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Application of UNICAP Rules to Indirect Costs of the Purchase of Land for Raising Almond Trees

-by Robert P. Achenbach, Jr.

A recent Ninth Circuit Court of Appeals decision affirmed the Tax Court's interpretation of the application of the uniform capitalization (UNICAP) rules to orchard crops.¹ In particular, the case makes clear the requirement of capitalizing indirect costs relating to the purchase of farmland to be used for the production of almonds and other tree nuts, but could easily apply to any tree crop with more than a two year production period.

UNICAP General Rules

The I.R.C. § 263A UNICAP rules require capitalization of the direct costs and a portion of indirect costs, including interest expenses, incurred or paid to produce certain real property or tangible personal property.² The rules allow farmers to elect out of the uniform capitalization rules, except for (1) corporations and partnerships required to use accrual accounting, (2) farming syndicates, (3) tax shelters, and (4) some citrus producers.³ For pistachio growers, the election requires the consent of the Commissioner.⁴

I.R.C. § 263A provides a number of exceptions to the general capitalization requirements, including an exception for taxpayers (corporations, partnerships and individuals, but not tax shelters) that acquire property for resale and have \$25 million or less of average annual gross receipts for the preceding three taxable years.⁵

Costs required to be capitalized by the UNICAP rules are to be added to the basis of property (i.e., not currently deducted) and may be recovered through depreciation (including bonus depreciation), amortization, cost of goods sold, or an adjustment to basis when the property is disposed of by the taxpayer.

Indirect Interest Expenses

Indirect interest expenses are subject to the UNICAP rules only as to property produced or acquired and which is:

- real property with a class life of at least 20 years,
- property with a production period of more than two years, or
- property with a production period of more than one year and a cost exceeding \$1 million.⁶

* Publisher and editor of the Agricultural Law Press.

The “production period” is the period beginning on the date production of the property begins and ending on the date on which the property is ready to be placed in service or held for sale.⁷

The Facts of the Case

The taxpayers were three cash method entities taxed as partnerships which were owned directly or indirectly by one or more members of a common group of individuals and trusts. The court found that the three entities were related parties in that two individuals, husband and wife, owned directly or indirectly 50 percent or more of each entity. Two of the taxpayers borrowed funds to purchase farmland owned by an unrelated party and the third taxpayer borrowed funds which were further loaned to the other two entities to assist in the purchase of the farmland.

The purchased property was used primarily for growing flowers for sale as plants and the taxpayers intended to use the land for growing almonds, and the land would not produce almond crops for several years. Thus, the taxpayers incurred interest charges on the loans during the first three years that the land was prepared and the trees planted for the orchards and also incurred property taxes on the purchased land.

The taxpayers claimed the property taxes and interest expenses as current business deductions but the IRS denied the deductions and limited the deductions attributable to the land and almond trees to those allowed under the UNICAP rules.

The Taxpayers’ Positions

The taxpayers argued that (1) the interest and property taxes were related solely to the purchase of the farmland because it was not produced by the taxpayers and (2) the purchase of the land did not require the production of the almond trees (i.e., the land could have been, and formerly was, used for other crops); therefore, the UNICAP rules did not apply.

The Tax Court’s Analysis

The Tax Court stated that the growing of the almond trees is a production of those trees within the reach of the UNICAP rules because the rules apply to real property “produced by the taxpayer” for the taxpayer’s use in a trade or business.⁸ The statute does not define the term “real property” for purposes of the UNICAP rules, but the regulations define the term to include

“land” and “unsevered natural products of land” and state that “unsevered natural products of land” generally include growing crops and plants, such as almonds, where the preproductive period of the crops or plants exceed two years.⁹ In addition, the term “produced” includes the raising and growing of agricultural commodities.¹⁰

The court stated that the land itself need not be produced by the taxpayers but that the land and the almond trees were sufficiently intertwined in the sense that the almond trees cannot grow without the underlying land and the entities’ placing in service of the almond trees required that the entities also place in service the underlying land. The court ruled that, although the property taxes and the interest were closely attributable to the acquisition of the land than with the almond trees, the payment of those costs was both necessary and indispensable to the growing of the almond trees so as to be considered a cost of producing those trees.

Thus, the Tax Court held, and the appellate court affirmed, that the land purchase loan interest and property taxes were indirect expenses of the production of the almond trees and required to be capitalized.

ENDNOTES

¹ Wasco Real Properties I, LLC v. Comm’r, 2018-2 U.S. Tax. Cas. (CCH) ¶ 50,511 (9th Cir. 2018), *aff’g*, T.C. Memo. 2016-224. The appellate decision is designated as not for publication.

² See Harl and Achenbach, *Agricultural Law*, § 28.08 (2018).

³ I.R.C. § 263A(d)(3). See Harl and Achenbach, *Agricultural Law*, § 28.08[2][b][vi] (2018) and Achenbach, *Farm Income Tax Manual*, § 3.19[2] (2018) for discussion of this election for farmers.

⁴ Treas. Reg. § 301.9100-8.

⁵ I.R.C. §§ 263A(i), 448(c).

⁶ I.R.C. § 263A(f).

⁷ I.R.C. § 263A(f)(4)(B).

⁸ I.R.C. §§ 263A(b)(1), (c)(1).

⁹ Treas. Reg. § 1.263A-8(c)(1), (2).

¹⁰ Treas. Reg. § 1.263A-4(a)(1).

CASES, REGULATIONS AND STATUTES

BANKRUPTCY

CHAPTER 12

MODIFICATION OF PLAN. The debtor filed for Chapter 12 and filed a plan. The plan provided for four annual payments to a creditor, Seed Consultants, Inc. (SCI), amounting to \$13,750 each year. Farm Credit Mid-America filed an objection to the plan and the debtors submitted an agreed order resolving the Farm Credit

objection but also providing for an annual payment of \$13,000 without naming SCI as the recipient. Although SCI received notification of the new agreement, it did not file an objection because the agreement did not name the recipient of the \$13,000 annual payment, thus believing that the payment referred to some other claim. To further complicate matters, the debtors made the first \$13,750 payment but SCI received only \$9,109.74 because the Chapter 12 trustee retained the trustee’s fee from that payment. Thus, SCI sought payment of the balance of \$4,640.26 to cure the default of the first annual payment. The debtor argued that the agreement with Farm Credit modified the plan to provide annual