

Internal Revenue Service
Audit Technique Guide

Farmers

July 2006

Provided by:
Independent Accountants Association of Illinois



Distributed by the Independent Accountants Association of Illinois, whose members are small businessmen serving the accounting and tax needs of small businesses and individuals. Members and their clients need to know what weaknesses and warning signs they have with their own accounting and tax systems – AND to learn how to improve them.

Internal Revenue Service

Farmers

Audit Technique Guide (ATG)

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The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *U.S. Government Printing Office Style Manual*.



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Audit Flow

Purpose of Guide

The Information Document Request

The Pre-Audit

The Initial Interview

The Audit

Purpose of Guide

This guide has been written to provide you with a general understanding of the farming operation. It is important to have an understanding of the various facets of a farm operation in order to adapt auditing techniques to different situations. Agriculture continues to be the major industry in many states.

CAUTION: Agriculture is subject to both economic and weather fluxuations. Production and yeild differences may exist between different areas of the country or even within a state. Examiners need to be conscious of these elements that may affect the examination.

Compliance Potential

There are several reasons why farming might lend itself to underreporting income. Some of these reasons are:

1. Most income is received from non-information return sources.
2. Crops are not sold on a daily basis.
3. Books may be very elementary (e.g., a single entry system).
4. There may be a lack of internal control since the farmer is responsible for receiving, recording and depositing all income.
5. There may be no internal controls to test income.

Example

A farmer received, recorded and deposited all his income. The money received was deposited into two different bank accounts. The farmer showed one of the accounts to the agent and everything checked out. He failed to mention the other account. The agent looked at bank deposit statements, grower year end statements and traced the income. She discovered another account which had almost \$700,000 in it. The taxpayer's response was he received this income and deposited the income to the other account. He would only withdraw money from this account as needed, and at that time, he would report the money as taxable. This was the taxpayer's way of deferring his income. Income is reportable as received per IRC § 61. The agent made the adjustment and collected the tax due.

General information has been provided in the following pages that may be useful in your examinations.

The Information Document Request (IDR)

Audits of farms are helped by the use of specific Information Document Requests (IDR) and initial interview questionnaires. Examples of farm questions for IDRs are:

- Hours worked on the farm, including the spouse, especially if there is a potential Passive Activity issue.
- Detailed depreciation schedule.
- Records of all loans and repayments.
- Grower statements and other primary income records.
- Deferred Payment contracts, if applicable.
- Crop maps with acres, type of plants and year of planting.
- Crop reports including insurance damage reports.

These are guides only for requesting information relating to different farming entities. Always look to customize the IDRs based on local information, information in other chapters applicable to your taxpayer, and your specific knowledge of the taxpayer.

Try to use the front-loading technique, if possible. Front-loading is requesting certain items in the IDR be mailed to your office before the initial interview. In the case of a farmer, items to be requested up-front include:

1. Copies of prior and subsequent year returns.
2. Copies of shareholder or partner returns.
3. The working trial balance.
4. Listing of all related entities, including ownership percentage and business relationship.
5. The crop map.

By requesting this information before the initial interview, you can perform a productive pre-audit of the farmer and set a more accurate preliminary scope of the examination.

The Pre-Audit

The Structural Analysis

One of the most important items in the audit process is the structural analysis. A good structural analysis can lead an examiner to a variety of issues not apparent from visual inspection of the return. It can also lead to the examination of other entities which could prove to be more productive than the initial entity under exam. It is very important to determine during the pre-audit what other entities are involved. This can be started by requesting a listing of related entities before the initial interview. It is important to document if there are no related entities. For most farmers this usually isn't the case. Just because the farmer owns no direct interest in another farming entity, does not mean there are no related parties. During the interview, question the farmer about family members who farm or who own a farm-related business (i.e., supplier, packer, broker, etc.).

Under IRC §267, Transactions Between Related Parties, the definition of related parties is very broad and can cover a variety of situations. (See Chapter 2, Income).

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The structural analysis needs to include:

1. Ownership percentage in an entity
2. Business transactions including:
 - Services provided or shared
 - Crops sold or marketed
 - Items rented or leased
 - Any lending activity
3. Each entity's accounting method
4. Each entity's fiscal year end

The following is an example of what should be included in a structural analysis:

There are two 1065 farm taxpayers A and B. The initial entity was 1065 taxpayer A. There is also an 1120S Processor entity, an 1120 Harvester entity, and two related 1040's – taxpayers 1 and 2. All are cash basis.

As background:

- Processor processes for all farms mentioned and non-related farms.
 - Harvester harvests for related farms and 1040 taxpayer 1's sole proprietorship.
 - Processor advances money to both 1065 farms, but not to 1040 taxpayer 1.
 - 1040 taxpayer 1 rents processing plant to processor
 - 1040 taxpayer 2 loans money to harvester
 - both 1040's own directly 50% of each 1065 and 1120S
-

All of this information will probably not be available during the pre-audit, but as your structural analysis flow-chart is updated, new issues can emerge. K-1 linkage software will hopefully provide more up-front information in assigned cases.

Choice of Entity

There are many reasons why a farmer chooses to operate in a particular type of entity. Many of these reasons are not tax motivated. They include such considerations as water rights, workman's compensation insurance, government regulations, estate planning, and simplification of accounting systems. However, the form of entity can also have tax implications.

Sole Proprietorships

There are many small farms still being operated as sole proprietorships. This is the simplest method for the farmer. Many farmers want their families to continue farming in future generations. To bring their children into the farming business, many sole proprietorships are at some point in time converted to another entity.

Corporations

Corporations do offer liability protection. However, for large farming operations this usually is not the entity of choice. The accrual accounting methods under IRC § 447 for corporations engaged in farming, can have a substantial tax effect for large farming businesses. Under IRC § 447, S-Corporations are not considered to be corporations and are exempt from the accrual requirements (See Chapter 2, Income). Always remember to include a corporation's share of pass-through gross receipts to determine if IRC § 447 applies.

Partnerships and S-Corporations

It may be more advantageous for the large farmer to separate his activity into multiple partnerships and S-Corporations. As long as no C-Corporations are involved, the farmer has full use of the cash method of accounting. Business operations can be divided in a number of ways. They usually are divided by operation, such as ginning, harvesting, processing, marketing, and farming. In some cases, they are also fragmented by ownership. A farmer may have various ownership percentages in many entities that farm. It is also common for a farming entity to join in a partnership with another farming entity to create a new entity that provides a service for each farm. In this way the farmer is able to control all levels of production of his crop, from planting to eventual sale to the consumer.

CAUTION: When examining either of these types of entities, remember the material participation rules of IRC § 469. All partners or shareholders may not be materially participating. Consider the material participation/passive activity issue before IRC §183 Not Engaged in for Profit.

Family Limited Partnerships

Family Limited Partnerships (FLP) are typically an estate planning tool. The use of FLPs is becoming more common in many different areas. Farming is only one industry utilizing the FLP. FLPs transfer assets from an older generation to a younger generation. This can be done by creating a partnership to which a farmer transfers assets, such as land. The farmer then gifts limited partnership interests to his children while he maintains a general interest. Usually the general interest is a small percentage while the limited interests are quite large. It is important to note the farmer is gifting an interest in the partnership, not an interest in the partnership's assets. If this is all done correctly, the farmer is able to avoid substantial gift taxes by discounting the value of the limited partnership interest. The discounting can easily be from 20% - 50% of the value of the assets.

Example

Farmer A and his wife form a partnership contributing land with a FMV of \$1,000,000. The value of the limited partnership interests is discounted to \$500,000. They then each gift limited partnership interests as follows:

\$11,000 each to four children and their spouses (2x11X8)	\$176,000
\$11,000 each to a trust with their 10 grandchildren as beneficiaries (2x11x10)	<u>\$220,000</u>
Total tax free gift	\$396,000

If they had given the land and not the limited partnership interest, the taxable gift would have been \$302,000 for each spouse (\$1,000,000 - \$396,000 divided by 2). But since they chose to use a FLP, the taxable gift is \$52,000 for each spouse (\$500,000 - 396,000 divided by 2).

Note that the annual exclusion amount per donee for gift taxes changed in the 2002 tax year to \$11,000.

This can be a substantial savings in both gift tax and in the use of the unified credit, see IRC § 2505, Unified Credit Against Gift Tax. If the discount appears to be excessive or questionable, consult with an estate tax attorney. There are numerous factors that need to be considered when reviewing a FLP. These are outlined in IRC § 704(e), Partner's Distributive Share, and explained in detail in *Tax Management Portfolio 722-2nd, Family Limited Partnerships*.

Trusts

Many large farming businesses use trusts as part of their operations. This is usually done for estate planning purposes. The auditing of trust returns is within the scope of the general program revenue agent and should always be considered when reviewing a multi-entity farm. Auditing a farming trust is essentially the same as auditing any other farming entity. The only real differences are in the areas of distributions and report writing. The area of distributions can be complex and if distributions are an issue, further research on the part of the agent will be required.

Items to consider when reviewing a trust return are:

1. What kind of trust return are you reviewing?
 - a. Complex Trust - These are taxed at a higher rate than individuals. If this is a complex trust, is income correctly being taxed at this level or is the trust diverting income to an entity with a lower tax rate?
 - b. Simple Trust - If this is a simple trust, it passes income to trust beneficiaries, but cannot pass-through operating losses.
 - c. Grantor Trust - Usually a return is not required to be filed for a grantor trust. It is an estate planning tool commonly referred to as a living trust.
2. If trusts are for the benefit of minor children, are their parents including distributions made to the children as income for relief of support obligations? (*IRC § 677, Income for Benefit of Grantor.*)

3. Is the trust really a trust?

These are just a sample of the questions that can arise in the area of trust audits. If you open a trust return for examination, there are many sources of useful information:

- *Federal Income Taxation of Estates and Trusts* published by Warren, Gorham & Lamont is an excellent source for trust information. Various trust topics are also detailed in some of the Tax Management publications.
- *Tax Management Portfolio 700-2nd, Choice of Entity* details the rules regarding taxing trusts as associations. This portfolio also covers many different aspects regarding choices of entities.

Limited Liability Partnerships (LLP) and Limited Liability Company (LLC)

LLPs and LLCs are fairly new types of entities. There is some case law available. The purpose of LLPs and LLCs is to shield the owners from liability while avoiding the double taxation of using a corporation. LLPs and LLCs are more advantageous than S-Corporations. They have limited liability in pass-through form and partnership advantages such as: the inclusion of all entities' liabilities in basis, ease of contributions, and distributions of property. In farming entities, what often happens is, an LLP or LLC is formed for the operation of the farming business only, not for the holding of the assets. The assets are frequently being held by other entities. This may shield the owners from any lawsuits pertaining to the business.

Look at the following areas of the returns for potential issues:

1. If assets are being kept out of the LLPs and LLCs to shield them from creditors, are the assets being rented from related parties at fair market value?
2. The liability section of the balance sheet is also a significant area of interest. The members are able to claim their share of most entity liabilities in basis, but there are numerous additional rules regarding who is liable for which liability. The at risk rules of IRC § 465 also apply to losses from LLPs and LLCs.
3. How it was formed is an important issue to address. Was it previously a corporation or a partnership? This could trigger taxable events such as distributions, corporate liquidations, etc.

Most code sections under Subchapter K apply to LLPs and LLCs. There are also private letter rulings regarding many aspects of LLPs and LLCs. *Tax Management Portfolio 725-2nd, Limited Liability Companies*, is an excellent source of information regarding the tax treatment of these new entities.

The Crop Map

Always request a complete crop map for the year under audit. Have the farmer include: acres of each crop planted and/or vacant, which parcels are owned and which are

rented, location of one parcel compared to another, and the year planted for trees and vines. This can be a valuable tool in many areas of the exam.

The crop map can be used to determine the farm area to tour. Touring row crop parcels miles away from the farm shop can be a waste of valuable time. Vacant land owned by a farmer who has trees and vines could warrant a physical inspection. Remember, the crop map is for the year of audit and the actual tour is at least one crop year later. In row crop farming, the tour and the map won't coincide due to crop rotation.

The crop map can be a useful audit tool. You can:

1. Compare the map with industry averages
2. Compare the crop map with lease agreements. Verify income and expenses are properly allocated.
3. Map out distances between parcels. How far away is one parcel from another? Some parcels are located in other counties. How does the farmer transport equipment from one location to another? Should there be highway use tax returns or are some parcels being harvested by other parties?
4. For trees and vines, review the map for the year planted to see if IRC § 263A, Uniform Capitalization of Costs--UNICAP should be considered (See Chapter 4, Expenses). Always take the year planted under consideration when estimating income using industry averages. New plantings take years to come into full production and should always be considered.

Using Industry Averages

Industry averages can be tools in estimating both income and expenses. They can be used to either expand or limit the scope of your audit.

Income Averages

For income averages, contact your local county department of agriculture for production in your area. In many states, these county crop production reports are published yearly and include all crops produced in the county. They can also include highlights of that specific crop year. Here you can learn about major storm or insect damage to a particular crop and timetables for each crop from planting to harvesting. The information you will be focusing on is the production per acre and the value per unit. By using the crop map provided by the farmer you can compute the estimated income by multiplying acres planted on the map, times production per acre, times value per unit and comparing this to the income for that particular crop reported on the farmer's trial balance.

Example

If you were auditing a farmer for 20XX who grew broccoli on 150 acres:
 $150 \text{ acres} \times 5.18 \text{ tons/acre (County average yield)} = 777 \text{ tons}$

$777 \text{ tons} \times 511 \text{ dollars/ton (County average payment)} = \$397,047$

If the farmer is reporting a reasonable amount compared to the average, you can limit your audit scope accordingly. If not, then further audit work needs to be performed.

Using income averages needs to be done with caution. If the farmer's income is far below the industry average, ask the farmer specific questions regarding that particular crop during the initial interview. The farmer may have had unusually low yield or price. Most farmers can tell you exactly why a yield or a price is low for a given year.

Expense Averages

In many states, sample production costs are available for a wide variety of crops. These can be prepared by a university agricultural extension. Similar estimates can sometimes be obtained by contacting county farm advisors. As with income, these are only guides and should be used with appropriate interview questions. The sample cost analysis worksheets available can be very detailed. They can include costs to establish permanent plantings and costs to produce a crop. For example, information is available for California from the University of California Cooperative Extension at <http://coststudies.ucdavis.edu>. The worksheets can break down the costs of operating a particular type of farm. Sample costs are not always available for each crop year, but they can be adjusted to reflect current costs per hour for labor, price per item for capital purchases, etc.

These averages can be used for determining if expenses are reasonable and the amounts of costs to capitalize under IRC § 263A, UNICAP. If only a portion of the taxpayer's acreage is subject to these rules, see Chapter 4, Expenses. For example, if the farmer has 100 acres of new vines and also has 500 acres of existing vines, you can use these estimates to allocate costs between the new acreage (capital costs) and the existing acreage (current expenses).

The Initial Interview

Interview Questions

The initial interview of the farmer, as in all audits, is very important. Being knowledgeable in farm terminology will help you get the most from the interview, since it puts the taxpayer more at ease to freely discuss business operations, problems, yields, purchases, improvements built, hobbies, children, new plantings, etc. Always look for ways to customize the interview questions based on knowledge of the taxpayer and specific products. Initial interview questions for general farms, beef, dairy, swine,

sheep, farm vehicles and exotic animals are available in ATGs' and from the SB/SE Agriculture Technical Analyst at <http://sbse.web.irs.gov/TG/TGContact.htm>. The IDR and initial interview questionnaire can be used together to ensure pertinent questions and documents are received. Add, modify or delete questions to customize the initial interview to the farmer.

Initial interviews of farmers can be hard to arrange. To accommodate the farmer, try combining the business tour with the initial interview. During your tour, use correct terminology, ask open-ended questions, don't be afraid to ask for explanations, and **DON'T PRETEND TO UNDERSTAND SOMETHING IF YOU REALLY DON'T**. Use it as an opportunity for the farmer to teach you about the industry. Substance vs. Form and Active vs. Material participation cases are many times won or lost based on information gathered by the auditor during the initial interview. Address these issues immediately if they arise.

Tour of Business

Insist that the person giving the tour be knowledgeable and consider the following:

1. Do you see young vines/trees? - When were they planted? When is the first harvest? Check the depreciation schedule for the capitalization of the vines/trees and for the overhead capitalized costs per IRC § 263A, UNICAP (*See Chapter 4, Expenses*).
2. Do you see improvements? - Look for things such as stakes, trellises, fences, irrigation systems, buildings, etc.
3. Are there houses on the property? - Many taxpayers have bought additional farms as people retire and leave. This can create rental income or employee housing issues.
4. Are there calves at a dairy? - Dairies have a high incidence of unreported calf sales. Ask and verify what is done with the bull calves. If the calves are being sold for cash, they may be seen tethered by the corrals waiting to be taken to the auction yard or to be picked-up by a buyer.
5. What kind of machinery is there? - The farm machinery should match the crop produced. If it doesn't, then there could be income from renting out the specialized equipment. For example, if a grape farmer has a cotton picker or an almond shaker, this should be questioned.
6. Do you see large trucks? - Some farmers have large trucks to haul their crops to the packing houses. During the non-harvest season they may haul hay or other commodities for additional income.

The Audit

Crop Accounting Records

Always request crop accounting records in your IDR. If they are not provided, ask the farmer during the interview. A farmer may have these records, but may be unfamiliar with the accounting term/name used. The information contained in the crop accounting

records can be used to adjust the scope of your exam to focus on areas with the most likelihood of adjustment.

At the beginning of the season, the farmers frequently need to prepare a budget for that year's crop. Budgets are needed for a variety of reasons, including obtaining crop financing for the coming year. The budget usually includes estimated income and expenses for each crop produced. In most crop accounting systems, the budgets are compared to the actual year-end and any variances are noted. Many computer systems also include the actual amounts from the prior year. When a farmer grows a wide variety of crops, these records can be invaluable. The examiner can focus the audit on the accounts with substantial variances rather than the accounts that are within the budgeted amounts.

Crop Loans

Crop loan records can be used in a variety of ways during an exam. Crop loan records should include:

- Loan Agreement; including a statement regarding collateral.
- Loan History/Activity; including the month subsequent to the Fiscal Year End
- Crop Budget or Financial Statements used to obtain the loan.

Crop loan records first need to be examined for any related party issues. Financing can be obtained directly from related parties or from third parties (such as banks) using "shared" loans for various related farms. Look at the loan agreement and see that the borrower is the farmer under exam and that the lender is truly an unrelated third party.

