MSSP

Market Segment Specialization Program

Grain Farmers

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Chapter 1

INTRODUCTION

PURPOSE OF GUIDE

This guide provides you with a general understanding of **farming** operations so you will have the expertise necessary to communicate knowledgeably with farmers and/or their representatives.

Farm operations can be quite varied as to the products, operating cycles, and degree of sophistication. It is important to have an understanding of the various facets of a farm operation so you can adapt your auditing techniques to each different situation.

Life for the farmer in the 1990's has changed significantly from prior generations. Today's farmer often has a college degree in Agricultural or **Horticultural** Science, and uses computers and other technology. It is often necessary for many farmers and/or their spouses to be employed off the farm to provide an adequate income.

COMPLIANCE POTENTIAL

There are several reasons why grain production might lend itself to underreporting income. Among these reasons:

1. Most income is received from non-information return sources. Only cash rent, machine hire, patronage dividends, and most Government payments will have Forms 1099 issued.

2. Income is received in an irregular manner. Crops are not sold on a daily basis. They may be sold immediately after harvest or held and sold later in the year or in a subsequent year.

3. The books maintained may be very elementary, for example, a single entry accounting method. A basic system could be merely a checking account deposit and check spread.

4. There is usually a lack of internal control since the farmer is responsible for receiving, recording, and depositing all income.

5. There are usually no internal controls that can be used to test income reporting (for

example, numbered sales invoices or customer accounts).

NATURE OF FARMING

The nature of farming involves many risks. It also requires a substantial amount of capital. These are discusses below.

Risk

All businesses are subject to many risks and require various decisions to minimize and overcome these risks. The farming industry differs from other businesses since it is a true competitive, market-driven industry. The farmer has no control over the price received, and all crops produced may be sold at the same price. Unlike other businesses, the farmer does not use marketing strategies as they have very little effect on the price received for the products. The inability to control price is a **major risk** confronting the farmer, especially since the production cycle generally occurs on a yearly basis. Furthermore, the farmer has no control over the prices of the fuel, fertilizer, chemicals, and equipment used in the production of grain.

Unlike other businesses, nature is a significant risk in farming. Entire crops can be destroyed by a natural disaster such as drought, flood, or hail. Crop diseases and pests can also cause major losses and even destroy an entire crop.

Nature and market price risks make farming a series of high stake gambles. However, both market price and nature risks can be minimized by reducing the risk.

1. Risks from nature can be shifted by buying crop insurance. This shifts the risk to a pool of similar participants. The amount of coverage is variable so more or less of the risk can be reduced.

2. Market price risk can be reduced in three ways:

   a. Sell **forward contracts** at agreed prices to hedge the risk of price declines. A forward contract may also be used to reduce the risk of price increases in connection with acquisitions of inventory and non-inventory supplies.

   b. Sell regulated futures contracts, through which the risk is reduced to a **speculator** who buys the contract. This is known as hedging. The principle risk of hedging is the lost income opportunity if the market price should go up.

   c. Participate in the Government's farm programs, through which the farmer receives a **deficiency payment** (the difference between a set price and the market price).

Historically, the farmer has retained these risks and has taken his or her chances with fate. Today's farmer has a substantial investment in fixed assets and planting production costs, so the risks are even higher. A prudent business person needs to reduce some of the risk to remain in business and have some certainty in the future. The farmer must make many difficult decisions in how much risk shifting can be afforded.

Capital

Farming is a capital-intensive industry. Land, improvements, equipment, production costs and livestock all require substantial capital outlays in direct relation to the size and income of each farmer. For example, a farmer with 640 acres of land, of which 600 acres are planted to corn (no livestock), could require a total capital outlay of:

Land 640 acres @ $750/acre	$480,000
Buildings	120,000
Equipment:	
Tractor	60,000
Combine & Cornhead	80,000
Planter & Tillage Equip.	30,000
Other Equipment	10,000
Production Costs	72,000

Total	$852,000
	x 10%

Capital Carrying Costs @ 10%	$ 85,200
	========

If the 600 acres of corn produces 120 bushels per acre that sell for $2.30 per bushel, the farmer has $165,000 gross income of which more than 50 percent would be used for capital carrying costs.

The capital requirements can be reduced by renting farmland. Retired farmers normally retain their land ownership, so they can rent it to others. There are also many outside investors who own farmland. Due to these factors and the cost of acquiring land, many farmers rent part of their land.

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Chapter 2

PRODUCTION CYCLES

INTRODUCTION

There are many different kinds of crops produced by today's farmers. Most of these crops are planted in the spring and harvested in the fall. An exception is winter wheat, which is planted in the fall and harvested in June and July. It is very important to remember when you examine farm returns that you do not schedule work with the farmer during harvest. If you schedule an on-farm appointment during this time period, the farmer will quickly get the impression that you know very little about farming.

When auditing a farm operation, it is essential that you understand the production and distribution cycles of the crops grown by the farmer. In other industries, you are able to walk into a manufacturer's place of business and view the production cycle from raw goods to finished product. In a farm operation you can only see one stage of the production cycle at a time. This chapter is meant to familiarize you with the production cycles of feed grains grown by U.S. producers.

Following this introduction, you will find a short description of the production cycles of the major feed grain -- wheat, corn, soybeans, and sorghum. Alfalfa is also included since it is a major crop grown on grain farms and has a distinctly different production cycle. Cereal grains such as oats, barley, and rye have production cycles similar to wheat. Rice is a primary cereal grain but it has a much different production cycle and should be the subject of it's own guide.

Oilseed crops are also an important aspect of the farming industry; however, they are not covered in this guide. Some of the crops in the oilseed family include: flax, sunflowers, safflowers, and canola.

You should become aware of the crops grown in your area. If you need more production information on the crops described in this section or on other crops in your area, you can contact your local county extension office.

WHEAT

Wheat is one of the major grains produced for human consumption. Wheat is a stemmed annual grass plant with a single head that produces the grain. Wheat is unusual in that it can be planted at two different times of the year. Some wheat is planted in the spring and harvested in the fall. However, in the central and southern areas of the Great Plains, wheat is planted in the late fall and harvested the following spring. This wheat is commonly called winter wheat. **Soft spring wheat** is generally used as feed or to make flour for pasta, while **hard winter wheat** is milled for flour. By planting winter wheat, farmers can also plant another crop in the late spring to early summer to be harvested in the fall. This allows the farmer to receive income from two crops in the same year, and is commonly referred to as **double cropping.** The rest of this section will concentrate on the production of winter wheat.

Winter Wheat

Winter wheat is the only crop whose growing season includes winter. Thus, it has the longest production period. The seed is planted in the fall, and the plant becomes established before it goes into winter dormancy. The growing season starts in the late winter, with spring rains feeding the plant growth and grain development. Ideally, the wheat is harvested before the hottest and driest parts of summer arrive. In areas of marginal rainfall, land is usually left **fallow** (idle) to allow moisture retention for the next crop. In areas of higher rainfall and a longer growing season, a second crop (soybeans or milo) is often planted right after wheat harvest, giving rise to the concept of double cropping. Double cropping wheat with soybeans provides a major part of the nitrogen which is the primary nutrient needed by wheat.

Soil Preparation and Planting

Most wheat is grown on **highly erodible land**, resulting in conservation tillage methods being used. A field **cultivator** or **disc** is used to till the prior crop's stubble or stalks. Wheat is then planted using a **drill**, which places the seed into the soil in very narrow rows using **colters** (disc) and shoes to open the row. Spring-loaded packing wheels then tamp the row, resulting in a better seed to soil contact. Seed wheat can be drilled directly into soybean ground without any prior tillage.

Fertilization

Fertilizer use is generally limited to nitrogen, phosphorous, and potassium. All three can be applied as **pre-plant**, or phosphorous and potassium can be applied at planting. In addition to the pre-plant application, nitrogen should also be applied in early spring.

Harvesting and Storage

Wheat is harvested by a **combine**. Harvesting may be done by the farmer or by custom harvest crews. If custom harvesters are used, you need to review the harvesting contract or contact your local county extension agent for the average rates charged. Custom harvesting is normally billed on an established amount per acre plus an additional charge per bushel. A farmer who has row crops, in addition to wheat, usually owns a combine, which can be used to harvest all grain crops grown.

Ideally wheat is harvested at a minimum level of moisture so it can be stored without drying. Ripe wheat is quite susceptible to wind and/or moisture damage, thus timing is critical when the grain is ready to harvest. For this reason, when scheduling an appointment with a wheat farmer, contact the farmerfirst so you **DO NOT SCHEDULE AN EXAMINATION DURING HARVEST.**

Marketing

Harvested wheat is usually trucked out of the fields during harvest and taken to the local **co-op** or **elevator**. The farmer will either store the wheat or sell it to the elevator. Wheat is usually stored to be sold when market conditions are most advantageous. Since most wheat is ground into flour, it must be transported to some type of elevator to await further shipment. Therefore, most wheat sales will be to the local elevator. When wheat has such a poor quality (for example, unable to timely harvest due to rain) that it may be severely docked (price cut) if sold, or if wheat prices are low in comparison to corn prices, the wheat may be used as feed by the farmer or sold to the feedlots for feed.

See Exhibit 2-1 for a flow chart of winter wheat's production cycle and the equipment used throughout the cycle.

CORN

Corn is used as a feed grain and for human consumption. It is the principle feed grain grown in America. Corn requires good soil and large amounts of water, but produces many more bushels per acre than other feed grains. It is grown throughout the country, but the Midwest farm belt is the primary producing area. Because of the need for large amounts of water, corn is often irrigated where water sources are available. The production potential difference between **irrigated** and non-irrigated land is quite substantial, so it is necessary to ascertain how many acres of corn are irrigated.

Corn is a stemmed annual grass plant that can grow to 7 or 8 feet tall. It is pollinated from the **tassels**, and produces one to two ears per plant. It grows rapidly with large quantities of water, and hot, windy weather. Corn is susceptible to various worms and insects which require **pesticides** to control. Weedcontrol is also necessary because of the long growing season.

Soil Preparation

Plowing is the conventional method of preparing the ground for planting. The **plow** turns the soil over and covers any prior crop residue. Subsequent passes are necessary for discing and **harrow**ing to smooth the ground for planting. This method is expensive in terms of fuel, labor, and equipment. It causes sloped fields to become susceptible to topsoil erosion from wind and rain. To conserve topsoil and reduce the costs of producing the crop without a corresponding drop in income (yield), a new concept in **conservation tillage**, often called **no-till** or **low-till**, has entered the farming industry. In addition to reducing erosion, these methods reduce the number of trips over the field for soil preparation and cultivation. Field cultivators have replaced the plow.

Highly erodible land must maintain a certain percentage of plant residue to reduce erosion in order for the farmer to remain eligible for any Government subsidies on that land.

Planting

Corn is planted in rows using a **row crop** type of **planter**, which can also be used for planting milo and soybeans. The corn may be cultivated several times for weed control and soil aeration. If no-till or low-till procedures are used, the need for **cultivation** is eliminated; however, special planters are required, and **herbicides** must be applied to control weeds.

Corn requires large amounts of fertilizer, particularly nitrogen. Nitrogen may be applied before planting, at planting time, or as a **side-dressing** after the corn is up. Total fertilizer use is greater on corn than on any other crop grown in the United States.

Irrigation

Corn requires more rainfall than other crops. It has two short, critical growing periods (tasseling and silking) where lack of water can cause severe yield losses. Irrigation will result in significantly higher yields over dry land production. Irrigation will be used where there are adequate water sources and inadequate rainfall.

Early irrigation was done exclusively by flooding on flat **bottom land**, where water would run down the **furrows** from one end of the field to the other. This often required the fields to be leveled. This method is labor intensive and cannot be used if there are any hills, but it is still in use today in certain areas.

Most irrigation of corn (and other crops) is now done by **center pivot** systems. The water enters at the center pivot into a long length of overhead pipe where it is sprinkled onto the field. A mast assembly with drive wheels supports the pipe and moves the sprinkler around in a circle. Some systems have a boom on the end which is controlled to extend at the corners so the coverage is closer to a square than a circle. Once set up, it can irrigate a field for the growing season with minimal labor.

In most areas, the water is supplied by wells from an underground **aquifer**. Because irrigation depletes the aquifer, some states now exercise more control over usage and drilling new wells.

Irrigation requires a substantially higher initial investment in land, equipment, and water wells. Well pump operation also increases expenses.

Harvesting

The corn is harvested in the fall (usually October) by combines with corn head attachments. Corn heads cannot be used for any other type of crop. The corn is shelled off the cob by the combine so that only the grain is hauled out of the field. Because wet corn is susceptible to mold, it is often dried before storage and aerated afterward. Dryers require large amounts of fuel (propane). Corn can also be stored in wet bins such as "Harvestores," which control the air. The wet corn is usually fed to livestock on the farm, since it cannot be sold and shipped outside of the area. Corn pickers may still be used in some areas where the corn is left on the cob and stored in **cribs** to dry naturally. This ear corn can be ground into livestock feed or shelled the next year. Ear corn is usually not marketed until the following year.

Silage

Due to its high fiber and nutrient content, the entire corn plant can be chopped into **silage** for cattle feed before the plant matures and dries up. During times of drought, corn may be chopped for feed to salvage some of the plant when there would be very little grain produced. Silage is most often produced for the farmer's own livestock, but it can be sold to other livestock feeders. It is used to fatten cattle.

Marketing

After the corn is harvested, it can be stored on the farm for future sale or consumption, hauled to an elevator for sale or storage, or sold to feed consumers. Feedlots are the largest consumers of corn. Corn farmers will usually have sufficient on-farm storage for a typical crop, especially if the corn is used as livestock feed. The on-farm storage facilities also allow the farmer to **seal** (store) the corn through CCC loans made on the stored grain (see Government Farm Programs chapter).

By marketing the corn and silage as feed for livestock, the farmer can reduce drying, handling and hauling costs.

See Exhibit 2-2 for a flow chart of corn's production cycle and the equipment used throughout the cycle.

SOYBEANS

Soybeans are a row crop with a production cycle similar to corn. They are high in protein and have a variety of uses. Soybeans require less moisture than corn so their importance to the farmer has continued to grow over the last few decades.

Soybeans are broad-leaf plants which produce beans within their pods. They grow about 2 to 3 feet high. Unlike corn and sorghum, soybeans do not generate a lot of material in their stalks or roots, thus the soil is more susceptible to erosion. Soybeans are often rotated with corn for several reasons:

1. Corn is a grass while soybeans are a broad-leaf

2. Rotating corn and soybeans allows the use of different herbicides, which can break up the pest cycles

3. Soybeans are a **legume** which add nitrogen to the soil for a subsequent corn crop

4. Corn can be planted in soybean ground with little or no tillage.

Double Cropping

While soybeans can be planted as a single crop during the year, because of their shorter growing season, they are often used for double cropping. For instance, the farmer harvests his or her winter wheat crop in June and plants a soybean crop in the wheat stubble. This allows the growing and harvesting of two crops in a single year. Double cropping is normally found in the middle and southern areas of the United States where the growing season is longer.

Harvesting and Uses

Soybeans are harvested in the fall by a combine using a row crop (cutter) head attachment. They are processed by extrusion, which means soybean oil is extracted from the meal when the bean is crushed. Both oil and meal are used for various human food products, but the meal is also a primary protein source in livestock feed. Raw soybeans are not fed directly to livestock. Since farmers cannot process soybeans themselves, they must sell their soybeans either to elevators or directly to soybean processors. Large processors, such as Con-Agra, Cargill, and Archer Daniels Midland (ADM), have large soybean collection points, which help the farmer to eliminate the elevator middleperson.

Soybean production is currently undergoing a significant change. More soybeans are being planted like the cereal grains with a drill, rather than as a row crop. This means that soybeans are now being grown more like wheat than like corn.

SORGHUM (MILO)

Grain sorghum is a row crop with a production cycle similar to corn's; therefore, only the differences will be emphasized.

Sorghum is a grass plant similar to corn, but the grain grows on a head like wheat, rather than on ears. Sorghum generally grows to a height of about 3 feet, but some types, especially those used for silage, will grow much taller, creating more plant to be chopped for feed.

Planting

Sorghum is planted about the same time as soybeans (anytime from late April to early July). Its growing period is shorter than corn's, making it more drought resistant.

Sorghum can be grown in areas that do not have enough rainfall for corn production. It is often grown in rotation either with soybeans or wheat. It is also used as a double crop with wheat, and it is planted right after the wheat has been harvested.

Harvesting

Sorghum is harvested in the fall by a combine using a row crop (cutter) head attachment. It is used primarily as feed for livestock. The milo stubble (stalk residue) remaining in the field can be used as pasture for cattle, but the cattle cannot be turned onto the stubble until at least 3 days after a killing frost. During drought years milo stalks can contain prussic acid, which is fatal to cattle.

See Exhibit 2-2 for a flow chart of milo's production cycle and the equipment used throughout the cycle.

ALFALFA

Alfalfa, a flowering plant with a purple bloom, is the principal hay crop grown in the

United States. It is a substantial source of protein and fiber for livestock feed. It is the only major field crop that can be harvested several times in one growing season and is a perennial (continues to grow year after year). It is a legume, meaning it adds nitrogen to the soil which can be used by any subsequent crop planted. This makes it an important part of crop rotation plans. Alfalfa responds well to irrigation and is a viable alternative to irrigated corn when the water supply is limited. It is drought-tolerant. Usually, only production is lost, not the plant itself.

Soil Preparation and Planting

Soil preparation is similar to wheat, using a field cultivator and a disc. Planting is usually done by a drill, but alfalfa can be planted by **broadcasting**, with a cover/companion crop of spring oats. The oats help shade and protect the young alfalfa plants. The oats are removed early, by either cutting and baling or by combining for the oat grain, to allow better alfalfa growth. If the oats are combined, the oat straw is then **baled** so it will not be collected with the first alfalfa crop.

Grazing

Livestock will **bloat** and possibly die from overgrazing on growing alfalfa. Grazing livestock on growing alfalfa requires constant supervision and is seldom done in livestock feeding operations.

Harvesting and Storage

Alfalfa is usually cut at the one-tenth bloom stage, with new growth starting at the crown of the plant. Alfalfa can generally grow to maturity every 28 to 30 days, depending on growing conditions and the amount of water available. This allows the harvesting of three to five crops per year. Alfalfa harvesting is done by baling, stacking or chopping. The alfalfa is cut directly in chopping, but baling and stacking requires three separate preliminary steps:

1. Cutting
2. **Conditioning**
3. Windrowing.

Alfalfa can be cut using a **sickle mower**. This requires subsequent trips by a conditioner and then a **rake**. A conditioner crimps (crushes) the stems which speeds the drying process. A rake gathers the alfalfa into a windrow (a large, continuous row of intertwined hay). A rake can also be used to turn a windrow over to accelerate drying. Alfalfa must be cured and dried before it is baled. A **swather/windrower** can cut, condition and windrow in just one pass.

Most alfalfa is harvested by baling. Baling can be done in small or large bales, and the **bales** can be either square or round. Small square (actually rectangular) bales are tied by two strands of either wire or twine. The small bales are better suited for inside storage, but more labor is required, even with bale handling equipment. Large bales, both round and square, are being used much more extensively now. These are handled exclusively by mechanical equipment.

Large round bales are produced by the baler picking up the windrows, rolling them into large horizontal cylinders and then tying them with twine. Round bales more effectively shed rainfall, so they are better suited for outside storage. They are handled by large picks (spears) mounted on trucks, tractors, or loaders. Large bales are easier to load on trucks for shipping and can be fed to livestock with minimal labor.

It is not uncommon to have a part or all of the alfalfa harvesting done by a custom operator. The fee is either a specific amount per bale or a share of the hay crop.

If the alfalfa is to be stacked, the windrows are collected into small stacks, or swept and then stacked into large stacks. The stacks are left in the field and moved to the feeding area as needed.

Farmers can enter into a contract with a local dehydration plant to harvest their alfalfa. The alfalfa is chopped and hauled to the dehydration plant, where it is dried and processed. The dehydrated alfalfa is mixed with other ingredients for livestock feed. This method eliminates the need for haying equipment, since the dehydration plant usually performs all of the harvesting operations.

Marketing

Alfalfa hay is marketed or disposed of by any or all of the following methods:

1. Selling the baled alfalfa to livestock producers

2. Contracting with a local dehydration plant

3. Feeding the alfalfa to the farmer's own livestock.

Alfalfa hay is sold by the ton, whether to livestock producers or to dehydration plants.

See Exhibit 2-3 for a flow chart of alfalfa's production cycle and the equipment used throughout the cycle.

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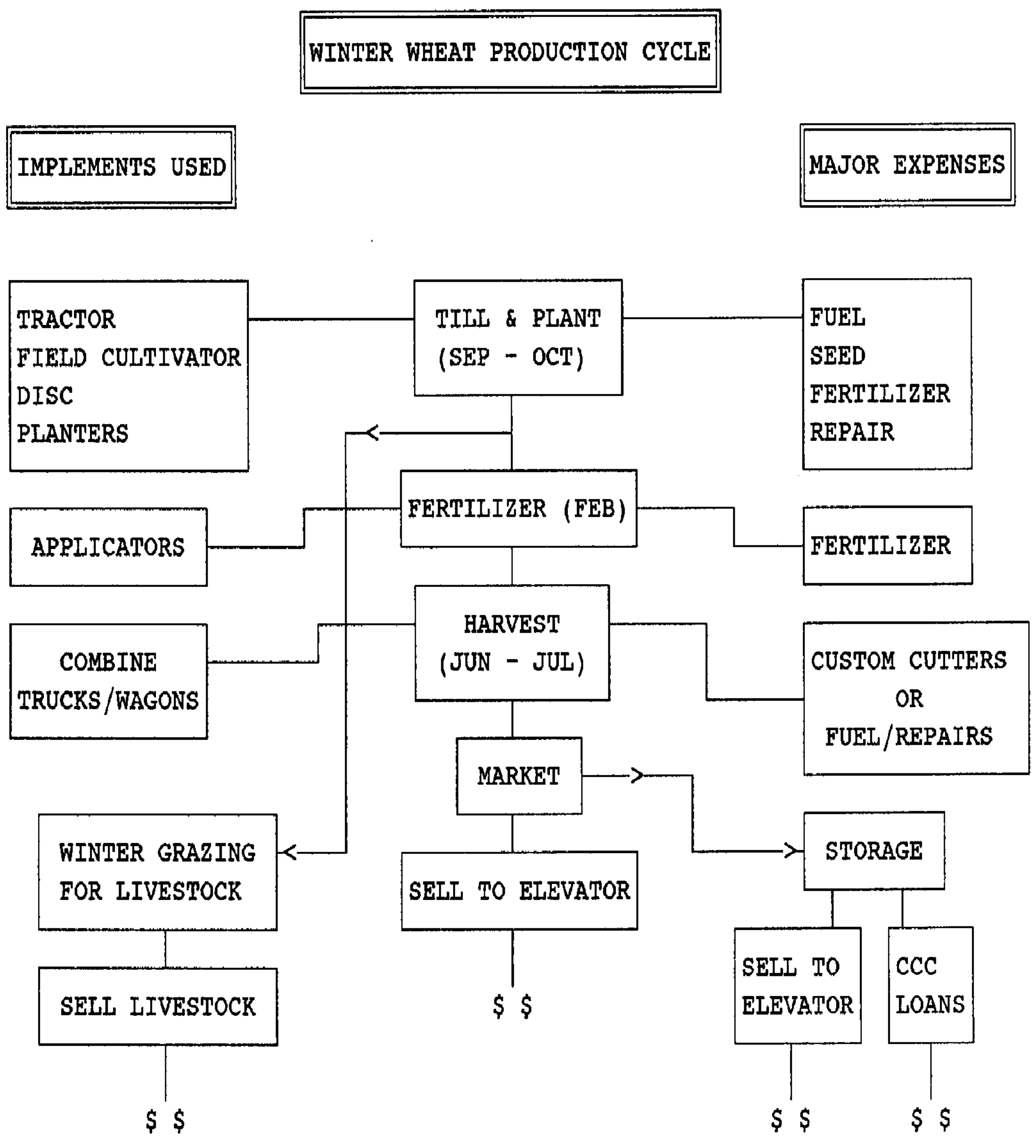
Exhibit 2-1



WINTER WHEAT PRODUCTION CYCLE
IMPLEMENTS USED
MAJOR EXPENSES
TRACTOR
FIELD CULTIVATOR
DISC
PLANTERS
TILL & PLANT
(SEP - OCT)
FUEL
SEED
FERTILIZER
REPAIR
APPLICATORS
FERTILIZER (FEB)
FERTILIZER
COMBINE
TRUCKS/WAGONS
HARVEST
(JUN - JUL)
CUSTOM CUTTERS
OR
FUEL/REPAIRS
MARKET
WINTER GRAZING
FOR LIVESTOCK
SELL TO ELEVATOR
STORAGE
SELL LIVESTOCK
$ $
SELL TO
ELEVATOR
CCC
LOANS
$ $
$ $
$ $

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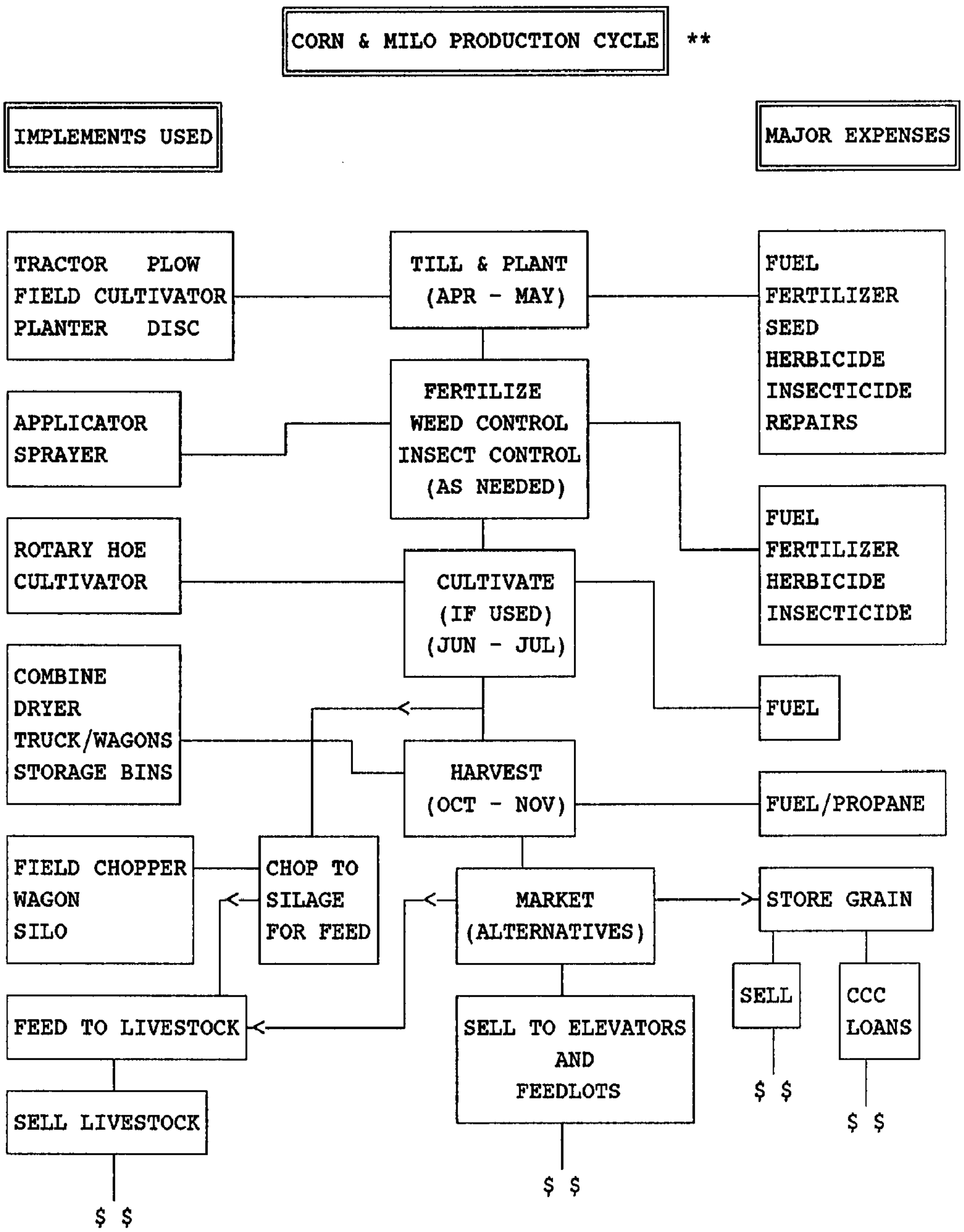
Exhibit 2-2



** SOYBEAN PRODUCTION CYCLE IS THE SAME, EXCEPT SOYBEANS ARE NOT CHOPPED AS SILAGE AND CANNOT BE FED TO LIVESTOCK UNTIL PROCESSED.

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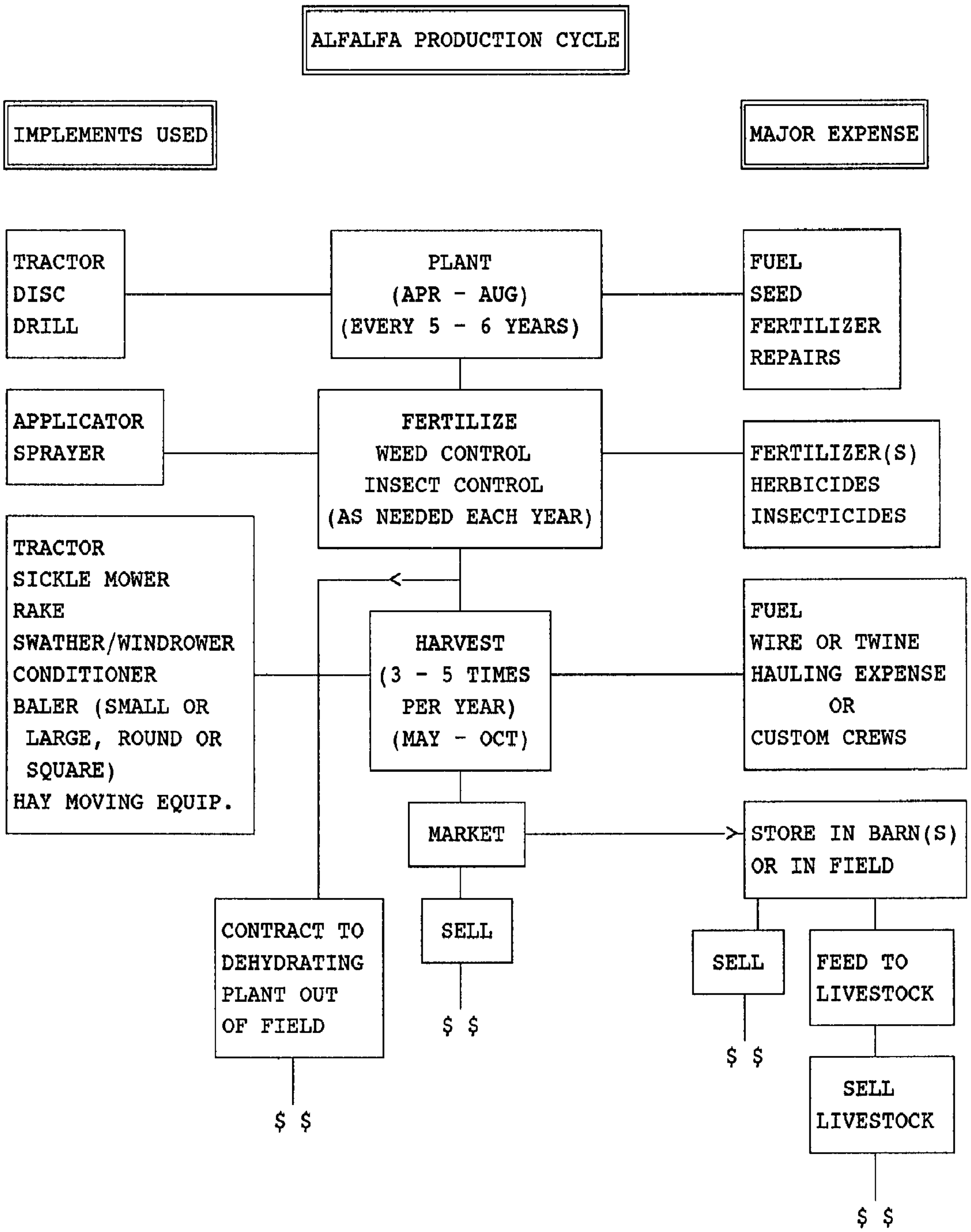
Exhibit 2-3


ALFALFA PRODUCTION CYCLE
IMPLEMENTS USED
MAJOR EXPENSE
TRACTOR
DISC
DRILL
PLANT
(APR - AUG)
(EVERY 5 - 6 YEARS)
FUEL
SEED
FERTILIZER
REPAIRS
APPLICATOR
SPRAYER
FERTILIZE
WEED CONTROL
INSECT CONTROL
(AS NEEDED EACH YEAR)
FERTILIZER(S)
HERBICIDES
INSECTICIDES
TRACTOR
SICKLE MOWER
RAKE
SWATHER/WINDROWER
CONDITIONER
BALER (SMALL OR
LARGE, ROUND OR
SQUARE)
HAY MOVING EQUIP.
HARVEST
(3 - 5 TIMES
PER YEAR)
(MAY - OCT)
FUEL
WIRE OR TWINE
HAULING EXPENSE
OR
CUSTOM CREWS
MARKET
STORE IN BARN(S)
OR IN FIELD
CONTRACT TO
DEHYDRATING
PLANT OUT
OF FIELD
SELL
SELL
FEED TO
LIVESTOCK
SELL
LIVESTOCK
$ $
$ $
$ $
$ $

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Chapter 3

EXAMINATION TECHNIQUES

DOCUMENT REQUEST

Items you will need for your examination should be listed on you Information Document Request. These are discussed below.

