

Farmers ATG - Chapter Seven: General Livestock

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Introduction

The livestock industry is as varied as any other area of farming and agriculture. Methods of bookkeeping within each operation will differ. Due to these variations, this chapter provides a focus on the business of breeding, raising, buying, and selling livestock.

The volatility of this market segment makes it one of the most dynamic of any industry we will audit. Domestic and international markets, weather conditions, natural disasters, medical and health considerations, as well as, the interrelationship between livestock and grain and/or feed markets are all contributing factors. Financial records will reflect the results of these factors.

Keeping in Touch with the Industry

Familiarity with an industry being audited will provide a basis for analysis of the information encountered during the audit. It can also yield insights into the attitude and concerns of the taxpayers involved.

One of the fastest growing and most current sources of information is the Internet (net). Searches in the appropriate data base using the right key-words can yield big results. Websites maintained by governmental agencies, universities, and various trade or industry organizations may provide the extra information needed for a proper understanding of your audit. However, any information should be verified given the potential unreliability of certain sources of information.

The [USDA website](#) contains a wealth of information about animal production and livestock in general.

Compliance Potential

As in every business, the means for underreporting income is as varied as those who choose to undertake such ventures. The most successful rancher may fail to disclose all income because of the accompanying income tax benefits. Farmers having a very good year with a sudden turnaround just before filing time may be dealing with a cash flow crunch.

Watch for the following situations during audits:

- Sales of livestock through atypical sources. Most livestock in feedlots are sold to buyers from packing plants, other ranchers or to the feedlot directly resulting in easily traced transactions. Livestock sales directly from the ranch, either before placement in feedlots or for those animals which are not normally placed in feedlots, may be to any number of sources with little or no documentation.
- Bartering may account for some sales, especially in registered or specialized livestock which have higher values. Swapping equipment or services for breeding stock or some exotic animal may be found.
- Use of multiple bank accounts with reliance on the bank records for reporting purposes lends itself to misreporting due to exclusion of some records. Funds may also be deposited or invested directly in certain types of accounts which may not be considered in the reporting process e.g. sales proceeds used to directly pay off loans. Watch for transfers to/from savings, money market, and investment accounts or certificates of deposit. Any deposits from non-taxable sources, e.g. return of previous investment, should be traced to the source of the originally invested funds.
- Personal expenses deducted as farm expenses are the most common form of misreporting among farmers and ranchers. Farming is a life-style which takes tremendous dedication and focus. All aspects of a farmer's life are centered on the crop or animal and are therefore easily considered to be financially related to the business. Customarily, you will find personal expenses in insurance, gasoline, interest, taxes, utilities, and repairs. Has your farmer elected the 75-percent non-recordkeeping rule of Treas. Reg. section 1.274-6T(b) but failed to limit any expenses other than depreciation? What about a reversal of expenses related to animals butchered for personal consumption?
- Funding livestock activities may result in certain taxable transactions which are not properly reported. Funding transactions between individuals and related business entities may be at little or no interest and require processing as below market interest rate loans. These transactions may also be disguised dividends. Additionally, other taxable funds may be used directly for purchases or against loans without being accounted as income. Family operations may also result in loans which become gifts to other family members resulting in potential gift tax issues.

General Livestock Risks

The livestock industry is dynamic. Working within a true supply and demand economy, the balance between income and expenses can dramatically tilt toward profit or loss depending on any number of factors:

Market Fluctuations -- changes in supply and demand for the particular animals can run the price up or down. For example, an individual in the livestock industry may increase production during a market trending upward to take advantage of higher prices; however, higher prices typically result in an oversupply of animals, which then pushes prices down and the overextended or insufficiently capitalized ranchers may then be forced out of the business, which then causes prices to rise again. This cycle is common and changes the financial viability of those involved in the livestock industry rapidly.

Weather -- drought, flood, heat spells and blizzards can result in feed cost increases, reduced availability of grazing pasture, or outright death to animals through heat exposure, drowning, or isolation with subsequent starvation.

Health -- as new information, whether fact or supposition, is publicized about health considerations of certain food animals, the public quickly reacts to demand more or less of the animal based on the information. Reaction to England's "mad cow disease" hit the cattle market quickly and hard for a short period of time. Industry efforts to combat these problems are directly related to the recovery time. Long range efforts may be necessary to rebuild markets, e.g., have you heard that the "new white meat" is pork?

Feed -- seemingly unrelated situations can result in growth or dumping of certain markets. A need to ship more feed corn overseas due to crop losses in another part of the world reduces domestic availability of the feed which increases costs for the rancher and reduces profitability.

Conclusion

This chapter is not a "cookbook" to help you take the proper steps to audit adjustments in the livestock industry. It is a GUIDE which can point in certain directions and allow you to arrive at your own, carefully considered, properly determined conclusions.

Industry Issues

Certain aspects of the livestock industry are common regardless of the type of animal. These concepts can be applied to each operation.

Breeder Operation

A breeder operation will generally begin with the purchase of animals proven to be able to reproduce. A single male (or small number of males) is acquired along with numerous females to which the males are bred. Control is exercised to prevent of inbreeding due to the undesirable

genetic consequences. This control may take the form of limited access of the males to the females for breeding or exchange of males in breeding stock before female offspring are ready to reproduce. Stud services or invitro fertilization (artificial insemination) may also be employed.

Of the resulting offspring, generally only the females will be kept to build the breeding base. In some cases, the offspring will be raised to sell as breeders to other operations. Breeding females will often be sold with offspring as proof of reproductive ability. Otherwise, offspring will likely be sold for fattening/slaughter. In other cases, the farmer/rancher will raise the offspring to slaughter stage completely.

After the animals pass the practical breeding age, undesirable characteristics may begin to appear so breeding stock will be sold. Fresh stock is obtained by retaining desirable offspring as breeding stock or purchased to continue the operation.

In the case of specialized animals, usually a registered breed, the initial acquisition process will be similar to the general breeding operation, except that both males and females will be registered. These breeding animals are highly controlled with the offspring being registered at birth to validate breeding lineage and to increase marketability. In addition to the offspring being sold, semen and embryos may be sold as well. Sales or transfers of any registered animal typically result in the transfer of the registry information, as recorded by the appropriate breed association.

Fattening/Feeding Operation

In a fattening/feeding operation, young or mid-maturity animals are purchased to feed up to the next level of maturity or for slaughter. Often the males will be castrated to eliminate aggressiveness and the possibility of breeding since the fattening process is more effective.

If raised to the next level of maturity, these animals will normally be sold in small lots of several animals. This may be done through a sale barn/stockyard or individually to another rancher. When fattened for slaughter, the animals may continue to be grazed or, more likely, moved to a feedlot. Tight control is kept on the animals when moved to the feedlot. Because the feedlot charges by the animal/by the day and must act responsibly for the well being of the animals up to the time they are moved from the feedlot, their recordkeeping is extensive. Tracking weight to justify the feed charges and monitoring health when weight is not reacting as predicted, there is little likelihood that these records would not be available. Determining the number of animals placed in the feedlot along with the source and disposition of the animals is essential to determining income.

Most slaughter houses and packing plants have buyers making the rounds to the feedlots and selecting animals for purchase. The purchase offer is either accepted by the feedlot as agent for the rancher or communicated to the rancher for consideration. If the offer is accepted, the sale is completed with detailed sales documents provided. The rancher settles up with the feedlot for any pending expenses on the lot(s) sold.

Animals determined to be undesirable will be set aside and are usually sold through special sales or to certain slaughterhouses for purposes other than human consumption. Sales documentation from those buyers is also available.

Issues

IRC section 1231

For certain cases, IRC section 1231 provides special rules for the treatment of gains and losses arising from business property. IRC section 1231 refers to such gains and losses as "section 1231 gain" and "section 1231 loss." IRC section 1231(a)(3)(A) defines "section 1231 gains" as "(i) any recognized gain on the sale and exchange of property used in the trade or business, and (ii) any recognized gain from the compulsory or involuntary conversion * * * into other property or money of (I) property used in the trade or business, or (II) any capital asset which is held for more than one year and is held in connection with a trade or business or transaction entered into for profit." IRC section 1231(a)(3)(B) defines "section 1231 loss" as "any recognized loss from a sale or exchange or conversion described in" the previous sentence.

IRC section 1231(b)(1) provides a general rule defining the term "property used in the trade or business" (section 1231 property). This general rule does not apply to livestock. The general rule restricts the definition of "property used in the trade or business" to, among other things, depreciable property, held for more than 1 year, "which is not (A) property of a kind which would be includable in the inventory of the taxpayer if on hand at the close of the taxable year, [or] (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, * * *."

The special definition that is used in the case of livestock is found in IRC section 1231(b)(3) which defines "property used in the trade or business" as including "(A) cattle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and (B) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry. "

Treas. Reg. section 1.1231-2(a) states: "(3) For the purposes of section 1231, the term 'livestock' is given a broad, rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. However, it does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc."

See the Dispositions of Property Used in Farming chapter of Publication 225, Farmer's Tax Guide, for a discussion of various types of dispositions. The following represents a basic indication of reporting requirements for certain types of sales.

CLASS OF ANIMAL	TYPE OF ASSET	SALE REPORTING
Purchased for breeding	Depreciable when placed in service IRC section 1231 property	Form 4797 - asset used in trade or business

CLASS OF ANIMAL	TYPE OF ASSET	SALE REPORTING
Offspring raised for breeding purposes	IRC section 1231 property generally zero basis ¹	Schedule D - before placed in service Form 4797
Offspring raised for sale as a breeder	Ordinary Income Asset	Schedule F -- sale of raised animals
Offspring sold as cull	IRC section 1231 Property	Form 4797 ²
Young animal purchased to feed to mid-maturity	Ordinary Income	Schedule F -- sale of animal purchased for resale
Animal purchased to feed to final slaughter	Ordinary Income Asset	Schedule F -- sale of animal purchased for resale

¹Generally, "offspring raised for breeding purposes" have no basis. However, the basis of raised livestock would include costs of raising the animal which were not deducted during the years that the animal was being raised. See Publication 225, Farmers Tax Guide. However, "offspring raised for breeding purposes" but sold or disposed of before being placed in service are generally IRC section 1231 property. This depends on all of the facts and circumstances of each case, See Treas. Reg. sections 1.1231-2(b)(1) and 1.1231-2(b)(2) ex. 1.

²Determining when culls are IRC section 1231 property is often a factual question. See Treas. Reg. section 1.1231-2(c)(2) examples.

There may be exceptions to some of the examples in the preceding table. Whether livestock is held for draft, breeding, dairy, or sporting purposes depends on all the facts and circumstances in each case. See Treas. Reg. section 1.1231-2(b)(1).

