CASH ACCOUNTING FOR FARM AND RANCH CORPORATIONS

by Neil E. Harl

As a new taxpayer, a farm or ranch corporation may elect the cash or accrual methods of accounting if the corporate books are so kept and the method clearly reflects income. Indeed, IRS has ruled that a corporation may report on the cash method of accounting even though books are kept on the accrual method if the corporation maintains work papers reconciling accrual method book income to cash method taxable income. The method of accounting should be elected clearly on the initial corporate income tax return.

Required accrual accounting

With four exceptions, however, a farm or ranch corporation with gross annual receipts of more than $1 million must use accrual accounting and capitalize preproduction period expenses. Relatively few incorporated operations have gross incomes above that level. However, most of those above the $1 million level can come within the four exceptions.

Exceptions to accrual accounting

Farm or ranch corporations with gross annual receipts above $1 million may nonetheless be or remain on cash accounting if the operation comes within one or more of four exceptions.

- S corporations.
- Family corporations if at least 50 percent of the stock is owned, directly or indirectly, by members of the same family.
- Corporations engaged in the business of farming as of October 4, 1976, if members of two families own, directly or through attribution, at least 65 percent of the total voting stock and at least 65 percent of all other classes of stock.
- Corporations engaged in the business of farming as of October 4, 1976, if three families own at least 50 percent of the total combined voting power of all classes of voting stock and at least 50 percent of all other classes of the corporation's stock, and substantially all of the remainder of the corporation's stock is owned by the corporate employees or their families or an exempt trust for the benefit of employees.

The accounting rules do not apply to nurseries and sod farms or to the raising or harvesting of trees (other than fruit or nut trees).

Gross receipts over $25 million

Closely held and family-owned farm corporations with gross receipts in excess of $25 million in any year after 1985 are required to use accrual accounting under a 1987 amendment. Corporations subject to the rule include family-owned and closely held corporations not required by prior law to use the accrual method of accounting.

Suspense account. If a family- or closely held corporation is required by the 1987 amendment to change its method of accounting, the corporation is to establish a suspense account in lieu of making adjustments that would otherwise have to be made. If the farming business contracts or the corporation ceases to be a family corporation, part or all of the suspense account must be included in income.

Any "transfer in a corporation" after December 15, 1987, is treated as a transfer to a person whose ownership would not qualify the corporation as a family corporation unless it is a transfer to a member of the family of the transferor or to a member of a family that, on December 15, 1987, held stock in the corporation that qualified the corporation under I.R.C. § 447(h).

Integrated operations. An integrated operation may be considered a farmer if it participates significantly in the growing process and bears substantial risks of loss from that process. Thus, activities of an entity which was engaged in the production of hybrid seed corn and contracted for almost 50 percent of its production were included in the trade or business of farming including processing, inspecting and packaging.

The $5 million rule

In general, corporations with more than $5 million of gross receipts must use accrual accounting but that limit specifically does not apply to farming businesses.
FOOTNOTES

1 I.R.C. § 446. See generally 7 Harl, Agricultural Law § 54.05 (1992).
2 Ltr. Rul. 9103001, no date given.
3 See R. Shisler Farms, Inc. v. Comm'r, T.C. Memo. 1974-141.
4 I.R.C. § 447.
8 I.R.C. § 447(a).
10 Id.
11 I.R.C. § 447(i).
12 Id.
13 I.R.C. § 447(i)(5)(B). See Ltr. Rul. 8842036, July 26, 1988 (merger of parent chicken processing corporation with subsidiary chicken raising corporation did not cause recapture of parent corporation's suspense account where majority shareholders in both corporations were members of same families); Ltr. Rul. 8909024, Dec. 8, 1988 (gross sales of subsidiary corporation which was not engaged in farming did not affect suspense account for parent farming corporation); Ltr. Rul. 9035027, May 31, 1990 (merger following which remaining entity was family corporation did not result in inclusion of suspense account in income; S corporation election by remaining family corporation did not result in inclusion of suspense account, either); Ltr. Rul. 9106009, Nov. 6, 1990, (S corporation election did not cause inclusion in income of suspense account balance; any reduction or recapture of suspense account treated as recognized built-in gain); Ltr. Rul. 9117055, Jan. 30, 1991 (suspense account not recaptured or reduced by proposed merger or by newly merged corporation's S election and new corporation succeeded to suspense account; income during recognition period is built-in gain); Ltr. Rul. 9129008, April 12, 1991 (S corporation election did not require income inclusion; gross receipts for short-year annualized); Ltr. Rul. 9145016, July 31, 1991 (on change in fiscal year, gross receipts annualized for purposes of I.R.C. § 447(i)(3) calculation).
14 Maple Leaf Farms, Inc. v. Comm'r, 64 T.C. 438 (1975) (integrated duck raising and processing operations). See Ltr. Rul. 8936023, June 9, 1989 (gross receipts from feed produced in mill and sold to competitor, gross receipts from other feed sales and gross receipts from management services to unrelated third parties were gross receipts from farming).
16 I.R.C. § 448(b)(1).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

POSSESSION. The plaintiffs sought damages from the defendant for the removal of trees from the plaintiffs' land. The defendant claimed title to the disputed area by adverse possession of over 10 years. The court held that the defendant acquired the disputed land by adverse possession where the defendant paid the mortgages on the property, paid the taxes on the property, marked the boundary line, and cut timber from the property. The plaintiffs argued that the defendant's period of possession was broken by a life estate created in a predecessor owner because the defendant owned only a future interest in the disputed property during the life estate. The court held that once the adverse possession period started, a life estate did not suspend the possession period. Miller v. Leaird, 413 S.E.2d 841 (S.C. 1992).

BANKRUPTCY

GENERAL

AVOIDABLE LIENS. Prior to obtaining a divorce, the debtor and former wife owned the debtor's residence as joint tenants. Under the divorce decree the debtor was awarded the residence in fee subject to a lien in favor of the wife. The debtor claimed the homestead as exempt and attempted to avoid the divorce decree lien as impairing the exemption. The court held that under Farrey v. Sanderfoot, 111 S. Ct. 1825 (1991) (see 2 A.L.D. p. 111), the lien was not avoidable because the lien attached prior to or simultaneously with the creation of the debtor's interest in the residence. Matter of Macke, 136 B.R. 209 (Bankr. S.D. Iowa 1992).

ESTATE PROPERTY. In satisfaction of a secured debt to a PCA, the debtor transferred farm land to the PCA in lieu of foreclosure but reserved 120,000 pounds of the peanut quota assigned to the farm land. The debtor attempted to attach the 120,000 pound peanut quota to another farm but the ASCS ruled that because the farm was not in a contiguous county, the poundage quota remained with the deeded farm. The PCA had sold the deeded farm to two other individuals who knew they were not purchasing any part of the reserved 120,000 pound peanut quota. The court held that the 120,000 pound peanut quota remained bankruptcy estate property and ordered the new owners to sell the quota and remit the proceeds to the debtor. Matter of Williams, 136 B.R. 311 (Bankr. M.D. Ga. 1992).

EXEMPTIONS.

ALIMONY. The debtor was not allowed an exemption for an award of alimony because the court held that the