Farm Records

Like other business people, farmers are required to keep records which will enable them to file an accurate income tax return. The usual records a farmer keeps include cancelled checks, some paid bills, and a farm income and expense book. Expect the farmer to have adequate and complete records supported by sales slips, invoices, receipts, deposit slips, cancelled checks, and any other documents needed to explain entries on a tax return. Many farmers have a formalized accounting system that is easy to follow and verify, but like many other taxpayers, some farmers do not keep good books and records. You will often find that the farmer is not prepared to present all the records you have requested for the examination.

The best way to handle this is to list the records you have been furnished and decide what records you still need to verify the items under examination. List the items you need on an Information Document Request (IDR), Form 4564, and give it to the farmer or the representative. If the farmer no longer has the records, then the farmer or the representative should make any necessary requests to appropriate third parties as soon as possible, to give the third parties as much time as needed to search for their copies of the documents. Whenever possible, the farmer, not you, should place the requests for third party records. The third party is likely to be more responsive and cooperative for a customer than for the IRS. Also, this allows you to devote your time to the examination of the books and records that are available.

Remember, although you need to try and work with whatever the farmer can provide, you are not required to accept a conglomeration of the farmer's records and put a set of books together. Always make it a point to shift as much of the burden to the farmer as possible for collecting and separating records. If the situation warrants, the rules for issuing an inadequate records notice are as applicable to a farmer as to any other taxpayer.

Books and Records Needed

When you are conducting the pre-examination analysis, list the books and records you'll need at the beginning of the examination. To speed up the examination process, mail an IDR along with the appointment letter. This will improve your chance of having the records you need available when you start the examination.

See the sample IDR at Exhibit 3-1 for a list of records commonly requested for farm examinations. You may need to adapt this list to the farming operation you're examining. The sample IDR is not an official IRS document. It's only intended as an example. You may develop your own personalized records request, or you may prefer to mail a completed Form 4564 with your initial appointment letter.

INTERVIEW

You will to interview the farmer and the farm site. How to prepare for these interviews are discussed below.

Initial Interview

The initial interview is considered the most important part of a quality examination. During the initial interview, allow the farmer time to discuss himself or herself, family, farming operation, style of living, successes, failures, hobbies, financial history and sources of income, including those of other family members.

An effective way to secure a lot of information is through casual conversation. This will put the farmer at ease so he or she will feel comfortable with you. Any pertinent questions or comments designed to lead the farmer into a conversation about his or her personal situation will suffice. If casual conversation is not effective, you may want to follow your interview outline in order to secure the information needed. If you use the outline, use it only as an aid. Do not substitute the outline for original and spontaneous questions. If you adhere strictly to the interview outline, you will seriously handicap your flexibility in asking appropriate follow-up questions.

Take notes during the interview. If the farmer says something that is contrary to what is reported on the return, your notes should be very specific.

After the interview, it is helpful to prepare a written summary of what transpired and the main points discussed. These notes should be made a part of your workpapers, and may prove beneficial in making decisions about the examination at a later date.

A sample interview outline for farm examinations is provided for you at Exhibit 3-2 to use until you develop your own interview style. Remember this sample initial interview does not cover all the questions that might be necessary in any given audit. It is just a starting point. You can add or delete questions as you see fit for each examination.

Visual Inspection

For field examinations, the initial interview will normally be conducted at the farm site. If the initial appointment is with the farmer's representative, be sure to schedule a tour of the farm early in the examination. When you arrive at the farm, be observant of everything around you. What types of buildings, machinery, and vehicles are there? Is there livestock? If so, what kind? Do other people live on the farm, maybe parents or an older son or daughter? If so, the farmer might be farming with someone else.

All the things you see when first observing the farm may generate other questions that should be asked during the initial interview. As you take a tour of the farm after the initial interview, it might be a good time to ask any other questions that come to mind.

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Exhibit 3-1

SAMPLE RECORDS REQUEST

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: Name of Taxpayer and Co. Div. or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

1) If prior Federal or State examinations have been made, a copy of the latest audit report.
2) Detailed depreciation schedules and records.
3) Employment Tax Forms 943 and 940, if applicable, for the year under examination and for the current year, if filed.
4) Highway Use Tax Form 2290 for the year under examination, if liable.
5) Excise Tax Form 720 for the year under examination, if liable.
6) Retained copy of your Form 1040 for ______ and ______.
7) All Forms 1099 filed for _______.
8) All Forms 1099 received for ______.
9) Your farm record book for _______.
10) All books, journals, ledgers and summaries concerning your income, expenses, and deductions.
11) Bank statements, cancelled checks, and deposit slips for all business and personal checking and savings accounts for Dec.__, all of __, and Jan.___.
12) Records of bank loans, mortgages and all payments made during the year, stock and bond investments and other invested funds for the period December ______ - January _____ (both business and personal).
13) Copy of your loan liability ledger (get this from your bank).
14) All records of loans at Federal Land Bank, PCA and FmHA for _____, if any.
15) Any workpapers used in preparing your returns.
16) Record of livestock inventory at beginning and end of _____, and of sales of livestock during ______.
17) Purchase invoices and/or closing statements covering all acquisitions of capital items acquired during _____. This includes both real estate and personal property such as cars, machinery, equipment and livestock.
18) Records covering purchases or sales of real estate or other property.
19) All expenses invoices and receipts retained for _____.
20) All co-op and/or elevator statements for sales and purchases for ______.
21) All records you have in regards to Agricultural Program Payments and Commodity Credit Loans for _______.
22) All brokerage statements for _______.
23) Information on any nontaxable income received during 19__. This includes social security benefits, gifts, inheritances, etc.
24) To assist you in planning for the examination, the following issues will be examined. However, I may have questions and need further information on other issues during the examination.
   a)
   b)

Please have the above items available so that your examination can be conducted in an efficient and timely manner.

Information Due By__________ At Next Appointment [ ] Mail In [ ]

FROM:	Name and Title of Requester	Date
	Office Location	Phone:

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Taxpayer's Name	**xx-xx-xx**
XXXX - 1040	**Agent Name**
Initial Interview	WP/B#

DESCRIPTION OF FARMING OPERATION

Have you ever been involved in any partnerships or corporations?
Is your farm operated as a joint venture or partnership?

Describe farming operation:

1) How did you get into farming?

2) When did you start farming?

3) Do you farm alone, or with someone else?

4) Do you have any farm workers? Full time employees?
Part time employees? Contract laborers?
Do you pay any farm workers with commodities or other non-cash items?
If so, how do you treat such payments for employment tax purposes?
Are there any written agreements in existence regarding non-cash payments?

5) How many acres do you own?

6) How many acres did you rent from others?

7) How many acres did you lease to others?

8) How many total tillable acres do you farm?

9) How many acres do you run cattle on?

10) How many acres are in hay?

CROPS

1) What crops did you grow in ______?

   Number of acres ___________?

   Number of acres irrigated __________?

   Bushels per acre __________?

2) When do you usually sell the crop? In year grown or following year?

3) When did you sell your 19__ crop?

4) Where did you sell your grain?
   (List all elevators sold to)

5) How much of the crop was sold? Consumed as feed?
   Please provided documentation regarding feed consumption.

6) What elevators and co-ops do you purchase from?

7) Did you sell any grain to other farmers for feed or seed?

8) Are you involved in any government farm programs (CCC, CRP, LDP, etc)?

9) Did you receive any commodity credit loans during _______?

10) When do you report commodity credit loans in income?
    When received or when redeemed?

11) Did you pay back any CCC loans or forfeited grain in payment of CCC loans during ______?

12) Did you purchase any Commodity Certificates in ______?
    If so, were they sold?

13) What did you do with the Commodity certificates received from ASCS in ___?

14) Were they used to pay off CCC Loans?

15) Did you enter into or terminate any commodity transactions in ________?
    If so, where on this return were gains (losses) reported?

LIVESTOCK

1) Did you own any livestock?
   If yes, what kind?

2) How many head of each owned?

3) Was livestock raised or purchased for resale?

4) When do you usually sell the livestock?

5) When did you sell livestock in _______?

6) Where do you sell them?

7) Do you milk cows?
   How many head milked? (Average)
   Where was the milk sold?

8) Did you own any chickens, turkeys, or other poultry?
   If so, were any eggs or poultry sold?

9) How many cattle, pigs, chickens, etc., were butchered for personal consumption during a year?

10) Did you sell, trade, or give away any animals to others for butcher?

11) Did you ever sell livestock or grain on a deferred sales contract?

12) How did you determine what portion of the following expenses were personal and what were business?

    a) Utilities?
    b) Gasoline?
    c) Insurance?
    d) Taxes?
    e) Interest?

13) What vehicles did you have registered for highway use during _______?

	Make & Model	Gas or Diesel	Taxable Gross Wt.	% Business Use Claimed	Comments
	------------------	--------	-----------	---------------	--------------
Cars					
Pickups					
Trucks					
Others					

Chapter 4

EMPLOYMENT TAXES

IRM 4034 REQUIRED FILING CHECKS - EMPLOYMENT TAXES

Farmers who file Schedule F returns or corporate income tax returns, may also be required to file returns for compensation paid to individuals for services. The additional returns include:

1. Form 943, Employers Annual Tax Return for Agricultural Employees;

2. Form 940, Employers Annual Federal Unemployment Tax Return;

3. Form 1099, Information Return; and

4. Form 945, Annual Return of Withheld Federal Income Tax.

The type of return required depends on whether there is an employer-employee relationship, or the farmer hires an independent contractor. For an in-depth discussion on determining employment status, refer to the training material "Independent Contractor or Employee?", Training 3320-102 (Rev. 10/96) TPDS 84238I.

FORM 943, EMPLOYERS ANNUAL TAX RETURN FOR AGRICULTURAL EMPLOYEES

Farm employers report wages paid to employees, and the employment taxes attributable to those wages, on Form 943. Unlike Form 941, Quarterly Employment Tax Return, required from non-farm employers, Form 943 is filed annually and is due on or before January 31st of the year following the year covered by the return.

Social security taxes, medicare taxes, and income tax withholding apply to all cash wages paid to employees for farm work. A farmer is liable for these employment taxes if there are one or more agricultural employees, including a spouse, parents, or children age 18 or over, and if one of two of the following conditions is met:

1. The farmer has paid the employee $150 or more in cash wages during the calendar year, or,

2. The farmer has paid at least $2,500 in total wages for all farm labor during the

year.

There is an exception to the above conditions. Wages paid to a seasonal farm worker, who receives less than $150 in annual cash wages, are not subject to employment taxes, even if the farmer-employer pays $2,500 or more in that year to all farm workers, if the farm worker:

1. Is employed as a hand-harvest laborer (for example, fruit and vegetable pickers)

2. Is paid by the piece in an operation that is usually paid on a piece-rate basis in the region of employment

3. Commutes daily from his or her home to the farm

4. Was employed in agriculture less than 13 weeks in the preceding calendar year.

However, wages paid to these workers **are used** in considering the $2,500 or more test, for determining the employment tax coverage of other farm workers.

A farmer may employ a crew leader who provides workers and pays their wages for the agricultural services performed. If there is no written agreement specifying that the crew leader is the farmer's employee, and the crew leader pays the farm workers on his or her own behalf or on behalf of the farmer, then the crew leader, rather than the farmer, is the employer and is responsible for withholding and paying the employment taxes on the workers' wages.

LAW CHANGES AND POTENTIAL EXAMINATION ISSUES

Several changes were made to the social security payment requirements with respect to farm employment as of January 1, 1988. The income tax withholding requirements were also changed with regard to cash wage payments made after December 31, 1989. Changes and potential issues could arise if the farmer is following the employment tax rules in effect before these dates.

1. Income tax withholding became mandatory for cash wages paid to farm employees after December 31, 1989. Before that, income tax withholding was voluntary, and by agreement between the employee and farmer.

2. Wages paid to a farmer's children, aged 18 and above, for agricultural services are subject to social security taxes beginning with payments made after December 31, 1987. Prior to this a farmer's children had to be age 21 or above before social security tax applied to their wages.

3. Any wage payments to a spouse are subject to social security taxes beginning with payments received after December 31, 1987. Before this, wages to a spouse were exempt from social security tax.

4. Before January 1, 1988, a farmer was subject to social security taxes for cash wages paid to an employee who performed farm-related services on 20 or more days during the year. This requirement was replaced by the $2,500 total wage test for determining if there is a social security tax liability.

TREATMENT OF NON-CASH WAGES

The 1950 amendments to the Social Security Act brought agricultural labor under social security coverage. The amendment included an exemption for noncash wages. In defining wages for purposes of employment taxes, IRC section 3121(a)(8)(A) provides an exclusion for payments paid in any medium, other than cash, for agricultural labor. Cash payments include checks and other monetary media of exchange, but does not include payments in the form of food, farm products, or other goods and commodities.

The regulations provide no guidance or examples of when payments in commodities for agricultural labor might be considered the same as cash and, therefore, not qualified for the exclusion from employment taxes. Consequently, an increasing number of farmers, particularly farm corporations, pay their officers and shareholders in grain or livestock. The result is the avoidance of social security and unemployment taxes even though the products are often sold for cash a short time after the commodities are transferred to the employee.

Whether putative noncash payments are, in substance, equivalent to cash payments, has become a contentious issue. The "substance over form" analysis is inherently factual, and each case should be evaluated on its own facts. In a market segment understanding, the Service has identified six factors for use in determining whether a bona fide transfer of a noncash medium has occurred. These factors are as follows:

1. Existence and extent of documentation

2. Marketing and negotiation of a subsequent sale of the commodity by the employee

3. Shifting the risk of gain or loss to the employee

4. The length of time between the employee's receiptand sale of the commodity

5. Bearing the costs incident to the ownership

6. Ready identifiability of the transferred commodity.

In addition, compensation arrangements under which virtually all of employee compensation is paid in commodities should be scrutinized carefully. Because some cash is necessary to meet the expenses of everyday life. This type of payment is often equivalent to cash.

Examples of farm employment agreements examiners may encounter in which wages are being paid in commodities, include:

1. The farmer computes the number of hours the employee worked at an hourly wage, converts the amount owed into a specific amount of commodities, and pays that amount in commodities.

2. The farmer pays the employee a fixed amount of grain or fixed number of livestock for the services performed.

3. The farmer pays the employee based on a percentage of the crop or livestock produced. This is known as **share cropping.**

4. The farmer pays the employee in both cash and commodities.

Examiners must consider a number of facts in determining whether the IRC section 3121(a)(8)(A) exclusion from wages for in-kind commodity payments applies, when examining farmers who are paying employees this way. This is especially true of those who operate in corporate form and pay a substantial portion of officer salaries in the form of commodities. Facts which should be developed include:

1. Obtain a copy of the written employment contract (if any). If the agreement was oral, obtain a complete explanation of the terms. Any deviations in payment or computation of wage amounts, from those specified in the employment agreement, should be fully documented.

2. Determine whether the payment in commodities was a fixed amount, a percentage of total production, or based on a formula where the number of hours worked and an hourly wage were considered. Was the amount determined before or after the harvest or the sale of the farmer-employer's crop? Was the employee allowed cash advances or distributions against future sale proceeds?

3. Determine how and when the employee was to take possession of the commodity compensation. Was the commodity separated from or commingled with the farmer-employer's commodities until sale? What costs did the employee incur after receiving the commodities as wages?

4. Determine when the employee converted the commodity to cash. How long was the commodity held before conversion? Did the employee deliver the commodities to the market? Were the commodities delivered with and sold at the same time as the employer-farmer's commodities? Were they sold separately? Did the purchaser treat the employee's commodity as a separate transaction? Did the employee receive payment from the purchaser or did the farmer-employer provide the payment?

5. Were in-kind wage payments available to all employees, or only to officers or shareholders? What is the farmer-employer's history of paying wages in cash versus in commodities? Are commodity payments available only to family members, (owner-employees in the case of corporations) for the purpose of avoiding employment taxes?

EXAMPLES OF NONCASH WAGE AGREEMENTS

There have been no court decisions regarding the issue of noncash compensation. A number of National Office Technical Advice Memorandums and one Revenue Ruling have been issued, providing examples of farmers using noncash wage agreements with employees, and the IRS's position regarding those facts and circumstances. Refer to the following ruling if you encounter this issue:

Rev. Rul. 79-207, CB 1979-2, 351

The facts and circumstances of each case must be considered. Where the facts indicate the economic substance of the transaction was to pay the employee in cash, and the payment of commodities as wages was for the purpose of avoiding social security taxes, an employment tax issue should be raised.

SELF-EMPLOYMENT TAX ATTRIBUTABLE TO COMPENSATION IN COMMODITIES

In those cases where the officer/shareholder and/or other employee(s) are receiving a **percentage** share of the commodities produced on the farm, an alternative position could be raised on the employee's return by the imposition of self-employment tax. This would negate the overall tax benefit intended by the farmer under examination. This issue is based on the stated language in the employment and self-employment tax statutes. There are no regulations, rulings, or court cases to support or preclude this issue.

IRC section 3121(b)(16) excludes from the definition of employment: "service performed by an individual under an arrangement with the owner or tenant of land pursuant to which --

(A) such individual undertakes to produce agricultural or horticultural commodities (including livestock ***) on such land,

(B) the *** commodities produced by such individual, or the proceeds therefrom, are to be divided between such individual and such owner or tenant, and

(C) the amount of such individual's share depends on the amount of *** commodities produced;"

An individual who has a share cropping arrangement is thus statutorily excluded from being an employee irrespective of if that person is an employee or an independent contractor. If there is no employment, then there are no "wages" under IRC section 3121(a).

IRC section 1402(a) provides that income from any trade or business is net earnings from self-employment and thus subject to self-employment tax. Being an employee is considered a trade or business so that IRC section 1402(c)(2) excludes services by an individual as an employee from self-employment income. However, subparagraph (B) then excludes "services described in section 3121(b)(16)" from the definition of employee services that are being excluded.

The income from the share cropping arrangement is thus statutorily included as self-employment income. Arguments about whether the person is an employee or contractor should be moot.

FILING RETURN AND DEPOSITING TAX

Effective January 1, 1993, new rules were established for determining when a farmer-employer must deposit social security and income withholding taxes, although the old deposit rules could continue to be used for the 1993 calendar year. For calendar years after 1993, the new deposit rules must be used. If employment taxes of $100,000 or more should accumulate at any time during the year, then the 1 day deposit rule applies. If total taxes paid during a lookback period were $50,000 or less, monthly deposits must be made. If total taxes paid in the lookback period were more than $50,000, semiweekly deposits are required. Circular A, Agricultural Employer's Tax Guide provides a complete explanation of the deposit requirements.

FORM 940, EMPLOYERS ANNUAL FEDERAL UNEMPLOYMENT TAX RETURN

Farmer-employers who pay cash wages must pay Federal unemployment tax (FUTA), if either of the following tests is met:

1. The farmer pays **<u>cash</u>** wages of $20,000 or more to farm employees in any calendar quarter during the current or preceding year, or,

2. The farmer employs 10 or more employees for some part of at least 1 day during each of 20 different calendar weeks in the current or preceding year.

As with social security tax, unemployment tax applies only to cash wages paid to farm employees. IRC section 3306(b)(11) provides that "wages" do not include remuneration paid for agricultural labor in any medium other than cash for purposes of FUTA. See the previous discussion for when payments other than cash are considered the same as cash.

Farm workers provided by a crew leader are considered employees of the farmer for purposes of FUTA unless:

1. The crew leader is registered under the Migrant and Seasonal Agricultural Worker Protection Act, or

2. Substantially all the workers supplied by the crew leader operate or maintain tractors, harvesting or crop dusting machines, or other machines supplied by the crew leader.

If the farmer-employer is subject to FUTA, Form 940 must be filed by January 31 of the year following the calendar year for which the tax is due. When the amount of tax due is more than $100 for the quarter, the tax must be deposited by the end of the month following the close of the quarter. If the amount of tax due is less than $100, no deposit is required, but the tax must be added to the amount subject to deposit for the next quarter. If the total tax due for the year is less than $100, it may be paid when the Form 940 is filed.

<u>FORM 1099, INFORMATION RETURNS</u>

When a farmer makes reportable payments of $600 or more during a calendar year for business purposes to an individual, Form 1099 must be filed to report these payments. Information returns are not required if the payments are made to a corporation. Reportable payments include interest, rent, royalties, commissions, and nonemployee compensation. If a contractor (who is not a dealer in supplies) performs services for which he or she also provides the supplies needed, the farmer must report the entire payment for supplies and services on the Form 1099 issued to the contractor. Payments for trucking grain and livestock are excluded from the Form 1099 filing requirements (Treas. Reg. section 1.6041-3).

Payments reportable on Forms 1099 are generally not subject to FICA and income tax withholding. If the individual receiving payments does not provide the farmer with a valid social security number, the farmer is required to withhold 31 percent of the payments for income tax. This is called backup withholding. Before January 1, 1993, the withholding rate was 20 percent. The farmer reports and pays backup withholding tax on Form 945, Annual Return of Withheld Federal Income Tax. Backup withholding deposits must be deposited separately from other payroll taxes. The deposit rules are basically the same as those previously discussed for payroll taxes, but the "Form 945" box on the Federal Tax Deposit Coupon (Form 8109) should be checked. If the farmer cannot document having the payee's social security number at the time the payments were made, backup withholding would apply if total payments were $600 or more.

The farmer must give a copy of the Form 1099 to each person to whom payment was made by January 31 of the year following the calendar year in which the payment is made, and file it with the IRS on or before February 28 following the end of the calendar year in which the payments are made. Examples of individuals to whom farmers should issue Forms 1099 include: veterinarians, attorneys, accountants, mechanics, custom harvesters and chemical appliers who provide their own equipment, and land owners.

In examining a farmer's Form 1099 filing requirements, procedures that should be considered include:

1. Obtain PMFOL (Payor Master File) transcripts to determine if the farmer has filed Forms 1099.

2. Inspect Forms 1099 to determine if the farmer obtained social security numbers.

3. Inspect Forms W-9, or any documentation maintained by the farmer, to show that the farmer obtained social security numbers before making payments.

4. Review expense accounts such as labor, machine hire, legal fees, rent, and interest for payments to individuals who were not issued Forms 1099. If social security numbers were not obtained, backup withholding would apply.

5. Inspect CP 2100 notices issued to the farmer by the service center, giving notification of incorrect social security numbers for Forms 1099 filed. If the farmer made no attempt to obtain correct numbers, backup withholding may apply.

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Chapter 5

ACCOUNTING

ACCOUNTING PERIODS

All taxpayers compute taxable income for a period known as the "taxable year." A farmer adopts a taxable year on or before the time (not including extensions) for filing his or her first income tax return per Treas. Reg. section 1.441-1T(b)(2).

The majority of farmers use the calendar year (a 12-month period ending on December 31). IRC section 441(g) specifies situations that require the use of this accounting period.

Should you encounter the use of a fiscal year during a farm examination, refer to IRC section 441(e) and IRC section 441(f) and the corresponding regulations. The use of a fiscal year is allowed only if it is established as the annual accounting period, and the farmer's books are maintained on that basis.

Partnerships and Subchapter S-Corporations

A partnership is required to conform its tax year to the tax year of either its majority partners, its principal partners, or a calendar year, in that order, unless it can establish a substantial business purpose for using a different tax year. Majority partners and principal partners are defined in IRC section 706(b).

An S-Corporation must use a calendar year unless the corporation establishes a substantial business purpose for using a different tax year. When considering the farmer's claim of a substantial purpose regarding both S-Corporations and partnerships, consult Treas. Reg. section 1.442-1(b)(1).

IRC section 444 allows partnerships and S-Corporations to elect a tax year other than the required tax year if payments are made as required by IRC section 7519. Such payments are intended to represent the value of the tax deferral obtained by the partners and shareholders, from using a year other than a required tax year. If you find an entity that has made an IRC section 444 election, you will need to verify the proper and timely election and the timely payment of deposits.

ACCOUNTING METHODS

The different type of accounting methods you may encounter are discussed below.

Cash Receipts and Disbursements Method (Cash Method)

The cash method of accounting is used by most farmers due to the ease of record keeping. Some tax advantages derived are:

1. All taxable income, whether received in cash or property, is included in income in the year actually or constructively received;

2. Farm expenses are deductible only in the taxable year paid; and

3. Inventories are not used to determine income.

Constructive Receipt

Refer to the "Income" chapter of this Guide for narrative, examination techniques, and references regarding constructive receipt.

Farm Expenses

The farmer is the only producer/manufacturer who can adjust taxable income by accelerating or deferring expenses between years. Expenses of a cash method farmer are generally deductible only in the tax year paid, but in the case of a farming syndicate, as defined in IRC section 464(c), a deduction for prepaid supplies is deductible only in the year the supplies are actually used or consumed.

Inventories (Cash Method)

In contrast with non-farm taxpayers engaged in the business of production/manufacturing, cash method farmers are **not** required to use inventories to determine income (Treas. Reg. section 1.471-6(a)). However, a cash method farmer cannot deduct commodities, such as livestock or grain held for resale, in the year acquired, unless the purchase and the sale occur in the same year. The farmer can only take these purchased items as a reduction of gross income in arriving at gross profit for the year the proceeds from the sale of the product are included in income (Treas. Reg. section 1.61-4(a)).

For further information regarding the sale of items bought for resale, refer to the "Sales of Livestock" chapter.

Accrual Method

Farmers may generally adopt either the cash or the accrual method of accounting; however, IRC section 447 requires farm corporations, with certain exceptions, to use the accrual method of accounting. Subchapter S-Corporations and corporations with less than $1 million in gross receipts for each prior taxable year beginning after December 31, 1975, are excepted, along with specified family corporations.

The purpose of the accrual method is to match income and expenses properly. Under this method of accounting:

1. All items of income from farming operations are included in gross income when earned, even though payment may be received in another tax year.

2. Expenses are deductible in the tax year the farmer becomes liable for them, whether or not they are paid in that year.

Income

Generally, income is reportable in the taxable year when all the events which fix the right to receive such income have occurred, and the amount can be determined with reasonable accuracy. This method can be beneficial to the farmer. Deductions, net operating losses, and credits can be used effectively in years when cash receipts are insufficient. Borrowing to prepay expenses (for a cash basis farmer) would not be necessary.

Expenses

All events which establish the liability must have occurred. The farmer must be able to reasonably determine the amount of the liability, and economic performance must have occurred in order to deduct expenses. Economic performance generally occurs as the property or services are provided, even if the expenses are not paid. An exception for recurring items allows certain expenses to be treated as incurred in a tax year even though economic performance is lacking (IRC section 461(h)(3)).

Inventories (Accrual Method)

A farmer using the accrual method of accounting must use an inventory to compute gross income. Inventory should include all unsold items at the end of the tax year, whether raised or purchased, that are held for sale or for use as feed, seed, etc. There is no requirement to inventory growing crops, unless a pre-productive period of more than 2 years exists. The farmer should maintain complete inventory records. All factors that enter into inventory valuation such as count, measurement, quality, and weight, should be reflected where applicable.

Special Methods of Accounting for Certain Items

Special methods of accounting are described in various sections of the Internal Revenue Code and Treasury Regulations. The **crop method** is an example of a special method of accounting. Under this method, the entire cost of producing the crop, including the expenses of seed or young plants, must be deducted in the year the income from the crop is realized. The method may be used, with the consent of the Commissioner, when a crop:

1. Is planted in one year and harvested in another,

2. Takes more than a year from planting to gathering and disposition.

A winter wheat producer could elect this method, but would see no tax advantage by doing so.

Other special methods relate to installment sales (IRC section 453), and to soil and water conservation expenditures (IRC section 175). These topics are covered in other chapters of this Guide.

Combination (Hybrid) Methods

The most common method of accounting farmers use is a combination of the cash and accrual methods. This method is allowed by IRC section 446(c). Farmers may specifically use the accrual method for purchases and sales and the cash method for all other items of income and expenses.

Change in Accounting Method

A farmer is required to obtain IRS permission to change an accounting method, even if the new method is proper or is permitted under the Code or regulations. There are two exceptions to this requirement, which will be discussed later.

A change in accounting method includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. A material item is defined as follows: An item which involves proper timing of declaring income or claiming a deduction. The key element is timing. Changes in an accounting method of a farmer include the following:

1. A change from the cash to the accrual method or vice versa

2. A change in the method or basis used to value inventories

3. A change involving the adoption of any other specialized method of computing net income, such as the crop method, or a change in the use of a specialized method

4. A transfer of draft, dairy, or breeding animals from inventory to a fixed asset account

5. A situation where the farmer has chosen to report loans from the Commodity Credit Corporation as income in the year received and now wants to change to a different method.

IRS consent to change an accounting method is **not** **required** in these farming situations:

1. A change from valuing livestock inventory at cost, or the lower of cost or market, to the unit-livestock-price method, or,

2. A required change to the accrual method by a family farm corporation when gross receipts exceed $25 million necessitating the establishment of a suspense account. Refer to IRC section 447(i).

Misclassifying an item with no resulting timing difference is not an accounting method issue; nor are corrections of mathematical or posting errors, or errors in the computation of tax liability.

Form 3115 is to be filed when requesting a change in an accounting method, which includes the change of the accounting treatment of any item. In most cases, the application must be filed within the first 180 days of the tax year for which the change is requested. When a farmer requests a change in the method of reporting Commodity Credit loans, he or she must request the application of Revenue Procedure (Rev. Proc.) 83-77. This procedure extends the time for filing an application from the first 90 days of the tax year for which a change is requested, to the first 180 days of that year.

Rev. Proc. 92-20 provides general procedures under IRC section 446 to change a method of accounting. An applicant usually receives more favorable terms and conditions for any change in method, if an application to change the accounting method is filed prior to contact for examination by the IRS. Even farmers contacted for examination have "windows of opportunity" to change voluntarily, but get less favorable treatment than if the farmer had requested the change before contact. Farmers who are under examination and do not voluntarily change an improper accounting method, are entitled to significantly less favorable treatment. The change is made during the examination process.

When you encounter a change of accounting method during an examination, ask if the farmer filed an application for permission to change before he or she was contacted for audit. If so, request a copy of the application and determine if the IRS granted formal approval. If not, compute the required change in accordance with Rev. Proc. 92-20 and IRC section 481. The IRC section 481(a) adjustment represents the cumulative differences between the present and proposed methods of accounting, as of the beginning of the year of change.

Rev. Proc. 92-20 is effective with respect to Forms 3115 filed on or after March 23, 1992. Forms 3115 filed before that date are subject to the provisions of Rev. Proc. 84-74.

INVENTORY VALUATION METHODS

Farmers seldom use "cost" or "lower-of-cost-or-market" when valuing inventories, because of the difficulty in determining actual cost. You probably won't see the use of these methods. If you encounter one of these methods, refer to Treas. Reg. sections 1.471-3 and 1.471-4.