Only livestock (property) "used in the trade or business" qualifies for IRC section 1231 handling. Any animals purchased for resale must be included in inventory and its cost is recovered at the time of sale. The classification of income as Schedule F or IRC section 1231 affects the computation of self-employment tax.

Animals sold which were purchased for breeding purposes but not yet placed in service are not depreciable, but are considered to be held for use in the trade or business and qualify for IRC section 1231 reporting. In a business which includes both breeding and purchasing for resale, carefully determine the purpose for which the animals were purchased.

IRC section 162

IRC Section 1.162-12(a) of the regulations provides that amounts expended in purchasing work, breeding, or dairy animals are regarded as investments in capital, and shall be depreciated unless such animals are included in an inventory in accordance with section 1.61-4 of the regulations.

This includes, but is not limited to freight, registration fees, and health related expenses (inoculations, testing, etc.) Regarding the value of a pregnant animal and the unborn offspring or a mother/offspring pair an allocation should be made by subtracting from the purchase price the value of the mare not in foal, to arrive at the value of the unborn foal or offspring. Cf., *Gamble v. Commissioner*, 68 T.C. 800, 820-21 (1977), acq., 1986-2 C.B. 1. Although directly related to race horses, the concept is applicable to any pair purchases.

Costs of feeding, handling, and caring for animals in either a breeding or fattening operation are current expenses and currently deductible.

If livestock die from disease, are destroyed because of disease, or are sold or exchanged because of disease, even though the disease is not of epidemic proportions, such occurrences are treated as involuntary conversions. No deduction is allowed for value of raised livestock that die if the cost of raising them has been deducted as an expense. Deaths of depreciable animals are not reported on Schedule F.

Farm labor issues may involve "payment in kind." A market segment understanding (MSU) has been issued regarding farm labor when payment is in the form of a product of the farm. The title of the document is Noncash Remuneration for Agricultural Labor IRC Section 3121(a)(8)(A) [See Appendix C]. Private letter rulings 9202003 and 9322003 deal with this issue and provide some notable descriptive applications.

IRC section 61

Treas. Reg. section 1.61-4(a) of the regulations provides, in part, for farmers using the cash receipts and disbursements method of accounting, that the profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs. However, in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable.

IRC section 168

Rev. Proc. 87-56 (1987-42 I.R.B. 4, 1987-2 C.B. 674) and Rev Proc 88-22 (1988-18 IRB 38, 1988-1) states that for property not described in any asset class life or used in a described activity, a 7-year class is assigned for the general MACRS method (GDS) and 12-year recovery period for ADS.

Immature livestock acquired for draft, dairy, or breeding purposes, is eligible for depreciation when it reaches maturity. This means depreciation begins when it reaches the age when it can be worked, milked, or bred. When this occurs, basis for depreciation is the initial cost for the immature livestock plus freight and other costs related to the acquisition.

Since the expenses of raising animals are deductible currently, there is no depreciable basis, and therefore, no depreciation for animals raised and used in a trade or business.

Cattle Industry

Introduction

Small breeder operations will likely be run on moderately sized ranches or use leased grazing land. Some grain farmers will run small herds on wheat for a period of time. These ranches face a greater risk of loss due to longer holding period (weight gains while grazing is slower than feedlot gains) and greater potential for health problems. Absorbing losses of a few deaths when a small number of animals are available for sale is a major financial blow. Many of these ranchers are into cattle on short term basis and will get in and out frequently.

Large operations may be measured by sections (640 acres) with herd sizes in the thousands. The risks of loss because of deaths are lessened in these operations because of the number of animals available to absorb the cost. Losses and gains from changes in market prices, however, affect the profit more dramatically due to the number of head involved. These ranchers are generally in the business for the long term, maintaining a herd at all times, although the size of the herd may vary with profitability.

Bulls are purchased for breeding purposes and held for 3 - 4 years when access to the cows is unrestricted. The cost of bulls is not related to weight, but is closely tied to breeding history and physical characteristics. As a result, the cost will be much higher than slaughter cattle.

Most ranchers schedule breeding to allow for late winter/early spring calving. The gestation period for cattle is 9 months so breeding takes place from May to July. Summer born calves are in greater danger of death due to heat stress. Some ranchers also calve in the fall (September to October) so breeding takes place from December to February.

Some ranchers will buy cow/calf pairs. The calf can be up to 5-6 months old and may weigh from 400 - 600 pounds but is not yet weaned. The cow will probably also be bred. The value of pairs is higher than stocker or feeder cattle due to their purchase for breeding. The cows will be used for breeders. Bull calves may be raised for breeding but will more likely be castrated, made steers, to raise or sell for fattening. Heifer calves can be sold or held for breeding. Closed herd ranchers raise virtually all breeding stock without outside purchases.

Cows are retained until too old to produce healthy calves and are then sold at a price which will vary with the health and condition of the cows. Periodic culls from the herd will result in sales prior to aging considerations. These animals may still be viable as breeders and should bring appropriate prices.

Yearlings, or stocker, cattle are purchased at 400 - 700 pounds and are often placed on pasture (wheat or grass) or corn silage. This process is known as back grounding. Immediate placement in feedlots is a possibility dependent on feed costs. Grazing on grass results in slow growth but is good to balance with wheat grazing so moves from field to field are common. Weight gains are slow in smaller animals and increase with size. The capacity of pasture changes with region. West Texas rangeland will only support 20-25 pair per section (640 acres) while wheat supports up to 5 pair per acre.

Winter wheat pasture is available for grazing during early November. By February, March 10 at latest, the cattle must be moved off to allow finishing and harvesting of wheat crop. Common expense for wheat pasture grazing is based on cost per pound (or 100#) gains of the calves (not cows.)

Feeder (market) cattle are placed by lot in feed yards at 700 - 900 pounds. Larger animals will finish out more quickly at a lower cost. The weight goal for fat or slaughter cattle is 1,100 - 1,200+ pounds. The feedlot will provide standard feed, custom feed mixtures on request, health monitoring and treatment, and act as sales agent for certain fees. Often these fees, related to "lots" of cattle, will be deducted from sales proceeds passed through the feedlot to the rancher. Final settlement must be made at the time the last of a lot is sold.

Corn cost is a major contributing factor in placement of cattle in feedlots. With an average ratio of 10 pounds of feed for 1 pound of growth, a corn price of \$5.00/cwt (per hundred weight) will mean \$.50 feed cost for a 1-pound weight gain. This added to the previous purchase and care costs makes it much more difficult to realize a gain on the sale of the cattle. Corn at \$3.50/cwt is generally the cost equivalent of grazing. Corn costing \$5.00/cwt causes a major drop in cattle inventories unless some other factor increases profit potential.

Ranchers practicing risk management may hedge against market changes. Hedging is a common technique used by businesses to reduce risk resulting from certain assets, liabilities or foreign currencies. Various financial products are used to reduce risk, such as futures contracts, forward contracts, options on futures and notional principal contracts. Farmers, cattle feeders and feedlots generally enter into hedging transactions to reduce the risk of price changes with respect to inventory and non-inventory supplies. Transactions of unrelated commodities are not considered hedging. For complex situations in hedging, contact a Financial Products Specialist for assistance.

Issues

- Ensure deductibility of expenses. Commonly included personal expenses include interest, fuel, insurance, supplies, repairs, utilities and taxes.
- See Rev. Rul. 86-24 (1986-8 I.R.B. 7, 1986-1 C.B. 80) and Rev. Rul. 87-105 (1987-43 I.R.B. 13, 1987-2 C.B. 46), which set forth the treatment of costs incurred to purchase non-purebred cows that are implanted with fertilized embryos of purebred calves. Rev. Rul. 86-24 contains a discussion about the subsequent treatment of sales proceeds when, after the calves are born, the cows and calves are sold separately. Essentially, there must be an allocation made in the original purchase price between the cow and the implanted embryo. The portion of the original purchase price that equals the fair market value of the cows is allocated to the cows and the remaining amount is allocated to the calves. Neither the costs attributable to the cows, nor the costs attributable to the calves are currently deductible. The cows and calves are neither capital assets nor IRC section 1231 assets. Gain or loss from the sales of the cows or the calves is ordinary.
- Many operators rely on bank records for tax reporting purposes. As a result, certain types of income may be excluded from reporting. Be aware of possible bartering with the exchange of livestock for other assets or services. Furthermore, feedlot cattle sales proceeds may be used to directly reduce cattle loans and never show up on bank records.

- By-product sales include manure either packaged or in bulk for fertilizer. Calves may be sold if not necessary for expansion of the breeding herd. Breeders with quality bulls may provide stud services or sell semen.
- Steers cannot be depreciated as property used in a trade or business of breeding since they are not capable of reproducing. The pre-productive period for heifers commences on their conception and ends when they deliver their first calf.
- In the case of a feeder operation fully utilizing feedlots look for evidence of management decisions delegated to managers, foremen or other employees. If the taxpayer is not involved in these decisions the possibility of actual material participation is reduced.

Dairy Cattle Industry

Introduction

Dairy farming differs from other types of farm enterprise in the frequency of income. With milk and cream sales weekly, rather than sales tied to an annual harvest, continuous cash flow has provided a valuable economic aid in this aspect of the farming industry. Expenses are high for feed and nutritional supplements fed to cattle to meet the metabolic needs of the animals during constant lactating.

Disease presents danger, but improvements in health care and breeding have reduced the potential problems over the years. Improvements continue to be made.

The cattle chosen for use in the dairy process often are "grade cattle" with no pedigree but with predominant characteristics of certain dairy breeds. These farms focus on commercial production seeking maximum returns with minimum investment. The quality of milk will not generally suffer in this herd configuration.

Farms utilizing purebred cattle often are involved in the side line activities of breeding for resale and competing in shows and fairs. Operations of this nature, to be truly successful, will be involved in careful recordkeeping of breeding dates, calving dates, sales, transfers and other information. Tagging and tattooing, sketches and photographs, and proper registration procedures will all be meticulously followed to maximize the results of the processes.

The breed chosen for a particular operation may be tied to the requirements of the principle buyer regarding the makeup of the milk in solids, fats, proteins, etc. Feed components and nutritional additives will also be geared toward these requirements. Proteins, fats, carbohydrates, and minerals and vitamins are all balanced to provide maximum yield.

Feeds acquired may include alfalfa, clover, soybean hay, and certain grass hays. Care is taken to acquire feed which has been properly processed and cured to realize the greatest nutritional benefit. Corn, sorghum, and grass silage may also be purchased, stored in silos or bunkers, and fed as a part of the overall feeding strategy. Some types of cattle may also require grains to supply the requirements of body maintenance and milk production. A wide variety of supplements may be included in feed mixtures to produce the desired result.

