Farmers ATG - Chapter Two - Income

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Lead sheets referenced in this text are subject to revisions.

Contents

Income Issues

Introduction

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.

The initial interview can be an important tool for gathering information to access the potential for unreported income. Most farmers are working managers and are very familiar with their operation. They can tell you exactly how many acres they own and/or rent, how many acres were in each crop, what the yield was and the price received, how many acres of pasture, how many head of cattle owned and the make up of their herd, etc.

Your goal in the interview is to gain an understanding of the farmer's operation. By ascertaining the capacity for production, you can determine the potential for unreported income from primary farm income. By determining the nature of the operation, you can determine the potential for by-products, waste, and other sources of income related to the farming operation. And, by learning the taxpayer's financial status you can better assess the potential for income from non-farming sources.

A source of non-farming income for the farmer is hunting and fishing leases. Many farmers are leasing their ground out for hunting, providing hunting tours/packages or are looking to other sources of income to help offset rising costs. Make sure these types of questions are asked during the initial interview.

By the end of the interview you should make a "big picture" assessment of the potential for unreported income. You should have a clear picture of the participation of the taxpayer in the farming operation and an assessment of the taxpayer's family, including grown family members who may also be participating and living off the operation.

During the income probe, account for the production limits to get an estimate of the income potential. For example, compare the acres owned and rented to the yield accounted for with sales. Ask the taxpayer:

- How many acres of each crop was planted (request FSA Form 578);
- What the yield per acre was (from insurance crop production records); and
- The price received (from Coop or elevator settlement sheets).

Ask about double cropping and other secondary income from the land. Compare this information to the amounts reported.

The National Agricultural Statistics Service Web site maintained by the USDA includes published information by state and county on crop yields, production levels, farming custom rates, etc. that can be useful in cases where there are transactions between related entities or where unreported income is suspected. This information can be used to establish fair value of custom work or make a production limits analysis to test income reported on the return. Production limit tests just give an estimate of the potential yield. It is not meant to be the only technique used and adjustments should not be made based solely on this test. It can help determine if additional time spent on other techniques is likely to be productive.

Methods of Accounting for Farming – Cash/Accrual/Hybrid

Background

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 this can be utilized in making a determination whether or not a farmer has constructive receipt of deferred income. This section also discusses special methods of accounting and change in accounting methods.

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 section 446(a) provides that a taxpayer shall compute its taxable income in the same manner in which it keeps its books and records. IRC 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. IRC 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 2006 then delivers and sells the crops in the late fall of 2006. The farmer receives payment for the crops in January 2007. Assuming that there is no constructive receipt issue, the farmer reports his crop sale income in 2007. However, since that farmer incurred and paid his expenses for seed, labor, water, fertilizer, etc., in 2006, those costs are deductible in that year.

To prohibit and limit abuse potential, Congress enacted IRC 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. In contrast, cash basis farmers are not required to use inventories to determine income (Treas. Reg. section 1.471-6(a)). However, a cash method farmer cannot deduct commodities, such as livestock or grain held for resale, in the year acquired, unless the purchase and the sale occur in the same year. The farmer can only take these purchased items as a reduction of gross income in arriving at gross profit for the year the proceeds from the sale of the product are included in income (Treas. Reg. section 1.61-4(a)).

IRC 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 percent of each class of stock is owned by the members of the same family (See IRC section 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 section 448. Remember that "farming" is defined in Treas. Reg. section 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. section 1.446 - 1(c)(2)(i)). However, farmers are exempt from the usual code requirements to maintain an inventory. IRC section 263A does not apply to plants with a preproductive period of less than two years or to animals. See IRC section 263A (d)(1)(A). Consequently, very few farming operations will ever be required to adopt the accrual method of accounting.

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

Note that any corporation, partnership or tax shelter which is required to use the accrual method of accounting under IRC section 447 or 448 must comply with the requirement of IRC section 263A, UNICAP.

IRC 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 percent 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.

Special Methods of Accounting

The crop method is an elective method that requires IRS consent. This method may be used if crops are not harvested and sold in the same year in which they are planted. In this case, the cost of producing the crop is deducted in the year in which income is realized from the crop (Treas. Reg. section 1.162-12(a)). A winter wheat producer could elect this method, but would see no tax advantage by doing so.