Two additional inventory valuation methods are available to farmers:

1. The **farm-price method**, and,

2. The **unit-livestock-price method**.

The farmer may choose either method, but once a method is elected, it is binding for the current year and all subsequent years. The farmer must request and receive authorization from the Commissioner to change to one of the other inventory valuation methods, which is discussed later.

Farm-Price Method

Inventories are valued at market price less direct cost of disposition (Treas. Reg. section 1.471-6(d)). Market price is determined by the current price at the nearest market, in quantities the farmer would normally sell. Where no open market exists, or where quotations are nominal due to inactive market conditions, the farmer must use such evidence as may be available of a fair market price at the date or dates nearest the inventory valuation (for example, grain and livestock price quotes in the newspaper). Cost of disposition includes broker's commission, freight and hauling to market, and other marketing costs. This is the method commonly used by accrual grain producers.

When this method is used, it must be applied to the entire inventory, with the exception of livestock, which at the taxpayer's election, may be valued using the unit-livestock-price method.

Unit-Livestock-Price Method

Under this method, livestock is grouped or classified according to kind and age, and a standard unit price is used for each animal within a class or group. The standard unit prices assigned must reasonably account for the normal costs incurred within such classes or groups. The classifications selected and the unit prices assigned are subject to approval by the IRS upon examination of the farmer's return. Once a return is examined and prices and classifications are approved, consistent application must be followed in all later years.

A farmer 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. Such method accounts only for an increase in the cost of raising an animal to maturity. It does not provide for any decrease in the market value of an animal after it reaches maturity. Hay grown by a farmer solely for feeding animals is not required to be inventoried.

All livestock **purchased** primarily for sale must also be included in inventory. Animals purchased for draft, breeding, dairy, or sporting purposes may be included in inventory, or subject to depreciation after maturity. If the livestock purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with established unit prices. Animals purchased after maturity must be inventoried or capitalized at their purchase price.

A livestock producer who adopts a constant unit-price method of valuing livestock inventories and files returns on that basis, will be considered as having elected the unit-livestock-price method. A farmer who uses the cost, or lower-of-cost-or-market-method of inventory valuation for livestock, may adopt the unit-livestock-price method without formal application for permission. However, a change from the farm-price method to the unit-livestock-price method requires Commissioner approval. In addition, a change from the unit-livestock-price method to any other inventory valuation method requires formal approval.

Uniform Capitalization Rules

Grain farmers (cash or accrual), with or without livestock, are generally not required to capitalize inventory costs under IRC section 263A. Only large corporations, certain partnerships, and tax shelters, required to use the accrual method of accounting need follow the provisions of IRC section 263A. (IRC section 448(a).)

If you examine a farmer who is required to use the uniform capitalization rules, you should research the code and regulations for the appropriate costs to be included in inventory.

RESOURCES

Reference		Contents
IRC	Treas. Reg.	
61		Gross income defined.
	1.61-4	Gross income of farmers.
263A		Capitalization and inclusion of certain expenses in inventory costs.
441		Period for computation of taxable income.
442		Change of annual accounting period.
	1.442-1(b)(1)	Establishment of a substantial business purpose when requesting Commissioner approval for a change of an annual accounting period.
444		Election of taxable year other than required taxable year. (Partnerships, S-corporations, personal service corporations).
446		General rule for method of accounting.
447		Method of accounting, corporations engaged in farming.

Reference		Contents
IRC	Treas. Reg.	
448		Limitation on use of cash method of accounting.
451		General rule for taxable year of inclusion.
461		General rule for taxable year of deduction.
461(h)		Certain liabilities not incurred before economic performance.
464		Limitations on deductions for certain farming operations. (Farming syndicates).
471		General rule for inventories.
	1.471-6	Inventories of livestock raisers and other farmers.
706		Taxable years of partner and partnerships.
1378		Taxable year of S-corporation.
7519		Required payments for entities electing not to have required taxable year.

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Chapter 6

INCOME

INTRODUCTION

Income to the farmer consists primarily of sales of grain, livestock, produce, or other products of the farm. Other sources of farm income can include:

* Miscellaneous income from farm labor or custom work
* Government benefit checks
* Rents
* Royalties
* Other similar activities.

A farmer's sales generally fall into five classifications:

1. Stock in trade (livestock, grain, and other products of farming). Income from these sales ordinarily will be entered on page 1 of Schedule F.

2. IRC section 1231 assets (buildings, machinery & equipment, and livestock held for draft, dairy, breeding, etc.). Income from the sale of IRC section 1231 assets, and any corresponding IRC section 1245 gain, is initially entered on Form 4797. It is then carried to Schedule D or directly to page 1, Form 1040. Please refer to the "Sales of Livestock" chapter for a more detailed explanation.

3. Other property used in farming which does not meet the requirements for IRC section 1231 treatment (draft, breeding, dairy, or sporting animals held for less than the required period and other assets used in the business but held 1 year or less). Income from these sales will usually be reported in Part II of Form 4797.

4. Capital Assets (farmhouse, stocks and bonds, personal automobile, etc.). Gains from the sale of capital assets are usually reported directly on Schedule D, and are discussed in the "Basis and Sales of the Farm and Farm Assets" chapter.

5. Farm land, which is classified as an IRC section 1252 asset. The gain from a disposition of farm land is regulated by IRC section 1252. The tax treatment of sales under IRC section 1252 is similar to that under IRC section 1245.

The gross profit percentage for farming can be misleading since there is generally no income pattern among individual farmers. This is due to the variation in the size of farms, methods of marketing, etc. For example, if a farmer sells the current year's crop and part of last year's crop in the current year, this gives a distorted picture of current year receipts.

Many farmers now have an additional source of income from one or more family members working away from the farm. This area needs to be inspected for potential unreported income from contract labor or self-employment.

Be sure all income generated by the farm has been reported. Income includes not only cash received, but also the value of any merchandise or services received in exchange for farm products. Bartering income is taxable (Rev. Rul. 80-52).

SALE OF CROPS AND PRODUCED ITEMS

The farmer starts with the capital -- land, buildings, and equipment, and adds to that the labor and raw materials necessary to produce the completed product. Raw materials could include fertilizer, seed, chemicals, feed, breeding animals, or any number of other items. Then, over some period of time, the product is "manufactured," that is, raised until it becomes a completed product.

A Revenue Agent must determine that all products produced and sold have been included in income. The sale of all raised livestock, produce, grains, and other products are combined and reported on the same line of Schedule F.

When the farmer sells the crops raised on the farm, payment can be in the form of money or property and services (use fair market value (FMV) to determine income). Whichever is used for payment is treated as ordinary income. The profit from the sale of any crops bought for resale is also ordinary income. The amounts received must be reported in income in the year received. The profit or loss from the sale of crops bought for resale is the difference between the basis in the crop purchased and any payment received.

The net proceeds from the sale of a crop by someone acting as the farmer's agent must be included in gross income for the year the agent receives payment, even though there is an arrangement with the agent that the farmer will not be paid until a later year.

Example 1

Alice Chambers contracts with an agent, Dale Jenkins, to sell her corn to the local elevator on December 27, 1994. She asks Dale to remit the sales proceeds to her in January 1995, instead of in December 1994. Even though she received the funds in 1995, she must include the sale of the corn in her income in 1994.

Growing crops (inventory) are those that remain unharvested at the end of the taxable year. These include all cultivated plants grown for sale, feed, seed, and the farmer's own consumption.

The ultimate disposition of the growing crop, whether before or after harvest, typically results in ordinary income to the accrual basis farmer when the farmer is entitled to the income.

When a crop is held and used for feed, it can be treated in one of two ways:

1. The income can be reported and an equal, offsetting feed expense shown

2. No crop income reported and no feed expense deducted.

In areas where the growing season is long, crops can be double cropped. Normally the two crops will include wheat and either soybeans or milo. Once the wheat (planted the previous fall) is harvested in June or July, the ground is immediately replanted into soybeans or milo.

The following is a compilation of the most common types of crops and the possible income sources from those crops.

Grain Crops

Wheat, Sorghum or Milo, Corn, Soybeans, and Oats are the grain crops discussed below.

Wheat

In the late fall and early winter, the wheat field may be rented out as pasture for cattle. This does not harm the harvest value. It can also be cut for hay in May, when it has just started to head out. When the wheat is cut for hay, it cannot be harvested. When the wheat is harvested, it can be sold immediately or stored and sold at some future date. The straw resulting from the harvest can be baled and sold.

Sorghum (Milo)

Milo can be sold when harvested or stored for a time before being sold. After harvest, the milo stalks (stubble) can be rented out as pasture for cattle in the fall after a hard frost. Milo can also be stored and used as feed for the farmer's livestock. Milo is a short season crop. It can be planted in the spring and harvested in the late summer or it can be double cropped, planted after the wheat is cut in June or July and harvested in the late fall.

Corn

Corn can be cut green and used as silage. If the corn is harvested, in the fall, it can be sold immediately or stored for future sale. It can also be stored and used as feed for livestock. After harvest, the corn stalks can be rented out as winter pasture for cattle.

Soybeans

Soybeans are normally harvested in the fall. They can be sold immediately or stored for later sale. Soybeans must be processed into meal before being fed to livestock.

Oats

Oats are planted in the spring and harvested in late summer. They can be cut for hay when they have just started to head out. If oats are used for hay, they can't be harvested. When oats are harvested, they can be sold immediately or stored, then sold. Oats are often used in livestock feeds.

Hay Crops

Hay crops are another source of income to the farmer. Generally once a field is planted to hay, it can be used for hay for many years without replanting. Alfalfa has a life of 4 to 5 years. Brome and prairie hay can be grown in the same field indefinitely.

Brome

Brome is usually cut once a year, from late spring to early summer. The hay is baled and can be fed to all types of livestock. The field can be used to pasture livestock in the fall.

Alfalfa

Alfalfa is a very high protein crop that is used as livestock feed. It can be cut and baled for hay, chopped into silage, or ground and compressed into pellets. Alfalfa is usually cut three to five times a year.

Prairie Hay

This hay consists of native grasses. It is normally cut and baled in the summer and used as feed for all livestock.

CONSTRUCTIVE RECEIPT OF INCOME VERSUS INSTALLMENT SALE REPORTING OF INCOME

Installment Sales

Before the 1980 Installment Sales Revision Act took effect, if a farmer did not have a valid deferred payment contract, income from the sale of crops or livestock had to be reported in the year of sale (constructive receipt). The 1980 Act postponed reporting income on installment sales (one or more payments received after the year of sale) until the year in which the payment was received. This was true even without a valid deferred payment contract, as long as the seller did not receive evidence of any indebtedness that was payable on demand or readily tradable (IRC section 453(f)(3) & (4)).

With the passage of the 1986 Tax Reform Act, valid deferred payment contracts or installment agreements are once again important for farmers. The 1986 Act prevents taxpayers from using the installment method of reporting income when calculating Alternative Minimum Tax (AMT) income (IRC section 56(a)(6)).

After the 1986 Tax Reform Act, installment reporting postpones grain and livestock income for regular tax purposes, but not for Alternative Minimum Tax purposes. To avoid AMT on constructive receipt of grain sale income, farmers must have a valid deferred payment contract.

A farmer must elect **not** to report income on the installment method before he or she will have constructive receipt of income. In other words, unless the farmer elects to report the constructive receipt of income in the year of the sale, income from a sale (where any payment is to be received in a taxable year after the year of sale) is to be reported on the installment method.

Example 2

No Constructive Receipt: Janet Jasper delivered 12,000 bushels of her corn to the elevator on October 20, 1994, and signed a contract with the elevator that obligated the elevator to pay her $2.55 per bushel for the corn on January 5, 1995. Under the contract, she was not allowed to sell, assign, transfer, pledge,or convey the contract or any of her rights in the contract.

Janet had no legal right to receive payment before January 5, 1995. Consequently, she is treated as receiving income on that date and, therefore, she reports the sale of the corn on her 1995 income tax return for both regular and AMT tax purposes.

Constructive Receipt

Income, although not actually in the farmer's possession, is constructively received in the taxable year during which:

1. It is credited to the farmer's account

2. Set apart for the farmer

3. Made available so the farmer can draw upon it at any time

4. The farmer can draw upon it if notice of intent to withdraw was given.

For example, the receipt of a check is constructive receipt of funds, even though not deposited or cashed during the tax year received.

Income is not constructively received if the farmer's control of its receipt is subject to substantial limitations or restrictions.

Farmers often enter into contracts in which income derived is not received until a later taxable year. A number of rulings and court decisions have considered the correct year of income inclusion for cash basis farmers when farm commodities are sold under deferred payment contracts. The determination usually hinges on a bona fide contract entered into at arms-length, and the provision that the farmer cannot withdraw the proceeds under any circumstance until the following year. The courts have also looked at a taxpayer's past practices and whether or not income was materially distorted when selling commodities.

If any items are sold under a deferred payment contract that calls for payment(s) in the following year(s), there is no constructive receipt in the year of sale.

Example 3

Constructive Receipt: Connie Greene delivered 5,000 bushels of her corn to the elevator on October 1, 1994, and negotiated a sale price of $3 per bushel. Before the elevator cut the check for the corn, Connie talked to Janet Jasper and decided that she should defer her payment until January 1995. Connie told the elevator to wait and send her check after January 1, 1995.

Connie had a legal right to receive her payment in 1994 and deferred receiving the check to 1995. Even though Connie was in constructive receipt of the income in 1994, if she does not elect out of installment reporting, she must report the income in 1995 for regular income tax purposes. She may choose to elect out of installment reporting and report the income in 1994 for regular tax purposes. Under the Alternative Minimum Tax, Connie has no choice. She may not use installment reporting and must, therefore, report the income in 1994 for AMT purposes. If Connie uses the installment method of reporting for regular tax purposes, she must report the sale of grain as an adjustment on line 4m of her 1994 Form 6251.

Examination Techniques

Potential areas of abuse include:

1. AMT adjustments when the installment method of reporting income is used

2. Checks received from the sale of livestock or crops in December, held and not deposited until January

3. Sales made on December 31, so that there is no way the check will be received until January.

4. Sales in which the agreement to defer payment occurs after the farmer obtains the right to receive payment.

Resources

The income tax requirements for income under the installment agreement method versus the constructive receipt method have not yet been resolved. This is shown in the conflict between the constructive receipt doctrine of Rev. Rul. 58-162 and Rev. Rul. 73-210, and the cash equivalency doctrine of Watson v. Commissioner, 613 F.2d 594 (5th Cir., 1980) and Griffin v. Commissioner, 73 T.C 933 (1980).

The significant issue is whether the constructive receipt or the cash equivalency doctrine was applied, because a farmer could use the installment method of reporting income even if the contract did not meet the deferred payment requirements.

The 1986 Tax Reform Act, P.L. 99-514, brought this issue to the forefront by adding IRC section 56(a)(6). This section prohibits the use of the installment method for reporting AMT income. Thus, for sales after March 1, 1986, a farmer cannot use the installment method to report income for AMT purposes. If the contract does not qualify for deferred payment treatment, the full sales proceeds must be included in AMT income in the year of the sale.

CROP SHARES

Crop shares are rental payments made to a farmer-landlord based on a percentage of the yield of the crop, and usually payable in kind (Rev. Rul. 56-496).

The regulations state that crop share rents are to be treated as income by either a cash basis or an accrual basis farmer only when the shares are reduced to money or its equivalent. Accrual basis farmers do not inventory crop share rents on hand at the end of the year.

If the landlord receives crop shares and uses them as feed in his or her farming operation, he or she must include the FMV of the crop shares in gross income. At the same time, under IRC section 162 the landlord will be entitled to a trade or business deduction for livestock feed equal to the value of crop shares included in gross income (Rev. Rul. 75-11).

If the farmer makes a gift or contribution of the crop shares, gross income must be recognized in an amount equal to the FMV of the crop shares at the time of the gift or donation, not when the crop shares are converted to cash or an equivalent by the receiver.

Crop share rental income is excluded from self-employment income unless the landlord materially participates in the production of agricultural products, or production management. The concept of material participation was developed to help distinguish why rents are treated as passive income, while income from farming is treated as self-employment income.

Material participation is necessary to build a social security base and may be necessary if current use valuation is to be used for Federal estate tax purposes. Material participation may cause social security payments to be decreased for persons eligible to receive such payments. Therefore, if crop shares are rents, self-employment tax does not apply. Because the crop shares are not classified as earned income, any amount of crop share income can be received without a reduction of current social security benefits.

Material Participation

Crop shares present a problem because some farmers are virtually in partnership with their tenants. In those circumstances, the income should be treated as if it were earned income from farming. In many of these situations, a formal partnership may not be found and certainly would not be desired by the parties involved. Therefore, the concept of material participation was developed. If a landowner materially participates with the tenant in making the decisions and paying some of the farming costs, the landowner is considered to be an active farmer rather than a passive landlord. His or her share of the crops thus would be characterized as farm income rather than rental income. This distinction was adopted by the Congress in 1956 and is now set out in the statute for Social Security purposes.

Examination Techniques

Areas of potential abuse arise when:

1. Active income is classified as passive income

2. Income earned by the farmer is reported by another family member(s) (normally a spouse or children). This is done so that social security payments will not be affected or reduced by earned income.

VARIOUS CONTRACTS

The farmer may attempt several methods to defer the reporting of income. Examples of allowable methods are holding the crop until the next year, or securing a Commodity Credit Corporation **(CCC)** loan which may not be income. For discussion on CCC loans, please see the "Commodity Credit Corporation Loans" section of the "Government Farm Programs" chapter.

A farmer may also try to find ways to sell products in the current tax year if the price is favorable, but delay inclusion of the income for tax purposes until the following year. Two types of contracts used to accomplish this are **Deferred Product Sales** and **Price Later Contracts**.

Deferred Product Sales

In 1980, Congress enacted the Installment Sales Revision Act of 1980, which amended IRC section 453. The change in the installment sales provisions opened a new method of income deferral for farmers.

IRC section 453(a) provides that income from an installment sale shall be taken into account under the installment method. IRC section 453(b)(1) defines an installment sale as receipt of at least one payment after the close of the taxable year in which the disposition occurs. The installment sale provisions are generally not available to dealers. However, a dealer disposition does not include the disposition on the installment plan of any property used or produced in the business of farming; therefore, farmers can sell on the installment basis (IRC section 453(b)(2)(A)).

You must determine if the farmer has made any such installment sales. Your concern on Schedule F is that all ordinary income items have been included in income. If the farmer has sold grain, livestock, or other products on the installment basis, there should be a contract stating the selling price and the dates payments are to be made. Ask for copies of such contracts to insure that the income is properly reported in the correct tax year.

Price Later Contracts (PLC)

A Price Later Contract (PLC) is for the sale of a product in which the title passes to the buyer upon delivery of the product. The PLC specifies a period (the pricing period) for fixing the purchase price of the grain, starting with the date of the PLC. On any business day during the pricing period, the farmer sets the price for his or her grain by selecting a price quoted by the buyer for similar grain, on that day.

IRC section 61 provides that gross income means income from whatever source derived, unless specifically excluded elsewhere in the Code. Treas. Reg. section section 1.61-4(a) provides, in part, that a farmer using the cash receipts and disbursements method of accounting shall include in his or her gross income for the taxable year the amount of cash and the value of merchandise or other property received during the taxable year from the sale of produce which he or she raised. Further, Treas. Reg. section 1.61-4(c) provides additional rules for certain farm receipts.

IRC section 453 permits a taxpayer who sells real property and a nondealer who sells personal property to report gain on the installment method. IRC section 453(f) provides that receipt of a bond or other evidence of indebtedness which is payable on demand shall be treated as receipt of payment. Therefore, since a price later contract constitutes indebtedness on demand, there would be no payment to be received after the close of the taxable year in which the sale occurs. Thus, a farmer executing a price later contract would not be able to use the installment sale provisions of IRC section 453.

Example 4

Jack Lane, who uses the cash receipts and disbursements method of accounting, places his 1992 grain into storage. In the spring of 1993, he enters into a PLC for the sale of his 1992 stored grain to be relieved of storage costs.

The terms of the PLC specify that the contract is for the sale of the grain, not storage, and that title passes to the buyer (the elevator) upon delivery of the grain. The PLC specifies a 365-day period (the pricing period) for fixing the purchase price of the grain, starting with the date of the PLC. Mr. Lane is to set the price by selecting, on any business day during the pricing period, a price being quoted by the buyer on that day for similar grain. If he fails to set the price, the price will be the buyer's offered price on the last day of the pricing period.

Mr. Lane fixed the price in January of 1994 and the elevator made payment to him at that time. Pursuant to IRC section 61 and IRC section 1001, the total sales price is includable in his gross income in 1993.

DISTRIBUTIONS FROM COOPERATIVES

A **cooperative** (co-op) is an enterprise owned by and operated for the benefit of those using its services. Farm co-ops can provide a wide selection of services to the farmer. These include selling the farmer's crop and purchasing products for the farmer's use. Commonly, the items purchased are needed for the farm, such as, seed, fertilizer, and equipment, but they may include personal items as well.

Patronage Dividends

Co-ops operate at cost. That is, farm co-ops return to farms the net profits from the cooperative business in proportion to the amount of business conducted by each farmer.

Usually, the rebate of the co-op business profits to the farmer is a **patronage dividend**, deductible by the co-op and included in the income of the farmer. This patronage dividend may be paid in the form of money, property, or **scrip**. The amount of money, the fair market value of the property, or the face value of the scrip is included in the income of the farmer.

The scrip paid to farmers is usually in the form of a written notice of allocation or a **per-unit retain certificate**, evidencing an obligation from the cooperative to the farmer. An important consideration is whether this scrip is qualified or nonqualified. A qualified written notice of allocation or a qualified per-unit retain certificate is one that the farmer has consented to include in his or her income upon its receipt.

These same forms of scrip are not included in the farmer's income when issued in nonqualified form. The issuance of nonqualifying scrip is not a patronage dividend taxable to the farmer. Rather, the amounts paid to redeem nonqualified written notices of allocation or nonqualified per-unit retain certificates will be included in the farmer's income upon redemption.

Patronage dividends are reported to the farmer on Form 1099-PATR. The patronage dividends should be reported on the farmer's return for the year in which they are received. Patronage dividends usually are subject to self-employment tax. However, patronage dividends received in crop share arrangements are reported on line 2 of Form 4835 and are not subject to self-employment tax.

There are two exceptions to the inclusion of the patronage dividends in the farmer's income, other than the rule applicable to scrip issued in nonqualified form. First, amounts received with respect to purchases of supplies, equipment, or services which were not intended for use in a trade or business or an IRC section 212 activity are not included in the farmer's income. In some instances, an allocation must be made for this purpose. For example, where gasoline is purchased from a cooperative for both farm and personal use. Second, amounts properly taken into account as an adjustment to the basis of property are not included in the farmer's income.

Other Receipts

Amounts received by farmers other than patronage dividends are treated under other tax rules. Such amounts might be taxable as compensation for services, dividends on stock, or interest on loans, or such amounts might be nontaxable, as in the case of a return of capital.

Examination Techniques

Often the farmer reports patronage dividends on the tax return erroneously in one of two ways:

1. The farmer reports the dividends on the front of Form 1040 as dividend income. By reporting the dividends in this manner, the farmer avoids self-employment tax on this income.

2. The farmer only reports the amount of patronage dividends received in cash. The dividend should include the fair market value of other property received as patronage dividends, such as stock, the face value of qualified scrip issued to the farmer, and amounts received in redemption of previously issued nonqualified scrip.

EASEMENTS AND RIGHTS-OF-WAY

Income received by farmers to grant easements or rights-of-way on their property for flooding land, laying pipelines, or constructing electric and telephone lines, etc., may result in income, a reduction of all or part of the basis of the property, or both.

Example 5

Fred Falls sold a right-of-way for a gas pipeline through his property for $1,000. Only a specific part of his farmland was affected. He reserved the right to continue farming the surface land after the pipe was laid.

1. If the $1,000 received for the right-of-way is less than the basis of the property allocated to the portion of land affected by the right-of-way, then the basis is reduced by $1,000.

2. If the amount received is more than the basis of the affected portion of the land, the excess is gain from the sale of IRC section 1231 property.

3. If, instead of selling a right-of-way, he sold part of his land, he would have a gain or loss from the sale of IRC section 1231 property.

4. If during construction of the line, growing crops were damaged and he later received a settlement of $250 for this damage, then the $250 he received in damages is income.

Easements and rights-of-way will normally be split between permanent damages and crop damages. There should be a signed document indicating the amount of permanent damages and the amount of crop damages.

OTHER FARM INCOME

The majority of farm income is derived from sales of products and Government payments. Some of the more common sources of other farm income include fuel tax credits and refunds, machine work, and commodity futures transactions (hedging). These items are discussed in later chapters.

Machine Work

Machine work is work performed by the farmer or the hired help on someone else's farm. The farmer might contract with another farmer to do such work as combining, cutting or baling hay, spreading fertilizer or to allow the use of equipment by another farmer. The farmer may be paid in cash, check, services, or merchandise. This income is taxable, but you will not always find it reported on Schedule F as required.

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Chapter 7

GOVERNMENT FARM PROGRAMS

AGRICULTURAL PROGRAM PAYMENTS

The United States Department of Agriculture **(USDA)** is responsible for implementing the farm programs legislated by Congress. Some of the divisions of the USDA that many farmers will be involved with are:

1. **Agricultural Stabilization and Conservation Service (ASCS)** is the key office for most of the government payments. The ASCS is usually the starting point for the farmer to register and qualify for many crop and land related payments.

   The ASCS maintains a file for each farmer, identifying land owned by farm number. ASCS records acreage, crops grown, program participation, and payments made. It also maintains other information such as aerial photographs, sharecrop arrangements, and data about other farms located in other counties.

   Many of the programs of other USDA divisions are requested by the farmer at the ASCS office. ASCS then calls in the other division(s) to provide the service(s) requested. Any payments to the farmer are usually made by the ASCS office, not by the Soil Conservation Service (SCS) or the Commodity Credit Corporation (CCC).

   For example, to take out a CCC loan the farmer will go into the ASCS office, request the loan and receive payment from CCC at the ASCS office. Another example: A farmer wants to build a farm pond and receive cost sharing. The request can be made either at the ASCS office or the SCS office. The actual work will be done by the SCS, but the ASCS will make the cost share payment to the farmer.

2. **Soil Conservation Service (SCS)** provides engineering assistance to farmers in building dams, leveling land, surveying, and other related services. These services are free and are not taxable to the farmer.

   Some conservation practices and projects are eligible for payments by the Government to share in the cost to the farmer. These payments and their tax treatment are covered separately later in the guide.

3. **Commodity Credit Corporation** (CCC) is the source of the majority of the payments made to farmers. CCC makes loans, price support payments, storage

payments, and other payments that may be taxable when received, in a later year, or not at all. Each of these payments is discussed in detail later in this chapter.

4. **Farmers Home Administration (FmHA)** makes real estate loans, operating loans, and loans to purchase machinery, grain bins, or other equipment purchases by the farmer. They also make loans on certain Government housing that is not related to farming. In addition, FmHA makes disaster loans and emergency loans.

Farmers can receive many different types of payments from the Government as a result of various farm programs. An understanding of the purpose of these payments is the key to determining their effect on the farmer's income. The terms farm program payments and **agricultural (ag) subsidy payments** can be used interchangeably. A brief discussion of the more common types of payments follows this introduction to Government programs.

Agricultural program payments may or may not be reported to the farmer and/or the IRS. This guide will identify the payments and how or if they are reported to the farmer and the IRS.

Should the farmer not have the information you need on Government payments, it can be requested from the local ASCS office or any other agencies with which the farmer has dealt. Depending on the local policies of these offices, you may be able to obtain the information directly without use of a Summons. You may need to get the farmer to sign a Form 6014, Authorization--Access to Third-Party Records for Internal Revenue Service Employees, if the local office requires special authorization.

Some of the records that should be in the farmer's file in the ASCS office include:

1. Certifications for program eligibility

2. Payment records

3. Contracts

4. Aerial photographs

5. Number of acres and the crops grown

6. Production data (only regarding disaster payments)

7. Crop share arrangements

8. Cash rent arrangements

9. Farm production reports.

Limitation on Total Payments

There is a $50,000 limit per entity for total payments made by the ASCS office. Often farmers are innovative in setting up entities in order to qualify for additional $50,000 limitations. Many issues can arise when these farming entities use the same land, equipment, and have other related transactions. One issue to be alert for is a self-employment tax issue. If the spouse is receiving payments separately for purposes of obtaining another $50,000 limit, then both spouses are liable for self-employment tax as separate farmers. Each spouse can be a person for ASCS purposes. Each could legally draw up to $50,000 of payments if ASCS requirements are satisfied.

CASH PAYMENT PROGRAMS

These payments are taxable in the year received and are reported to the farmer and to IRS on Form 1099-G. They must be included in income, whether they are received in cash, materials, services, or commodity certificates (Treas. Reg. section 1.61-4). The full amount received is reported on Form 1099-G even if a check is returned to the Government for cancellation or if any of the payments are refunded to USDA. The amount refunded to the USDA is deductible on Schedule F in the year of repayment. See Exhibit 7-1.

Payments under the wheat, feed grains, upland cotton, and rice programs combined cannot exceed $50,000 per year for each individual, partnership, trust, or corporation. Be alert for schemes in which farms are divided into segments owned by corporations, trusts, or partnerships to circumvent the maximum reimbursement of $50,000 per entity. Many farm couples are claiming to be partnerships (when they actually are not) for ASCS purposes to get two $50,000 limits. Generally, ASCS requires a copy of the partnership agreement or other documents proving the partnership exists.

The Deficiency Program

The prices received by farmers for their grain is sometimes very low. To alleviate this problem, the ASCS sets target prices for the different types of grain. When the farmer sells his or her grain, if the market price is lower than the target price and the farmer is in the Government program, the ASCS will pay the deficiency. This deficiency is the difference between the market price and the target price for certain types of grain. If the market price is higher than the target price there is no deficiency, and the farmer will only receive what the grain is sold for. Target prices, which are the same everywhere in the United States, are posted at each local ASCS office.

Loan Deficiency Payments

Instead of requesting a loan, a farmer may request a loan deficiency payment **(LDP)**. The LDP is the difference between the county loan rate and the posted county price **(PCP)**. The farmer will receive a check for the difference between the two rates. The LDP rate is based on the loan rate and the PCP for the county where the commodity is stored, but the payment is a deficiency payment and taxable in the year received. It is not a loan and does not qualify for the election under IRC section 77.

Example 1

Sedgwick County loan rate	$2.56	per bushel
PCP for the day is	$2.40	per bushel
Loan Deficiency Payment	$ .16	per bushel
	=====	

The farmer would receive $0.16 per bushel as a loan deficiency payment. The commodity would not be eligible for any additional price support benefits.

Posted County Price

The Posted County Price for each county changes daily. The PCP is figured by taking the terminal price less the county differential for two different locations. The higher of the two rates is the posted county price for that business day. The PCP is used for both the marketing loan repayment and the LDP.

Beneficial Interest

For LDP's, a farmer must have a beneficial interest in the commodity from the time of harvest through the date the LDP is requested. This beneficial interest must be retained continuously until the commodity is redeemed, or until CCC takes title to the commodity.

The Diversion and Set-aside Program

The reason grain prices stay low is due to a surplus of grain on the market. There isn't enough demand to drive prices up. To decrease the supply of grain, the ASCS pays farmers to not grow crops on their land. The payment depends on the number of acres put into the program and the prior bushels per acre production of the particular grain grown on those acres. Sometimes the farmer is required to seed the set-aside acres to grass for a period of time. The local ASCS office can furnish you with necessary information if your taxpayer is taking part in this program.

The Farm and Warehouse Storage Program

Farmers sometimes store Government-owned grain. The ASCS pays the farmer for the use of the storage facilities. If the grain is stored on-farm, the grain will be measured by ASCS to determine the amount. See Exhibit 7-2.

CONSERVATION

The ASCS will pay a part or all of the costs associated with certain projects that are primarily for conserving soil and water resources, protecting or restoring environment, improving forests, or providing a habitat for wildlife. ASCS will either pay the costs directly or reimburse the farmer for these conservation projects. These conservation payments are reported to the farmer and IRS annually on Form 1099-G.

The amount of the cost share depends on each county's funding limitation. Each county has a total amount allocated for these payments and must allocate that amount to the farmers participating. The allocation depends on the number of farmers applying for cost share, whether they received cost share in prior year(s), and if there are funds available to pay each applicant the full amount requested, up to the limit set by the county.