Pasturing considerations include the adequacy of grazing material, type of material, and effect of material on the health of the cattle and the milk produced. The use of pasturing will be determined by the style and methodology of the farmer as well as availability of satisfactory fields. Pastured animals will require return to the milking barn twice daily. This travel plus the potential of bloat, poisoning hazard and undesirable flavoring of milk due to certain types of forage tend to weigh against pasture usage. The positive aspects include cleaner and better rested animals, yards and lots requiring less cleaning, a reduced fly problem, and the reduction of mastitis and foot rot.

Regenerating dairy herds through breeding the cows and retention of the heifer calves for future inclusion in the herd is very common. This limits the possibility of introducing disease into the herd through purchased cattle. Calves may be placed with nurse cows which do not fit the herd requirements well, but are still beneficial for this purpose. The heifer calves retained will not be productive milk producers until two years old. Feeding young heifers requires special considerations to properly prepare them for breeding and milk production.

Bull calves are generally sold although they may be kept for use in later breeding. The earliest a bull calf will likely be placed in service is 12 months on a restricted basis. Rather than retaining and maintaining bulls for the herd, dairy farmers may use stud services or, more likely, artificial insemination.

Animals purchased for replacement or expansion of the herd will require special handling and testing to avoid contamination of the herd. These additional cost measures can result in the avoidance of additional expenses later.

Veterinary expenses are common in dairy operations. The following conditions, among others, will usually warrant involvement of a veterinarian: (1) Sickness due to disease-producing organisms such as mastitis, metritis, and pneumonia, (2) problems in calving or retained afterbirth, (3) tests for brucellosis, tuberculosis, leptospirosis, vibrio, and trichomoniasis in bulls, (4) pregnancy and breeding problems, (5) injuries, and (6) cows off feed.

Modern milking equipment and facilities are costly and require certain maintenance and testing to ensure proper functioning and to limit disease potential within the herd as well as the product. Stainless steel is common and the related initial cost is high. Barns may range from conventional types to fully automated high-tech facilities. Equipment will exist for all stages of animal and product handling. Elevators, augers, and conveyers are used in feed movement along with feed carts, silos, mixers and grinders. Milking machines, pumps, and storage or transport tanks handle the milk produced. Barn cleaning equipment, manure spreaders, along with manure dryers and packaging equipment may be used. Many types of equipment are necessary to facilitate dehorning, hoof trimming, bleeding and testing the cattle.

Additional equipment will be used for pasture care and production. Expenses for seed, fertilizer and chemicals, and possibly pasture lease will be reasonable in operations utilizing pasturing.

Industry Facts

Major dairy breeds include: Ayshire, Brown Swiss, Guernsey, Jersey, and Holstein-Friesian. Another popular dairy breed is the Milking Shorthorn. Mature cow weights of these breeds will vary from 1,000 to 1,400 lbs.

Internet research at the website maintained by the [USDA Economic Research Service](#) will provide production figures (measured in pounds) for the various breeds as well as other important information.

Issues

In addition to the following, see the discussions under beef cattle for other applicable information.

- Milk sales will be primarily through cooperatives with detailed records provided to the dairy.
- Rev. Rul. 77-168 (1977-1 C.B. 248) deals with the method of computing basis for their milk base when additional milk base is purchased following the receipt of the initial allocation. In computing the gain on the sale, the "first-in, first-out" method described in Treas. Reg. section 1.1012-1(c)(1) must be used in computing basis. The full text of the revenue ruling provides further details.
- By-product sales include manure either packaged or in bulk for fertilizer. Calves may be sold if not necessary for expansion of the dairy herd. They can be sold to individuals or through a sale barn. Breeders with quality bulls may provide stud services or sell semen. Milk, and milk products, may be prepared for direct sale from the dairy.
- Certain areas of the country have quotas or allotments for such commodities as milk. The cost of the quota or allotment is its basis. If you acquire a right to a quota with the purchase of land or a herd of dairy cows, allocate part of the purchase price to that right.

Horse Industry

Introduction

Operations dealing with horses will encompass a variety of end results. Whether the operation is dealing with race, show, work, or special purpose horses will determine the level of investment and "polish" which is applied to the appearance of the operation. Without getting into specifics by breed, the following will recount the possible structure of the operations.

Most horse operations will be breeding race, show, work or special purpose horses. However, ancillary operations for training and boarding might also be encountered.

Training operations will take in horses and provide feed, boarding, and training appropriate to the purpose of the horse. Race horses, whether Thoroughbreds, Quarter Horses, walkers, trotters, or other types, will be provided appropriate training over a period of time. Show horses, likewise,

receive extensive training and grooming. The trainers will charge fees for feed and board on a daily rate and charge out the training at flat rates, hourly rates, or may accept an interest in the horse as a fee. This type of fee requires determination of value for inclusion as income in the current year. The amount determined as income would become the basis of the interest. The horse owner would recognize the transfer of the interest as a sale and realize a gain or loss on the transfer as it relates to the basis of the horse. See McDougal et al. 62 T.C. 720 (1974) for this court decision.

A boarding facility will normally provide only feed, board, and general care. These services will be priced out on a daily basis with special charges for unusual care situations as they arise. The necessity of veterinary services would be an example of unusual situations.

Breeding work horses will entail many of the same aspects of other breeding operations without the high level of appearance. Emphasis on the work characteristics of the horses is common with purebred considerations downplayed. Working horses would be those used in other operations for draft purposes or herding and rounding up other animals. Riding fences in rugged terrain to determine and execute repairs would be another function of work horses.

Special purpose horses would include those trained for rodeo, riding, hackney, or other such uses. Some overlap of other areas may be possible. The market for these horses is not extensive but lack of recordkeeping might result in tracking difficulties.

Race and show horses will likely be 100-percent registered purebreds with detailed tracking information available in the taxpayer's records and through the breed associations. The larger, more serious operations will limit activity to animals with known breeding lineage of successful animals to attempt to maximize potential. Seldom will a horse with an unproven lineage rise to the top of the sport. When this does occur, these animals will be highly documented to ensure profitability from future breeding activities.

Expenses related to horse breeder operations will include purchases of animals, veterinary fees to keep the animals in the best health condition, facilities for boarding, feeding, and training, fees for breeding services (either stud or artificial insemination,) insurance coverage of the animals to compensate for losses due to injury or accident, advertising and promotion, and specialized feed materials.

Events, shows and races, involving the animals will require entry fees which are deducted as current expenses. A certain type of race, known as a "futures", involves periodic payments of entry fees toward a future event. These payments are also deducted currently even though the animal may be unable to participate for any number of reasons.

Race horses have been subject to "syndication," the partitioning of ownership among, typically, up to 40 shareholders. The syndicated shares often contain breeding rights for the owners in addition to rights to profits. See IRC section 464 for the technical definition and application of rules for farming "syndicates."

Stud services are a common source of income for owners of recognized successful animals. The services may carry guarantees related to conception. A private treaty is a one-on-one breeding agreement which may have any type of special arrangement imaginable. No foal free return (NFFR) allows subsequent year attempt if no foal is conceived in current year. No foal no fee (NFNF) guarantees foal or no liability is incurred. Neither NFFR nor NFNF are common in the United States. The live foal guarantee likely carries a higher stud fee due to the additional financial risk to the stallion owner. If no live foal is produced, the mare may return for service or, possibly, another mare may be substituted. These guarantees may affect income.

Weaning foals takes place from 4 to 6 months of age. Colts, as young as 12-months, can impregnate mares. However, normal usage as a stallion will not take place until 2 years. The decision to castrate (geld) colts will often be made between 1 and 2 years of age, depending on the ability to keep the colt separate from mares. Training will begin early with temperament being the primary goal. Eventual addition of saddle and bridle will prepare the foal for being mounted by the age of two years when it has achieved the majority of its growth. A 3-year old should be in its prime and require only fine tuning training for further improvement.

For more information, please see the MSSP audit guide for IRC Section 183 – Farm Hobby Losses for Cattle Operations and Horse Activities.

Issues

- Transfer of an interest percentage in an animal in exchange for training or other services is considered a sale or exchange which results in the recognition of gain or loss for the fair market value of the interest transferred compared to the basis of the animal. See McDougal et al. 62 TC 720 (1974) for the related court decision.

Treas. Reg. section 1.1231-2(c)(1) provides that:

"* * *Whether a horse is held for racing purposes shall be determined in accordance with the following rules:

- (i) A horse which has actually been raced at a public race track shall, except in rare and unusual circumstances, be considered as held for racing purposes.
- (ii) A horse which has not been raced at a public track shall be considered as held for racing purposes if it has been trained to race and other facts and circumstances in the particular case also indicate that the horse was held for this purpose. [accompanying clarification included]
- (iii) A horse which has neither been raced at a public track nor trained for racing shall not, except in rare and unusual circumstances, be considered as held for racing purposes." [Examples follow in the regulations.]

- The horse industry is not standard in its marketing of animals. Horses are not generally sold in quantities like other animals. Individual sales are the norm and factors related to subjective characteristics of the horse greatly affect pricing.
- Animals not fitting the requirements of the operation will be culled and sold. These sales may be through auctions or sale barns, but most will be directly to buyers. Documentation may be less detailed on these sales than sales of high quality animals.

- Syndication sales will normally involve significant amounts to be recognized. Stud services will be a recurring source of income in many instances.

Sheep and Goat Industry

Sheep

From the American Sheep Association website:

Sheep breeding in the United States has a long and progressive tradition of breed development and genetic improvement. Seedstock producers breed some of the finest, most genetically superior sheep available. There are 47 breeds and types of sheep in the U.S. with several breeds having originated in this country.

U.S. sheep breeds provide a diverse range of performance for growth, carcass merit, reproduction, milk, and wool characteristics. This genetic variability can be used to optimize production under varying climatic conditions. Your farmer can describe the criteria and reasoning for the breed they have chosen.

There are six different types of breeds in the U.S. They are: meat breeds, fine wool breeds, long wool breeds, dual purpose breeds, hair and double-coated breeds and minor breeds. ” [Detailed information](#) on each breed can be found at a website maintained by the American Sheep Association.

Sheep which produce multiple births (commonly twinning) are tremendous assets in either operation. Though lambing is usually an annual event, some may push for a second lambing in a year. Availability of adequate pasture or supplemental feed will be the controlling factor in this decision.

