Market Segment Specialization Program

Poultry Industry

Training 3123-013 (03/2002)
TPDS No. 87537E

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Poultry Industry

Table of Contents

Page No.

INTRODUCTION

Chickens.....ix
Primary Breeders.....ix
Breeders.....x
Broilers.....xi
Layers.....xi
Turkeys.....xii
Support Operations.....xii
Ducks.....xiii
Geese.....xiii

CHAPTER 1, IRC SECTION 447(i)

Introduction.....1-1
Prior Law.....1-1
IRC section 447.....1-2
Gross Receipts Test.....1-3
Family Corporations.....1-4
IRC section 481.....1-4
Suspense Account.....1-5
Recapture Rules ─ Suspense Account.....1-6
Changes Made by Taxpayer Relief Act of 1997.....1-7
Summary.....1-7

CHAPTER 2, FARM PRICE

Introduction.....2-1
Inventories.....2-2
Farm-Price Method.....2-3
Garth.....2-3
Farm Inventory.....2-5
Market.....2-6
Market Conversion.....2-9
Cost of Disposition.....2-11
Technical Advice Memorandum.....2-12
Summary.....2-13

CHAPTER 3, UNIT LIVESTOCK PRICE

Introduction....3-1
General....3-1
Livestock....3-2
IRC section 263A....3-4
Audit Techniques....3-5
Summary....3-6

CHAPTER 4, PREPAID FEED

Introduction: Cash Basis Taxpayer....4-1
Revenue Ruling 79-229, 1979-2 CB 210....4-2
Payment for Feed versus Deposit....4-3
Business Purpose versus Tax Avoidance....4-3
Distortion of Income....4-4
IRC section 464(f) Limitation....4-4
Case Scenario....4-5
Payment for Feed versus Deposit....4-5
Business Purpose or Tax Avoidance....4-6
Distortion of Income....4-7
Case Law....4-7
Audit Techniques....4-8
Summary....4-8

CHAPTER 5, SECTION 108 ─ INCOME FROM DISCHARGE OF INDEBTEDNESS

Introduction....5-1
IRC section 108....5-2
Income from Discharge of Indebtedness....5-3
Definition of Farming....5-4
Qualified Farm Indebtedness....5-5
Limitation....5-6
Reduction of Tax Attributes for Farmers....5-7
IRC section 1017....5-9
Forgiveness of Shareholder Debt....5-9
Acquisition of Debt by Related Party....5-10
Audit Techniques....5-10
Summary....5-11

CHAPTER 6, SWEETHEART DEALS

Introduction....................6-1
Pre-1986 Law....................6-2
Post-1986 Law....................6-3
    IRC section 263A....................6-4
Sweetheart Deals....................6-4
Audit Techniques....................6-6
Summary....................6-7

CHAPTER 7, GROWER ISSUES

Introduction....................7-1
Expenses....................7-1
    Utilities....................7-2
    Insurance....................7-3
    Miscellaneous....................7-3
    Depreciation....................7-4
Net Check ─ Double Deduction....................7-6
Financing Arrangements....................7-8
Audit Techniques....................7-9
Summary....................7-10

CHAPTER 8, FARM LABOR

Introduction....................8-1
Growers....................8-2
    Industry Practice....................8-2
Farm Workers....................8-3
    Behavioral Control....................8-3
    Financial Control....................8-4
    Relationship of the Parties....................8-4
Withholding on Employees....................8-5
Audit Techniques....................8-5
Summary....................8-7

CHAPTER 9RESEARCH CREDIT

Introduction....................9-1
IRC section 41....................9-3
Base Amount....................9-4
IRC section 174....................9-6
    Qualified Research....................9-6
Audit Techniques....................9-7

Summary 9-8

CHAPTER 10, MISCELLANEOUS ISSUES

Introduction..10-1
Annual Accounting Periods 10-1
52/53 Week Year 10-1
Accruals 10-2
Depreciation...10-2
Prior Law 10-3
IRC section 447(i)...10-4
IRC section 168(b)(2) 10-4
IRC section 263A(e)(4) 10-4
Issue 10-5
Unreported Income 10-6
Bartering 10-6
Form 1099 to Executives 10-7
Personal Expenses of Shareholders/Officers 10-8
Audit Techniques..10-8
Summary 10-11

CHAPTER 11, RESOURCES

Introduction...11-1
Possible Avenues of Research 11-1
Magazines and Publications..11-2
Associations 11-3
Research Facilities 11-4
Market Services 11-4
State Agricultural Statistical Services 11-5
Records 11-8

GLOSSARY..G-1

INTRODUCTION
TO THE POULTRY INDUSTRY

The purpose of this guide is to highlight issues that are specific to or have a large impact on the poultry industry. Most of the issues in this guide relate directly to the major companies rather than the individual farmers. However, one chapter has been devoted to the issues normally found in conjunction with a poultry grower audit. For more general issues concerning individual farmers, please refer to the MSSP Grain Farmers (3149-122), TPDS #83960J.

The poultry industry has come a long way from the individual farmer hand raising a small number of birds. It is dominated by multi-million dollar vertically integrated corporations that contract with individual farmers to grow company owned birds under strict company guidelines. The United States is a large player in this industry but it is by no means the top producer.

There are several specialized segments of the poultry industry which require different techniques and knowledge of the examining officer. The following is a brief outline of these segments as they exist in the chicken and turkey industries and to a lesser degree in the duck and geese industry.

CHICKENS

The poultry industry is dominated by the chicken companies, some of which are also major players in the turkey markets. Most of these companies are fully or partially integrated; encompassing the breeding, growing, processing, and marketing of chicken and turkey products. However, some companies specialize. For example, there are companies that deal only with primary breeders, companies that deal in table eggs and layers, and companies whose primary business is selling live broilers.

Primary Breeders

The first step in poultry production is normally the primary breeder company that invests heavily in research and genetic engineering. They spend considerable time and effort in upgrading their selective gene pools in order to provide the major broiler companies with faster growing, more efficient birds. Efficiency is based on the bird's ability to convert feed to weight; its feed conversion ratio.

As part of the primary breeder company's research, flocks are produced which are not for sale as fully developed breeders and thus must be slaughtered. Since many of these companies do not have slaughter facilities they contract this service through processing companies with strict controls designed to keep specific gene pool information a secret.

Primary breeders are the grandparent stock which produce the breeder eggs. These eggs are taken to hatcheries, which are normally company owned, and hatched into the basic breeder chicks for sale to the producer companies. Many primary breeder companies will only sell hatched chicks rather than eggs for security and quality control reasons. Some of these companies are fully or partially owned by a larger chicken producer.

Breeders

Most of the major chicken producers purchase regular breeder chicks or eggs from the primary breeder companies. Which company they purchase from depends on the size of bird they need as well as any special qualities they are looking for in the finished product. It is not unusual for producers to purchase one strain of hens to be bred with a different strain of rooster in order to produce a particular type of broiler chick. Some producers also maintain a few primary breeder flocks as well as purchasing outside breeder chicks.

Breeder chicks are placed in pullet houses and raised until approximately 20 weeks of age. At that time they are placed in wooden cages which are stacked on semi-trailers, and moved to breeder houses where they will remain during the 40 week laying cycle. Within 4 weeks of being placed in the breeder houses, the hens will begin producing enough eggs to make it profitable for the company to haul the eggs to their hatcheries. This is typically 50 percent production or one egg every other day. From age 0 to 24 weeks, birds are considered pullets. From 24 weeks on they are full-fledged breeder hens.

The typical breeder house is 400 feet by 40 feet and houses 6,800 or more hens and 700 or more roosters. Raised slats line each side of the house with a floor-level walkway running through the middle. The birds are fed once each day early in the morning. Eggs are normally gathered three times a day and stored in a cooled egg room to prevent incubation.

Due to the hen's sensitive nature it is not feasible to move a flock once laying has started without causing a substantial, but temporary, drop in egg production. A move may cause the birds to go into "molt" which will knock them out of the egg laying business for several weeks. Thus, breeder flocks are seldom sold once they have been moved to the breeder houses. Any such flock sales during a laying cycle are conducted as a sale of the contract in order to avoid moving the flock.

It is possible to keep a breeder flock after a regular laying cycle, allow it to go through a molt, and carry it through a second laying cycle. This is not a normal practice due to the decreased egg production versus the costs of a second cycle. However, it is a much more typical practice with primary breeders.

At the end of each laying cycle the breeder house is cleaned out, sprayed, and new sawdust is spread in preparation for the next flock. The old litter can be used or sold by the grower as fertilizer.

Primary breeders and breeders weigh from 7 to 9 lbs. at maturity. Their meat is not as tender as the broilers and it is typically used in soups or similar products.

Broilers

Broilers are the main meat producing bird for the poultry industry. Broiler eggs are picked up from the breeder houses twice a week, and delivered to the hatcheries. The incubation period typically runs 21 days. The resulting broiler chicks are placed in grow-out facilities, where they are fed, watered, and medicated under strict company guidelines intended to maximize their weight to feed ratio.

The grow-out houses for broilers and pullets are very similar. Like breeder houses they are typically 400 feet by 40 feet steel truss, open span buildings. Some buildings have wire mesh windows that run the entire length on each side and are covered by heavy-duty curtains that can be raised or lowered for temperature control. Fans, foggers, and gas stoves are placed throughout the houses to help keep the temperature at productive levels.

There are three basic types of flocks for broiler purposes. Mixed flocks are the typical broiler flock containing males and females. These flocks are normally grown to approximately 3.8 lbs. through 4.4 lbs. An all-female flock is raised when smaller weight is desirable since the females tend to out perform the males in the earlier stages. Typically, an all female flock is raised to be sold as Cornish hens with weights up to 2.2 lbs. Flocks containing all males are used when larger birds, normally over 4.8 lbs., are needed due to their ability to outperform the females in obtaining the larger weights.

Layers

These are very specialized birds that have been bred to be finely honed egg producing animals and are very different from the breeder lines. They produce the table eggs sold in stores. Current layers weigh approximately 3 pounds and would fit in the palm of your hand. The lack of extra weight keeps feed from being diverted to muscle upkeep and away from egg laying. This efficiency results in approximately 280 eggs per bird each year. Unlike breeders, it has been profitable for companies to hold the layer flocks through at least one molt period and a second laying cycle.

Like their breeder counterparts, chicks (pullets) are placed in pullet houses until they are approximately 21 weeks of age at which time they are moved to layer houses. These houses are vastly different from, and much more expensive than, breeder houses. The hens are housed in stacked cages with 2 to 10 hens per cage. The houses are fully automated to provide a constant supply of feed and water to each cage and to maintain environmental control. Eggs are collected by conveyor belts that run from the cages to the egg room where they are sorted and packaged.

Once the birds are no longer valuable as layers they have little value for any other purpose. They are too small to contain much usable meat and are normally sold for much less per pound than breeder hens.

TURKEYS

There are several differences between the chicken and turkey industries that should be noted. One main difference is the turkey industries' use of artificial insemination. Unlike breeder chicken flocks where hens and roosters are housed together, breeder turkey hens are housed separate from breeder turkey toms and all fertilization takes place artificially. Breeder hens reach a marketable production stage at 30 to 32 weeks, lay for an average of 24 weeks, and produce an average of 70 eggs per hen. At the end of their laying cycle these birds can be processed as regular meat turkeys. This is very different from the chicken breeders that have a lower meat value at the end of their cycle than the broilers.

Meat turkeys are raised for 14 to 17 weeks with tom turkeys being raised longer than hens. The toms gain weight much faster than hens, and have a higher conversion of feed to meat ratio. Given this difference tom eggs have a higher market value than the hen eggs. Overall, turkey eggs are relatively expensive due, in part, to the low number of eggs produced by each hen during the laying cycle.

Most turkey farms maintain three separate grow-out houses that are connected by enclosed walkways. Each house is progressively larger to accommodate the turkeys as they progress from a chick to a mature size. Thus each unit of three houses contains three flocks at staggered levels of growth.