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

Change in Accounting Method

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

Changes in an accounting method of a farmer include the following:

- A change from the cash to the accrual method or vice versa;
- A change in the method or basis used to value inventories;

- A change involving the adoption of any other specialized method of computing net income, such as the crop method, or a change in the use of a specialized method;
- A transfer of draft, dairy, or breeding animals from inventory to a fixed asset account; and
- A situation where the farmer has chosen to report loans from the Commodity Credit Corporation as income in the year received and now wants to change to a different method.

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

- A change from valuing livestock inventory at cost, or the lower of cost or market, to the unit-livestock-price method; or
- A required change to the accrual method by a family farm corporation when gross receipts exceed $25 million necessitating the establishment of a suspense account. See IRC section 447(i).

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

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

The general procedures to change a method of accounting vary depending upon the type of changes made. Thus, if you have this issue, it is best to look up the most current procedures.

The Accounting Methods Lead Sheet can be utilized for this issue. (See Appendix A - Accounting Methods Leadsheet)

Income Deferral and Constructive Receipt

Background

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.

When 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 which 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 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.

Constructive Receipt

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 [IRC section 451(a)]. The concept of constructive receipt has been addressed in Tax Court opinions for more that 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. section 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).

Deferral of Income

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

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

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.

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.

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.

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.

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. The Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-234, Section 15301(a) amended Internal Revenue Code Section 1402(a)(1) providing that CRP payments to individuals receiving benefits under section 202 or 223 of the Social Security Act (disability and retirement benefits) are excluded from SECA tax. This provision applies to payments made after December 31, 2007.

Other Types of Agricultural Subsidy Payments

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 Web site 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:

- Certifications for program eligibility;
- Payments record;
- Contracts;
- Aerial photographs;

- Number of acres;
- Production data only regarding disaster payments;
- Crop share arrangements;
- Cash rent arrangements; and
- 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: Forms and Publications.

The CCC forms are either part of the loan report printouts or available at the USDA forms Web site.

Loans

Background

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

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:

- Commodity Credit Corporation loans;

- Conventional bank loans;
- Bank lines of credit;
- Approved credit from suppliers (open accounts); and
- 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. section 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 section 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 IRC section 77.

IRC section 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

- A taxpayer may elect, at any time, to report CCC loans as income in the taxable year in which the loan is received (IRC section 77(a)).
- 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 section 77(b)). Effective for tax years ending on 12-31-2001 and later, 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.
- The election to treat CCC loans as income applies to all commodities for that taxpayer (Treas. Reg. section 1.77-1).
- 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 section

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).

- IRC section 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.)

- The Fifth Circuit Court of Appeals held in *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963), *aff'd and rev'd* 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.
- 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

CCC Loans are common. An Information Document Request (Form 4564) should be sufficient to determine if CCC loans were obtained.

Once identified, determine if there has ever been an election filed under IRC section 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 later, 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).

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.

Forms 1099 are filed for most taxable transactions. Effective for loans repaid on or after January 1, 2007 the Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-234 Section 15353 enacted IRC Section 6039J requiring that “The CCC…shall make a return…setting forth any market gain realized by a taxpayer during the taxable year in relation to the repayment of a loan issued by the CCC, without regard to the manner in which such loan was repaid.” The use of CCC certificates to pay off nonrecourse marketing assistance loans at less than the loan amount is subject to this provision.

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:

- Defer or postpone the recognition of income;
- Distribute income to a shareholder/partner; or
- 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 section 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.

Date: Oct. 20X1

Description of Action: 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

Year end analysis of the note payable account:

- General ledger analysis. Thorough review of the last quarter (fiscal, calendar);
- Inspect all year end short term note payables (30, 60, 90 days); and
- Determine relationship between payee and group.

Match product sales (bulk) to income recognition:

- General ledger analysis;
- Invoice(s) for delivery of product to broker;
- Invoice(s) for sale of cotton by the broker;

- Canceled checks for (all) payments.

Flowchart transactions Diagram:

- Product delivery (date, amount, recipient);
- Loan executions (date, amount, recipient);
- Sale Proceeds (date, amount, recipient); and
- 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 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 flow through entities

Partnerships and other flow through entities have a basis which is impacted by loans.

It is important to determine if any loans included in the basis are "at risk" to the partner/shareholder.

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 follow-throughs. Who is "at risk," the shareholder or the corporation? There could be a potential dividend issue.