A starter flock of sheep may be developed by purchasing older ewes culled from other flocks and investing in a quality ram. Others may invest in younger ewes at a higher cost. In most operations, ewes will be considered old and likely to be replaced at the age of 7 to 8 years although they may be productive to the age of 10 to 12.

Sheep give birth to (lamb) their young, in spring and the lambs grow to market age during the available time of abundant pasture. Sales in late summer or early fall correspond to the decrease in pasture availability thus reducing the need for special feed considerations during winter months. Rotation of grazing fields is necessary to avoid denuding the land. Movement will usually take place within a 10 to 14 day period for maximum benefit especially if the pasture has been divided into smaller areas which allow a more even grazing. Inclusion of goats in the grazing flock is beneficial where brush has developed. Goats, being browsers, will clear the larger plants while the sheep graze the grasses. Sheep may be used in orchard operations among the trees to help keep the area clear.

Woven wire fencing will be common to contain the sheep and to prevent intrusion by dogs. Electric fencing may be used to cordon off small pasture sections for grazing control.

Other than pasturing, supplement grain feeding is common during reproductive periods. Whole grains, other than barley, and alfalfa hay are commonly used. Windfall apples, molasses, and discarded produce from grocery stores, such as lettuce, cabbage, broccoli, celery, and various fruits in limited quantities are good additives to the diet.

Rams are chosen for many characteristics which will be passed on genetically. Generally placed in service at 2 years, one ram for 25 to 30 ewes is a standard practice. With proper feeding and control of servicing ewes, the ram should be productive for a period of 6 years. Some operations will change rams more frequently within the business strategy. With a gestation period of 5 months (148 to 152 days) breeding in August will produce January lambs. Adjustment of the breeding date is common to control lambing.

Ewe lambs, less than 2 years of age, should have attained a weight of 85 - 100 pounds by breeding time. Earlier breeding may stunt their growth, reduce their reproductive lifetime, and create teeth problems earlier which lead to feeding and related problems. The ideal ewes for breeding are those who are a twin or triplet since this trait is passed on through the ewe.

Castration of ram lambs can take place early, as soon as the testicles have descended into the scrotum at about 10 days old. This process is not necessary if the lamb is to be marketed for meat at 5 or 6 months of age or will be used or sold as a breeding ram. In wool operations, castration and docking the tail are both recommended early on.

Sheep are susceptible to several types of diseases which will affect the acceptability as breeders and may endanger life. Veterinary expenses are routine to treat pneumonia, scours (diarrhea), navel ill, constipation, entropion (inverted eyelids), urinary calculi, white muscle disease, enterotoxemia (overeating disease), parasites, tetanus, coccidiosis, acidosis, and polio. There are also a number of diseases related to pregnancy.

Shearing the wool is an annual event done as early in the season as practical. Ewes may be sheared before lambing allowing for ease of assistance during the lambing process if necessary. The wool will be graded on count, blood, or micron and determine its quality in various applications. Sales of the wool will be contracted to textile manufacturers or hand spinners or may be sold to others for quilt batts, rug yarn or felting.

Lambs may be sold directly to consumers as locker lambs which are custom butchered for the buyer. The seller receives the price per pound of processed meat and pays a nominal slaughter fee per animal to the butcher. Mutton is the meat from mature animals. Ram rental may result in receipt of choice of lambs for service provided.

Guardian sheep dogs may be raised by some operations as additional sources of income as well as for use with the flock. A variety of breeds have been used for this purpose.

The following are fact sheets about sheep and lamb production in the USA (click on the links below)

- [Fast Facts](#)

- [Wool Facts](#)

Goats

Goats can have many purposes for the persons raising them:

- [Dairy](#) for example, milk, cheeses, soaps, etc.
- Meat. The [Meat Goat Production and Marketing Handbook](#) is easily researchable and contains information on meat goat issues.
- Brush Cleanup (some unwanted weeds, shrubs, etc.).
- Pack Goats. The [USDA Agricultural Research Service](#) website provides useful information on pack goats. An additional useful site maintained by the North American [Pack Goat](#) Association contains useful information relating to pack goats.
- Fiber and [textiles such as Mohair, Angora, Cashmere](#).
- Breeding (generating quality traits into specific breeds).
- [Showing](#) (County Fairs, 4H, FFA, professional shows, etc.).
- [Pleasure](#) (for companion animals, fun or learning).
- [Harness](#) (for loads or transportation via carts - work or pleasure).

In the United States there are three distinct types of goats:

1. Dairy goats, raised under intensive management primarily for milk;
2. Spanish or Mexican goats, produced under extensive range conditions for meat; and
3. Angora goats, also managed rather extensively, primarily for fiber.

Regarding the meat of goats, called chevon, the U.S. Department of Agriculture Food Safety and Inspection Service indicates kids (goats under a year of age) are often slaughtered when 3 to 5 months of age and weighing from 25 to 50 pounds. Kids do not store much body fat until they are about a year of age. Many goats are older and heavier when marketed, but most, except aged cull goats, are slaughtered when less than a year of age. The meat of older goats is darker and less tender, but more juicy and flavorful than kid. The meat from males is lighter in color and lower in fat. The meat from females is more desirable for steaks and chops, and is more tender. Retail cuts of goat are similar to those for lamb or mutton. Goat should have light pink to bright red, firm, fine-grained flesh with well-distributed white fat. In some breeds of goat there can be color variation between males and females in other breeds there is no difference. Excess males and cull goats are also used for meat.

Spanish and Angora goats are increasing in numbers in the Southwestern states, primarily in Texas. On brushy ranges they improve the pasture for cattle and sheep by eating large amounts of twigs, shrubs, and brush.

Fiber emphasis herds will have many characteristics of wool operations of sheep. See the information previously presented for this information.

Dairy goats in the United States are represented by five major breeds or their crosses. Nubian, French Alpine, Toggenburg (Toggs,) Saanen, and LaMancha are the popular breeds. As with

dairy cattle, the breed choice is determined by desired production of butterfat vs. milk. Production levels are greatly affected by diet, nutrition, weather, and other factors. Production will generally be stated in pounds produced in a 305 day period (allowing for a 2-month dry period prior to breeding for rest and repair).

Herd animals may be registered purebred or grade animals. Cost considerations and focus of the business will determine breed choices. Price of animals is affected by the buyer market with variations due to purebred acquisition needs or performance characteristics of sire and dam. Star milkers are rated "*", "**", "***", or "****" depending on personal performance and performance of dam and granddam.

Seldom is a single-use agricultural building necessary for goats as long as it is dry and free of drafts. Goats are susceptible to pneumonia and shelter housing must provide adequate protection. Being herd animals, they are seldom kept in individual stalls. Additional space for milk stations and appropriate equipment as well as freedom of movement is necessary.

Being browsers, pasturing is not as practical for goats as for cattle or sheep. Trees, bushes, and shrubs are required vegetation for goats in the open. Grasses will not be touched unless other, more adequate, feed is not available. Proper feeding in the barn is the preferred method for most herds. Allowance for a sunny exercise yard is necessary for the fitness and overall health of the herd. Fencing must be very sturdy, such as chain link or stock fencing, and 4 feet high since goats will lean on, crawl under or jump over fences. Electric fencing can be used most effectively after "training" the goats about its effects.

Goat feeds will provide nutrition necessary for the lactating animal and should be fed in accordance with the production of milk in mind. The strain of milk production requires additional feed and nutrients which are not necessary when the goats are not lactating. Some operations will grow a portion of the feed required for the herd, but most feed will be brought in pre-mixed or in components custom mixed for the desired result in the herd.

Grooming needs of goats include hoof trimming, disbudding horns, tattooing, hair trimming, and castrating. Some specialized equipment may be used for these functions, but low-cost equipment is also available. Castration of buck kids is not necessary for meat animals, but is recommended if the kids are kept for over 3 months and not kept separate from does.

Health issues include abortion, abscess (neck or shoulder region,) brucellosis (Bang's disease,) bloat, colds, cuts, cystic ovary, goat pox, and several others. Most are treatable but when deaths occur an autopsy is usually performed to determine the course of action for the herd.

A buck will be capable of breeding by 3 to 4 months of age, however, limited service in bucks less than a year old is recommended. Mature bucks can service more than 100 does per year in some cases. Operations with a small number of does may resort to studs for servicing breeding needs.

The gestation period for a doe is 145 to 155 days. A Doe generally comes into heat only in the fall and early winter. This results in spring kidding. The herd will be bred over a period of time

to balance the lactation curve and provide milk at all times. Births will be twins in most cases with one to five kids possible. Separate stall facilities for birthing are recommended.

Buck kids are weaned at 10 weeks with doe kids weaning at 8 weeks. Grain feeding starts after weaning and doelings are switched to a milking ration at 6 months. The first breeding will take place when the doe is 7 months old and weighs 75 - 80 pounds.

Butchering may take place at four different stages. Newborns may be butchered at birth and dressed out like rabbits. Milk fed kids weighing from 20 - 30 pounds are popular with some religious groups around Easter and provide another source of income to the farmer. Buck kids raised for meat are castrated early and fed out for 6 to 8 months. Finally, cull does and old animals may be processed into jerky, salami, or other processed meats using less desirable cuts of meat.

The milk itself will be sold to commercial processors or will be processed on site for subsequent sale. Good records should be available for the herd if the goat keeper is planning on making the most of the operation. Knowing production history, health problems, and other information on the animals is necessary to determine culling and replacement requirements.

Goats come in many different sizes, colors and breeds, and each of these has their own specific characteristics.

Issues

- Depending on the setup, there is a higher potential for personal use of sheep and goat products than with some other animals.
- Potential sources of sheep and goat related income include locker lambs & kids, mutton, stud rental, breeding stock, lamb pelts and pelt products, shearing for hire, cheese from milk, manure for gardens, soap and candles, special uses of wool, building sheep and goat "furniture", locker hooking with fleece, felt making with fleece, special breeds and colors, selling wool to spinners, handspun yarn and products, cottage-industry processing, livestock dog breeding, incentive payments, merchandising products, and teaching.
- Breeding stock for sheep and goats is 5-year property for depreciation purposes.

Swine Industry

From the National Pork Producers website:

Facts and Figures

- Hogs are a source of nearly 40 drugs and pharmaceuticals on the market.
- Pork is the world's most widely eaten meat
- Pig skin is used to treat massive burns in humans due to its similarity to human skin
- The pig is rated the fourth most intelligent animal.
- There are more than 180 species of pigs, found on every continent except Antarctica.

- Pigs are often thought to be dirty, but actually keep themselves cleaner than most pets. They are seen lying in mud because they do not have sweat glands and constantly need water or mud to cool off.
- Swine research led to the development of the CAT scan, a technology for examining internal organs without surgery.