Most of the facilities used to house the different chicken and turkey flocks are owned by independent farmers who operate under contract with the poultry companies. The farm owners provide the facilities, utilities, and labor. The companies supply the poultry, feed, veterinary, technical, and catch and haul services. Since the companies do not own the facilities they can and have sold the contracts, thus allowing the flocks to remain in place until they reach maturity or finish laying.

What is provided by the company versus furnished by the farmer can be different for each company. The contracts covering each type of flock arrangement are very detailed in nature and outline each party's responsibility.

SUPPORT OPERATIONS

To supply the feed required by the numerous flocks the poultry companies have strategically located feed mills to service its contract growers. These company-owned feed mills seldom have any outside sales. They are devoted to buying, mixing, and delivering feed for the internal operations.

Hatcheries are also located throughout the company's major locations. They are used to hatch eggs received from the company breeder flocks. If the company experiences an oversupply of broiler eggs they will normally sell the eggs rather than try to sell the hatched broiler chicks.

DUCKS

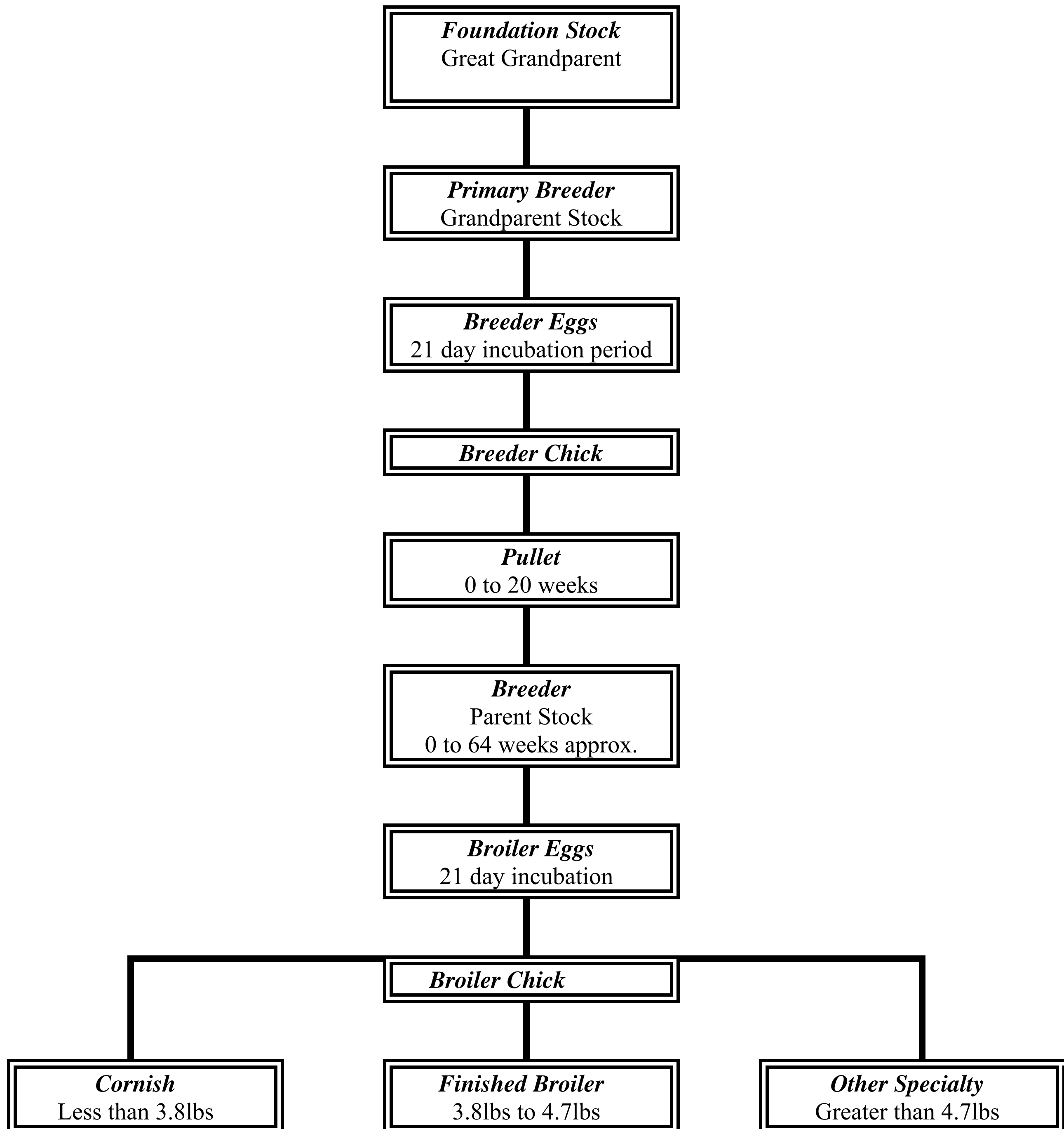
This industry was started in Suffolk County on Long Island, NY and has now spread to a few other areas in the United States. Grow out houses are often partitioned to allow the birds to be started at one end of the house and moved along as they grow until they are ready for market. The average market age is 7 weeks at a weight of 7 pounds. The chicks are started inside and moved to outside runs between the age of 3 to 4 weeks.

GEESE

Small farms are the norm for geese production with flocks of 100 to 300. Most of the flocks are range grown and require little care after the first few weeks. Although goose is still a specialty food in the United States, there has been an increasing demand for goose down in the recent years.

This page left intentionally blank.

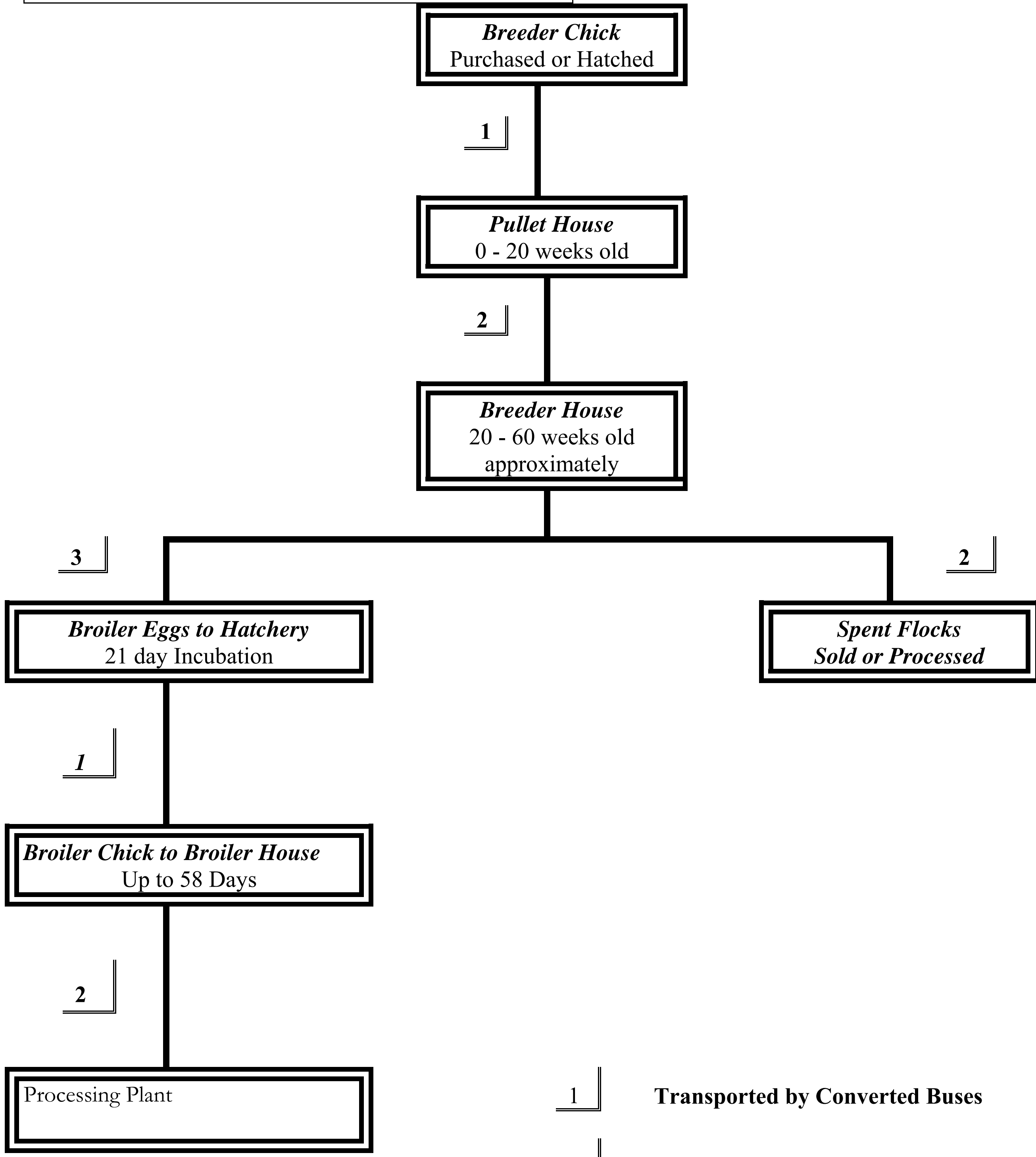
Exhibit 1



Broiler Chicken Life Line 1

This page left intentionally blank.

Flock Movement



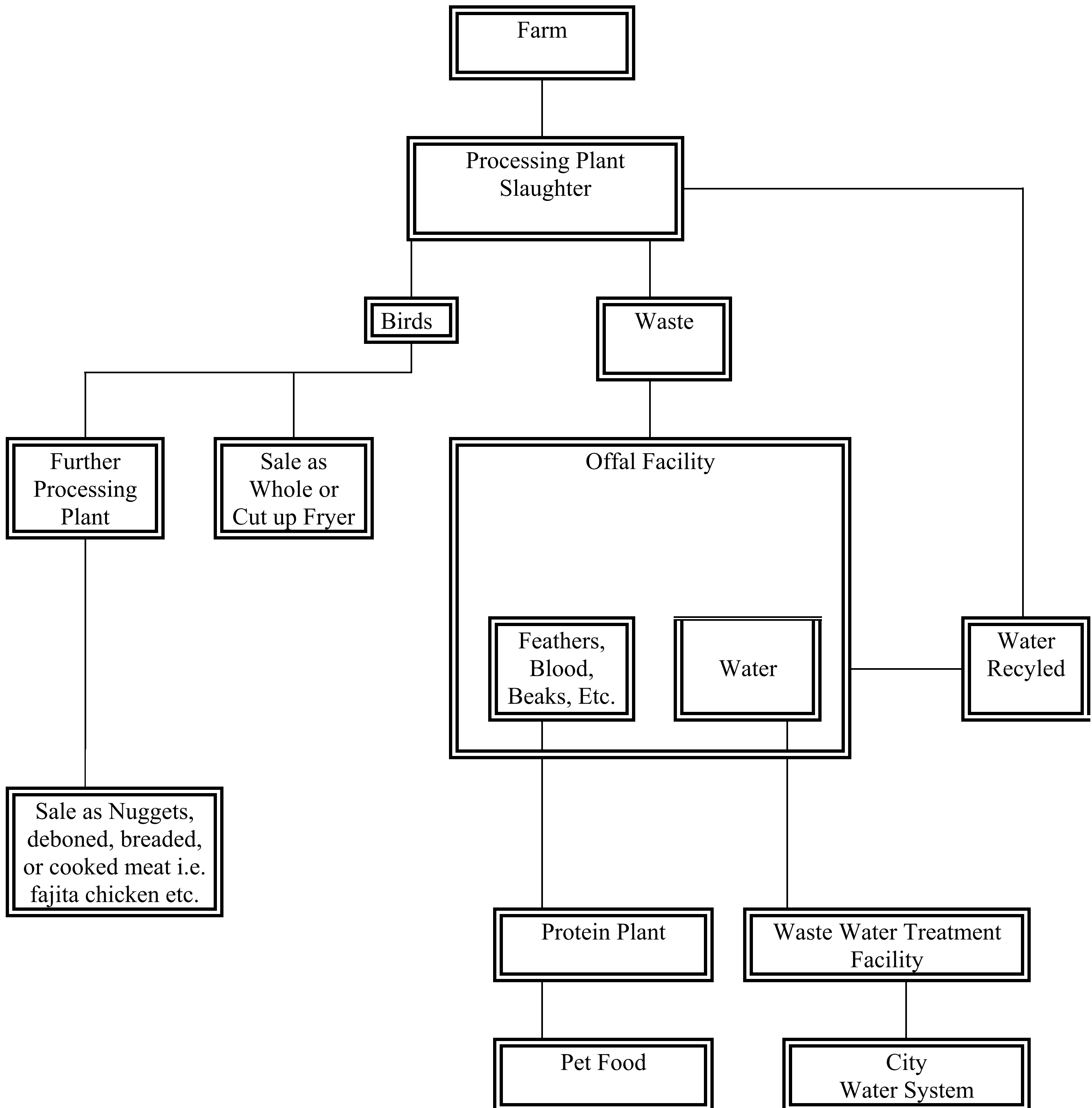
3

Transported by Refrigerated Egg Trucks

This page left intentionally blank.