The amount paid can be up to 50 percent of the cost. The project must meet Government specifications. The work will be inspected by engineers, conservationists, and other Government personnel who certify it has been done according to the guidelines. If the farmer proceeds without following the guidelines, cost sharing may not be received, even though payment was originally approved.

Cost Sharing Exclusion

Part or all of the payments received for certain cost-sharing conservation programs can be excluded from the farmer's income. IRC section 126(A) provides a list of the programs certified by the Secretary of Agriculture. However, they can be excluded only if they meet **all** **three** of the following tests:

1. A payment must be for a capital expenditure before it can be excluded from income. Farmers cannot exclude from income any part of a payment for an expense that could be deducted in the current tax year. Nor may a farmer exclude from income, a payment that is rent for the use of property or compensation for services. The payments must be included in income and the cost taken as a deduction on Schedule F.

2. A payment is excludable only if IRS determines it doesn't substantially increase a

farmer's annual income from the property on which made. An increase in annual income is substantial if it exceeds the greater of:

a. 10 percent of the average annual income derived from the affected property prior to the improvement

b. An amount equal to $2.50 times the number of affected acres.

3. A Payment can be excluded from income only if the Secretary of Agriculture certifies that it was made primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

If all of these tests are not met, the farmer may not exclude the conservation program payments on Schedule F.

<u>Income Realized</u>

The amount of gross income realized from a payment under these cost sharing programs is the value of the improvement, reduced by the excludable portion and the cost of the improvement.

The value of the improvement is calculated by multiplying the FMV by a fraction. The numerator of the fraction is the total cost of the improvement (including all amounts paid by the farmer and the Government) reduced by the sum of:

1. Any Government payments under a program not listed in IRC section 126(a);

2. Any portion of a Government payment under a program listed in IRC section 126(a) that the Secretary of Agriculture has not certified as primarily for purposes of conservation; and

3. Any Government payment that is for rent or compensation for services.

The denominator of the fraction is the total cost of the improvement.

Excludable Portion

The excludable portion is the present FMV of the greater of:

1. 10 percent of the prior average annual income from the affected acreage, or

2. $2.50 times the number of the affected acres.

The prior average annual income is the average gross receipts from the affected acreage for the last 3 tax years before the tax year in which installation of the improvement was started.

Example 2

In 1992, 100 acres of land was reclaimed by Nick Mills under a contract with the ASCS. The total cost of the improvement was $500,000. ASCS paid $490,000. Mick paid $10,000. The value of the cost-sharing improvement is $15,000. The present FMV under the first exclusion (10 percent of prior average annual income) is $1,380. Under the second exclusion the value is $2,500 ($2.50 times the number of affected acres). The excludable portion is the greater of these amounts, $2,500; therefore, the amount to be included in Nick's gross income is as follows:

Value of improvements under cost-sharing program	$15,000
Mick's share of the cost of the improvement	<10,000>
Excludable portion	< 2,500>

Amount included in income	$ 2,500
	========

The total received is reported on line 6a, Schedule F. The taxable amount only is reported on line 6b.

Effects of the Exclusion

When calculating the basis in property acquired or improved, using cost sharing payments excluded from income, subtract the amount of those payments from the capital costs. The basis cannot reflect any amounts excluded from income. Moreover, when the property is sold, part or all of the gain may be ordinary income rather than a capital gain (IRC section 1252).

No depreciation, amortization, or depletion deduction is allowed for the part of the cost of the property for which a cost sharing conservation payment is received and excluded from income.

To the extent the exclusion applies, an attachment should be added to the tax return for the tax year the last improvement payment was received from the Government. The dollar amount of the cost funded by the Government, the value of the improvement, and the amount excluded should be stated on the attachment.

Electing Out

A farmer may elect **not** to exclude all or part of any payments received under these programs. The election must be made not later than the due date, including extensions, for filing the tax return. If the farmer elects not to exclude these payments, none of the restrictions and rules discussed above under "Effects of the Exclusion" apply.

CONSERVATION RESERVE PROGRAM PAYMENTS (CRP)

The Conservation Reserve Program **(CRP)** is designed to take highly erodible cropland out of production for a 10-year period. Instead of planting a crop on marginal farmland, the owner of the farmland enters into an agreement with the Government not to plant any crops for 10 years. In return, the Government pays the owner a significant dollar subsidy for 10 years. (For example, Arkansas is limited to $50/acre and Kansas $55/acre). It is advantageous to do this because the only expenses the owner has are real estate taxes, seed for planting a cover crop such as clover or grass, and expenses for mowing the cover crop. The farmer is also entitled to cost sharing payments from the Government for these expenses. The payments are income to the recipient in the year received. These payments are reported on Form 1099-G and are clearly identified as "Program (1) Agricultural Conservation."

A landowner who is a landlord will receive 100 percent of the CRP payments. The landlord's tenant farmer will receive none of the CRP payment. The tenant farmer signs a USDA form indicating agreement that he or she is not entitled to 50 percent of the CRP payments. In return, the landlord agrees (either orally or in writing) to pay the tenant farmer a generous yearly amount to plant and mow the cover crop to meet the USDA maintenance regulations.

Per USDA regulations, land entered in CRP is not treated as rental property. The annual payments made under this program are to compensate the owners for the potential income from their land had they devoted such land to the production of an agricultural commodity.

The IRS exam issue is whether CRP income is earned income reportable on Schedule F and subject to self-employment tax, or rental income not reportable on Schedule F and not subject to self-employment tax.

CRP payments are clearly reportable on Schedule F and are subject to self-employment tax when received by landowners, who are operating farmers and materially participate in the production or management. On the other hand, if the annual payment is received by an owner who does not materially participate, the payment should be treated as rental income and excluded from net earnings for self-employment tax purposes. An example of an owner who does not materially participate would be a retired farmer who would have rented the land to another party had it not been entered into the Conservation Reserve Program. Land owners (also called landlords) who do not materially participate report their farm related income and expenses on Form 4835, rather than on Schedule F. Form 4835 is specifically designed for land owners who rent their farms on a crop share basis to tenant farmers and who do not materially participate in the operation of the farm.

Resources

1. The Chief Council's offfice of IRS has stated that where the farm operator or owner is materially participating in the farm operation, CRP payments constitute receipts from farm operations includable in net earnings from self-employment. The Commissioner of Social Security agrees.

2. For landowners who retire after putting land into CRP:

    a. Some believe that the taxpayer's status at the time the agreement was entered into determines liability for self-employment tax; Notice 87-26 (dairy termination payments); Rev. Rul. 60-32 (soil bank payments).

    b. Others believe it is the taxpayer's status at the time the payment is received that determinesliability for self-employment tax. Soc. Sec.Rul. 67-42 (cropland adjustment income).

COMMODITY CREDIT CORPORATION LOANS

Farmers can receive loans from CCC and use their crops to secure the loans. The grain used to secure the loan is valued at a certain dollar amount per bushel and the farmer can borrow up to a certain percentage of this dollar amount. The farmer repays the loan to CCC (termed a **redemption)** or turns the grain over to CCC in satisfaction of the loan (termed a **forfeiture** of grain). If the loan is repaid, the farmer must also pay interest; however, if the grain is turned over (forfeited) to CCC, no interest is charged.

Farmers can also repay the CCC loans with commodity certificates received from the USDA (ag subsidy payments), or purchased from third parties (for example, elevators).

The farmer can recognize a gain or loss on the sale and exchange of these certificates. This area of CCC loans and commodity certificates is a consistently lucrative adjustment area for IRS examiners. These gains are frequently omitted from the tax return, as there are no reporting requirements for the CCC loan amounts. There are reporting requirements for other payments derived from these loans. These payments are discussed later in this chapter.

Commodity Credit Loans

Normally, farmers report income from a crop in the year it is sold. However, if they pledge part or all of their crop to secure a CCC loan, they can elect to report the loan proceeds as income in the year the loan is received (IRC section 77).

When a farmer receives the first loan from the CCC, there is a choice of reporting the loan proceeds under one of two methods:

1. **Loan Method:** The loan is treated as any other loan (no income is reported because the debt equals the amount received).

2. **Income Method:** The CCC loans are treated as income in the year they are received. This method of reporting the CCC loans cannot be changed unless the IRS gives permission to withdraw the election. The income election is considered as an adoption of an accounting method and is binding on all future years (Treas. Reg. section 1.77-1). If a farmer has treated all previous CCC loans as loans, the election to treat subsequent loans as income can be made without the approval of the IRS.

   The IRC section 77 income method election must be made on a timely filed return; it cannot be adopted on an amended return (Rev. Rul. 56-358).

The tax treatment of the CCC loan in the year of receipt can affect reportable income in either the year the loan is paid off or forfeited, or the year the grain is sold or fed.

The election is binding on **all** future CCC loans until permission to change the accounting method is granted. The election applies to all crops and to all subsequent years.

Example 3

Mary Hill received a $10,000 CCC loan in 1993, for corn grown in 1992. If she made the election to include CCC loans in income when received, she would report $10,000 as 1993 Schedule F income. If she did not make the election, she wouldn't report this $10,000 CCC loan when received. There would be no tax consequences to Mary until the corn was forfeited to CCC in satisfaction of the loan or the loan was paid off **(redeemed)** and the corn was sold or fed.

Loan Method

When a farmer does not elect to report CCC loan proceeds as income per IRC section 77, nothing is reported when the CCC loans are received. The farmer has various options to repay the CCC loan, and each of these options has a different effect on income:

1. If the grain securing the loan is later forfeited in satisfaction of the loan, the farmer recognizes income equal to the loan amount on the date of forfeiture.

2. If the grain is sold and the CCC loan redeemed, the loan proceeds and the loan repayment are a wash and create no tax consequence. The farmer simply reports the grain sale proceeds as Schedule F income in the year of sale.

3. If the CCC loan is redeemed but the grain is not sold until the subsequent year, the amount of the loan repaid cannot be deducted because the loan proceeds were not included in income. Think of this simply as a true loan situation in which you first receive a loan and then pay it back with no effect on income. When the redeemed grain is later sold, the full sale proceeds will be income because there is no tax basis in the grain.

Example 4

Sara Brown received a $12,000 CCC loan in year 1 secured by 4,000 bushels of wheat. She does not include CCC loans in income when received. In year 2, she repays the $12,000 loan and later, in year 2, sells 2,000 bushels of the wheat for $7,000. In year 3, she sells the remaining 2,000 bushels for $7,500. How much income and expense would Sara report in each year?

Year 1: She would not report any income or expense regarding the loan.
Year 2: She would not report any income or expense as a result of paying off the loan, but she would report the $7,000 grain sale proceeds in income. She has no tax basis in the 2,000 bushels of redeemed wheat, but she may deduct any interest she pays to CCC.

Year 3: She would report $7,500 income from the sale of the remaining 2,000 bushels of wheat.

Type of Action	Amount	Income	Remaining Basis in Grain
CCC loan proceeds (year 1)	$12,000	$ 0	$ 0
Repaid CCC loan (year 2)	($12,000) ($12,000)	$ 0	$ 0
2,000 bushels sold (year 2)	$ 7,000	$ 7,000	$ 0
2,000 bushels sold (year 3)	$ 7,500	$ 7,500	$ 0
Totals	$14,500	$14,500	$ 0

Note: Over the 3-year period Sara Brown's net increase in cash is $14,500. This is equal to the total grain sale proceeds of $14,500 ($7,000 + $7,500). This will always be true, because the loan proceeds and the loan pay back are a wash. The only difference is in the timing of reporting the income and expenses.

Compare the results of this method with the income method.

Income Method

When a farmer elects to report CCC loan proceeds as income per IRC section 77, all CCC loans received during the year must be included in income. The farmer still has various options to pay off CCC loans, and each has a different effect on income:

1. If the grain securing the loan is later forfeited to CCC in satisfaction of the loan, there is no tax consequence on the date of forfeiture.

2. If the loan is redeemed, the farmer is treated for income tax purposes as repurchasing the grain and acquiring a cost basis in the grain equal to the amount of the redeemed loan. Upon a subsequent sale of the grain, whether in the year of redemption or in a later year, the farmer will realize income (reportable on Schedule F) in the amount by which the sale proceeds exceed the farmer's basis in the grain (the amount repaid to the CCC). The farmer is not permitted to file an amended return excluding the CCC loan from income for the earlier year. This analysis applies even if the redemption occurs in the same year in which the CCC loan is received.

Note: Under the income method, check to see how the farmer disposed of, or plans to dispose of the grain. If fed or held as inventory for feed, the grain is deductible in the year removed from the CCC storage lien (for example, at repayment of the CCC loan). If the grain is held with the intention of selling it in a following year, the basis in the grain is not deductible until the grain is actually sold. See Exhibit 7-2.

Interest paid to CCC is deductible in the year paid regardless of which method is used.

Example 5

Tom Baxter received a $12,000 CCC loan in year 1 secured by 4,000 bushels of wheat. He has elected to report CCC loans in income when received. In year 2, he repays the $12,000 loan and later in year 2 sells 2,000 bushels of the wheat for $7,000. In year 3, he sells the remaining 2,000 bushels for $7,500. How much income and expense would Tom Baxter report in each year?

Year 1: He would report $12,000 in income,the amount of the loan received When he reports the CCC loan asincome, he establishes a tax basis inthe grain which is equal to the CCCloan amount.

Year 2: There are no tax consequences whenTom redeems the CCC loan. The $12,000 loan amount is his basis in the wheat. Tom no longer has a CCC loan outstanding on the 4,000 bushels of wheat.

When Tom sells 2,000 bushels of the redeemed wheat to the elevator, he has sold one-half of the wheat for which he received a $12,000 loan from CCC in year 1 and elected to report as income. The sale results in Tom's recognition of income in the amount of $1,000 ($7,000 sales proceeds minus the $6,000 basis in the grain sold (2,000/4,000 X $12,000). Tom's basis in the remaining 2,000 bushels is $6,000.

Year 3: When Tom sells the remaining 2,000 bushels of wheat to the elevator for $7,500, he recognizes income in the amount of $1,500. ($7,500 sale proceeds minus the remaining $6,000 basis). This income is reportable on Schedule F, lines 1.

The following chart shows the effects for each of the years in Example 5:

Type of Action	Amount	Income	Remaining Basis in Grain
CCC loan proceeds (year 1)	$12,000	$12,000	$12,000
Repaid CCC loan (year 2)	($12,000)	$ 0	$12,000
2,000 bushels sold (year 2)	$ 7,000	$ 1,000	$ 6,000
2,000 bushels sold (year 3)	$ 7,500	$ 1,500	$ 0
Totals	$ 14,500	$14,500	$ 0

Note: Over the 3-year period the net income on the CCC loans was $14,500. This is equal to the grain sales proceeds of $14,500 ($7,000 + $7,500). This will always be true because the loan proceeds and the loan pay back will wash. The only difference is the timing of reporting the income.

Market Gain

Beginning in 1991, farmers can pay off their CCC loans on cotton, rice, soybeans, feed grains, and wheat by paying the lower of the face amount of the loan or a price determined by the market. When a pay back is less than the original loan amount, the farmer can realize a **market gain**.

When the farmer originally makes the loan, the amount received is computed using the number of bushels times the posted county price (PCP). When the loan is repaid, it is repaid at the current PCP. The farmer does not have to repay any interest when the marketing loan repayment option is exercised. If the PCP is lower at the time of repayment than at the time the loan was taken out, the farmer has realized a market gain. If the PCP is higher, the farmer realizes a market loss.

Since the ASCS has no reporting requirements on CCC loans, the original loan amount is not reported. The gain realized on this transaction is reported by the ASCS on Form 1099-G. If the number of bushels and price difference is large, the gain can be significant.

Example 6

Ben Brown is a cash basis taxpayer who has elected to report CCC loans as income. He received a CCC Loan of $76,800 on February 1, 1994, on 30,000 bushels of wheat when the PCP rate was $2.56 per bushel. This $76,800 loan was properly reported as income on line 7a of Schedule F in 1994. He repaid the loan with $72,000 on December 13, 1994, when the PCP rate was $2.40 per bushel. Ben realized a gain in 1994 on the transaction of $4,800 ($2.56 - $2.40 = $0.16 X 30,000 bushels)

Note: This gain should be reported on Schedule F as an increase to Government program income.

This transaction is further complicated by a farmer's sale of an option to purchase the commodity at a specified price. With the sale of the option, the farmer gives the merchant (usually a co-op) authority to act as the farmer's agent for purposes of redeeming the loan. The agent realizes the benefits of a reduction in the amount to be paid to redeem the commodity.

Example 7

Assume the same facts as in Example 6 except that in 1994, Ben Brown sold his right to redeem the wheat to Judy Madison for $6,000 and Judy later redeemed the commodity by paying $72,000 to the CCC. The CCC reported a $4,800 marketing loan gain on Ben Brown's Form 1099-G for 1994.

Ben Brown must report the $6,000 received from Judy as other income on Schedule F in 1994. Having sold the right to redeem the wheat, he doesn't realize any additional income from the marketing loan gain. On Schedule F in 1994, he should report the $4,800 from Form 1099-G as additional government program income (line 6a), but exclude it on line 6b.

Note: Judy has a $78,000 ($72,000 + $6,000) basis in the wheat.

If Ben Brown **had not made the election** to report CCC loans as income, he would report $6,000 of income when Judy purchased the right to redeem the commodity and another $76,800 of income when Judy assumes the loan. He would report the $4,800 marketing gain on line 6a, but not on line 6b of Schedule F.

Examination Techniques

The marketing loan gain could be reported on the "Other Income" line as a discharge of indebtedness income, Form 1040, page 1. This exempts the income from self-employment tax. The IRS's position is: This income is not a discharge of indebtedness under IRC section 108, but income subject to self-employment tax.

The table below summarizes the income tax treatment of the various dispositions of CCC loans and grain.

INCOME TAX TREATMENT OF VARIOUS DISPOSITIONS OF CCC LOANS AND GRAIN

(IRC section 77)

	Treatment of CCC Loan When Received	
Disposition of the Loan or Grain	Treated as Income (e.g., farmer made IRC 77 section Election)	Treated as Loan (e.g., farmer didn't make IRC section 77 Election)
Loan paid by forfeiting grain	No further income to be reported.	Amount of loan reported as income.
Grain redeemed by paying off loan with cash	Farmer has basis in grain equal to loan.	Farmer has a zero basis in the grain.
Redeemed grain is sold	Farmer has income (loss) equal to sale price less amount of loan, which is the basis in the grain.	Farmer has income equal to sale price.
Redeemed grain is fed	Farmer has a feed deduction equal to amount of the loan, which is the basis in the fed grain.	Farmer has no deduction.

When grain securing CCC loans is forfeited, the settlement amount is reported on Form 1099-A. For the farmer who elected to report the loan as income in the year of receipt, the forfeiture amount is shown on Schedule F line 7b, but not on line 7c. The farmer who did not elect to treat CCC loans as taxable income in the year of receipt, shows the forfeiture amount from the 1099-A on line 7b and line 7c.

If the loan is settled at an amount less than the original amount, the difference is reported as market gain on Form 1099-G. See the discussion on market gain preceding this section.

GENERAL RULES FOR REPORTING LOAN DATA

The Commodity Credit Corporation (CCC) is required to file an information return when either of the following occurs:

1. CCC acquires an interest in collateral offered as full or partial satisfaction of the CCC price support loan

2. CCC has reason to believe that collateral, in which it has security interest, has been abandoned.

Loan collateral acquisitions are commodity loans. CCC's loan acquisition date is the date the collateral pledged as security for the CCC loan is acquired. The acquisition date is the earlier of the following dates:

1. The date title is transferred to CCC;

2. The date of possession, when the burdens and benefits of ownership are transferred to CCC.

ASCS offices must report the following data to the IRS by loan number and the original percentage share value of all producer ID numbers associated with the loan at acquisition:

1. The balance of the principal outstanding

2. Gross proceeds

3. The appraisal value for all collateral.

This activity is reported by the CCC to the IRS and the producer on a CCC-1099-A or IRS-1099-A.

Three different types of reporting activities include:

1. Forfeitures, for warehouse-stored loans

2. Settlements, for farm-stored loans

3. Abandonments, if the abandoned farm-stored collateral is acquired in satisfaction of the CCC loan.

Note: The abandonment transaction is recorded as a settlement. Any expenses incurred by the ASCS office in the delivery of the commodity are charged to the producer.

Reporting Program Payments

CCC is required to file an information return (Form CCC-1099-G) when a CCC program payment is issued to a person during the calendar year. A program payment is a CCC disbursement of funds to a program participant who meets the provisions of the program. A program payment is considered made in the calendar year in which issued, not in the calendar year it is earned.

Program Payments That Are Reported on Form CCC-1099-G

1. Agricultural Conservation Program

2. Cotton Loss Settlement

3. Dairy Programs

4. Deficiency Program

5. Disaster Program

6. Livestock Emergency Assistance Program

7. Emergency Conservation Program

8. Emergency Feed Program

9. Loan Deficiency Program

10. Farm and Warehouse Storage

11. Feed Grains and Cotton Voluntary Diversion
12. Forestry Incentives Program
13. Milk Marketing Fee
14. Naval Stores Conservation Program
15. Distress Commodity Loan Expense
16. Marketing Rice and Inventory Program
17. Rural Clean Water Program
18. Water Bank Program
19. Interest Payment
20. Wool and Mohair Programs
21. Market Gains
22. Conservation Reserve Program
23. Colorado River Salinity Control
24. Other payments to producers, producer's assignee, and U.S. Government agencies for debts the producer owes.

<u>What Payments Are Not Reported on Form CCC-1099-G</u>

1. Price support commodity loan payments. These payments are loans that are reported on CCC-1099-A only when CCC acquires the collateral.
2. Commodity purchases at the county office level. This is a purchase of commodities.
3. Farm facility loan program (FFLP) payments, because they are loans.

<u>When Payments Are Reported on Form CCC-1099-A</u>

1. CCC acquires an interest in collateral offered in full or partial satisfaction of the CCC price support loan.

2. CCC has reason to believe that collateral in which it has a security interest has been abandoned.

COMMODITY CREDIT CERTIFICATES (PIK)

The Food Security Act of 1985 authorized certain program payments to be made on a noncash basis. Accordingly, farmers earning payments under the diversion and set-aside, and conservation reserve programs receive **commodity certificates** instead of cash. The commodity certificate is simply a specially designed certificate with a dollar amount specified. It also shows the issue date, county where issued, expiration date, type of **commodity**, and the individual to whom issued. The back of the certificate provides space for endorsements by the transferor of the certificate. Farmers commonly refer to commodity certificates as **PIK** certificates or simply as certs. PIK stands for Payment in Kind, which was a former Government program in which farmers received program payments in actual commodities.

An initial holder of a commodity certificate can choose one of the following options in order to receive benefits from the certificate:

1. Return the certificate to the issuing county ASCS office for cash. This option is seldom exercised.

2. Sell or transfer the certificate to another farmer or commercial entity, either for cash or for certain products used in farming. This is done frequently. The certs are often sold to elevators.

3. Use the certificate to redeem CCC loans. This was a frequent occurrence, especially in 1986, 1987, and early 1988.

Subsequent holders of a commodity certificate can choose one of the following options:

1. Sell or transfer the certificate.

2. Use the certificate to redeem CCC loans.

3. Exchange the certificate for commodities from CCC inventory.

The face value of the commodity certificates (certs), received by the farmer as payment for farm programs, is includable as income on the farmer's Schedule F in the year the certs are received. The amount included in income becomes the farmer's cost basis, to figure any gain or loss if the certs are sold to third parties or used to redeem

CCC loans. As with all ag subsidy payments, the face value of commodity certificates is included in the annual Form CCC-182 sent to the farmer and the IRS.

A farmer can use the commodity certificates in several ways, and the income or loss that can result depends on the circumstances.

Note: This program is almost obsolete. No new PIK certificates are being issued.

CROP INSURANCE AND DISASTER PAYMENTS

Historically, the Federal Government has assumed significant risks for farmers' crop losses, in the form of disaster assistance payments. As demonstrated by the 1985 and 1990 farm bills, the farmer will be required to assume more risk. Farmers may opt to manage their exposure to such major perils as drought, frost, hail, and wind by insuring their crop(s) with **Multiple Peril Crop Insurance** (MPCI). Such insurance is sometimes referred to as **Federal Crop Insurance**, since the policies are sold or reinsured by the Federal Crop Insurance Corporation. The insurance is purchased through regular insurance companies, and any claim proceeds are received through those same companies.

Farmers may still qualify for crop disaster payments as the result of damage to crops or the inability to plant crops due to a natural disaster. ASCS is responsible for administering this USDA program. In general, a farmer is eligible for crop disaster payments if the following conditions are met:

1. The farmer certifies that 50 percent of annual gross receipts were received from farming, ranching, and forestry operations and that annual gross receipts from these operations did not exceed $2 million;

2. Farmers with highly erodible cropland (wind or water erosion) must have an approved conservation plan on file with the Soil Conservation Service;

3. Farmers without crop insurance must suffer at least a 40 percent loss, while those individuals carrying crop insurance must demonstrate at least a 35 percent loss. Uninsured farmers incurring losses in excess of 65 percent must agree to obtain commercial crop insurance in the following year. It must be a multi-peril policy -- crop hail insurance will not qualify.

Generally, crop insurance proceeds received as the result of crop damage must be included in income on Schedule F in the year received (Treas. Reg. section 1.61-4(c)). The farmer is allowed to deduct the cost of such insurance premiums as a business expense. For tax purposes, disaster payments received under the Agriculture Act of

1949 or Title II of the Disaster Assistance Act of 1988, as amended, are treated as crop insurance proceeds (IRC section 451(d)). However, Treas. Reg. section 1.451-6(a)(1) withdrew the requirement that Federal disaster payments relate to a specific act in order to receive such treatment. Now, the payments must be received as a result of destruction or damage to crops caused by drought, flood, or other natural disaster, or the inability to plant crops due to such a natural disaster.

For cash method farmers, there is an exception to the general rule that crop insurance and disaster payments must be reported in the year they are received. That exception allows the farmer to postpone reporting a payment for 1 year.

To qualify for the exception, a farmer must be able to show that, under his or her normal business practice, the income from the crop for which the payment is received would have been reported in a year following the receipt of payment; that is, the crop destroyed or damaged would have been sold in the year following the receipt of the payment.

Farmers who qualify for this exception have the option of reporting the insurance proceeds as income in the year received or as income in the following year.

To make this election, the farmer must attach a statement to his or her tax return, or amended return, for the year the damage took place. A mere disclosure on the return that insurance proceeds are being deferred is not a proper election (Rev. Rul. 74-145). The statement must include the farmer's name and address and contain the following information:

1. A statement that the farmer is making this election under IRC section 451(d) and Treas. Reg. section 1.451-6;

2. Identification of the specific crop or crops destroyed or damaged;

3. A statement that under normal business practice the farmer would have included income derived from the destroyed or damaged crops in gross income for a tax year following the tax year of the destruction or damage;

4. The cause of the destruction or damage and the date it occurred;

5. The total amount of insurance payments received, itemized with respect to each specific crop, and the date each payment was received;

6. The name(s) of the insurance carrier(s) from whom they received payments.

One election covers all the crops from a farm. If a farmer has more than one separate and distinct farming operation on which different crops are grown and separate books are kept, then two separate elections should be made to defer reporting insurance proceeds received for crops grown on each of the farms. The election is binding unless the District Director consets to a change (Treas. Reg. section 1.451-(6)(a)(2) and Rev. Rul. 74-145).

Example 8

Sawyer Bates, a cash method farmer, lost his entire 1990 wheat crop, as a result of hail. Sawyer normally sells the crop shortly after harvest. The insurance policy entitled him to $25,000. A check was issued for $20,000 representing the $25,000 proceeds minus unpaid premiums of $5,000.

Since Sawyer would normally sell his crop in1990, he may not elect to postpone reporting the insurance proceeds.

Example 9

Use the same facts in Example 8, except Sawyer normally sells the crop in the following tax year.

Since Sawyer would normally sell his crop in 1991, he may elect to postpone reporting the insurance proceeds. If Sawyer makes the election, he would report the $25,000 insurance proceeds in 1991, and deduct the $5,000 insurance premiums paid in 1990.

Examination Techniques

1. Inspect prior year(s) return(s) for election to defer crop insurance proceeds, then confirm those amounts were reported as income in the year under examination.

2. Form 1099-MISC is used to report the gross amount of insurance proceeds. The 1099-MISC can be reconciled to deposits by requesting the check stub from the farmer or calling the local insurance agent.

Chapter 8

HEDGING FARM COMMODITIES

DEFINITION OF A HEDGING TRANSACTION

Hedging is a common technique used by businesses to reduce risk resulting from certain assets, liabilities, or foreign currencies. Various financial products are used to reduce risk, such as futures contracts, forward contract, options on futures, and notional principal contracts. Farmers, cattle feeders, and feedlots generally enter into hedging transaction to reduce the risk of price changes with respect to inventory and noninventory supplies.

Gain or loss from such a transaction will qualify as ordinary gain or loss only if it satisfies the definition of a hedging transaction in Treas. Reg. section 1.1221-2(b). The regulations under section 1221 are effective retroactively and apply to all open tax years. Treas. Reg. section 1.1221-2(b) defines a hedging transaction as a transaction entered into in the normal course of the taxpayer's trade or business primarily to reduce risk of price or interest rate changes or currency fluctuations.

The reduction of risk must be with respect to ordinary property held or to be held, ordinary obligations incurred or to be incurred, or borrowings made or to be made. This means that a transaction hedging an anticipated asset acquisition may be a good hedging transaction under the regulations. For example, if a cattle feeder enters into a long futures contract in feeder cattle, the transaction may qualify as a hedging transaction under the regulations.

Property is ordinary property only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss regardless of the taxpayer's holding period. Thus, for example, property used in a trade or business within the meaning of IRC section 1231(b)) is not ordinary property because gain resulting from the sale or exchange of the IRC section 1231 asset may be treated as capital. The same applies for noninventory supplies such as corn used to feed cattle, since gain or loss from the sale of such property is capital. However, the regulations provide an exception in situations where noninventory supplies are consumed rather than sold. Specifically, Treas. Reg. section 1.1221-2(c)(5)(ii)) provides that if a taxpayer sells only a negligible amount of a noninventory supply, then, only for purposes of determining whether a transaction to hedge the purchase of that noninventory supply is a hedging transaction, the supply is treated as ordinary property. Thus, a long futures position hedging a cattle feeder's supply of corn may qualify as a hedging transaction under the regulations if it is determined that the taxpayer sold only a negligible amount of its corn supply.

The regulations make clear that short sales and options may qualify as hedging transactions. (Treas. Reg. section 1.1221-2(a)(2)). Moreover, because the regulations broadly construe the term "risk reduction," even a written put option hedging an anticipated asset acquisition may be a good hedge under the regulations. (Treas. Reg. section 1.1221-2(c)(1)(iii)).

In addition, a taxpayer is not required to hedge its entire risk. Instead, transactions hedging a portion of a taxpayer's risk may qualify as a hedging transaction under the regulations. Examiners should focus on whether a transaction reduces a type of risk enumerated in the regulations. It is appropriate for an examiner to consider whether a taxpayer is overhedged, and to the extent the taxpayer is overhedged, it is not reducing risk, and, therefore, the transaction does not qualify as a hedging transaction under the regulations. Similarly, using insurance concepts to test the validity of hedging transactions is inappropriate. (Treas. Reg. section 1.1221-2(a)(3)). In other words, an examiner should not focus on whether the taxpayer has shifted risk to another individual or entity. Rather, the focus of an examiner's inquiry should be whether the taxpayer has reduced risk.

These regulations are the exclusive means by which gain or loss from a hedging transaction qualifies as ordinary gain or loss. (Treas. Reg. section 1.1221-2(a)(3)). Consequently, prior case law is irrelevant in determining whether a taxpayer was hedging.

THE FUTURES MARKET

There are various marketing tools that can be used to protect the price of a commodity. The futures market is used frequently because it offers actual futures contracts and futures options. The most popular are the actual futures. Futures contracts have the highest risk of loss and are the most expensive. Also, futures require **margin money** to be deposited. Margin money is cash or equivalent required to guarantee fulfillment of a futures contract.

Futures **options** can provide the same price insurance and are much less expensive. There are two kinds of options: **Puts** and **Calls**. Both can be bought or sold by anyone. Generally there is no margin money required for options because the cost of the option is paid up front; however, sellers of puts and calls are required to maintain margins in their accounts. The put is an option to sell short a commodity futures contract, but not an obligation. A call is an option to purchase a contract, but it too is not an obligation. The **buyer has a choice** of whether or not to exercise an option, while the **__seller__** of an option **__is obligated__** to sell.

