

Farmers (ATG) Chapter Nine - Grain

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Introduction

Farming Basics – Risks, Crops and Production Cycle

Risk

All businesses, including farming, are subject to many risks and require various decisions to minimize and overcome these risks. Historically, the farmer has retained the risks associated with farming, i.e., taken his or her chances with fate. Today's farmer has a substantial investment in fixed assets and planting production costs, so the risks are even higher. A prudent business person needs to reduce some of the risk to remain in business and have some certainty in the future. The farmer must make many difficult decisions in how much risk shifting can be afforded.

The farming industry differs from other businesses as it is a true competitive, market-driven industry. The farmer has no control over the price received, and all crops produced may be sold at the same price. If the farmer does not use marketing strategies the inability to control price is a major risk confronting the farmer, especially since the production cycle generally occurs on a yearly basis. Furthermore, the farmer has no control over the prices of the fuel, fertilizer, chemicals, and equipment used in the production of grain.

Unlike other businesses, nature is a significant risk in farming. Entire crops can be destroyed by a natural disaster such as drought, flood, or hail. Crop diseases and pests can also cause major losses and even destroy an entire crop.

Nature and market price risks make farming a series of high stake gambles. However, both market price and nature risks can be minimized.

- Risks from nature can be shifted by buying crop insurance. This shifts the risk to a pool of similar participants. The amount of coverage is variable so more or less of the risk can be reduced.
- Market price risk can be reduced in three ways:
 - Sell forward contracts at agreed prices to hedge the risk of price declines. A forward contract may also be used to reduce the risk of price increases in connection with acquisitions of inventory and non-inventory supplies.
 - Sell regulated futures contracts, through which the risk is transferred to a speculator who buys the contract. This is known as hedging. The principle risk of hedging is the lost income opportunity if the market price should go up.
 - Participate in the Government's farm programs, through which the farmer receives a deficiency payment (the difference between a set price and the market price).

Crop/Grain Production Cycles

There are many different kinds of crops produced by today's farmers. Most of these crops are planted in the spring and harvested in the fall. An exception is winter wheat, which is planted in the fall and harvested in June and/or July. It is very important to remember when you examine farm returns that you do not schedule work with the farmer during planting and harvest. If you schedule an on-farm appointment during this time period, the farmer will quickly get the impression that you know very little about farming.

When auditing a farm operation, it is essential that you understand the production and distribution cycles of the crops grown by the farmer. In other industries, you are able to walk into a manufacturer's place of business and view the production cycle from raw goods to finished product. In a farm operation you can only see one stage of the production cycle at a time. This chapter is meant to familiarize you with the production cycles of feed grains grown by U.S. producers.

Following this introduction, you will find a short description of the production cycles of the major feed grain —wheat, corn, soybeans, and sorghum. Alfalfa is also included since it is a major crop grown on some grain farms and has a distinctly different production cycle. Cereal grains such as oats, barley, and rye have production cycles similar to wheat.

You should become aware of the crops grown in your area. If you need more production information on the crops described in this section or on other crops in your area, you can contact your local county extension office.

Wheat

Wheat is one of the major grains produced for human consumption. Wheat is a stemmed annual grass plant with a single head that produces the grain. Wheat is unusual in that it can be planted at two different times of the year. Some wheat is planted in the spring and harvested in the fall. However, in the central and southern areas of the Great Plains, wheat is planted in the late fall and harvested the following spring. This wheat is commonly called winter wheat. Soft spring wheat is generally used as feed or to make flour for pasta, while hard winter wheat is milled for flour. By planting winter wheat, farmers can also plant another crop in the late spring to early summer to be harvested in the fall. This allows the farmer to receive income from two crops in the same year, and is commonly referred to as double cropping. The rest of this section will concentrate on the production of winter wheat.

Winter Wheat

Winter wheat is the only crop whose growing season includes winter. Thus, it has the longest production period. The seed is planted in the fall, and the plant becomes established before it goes into winter dormancy. The growing season starts in the late winter, with spring rains feeding the plant growth and grain development. Ideally, the wheat is harvested before the hottest and driest parts of summer arrive. In areas of marginal rainfall, land is usually left fallow (idle) to allow moisture retention for the next crop. In areas of higher rainfall and a longer growing season, a second crop (soybeans or milo) is often planted right after wheat harvest,

giving rise to the concept of double cropping. Double cropping wheat with soybeans provides a major part of the nitrogen, which is the primary nutrient needed by wheat.

Soil Preparation and Planting (Wheat)

Most wheat is grown on highly erodible land, resulting in conservation tillage methods being used. A field cultivator or disc is used to till the prior crop's stubble or stalks. Wheat is then planted using a drill, which places the seed into the soil in very narrow rows using coulters (disc) and shoes to open the row. Spring-loaded packing wheels then tamp the row, resulting in a better seed to soil contact. Seed wheat can also be drilled directly into the ground without any prior tillage in a process called "no-till".

Fertilization (Wheat)

Fertilizer use is generally limited to nitrogen, phosphorous, and potassium. All three can be applied as pre-plant or phosphorous and potassium can be applied at planting. In addition to the pre-plant application, nitrogen should also be applied in early spring.

Harvesting and Storage (Wheat)

Wheat is harvested by a combine. Harvesting may be done by the farmer or by custom harvest crews. If custom harvesters are used, you need to review the harvesting contract or contact your local county extension agent for the average rates charged. Custom harvesting is normally billed on an established amount per acre plus an additional charge per bushel. A farmer who has row crops, in addition to wheat, usually owns a combine, which can be used to harvest all grain crops grown.

Ideally wheat is harvested at a minimum level of moisture so it can be stored without drying. Ripe wheat is quite susceptible to wind and/or moisture damage, thus timing is critical when the grain is ready to harvest. For this reason, when scheduling an appointment with a wheat farmer, contact the farmer first so you do not schedule an examination during harvest.

Marketing (Wheat)

Harvested wheat is usually trucked out of the fields during harvest and taken to the local co-op or elevator. The farmer will either store the wheat or sell it to the elevator. Wheat is usually stored to be sold when market conditions are most advantageous. Since most wheat is ground into flour, it must be transported to some type of elevator to await further shipment. Therefore, most wheat sales will be to the local elevator. When wheat has such a poor quality (for example, unable to timely harvest due to rain) that it may be severely docked (price cut) if sold, or if wheat prices are low in comparison to corn prices, the wheat may be used as feed by the farmer or sold to the feedlots for feed.

Wheat can be retained for seed wheat. Seed wheat may be used by the farmer for the next year's crop or sold to other farmers for seed. The young, growing wheat can also be used for cattle grazing in the winter without damaging the resulting grain crop. When interviewing the taxpayer,

make sure to ask about other sources of income from wheat pasture and seed wheat, etc. Wheat is typically sold by the bushel (60 pounds).

Corn

Corn is used as a feed grain, for human consumption and for ethanol production. It is the principle feed grain grown in America. Corn requires good soil and large amounts of water, but produces many more bushels per acre than other feed grains. It is grown throughout the country, but the Midwest farm belt is the primary producing area. Because of the need for large amounts of water, corn is often irrigated where water sources are available. The production potential difference between irrigated and non-irrigated land is quite substantial, so it is necessary to ascertain how many acres of corn are irrigated.

Corn is a stemmed annual grass plant that can grow to 7 or 8 feet tall. It is pollinated from the tassels, and produces one to two ears per plant. It grows rapidly with large quantities of water, and hot, windy weather. Corn is susceptible to various worms and insects which require pesticides to control. Weed control is also necessary because of the long growing season.

Soil Preparation (Corn)

Plowing was the conventional method of preparing the ground for planting. It is less commonly used now as it is expensive in terms of fuel, labor, and equipment. It also can cause sloped fields to become susceptible to topsoil erosion from wind and rain. To conserve topsoil and reduce the costs of producing the crop without a corresponding drop in income (yield), farmers are using more conservation tillage, often called no-till or low-till. Conservation tillage allows plant residue to be maintained in the field and is now widely used by the farming industry. In addition to reducing erosion, these methods reduce the number of trips over the field for soil preparation and cultivation. Field cultivators are replacing the plow.

Highly erodible land must maintain a certain percentage of plant residues to reduce erosion in order for the farmer to remain eligible for any Government subsidies on that land.

Planting (Corn)

Corn is planted in rows using a row crop type of planter, which can also be used for planting milo and soybeans. The corn may be cultivated several times for weed control and soil aeration. If no-till or low-till procedures are used, the need for cultivation is eliminated; however, special planters are required, and herbicides must be applied to control weeds.

Corn requires large amounts of fertilizer, particularly nitrogen. Nitrogen may be applied before planting, at planting time, or as a side-dressing after the corn is up. Total fertilizer use is greater on corn than on any other crop grown in the United States.

Irrigation (Corn)

Corn requires more rainfall than other crops. It has two short, critical growing periods (tasseling and silking) where lack of water can cause severe yield losses. Irrigation will result in significantly higher yields over dry land production. Irrigation will be used where there are adequate water sources and inadequate rainfall.

Early irrigation was done exclusively by flooding on flat bottom land, where water would run down the furrows from one end of the field to the other. This often required the fields to be leveled. This method is labor intensive and cannot be used if there are any hills, but it is still in use today in certain areas.

Most irrigation of corn (and other crops) is now done by center pivot systems. The water enters at the center pivot into a long length of overhead pipe where it is sprinkled onto the field. A mast assembly with drive wheels supports the pipe and moves the sprinkler around in a circle. Some systems have a boom on the end which is controlled to extend at the corners so the coverage is closer to a square than a circle. Once set up, it can irrigate a field for the growing season with minimal labor.

In most areas, the water is supplied by wells from an underground aquifer. Because irrigation depletes the aquifer, some states now exercise more control over usage and drilling new wells.

Irrigation requires a substantially higher initial investment in land, equipment, and water wells. Well pump operation also increases expenses.