Unrelated Third Party Financing

Look at the loan activity detail. Since most farmers are cash basis always: **TRACE THE MONEY.**

1. Trace all reductions in the loans to actual payments by the farmer. Many crop loan agreements include payments to be made directly to the loan from the crop purchaser. These payments are never deposited to the farmer's bank accounts and can be sources of unreported income if the farmer does not have double entry books.
2. The timing of the loan repayments may also be an indication of a potential issue. Repaying a loan in the month subsequent to the end of the fiscal year is an indication of a possible deferred payment contract (See Chapter 2, Income).

Related Party Financing

If the loans are obtained from related parties or the proceeds are shared by related parties, TRACING THE MONEY is even more important.

1. ALWAYS review both sides of these transactions. Use T Accounts or journal entries to visualize the tax consequences to both parties.

2. If a related entity is acting as a broker for the farmer, determine when payment was constructively received for the crops. The loan proceeds could be income to the farmer. This may sometimes involve reviewing the books of a related party, but the information may also be available from the farmer under exam. If the books of a related party need to be reviewed, that return can be opened for exam.
3. ALWAYS remember to review IRC § 267 to determine who is related. IRC § 482 is available to more clearly reflect income between related parties. The *Substance vs Form* rules should be reviewed when there is a question regarding whether a transaction between related parties is arms length.

Crop Contracts

Crop contracts should be reviewed for all crops produced by the farmer. Usually an entire crop is sold to one purchaser, but sometimes crops are sold to a variety of purchasers. Review crop contracts for quantity sold, payment terms and delivery terms.

Quantity Sold

The crop contracts will have some detail regarding quantity sold. Compare to industry averages to determine if the quantity is reasonable. The quantity detail on the contracts will vary by type of crop. It can include number of acres, bales, boxes or pounds of crop.

- If stated in acres, compare the acres on the contracts with the acres from the map.
- If stated in quantity, compare the quantity on the contracts with the quantity obtained using industry averages.

Payment Terms

If the payment is not being deferred, your next step is to compare the grower statements with the taxpayer's books.

If payment is being deferred until after the close of the farmer's fiscal year end, is this a valid deferred payment contract? (See Chapter 2, Income)

If the deferred payment contract is in question, ALWAYS get a photocopy for your workpapers. There are many factors to consider in determining if this is a valid deferred payment contract.

Do the payment terms include crop advances or payments on behalf of the farmer? If so, are these properly included into income when the money or the benefit is received?

Delivery Terms

One major factor in determining if a deferred payment contract is valid, is the date the contract was entered into versus the delivery date. A copy of the contract along with

copies of delivery tags or delivery dates on the grower statements can be very important to answer some of these questions. (Chapter 2, Income Deferral)

Grower Statements

All purchasers of crops provide some form of grower statements. These can be provided monthly or at the end of the crop year. The grower statements will include:

Quantity Delivered

1. Compare the quantity delivered to the quantity described in the contract.
2. Compare the contract number with the grower number on the statement. Some farmers have multiple accounts with one purchaser.
3. Question any large variances in quantity delivered.

Quantity Accepted

If only part of the delivered crop was accepted or if there is a large unexplained variance between the quantity contracted and delivered, question the farmer. If a large amount of crop was rejected or not delivered, this should have been brought to your attention during the initial interview.

1. What happened to any rejected crop?
2. Was it reconditioned and resold to another purchaser?
3. Was it sold in another type of market for a lesser price? This would include sales such as winery use, juices, cattle feed, etc.
4. Was it disposed of? If so, how did the farmer dispose of it?
5. Was it insured? Certain crops like cherries can not be insured.

Gross Payments, Deductions and Net Amount Due

1. Review all statements for your crop year covering all payments until the balance owing to the grower is zero.
2. Review how your farmer reports his income. Some farmers report net payments into income while others report gross payments and claim as expenses the deductions to gross payments.
3. Review for the following:
 - a. Were there advances - did the farmer report them as income when received?
 - b. Were there payments made to third parties? These can be payments on loans, payments for farm expenses, capital asset purchases, or for any number of reasons, either business or personal.
4. Compare the grower statements to the contracts to see that the payment terms agreed to in the contract are actually being followed.

THE GROWER STATEMENT IS ONE OF THE MOST IMPORTANT DOCUMENTS IN THE EXAMINATION OF A FARMER'S INCOME. If the farmer cannot provide the grower statements, copies can be obtained by following Third Party Contact procedures and requesting them from the packing house or broker.

Income

Introduction

Cash vs. Accrual

Income Deferral & Constructive Receipt

Agricultural Program Payments

Loans

Unreported Sales of By-products

Related Entities

Introduction

Purpose of this Chapter

Farm entities enjoy many unique benefits under the Internal Revenue Code. These advantages provide numerous opportunities for valid income deferral. This Chapter will examine some of the relevant income issues unique to farming entities.

Topics Covered

1. Cash Versus Accrual Methods for Farming

There are several methods of accounting for income. Farmers have been given an advantage in the Internal Revenue Code by being allowed to use the cash method of accounting. The cash method of accounting allows many farmers to claim the expenses of the current year's crops while postponing the recognition of income. In this section, you will find a brief overview of the requirements for use of the cash method of accounting, as well as the analysis to determine whether or not a farmer has constructive receipt of deferred income.

2. Income Deferral and Constructive Receipt

Farming entities under certain circumstances are allowed to deduct currently the expenses of growing and harvesting crops while deferring income to later years. Attempts to move income include the use of deferred income contracts and advances from packers.

3. Agricultural Program Payments

There are many governmental programs which provide benefits to farmers. Many of these program payments are taxable to the farmers as income.

4. Loans

Farmers receive loans from various government and related party sources. These loans should be reviewed for taxability.

5. Unreported Sales and By-Product Sales

Many farming activities produce salable by-products which occasionally go unreported and undetected in an examination.

6. Related Entities

Every examination of a farming entity should include an inquiry into any and all related entities. Transactions between these related entities should be examined for possible unreported income and improper income deferrals.

Cash vs. Accrual

Most farmers choose the cash method because of the tax advantages. Under the cash method, all income is included in the year it is actually or constructively received. Farm business expenses are deductible in the year in which they are paid. Finally, inventories are not utilized by farmers under the cash method.

IRC § 446(a) provides that a taxpayer shall compute its taxable income in the same manner in which it keeps its books and records. Section 446(b) provides that if the taxpayer has not chosen a method of accounting, or has chosen one which does not clearly reflect its income, the Service may impose upon that taxpayer a method of reporting income which does clearly reflect income. Section 446 provides that the following methods of accounting are permissible: the cash receipts and disbursements method, the accrual method, and other methods permitted by Subtitle A, Chapter 1 of the Code or any combination of the foregoing methods permitted under the regulations. A farmer must select a method of accounting his first year farming. Any later changes must be preceded by a request by the farmer and permission by the IRS. A taxpayer engaged in more than one business may use a different method of accounting for each business.

The cash method of accounting can produce tax advantages to the farmer as the following example illustrates:

Example

A farmer grows his crops in 2004 then delivers and sells the crops in the late fall of 2004. The farmer receives payment for the crops in January 2005. Assuming that there is no constructive receipt issue, the farmer reports his crop sale income in 2005. However, since that farmer incurred and paid his expenses for seed, labor, water, fertilizer and the like in 2004, those costs are deductible in that year.

To prohibit and limit abuse potential, Congress enacted Sections 447-Method, 448-Limitations and 464-Limitations. These sections limit certain farming corporations and tax shelters from using the cash method of accounting.

Non-farm taxpayers engaged in business must generally compute their income on the accrual basis and must generally compute inventories at the beginning and end of each taxable period in which the purchase or sale of merchandise is an income producing factor. Cash basis farmers are not generally required to compute inventories of growing crops or raised livestock.

Section 447 states that corporations or partnerships (which have corporations as partners), engaged in farming shall report their income on the accrual basis. However, S-Corporations and corporations with less than one million dollars of gross receipts in every year since 1975 are exempt from the accrual requirements. There is a further exemption from the accrual rules for family farm corporations. A family farm corporation may use the cash method of accounting if, since December 31, 1985, the corporation has never had gross receipts of more than \$25 million and at least 50% of each class of

stock is owned by the members of the same family (See *IRC § 447* for a further explanation).

Corporations and partnerships with a C corporation as a partner, engaged in farming may use the cash method of accounting under *IRC § 448*, if they have average annual gross receipts under \$5,000,000 for the prior 3-taxable year period. **Remember that “farming” is defined in *Treas. Reg. § 1.263A-4(a)(4)* as not including contract harvesting of crops grown or raised by another nor the operation of processing, slaughtering, packaging or canning of animals or produce.**

The accrual method of accounting must be used in any case in which it is necessary to use an inventory (*Treas. Reg. § 1.446 - 1(c)(2)(i)*). However, farmers are exempt from the usual code requirements to maintain an inventory. Section 263A does not apply to plants with a preproductive period of less than two years or to animals. See Section 263A(d)(1)(A). Consequently, very few farming operations will ever be required to adopt the accrual method of accounting. **Note** that any corporation, partnership or tax shelter which is required to use the accrual method of accounting under *IRC § 447* or *448* must comply with the requirement of *IRC § 263A*, UNICAP.

Section 447(e) defines members of the same family as an individual's brothers and sisters, aunts and uncles, grandparents, the ancestors and descendants of any of the foregoing, a spouse of any of the foregoing, and the estate of any of the foregoing. Stock owned directly or indirectly by or for a partnership or trust is treated as owned proportionately by its partners or beneficiaries. If 50% or more of the value of the stock in a corporation is owned directly or through a trust or partnership, by members of the same family, such members shall be treated as owning stock in a second corporation owned by the first corporation in the same proportion as such members own the first corporation.

Income Deferral and Constructive Receipt

Where a farmer grows and sells his crops in one year and receives payment for the crops in the subsequent year, there is a potential income deferral and constructive receipt issue. Every contract should be reviewed and a determination made as to the validity of the arrangement for tax purposes. The basic fact pattern is as follows:

Prior to the time the crops are ready to be harvested, the grower and the packer enter into an agreement for the grower to provide its crops to the packer. In some instances, the grower and packer agree that the grower will not be paid for his crops until after the first of the following year. The crops are then harvested and provided to the packer. Typically, in January of the following year, the packer pays the grower for his crops. The grower includes the income not in the year the crops were grown, but in the subsequent tax year.

The following analysis should be used to determine the treatment of deferred income contracts:

First, is there a written contract in place between the farmer and the entity to whom the crops were sold? If not, then the farmer likely had constructive receipt of the proceeds after the crops were delivered. This theory follows that all of the events fixing the

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farmer's right to the income has occurred after the crops were delivered. However, additional support for the theory the farmer had a right to receive the income should be sought. You should check with growers' associations and overall contracts between packers and growers' associations for operative terms affecting payment.

If there is a written contract in place, check first to see when it calls for the farmer to receive payment. Some contracts actually state that the farmer is to be paid when he requests payment. Occasionally, you will find contracts of this type where the farmer has never requested payment (usually from a related entity) and the income was actually earned several years ago and never reported simply because the farmer has never requested payment. In these circumstances, the farmer clearly had access to the money and should have reported the income in the first year during which he could have requested the money.

Next check to see when the contract was executed and examine all delivery receipts. The contract should have been executed prior to the first crop delivery. In order to properly defer income, the farmer must have contracted to receive deferred payments prior to the time that the crop proceeds were due and owing. Therefore, if the contract was not executed until after the crops were delivered, it is likely that the farmer actually had the right to the income, but later chose not to take possession of it until the next calendar year.

If the contract was executed prior to the delivery of the crops, verify that the parties actually followed the contract. Frequently, the farmer will receive "advances" from the purchaser of the crops under various theories. Sometimes the farmer receives the proceeds in the slightly disguised form of a "loan" which is later repaid as an offset against the income. This could qualify as income under a substance over form argument. Additionally, the farmer may owe the crop purchaser money for sums advanced during the growing season. These funds are often offset by the crop purchaser prior to the end of the farmer's calendar year and thereby qualify as income to the farmer. Occasionally, the farmer is simply paid some of the funds outright, prior to the day stated in the contract.

The above analysis is supported by the Internal Revenue Code and the current case law. A taxpayer reporting on the cash method of accounting must include an item in income for the taxable year in which such item is actually or constructively received [Section 451(a)]. The concept of constructive receipt has been addressed in Tax Court opinions for more than 50 years. Certain established principles have been used to address these issues. The seminal concept of these cases and one which courts have embraced has been set forth in Section 1.451-2(a), *Income Tax Regs.* See Benes v. Commissioner, 42 T.C. 358, 381 (1964), *aff'd*, 355 F.2d 929 (6th Cir. 1966); Young Door Co., Eastern Div. v. Commissioner, 40 T.C. 890 (1963); Gullett v. Commissioner, 31 B.T.A. 1067, 1069 (1935).

Treas. Reg. § 1.451-2(a) defines the term "constructive receipt" as follows:

(a) *General rule.* Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the

taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Under the constructive-receipt doctrine, a taxpayer recognizes income when the taxpayer has an unqualified, vested right to receive immediate payment. Ross v. Commissioner, 169 F.2d 483, 490 (1st Cir. 1948)]; Amend v. Commissioner, 13 T.C. 178, 185 (1949). The doctrine precludes the taxpayer from deliberately turning his back upon income otherwise available. Young Door Co., Eastern Div. v. Commissioner, *supra* at 894; Basila v. Commissioner, 36 T.C. 111, 116 (1961); Hamilton Nat'l Bank of Chattanooga v. Commissioner, 29 B.T.A. 63, 67 (1933).

In situations where the taxpayer has entered into a binding contract or agreement to defer income before it is earned, the income is not includable in income by a cash basis taxpayer until it is received. Robinson v. Commissioner, 44 T.C. 20 (1965); Oates v. Commissioner, 18 T.C. 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953). The rationale upon which this principle is based was fully set out in Oliver v. United States, 193 F.Supp. 930, 933 (E.D. Ark. 1961), as follows:

[Where a taxpayer] acquires an unconditioned vested right to receive the proceeds of the sale, and the buyer is ready, willing, and able to make payment, the taxpayer cannot avoid treating the proceeds as income for that year by voluntarily declining to accept payment during that year, or by requesting the purchaser not to pay him until a later year, or even by voluntarily putting himself under some legal disability or restriction with respect to payment. In such circumstances, he will be deemed in constructive receipt of the income notwithstanding his refusal to accept payment or his self-imposed restraints on payment.

On the other hand, where such a stipulation [deferring the receipt of income] is entered into between buyer and seller prior to the time when the seller has acquired an absolute and unconditional right to receive payment, and where the stipulation amounts to a binding contract between the parties so that the buyer has a legal right to refuse payment except in accordance with the terms of the agreement, then the doctrine of constructive receipt does not apply, and the taxpayer is not required to report the income until actually received by him.

Agricultural Program Payments

Income Sources From Government Agencies

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

1. The Farm Service Agency (FSA) is the key office for most government payments. The FSA is usually the starting point for the farmer to register and qualify for many crop and land related payments.

The FSA maintains a file for each farmer, identifying land owned by farm number. The FSA records acreage, crop 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 used by the farmer are through the local FSA office. Any payments to the farmer are usually made by the FSA office, not by the Commodity Credit Corporation (CCC), etc.

2. Natural Resources Conservation Service (NRCS), formerly called the Soil Conservation Service (SCS), through its Agricultural Management Assistance (AMA) department, provides engineering assistance to farmers in building dams, leveling land, surveying, and other related services. These services are free and not taxable to the farmer. The AMA will share in costs of improvements for water management, erosion control, trees for windbreaks or transition to organic farming by either paying the costs directly or reimbursing the farmer.
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. The CCC is now part of the FSA.
4. The Farm Loan Program, formerly the Farmers Home Administration (FmHA) makes real estate loans, operating loans, and loans to purchase machinery, grain bins, or other equipment purchases by the farmer. The Farm Loan Program is currently part of the FSA. Additionally, it will make disaster loans and emergency loans.
5. Conservation Reserve Program (CRP), now part of the FSA, is designed to take highly erodible cropland out of production for ten to fifteen year periods. Instead of planting a crop on marginal farmland, the owner enters into an agreement with the government not to plant any crops on said land for ten to fifteen years and in return the government pays the owner a subsidy for those years. Per USDA regulations, land entered in CRP is not treated as rental property. Payments made under this program are reportable on Schedule F and subject to self-employment tax.

Farmers may receive different types of government payments. Understanding the purpose of these payments is the key in determining their effect on the farmer's income. The terms "farm program payments" and "agricultural (ag) subsidy payments" can be used interchangeably. Researching the USDA website will assist the examiner.

The 1996 Farm bill made several changes to the Department of Agriculture. The farm bill established the Production Flexibility Contract (Form CCC-478), a one time sign-up process for the entire 1996 through 2002 period. The Production Flexibility Contracts (PFC) program was succeeded by the Direct Payments program, created by Farm Security and Rural Investment Act of 2002. Also created were the Counter-Cyclical Payments and Marketing Assistance Loans programs. The marketing assistance loans have a 9-month maturity and accrue interest. They are “nonrecourse loans”, meaning only the collateral crop can be used if the loan is forfeited.

If information is not available from the taxpayer, it can be requested from your local FSA office or any other agency with which the farmer has dealt. Depending on office policy, you may be able to obtain the information directly without use of a summons. You may need to get the farmer to sign a permission note to allow access to their records that should include:

1. Certifications for program eligibility
2. Payments record
3. Contracts
4. Aerial photographs
5. Number of acres
6. Production data only regarding disaster payments,
7. Crop share arrangements
8. Cash rent arrangements
9. Farm production reports.

Some of the reporting documents used are:

- Form 1099-A, Acquisition or Abandonment of Secured Property
- Form CCC-1099-A-1, Report of Loan Forfeiture, Settlement, and Abandonment to Producer
- Form CCC-1099-A, Producer Forfeiture, Settlement and Abandonment Record
- Form 1099-G, Certain Government Payments
- Form CCC-1099-G-1, Notice of Correction for Payments Under Agricultural Programs
- Form CCC-500, Loan Repayment Receipt
- Form CCC-677, Farm Storage Note and Security Agreement
- Form CCC-677SP, Farm Storage Note and Security Agreement for Special Producer Storage Loan Program
- Form CCC-678SP, Warehouse Storage Note and Security Agreement for Special Producer Storage Loan Program
- Form CCC-684, Note and Security Agreement Continuation Sheet – Schedule of Commodity
- Form CCC-709, Direct Loan Deficiency Payment Agreement

The IRS forms can be found at: <http://www.irs.gov/formspubs>. The CCC forms are either part of the loan report printouts or available at the USDA forms website: <http://forms.sc.egov.usda.gov/eforms/formsearchservlet>.