__THE OPTIONS MARKET__

The **options market** is gaining popularity because of the reduced risk, but the temptation to **speculate** is present, the same as in actual futures contracts. Hedgers should buy only enough options to cover their actual positions in the cash market. Options are offered in the same months that the underlying futures contracts are offered. They expire 1 month prior to the actual futures, except for feeder cattle options which expire in the same month as the futures contract. For example, an October live cattle put option would expire in September instead of October when the futures contract expires; whereas, an October feeder cattle option would expire in October. When an option is sold, the seller is paid a premium. The premium is not collected until the option is exercised or expires. The seller of an option can be required to pay in margin money to cover any possible losses. This is because the seller is at risk and will lose money if the purchaser exercises the option. The purchaser will only exercise the option if he or she can make a profit. If that happens, the seller will suffer an offsetting loss.

Buying calls provides protection against rising prices. These transactions allow a person to limit the amount paid for replacement inventory. Buying a put provides protection against declining prices. A person can guarantee the price at which a product eventually will be sold. Thus, put and call options provide the same kind of price protection provided with long and short positions in the futures markets.

As with actual futures contracts, a hedger should purchase only the number of options necessary to cover the cash market (actual) position. Any excess is overhedging and to the extent the taxpayer is overhedged, there is no reduction of risk and the transaction does not qualify as a hedging transaction.

__HEDGING CATTLE__

Most farm hedging issues are limited to cattle. Futures and options are offered for live cattle and feeder cattle. Live cattle contracts can only be used to hedge mature cattle sold or purchased. They are also referred to as **fat cattle**. A live cattle contract represent 40,000 pounds. To determine the number of head a contract represents, you will need to know at what weight the taxpayer sells its cattle. For example, if the cattle are fattened to an average weight of 1,250 pounds, a contract would represent 32 head (40,000 / 1,250). If the cattle are marketed at 1,100 pounds the contract would cover 36 head (40,000 / 1,100). This computation is necessary to determine if the taxpayer is overhedged. A producer places a hedge by entering into the correct number of futures contract(s) to sell feeder cattle or, by purchasing the correct number of put options to sell the same number of feeder cattle future contracts.

Feeder cattle contracts are used to hedge replacement cattle for feedlots. The contracts are for 50,000 pounds of cattle. If feeder cattle are to be purchased in the future, the taxpayer will need to go long in the market. This means that feeder cattle contracts or call options will be purchased. Again, it is important to determine how many head will be covered by a contract. In the feeder cattle market, ranchers maintain breeding herds that produce the cattle. These ranchers hedge their finished product by selling short feeder cattle contracts or by purchasing put options on feeders. Related to the feeder cattle industry are taxpayers who purchase small cattle and place them in starter feedlots. These cattle are later sold to other cattlemen who also place them in feedlots. These taxpayers could be entering into futures contracts to both buy and sell feeder cattle. They would enter futures contracts to buy feeder cattle to hedge calves to be purchased for their feedlots and enter futures contracts to sell feeder cattle to hedge the price of those calves when they are ready for sale.

HEDGING GRAIN CROPS

Futures and options are used for growing grain crops and for hedging purchased grain used for feeding cattle or for resale by grain dealers. The same rules and techniques will apply to grain as to those for cattle. Grain farmers normally do not purchase grain, they only sell it. Most farmers have patterns of grain selling. Some sell near harvest time each year and many sell at yearend or carry grain over and sell in January. This is important to know because the producer should generally use the correct futures month. If a farmer normally sells wheat in December, then December wheat futures should be used, however, this is not always necessary to be a valid hedge.

Be aware that farmers sometimes forward contract grain. They deliver grain to the elevator and then contract with the elevator to receive a fixed or pre-agreed price in the following year, usually January. In this situation, there is no need for price protection because the price is already set. Any dealings in the futures market would not reduce risk and, therefore, would not qualify as a hedging transaction under the regulations.

TRANSACTION ANALYSIS

Hedging issues often result in unagreed cases. An unagreed case will require a detailed analysis of the farmer's trading accounts. Each transaction will have to be listed, and the workpapers need to reflect:

1. Date entered

2. Position (long/short)

3. Commodity identification

4. Trading price

5. Date closed

6. Settlement price

7. Gain/loss.

Sometimes it is difficult to trace the transactions from start to finish. It is almost impossible to do this without the daily trade confirmation sheets, because they include all the identifying details.

A good way to check the accuracy is to look at open positions listed on the month end reports. If a contract is still shown as open and the report fails to show it, go back and find when it was closed. Compare the contracts shown as open at the end of the month with those shown in open status on the broker's month end summaries.

IDENTIFICATION RULES

The final Treas. Reg. section 1.1221-2(e) requires that hedging transactions must be identified before the close of the day on which they are entered into, and the items or aggregate risk being hedged must be identified within 35 days of entering into the hedging transaction. The required identification must be made on, and retained as part of, the taxpayer's books and records. The presence or absence of identification must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes (Treas. Reg. section 1.1221-2(e)(4)). Figure 8-1 shows the tax treatment of transactions under these identification rules.

Figure 8-1

SUMMARY OF CHARACTER OF TRANSACTIONS UNDER THE IDENTIFICATION RULES

	QUALIFIED HEDGING TRANSACTION PER REGULATIONS		NON-QUALIFIED HEDGING TRANSACTION	
	CHARACTER OF		CHARACTER OF	
	GAIN	LOSS	GAIN	LOSS
IDENTIFIED TRANSACTION PER REGULATIONS	ordinary	ordinary	ordinary	capital
NON-IDENTIFIED TRANSACTION AND NO REASONABLE BASIS *	ordinary	capital	capital	capital
NON-IDENTIFIED TRANSACTION AND A REASONABLE BASIS **	capital	capital	capital	capital
INADVERTENT ERROR ***	ordinary	ordinary	N/A	N/A

* No reasonable basis for treating the transactions as other than a hedging transaction. Treas. Reg. section 1.1221-2(f)(2)(iii).

** Reasonable basis for treating the transactions as other than a hedging transaction.

*** Failure to identify the transaction was due to inadvertent error, the transactions were hedging transaction per the regulations, and all of the hedging transactions in all open years are being treated on either original or amended returns as hedges per the regulations. Treas. Reg. section 1.1221-2(f)(2)(ii).

The identification requirements apply to transactions entered into on or after January 1, 1994. (Treas. Reg. section 1.1221-2(g)(1)(i)). However, for transactions entered into before January 1, 1994, and that remained open on March 31, 1994, a taxpayer must have made an identification by March 31, 1994. (Treas. Reg. section 1.1221-2(g)(1)(ii)).

TIMING RULES

The character of gains and losses from business hedging transactions and has been clarified by final regulations. Gains or losses from most common business hedges are to be treated as ordinary rather than capital. Currently hedging transactions are recognized when closed under IRC section 1001. Mismatches of income and expense have occurred between the hedged property and the hedging transactions. Also, taxpayers have manipulated the timing of gains and losses from hedging transactions. The final regulations require taxpayers to choose a method of accounting that clearly reflects income, and matches the recognition of hedged gain or loss from the transaction to the property. (Treas. Reg. section 1.446-4). These rules apply to hedging transactions entered into on or after October 1, 1994.

More than one method of accounting for a particular type of hedging transaction may clearly reflect income. A taxpayer may choose any method that clearly reflects income and may use different methods for different types of hedging transactions and for transactions that hedge different types of items. The Service and Treasury expect that the hedge accounting methods employed by most taxpayers for financial accounting purposes will satisfy the clear reflection standard in the regulations. However, the method chosen must be used consistently and be changed only with the consent of the Commissioner. (Treas. Reg. section 1.446-4(c)).

The regulations require taxpayers to maintain books and records containing a description of the accounting method used for each type of hedging transaction in sufficient detail to demonstrate how the clear reflection standard is met. (Treas. Reg. section 1.446-(d)(1)). For each hedging transaction, in addition to the identification required by Treas. Reg. section 1.1221, Treas. Reg. section 1.446 requires whatever more specific identification is necessary to verify the application of the method of accounting used by the taxpayer for that transaction. (Treas. Reg. section 1.446-(d)(2)).

EXAMINATION TECHNIQUES

Hedging losses should be entered as negative amounts in "other income" on schedule F. However, they are seldom found there. Some losses are deducted as separate items in other expenses and are occasionally found in either cost of sales or in cattle costs. When the gross profit on a return appears low or cattle costs are high in relation to sales, the examiner should consider scrutinizing the accounts for losses from futures transactions since this will not be reflected as separate deductions.

When examining a hedging issue, it is very important to secure the brokers statements and the taxpayers worksheets or other records identifying the hedging transactions. At minimum the daily transaction sheets and the monthly summary statements should be secured. The hedger should normally be trading in the same commodity futures contracts as those commodities he is selling or purchasing. The records must show that the commodity hedged is in an amount that is equal to or less than what is being produced, bought, or raised for resale. The contract quantities will be in bushels or pounds. The weight at which the taxpayer normally sells or buys cattle will determine the number of head that his live cattle or feeder cattle contracts will represent. For example, a cattleman who sells fat cattle at 1,100 lbs. will protect more cattle with a contract than the producer that sells at 1,250 lbs.

To examine grain crop hedging it is necessary to secure inventory records, purchase invoices, sales invoices, and the taxpayers documents identifying the hedges. When inspecting the brokers statements, compare the closing dates of the futures to the purchase or sale dates of the related commodity. There should be some relationship between them. Brokers statements reflecting futures trading in unrelated commodities are an indication that the taxpayer is not reducing risk as required. Usual commodity transactions that do not reduce risk for farmers are: eggs; pork bellies; coffee; silver; gold; copper; and boxed beef. These commodities have no relation to the normal course of business for a farmer, cattlemen, grain dealer, or feedlot operator.

Chapter 9

CANCELLATION OF INDEBTEDNESS

GENERAL RULE

A discharge of indebtedness takes place when a creditor reduces, in whole or in part, the amount owed. As a general rule, a debtor realizes ordinary income from the discharge of indebtedness equal to the difference between the amount due on the debt and the amount paid for its discharge. If the debt is discharged without any payment by the debtor, the entire amount of the indebtedness is the realized gain. (United States v. Kirby Lumber Co., 284 U.S. 1 (1931), X-2 C.B. 356 (1931); IRC section 61(a)(12)).

For purposes of the discharge of indebtedness rules outlined in IRC section 108, indebtedness of the farmer is defined as: any indebtedness that the farmer is liable for or subject to on property which the farmer holds.

The general rule is that taxable income includes discharge of indebtedness income. However, there are several important exceptions in the law to this rule. These exceptions involve the cancellation of a deductible debt, the reduction of a purchase-money debt, and the cancellation of a debt intended as a gift.

Discharge of Deductible Debt (IRC section 108(e)(2))

A farmer does not recognize income from the discharge of indebtedness if the payment of such debt would have entitled him to a deductible expense.

Example 1

Roy Cole is a cash basis farmer who owed his local bank $50,000 principal and $5,000 of interest. Roy is solvent and is not in bankruptcy. The bank makes Roy an offer to forgive the $5,000 interest, if he can arrange a loan with another lender and repay the $50,000 principal in full. Roy refinances with another lender and repays the $50,000. The $5,000 of interest is then forgiven. The $5,000 is not taxable, since the interest would have been deductible if paid.

Reduction of Purchase Money Debt (IRC section 108(e)(5))

If the seller reduces the amount of **purchase-money debt** still owed on property, the purchaser of that property will not realize income from the discharge of indebtedness.

The reduction of the debt is treated as a purchase-money adjustment for both the seller and the buyer only if:

1. The reduction would (but for this exception) result in income from the discharge of indebtedness;

2. The reduction does not occur in a bankruptcy case or when the purchaser is insolvent;

3. The debt has not been transferred by the seller to a third party;

4. The property hasn't been transferred by the buyer to a third party;

5. The reduction in the amount of debt is due to factors involving direct agreements between the buyer and the seller.

Example 2

In 1990, Ray Moore purchased land from Ben Tate for $250,000 on contract. Ray paid $25,000 down and owed Ben $225,000 of the purchase price. In 1992, when the outstanding amount of the purchase-money debt was $220,000, Ben agreed to reduce the debt by $20,000. Ray was not in bankruptcy or insolvent.

Ray treats the reduction of debt as a purchase-price adjustment rather than as income from the discharge of indebtedness. Thus, Ray must reduce his basis in the property by $20,000.

Cancellation by Gift (IRC section 102)

Gifts or bequests are excluded from gross income. Congress recognized that the presence of donative intent on the part of the creditor is difficult (if not impossible) to establish in a business setting. The committee reports accompanying the Bankruptcy Tax Act of 1980 state: "*** it is intended that there will not be any gift exception in a commercial context (such as, a shareholder-corporation relationship) to the general rule that income is realized on discharge of indebtedness." Thus, the gift exception generally applies only in noncommercial contexts.

EXCLUSIONS FROM INCOME (IRC section 108(a)(1))

Debtors who are in bankruptcy or insolvent, and (in certain circumstances) farmers, are exempted from recognizing income from discharge of indebtedness. They are required instead, to reduce certain tax attributes (for example, net operation loss

(NOL), general business credit, minimum tax credit, capital loss, basis in property, passive activity loss, credit carryover, and foreign tax credit) (IRC section 108(b)). In addition, in the case of a taxpayer other than a C-Corporation, the discharged amount of qualified real property business indebtedness may be excluded.

Title 11 Case

IRC section 108(a)(1)(A) provides that income from the discharge of indebtedness is excluded from gross income, if the debt discharge occurs in a bankruptcy case under Title 11 of the U.S. Code. For the exclusion to apply, the farmer must be under the jurisdiction of the court, and the discharge of debt must be granted by the court or under a plan approved by the court.

Example 3

Amy Barton is under the jurisdiction of the bankruptcy court. Amy has assets with a total fair market value of $25,000 and a basis of $23,500. Amy also has liabilities totaling $33,500. The court grants a discharge of liabilities of $21,000, requiring Amy to transfer assets with a FMV of $6,000 and a basis of $3,500 to creditor James White. Amy **realizes** discharge of indebtedness income of $15,000 ($21,000 - $6,000).

Because the discharge occurs in a Title 11 bankruptcy case, Amy **does not recognize** any income, but must reduce her tax attributes or benefits by the amount of the excluded income.

Insolvency

IRC section 108(a)(1)(B) provides that income from the discharge of indebtedness is excluded from gross income if the discharge of debt occurs when the farmer is "insolvent" outside of bankruptcy. This exclusion is limited to the amount by which the farmer is insolvent. A farmer is insolvent when he or she has an **excess of liabilities over the fair market value of assets**, as determined immediately **before** the debt is discharged (IRC section 108(d)(3)).

For purposes of determining the farmer's insolvency, property exempt from the claims of creditors is not included in determining the FMV of the farmer's assets. Since exempt assets are not subject to the claims of creditors, no economic gain is realized from a "freeing of assets" due to the discharge of indebtedness. Those assets which are considered exempt from the claims of creditors are determined under state law.

Example 4

Janice Zapata has liabilities of $40,000 and assets with a FMV of $34,000. Her creditors agree to discharge $10,000 of her liabilities, if she repays the remaining $30,000. Under state law, $3,000 of Janice's assets are exempt from the claims of creditors. Her insolvency is computed as follows:

FMV of assets	$ 34,000
Less: Exempt assets	3,000

Balance of nonexempt assets	$ 31,000
Less: Liabilities	40,000

Amount of Insolvency	$ 9,000
	=========

Janice can exclude $9,000 of debt-discharge income, the amount not in excess of her insolvency. The balance of the discharged debt, $1,000 ($10,000 - $9,000), must be included in gross income.

The insolvency exclusion under IRC section 108 applies **only** to income from the discharge of indebtedness. For all other types of income (for example, wages, rents, income, and gains from dealings in property), the solvency of the farmer is irrelevant (Estate of Delman v. Commissioner, 73 T.C. 15, 32 (1979)). Thus, an insolvent farmer, who transfers property to a creditor in discharge of indebtedness will not qualify for the insolvency exclusion on that portion of the gain attributable to the deemed disposition of property. See the "Foreclosures, Repossessions, and Abandonments" chapter for analysis.

Qualified Farm Indebtedness

Under IRC section 108(a)(1)(C), gross income does not include income from the discharge of indebtedness if the debt discharged is qualified farm indebtedness, and the discharge is made by a qualified person. Form 1099-C, Cancellation of Debt, should be issued.

Under IRC section 108(g)(2), the debt of a farmer is considered qualified farm indebtedness if:

1. The farmer incurred the debt directly in the business of farming, and

2. For the 3 taxable years preceding the taxable year in which the discharge of indebtedness occurs, 50 percent or more of the farmer's total gross receipts is

attributable to the business of farming.

Under IRC section 108(g)(1)(B), a qualified person is any federal, state or local government, or any agency or instrumentality thereof, or a person who actively and regularly engages in the business of lending money and is not:

1. A person related to the farmer,

2. A person from whom the farmer acquired the property securing the debt (or a person related to such person), or

3. A person who receives a fee with respect to the farmer's investment in the property securing the debt (or a person related to such person).

Example 5

In 1991, the U.S. Department of Agriculture discharged a $12,000 debt, incurred by Jack Marshall in the course of his farming business. For the 3 years immediately preceding the year the debt is discharged, 50 percent or more of Jack's total gross receipts were attributable to his farming business.

The discharge of the $12,000 debt is excludable from Jack's income under IRC section 108(a)(1)(C) since the discharge was made by a qualified person, and the discharged debt was qualified farm indebtedness. Jack must reduce his tax attributes by the amount of the excluded debt-discharged income.

The exclusion of income from discharge of qualified farm indebtedness, under IRC section 108(g)(3), is limited to the farmer's adjusted tax attributes and adjusted basis of qualified property held as of the beginning of the taxable year following the year of discharge. If the discharged debt exceeds the sum of the adjusted tax attributes and the adjusted basis of qualified property, the excess is included in gross income. Qualified property is defined as any property which is used or held for use in a trade or business, or for the production of income.

Qualified Real Property Business Indebtedness

Under IRC section 108(a)(1)(D), gross income does not include income from the discharge of indebtedness if the debt discharged is qualified real property business indebtedness. Qualified real property business indebtedness is defined in IRC section 108(c)(3) as indebtedness that is not qualified farm indebtedness, and that was incurred or assumed by the taxpayer in connection with, (or, if incurred on or after January 1, 1993, was incurred to acquire, construct, reconstruct, or substantially improve) real property used in a trade or business and is secured by such real property.

However, under IRC section 108(c)(2), the amount of qualified real property business indebtedness that can be excluded cannot exceed the excess of the outstanding principal amount of such indebtedness over the fair market value of the taxpayer's real property used in a trade or business that secures the indebtedness. In addition, the amount excluded cannot exceed the aggregate adjusted bases of depreciable real property immediately before the discharge (determined after reduction of basis as required by other sections of IRC section 108). Any amount of qualified real property business indebtedness that is excluded under IRC section 108(a)(1)(D) must be applied to reduce the basis of the depreciable real property of the taxpayer.

Priority of Exclusions

A farmer who has a debt discharged in a bankruptcy proceeding, treats the discharge as an exclusion from income under the Title 11 exclusion provision and the qualified real property business indebtedness exclusion. This exclusion takes precedence over any other exclusions. The insolvency or farm indebtedness exclusions cannot be applied to a discharge which occurs in a Title 11 case (IRC section 108(a)(2)(A)).

For debts discharged outside of bankruptcy, the insolvency exclusion takes precedence over the farm indebtedness exclusion. In other words, a farmer whose debts are discharged outside of bankruptcy must first apply the insolvency exclusion to the debt discharged amount before the farm indebtedness exclusion or the qualified real property business indebtedness exclusion can apply.

The order in which the exclusions apply is important, because the order of reduction in tax attributes following the discharge of qualified farm indebtedness differs from the order used for bankruptcy or insolvency.

REDUCTION OF TAX ATTRIBUTES

IRC section 108(b) requires a farmer to reduce certain specified tax attributes or benefits, if the farmer is eligible to exclude from current taxable gross income certain income realized from the discharge of indebtedness. The amount excluded from current income is in effect deferred and used to reduce future, potential tax savings.

Order of Reduction

Unless the farmer makes an election to first reduce the basis of depreciable property, the excluded debt-discharged income is applied to reduce the farmer's tax attributes in the following order (IRC section 108(b)(2)):

1. Net operating loss.

2. General business credit.

3. Capital loss.

4. Basis of depreciable and nondepreciable property.

5. Foreign tax credit.

Amount and Manner of Reduction

The tax attributes are generally reduced dollar for dollar of excluded income realized from the discharge of indebtedness. The exception is the credit carryovers which are reduced 33 1/3 cents for each dollar. The reduction of tax attributes is made after the determination of tax for the taxable year of the discharge.

The reduction to the credit carryovers is applied in the order in which the carryovers are taken into account for the taxable year of the discharge. Thus, the reduction to NOL's and capital loss carryovers is first made to any loss for the taxable year of the discharge, and then to any carryovers in the order of the tax years from which each carryover arose.

In the case of depreciable and nondepreciable property, any basis reduction is determined under the rules provided in IRC section 1017.

Reduction of Basis: Bankrupt or Insolvent Debtors

Under IRC section 1017(a), the basis reduction required by IRC section 108(b)(2) or IRC section 108(c)(1) applies to the basis of any property the farmer held at the beginning of the taxable year following the taxable year in which the discharge occurred.

If the canceled debt income is excluded due to bankruptcy or insolvency, the reduction in basis of property is limited. IRC section 1017(b)(2) provides that the reduction in basis, under IRC section 108(b)(2), cannot be more than the amount by which the total basis of property the farmer holds **exceeds** the farmer's total liabilities, computed immediately after the discharge. This limitation to the reduction in the basis of assets does not apply if the farmer bypasses the required order of tax attribute reductions specified in IRC section 108(b)(2) and elects to first reduce the basis of depreciable assets owned.

Until further regulations are issued, in the case of a cancellation or reduction of indebtedness in any bankruptcy proceeding, the reduction in the basis of assets is made in the following order (Treas. Reg. sections 1.1016-7 and 1.1016-8):

1. Against the property for which the debt was incurred, except inventories and receivables.

2. Against property subject to a lien (other than a lien securing indebtedness incurred to purchase such property), except inventories and receivables.

3. Against any other property, except inventories and receivables.

4. Against inventories and receivables.

Reduction of Basis: Discharge of Qualified Farm Debt

If the basis reduction required by IRC section 108(b)(2) is due to the exclusion of income realized from the discharge of qualified farm debt, IRC section 1017(b)(4) provides that the excluded income shall be applied only to reduce the basis of qualified property (any property used or held for use in a trade or business or for the production of income). The reduction must occur at the beginning of the taxable year following the taxable year in which the discharge occurs. The reduction to the basis of qualified property is applied in the following order:

1. Depreciable property.

2. Land used or held for use in the business of farming.

3. Any remaining qualified property not described in (1) or (2) above.

Election to Reduce Basis of Depreciable Property

As an alternative to the ordering rules for attribute reduction specified in IRC section 108(b)(2), a farmer may elect (by filing Form 982 with the tax return in the year discharge occurs) to first apply any portion of the excluded income to reduce basis of depreciable property. This election is available under IRC section 108(b)(5) for farmers with debt-discharged income excluded due to bankruptcy, insolvency, or to the discharge of qualified farm indebtedness. Any excluded debt-discharged income which is not absorbed by the basis of depreciable property, is then used to reduce other tax attributes in the prescribed order.

Definition of Depreciable Property

Under IRC section 1017(b)(3)(B), depreciable property is any property subject to an allowance for depreciation, but only if the basis reduction reduces the amount of depreciation or amortization which would otherwise be allowable for the period immediately following the reduction. In certain instances, depreciable property may include a partnership interest, stock held by a parent in a subsidiary, or real property held as inventory (IRC section 1017).

The reduction in basis takes place at the beginning of the taxable year following the taxable year in which the discharge occurs. It cannot exceed the total adjusted basis of depreciable property the farmer holds at that time.

Under IRC section 108(b)(5), the reduction of the basis of depreciable property the farmer holds follows the same order specified in Treas. Reg. sections 1.1016-7 and 1.1016-8 for the reduction of basis of assets under IRC section 108(b)(2).

Recapture of Basis Reductions

If the basis of property is reduced under IRC section 108(b)(2) or IRC section 108(b)(5), any non-IRC section 1245 or non-IRC section 1250 property is treated as IRC section 1245 property. Any reduction is treated as a depreciation deduction subject to recapture. This recapture rule applies to any reduced-basis property, whether depreciable or non-depreciable, and whether or not a disposition of such asset would otherwise be subject to recapture under IRC section 1245 or IRC section 1250. In the case of IRC section 1250 property, the computation of the amount of straight-line depreciation under IRC section 1250(b) is made as if there had been no reduction of basis under IRC section 1017.

Example 6

In 1987, Fred Pratt, a solvent farm debtor, had $600,000 of qualified farm indebtedness discharged by the bank. As a result, Fred excluded discharge of indebtedness income by reducing attributes, including $250,000 of basis in land. In 1990, Fred sold the land to Jay Baxter on contract. Terms were 20 percent down, with balance payable over 15 years at 10 percent interest.

Since the land is non-IRC section 1245 or non-IRC section 1250 property, it is treated as IRC section 1245 property. The installment sale provisions under IRC section 453(i) would trigger recapture income of $250,000 in 1990.

PARTNERSHIPS AND S-CORPORATIONS

IRC section 108(d)(6) provides that the gross income exclusion (of income realized from discharge of indebtedness due to bankruptcy, insolvency, or discharge of qualified farm indebtedness), as well as the related tax attribute reductions be applied at the partner's level, not the partnership's level. Thus, an insolvent or bankrupt partnership must recognize income from the discharge of a partnership debt, and treat it as an income item allocatable to its partners under IRC section 702(a). While the partner's basis in the partnership is increased by the allocated amount of debt-discharge, a corresponding reduction in the partner's share of partnership liabilities results in a decrease in basis.

If the partners are bankrupt or insolvent, they may rely on the bankruptcy or insolvency exceptions to exclude the allocated debt-discharge amount from their gross income.

Example 7

ABC Partnership is the debtor in a bankruptcy case in which a partnership liability of $30,000 is discharged. The partnership has three partners (Abe Allen, Bill Benton, and Chad Camden) with equal distributive shares of partnership income and loss items. Partner Abe is the debtor in a bankruptcy case; partner Bill is insolvent (by more than $10,000), but is not a debtor in a bankruptcy case; and partner Chad is solvent and is not a debtor in a bankruptcy case.

In the case of bankrupt partner Abe, his share ($10,000) of the debt discharged amount must be applied to reduce his tax attributes, unless he elects first to reduce the basis of depreciable assets owned. The same tax treatment applies in the case of insolvent partner Bill. Solvent partner Chad must recognize $10,000 of income from the discharge of indebtedness.

Unlike partnerships, the exceptions for exclusion of debt-discharged income in the case of S-Corporations are applied at the corporate level. This rule insures that the shareholders of all corporations are treated in the same manner. Any debt discharged income excluded (due to bankruptcy, insolvency, or discharge of qualified farm debt) reduces the corporation's tax attributes.

SHAREHOLDER-CORPORATION TRANSACTIONS

A corporation realizes income from the discharge of indebtedness under IRC section 108(e)(6) to the extent that the amount of debt transferred to a corporation as a contribution to capital exceeds the shareholder's basis in the debt. Thus, the discharge of indebtedness rules apply when a cash-basis farmer contributes a debt (representing an accrued and deductible expense) to the capital of an accrual-basis corporation.

In general, this provision will not affect transactions between farmers and their family farm corporations, since each entity usually employs the cash method of accounting. In those instances where a family farm corporation is required by IRC section 447 to use the accrual method, the matching provisions under IRC section 267 further serve to eliminate inconsistent reporting of transactions between farmers and their family corporations.

Forgiveness of Shareholder Debt

The discharge of indebtedness of a shareholder by a corporation is treated as a distribution of property. A solvent shareholder whose debt to a corporation is forgiven realizes dividend income to the extent of the corporation's earnings and profits available for distribution.

If the shareholder's debt is canceled in connection with the complete liquidation of the corporation, the cancellation is treated as a distribution in exchange for the shareholder's stock. Consequently, the debt cancellation enters into the determination of the shareholder's gain or loss on the liquidation.

ACQUISITION OF DEBT BY RELATED PARTY

If a debtor's outstanding debt is acquired from an unrelated creditor by a party related to the debtor, IRC section 108(e)(4) treats the acquisition as if it were made by the debtor. As a result, the debtor realizes income from the discharge of indebtedness, measured by the adjusted basis of the related person in the debt on the acquisition date. (Treas. Reg. section 1.108-2(f)(1)). This provision may apply to those acquisitions effected within 6 months of a party becoming related (Treas. Reg. section 1.108-2(c)(3)).

If the acquisition of a debt results in debt-discharged income under related-party rules, the transfer of the debt as a contribution to capital by the related party to the issuing corporation will not result in income a second time.

EXAMINATION TECHNIQUES

Income from the discharge of indebtedness can arise in a wide array of circumstances. Identifying those situations that result in a discharge of indebtedness is the key to this area of tax law. This is not always easy, since a farmer may not recognize that a taxable event has occurred or may incorrectly apply the exclusion provisions of IRC section 108.

Examiners, in addition to reviewing the farmer's books and records, should review the tax return and any attachments (such as Form 982) for indications of discharge of indebtedness. The initial interview also provides the examiner with an excellent opportunity to ask questions about the farmer's financial position and the existence of any canceled debts. Audits have produced sizeable adjustments in the following areas:

1. Solvent partners incorrectly exclude debt-discharged income due to the insolvency of the partnership. Insolvent partners have also attempted to exclude their

distributive share of partnership income as debt-discharged income. Examiners should review any decrease in partnership liabilities and ensure that debt-discharged income, as well as other items of partnership income, are correctly reported on the partner's return.

2. When debtors perform services in payment of debt, no income is realized from the discharge of indebtedness. The debtor is considered to have received taxable compensation equal to the amount of debt canceled. Hence, no income can be excluded under IRC section 108(a), irrespective of the status of the farmer (Treas. Reg. section 1.61-12(a)).

3. Farmers incorrectly reduce attributes by the earliest year of any attribute instead of reducing attributes in the prescribed order (NOL'S, credits, capital loss, etc.).

4. The election to first apply any portion of the excluded income to reduce basis of depreciable property **<u>must</u>** be made on Form 982 in the taxable year of discharge. After notification of an examination, the farmer cannot invoke the provisions of IRC section 108(b)(5).

5. Farmers incorrectly consider land as depreciable property when making an election under IRC section 108(b)(5).

6. Corporations whose debt was acquired at a discount from a bank or government agency by a controlling shareholder (related party) improperly omit the discharge of indebtedness income on Form 1120.

7. Farmers improperly assert that when loans are forgiven, by a lender not regularly engaged in the business of lending money, they can avail themselves of the provisions of IRC section 108(a)(1)(c). See "Acquisition of Debt by Related Third Party" above.

8. Property which is neither IRC section 1245 property nor IRC section 1250 property, must be treated as IRC section 1245 property when basis was reduced due to discharge of indebtedness. Farmers fail to apply the recapture provisions to certain sales of farmland in accordance with IRC section 1017(d). Also, the installment sale provisions under IRC section 453(i) provide for recognition of recapture income in the year of disposition.

9. Disputes may arise in determining the extent of a farmer's insolvency. The following sources may prove useful in establishing the property's valuation:

   a. Obtain a county map from an abstracter, then reference the properties in question along with sales of comparable properties.

b. Review any appraisals used by the farmer and lending institution in discharging the obligation.

c. Consider obtaining an independent appraisal.

d. Contact local abstracters or realtors who specialize in sales of farmland to obtain listings of comparable sales and other market information pertinent to your geographical area.

e. Some states impose an excise tax on the transfer of property. This may be used to closely approximate the selling price of property. For example, Oklahoma requires "document stamps" on property transfers. (Note: This is not always a reliable indicator of value, as there is no prohibition from purchasing extra stamps.)

f. In Kansas, a "sales price validation questionnaire" is filed by the seller or the seller's agent with the Register of Deeds Office in the county in which the property is located. The agent may obtain a copy of this form by issuing a summons. This potential source of information should be considered on a state-by-state basis.

g. Also, the Kansas Society of Farm Managers and Appraisers publishes a list of farmland sales by county, but many sales are omitted from this publication. Experienced appraisers will not rely solely on the sales contained in this publication. Check and see if your state has a similar publication.

h. Estimate equipment values by contacting area implement dealers and farm auctioneers.

i. In evaluating whether to extend credit for the acquisition of farmland, a lender has two primary considerations: The company's cash-flow and the equity in collateral.