In 2005, in the United States, there were nearly 35,000 direct, full-time equivalent pork producing jobs, which helped generate an additional 515,000 indirect jobs. The industry produced nearly \$21 billion in personal income from total sales of more than \$97 billion and added \$34.5 billion to the country's gross national product.

Today there are more than 67,000 pork operations compared with nearly 3 million in the 1950s. Farms have grown in size; 53 percent of them now produce 5,000 or more pigs per year. Nearly 21 billion pounds of pork were processed from about 105 million hogs in 2006. Nearly 3 billion pounds of pork valued at more than \$2.6 billion was exported in 2005.

The U.S. pork industry is experiencing phenomenal growth as it continues to meet worldwide consumer demand for what has become the most popular meat product. Today the United States is one of the world's leading pork-producing countries and is second – tied with Denmark – to Canada as the largest exporter. The top 10 pork producing states, in rank order, are Iowa, North Carolina, Minnesota, Illinois, Indiana, Nebraska, Missouri, Oklahoma, Kansas and Ohio. The top export markets for U.S. pork include Japan, Mexico, Canada, South Korea, China and Russia.

Key to the growth in the U.S. pork industry is the American pork producer, who continues to become more efficient through modern production practices, state-of-the-art innovations and scientific advancements. U.S. pork producers are climbing to the top while adhering to high standards of animal care and well-being and proudly practicing good environmental stewardship.

Pork production requires many inputs to complete the complex process of producing high-quality pork products such as bacon, ham and pork chops. Feed grains, high-protein feed ingredients, vitamins, minerals and water are used to produce hogs that go to market and eventually become pork and pork products. Feed is the major production input to the pork production process. In fact, feed accounts for more than 65 percent of all production expenses. Corn, barley, milo (grain sorghum), oats and sometimes wheat are used to provide dietary energy in the form of carbohydrates and fat. The U.S. pork industry used 1.08 billion bushels of U.S. corn and 265 million bushels of U.S. soybeans in 2004. It takes 216 million bushels of corn and 9.63 million tons of soybean meal to produce 105.3 million market hogs. Each hog that is marketed in the United States consumes 12 bushels of corn and 130 pounds of soybean meal. At current prices, feed costs alone are \$62 per pig.

There is more than just meat produced when a pig is raised. Many of the co-products, such as replacement heart valves and skin grafts for burn victims, save lives or allow people to lead normal lives in spite of illness (insulin). Others are used in making many food and industrial products such as gelatin, plywood adhesive, glue, cosmetics and plastics. By far the largest volume co-product of pig production is manure, an effective, low-cost source of nutrients for crops and pastures. In fact, decisions regarding the type of buildings to construct frequently

depend on the producer's need for and ability to efficiently use the nutrients found in pig manure. When properly handled and applied, manure can be an asset to pig operations and provide extra income to operators by reducing the need to purchase petroleum-based fertilizer.”

Hogs and Pigs Total Hogs & Pigs for 2008		
State Rank	State	Total Hogs & Pigs
1	Iowa	19,400 thousand head
2	North Carolina	10,100 thousand head
3	Minnesota	7,600 thousand head
4	Illinois	4,350 thousand head
5	Indiana	3,700 thousand head

Concentration of hog operations have resulted in new concerns including environmental impacts as described on the [EPA website](#).

At the present time there are no Federal mandates, i.e. each state has control of environmental issues. As an example, in Iowa, operations that wish to build facilities that will house more than a specified number of hogs MUST have a manure management plan on file with the Iowa DNR AND the county board of supervisors. Additionally, Iowa DNR must approve building of confinement facilities. A look at the information contained on the website showed that there are 45 application forms that may be needed for any operation.

In NPPC's (National Pork Producers Council) Swine Care Handbook for Pork Producers Using Environmentally Controlled Housing, five goals for waste management systems are listed. They are:

1. maintaining acceptable levels of health and production through clean facilities;
2. proper management of water, soil, and air resources;
3. minimizing odors and dust;
4. minimizing vermin and parasites; and
5. complying with local, state, and federal laws, regulations, and policies.

In general, if the fifth goal is met, the others usually follow.

Similar to other types of livestock, a variety of breeds are available each with its own characteristics and temperaments. Consumer and market demand will determine the choice made by the breeder. Let the farmer tell you what breed is used in the operation and why. Whether Berkshire, Chester White, Duroc, Hampshire, Yorkshire, Landrace, Poland China, Hereford, or any other of a number of breeds, the farmer will likely enjoy describing the reasons for his/her choice.

The pig site maintains a glossary to the [various swine breeds](#). On either side of the glossary are additional links regarding herd health and other information that may be of value.

The facilities may consist of the simplest hutch and well-built pen or the high-tech, computer-controlled, totally enclosed confinement building. Considerations will include finances, extent of operation, and health and waste factors. Daily attention is required for hog operations for feeding, health analysis, facility condition and waste processing. Large operations will likely be more modern, enclosed facilities with automation for many functions, such as feeding and waste removal. The facilities may include "mistlers" or "foggers" to spray fine water particles and assist in the cooling of the animals during potential heat stress periods.

Smaller operations may utilize pasturing to some extent during moderate weather. If used for clearing, movement from one pasture to the next will take place every 2 to 3 weeks. Due to the rooting process, the use of hogs on potato or other root crop after harvest will generally provide enough food for the hogs and a well cleared field in the process.

A boar can be kept on site for operations with 10 or more sows. Boars can service one sow daily when under one year of age and double that when fully mature. It appears that most large operations now collect semen from boars selected for genetic traits and manually inseminate the sows/gilts. Young females are called gilts until the second pregnancy and are then known as sows. Gilts can reproduce as early as 9 months of age but are often held back until a full year old to increase the number of eggs and, thus, the size of the litter.

Gestation is an average of 114 days. Today, piglets are more commonly weaned at 10 to 14 (SEW pigs) days to control disease and to get the sows back into the breeding cycle quicker. Boar piglets should be castrated, barrowed, within 2 weeks of birth. Barrows will be fattened for slaughter. Gilts may be maintained for future breeding. Teeth clipping, tail docking, and ear notching are all processes which take place in the first few days of life. Feeder pigs can be sold at an average weight of 40 - 60 pounds and an age of 6 - 8 weeks. Barrows and gilts, not retained for breeding purposes, are usually sold at market weights of 220 - 280 pounds at the age of 5 - 6 months. Sows sold as breeding stock will weigh 300 - 700 pounds with price quotes categorized as under or over 500 pounds. Culled sows and old boars are generally sold to specialized slaughter houses through sale barns and can weigh from 300 pounds up.

Ratites and Alternative Livestock

Ratites (Ostrich, Emu, and Rhea)

Introduction

The Ratite family includes flightless birds with a flat, keelless breastbone (the keel is where the flight muscles connect). Most of their muscle is in their legs and thighs. In the wild, ratites eat seeds, herbaceous plants, insects, and small rodents. Ostriches, rheas, and emus are the ratites most commonly raised as livestock in the United States. Ratites produce red meat that is similar to beef or venison, and the hide makes fine leather products. The birds adapt to most climates, so long as they are given proper protection and management. Other ratites less commonly raised in

the United States are the cassowary from Australia and New Guinea, and the kiwi from New Zealand.

Shelter is required for the chicks to keep them warm and dry. Special fencing/pens are used for the adult birds - usually 5 to 6 ft high. A breeding pair of ostriches requires 1/2 to 2 acres of land. An Emu pair needs a pen approximately. 30 x 50 ft. Rheas need pens of 50 x 100 ft.

Marketing Options

The market for ostriches, emus, and rheas is limited and variable. The birds are no longer being sold only for breeding stock or as exotic pets. There is a commercial market for meat, hides, feathers, and emu oil.

Meat from ostriches and emus is a very lean red meat similar to beef or venison. However, ratite meat has a limited market depth, and must compete with beef, chicken, and pork for consumer acceptance. Ostrich hide has a well-established market, but emu hide tanning is not as consistent, so the market is smaller. Emu oil is gaining attention in the cosmetic and pharmaceutical industries, but ostrich oil has no market as of yet. Each emu, when slaughtered, can yield five or more liters of fat. When properly rendered, emu oil is a deep-penetrating oil that can be used as a moisturizer, or as a treatment for muscle aches.

The price of ratites has decreased greatly over the last few years as the industry shifted from a more limited breeding market to a commercial market. Learning how to raise ratites is time-consuming and will probably be very difficult for someone with no other livestock experiences. With better production and culling practices, a producer might be able to make a profit selling their ratites. However, many operations have been abandoned or reduced significantly because of the limited market.

Industry Facts			
Item	Rhea	Ostrich	Emu
Life Expectancy	50 years+	35 years+	20 years+
Size	7-9 ft.	5-6 ft.	4-5 ft.
Weight	350-450 lbs	125-150 lbs.	50-80 lbs.
Maturity (Breeding Age)	2-3 years	2-3 years	2 years
Eggs Per Year	30-50/year	20-40/year	35-40/year
Slaughter Age	12-14 months.	12-14 months.	12-14 months.
Dress Weight	80-100 lbs.	25-30 lbs.	20-25 lbs.
Industry Facts			
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Eggs Per Year	30-50/year	20-40/year	35-40/year
Slaughter Age	12-14 months.	12-14 months.	12-14 months.
Dress Weight	80-100 lbs.	25-30 lbs.	20-25 lbs.

Issues

- Sources of income can be from the sale of chicks or yearling birds as breeders, meat, eggs, oils, and other by products. Infertile eggs can be cleaned and sold intact for art or decorative uses.
- Many of these operations may be considered a hobby. For more information, please see the Audit Technique Guide for IRC section 183: Activities Not Engaged in for Profit.
- IRC section 1231(b)(3) of the Code specifically excludes "poultry" from the definition of livestock for purposes of IRC section 1231. The ratite family of birds (ostriches, emus, etc.) is not IRC section 1231 property. This exclusion from 1231 treatment only affects the tax treatment of the gain or loss realized upon the disposition of the animal.

Publication 225, Farmer's Tax Guide, states, "* * * livestock does not include chickens, turkeys, pigeons, geese, emus, ostriches, rheas, or other birds.

- IRC section 168: Ratites are not specifically described in any asset class and thus default into the 7-year GDS class-life category. The ADS recovery period is 12-years. Fences, rearing pens, incubators and hatchers are also 7 year property.

Alternative Livestock

Introduction

In addition to ratites previously discussed, there is a never ending stream of specialized animals being produced on farms in various parts of the country. Many of the animals are marketed for pets, sport, or show animals. Some are marketed as work or food animals while others have limited marketability due to restrictions related to the classification as "endangered" species. Others are strictly raised by those interested in the animal for no economic purpose.

