.

14. Estate of Whitaker v. Commissioner, 259 F.2d 379 (5th Cir. 1958), *aff'g*, 27 T.C. 399 (1956). A breeding fee was received when a fetus was in being subject to the possibility of refund if a fetus was not born alive. Estate of Whitaker, 259 F.2d at 382. See also Rev. Rul. 69-358, 1969-1 C.B. 139; Rev. Rul. 69-359, 1969-1 C.B. 140.

3. Made available so the taxpayer could have drawn on it; or
4. Could have been drawn if notice of intent to withdraw had been given.

One of the most common methods of deferring income is that of the deferred payment contract. Typically, this type of contract requires the sale and delivery of a commodity in one year with receipt of the proceeds of the sale in a later year.<sup>15</sup> The farmer enters into contracts under which the farmer has no legal right to demand and receive payment for the commodity sold during the year of delivery. The Service has concluded that if the contract is a bona fide arm's length contract requiring payment in the following taxable year, then the proceeds are includible in the year payment is actually received.<sup>16</sup> In *J.D. Amend*, a calendar year wheat farmer entered into contracts for the sale of his wheat for delivery and payment in January of the year following harvest of the crop. The taxpayer had consistently used this practice for four consecutive tax years and stipulated that delivery and payment could have taken place in the year of production, but contended that the practice used evened out the income flow. The Tax Court, in holding the taxpayer's method of reporting was proper, relied on the fact that the practice was consistent and that the contracts legally bound the taxpayer to accept payment the following year after harvest.

A second requirement for deferral of income to be effective in delaying taxation is that the purported "purchaser" must act as purchaser and not as agent or co-signee for the farmer. In a published ruling, for example, a father entered into a deferred payment contract with a market corporation for the sale of livestock, the terms of which required the market corporation to pay the seller after it resold the livestock in the auction market. The sales price, which was paid to the farmer in the year after the market corporation sold the livestock, was determined by the price received by the market corporation at auction, less its expenses. The ruling held that the risk of loss did not pass to the "buyer" under the facts, and that the contract was held to be one of consignment. Therefore, the seller had to include the proceeds in his gross income when the market corporation was paid.<sup>17</sup>

The Fifth Circuit has applied the agency theory where money received by a cotton gin in one year from the sale of a farmer's cotton was paid to the farmer in the following year. The Court held that the gin was the farmer's agent and receipt by it was receipt by its principal.<sup>18</sup> The Court found, based on the facts, that the taxpayer and the purported agent intended for there to be an actual sale. Moreover, the deferred payment contracts were treated differ-

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15. Rev. Rul. 58-162, 1958-1 C.B. 234.

16. *J.D. Amend v. Commissioner*, 13 T.C. 178 (1949). See, Horvitz, Persellin & Seago, *Income Recognition By Farmers Who Use Deferred Payment Contracts*, 7 J. AGRIC. TAX. & L. 195 (1983).

17. Rev. Rul. 70-294, 1970-1 C.B. 13.

18. *Warren v. United States*, 613 F.2d 591 (5th Cir. 1980) and *Arnwine v. Commissioner*, 76 T.C. 532 (1981), *rev'd*, 696 F.2d 1102 (5th Cir. 1983). For an opposite result, see *Crimmins v. United States*, 80-2 U.S.T.C. ¶ 9542 (D.N.D. 1980), *aff'd*, 81-2 U.S.T.C. ¶ 9576 (8th Cir. 1981). Taxpayers exercised no control over a purported agent's internal bookkeeping methods and, therefore, these records were not conclusive on the issue of taxpayer's intent.

ently than ordinary consignments. The funds were segregated from consignment proceeds and were used to purchase certificates of deposits.