Harvesting (Corn)

The corn is harvested in the fall (usually October) by combines with corn head attachments. Corn heads cannot be used for any other type of crop. The corn is shelled off the cob by the combine so that only the grain is hauled out of the field. Dry grain corn yield is measured by the bushel (56 pounds). Because wet corn is susceptible to mold, it is often dried before storage and aerated afterward. Dryers require large amounts of fuel (propane). Corn can also be stored in wet bins such as "Harvestores," which control the air. The wet corn is usually fed to livestock on the farm, since it cannot be sold and shipped outside of the area. Corn pickers may still be used in some areas where the corn is left on the cob and stored in cribs to dry naturally. This ear corn can be ground into livestock feed or shelled the next year. Ear corn is usually not marketed until the following year.

Silage (Corn)

Due to its high fiber and nutrient content, the entire corn plant can be chopped into silage for cattle feed before the plant matures and dries up. During times of drought, corn may be chopped for feed to salvage some of the plant when there would be very little grain produced. Silage is most often produced for the farmer's own livestock, but it can be sold to other livestock feeders. It is typically used to fatten cattle.

Marketing (Corn)

After the corn is harvested, it can be stored on the farm for future sale or consumption, hauled to an elevator for sale or storage, or sold to feed consumers. Feedlots are the largest consumers of corn. Corn farmers will usually have sufficient on-farm storage for a typical crop, especially if the corn is used as livestock feed. The on-farm storage facilities also allow the farmer to seal (store) the corn through CCC loans made on the stored grain (see Government Farm Programs chapter).

By marketing the corn and silage as feed for livestock, the farmer can reduce drying, handling and hauling costs. The corn stalks remaining in the field after harvest can be used as pasture for cattle or baled for bedding.

Soybeans

Soybeans are a row crop with a production cycle similar to corn. They are high in protein and have a variety of uses. Soybeans require less moisture than corn so their importance to the farmer has continued to grow over the last few decades.

Soybeans are broad-leaf plants which produce beans within their pods. They grow about 2 to 3 feet high. Unlike corn and sorghum, soybeans do not generate a lot of material in their stalks or roots, thus the soil is more susceptible to erosion. Soybeans are often rotated with corn for several reasons:

- Corn is a grass while soybeans are a broad-leaf
- Rotating corn and soybeans allows the use of different herbicides, which can break up the pest cycles
- Soybeans are a legume which add nitrogen to the soil for a subsequent corn crop
- Corn can be planted in soybean ground with little or no tillage.

Double Cropping (Soybeans)

While soybeans can be planted as a single crop during the year, because of their shorter growing season, they are often used for double cropping. For instance, the farmer harvests his or her winter wheat crop in June and plants a soybean crop in the wheat stubble. This allows the growing and harvesting of two crops in a single year. Double cropping is normally found in the middle and southern areas of the United States where the growing season is longer.

Harvesting and Uses (Soybeans)

Soybeans are harvested in the fall by a combine using a row crop head attachment. They are processed by extrusion, which means soybean oil is extracted from the meal when the bean is crushed. Both oil and meal are used for various human food products, but the meal is also a primary protein source in livestock feed. Raw soybeans are not fed directly to livestock. Since farmers cannot process soybeans themselves, they must sell their soybeans either to elevators or directly to soybean processors. Large processors, such as Con-Agra, Cargill, and Archer Daniels Midland (ADM), have large soybean collection points, which help the farmer to eliminate the elevator middleperson.

Soybean production is currently undergoing a significant change. More soybeans are being planted like the cereal grains with a drill, rather than as a row crop. This means that soybeans are now being grown more like wheat than like corn. Like wheat and corn, soybeans are sold by the bushel.

Sorghum (Milo)

Grain sorghum is a row crop with a production cycle similar to corn's; therefore, only the differences will be emphasized.

Sorghum is a grass plant similar to corn, but the grain grows on a head like wheat, rather than on ears. Sorghum generally grows to a height of about 3 feet, but some types, especially those used for silage, will grow much taller, creating more plant to be chopped for feed.

Planting (Sorghum)

Sorghum is planted about the same time as soybeans (anytime from late April to early July). Its growing period is shorter than corn's, making it more drought resistant.

Sorghum can be grown in areas that do not have enough rainfall for corn production. Although irrigation is not always necessary, the potential production difference (as with corn) between irrigated and non-irrigated land is substantial. It is often grown in rotation either with soybeans or wheat. It is also used as a double crop with wheat, and it is planted right after the wheat has been harvested.

Harvesting (Sorghum)

Sorghum is harvested in the fall by a combine using a row crop head attachment (under proper conditions, a reel attachment may also be used). Sorghum is used primarily as feed for livestock. The milo stubble (stalk residue) remaining in the field can be used as pasture for cattle, but the cattle cannot be turned onto the stubble until at least 3 days after a killing frost. During drought years milo stalks can contain prussic acid, which is fatal to cattle.

Alfalfa

Alfalfa, a flowering plant with a purple bloom, is the principal hay crop grown in the United States. It is a substantial source of protein and fiber for livestock feed. It is the only major field crop that can be harvested several times in one growing season and is a perennial (continues to grow year after year). It is a legume, meaning it adds nitrogen to the soil which can be used by any subsequent crop planted. This makes it an important part of crop rotation plans. Alfalfa responds well to irrigation and is a viable alternative to irrigated corn when the water supply is limited. It is drought-tolerant. Usually, only production is lost, not the plant itself.

Soil Preparation and Planting (Alfalfa)

Soil preparation is similar to wheat, using a field cultivator and a disc. Planting is usually done by a drill, but alfalfa can be planted by broadcasting, with a cover/companion crop of spring oats. The oats help shade and protect the young alfalfa plants. The oats are removed early, by either cutting, baling or by combining for the oat grain, to allow better alfalfa growth. If the oats are combined, the oat straw is then baled so it will not be collected with the first alfalfa crop. Once planted, alfalfa has a lifespan of 5-8 years.

Grazing (Alfalfa)

Livestock will bloat and possibly die from overgrazing on growing alfalfa. Grazing livestock on growing alfalfa requires constant supervision and is seldom done in livestock feeding operations.

Harvesting and Storage (Alfalfa)

Alfalfa is usually cut at the one-tenth bloom stage, with new growth starting at the crown of the plant. Alfalfa can generally grow to maturity every 28 to 30 days, depending on growing conditions and the amount of water available. This allows the harvesting of three to five crops per year. Alfalfa harvesting is done by baling, stacking or chopping. The alfalfa is cut directly in chopping, but baling and stacking requires three separate preliminary steps:

1. Cutting
2. Conditioning
3. Windrowing

Alfalfa can be cut using a sickle mower. This requires subsequent trips by a conditioner and then a rake. A conditioner crimps (crushes) the stems which speeds the drying process. A rake gathers the alfalfa into a windrow (a large, continuous row of intertwined hay). A rake can also be used to turn a windrow over to accelerate drying. Alfalfa must be cured and dried before it is baled. A swather/windrower can cut condition and windrow in just one pass.

Most alfalfa is harvested by baling. Baling can be done in small or large bales, and the bales can be either square or round. Small square (actually rectangular) bales are tied by two strands of either wire or twine. The small bales are better suited for inside storage, but more labor is required, even with bale handling equipment. Large bales both round and square, are being used much more extensively now. These are handled exclusively by mechanical equipment.

Large round bales are produced by the baler picking up the windrows, rolling them into large horizontal cylinders and then tying them with twine. Round bales more effectively shed rainfall, so they are better suited for outside storage. They are handled by large picks (spears) mounted on trucks, tractors, or loaders. Large bales are easier to load on trucks for shipping and can be fed to livestock with minimal labor.

It is not uncommon to have a part or all of the alfalfa harvesting done by a custom operator. The fee is either a specific amount per bale or a share of the hay crop.

If the alfalfa is to be stacked, the windrows are collected into small stacks, or swept and then stacked into large stacks. The stacks are left in the field and moved to the feeding area as needed.

Many farmers enter into a contract with a local dehydration plant to harvest their alfalfa. The alfalfa is chopped and hauled to the dehydration plant, where it is dried and processed. The dehydrated alfalfa is mixed with other ingredients for livestock feed. This method eliminates the need for haying equipment, since the dehydration plant usually performs all of the harvesting operations.

Marketing (Alfalfa)

Alfalfa hay is marketed or disposed of by any or all of the following methods:

1. Selling the baled alfalfa to livestock producers
2. Contracting with a local dehydration plant
3. Feeding the alfalfa to the farmer's own livestock.

Alfalfa hay is typically sold by the ton to both livestock producers and commercial or cooperative dehydration plants.

Basic Examination Techniques

Basic Farm Records

Like other business people, farmers are required to keep records which will enable them to file an accurate income tax return. The typical farmer's records usually include cancelled checks, paid bills, and a farm income and expense book. Farmers may have a formalized accounting system that may be computerized, making the records easy to follow and verify, but like many other taxpayers, some farmers do not keep good books and records.

Remember, although you need to try and work with whatever the farmer can provide, you are not required to accept a conglomeration of the farmer's records and put a set of books together. Always make it a point to shift as much of the burden to the farmer as possible for collecting and separating records. If the situation warrants, the rules for issuing an inadequate records notice are as applicable to a farmer as to any other taxpayer.

Books and Records Needed

When you are conducting the pre-examination analysis, list the books and records you'll need at the beginning of the examination. As required, mail the focused Information Document Request (IDR) along with the appointment confirmation letter.

Document Request

All items you will need for your examination should be listed on your IDR. The types of records are discussed above.

Interview

You will want to interview the farmer and tour the farm site. How to prepare for these interviews are discussed below.

Initial Interview

Prior to the initial interview review the return(s) closely for context and patterns in the business operation. The initial interview is considered the most important part of a quality examination. During the initial interview, allow the farmer time to discuss himself or herself, family, farming operation, style of living, successes, failures, hobbies, financial history and sources of income, including those of other family members.

An effective way to secure a lot of information is through casual conversation. This will put the farmer at ease so he or she will feel comfortable with you. Any pertinent questions or comments designed to lead the farmer into a conversation about his or her personal situation will suffice. If casual conversation is not effective, you may want to follow your interview outline in order to secure the information needed. If you use the outline, use it only as an aid. Do not substitute the outline for original and spontaneous questions. If you adhere strictly to the interview outline, you will seriously handicap your flexibility in asking appropriate follow-up questions. Take notes during the interview. If the farmer says something that is contrary to what is reported on the return, your notes should be very specific.

