Farmers ATG - Chapter Five - Cotton

NOTE: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

Contents

Cotton Production Cycle

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

Cotton Terminology

Bale	The measured item sold to the purchaser is a cotton bale. It consists of the cotton lint after ginning. It weighs 500 pounds.
Boll	The white “flower” of the cotton plant that is harvested for cotton.
CCC Loans	Government loans secured by cotton and other commodities. See IRC Â§ 77.
Classing/Grading	Classing or grading is done at the gin by the USDA. Samples are pulled from each bale and are analyzed for color, micronaire, strength, length and moisture content. The price received for the cotton is determined by its grade.
Cooperatives	Some gins are ginning cooperatives. A co-op gin is a tax exempt entity owned by the farmers. They can only be examined by the exempt organization division. A farming cooperative issues patronage dividends and makes per unit retain allocations.
Defoliants	Sprayed on plants to make the leaves fall off prior to picking. This makes it easier for mechanical picking and diminishes boll staining.
Gin	Place where cotton module is processed into a bale. The gin is a

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

Cotton Farming Information

Yields and Prices

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

Cotton comes in many varieties. One variable in cotton price is the variety planted. Acala and Upland are standard varieties with prices in the 70 to 80 cents per pound range. Pima is a whiter, more premium variety with a price in the 90 cent to $1.10 range.

Audit Techniques

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

Planting and Growing

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

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

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

Audit Techniques

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

Ginning

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

As the bales are coming off of the gin press, a gin employee uses a cookie cutter type of tool to remove a sample from each bale. Each sample is identified as being from a particular bale. The USDA picks up these samples from each gin on a daily basis. The samples are returned to the USDA laboratory where they are put on trays and tested for moisture content, strength, length, color and micronaire. The samples and test information are sent to the classing department to be assigned a grade. The price the farmer receives for his cotton is determined by the grade of the cotton. The grade information is input on computer and is available for immediate downloading by each gin. The entire grading/classing process takes from three to four days.

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

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

Audit Techniques

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

Storage

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

Audit Techniques

The issue of storage is important if there is a potential issue regarding the date title passed. As you learned in Chapter 2, Income, there are many factors which govern whether a deferred payment contract is valid. There are also many sales contracts that are not technically deferred payment contracts, but where a portion of the sales proceeds are being deferred. If timing of income is an issue, you need to use the following techniques.

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

Sales

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

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

Price Later Contracts

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

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

An invoice to finalize the sale at the fixed price.

Pricing by Grade Contracts

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

Option Contracts

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

Deferred Payment Contracts

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

Audit Techniques

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

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

Government Programs

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

Audit Techniques

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

CCC Loans

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

The cotton can be redeemed from the loan by either the farmer or the subsequent buyer by paying the redemption price to the FSA. Redemption terms for the buyer are usually detailed in cotton contracts. The redemption price is based upon the adjusted world price at the time of redemption. If the adjusted world price goes below the loan rate, the farmer can redeem his cotton for less than the amount of the loan that he received. The difference between the loan proceeds and the redemption rate is called a market gain and is taxable to the farmer. If they have elected to include the loan into income (See Chapter 2, Income), they will have a new cost basis (the amount of the redemption) and can then sell to a buyer at a future time when prices go up. In this way, CCC loans can be used by knowledgeable farmers to insure profits, not just as a form of financing. In any case, the amount of the market gain is a taxable event in the year of redemption.

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

Audit Techniques

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