Exhibit 3

Processing Division



It is not unusual for the Processing Plant to perform some further processing activities in addition to its

regular slaughtering functions.

This page left intentionally blank.

Chapter 1

IRC SECTION 447 ─ ACCRUAL VS. CASH

CONTENTS

Introduction
Prior Law
IRC section 447
    Gross Receipts Test
    Family Corporations
    IRC section 481
    Suspense Account
Recapture Rules ─ Suspense Account
Audit Techniques
Changes Made by Taxpayer Relief Act of 1997
Summary

INTRODUCTION

Due to its dependence on nature, farming is a highly risky business that calls for extremely large capital outlays. To compensate for these risks, as well as to preserve this important industry, Congress has granted special status to farmers ranging from farm subsidy payments to unique tax rules.

PRIOR LAW

As early as 1919 regulations outlined the freedom of farmers to select either the cash or accrual method. The regulations further allowed farmers to take a current deduction for expenses incurred in the raising of crops and animals. Treas. Reg. section 1.471-6(a) still provides that:

> A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the

Commissioner as provided in Regulation 1.446-1(e).

Before the 1976 Tax Reform Act farmers could operate their farms as corporations and still use the cash method of accounting. Since the operation of non-farming activities could taint the farming business and result in the loss of the cash election, many of the poultry companies set up separate corporations for the different business lines. These separate companies were normally part of the consolidated group of which only the farming company used the cash basis of accounting. This provided ample opportunities for the consolidated group to control the timing and treatment of various deductions.

Example 1

The farming corporation would pay a fee to a related processing company while retaining ownership of the birds. Since the farming corporation is not required to keep inventories and the processing entity would not have a finished inventory, all processing expenses would be currently deductible.

IRC section 447, as set forth in 1976, limited the methods of accounting available to certain corporations engaged in farming while maintaining various exclusions. The major exception allowed corporations which qualified as family farms under IRC section 447(c)(2) to use the cash method of accounting. This was a substantial benefit for many of the major farming corporations since most met the rules for family corporations. Several of these family-farming corporations were billion dollar public companies.

Under current law, a taxpayer need not set up separate corporations or separate trades or businesses to make use of the cash method for farming activities. So long as the taxpayer is not prohibited (for example, by IRC section 447) from using the cash method for its farming activities, the taxpayer may use the cash method for its farming activities and an accrual method for its processing or other non-farming activities.

IRC SECTION 447

Although IRC section 447 received several amendments over the next 10 years it wasn't until the Omnibus Budget Reconciliation Act of 1987 that Congress responded to the increasing public outcry against the tax benefits received under this section by some of the largest corporations in the United States. The changes were directed at the major C corporations that had previously qualified under the guise of family

farms.

S corporations were not affected by the changes and may still use the cash method of accounting no matter how large the business.

Gross Receipts Test

Through the Omnibus Budget Reconciliation Act Congress passed IRC section 447(c)(2) setting forth a gross receipts limitations for farming corporations and effectively bars large farming companies from using the cash method of accounting.

The actual test is outlined in IRC section 447(d) and contains separate rules for regular farming corporations versus corporations that meet the family farm rules. For regular farming corporations, each taxable year beginning after December 31, 1975, is reviewed to determine if the corporation (and any predecessor corporation) had gross receipts in excess of $1 million. If any of the prior years exceeded this limit, the corporation does not qualify to use the accrual method under IRC section 447(c) for the current year. A controlled group is treated as one corporation for purposes of the general gross receipts test.

IRC section 447(d)(2) contains special, more favorable, rules for family farm corporations. The gross receipts limitation is adjusted upward from 1 million to 25 million and is applied to years after December 31, 1985, instead of December 31, 1975. It makes another concession by providing that in the case of controlled groups, the gross receipts of the other members of the group are taken into account only in proportion to the fair market value of the stock of the other corporation owned by the family corporation.

Although a farming company may initially appear to be well under the gross receipts limitation, a one cent error in computing the per pound market value between related corporations could result in a understatement of millions on companies with sales of one million birds per year. This applies a considerable amount of pressure on the companies to hold down the selling price.

Example 2

Company XYZ's farming subsidiary used a 5 cents per pound processing cost in converting from a processed market value to a live bird value. When asked how the 5 cents was determined, the company put forth that it was the "industry standard." After reviewing processing records from the processing subsidiary actual processing costs were verified as 4-cents per pound. This decrease in processing costs will increase the market value of a live bird thus increasing gross receipts from farming as well as the bird's inventory value.

Poultry companies keep extensive reports that provide the price per pound by flock for each step of the process. Since they deal with millions of birds each year, a half cent per bird change can be the difference between a profit or a loss. A partial listing of potential

records kept by the companies can be found in the Resource chapter.

The gross receipts test can be one of the most subjective limitations under this code section. It is also the one most vulnerable to manipulation.

Family Corporations

There are two definitions set forth under IRC section 447(d)(2)(C) for family corporations. Under the first definition, a family corporation means where members of the same family own at least 50 percent of the combined voting power of all voting stock and at least 50 percent of all other classes of stock of the corporation.

The second definition of family corporation refers back to IRC section 447(h) and provides very specific guidelines whereby companies will qualify as a family corporation. These include minimum requirements on the percentage of stock held by family members as well as employee stock ownership. Further, it only applies to corporations in existence on October 4, 1976. Most companies who are covered by this exception will fall well within the rules. However, it should be noted that many laws are written with specific taxpayers in mind thus there may be one or two companies which are directly on point.

For purposes of IRC section 447 members of the same family are broadly defined to include the individual, brothers, sisters, "the brothers and sisters of said individual's parents and grandparents, the ancestors and lineal descendants of any of the foregoing, spouse of any of the forgoing, and the estate of any of the foregoing." IRC section 447(e) goes on to outline how these rules apply to partnerships, corporations and trusts that are shareholders in the farming corporation.

IRC section 481

Most examiners dealt with an IRC section 481(a) adjustment. IRC section 481 outlines the adjustments necessary to prevent amounts from being duplicated or omitted when changing accounting methods. These adjustments are determined as of the beginning of the year of change.

The major differences encountered in moving between the cash method and an accrual method involve accounts receivable, inventories, and accounts payable. When a company has been on the cash method for

many years there is a potential for substantial

differences from an accrual method that will result in some very large IRC section 481(a) adjustments.

These IRC section 481(a) adjustments are included in the income or expense for the year of change. However, Congress realized the tremendous burden this could place on taxpayers in some cases and provided the possibility of some relief. IRC section 481(b) outlines this relief that can result in lower taxes for some taxpayers.

Suspense Account

IRC section 447 required numerous farming corporations to switch from the cash method to an accrual method for a taxpayer's first taxable year beginning after December 31, 1987. For companies that had not only used the cash basis for many years, but had also increased in size, the IRC section 481(a) net adjustment already built up by the beginning of the year of change was substantial. The affected companies lobbied strongly against bringing the entire adjustment amount into current income, even under the special relief provisions of IRC section 481(b). In response to these requests, Congress softened the impact considerably by including IRC section 447(i) that defers a large portion of the adjustment with a suspense account, but only in the case of family corporations as defined by IRC section 447(d) described above.

The initial opening balance of the suspense account under IRC section 447(i)(2) is the lesser of the net IRC section 481(a) adjustment calculated for the year of change or the net IRC section 481(a) adjustment calculated as of the beginning of the preceding taxable year. If the net IRC section 481 adjustment for the year of change exceeds the adjustment for the prior year, the excess is included in the year of change. This prevents taxpayers from arbitrarily "beefing up" their IRC section 481(a) adjustment for the year of change.

Example 3

The tax year of Farming Corporation A, a family corporation as defined in IRC section 447(d)(2)(C), ends on September 30 of each year. It did not meet the exceptions under IRC section 447(c) and accordingly was forced to change from the cash to an accrual method of accounting. Its first tax year beginning after December 31, 1987, was the 8909 year which started on October 1, 1988. In setting up its suspense account, it would look to the net IRC section 481(a) adjustment as of September 30, 1988 and September 30, 1987. If the September 30, 1987, amount is less

than the September 30, 1988, amount (this would be the normal situation) the September 30, 1987, amount would go into the suspense account. The difference between the September 30, 1987, and the September 30, 1988, amounts would be included in the tax return for the year of change, 8909.

The agent should carefully review how the Section 481(a) net adjustment for each applicable date was calculated. If the company used a particular inventory method for the September 30, 1987, calculations, the same method should be used for September 30, 1988. The same type of accounts receivable should be picked up in each year. Consistency is very important to ensure the appropriate beginning suspense account balance. When different methods or philosophies are employed, the resulting numbers are not comparable. The amount in the suspense account becomes very important if the recapture provisions are activated.

RECAPTURE RULES — SUSPENSE ACCOUNT

Once the suspense account is established it will remain constant unless one of the recapture provisions under IRC section 447(i) is triggered. Any resulting reduction in the suspense account should be included, in full, in the taxable year of the reduction.

The first recapture rule compares the gross receipts of the company for the current year to the gross receipts for the year preceding the year of change (or the most recent year in which a reduction was made to the suspense account due to this gross receipts rule). If the gross receipts for the current year are less than in the computation year, the suspense account is reduced by a percentage equal to the percentage of the gross receipts reduction.

Example 4

Current year gross receipts are $54 million. No reduction in the suspense account has been required for any prior year. Gross receipts in 8806, the year preceding the year of change, were $60 million. The suspense account currently stands at $25 million. Under IRC section 447(i)(3) the suspense account will be reduced by $2,500,000 which is 10 percent ($6,000,000/$60,000,000) of the suspense account balance.

The second recapture rule focuses on family ownership. If a family farming corporation ceases to meet the rules for family ownership, the full suspense account is pulled into the current year's taxable income. IRC section 447(i)(5)(B) covers specific ownership transfers that will not trigger recapture. These provisions substantially hinder mergers or acquisitions of the affected farming corporations by outside parties. Most potential buyers would be put off by the need to pull the suspense account into income when the ownership changes.

AUDIT TECHNIQUES

- Since many of the farming corporations sell their finished product to related entities the selling price should be closely reviewed to verify how it was determined. The company should use some type of independent source such as the Georgia Dock price quotes that are per pound amounts based on a whole processed bird. If the company is selling a live bird, on the farm, several adjustments to the Georgia Dock price will be necessary to convert it to a live price which can be used in related party sales; that is, delivery costs, processing costs, reduction based on the live yield. These values can be verified through invoices from third parties that performed the services or internal records from the related corporation. The amounts paid for delivery or processing to the related corporation should not be considered indicative of the true cost. Both of these items are often based on internal reasons rather than the actual value of the services rendered.

- To verify the ownership status of a farming corporation the company stock book should be reviewed and all shareholders should be identified. After identifying the various owners, their relationships should be analyzed. Most problems are found not in the individual ownership but in the sometimes tangled stock ownership by partnerships, trusts, and other corporations.