If the contract approves the receipts of the income for more than one year, the IRS may attack the contract and require inclusion of the income in the year of sale. Authority for inclusion of the income is found in IRC section 1001(b).<sup>19</sup> The Ninth Circuit in *Warran Jones Co. v. Commissioner*,<sup>20</sup> construed the legislative history of section 1001(b) of the Code as meaning that when income is realized in the form of property, the measure of such income is the fair market value of the property at the date of its receipt. Moreover, the Court could find no indication that Congress intended that there must be a "readily realizable market value" for property in order for the provisions of section 1001(b) to become applicable. Rather, it was concluded that Congress intended to establish the more definite rule that if a fair market value was ascertainable, such value must be reported as an amount realized. The Court noted that Congress clearly understood the consequences of such concept of taxation by enacting the installment basis for reporting gain. In *Warren Jones*, payment for crops was deferred for two years. Although this two-year deferral was not mentioned in the IRS rationale for requiring immediate inclusion in income, it may well be of practical significance in indicating continuing IRS resistance to deferrals of more than one year.<sup>21</sup>

Inclusion of income from sale of crops deferred for more than one year can be avoided by reporting under the installment sales rules.<sup>22</sup> This option was not available in the typical situation prior to the adoption of the Installment Sales Revision Act of 1980 due to the "two payment rule" of the old installment sales reporting rules.<sup>23</sup> Furthermore, deferred payments from crops and livestock held primarily for sale could not get the preferential treatment.<sup>24</sup>

The Installment Sales Revision Act of 1980 removes these limitations, so long as the property is not required to be included in inventory under the farmer's method of accounting regardless of whether or not the farmer holds the property for sale.<sup>25</sup> Since installment sales treatment applies automatically to eligible transactions, unless a taxpayer elects otherwise, application of IRC section 1001(b) will no longer be an available means for the Commissioner to cause inclusion of deferred payment sales of farm property.

The cash receipts and disbursements method of accounting is very attractive to taxpayers needing a "one shot" deduction. Typically, this deduction is provided through a tax shelter limited partnership or Subchapter S corpora-

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19. I.R.C. § 1001(b) (1982). "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. . . ." *Id.*

20. 524 F.2d 788 (9th Cir. 1975).

21. See T.I.R. 1264, in which the IRS challenges multiple year deferrals.

22. I.R.C. § 453A (1982).

23. Pub. L. 96-471, § 2, 91 Stat. 2247.

24. Former I.R.C. § 453(b)(1) (1982).

25. S. REP. NO. 1000, 96th Cong., 2d Sess., 94 Stat. 2247.



tion which purchases large quantities of feed to be fed to cattle sold in following years. The feed expense is distributed to the investors which they can deduct with no offsetting income. IRC section 464, however, was enacted to prevent this abuse. That section prevents any farming syndicate from deducting amounts paid for feed, seed, fertilizer or other similar farm supplies until the taxable year in which such feed, seed, fertilizer or other supplies are actually used or consumed. A fairly detailed definition of the farming syndicate is provided in IRC subsection 464(c).<sup>26</sup>

Other methods utilized by the Internal Revenue Service to attack the efficacy of deducting disbursements in the year made by a taxpayer using the cash receipts and disbursements method of accounting include the material distortion of income test. Factors considered by the Internal Revenue Service under this test include (1) the materiality of the expenditures in relationship to the taxpayer's income; (2) the useful life of the assets; (3) the purpose for making the payment; (4) the amount of the payment in relationship to payments in prior years; (5) the time of the year the payment was made; and (6) the effect of the payment on federal taxes from year to year. The United States Supreme Court, however, has stated that the cash method of accounting for sales of breeding livestock would substantially distort the economic picture of the taxpayer's ranching operations and that this distortion, and sacrifice in accounting accuracy, represents a historical concession by the Secretary and the Commissioner to provide an expedient bookkeeping system for farmers and ranchers in need of a simplified accounting procedure. Therefore, the IRS, under the distortion of income theory will, not likely, be successful in attacking these deductions. If a distortion is egregious, however, taxpayers can expect IRS inquiries. Typically, the egregious situations arise when a large one-time prepayment of expenses is made by a person not normally in the business of farming.<sup>27</sup>

### *Accrual Method of Income Accounting*

A farmer who uses the accrual method must use inventories to determine his gross income.<sup>28</sup> The accrual method of accounting causes income to be reported more evenly than the cash receipts and disbursements method and income will be, as a general rule, reported much earlier. The present eco-

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26. I.R.C. § 464(c), states:

For purposes of this section, the term "farming syndicate" means—(A) a partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale, or (B) a partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, if more than 35% of the losses during any period are allocable to limited partners or limited entrepreneurs.

