Farmers ATG - Chapter One - Audit Flow

Publication Date - July 2006

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Purpose of Guide

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

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

Compliance Potential

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

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

   Example

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

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

The Information Document Request (IDR)

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

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

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

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

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

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

The Pre-Audit

The Structural Analysis

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

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

The structural analysis needs to include:

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

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

> There are two 1065 farm taxpayers A and B. The initial entity was 1065 taxpayer A. There is also an 1120S Processor entity, an 1120 Harvester entity, and two related 1040's - taxpayers 1 and 2. All are cash basis.
>
> As background:
>
> - Processor processes for all farms mentioned and non-related farms.
> - Harvester harvests for related farms and 1040 taxpayer 1's sole proprietorship.
> - Processor advances money to both 1065 farms, but not to 1040 taxpayer 1.
> - 1040 taxpayer 1 rents processing plant to processor
> - 1040 taxpayer 2 loans money to harvester
> - both 1040's own directly 50% of each 1065 and 1120S

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

Choice of Entity

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

Sole Proprietorships

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

Corporations

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

Partnerships and S-Corporations

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

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

Family Limited Partnerships

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

Example

> Farmer A and his wife form a partnership contributing land with a FMV of $1,000,000. The value of the limited partnership interests is discounted to $500,000. They then each gift limited partnership interests as follows:
>
> $11,000 each to four children and their spouses (2x11X8) equals $176,000
>
> $11,000 each to a trust with their 10 grandchildren as beneficiaries (2x11x10) equals $220,000
>
> Total tax free gift of $ 396,000 ($176,000 + $220,000 = $396,000)
>
> If they had given the land and not the limited partnership interest, the taxable gift would have been $302,000 for each spouse ($1,000,000 - $396,000 divided by 2). But since they chose to use a FLP, the taxable gift is $52,000 for each spouse ($500,000 - 396,000 divided by 2).
>
> **Note:** that the annual exclusion amount per donee for gift taxes changed in the 2002 tax year to $11,000.

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

Trusts

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

Items to consider when reviewing a trust return are:

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

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

- Federal Income Taxation of Estates and Trusts published by Warren, Gorham & Lamont is an excellent source for trust information. Various trust topics are also detailed in some of the Tax Management publications.

- Tax Management Portfolio 700-2nd, Choice of Entity details the rules regarding taxing trusts as associations. This portfolio also covers many different aspects regarding choices of entities.

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

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

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

1. If assets are being kept out of the LLPs and LLCs to shield them from creditors, are the assets being rented from related parties at fair market value?
2. The liability section of the balance sheet is also a significant area of interest. The members are able to claim their share of most entity liabilities in basis, but there are numerous additional rules regarding who is liable for which liability. The at risk rules of IRC § 465 also apply to losses from LLPs and LLCs.

3. How it was formed is an important issue to address. Was it previously a corporation or a partnership? This could trigger taxable events such as distributions, corporate liquidations, etc.

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

The Crop Map

Always request a complete crop map for the year under audit. Have the farmer include: acres of each crop planted and/or vacant, which parcels are owned and which are rented, location of one parcel compared to another, and the year planted for trees and vines. This can be a valuable tool in many areas of the exam.

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

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

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

Using Industry Averages

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

Income Averages

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

Example

> If you were auditing a farmer for 20XX who grew broccoli on 150 acres:
> 150 acres x 5.18 tons/acre (County average yield) = 777 tons
>
> 777 tons x 511 dollars/ton (County average payment) = $397,047
>
> If the farmer is reporting a reasonable amount compared to the average, you can limit your audit scope accordingly. If not, then further audit work needs to be performed.
>
> **Using income averages needs to be done with caution.** If the farmer's income is far below the industry average, ask the farmer specific questions regarding that particular crop during the initial interview. The farmer may have had unusually low yield or price. Most farmers can tell you exactly why a yield or a price is low for a given year.

Expense Averages

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

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

The Initial Interview

Interview Questions

The initial interview of the farmer, as in all audits, is very important. Being knowledgeable in farm terminology will help you get the most from the interview, since it puts the taxpayer more at ease to freely discuss business operations, problems, yields, purchases, improvements built, hobbies, children, new plantings, etc. Always look for ways to customize the interview questions based on knowledge of the taxpayer and specific products. Initial interview questions for general farms, beef, dairy, swine, sheep, farm vehicles and exotic animals are available in ATGs' and from the SB/SE Agriculture Technical Analyst at The IDR and initial interview questionnaire can be used together to ensure pertinent questions and documents are received. Add, modify or delete questions to customize the initial interview to the farmer.

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

Tour of Business

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

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

6. Do you see large trucks? - Some farmers have large trucks to haul their crops to the packing houses. During the non-harvest season they may haul hay or other commodities for additional income.

The Audit

Crop Accounting Records

Always request crop accounting records in your IDR. If they are not provided, ask the farmer during the interview. A farmer may have these records, but may be unfamiliar with the accounting term/name used. The information contained in the crop accounting records can be used to adjust the scope of your exam to focus on areas with the most likelihood of adjustment.

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

Crop Loans

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

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

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

Unrelated Third Party Financing

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

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

Related Party Financing

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

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

Crop Contracts

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

Quantity Sold

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

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

Payment Terms

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

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

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

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

Delivery Terms

One major factor in determining if a deferred payment contract is valid, is the date the contract was entered into versus the delivery date. A copy of the contract along with copies of delivery tags or delivery dates on the grower statements can be very important to answer some of these questions. (Chapter 2, Income Deferral)

Grower Statements

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

Quantity Delivered

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

Quantity Accepted

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

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

Gross Payments, Deductions and Net Amount Due

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

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