Loans

Introduction

Farmers have access to many sources of financing. Some are unique to farming such as the Commodity Credit Corporation, others are traditional like banking institutions. It is not unusual for a farmer to have a substantial line of credit which is collateralized by farm property or proceeds. It is also common for suppliers to extend credit by providing flexible open accounts.

The common sources of financing are:

1. Commodity Credit Corporation loans
2. Conventional bank loans
3. Bank lines of credit
4. Approved credit from suppliers (open accounts)
5. Loans from related parties

Regardless of the source, in general, bona fide *loans* are not included in gross income. They do not represent sales of inventory nor fees from rentals (*Treas. Reg. § 1.61-4*). However, there can be exceptions to this general rule.

Treating Loans as Income

There are transactions in which loan proceeds are included in income. One example is CCC Loans with an IRC § 77 Election.

Commodity Credit Corporation Loans

CCC loans were discussed in Chapter 1, Audit Flow. This section will highlight the income recognition election for CCC loans under Section 77.

Sec.77. Commodity credit loans.

- (a) *Election to include loans in income.*
Amounts received as loans from the Commodity Credit Corporation shall, at the election of the taxpayer, be considered as income and shall be included in gross income for the taxable year in which received.
- (b) *Effect of election on adjustments for subsequent years.*
If a taxpayer exercises the election provided for in subsection (a) for any taxable year, then the method of computing income so adopted shall be adhered to with respect to all subsequent taxable years unless with the approval of the Secretary a change to a different method is authorized.

Election impacts treatment

1. A taxpayer may elect, at any time, to report CCC loans as income in the taxable year in which the loan is received (*IRC § 77(a)*).
2. The election, once made, applies to all subsequent taxable years unless permission is obtained from the IRS to change back to treating loans as loans (*IRC § 77(b)*). Effective for tax years ending on 12-31-2001 and latter, a farmer can file using the "Automatic Change Procedures" (Rev. Proc. 2002-9, 2002-1 C.B. 327). For more detailed information, see IRS Pub. 538, Accounting Periods and Methods, Change in Accounting Method.
3. The election to treat CCC loans as income applies to all commodities for that taxpayer (*Treas. Reg. § 1.77-1*).
4. If the election is made to treat CCC loans as income, and the farmer forfeits the crop to CCC, any extra amount received by the CCC on sale of the commodity is income to the taxpayer in the year of receipt by the taxpayer. (*Treas. Reg. § 1.77-2(a)(1)*). The excess sales price over the amount previously reported in income is taxable as ordinary income (*Rev. Rul. 80-19, 1980-1 C. B. 185*).
5. *IRC § 77* once elected applies to all CCC loans in that year.

Exceptions to be considered

The circuit courts are not in agreement in regards to the treatment of CCC loans which are redeemed the same year (Research the circuit with precedent in your state.).

1. The Fifth Circuit Court of Appeals held in *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963), *aff'g and rev'g* 38 T.C. 153 (1962), that no income was realized from the loan allocable to a crop that was redeemed in the same taxable year.
2. The Ninth Circuit Court of Appeals holds that the loan is income even though redeemed. *United States v. Isaak*, 400 F.2d 869 (9th Cir. 1968) (The loan is the taxable event).

Audit Consideration

1. CCC Loans are common. An Information Document Request (Form 4564) should be sufficient to determine if CCC loans were obtained.
2. Once identified, determine if there has ever been an election filed under *IRC § 77*. If yes, then this election will still be in effect unless Change in Accounting Method (Form 3115) has been filed and approved by the Internal Revenue Service. For tax years ending on 12-31-2001 or latter, the farmer can presume to have IRS approval, if they have complied with the provisions of the automatic change procedures, which includes not being under examination, along with 5 other prohibitions. (Pub 538)
3. If the taxpayer is uncooperative, follow third party contact procedures to get information from the local FSA office. The CCC is a federally insured institution.
4. Forms 1099 are filed for most taxable transactions. However, the use of CCC certificates to pay off nonrecourse marketing assistance loans at less than the loan amount, as of 2004, will not have a Form 1099 generated for the gain/relief of indebtedness income amount. (IRS News Release, IR-2004-38)

Substance over form

In order to identify if *loan* transactions are bona fide, efforts must be taken to determine the facts of each event. Each *loan* transaction must be reviewed on its own merit. A loan can be used to:

1. Defer or postpone the recognition of income
2. Distribute income to a shareholder/partner, or
3. Shift income from one related entity to another

Affiliated Groups

Be aware, when reviewing a transaction, to look for “related” entities in the sense of ownership (IRC §267) as well as business relationships. Often a supplier, broker, and third party customer will have a “working relationship” with the farmer (customer). This lends itself to creative loan financing for mutual benefit.

In farming it is common to have large affiliated groups with financing, farming, sales, processing, packing/storage and manufacturing entities as part of the group. When the crop being grown is cotton, one of the members of the group will often be a cotton processing plant--Gin. These affiliates can be corporations, partnerships, S-Corporations and even trusts. As a result, the shifting of income can be beneficial on many levels.

Deferral or postponement of income recognition

In the example below, taken from a real case, the execution of the promissory note deferred or postponed the recognition of income from one year (20x1) to the subsequent year (20x2). The issue raised was the “substance versus form” (Crop: COTTON).

Example

ABC Inc. is a farming corporation in an affiliated group. XYZ Inc., a financing company, and MNO Gin Partnership, are members of the Group. ABC Inc. has a December 31 year end.

<u>Date</u>	<u>Description of Action</u>
Oct. 20X1	MNO Gin Partnership delivers ABC's Cotton to its broker to be sold.
Nov. 20X1	The broker executes a short term promissory note (60 days) with XYZ Inc. for \$1,500,000. A check is issued to XYZ Inc.
Jan. 1, 20X2	The broker sends a check to ABC Inc., Farmer for \$1,520,000 (The proceeds from the sale of the Cotton)
Jan 2, 20X2	XYZ Inc. repays the broker for \$1,520,000 (Repaying the loan Plus interest).

Important facts developed during the examination showed that there was a long-standing relationship between the broker and the corporation (farmer). This year-end transaction was an annual practice. Further facts showed that the loans in subsequent

years were for the exact amount of the next year crop proceeds. The proceeds were consistently received during the first days of January. It is reasonable to contend that the crops had been sold in year x1 and that income (deferred by the loan) should have been recognized in that year. The facts may not be exact in each case. However, these are items to consider during an examination which will make an examiner more effective in identifying this issue. (The following items were compiled from actual examinations.)

Audit Considerations

A consistent business relationship with the broker(s).

A short term note (30, 60, 90 days) being executed at year-end by the broker.

Loan proceeds paid to the financing member of the affiliated group. It is not necessary for the financing company to be a member of the affiliated group for the issue to be raised. The issue is still applicable with an independent financing company because the *loan* is the tool being used to defer the income. However there will most likely be some form of relationship between these entities.

Proceeds from the sale of the cotton paid to the Gin partnership. Gins are customarily partnerships because of the tax benefits. As a result, basis issues can be adjacent issues in regards to loans. At risk rules do apply (This will be discussed in a later section).

Repayment of the loan made by the cotton gin partnership instead of by the financing institution.

Audit Techniques

1. Year end analysis of the note payable account
 - a. General ledger analysis. Thorough review of the last quarter (fiscal, calendar).
 - b. Inspect all year end short term note payables (30, 60, 90 days).
 - c. Determine relationship between payee and group.
2. Match product sales (bulk) to income recognition
 - a. General ledger analysis.
 - b. Invoice(s) for delivery of product to broker
 - c. Invoice(s) for sale of cotton by the broker
 - d. Canceled checks for (all) payments
3. Flowchart transactions Diagram:
 - a. Product delivery (date, amount, recipient).
 - b. Loan executions (date, amount, recipient).
 - c. Sale Proceeds (date, amount, recipient).
 - d. Loan repayment (date, amount, recipient).

Note: Remember the issue is not whether the loan itself is viable or bona fide, but the deferral of income recognition. The underwriter and/or the value of the note, if sold at a discount to a third party, may be an issue as well, but it's subordinate to the deferral issue.

Court Cases:

There are cases which address the lack of substance in a transaction. Due to the legal nature of the issue, involving Counsel in the development stages of these issues is invaluable.

Reference the Income Section (Page 2-5) for applicable court cases.

Distribution of income to a shareholder/ partner

One method used to distribute income to a shareholder is through loans. Agriculture is highly susceptible to this method because of the family nature of the business. In both corporations and partnerships, there is a tax benefit of using a *loan*.

Corporations

Loan transactions will be found in the loans to shareholders balance sheet account. Identifying *loans* in this account is customarily achieved through a comparative analysis of the year end balance sheets (see sample audit procedures below).

Partnerships and Flowthrough Entities

Partnerships and other flowthrough entities have a basis which is impacted by *loans*.

1. It is important to determine if any loans included in the basis are “at risk” to the partner/shareholder.
2. Be aware of the source of the funds. A partner may own the controlling interest in a corporation and be using loans from the corporation to increase his/her basis for flowthroughs. Who is “at risk,” the shareholder or the corporation? There could be a potential dividend issue.

Audit Considerations

1. Constructive Dividend. [IRC § 301(a) & (c)(1)]
2. Cancellation of shareholder indebtedness by Corporation. [Treas. Reg. § 1.301-1(m)]
3. Earnings and Profits available for dividend.

Audit Procedures

1. Reconcile line item per return to the General Ledger (GL).
2. Compare beginning GL balance to ending GL balance. Investigate significant changes.
3. Review GL for unusual entries.
4. Determine whether bona fide debtor-creditor relationship exists. Inspect corporate minutes, promissory notes, date issued, repayment dates, fair market interest rate. Repayments made?
5. Trace source of repayments to verify they are being made by shareholder.
6. Ascertain whether current year's increases represent dividend distribution, compensation, or possible diversion of income.
7. Determine that interest income has been properly reported. Possible issue of no/low interest being charged (Note: IRC § 7872 interest income to corporation and correlative interest expense to shareholder).

Shifting income from one related entity to another

Loans can be used as instruments to move income items from one entity to another. Again, this is an area which would involve a controlled group.

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Example

X is a retail corporation which sells farming supplies. X Corporation sold some farm products to ZZ Farming Inc. on account. ZZ Farming Inc. was having a bad season and was unable to fulfill the terms of the payment. Y Corporation, a finance company, had also been loaning ZZ Farming Inc. funds to assist in the farming operation. Y Corporation bought the account receivable from X Corporation. Y Corporation booked the transaction on its books as follows:

Debit	Note Receivable	\$300,000	
Credit	Cash		\$300,000

The end of year, Y Corporation wrote off \$300,000 of the ZZ Farming Inc. note receivable as a bad debt. Y Corporation moved the account to its books by treating it as a *loan* to ZZ Farming Inc., combining it with the balance of ZZ's outstanding loans. It is now subject to IRC §165 instead of IRC §166. Because ZZ's loans were secured by land and crop proceeds, the bad debt fails to meet the requirements of IRC §166.

Conclusion

In general, bona fide *loans* are not included in income. However, we have discussed in this chapter several uses of *loans* in the farming industry where this is not the general rule. Recognition of these areas will give an examiner a head start in identifying income issues related to *loans*. The key is to develop the transaction to its entirety and not to regard the *loan* document alone as the criteria for non-recognition of income.

Unreported Sales of By-products and Secondary Sources of Income

Various items of income can be overlooked by farmers. The sources of unreported income are many and varied. The following have been identified.

1. Manure may be dried, packaged and sold as fertilizer.
2. Corn cobs may be sold for use in making plastics, perfumes, etc.
3. Dairy farmers usually have more calves than they can use in their operations. Some heifer calves may be raised to replace dairy cows. Bull calves may be raised for breeding purposes. The remaining calves are usually sold at various stages, for example, as bred heifers to other farmers to use as replacement stock, as calves to be used in veal operations, and as steers to be marketed for meat.
4. Dairy and beef farmers may raise grain and hay to feed their animals. Sometimes excess grain and hay may be sold to local elevators, commodity buyers, or directly to neighboring farmers.
5. Farmers with wooded areas may sell off trees for lumber, firewood, or landscaping.
6. Untilled land may be rented for pasture.
7. The soil itself may be sold as topsoil, sand, sod, fill, gravel clay, etc.
8. To help offset the high cost of machinery, the farmer may do custom work for other farmers.
9. Crop insurance proceeds may properly go unreported in the year received if the farmer elected to report them in the year the crop would normally be sold.

However, if the crop insurance proceeds are deferred, the farmer must report the income in the subsequent year. All tracks to the income, such as deposits, reported by the payee would be in the prior year which may not be under examination.

10. Income from hunting privileges and/or guide services may not be reported.
11. Grain and bean crops may sell the straw which is sometimes baled and sold for cattle feed.
12. Citrus pulp and tomato pulp is sold by the processor, not the farmer; thus income to the processor, not the farmer. The pulp is a by-product of the juice making process.
13. Orchard and vineyard prunings are often shredded or bundled and sold to co-generation plants. Quite often wood is sold as cords of firewood.
14. Raisin stems and floor sweepings are sold by the packer for cattle feed. There is no income to grower.
15. Almond shells are sold to co-generation plants. Almond hulls are sold for cattle feed. Sale proceeds are received from the huller.
16. Prune pits and olive pits may be sold for cattle feed.
17. Cotton farmers sell cotton seed as by-product. One bale of cotton produces 800 pounds of seed. The seed is usually sold through the cotton gin. Seeds can be used for cattle feed and oil. Gin Trash is stems, leaves, etc. These can be sold for animal bedding, soil amendments, and to co-generation plants.

Unreported income is not readily determinable by looking at the tax return. However, the examiner should be aware of what types of income sources various farmers should have. For example, dairy farmers should show sale of calves or cows.

When examining expenses, be alert to the relationship of the expense to the income that is being reported. Some examples are:

1. Cattle farmers having expenses for plastic bags or packaging materials could indicate the taxpayer has income from fruits, vegetables, etc.
2. Repair accounts showing the cost of sharpening a chain saw may indicate the sale of logs or lumber.
3. A depreciation schedule showing tandem dump-truck and loader as an asset may indicate the farmer is selling soil, fill, etc.

Related Entities

Introduction

Farming usually starts as a family business. There will be uncles, brothers, sisters, children, etc. either involved with the farm or having a farm of their own. Transactions for farms between related persons and related entities are therefore common and the issues raised are addressed in certain code sections and court cases.

Sometimes the reasons for related entities to exist are due to regulatory agencies. In the past, the drier regions saw a large increase in the number of farm partnerships due to federal water restrictions. Some of the more common farm entities and reasons for existing are listed below:

1. Incorporated to limit liability exposure.
2. Partnerships to gain help or land to farm.
3. Controlled groups of different entities to farm different lands and/or increase buying power.
4. Sole proprietorships for the home farm.

Audit Issues and Techniques

The reasons for having more than a single entity are numerous. Several tax issues can occur. Income can be affected by delaying the payment until after a year-end, non-payment, use of non-arm's-length transactions, such as no/low interest loans, services, rentals and sales of entities with related parties.

A flowchart of all the related entities with their ownership percentages and major transactions will help throughout audits with related parties. The term "related" can have many interpretations to taxpayers and representatives. In Example B (below), the management entity in the actual case was owned by a sole shareholder unrelated to the taxpayer(s). The auditor pursued this anomaly and found the shareholder had no day-to-day control over the operations of the company nor did he have signature authority over any of the bank accounts. Substance versus form says this is a related entity. Another example was a corporation owned one-sixth by one taxpayer, which was not listed as related. It was found to be operated by the taxpayer's staff and handled all the almond income of the taxpayer. Timing issues were found (see Example A).

Related entities can also be packing houses, brokers, storage plants, insurance companies, etc. After determining the related parties, you should update and review the related entities flowchart to determine the constructive ownership percentages by applying the rules of attribution per IRC § 267. If there is a large corporation and gross income is near \$25,000,000, then check IRC § 447 to determine if it should be using the accrual method of reporting income. Sometimes an agent would start an audit of a simple tax return and have that lead to opening audits of larger related entities.

Examples of tax issues

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- A. Related entity sells the crop of a taxpayer, but does not pay the proceeds due until after the year-end of the taxpayer, with no deferred payment contract. IRC §§ 61 and 461 govern this issue.
- B. Similar to A, a management entity sells the crop of taxpayer(s) and there is a deferred payment contract that moves payment to the following year. The management entity loans the taxpayer(s) prior to the year-end money that is repaid the following year by “netting” crop proceeds against the outstanding loan amounts. Notes were executed and interest is paid. This is a substance versus form case in which several factors must be considered.
 - 1. Was the management entity formed/financed by the taxpayer receiving the benefit?
 - 2. Were the liabilities for any loans and payments legally those of an unrelated third party?
 - 3. Was there some business or regulatory reason to structure the transaction in this manner?
 - 4. Whose capital is invested in the transaction?
 - 5. How many non-related parties are there in the transaction?
- C. Rental expense per contract is not paid to the related taxpayer. This is an IRC § 482 issue that must be developed by cash usage analysis and proof that a tax benefit was obtained.
- D. Farming services are performed by a related entity but are allocated in a manner to create tax benefits rather than based on relevant facts. This is an IRC § 482 issue that requires learning the allocation method and analyzing the tax returns of the related entities for the amount of tax benefits obtained.
- E. Similar to D above, almond income was received by a related entity and allocated to entities differently from their crop percentages. The entities reporting the sales had losses being carried forward and the entities not reporting the sales had taxable income. This was a manipulation for tax benefits (*IRC § 61 or 482*).
- F. Income can also be reclassified to be passive in order to offset suspended passive losses. The spread analysis, comparing several years of tax returns, could show this (*IRC § 469*).
- G. Unharvested crop costs can be sold to a related entity to transfer a loss, where the selling entity already is carrying forward unused losses (*IRC § 267*).

Pertinent Code Sections

IRC § 267 does not allow the deduction of losses on sales or exchanges between related persons, but does not apply to a complete liquidation. It also addresses the matching of payee income and payor deduction in cases where the methods of accounting are different. This means an accrual basis taxpayer cannot deduct expenses to a related person or related entity that is cash basis until the accrued expense is paid unless the recipient, under their method of accounting, reports the receivable as taxable income.

IRC § 267(b) defines who related taxpayers are and IRC § 267(c) defines the constructive ownership of stock.

IRC § 482 authorizes the allocation of income, deductions, credits or allowances in order to clearly reflect the income on transactions between related entities. It is commonly used by the international auditors on transfer pricing issues between foreign
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corporations and their U.S. subsidiaries. The purpose of IRC § 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with such transactions. It is meant to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer in a manner that reasonably reflects the relative economic activity undertaken by each taxpayer.