- Any ownership changes except direct transfers to a family member should be closely reviewed in conjunction with this Code section.

CHANGES MADE BY TAXPAYER RELIEF ACT OF 1997

TRA of 1997 substantially changes the rules regarding suspense accounts for family farm corporations. It provides that no new suspense accounts may be created for years ending after June 8, 1997. It also provides for phasing out existing accounts over a 20-year period.

SUMMARY

IRC section 447 allows the cash method of accounting to be used by specific farming corporations. In 1987 law changes affecting IRC section 447 forced many of the larger farming corporations from the cash method to an accrual method of accounting. A large portion of the IRC section 481(a) net adjustment was allowed to be deferred under IRC section 447(i) by use of a suspense account. The deferral should be reviewed each year in case any of the recapture rules will come into play.

It should be noted that Sub Chapter S farming corporations are not affected by the limitations outlined above due to an exclusion provided in IRC section 447(c). Thus, many farming corporations have changed to Sub S status in order to continue to use the cash method. These entities may qualify as a farming syndicate under IRC section 464 or a tax shelter under IRC section 448(a)(3) which have very restrictive rules of their own although IRC section 464 has limited applicability for tax years beginning after 1986 (IRC section 464(g)). The shareholder is also subject to the at risk provisions of IRC section 465 and the underlying limitations.

CHAPTER 2 "

FARM PRICE INVENTORY

CONTENTS

Introduction
Inventories
Farm-Price Method
Garth
Farm Inventory
Market
Market Conversion
Cost of Disposition
Technical Advice Memorandum
Summary

INTRODUCTION

The audit techniques in this chapter are contained within each section to provide a simple and quick reference for the specific type of bird.

To reduce a potentially overwhelming recordkeeping burden, Congress initially allowed most farmers to compute their tax returns under the cash method of accounting. One of the largest benefits farmers received by using this method was the ability to currently deduct the costs of raising plants, crops, and animals in the year paid, rather than including such costs in inventory and recovering them in the year the plants, crops, and animals were sold.

Under the prior law most of the major consolidated farming corporations maintained separate subsidiaries for the processing and farming activities to provide distinct dividing lines between the different businesses. The processing subsidiaries used the accrual method of accounting including the use of inventories. The farming entities used the cash method of accounting with no (or maybe little) inventories. These cash method farming companies realized a substantial advantage over non-cash competitors.

When IRC section 447 was passed in 1988, it required most of the large farming corporations to change to an accrual method of accounting. The companies were free to select one of the inventory methods allowable for tax purposes, of which two, the farm-price and unit-livestock-price methods were specifically designed for farmers. Since inventories had not

previously been required of farming entities, neither of these methods had generated a lot of use or interest in prior years. Farm-price, in particular, had generated very little in the way of case law or other guidance.

INVENTORIES

The general rule for inventories under IRC section 471 reads:

> Whenever, in the opinion of the Secretary the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as clearly reflecting the income.

This regulation establishes two basic tests to which each inventory must conform. The inventory method must reflect, as nearly as possible, the best accounting practice in the trade or business of the taxpayer. This does not mean that inventory rules must be uniform. It simply requires that consideration be given to the trade customs of the taxpayer's line of business.

The farm-price method and the unit livestock price methods outlined in regulations are specifically designed for a farmer's unique needs. Although both methods are available for farmers, they are by no means required to use either method and in fact, many companies in the farming industry use one of the mainstream inventory methods such as Lower of Cost or Market (LCM).

The second test for inventories requires that the selected method clearly reflect the taxpayer's income. Whether or not income is clearly reflected has been the subject of numerous tax cases that provide substantial guidance if this question arises during an examination. For the most part this has not been a major issue with the farm-price method since it is specifically allowed in the regulations. Except in extraordinary circumstances, the courts have frowned on the Commissioner rejecting any method, as not clearly reflecting income, when the method is allowed under the Code or regulations.

It is a question of fact under IRC section 471 as to which basis of valuation for inventory goods will constitute the best accounting practice in the trade or business and will most clearly reflect income.

FARM-PRICE METHOD

Treas. Reg. section 1.471-6 is titled "Inventories of Livestock Raisers and Other Farmers". Subsection (c) of this regulation states:

> Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock- price method".

Again, the taxpayer's status as a farmer plays a major part in the allowance of a potential benefit. This emphasizes the need to determine if the taxpayer falls under the definition of a farmer early in the examination. Although the farm-price method can and should be disallowed if the taxpayer is not a farmer or livestock raiser, the agent should complete the gathering of all facts in order to develop any alternative positions.

Treas. Reg. section 1.471-6(d) describes the farm-price method as:

> ***[t]he valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the unit-livestock-price method.

Based on the above wording, several problem areas have surfaced over the years. Typically, these areas would have been fully litigated and settled years ago when the regulations were first written. However, since farmers were not required to use inventories the problems were seldom noticed and the monetary amount was nominally small; there are very few court cases, revenue rulings, etc., to provide guidance.

Garth

To better understand some of the problems which have been encountered in the examination of the farm-price method a good starting place is ***Garth v. Commissioner***, 56 T.C. 610, (1971) ***acq.,*** 1975-1 C.B.1. During the early 1960's Garth's Poultry and Egg Service, Inc. was engaged in the sale of commercial table eggs. It purchased layer pullets as day old chicks and sold the birds as spent hens after their productive laying cycles were complete. No hens **were ever** sold or purchased as laying hens. No started pullets **were ever** sold or purchased as starter pullets.

The company elected the farm-price method and consistently valued its entire inventory of birds based on meat processing prices. The Government contended that chickens were not livestock under the Internal Revenue Code

thus they were not subject to the farm price election. The Government also offered two main alternate positions. The first claimed that the commercial layers were capital assets subject to depreciation, not inventory. The second position argued that even if commercial layers were inventoriable livestock, it was not possible to determine a market value since, at that time, there was no market for the hens as layer hens. Thus, the farm-price method could not be used for the mature layers.

In ruling for the taxpayer, the Tax Court felt that the crux of the issue revolved around the question of whether the layers were property subject to depreciation or property that should be inventoried. After determining that Garth was a farmer and entitled to the farm-price method, the court defined poultry as livestock for purposes of IRC section 471. Once poultry was confirmed as livestock it could be inventoried or depreciated at the taxpayer's election. Revenue Ruling 75-37, 1975-1 C.B. 148, supported the ***Garth*** ruling in acknowledging that poultry is livestock for purposes of the regulations underlying IRC section 471.

One of the most important aspects of ***Garth*** was its attention to the use of the meat processing market over the layer hen market. The court's ruling highlighted the lack of any consistent market for producing layer hens while pointing out that even if there had been an active market for layers Garth did not sell layers **as layers**. They sold them only in the meat processing market. Under the ***Garth*** ruling each taxpayer should look to the market in which they routinely sell when calculating inventory values. This sounds simple but can actually be very complicated.

Example 1

Lori Lake has several commercial layer flocks and breeder flocks. She is in the business of selling commercial table eggs and broiler eggs to unrelated third parties. Under the ***Garth*** ruling the broiler eggs would be valued in the broiler egg market and the commercial eggs in the commercial egg market. The relevant markets in this case are easy to identify.

Example 2

Farmer Jones purchases baby chicks, raising them for 8 weeks, and processes the birds for use in his name brand TV dinners that he sells to grocery stores. The market in which he sells is the wholesale grocery market for TV dinners. Using the Court's logic it would appear that baby chicks would be valued in the TV dinner market. This would be a very difficult if not impossible undertaking.

As can be seen in Examples 1 and 2 the Tax Court in ***Garth*** did not envision or address the type of integrated companies that currently dominate the poultry industry. Most of these companies would find it impossible to adhere

to the logic in the Garth ruling. If it were simply a question of selling a chicken as a cornish, a broiler, or a pullet it makes sense to use the market in which the taxpayer routinely sells when the bird is sold outside the consolidated group. However, when the bird is used internally **the examiner should look at how it is used by the** taxpayer.

Example 3

In Example 2, the internal use for the broilers was meat for a TV dinner; thus, it is used in the meat processing market. The birds owned by Farmer Jones would be valued based on the prevailing meat processing market price established on the last day of his tax year.

Farm Inventory

When taxpayers elect to use the farm-price method, they are required to use it for their entire inventory except for livestock they have elected to inventory under the unit-livestock price method. There is some controversy as to what is meant by the entire inventory. At first glance, it would appear to include any and all inventories owned by taxpayer under any circumstances. As experienced students of tax law, we know it's not that simple.

The "entire inventory" of a farmer for purposes of the farm-price method has been taken to mean all **farming** inventories. Put another way, inventories belonging to the farming business. A main part of the reasoning behind this viewpoint is based on a review of the regulations as well as the basic rules under inventories that allow a taxpayer to elect a different inventory method for each trade or business. The regulation allowing the farm-price method is directed at, and allowable only to, farmers. Treas. Reg. section 1.471-6(c) allows the farm-price method for the express purpose of relieving farmers of "the difficulty of ascertaining actual cost of livestock and other farm products ***." This supports that farming is a separate trade or business.

"All farming inventory" can be a limiting definition by excluding inventory that is not part of the farming operations. A farmer who is part of a large consolidated corporation would be able to use the farm-price method for the livestock, feed, and other items relating to the farm activities while the processing operations used LCM for the finished product. This follows the division between farming and processing activities as outlined in Treas. Reg. section 1.263A-4(a)(4)(ii). The actual point of division is not always clear.

Example 4

Company A purchases baby chicks, raises them for 6 weeks then pays Company B to process the birds for sale as whole fryers to retailers. Company A retains title to the birds. The processed

birds are a farm product of Company A for inventory purposes. Company A may use the farm price method to account for the costs of raising the birds for 6 weeks. Since Company B is processing the birds under a contract with Company A, Company A is treated as though it is processing the birds. See Treas. Reg. section 1.263A-2(a)(1)(ii)(B)(1). Company A may not use the farm price method to account for the costs of processing the birds.

Example 5

Instead of paying a processing fee, Company A transfers the birds to a member of its affiliated group at an internally generated price. Company A's inventory does not include the birds once they have been transferred to the related company.

The examiner should be alert to any inventory items that appear to be misclassified between the farming and other operations. For example, moving feed from farm inventory to processing inventory can cause major distortions in the inventory valuations especially when IRC section 263A is considered. Also, the examiner would need to make sure that farm-price inventory costs are not part of the IRC section 263A calculations. See Treas. Reg. section 1.263A-4.

Market

Remember that most of us still see farming through nostalgia tinted glasses. We have a mental picture of an individual farmer raising a small brood of chicks then bringing them to a market in a wire cage or chicken coop for sale to ***. Well maybe we don't buy our chicken in this manner but we haven't really thought about the steps past this point. If the farm-price method is any indication, neither did anyone else think about the steps. This becomes readily apparent when the actual poultry markets are reviewed.

Using your new knowledge that the poultry industry is dominated by major corporations which are vertically integrated, you have probably already realized that poultry markets have undergone substantial changes since the market days envisioned above. These companies process millions of birds each week, which requires the ability to move the product quickly from the farm to the buyer and the need for a stable demand. Vertical integration has also had a major impact causing the markets to contain some unusual quirks.

Different market conditions exist for each of the various poultry products. The following general outline should provide you with practical information on each stage. The chapter on Resources provides some sources available to determine the market price for any type of poultry product on a specific day,

week, month, or year. However, finding these sources is an on-going process and the listed sources are not all inclusive.

Primary Breeders

These are the most valuable birds in the industry whose genetics are well guarded. The only known **open** market for mature primary breeders is the spent hen market since they are not normally for sale. Since these birds can be worth from $5 to $10 each and the spent hen market is normally under $2 per bird; use of the spent hen market is a sizable benefit to the taxpayer.