After the interview, it is helpful to prepare a written summary of what transpired and the main points discussed. These notes should be made a part of your workpapers, and may prove beneficial in making decisions about the examination at a later date.

Remember to target the initial interview questions to the type of farm operation that is reported on the return. If, during the interview, the examiner determines that the type of farm operation reported on the filed return is incorrect, redirect the interview to the type of business that was being carried on during the year under examination.

Visual Inspection

For field examinations, the initial interview will normally be conducted at the farm site. If the initial appointment is with the farmer's representative, be sure to schedule a tour of the farm early in the examination. When you arrive at the farm, be observant of everything around you. What types of buildings, machinery, and vehicles are there? Is there livestock? If so, what kind? Do other people live on the farm, maybe parents or an older son or daughter? If so, the farmer might be farming with someone else.

All the things you see when first observing the farm may generate other questions that should be asked during the initial interview. As you take a tour of the farm after the initial interview, it

might be a good time to ask any other questions that come to mind. For example, if you see forage equipment but the farmer does not have forage crops, question the farmer regarding custom work done for others.

Online Resources and Information

Set forth below are various websites that may be helpful in conducting farm examinations:

MOST states have a land grant university. The extension services maintained by these universities can be a source of regional rental rates, custom hires rates, historic prices etc. The USDA maintains a website with state and national partners which include information relating to extension services. At the [USDA State and National Partners site](#) you will find a United States map – click on the state you wish to research.

[Agriscap](#) maintains a website with links to seventy-nine United States and foreign college agricultural sites.

The [National Ag Law Center website](#) contains subject-based reading rooms which consist of electronic resources for agricultural law topics.

The [Center for Agricultural Law and Taxation website](#) is maintained by Iowa State University. This site is a source for agricultural law and taxation.

The University of Illinois maintains a website which is an archived repository of [Farm Income Tax Schools texts](#). It is easily researchable and contains information beyond agriculture issues.

The [USDA National Agriculture Statistics Service website](#) provides useful US Agriculture statistics.

Employment Taxes

Internal Revenue Manual (IRM) 4.10.5

Required Filing Checks —Employment Taxes

Farmers that file Schedule F returns or corporate income tax returns may also be required to file returns for compensation paid to individuals for services. The additional returns include:

- Form 943, Employers Annual Tax Return for Agricultural Employees;
- Form 940, Employers Annual Federal Unemployment Tax Return;
- Form 1099, Information Return; and
- Form 945, Annual Return of Withheld Federal Income Tax.

The type of return required depends on whether there is an employer-employee relationship, or the farmer hires an independent contractor. For an in-depth discussion on determining

employment status, refer to the training material “Independent Contractor or Employee?” Training 3320-102 (Rev. 10/96) TPDS 84238I.

Form 943, Employers Annual Tax Return for Agricultural Employees

Farm employers report wages paid to employees and the employment taxes attributable to those wages, on Form 943. Unlike the Form 941, Quarterly Employment Tax Return, required from non-farm employers, Form 943 is filed annually and is due on or before January 31st of the year following the year covered by the return.

Social security taxes, Medicare taxes, and income tax withholding apply to all cash wages paid to employees for farm work. A farmer is liable for these employment taxes if there are one or more agricultural employees, including a spouse, parents, or children age 18 or over, and if one of two of the following conditions is met:

1. The farmer has paid the employee \$150 or more in cash wages during the calendar year, or,
2. The farmer has paid at least \$2,500 in total wages for all farm labor during the year.

There is an exception to the above conditions. Wages paid to a seasonal farm worker, who receives less than \$150 in annual cash wages, are not subject to employment taxes, even if the farmer-employer pays \$2,500 or more in that year to all farm workers, if the farm worker:

- Is employed as a hand-harvest laborer (for example, fruit and vegetable pickers)
- Is paid by the piece in an operation that is usually paid on a piece-rate basis in the region of employment
- Commutes daily from his or her home to the farm
- Was employed in agriculture less than 13 weeks in the preceding calendar year.

However, wages paid to these workers are used in considering the \$2,500 or more test, for determining the employment tax coverage of other farm workers.

A farmer may employ a crew leader who provides workers and pays their wages for the agricultural services performed. If there is no written agreement specifying that the crew leader is the farmer's employee, and the crew leader pays the farm workers on his or her own behalf or on behalf of the farmer, then the crew leader, rather than the farmer, is the employer and is responsible for withholding and paying the employment taxes on the workers' wages.

Law Changes and Potential Examination Issues

Several changes were made to the social security payment requirements with respect to farm employment as of January 1, 1988. The income tax withholding requirements were also changed with regard to cash wage payments made after December 31, 1989. Changes and potential issues could arise if the farmer is following the employment tax rules in effect before these dates.

- Income tax withholding became mandatory for cash wages paid to farm employees after December 31, 1989. Before that, income tax withholding was voluntary, and by agreement between the employee and farmer.
- Wages paid to a farmer's children, aged 18 and above, for agricultural services are subject to social security taxes beginning with payments made after December 31, 1987. Prior to this a farmer's children had to be age 21 or above before social security tax applied to their wages.
- Any wage payments to a spouse are subject to social security taxes beginning with payments received after December 31, 1987. Before this, wages to a spouse were exempt from social security tax.
- Before January 1, 1988, a farmer was subject to social security taxes for cash wages paid to an employee who performed farm-related services on 20 or more days during the year. This requirement was replaced by the \$2,500 total wage test for determining if there is a social security tax liability.

Treatment of Non-Cash Wages

The 1950 amendments to the Social Security Act brought agricultural labor under social security coverage. The amendment included an exemption for non-cash wages. In defining wages for purposes of employment taxes, IRC section 3121(a)(8)(A) provides an exclusion for payments paid in any medium, other than cash, for agricultural labor. Cash payments include checks and other monetary media of exchange, but do not include payments in the form of food, farm products, or other goods and commodities.

The regulations provide no guidance or examples of when payments in commodities for agricultural labor might be considered the same as cash and, therefore, not qualified for the exclusion from employment taxes. Consequently, an increasing number of farmers, particularly farm corporations, pay their officers and shareholders in grain or livestock. The result is the avoidance of social security and unemployment taxes even though the products are often sold for cash a short time after the commodities are transferred to the employee.

Whether putative non-cash payments are in substance, equivalent to cash payments has become a contentious issue. The “substance over form” analysis is inherently factual, and each case should be evaluated on its own facts. In a market segment understanding (Full text at Appendix B, General Livestock chapter), the Service has identified six factors for use in determining whether a bona fide transfer of a noncash medium has occurred. These factors are as follows:

- Existence and extent of documentation;
- Marketing and negotiation of a subsequent sale of the commodity by the employee;
- Shifting the risk of gain or loss to the employee;
- The length of time between the employee's receipt and sale of the commodity;
- Bearing the costs incident to the ownership; and
- Ready identifiably of the transferred commodity.

In addition, compensation arrangements under which virtually all of employee compensation is paid in commodities should be scrutinized carefully. Because some cash is necessary to meet the expenses of everyday life, this type of payment is often equivalent to cash.

Examples of farm employment agreements examiners may encounter in which wages are being paid in commodities, include:

- The farmer computes the number of hours the employee worked at an hourly wage, converts the amount owed into a specific amount of commodities, and pays that amount in commodities;
- The farmer pays the employee a fixed amount of grain or fixed number of livestock for the services performed;
- The farmer pays the employee based on a percentage of the crop or livestock produced. This is known as share cropping; and
- The farmer pays the employee in both cash and commodities.

Examiners must consider a number of facts in determining whether the IRC section 3121(a)(8)(A) exclusion from wages for in-kind commodity payments applies, when examining farmers who are paying employees this way. This is especially true of those who operate in corporate form and pay a substantial portion of officer salaries in the form of commodities. Facts which should be developed include the following.

- Obtain a copy of the written employment contract (if any). If the agreement was oral, obtain a complete explanation of the terms. Any deviations in payment or computation of wage amounts, from those specified in the employment agreement, should be fully documented
- Determine whether the payment in commodities was a fixed amount, a percentage of total production, or based on a formula where the number of hours worked and an hourly wage were considered. Was the amount determined before or after the harvest or the sale of the farmer-employer's crop? Was the employee allowed cash advances or distributions against future sale proceeds?
- Determine how and when the employee was to take possession of the commodity compensation. Was the commodity separated from or commingled with the farmer-employer's commodities until sale? What costs did the employee incur after receiving the commodities as wages?
- Determine when the employee converted the commodity to cash. How long was the commodity held before conversion? Did the employee deliver the commodities to the market? Were the commodities delivered with and sold at the same time as the employer-farmer's commodities? Were they sold separately? Did the purchaser treat the employee's commodity as a separate transaction? Did the employee receive payment from the purchaser or did the farmer-employer provide the payment?
- Were in-kind wage payments available to all employees, or only to officers or shareholders? What is the farmer-employer's history of paying wages in cash versus in commodities? Are commodity payments available only to family members, (owner-employees in the case of corporations) for the purpose of avoiding employment taxes?

Examples of Non-cash Wage Agreements

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.

There have been no court decisions regarding the issue of noncash compensation. A number of National Office Technical Advice Memorandums and one Revenue Ruling have been issued, providing examples of farmers using noncash wage agreements with employees, and the IRS's position regarding those facts and circumstances. Refer to the following ruling if you encounter this issue:

Rev. Rul. 79-207, CB 1979-2, 351

The facts and circumstances of each case must be considered. Where the facts indicate the economic substance of the transaction was to pay the employee in cash, and the payment of commodities as wages was for the purpose of avoiding social security taxes, an employment tax issue should be raised.

Self-Employment Tax Attributable To Compensation in Commodities

In those cases where the officer/shareholder and/or other employee(s) are receiving a percentage share of the commodities produced on the farm, an alternative position could be raised on the employee's return by the imposition of self-employment tax. This would negate the overall tax benefit intended by the farmer under examination. This issue is based on the stated language in the employment and self-employment tax statutes. There are no regulations, rulings, or court cases to support or preclude this issue.