Audit considerations:

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

Audit procedures:

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

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 section 165 instead of IRC section 166. Because ZZ's loans were secured by land and crop proceeds, the bad debt fails to meet the requirements of IRC section 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 and By-Product Sales

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

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

- Manure may be dried, packaged and sold as fertilizer.
- Corn cobs may be sold for use in making plastics, perfumes, etc.
- 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.
- 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.
- Farmers with wooded areas may sell off trees for lumber, firewood, or landscaping.
- Untilled land may be rented for pasture.
- The soil itself may be sold as topsoil, sand, sod, fill, gravel, clay, etc.
- To help offset the high cost of machinery, the farmer may do custom work for other farmers.
- 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.
- Income from hunting privileges and/or guide services may not be reported.
- Grain and bean farmers may sell the straw which is sometimes baled and sold for cattle feed.

- 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.
- Orchard and vineyard prunings are often shredded or bundled and sold to co-generation plants. Quite often wood is sold as cords of firewood.
- Raisin stems and floor sweepings are sold by the packer for cattle feed. There is no income to grower.
- Almond shells are sold to co-generation plants. Almond hulls are sold for cattle feed. Sale proceeds are received from the huller.
- Prune pits and olive pits may be sold for cattle feed.
- 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.
- Fuel tax credit from a previous period may not be reported as income and/or credit may be claimed for fuel that was delivered tax free. The credit may also be claimed on fuel for highway use and no credit is allowable.

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.

Examination alerts

When examining expenses, be alert to the relationship of the expense to the income that is being reported. The following are examples of examination clues.

- Cattle farmers having expenses for plastic bags or packaging materials could indicate the taxpayer has income from fruits, vegetables, etc.
- Repair accounts showing the cost of sharpening a chain saw may indicate the sale of logs or lumber.
- A depreciation schedule showing tandem dump-truck and loader as an asset may indicate the farmer is selling soil, fill, etc.
- The presence of a semi tractor and trailer on the depreciation schedule with fuel expenses in the “off season” and/or tax expenses that includes highway use tax when the size of the farmer’s operation would indicate the farmer should haul less than 7,500 miles per year and be exempt from the tax, may indicate that the taxpayer is hauling grain or livestock for others.
- Machinery in excess of that generally used on a farm of the taxpayer's size and type may indicate that the farmer does custom work.
- A supply or repair account showing excessive welding supplies may indicate that the farmer does repair work for others or is manufacturing something for sale.

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.

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:

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

Audit Issues and Techniques

The reasons for having more that a single entity are numerous. Several tax issues can occur. Income can be affected by delaying the payment until after a year-end, nonpayment, use of non-arms-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 section 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

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 sections 61 and 461 govern this issue.
B. Similar to the first tax issue, 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.
    a. Was the management entity formed/financed by the taxpayer receiving the benefit?
    b. Were the liabilities for any loans and payments legally those of an unrelated third party?
    c. Was there some business or regulatory reason to structure the transaction in this manner?
    d. Whose capital is invested in the transaction?
    e. 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 section 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 section 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 section 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 section 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 section 267).

Pertinent Code Sections

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

IRC section 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 corporations and their U.S. subsidiaries. The purpose of IRC section 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. section 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. section 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.

Examining Farmer Income Records

Introduction

Farming is a large market segment of the Gross National Product and the profit margins are sometimes very narrow. In recent years, farmers have been keeping better records of income. These records are used by financial institutions to determine credit worthiness. Because of this farmers may have very detailed records with respect to profit and loss of the business. Computer records are more common than not so that the business can be constantly evaluated for profitability. Still, a basic record is the farmer’s bank account deposits.

Audit Issues and Techniques

An example of an examination procedure follows.

- Reconcile the amounts on the return to the taxpayer's record book, ledger, or computer printout of profit and loss statement.
- Make sure all entries in a ledger or record book are spread correctly in the various categories of income i.e., sales of items purchased for resale, sales of products raised etc. If there is a nontaxable column, review entries to make sure there are no taxable items listed.
- If the taxpayer is using a monthly system with a year end recap, make sure the recap sheet or page contains all the monthly totals and that they are properly entered on the recap sheet.
- Make math verification checks. Verify a recap sheet and test three or four of the monthly totals. If no errors exist, accept the totals as mathematically correct.
- Place all the available records of original entry in order and reconcile them to the record book or ledger entries and the computer printout of detailed listings.