Many of the primary breeder companies are affiliated with or owned by one of the large, integrated poultry companies. This association is very beneficial to the primary breeder companies since only 1 in 10 roosters and 1 in 100 hens qualify as breeding stock. The remaining birds are young enough to be processed by the poultry companies as broilers.

Breeders

There are three basic stages for breeders, starting with **breeder chicks**. The primary breeder companies are in the business of selling their breeder chicks. The prices vary depending on the breed (Arbor Acres, Ross, Peterson) and its current reputation in the industry. Market price can be determined by the price paid by the company for its supply of breeder chicks or through the primary breeder companies' records. It is important to obtain the prices from the actual primary breeder company from whom the poultry company purchases its breeder chicks.

The second stage is **started pullets,** which encompasses the birds from a few days old until they are placed in the breeder house. During this time, they can be sold as started pullets for which there is an active market. Up to a certain size and age they can also be sold on the meat processing market as a broiler. Considering that pullets are much more expensive than broilers, it would indicate desperate times if a company actually did process its pullets.

Under the final stage of **breeder,** the birds (hens and roosters) can only be sold as spent hens, which is essentially a salvage sale. A review of the company spent hen sales close to the year-end will provide the market prices and any related disposition costs.

Exhibit 2-1 provides an example of the abuses (zero value) which can occur in the valuing of breeders.

Broiler Eggs

Eggs are collected three to four times a day from the breeder houses and kept in a cooled egg room which is part of the breeder house. The eggs are picked up and taken to hatcheries or for sale outside the consolidated group at least once a week with twice a week being the norm. There is a very active market for broiler eggs (a.k.a. fertilized eggs).

Market prices for these eggs run as much as 400 percent higher than those for commercial eggs.

All flocks produce some cull eggs. These are eggs with hairline cracks, over or under sized, excessively dirty, etc. Experience has shown that these eggs will not hatch so they are "culled." Some companies sell these to egg breaker plants or in their company stores for employees. Most market guides will include quotes for culls.

Broilers

Broilers are the main meat producing bird and enjoy the most active markets. The birds can be sold live on the farm or delivered to the buyer. Georgia Dock is considered the standard market quote for broilers although there are several other quotes available. Exhibit 2-2 provides an outline of some abuses (zero value) found in the broiler valuations.

Cornish

Cornish are similar to broilers, except they are worth more per pound. Ensure a cornish market price is used, not a broiler price. Since cornish are sold as a whole packaged bird the best way to determine market would be to look at the taxpayer's actual sales.

Turkeys

Several differences are found between the raising of chickens and the raising of turkeys. Toms and hens are kept separate and artificial insemination is used to fertilize the eggs. Due to the extra costs involved and the substantially lower egg production experienced by turkeys, the eggs are much more valuable than broiler eggs. There are separate market quotes for turkeys.

Unlike the chicken markets, there is no distinction between breeders and their offspring in the meat processing market. When breeders finish their laying

cycle, they are sold for the same prices as the meat producing flocks.

Layers

These birds are a totally different genetic line from the breeders. They are bred for their egg laying abilities without any need for meat producing qualities. The baby chicks are purchased from companies similar to the primary breeder companies.

Most of the integrated companies do not deal in layers or commercial table eggs. This market includes a large number of independents similar to Garth's Poultry and Egg, Inc. where chicks are purchased, table eggs are sold, and the layers are sold off as spent hens. Since meat producing is not a desired quality, the spent hens are not very desirable even as spent hens. Depending on the current market, layers may bring less than 1 cent per pound at the end of their cycle and in some cases, the companies are hard pressed to dispose of the birds.

The current state of the spent layer market brings some interesting questions to the forefront. If no market exists for spent layers how can the taxpayer apply the farm-price method to these birds? Can it be said that the taxpayer participates in the spent layer market over the layer market when the first market no longer exits? At this time, these questions have simply not been addressed.

Similar to breeders there is a started pullet market for those companies who do not have the facilities to raise the chicks. The price for started pullets can vary from one geographical area to another. If your taxpayer is engaged in purchasing or selling started pullets, the best source for market prices is their actual transactions.

Commercial Eggs

Probably one of the most active markets pertains to commercial eggs. These are the eggs sold in grocery stores to retail consumers. The market quotes cover all grades and sizes, including culls. The companies include some independents up to and including a few of the large integrated firms.

Market Conversion

Each market is based on a particular product that must be identified before the market prices are to have any meaning. As noted above, the market quotes from Georgia Dock are normally used to value broilers. This can only be done if we know the basis for the Georgia Dock calculations. The starting point would be to identify the product in the taxpayer's inventory versus the product used by the market in computing its quotes.

Georgia Dock is a per pound quote for broilers, based on a whole processed bird. It is collected and published by the Georgia Department of Agriculture. Most of the broilers in a farmer's ending inventory will be live birds on the farm. To convert the Georgia Dock number to a live price you will need to know the processing costs and the meat yields. The Dock price is reduced by the per pound processing costs and the conversion losses or meat yield. If the processing costs are based on pounds processed, they will be deducted after the reduction for the yield. The best place to obtain the information needed is from the company's own records.

Example 6

The Georgia Dock quote for May is 63.50 cents per pound. If the processing fee is 5 cents per **processed** pound and the yield is 88 percent, the equivalent live price per pound is computed as follows:

Georgia Dock	63.50		
Yield			.88
			55.88
Processing Fee			5.00
Per pound live value		50.88	
			=====

Yield is the amount of meat left after processing versus the live weight. If a live broiler weighs 5 pounds and after processing the same broiler "yields" 4.5 pounds of salable meat, the conversion ratio or yield is 90 percent (5/4.5). The remaining 10 percent of the broiler consist of feathers, head, beak, etc.

Contrary to the belief stated in the regulations that detailed record keeping would be a burden to farmers, the poultry industry keeps extremely thorough records outlining each cost on a per pound basis. If you can think of a question concerning the profit or expense on each pound of meat sold, the company probably has a report that provides the answer. A list containing some of the typical records kept by the integrated companies is included in the chapter on Resources.

If a company hires out its broiler processing to an unrelated third party, the processing fee is easy to identify. For companies processing their own broilers, the processing costs per pound **will** be outlined in the internal reports covering either the processing plants or cost recaps. Depending on the company, the reports can be weekly, monthly, or annually, as well as by division, by location, etc. It can occasionally make a substantial difference which report numbers are used. The watch words here are consistency and compatibility.

Example 7

Company A has two different processing plants. All of its broilers grown in Georgia are processed in Plant 1. These birds have an average processed weight of 5.4 pounds and average 4 cents per pound for processing. The birds processed in Plant 2 average 3.8 pounds with processing costs of 3 cents per pound. The company has been computing the market price by location. Unless both plants process the same number of birds each year, changing to a company wide average could distort the inventory values.

Any time the company changes the numbers used in the inventory calculations it should cause the examiner to be curious. Generally, a change in the method used to compute the inventory is a change I method of accounting under section 446(e), which requires the Commissioner's consent for the change to be made. Questions to ask include:

- What did the taxpayer do last year?
- Why are they changing?
- Are the locations compatible?
- Does the change make any difference to the final inventory numbers?
- If they changed from using an annual number to the last month of the year, is there anything different about the last month which could cause major differences from the rest of the year?

Invariably, adjustments to actual market quotes are necessary to compensate for any differences in the products valued. When you consider that an eighth of a cent change can make a major difference when spread across a multi-million pound inventory, the need to thoroughly review any adjustment is apparent.

One way to identify taxpayers who have used unrealistic market numbers is to compare the balance sheet inventory numbers with the COGS inventory. The balance sheet is normally a book number and the COGS is a tax number. If there are large differences between book and tax inventory, a problem is indicated. The Form M-1 should contain an entry for the current year inventory differences although this may not be readily apparent since Form M-1 names are not always descriptive.

Cost of Disposition

Once the market value for each farm product has been calculated any costs associated with disposing of or selling the product is allowed as a reduction for inventory purposes. Remember to consider the market in which the product is valued versus the current location of the inventory. If Georgia

Dock is used and the flocks are on the farm there will be a per pound cost to load and haul the birds to a processing plant. The total delivery cost should be available from the company's records. There would be no costs of disposition if the buyer paid for delivery.

TECHNICAL ADVICE MEMORANDUM

The only recent guidance involving the poultry industry and the farm-price method can be found in a Technical Advice Memorandum. Remember that TAMs are not formal guidance and may not be cited as precedence. Nevertheless, the analysis in a TAM may reveal how the author of the TAM interprets the law. The taxpayer was a fully integrated poultry company that filed a consolidated federal income tax return with its wholly owned farming subsidiary (Farm Sub). Farm Sub raised layers, primary breeders, breeders, and broilers which it inventories under the farm-price method.

The issue addressed in the TAM was whether Farm Sub had properly valued its inventories based on the farm-price method. Taking the court's ruling in ***Garth*** into account the TAM looks to the market in which the company participates to determine the proper valuation while firmly rejecting the use of a nominal or zero amount.

Spent hen markets were to be used in valuing primary breeders, layers, and breeders since these were the only markets in which the company participated. In the case of immature broilers the ruling called for a valuation that increased in value as the broilers approached maturity. Two valuation techniques follow the TAMs ruling in determining the inventory value of immature broilers.

Since broilers are sold on a per pound basis in the open markets it would appear that weight would be the best indicator of an immature birds' market value. Under this method a one pound broiler would be valued based on the per pound market price quoted at year-end less the cost of disposition. If the Georgia Dock price, as converted to live values, was 53.50 cents per pound and the cost of disposition was 3 cents per pound the immature broiler would be worth 50.50 cents in the ending inventory.

The problem encountered in using weight is most companies do not keep detailed records concerning a broiler's weight gain during its grow out period simply because this information is not needed for any internal purposes. They do keep records that show how much the birds have gained at maturity, and can estimate, based on studies, how much the birds will gain during each week prior to maturity. It should be remembered that even a small difference will have a major impact on the final numbers thus a valuation based on weight can be easily manipulated.

The second technique uses the age of an immature broiler as of the ending inventory date. The following example provides an outline of how age can be used to determine the market value.

Example 8

A Company's ending inventory includes 21-day-old broilers. The company grows its birds for 42 days at which time they weigh 4 pounds. The live value on the last day of the tax year for mature broilers is 50.50 cents per pound. The value of the company's mature broilers is $2.02 (50.5 x 4). The 21-day-old broilers are 50 percent (21/42) grown. Their inventory value would be determined by multiplying the 50 percent by the mature value of $2.02 for a value of $1.01.

The age method in Example 8 has its own problems although it is definitely the simplest method available. Since the birds do not grow at a standard, daily rate the age method will not be fully accurate. To settle these, and other problems, the valuation of immature broilers will probably include a visit to the courts before a final method is fully defined.

Whichever method is selected it should be used consistently. A change in method will usually qualify as a change in accounting method under IRC section 446(e).

This chapter highlights how important definitions are to the interpretation of numerous Code sections. If part of an integrated company does not qualify as a farming business for purposes of the farm-price inventory, it will also not qualify for many of the farm benefits. The dividing line between the farming and non-farming operations of these integrated companies can be very significant. **The agent should ensure that the company has used the same definition for all farm issues.**

SUMMARY

The farm-price method is available to farmers, including livestock raisers, in valuing their inventories. The market price used is very important due to the volume of pounds in ending inventory and should be carefully analyzed. Any adjustments needed to make the market price comparable in form to the actual inventory should also be subjected to a close review.

As the method is used by more taxpayers, various inequities and interpretation problems are surfacing. It can be expected that court cases will address some of the questions, however new legislation would be welcomed. As the poultry industry becomes more integrated and internal use defines the

actual "market" for a bird, the farm-price method will need some fine tuning that only new regulations or Code can implement.

Also, Treas. Reg. section 1.446-1(e)(2)(ii)(c) provides that a change in a system of valuing inventory is a change in method of accounting. A taxpayer may not unilaterally change to a different system (method) of valuing inventory from the one it previously used. IRC section 446(e) and the regulations thereunder require a taxpayer to obtain advance consent from the Commissioner before changing its method of accounting, even when changing from an improper method to a proper method.