IRC section 3121(b)(16) excludes from the definition of employment: “service performed by an individual under an arrangement with the owner or tenant of land pursuant to which —

- A. such individual undertakes to produce agricultural or horticultural commodities (including livestock ***) on such land,
- B. the *** commodities produced by such individual, or the proceeds there from, are to be divided between such individual and such owner or tenant, and
- C. the amount of such individual's share depends on the amount of *** commodities produced;”

An individual who has a share cropping arrangement is thus statutorily excluded from being an employee irrespective of it if that person is an employee or an independent contractor. If there is no employment, then there are no “wages” under IRC section 3121(a).

IRC section 1402(a) provides that income from any trade or business is net earnings from self-employment and thus subject to self-employment tax. Being an employee is considered a trade or business so that IRC section 1402(c)(2) excludes services by an individual as an employee from

self-employment income. However, subparagraph (B) then excludes “services described in section 3121(b)(16)” from the definition of employee services that are being excluded.

The income from the share cropping arrangement is thus statutorily included as self-employment income. Arguments about whether the person is an employee or contractor should be moot.

Filing Return and Depositing Tax

Effective January 1, 1993, new rules were established for determining when a farmer-employer must deposit social security and income withholding taxes, although the old deposit rules could continue to be used for the 1993 calendar year. For calendar years after 1993, the new deposit rules must be used. If employment taxes of \$100,000 or more should accumulate at any time during the year, then the 1 day deposit rule applies. If total taxes paid during a look back period were \$50,000 or less, monthly deposits must be made. If total taxes paid in the look back period were more than \$50,000, semiweekly deposits are required. Circular A, Agricultural Employer's Tax Guide provides a complete explanation of the deposit requirements.

Form 940, Employers Annual Federal Unemployment Tax Return

Farmer-employers who pay cash wages must pay Federal unemployment tax (FUTA), if either of the following tests is met:

1. The farmer pays cash wages of \$20,000 or more to farm employees in any calendar quarter during the current or preceding year, or,
2. The farmer employs 10 or more employees for some part of at least 1 day during each of 20 different calendar weeks in the current or preceding year.

As with social security tax, unemployment tax applies only to cash wages paid to farm employees. IRC section 3306(b)(11) provides that “wages” do not include remuneration paid for agricultural labor in any medium other than cash for purposes of FUTA. See the previous discussion for when payments other than cash are considered the same as cash.

Farm workers provided by a crew leader are considered employees of the farmer for purposes of FUTA unless:

1. The crew leader is registered under the Migrant and Seasonal Agricultural Worker Protection Act, or
2. Substantially all the workers supplied by the crew leader operate or maintain tractors, harvesting or crop dusting machines, or other machines supplied by the crew leader.

If the farmer-employer is subject to FUTA, Form 940 must be filed by January 31 of the year following the calendar year for which the tax is due. When the amount of tax due is more than \$500 for the quarter, the tax must be deposited by the end of the month following the close of the quarter. If the amount of tax due is less than \$500, no deposit is required, but the tax must be added to the amount subject to deposit for the next quarter. If the total tax due for the year is less than \$500, it may be paid when the Form 940 is filed.

Form 1099, Information Returns

When a farmer makes reportable payments of \$600 or more during a calendar year for business purposes to an individual, Form 1099 must be filed to report these payments. Information returns are not required if the payments are made to a corporation. Reportable payments include interest, rent, royalties, commissions, and nonemployee compensation. If a contractor (who is not a dealer in supplies) performs services for which he or she also provides the supplies needed, the farmer must report the entire payment for supplies and services on the Form 1099 issued to the contractor. Payments for trucking grain and livestock are excluded from the Form 1099 filing requirements (Treas. Reg. section 1.6041-3).

Payments reportable on Forms 1099 are generally not subject to FICA and income tax withholding. If the individual receiving payment does not provide the farmer with a valid social security number, the farmer is required to withhold 28 percent of the payments for income tax. This is called backup withholding. The farmer reports and pays backup withholding tax on Form 945, Annual Return of Withheld Federal Income Tax. Backup withholding deposits must be deposited separately from other payroll taxes. The deposit rules are basically the same as those previously discussed for payroll taxes. Taxpayers must use Electronic Funds Transfer (EFT) to make all federal tax deposits. Generally, an EFT is made using the Electronic Federal Tax Payment System (EFTPS). A taxpayer who does not want to use EFTPS, can arrange for a tax professional, financial institution, payroll service, or other trusted third party to make electronic deposits on the taxpayer's behalf. Also, a taxpayer may arrange for a financial institution to initiate a same-day wire payment on the taxpayer's behalf. EFTPS is a free service provided by the Department of Treasury. If the farmer cannot document having the payee's social security number at the time the payments were made, backup withholding would apply if total payments were \$600 or more.

The farmer must give a copy of the Form 1099 to each person to whom payment was made by January 31 of the year following the calendar year in which the payment is made, and file it with the IRS on or before February 28 following the end of the calendar year in which the payments are made. Examples of individuals to whom farmers should issue Forms 1099 include: veterinarians, attorneys, accountants, mechanics, custom harvesters and chemical applicators who provide their own equipment, and land owners.

In examining a farmer's Form 1099 filing requirements, procedures that should be considered include:

- Obtain PMFOL (Payor Master File) transcripts to determine if the farmer has filed Forms 1099.
- Inspect Forms 1099 to determine if the farmer obtained social security numbers.
- Inspect Forms W-9, or any documentation maintained by the farmer, to show that the farmer obtained social security numbers before making payments.

- Review expense accounts such as labor, machine hire, legal fees, rent, and interest for payments to individuals who were not issued Forms 1099. If social security numbers were not obtained, backup withholding would apply.
- Inspect CP 2100 notices issued to the farmer by the service center, giving notification of incorrect social security numbers for Forms 1099 filed. If the farmer made no attempt to obtain correct numbers, backup withholding may apply.

Compensation to Spouse or Family Members

Reasonable wages or other compensation paid to the farmer's spouse or children for doing farm work is deductible, but the farmer must be able to show that a true employer-employee relationship exists (Rev. Rul. 72-23). Ordinarily, an employment relationship is present if:

- Substantial duties are performed;
- The amount of pay is reasonable in relation to the work performed; and
- Payment is actually made.

Wages paid to a farmer's children are deductible even if the children use the money to buy clothes or other necessities which the parent would otherwise be obligated to provide (Rev. Rul. 73-393). This ruling should be considered any time a farmer is deducting as wages an amount paid other than by cash. If it can be determined that the item(s) given to the child in lieu of cash are what a parent would normally be expected to furnish, then the wages would not be deductible as labor expense. This rule is applied because providing such items in kind cannot be distinguished from the discharge of the parent's duty of support. More and more farmers are paying wages to their spouses to obtain various tax benefits such as 100 percent deductibility of health insurance, allowance of an IRA deduction for the spouse, and a reduction in the farmer's self-employment tax. Be sure there is a legitimate employer-employee relationship if the farmer deducts wages paid to a spouse.

Examination Techniques

During the initial interview establish the number of children the farmer has, their ages, whether they are at home or away, the number of vehicles and who drives them. Determine if the farmer has hired help other than his/her children and how their compensation is determined.

Non-cash wages

Non-cash wages include food, lodging, clothing, transportation passes, other goods and services. Non-cash wages paid to farm workers, including commodity wages, are not subject to social security or Medicare taxes. The value of non-cash wages is reported on Schedule F in income and as a wage deduction by the farmer (nets to zero as the non-cash wage has no basis). The value of non-cash wages is then reported on line 1 of the W-2 for the worker. When the worker sells the commodity, the sale is reported on Schedule D with the cost being the amount of wages reported on the W-2.

Farm Inventory

Basic Requirements

If a farmer is required to keep an inventory, a complete record of inventory should be kept as part of the farm records. This record should show the actual count or measurement of the inventory. It should also show all factors that enter into its valuation, including quality and weight, if applicable.

Accounting for Inventory

Generally, if a business produces, purchases, or sells merchandise, it is required to keep an inventory and use the accrual method of accounting for purchases and sales of merchandise. However, if a qualifying taxpayer or a qualifying small business taxpayer has an eligible business, the cash method of accounting can be used, even if merchandise is produced, purchased, or sold. If qualified, the taxpayer can choose not to keep an inventory, even if they do not change to the cash method of accounting.

A qualifying taxpayer is a taxpayer that for each prior tax year ending after December 16, 1998, has average annual gross receipts of \$1 million or less for the 3-tax-year period ending with that prior tax year. A tax shelter cannot be a qualifying taxpayer. See Publication 538 for more information.

A qualifying small business taxpayer¹ is a taxpayer that: (a) for each prior tax year ending after December 31, 2000, has average annual gross receipts of \$10 million or less for the 3-tax-year period ending with that prior tax year; and (b) whose principal business activity is not an ineligible activity. Certain other requirements must be met. See Publication 538 for more information.

¹Please be aware that the qualifying small business taxpayer exception does not apply to a farming business. However, if a qualifying small business taxpayer is engaged in a farming business, this exception may apply to their nonfarming businesses, if any.

Hatchery business - A hatchery business that uses the accrual method of accounting must include in inventory eggs in the process of incubation.

Products held for sale - All harvested and purchased farm products held for sale or for feed or seed, such as grain, hay, silage, concentrates, cotton, tobacco, etc., must be included in inventory.

Supplies - Supplies acquired for sale or that become a physical part of items held for sale must be included in inventory. Deduct the cost of supplies in the year used or consumed in operations. Do not include incidental supplies in inventory as these are deductible in the year of purchase. Supplies can be prepaid and consumed in the next year (Rev. Rul. 79-229).

Livestock - Livestock held primarily for sale must be included in inventory. Livestock held for draft, breeding, or dairy purposes can either be depreciated or included in inventory (See also Unit-livestock-price method). A taxpayer in the business of breeding and raising chinchillas,

mink, foxes, or other fur-bearing animals, must treat these animals as livestock for inventory purposes.

Growing crops - Generally, growing crops are not required to be included in inventory. However, if the crop has a preproductive period of more than 2 years, a taxpayer may have to capitalize (or include in inventory) costs associated with the crop. See Uniform Capitalization Rules under IRC section 263A.