A few of the animals you may encounter on the "alternative livestock" farms include miniature donkeys, miniature horses, the llama family (vicuna, guanaco, alpaca, and llama,) deer, elk, reindeer, bison, miniature pigs, sport sheep, lemurs, big cats, wallabies, wallaroos, monkeys, parrots, alligators, and munchkin cats. The list is endless.

Specialized publications are available for buyers and sellers of these animal varieties. Auctions for these animals are limited to a few locations throughout the country resulting in high travel and transportation costs or alternative marketing methods (video, Internet, and nation-wide advertising.)

Costs of beginning operations is high depending on the special requirements of the species in housing, feed, medical attention, and (potentially) import fees and related expenses. Risks of loss are extremely high.

Additional sources of income are derived by the active farmer with facilities for feeding and boarding animals in which others have invested. These investors will likely be subject to passive activity loss limitations and should be the subject of Form 5346, Examination Information Reports when encountered through audits of active farms.

Issues

- Determine if the animal qualifies as "livestock" within the definitions provided in the code. Look at considerations of whether the operation qualifies as a "farm."
- Watch for all possible sources of income. Depending on the animal, fees for tours may be a source of income. Feathers from some birds may bring income as decorator and designer item.
- Animals not specifically described in any asset class default into the 7-year GDS class-life category. The ADS recovery period is 12-years. If purchased for resale, the animals are not eligible for any depreciation.
- Immature animals purchased for breeding are not eligible for IRC section 179 expensing election. Determine the date the animal was placed in service.

Appendix - A

Interview Questions - by Type

The following interview questions are only suggested questions. As with any interview questionnaire, use these only as a guideline. Modification of the questions to fit the needs of each audit is absolutely necessary.

Development of your interviewing skills requires careful listening, quick assimilation of the information provided, and the ability to follow-up. Asking open ended questions to allow discussion, rather than closed end answers, brings out much more information. Piecing the information together results in a complete picture of the taxpayer's operation.

Beef Interview Questions

- How many cows did you have in the year of audit?
- What breed is your herd?
- Do you sell the calves from your herd or finish the feeders out?
- Do you keep some of the heifer calves for herd replacement?
- Do you use a bull for breeding purposes or do you use artificial insemination?
- Do you market your cattle through any third party marketing agent and, if so, who is it and where are they located?
- Where do you market your cull cattle?
- Do you have any arrangements with veterinarians for a regular herd health care program?
- How many head of cattle do you market each year?
- What is the weight of the cattle when you market them?
- Do you sell locker beef? Number of Head? Where Slaughtered? Price Charged?
- Does your tax return reflect an amount for personal consumption?
- Did you buy any feeders during the year of audit and, if so, how many and from whom were they acquired?
- If the herd was purchased, how was the acquisition financed?
- Describe the feeding program. Are the feeders finished off in a feedlot or on pasture? (What are the feeds? silage, hay, shelled corn, or some combination.)

Dairy Interview Questions

- How many cows did you have in the year of audit including the dry cows?
- What breed is your herd?
- What is the average age of the herd?
- To whom do you sell your milk?
- How much do they pay you per hundred weight of milk?
- What do you do with the calves?
- Do you keep the heifer calves for herd replacement?
- Do you use a bull for breeding purposes or do you use artificial insemination?
- How many times a day do you milk?
- Have you been on a DHIA (Dairy Herd Improvement Association) test?
- What is your herd's average milk production?
- Who picks up the milk at the farm and does the dairy deduct the trucking from your check?
- Do you pay wages with commodities?
- What commodities? Explain.
- Do you market your milk through any third party marketing agent and if so who is it and where are they located?
- Where do you market your cull cattle?
- Who are your suppliers of feed and supply items?
- Do you have any arrangements with veterinarians for a regular herd health care program?

Swine Interview Questions

- How many hogs did you have for breeding purposes in the year under audit?
- What breed is your herd?
- What is the average litter size?
- How many litters a year do you average?
- At what age do you wean the pigs?
- Are you a farrow to finish, a feeder, or a farrow only operation?
- Do you keep any gilt back for herd replacement?
- Do you use a boar or artificial insemination for breeding purposes?
- Do you market your hogs through any third party marketing agent and if so who is it and where are they located?
- Where do you market your stock?
- Who are your suppliers of feed and supply items?
- Do you have any arrangements with veterinarians for a regular herd health care program?
- Do you advertise to sell breeding stock or feeder pigs?
- Do you sell any pork directly to consumers after butchering a hog? (like whole hog sausage or a pig for a pig roast)
- Have you included an amount for your own personal consumption on your tax return?

Sheep Interview Questions

- What is the size of your flock in the year under audit?
- What breed is your flock?
- What is the average number of lambs per ewe?
- When do you lamb?
- Do you feed out the lambs or sell them as feeder lambs?
- Do you keep any lambs back for flock replacement?
- Do you market your sheep through any third party marketing agent and if so who is it and where are they located?
- Where do you market your stock?
- Do you advertise to sell breeding stock or feeder lambs?
- Do you sell any lambs directly to consumers for butchering?
- Have you included an amount for your own personal consumption on your tax return?
- When do you shear?
- Who shears the flock?
- Who buys the wool after the shearing?
- Do you shear the lambs before you sell them?
- Have you received any wool subsidy payments from the government?

Exotic Animal Interview Questions

- What types of animals are you raising?
- What is it that you are going to sell? Eggs? Meat? Pets? Fur?
- How long have you been raising them?
- What is the history of your operation? (profit or loss)

- Do you keep any animals back for replacement purposes?
- How and where do you market your stock?
- Do you advertise and if so how?
- Is there personal consumption of your stock shown on your tax return?
- What are your plans for the future of the venture?
- Describe any special problems or practices that I should be aware of that are unique to your industry.

Appendix - B

United States Department of Agriculture

The Economic Research Service of the [USDA](#) provides statistical information related to agricultural operations within the United States. Much of this information is obtained from surveys of farmers throughout the United States. This research is then reduced to the averages shown in the tables.

Another branch of the USDA is the [National Agricultural Statistical Service \(NASS\)](#) . The information provided through NASS is based on factual information accumulated through the agricultural marketing operations within each state and reported at the state or national level. Comparative data for the current year-to-date and one prior year are generally published.

Appendix - C

Market Segment Understanding Guidelines for Agricultural Labor — Noncash Remuneration

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I. Introduction

The purpose of these guidelines is to assist examiners, taxpayers, and practitioners in determining whether in-kind payments for agricultural labor constitute “wages” for federal employment tax purposes. This document describes the legislative background and development of the controversy, sets forth the current employment tax statutes and regulations pertaining to noncash remuneration, explores the application of the common law “substance over form” doctrine to this issue, and identifies factors that are relevant to an analysis of this type of transaction. The document concludes with a brief discussion of the reporting and income tax obligations of employers and employees in connection with noncash remuneration.

Remuneration paid in any medium other than cash for agricultural labor is generally excluded from “wages” for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and federal income tax withholding purposes. Although employers and employees may achieve tax savings through in-kind compensation under these provisions, the employees' social security benefits can be correspondingly reduced or eliminated.

Whether putative noncash payments are, in substance, equivalent to cash payments has become a contentious issue between the Internal Revenue Service and members of the farm community. The inherently factual nature of the “substance over form” analysis has prompted many to criticize the Service for applying the law inconsistently.

A review at cases in the Des Moines District revealed, however, that the Service raised a valid issue in 90 to 95 percent of the cases. Most of these cases involved a proximate cash transaction, i.e., the in-kind payment was made nearly simultaneously with the sale of the commodity without the service provider actually exercising dominion and control over the commodity. Thus, although the payments may have been noncash in form, they were cash in substance.

Because formal guidance on the application of the “substance over form” doctrine to this issue is lacking, a task force representing the farm community and the Service convened to produce additional guidance. The Compliance 2000 philosophy of reducing taxpayer and Service burdens and resolving issues by means other than enforcement provided the impetus for the task force and this document.

The following information is intended to educate examiners, taxpayers, and practitioners. It does not represent a binding position on any party as the facts and circumstances of each case determine whether a payment constitutes “wages” for employment tax purposes. Nevertheless, we believe this document contains useful information for taxpayers and practitioners attempting to comply with the law and for Service personnel attempting to enforce the law equitably and consistently.

II. Background

Agricultural labor was first brought under the social security system by Public Law 734, the Social Security Amendments of 1950. Public Law 761, the Social Security Amendments of 1954,

expanded coverage to self-employed farmers. Public Law 880, the Social Security Amendments of 1955, was enacted, in part, to clarify the treatment of share farming arrangements.

Congress enacted the current employment tax wage exception for noncash remuneration for agricultural labor in Public Law 734. In creating this exception, Congress was addressing Treasury's interpretation of existing law, which did not specifically exclude meals and lodging provided for the convenience of the employer from wages. See H.R. Rep. No. 1189, 1956-2 C.B. 1248, 1259. *Mim.* 5657, 1944 C.B. 550, held that meals and lodging provided for the convenience of the employer, which were excluded from gross income, were wages for FICA purposes.

Congress was also concerned about record keeping burdens on agricultural employers. See H.R. Rep. No. 1698, 1954-2 C.B. 676, 680-681. The legislative history supports the view that Congress was aware that farm employers commonly provided employees with meals and lodging and that there would be significant associated record keeping burdens were meals and lodging not excluded from wages. Notwithstanding this point, IRC section 3121(a)(8)(A), as enacted, did not limit the exclusion from payroll taxes to meals and lodging.

III. Applicable Law

A. Statutory Authority

Under IRC sections 3121(a)(8)(A), 3306(b)(11), and 3401(a)(2), remuneration paid in any medium other than cash for “agricultural labor” is excluded from “wages” for FICA, FUTA, and income tax withholding purposes. Accordingly, remuneration paid to employees for agricultural labor, which would otherwise be subject to employment taxes, is statutorily excepted from these taxes.

To qualify under this provision, the services performed must be “agricultural labor” within the meaning of IRC section 3121(g) of the Code³. In general, the term includes all services performed on a farm in connection with the raising or harvesting of agricultural or horticultural commodities. Also included are services performed in connection with the operation, management, conservation, improvement, or maintenance of the farm and its tools and equipment.