Income original entry records available may include:

- bank statements and deposit slips for checking accounts, savings account records (including CDs), investment accounts or hedge accounts;
- check stubs, scales tickets, sales slips for sales of the farm commodities (such as grain, dairy products, livestock, potatoes, etc.);
- Forms 1099 for patronage dividends, interest income, United States Department of Agriculture (USDA) program payments, hedge accounts;
- Form 500 from Commodity Credit Corporation (CCC) for CCC loan information; and
- check stubs for state gasoline tax refunds.

Bank deposit analysis can be completed using available work papers in the Report Generation System.

While doing the review of the records, make various oral inquiries of the taxpayer, paying particular attention to farm product sales information to see that all income from farm product sales is properly included in income. Any differences between the records of original entry and the taxpayer's records should be noted and reconciled with the assistance of the taxpayer. Unexplained differences should be developed as unreported income.

Pre-audit analysis for a return with an attached Schedule F or Form 4835 that reports income from Agricultural Payments should include research on the Environmental Work Group Web site. This Web site is searchable by name of individual or name of business and lists payments made by the United States Department of Agriculture (USDA) to the farmer. It also shows what states and counties are making payments to the farmer. If the farmer is a land owner and/or an owner of another farming entity this information will also be available. The information provided regarding agricultural program payments is detailed for each year available. This research can alert the examiner to the fact that the farmer has taken Commodity Credit Corporation (CCC) loans. If there is a "Market Gain" or "Commodity Certificates" amount reported at the Web site for any given year, the examiner is certain that in that tax year the farmer had CCC loans – there is no way to generate a “Market Gain” or “Commodity Certificate” amount UNLESS there has been a CCC loan repaid.

Other areas you should also keep in mind and look for when going over records for possible adjustments to income are:

- Milk/Dairy sales. The last check stub for the year usually shows the gross dairy sales for the year, the net amount received for the year and the amounts deducted to determine net sales. This information is very useful for the following reasons:
    - If the gross amount for the year reconciles to the return, time can be saved because the gross income is known to be included in income.
    - If the taxpayer includes only the net amount of receipts and also deducts the items (such as trucking, ADA dues, etc.) deducted from the check as expenses, adjustments must be made to income. Also, it is not unusual to find that part of sales are assigned to banks to pay off loans or put into savings, with the farmer reporting only the net check as income. There may also be non deductible assignments from the checks. The examiner must determine the proper income and the proper allowed expenses.
- Grain sales check stubs should be reviewed because sometimes the farmer will report the net check and deduct, as expense, the deduction from the check for accounts receivable by the elevator for feed, seed, fertilizer, and supplies purchased. This has the effect of a double deduction.
- Livestock sales slips should be reviewed to be sure gross versus net proceeds reporting is handled correctly to properly reflect income and that the various sales are reported correctly on the return. Many times farmers show sales of steers on Form 4797 and take capital gains – this treatment is incorrect because a steer is NOT breeding stock. Also, the weight figures can give you an idea as to whether or not there is a holding period issue to pursue on breeding stock sales.
- Loan liability ledgers from banks and other lenders can be sources of income adjustments. Deposits that are identified as loans can be verified as such and principal and interest payments shown on the ledger should be reconciled to canceled checks. Many times commodity checks are turned over to pay loans and not reported as income.
- Regarding CCC loans, be aware of the election provision of IRC section 77 whereby the farmer can elect to treat the loan proceeds as income in the year received. The proceeds ARE NOT income unless the election is made. This election is fairly common. If the election is made, the farmer will report ALL loan proceeds received during the year of the election as income. A farmer CANNOT report only loan proceeds on corn loans as income and treat loan proceeds on soybeans as loans. ALL loan proceeds for the year must be reported as income if the IRC section 77 election is made. Revenue Procedure 2002-9 provided for an automatic change of accounting for CCC loans. If the farmer had elected to treat the CCC loans as income and now wishes to change to NOT treating the loan proceeds as income, he can attach Form 3115 (with minimal information required) to the tax return for the year that the farmer wishes to change his

accounting method for CCC loans. There is no IRC section 481 adjustment because of the cutoff nature of reporting under IRC section 77, i.e., loan proceeds received in the year of election is income in that year. Should the farmer decide in a subsequent year that he wishes to report CCC loan proceeds as income, he will simply report the income from loans received during the tax year as income on Schedule F or From 4835 attached to the return filed for that year. He may attach a statement to the return reiterating the fact that he has made the election under IRC section 77. The farmer cannot change from elected IRC section 77 income recognition to loan treatment if he has changed from the income recognition method in the previous 5 years.