Items to include in inventory - Inventory should include all items held for sale, or for use as feed, seed, etc., whether raised or purchased, that are unsold at the end of the year.

Required to use accrual method - The following applies if the accrual method of accounting is required to be used.

- The uniform capitalization rules apply to all costs of raising a plant, even if the preproductive period of raising a plant is 2 years or less.
- The costs of animals are subject to the uniform capitalization rules.

Inventory Valuation Methods²

- Cost
- Lower of cost or market
- Farm-price method
- Unit-livestock-price method

² *If livestock inventory is valued at cost or the lower of cost or market, IRS approval to change to the unit-livestock-price method is not needed. However, if livestock inventory is valued using the farm-price method, then permission from the IRS must be obtained to change to the unit-livestock-price method.*

Cost method. The actual cost of each item or animal is used.

Lower of cost or market method. Compare the market value of each item on hand on the inventory date with its cost and use the lower of the two as its inventory value. Each item in inventory must be valued separately. Under ordinary circumstances for normal goods, market value means the usual bid price on the date of inventory. This price is based on the volume of merchandise normally purchased.

Farm-price method. Under this method, each item, whether raised or purchased, is valued at its market price less the direct cost of disposition. [Treas. Reg. § 1.471-6(d)] Market price is the current price at the nearest market in the quantities the farmer would normally sell. Where no open market exists, or where quotations are nominal due to inactive market conditions, the farmer must use such evidence as may be available for a fair market price at the date or dates nearest the inventory valuation (for example, grain and livestock price quotes in the newspaper). Cost of disposition includes broker's commissions, freight, hauling to market, and other marketing costs. When this method is used, it must be applied to the entire inventory, with the

exception of livestock, which at the taxpayer's election may be valued using the unit-livestock-price method.

Unit-livestock-price method. This method recognizes the difficulty of establishing the exact costs of producing and raising each animal. Livestock is grouped or classified according to kind and age, and a standard unit price is used for each animal within a class or group. The standard unit prices assigned must reasonably account for the normal costs incurred within such classes or groups. The classifications selected and the unit prices assigned is subject to approval by the IRS upon examination of the farmer's return. Once a return is examined and prices and classifications are approved, consistent application must be followed in all later years.

Annual reevaluation of unit livestock prices must be conducted and the prices adjusted upward or downward to reflect increases or decreases in the costs of raising livestock. IRS approval is not required for these adjustments. Any other changes in unit prices or classifications do require IRS approval.

A farmer who elects to use the unit-livestock-price method must apply it to all livestock raised, whether for sale, or for draft, breeding, or dairy purposes. Such method accounts only for an increase in the cost of raising an animal to maturity. It does not provide for any decrease in the market value of an animal after it reaches maturity. Hay grown by a farmer solely for feeding animals is not required to be inventoried.

All livestock purchased primarily for sale must also be included in inventory. Animals purchased for draft, breeding, dairy, or sporting purposes may be included in inventory, or subject to depreciation after maturity. If the livestock purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with established unit prices. However, in the year of purchase, do not increase the cost of any animal purchased during the last 6 months of the year. Animals purchased after maturity must be inventoried or capitalized at their purchase price.

A livestock producer who adopts a consistent unit-livestock method of valuing livestock inventories and files returns on that basis, will be considered as having elected the unit-livestock-price method. A farmer, who uses the cost, or lower-of-cost-or-market-method of inventory valuation for livestock, may adopt the unit-livestock-price method without formal application for permission. However, a change from the farm-price method to the unit-livestock-price method requires Commissioner approval. In addition, a change from the unit-livestock-price method to any other inventory valuation method requires formal approval.

Uniform capitalization rules. A farmer can determine costs required to be allocated under the uniform capitalization rules by using the farm-price or unit-livestock-price inventory method. This applies to any plant or animal, even if the farmer does not hold or treat the plant or animal as inventory property.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Income

Background

Income to the farmer consists primarily of sales of grain, livestock, produce, or other products of the farm. Other sources of farm income can include:

- Miscellaneous income from farm labor or custom work
- Government benefit checks
- Rents
- Royalties
- Other similar activities.

A farmer's sales generally fall into five classifications:

1. Stock in trade (livestock, grain, and other products of farming). Income from these sales ordinarily will be entered on page 1 of Schedule F.
2. IRC section 1231 assets (buildings, machinery & equipment, and livestock held for draft, dairy, breeding, etc.). Income from the sale of IRC section 1231 assets, and any corresponding IRC section 1245 gain, is initially entered on Form 4797. It is then carried to Schedule D or directly to page 1, Form 1040. Please refer to the "Sales of Livestock" chapter for a more detailed explanation.
3. Other property used in farming which does not meet the requirements for IRC section 1231 treatment (draft, breeding, dairy, or sporting animals held for less than the required period and other assets used in the business but held 1 year or less). Income from these sales will usually be reported in Part II of Form 4797.
4. Capital Assets (farmhouse, stocks and bonds, personal automobile, etc.). Gains from the sale of capital assets are usually reported directly on Schedule D, and are discussed in the "Basis and Sales of the Farm and Farm Assets" chapter.
5. Farm land, which is classified as an IRC section 1252 asset. The gain from a disposition of farm land is regulated by IRC section 1252. The tax treatment of sales under IRC section 1252 is similar to that under IRC section 1245.

The gross profit percentage for farming can be misleading since there is generally no income pattern among individual farmers. This is due to the variation in the size of farms, methods of marketing, etc. For example, if a farmer sells the current year's crop and part of last year's crop in the current year, this gives a distorted picture of current year receipts.

Many farmers now have an additional source of income from one or more family members working away from the farm. This area needs to be inspected for potential unreported income from contract labor or self-employment.

Be sure all income generated by the farm has been reported. Income includes not only cash received, but also the value of any merchandise or services received in exchange for farm products. Bartering income is taxable (Rev. Rul. 80-52).

Growing crops (inventory) are those that remain unharvested at the end of the taxable year. These include all cultivated plants grown for sale, feed, seed, and the farmer's own consumption.

The ultimate disposition of the growing crop, before or after harvest, typically results in ordinary income to the accrual basis farmer when the farmer is entitled to the income.

Sale of Crops and Produced Items

The farmer starts with the capital, land, buildings, and equipment, and adds to that the labor and raw materials necessary to produce the completed product. Raw materials could include fertilizer, seed, chemicals, feed, breeding animals, or any number of other items. Then, over some period of time, the product is “manufactured,” that is, raised until it becomes a completed product.

A Revenue Agent must determine that all products produced and sold have been included in income. The sale of all raised livestock, produce, grains, and other products are combined and reported on the same line of Schedule F.

When the farmer sells the crops raised on the farm, payment can be in the form of money, property or services (use fair market value (FMV) to determine income). Irrespective of the manner of payment, it is treated as ordinary income. The profit from the sale of any crops bought for resale is also ordinary income. The amounts received must be reported in income in the year received. The profit or loss from the sale of crops bought for resale is the difference between the basis in the crop purchased and any payment received.

The net proceeds from the sale of a crop by someone acting as the farmer's agent must be included in gross income for the year the agent receives payment, even though there is an arrangement with the agent that the farmer will not be paid until a later year

Example 1

Alice Chambers contracts with an agent, Dale Jenkins, to sell her corn to the local elevator on December 27, 2004. She asks Dale to remit the sales proceeds to her in January 2005, instead of in December 2004. Even though she received the funds in 2005, she must include the sale of the corn in her income in 2004.

Commission sale barns have been held to be agents for the seller.

A recent court case, *Scherbart v. Commissioner*, 453 F.3d 987, affirming T.C. Memo 2004-143, concluded that Mr. Scherbart could not defer “value added” payments from a co-op that were computed in November even though Mr. Scherbart was offered an option to defer the payment to January. The court concluded that there were no installment agreements, the co-op was an agent for Mr. Scherbart and Mr. Scherbart voluntarily deferred the payments.

See also Rev. Rul. 70-294, 1970-1 C.B. 13 and Rev. Rul. 79-379, 1979-2 C.B. 204.

When a crop is held and used for feed, it can be treated in one of two ways:

1. The income can be reported and an equal, offsetting feed expense shown

2. No crop income reported and no feed expense deducted.

In areas where the growing season is long, crops can be double cropped. Normally the two crops will include wheat and either soybeans or milo. Once the wheat (planted the previous fall) is harvested in June or July, the ground is immediately replanted into soybeans or milo.

The following is a compilation of the most common types of crops and the possible income sources from those crops.

Grain Crops

Wheat, Sorghum or Milo, Corn, Soybeans, and Oats are the grain crops discussed below.

Wheat

In the late fall and early winter, the wheat field may be rented out as pasture for cattle. This does not harm the harvest value. It can also be cut for hay in May, when it has just started to head out. When the wheat is cut for hay, it cannot be harvested. When the wheat is harvested, it can be sold immediately or stored and sold at some future date. The straw resulting from the harvest can be baled and sold.

Sorghum (Milo)

Milo can be sold when harvested or stored for a time before being sold. After harvest, the milo stalks (stubble) can be rented out as pasture for cattle in the fall after a hard frost. Milo can also be stored and used as feed for the farmer's livestock. Milo is a short season crop. It can be planted in the spring and harvested in the late summer or it can be double cropped, planted after the wheat is cut in June or July and harvested in the late fall.

Corn

Corn can be cut green and used as silage. If the corn is harvested, in the fall, it can be sold immediately or stored for future sale. It can also be stored and used as feed for livestock. After harvest, the corn stalks can be baled and sold as bedding or as fodder to cellulosic ethanol plants, or the corn stalk ground can be rented out as winter pasture for livestock.

Soybeans

Soybeans are normally harvested in the fall. They can be sold immediately or stored for later sale. Soybeans must be processed into meal before being fed to livestock. Soybean oil is extracted by processing. Some uses of the oil are in food preparation or in biodiesel production.

Oats

Oats are planted in the spring and harvested in late summer. They can be cut for hay when they have just started to head out. If oats are used for hay, they can't be harvested. When oats are

harvested, they can be sold immediately or stored, then sold. Oats are often used in livestock feeds. Oat stubble, the plant stalk remaining in the field following harvest, can be baled and sold for livestock bedding.