The chapter on Resources in this Guide contains useful information on locating markets, obtaining quotes, etc. It provides a list of USDA contacts and industry magazines.

Exhibit 2-1

Real Life Example
Farm Price Values

Breeders

Description	Taxpayer's Value	Available Market
Breeder Eggs	*Zero Value*	*Regular Egg Market*
Breeder Chick	*Zero Value*	*Open Market*
Pullet 0 to 20 weeks	*Zero Value*	*Open Market (Mature) Broiler Market (6wks) Spent Hen (+6wks)*
Breeder 2 to 24 weeks	*Zero Value*	*Spent Hen*
Productive Breeder	*Spent Hen Value*	*Spent Hen*

This page left intentionally blank.

Exhibit 2-2

Real Life Example
Farm Price Values

Broilers

Description	Taxpayer's Value	Available Market
Breeder Eggs	*Zero Value*	*Broiler Egg Market*
Broiler Chick	*Zero Value*	*Open Market*
One day old up to earliest slaughter dates	*Zero Value*	*No Market Contact could be sold*
Earliest Slaughter up to Average Slaughter Date	*Zero Value*	*Open Market*

Average Slaughter to Actual Slaughter

Broiler Market (Georgia Dock)

Open Market

This page left intentionally blank.

__CHAPTER 3__

UNIT LIVESTOCK PRICE

CONTENTS

Introduction
General
Livestock
__IRC section 263A__
Audit Techniques
Summary

INTRODUCTION

In 1944, Treasury amended the regulations to include the Unit Livestock Price Method (ULP) of computing livestock inventories for those farmers who had elected the overall accrual method of accounting. Prior to this amendment such farmers were limited to cost, lower of cost or market, or the farm-price method of inventory valuation for livestock.

Over the years ULP has generated more case law than the farm-price method yet substantially less than any of the other inventory methods. Similar to the farm price method, various problems are just now beginning to emerge due to the requirement that many farming companies use an accrual method.

GENERAL

Unlike the farm-price method that applies to all farm inventory, the Unit-Livestock-Price method is only available for the valuation of livestock. __See__, Treas. Reg. section 1.471-6(c). All other inventory must be valued under one of the other allowable methods. Thus it is possible for a farmer to elect the farm-price inventory for its farm inventory while also electing ULP for its livestock. It should be noted that this is the only situation under which the farm price allows the livestock to be valued differently than the rest of the farm inventory. __See__, Treas. Reg. section 1.471-6(d).

Under the ULP method, a taxpayer adopts a standard unit price for each animal within a particular class. As a general rule, once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years. For taxable years beginning after August 22, 1997, a taxpayer using the unit livestock method must, however,

annually reevaluate the unit livestock process and must adjust the prices upward to reflect increases in the costs of raising livestock. The consent of the Commissioner is not required to make such upward adjustments. No other changes in the classifications of animals or unit prices shall be made without the consent of the Commissioner [Treas. Reg. section 1.471-6(f)].

Normally, the taxpayer will identify the different categories or classes of animals in their business based on age and kind. For example, animals held for sale would be in a different classification than animals held for breeding purposes. Chicks would be in a different class than pullets or mature birds. The unit prices and classifications are subject to the Commissioner's approval. See, Treas. Reg. section 1.471-6(e).

This method accounts only for an increase in the cost of raising an animal to maturity. It does not provide for any decreases in market value which may occur after the animal reaches maturity.

Livestock

Poultry is specifically excluded from the definition of livestock of several Code sections including IRC section 1033(e) which pertains to gain or loss from involuntary conversions due to drought. This exclusion fueled uncertainty as to whether or not poultry was considered livestock for other parts of the Code.

In 1971 ***W.P. Garth v. Commissioner***, 60 TC 610, (***Acq***.) firmly established poultry as livestock for purposes of IRC section 471. Since this court case, poultry has gained access to many other farm benefits under the Code, including the rules for single purpose structures discussed in the chapter on Grower Issues.

If elected, ULP applies to all raised livestock and to any livestock that is purchased prior to maturity and raised to maturity. This is true regardless of the final purpose or destination of the animal. Thus, all **raised** livestock held for sale and **raised** livestock held for draft or breeding dairy will be included in the ULP inventory. See, Treas. Reg. section 1.471-6(f).

Example 1

As part of its farming business, Poultry Inc. purchases broiler chicks and raises them to maturity. Under the ULP election the company would include the purchased broiler chicks in its ULP inventory calculations.

All livestock **purchased** primarily for sale must also be included in inventory. Animals purchased for draft, breeding, or dairy **may** be included in inventory, **or** capitalized and subject to depreciation after maturity. Thus, an accrual basis farmer using ULP may exclude from inventory only purchased production livestock. Treas. Reg. section 1.471-6(g).

If livestock is not mature at the time of purchase, the purchased cost should be increased at the end of each taxable year based on the established standard unit prices until the animal reaches maturity. The increase in unit price for purchased livestock for any given tax year is to be made only for animals purchased in the first 6 months of the year [Treas. Reg. section 1.471-6(g)].

Tax shelters, as defined in Treas. Reg. section 1.263A-4(a)(2)(ii), that use the unit livestock method for inventories must include in inventory the annual standard unit price for all animals that are acquired during the taxable year, regardless of whether the purchases are made during the last 6 months of the taxable year. Taxpayers required by IRC section 447 or 448(a)(3) to use an accrual method that uses the unit livestock method must modify the annual standard price in order to reasonably reflect the particular period in the year in which purchases of livestock are made, if such modification is necessary in order to avoid significant operation of the unit livestock method [Treas. Reg. section 1.263A-4(c)(1).

Example 2

Poultry, Inc. purchases breeder chicks for $1.12 each at the beginning of their current tax year. The chicks are held through a full laying cycle. The standard unit price of a mature breeder is $3.85. Since a breeder chick reaches maturity at 25 weeks of age the birds should be valued at $3.85 as of the end of the current tax year.

Example 3

Cattle, Inc. has the following costs of raising its animals:

Calves	--	$145.00
Yearlings	--	$425.00
Two-year old	--	$800.00
Mature Animals	--	$980.00

The cost of each animal in inventory is updated until the animal reaches maturity. A raised calf will be valued at $145 in the first year's ending inventory. The second year $280 is added to its value for a total of $425. The third year $375 and the fourth year $180 for a mature value of $980.

In ***Auburn Packing Co.***, 60 T.C. 794, Dec. 32,103, a cattle feedlot operator who used an accrual method of accounting was allowed to use ULP even

though it kept track of its animals on the FIFO basis. Thus, it had no animals on hand at the end of the year that were treated as having been acquired in the first 6 months. Since none of the livestock were treated as acquired in the first 6 months no increase was made to the unit price. The court nevertheless held that the specific allowance of ULP in the regulations, and the consistent application of ULP by the taxpayer, meant that its method of accounting clearly reflected income.

The court finding in ***Auburn Packing*** may not apply to most of the current situations. Examiner should carefully review the facts and circumstances of any case where unit price increases have not been incorporated into inventory values.

It is normally to a farmer's advantage to capitalize and depreciate purchased production livestock rather than to place it in inventory. The major advantage is that the capitalized asset can be depreciated once the livestock reaches maturity. This allows a faster write off than keeping the livestock in inventory until its useful life ends and it is sold or slaughtered. It allows capital gain treatment that can be a substantial benefit.

IRC SECTION 263A

The Tax Reform Act of 1986 ushered in IRC section 263A that has had a profound effect on the calculation of inventory valuations. Under IRC section 263A, taxpayers that are required by IRC sections 447 to use an accrual method of accounting or prohibited by section 448(a)(3) from using the cash method for their farming activities must capitalize all direct and an allocable portion of the indirect costs allocable to the livestock. This would include costs that vary depending on the amount produced (such as feed) as well as fixed costs that generally do not change based on production (such as depreciation on machinery or poultry houses). Taxpayers that are not required by either AIARAC section 447 or 448(a)(3) to use an accrual method of accounting or the prohibited from using the cash method, respectively, for their farming activities are exempt from the rules under IRC section 263A requiring the capitalization of the costs allocable to the livestock.

In the case of a taxpayer subject to the rules under IRC section 263A requiring the capitalization of the costs allocable to the livestock (that is, a taxpayer that is required by IRC section 447 or 448(a)(3) to use an accrual method of accounting or prohibited from using the cash method, respectively), that is using the unit livestock method, the unit prices must include all costs required to be capitalized under IRC section 263A [Treas. Reg. section 1.263A-4(c)(1)]. Costs that are typically required to be capitalized under IRC section 263A include the acquisition costs of the animal and the costs of management, feed, maintaining pasture or pen areas,

breeding, artificial insemination, veterinary services and medicine, livestock hauling, bedding, fuel, electricity, hired labor, tax depreciation, and repairs on buildings and equipment used in raising the animals, farm overhead, taxes, and IRC section 263A(f) interest [Treas. Reg. section 1.263A-4(b)(1)(ii)].

As shown above, IRC section 263A expanded the costs to be included in the standard unit calculation. A taxpayer that is subject to the rules under IRC section 263A requiring the capitalization of the costs allocable to the livestock (that is, a taxpayer that is required by IRC section 447 or 448(a)(3) to use an accrual method of accounting or prohibited from using the cash method, respectively), that is using the unit livestock method and that does not include all of the IRC section 263A costs in its unit prices is using an impermissible method of accounting. The taxpayer must change its method of accounting in order to include all of the IRC section 263A costs in its unit prices. This is a change in method of accounting that requires the consent of the Commissioner.

AUDIT TECHNIQUES

1. The categories shown under the farm price method are a good starting point for classifications under ULP. However, there should be a further breakdown for broilers due to the numerous end products. For example, if your taxpayer raises cornish hens, broilers, and roasters (a large roasting bird) it would need to have three classes for its broilers. Layers and breeders should definitely be separate, as should broiler eggs and layer eggs. Since each of these have different backgrounds, the costs can be very different.

2. The primary problem area today related to computation under the IRC section 263A and the related regulations. Many companies have never updated their standard unit costs for the 263A costs. Request the calculation worksheets which outline how the company computed their standard units as well as the year they were last updated. If the costs are old, request the necessary current costs to update the standard units. In many cases, although the taxpayer may not agree with the adjustment they are cooperative in providing updated computations. This can help save time and allow the taxpayer to agree with the facts.

3. When ULP is used for livestock a different method must be used for all other farm inventory. Request the inventory workpapers for feed, finished goods, etc., and verify that these are properly valued. Occasionally taxpayers will not value their inventories of purchased feed. For the large integrated poultry companies, this can be a substantial issue.

4. The following is a list of expenses included in the unit price for broilers based on a current examination.

a. Feed ─ Based on actual costs for birds processed in the last month of the tax year.

b. Grower Pay ─ Ratable over the growing cycle
c. Labor
d. Shavings
e. Sanitation
f. Field Vaccine
g. Truck Expense
h. Office Salaries
i. Communications
j. Depreciation
k. Rent
l. Insurance
m. Taxes
n. Other/Miscellaneous
o. Medications
p. Feed Hauling

This should provide a starting point from which to review the costs included by your taxpayer.

5. Consistency is extremely important in the ULP calculations. Most of the poultry companies have inventories that include millions of birds. Any changes in the computations can have a major impact on the inventory values. Be sure to ask the taxpayer if they have **ever** made any changes, the nature of changes, and whether the Commissioner's permission was requested.

At a minimum match the beginning and ending inventory computations. Review back year returns for any unusual changes in beginning and ending inventories for possible changes in computations.

Except as otherwise provided in Treas. Reg. section 1.471-6(f), a change in unit prices or classifications is a change in method of accounting that may only be made with the consent of the Commissioner. Treas. Reg. section 1.471-6(f) provides that for years beginning after August 22, 1997, a taxpayer is not required to obtain the consent of the Commissioner in order to make the required upward adjustments in the unit prices that are necessary to reflect increases in the costs of raising livestock.