See also *Clement v. United States*, 580 F.2d 422 (Ct. Cl. 1978) and *Dunn v. United States*, 468 F. Supp. 991 (S.D.N.Y. 1979), in both of which a one-time prepayment of feed expenses was challenged successfully.

27. See *Clement*, 580 F.2d 422 (Ct. Cl. 1978); *Dunn*, 468 F. Supp. 991 (S.D.N.Y. 1979).

28. Treas. Reg. § 1.61-4(b) (1972).

conomic and financial crisis in agriculture may result in a significant re-examination of the virtues of the accrual method of accounting, particularly from a lender's point of view. Far more sophisticated methods of bookkeeping, cash-flow analysis and computation of net income, are being applied by the farm community than in the past. Since only the accrual method is a true picture of the actual income, and hence the economic health, of a farm enterprise its use for income analysis and loan evaluation purposes may become much more widespread.

The farmer's gross income on an accrual method is determined by adding the total of the income described in the following paragraphs (1) through (5) and subtracting therefrom the total of the items described in paragraphs (6) and (7). These items are as follows:

1. The sales price of all livestock and other products held for sale and sold during the year;
2. The inventory value of livestock and products on hand and not sold at the end of the year;
3. All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;
4. Any subsidy or conservation payments which must be considered as income;
5. Gross income from all other sources;
6. The inventory value of livestock and products on hand and not sold at the beginning of the year; and
7. The cost of any livestock or products purchased during the year (except livestock held for draft, dairy, or breeding purposes, unless included in inventory).<sup>29</sup>

By excluding items 3, 4 and 5 which are items of income not involved in inventories, the formula of the regulations can be recast as follows:

(Closing value of inventory plus sale of inventory items during the year) minus (beginning value of inventory plus costs of purchases during the taxable year) equals gross income.

Manipulation of the different elements of the formula reveals several interesting aspects of accrual accounting. First, increases in inventory will increase gross income. Second, if a "value" for inventory has to be established, the method of valuing inventory will have a substantial impact on gross income. For instance, if inventory values are fluctuating, valuing the inventory under the FIFO (first in-first out) method may produce drastically different results as compared to the LIFO (last in-first out) method of inventory valuation. Third, changes in inventory methods during a taxable year which result in tax savings for that year may require approval of the Commissioner.<sup>30</sup>

Farmers may use either the cash or accrual method of accounting,<sup>31</sup> however, some farm corporations and partnerships have to use the accrual method

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29. Treas. Reg. § 1.61-4(b) (1972).

30. FARMERS TAX GUIDE, *supra* note 12, at 7.

31. Treas. Reg. § 1.61-4 (1972); Treas. Reg. § 1.471-6 (1960).

of accounting beginning in 1977.<sup>32</sup> Exceptions to that rule are S corporations, a corporation of which at least fifty percent of the total combined voting power of all classes of stock entitled to vote and at least fifty percent of the total number of shares of all other classes of stock of the corporation, are owned by members of the same family as defined in IRC subsection 447(d) and the corporation has gross receipts less than \$1,000,000.<sup>33</sup> Certain closely held corporations are also excepted from the rule.<sup>34</sup>

### *Inventory Methods*

The Internal Revenue Service has sanctioned four inventory valuation methods, which are discussed as follows:<sup>35</sup>

1. The cost method;
2. Lower of cost or market method;
3. Farm-price method;
4. Unit-livestock-price method.

### *The cost method*

Under this method, inventory items are valued at the actual cost of producing them. A purchased item is valued at its actual purchase price plus any additional costs which add value to the item.<sup>36</sup> The cost method is the most realistic, and on its surface, appears simple. But it is very difficult to establish the cost of each unit or raised livestock owned by a farmer that is included in inventory. For a feeder, however, maintenance of adequate records on purchased livestock may be done.