Treas. Reg. § 1.482-2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances, services and property. The standard used to determine the true taxable income of a controlled taxpayer is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. The definition of the terms "controlled taxpayer," etc. are at Treas. Reg. § 1.482-1(i)(5).

Sometimes the taxpayers or return preparers say that the original transactions were erroneously recorded. If this is given as an audit issue position, review *Utley v. Commissioner*, 906 F.2d 1033 (5th Cir. 1990). It did not allow the taxpayers to recharacterize a transaction contended to be an accounting error.

Basis on Farm Assets

Introduction

Like Kind Exchanges

Gifted Property

Inherited Property

Farm Sale

Cost Recovery - Depreciation and Depletion

Introduction

Basis is the amount a property owner can recover as a lump sum when the property is sold, or can charge off as annual deductions through depreciation. The original basis can be changed through capital improvements or by claiming deductions such as depreciation and casualty losses.

Basis equals cost of purchase. This includes all expenses incurred such as 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 permanent improvements.

Basis is determined by how the property was purchased. Property can be purchased, acquired in a trade, received as a gift, or inherited.

Like Kind Exchanges

Basis of property acquired through a like kind exchange is equal to the basis of the property exchanged. When cash is paid in a non-taxable exchange, the basis of the property acquired is the basis of the property traded plus the cash difference paid. An exchange could involve more than one kind 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 exchange. The balance of basis is then allocated to the like-kind exchange.

See the new regulations issued under IRC § 1031 for details regarding meeting the like kind requirements, identifying and exchanging property rules.

Gifted Property

To determine the basis of such property consider the following:

1. The original owner's basis in the property before the transfer
2. The FMV of the property when given, and;
3. The amount of tax paid.

The new owner's basis in the property received is usually the smaller of the FMV or the donor's adjusted basis. If tax is paid on the transfer, then a part of that amount is added

to the donor's basis in arriving at the new owner's basis (*See IRC § 1015(a), Treas. Reg. § 1.1015-1 for additional information.*).

Inherited Property

The basis of any property, real or personal, acquired from a decedent is usually its FMV on the date of the decedent's death. If the farm is a joint holding, the surviving spouse is entitled to a stepped-up basis on ½ of such property. If a federal 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 alternate valuation date. Under this method, property is valued at the date six months after the decedent's death, if not sold or otherwise disposed (*See IRC § 2032 for other information on alternate valuation.*).

The basis in inherited property may be figured under the special "farm real property valuation method." IRC § 2032A. 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 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 gain is recognized 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.

If the farmer makes an irrevocable election and pays the interest on the additional estate tax figured from the date nine months after the decedent's death until the due date for paying the additional estate tax, then the basis in the property is increased to its FMV on the date of the decedent's death or the alternative valuation date. The increase in basis is considered to have occurred immediately before the event that results in 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 identification number; a statement identifying the election as an election under IRC § 1016(c); and a list specifying the property for which the election is made.

Farm Sale

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

Farmers are eligible to exclude the gain on the sale of the personal residence under the following conditions:

- The farmer (taxpayer) has owned and used the home as his/her personal residence for at least 2 of the last 5 years.
- The farmer has not used the exclusion in the last 2 years.
- The gain on the residence does not exceed \$250,000 (\$500,000 on a joint tax return). IRC § 121.

A loss on the sale of a farm residence is personal, and therefore, is not deductible. Although not conclusive, provisions in the contract of sale may be evidence as to the value of the residence, particularly if the transaction is between non-related parties. Also note, when the underlying farm land is sold and the principal residence is retained and the house moved to another lot, the gain realized on the land where the house was originally located is not excludable.

Land adjacent to the personal residence and not used in farming is includable as part of the personal residence. The amount of land that can be allocated to the personal residence has been the subject of court cases and should be researched for current guidance.

The sale of unharvested crops with a farm reduces the tax obligation for some farmers, since the crops acquire capital gain status (See IRC § 1231). To qualify for capital treatment the unharvested crops must be sold with the land and meet the following requirements:

1. Land must have been held more than one 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 a 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 the land and the seller seeks capital gain treatment, 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 excluded from farm operating expenses. Crop production costs include all cash expenses and fixed overhead costs, such as depreciation (IRC § 268).

Remember that if the farmer "elected out" of IRC § 263A on an orchard or vineyard, it is treated as IRC 1245 property. This means that if there is any gain when it is sold, you must recapture the preproductive expenses that would have been capitalized except for the "election". This is when having local cost studies of establishing orchards and/or vineyards is useful to either support the farmer's estimates or to use if records are not available.

Cost Recovery - Depreciation and Depletion

Because farming is a capital intensive industry, a farmer is allowed cost recovery or depreciation on machinery, equipment, and buildings. Depreciation is also allowed on purchased livestock acquired for breeding, draft, and sporting purposes, unless the farmer uses the accrual method of accounting and the livestock is included in inventory. A significant expense on a farm return is depreciation.

The same depreciation rules apply to farming as to any other business. In addition to MACRS, farmers and other taxpayers have three options for depreciating property acquired after 1986 (*IRC § 168*).

1. Use straight-line method over the regular MACRS recovery period.
2. Use straight-line method over the regular Asset Depreciation System (ADS) midpoint (also known as class life or ADS class life). This method is usually referred to as alternative MACRS.
3. Use 150% 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% MACRS.

NOTE: Vineyards and orchards are limited to straight-line depreciation.

Farm property placed in service after 1988 is limited to the 150% declining balance on property used in a farming business with less than a MACRS recovery period of 15 years, rather than the 200% available for non-farm property. This change was enacted with TAMRA 88.

There are limits in the depreciation deduction a farmer may claim on listed property placed in service after July 18, 1994. If not used more than 50% in a qualified business, the deduction is denied. If the property was placed in service before 1987, the property must be depreciated using the straight-line method over a longer life. Dollar limitations change yearly (*IRC § 280F*).

Alternative Minimum Tax (AMT) Adjustment

If the farmer is correctly using the 150% declining balance rate for farm assets placed in service after 1988, there will be an Alternative Minimum Tax (AMT) adjustment. The 150% 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 an adjustment will be required in computing AMT.

IRC § 179 Deduction

IRC § 179 is an election that must be made in the tax year that the property is placed in service. The maximum Section 179 deduction for taxable years beginning after 2002 and before 2008 is limited to \$100,000 with an adjustment for inflation for any taxable year beginning in a calendar year after 2003 and before 2008. The ceiling is reduced by the excess cost of qualified property placed in service during the year over \$400,000, which is subject to the above mentioned adjustment for inflation. Qualified property is

tangible, depreciable IRC § 1245 property that is purchased for use in the active conduct of a farm business.

The following properties do not qualify for IRC § 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 § 179 expense
4. The property acquired from a spouse, ancestor, lineal descendant, or a controlled entity
5. Trees and vines. See “e” below, per Rev. Rul. 67-51, 1967-1 C.B. 68.

IRC § 179 Recapture

Gains from sales of IRC § 179 assets are treated as IRC § 1245 gains. The amounts expensed are recaptured as ordinary income in the year the asset is sold. The IRC § 179 expense deduction is combined with depreciation allowed to determine the amount of gain reported as ordinary income on 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% or less, the IRC § 179 recapture is applicable no matter how long the property was held for business use. The amount recaptured is the excess of the IRC § 179 deduction over the amount that would have been deducted as depreciation.

Special Depreciation Allowance

Farmers are eligible for the special allowance for additional depreciation for certain property acquired after September 10, 2001 and before January 1, 2005. Refer to Pub. 225 for the definitions and tests. IRC §168(k).

1245 Property

1. Tangible personal property such as equipment, machinery, tools and trucks (Buildings and structural components are not included).
2. Other tangible properties, for example, are:
 - a. Fences in connection with raising livestock
 - b. Paved feedlots
 - c. Water wells that provide water for poultry, livestock, or irrigation of crops
 - d. Drainage tiles
 - e. Groves, orchards and vineyards if productive (Exempt from IRC §179 per Rev. Rul. 67-51)
 - f. Bins, gas storage tanks, silos
3. Livestock used for breeding cattle, hogs, sheep, and dairy cattle [purchased, not raised].
4. Single purpose livestock or horticultural structures.

Mineral & Water Rights

Review the schedule of capital assets. If mineral rights, including water rights, are on the schedule, how they were acquired needs to be questioned. Mineral rights can be acquired in various ways. They can be purchased along with the land or they can be

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bought and sold separately. If purchased as part of the land, review the allocation. If an allocation was made, there should be an appraisal from a geologist. Mineral rights are a capital asset similar to land. A farmer who owns an economic interest in producing mines: oil, gas, or geothermal wells, or any other natural deposits 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. The depletion deduction can be figured by either the cost method or the percentage method. Water rights are not depletable but may be subject to amortization in limited situations. As long as a farmer continues to be the owner of the land, then a loss cannot be claimed on worthless mineral rights. Any losses when the land is sold are capital losses.

Example

An oil company drills a test well that does not produce on land rented from a farmer. Assuming that the farmer owns the mineral rights, he would only be entitled to a capital loss on the mineral rights when the land is sold, not when the well stops producing. The situation is well described in *Louisiana Land & Exploration Co. v. Commissioner*, 161 F.2d 842 (5th Cir. 1947).

Cost Depletion

Cost depletion, for water rights, is allowed when it can be demonstrated that the ground water is being depleted and that the rate of recharge is so slow that once extracted, the water is lost to the farmer and to immediately succeeding generations. [See *Rev. Rul. 82-214*, 1982-2 C.B. 115 and *Rev. Rul. 65-296*, 1965-2 C.B. 181.]

Percentage Depletion

This method may not be used for standing timber, soil, sod, dirt, water, or turf. The percentage depletion deduction cannot be more than 50% of the property's taxable income determined without the depletion deduction and any net operating loss deduction.

For tax years beginning before January 1, 2005, the percentage for oil and gas properties is limited to 100% of the taxable income from the property (computed without the allowance for depletion). For tax years beginning after December 31, 2004, the taxable income is computed without the allowance for depletion and without the deduction under section 199. The 50% limitation still applies to all other depletable properties (IRC § 613). This distinction is important because farmers often have oil and gas interests.

Consider the following when water depletion expense is present:

1. How was the ground water acquisition valued?
2. What is similar land selling for that does not have a good water supply?

3. Has the farmer sold farmland on which water depletion was taken? If so, has the basis of the farmland been adjusted by any cost depletion deductions claimed in prior years.

Commodity Bases

A commodity base is an amount used by the federal government to determine the amount of federal payments a farmer is entitled to receive if he chooses to participate in a federal program (see Chapter 2, Income). Commodity bases are available for most commodities, such as corn, cotton, wheat, and rice. Over the years the types of programs have varied. As of January 1996, the former payment program which included target prices, deficiency payments and acreage reduction payment programs was replaced with a new program (1996 U.S. Farm Bill) based on flexible production (see Chapter 2, Income). In order to qualify for the old programs, the farmer had to establish a production base in each commodity. This production base is a capital asset attached to the land and no amortization is allowed. If a parcel of land is purchased from a farmer who has established various commodity bases, then a part of the purchase price is allocable to the bases (*Rev. Rul. 66-58, 1966-1 C.B. 186*). Under the old program, the base amount was adjusted yearly based on yield. A decrease in a base amount does not entitle the farmer to a loss for the decrease [*Rev. Rul. 74-306, 1974-2 C.B. 58, explains that a deduction for this kind of a loss is not allowable under IRC § 165(a).*]

The 1996 U.S. Farm Bill programs were replaced by the 2002 Farm Security and Rural Investment Act (FSRIA), which provided for three different types of payments for more farm commodities:

- Marketing Assistance Loans: similar to prior program, including Loan Deficiency Pmts (LDP), Marketing Loan Gains (MLGs), Certificate Exchange Gains and Forfeiture Gains.
- Direct Payments: replaced Production Flexibility Contracts (PFC) and Agricultural Market Transition Act (AMTA) payments.
- Counter Cyclical Payments (CCP): new.

Farmers could decide to:

1. Keep their current program base acres, or update their base acres to reflect 1998-2001 cropping patterns.
2. Not update their base acres, and if soybeans are being grown, a soybean base will be created. The farmer can have some other crop base acres shifted into the soybean base.
3. Update base acres and keep old program yields based on 1981-1985 levels or update yields based on 1998-2001 levels.

Program yields cannot be updated unless the base acres are updated. Loan Deficiency Payments or marketing loans have the same rules as in the prior program, but with new average loan rates. They can be taken any time from harvest until May 31 of the following year. Direct Payments are based on the old program yields and the calculated "old" soybean yield, which become fixed once the base acres are determined.

Payments for 2002 will be made as soon as possible after December 1; however, the

FSA will deduct advance AMTA payments on 2002 crops first. In following years, up to 50 percent will be paid in December prior to the crop year, and the rest in October in the harvest year. Counter Cyclical Payments are made when the national average prices are below the target levels specified in the bill by more than the amount of the direct payment rate. They will be paid up to 35 percent in October of the harvest year (based on projected prices), up to 35 percent in February, and the remainder after September 1.

Basis on Farm Assets - Potential Issues

1. A full year depreciation claimed on assets not held a full year.
2. A full year depreciation claimed on assets purchased at the year end.
3. The most common issue is the allocation of cost to land and improvements. More often than not, an unreasonably low value will be placed on the land. Land is a non-depreciable asset and is not deductible. (See example below)
4. Cultural expenses included in the sale of a farm with unharvested crops must be capitalized in the year of purchase by the buyer. The cost can be deducted in the year that the income from the crops is received. Look at the purchase escrow to see what the purchaser paid for these unharvested crops. Make sure that the right amount was allocated appropriately (See Rev. Rul. 85-82, 1985-1 C.B. 57).

Potential Issue – Example

Daniel Boone purchases a ranch for \$300,000. The price includes farm equipment, a well and 40 acres of grape vineyards. Since purchase contracts do not show an allocation of assets, Mr. Boone may attempt to assign more cost to depreciable assets. To assess if this has occurred:

A good technique is to request the taxpayer's property tax statement. This will show the ratio between land and improvements. If the statement shows that land is 40% of the total property value, then you know that at least 40% is not depreciable. The remainder should be allocated appropriately among the other assets purchased.

$\$300,000 \times 40\% = \$120,000$ Land

\$180,000 Improvements (depreciable amount)

Remember that you can use information from the Department of Agriculture Offices. They have a lot of information that could be helpful.

Information on land values can be obtained by contacting the local state chapter of the American Society of Farm Managers and Rural Appraisers by using their website: www.asfmra.org. The California Chapter of the American Society of Farm Managers and Rural Appraisers website is: www.calasfmra.com. However, they have the following disclaimer: "Remember the value and lease data presented in the report represents a general range of sales and rental data for each stated market. Specific sales or leases may be higher or lower than the ranges noted in any given region. Due to the many factors that characterize agricultural properties in the state, one should not assume that all properties in a certain area – or of a particular crop – will fall within the ranges shown." Additional research will be required to accurately estimate the value of specific parcels.

Expenses

Introduction: Farm Business Expenses

Related Entities

Capital vs. Reoccurring Costs

Contract Labor

Outside Services Informational Sources

Introduction: Farm Business Expenses

IRC § 162 and Treas. Reg. § 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.

Most farmers use the cash method of accounting to record their expenses. When using the accrual method of accounting, 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.

Deposits or Payments

Farmers often write a substantial number of checks during the last few days of the tax year to pay expenses. Large disbursements should always be part of your examination. You must then determine if the disbursement is a payment or a deposit. Whether an expenditure is a payment or a deposit depends on the facts and circumstances of each case.

A deposit to be applied against a future expense is **not deductible**. Although a check is written, no deduction is allowable until the expense is actually incurred. The following factors, although not all inclusive, are indicative of a **deposit** rather than a payment.

1. The absence of specific quantity terms.
2. The right to a refund of any unapplied payment credit of the contract. *See Lillie v. Commissioner, 45 T.C. 54 (1965), aff'd per curiam, 370 F.2d 562 (9th Cir. 1966).*
3. The treatment of the expenditure as a deposit by the seller.
4. The right to substitute other goods or products as specified in the contract.

These factors apply to all farm expenses for which a payment is made prior to delivery.

The issue arises when the seller treats the farmer's payment as a deposit and does not report the amount paid by the farmer as income. However, the farmer takes the amount paid as an expense. This is a common occurrence in the farming industry for fertilizer, feed, grain, etc. This transaction could have one of three consequences:

1. The disallowance of the expense to the farmer.
2. Income to the seller.
3. A change in accounting method.

Prepaid Expenses

IRC § 464 limits the allowable deduction for prepaid supplies if they exceed 50% 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. IRC § 464 rules are designed to prevent taxpayers that are not farmers from using a farm to shelter income.

Exceptions: the limit on the deduction for prepaid farm supplies does not apply to a farm-related taxpayer where either of the following apply.

1. The prepaid farm supplies expense is more than 50% of the deductible farm expenses because of a change in business operations caused by extraordinary circumstances.
2. The total prepaid farm supplies expense for the preceding 3 tax years is less than 50% of the total other deductible farm expenses for those 3 years.

A taxpayer is a farm-related taxpayer if any of the following tests apply:

1. Main home is on a farm.
2. Principal business is farming.
3. A member of the family meets test (1) or (2).

For this purpose, family includes your brothers and sisters, half-brothers and half-sisters, spouse, parents, grandparents, children, grandchildren, and aunts and uncles and their children.

Rev. Rul. 79-229, 1979-2 C.B. 210, sets out **three tests** that must be met in order to deduct the cost of a supply purchased in the current taxable year which will be used in the subsequent taxable year.

1. The expense must be 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 to a refund or repurchase.
2. The prepayment is not merely for tax avoidance, but has a specific business purpose. Examples of business benefits are:
 - a. Fixing maximum prices.
 - b. Securing an assured feed supply.
 - c. Securing preferential treatment in anticipation of shortages.
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 materiality of the expenditure in relation to the taxpayer's income for the year.
 - c. The time of the year the purchase is made.
 - d. The amount of the expenditure in relation to past purchases.

Inspect check endorsements, flip checks, and check with suppliers to determine the validity of the expense.

Remember Rev. Rul. 79-229 was written before the passive activity rules of IRC § 469 were enacted. Consideration of IRC § 469 could further limit farming expenses. The Passive Activity Loss website on the IRS intranet has a section on farms with common issues, interview questions and many examples and cites to use in determining if there is an issue. Pub. 225 discusses the prepaid farm supplies and livestock feed issue with several examples.