6. Many of the references in the Code and regulations cover the cattle industry and are not applicable to poultry.

7. Examiner should ensure that all appropriate classifications and age groups were used by the taxpayer. Breeder chicks typically cost over $1 each while broiler chicks are more likely to cost less than $.20 each. If breeder chicks were included in the same group as broiler chicks this would substantially affect the unit price used for the group.

SUMMARY

ULP is allowable to livestock farmers for the valuation of livestock only. It is normally used in conjunction with another inventory method. Once the election to use ULP is made it can only be changed with the Commissioner's permission. Treas. Reg. section 1.471-6(f) requires the taxpayer to annually update unit prices for tax years beginning after August 22, 1997.

The calculations for unit price and the classification groups provide substantial opportunity for error and should be closely reviewed.

This page left intentionally blank.

Chapter 4

PREPAID FEED

CONTENTS

Introduction: Cash Basis Taxpayer
Revenue Ruling 79-229, 1979-2 C.B. 210
Payment for Feed versus Deposit
Business Purpose versus Tax Avoidance
Distortion of Income
IRC Section 464(f) Limitation
Case Scenario
Payment for Feed versus Deposit
Business Purpose or Tax Avoidance
Distortion of Income
Case Law
Audit Techniques
Summary

INTRODUCTION: CASH BASIS TAXPAYER

The issue of prepaid feed relates to cash basis farmers and will include not only individual Schedule F filers, but may include:

- S Corporations
- Corporations whose gross receipts for each tax year beginning after 1975 are $1 million or less
- Corporations or partnerships with corporate partners, whose trade or business is operating a nursery, or sod farm, or raising or harvesting trees (other than fruit and nut trees)
- Certain family farm corporations.

A family farm corporation can use the cash method of accounting if its annual gross

receipts for each tax year beginning after 1985 are $25 million or less and it qualifies as one of the following:

1. Corporations in which at least 50 percent of the total combined voting power of all classes of stock entitled to vote and at least 50 percent of the total number of shares of all other classes of stock of the corporation are owned by members of the same family.

2. Corporation, if on October 4, 1976, and since then, members of two families own directly or indirectly, at least 65 percent of the total combined voting power of all classes of stock entitled to vote and at least 65 percent of the total number of shares of all other classes of stock of the corporation.

3. Corporation, if on October 4, 1976, and since then, members of three families own, directly or indirectly, at least 50 percent of the total combined voting power of all classes of stock entitled to vote and at least 50 percent of the total number of shares of all classes of stock and substantially all of the remaining stock is owned by corporate employees or their family members or by a tax-exempt employees' trust for the benefit of the corporation's employees.

The entities noted above are not required to use an accrual method of accounting. A current year deduction for prepaid feed expenses is normally a matter of concern for cash basis farmers only.

Generally, yearend payments are made for a variety of expenses including the most prominent, feed. Although the transaction is not consummated until delivery and the feed not consumed until the subsequent year; the taxpayer will claim the deduction in the year paid. This generates the tax concept of -- **Advanced Payment of Feed.**

Advance payments for feed are considered under Revenue Ruling 79-229, 1979-2 C.B. 210. The failure of the taxpayer to meet any of the three tests stipulated within the ruling will cause a disallowance of any deduction.

REVENUE RULING 79-229, 1979-2 C.B. 210

A cash basis taxpayer engaged in the business of raising or feeding livestock may deduct, in the year of payment, amounts paid for livestock feed to be consumed in a subsequent year provided:

1. The expenditure is for the purchase of feed rather than a deposit.

2. The prepayment is made for a business purpose and not for tax avoidance.

3. The deduction will not result in a material distortion of income.

Careful development of the facts is essential since all three of the tests must be met for the deduction of the prepayment. The taxpayer's records will be critical to the

successful pursuit of the issue. Review of each test will focus attention on the benefits of early development of the facts.

Payment for Feed versus Deposit

- Is the price fixed by contract?

- Is the amount fixed by contract?

  The fact that there is a stated quantity and the price is not fixed, but based upon market price at delivery, will not, standing alone make the transaction a deposit.

- Can the purchase price be refunded?

  If the purchase price is refundable, it may be a deposit.

- Is the treatment of the expenditure used as a deposit by the seller?

- Does taxpayer have right to substitute other goods or products for the feed (other than varying the ingredients to accommodate the dietary requirements of the livestock)?

The treatment of the expenditure by the seller may be dictated by the seller's method of accounting. However, the seller's treatment as a deposit is a factor for disallowance. In addition, if substitution of goods or products is present, this may also provide a basis for a deposit versus payment.

Revenue Ruling 79-229 states that, "the following factors, although not all inclusive are indicative of a deposit rather than a payment: the absence of specific quantity terms; the right to a refund of any unapplied payment credit at termination of the contract ***; the treatment of the expenditure as a deposit by the seller."

Business Purpose Versus Tax Avoidance

This test requires the prepayment be made for a business purpose rather than for tax avoidance, and again is largely determined by factual circumstance. Is there a reasonable expectation that the taxpayer will receive some business benefit because of the prepayment? The following are examples of business benefit:

- Fixing maximum prices and securing an assured feed supply.

- Securing preferential treatment in anticipation of a feed shortage.

A taxpayer making the payment in the last few days of the tax year generates the concern relative to tax avoidance. The tax year of the taxpayer may itself be a material factor. If the purchase of feed is made when the costs are generally at

their lowest, then there is more credibility that a business purpose exists. If the year end purchase coincides with high feed prices, the purpose may lend itself more to tax avoidance.

Distortion of Income

There are several factors to consider when determining whether income has been distorted:

- Has an asset resulted with a useful life beyond the taxable year paid?
- Is this materiality of the expenditure to the taxpayer's income?
- Was customary, legitimate business practice followed?
- Is the amount of expenditure in relation to past purchases?
- What is the timing of expenditure?

Exhibit 4-1 provides interview questions directed towards a Company claiming a prepaid feed deduction involving hedging transactions.

IRC SECTION 464(f) LIMITATIONS

IRC section 464(f) provides a mechanical test for determining when prepaid farming expenses are allowed to a cash basis farm taxpayer. Generally, the statute precludes deduction for prepaid feed and supplies expenses until the year consumed to the extent they exceed 50 percent of deductible non-prepaid farming expenses for each year. Therefore, if the taxpayer has met the requirements of Revenue Ruling 79-299, they would still be subject to the limitation of IRC section 464(f). IRC section 464(f) does not revoke or in any way replace the provisions set forth in the Revenue Ruling.

The Service addresses prepaid feed issues on a case by case basis. Each case contains a variety of facts and circumstances. Some involve commodity futures with purchases from national leaders in feed supply, while others involve local feed transactions.

CASE SCENARIO

The following case scenario identifies the facts and thought process demonstrating the Service's position in applying the three tests of Revenue Ruling 79-229:

> The taxpayer is a Sub Chapter S corporation utilizing the cash method of accounting with a tax year ending in October. At yearend, they generally contract with a leading national supplier of feed ingredients to provide weekly deliveries throughout a period beginning in the next fiscal year. The total contract price is paid prior to the close of the current fiscal year. The farm is also involved in hedging transactions, entering into purchases of futures contracts. All futures contracts are closed by offset during October.
>
> Prices for the feed are established beginning with prices charged in the futures market and consist of two components -- **Futures Price** and **Basis.** The **Futures-Price** is established on the Chicago Board of Trade. **Basis** is the difference between the futures price of the item and the cash price for local delivery.
>
> Although contracts specify the quality of feed to be delivered, industry standards allow for deviations. If lower quality commodities are shipped, the contract price is adjusted downward to reflect the market value of the lower quality feed. The cost adjustment is taken into account by increasing the amount of grain to be delivered in the next contract. Likewise, when higher quality commodities are shipped, the contract price is increased and is reflected by a smaller shipment in the next contract. At yearend, any net underpayment is resolved by shipping additional product. If over-shipments remain at yearend, the taxpayer pays the supplier.
>
> The feed supplier treats the prepayment as a liability (deposit) and recognizes the income from the contract as the grain is shipped. The supplier is an accrual basis taxpayer.

Payment for Feed versus Deposit

Under the Revenue Ruling, factors that are indicative of a deposit rather than purchase include:

- Absence of specific quantity terms
- Right to a refund if any unapplied payment or credit at the termination of the contract
- Treatment of the expenditure as a deposit by the seller
- Right to substitute other goods or products for the feed ingredients specified in the contract.

The aforementioned scenario contains specific quantity terms. Debits due from and credits due to the taxpayer from over or under deliveries or quality differentials are netted monthly. At yearend, any debit or credit balances are resolved by additional

shipments or cash payments. Accordingly, by virtue of its right to receive an additional amount of feed equal to a yearend credit balance, the taxpayer receives the economic equivalent of a refund. Moreover, if the taxpayer chooses not to enter into a contract in the next year, it is likely that a cash refund would be made for any outstanding credit amount. This factor is deemed to be in the Government's favor.

Other criteria supporting treatment of the payment as a deposit are that the supplier treats the payment as a deposit and the supplier, pursuant to industry practice, may substitute the goods specified in the contract with goods of lesser or greater quality.

Business Purpose or Tax Avoidance

It has been established that the contracts are entered into and payments made just prior to the close of the tax year.

In the ***Clement v. United States,*** 500 F.2d.422 (CT. C1.1978), the court held that payments made near the end of the tax year were not for a tax avoidance purpose when there was a legitimate business purpose served by the prepayment. The business purpose sanctioned by the ***Clement*** court case included: fixing a maximum price; obtaining a guaranteed supply while avoiding effects of feed shortages; and obtaining advantages in negotiation of storage and delivery terms.

Although entering into a supply agreement may have a legitimate business purpose, it does not necessarily follow that there is a business purpose served for prepaying the contracts. Recall that the contract prices are based upon the combination of futures prices for the commodities plus basis reduced to present value. Thus, it makes no difference to the supplier whether payments are made at delivery or when the contracts are entered into, because taking the time value of money into account, the supplier would receive exactly the same amount. The only reason for the prepayments, it would appear, is to accommodate an early tax deduction. Remember too, that the three tests in Revenue Ruling 79-229 must be applied independently. Thus, even if payment has a business purpose, a current deduction may not be permitted if the payment was a deposit, or the deduction would materially distort income [***Clement v United States, supra***].

Distortion of Income

Based upon statistics of gross income compared to feed usage, and compared to profits, an argument exists for distortion of income. This particular case reflects the following values for the fiscal years 1992 and 1993:

- Gross income increased 33 percent or $51.5 million
- Feed consumption increased 14.3 percent or $12.7 million
- Net income **decreased** by $.2 million.

Since feed costs are the single largest variable involved in raising livestock, the smaller increase in feed consumption versus gross income would indicate a substantial increase in net income. As noted above this was not the case. Per a review of feed costs the prepaid feed expense more than doubled from $36.9 million to $76.5 million, thus causing the financial results for 1993 to be materially distorted. In 1994, with a 6 percent increase in gross income and 19 percent reduction in feed consumption with prepaid feed reduced from $76.5 million to $64.3 million; net income increased to $8.7 million, an increase of 443 percent over 1993.

Although the distortion in the taxpayer's income cannot be contributed to the prepayment deduction alone, it is a major factor.

This example may be a sophisticated approach with the infusion of the commodity futures contracts. However, only the taxpayer’s resources and ingenuity limit the variety of situations.

CASE LAW

There are several cases, both prior to and subsequent to, the Revenue Ruling. The Government's success rate on these cases is not impressive, yet today's taxpayers are taking more aggressive positions on the premise that examiners may not be willing to invest resources into an area where legislative history has been favorable to the taxpayer. It is paramount that the facts of each situation be determined and explored for pursuit.