In dealing with purchased commodities, the question arises as to the identification of the items sold. Theoretically, a perpetual inventory could be maintained which would identify each item entering inventory, trace that item, and identify the item as it leaves inventory. As a practical matter the maintenance of such an inventory for large quantities of relatively fungible items is not practical. Accounting conventions have, therefore, been established for the purpose of averaging the costs of portions of inventory, as sold, which take the following form:

1. Assumption that the items sold constitute the first items purchased and assignment of costs to items sold in the order in which the items were purchased (the FIFO method), or
2. Assumption that the items sold are the last items purchased and assignment of cost to items sold in the reverse order in which the items have been purchased (the LIFO method).

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32. I.R.C. § 447 (1982).

33. Id. at § 447(c), (e).

34. Id. at § 447(h).

35. FARMERS TAX GUIDE, *supra* note 12, at 7.

36. I.R.S. PUB. NO. 538, ACCOUNTING PERIODS AND METHODS 15 (Rev. Oct. 1985).

### *Lower of Cost or Market Method*

Under this method, the actual cost of producing an item or if the item is purchased, its purchase price plus additional costs, is compared with the cost of replacing the item and the item is valued at the lower of these two figures. The comparison has to be made for each item of inventory and cannot be made on the total inventory. The current cost of replacing an item is the current bid price at the inventory date for items of like grade or quality in the quantities taxpayer usually buys.<sup>37</sup> The lower of cost or market method of accounting is virtually impossible for any farmer or rancher that has a substantial number of livestock to use. Under this method, the taxpayer's income tends to follow fluctuations in the market from which he buys, but fluctuation in taxable income is limited by the fact that cost is used where lower than market.

### *The Farm Price Method*

The Treasury adopted the farm price method as a result of the difficulties in determining cost.<sup>38</sup> The method provides for the valuation of inventories at market prices less the estimated direct costs of disposition. This method is a much more convenient method than the cost or lower of cost or market method. A taxpayer's taxable income tends to follow fluctuations in the market in which he sells under this method and as a result taxable income tends to fluctuate more than under the lower of cost or market method. If the taxpayer uses the farm price method, it must be applied to the entire inventory unless livestock is carried under the unit livestock price method.<sup>39</sup>

### *Unit Livestock Price Method*

Under this method, a farmer groups or classifies his livestock according to their kind, sex and age and a standard unit price is given to each class of animals. The year, prices and classification have to be approved by the District Director when the taxpayer's income tax return is examined.<sup>40</sup> When a taxpayer has established a classification or unit price, it may be changed only with the approval of the Commissioner.<sup>41</sup> The taxpayer who elects to use the unit livestock price method must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Any livestock purchase must be included in inventory at cost if the unit livestock price method is used. However, animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not

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37. *Id.*

38. Treas. Reg. § 1.471-6(d) (1960).

39. *Bamert v. Commissioner*, 8 B.T.A. 1099 (1927).

40. Treas. Reg. § 1.471-6(e) (1960).

41. *Id.* A livestock raiser who uses this method must apply it to all livestock raised, whether for sale, draft, dairy or breeding purposes. Treas. Reg. § 1.471-6(f) (1960). The regulation was upheld in *United States v. Catto*, 384 U.S. 102 (1966).

mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first in, first out method of valuing inventories must be applied.<sup>42</sup>

The four inventory methods are best explained through examples. For purposes of simplicity, assume Farmer B owns one cow, which cost \$375.00 to raise which becomes the opening inventory for 1984. On January 20, 1984, he sells the cow for \$500.00. On June 1, 1984, he buys two immature cows for \$380.00 each, and incurs \$30.00 of cost for each of them for the rest of 1984. Thus, each of the two purchased cows, if valued at cost, would be valued at \$410.00. Assume the following valuations under other methods as of December 31, 1984.

Lower of cost or market	\$390.00 each
Farm price	\$440.00 each
Unit price	\$425.00 each

Taxpayer's gross income from cattle in 1984 will depend on the inventory valuation method used. His gross income will be sales minus cost of goods sold (i.e., opening inventory, plus costs of livestock purchased or added to inventory during the year, minus closing inventory). The value of the inventories depends on which method is chosen.