Hay Crops

Hay crops are another source of income to the farmer. Generally once a field is planted to hay; it can be used for hay for many years without replanting. Alfalfa has a life of 4 to 5 years. Brome and prairie hay can be grown in the same field indefinitely.

Brome

Brome is usually cut once a year, from late spring to early summer. The hay is baled and can be fed to all types of livestock. The field can be used to pasture livestock in the fall.

Alfalfa

Alfalfa is a very high protein crop that is used as livestock feed. It can be cut and baled for hay, chopped into silage, or ground and compressed into pellets. Alfalfa is usually cut three to five times a year.

Prairie Hay

This hay consists of native grasses. It is normally cut and baled in the summer and used as feed for all livestock.

Constructive Receipt of Income versus Installment Sale Reporting Of Income

Constructive Receipt

The general rule of Treas. Reg. §1.451-2 is that income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

This means that, income, although not actually in the farmer's possession, is constructively received in the taxable year during which:

- It is credited to the farmer's account;
- Set apart for the farmer;
- Made available so the farmer can draw upon it at any time; or
- The farmer can draw upon it if notice of intent to withdraw was given.

For example, the receipt of a check is constructive receipt of funds, even though not deposited or cashed during the tax year received.

Income is not constructively received if the farmer's control of its receipt is subject to substantial limitations or restrictions. Where the farmer (seller) has the right to the proceeds of a sale of grain upon delivery, the courts have held that any delay in payment due only to the seller's own volition puts the farmer seller in constructive receipt of income.

An accrual basis taxpayer reports the item as income, because such items are due (payable) to the taxpayer.

Farmers often enter into contracts in which income derived is not received until a later taxable year. A number of rulings and court decisions have considered the correct year of income inclusion for cash basis farmers when farm commodities are sold under deferred payment contracts. A taxpayer's facts and circumstances should be evaluated during an examination to determine whether income should be reported in the year of sale or the subsequent year even when a contract exists. The determination usually hinges on a bona fide contract entered into at arms-length, and the provision that the farmer cannot withdraw the proceeds under any circumstance until the following year. The courts have also looked at a taxpayer's past practices and whether or not income was materially distorted when selling commodities.

If any items are sold under a deferred payment contract that calls for payment(s) in the following year(s), there is no constructive receipt in the year of sale, Rev. Rul. 58-162.

Although, the taxpayer entered into a deferred payment contract with a livestock market, the sale of cattle at an auction through the livestock market was determined recognizable by the cattle breeder in the year of the sale even though a portion of the proceeds were paid to the breeder in the subsequent year. In this case, the livestock market was acting as the agent of the taxpayer and was not the purchaser. Rev. Rul. 70-294 (distinguishing; Rev. Rul. 58-162).

Installment Sales

An installment sale is a sale of property where a farmer receives at least one payment after the tax year of the sale. For example, a farmer can defer income from the sale of crops or livestock in the year of the sale by deferring receipt of payment until the following year through a deferred payment contract. If the farmer realizes a gain on an installment sale, the farmer may be able to report part of the gain upon receipt of each payment. This method of reporting a gain is called the installment method. This method cannot be used to report a loss. Alternatively, a farmer can make an election to report all of his/her gain in the year of sale.

A farmer must use the installment method unless he makes a proper election to not have the installment method apply. In other words, unless the farmer elects to report the constructive receipt of income in the year of the sale, income from a sale (where any payment is to be received in a taxable year after the year of sale) is to be reported on the installment method.

Under IRC §453(b)(2), a dealer is not allowed to report sales on the installment method. However, IRC §453(l)(2)(A) excludes the disposition of any property used or produced in the trade or business of farming from being treated as a dealer disposition.

Example 2

Janet Jasper delivered 12,000 bushels of her corn to the elevator on October 20, 2004, and signed a
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contract with the elevator that obligated the elevator to pay her \$2.55 per bushel for the corn on January 5, 2005. Under the contract, she was not allowed to sell, assign, transfer, pledge, or convey the contract or any of her rights in the contract.

Janet had no legal right to receive payment before January 5, 2005. Consequently, she is treated as receiving income on that date and, therefore, she reports the sale of the corn on her 2005 income tax return for both regular and AMT tax purposes.

Example 3

Connie Greene delivered 5,000 bushels of her corn to the elevator on October 1, 2014, and negotiated a sale price of \$3 per bushel. Before the elevator cut the check for the corn, Connie talked to Janet Jasper and decided that she should defer her payment until January 2015. Connie told the elevator to wait and send her check after January 1, 2015.

Connie had a legal right to receive her payment in 2014 and deferred receiving the check to 2015. Connie did not enter into a written deferred payment contract that restricted her to the funds. Therefore, the sale is reportable in 2014.

However, if Connie and the elevator entered into a bona fide arms-length deferred payment contract that restricted Connie's access to the funds until 2015, Connie would report the sale of the corn on her 2015 tax return. If she does not elect out of installment reporting, she must report the income in 2015 for regular income tax and Alternative Minimum Tax (AMT) purposes. She may choose to elect out of installment reporting and instead report the income in 2014 for regular tax and AMT purposes.

Examination Techniques

Potential areas of abuse include:

- Checks received from the sale of livestock or crops in December, held and not deposited until January;
- Sales made on December 31, so that there is no way the check will be received until January; and
- Sales in which the agreement to defer payment occurs after the farmer obtains the right to receive payment.

The income tax requirements for income under the installment agreement method versus the constructive receipt method have not yet been resolved. This is shown in the conflict between the constructive receipt doctrine of Rev. Rul. 58-162 and Rev. Rul. 73-210, and the cash equivalency doctrine of *Watson v. Commissioner*, 613 F.2d 594 (5th Cir. 1980) and *Griffin v. Commissioner*, 73 T.C 933 (1980).

The significant issue is whether the constructive receipt or the cash equivalency doctrine was applied, because a farmer could use the installment method of reporting income even if the contract did not meet the deferred payment requirements.

Crop Shares

Crop shares are rental payments made to a farmer-landlord based on a percentage of the yield of the crop and usually payable in kind (Rev. Rul. 56-496).

The regulations state that crop share rents are to be treated as income by either a cash basis or an accrual basis farmer only when the shares are reduced to money or its equivalent. Accrual basis farmers do not inventory crop share rents on hand at the end of the year.

If the landlord receives crop shares and uses them as feed in his or her farming operation, he or she must include the FMV of the crop shares in gross income. At the same time, under IRC section 162 the landlord will be entitled to a trade or business deduction for livestock feed equal to the value of crop shares included in gross income (Rev. Rul. 75-11).

If the farmer makes a gift or contribution of the crop shares, gross income must be recognized in an amount equal to the FMV of the crop shares at the time of the gift or donation, not when the crop shares are converted to cash or an equivalent by the receiver.

Crop share rental income is excluded from self-employment income unless the landlord materially participates in the production of agricultural products, or production management. The concept of material participation was developed to help distinguish why rents are treated as passive income, while income from farming is treated as self-employment income.

Material participation is necessary to build a social security base and may be necessary if current use valuation is to be used for Federal estate tax purposes. Material participation may cause social security payments to be decreased for persons eligible to receive such payments. Therefore, if crop shares are rents, self-employment tax does not apply. Because the crop shares are not classified as earned income, any amount of crop share income can be received without a reduction of current social security benefits.

Material Participation

Crop shares present a problem because some farmers are virtually in partnership with their tenants. In those circumstances, the income should be treated as if it were earned income from farming. In many of these situations, a formal partnership may not be found and certainly would not be desired by the parties involved. Therefore, the concept of material participation was developed. If a landowner materially participates with the tenant in making the decisions and paying some of the farming costs, the landowner is considered to be an active farmer rather than a passive landlord. His or her share of the crops thus would be characterized as farm income rather than rental income. This distinction was adopted by the Congress in 1956 and is now set out in the statute for Social Security purposes.

Examination Techniques

Areas of potential abuse arise when the following occurs.

1. Active income is classified as passive income.
2. Income earned by the farmer is reported by another family member(s) (normally a spouse or children). This is done so that social security payments will not be affected or reduced by earned income.

Use of Contracts to Defer Income Recognition

The farmer may attempt several methods to defer the reporting of income. Examples of allowable methods are holding the crop until the next year, or securing a Commodity Credit Corporation (CCC) loan which may not be income. For discussion on CCC loans, please see the "Commodity Credit Corporation Loans" section of the "Government Farm Programs" chapter.

A farmer may also try to find ways to sell products in the current tax year if the price is favorable, but delay inclusion of the income for tax purposes until the following year. Two types of contracts used to accomplish this are Deferred Product Sales and Price Later Contracts.

Deferred Product Sales

In 1980, Congress enacted the Installment Sales Revision Act of 1980, which amended IRC section 453. The change in the installment sales provisions opened a new method of income deferral for farmers besides deferred payment contracts, Rev. Rul 58-162.

IRC section 453(a) provides that income from an installment sale shall be taken into account under the installment method. IRC section 453(b)(1) defines an installment sale as receipt of at least one payment after the close of the taxable year in which the disposition occurs. The installment sale provisions are generally not available to dealers. However, a dealer disposition does not include the disposition on the installment plan of any property used or produced in the business of farming; therefore, farmers can sell on the installment basis (IRC section 453(b)(2)(A)).

You must determine if the farmer has made any such installment sales. Your concern on Schedule F is that all ordinary income items have been included in income. If the farmer has sold grain, livestock, or other products on the installment basis, there should be a contract stating the selling price and the dates payments are to be made. Ask for copies of such contracts to insure that the income is properly reported in the correct tax year.

Price Later Contracts (PLC)

A Price Later Contract (PLC) is for the sale of a product in which the title passes to the buyer upon delivery of the product. The PLC specifies a period (the pricing period) for fixing the purchase price of the grain, starting with the date of the PLC. On any business day during the pricing period, the farmer sets the price for his or her grain by selecting a price quoted by the buyer for similar grain, on that day.