    1) Cash-Flow:

    Due to the size and ever changing nature of some entities, the lender may experience difficulty in analyzing the company's cash-flow. Change is manifested in several ways: 1) management is constantly acquiring or selling property; 2) management opts to transfer land among related entities in order to maximize agricultural program payments;

3) management may choose to use some entities as operating companies (tenants) and other entities (landlords) to hold title to farmland. Therefore, the lender tends to rely on cash-flow projections for the farmer's entire operation.

2) Equity in Collateral:

As a general rule, agricultural lenders try to limit farmland loans to between 60 percent and 70 percent of appraised value. The Farm Credit System limits it's loans to 65 percent of appraised value. Factors that may affect the value of a parcel of land include: 1) quality and depth of water; 2) accessibility of the property; 3) topography; 4) the amount of wasteland. A farmer often argues that a blockage factor should apply to large parcels of land. However, the IRS has generally disregarded such arguments.

Review the lender's appraisal and loan approval workpapers. These documents may address the blockage factor by indicating whether the property could be divided into tracts of any size for the purpose of marketing, and whether the tracts could be operated independently. The appraiser or lender will consider the adequacy of roads, irrigation wells, etc.

Real estate mortgages are of public record and may be inspected at the Register of Deeds Office. The recorded mortgage may provide some evidence of value by using the 60 percent to 70 percent rule-of-thumb to estimate the property's value at the time a mortgage is recorded. Consider the following:

a) Mortgages on comparable farmland.

b) Mortgages initiated by refinancing from a new lender in a later year.

This list is not inclusive, but provides ideas of the kinds of adjustments to look for.

Chapter 10

FORECLOSURES, REPOSSESSIONS, AND ABANDONMENTS

DEBT DISCHARGED BY TRANSFER OF PROPERTY

During the last several years, many farmers have been forced to give up their properties in order to discharge their debt obligations. In many cases, the property transferred has been worth much less than the amount of the debt discharged by the transfer. A farmer who transfers property in satisfaction of a debt may realize a gain or loss, and in some cases, income from discharge of indebtedness.

Transfer Treated as a Sale or Exchange

A farmer who transfers property, voluntarily or by foreclosure, in full or partial satisfaction of a debt, is treated as having sold or exchanged the property. If the debt satisfied as a result of the property transfer is a recourse debt, the debtor-transferor may also realize income from the discharge of indebtedness (Treas. Reg. sectionn 1.1001-2(a)(2)).

In most instances, a farmer's obligations will be recourse through the printed form of a note and a recorded mortgage for real estate. However, a farmer who wants to purchase land may be unable to secure financing from a conventional lender; thus, seller financing must be obtained to complete the deal. This type of financing usually takes the form of a land contract, commonly referred to as a contract for deed, real estate contract, or installment sales contract. In the event of default, the seller's remedy is often restricted to repossession of the property. Absent the buyer's personal liability, these financing arrangements are considered nonrecourse.

Discharge of Recourse Debt

If the debt satisfied by the transfer of the property is recourse (personal liability), Treas. Reg. section 1.1001-2(a) treats the property as if it were sold by the debtor at fair market value (FMV). Thus, the debtor-transferor realizes a gain or loss from the sale of the property to the extent the deemed sales proceeds (FMV) exceed the adjusted basis of the property. If the debt exceeds the FMV of the property and the creditor releases the debtor from the remaining liability, the difference is taxable as income from the discharge of indebtedness (Rev. Rul. 90-16; Treas. Reg. sections 1.166-6(a); 1.1001-2(c), Example (8)).

Discharge of Nonrecourse Debt

If the debt satisfied by the transfer of the property is nonrecourse (no personal liability), the full amount of the canceled debt is treated as proceeds from the sale or exchange of the property, even if the value of the property is less than the unpaid balance of the debt (J.F. Tufts, S.Ct., 83-1 U.S.T.C. 9328).

Consequently, any gain or loss from the transfer of property in satisfaction of a nonrecourse debt is treated as arising entirely from a disposition of the property, and none of the cancelled debt is considered income from discharge of indebtedness under IRC section 61(a)(12). The distinction between any gain resulting from the sale of property and income from the discharge of indebtedness is critical, because income from the discharge of indebtedness may be excluded from gross income (IRC section 108; Treas. Reg. section 1.1001-2(c), Example (7)).

Discharge of Debt Secured by Property

The discharge of a recourse or nonrecourse debt without a corresponding transfer of property results in income from discharge of indebtedness (Rev. Rul. 82-202), whether or not the debt exceeds the value of the property (Rev. Rul. 91-31).

Example 1

John Tate borrowed $1,000,000 from ABC Bank to purchase a parcel of land from Joyce Jenkins. The debt was evidenced by a note which was secured by the land. John had no personal liability with respect to the note (nonrecourse debt). When the value of the land was $800,000 and the outstanding principal on the note was $1,000,000, ABC Bank agreed to modify the terms of the note by reducing the note's principal to $800,000. John realized income from the discharge of indebtedness of $200,000 as a result of the modification of the debt.

If John had originally acquired the property on contract (for example, seller financed), the above would constitute a "purchase-money adjustment" within the scope of IRC section 108(e)(5). See the "Cancellation of Indebtedness" chapter.

In Rev. Rul. 92-53, the IRS stated that the amount by which a nonrecourse debt exceeds the FMV of the property securing the debt is taken into account in determining whether a farmer is insolvent (IRC section 108(d)(3)), but only to the extent that the excess nonrecourse debt is discharged.

Character of Gain or Loss

A gain or loss recognized on the transfer of property through foreclosure or repossession is taxed the same way as a gain or loss from sales or exchanges (IRC section 1001(c); IRC section 61(a)(3)). A gain from property held for personal use is taxed as capital gain. Property used in a trade or business and held for more than 1 year is IRC section 1231 property. Gain or loss from the sale or exchange of IRC section 1231 property, whether by foreclosure or repossession, may qualify as long-term capital gain or loss.

Example 2

In 1988, Art Benton entered into a contract to buy land from Bart Douglas for $300,000. The terms were 10 percent down with the balance payable over 15 years. Interest is to be computed on the declining principal balance at 10 percent. Art claimed total water depletion of $25,000 for 1989 and 1990. In 1991, he assigned the property with a FMV of $220,000 to Charles Decatur who assumed the unpaid balance of $260,000. Art was insolvent in 1991.

Art would have a basis of $275,000 ($300,000 -$25,000) in the land. If the debt was recourse, Art would have a $55,000 ($220,000 - $275,000) IRC section 1231 loss and $40,000 ($260,000 - $220,000) discharge of indebtedness income. Some of the discharge of indebtedness income would be excludible to the extent of his insolvency. If the debt was nonrecourse, he would have a $15,000 ($260,000 - $275,000) IRC section 1231 loss.

Abandonment of Property

If property securing payment of a debt is the sole means of paying that debt, the abandonment of that property results in the debtor realizing income from the release of the debt. Likewise, a debtor who abandons property secured by a recourse debt, will realize income from discharge of indebtedness if the lender cancels the debt. The property has been abandoned when the farmer irrevocably discards it, cannot use it again or retrieve it for sale or exchange.

Information Reporting

Under IRC section 6050J, a farmer may receive Form 1099-A, Information Return for Acquisition or Abandonment of Secured Property, if a lender:

1. Acquires an interest in any property which is security for the farmer's indebtedness in full or partial satisfaction of the debt;

2. Has reason to know that the property has been abandoned.

A lender is treated as acquiring an interest in property that secures a debt if:

1. The lender purchases the property at a sale held to satisfy the debtor's loan (for

example, a foreclosure sale); or

2. The property is sold to a third party, and the sales proceeds are applied to satisfy any portion of the lender's loan.

The reporting requirements under IRC section 6050J apply to real property (for example, a personal residence), intangible property, or tangible personal property held for investment or used in a trade or business.

EXAMINATION TECHNIQUES

1. A gain on a property transferred due to repossession or abandonment is sometimes incorrectly characterized as income from discharge of indebtedness. The farmer may do this in an attempt to exclude the gain under IRC section 108. For example:

   a. A number of farmers incorrectly compute gain from the foreclosure of property subject to nonrecourse debt. The farmer will often use the fair market value of the property instead of the amount of the discharged debt as the measure of gain.

   b. Farmers treat gain from the foreclosure of property secured by nonrecourse debt as debt-discharged income and exclude the gain because of insolvency. Examiners should carefully review the character of any excluded income to ensure that it is debt-discharged income, as opposed to some other type of income.

2. The examiner should review information returns (Form 1099-A) issued to the farmer to ascertain that the farmer has correctly reported all transactions relating to the issuance of the Forms 1099-A. Many times Forms 1099-A issued by the FmHA are incorrect and are virtually impossible to get corrected.

Chapter 11

FARM BUSINESS EXPENSES

INTRODUCTION

Generally speaking, farm business expenses are like other business expenses on a tax return. IRC section 162 and Treas. Reg. section 1.162-12 provide for the deduction of ordinary and necessary expenses, paid or incurred in connection with the operation and maintenance of a farm. This chapter discusses the various expense items unique to farm returns, as well as audit techniques used to verify those expenses.

METHODS OF ACCOUNTING

Most farmers use the cash method of accounting to record their expenses. If the accrual method is used, farm business expenses are not deductible until economic performance occurs. Economic performance generally occurs as the property or services are furnished to the farmer and the liability is incurred. See the "Accounting" chapter for a more detailed explanation of accounting methods.

DEPOSIT OR PAYMENT

During the examination of farm returns, you will find that farmers quite often write a substantial number of checks during the last few days of the tax year to pay expenses. If the disbursement involves an item you are examining, you must determine if it was a deposit or payment. Whether an expenditure is a deposit or a payment depends on the facts and circumstances of each case.

A deposit to be applied against future expenses is not deductible. Even though a check was written, no deduction is allowable until the expenses are actually incurred. For a disbursement to be considered a payment, the farmer must prove:

1. The payment was not refundable

2. The payment was made under an enforceable sales contract.

These rules apply to all farm expenses for which a payment is made prior to delivery. The next topic discusses certain limitations of payments made for some specific expense items.

PREPAID EXPENSES

IRC section 464 limits the allowable deduction for prepaid farm supplies. Under this section, amounts paid for feed, seed, fertilizer, and similar farm supplies are only allowable to the extent they do not exceed 50 percent of the total deductible farm expenses (excluding prepaid supplies) for the taxable year. If the prepaid farm supplies have actually been used or consumed, the amount is fully deductible. The IRC section 464 limitation would usually not apply to most farming operations, as 50 percent of **all** expenses would be a substantial amount.

If the cash method is used, a deduction is allowable in the year paid for the cost of supplies used or consumed, but no deduction is allowable for advance payments of supplies that will be used or consumed in a later tax year, unless each of the three following conditions is met:

1. The expense is a "payment" for the purchase of supplies, not a deposit. The amount is considered a payment, if it was made under a binding commitment to accept delivery of a specific quantity at a fixed price, and the farmer is not entitled, under a contract provision or business custom, to a refund or repurchase. Factors that show an expense is a deposit rather than a payment include:

    a. A specific quantity wasn't stated in the contract or in the invoice

    b. The farmer was entitled to a refund of any unapplied payment or credit at the end of the contract

    c. The seller treats the amount received from the farmer as a deposit and not a sale

    d. The right exists to substitute other goods or products for those specified in the contract.

2. The prepayment is not merely for tax avoidance, but has a specific business purpose. For example, business purposes might include fixing maximum prices and securing an assured feed supply, or securing preferential treatment in anticipation of a feed shortage.

3. The deduction does not result in a material distortion of income. Some factors to consider in determining whether there is a material distortion of income are:

    a. The farmer's customary business practices in conducting the farming operation

    b. The amount of the expense in relation to past purchases

c. The time of the year the purchase is made

d. The amount of the expense in relation to income for the year.

If the farmer fails to meet any of these three tests, no deduction is allowable in the current year for supplies used or consumed in a later tax year.

When examining farm expenses, pay particular attention to expenditures incurred during the last month of the tax year. This is the period of time farmers normally prepay expenses (for example, seed, feed, fertilizer, etc.). Verify that these payments pertain to the tax year under examination.

GENERAL FARM EXPENSES

General farm expenses include feed, seed, fertilizer, chemicals, fuel, insurance, taxes, interest, rent, storage and warehousing, and labor hired. These are discussed below.

Feed

Feed expense for livestock is generally deductible when paid. Most of the rules that apply to the deductibility of prepaid feed are contained in Rev. Rul. 79-229. The gross profit on sales of livestock can be compared to the feed cost to determine if this cost is excessive. The cost of raised feed is deducted as the costs of production are incurred. No additional deduction is allowed when the grain is fed, unless the amount is also included in income. For feed expense of cattle in feedlot see the Examination Techniques section in the "Sales of Livestock" chapter.

Seed

The cost of seeds and plants used to produce crops for sale is deductible when paid. However, there are two exceptions to this rule:

1. The planting may constitute a capital expenditure if it has a value lasting over several taxable years (for example, orchards and timber farms)

2. If the crop method of accounting was elected, the cost of the seeds or plants will not be deductible until the year when income from the crop is realized.

A large seed expense could be indicative of seed purchases for sales to other farmers. Look for any income from seed sales in this situation.

Fertilizer

The full cost of fertilizer, lime, or other soil conditioners is deductible as a current expense, if the effectiveness of the material applied will not last longer than 1 year. If the effectiveness lasts longer than 1 year, the expense of acquisition is a capital expenditure; however, under IRC section 180 a farmer can elect to currently deduct such expenditures that should otherwise be capitalized. Thus, all fertilizer costs will usually be deducted as current expenses. Most grain farmers will have substantial fertilizer expenses.

Chemicals

Chemicals used on a farm to control weeds (herbicides) or insects (insecticides) are deductible. Herbicides play an important part in no-till cultivation. Therefore, these costs may be significant.

Fuel

The cost of diesel, gasoline and other fuels and oil used in farming operations is deductible. Look closely at fuel purchases to verify that no fuel is diverted for personal use. See the "Credits" chapter.

Insurance

Crop insurance is used to cover crop losses from natural disasters. This can be a major expense for grain farmers. Premiums paid for casualty insurance on all farm property, liability insurance, and health/accident insurance covering employees are deductible expenses. Premiums paid for a disability policy, providing payments to the farmer in case of an accident or sickness, are personal expenses and are not deductible. Up to 25 percent of health insurance premiums can be deducted as an adjustment to income on page 1, Form 1040. This deduction is allowable only through tax years ending on or before December 31, 1993. If no deduction was taken on page 1, Form 1040, then it is possible that the entire amount was deducted on Schedule F.

By hiring a spouse as an employee, a farmer can take advantage of IRC section 105, which allows small businesses to deduct 100 percent of costs of employee benefits. A farmer transfers the family insurance plan to the spouse's name, listing the farmer as a dependent. All family health insurance premiums and uninsured medical costs are then deductible as business expenses. The 100 percent deductions can be taken only after the farmer and spouse have formalized their employer-employee relationship. They need a written employment agreement outlining the spouse's duties. The agreement also must specify reasonable wages and benefits. The IRS does not permit employee discrimination, the same benefits must be made available to all employees.

Taxes

A farmer can deduct as a business expense the following taxes:

1. Real estate and personal property taxes on farm business assets

2. Social security and medicare taxes paid to match the amount withheld from the wages of farm employees

3. Federal unemployment taxes on farm employees

4. One-half of self-employment tax (adjustment to income on page 1, Form 1040)

5. Federal use taxes paid on highway motor vehicles used for farming.

Taxes paid on the portion of farm assets used for personal purposes and Federal or state income taxes are not deductible as farm expenses, although such taxes can be deducted on Schedule A, Form 1040, if the farmer itemizes deductions.

State or local sales taxes imposed on the purchase of capital assets for use in farming operations should be added to the basis of the asset acquired, not separately deducted.

Interest

Interest paid on farm mortgages and other obligations incurred to carry on farming operations is deductible as a business expense. If the farmer uses the cash method, the interest is deductible in the year of payment. Accrual method farmers may deduct interest as it accrues. Most farmers' business and personal assets and loans are so intertwined, it is possible that personal interest could be deducted on Schedule F (for example, a loan on a personal car could be obtained through an addition to an operating loan). If the proceeds of a loan are used for both business and personal purposes, ensure the interest is properly allocated. Since personal interest is no longer deductible on Schedule A, this could be a significant issue.

Example 1

Joan Douglas borrowed $60,000 at 11 percent interest on January 1,1993. She used $30,000 of the loan for farm purposes, $20,000 to buy U.S. Treasury bonds, and $10,000 for family living expenses. The U.S. Treasury bonds paid $1,600 in interest income in 1993. Joan paid $6,600 in interest for 1993. Joan may deduct $3,300 (30,000/60,000 * 6,600) on Schedule F. $2,200 (20,000/60,000 * 6,600) is investment interest and is deductible as an itemized deduction subject to the investment income limitations. The remaining $1,100 (10,000/60,000 * 6,600) is nondeductible personal interest.

Rent

Rent paid in cash may be deducted on Schedule F in the year paid; however, rent paid in crop shares is nondeductible, since the cost of raising the crops was deducted as a farming expense. Advance payments of rent may only be deducted in the year to which they apply, regardless of the farmer's method of accounting. Be alert for yearend rent payments. A tendency is to prepay rent like other expenses, but prepaid rent is not deductible. The first half of rent is usually due on March 1. Many times farmers will pay rent to a spouse to reduce the self-employment tax liability. If this occurs, verify that there is a true lessor-lessee relationship.

Storage and Warehousing

The cost of grain storage or other warehousing is deductible. These costs are generally deducted from sales proceeds when the stored grain is sold. A double deduction can occur if the farmer reports only the net amount of the sale and then claims a deduction for storage and warehousing costs.

Labor Hired

The farmer may deduct reasonable wages paid for regular farm labor, piecework, contract labor, and other forms of labor hired to perform farming operations. Wages may be paid in cash or property, such as inventoried items, capital assets, or assets used in the farmer's business. See the "Employment Taxes" chapter for details on wages paid in commodities.

Generally, the form of payment does not affect the deduction, but it may have other consequences affecting taxability or timing. For example, the transfer of appreciated property to an employee as wages would give rise to a compensation deduction in the amount of the fair market value of the property, but it also requires recognition of income by the farmer to the extent of such appreciation (Rev. Rul. 69-181).

Reasonable wages or other compensation paid to the farmer's spouse or children for doing farm work is deductible, but the farmer must be able to show that a true employer-employee relationship exists (Rev. Rul. 72-23). Ordinarily, an employment relationship is present if:

1. Substantial duties are performed

2. The amount of pay is reasonable in relation to the work performed

3. Payment is actually made.

Wages paid to a farmer's children are deductible even if the children use the money to buy clothes or other necessities which the parent would otherwise be obligated to provide (Rev. Rul. 73-393). This ruling should be considered any time a farmer is deducting as wages an amount paid other than by cash. If it can be determined that the item(s) given to the child in lieu of cash are what a parent would normally be expected to furnish, then the wages would not be deductible as labor expense. This rule is applied because providing such items in kind cannot be distinguished from the discharge of the parents duty of support.

More and more farmers are paying wages to their spouses to obtain various tax benefits such as 100 percent deductibility of health insurance, allowance of an IRA deduction for the spouse, and a reduction in the farmer's self-employment tax. Be sure there is a legitimate employer-employee relationship if the farmer deducts wages paid to a spouse.

Examination Techniques

During the initial interview establish the number of children the farmer has, their ages, whether they are at home or away, the number of vehicles and who drives them. Determine if the farmer has hired help other than his/her children and how their compensation is determined.

See the "Employment Taxes" chapter for additional information.

REPAIRS AND MAINTENANCE

The cost of repairing and maintaining equipment is deductible. The cost of replacing equipment is a capital expenditure subject to depreciation. Likewise, the cost of an extensive overhaul is a capital expenditure if the overhaul adds value, prolongs the life of the equipment, or adapts it to a new or different use.

Just because the amount of an expenditure is large does not necessarily mean it's a capital expenditure. Sometimes there is a fine line between repair and improvement. For example, the purchase of a used transmission for a farmer's loader (cost $17,500) was a repair because it returned the equipment to its previous operational state, but an engine overhaul for the same loader (cost $15,437) was an improvement because it extended the life of the equipment (Jacks v. Commissioner, 55 T.C. Memo. 968 (1988)).

MEALS AND LODGING

If the requirements under IRC section 119 are met, meals and lodging furnished to an employee for the employer's benefit (the lodging must be accepted as a condition of employment), may be excluded from income by the employee. The farmer may deduct the expense as a business expense.

A farmer who incorporates the farming operation and continues to operate the business becomes not only the employer, but also the employee. Therefore, the farmer/employer can furnish meals and lodging to the farmer/employee and claim a deduction for it. Treas. Reg. section 1.119-1(c)(2) provides that IRC section 119 is applicable only to meals furnished "in kind" by the employer. The IRS has taken the position that the term in kind refers only to meals prepared for consumption, and does not include groceries furnished to the employee (Rev. Rul. 77-80).

Lodging furnished to an employee for the convenience of the employer includes the value of any necessary utilities (for example, electricity, gas, water, sewage service, and telephone).

PERSONAL LIVING EXPENSES

The law specifically prohibits the deduction of certain personal living expenses. Since a farmer generally lives on the farm, these expenses might be deducted somewhere on Schedule F. These nondeductible expenses can include, but are not limited to:

1. Rent and insurance premiums paid on property used as a residence

2. Life insurance premiums on the farmer or the farmer's family

3. The cost of owning and maintaining vehicles or horses for personal use

4. Allowances to children

5. Attorney's fees and legal expenses incurred for personal matters

6. Household expenses

7. The cost of purchasing or raising produce or livestock consumed by the farmer's family.

Many of the checks a farmer writes for expenses during the year can be partially business and partially personal. These may include amounts paid for gasoline, oil and fuel, water, rent, electricity, automobile upkeep, insurance, interest, and taxes. The personal portion of these expenses is not deductible and must be allocated. Be particularly alert for payments to co-ops or farm stores, where a portion of the amount might be personal (for example, dog and cat food, clothing, groceries, etc.).

Examination Techniques

During the initial interview it is important to have a clear understanding of the farmer's life-style, the ages of any children, and utilities used, to determined a reasonable allocation of business and personal expenses. There are no specific guidelines for percentages to be used in allocating expenses. The farmer has the responsibility to demonstrate that the allocations are reasonable based on the facts.

SOIL AND WATER CONSERVATION EXPENSES

A farmer can elect to deduct expenses incurred for either soil or water conservation or for the prevention of erosion of land used in farming. If no election is made, these expenditures must be added to the basis of the land. The deduction cannot exceed 25 percent of the farmer's gross income from farming. Any amount in excess of 25 percent may be carried over to later years.

The expenses for soil and water conservation must be consistent with a plan approved by the Soil Conservation Service (SCS). If no plan exists, the expenses must be consistent with a soil conservation plan of a comparable state agency to be deductible.

For each year soil and water **conservation expenses** are claimed, Form 8645, Soil and Water Conservation Plan Certification, must be completed and attached to the income tax return. The form is used to certify that the expenses are consistent with an approved conservation plan. Form 8645 does not have to be completed if there is a carryover from a prior year.

Deductible expenses are those made with regard to land that is currently or was previously used for farming by the farmer or the farmer's tenant. The use of the land for farming can be either at the time of, or before the expenditures are made. It is important to differentiate between soil and water conservation expenditures and land clearing costs. Soil and water conservation expenditures include, but are not limited to:

1. Treating or moving earth (for example, leveling, conditioning, grading, terracing, contour furrowing, or restoration of fertility)

2. Constructing, controlling, and protecting diversion channels, drainage ditches, irrigation ditches, earthen dams, water-courses, outlets, and ponds

3. Eradicating brush

4. Planting windbreaks.

The farmer has a choice at the time the expense is incurred. The expense can be capitalized as a cost of the land. This ultimately affects any gain or loss on disposition. Otherwise, an election can be made to expense the amount under IRC section 175. Once the farmer makes this expense election, it becomes the only method available to claim soil and conservation expenses. If the farmer ceases farming or dies before the entire cost has been deducted, the amount that has not been deducted is lost forever. It cannot be added to the basis of the land to reduce any gain on the sale of the farm.

Chapter 12

BASIS AND SALES OF THE FARM AND FARM ASSETS

BACKGROUND

Tax management begins when a farm is purchased. Decisions made on allocation of the purchase price will affect the amount of income tax paid when the farm is sold. If the farm is transferred to children or other beneficiaries, these decisions will affect the income tax status of those receiving the farm.

When buying a farm, a new owner acquires a collection of assets including land, buildings, fences, and often, natural materials such as timber or gravel. The tendency on the part of the farmer and the preparer is to inflate the basis of the depreciable assets and undervalue the nondepreciable assets, such as land and personal residences. Amounts allocated to depreciable property will be recovered relatively soon in the form of depreciation deductions. Larger amounts allocated to this property will result in larger depreciation deductions. For example, a farmer might allocate part of the purchase price of a piece of land to **residual fertilizer** (from previous applications which has not been depleted by crop production), claiming that although the residual fertilizer raised the cost of the land, it will be exhausted during crop production. By assigning part of the cost of the land to residual fertilizer, the farmer lowers the cost of the land, which is nondepreciable. The IRS has denied such deductions when the farmer was unable to provide data indicating the level of soil fertility attributable to the previous owner. The farmer should be able to prove beneficial ownership of the residual fertilizer supply, the presence and extent of the residual fertilizer, and that the residual fertilizer is, in fact, being exhausted.

Determine if the value assigned to each asset acquired on the farm is reasonable. The most widely used and accepted examination technique to determine fair market value (FMV) is reliance on property values established by the county assessor's office. These values are available to the public. Every building on a tract of land is assigned a value by the county assessor. Land improvements (tile, fence, water wells) are usually not valued. Remember that trying to determine FMV is usually subjective.

BASIS OF FARM ASSETS

Basis plays an integral part in determining gain or loss on the liquidation of a farm business. A gain or loss should be determined for each item of property sold by comparing its selling price to its adjusted basis. Basis is the value a property owner can recover as a lump-sum when that property is sold, or can charge off as an annual deduction through depreciation. The original basis is changed through capital improvements or by claiming deductions such as depreciation and casualty losses.

When property is purchased, its basis equals cost. This includes the cost of the property plus charges for freight, installation, and other expenses incurred in securing the property and preparing it for service. When land is purchased, basis includes the purchase price plus legal and recording fees, abstract fees, surveys, and payments for nondepreciable permanent improvements.

The way property is acquired determines its basis. Property can be purchased, acquired in a trade, received as a gift, or inherited.

Property Acquired in Trade

When property is acquired through a like-kind exchange, (for example, a trade), the gain or loss is deferred. The basis of such property is equal to the basis of the property exchanged. When cash is paid in a nontaxable exchange, the basis of the property acquired is the basis of the property traded plus the cash difference paid. For example, if a tractor with a basis of $25,000 is traded for another tractor and $10,000 cash, the tractor acquired has a basis of $35,000.

If cash is received instead of paid during an exchange, or the property is not like-kind, the result is a partially nontaxable transaction. In this case, computing basis requires adjusting the basis of the old property. The basis of the property acquired is the basis of the old property, reduced by money received or any loss recognized on the trade, and increased by additional costs incurred or any gain recognized on the exchange.

A farmer preparing to retire may start disposing of farm assets by the use of nontaxable exchanges. Such an exchange could involve more than one type of property and basis must be divided among the properties received in the exchange. The basis of any unlike property is its FMV on the date of the exchange. The balance of basis is then allocated to the like-kind property.

Example 1

Mark Sutter has a basis of $40,000 in real estate held as an investment. The property is traded for a different tract of real estate with FMV of $35,000 plus a truck with FMV of $6,000, plus $2,000 in cash. A $3,000 gain is realized on the trade. The basis in the properties received is calculated as follows:

Basis of real estate transferred	$ 40,000
Minus: cash received	< 2,000>
Plus: gain recognized	3,000

Basis of properties received	$ 41,000
	========

The $41,000 must be divided between the real estate received and the truck. The truck's FMV is $6,000 and that much basis must be allocated to the truck. The balance of property basis ($41,000 - $6000 = $35,000) is allocated to the real estate received.

Trading farm property can produce substantial tax savings by protecting part or all of the gain from immediate taxation. The following explains some of the basic rules of non-taxable trades:

1. Both real estate and personal property used in the business qualify for nontaxable exchanges.

2. The property involved must be held "for productive use in a trade or business or for investment." Qualifying farm property includes: farmland and buildings; draft, breeding, and dairy livestock; and equipment.

3. Like-kind property must be exchanged. For business real estate, the like-kind rule is flexible: the farmer may exchange any income producing real estate. Farm real estate may be exchanged for a city apartment, timberland, or other real estate used to produce income.

   For personal property, the like-kind rule is more restrictive. The farmer may trade only dairy cows for other dairy cows; only farm equipment for other farm equipment. Livestock producers assume they can trade **heifers** for **steers**, but the law specifically states that heifers and steers are not like-kind properties.

4. The trade can be a multi-party exchange.

   <u>Example 2</u>

   Ann Tate owns property which she wants to exchange for property owned by Chuck Mitchell. Doug Weber wants to buy Ann's property. The parties in this situation may accomplish a like-kind exchange qualifying for nonrecognition treatment. Using a three party exchange, Doug can buy Chuck's property and transfer this property to Ann in exchange for Ann's property.

This transaction is allowed tax-free treatment even though Ann located the exchange property, which Doug then bought from Chuck solely for the purpose of the exchange.

5. The property acquired must be used for business or investment. If a farm is traded for city rental property and the city property is immediately sold, the trade does not qualify as nontaxable.

If during a trade, cash is received, or if the property traded or received is mortgaged, part of the gain may be recognized and taxable immediately.

Example 3

Tim Harris trades a farm for an apartment house. No cash is exchanged, but in the trade Tim is relieved of a $20,000 mortgage on the farm. Tim assumes no mortgage on the apartment house. For tax-reporting purposes, Tim is treated as if he had received $20,000 in cash.

6. See the new regulations issued under IRC section 1031 for details regarding: meeting the like-kind requirement (same general asset class or same product class); identifying and exchanging property rules; and the use of a qualified intermediary.

Property Received as a Gift

In order to determine the basis of property, the following information needs to be determined:

1. The original owner's basis in the property just before the transfer

2. The FMV of the property when given

3. The amount of gift tax paid.

Basis for the new owner of property received as a gift is usually the smaller of FMV or the donor's adjusted basis. If gift tax is paid on the transfer, however, a part of that amount is added to the donor's basis in arriving at the new owner's basis.

The basis of property received by gift after 1976 equals the donor's basis, plus the part of gift tax due to appreciation in value during the time the donor owned the property. The part of **gift tax due to property appreciation** is determined by the following formula:

$$\text{Total gift tax} \times \frac{\text{Fair market value of the gift less the donor's basis}}{\text{Total amount of the gift}}$$

The recipient's basis for a gift received before 1977 equals the donor's basis plus the total gift tax paid. However, the recipient's basis, as increased by any gift tax paid, cannot be more than the property's FMV when it was given.

Inherited Property

The basis of inherited property is usually its FMV at the time of the decedent's death. If taxpayer's jointly own farm property, the surviving spouse is entitled to a stepped-up basis on only one-half of such property. If a Federal estate tax return is required, and if the property must be included in the decedent's gross estate, the basis is the FMV at the date of death, or, if elected, the alternative valuation date. The alternative valuation date is prescribed by IRC section 2032. Under this method property is valued at the date 6 months after the decedent's death, if not sold, distributed, or otherwise disposed of within 6 months after death. If the property is disposed of within the 6-month time period, the amount used to determine basis is the value of the property at the date of disposition.

If a farmer gives property to a person who dies within 1 year of the gift, and the original owner inherits the property back, there is an exception to this rule. If the death occurred after 1981, the inherited property's basis equals the deceased person's basis just before death, which is the same as the original owner's basis before the original gift. In this case, FMV does not affect basis.