*Cost Method.* Closing inventory is \$820.00 (2 times \$410.00). Income is: \$500.00 less (\$375.00 plus \$820.00 minus \$820.00), or \$125.00.

*Lower of Cost or Market Method.* Closing inventory is \$780.00 (2 times \$390.00). Income is \$500.00 less (\$375.00 plus \$820.00 minus \$780.00) or \$85.00.

*Farm Price Method.* Closing inventory is \$880.00 (2 times \$440.00). Income is \$500.00 less (\$375.00 plus \$820.00 minus \$880.00), or \$185.00.

*Unit Price Method.* Closing inventory is \$850.00 (2 times \$425.00). Income is: \$500.00 less (\$375.00 plus \$820.00 minus \$850.00), or \$155.00.

On January 1, 1985, taxpayer sells one of his cows purchased in 1984 for \$650.00. His income from this sale under the various methods is:

Cost Method. (\$650.00 - \$410.00)	\$240.00
Lower of Cost or Market Method (\$650.00 - \$390.00)	260.00
Farm Price Method. (\$650.00 - \$440.00)	210.00
Unit Price Method. (\$650.00 - \$425.00)	225.00

Where the lower of cost or market method is used, taxpayer's 1985 income would be less than \$260.00 if the replacement price falls in 1985 since closing inventory would be reduced; it would be more than \$260.00 if the replacement price rises, though income is limited by the fact that cost is used for closing inventory when the replacement price exceeds cost. When the

42. Treas. Reg. § 1.471-6(g) (1960).

farm price method is used, taxpayer's 1985 income would be less than \$210.00, if the market price falls in 1985; it would be more than \$210.00, if the market price rises in 1985.<sup>43</sup>

### *Hybrid Method of Accounting*

The Regulations specifically allow combinations of accounting methods if such combination clearly reflect income, and are consistently used.<sup>44</sup> A taxpayer using an accrual method of accounting with respect to purchases and sales may, at the same time, use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business must use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses must use an accrual method in computing items affecting gross income from his trade or business.<sup>45</sup> If a taxpayer owns more than one business, he or she may use different methods of accounting for each business.<sup>46</sup>

Application of the clear reflection of income test by the IRS injects uncertainty into any kind of combination of accounting methods. The most common hybrid method of accounting used by farmers, especially feedlot operators, which would appear to be subject to this test, is the inventory/cash method. In the typical situation, the feedlot operator maintains inventories of feeder cattle under the cost method of accounting, but all other aspects of the operation on the cash method.

The Tax Court has impliedly approved inventory/cash accounting, although it has never ruled specifically on whether such a method clearly reflects income. As stated above, in *Hi-Plains Enterprises, Inc. v. Commissioner*,<sup>47</sup> the taxpayer owned a feedlot and the cattle being fed in the feedlot were owned approximately fifty percent by taxpayer and fifty percent by customers. The entire operation was conducted as one business, with the exclusive management in the taxpayer. In making its tax returns, the taxpayer deducted the total amount expended for cattle feed during the taxable year as an item of expense. Its taxable income was the amount received from the sale of its own cattle and receipts from its customers, less necessary costs and expenses. The taxpayer took inventories of all its livestock and departed from the strict cash basis method in returning its income by computing gross profit through adding to gross receipts the value of livestock on hand at the end of the year and by subtracting therefrom, along with other costs, the value of livestock on hand at the beginning of the year. The specific issue focused on by the Tax Court was whether or not the taxpayer was a "farmer" entitled to report its income on the cash and receipt disbursements method. The Tax

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43. Example taken from 18 FED. TAX COORD. 2d (RIA) ¶ N-1102.

44. Treas. Reg. § 1.446-1(c)(1)(iv)(a) (1973).

45. *Id.*

46. Treas. Reg. § 1.446-1(c)(iv)(d) (1973).

47. 60 T.C. 158 (1973), *aff'd*, 496 F.2d 520 (10th Cir. 1974).

Court held the taxpayer was a farmer. The Tax Court in rendering that opinion, impliedly approved the inventory/cash method of accounting.