IRC section 61 provides that gross income means income from whatever source derived, unless specifically excluded elsewhere in Treas. Reg. section 1.61-4(a) provides, in part, that a farmer using the cash receipts and disbursements method of accounting shall include in his or her gross income for the taxable year the amount of cash and the value of merchandise or other property received during the taxable year from the sale of produce which he or she raised. Treas. Reg. section 1.61-4(c) also provides additional rules for certain farm receipts.

IRC section 453 permits a taxpayer who sells real property and a nondealer who sells personal property to report gain on the installment method. IRC section 453(f) provides that receipt of a bond or other evidence of indebtedness which is payable on demand shall be treated as receipt of payment. There was some thought that use of a PLC would prevent the farmer from availing himself of the installment sale provisions of IRC section 453. See Calvin P. Applegate, 94 T.C. 696 (1990), aff'd, 980 F.2d 1125 (7th Cir. 1992) (contracts were not obligations payable on demand).

A farmer executing a price later contract who wishes to effectively defer income should incorporate an income deferral provision into the PLC so that even if the price is set during the tax year the income is deferred.

Distributions from Cooperatives

A cooperative (co-op) is an enterprise owned by and operated for the benefit of those using its services. Farm co-ops can provide a wide selection of services to the farmer. These include selling the farmer's crop and purchasing products for the farmer's use. Commonly, the items purchased are needed for the farm, such as, seed, fertilizer, and equipment, but they may include personal items as well.

Cooperatives have changed in recent years through consolidations and mergers. The needs of farmers have changed and the cooperatives have kept pace with the member needs. Many cooperatives provide a multitude of agronomy services to aid farmers in precision farming and value added products.

One of the latest means by which cooperatives in the grain belt have served member needs is to set up separate companies that build large grain storage and handling facilities, generally on co-op land. Co-op members are allowed to purchase "grain condos". While this arrangement shifts responsibility for grain quality to the co-op, the farmer retains beneficial ownership of the grain for purposes of Agricultural Program Payments. Ownership of the "condo" could generate allowable depreciation expense for the farmer.

Note: Many rural areas also have utility cooperatives, which may also be a source of expenses and dividends for farmers, especially since many rural electric cooperatives are looking to alternative methods for electricity generation.

Patronage Dividends

Co-ops operate at cost. That is, farm co-ops return to farms the net profits from the cooperative business in proportion to the amount of business conducted by each farmer.

Usually, the rebate of the co-op business profits to the farmer is a patronage dividend, deductible by the co-op and included in the income of the farmer. This patronage dividend may be paid in the form of money, property, or scrip. The amount of money, the fair market value of the property, or the face value of the scrip is included in the income of the farmer.

The scrip paid to farmers is usually in the form of a written notice of allocation or a per-unit retain certificate, evidencing an obligation from the cooperative to the farmer. An important consideration is whether this scrip is qualified or nonqualified. A qualified written notice of allocation or a qualified per-unit retain certificate is one that the farmer has consented to include in his or her income upon its receipt.

These same forms of scrip are not included in the farmer's income when issued in nonqualified form. The issuance of nonqualifying scrip is not a patronage dividend taxable to the farmer.

Rather, the amounts paid to redeem nonqualified written notices of allocation or nonqualified per-unit retain certificates will be included in the farmer's income upon redemption.

Patronage dividends are reported to the farmer on Form 1099-PATR. The patronage dividends should be reported on the farmer's return for the year in which they are received. Patronage dividends usually are subject to self-employment tax. However, patronage dividends received in crop share arrangements are reported on line 2 of Form 4835 and are not subject to self-employment tax.

There are two exceptions to the inclusion of the patronage dividends in the farmer's income, other than the rule applicable to scrip issued in nonqualified form.

1. First, amounts received with respect to purchases of supplies, equipment, or services which were not intended for use in a trade or business or an IRC section 212 activity are not included in the farmer's income. In some instances, an allocation must be made for this purpose. For example, where gasoline is purchased from a cooperative for both farm and personal use.
2. Second, amounts properly taken into account as an adjustment to the basis of property are not included in the farmer's income. For example, where equipment is purchased and a dividend is paid for that specific purchase.

Other Receipts

Amounts received by farmers other than patronage dividends are treated under other tax rules. Such amounts might be taxable as compensation for services, dividends on stock, or interest on loans, or such amounts might be nontaxable, as in the case of a return of capital.

All cooperatives provide for a discounted redemption from the estate of a deceased patron. Discount charts are calculated based on the value of borrowed funds and the age of the certificates. If desired, the heirs of a former patron may elect to have an immediate redemption of all certificates owned by the estate at these discounted values. Such redemptions give rise to an ordinary loss to the farmer in the amount of the discount. See Rev. Rul.70-407, 1970-2 C.B. 52. Otherwise, the certificates will be redeemed as authorized by the board.

Examination Techniques

Often the farmer reports patronage dividends on the tax return erroneously in one of two ways.

1. The farmer reports the dividends on the front of Form 1040 as dividend income. By reporting the dividends in this manner, the farmer avoids self-employment tax on this income.
2. The farmer only reports the amount of patronage dividends received in cash. The dividend should include the fair market value of other property received as patronage dividends, such as stock, the face value of qualified scrip issued to the farmer, and amounts received in redemption of previously issued nonqualified scrip.

Easements and Rights-Of-Way

Income received by farmers to grant easements or rights-of-way on their property for flooding land, laying pipelines, or constructing electric and telephone lines, etc., may result in income, a reduction of all or part of the basis of the property, or both.

Example 5

Fred Falls sold a right-of-way for a gas pipeline through his property for \$1,000. Only a specific part of his farmland was affected. He reserved the right to continue farming the surface land after the pipe was laid.

1. If the \$1,000 received for the right-of-way is less than the basis of the property allocated to the portion of land affected by the right-of-way, then the basis is reduced by \$1,000.
2. If the amount received is more than the basis of the affected portion of the land, the excess is gain from the sale of IRC section 1231 property.
3. If, instead of selling a right-of-way, he sold part of his land, he would have a gain or loss from the sale of IRC section 1231 property.
4. If during construction of the line, growing crops were damaged and he later received a settlement of \$250 for this damage, then the \$250 he received in damages is income. This income is reported on Schedule F just as the crop sale would be.

Easements and rights-of-way will normally be split between permanent damages and crop damages. There should be a signed document indicating the amount of permanent damages and the amount of crop damages.

Other Farm Income

The majority of farm income is derived from sales of products and Government payments. Some of the more common sources of other farm income include fuel tax credits and refunds, machine work, and commodity futures transactions (hedging). These items are discussed in later chapters.

Machine Work

Machine work is work performed by the farmer or the hired help on someone else's farm (it should be noted that machine work and custom hire are generally synonymous). The farmer might contract with another farmer to do such work as combining, cutting or baling hay, spreading fertilizer or to allow the use of equipment by another farmer. The farmer may be paid in cash, check, services, or merchandise. This income is taxable, but you will not always find it reported on Schedule F as required.

Hedging Farm Commodities

Hedging Transactions - Defined

Hedging is a common technique used by businesses to manage the risk of interest rate changes, price changes, or currency fluctuations, with respect to borrowings, ordinary property or ordinary obligations. Various financial products, such as futures contracts, forward contracts, options on futures, and notional principal contracts, are used to reduce risk. 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. They also can buy and sell commodity futures as speculators. The principal matter of concern from an income tax perspective in the farm and ranch area is the line between hedging and speculation.

Property is ordinary property only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss regardless of the taxpayer's holding period. For example, property used in a trade or business within the meaning of IRC section 1231(b) is not ordinary property because the gain resulting from the sale or exchange of the IRC section 1231 asset may be treated as capital. The same applies for non-inventory supplies such as corn used to feed cattle, since gain or loss from the sale of such property is capital. However, the Code provides an exception in situations where supplies are consumed rather than sold. Specifically, IRC section 1221(a)(8) provides supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer are not considered capital assets. Thus, consumable supplies receive ordinary gain or loss treatment and a long futures position hedging a cattle feeder's supply of corn may qualify as a hedging transaction under the Code.

A taxpayer is not required to hedge its entire risk. Instead, transactions hedging a portion of a taxpayer's risk may qualify as a hedging transaction under the Regulations. Examiners should focus on whether a transaction reduces a type of risk enumerated in the Regulations. It is appropriate for an examiner to consider whether a taxpayer is over-hedged. To the extent the taxpayer is over-hedged, it is not reducing risk, and, therefore, the transaction does not qualify as a hedging transaction under the Regulations.

These Regulations are the exclusive means by which gain or loss from a hedging transaction qualifies as ordinary gain or loss. (Treas. Reg. Section 1.1221-2(a)(3)) Consequently, prior case law is irrelevant in determining whether a taxpayer was hedging.

A forward contract is a non-exchange traded agreement between two parties to buy or sell a specified quantity of a commodity at the current price for delivery or settlement at a specified future date. A commodity futures contract is a standardized, exchange-traded contract for the sale or purchase of a fixed amount and quality of a commodity at a future date for a fixed price.

Businesses may enter into commodity futures contracts or forward contracts and may acquire options on commodity futures contracts as either of the following:

- Hedging transactions; and
- Transactions that are not hedging transactions (Speculative Ventures).

Gain or loss from such transactions will qualify as ordinary gain or loss only if it satisfies the definition of a hedging transaction. IRC section 1221(b)(2)(A) defines a hedging transaction as a transaction entered into in the normal course of the taxpayer's trade or business primarily to

reduce the risk of price changes, interest rate changes or currency fluctuations. Commodity futures gains and losses that do not qualify as hedges and that do not involve contracts primarily for sale to customers in the ordinary course of a trade or business are treated as capital gains and losses.

If a farmer enters into commodity forward contracts, futures contracts or options on futures contracts to protect himself/herself from the risk of unfavorable price fluctuations, and the contracts cover an amount of the commodity within their range of production, the transactions are generally considered hedging transactions. They can take place at any time the farmer has the commodity under production, on hand for sale or reasonably expect to have it on hand. There can be an “anticipatory” hedge with respect to a hedge of a change in price on goods to be acquired or sold.