The basis in inherited property may be figured under the special "farm real property valuation method." This method values the qualified real property at other than its FMV by valuing it on the basis of its use as a farm. If this method of valuation is used for estate tax purposes, the value is elected as the basis of the property for the heirs. The qualified heirs should be able to get the value from the executor or personal representative of the estate.

The basis of the property for the qualified heir who receives special-use valuation property, is the estate's or trust's basis in that property immediately before distribution. If the estate or trust recognizes a gain because of post-death appreciation, the basis is increased by this amount. Post-death appreciation is the difference between the property's FMV on the date of distribution and the property's FMV on either the date of the farmer's death or the alternative valuation date.

The basis in special-use valuation property received from the estate of a decedent who died after 1981, may be increased if it is subject to the additional estate tax. This tax is assessed if, within 10 years after the death of the decedent, the property is disposed of to a nonfarm family member or the property ceases to be used for farming. This tax may apply if the property is disposed of in a like-kind exchange or is involuntarily converted.

The basis in the property is **increased** to its FMV on the date of the decedent's death or the alternative valuation date, if the farmer makes an irrevocable election and pays the interest on the additional estate tax figured from the date 9 months after the decedent's death until the due date for paying the additional estate tax. The increase in basis is considered to have occurred immediately before the event that results in the additional estate tax. An election is made by filing Form 706-A, with a statement containing: the farmer's name, address and taxpayer identification number; the estate's name, address and taxpayer identification number; a statement identifying the election as an election under IRC section 1016(c); and a list specifying the property for which the election is made.

SELLING THE FARM

Selling a farm involves disposing of both business and nonbusiness property. Land, machinery, livestock, and other assets used in farming are business property, while the farm residence is nonbusiness property. For each type of property, the tax treatment is different. Gains and losses may be either capital or ordinary depending upon the asset.

Selling the Farm Residence

Farmers are eligible to postpone recognition of gain realized from the sale or exchange of a principal residence to the extent that the proceeds are reinvested in another residence, just like any other taxpayer. (IRC section 1034)

If the residence is sold as a part of the entire farm, a problem may arise in apportioning the basis and the selling price between the "residence" and the remainder of the farm. The apportionment of basis may have been severely restricted by earlier allocations of basis among depreciable items of property. The term residence is defined broadly by the regulations which provide little guidance as to the portion of a farm that would be eligible for postponement of gain. The residence may not include any part of the premises used for business purposes, such as a garage housing a truck used in the farm business.

Furthermore, a farmer may exclude up to $125,000 of gain on the sale of a principal residence if either the farmer or spouse has reached age 55 before the residence is sold. To be eligible, the property must have been owned and used as the farmer's principal residence for at least 3 of the last 5 years prior to sale. For a retiring farmer, this means that the residence portion of the farm must be sold within 2 years after leaving the farm and taking up residence elsewhere (IRC section 121).

Several problems occur when determining gain or loss on the sale of a farm residence. These include: ascertaining the portion of the farm included in the "residence"; determining the amount of the unallocated basis for the farm that is allocable to the residence; and calculating the portion of the sales price attributable to the residence. Although not conclusive, provisions in the contract of sale may be evidence as to the extent and value of the residence, particularly if the transaction is between non-related parties. Also note, when the principal residence is sold and the house moved to another lot, the gain realized on the land where the house was originally located is not excludable.

Losses on the sale of a farm residence are personal, and therefore, are not tax deductible. If a farm is sold for a single price under circumstances where a loss would be sustained on the residence portion, the transaction should be treated as two separate sales, the residence and the rest of the farm. The loss on the residence portion would be nondeductible.

Standing Crops Sold With A Farm

The sale of unharvested crops with a farm reduces the tax obligation for some farmers, since the crops acquire capital gain status (IRC section 1231). This limits the tax rate to 28 percent. Without capital gains, the top rate could be as much as 39.6 percent. To qualify for capital gain treatment, unharvested crops must be sold with the land and meet the following requirements:

1. The land must have been held more than 1 year and be used in the taxpayer's business of farming

2. The crop and land must be sold at the same time and to the same person

3. The seller does not retain a right or option to reacquire the land, unless this right occurs as part of a security interest in a mortgage.

The crop's stage of maturity does not affect its capital gain status. A crop at any stage, as long as it is unharvested, qualifies.

When unharvested crops are sold with land and the seller seeks capital gain treatment for them, the cost of producing the crops must be treated as a capital investment, not as an operating expense. Crop production costs should be added to the basis of the property and then excluded from farm operating expenses. Crop production costs include all cash expenses, and fixed overhead costs, such as depreciation (IRC section 268).

Sometimes the seller wants to secure capital gain treatment for unharvested crops in the tax year after most production costs are incurred. For example, land may be sold with winter wheat as an unharvested crop. Here an amended return should be filed for the year before the tax year of the farm sale. Operating expenses related to the wheat crop are removed from total farm operating expenses for the prior year and added to the basis of the farm land sold.

Installment Sales

Many farmers choose to sell their farms on the installment method. This spreads the reporting of the gain over several years. It can offer substantial tax relief and is beneficial when used in the sale of property not subject to depreciation recapture.

Taxable income from installment sales is computed as follows:

$$\text{Amount received in any year} \times \frac{\text{Gross profit (selling price - basis)}}{\text{Contract price (sales price - mortgage assumed by buyer)}}$$

Form 6252 is used to report installment sales income.

Under the Tax Reform Act of 1984, installment sales of personal or real property are restricted if there is a recapture of depreciation. Any gain caused by depreciation deductions over the life of personal property must be reported as ordinary income under IRC section 1245. The recaptured gain is taxed in the first year of the installment period, and the basis is adjusted by an amount equal to the recapture. This shifts the taxation of gain due to depreciation recapture on personal and real property from the entire installment period to its first year.

Example 4

Mike Fairfield sells his raised dairy cows, machinery, and equipment to son, Tom, for $260,000. The cows are valued at $120,000 and the machinery at $140,000. Tom will pay $20,000 down and $80,000 plus interest annually for 3 years. Mike's machinery and equipment have an adjusted basis of $64,000; its original basis was $200,000. Mike's gain on the sale of machinery and equipment is $76,000 ($140,000 - $64,000). The entire gain of $76,000 is recaptured depreciation under IRC section 1245, since the $136,000 ($200,000 - $64,000) of depreciation claimed in prior years is greater. Mike must recognize the $76,000 gain from the sale of the machinery in the year of sale. He will report the $120,000 cattle sale on the installment method.

A gain can occur if property is sold on the installment sales method to a relative, such as a spouse, child, grandchild, parent, or to a controlled corporation, trust, or estate. If the buyer, a relative, resells the property within 2 years, the original seller, must report the balance of gain from the original sale. This could consolidate into a single year, the gain that would have been reported over the remaining years of the installment contract. The resale rule does not apply if the second sale is also an installment sale where the payments extend to or beyond the original installment sale payments. The rule also does not apply after the death of either the installment seller or buyer, involuntary conversions of the property, and nonliquidation sales of stock to an issuing corporation.

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Chapter 13

DEPRECIATION, COST RECOVERY, AND IRC SECTION 179

INTRODUCTION

Farming is a capital intensive industry requiring heavy cash outlays for machinery and equipment. A farmer is allowed cost recovery or depreciation on machinery, equipment, and buildings. The farmer is also allowed depreciation on **purchased** livestock acquired for dairy, breeding, draft, and sporting purposes, unless the accrual method is used and the livestock is included in inventory. Depreciation is usually a significant expense on farm returns. This chapter concentrates on the rules for the Modified Accelerated Cost Recovery System (MACRS) and the expense election under IRC section 179.

DEPRECIATION AND COST RECOVERY

The same depreciation rules apply to farming as to any other business. Under MACRS, the recovery classes of property are 3, 5, 7, 15, and 20 years. In addition, most real property is classified as either residential rental, or nonresidential (commercial) real property, with assigned recovery periods of 27.5 and 31.5 years respectively. However, farm buildings, such as barns and machine sheds, are assigned a 20-year recovery period.

In addition to MACRS, farmers and other taxpayers have three options for depreciating property acquired after 1986. The options are:

1. Use straight-line method over the regular MACRS recovery period.

2. Use straight-line method over the regular Asset Depreciation Range (ADR) midpoint life (also known as class life or ADR class life). This method is usually referred to as alternative MACRS or alternate MACRS.

3. Use 150 percent declining balance method over the longer ADR midpoint life. This method is available for property other than real property, and is usually referred to as 150-percent MACRS or Alternative Minimum Tax (AMT) MACRS.

Depreciation on farm property placed in service after 1988 is limited to 150 percent declining balance on property used in a farming business with less than a MACRS recovery period of 15 years, rather than the 200 percent available for nonfarm property. This very important change was enacted with the Technical and Miscellaneous Revenue Act of 1988 (TAMRA-88). There is an exception to the 150 percent declining balance rule for property placed in service before July 1, 1989, that was under construction or under a binding written contract before July 14, 1988.

The MACRS class life depends on the Asset Depreciation Range (ADR) midpoint life of the property. See the following table:

MACRS Class	ADR Midpoint Life
3-year	4 years or less
5-year	More than 4 but less than 10
7-year	10 or more but less than 16
10-year	16 or more but less than 20
15-year	20 or more but less than 25
20-year	25 or more, other than 1250 property with an ADR life of 27.5 or more
27.5-year	Residential rental property
31.5-year	Nonresidential real property *

* 39 years for property placed in service on or after May 31, 1993.

Assets are placed in one of the eight MACRS classes, whether or not the farmer wishes to use a longer period resulting in a smaller depreciation deduction each year.

Alternative Minimum Tax (AMT) Adjustment

If the farmer is correctly using the 150 percent declining balance rate for farm assets placed in service after 1988, there will still be an Alternative Minimum Tax (AMT) adjustment. The 150 percent declining balance method for farm property under normal MACRS rules is calculated using the MACRS recovery period, but under AMT rules, the depreciable life is defined as the alternative MACRS life. Usually, this is a longer time span, and the adjustment will still be required in computing AMT.

See the following table for the recovery periods for common farm assets.

RECOVERY PERIODS FOR COMMON FARM ASSETS

Assets	**MACRS**	**Alternative MACRS**
Airplane	5	6
Auto (Farm Share)	5	5
Calculators	5	6
Cattle (Dairy or Breeding)	5	7
Citrus Groves	15	20
Communication Equipment	7	10
Computer and Peripheral Equipment	5	5
Computer Software	7	12
Copiers	5	6
Cotton Ginning Assets	7	12
Farm Buildings (General Purpose)	20	25
Farm Equipment and Machinery	7	10
Fences (Agricultural)	7	10
Goats (Breeding or Milk)	5	5
Grain Bin	7	10
Greenhouse (Single Purpose Structure)	10**	15
Helicopter (Agricultural Use)	5	6
Hogs (Breeding)	3	3
Horses (Nonrace, Less Than 12 Yrs. of Age)	7	10
Horses (Nonrace, 12 Yrs. of Age Or Older	3	10
Logging Equipment	5	6
Machinery	7	10
Mobile Homes on Permanent Foundations (Farm Tenants)	15	20
Office Fixtures & Furniture, Office Equip.	7	10
Orchards	10***	20
Paved Feedlots	15	20
Property with No Class Life	7	12
Pumps and Above Irrigation Equip.	7	10
Rental Property (Nonresidential)	31.5*	40
Rental Property (Residential)	27.5	40
Research Property	5	12
Sheep (Breeding)	5	5
Single Purpose Agricultural Structure	10**	15
Single Purpose Horticultural Structure	10**	15

Solar Property	5	12
Tile (Drainage), Water Wells	15	20
Tractor Units for Use Over-the-Road	3	4
Trailer for Use Over-the-Road	5	6
Truck (Heavy Duty, General Purpose)	5	6
Truck (Light, Less Than the 13,000 lbs)	5	5
Underground Pipe and Well	15	20
Vineyard	10***	20
Wind Energy Property	5	12

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* 39 years for property placed in service on or after 5/31/93.
** 7 if placed in service before 1989.
*** 15 if placed in service before 1989.

IRC SECTION 179 DEDUCTION

IRC section 179 expense election can be claimed on tangible, depreciable IRC section 1245 property, that is purchased for use in the active conduct of a farming business. Relating to farming, IRC section 1245 property includes the following:

1. Tangible personal property such as machinery, equipment, tools, and trucks. This **does not** include buildings and structural components.

2. Other tangible property or bulk storage facilities for **fungible commodities**. For example:

   a. Fences used in connection with raising livestock

   b. Paved feedlots

   c. Water wells that provide water for poultry, livestock or irrigation of crops

   d. Drainage tile

   e. Groves, orchards, and vineyards if productive

   f. Grain bins

   g. Corn cribs

h. Gas storage tanks

i. Silos.

3. Livestock, other than horses, used for breeding or dairy purposes (for example, purchased (but not raised) breeding cattle, hogs, and sheep, and dairy cattle). **Horses can never qualify for the IRC section 179 expense.**

4. Single purpose livestock or horticultural structures.

The election to take an IRC section 179 deduction must be made in the tax year the property is placed in service. The expense election is properly made on Part 1 of Form 4562. The election cannot be made on an amended return filed after the due date of the return (including extensions). The dollar limit of the IRC section 179 deduction is $17,500 for 1993 and 1994. For the cost of each dollar of IRC section 179 expense, property placed in service in excess of $200,000 in a tax year reduces the maximum expense allowable (but not below zero) by $1.

The $17,500 limit applies to both the partnership and to each partner. The partnership determines its IRC section 179 deduction subject to the limits. It then allocates the deduction among its partners. A partner who has IRC section 179 allocation from several sources, could be in a situation where not all of the IRC section 179 expense allocated could be used because of the $17,500 limitation. This also applies to S-Corporations and their shareholders.

The IRC section 179 deduction is limited by the net profit derived from the farmer's active conduct of all trades or businesses during the year. Net profit is computed before the IRC section 179 deduction. Any disallowed IRC section 179 deductions are carried forward to succeeding years. The deduction of current plus carryover amounts is limited to $17,500 in any year. Wage income is considered as income from a trade or business for this limitation (Prop. Treas. Reg. section 1.179-2(c)(5)(iv)).

Example 1

In 1993, ABC partnership placed into service qualifying property with a cost of $205,000. Because the cost of the property exceeds $200,000, the $17,500 maximum amount must be reduced dollar for dollar by the excess. The maximum dollar amount is $12,500 ($17,500 - $5,000). The partnership's business income for the year was $15,000. Accordingly, the full $12,500 is available for allocation to the partners.

There are two partners in the ABC partnership, Homer Ramsey and Ted Sharp.

Homer can deduct the full amount allocated to him ($6,250) because he has no other IRC section 179 property placed in service in 1993. However, Ted operates a farm that placed $16,000 of IRC section 179 property into service in 1993. The farm had taxable income of $12,000. Since Ted has $6,250 allocated to him from ABC, he can elect to deduct only $11,250 for the property used on his individual farm because his maximum IRC section 179 deduction is $17,500.

The following properties do not qualify for the IRC section 179 deduction:

1. Property acquired by gift or inheritance

2. Property acquired by estates or trusts

3. For property traded in, only the cash paid is deductible as an IRC section 179 expense

4. The property acquired from a spouse, ancestor, lineal descendant, or a controlled entity.

Listed Property

There are limits on the depreciation deduction a farmer may claim on listed property placed in service after June 18, 1984. If not used predominantly (more than 50 percent) in a qualified business, the IRC section 179 deduction on the property is denied. Furthermore, if placed in service before 1987, the property must be depreciated using the straight-line method over a longer life.

Passenger automobiles are listed property, including any four-wheel vehicle manufactured primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less unloaded gross vehicle weight. In addition, there are dollar limitation rules for the deduction the farmer may claim each year for passenger automobiles. The dollar limits change yearly (IRC section 280F).

Certain types of special purpose farm vehicles, such as tractors and combines, are excluded from the application of the limitations because they are suited only for use in the farming operation.

IRC section 179 Recapture

Gains from the sale of IRC section 179 assets are treated like IRC section 1245 gains. The amounts expensed are recaptured as ordinary income in the year the asset is sold. The IRC section 179 expense deduction is combined with depreciation allowed to determine the amount of gain reported as ordinary income on Part III of Form 4797. This also includes sales on the installment method.

If property placed in service after 1986 is converted to personal use, or if the business usage drops to 50 percent or less, the IRC section 179 recapture is applicable no matter how long the property was held for business use. The amount recaptured is the excess of the IRC section 179 deduction over the amount that would have been deducted as depreciation.

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Chapter 14

DEPLETION

INTRODUCTION

A farmer who owns an economic interest in mines; oil, gas or **geothermal wells;** other natural deposits, such as gravel, sand, and topsoil; or standing timber may deduct a reasonable amount for depletion. Economic interest exists if the farmer has a legal right to receive income from the sale of natural resources. The farmer does not have an economic interest if there is only a right to buy or process the mineral deposits or the timber.

The depletion deduction can be figured by either the cost method or the percentage method.

WATER DEPLETION

Farmers who extract ground water from the Ogallala Formation Aquifer for irrigation are allowed cost depletion as shown in Rev. Rul. 62-214, 1982-2 C.B. 115, amplifying Rev. Rul. 65-296, 1965-2. Cost depletion is allowed when it can be demonstrated that the ground water is being depleted and that the rate of recharge is so low that once extracted, the water is lost to the farmer and immediately succeeding generations.

Example

In 1981, Jim Wilcox, a calendar-year farmer, acquired some farmland on which he planned to irrigate his crops by extracting water from the Ogallala Formation. He paid $12,000 for the property. The cost of the land was $10,000, and the cost of improvements, $2,000. The improvements included an irrigation well, which was producing an ample supply of water from a reservoir, with a depletable saturated thickness on the date of purchase of 250 feet. Without the water, the land would have been worth only $6,000. At the beginning of 1982, the depletable saturated thickness was 200 feet. It decreased to 190 feet by the end of the year. In 1983, there was a further net decline of 20 feet. In 1984, the water formation actually rose above the previous year's saturated thickness, so there was no actual depletion of the water. In 1985, the water level sank 15 feet. Of this amount, 10 feet were merely recapture of the prior excess, so that only the net decline of 5 feet was depletable. It is assumed that in some year subsequent to 1985, the remaining water would be drained off, and from that time on there would be no more water to deplete.

The cost depletion computation and depletion summary for 1982 and subsequent years are shown below.

Cost of land and improvements at acquisition	$12,000
Less: Cost of Improvements	(2,000)

Cost of land (surface and ground water)	10,000
Less: FMV of surface land at acquisition	(6,000)

Cost of Ground Water at acquisition	$ 4,000
	========

Depletable saturated thickness of Ogallala Formation at the date of acquisition was 250 feet.

Depletion Summary

Year	Start of Year*	End of Year*	Net Decrease*	Unit Cost Per Foot**	Depletion Allowance***
1982	200	190	10	$16	$160
1983	190	170	20	16	320
1984	170	180	none	16	none
1985	180	165	5	16	80

* Saturated Thickness (in feet)

$$\text{** Unit Cost} = \frac{\text{Original Basis}}{\text{Number of Feet}} \quad (\$16/\text{foot} = \$4{,}000/250 \text{ feet})$$

$$\text{***Depletion Allowance for Taxable Year} = \text{Unit Cost Per Foot} \times \text{Decrease in Saturated Thickness}$$

PERCENTAGE DEPLETION

Farmers may use the percentage depletion method to compute depletion on certain mines, wells, and other natural deposits. This method may not be used for standing timber, soil, sod, dirt, or turf. To compute percentage depletion, multiply the property's gross income for the tax year by the depletion percentage for that type of property. The percentage depletion deduction cannot be more than 50 percent of the property's taxable income determined without the depletion deduction and any net operating loss deduction.

For tax years beginning after December 31, 1990, percentage depletion for oil and gas properties is limited to 100 percent of the taxable income from the property (IRC section 613). The 50-percent limitation still applies to all other depletable properties. This distinction is important because farmers often have oil and gas interests.

EXAMINATION TECHNIQUES

The following is a list of possible audit techniques to use when approaching a claimed water depletion expense. To determine if the computation of the water depletion is correct, refer to Rev. Proc. 66-22, 1966-1 C.B. 624.

1. Determine if the farmer has established that the land acquired is actually worth more due to the water available for irrigation purposes. (For example: What is similar land selling for that does not have a good water supply?)

2. Determine if the farmer is using the correct computation of the saturated thickness at the time of acquisition. The U.S. Geological Survey publishes a booklet annually listing the thickness of the Ogallala Formation and other aquifers in selected areas.

3. Determine how the water level computation was obtained. The U.S. Geological Survey takes annual readings on certain wells, usually in each county. Comparison between the farmer's readings and the U.S. Geological Survey readings could indicate whether or not the computation is accurate.

4. If the farmer has sold farmland on which water depletion was taken, the basis of the farmland must be adjusted by any cost depletion deductions claimed in prior years. Prior year returns should be inspected for any water depletion deductions.

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Chapter 15

SALES OF LIVESTOCK

INTRODUCTION

Most farmers today have more than one source of income from the farm. Very few raise grain or livestock exclusively. Today's farmer must diversify in order to survive. Many grain producers feed part of their raised corn, milo, and/or hay crops to their livestock. Thus, it is important to ascertain if a grain producer also has a livestock operation. By marketing crops through a livestock feeding operation, the farmer saves on handling and shipping costs of grain to be sold and of purchased livestock feed.

Corn and milo fields will have some grain the combine cannot retrieve, as well as husks and other residues that provide feed for livestock. This is an additional, inexpensive way to pasture and feed cattle in the fall and winter. For this reason, farmers may buy feeder calves to pasture on the harvested fields. Corn and hay crops would most likely be fed to purchased feeder cattle. Corn and milo crops could be fed to feeder pigs. The farmer who has substantial land in pasture and hay could also have a **cow/calf** breeding operation to utilize the pasture. A cow/calf operation is **ranching**, which is not included in this guide. Nonetheless, some information on ranching is necessary, since some grain producers may have a breeding herd. A hog breeding operation does not require land in pasture and hay, but does require grain and is quite labor intensive.

The type of livestock sold determines where the sale will be reported on the tax return. Income from all livestock held primarily for sale is reported on Schedule F. Receipts from the sale of **raised** calves or hogs are entered on Schedule F, line 4. Sales of livestock **purchased** for resale are entered on line 1 of Schedule F. A cash basis farmer deducts the purchase price in the year of sale on Part I of Schedule F, while an accrual basis farmer takes the deduction on Part III. Sales of livestock held for draft, breeding, or dairy purposes are reported on Form 4797 and can ultimately be reported on Schedule D.

Examination Techniques

Since sales of livestock on the Form 4797 are not included in self-employment income, a farmer may report non-qualifed livestock on Form 4797 to avoid self-employment tax.

SALE OF ITEMS BOUGHT FOR RESALE

Like other taxpayers in a trade or business, the farmer can purchase items which will be sold later. In the retail trade this would be inventory. For the farmer, these purchases can include such things as feeder calves and **feeder pigs**. Feeder calves are young beef cattle weighing around 500 pounds, which the farmer will feed and raise until they are ready to be sold. The weight at which the calves are sold depends on whether the farmer is **backgrounding** the cattle (putting them on pasture until they weigh 700 - 900 pounds), or holding them all the way the way through the **feedlot** to slaughter, at which time they would weigh 1,000 to 1,200 pounds. Feeder pigs are young swine weighing about 50 pounds when purchased, and are raised by the farmer until they reach market weight (200 to 240 pounds), at 6 to 9 months of age. Purchases of livestock for subsequent resale represent the largest category of items purchased for resale.

A unique difference between farmers and other businesses involves items purchased for resale. In other industries the IRS **requires** the taxpayer to use inventories and the accrual method of accounting to report income from the sale of purchased goods. A farmer may elect to use inventories and the accrual method of accounting, or the cash receipts and disbursements method. To the cash basis farmer, cattle and hogs purchased to be fed and resold are not technically inventory. This creates a unique bookkeeping problem. The purchase cost is treated as a deferred cost under IRC section 61, to be deducted on Schedule F upon the sale of the livestock. Other acquisition costs such as trucking and commissions should also be capitalized and added to the cost of the livestock (Rev. Rul. 80-102). The farmer must match the cost of the purchased items to the sale of those items. The potential for a double deduction of these items in 2 years is high. Remember, the cost of cattle or hogs cannot be deducted until they are sold.

Examination Techniques

1. The cost of calves purchased near the end of the year may be deducted on the Schedule F, even though they are on hand at the year's end and actually sold the following year. The expense could be deducted again when the cattle are sold. Purchases in the last 6 months of the year and sales in the first 6 months of the subsequent year should be scrutinized to verify that purchases were properly deducted in the year of sale.

2. Death losses on purchased livestock can be deducted at cost in the year of death. Be sure the deduction is not taken twice (for example in the year of death and again when the remainder of the livestock are sold). **No deduction is allowed for death losses of raised livestock.**

SALE OF LIVESTOCK HELD FOR DRAFT, BREEDING OR DAIRY PURPOSES

Livestock and dairy farmers often purchase breeding and dairy animals that appear on Form 4562, Depreciation and Amortization Schedule; however, livestock and dairy farmers may use animals they have raised for breeding and dairy purposes. Purchased breeding and dairy animals are depreciable on Form 4562, while raised animals are not.

It is important to differentiate between livestock held primarily for sale in the ordinary course of business, and livestock held for draft, breeding, dairy, or sporting purposes. Sales of the former are always reported on Schedule F, while the latter are properly reported on Form 4797. This is true regardless of whether the animals are purchased or raised. Farmers may try to report livestock held for resale on Form 4797 to avoid self-employment tax on those sales.

The holding period of draft, breeding, dairy, or sporting animals determines where on Form 4797 these sales are reported. The holding period for horses and cattle "used in the farming business" is more than 2 years (IRC section 1231). The holding period for all other livestock used in the farming business is more than 1 year. Breeding hogs (**sows** & **boars)** are the most common livestock in the more than 1 year category. If the holding period is not met, the gain or loss on the sale of livestock used in the farming business must be reported in Part II, Form 4797, Ordinary Gains and Losses. If the holding period is met, the gain or loss will be reported in either Part I or Part III. The gain on the sale of purchased livestock meeting the holding period and used in the farming business should be reported in Part III. Part III is used to properly recapture any ordinary gain on depreciable purchased livestock under IRC section 1245. The gain or loss on all other livestock (purchased or raised) meeting the holding period and "used in the farming business" should be reported in Part I.

DROUGHT SALES OF LIVESTOCK

Livestock producers who are forced to sell animals because of a shortage of water or feed, or other consequences of a drought, may be able to postpone the recognition of income from the proceeds of those sales.

There are two different tax treatments, both of which apply only to drought sales in excess of normal business practices. The first applies to draft, breeding, or dairy animals that will be replaced within a 2-year period. The second applies to all livestock, and allows a 1-year postponement of the reporting of sales proceeds.

Livestock Held for Draft, Breeding or Dairy Purposes (Tax Treatment #1)

If livestock (other than poultry) held for any length of time for draft, breeding, or dairy purposes is sold because of drought conditions, the gain realized on the sale does not have to be recognized, if the proceeds are used to purchase replacement livestock within 2 years from the end of the tax year in which the sale takes place.

Note: There is no required holding period for this provision as there is in IRC section 1231.

The new livestock purchased must be used for the same purpose as those sold due to drought -- breeding stock must be replaced with breeding stock, dairy cows with dairy cows, etc.

The farmer must show the drought caused the sale of more livestock than would normally have been sold. Only the animals that would not have been sold can be replaced without recognition of gain. For example, if the farmer normally sells one-fifth of the herd each year, only the sales in excess of one-fifth will qualify for this provision. Under this treatment, there is no requirement that the drought conditions cause an area to be declared a disaster area by the Federal Government.

The farmer has a basis in the replacement livestock equal to the basis in the livestock sold, plus any amount invested in the replacement livestock that exceed the proceeds from the sale of the animals replaced.

The election to defer the recognition of gain by reducing the basis of the replacement livestock is made by attaching a statement to the tax return including the following:

1. Evidence of the drought conditions that forced the sale or exchange of the livestock

2. A computation of the amount of gain realized on the sale or exchange

3. The number and kind of livestock sold or exchanged

4. The number of livestock of each kind that would have been sold or exchanged under usual business practices of the farmer with no drought.

Example 1

Mary Ramsey normally sells 10 cows from her beef herd each year. In 1992, drought conditions reduced her hay crop, so she did not have enough feed to carry her normal herd through the winter. Consequently, she sold 25 cows rather than

10 in 1992. She plans to purchase an additional 15 cows in 1993 to replace the extra 15 that were sold.

Only 15 of the cows sold in 1992 qualify for the deferral of gain due to drought. Mary can elect to defer the gain by:

1. Not reporting the gain on those 15 cows on her 1992 tax return, and

2. Attaching the following statement to the return:

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Election under IRC section 1033(e) to Postpone Recognition of Gain from Livestock Sold Because of Drought

The drought conditions evidenced by the rainfall report attached to this statement caused the taxpayer to sell 25 head of beef cows rather than 10 head in 1992. The raised cows have a zero basis. The 25 cows sold for a total of $12,500. Taxpayer elects to defer the recognition of gain on the 15 extra head that were sold (15/25 X $12,500 = $7,500 of gain) under IRC section 1033(e).

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If Mary Ramsey reinvests $7,500 on 15 replacement cows in 1992, she will have a zero basis in the replacement cows. If she reinvests more than $7,500 in 15 cows, the excess will be her basis in the cows. If she reinvests less than $7,500 in 15 cows, the excess of $7,500 over the amount reinvested must be reported as income. If she only buys 14 cows in 1993 and 1994, $500 of gain (for the cow not replaced) must be reported regardless of what she paid for the 14 cows. Mary should report the purchase of the replacement cows on her 1993 return. If there is additional income, it is reportable in 1992 by filing an amended return for that year.

Deferring Income to Subsequent Year (Tax Treatment #2)

If any livestock are sold because of drought conditions, the farmer may be eligible for another exception to the general rule that the sales proceeds must be reported in the year received. This exception allows the farmer to postpone reporting the income by one year.

In order to defer the income to the next year the following conditions must be met:

1. The taxpayer's principal business must be farming

2. The farmer must use the cash method of accounting

3. The farmer must show that the livestock would normally have been sold in the following year

4. A drought that caused an area to be declared a Federal disaster area must have caused the sale of livestock.

It is not necessary that the livestock be raised or sold in the declared disaster area, just that the drought that caused an area to be declared a disaster area caused the sale of the livestock. Also, the sale can take place before or after an area is declared a disaster area as long as the same drought caused the sale.

The number of animals that would normally be sold with no drought is determined primarily by the past history of the farmer. If the farmer generally holds all calves until the year after they are born before selling them, but was forced because of drought conditions to sell them in the year they were born, the proceeds from this sale may be reported in the year following the year of the sale. The computation for amount of income that can be postponed is shown in the following example:

> **<u>Example 2</u>**
>
> Because of drought conditions, Beau Perry sold 750 head of sheep in 1992, instead of the 500 head he normally would sell. He received $75,000 for the 750 head sold. He can postpone reporting the sale of only 250 sheep. The dollar amount is calculated by dividing the sale proceeds by the 750 sheep sold, and multiplying the result by the 250 for which he can postpone the proceeds. Therefore, ($75,000/750 X 250), or $25,000 can be reported in 1993, rather than in 1992.

The farmer has an option of reporting the income in the year of the sale or of electing to report the income in the following year. The election must be made by the due date of the return (including extensions) for the tax year in which the drought sale occurred. The election is made by attaching a statement to the return that includes the following information:

1. A declaration that the farmer is making an election under IRC section 451(e).

2. Evidence of the drought conditions that forced the early sale or exchange of the livestock and the date, if known, on which the area was designated as eligible for Federal assistance as a result of the drought conditions.

3. A statement explaining the relationship of the designated drought area to the early sale or exchange of the livestock.

4. The total number of animals sold in each of the 3 preceding years.

5. The number of animals that would have been sold in the taxable year had the farmer followed his or her normal business practice in the absence of drought.

6. The total number of animals sold and the number sold on account of drought during the taxable year.

7. A computation of the amount income to be postponed for each class of livestock.

This election applies to all livestock held for sale, whether raised or purchased for resale. It also applies to livestock used for draft, breeding, dairy, or sporting purposes and held for less than 2 years in the case of cattle or horses, and less than 1 year for other livestock.