The taxpayer in *Hi-Plains Enterprises, Inc.* maintained inventories on the FIFO basis, which was not objected to by the Tax Court. It follows that once the hybrid accounting method is permitted any of the permissible methods of valuing inventory should be allowed. Inventory valuation methods are, by nature, accounting conventions designed to produce a conceptualized valuation of numerous items considered incapable or impractical of actual tracing. Each inventory valuation method is designed to produce an accurate reflection of income *in the long run*. Over sufficient lengths of time the net income resulting after the application of any of the income valuation methods should be roughly equal. In the short run each method will produce varying amounts of net income depending upon whether the markets for the inventory product are increasing or declining. For example, the FIFO method will result in lower inventory valuation and higher income receipt on an increasing market, and the LIFO method will result in a higher inventory valuation and lower income receipts on an increasing market. It follows, that the important thing in determining whether an inventory valuation method realistically reflects income, is its consistency, not the method of valuation.

In *Carter v. Commissioner*,<sup>48</sup> the taxpayer reported his income on the cash method but in reporting gross income from cattle sales used the cost method of inventory. Taxpayer argued, as a matter of law, he should not use inventories because he filed his first return on the cash basis. The Tax Court disagreed stating that the taxpayer had consistently used the cash basis plus inventories in computing income. The Tax Court cited *SoRelle v. Commissioner*,<sup>49</sup> where it was recognized that income returned on a cash basis plus inventories could clearly reflect income if there were no accounts receivable or accounts payable in regard to the purchase and sale of the items which were inventoried. The Tax Court went on to hold that the taxpayer did not prove any facts which would justify holding that the Commissioner's determination that taxpayer's method of accounting clearly reflected income. Also, the inventory/cash basis hybrid method of accounting has not been approved in a non-farm situation.<sup>50</sup>

In *Stoller v. United States*,<sup>51</sup> the taxpayer was engaged in the seed and grain elevator business, was keeping his records on the cash basis, but also was taking inventories to compute gross income. In addition, the taxpayer had kept his business financial records and accounts on the basis of cash receipts and disbursements, taking into account inventories, and he reported income for federal income tax purposes on this basis. The government agreed that the method of reporting income (cash receipts and disbursements taking into account inventories) was proper and merely disagreed with the application in the

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48. 26 T.C.M. (P-H) 237 (1957), *appealed on other grounds*, 257 F.2d 595 (5th Cir. 1958).

49. 22 T.C. 459, 469-70 (1954).

50. Clark, 40 T.C.M. (P-H) 274 (1971).

51. 63-2 U.S.T.C. § 9605, 320 F.2d 340.

system concerning the treatment of sales and purchases. The court in requiring the accrual of certain sales and purchases stated:

While it may not be said that the courts were entirely in agreement on the limits of a combined cash and accrual method of accounting prior to the enactment of the Internal Revenue Code in 1954, the use of the part cash, part accrual method was sanctioned in *Glenn v. Kentucky Color & Chemical Co.*, 51-1 T.C. ¶9147, 186 F.2d 975 (6th Cir. 1951).<sup>52</sup>

In *Estate of Roe*,<sup>53</sup> the taxpayer argued that the use of inventories was inconsistent with the cash method of accounting. The government took the position that inventories should be used. The Court held as follows:

While it is true that the use of inventories is generally associated with the accrual system of accounting, there are instances when inventories can be used with the cash method and still clearly reflect income. . . . At any rate it is well known there are deviations from what is predominately a cash or accrual system. Petitioner's argument that we hold as a matter of law that the partnership's use of an inventory was wrong merely because it used a cash method of accounting is without merit.<sup>54</sup>

#### THE LIFO METHOD OF VALUATION

The Service has held that the use of a LIFO costing convention to determine the cost of cattle purchased in one year and sold in a later year is not a permissible method of accounting for cash basis farmers.<sup>55</sup> The National Office relied on Treasury Regulation section 1.61-4(a) which requires cash basis farmers to deduct the cost of livestock from the sales price in the year in which the sale occurs. The National Office holds that "cost" as used in that Regulation is intended to mean the actual cost of livestock and not the base year cost as determined under a LIFO costing convention. The LIFO method of accounting used by the taxpayer in the ruling caused ending inventories to be low, which increased the cost of goods sold, which decreased income. That effect only happens when the cost of the inventory items is rising. The authorities relied on by the National Office in their holding included *Commissioner v. Catto*,<sup>56</sup> in which the court held:

By selectively combining attributes of both methods, [the accrual method and the cash method] the respondents seek to fashion a hybrid system that would defeat the commissioner's goal of providing a unitary accounting method for all taxpayers. It clearly lay within the discretion of the Commissioner to reject such a hybrid system of accounting. . .<sup>57</sup>

The Supreme Court in *Catto*, made it clear that the basis of its holding was that it is within the discretion of the Commissioner to reject a hybrid system of accounting stating "Congress has granted the Commissioner broad

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52. *Id.* at 343-44.

53. 36 T.C. 939 (1960).

54. *Id.* at 952.

55. Priv. Ltr. Rul. 8406003 (Oct. 18, 1983).

56. 384 U.S. 102 (1966).

57. *Id.* at 117.



discretion in shepherding the accounting method used by taxpayers. . . ."<sup>58</sup> Therefore, the problem in *Catto* is not the use of a hybrid cash accounting and inventory method, which has since been clearly approved by the Courts and the Commissioner, but rather the particular type of hybrid system used by the taxpayer. In rationalizing the Commissioner's discretionary decision in *Catto*, the Supreme Court stated that the taxpayer did not embrace the cash method of accounting for the entire ranching operation rather, it sought to subject only their breeding livestock to the cash method and retain the advantages of the accrual method for the livestock raised for sale. It appears in the cases and rulings since *Catto* that the use of accounting methods which, in the long run, clearly reflect income is permitted even though in the short run one method or another may favor the Commissioner or the taxpayer. In other words, it makes no difference which accounting horse the taxpayer has chosen to ride as long as the taxpayer does not dismount without the Commissioner's permission. It is apparent from the ruling under discussion that the National Office had concluded that changing the taxpayer's accounting method would produce a short run benefit from the revenue and that the discussion of the ruling is mere rationalization for this conclusion. The ruling reflects increasing tendency of the Service to sacrifice the integrity of the tax system for short run enhancement of revenue. The ruling cannot, however, be cited as precedent and has no effect on taxpayers other than the taxpayer to whom it was issued.

The method of keeping books on the accrual basis and filing tax returns on the cash basis was impliedly approved for farmers in *Hi-Plains*<sup>59</sup> and *Cameron*.<sup>60</sup> Treasury Regulation section 1.61-4(b) requires the farmer using an accrual method of accounting to use inventories in determining his gross income. It appears that an accrual method farmer must use inventories to determine his gross income even if he elects to make his return upon a cash and receipt disbursement method under Regulation section 1.471-6 which he or she is entitled to do. In other words, if a farmer is keeping his books on the accrual basis, he must use inventories to determine his gross income, but still has the right to elect to make income tax returns on the cash method of accounting.

Thus, regulations do make a distinction which has not been widely recognized, between the taxpayer's *accounting method*, and the taxpayer's *reporting method*. Under the regulations, the taxpayer makes not one but two elections. The first election the taxpayer makes is that of an accounting method upon which the taxpayer's books are to be maintained. This method is to be either true cash or true accrual. The accrual taxpayer, who also qualifies as a "farmer," then has the further election to *report* income on either a cash or accrual basis. If the cash method of reporting is elected by an accrual taxpayer, the courts appear to establish that the accrual taxpayer may retain for reporting purposes the same inventory valuation method adopted in the tax-

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58. *Id.* at 114.

59. *Hi-Plains*, 60 T.C. 158.