Related Entities

Introduction

As stated in Chapter 2, Income, transactions between related persons or entities can be myriad. **Allocations of shared expenses** are common among related entities. Some of the things to consider are:

1. Determine the allocation method for shared expenses and sample checks and invoices to verify accuracy, reasonability and internal controls (IRC §162, etc.).
2. Watch for unusual allocations that might be manipulated for tax benefits to related entities. Use of a flowchart of the related entities and transactions should be used to help this analysis. "Substance Versus Form" and various code sections can apply, especially IRC § 482.
3. Crop loans are sometimes allocated to partnerships and then used as basis for flowing-through losses to the partners. Inspect for liability of the original crop loan and whose assets are being pledged. Sometimes a partner is not liable for the loan, but uses a share of the liabilities to deduct losses. This is covered in IRC § 704(d) - Partner's Distributive Share, Limitation on Allowance of Losses.
4. Watch for preproductive expenses being currently deducted by paying custom farming entities, rather than being capitalized by the entity owning the assets, as required by IRC § 263A.

Law

There are many revenue rulings, code sections and regulations enacted to address related party transactions. See the Code sections in Chapter Two - "Related Entities." Some of these are noted below:

1. Auto expenses of related employees are not exempted from the substantiation requirements merely because of an accounting to the employer. [*Temp. Treas. Reg. § 1.274-5T(f)(5)(ii)*]
2. Anti-Churning rules. Property owned or used at any time by the taxpayer or related party, except for residential rental property or non-residential real property. See IRC § 168(f)(5)(B) for additional details.
3. Deductions for rentals between related parties or controlled entities are not allowed in excess of a reasonable rental. (*Social Psychological Services, Inc. v. Commissioner, T.C. Memo. 1993-565*)
4. Installment sales. In general, disposition of property within two years after a sale between related parties triggers recognition of gain by the initial seller based on the seller's gross profit ratio to the extent the amount realized from the second disposition exceeds actual payments made under the installment sale. [*IRC § 453(e)*]
5. Imputed interest rate for members of the same family. An installment sale of land qualifies for imputed interest of no more than six percent compounded semi-

annually, for sales or exchanges of land between family members not exceeding \$500,000 during any calendar year. *[IRC § 483(e)]*

6. Acquisition of debt by a person related to the debtor from a person not related to the debtor results in the debtor's realization of discharge of indebtedness income, measured by the difference between the face value and fair market value of the indebtedness on the acquisition date. *[IRC § 108(e)(4)]*
7. Cash basis taxpayer can deduct an expense if it is paid to related accrual basis taxpayer, who was required to include it as income. This is also true for the reverse situation.
(IRC § 267)
8. A non-arms-length transaction between related taxpayers is subject to reallocation in order to clearly reflect income and expenses. *(IRC § 482)*
9. Election out of IRC § 263A requires that the Alternative Depreciation System, per IRC § 168(g)(2), must be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect. *[Treas. Reg. § 1.263A-4(d)(4)(ii)]*

Capital vs. Reoccurring Costs

Land Preparation

The proper tax treatment of costs incurred in a farming operation depends on whether the amount expended represents a deductible expense or a capital expenditure. Most expenses attributable to profit-seeking farm activities are deductible as either business expenses or as production-of-income expenses *(IRC § 162 & 212)*.

A capital cost is paid or incurred for the acquisition, improvement, or restoration of an asset having a useful life of more than one year. Capital expenses are generally not deductible, but they may be depreciable *(IRC § 263)*. Uniform capitalization rules also require you to capitalize or include in inventory certain expenses *(IRC § 263A)*.

The costs of the following items are costs you must capitalize. The costs of material, hired labor, and installation of these items must also be capitalized.

1. Water wells (including drilling and equipping costs)
2. Preparatory costs such as:
 - a. Clearing land for farming (survey and layout of field)
 - b. Leveling and conditioning land (fumigation and discing)
 - c. Purchasing and planting trees and vines (digging)
 - d. Building irrigation canals and ditches
 - e. Laying irrigation pipes and installing drain tile
 - f. Modifying channels, streams and dams
 - g. Constructing earth, masonry or concrete tanks and reservoirs
 - h. Fertilizer and lime application benefits that last substantially longer than one year (except for election of IRC § 180)

Common reoccurring land expenses are current farm deductions in the year in which they are paid or incurred where the benefits generally do not last substantially longer than one year (but only after the plants are producing in marketable quantities).

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1. Pesticides, herbicides, and other chemicals applied to crops or farmland yearly
2. Insecticide spraying and dusting
3. Discing for weed control and for ground maintenance
4. Fertilizer, lime and other materials that enrich, neutralize, or condition farmland

For information to help you determine which pesticides are preparatory land costs or reoccurring costs, contact the local county Agricultural Commissioner's Office. They will also have information regarding pesticide use permits.

Another source of information is the state university agricultural publications. The following data is an example of the information contained within one of their publications entitled "To Establish a Vineyard and Produce - RAISINS."

Site Preparation

The land is subsoiled twice to a depth of 2 -3 feet, breaking underlying plowpan or hardpan to improve root and water penetration. Afterwards the ground is disced twice to break up large clods of soil, smoothing the ground in advance of leveling. Leveling consists of three passes with a landplane. The bare ground is fumigated, to control soil nematodes and pathogens. All of the land preparation operations are contracted out to commercial companies. Most operations that prepare the vineyard for planting are done in the year prior to planting.

Planting

Planting the vineyard starts by laying out and marking vine sites in late winter. Holes are dug and vines are planted. About 605 vines are planted per acre during the first spring. In the second year, 25 vines per acre are replaced due to damaged vines, etc..

Following planting, a pre-emergent residual herbicide is applied for weed control through most of the first year growing season.

Vineyard Floor Management

Weed control in the vine row and middles are managed with multiple discing and herbicides. The row middles are disced from March through August. A total of four discings per season are included. The vine rows are strip-sprayed with different combinations of pre-emergent herbicides during winter each year.

Occasionally, an issue arises regarding a farmer's expensing of costs associated with leveling or otherwise preparing land for use. Most of these questions have been resolved by IRC § 175.

Section 175 provides that if a taxpayer is engaged in farming, expenses incurred for soil and water conservation may be deducted as a current business expense. The Regulation provides further clarification on this issue.

The Tax Court, in *Estate of Straughn v. Commissioner*, 55 T.C. 21 (1970), went further to state that the expenses of leveling land, breaking up the "hardpan" below the surface, were deductible even though it made the farmland usable for many crops for which it was not previously suited. The Court found the fact that the land had been used for farming prior to the taxpayer's purchase of the land made the costs deductible in the CH 4 Farmer ATG July 2006

year incurred. In *Straughn*, the Court stated that the law provided for the deduction, if the land had been used for farming (i.e. the planting of crops of any kind, not the raising of livestock). Therefore, if the use of the land goes from growing one kind of crop to growing any other kind of crop, it would appear to be acceptable to expense the costs associated with soil and water conservation.

However, if the land had not been used for farming immediately prior to the time the conservation measures were undertaken, we could argue that the costs are capital costs of readying the land for farming use. In *Amfac, Inc. v. Commissioner*, 626 F. 2d 109 (9th Cir. 1980), the Tax Court disallowed the claimed expenses. The Court found that a company had used the land for farming at a prior time, but it was long before the recorded history of the company. The Court found that this was just simply too long. However, in *Behring v. Commissioner*, 32 T.C. 1256 (1959), the Tax Court found a company's cost of leveling farmland for planting was not capital when the land had previously been used for farming, even though the land had not been used for farming in 30 years.

Written recommendations are required for many pesticides and are made by licensed pest control advisors. For information and pesticide use permits, contact the state or local county Agricultural Commissioner's Office. For additional production information, contact one of your local viticulture farm advisors.

The following table was prepared by University of California Cooperative Extension as sample costs to establish a vineyard and produce Thompson Seedless Raisins in the San Joaquin Valley of California in 2003.

Labor Rate: \$9.51/hr. machine labor	
Vines per Acre 605	9.0 Tons per acre Fresh
\$8.23/hr. non-machine labor	

Planting Costs	1st Year	2nd Year	3rd Year
Land Preparation - Chisel 2X (Custom)	120		
Land Preparation – Disc/Apply Herbicide	7		
Land Preparation - Float	7		
Land Preparation – Disc (Incorporate Herbicide)	5		
Survey & Layout Vineyard	82		
Dig & Plant, Cover Vines	182	2	
Vines on rootstock: 605 per acre (2% Replant in 2nd Year)	1,724	34	
Install Trellis system		3,100	
Total Planting Costs	\$2,127	\$3,136	\$0

Cultural Costs	1st Year	2nd Year	3rd Year
Weed Control – Spot Spray	18	12	12

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Prune - Dormant		55	94
Fertilize	7	9	9
Irrigate	79	112	152
Training (Sucker, Tie & Train)		331	209
Weed Control - Disc. Middle		10	10
Insect Control (Leafhoppers)			28
Disease Control - Mildew			44
Insect Control(Worms)/Disease(Mildew)/Fertilize(Zinc)			30
Weed Control - Winter Strip Spray		54	54
ATV Use	26	26	26
Pickup Truck Use	51	51	51
Total Cultural Costs	\$181	\$660	\$719

Cash Overhead Costs	1st	2nd	3rd
	Year	Year	Year
Office Expenses	75	75	75
Liability Insurance	5	5	5
Sanitation Services	12	12	12
Property Taxes	68	68	69
Property Insurance	6	6	6
Investment Repairs	26	26	26
Total Cash Overhead Costs	\$192	\$192	\$193

The grapevines are expected to begin yielding fruit in three years and be productive for an additional 22 years (25 year life of asset).

Therefore, expenses incurred in the first three years in establishment and cultural practices for the production of raisins represent a capital expense (See Uniform Capitalization). All other reoccurring expenses are current expenses.

The cost studies like the one above are available for most crops, see Outside Services Informational Sources at the end of this chapter. Many farmers have not allocated overhead expenditures to plantings on their books and therefore these studies provide normal costs per acre that should be shared with and refined by the farmer for capitalization of preproductive costs. Any large changes recommended by the farmer should be accompanied by reasonable explanations and supporting documents.

Uniform Capitalization

This area of income tax administration is for costs incurred after December 31, 1986. There is increasing case law in this area as it pertains to agricultural growers. Most of the following is editorializing on the statute and regulations. This is intended as only a brief overview of this complex law to administer in examinations of agricultural growers.

Scope

This discussion does not include "growers" who raise animals, Christmas, ornamental, or other nursery trees or flowers, though they are subject to the rules of IRC § 263A for

other crops or property produced. It also does not apply to growers of plants (food and fiber) required to capitalize cost into an ending inventory under statutes other than IRC § 263A.

General Discussion

This was part of the Tax Reform Act of 1986. IRC § 263A is entitled “Capitalization and inclusion in inventory costs of certain expenses.” It requires certain taxpayers to capitalize not only direct labor and direct materials but also certain “allocable indirect costs.”

Also, this statute can be looked upon as a “disallowance provision” because IRC § 263A(a) stated, in part, “Nondeductibility of certain direct and indirect costs.”

The Accounting Concept of “Cost”

Cost is the amount of cash or equivalent given to acquire property or a service. The cost of properties or services acquired and on hand at any particular time represents assets. Such costs may also be referred to as “unexpired costs.” As the assets are sold or consumed, they become “expired costs” (or “expenses”).

Self Constructed Assets

An asset is any physical thing (tangible) or right (intangible) that has a monetary value.

A manufacturer builds a machine that produces the end product and it takes him three years to build this machine. How should the “stream of costs” that occurs over these three years be handled? This “stream” would include the entrepreneurial management, general labor cost, land, cost of materials, plant use, tools, etc., the capital (use of money) cost, all to construct this machine.

Generally Accepted Accounting Principles, GAAP, would require that these costs be collected or bundled together as “unexpired costs.” When the machine begins to produce the end product, depreciation of these costs should begin. There would be an attempt to match the recognized outflow of cost with the recognized inflow of income that the machine generates.

Application to Agricultural Growers

These are divided into two groups:

1. Annual Planters - for these growers the general farm cycle is as follows:

The farmer starts with bare land, prepares it, plants seeds, waters, fertilizes, protects, nurtures, harvests the end product, removes or plows under waste and returns to bare land.

Examples are many: tomatoes, onions, peppers, melons, cotton, corn, wheat, etc.. These “annual planters,” because their preproductive period is less than two years, are not subject to IRC § 263A.

2. Trees and Vines (Self-Constructed Farm Assets)

These farmers hold the land, plan its development, prepare it for planting, hire the labor to plant the young seedlings, nurture them with water, sprays, stakes, etc.. It may take over three years to develop these assets that produce the agricultural commodity.

a. Crops Subject to IRC § 263A

The IRS has identified the following **crops which have a nationwide weighted average preproductive period in excess of two years**:

almonds, apples, apricots, avocados, blueberries, blackberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, papayas, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, raspberries, tangelos, tangerines, tangors, and walnuts. *Notice 2000-45, 2000-2 C.B. 256.*

For purposes of determining whether a plant has a preproductive period in excess of two years, the preproductive period of plants grown in commercial quantities in the United States is based on a nationwide weighted average and **not on the experience of the individual farmer**. See example 4 of Treas. Reg. § 1.263A-4(b)(2)(i)(D), where a farmer produced in marketable quantities in less than 2 years, but was still required to capitalize the preproductive expenses.

b. Costs Subject to IRC § 263A

Costs typically required to be capitalized under IRC § 263A include the acquisition costs of the seed, seedling, or plant, and the costs of planting, cultivating, maintaining, or developing such plant during the preproductive period. These costs include, but are not limited to, management, irrigation, pruning, soil and water conservation (including costs that the taxpayer has elected to deduct under section 175), fertilizing (including costs that the taxpayer has elected to deduct under section 180), frost protection, spraying, harvesting, storage and handling, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes (except state and Federal income taxes) and interest required to be capitalized under IRC § 263A(f). Treas. Reg. § 1.263A-4(b)(1)(i).

c. Defined “Preproductive Period”

The statute is silent as to the beginning of the preproductive period. “In general, for purposes of this section [IRC § 263A], the term ‘preproductive period’ means—(i) in the case of a plant which will have more than 1 crop or yield, the period before the 1st marketable crop or yield from such plant...” *IRC § 263A(e)(3)*

“The actual preproductive period of a plant begins when the taxpayer first incurs costs that directly benefit or are incurred by reason of the plant. Generally, this occurs when the taxpayer plants the seed or plant.” *Treas. Reg. § 1.263A-4(b)(2)(i)(C)(1).*

d. Defined “marketable quantities”

“In the case of a plant that will have more than one crop or yield, the actual preproductive period ends when the plant first becomes productive in marketable quantities.” *Treas. Reg. § 1.263A-4(b)(2)(i)(C)(2)(i)*.

Plants that will have more than one crop or yield become productive in marketable quantities when the yield is deemed to be more than a de minimis portion of the estimated full production amount and that should be in combination with a net profit that reasonably contributes to the overhead costs of those plants. *Treas. Reg. § 1.263A-4(b)(2)(i)(C)(2)(ii)*.

Research Technical Advice Memorandums (TAM), etc. for discussions of “marketable quantities”. Also, *Pelaez and Sons, Inc. v. Commissioner*, 114 T.C. 473 (2000), *aff’d*, 253 F.3d 711 (11th Cir. 2001).

Electing Out of the IRC § 263A Rules

Almond and citrus tree growers can not elect out of capitalizing preproductive expenses for the initial 4 years. IRC § 263A(d)(3)(C)

Other tree and vine farmers can elect out of the Uniform Capitalization rules in the first year the farmer has § 263A costs by not capitalizing the preproductive cost and applying special rules:

Section 1245 treatment upon disposition and required use of the Alternative Depreciation System (ADS) under IRC § 168(g)(2) for all assets used in farming and placed in service in the year preproductive costs begin. The required use of ADS depreciation extends to related persons, which includes partnerships owned 50% or more by the electing taxpayer or members of the taxpayer’s family. IRC § 263A(d)(3) & (e)

Section 263A Capitalization of Preproductive Cost with Respect to Orchards and Vineyards can be determined by answering the following questions: 1. Is the grower required to use the accrual method of accounting? If Yes, then IRC § 263A applies. If No, then: 2. Did the grower replace plants lost in a casualty? If Yes, then IRC § 263A does not apply. If No, then: 3. Is the Weighted Nationwide Average Preproductive Period, per Notice 2000-45, two years or less? If Yes, then IRC § 263A does not apply. If No, then: 4. Did the grower elect out of IRC § 263A by A.) Not Capitalizing the Preproductive Period Costs and B.) Applying the special rules of: a) IRC § 1245 treatment upon disposition of the property and b) Required use of the Alternative Depreciation System (ADS) for all assets used in farming and placed in service by the taxpayers or related entities upon commencement of incurring preproductive costs. If Yes, then IRC § 263A does not apply. If No, then: 5. Did the grower incur/pay the Preproductive Period Costs of planting, cultivation, maintenance, or development of a citrus or almond grove? If Yes, then IRC § 263A applies. If No, then IRC § 263A does not apply.

Miscellaneous Deductions:

IRC 114, Extraterritorial Income Exclusion, ETI, was added by P.L. 106-519, Sec 3(a), effective for foreign sales after 9-30-2000. Farmers were allowed to claim a deduction
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in the Other Expenses category of the Sch F by completing Form 8873 with the allocated foreign sales income and expenses for the allowable deduction amount. This was repealed by P.L. 108-357, Sec 101(d)-(f) with phase-out allowance of 80% in 2005 and 60% in 2006 of the otherwise-applicable pre-repeal ETI exclusion.

IRC 199, Domestic Production Deduction, DPD, was enacted by P.L. 108-357, Sec 102(a), effective for tax years beginning after 12-31-2004. This deduction is phased-in based on the lower of qualified production activities income or taxable income. The phase-in percentages for tax years beginning in: 2005 or 2006 is 3%; 2007 thru 2009 is 6%; and 2010 and forward is 9%. The deduction is limited to no more than 50% of W-2 wages paid for the taxable year.