³*IRC sections 3306(k) and 3402(a)(2) of the Code cross-reference IRC section 3121(g) for FUTA and income tax withholding purposes.*

B. "Substance over Form" Analysis

The incidence of taxation depends upon the substance of a transaction. The tax consequences arising from a sale or other disposition of property are not determined solely by the means employed to transfer legal title. The leading “substance over form” case is *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) [45-1 USTC ¶9215], 1945 C.B. 58. In that case, the Supreme Court stated that:

[T]he transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person can not be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

The determination of whether the exception from wages under IRC section 3121(a)(8)(A) applies depends upon whether, under the facts and circumstances viewed as a whole, a bona fide transfer of the noncash medium from the employer to the employee has occurred. Although many factors may be relevant for purposes of determining whether a bona fide transfer of in-kind compensation has occurred, the inquiry can be reduced to two components: whether the employee exercises dominion and control over the commodity, and whether the payment is equivalent to cash.

Other factors may be present in a particular case that tends to establish that the in-kind payment was without substance and was made with the principal purpose of avoiding employment taxes. For example, evidence that the employer was purchasing farm products on the open market for purposes of making in-kind payments is a strong indication that the arrangement lacks substance. A farm employer that produces both hogs and corn, for instance, could use raised feeder pigs or corn to compensate its employees. Remuneration paid in some other medium that was purchased solely to compensate the employee would not be excluded from wages under IRC section 3121(a)(8)(A). This and other factors should be weighed with other evidence in determining whether a bona fide transfer of noncash remuneration occurred.

1. Exercise of Dominion and Control by the Employee

Whether an employee has exercised dominion and control over a commodity depends on the facts and circumstances surrounding the transfer of that commodity. Examiners should look at objective factors to determine whether the employer has relinquished dominion and control and whether the employee has exercised dominion and control. Relevant factors include: (1) existence and extent of documentation, (2) marketing and negotiation of the subsequent sale of the commodity by the employee, (3) shifting the risk of gain or loss to the employee, (4) the length of time between the employee's receipt and sale of the commodity, (5) bearing the costs incident to ownership, and (6) ability to identify the transferred commodity.

a. Documentation — Similar to most tax issues, documentation of a transaction enables examiners to better understand and analyze the transaction. Documentation also offers evidence of the parties' intent upon entering the transaction. Nevertheless, it is always the examiner's job to look behind the documents to determine whether the substance of the transaction is in accord with its written form. Documentation of both the employment relationship, including compensation practices, and the transfer of commodities is extremely important evidence in establishing a bona fide transfer of noncash remuneration.

Evidence of Transfer. Commodities typically used to compensate employees include livestock, grain, breeding rights, and milk products. Written evidence of transfer of these commodities is

essential. Receipts, contracts, bills of sale, and other instruments of conveyance vary according to the type of commodity involved, but all are useful indicia of transfer. Other related documentation is also important, including sales records, weigh tickets, required veterinary inspection certificates, and maintenance receipts reflecting that recipients have incurred storage and feed costs. Breeding certificates and formal registration records are important reflections of true transfers of breeding rights and registered animals.

The release of any security interests that a lender may have in the farm employer's commodities is also crucial to completing a transfer. In many instances, farmers will have ongoing lines of credit with local lenders, and the sale and transfer of property securing the loan can only be accomplished through formal release of the security interest by the lender. It is important for IRS examiners to determine whether the employer followed these formal prerequisites to completing a valid transfer. Failure of the employer to inform the lender that the commodity is being transferred suggests that the commodities remain under the dominion and control of the employer.

Although a farmer-originated bill of sale, receipt, or other documentation is evidence of transfer, the substance of the transaction must also indicate that a transfer has occurred. For example, the employee's failure to pay the costs associated with storing or maintaining the commodity indicates that a substantive transfer has not occurred.

Documents evidencing transfer that are functionally equivalent to cash are considered to be cash. For example, a scale ticket issued by a grain elevator acknowledging its receipt of grain would not normally be convertible to cash but it does reflect an identifiable amount of grain. In contrast, a warehouse receipt, or some variation, issued by a grain elevator is frequently treated as negotiable. Payment by such a readily negotiable document would likely be deemed to be the functional equivalent of cash and not covered by IRC section 3121(a)(8)(A). See Rev. Rul. 79-207, 1979-2 C.B. 351. This topic is discussed in greater detail below.

Employment Contract. Clearly, for the employment tax exception for noncash remuneration paid for agricultural labor to apply, an employment relationship must exist. See e.g., Rev. Rul. 56-659, 1956-2 C.B. 332 (dealing with share farming arrangements); *Crawford v. Commissioner*, T.C. Memo. 1984-433 [CCH Dec. 41,420(M)] (dealing with partnerships). Only payments to an employee qualify for this employment tax exception. An individual receiving an in-kind payment as a self-employed individual, within the meaning of IRC section 1402 of the Code, is subject to Self-employment Compensation Act (SECA) tax. The services performed by the employee must be "agricultural labor," as defined in IRC section 3121(g). A description of the employee's duties in a contract helps to determine whether these duties constitute "agricultural labor."

These requirements having been met, documentation of the wage payment agreement is a factor, though not bearing sufficient weight to override the substance of a transaction, to be considered in determining whether a purported in-kind payment represents a bona fide payment of noncash compensation. Stated more succinctly, the substance of the in-kind payment cannot merely be "papered" to obtain the benefit of IRC section 3121(a)(8)(A).

A substantive arrangement to make in-kind compensation payments will ideally be described formally in a written contract or employment agreement. In addition to employment contracts, corporate minutes or resolutions reflecting a formal adoption of the program may also provide some indication that in-kind payments were not, in substance, cash payments.

Anything in the way of a posted employee announcement or any written documents describing the program should be requested. The absence of any of these documents about a program to compensate employees through agricultural commodities could reflect an effort to avoid paying employment taxes or the existence of a partnership or tenant relationship. It is important to note that a farmer may have different types of workers, including mechanics, truckers, or other “outside” workers and these guidelines may apply differently to each type of worker. Again, this discussion of documentation is in no way intended to imply that the substance of a transaction that would not otherwise withstand scrutiny may be merely documented to obtain the benefits of IRC section 3121(a)(8)(A).

b. Employee Marketing and Negotiation of the Sale of the Commodities —Independent sales transactions by the employee are important. Failure of the employee to negotiate an independent sale reflects a failure by the employee to exercise dominion and control over the commodity and could indicate that a bona fide transfer has not occurred.

After a transfer to the employee has occurred, the employer must not act in concert with the employee in management, maintenance, or marketing and disposition of the transferred commodity. If any portion of this decision-making process remains with the employer, a rebuttable presumption that a transfer has not been completed is created. For example, the employer may not direct the elevator/purchaser to issue a check for a given quantity of grain or livestock that is payable to the employee. Such action reflects a failure by the employee to exercise dominion and control. However, this does not preclude the employee from contracting with the employer for such services in an arm's-length transaction.

If the sale of the commodity by the farm employer is in unison with the disposition of the employees' commodities, the entire arrangement suggests that the parties are merely deferring the receipt of cash to a convenient time under the control of the employer rather than the employee. However, given the fact that marketing of farm products is largely controlled by the demands of purchasers (livestock yards, meat packers, grain or milk processors, etc., or as a result of economy of scale or other bona fide business reasons), an employee who is paid with an agricultural commodity will occasionally be unable to demonstrate independent marketing by selling in transactions that are separate from those of the employer. Similarly, a farm worker may encounter problems in disposing of small quantities of livestock and grain as well as milk and other items. Accordingly, the worker must necessarily associate his or her commodities with those of the farm employer to facilitate the sale of those commodities. Such a unified arrangement creates a rebuttable presumption that suggests cash equivalency rather than a bona fide commodity transfer. Taxpayers must be able to demonstrate that there are significant objective reasons for the employee to act in concert with the employer in marketing products.

In the event an employee sells a commodity in unison or in collaboration with the employer, a single payment (i.e., a check to one payee) is strongly indicative of marketing by the employer

and could be fatal to the wage exception. Furthermore, the sale of a commodity by an employee back to the employer should, under no circumstances, be considered a bona fide transfer. A purchase by the employer indicates lack of independence and would be fatal to an attempt to seek exemption.

c. **Employee Assumes the Risk of Gain or Loss** —An employee must assume the risk of loss with respect to both price fluctuation and change in the quality or nature of the commodity from the time the commodity is transferred until the time of sale by the employee. The greater the risks assumed by the employee, the more likely the transaction will be respected.

When the employer agrees to compensate the employee in terms of future commodity production, the greatest risk is assumed when the compensation arrangement is based on a fixed percentage of production. The employee assumes the physical risk in that the yield may be below expectations or the quality may be deficient. The employee is also subject to the risk of price fluctuation as the commodity develops. In this type of payment arrangement, however, the employee may, in fact, be a share farmer with earnings subject to SECA tax.

When the compensation arrangement is based on a fixed quantity of a commodity, the risk of loss is less. The employee is insulated from production risks but remains vulnerable to price fluctuation during the growing season. In addition, some physical risk may be established through delaying the sale of the commodity after receipt.

When the compensation arrangement is based on a fixed dollar value of a commodity, any physical or price fluctuation risk incurred involves holding the commodity after the transfer. This type of arrangement is the most likely to be considered a cash equivalent, due not only to the low-level risk of loss but also to the indication that the transaction was intended to be a substitute for cash.

It is important that the examiner consider whether the employer has somehow indemnified the employee against loss or deterioration or insured replacement of unmarketable commodities resulting from theft, vermin, pestilence, spoilage, death, etc. An obligation of the employer to replace lost commodities creates a presumption that the employee has not assumed the benefits and burdens of ownership and that the employer has not relinquished dominion and control over the commodity.

An employee who is compensated based on a percentage of production, e.g., 10 percent of harvested crops or hogs produced, will be presumed to be at risk if the employer does not guarantee replacement or minimum units of production. To this end, the employer will be required to maintain production records to support the basis for the wages paid in kind, e.g., if the employer harvests 10,000 bushels of corn, the employer must show a payment based on the actual yield. Any loss of production during storage must be borne proportionately by the employer and employee. Payments based on a percentage of quantities marketed will be presumed to be equivalent to cash.

d. **Employee's Holding Period** —Although an employer may pay employees in kind, the length of time between the transfer of the commodity to the employee and its disposition for cash or

deferred payment must be scrutinized. The length of time an agricultural commodity is held by an employee can be indicative of the parties' intent. However, there is no bright line test. As discussed in the cash equivalency section below, the longer the period between transfer of the commodity from the employer to the employee and subsequent conversion to cash, the less likely it is that the payment is equivalent to cash. The ultimate impact of a holding period by an employee is to be determined by an objective analysis of all relevant facts and circumstances, including those enumerated herein. For example, a compensation package consisting of only noncash remuneration creates the presumption that the employee must necessarily engage in a proximate cash transaction to provide for basic sustenance. See also the discussion of cash equivalency, *infra*.

