

# Farmers ATG - Chapter Four - Expenses

**Publication Date** - July 2006

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# 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).

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 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 per hour machine labor**

**Vines per Acre 605**

**\$8.23 per hour non-machine labor**

**9.0 Tons per acre Fresh**

<b>Planting Costs</b>	<b>1st Year</b>	<b>2nd Year</b>	<b>3rd Year</b>
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	
<b>Total Planting Costs</b>	<b>\$2,127</b>	<b>\$3,136</b>	<b>\$0</b>

<b>Cultural Costs</b>	<b>1st Year</b>	<b>2nd Year</b>	<b>3rd Year</b>
Weed Control - Spot Spray	18	12	12
Prune - Dormant		55	94
Fertilize	7	9	9
Irrigate	79	112	152
Training (Sucker, Tie & Train)		331	209
Weed Control - Disc. Middle		10	10

<b>Cultural Costs</b>	<b>1st Year</b>	<b>2nd Year</b>	<b>3rd Year</b>
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
<b>Total Cultural Costs</b>	<b>\$181</b>	<b>\$660</b>	<b>\$719</b>

<b>Cash Overhead Costs</b>	<b>1st Year</b>	<b>2nd Year</b>	<b>3rd Year</b>
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
<b>Total Cash Overhead Costs</b>	<b>\$192</b>	<b>\$192</b>	<b>\$193</b>

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 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 can be found below in the section on Farm Labor Contractors below.

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.

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 below).

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 of January 1, 2005, at the

[California Department of Insurance Web site](#). 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.

	<b>Strawberry</b>	<b>Cotton</b>	<b>Orchards (Citrus &amp; Deciduous)</b>	<b>Vineyard</b>
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:
    - o State Government - State Department Food and Agriculture
    - o Federal Government:
    - o Bureau of Land Management
  7. Bureau of Reclamation
    - o Universities:
    - o Crop Improvement Association:
    - o 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.