Loan Issues

Loans can be repaid by any of the following methods:

- by checks written directly from the commodity purchaser to CCC, (frequently done because CCC requires payment before releasing the commodity to the farmer or requires notification of intent to sell the pledged commodity whereby the CCC permits sale with payment being made directly to CCC for the loan principal on the quantity of commodity sold);
- by checks written by the farmer to CCC to repurchase his grain to sell at a later date or to use in the farm business as feed for livestock; or
- by the farmer purchasing Commodity Certificates with immediate transfer to CCC to pay the loan.

CCC loans are NONRECOURSE loans. The farmer pledges the commodity for the loan. If the farmer fails to repay the loan, the USDA takes the pledged commodity and the farmer is not liable for any amounts that the USDA does not recoup through its subsequent sale of the commodity. Generally, CCC loans mature 9 months from the first day of the month following the date of the loan disbursement.

Accounting for these loans, repayments and the requirements with respect to the election are sometimes very confusing to the farmer and errors can be made. Part of the examination should include examiner evaluation of the documents and make inquiries of the farmer to see if these transactions are handled correctly on the return.
Loan repayments can be for less than the principal amounts. When commodity prices (specifically Posted County Prices (PCP)) are lower than the loan rate the farmer is only required to repay at the PCP. THIS transaction will result in a Market Gain to the farmer. If the farmer and/or elevator repay with checks the Market Gain is reported on Form 1099-G. If the farmer purchases Commodity Certificates with a check and immediately uses the certificates to pay the CCC loan, the market gain will not be reported on a Form 1099-G for loan repayments made with Commodity Certificates before January 1, 2007. Prior to the 1099-G for 2007, there were 2 ways to determine if the farmer used certificates to repay the loan.

- Inspect the CC Form 500 and examine the “Remarks” section which will state the certificate number(s) used to repay the loan. This section will also state the computed and realized market gain that should be included in income if the farmer has not elected IRC section 77 income method.
- Review the farmers’ program payment history at the Environmental Working Group (EWG) Web site which will show “Commodity Certificates” separately from market gains.

The dollar amount reported at EWG for commodity certificates is the market gain realized on the transaction using commodity certificates that should be included in income if the farmer has not elected IRC section 77 income recognition.

The examiner will still want to review either or both of these sources and talk to the farmer about how he handled these transactions to ensure that they were handled correctly on the return. Several factual scenarios showing typical adjustments are set forth below.

- Taxpayers who have not made the IRC section 77 election, i.e., farmers who treat loan proceeds as loans, may inadvertently report only the overruns as income when the grain is sold. This is because the taxpayers rely only on bank deposits to compute income. Thus, when they get the loan, they do not report it as income. In subsequent years, the grain is sold and the elevator issues a check directly to CCC to pay the loan and gives any balance (overrun) to the farmer. The farmer deposits the overrun and when computing income at the end of the year from deposits thus reports as income only the overrun. Because the original loan proceeds were not included in income the entire sale of the pledged commodity should be included in income. The reason the elevator will issue checks to CCC is that it may be required to do so by CCC.
- Other issues can occur when a taxpayer has made a change in accounting method under IRC section 77 or Rev. Proc. 2002-9.
    - The farmer may have elected to treat CCC loans as income in 2005 and changed to loan treatment in 2006. A loan taken in November of 2005 would be included in 2005 income but the farmer may not make loan repayment until 2006. If the farmer is not clear on the treatment he may report the sale of the grain in 2006 when he sells the grain thinking that the loan was treated as a loan when received, double reporting of income.
    - Conversely, if the farmer changes from loan method in 2005 to income method in 2006, he may pay back a loan in 2006 that was received in 2005 and not report the sale of the grain in 2006 because he thinks he reported all 2006 loan proceeds as income when in reality the loan proceeds were received in 2005 and not reported in income.
- If the election has been made to treat these loans as income in the year in which the proceeds are received, and the loan is subsequently repaid, the Service’s position is that the repayment cannot be deducted. Instead, the amount of the loan so reported is added to the basis of the crops for purposes of computing gain or loss on the later sale of the crops. See IRC section 1016(a)(8) and Treas. Reg.

section 1.1016-5(e). Reduction of basis of the pledged crops is required if the taxpayer has been relieved of any part of the liability for the loans.