Therefore, a farmer has an option for draft, breeding, or dairy livestock and horses held less than 2 years or for other livestock held less than 1 year. The farmer can elect to defer the income to the subsequent year per tax treatment #2, or if the animals are replaced, the farmer can exclude the gain on the sale, if the animals are replaced within 2 years of the end of the tax year of the sale, per tax treatment #1.

EXAMINATION TECHNIQUES

1. Look carefully at sales receipts. Sales of steers can be reported on Form 4797 as breeding livestock, when they should be reported on Schedule F. Also, heifers held for resale might be reported as sales of breeding livestock. Weight can be an indication of age and use. If the weight of the heifer is less than 900 pounds, she has probably been held less than 24 months, and was most likely not held for breeding purposes. The sale should be reported on Schedule F. Look carefully at sales receipts.

2. Some farmers use proceeds from sales of livestock to pay off loans used to acquire that livestock, or as payments on other farm or personal loans. The check from the sale is endorsed directly to the lending institution and might not be reported on the farmers books as income. A farmer's liability ledger should be inspected, and the source of payments verified to determine that no sales proceeds from livestock or grain were used to pay debts and inadvertently omitted from income.

   Along the same lines, farmers might use the proceeds from the sale of livestock to make down payments or totally acquire other assets, (for example, a pickup truck), and that sale could be omitted from income. Be sure and verify the source of all asset acquisitions.

3. If the farmer has cattle in a feedlot, it is possible to duplicate the feedlot expenses on the tax return. The feedlot writes the farmer a net check on the sale of the feeder cattle. A net check is the gross sales price of the cattle, less feedlot expenses such as, feed, veterinary, **yardage**, interest, etc., and is the amount actually paid to the farmer on disposition of the cattle. Sometimes only the net check is reported as income, and a deduction is taken for all of the feedlot expenses. If the net check is reported as income, ensure that none of the expenses withheld from the sales proceeds are deducted.

Chapter 16

CREDITS

INTRODUCTION

Like other businesses, the farmer is entitled to use various credits including general business credit and fuel tax credit. Some of the property qualifying for these credits is unique to farming. The Tax Reform Act (TRA '86) greatly limited the use of investment tax credits. As with other taxpayers, farmers' tax credit carryovers after 1986, must be reduced. Furthermore, the farmer has available a credit for rehabilitation of certain structures and a business energy credit. There will be instances when the farmer will be required to recapture investment tax credit.

Another credit the farmer may use is the fuel tax credit. This credit allows the farmer to avoid paying excise taxes on gasoline, diesel, and special fuels, when the fuel is used on the farm in off-road equipment and farm machinery. The fuel credit can present several examination issues. These issues include: claiming a credit when the farmer is not entitled to it; failing to report the credit as income; or claiming excess credits.

GENERAL BUSINESS CREDIT

There are several general business credits a farmer may use. Regular investment tax credit; forestation and reforestation; rehabilitiation credit; business energy investment credit; basis adjustment; carrybacks and carryovers; and recapture of investment credit are discussed below.

Regular Investment Tax Credit

TRA '86 greatly reduced the use of investment tax credits; however, the law did provide for certain exceptions, including forestation and reforestation.

Forestation and Reforestation

The farmer is allowed to claim the regular investment tax credit of up to $10,000 on forestation and reforestation expenses. The farmer must be in the business of growing trees for sale or for use in the commercial production of timber products. The basis in the property must be reduced by 50 percent of the investment tax credit claimed.

Rehabilitation Credit

Another credit the farmer might take advantage of is the rehabilitation credit. This is an investment credit taken for expenses incurred to rehabilitate or reconstruct certain buildings. The applicable credit rates are 10 percent of the expenses for buildings that were placed in service before 1936, and 20 percent for certified historic structures. The 20 percent credit applies to both residential and nonresidential buildings, while the 10 percent credit applies to nonresidential property only.

To claim the credit the farmer must substantially rehabilitate a building used in a trade or business. The rehabilitation must be done within a 24-month period selected by the farmer, and the expenses must be more than the greater of $5,000 or the adjusted basis in the building. This credit does not appear to be used much by the farming industry.

Business Energy Investment Credit

The business energy investment credit is equal to 10 percent of the basis of energy property placed in service before 1992 (subject to reduction if the property is financed by tax-exempt private activity bonds or by subsidized energy financing). No energy credit is allowed for that portion of the property's basis for which a rehabilitation credit is claimed.

Energy property includes:

1. Solar or **geothermal** property.

2. Property the construction, reconstruction, or erection of which is completed by the farmer (or for acquired property, the original use of the property must commence with the farmer).

3. Property subject to depreciation or amortization deductions.

4. Property meeting quality and performance standards in effect at the time of acquisition.

Basis Adjustment

The basis of property for which an investment credit is claimed is reduced by 100 percent of the rehabilitation credit and by 50 percent of the energy credit or the reforestation credit. The reduced basis is used to compute depreciation and any gain or loss on the disposition of the property.

Examination Techniques

The examiner must determine if the farmer is allowed to take any of these credits. If the energy credit is claimed, ensure that the property is actually one of the types for which the credit is allowed (for example, only some areas can use geothermal property in the United States). Finally, if the credit is allowable, determine if the correct reduction in basis has been made.

Carrybacks and Carryovers

In past years, many farmers accumulated substantial amounts of unused investment and other credits. These accumulations came about due to the poor farm economy and large investments in equipment. The rules for the use of unused credits are no different for farmers than for any other taxpayer. The farmer can carry the credit back for 3 years or forward for up to 15 years, using the credits in the order in which they were earned. Pay close attention to the unused investment credit. If it was not carried back prior to being carried forward, and the statute of limitations is closed on the return for the year in which the credit originated, the investment tax credit carryforward can be disallowed to the extent it should have been carried back.

A high percentage of farm returns have unused investment credit. This creates problems in carrybacks, carryovers, and recovery of the tax for adjustments made. This may result in no additional tax in the year of examination, but does reduce the unused investment credit. An examiner might be required to pick up a prior year return to correct the amount previously carried back and refunded.

TRA '86 provided a further reduction be made to credits carried over to 1987 and subsequent years. The basic rule is: Any portion of the business credit carryforward attributable to the regular investment credit that is carried into 1987 and subsequent years must be reduced by 35 percent. This is a one-time reduction.

Examination Techniques

During an examination, make sure the claimed carryover is correct. The best way to do this is to use copies of prior year tax returns. Math errors are often found and credits used have often not been deducted from the carryover amount. It is equally important to ensure that the one-time 35 percent reduction of investment credit carryover into 1987 was properly made. An examination of the depreciation schedule may indicate a disposition of assets without a reduction of the credit carryover.

Recapture of Investment Credit

The recapture rules for farmers, under IRC section 47, are the same as for other taxpayers. However, recapture is usually an issue on farm examinations because farmers frequently trade or otherwise dispose of equipment, and may fail to recapture the credit.

Dispositions

An outright sale of property is the clearest example of a disposition. Another type of disposition occurs when the farmer exchanges or trades worn-out or obsolete assets for new ones. There is also a disposition for recapture purposes if the property ceases to be qualifying property. Examples of this include: farm property converted to personal use, or a single-purpose livestock structure no longer qualifying as a single purpose structure. One of the most common dispositions made by a farmer is the sale or gifting of assets to a related party, often between the farmer and child or grandchild. Both of these dispositions result in a recapture of the credit. A related issue may also arise on the recipient's tax return, since investment credit is not allowed on acquisitions from a related party.

Foreclosure and bankruptcy have been common in the farming industry during the past few years. A transfer of property by foreclosure is a disposition. Property transferred to a trustee in bankruptcy to liquidate the assets and to make distributions to the creditors is also a disposition, at the time the assets are transferred to the trustee. Not all transfers of property are dispositions. A transfer by a farmer because of a change of doing business does not cause a disposition. A transfer between spouses due to a divorce and a transfer by reason of the death of the farmer are not dispositions.

Examination Techniques

An important thing to be aware of is that farmers frequently trade, transfer, gift, or sell assets, and may not recapture the credit. Look for assets that have been removed from the depreciation schedule from one year to the next for an indication that an investment credit recapture issue may exist. Also, be sure to ask about any abandoned or retired equipment while conducting a tour of the farm.

FUEL TAX CREDITS

There are two types of fuel tax credits that might be claimed on a farm return. The first is a credit for the payment of excise taxes on gasoline, diesel fuel, and special motor fuel used in farming. The second is a credit for the sale or use of alcohol as a fuel. This credit can be for straight alcohol or for alcohol in mixtures with other fuels.

Excise taxes paid by farmers are primarily imposed at the seller/distributor level; therefore, filing excise returns is usually not required. However, for required filinf checks, the examiner needs to be aware of situations where an excise tax return is required and when a tax can be refunded or claimed as a credit.

Federal Gas Tax Rates

	Diesel	Gasoline	Gasohol (10%)
Effective 12/1/90 through 9/30/93	20.1	14.1	8.7
Effective 10/1/93	24.4	18.4	13.0

Excise Tax Credit

In general, the farmer who owns, operates, or rents a farm may claim this credit for all fuels delivered to the farm with the tax included and used for farming purposes. The credit can also be claimed for the tax on fuel used on the farmer's farm by a neighbor or a custom operator who performed services for the farmer. The credit is determined by taking the number of gallons of fuel purchased (tax paid), and used off-highway for business, multiplied by the amount of tax per gallon. The primary matters to be resolved in this area during a farm examination are:

1. Was the fuel used for farm purposes?

2. How many gallons of fuel were actually used?

3. How many total gallons of fuel were purchased with tax included?

It is imperative to verify that the farmer is not claiming the credit on any fuel delivered tax free.

Farming Purpose

Gasoline is used for farming purposes if it is used in carrying on the business of farming in the United States by:

1. Cultivating the soil

2. Raising or harvesting any agricultural or horticultural commodity

3. Raising, shearing, feeding, caring for, training or managing livestock, bees, poultry,

or fur bearing animals and wildlife.

If a farmer has a custom operator do work on the farm, the farmer is allowed to claim the credit on the gallons of gasoline used on the farm by the custom operator, however, the farmer may not claim the credit for fuel used doing custom work for others on their farms. The point is, a person using fuel on another's farm cannot purchase diesel fuel tax free; nor can that person later file a claim or credit for refund for off-highway business use. The owner, tenant, or operator of the farm is deemed to be the ultimate purchaser of such fuel and is the only person who can claim the credit (Treas. Reg. section 48.6420-4).

Note: As of this writing, the regulations under IRC section 6420, pertaining to gasoline, have not changed. However, new proposed regulations regarding diesel fuel will allow custom harvesters to purchase clear diesel fuel tax free, as long as the fuel is for use on a farm for farming purposes. Please consult the current regulations before pursuing this issue.

Not Used for Farming Process

Gasoline is not used for farming purposes when used:

1. Off the farm, such as on the highway, even if used to transport livestock, feed, crops, or equipment.

2. In a highway motor vehicle even if most of the driving is on the farm.

3. For personal use such as mowing the lawn or boating.

4. In processing of farm products.

Diesel Fuel

One of the largest expenses to a farmer is for the diesel fuel used to operate tractors, combines, motorized machinery, and irrigation pumps. Diesel fuel is purchased from the distributor **tax free**. Every year the farmer must provide a certificate to the distributor authorizing the purchase of diesel fuel tax free. For purchases after January 1, 1994, the farmer can continue with the certificates or buy **dyed fuel**. Because of severe penalties for using dyed fuel in highway vehicles, the farmer will probably continue using certificates and purchasing undyed fuel. Farmers also use the high sulphur fuel that truckers cannot use.

The farmer may have diesel powered trucks, pickups, and automobiles which require **taxed** fuel. Tax-paid fuel could be obtained from gas station pumps in town or stored in a separate, on-farm fuel tank. Receipts and invoices will indicate if tax is paid. Use of tax-free fuel for taxable highway use from the on farm tanks requires filing Form 720 to pay the tax. The initial document request and interview should ascertain if there is an issue or concern.

New Tax Law on Dyed Diesel

A unique aspect concerning farmers and diesel fuel became effective January 1, 1994. Except for the period April 1, 1988, to December 31, 1988, farmers have had the privilege of purchasing diesel fuel tax free for "use on the farm for farming purposes." Since January 1, 1989, they have been required to execute and give the fuel vendor an exemption certificate certifying that all diesel fuel purchased tax free was to be "used on the farm for farming purposes." Such vendors are required to be registered with IRS on Form 637 as a "wholesale distributor." The certificate was renewable every 12 months. As a result of this law, farmers should not be taking a credit on Form 4136 for the tax on diesel fuel. Only in rare instances would a farmer have cause to claim a credit for diesel fuel. For example, a farmer might pay the tax on the fuel because the vendor was not registered with the IRS as a "wholesale distributor."

Effective January 1, 1994, the point of taxation on diesel fuel moved from the wholesale distributor level to the terminal rack. Each owner of diesel fuel at the terminal is liable for the tax on the sale of diesel fuel as it leaves the rack system. There is an exception to the tax if the fuel is either dyed red (according to IRS regulations), or dyed blue (according to EPA regulations). The blue fuel is high in sulphur and is for off-road use only. The red fuel is low in sulphur and also for off-road use, but there are some exceptions. Red fuel may be used in highway vehicles by State or local governments, school buses, qualified local buses, and intercity buses, among others.

Once the tax is paid on the undyed fuel at the rack level, there are two situations in which the fuel can be sold tax free:

1. To a state or local government for its exclusive use; or

2. To a farmer for "use on the farm for farming purposes" as defined in Treas. Reg. section 48.6420-4. Once again, the purchaser must make an exempt certification to the vendor. Since the provision was made for the farmer to be able to purchase undyed fuel tax free, the farmer may not file a claim for refund or take a credit on Form 4136. Only the ultimate vendor of the fuel may make such a claim. Thus, for periods after January 1, 1994, if the farmer pays the tax on the fuel and uses it on the farm for farming purposes, he/she is stuck with the tax. (No credit may be claimed for the tax paid, but it can still be deducted.)

Gasoline

Gasoline **cannot** be purchased tax free. The tax paid on this fuel is refunded only by claiming a refundable credit on Form 4136 and attaching it to the income tax return. Many farmers have gasoline powered tractor(s) and/or machinery used for farming that require claiming the credit. Older and smaller tractors are often gasoline powered, but are mostly used for nonfield or light field work, so the usage and credit should not be large in relation to the total fuel cost.

Since all gasoline is tax paid, there may not be separate, on-farm gas tanks for personal and business use. Thus, there will be no specific record of non-taxable use. The farmer's, and/or preparer's, workpapers can be used to determine the credit, and should indicate the gallons used for highway purposes. Be alert for the number of vehicles used by the farmer and family members. They may be using fuel in personal vehicles from the farm tank and not accounting for that personal fuel.

Claiming the Credit

Farmers claim the credit on Form 1040, using Form 4136 for the actual computation. The credit is considered prepaid, so the farmer will be refunded the amount claimed, even if no tax is due. If the farmer makes a claim for a fuel tax refund, and the fuel taxes were included in the deduction for fuel on Schedule F, **income must be included in an amount equal to the claim**. Reporting the income, the timing, and the credit, itself, are three important issues in the examination.

Cash Method

If the farmer is on the cash method of accounting, and has deducted the full cost of the fuel purchased as an expense on Schedule F, the claim for fuel tax refund will be made on the return for the year the taxes were paid. The refund is considered paid in the year the return is filed. The farmer then includes the amount of the claim as income on Schedule F in the following tax year.

Example

Frank Drew is a calendar year taxpayer. During 1992, he used gasoline on his farm for farming purposes, and deducted the cost of the fuel on Schedule F, including $100 of excise taxes paid on the gasoline. Frank claims a $100 credit on his 1992 tax return, when it is filed in 1993. Frank must then report the $100 as income on Schedule F of his 1993 tax return.

Accrual Method

An accrual method farmer must compute the amount of the credit due at the close of the tax year and include that amount in gross income on Schedule F in that same tax year.

Examination Techniques

Examination issues to be aware of include:

1. Credit claims for gasoline used in highway vehicles

2. Gasoline used in custom work

3. Gasoline used for nonfarm purposes

4. Claims for credits on diesel fuel purchased tax free.

There are several ways to verify the gallons allowable for the credit.

1. Many states refund the state taxes paid on gasoline used on the farm. Check to determine if any differences exist between the amount claimed for the state and the federal purposes.

2. During the initial interview, ask the farmer which equipment is diesel powered, as opposed to gasoline powered. On today's farms most of the big equipment is diesel powered. Ask the farmer about how many gallons of fuel a piece of equipment uses per hour, per day or per acre, and how much that piece of equipment was used. From this information, it is possible to compute the number of gallons used.

3. It is also possible to back into the allowable number of gallons available for the credit. Begin by computing the gallons of gasoline used in highway vehicles and subtract that number from the total gallons of bulk gasoline purchased to arrive at gallons used for farming. In general, the farmer has a good working knowledge of the highway use of vehicles, so ask questions. When looking at the purchase invoices, note the gallons of unleaded gasoline purchased, since it is generally unsuitable for farm-equipment use.

4. Request the invoices to determine that the gallons were actually purchased with the tax included. From the invoices, it is possible to determine the total number of gallons of diesel fuel, leaded and unleaded gasoline, and any other special motor fuels purchased. It is also possible to determine from the invoices if the taxes were

paid when the fuels were purchased.

To verify the amount of fuel tax credit that must be included in income in the year under examination, all that is necessary is to inspect the farmer's prior year tax return and note the amount of fuel tax credit claimed in the prior year. This is the same amount that must be included in income for the current year.

IRC Section 6675 Penalty

IRC section 6675 provides that if a person makes a claim related to gasoline used on a farm for an excessive amount, and it was not due to reasonable cause, there is a penalty equal to the greater of the following amounts:

1. Two times the excessive amount; or

2. $10.

The penalty applies when nonfarmer claimants and custom operators claim the credit, or when farmers claim the credit on the total gallons of gasoline purchased, rather than the amounts used for farming purposes. Form 4136 clearly states what is a farm purpose and who is entitled to make a claim for the credit. Therefore, a farmer making an improper claim normally does not have reasonable cause, and the penalty should be computed and proposed.

GLOSSARY

Agricultural (ag) Subsidy Payments -- Any of the many different types of payments from the government for various farm programs. These payments are ordinary farm income.

Aquifer -- A water bearing rock formation under the ground.

ASCS -- Agricultural Stabilization and Conservation Service. As an agency of the USDA it administers programs concerning farm products and agricultural conservation.

Backgrounding -- Putting cattle on pasture prior to movement to a feedlot. The cattle usually remain on pasture until they weigh 700 to 900 pounds.

Baler -- The machine used to bale hay.

Bales -- Hay that has been cut, bound and tied into "packages." Bales can be as small as 50 pounds and as large as 2,000 pounds.

Barrow -- Castrated male hog.

Bloat -- A swelling of the rumen or intestinal tract of a domestic animal, caused by the gases from fermentation of green forage.

Boar -- A mature male hog which is part of the breeding herd.

Bottom Land -- Low-lying land along a stream or river.

Bred Heifer -- A cow pregnant with her first unborn offspring.

Breeding Livestock -- Mature male and female animals that are used to reproduce offspring. The offspring are then sold as a product of the farm.

Broadcasting -- Planting seeds by scattering them over the land.

Buck -- An adult male sheep.

Bull -- A mature male cattle which is part of the breeding herd.

Butcher Hogs -- Purchased as feeder pigs at a weight of 40 to 50 pounds and raised until 6 to 9 months old. Their normal selling weight is 200 to 240 pounds.

Calf -- Young cattle less than a year old.

Calls -- An option to purchase a commodities futures contract.

Cash Market -- A market where the actual commodity is bought and sold through individual deals between buyers and sellers for immediate delivery against payment. (AKA, Physical or Spot Market).

Cash Price -- Price in the cash market for actual or spot commodities with delivery through customary market channels.

CCC -- Commodity Credit Corporation. It is a corporation within the USDA, wholly owned by the U.S. Government. It conducts price support, export, and storage programs. In carrying out these programs, it engages in buying, selling, and lending activities.

CCC Loans -- Government loans made by the CCC.

Center Pivot -- A method of irrigation by which water is sprinkled on fields from overhead pipes that move across the field on drive wheels.

Closing Option Transaction -- Cancels a previously established long or short option position.

Colt -- A young male horse, or a horse under a year old.

Colter -- The blade or wheel on a plow which makes vertical cuts in the sod.

Combine -- A piece of equipment used to harvest crops. Different attachments to the front of the combine adapt it for various crops.

Commodity -- An economic good (for example, agricultural product) or an article of commerce.

Commodity Certificates -- Specially designed certificates with a dollar amount specified. They also show the issue date, county where issued, expiration date, type of commodity, and individual to whom issued.

Conditioning -- The act of crushing the plant stalks of cut hay (for example, alfalfa or brome) to allow faster drying.

Conservation Expenses -- Costs related to water and soil conservation programs (for example, terraces, water ways and dams).

Conservation Tillage -- Using no-till or low-till methods of planting crops to preserve moisture and prevent erosion on highly erodible land.

Cooperative (Co-op) -- An enterprise owned by and operated for the benefit of those (farmers) using its services.

Cow -- A mature female cattle which is part of the breeding herd.

Crib -- A grain bin that has heavy wire or wooden slatted sides used to store and dry corn.

Crop Method of Accounting -- A method of accounting in which the entire cost of producing a crop must be deducted in the year the income from the crop is realized.

CRP -- Conservation Reserve Program. It is designed to take highly erodible crop land out of production for a 10-year period.

Cull Cows -- Female cattle which are no longer productive or profitable.

Cultivation -- The act of preparing and improving land by fertilizing or working the soil.

Cultivator -- A piece of equipment used to turn the soil and kill weeds in all row crops. It is only used after the crop has come up and very seldom used after the crop gets over 2 to 4 feet high.

Deferred Product Sale -- The sale of a farm commodity by a cash method farmer using the contract to fix sale value at time of delivery, but deferring receipt of the proceeds until the following tax year.

Deficiency Payment -- The difference between the county loan rate and the posted county price. It is paid to the farmer if market prices on grain are less than target prices set by ASCS.

Disk (disc) -- An implement used to work up the soil. It is a harrow with a series of disks (thin, flat circular plates) set on edge or at an angle on one or more axles.

Double Cropping -- The practice of harvesting two separate crops from the same field in the same year. Normally the two crops will include wheat and either soybeans or milo.

Drill -- An implement used to plant seeds. It has cutting edges that are used to sow seeds into rows or furrows.

Dyed Fuel -- Diesel fuel colored to indicate it is for off-road use only, and whether it is high in sulfur (blue dye) or low in sulfur (red dye).

Elevator -- A large storage building used to store grain produced by the farmer. (Usually owned by a co-op.)

Ewe -- An adult female sheep.

Fallow -- Land that has been tilled or plowed and then left unseeded during a growing season.

Farm-Price Method of Inventory Valuation -- Inventories are determined by the current price at the nearest market less the direct cost of disposition.

Farming -- The act of cultivating, operating, or managing a farm for profit, either as an owner or a tenant.

Farrow -- A verb, meaning to give birth. This term is used with hogs.

Fat Cattle -- A term used on the commodities market for feeder cattle ready for slaughter.

Federal Crop Insurance -- Another name for Multiple Peril Crop Insurance, since policies are sold or reinsured by the Federal Crop Insurance Corporation.

Federal Land Bank -- The land bank was authorized by Congress in 1916. It provides long-term loans (5 to 40 years) to farmers. Farmers may receive loans for general agriculture purposes, such as buying land and constructing or remodeling farm buildings.

Feeder Cattle -- Steers or heifers generally purchased at the age of 6 to 9 months and at a weight of 500 to 700 pounds. They are fed in a feedlot until ready for slaughter at 12 to 14 months of age, when their normal selling weight is 1,000 to 1,200 pounds.

Feeder Pigs -- Pigs held until 6 to 8 weeks of age. Their usual selling weight is 40 to 60 pounds.

Feedlot -- A place used to feed out cattle for slaughter.

Filly -- A young female horse.

FmHA -- Farmers Home Administration. It is an agency of the USDA that provides loans to farmers for farm supplies, land purchases, and living needs. In most cases it will only lend money if the farmer has no other source of credit.

Foal -- A colt or filly less than a year old.

Forfeiture -- A term used in agriculture to denote when a farmer turns over pledged grain to the CCC in satisfaction of a loan.

Forward Contracts -- A contract that is entered into between two parties for delivery of a specified quality and quantity of a commodity at a specified future date for a price agreed upon in advance or to be determined at the time of delivery. A forward contract is not traded on an established exchange or board of trade.

Fungible -- Of such a kind or nature that one specimen or part may be used in place of another specimen or equal part in the satisfaction of an obligation.

Fungible Commodity -- A commodity where one part cannot be identified from another (for example, corn, wheat, oats, soybeans, and like grains).

Furrow -- A long, narrow, shallow trench made in the ground by a plow or other farm implement.

Futures -- A term used to designate standardized contractsfor purchase and sale on a commodity exchange of commodities for future delivery.

Futures Contract -- A firm commitment to deliver or to receive a specified quantity and grade of a commodity during a designated month with the price determined by public outcry of exchange members.

Gelding -- A castrated male horse.

Geothermal -- Having to do with the internal heat of the earth.

Geothermal Well -- A water source which flows through a geothermal heat source, providing warm water.

Gilt -- A female hog less than a year old.

Grain Bin -- A round metal building used to store grain on the farm.

Hard Winter Wheat -- Wheat that is planted in the fall and harvested in late spring or early summer of the following year. It is milled for flour.

Harrow -- A farm implement having a heavy frame with sharp teeth or upright disks, used to break up and level off plowed ground.

Hedge -- A transaction that a taxpayer enters into in the normal course of it's business primarily to reduce the risk of interest rates, price changes, or currency fluctuations.

Heifer(s) -- Female cattle that have not produced a calf.

Herbicide -- Chemicals used to destroy weeds.

Herd -- A group of cattle.

Highly Erodible Land -- Land that is subject to severe erosion from wind, rain, etc.

Horticulture -- The science or art of cultivating fruits, vegetables, flowers or plants.

Irrigate -- To supply dry land with water by means of ditches, pipes, or streams.

Lamb -- Any sheep less than a year old.

Lambs, Feeder -- Generally purchased at about 20 pounds and raised until 8 or 9 months of age. Their normal selling weight is 90 to 100 pounds. They are usually purchased in early summer and sold in late fall of the same year.

LDP -- Loan Deficiency Payment. It is the difference between the county loan rate and the posted county price.

Legume -- A plant that has pods that split into two valves with the seeds attached to the lower edge of one of the valves. This typically includes peas, beans, clover, and alfalfa.

Litter -- A collective term for pigs farrowed by a sow.

Long Position -- The portion of a balanced transaction in futures represented by a purchase or contract to purchase.

Machine (Custom) Work -- Work performed by the farmer, or hired help, on someone else's farm.

Mare -- An adult female horse.

Margin Money -- Cash or its equivalent posted as a guarantee of fulfillment of a futures contract. It is not a part payment or purchase.

Market Gain -- The difference between the original CCC loan made to the producer and the lower amount for which the loan was settled.

Multiple Peril Crop Insurance -- Crop insurance against major disasters such as drought, frost, hail, and wind.

No-Till, Low-Till -- Methods of preparing land for planting that allow plant residue to be maintained in the field to reduce erosion.

Opening Option Purchase -- A transaction by which an investor establishes a position in the options market.

Options -- The right to buy or sell something in a specified period of time and at a specified price.

Patronage Dividends -- All farmers who purchase feed, seed, fertilizer, gas, etc. from the co-op receive patronage dividends on these purchases. These dividends constitute ordinary farm income.

PCA -- Production Credit Association. It is a non-governmental agency, which makes government insured loans to farmers. The PCA generally provides a line of credit to the farmer.

PCP -- Posted County Price. It is computed by taking the terminal price less the county differential for two different locations in a county. The higher of the two rates is the PCP for that business day.

Per-Unit Retain Certificate -- Written notes stating amount of an allocation to the farmer by a co-op for products sold for the farmer. It can be paid in money, other property, or qualified certificates. It receives the same tax treatment as patronage dividends.

Pesticides -- Chemicals used to kill pests, especially insects and rodents.

PIK -- Payment In Kind (for example, payment in bushels of grain, bales of cotton, etc.). Payments under this program are no longer being made to farmers.

Planter -- A farm implement used to plant (drill) small grain, (for example, wheat and oats) into close furrows (rows). Row crops such as corn, cotton, and soybeans are planted with a row planter that uses widely spaced rows instead of close furrows.

Plow -- A piece of farm equipment used to cut, lift, and turn over soil in preparation for seeding.

Pre-Plant -- The process of applying fertilizer to fields prior to planting seeds.

Price Later Contract -- A contract for the sale of a product with title to the product passing to the buyer upon delivery of the product, and payment for the product made at a later date.

Producer -- A term used by the ASCS to designate the farmer or person entitled to participate in farm programs.

Purchase Money Debt -- A purchaser's debt to a seller of property which arises from the purchase of that property.

Puts -- An option to sell short a commodities futures contract.

Quonset -- A steel building with a semicircular roof, used for work space, storing equipment, and storing grain.

Rake -- An implement used to gather and turn cut hay.

Ram (Buck) -- A male sheep.

Ranching -- The act of raising livestock (for example, cattle, horses, or sheep).

Redemption (Redeemed) -- Repayment of a CCC grain loan by the farmer.

Residual Fertilizer -- Fertilizer from previous applications which has not been depleted by crop production and is still active in the soil.

Rotary Hoe -- A farm implement like a harrow consisting of a series of freely turning spike-rimmed wheels.

Row Crops -- Crops that are planted in rows approximately 18 to 30 inches apart.

SBA -- Small Business Administration. It is an independent agency of the U.S. Government, that promotes and protects the interests of small businesses and farmers, by offering aid in the form of loans, counseling, and information on management.

Scrip -- A written notice of allocation or per-unit retain certificate, evidencing an obligation from the cooperative to the farmer. It may be qualified or nonqualified.

SCS -- Soil Conservation Service. It provides engineering services to farmers.

Sealed -- A common term used to describe grain under CCC loan stored on the farm.

Share Cropping -- A process by which a land owner and a tenant farmer, farm the land or raise livestock, and share the expenses and income according to a prearranged agreement. (AKA, Crop Sharing).

Shoat -- A young hog weighing 100 to 150 pounds.

Short Position -- The leg of a balanced transaction in futures that is obtained by the sale of a future. A short position is terminated by an offsetting purchase or by delivery of the underlying commodity.

Sickle Mower -- An implement used to mow hay.

Side-Dressing -- The process of applying fertilizer with the seeds during planting.

Silage -- A form of feed for livestock. It is made by putting grain in a silo or bunker and allowing it to ferment.

Silo -- A tall cylinder structure usually constructed of metal, wood, or concrete. It is sealed to exclude air, and primarily used for making and storing silage.

Soft Spring Wheat -- Wheat that is planted in the spring and harvested in the fall. It can be used as feed or as flour for pasta.

Sow -- A female hog.

Speculate -- The creation of risk with the hope of making a profit on commodity futures. Gains and losses from speculative commodity transactions are entered on Form 6781 and flow through to Schedule D.

Speculator -- An individual, not a hedger, who trades for profits by anticipating price movements.

Stallion -- A breeding male horse.

Steer(s) -- Castrated male cattle, either dairy or beef, raised for sale as meat.

Straddle -- A common investment strategy entered into to take advantage of price differences between the bought and sold positions.

Swather -- A machine used to cut hay or grain. A mowing machine blade cuts a wide path. The hay or grain is then left in long windrows behind the machine.

Tassel -- The pollen-bearing inflorescence on a corn plant resembling a tassel.

Tenant Farming -- Tenant farmers may have a share cropping (crop sharing) arrangement with the land owner. Generally the owner provides land, buildings, and pays half of the production expenses. The tenant farmer then provides the labor, equipment, and the other half of the production expenses.

Unit-Livestock-Price Method of Inventory Valuation -- Livestock is grouped or classified according to kind and age, and a standard unit price is assigned for each animal within a class or group to determine inventory.

USDA -- United States Department of Agriculture. It works to maintain adequate supplies of farm products, to expand overseas markets for farm products, and to ensure reasonable prices for both farmers and consumers.

Warehouse Receipt -- A document evidencing possession by a licensed warehouse of the commodity named in the receipt.

Weanling -- A young animal just weaned from its mother.

Wether -- A castrated male sheep.

Windrower -- An implement used to arrange cut hay or grain left in a field to dry into long rows, prior to baling.

Yardage -- The fee paid for the use of the feedlot.