Audit Techniques

1. When inspecting returns always look for costs being deducted that appear to be excessive for the income reported. Determine if the costs are in the nature of establishing an orchard or vineyard.
2. If the farmer is currently deducting preproductive costs, check the detail depreciation schedule to verify that ADS life and straight line depreciation is being used on any farm assets placed into service during the preproductive period. If accelerated depreciation methods are used for the new assets, then there is an invalid election out of IRC § 263A. Also, if the farmer owns 50% or more of other farm entities, have they properly used ADS for all farm assets placed in service in a year of preproduction, within meaning of IRC § 263A(e)(2)(B)?
3. If there is an invalid election out, the examiner has two options: (1) Change of Accounting Method to capitalize costs for the plants – in closed and open years that should not have been deducted – IRC § 481(a) adjustment or (2) Allow the election out of IRC § 263A and change the depreciation on the farm assets placed into service to be straight line and ADS lives. Calculation of any IRC § 481(b) limitations on the additional tax amount can be done by either the examiner or representative.
4. When the books and records do not provide a means to separate operating costs of the mature plants from the preproductive plants, consider the use of industry studies that give estimates of development costs per acre that can be reasonably applied to your grower.
5. The less than two years to producing in marketable quantities argument as a reason for not capitalizing does not apply to plants listed in Notice 2000-45. How the marketable quantities amount was calculated should always be checked to supporting records.
6. Take a tour of the farm and note the type of machinery present, young trees and vines, etc. Ask questions about any of these and about the operations of the farm.

Contract Labor

Labor Expenses

A farmer will have a variety of farming expenses; one of the major expenses is labor. The farming industry is labor intensive because the production of commodities requires manpower throughout its production cycle.

Farm employment is sometimes hired out via Farm Labor Contractors (FLC). Farm Labor Contractors are required to be licensed by some states (check with your local state requirements). More detailed information is attached pertaining to FLC (Page 4-15).

Listed below are a few examination techniques that you need to be aware of:

1. Compare the wage expense to gross receipts. Remember the farmer, like the FLC, must meet the Social Security Taxes, Medicare Taxes, FUTA Taxes, SUI Reserve Fund, and Worker's Compensation.
2. Verify the wages and payroll taxes were paid. Order complete microfilm transcripts on the payroll taxes returns of the individual who is the employer (the farmer or FLC). Remember that Form 943 "Employer's Annual Tax Return for Agricultural Employees" and Form 940 "Employer's Annual Federal Unemployment (FUTA)" are required to be filed.
3. Verify all payroll taxes have been paid. If a large outstanding obligation exists, consider IRC § 3505(b). This code section may apply. See attachment on FLC for more detail. Also look for Federal Tax Deposit Penalties on IDRS transcripts using Command Code BMFOLT and Transaction Codes 180 and 186. The penalties are not deductible.
4. If the payroll transcripts reflect an outstanding balance, make sure the taxpayer is only deducting his share of payroll taxes. Also, verify that the employees' withholding and any employees' share is taken into consideration first before any credits are allocated to the employer.

Farm Labor Contractors

Farm labor contractors are required to be registered with the Federal Department of Labor in order to perform any of the covered activities under the Migrant and Seasonal Agricultural Worker Protection Act. This act contains the federal definition of a farm labor contractor (See page 4-15).

In addition to the federal registration, California and some other states impose a state licensing requirement for farm labor contractors (FLC). The state definition of a FLC pretty much mirrors that of the federal definition.

The state of California has amended its licensing requirements to require that all FLCs be current on their State and Federal payroll tax deposits before their license is renewed. The FLCs that want to continue in business have a motivation to come to the IRS and take care of their delinquent tax matters. This, however, does not resolve all the problems.

FLCs run into problems for the following reasons:

1. The competitive nature of the business
2. The lack of sophistication and sound business practices

In order to obtain a contract, the FLC will come in with a bid that is not sufficient to make payroll, pay overhead and still realize a profit. Growers will contract with the FLC to pay gross wages or a set price per hour plus a fixed percentage to cover the FLC's direct overhead and overhead expenses (See chart of acceptable industry standards, page 4-14).

In 1994, the IRS entered into a partnership agreement with the California State Department of Industrial Relations, Division of Labor Standards Enforcement (DLSE), which oversees the licensing of FLCs in the state. The agreement allows the IRS to make disclosures to the State of California relative to the FLC's compliance with federal employment tax reporting and paying requirements, by executing Form 8821 Tax Information Authorization. This agreement was to try to curtail the enormous abuses by FLCs in the area of employment tax reporting and paying.

IRC § 3505(b) states any person who supplies funds for the specific purpose of paying wages, with actual notice or knowledge that the employer does not intend to or will be unable to make timely payment or deposit of the withheld taxes, will be personally liable for a sum equal to the unpaid taxes. However, the liability is limited to 25% of the amount supplied to the employer for the specific purpose of paying wages. IRC § 3505 cannot be pursued administratively so a suit would have to be initiated. Pertinent questions for the grower related to his contract with the FLC include:

1. Has he ever provided money to the FLC for net payroll?
2. What is the commission rate for the contract?
3. Is there a written contract?
4. Has he paid the FLC in full for the contract?

These questions and any information along these lines would help document an IRC §3505 case.

In 1994, the "Agricultural Team" was established from all functions in the IRS Fresno, California POD (Revenue Agents, Revenue Officers and Auditors) to help in the implementation of the licensing agreement with DLSE.

Through past media and community outreach, coupled with the cooperative licensing agreement, there has been improvement in compliance. Where accounts were once written off as uncollectible while the FLC continued to accumulate liabilities, delinquent accounts have been reduced substantially. At the same time, the FLC is monitored to ensure that FTDs are made. Once FLCs resolve their accounts, they are monitored to make sure they stay in compliance.

Farm Labor Contractor Commission Rates

The commission rates below are examples of acceptable industry standards. The actual commission rate a Farm Labor Contractor (FLC) charges will vary slightly depending on the workers' compensation schedule and the State Unemployment Insurance rate. The workers' compensation rates below are pure rates as established by the State of California Workers' Compensation Insurance Commissioners Office as CH 4 Farmer ATG July 2006

of January 1, 2005, at www.insurance.ca.gov. Select “Consumers” on the home page and then “California Workers’ Compensation Rate Comparison”. Then select “WC Classification Description” and then go to the last 2 pages of that site for Appendix I, Pure Premium Rate Section. The description of each code classification is provided in the earlier pages. Modifications allowed to the insurers will make the actual rates higher.

The State Unemployment Insurance rate will be slightly higher or lower depending on the FLC’s usage of his reserve fund account.

	Strawberry	Cotton	Orchards (Citrus & Deciduous)	Vineyard
Social Security Taxes	6.20%	6.20%	6.20%	6.20%
Medicare Taxes	1.45%	1.45%	1.45%	1.45%
FUTA Taxes	0.80%	0.80%	0.80%	0.80%
SUI	5.10%	5.10%	5.10%	5.10%
Workers’ Compensation	5.85%	8.40%	10.28%	6.04%
FLC Operational Overhead	12.00%	12.00%	12.00%	12.00%
FLC Profit Margin	3.00%	3.00%	3.00%	3.00%
Commission	34.40%	36.95%	38.83%	34.59%

FLC operational overhead includes provisions for liability insurance, vehicle insurance, office rent, utilities, fuel, vehicle maintenance, supervisor and crewboss wages, toilets, drinking water, radio and cell phone communications, regulatory posters, and work related tools and equipment.

FLC profit margins are charges included to replace old equipment, vehicles, outdated, damaged, lost or stolen worker-related tools and replace or expand toilet facilities.

Farm Labor Contractors Defined

1. Under the Migrant and Seasonal Agricultural Worker Protection Act [29 USC § 1802(7)]

Any person, other than an Agricultural Employer (farmer, packer, processor and other fixed situs entities) or Association (coops) or employee thereof, who for money or other valuable consideration paid or promised to be paid, recruits, solicits, hires, employs, furnishes or transports, migrant or seasonal agricultural workers.

Note: Agricultural Employers and Associations and their employees cannot be Farm Labor Contractors (FLCs)

2. California Farm Labor Contractor Act (California Labor Code § 1682-1699)

Any person who, for a fee, employs workers to render personal services in connection with the production of any farm products, to, for, or under the direction of a third person [CA Labor Code § 1682(b)],

OR

Any person who, recruits, solicits, supplies or hires workers, on behalf of an employer engaged in the growing or producing of farm products,

AND

for a fee provides in connection therewith one or more of the following services:

- a. Furnishes board, lodging or transportation for such workers
- b. Supervises, times, checks amounts, weighs or otherwise directs or measures their work
- c. Disburses wage payments to such persons [CA LC § 1682(b)]

OR

Is employed by an FLC to transport by motor vehicle, workers to render personal services in connection with the production of any farm products, to, for or under the direction of a third person (CA LC § 1682.3)

OR

For a fee, transports by motor vehicle, workers to render personal services in connection with the production of any farm products, to, for or under the direction of a third person (CA LC § 1682.3)

BUT

does not include a commercial packing house engaged in both the harvesting and the packing of citrus fruit or soft fruit for a client or customer (CA LC § 1682.4).

Quarterly Filing

Subtitle F of the Internal Revenue Code provides the laws for the Procedure and Administration of the Code. Chapter 64, dealing with collection, is contained in Subtitle F. IRC § 6302(a) states that if the time and mode of collection of any tax is not provided for elsewhere in the Code, then the Secretary may establish the method and manner of collection by regulation.

Treas. Reg. § 31.6302-1(g) contains the rules for agricultural employers. That regulation provides that, in general, an agricultural employer will report agricultural wages paid to farm workers annually on Form 943. The regulation goes further to state that non-agricultural wages must be separately accounted for and paid over on separate deposit coupons from the agricultural employee.

It is clear that the Secretary has decided that Forms 943 are to be filed only annually. That being the case, we may not impose additional quarterly filing requirements on agricultural employers.

IRC § 7512 provides that those who do not timely deposit taxes shall maintain a separate bank account, deposit the withheld taxes therein immediately and maintain that account in trust for the United States. Section 7512 applies only to employment taxes under Subtitle C and taxes under Chapter 33. That being the case, IRC § 7512 is applicable to the taxes in question. Therefore, investigate the possibility of using this code section to assist taxpayers in their compliance efforts.

Outside Services Informational Sources

Since one of the purposes of this guide is to provide general understanding of farming operations necessary to adapt auditing techniques, there are outside entities which can provide us with a wealth of information and data regarding the farming industry. Listed below are only a few examples of outside services available:

1. *University of California Cooperative Extension (UCCE)* was established by an Act of Congress in 1914 and serves as an educational arm of the University of California to provide every citizen direct access to its knowledge and resources. Staff members of the University of California are stationed in counties as Farm Advisors; Nutrition, Family and Consumer Science Advisors; and 4-H Advisors. They provide practical information to the residents of their county through printed materials, public meetings, demonstrations, newsletters, news media, and individual contacts. The UCCE also prints "cost studies" on different commodities. These publications can be purchased for a small fee or go to <http://coststudies.ucdavis.edu>. These cost studies are very useful because they cover very detailed information pertaining to a specific commodity. They also publish Interrogated Pesticide Management Guidelines (IPM Guidelines). This publication also addresses pesticides for specific commodities. The state of California has several Extension Agents in different counties throughout the state. Check your local area for the nearest office.
2. *The County Ag Commissioner's Office* (California) is the office that issues pesticide permits to licensed pesticide applicators. They keep detailed records on such permits. Copies are sent to the state office of Pesticide Resources. Copies of such public records are available upon written request for a fee. A list of licensed pesticide applicators within the county is also available. Contact the local County Ag Commissioner's Office for more information.
3. *Local Agriculture County Fairs* are good sources of information that can provide you with news and information on what is happening in the agricultural community. Different vendors provide free information on commodities via pamphlets, charts, newsletters, videos, slide sets, catalogs, etc.. Agriculture supply vendors set up booths to display their goods and are there to answer questions. Ask the right question and you will be surprised at the information they are willing to share.
4. *Gas and Electric Companies* can also provide information regarding rebates (refunds) that are available to farmers who qualify for an energy efficiency

program. These programs differ each year. So, if you know that the farmer replaced or installed new pumps on their water wells, look for the additional income or offsetting adjustments.

5. *Marketing Boards, Crop Associations, and Crop Bureaus* are organizations that are formed by and for specific commodities (i.e., Walnut Marketing Board, Nisei Farmers League, Sunkist Growers, Inc., Blue Diamond Growers, Central California Almond Growers Association). A telephone call or written request to the entity might give you the answers to questions you might have regarding the commodity.
6. *Agricultural yellow page directories* that are published locally are an excellent source of information (i.e. Agriculture Net Yellow Pages). These publications are total agricultural resource guides. They contain names, telephone and fax numbers of vendors for Ag resources (i.e. suppliers, services, etc.). The vendors that are listed on the publication paid for such advertising but don't overlook this resource because other important information is enclosed. The publications also includes listings for Ag Associations, Government Agencies and Universities. A few are listed below:
 - a. State Government - State Department Food and Agriculture
 - b. Federal Government:
 - c. Bureau of Land Management
7. Bureau of Reclamation
 - Universities:
 - Crop Improvement Association:
 - Institute for Rural Studies
8. University Cooperative Extension
9. National and *Local Ag Insurance Companies* can be contacted for general information pertaining to crop damages. They sometimes keep charts on crop damages. They can provide you with additional information regarding rate changes, other crop events, etc.
10. *Don't forget one of the most reliable sources is the third-party letter.* For example
 - A Revenue Agent (RA) who used such a source was able to confirm that the farmer under examination had planted new grape vines. They took a photocopy of a purchase invoice from a vendor that specialized in soil fumigation using the chemical Methyl Bromide. The RA then mailed a copy to the vendor requesting that the vendor provide a copy of the work order and a map of the application site(s). The Revenue Agent used their knowledge that the chemical Methyl Bromide is used to control soil nematodes in site preparation for a new vineyard. The RA had obtained this information from the Cost Studies pamphlet that the University of California Cooperative Extension Fresno County (UCCE) published.

Cotton

Cotton Production Cycle
Cotton Terminology
Cotton Farming Information

Cotton Production Cycle

Month	Activity
January/February	Pre-Plant
April/May	Plant and Spray Insecticides
June	Thin, Spray Insecticides and Irrigate
July	Spray Insecticides and Irrigate
August	Final Irrigation
September	Apply Defoliant
October/ November	Harvest Pick Cotton Compress into Module Transport Module to Gin Gin Cotton into Bales and Seed
November/December	Chop Stalks and Disc Under

Cotton Terminology

Bale	The measured item sold to the purchaser is a cotton bale. It consists of the cotton lint after ginning. It weighs 500 pounds.
Boll	The white "flower" of the cotton plant that is harvested for cotton.
CCC Loans	Government loans secured by cotton and other commodities. See IRC § 77.
Classing/Grading	Classing or grading is done at the gin by the USDA. Samples are pulled from each bale and are analyzed for color, micronaire, strength, length and moisture content. The price received for the cotton is determined by its grade.
Cooperatives	Some gins are ginning cooperatives. A co-op gin is a tax exempt entity owned by the farmers. They can only be examined by the exempt organization division. A farming cooperative issues patronage dividends and makes per unit retain allocations.

Defoliant	Sprayed on plants to make the leaves fall off prior to picking. This makes it easier for mechanical picking and diminishes boll staining.
Gin	Place where cotton module is processed into a bale. The gin is a service provider and does not take title to the cotton. Here the seed is removed and is usually sold to the gin for a credit against baling costs.
Growth Regulators	Chemicals applied during blooming season to force plant to switch from vegetative growth to boll maturation.
Harvester	Machine used to mechanically remove bolls from the plant. Also called row pickers, they are designed to harvest multiple rows at a time. The number of rows of harvesting ability is usually an indication of the cost of the machine.
Lint	The part of the cotton plant flower used to make cotton. There are many varieties of cotton plants. The difference is in the quality of the lint. Common lints include Acala and Upland. Finer, more expensive lints include Pima.
Market Gain Payment	Market Gain Payments are associated with CCC Loans. If the adjusted world price of cotton falls below the loan rate, then the farmer needs only to repay that amount. The difference is a market gain.
Module	After cotton is harvested, it is dumped into a Module Builder. This machine compresses the cotton into a large block. After a module is built, the module builder moves on to build more modules. The block, or module, is left in the field until it is delivered to the gin.
Patronage Dividends	A co-op dividend taxable to the farmer issued on Form 1099.
Per Unit Retains	A non-cash allocation made by a co-op, taxable to the farmer.
Seed	Seed is the by-product in cotton production. It is usually sold to the gin for a credit against ginning costs, but it is sometimes sold directly by the farmer to specialized seed companies.

Cotton Farming Information

Yields and Prices

In California, cotton yield averages 1,250 pounds of lint and 2,200 pounds of seed per acre. The yields can vary depending upon local conditions. There are 500 pounds of lint per bale.

Cotton comes in many varieties. One variable in cotton price is the variety planted. Acala and Upland are standard varieties with prices in the 70 to 80 cents per pound

range. Pima is a whiter, more premium variety with a price in the 90 cent to \$1.10 range.

Audit Techniques

1. Since most sales contracts are stated in bales, the auditor must make a conversion from pounds to bales during the examination.
2. Use county averages or something similar in your area to estimate crop income (See Chapter 1, Audit Flow).

Planting and Growing

Cotton is planted in April or early May in either 30 inch or 40 inch row spacing. Production costs increase by approximately 1% with a lint yield increase of approximately 7% for 30 inch rather than 40 inch spacing. Cotton is planted on a rotational basis with other row crops, including tomatoes, corn, wheat and barley.

A variety of insecticides are used during the growing season. Most insecticides are applied from May through July. Cotton is sprayed for lygus, aphids and mites. Cotton is heavily irrigated during this period, and growth regulators are applied. In August, cotton fields receive their last irrigation, and the plants begin to die. Defoliants are applied prior to harvest to remove the last of the foliage from the plants. This leaves only the bolls on the plants and makes mechanical picking easier.

Cotton is harvested by a mechanical cotton picker. Cotton pickers come in a variety of sizes and can harvest from two to five rows at a time. The cotton bolls are stripped from the plants and deposited into a hopper. The lint is then dumped into a module builder. The module builder compresses the lint into a large block, approximately the size of a train car, and then moves on to make other modules. The modules are covered with tarps and left in the fields until they are trucked to the gin for processing. Most modules are moved as soon as possible to avoid staining from the ground and the weather.

Audit Techniques

Use the U.C. Cooperative Extension, Details of Costs and Returns Per Acre to Produce Cotton, from their website at <http://coststudies.ucdavis.edu>, to test the reasonableness of expenses claimed.

Ginning

The cotton modules are taken to the gin for processing into bales. The seeds and debris are separated from the lint, and the lint is compressed into a 500 pound bale. Each bale is assigned a bale number as it is ginned. This number stays with the bale from ginning until the ultimate sale.

As the bales are coming off of the gin press, a gin employee uses a cookie cutter type of tool to remove a sample from each bale. Each sample is identified as being from a particular bale. The USDA picks up these samples from each gin on a daily basis. The samples are returned to the USDA laboratory where they are put on trays and tested for moisture content, strength, length, color and micronaire. The samples and test information are sent to the classing department to be assigned a grade. The price the

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farmer receives for his cotton is determined by the grade of the cotton. The grade information is input on computer and is available for immediate downloading by each gin. The entire grading/classing process takes from three to four days.