- The purchase of assets acquired during the tax year should be verified to see if a commodity check was endorsed over to the vendor for payment of the purchase price. The amount of the commodity check is reportable as income.
- There may be IRC section 1245 gains on sales of equipment. Used equipment can be sold for almost as much as it was bought for in prior years, resulting in gain upon the sale. Many farmers and some tax preparers still do not understand the ordinary income rules under IRC section 1245. Make sure that Schedule D and Form 4797 of farm returns are reviewed to see if there is an issue. Some livestock is also IRC section 1245 property.

Gross versus Net Proceeds

Many times the proceeds from the sale of various farm products are received in the form of a net check. Some of the items that are deducted from the gross sale price to arrive at the net include: hauling expenses, commissions, personal health or life insurance, personal purchases, assignments for loan repayments, and assignment for payment on installment sales.

Some farmers record the net check as their gross receipts. This could result in the farmer being allowed to reduce gross income by non deductible personal living expenses. Gross income should be reported with the allowable business deductions claimed.

In other cases farmers take a check from the sale of a farm product directly to a bank to pay off a loan. If the money is not deposited in the farmer's checking account, it is possible that the sale may not be picked up.

Grain storage payments made by the ASCS may be credited to an outstanding loan account. These storage payments may be overlooked in reporting gross receipts. The tax return will not generally give the examiner a clue as to whether part of a farmer’s gross receipts has been omitted. This is because most farmers are on a cash basis and, therefore, can store crops (depending on the type of commodity) from year to year (this will create bunching of income when the commodity is eventually sold), or cash flows are not consistent because of variations in production and fluctuations in market prices from year to year.

Various examination techniques can be used to uncover unreported income. Some of them are:

- Reconcile milk vouchers to the farm record book;
- Reconcile livestock sales vouchers to the farm record book;
- Reconcile grain sales vouchers to the farm record book;

- Reconcile loan payments to canceled checks (Note: If the examiner finds loan repayments without a corresponding check, it may be that the payment was made with unreported income.); and
- Question the taxpayer or the county ASCS regarding payments made to or on behalf of the taxpayer, i.e., payments made directly from the purchaser to CCC for loan repayment.

Rules of Thumb and Other Information on Farming

Livestock and Farming – Basic Knowledge

See the General Livestock chapter for a discussion of cattle, hogs, horses, sheep, and other livestock.

Row Crops

Tenant Farmers/Crop Sharing

Often farmers rent land based on a share of the profit. There are various arrangements regarding who furnishes the equipment and repairs to equipment and buildings. Customary shares used are 25/75, 33/67, 40/60 and 50/50. The division depends on who is furnishing the expenses. Usually the landowner furnishes the land and buildings and pays for the expenses (taxes, herbicides, fertilizers, etc.) related to the land and buildings only. The tenant farmer pays for his share of the operating expenses and generally provides his own equipment and labor.

Double Cropping

Farmers can sometimes plant and harvest two crops on the same land in a year. For example, farmers often plant a wheat crop right after they harvest their soybean crop -on the same land. Then in the spring when they harvest the wheat they go back again with soybeans.

An indication that the farmer is double cropping wheat and beans would be the months he or she incurs seed expense and receives income. If his or her receipts for bean seed and chemicals, etc., are in late June or early July, he or she has planted late for the growing season. Likely, he or she had to wait to get a wheat crop off before he or she could plant the beans. Otherwise, he or she would have planted the beans a month earlier to maximize his or her yield and reduce his or her risk that the beans will not be mature before the end of the growing season.

Examiners will see wheat sales in mid to late June or early July and planting expenses for the soybeans and then, soybean sales in mid-November as well as planting expense for the wheat. If the farmer is only reporting his or her bean sales and not his or her wheat crop, examiners may identify unreported income from wheat based on the time of planting and harvesting his or her soybeans. This may be the only indication of the wheat crop if he or she did not deduct expenses relating to the wheat, as well as not reporting the wheat sales.

Wheat-Beans

Farmers usually refer to soybeans planted behind wheat as "wheat-beans." The yield for wheat-beans is usually less than single crop beans.

No-Till

This is a planting practice becoming more common due to the increased emphasis on soil conservation. The farmer will plant soybeans with a bean drill right in the wheat stubble after harvesting the wheat. This saves the expense of tilling the soil as well as reducing the loss of top soil from erosion by water run off and wind on the loose, unprotected plowed and prepared fields.