While there are no cases relating to holding periods, there is a substantial body of case law involving the federal taxation of transfers by gift. These cases indicate that the donor must clearly and unmistakably divest himself of dominion and control, immediately, absolutely, and irrevocably, for ownership to be transferred. *Weil v. Commissioner*, 82 F.2d 561 (5th Cir. 1936) [36-1 USTC ¶9183]. The employee must have time to exercise dominion and control over the use, enjoyment, and disposition of the in-kind payment, free from all employer-imposed constraints. The opportunity to raise, breed, store, pledge, consume, sell, or otherwise utilize a commodity in any manner the employee deems appropriate is evidence of dominion and control.

Transactions in which a commodity is transferred to an employee and subsequently purchased by the employer or a third party as part of a prearranged transaction between the employer and employee or the employer and a third-party purchaser will be considered to be equivalent to cash for employment tax purposes.

e. **Employee Bears Costs Incident to Ownership** —Due to the variety of agricultural products used to compensate employees (fruits, vegetables, grain, livestock, milk, flowers, etc.) and the timing of such payments in the life cycle of the product, the extent of maintenance and management that is required for each type of commodity necessarily depends on the facts and circumstances of each case.

The employee should be responsible for the costs necessary to maintain the commodity after receipt. For grain, this would typically involve storage fees. For livestock, the employee should be responsible for the care, feeding, and management of the animals from the time the payment is made until disposition. When the employee uses the employer's facilities, the arrangement should be at arm's-length. The employee's failure to incur these costs indicates that a bona fide transfer of the commodity did not occur.

Other important considerations are whether the farm employee has the facilities and equipment necessary to maintain the commodity. If not, does the employee rent facilities from the farm employer or a third party, or are these provided to the farm worker at no charge or a token amount as a wage “gross-up?” The latter situation denotes a lack of control by the employee and a failure to bear the burdens of owning the commodity, thereby indicating that the payment was equivalent to cash.

f. Identification of the In-Kind Payment —A bona fide payment in kind should involve the transfer of a specific, identified commodity or other product. The method of identifying the in-kind payment will vary according to the type of commodity or product.

Livestock. Hogs, cattle, and other livestock should be tagged, marked, branded, or segregated into separate pens at the time the commodity is transferred to the employee, and the transfer should be documented. Documentation should include a bill of sale referring to specific animals or groups of animals. The document should describe the animals with specificity, stating the type of livestock and the grade or quality. A bill of sale indicating a transfer of a specified number of pounds of slaughter cattle or hogs, for example, has not described the cattle with adequate specificity. Under this type of arrangement, not only would the employee fail to exercise dominion and control over specific animals, but the transaction would be equivalent to cash.

Other Farm Products. Farm products such as corn, wheat, soybeans, fruits, vegetables, and milk are fungible; that is, any unit of these commodities is indistinguishable from any other unit of a like grade or quality. Appropriate documentation of an in-kind payment in these types of commodities should also serve to identify the in-kind payment.

The documents evidencing the transfer of fungible farm products should identify the nature, grade, and quality of the commodities used for in-kind payment. They should also specify the location of the commodities and the method by which the employee's commodity will be separated from that which remains the property of the farm operator. The method of identification and separation will vary based on the type of commodity and the existing storage facilities. The greater the evidence of specific identification, the more likely the in-kind payment will be respected for employment tax purposes. Thus, for example, evidence that the fungible commodity payment was immediately transferred from the employer's facilities to a facility used exclusively for the storage of the employee's products presents the strongest case for a bona fide transfer. When commercial storage, such as a grain elevator, is used, the elevator operator must maintain a separate accounting for the employee's grain.

2. Cash Equivalency

The second prong of the “substance over form” analysis focuses on whether the in-kind payment is equivalent to cash. Several aspects of this analysis have been alluded to above in the discussions of documentation and the length of time the commodity is held by the employee.

Any agreement as to a specific dollar quantity of commodities, establishing a quantity of the commodity used for payment at the time of sale, will be considered to be an agreement for the payment of cash. Thus, the payment will not be excepted from “wages” for employment tax purposes.

Cash advances made to employees by an employer that are secured by a commodity or satisfied upon the sale of a commodity are considered to be cash wages. Similarly, the employer may not pay wages in Kind with the intent of guaranteeing a cash equivalent, e.g., “... the employee is guaranteed to be paid \$5,000 in the form of number 2 yellow corn on the date the corn is sold to

the elevator” An agreed upon cash payment that is subsequently converted to a commodity is also considered to be equivalent to cash.

In addition, payments made in documents that are readily negotiable are considered to be equivalent to cash. In Rev. Rul. 79-207, 1979-2 C.B. 351, a company paid its farm employees in commodity storage receipts rather than cash to avoid FICA taxes. The company immediately redeemed the employees' receipts for cash. The value of the storage receipts was equal to the amount that the employee would otherwise receive in cash. The ruling concludes that the cash value of the commodity storage receipts paid to the farm employees is, in economic reality, a payment in cash. Thus, it is not excepted from wages under IRC section 3121(a)(8)(A) of the Code.

Although relevant to the dominion and control analysis, *supra*, the length of time between payment in commodities and the disposition of the commodity is also reflective of the parties' intent as to cash equivalency. Transactions in which an employer makes an in-kind payment and then immediately sells the commodity for cash payable to the employee will be scrutinized. The same holds true for transactions in which the employer acts as an agent for the employee in obtaining cash for the employee. Payments in the form of marketable commodities that are bought back from the employee by the employer or a party related to or controlled by the employer are equivalent to cash.

An employer that pays an employee in kind, knowing that an immediate cash conversion will occur, will be liable for employment tax on the payment of those wages. In reviewing this type of arrangement, the economic reality of the transaction must be analyzed to determine whether the employer is simply paying cash indirectly rather than directly. An example of when the arrangement should be questioned is when the in-kind compensation is an employee's only source of income for his or her agricultural labor. It would be necessary for the employee to immediately convert the payment to cash to pay for life's necessities. Again, the length of time the commodity is held is relevant to this inquiry.

Payments under a deferred payment contract will, under almost all circumstances, be considered to be equivalent to cash because the sale of the underlying commodity has already occurred. Lastly, Generic Commodity Certificates⁴ will be considered to be equivalent to cash because the employer has never owned the commodity. These certificates merely convey a transferable right to receive commodities.

⁴*Governed by the Agricultural Act of 1949 and its amendments.*

IV. Income Tax Treatment of the Parties

A. Employer Income and Reporting

Payment of wages in commodities is a disposition of property under IRC section 1001 of the Code. Accordingly, any gain recognized by the employer on a bona fide in-kind payment is includable in the employer's gross income under IRC section 61(a)(3). See Rev. Rul. 69-181, 1969-1 C.B. 196. An income tax deduction is allowable for wages paid if income tax is withheld

as required by IRC section 3402 of the Code. Because agricultural wages paid in kind are not subject to withholding under IRC section 3402, the requirement would be met and the employer would be allowed a compensation deduction.

The employer is required to report the fair market value of the in-kind payment as “Wages, Tips, and Other Compensation” in Box 1 of the employee's Form W-2. If the exclusion from wages in IRC section 3121(a)(8)(A) applies, the value of the in-kind payment should not be included in Boxes 3 and 5, Social Security Wages and Medicare Wages.

B. Employee Income and Reporting

The fair market value of in-kind payments on the date of transfer should be reported by the employee's employer on Form W-2. The employee should report this amount on Form 1040 in the year the payment is received, regardless of whether the property is sold or otherwise disposed of during that year. However, any gain or loss recognized upon the subsequent disposition of the commodity should be reported on the employee's Schedule D. The employee's basis in the commodity would be the fair market value of the commodity on the date of transfer, i.e., the amount reported on the employee's Form W-2.

Assuming the employee is not receiving payment under a share farming arrangement, gains from the disposition of commodities received as compensation for services rendered are not necessarily subject to SECA tax. The determination is based upon facts and circumstances and revolves around timing, frequency, and nature of the commodity used to compensate for services. Casual, infrequent dispositions would not be determinative of self-employed status. On the other hand, commodities received that become the basis of agricultural production that are enhanced, maintained, and disposed with regularity in a business-like fashion may well subject the recipient to SECA tax liability. For example, gain on the sale of feeder pigs received as compensation under IRC section 3121(a)(8)(A) that are then placed in production and raised for market on a consistent basis would be subject to SECA tax.

Appendix - D

Suggested Web Pages For Further Research:

Cattle Industry:

View the various stages in beef production at the website maintained by [Cattle Producers](#).

A Dictionary of cattle terminology and definitions can be viewed at [Cattle Pages](#).

Other cattle information:

[Cattle Today](#)

[Cattle, Ranch, and Livestock](#)

[Global Cattle Industry](#)

Dairy Cattle Industry:

America's dairy farmers maintain a website [All-About-Cows](#).

A dictionary of dairy terminology and definitions can be viewed at [America's Dairy Farmers](#).

Horse Industry:

Information [About horses](#). [Scroll to bottom of page to find additional links].

Information [All about horses](#).

A [glossary of horse terms](#) which provides the meanings of words used when talking about horses, their care, and use can be viewed at a website maintained by About Horses.

The Department of Animal Science at Oklahoma State University maintains a website which is easily researchable and contains information about [different breeds of horses](#).

Sheep and Goat Industry:

The University of Maryland maintains a website that contains a wealth of [information about goats](#) in general AND it has information categorically segregated into MEAT goats, DAIRY goats, FIBER goats and PACK goats. It also contains a 412 page National Handbook from the University of Wisconsin about goats.

A sheep and goat specialist with the University of Maryland maintains a website where the [basics on sheep](#) are presented in a really fun format.

A sheep and goat specialist with the University of Maryland maintains a website which covers a [broad spectrum of sheep industry issues and economics](#).

A sheep and goat specialist with the University of Maryland maintains a website which discusses some [economic considerations](#) regarding sheep and goats.

At the [American Sheep Association](#) website there is useful information about sheep and links to other resources.

Swine Industry:

The EPA Agriculture Center website provides a useful [Pork Glossary](#).

The EPA Agriculture Center website provides useful information on [Pork Production](#).

The US Pork Center website contains a [subject-based library](#) which consists of electronic resources for pork topics.

Ratities and Alternative Livestock:

Oklahoma State University includes information relating to [Ostrich production](#) (PDF).

The American EMU Association website contains subject-based resources relating to [EMU ranching](#).