Seed is the by-product of cotton. Different gins have different arrangements for seed. Always inquire who gets the seed, the gin or the farmer. Usually the gin receives the seed as payment for ginning costs. Costs can be either higher or lower than the seed credit. Sometimes farmers sell the seed directly to seed companies. Seed prices usually run from \$140 to \$160 per ton.

Is the gin an independent gin or a cooperative? A co-op gin is jointly owned by the farmers. Co-ops are tax exempt organizations and have different tax requirements than independent gins. If the farmer is using a co-op gin, the farmer should be reporting taxable patronage dividends and per unit retains. These are reported on Forms 1099 (See Chapter 6, Raisin Grapes, for further information on patronage dividends and retains.).

Audit Techniques

1. Review ginning statements. Some gins are financing sources for the farmer. Many times the gin will advance the grower for cultural costs and pay the costs either to the farmer or directly to a vendor.
2. Review the books for seed income. If there is no seed income, the gin statements should show a seed credit. Use industry averages for your area to estimate seed income.
3. What is the name of the gin? If it is a co-op gin, then there should be either patronage dividends and/or per unit retains reported as income.
4. Don't forget bale numbers can be used for tracking purposes. This usually isn't a necessary step, but may be crucial in some cases.
5. Trace a bale number from a ginning statement to a purchase invoice detail.

Storage

Unlike other farm products, cotton is not perishable and can be stored for a long time. Sometimes the farmer stores the bales until he can receive a more favorable price. Sometimes the cotton is sold and then stored by the purchaser. The store date and which party pays for the storage can be important factors in cases where income is being deferred and there is not a valid deferred payment contract. The store date, or warehouse receipt date, is the date the bale arrives at the warehouse. Title to the bale passes directly from the farmer to the buyer. The date title passes can be anytime before, during or after the store date. If title passes during the storage period, the buyer will pay the storage and deduct the portion owed by the seller from the sales proceeds due to seller. Who pays insurance on the bales during the storage period is also an indication of ownership. If the farmer does not insure the bales at the warehouse, he probably no longer owns them. The bales should be insured by someone from the date they are ginned.

Audit Techniques

The issue of storage is important if there is a potential issue regarding the date title passed. As you learned in Chapter 2, Income, there are many factors which govern

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whether a deferred payment contract is valid. There are also many sales contracts that are not technically deferred payment contracts, but where a portion of the sales proceeds are being deferred. If timing of income is an issue, you need to use the following techniques.

1. What is the store date/warehouse receipt date for the cotton? This will either be on a warehouse receipt or on a purchase invoice. If there is a question regarding the date title passed, this date is crucial.
2. Who paid for the storage? Also crucial regarding issues of title.
3. Who insured the bales? This may be indicative but not conclusive. Again, this is only necessary if there is an issue regarding title.
4. Store dates can be used to determine the date title passes if there is not a valid deferred payment contract in place. A purchase invoice will show storage dates for specific bales of cotton.

Sales

As with all other crops, inspect all sales contracts for quantity and terms. Most contracts are stated in bales, therefore, the yield per acre (in pounds) needs to be converted to bales (500 pounds per bale). A cotton crop is usually not sold for an entire farm at one time. There can be a number of sales contracts for one farm, therefore a yield comparison is essential to ensure that all bales are accounted for with sales contracts.

Sales price can be set in the contract or it can be locked in at various times. Samples of the variety of pricing options are:

Price Later Contracts

It is common to lock in a price at a later date based upon New York Commodities Exchange Futures. If this is the case, there usually will be an initial contract or Grower Confirm Contract.

A fixation Agreement to lock in the price at the agreed upon date.

An invoice to finalize the sale at the fixed price.

Pricing by Grade Contracts

Sales prices will also vary by the grade of the cotton. Most contracts cover prices at a variety of grades.

Option Contracts

These are also sometimes used in the cotton industry. Check for details as to what event fixes the option and when the option expires.

Deferred Payment Contracts

Shipment dates and payment terms always need to be looked at for any inconsistencies in deferred payments which could invalidate the deferred payment contract. See Chapter 2 Income, for more information on Valid Deferred Payment Contracts.

Audit Techniques

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After reviewing all of the information and determining the validity of the deferred payment contract, do the following to verify income is correctly reported:

1. Compare the estimated yield production with the contracted bales to ensure you have all contracts. Since cotton is not perishable, some sales contracts can correctly be in a subsequent year. Always ask for all contracts for the crop year under audit and for any proceeds received during your fiscal year.
2. Review all grower statements during the year. Compare the bales on the statements/invoices with the bales on the contracts to verify receipt of all statements/invoices.
3. Compare the grower statements/invoices with the taxpayer's books to verify all income has been reported.
4. Look for advances and payments to third parties on the grower statements.
5. Look at the cash receipts journal for the month subsequent to your farmer's fiscal year end to verify that only income from valid deferred payments is being deferred.

Government Programs

There are many government programs pertaining to commodities. You can follow third party contact procedures and contact your local USDA/FSA office to inquire about participation in a particular program in a particular year (See Chapter 2, Income). Many government program payments are reported on Form 1099. When auditing a partnership, be sure to check for Forms 1099 issued in the partner's name.

Audit Techniques

Check Forms 1099 received and if there is any doubt, contact your local FSA office.

CCC Loans

CCC Loans are government loans to commodity growers secured by specific items. In the case of cotton, the farmer receives a loan for each bale of cotton pledged. The cotton is physically stored in a warehouse for the government, and ownership reverts to the government if the cotton is not redeemed from the loan within nine months. Most CCC loans are made through the FSA, a division of the US Department of Agriculture, but they can also be made by a licensed, private party, loan servicing agents or cooperative marketing associations. Loans through a servicing agency or cooperative marketing association are reported to the FSA and are treated as if made directly by the FSA. In other words, they operate as FSA county field offices, using the same forms and linked to the same nationwide computer system.

The cotton can be redeemed from the loan by either the farmer or the subsequent buyer by paying the redemption price to the FSA. Redemption terms for the buyer are usually detailed in cotton contracts. The redemption price is based upon the adjusted world price at the time of redemption. If the adjusted world price goes below the loan rate, the farmer can redeem his cotton for less than the amount of the loan that he received. The difference between the loan proceeds and the redemption rate is called a market gain and is taxable to the farmer. If they have elected to include the loan into income (See Chapter 2, Income), they will have a new cost basis (the amount of the redemption) and

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can then sell to a buyer at a future time when prices go up. In this way, CCC loans can be used by knowledgeable farmers to insure profits, not just as a form of financing. In any case, the amount of the market gain is a taxable event in the year of redemption.

The tax consequences of CCC loans are explained in detail in Chapter 2, Income, and IRC § 77.

Audit Techniques

1. When auditing CCC loan proceeds, review the records to verify that the redemption costs are capitalized into inventory and are not deducted until the bales are sold to the eventual buyer.
2. Ask the farmer if he has ever had CCC loans and if so, how he has treated them in the past. Remember the election to include loan proceeds in income is binding and applies to all CCC loans in any year subsequent to the election, until a Form 3115, Change in Accounting Method, is filed.
3. Records of market gains for bales redeemed for cash are available through the Department of Agriculture. Bales can also be redeemed using commodity credit certificates. These certificates are issued by the government and used as payments in lieu of cash. If you are examining a tax year where certificates were used for repayment, see Rev. Rul. 87-103, 1987-2 C.B. 41, IRS News Release 2004-38 or Pub. 225 for explanations of the various tax consequences.

Raisin Grapes

Overview of Industry

Growing Production Cycle for a Mature Vineyard

Development of a New Vineyard

Mature Productive Operating Vineyard

Method of Accounting

Rancher or Farmer

Gross Income

Expenses and Depreciation

Related Party Transactions

Overview of Industry

Sources of Information

The following general information has been secured through interviews with the Raisin Bargaining Association (RBA), the Raisin Administrative Committee (RAC), several raisin packers and growers, newspaper and magazine articles, RBA's contract with signatory packers, individual contracts between growers and packers, and statistics from the RAC.

Other than government agencies, the major stakeholders on the supply side of this industry include 1) the large single Cooperative packer and its member growers 2) RBA member packers 3) Non-RBA packers 4) RBA member-growers and 5) Independent growers.

The scope of this chapter does not include a discussion of the Cooperative and its member growers, Non-RBA growers, and Non-RBA packers. However, the majority of this chapter would apply to them.

The Cooperative is a RBA signatory packer, and RBA growers can deliver their raisins to the Cooperative. These growers do not become members of the Cooperative, and the Cooperative members are not bound by the field price established by the RBA/packer negotiations.

Grape Use, Raisin Production, and Raisin Varieties

Raisins are essentially produced from raisin variety grapes. A raisin variety grape grower may contract to sell these same grapes to a wine or juice processor, or to a table (fresh) grape packer. This would be the personal decision of the grower, mostly based on price, but on other business factors, too. In the 1990's, California's total annual grape production use averaged as follows: Raisins (45%), Wine (43%), and Table (12%). Three California counties, Fresno, Madera, and Tulare, produced nearly 100% of the nation's supply of raisin grapes and 40-45% of the world's supply.

Natural Seedless, Dipped Seedless, and Golden Seedless raisins are virtually all produced from Thompson Seedless grapes. For the 1995 crop, these three varieties of raisins accounted for 98.3% of the domestic raisin production. Both Dipped Seedless and Golden Seedless are “dehydrator” dried, whereas Natural Seedless are field or sun-dried.

In the 1960's and 1970's, California produced an average 260,000 annual tons. In the 1980's, domestic production ballooned to almost 400,000 annual tons, but raisin demand lagged far behind. These conditions culminated in the disastrous 2000 crop year of 439,531 tons with oversupply and low demand that hurt and depressed the raisin industry until the 2004 year recovery with lower supply and higher prices.

The Industry Stakeholders

RAC: The raisin industry has been based on a federal marketing order system since 1949. The marketing order for raisins has been fairly successful. The Raisin Administrative Committee (RAC) is overseen by the Agriculture Market Service of the United States Department of Agriculture. The RAC does not get involved in price establishment for the domestic market. The marketing order gets involved in market allocation (free and reserve tonnages), and blended raw product for export. With the addition of freight and import duties, the foreign consumers pay prices for California raisins that are quite comparable to our domestic consumers.

The free tonnage quantity must meet the domestic market demand and a major portion of the export demand. A new program implemented with the harvested 1995 crop required the entire domestic and export demand to be supplied with free tonnage. Income derived from the sale of reserve tonnage for free tonnage use is utilized under a cash adjustment program to keep our packers competitive in export markets.

The RAC never technically “owns” reserve tonnage. The reserve tonnage is maintained by the packers under the custodianship of the RAC. The marketing order dictates how reserve tonnage can be disposed and how the income derived from its disposition is disbursed to the grower equity holders. The reserve tonnage, in essence, becomes a mandatory industry co-op under the custodianship of the RAC.

The raisin trade demand is computed and announced on or before August 15th of each year. It is never estimated. It is established by a set formula, and since the formula was adopted, has never been changed once it has been computed and announced.

During the first week of October, the RAC sets the preliminary free tonnage percentage. The reason the figure is preliminary is because the final size of the crop has not and will not be determined until February of the next calendar year. This percentage is based on the trade demand; the preliminary free tonnage percentage is set conservatively. Normally, the final crop estimate and final free tonnage percentage is set by February 15th, following the harvest year.

Under the marketing order agreement, the signatory packers must report grower deliveries weekly to the RAC. The RAC billings to the packers for assessments are due to the RAC within ten business days of invoice date.

The RAC does not get involved in the terms and conditions of the sale of free tonnage raisins by growers to packers. No RAC actions will accelerate or delay payments between the growers and their respective packers for the sale of free tonnage raisins.

RBA: The RBA is a non-profit cooperative association established in 1966. It has approximately 2,000 raisin grower members (40% of the total raisin growers).

The benefits of membership for growers is a unified representative body. The cost of RBA membership to growers is 1% of the grower's crop proceeds payable by the packers from the grower's funds. The RBA returns these funds to the growers six months later.

When the RBA was formed, the original founding members felt it would be most prudent to execute a Master Contract with processors (packers) on behalf of the Association's grower members. These processors were deemed signatory packers. The Master Contract provided the foundation for price negotiations for members of the Association. The elimination of open price contracts was the primary catalyst responsible for the formation of the RBA.

This Master Contract is more formally called the "Raisin Bargaining Association, Inc. - Contract of Sale." It is for the mutual benefit of all and outlines the duties and responsibilities of member growers and signatory packers. There is a two-year contract for "Thompson Seedless" raisins between the RBA and the signatory packers. Under this Contract, a raisin "season" is defined as "that period of time commencing with September 1 of one calendar year and ending with August 31 of the following calendar year."

RBA members are required to complete Individual Agreements which set forth a number of key elements including, but not limited to, the name of the grower, the number of tons to be delivered, the number of containers required, and terms of payment. Most growers and their respective packers enter into these written Individual Agreements prior to harvest and delivery. The RBA supplies its signatory packers with Individual Agreement forms they can use with their respective growers.

However, a large number of growers continue the practice of setting payment terms through a handshake agreement, often by telephone. This handshake agreement is inconsistent with the requirement of the Master Contract to execute an Individual Agreement. Unfortunately, the practice was allowed for years to the point where it became quite routine between some packers and growers. The RBA has advised certain packers and member growers that this practice of using an oral agreement for payment terms is outdated. The number of verbal agreements has declined over the years.

Independent Packers: All packers other than the Cooperative. These are the signatory packers under the RBA contract. The terms "packer," "packing house" and "processor" are used interchangeably in the industry. "Processor" is the more correct term. The raisins pass through a manufacturing or improving process that transforms them from an inedible raw material to a finished consumable food product.

RBA Growers: Member growers, the 2,000 raisin growers discussed above.
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Non-RBA Packers: Other than the Cooperative, there are a few small packers that are not members of the RBA. Together, they produce a small fraction of 1% of the total finished raisin products.

Independent Growers: All growers other than RBA member growers and Cooperative growers.

Raisin Grower/Packer Contract for Raisin Delivery

Sometime before September 25th (RBA required date), a RBA grower "may" enter into an individual written agreement with a packer to deliver his raisins for sale and processing to an RBA member raisin packer. The word "may" is used because some times this agreement is verbal. The relationship between a grower and his packer is usually a long-term one. It is based on the quality of service, trust, and fairness, rather than price.

Raisins are normally harvested in September, then field dried for 11 to 21 days. The raisins are normally delivered to the raisin packers in October and November, but some may be delivered as early as the last week of September or as late as December. The packing house buys the "free tonnage" raisins from the grower when they are delivered and pass USDA inspection. They are also graded at delivery for quality and moisture; where growers can earn bonuses. This "free tonnage" price is bargained for between the RBA, its member growers, and the signatory packers. See discussion of "Free Tonnage" to follow:

The Packer shall acquire legal title to said raisins, subject to this Agreement, upon establishment of a reasonable price as provided under Paragraph 14. [*Raisin Bargaining Association, Inc. - Contract of Sale, Para 14(g)(3)*]

Said "reasonable price" shall be ascertained in the following manner: The Association shall announce an opening price or prices which the Association believes to be a "reasonable price" for each variety and grade or grades for any season on or before October 6th of such season. Such announcement shall be made upon the basis of consultations with individual packers and an examination by the Association of all available economic and supply data which influence the sale and purchase price of raisins. [*Raisin Bargaining Association, Inc. - contract of Sale, Para 14(b)*].

Concept of "Free Tonnage"

There are really two raisin businesses: domestic and export. The domestic price applies to the United States, Canada, and Mexico. The domestic price is kept high by the packer/grower price negotiations to protect our domestic raisin industry. If a packer chooses to sell raisins in the domestic market, he must do so at a price which will return his raw product, processing cost, and any profits the packer sets for himself. A packer may sell all of his free tonnage in the domestic market, export market, or a combination of both. Historically, roughly 70% of our annual raisin sales are domestic and 30% are export; however, some packers are much heavier in one market or another.

To compete on the world market where some foreign governments subsidize their raisin industry and production costs are lower, our United States sellers must enter the foreign market place with a much lower price to be competitive.

The RAC establishes a “free tonnage” quantity of raisins that it feels the industry can sell worldwide. As stated above, the preliminary free tonnage percentage is established during the first week of October, and the final free tonnage percentage is established by February 15th.

All raisins not designated as “free tonnage” are known as “reserves” or “reserve pool.” No packer secures permission from the RAC to sell any raisins in any outlet. Under the terms of reserve tonnage, offers are recommended by the RAC and approved by the Secretary. If packers choose to sell some of their free tonnage into the export market, they have no price regulations from the RAC. If they choose to sell into a specific export market, they can do so, and if they submit proof of export by providing the RAC with a copy of their ocean-on-board bill of lading, the RAC will pay them a cash adjustment amount which results in a blended raw product price. However, the RAC does not get involved in the price at which packers sell their raisins, either domestic or export.

The USDA Secretary must establish the free and reserve percentages. They become effective when published in the Federal Register.

The preliminary and final free tonnage percentages, as established by the RAC can be found at www.raisins.org and selecting Marketing Policy, then going to Part II – Pooling Operations Under The Raisin Program, #12, Reserve Pool Percentages, Natural Raisins, 1987-2001. The 2002 to 2004 figures were provided by fax.

Free Tonnage Percentage

Crop Year	Preliminary	Final	Date Established
1997	61	66	07-01-98
1998	85	100	01-15-99
1999	73	85	06-23-00
2000	35	53	08-01-01
2001	56	63	07-19-02
2002	45	53	04-02-03
2003	65	70	04-22-04
2004	100	100	10-15-04

This “free tonnage” is the amount the packers must purchase from their growers as established by RBA-Packer Contract. This Contract states the “Packer shall make an initial payment for raisins under this Agreement which are of standard quality and grade as herein described, excluding those raisins that have failed incoming inspection, on the

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basis of the preliminary free tonnage percentage recommended by the Raisin Administrative Committee... No part of such payment shall be refundable.”

