Agricultural Law Press
Publisher/Editor
Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.

* * * *

Issue Contents

Agricultural Law Digest

Volume 15, No. 9 April 23, 2004 ISSN 1051-2780

Is "Residual Fertilizer Supply" in Farmland Deductible?

— by Neil E. Harl*

Differences between taxpayers and the Internal Revenue Service over the deductibility of fertilizer, lime and other soil amendments have a long history.[1] The most recent conflict is over the question of whether premium fertilizer levels or the "residual fertilizer supply"[2] are deductible as fertilizer under the statutory provision enacted in 1960.

History of attempts to deduct fertilizer costs

In keeping with the view that all expenditures with a useful life of more than one year must be depreciated or amortized, the Internal Revenue Service in two early cases took the position (which was upheld by the U.S. Tax Court) that the cost of fertilizer and lime applied to land was a capital expenditure which had to be deducted over a period of years rather than all being deductible in the year applied.[3] In the first of the two cases, *Appeal of Sanford*,[4] the taxpayer expended funds in an effort to restore soil fertility (mostly in the form of labor) which were deducted currently. IRS took the position that expenditures were for the "preparation and upbuilding of the land for future crop production" and thus were capital in nature. The Tax Court agreed with the Commissioner.[5]

In the second case, *Swaney v. Commissioner*,[6] the taxpayer applied lime to farmland and deducted the entire cost as a current trade or business expense.[7] IRS argued that the cost of lime application was a capital expenditure which could only be deducted at the rate of 10 percent per year.[8] The Tax Court agreed that the expenditure was capital in nature but allowed a deduction at the rate of 25 percent per year.[9]

In a 1947 IRS ruling,[10] the cost of lime spread on farmland constituted an exhaustible capital expenditure that had to be amortized over the period of its effectiveness if the benefit of the lime application extends over a period of several years.

After several years of audit conflict over the issue of the rate of amortization for fertilizer, lime and other soil amendments, Congress enacted in 1960 a provision allowing a current deduction " for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to such land."[11] To deduct such expenditures currently, the taxpayer must be engaged in the business of farming[12] and the land involved must have been used for the production of crops, fruits or other agricultural products or for

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

Agricultural Law Digest is published by the Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405 (ph 541-302-1958), bimonthly except June and December. Annual subscription $110 ($90 by e-mail). http://www.agrilawpress.com Printed with soy ink on recycled paper.

the sustenance of livestock "before or simultaneously with the expenditures . . .."[13] The regulations state that "expenditures for the initial preparation of land never previously used for farming by the taxpayer or his tenant" are not subject to the election.[14]

The latest controversy

The latest controversy over deductibility of fertilizer, lime and other soil amendments came to light with release of a private letter ruling in late 1991.[15] In that ruling, *Ltr. Rul. 9211007*,[16] a farmer from West Central Minnesota purchased a farm but had the farmer's corporation (owned 64 percent by the farmer) purchase the "residual fertilizer supply" in the land acquired.[17] The acquired land was then leased to the farmer's corporation under a one-year lease. The farmer argued that the prior owner of the farm had applied fertilizer to the point where an increased level of fertilizer in the soil resulted, referred to as the "residual fertilizer supply."[18] The corporation (as the taxpayer in the ruling) claimed an amortization deduction over a seven-year period for the residual fertilizer supply.

IRS agreed that capitalized farm fertilization costs could be amortized, but the taxpayer must be the beneficial owner of the fertilizer in order to be permitted to claim an amortization deduction.[19] IRS noted that the farmer acquired the land containing the alleged residual fertilizer supply:

> ". . . which was incorporated into the land and, for all practicable purposes, was inseparable from the land. This fertilizer reportedly made the land more productive than it otherwise would have been. Although the taxpayer [the corporation] allegedly purchased any residual fertilizer supply in the land, the taxpayer was able to derive the benefit from it only by entering into a land lease agreement with the landowners . . ."

The ruling points out that the landowners were the beneficial owners of any fertilizer on the land and the corporation could not amortize any of the costs related to the fertilizer. [20]

The ruling denied a deduction for the residual fertilizer supply on two other grounds:

• As the ruling states, ". . . in order for a taxpayer to claim an amortization deduction for exhaustion of fertilizer acquired with the land, the taxpayer must establish the presence and extent of the fertilizer."[21] The ruling notes that the corporation ". . . did not measure nor was data provided to indicate, the level of soil fertility attributable to fertilizer applied to the land by the previous owner."[22] The ruling concludes that the corporation as the taxpayer failed to establish the extent of any residual fertilizer.

• The ruling also notes that, in order to amortize the cost of the fertilizer supply over time, the taxpayer must in fact be exhausting the fertilizer in the soil.[23] In the facts of the situation in the ruling, the soil test reports showed that the level of fertility in the majority of the parcels was not declining as is required for deductibility. As the ruling pointed out, ". . . the taxpayer has provided no evidence indicating the period over which the fertility attributable to the residual fertilizer supply will be exhausted, and if in fact what was claimed as the residual fertilizer level was declining."[24]

The current situation

Surprisingly, although the 1991 ruling[25] is substantial authority against deductibility of the residual fertilizer supply, no further authority has emerged in the dozen years since the ruling was published even though the practice of claiming a deduction has grown in some areas of the country. Quite clearly, in the interest of fairness and equity, further guidance is needed as to the guidelines for deductibility if any is to be allowed.

FOOTNOTES

[1] See generally 4 Harl, *Agricultural Law* § 28.04[1] (2004); Harl, *Agricultural Law Manual* § 4.03[3] (2004).

[2] See Ltr. Rul. 9211007, December 3, 1991.

[3] Appeal of J.H. Sanford, 2 B.T.A. 181 (1925); Swaney v. Comm'r, 5 B.T.A. 990 (1927), acq., II-2 C.B. 7.

[4] See note 3 *supra*.

[5] *Id*.

[6] 5 B.T.A. 990 (1927), acq., II-2 C.B. 7.

[7] *Id*.

[8] *Id*.

[9] *Id*.

[10] I.T. 3843, 1947-1 C.B. 12, obsoleted by Rev. Rul. 67-123, 1967-1 C.B. 383.

[11] I.R.C. § 180(a).

[12] Treas. Reg. § 1.180-1(a).

[13] I.R.C. § 180(b).

[14] Treas. Reg. § 1.180-1(b).

[15] Ltr. Rul. 9211007, Dec. 3, 1991.

[16] Dec. 3, 1991.

[17] *Id*.

[18] *Id*.

[19] See Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 254 (1939).

[20] *Id*.

[21] *Id*.

[22] *Id*.

[23] *Id*.

[24] *Id*.

[25] Ltr. Rul. 9211007, Dec. 3, 1991.