Courts emphasize two tests in evaluating commodity futures transactions as hedges or as speculative ventures:

Direct Relation Test

- There must be a direct relation between the taxpayer’s business and the commodity market transaction if the transaction is to be considered a hedge.
- The direct relation test requires that the amount of futures trading in the commodity involved and the timing of the purchases and sales must be related to the position the taxpayer is actually in. Thus, where the amount of futures trading exceeds substantially more bushels or number of head needed to provide price protection for actual bushels or number of head the farmer has or expects to have or the pattern of purchases and sales in futures is not consistent with securing price protection for the farmer’s actual business activity, the transactions are likely to be treated as speculative rather than hedges. Each instance is a facts and circumstances determination.

Insurance Test

- If futures’ trading is used to offset price changes in actual commodities, the futures transactions are hedging.
- If the commodity transactions are an integral part of the taxpayer’s business where the futures contracts are used as price insurance against subsequent price increases with respect to needed raw materials or price decreases for production to be sold, then they are considered to be a hedge.

Identification Rules

Treasury Regulation section 1.1221-2(f) states that in order to receive ordinary loss treatment, taxpayers must identify hedges when entered into along with the item or items hedged.

- Hedging transactions must be clearly identified in the books and records before the close of the day on which the taxpayer enters into the hedge.

- The hedged items or aggregate risk must be identified within 35 days after entering the hedging transactions.
- The identification must be made on, and retained as a part of, the taxpayer's books and records and must specify the hedging transaction and what is being hedged.
- The presence or absence of identification must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement, unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. Treasury Regulation section 1.1221-2(f)(4).

If a transaction is a hedge, but is not identified as a hedge in the books and records, the gains are ordinary and losses are capital. Furthermore, if a transaction is identified as a hedging transaction, but is not a hedge, the gains are ordinary, but the losses may be capital.

Marketing Tools Used To Protect the Price of a Commodity

The Futures Market

There are various market tools that can be used to protect the price of a commodity. The futures market is used frequently because it offers actual futures contracts and futures options. The most popular are the actual futures. Futures contracts have the highest risk of loss and are more expensive than options. Also, futures require margin money to be deposited. Margin money is cash or equivalent required to guarantee fulfillment of a futures contract.

Futures options can provide the same price insurance and are much less expensive. There are two kinds of options: Puts and Calls. Both can be bought or sold by anyone. A put is an option giving the holder the right, but not the obligation, to sell short a commodity futures contract. A call is an option giving the holder the right, but not the obligation, to purchase a futures contract. The buyer has a choice of whether or not to exercise an option. The seller of a put option is obligated to buy the underlying futures contract and the seller of a call option is obligated to sell the underlying futures should the buyer exercise the option. Generally there is no margin money required for owners of options because the cost of the option (premium) is paid up front; however, sellers of puts and calls are required to maintain margins in their accounts.

There are various market tools that can be used to protect the price of a commodity. The futures market is used frequently because it offers actual futures contracts and futures options. The most popular are the actual futures. Futures contracts have the highest risk of loss and are more expensive than options. Also, futures require margin money to be deposited. Margin money is cash or equivalent required to guarantee fulfillment of a futures contract.

The Options Market

The options market is gaining popularity because of the reduced risk. But the temptation to speculate is present, the same as in actual futures contracts. Hedgers should buy only enough options to cover their actual or expected positions in the cash market. Options are offered in the same months that the underlying futures contracts are offered. They expire 1 month prior to the actual futures, except for feeder cattle options which expire in the same month as the futures

contract. For example, an October live cattle put option would expire in September instead of October when the futures contract expires; whereas, an October feeder cattle option would expire in October. When an option is sold, the seller is paid a premium. The premium is not collected until the option is exercised or expires. The seller of an option is required to pay margin money to cover any possible losses. This is because the seller is at risk and will lose money if the purchaser exercises the option. The purchaser will only exercise the option if he or she can make a profit. If that happens, the seller will suffer an offsetting loss.

Buying calls provides protection against rising prices. These transactions allow a person to limit the amount paid for replacement inventory. Buying a put provides protection against declining prices. A person can guarantee the price at which a product eventually will be sold. Thus, put and call options provide the same kind of price protection provided with long and short positions in the futures markets.

As with actual futures contracts, a hedger should purchase only the number of options necessary to cover the cash market (actual or expected) position. Any excess is over hedging and to the extent the taxpayer is over hedged, there is no reduction of risk and the transaction does not qualify as a hedging transaction.

Hedging Cattle

Futures and options are offered for live cattle and feeder cattle. Live cattle contracts can only be used to hedge mature cattle sold or purchased. They are also referred to as fat cattle. A live cattle contract represents 40,000 pounds. To determine the number of head a contract represents, you will need to know at what weight the taxpayer sells its cattle. For example, if the cattle are fattened to an average weight of 1,250 pounds, a contract would represent 32 head ($40,000 / 1,250$). If the cattle are marketed at 1,100 pounds the contract would cover 36 head ($40,000 / 1,100$). This computation is necessary to determine if the taxpayer is over hedged. A producer places a hedge by entering into the correct number of futures contract(s) to sell feeder cattle or, by purchasing the correct number of put options to sell the same number of feeder cattle future contracts.

Feeder cattle contracts are used to hedge replacement cattle for feedlots. The contracts are for 50,000 pounds of cattle. If feeder cattle are to be purchased in the future, the taxpayer will need to go long in the market. This means that feeder cattle contracts or call options will be purchased. Again, it is important to determine how many head will be covered by a contract. In the feeder cattle market, ranchers maintain breeding herds that produce the cattle. These ranchers hedge their finished product by selling feeder cattle contracts or by purchasing put options on feeders. Related to the feeder cattle industry are taxpayers who purchase small cattle and place them in starter feedlots. These cattle are later sold to other cattlemen who also place them in feedlots. These taxpayers could be entering into futures contracts to both buy and sell feeder cattle. They would enter futures contracts to buy feeder cattle to hedge calves to be purchased for their feedlots and enter futures contracts to sell feeder cattle to hedge the price of those calves when they are ready for sale.

Hedging Grain Crops

Futures and options are used for growing grain crops and for hedging purchased grain used for feeding cattle or for resale by grain dealers. The same rules and techniques will apply to grain as to those for cattle. Grain farmers normally do not purchase grain, they only sell it. Most farmers have patterns of grain selling. Some sell near harvest time each year and many sell at year end or carry grain over and sell in January. This is important to know because the producer should generally use the correct futures month. If a farmer normally sells wheat in December, then December wheat futures should be used; however, this is not always necessary to be a valid hedge.

Be aware that farmers sometimes sell grain using deferred payment contracts. They deliver grain to the elevator and then contract with the elevator to receive a fixed or pre-agreed price in the following year, usually January. In this situation, there is no need for price protection because the price is already set. Any dealings in the futures market for that particular lot (number of bushels contracted on the deferred payment contract) would not reduce risk and, therefore, would not qualify as a hedging transaction under the regulations.

Transaction Analysis

Hedging issues often result in unagreed cases. An unagreed case will require a detailed analysis of the farmer's trading accounts. Each transaction will have to be listed, and the workpapers need to reflect:

- Date entered;
- Position (long/short);
- Commodity identification;
- Trading price;
- Date closed;
- Settlement price; and
- Gain/loss.

Sometimes it is difficult to trace the transactions from start to finish. It is almost impossible to do this without the daily trade confirmation sheets, because they include all the identifying details.

A good way to check the accuracy is to look at open positions listed on the month end reports. If a contract is still shown as open and the report fails to show it, go back and find when it was closed. Compare the contracts shown as open at the end of the month with those shown in open status on the broker's month end summaries.

Accounting Methods for Hedging Transactions

A taxpayer may choose any accounting method for a hedging transaction that clearly reflects income and may use different methods for different types of hedging transactions. The accounting method must reasonably match the timing of income, deduction, gain, or loss from a hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. (Note: Treasury Regulation section 1.446-4(e) for the requirements and limitations on the method that can be used for certain hedging transactions)

The Service and Treasury expect that the hedge accounting methods employed by most taxpayers for financial accounting purposes will satisfy the clear reflection standard in the Regulations. However, the method chosen must be used consistently and be changed only with the consent of the Commissioner. (Treasury Regulation section 1.446-4(c)).

The Regulations require taxpayers to maintain books and records containing a description of the accounting method used for each type of hedging transaction in sufficient detail to demonstrate how the clear reflection standard is met. (Treasury Regulation section 1.446-4(d)(1)) For each hedging transaction, in addition to the identification required by Treasury Regulation section 1.1221-2, Treasury Regulation section 1.446-4(d)(2) requires whatever more specific identification is necessary to verify the application of the method of accounting used by the taxpayer for that transaction.

Examination Techniques

Hedging losses should be entered as negative amounts in “other income” on schedule F. However, they are seldom found there. Some losses are deducted as separate items in other expenses and are occasionally found in either cost of sales or in expenses. When the gross profit on a return appears low or expense costs are high in relation to sales, the examiner should consider scrutinizing the accounts for losses from futures transactions since this will not be reflected as separate deductions.

When examining a hedging issue, it is very important to secure the brokers statements and the taxpayer’s worksheets or other records identifying the hedging transactions. At minimum the daily transaction sheets and the monthly summary statements should be secured. The hedger should normally be trading in the same commodity futures contracts as those commodities he is selling or purchasing. The records must show that the commodity hedged is in an amount that is equal to or less than what is being produced, bought, or raised for resale. The contract quantities will be in bushels or pounds. The weight at which the taxpayer normally sells or buys cattle will determine the number of head that his live cattle or feeder cattle contracts will represent. For example, a cattleman who sells fat cattle at 1,100 lbs. will protect more cattle with a contract than the producer that sells at 1,250 lbs.

To examine grain crop hedging it is necessary to secure inventory records, purchase invoices, sales invoices, and the taxpayer’s documents identifying the hedges. When inspecting the broker’s statements, compare the closing dates of the futures to the purchase or sale dates of the related commodity. There should be some relationship between them. Broker’s statements reflecting futures trading in unrelated commodities are an indication that the taxpayer is not reducing risk as required. Usual commodity transactions that do not reduce risk for farmers are: eggs, pork bellies, coffee, silver, gold, copper, and boxed beef. These commodities have no relation to the normal course of business for a farmer, cattlemen, grain dealer, or feedlot operator.