60. *Cameron v. Commissioner*, T.C. Memo 1982-259; *Cameron*, 51 T.C.M. (P-H) 1081 (1982).

payer's bookkeeping. Normally, taxpayers must report income upon the same method they maintain their books. The statute and regulations, however, expressly except farmers from this requirement with reference to the cash basis of reporting option. Once the taxpayer has selected an accrual basis of bookkeeping the taxpayer must, also, select the method of inventory valuation from among those permitted by the regulations. *Hi-Plains* and *Cameron* appear to indicate that if the method of inventory valuation chosen for accrual bookkeeping is a proper one it remains, also, proper for reporting purposes if the cash method is selected. The choice among the methods of inventory valuation recognized by the commissioner<sup>61</sup> is, consequently, a choice between equally valid costing conventions all of which result in a clear reflection of income in the long run.

On the other hand, had the fact situation in the ruling involved the FIFO costing convention, the taxpayer's reporting method might well have been approved. Perhaps the Service is merely saying that the FIFO convention is acceptable because it produces higher income on an inflationary market than the LIFO convention. In view of the current disastrous economic conditions in agriculture, and the decline in livestock prices in many areas of the country, it may be expected that the reaction of the Service will change. Since LIFO produces higher short run income on a declining market will the Service now find ways of rationalizing a rejection of FIFO because of its short run advantages to the taxpayer?

The logical step for the Commissioner to take is to administratively insist upon either accrual reporting or comprehensive cash reporting. Such a step is not possible, since the Commissioner has already lost that battle in the courts since the regulation allows farmers to keep inventories and still report their income on the cash receipt and disbursement method, unless the holding action designed force renewed taxpayer litigation of private accounting methods is to be undertaken.

In *Cameron*,<sup>62</sup> the Court rejected the Commissioner's assertion that a cash/inventory taxpayer could not report his income on the cash receipts and disbursements method because the taxpayer was not a farmer, stating:

In conclusion, we observe that for a long time the Commissioner has sought to persuade the courts to extricate him from the box in which he finds himself as a result of his inability to modify the option he has given farmers to choose between the cash and accrual basis of accounting. This case is but another chapter in that effort, for it would require us to indulge in word games sufficient to make Humpty Dumpty blush,<sup>63</sup> to hold this farmer to be anything but a farmer.

Since the taxpayer in *Cameron* did report his income on the cash receipt and disbursements method while keeping inventories, it follows that the Tax Court

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61. FARMERS TAX GUIDE, *supra* note 12, at 7.

62. *Cameron*, 51 T.C.M. (P-H) 1081 (1982).

63. "When I use a word," Humpty Dumpty said, in a rather scornful tone, "it means just what I chose it to mean—neither more nor less." L. CARROLL, THROUGH THE LOOKING GLASS, ch. 6.

would take the same attitude toward an attack by the Commissioner on such a method, if the issue was directly focused on, so long as the method clearly reflected income.

In the authors' opinion, the ruling is in error in holding that the LIFO method of inventory flow cannot be used by the taxpayer. The Regulations specifically permit the LIFO method of inventory.<sup>64</sup> It would necessarily follow that, if the LIFO method cannot be used as the national office holds in the Ruling, the FIFO method cannot be used either. In light of the substantial number of ranchers and farmers using the FIFO method of inventory flow with the cash receipts and disbursements method of accounting on other aspects of their operation, the ruling could cause many farmers and ranchers to have to change their method of accounting and return preparation. It would have a particular impact on cattle feeders, who must adopt some convention for inventory costing.

Permission to continue or adopt such a hybrid system can be requested, but, in light of Letter Ruling 8406003, it seems doubtful that there will be widespread authorization of the use of the cash/inventory accounting method for farmers unless the full operation of the farmer is put on some type of accrual system.

#### CONCLUSION

The special accounting and income reporting methods accorded farmers and ranchers have, as any tax advantage accorded to a special class of individuals, generated much controversy about who is entitled to the advantageous methods and how exactly those methods are to be implemented. So long as Congress sees fit to give farmers and ranchers beneficial income tax opportunities, there is little chance that such controversy will cease. With competent attorney and accountant advice and assistance, utilization of the tax accounting privileges can result in substantial income tax savings. For those farmers and ranchers who are economically strained due to the adverse agricultural economic client, such privileges are meaningless, however, for those farmers and ranchers still surviving and who want to remain surviving, use of the tax privileges provide one good means of attaining that goal.

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64. Treas. Reg. § 1.472-2(b) (1981).