For example, “free tonnage” works this way: let’s assume a grower with 100 tons delivers it all to his packer by November 1, 1999 under an established free tonnage price of \$1,425 per ton. Also, the preliminary free tonnage percentage announced in October of 1999 is 73%, and the final free tonnage percentage announced on February 15, 2000 is 85% (an additional 12%). Without consideration of any specifics in an individual contract with a packer regarding crop payment dates, the grower’s entitlement to receive proceeds for the 1999 crop would be as follows:

Number of Tons	100
100 X’s Final Free Tonnage Percentage	85%
“Free Tonnage” Tons	85
X’s Price Per Ton	\$1,425
Crop Proceeds Established Earned (E/E)	121,125
Less: Crop Proceeds Previously E/E (73 x1,425)	104,025
Additional Proceeds Established/Earned	\$17,100

Concept of “Price Per Ton”

As stated above, the “free tonnage” price is bargained for between the RBA, its member growers, and the signatory packers. Also, it was stated that there are really two raisin businesses; domestic and export. To give an idea of the disparity in price between “free tonnage” and “reserves” for recent years, examine the following which is found at www.raisins.org, select Raisin Industry News & Reports, then 2001-2002 Annual Report Statistical Tables, then Table 10:

Crop Year	Free Tonnage	Reserves Weighted	Average
1997	66% @ \$1,250	34% @ \$357.00	\$946.38
1998	100% @ \$1,290	0% @ \$0	\$1,290.00
1999	85% @ \$1,425	15% @ \$0	\$1,211.25
2000	53% @ \$877.50	47% @ \$294.00	\$603.00
2001	63% @ \$880	37% @ \$261.00	\$651.00
2002	53% @ \$745	47% @ \$205.00 As of 7/04	As of 7/04 \$490.00
2003	70% @ \$810	30% @ \$0.00 Not Final	As of 7/04 \$567.00
2004	100% @ \$1,210	0% @ \$0	Not Final \$1,210.00

Current amounts sometimes need to be obtained by contacting the RAC, which was done for the 2002, 2003 and 2004 amounts.

Reserve pools remain “open” until all of the tonnage in that pool is sold, income received, and expenses paid. Each pool stands on its own. All pools are audited by a Farmer ATG 6-13-06

public CPA firm, and following this final audit, the income in each pool is paid to equity holders. As income is received, the RAC makes progress payments, but each pool remains “open” until the final audit and final payment to equity holders is completed. Payments to equity holders (growers) in a reserve pool have no requirements schedule, but as a practice are made as sufficient funds are accumulated.

Note: The RAC does not accept deferred payment requests from growers for the reserve pool payments.

Interplay of Grower Receipt Requirements Under the RBA-Grower Contract and “Real World” Considerations

The Contract states, “Packer shall pay that portion of such payment (referring to payments based on the preliminary free tonnage percentage) to be paid to each grower-member of the Association (RBA) who delivers such raisins to Packer immediately after full delivery by such grower/member, provided that grower-member and Packer may defer such payment by mutual agreement in accordance with the Raisin Bargaining Association - Individual Agreement.”

The RBA’s meaning of “immediately” within the context of Para #17 is that it would be difficult for packers to make payment immediately upon the completion of delivery. The USDA work is not immediately available, and the raisins may require reconditioning. Additionally, since packers borrow money from banks to finance operations, their lenders would have to be contacted to make funds available for payment potentially every day. These factors alone would make it difficult to make such a prompt payment as suggested. If a packer and its grower could arrive at such unusual payment terms, the practice would be allowed under the Master Contract. However, if such a practice is taking place, it would be the absolute exception.

Further, in the Master Contract in Para #17, payment based on the final free tonnage is discussed: “Packer shall pay additional payments for such raisins to such grower-members and to the Association (RBA) on the basis of the difference between such final free tonnage percentage and such preliminary free tonnage percentage recommended by the Raisin Administration Committee no later than ten (10) working days after such final free tonnage percentage is published in the Federal Register.”

This recordation in the Federal Register usually takes place in the summer or as late as the fall of the year following the harvest year.

A grower member of the RBA has a 2 years bargained for price Master Contract that is used in the individual written agreements with RBA member packers. Membership in the RBA costs member growers 1% of their gross raisin proceeds, netted from the checks paid by the packers. The RBA returns these funds to the grower after holding and using them for six months. The RAC makes progress payments from each raisin pool to the respective growers who earned them. Non-RBA growers will have to negotiate their raisins’ price with packers, many of which have been doing business together for decades.

Growing Production Cycle for a Mature Vineyard

October – December	Post-harvest - Pruning, Cane Tying, Suckering
March – August	Herbicides Applied, Discings to Control Weeds, Irrigation
May	Fertilization (liquid nitrogen fertilizer and zinc)
May – July	Insect Spraying
September – October	Harvesting, Drying, Delivery to Processor, Inspection

Note: If the raisins do not pass USDA inspection (red tagged), they may be either returned to the grower, reconditioned by the packer, or reconditioned by an outside service. Reconditioning may include several procedures such as additional screening, vacuuming, or submersion into water.

Upon passing USDA inspection, the title to the raisins passes from the grower to the packer.

Development of a New Vineyard

A sample of vineyard development cost as compiled by the University of California - Cooperative Extension "Raisins, Thompson Seedless in the San Joaquin Valley" (1997) is shown in Chapter 4, Expenses.

It takes approximately three years to develop a producing vineyard. For example, if the seedling vine were planted in March 1997, "first leaf," March 1999 would represent "third leaf," with the first marketable harvest being in September 1999. Therefore, the preproductive period would be, at a minimum, 2 ½ years. Within the regulations under IRC § 263A, "grapes" are identified as a plant that has a nationwide weighted average preproductive period in excess of two years and, thus, is subject to UNICAP rules. See Notice 2000-45, 2000-2 C.B. 256.

Audit Techniques:

1. If the grape grower has not properly elected out of UNICAP, all preproductive costs as defined in Treas. Reg. § 1.263A-4(b)(1)(i) are subject to capitalization. This is a very comprehensive list of costs. Also, this capitalization of costs under IRC § 263A supersedes cost deductions allowed under IRC § 175 and 180.
2. A general discussion of IRC § 263A and "Capitalization of Production Period Cost with Respect to Plants" is found in Chapter 4, Expenses.
3. Pre-audit indications that the grower may be developing a new ranch can be abnormally high fertilizer, labor and water costs, or large grape stake expense being taken as an IRC § 179 deduction. A deduction for "seedlings" may be claimed on the tax return. Spread analysis may show abnormally large nonrecurring expenses being claimed in a particular year.
4. Ask initial interview questions about any new ranch development. A field inspection of all ranches should reveal whether this potential issue exists.

Mature Productive Operating Vineyard

A typical grower's business relationships consist of acquiring farm assets, hiring and paying for labor through a Farm Labor Contractor and specialty Outside Service providers, while receiving income from the packer and sometimes loans from either the packer or a lending institution.

Method of Accounting

Most growers will elect, if allowable, to be on the cash receipts and disbursements method of accounting. This will allow the grower opportunities to manipulate the reporting of income and expenses. It is not unusual for a grower to take actions to defer income and accelerate expenses. In most cases this accounting method is correct under the IRC and supportable under case law. But sometimes these manipulations will result in potential issues for the agent.

Audit Techniques

1. A spread analysis will indicate if there is possible improper reporting of expenses and income. If large fluctuations are detected, additional audit work needs to be performed.
2. When inspecting the cash receipts journal (or its equivalent), be aware of large deposits in early January. This could be an indication of a deferral from a prior year's harvested crop. Also, review the bank statements from the first month of the subsequent year.
3. When inspecting the cash disbursements journal (or its equivalent), be aware of checks written for large amounts in the last days of the fiscal year (See Chapter 4, Expenses). Look for checks paid to related parties. Look at the backs of these checks to be sure that they were presented to the bank by the payee within a reasonable period of time. If not, this may give rise to an issue of whether or not the grower actually paid the expense in the period for which he is seeking an expense deduction.

Rancher or Farmer

These terms are used interchangeably. In California there is a tendency to refer to this not as a farm, but as a "raisin ranch." A raisin rancher can be anyone. It could be a hands-on rancher living on his ranch, making all the decisions, doing his own pruning, acting as his own farm labor contractor, etc. The contrasting situation is an absentee raisin rancher who may have a totally unrelated career, who manages the ranch from a desk or hires a professional ranch manager. The agent will develop the factual background during the initial interview.

Audit Techniques

The facts may support a passive loss material participation issue under IRC § 469.

Gross Income

Raisin Receipts

Wide fluctuations in reported receipts seen in the Spread Analysis may be explained by factors that may or may not be in the grower's control. The grower may be buying and selling ranches, he may be pulling out vines to plant new ones, or he may have lost a portion of his crop receipts to rain, etc.. The agent should be concerned about grower controllable decisions that concern income tax reporting. The agent must identify the packer and the business arrangement between the grower and the packer. Most growers only deliver product to one packer.

Audit Techniques:

1. In the Initial Document Request (IDR) specifically ask for all grower-packer contracts and for the "Grower Payment Reports" for the year under examination. Consider a "frontload approach." Have the documents mailed to you prior to the first audit meeting. These documents are discussed later in this subsection.
2. A pre-audit indicator that the grower is deferring raisin receipts is a packer listed on Schedule B, Form 1040. Rather than an outright loan by grower to the packer, this interest is being earned on crop proceeds being left with the packer. The terms vary from packer to packer, but a standard arrangement is that the packer will pay prime rate, simple interest, no compounding, and interest beginning ten days after final delivery. The interest terms are set by the packer and are not part of any written agreement.
3. If delivery and payment are based on a verbal understanding with nothing in writing, it appears that the RBA Master Agreement is controlling if the farmer is an RBA grower. Thus, regardless of when the grower received payment from the packer, the amount based on the preliminary free tonnage percentage would be constructively received in the harvest year. This is when the price is fixed and determinable, and the grower has the unrestricted right to this amount. The amount based on the final free tonnage percentage is not established until the year following the harvest year. Therefore, that portion is not constructively received until the year following the harvest year.
4. If the delivery and payment are based on an individual written agreement, inspect the agreement. If it was executed after delivery, it appears the grower would have no bargaining power for payment terms because he has already performed. If the contract is executed prior to the first delivery to the packer and includes specific payment arrangements that state that grower cannot receive money prior to a certain date, and that date is in the following year, this appears to be a valid, bona fide deferred contract for tax purposes.

Whereas, a deferred payment contract, with the specific language "I will advise you when I want payment." probably is not a valid, deferred contract for tax purposes because the grower controls when he receives his payment and can readily ask for it anytime, including in the harvest year. It is not quite settled whether under a valid, bona fide deferred contract situation the grower can defer the receipts into years following the year following the harvest year. Constructive receipt and deferred payment contracts are covered under IRC § 451.

5. Inspect all "Grower Payment Reports," also known as "Settlement Statements," issued by the packer. They include extensive information regarding deliveries,

weights, bonuses earned, reductions for advances, assessments, shaking, hauling, etc. Potential issues are whether the grower is properly treating all advances as taxable in the year received, and whether the grower is both reporting a net proceeds amount for tax purposes and also duplicating the expense elsewhere on the Schedule F. Bank records should be analyzed for any unexplained deposits.

Patronage Dividends

These are not dividends in the ordinary sense (i.e. reportable on Schedule F, not Schedule B). They are received by the grower from the Cooperative. They are distributions of funds from the Cooperative to the member. They are always taxable in the year received and the Cooperative is required to issue Forms 1099-PATR. The Cooperative does not allow the growers to enter into any deferred payment contracts for patronage dividends.

RAC Payments

These are progress payments made by the RAC from individual reserve pools by crop year and grape variety. They are always taxable in the year received. The RAC does issue Forms 1099. The RAC does not allow the growers to enter into any deferred payment contracts for these RAC payments.

Audit Techniques

1. Inspect RAC check stubs for running totals for each reserve pool.
2. If the above is not available, consider contacting the local USDA field office to confirm the amounts paid to the grower.

Expenses and Depreciation

There are no expenses/costs that are particularly unique to raisin grape growers other than staking and trellis system costs. The agent wants to ascertain the Schedule F presented is not a blended farm commodities operation, but includes only costs of growing grapes. If other commodities are involved, the agent has to adjust his audit work accordingly.

Audit Techniques

1. A large deduction for "Cost of Pulled Vines" may indicate that the grower may have made a recent ranch purchase and: (a) an unreasonable high allocation of purchase cost was placed on the vines and (b) these soon to be pulled vines, in substance, had a much smaller value than the one assigned. This would be an issue of overstated expenses (vines) and an understated value of the land.
2. A "Cost of Purchased Crop" shown as a COGS or expense item would indicate that the grower purchased an immature crop. Was this done at arms-length from an unrelated party? Inspect the purchase escrow for the amount the grower was charged and compare this cost with what is claimed on the tax return (See Rev. Rul. 85-82, 1985-1 C.B. 57.)

3. Scan the detailed fixed asset schedule to determine if any of the assets lend themselves to personal use or if asset purchase invoice testing is justified. In the area of claimed expenses and depreciation, the agent should base his/her work on the audit risks.

Related Party Transactions

Related party transactions may not be evident from an inspection of the tax return, but can be developed from the initial interview. Check for any non arms-length transactions and related parties within the context of IRC § 267. Some examples of related party transactions are loans between the grower and packer, rentals between them and sales and purchases of ranches, equipment, etc. Also, the grower may be related to a goods and service provider.

Audit Techniques

1. Watch for formal and informal agreements between related parties in the allocation of income and expenses among themselves to verify that all receipts and expenses are fully and properly allocated among related parties. If the allocations are not properly being done, consider IRC § 482 for potential issues.
2. Watch for differences in method of accounting between related parties and apply IRC § 267(a)(2) when applicable.

Entities

Most raisin growers are proprietorships, showing their ranching activity on Schedule F's. Others examined may be corporations, general partnerships, family limited partnerships, or trusts. The agent must be prepared to administer all the tax laws, as applicable.

References

1997 University of California - Cooperative Extension "Raisins, Thompson Seedless in the San Joaquin Valley." Available at www.agecon.ucdavis.edu

Exhibit A: Code, Regulations, Revenue Rulings and Court Cases

Internal Revenue Code Section	Description	Page
IRC § 61	Gross income consists of all income, from all sources, such as compensation for services, business income, interest, rents, dividends and gains from the sale of property. Only items specifically exempt may be excluded. Gross income is the starting point in determining tax liability and is broadly defined.	1-1, 2-16
IRC § 77	Election to report Commodity Credit Loans as income when received	2-8, 2-9, 5-1, 5-7
IRC § 108	Income from Discharge of Indebtedness	4-4
IRC § 114	Extraterritorial Income Exclusion – repealed in 2004 by PL 108-357	4-11
IRC § 121	Exclusion of Gain from Sale of Principal Residence	3-3
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IRC § 175	Soil & Water Conservation Expenditures	4-6, 6-8
IRC § 179	Election to Expense Certain Depreciable Business Assets	3-4, 3-5, 6-9
IRC § 180	Expenditures by Farmers for Fertilizer, etc.	4-5, 6-8
IRC § 183	In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.	1-4

IRC § 199	Domestic Production Deduction	3-7, 4-11
IRC § 212	Expenses for the Production of Income	4-4
IRC § 263	Capital Expenditures	4-4
IRC § 263A	Uniform Capitalization Rules	1-6, 4-3, 4-4, 4-8, 4-9, 4-10, 4-11, 6-8.
IRC § 267	Related party transactions.	1-2, 1-10, 2-10, 2-15, 2-16, 4-4, 6-12
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IRC § 446	Accounting Methods-Examiner authority to change	2-2
IRC § 447	Method of Accounting for Corporations Engaged in Farming.	1-3, 2-2, 2-3, 2-15
IRC § 448	Limitation on Use of Cash Method of Accounting.	2-2, 2-3
IRC § 451	General Rule for Taxable Year of Inclusion of Gross Income	2-4, 6-11
IRC § 453	Installment Method of Reporting Sale	4-4
IRC § 464	Limitations on Deductions for Certain Farming Expenses	2-2, 4-2
IRC § 465	Deductions Limited to Amount at Risk	1-6
IRC § 469	Passive Activity Losses and Credits Limited`	1-4, 2-16, 4-3, 6-10
IRC § 481	Adjustments required by changes in method of accounting.	4-11
IRC § 482	Allocation of Income and Deductions Among Taxpayers	1-10, 2-16, 4-3, 4-4, 6-12
IRC § 483	Interest on Certain Deferred Payments	4-4
IRC § 613	Percentage Depletion	3-7
IRC § 677	Income for Benefit of Grantor	1-5
IRC § 704	Partner's Distributive Share	1-5, 4-3
IRC § 1015	Basis of Property Acquired by Gifts and Transfers in Trust	3-2
IRC § 1016	Adjustments to Basis	3-2
IRC § 1031	Exchange of Property Held for Productive Use or Investment	3-1

IRC § 1231	Property Used in the Trade or Business and Involuntary Conversions	3-3
IRC §1245	Depreciation Recapture	3-3, 3-5, 4-11
IRC § 2032	Alternate Valuation	3-2
IRC § 2032A	Valuation of Certain Farm, etc., Real Property	3-2
IRC § 2505	Unified Credit Against Gift Tax	1-4
IRC § 3505	Liability of Third Parties Paying or Providing for Wages	4-12, 4-13
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IRC § 7512	Separate Accounting for Certain Collected Taxes, etc.	4-16
IRC § 7872	Treatment of Loans With Below-Market Interest Rates	2-13

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Treas. Reg. §1.77-1 and §1.77-2(a)(1)	Election to consider Commodity Credit Corporation loans as income.	2-9
Treas. Reg. §1.162-12	Expenses of Farmers	4-1
Treas. Reg. §1.263A-4(a)(4)	Uniform Capitalization Rules for Farming Business – definition of “farming”	2-3
Treas. Reg. §1.263A-4(d)(4)(ii)	Required use of IRC 168(g) (2) by the taxpayer or related person making the election out.	4-4
Treas. Reg. §1.263A-4(b)(2)(i)(D)	Example 4 of required capitalization	4-9
Treas. Reg. §1.263A-4(b)(1)(i)	Preproductive period costs for plants	4-10, 6-8
Treas. Reg. §1.263A-4(b)(2)(i)(C)(1)	Preproductive period beginning	4-10
Treas. Reg. §1.263A-4(b)(2)(i)(C)(2)(i)	Preproductive period ending	4-10
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Treas. Reg. §1.274-5T(f)(5)(ii)	Exception for 10% direct or indirect ownership employees.	4-3

Treas. Reg. § 1.301-1(m)	Cancellation of shareholder indebtedness treated as distribution of property.	2-12
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Young Door Co., Eastern Div. v. Commissioner	40 T.C. 890 (1963)	2-4, 2-5
Gullet v. Commissioner	31 B.T.A. 1067, 1069 (1935)	2-4
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Oates v. Commissioner	18 T.C. 570 (1952), aff'd, 207 F. 2d 711 (7 th Cir. 1953)	2-5
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