Other Farm Related Issues

Family Partnerships

IRC section 704(e).

A family farm partnership with 10 or fewer partners will usually be considered to have reasonable cause for not filing a partnership return if it can show that all partners have fully reported their shares of all partnership items on their timely filed income tax returns. In addition the partnership must have no foreign or corporate partners, and each partner's proportionate share of each partnership item must be the same.

Unharvested Crops Sold With Land

IRC section 268.

For additional information concerning unharvested crops sold with land review the Grain Farmers chapter.

Domestic Production Activities

See IRC section 199.

Effective for tax years beginning after December 31, 2004, qualified taxpayers can claim a deduction on Form 8903 equal to the lesser of a phased-in percentage of taxable income (or adjusted gross income for individual taxpayers and estates and trusts) or qualified production activities income. For purposes of the deduction, only items that are attributable to the actual conduct of a trade or business are taken into account (Code Sec. 199(d)(5) & Reg. §1.199-8(c)(1), effective for tax years beginning after May 31, 2006; for earlier tax years, see Notice 2005-14 and Proposed Reg. §1.199-8(b)). The deduction cannot exceed one-half of the **W-2 wages paid** by the taxpayer during the year.

Please see the Domestic Production Activities Deduction section in Publication 225 and the Instructions for Form 8903 for more information on this issue.

Depletion - Mineral Rights - Water Rights

For additional information concerning depletion/mineral rights/water rights review the Grain Farmers chapter.

APPENDIX - A

Accounting Methods Lead Sheet

Accounting Methods Lead Sheet				
Tax Period	**Per Return**	**Per Exam**	**Adjustment**	**Reference**
Conclusion: (Reflects the final determination on the issue.)				
The following techniques are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.				
Audit Steps: (Document audit steps taken or to be taken.)				Workpaper Reference
1. Ask the taxpayer during the initial interview if there has been a change in the tax or book accounting treatment for any item during the current or prior year. This information may disclose				

any unauthorized method change.	
2. Review financial statements of the taxpayer, if available, for changes in accounting method. Pay close attention to the disclosures in the notes to the financial statements and the accountant's report.	
3. Verify that the taxpayer has complied with changes in accounting method based on the following circumstances: a. Generally, a C corporation, other than a personal service corporation, must use the accrual method of accounting if its average annual gross receipts exceed an average of $5 million for the three tax years preceding the current tax year (IRC section 448(c)). b. Other taxpayers whose annual gross receipts do not exceed $1 million may use the cash method (Rev. Proc. 2001-10).	
4. Ask if a Form 3115 has been filed for the examination year or a subsequent year. Obtain a copy of the Form 3115 from the taxpayer.	
5. Check to see if the ruling letter or the specific methods change administrative procedures (i.e. Rev. Proc. 97-37) were followed properly by the taxpayer when a Form 3115 was filed and the consent to change had been granted to the taxpayer.	
6. Call Headquarters for status of the Form 3115 filed by the taxpayer when a request is in process.	
7. Ascertain that the taxpayer's method of accounting clearly reflects income (IRC section 446(b)): a. Cash basis taxpayers who deduct the purchase of inventory in one year and report the income from the sale of said inventory in the next are not clearly reflecting income. b. Cash basis construction businesses that deduct paid expenses on unfinished jobs at year-end and report the income from said jobs in the next year are not clearly reflecting income.	

8. Determine if inventories exist and are an income-producing factor. Reg. section 1.446-1(a)(4)(i) states that the accrual method of accounting is required if inventories exist and inventory is an income producing factor. Section 263A defines jobs-in-process at year-end as inventory for a construction business.	
9. Refer to the Change of Accounting Technical Advisors if necessary.	
10. Review other sources of information: a. Accounting Method Technical Advisor Web Site. b. Industry Specialization Program (ISP) Digests of Issues. c. Market Segment Specialization Program (MSSP) Audit Guides. d. Industry specific information periodicals, accounting pronouncements, etc. where accounting method change issues are discussed.	
Facts: (Document the relevant facts.)	
Law: (Tax Law, Regulations, court cases, and other authorities. If Unagreed, include Argument.)	
IRC Section: § 446, 447, 448, 263A	
Specific citations:	
Taxpayer Position: (If applicable)	