This can best be illustrated by the most recent case involving Prepaid Feed ─ ***GREGG et al, O. L. v. United States,*** (1994,CAS) 74 A.F.T.R.2d 94-5073. Summary judgment was properly granted to IRS denying the rancher's prepaid feed expenses (taxpayer bought large amounts of feed at the end of each year and resold it to seller at the beginning of following year). Given the undisputed facts in this case, taxpayer's testimony was insufficient to raise fact issue as to the existence of business purpose for the prepaid expense: amount of feed purchased greatly exceeded amount that could be consumed by taxpayer's cattle; taxpayer's

only testimony for expansion plans was, "he always did want to get more cattle," and it was hard to conceive that the taxpayer would prepare for a large increase at the beginning of each year and then change his mind a few weeks later.

AUDIT TECHNIQUES

Due to the subjective nature of the tests for prepaid feed, an interview will be the best information gathering tool available to the examiner.

The interview outlined in Exhibit 4-1 provides guidance where the prepaid feed issues is intertwined with hedging transactions.

Exhibit 4-2 provides in-depth questions for the outside third party involved in the transaction as the seller.

SUMMARY

Although farmers are allowed to deduct prepaid feed expenses, there are specific rules they must meet. The farmer must have actually paid for feed versus having made a deposit for future purchases. There must be a business purpose and the deduction should not materially distort income.

As has been discussed throughout this guide, it is very important to determine if the taxpayer is a farmer. Special deductions and benefits are available for taxpayers who are farmers; thus, it can be a coveted title.

SAMPLE INTERVIEW QUESTIONS FOR PREPAID FEED WHEN HEDGING TRANSACTIONS ARE INVOLVED

The Service employs Financial Products Specialists (FPS) who are available to work cases with the examiner. The following questions were developed by an FPS for a prepaid feed case:

1. Who is the corporate official(s) authorized to make investment decisions?

2. Who approves the transactions?

3. What is the corporation’s hedging, trading and accounting policies regarding hedging and speculative transactions? INCLUDE all transaction policies involving financial products such as futures, forwards, options, and notional principle contracts.

4. What specific financial products does the corporation trade and for what purpose?

5. What records does the corporation maintain that related to the hedging activity?

   - REQUEST a copy of the hedge programs.

6. Does the corporation maintain records or computations reflecting the relationship between the financial products and the item(s) hedged?

   - REQUEST documentation of why and when each hedge is taken.

7. What brokerage accounts are maintained? (For example, margin accounts, hedging and non-hedging accounts, managed or discretionary accounts.)

   - REQUEST schedules, account agreements and margin agreements.
     - Documents which support account(s) (for example, signature card, authorization to transfer funds, hedge letter, power of attorney).
   - REVIEW any hedging journal entries with person being interviewed.

8. Were the transactions treated differently for book and tax? If so, how were they different?

This page left intentionally blank.

Date:
THIRD PARTY
INTERVIEW QUESTIONS RELATIVE
TO FEED PURCHASES

Initials: Persons Interviewed: Vendor:

Purchaser:
I, ____, state that:

I reside at ____.

1. Did you receive any prepayments from the taxpayer during the year? If so, on what dates?
2. Was this an outright purchase of feed or the right to purchase feed?
3. How long have prepayments been made between you and the taxpayer? Has he consistently made prepayments for the purchase of feed?
4. Did the taxpayer get a discount for his volume of purchases?
5. What was the original price of the feed and what was the discounted price?
6. What volume of purchase would you have required to receive this amount of discount?
7. Was this discount given to other purchasers during that year?
8. Could he have gotten a discount at other times during the year for a similar purchase?
9. Are there other discount methods available to the buyer? If so, please explain.
10. Who brought up the idea of a prepayment for feed? Was it you or the taxpayer?
11. What reasons for such a purchase were discussed?
12. Could the taxpayer have made a similar purchase 3 days or a week later as far as you were concerned? If not, why?
13. Did the taxpayer pay interest to you?
14. Did you pay the taxpayer interest?
15. What was the rate of interest charged and how did you reach an agreement on that rate?

16. Why was interest paid on a purchase? Is this normal?

17. Was there a storage fee involved?

18. Where is the feed picked up? Whose trucks are used?

19. How are the pick-up times determined? Are they prearranged or during normal business hours?

20. What happens if the taxpayer requires feed on the weekends?

21. How long could the delivery dates be extended? REVIEW letter of credit.

22. Could this be done at either party's request?

23. Does this contract fix a maximum price on the feed?

24. What happens if the price of feed changes? Increase/decrease?

25. Is an adjustment made to the contract price to reflect market value at the date of delivery?

26. Could the taxpayer substitute another ingredient or another asset of equal value?

27. Does your firm provide analysis of feed required for livestock growers? If so, is this cost included in the feed costs?

28. What happens if the payor wants a refund?

29. What would happen if the taxpayer went into "bankruptcy" and asked for a refund? Even though the contract states such and such, please explain what would really happen?

30. Who prepared the contract for sale?

31. Under the section "Terms", why was it required that the payment be received before a predetermined date? Whose idea was this requirement?

32. There is a section titled "Force Majeure". Please explain? Does this mean the taxpayer could possibly get a refund?

33. If feed ingredient costs went up could you actually incur a loss on this transaction?

34. What is your reason for entering into the arrangement?

35. Was the tax treatment/tax effect of this transaction discussed with the purchaser?

36. Does this mean the taxpayer has an assured feed supply?

37. Does ____________________________________ any of its shareholders own or have any interest in a farming operation that uses feed?

38. From whom do you get your feed?

39. Would you give the taxpayer preferential treatment in the case of a feed shortage? In anticipation of a feed shortage?

40. What if you needed all the feed milled for your own operation. Would the taxpayer still be assured of a feed supply after the contract had expired?

41. Where does the taxpayer rank in their amount of feed purchases?

42. Is that above or below your own related companies ranking and needs?

43. Does the taxpayer prepay all his purchases from you?

44. Do you require that all purchases be prepaid?

45. Would you or would you not advance the taxpayer feed on a credit?

46. How many purchases did you allow the taxpayer to make without any prepayment and how many times did the taxpayer prepay?

47. Is the prepayment of feed a condition normally imposed by you?

48. Why was the check made to __________________________ and the confirmation letter" from ________________________________? Do they file a consolidated return?

49. How was the receipt of these funds treated on your books for tax purposes? Are you on the cash basis or the accrual basis of accounting?

50. Do you have an annual price list for feed costs? If so, may I get copies?

51. Do you project your feed ingredient costs? If so, what information source do you use to make these projections? May I have copies of those also.

52. Was a letter of credit issued? Why or why not? Is this a normal procedure? Is it done or not done in some cases? At whose request would it normally be done?

53. Do you have a correspondence file for the taxpayer? May we see it or do I need to issue a summons to get it?

This page left intentionally blank.

IRC SECTION 108
INCOME FROM DISCHARGE OF INDEBTEDNESS

CONTENTS

- Introduction
- IRC section 108
  - Income from Discharge of Indebtedness
  - Definition of Farming
  - **Qualified Farm Indebtedness**
- **Limitation**
- **Reduction of Tax Attributes for Farmers**
- IRC section 1017
- Forgiveness of Shareholder Debt
- Acquisition of Debt by Related Party
- Audit Techniques
- Summary

INTRODUCTION

In 1931 the Supreme Court established the principle that any gain or savings from the reduction or discharge of a debtor's outstanding indebtedness, for less than the actual amount due, is income for federal tax purposes. See ***United States v. Kirby Lumber Co.,*** 284 U.S. 1 (1931). This was later codified under IRC section 61(a)(12).

However, there are situations where it would create a major hardship if a taxpayer were required to pay taxes on income from a discharge of indebtedness. For example, bankruptcy debts are routinely "settled" or discharged for less than the actual amount due. Under IRC section 61, the forgiven amount would be taxable income. Yet, when a person is already in a bankrupt or insolvent status they are not in a position to pay more taxes. Recognizing this inequity, Congress passed IRC section 108 that provided exceptions for insolvent or bankrupt taxpayers.

During the 1980's the number of farmers forced into selling the family farm increased dramatically. This caused substantial damage to the affected family and it became apparent that a separate exception for farmers would be beneficial. Thus Congress added IRC section 108(a)(1)(C) in 1986 which provides that gross income does not include any discharge of indebtedness if the indebtedness is from qualified farm indebtedness.

IRC SECTION 108

Under IRC section 108, relief is provided in three main situations in addition to the discharge of qualified farm indebtedness. The two most prevalent are discharges under a Title 11 (bankruptcy) case or where the taxpayer is insolvent. An exclusion is also provided for taxpayers, other than C Corporations, where the discharge pertains to qualified real property business indebtedness. The first two exclusions are involuntary; the taxpayer does not have the option to choose whether to exclude a debt discharge amount from income in these situations.

The term "insolvent" means **an excess of liabilities over the fair market value of assets.** The insolvency exclusion under IRC section 108 applies **only** to this excess. The determination is made immediately before the discharge of indebtedness and locks in the amount of the insolvency exclusion. IRC section 108(d)(3).

If an insolvent taxpayer is also in Title 11 bankruptcy, the exclusion for bankruptcy will take precedence and none of the discharge will be taxable. As discussed later, after excluding discharge of indebtedness amounts from gross income, the taxpayer must reduce other tax attributes pursuant to IRC section 108(b) other than qualified real property business indebtedness, for which the reduction is pursuant to IRC section 108(c). Taxpayers in bankruptcy or who are insolvent and who have not applicable tax attributes or who have exhausted those attributes, may exclude amounts of discharge of indebtedness income even though they have not remaining tax attributes available to be reduced.

> Example 1
>
> John's liabilities are $20,000 and the fair market value of his assets are $15,000 immediately prior to his realizing a debt discharge of $7,000. Based on the Code's definition, John's insolvency exclusion was $5,000 (20,000-15,000). He will *recognize* income from discharge of indebtedness in the amount of $2,000. Thus, cancellation of debt income is *recognized* to the extent John is made solvent by the discharge.
>
> If John had been in bankruptcy under Title 11 at the time of the discharge, the Title 11 exclusion would have taken precedence and he **would not** have *recognized* **any** taxable income from the discharge.

If your taxpayer does not qualify under Title 11 and is solvent then you need to look to the other two exclusions. For purposes of this chapter, we will be concentrating on the exclusion covering the discharge of farm indebtedness.

Income from Discharge of Indebtedness

Before any exclusion can be determined, it is necessary to define what is meant by income from the discharge of indebtedness. Generally, a discharge of indebtedness takes place when a creditor reduces, in whole or part, the amount owed. The income amount is easy to calculate when the creditor simply reduces the amount owed. Usually, though the creditor receives some type of non-cash payment which can complicate the identification of discharge income. When a creditor reduces a debt as compensation for services, that is treated as compensation and not as cancellation of indebtedness. See Treas. Reg. section 1.61-12(a).

In many cases, the debtor transfers property to the creditor under an agreement that either reduces or eliminates the debt. If property is transferred to satisfy a recourse debt (debtor is personally liable) the property is treated as if it were sold by the debtor at Fair Market Value (FMV). Thus, the debtor will realize gain or loss to the extent the FMV exceeds the adjusted basis in the property. Gain or loss from the sale of property is not subject to the exclusion provisions of IRC section 108.

If the recourse debt exceeds the FMV of the property and the creditor releases the debtor from the remaining liability, the difference is income from the discharge of indebtedness. (Revenue Ruling 90-16, 1990-1 C.B. 12. Treas. Reg. sections 1.166-6(b) and 1.1001-2(c), Example 8.) In such a case, a taxpayer may realize both cancellation of indebtedness income and gain or loss from the sale of property.

What if the property is transferred to satisfy a non-recourse debt? In that case, the full amount of the canceled debt is treated as proceeds from the sale or exchange of the transferred property and gain is measured by the difference between the basis of the transferred property and the amount of the debt. This is true even if the value of the property is less than the unpaid balance of the debt. (***J.F. Tufts***, 461 U.S. 300 (1983).

Example 2

In 1995 Joe York owed Mary Pope $100,000. During the year he transferred property with an adjusted basis of $75,000 and a FMV of $90,000 in full satisfaction of the debt.

If the debt is "recourse debt" Joe will realize a gain of $15,000 (90,000-75,000) and income from the discharge of indebtedness in the amount of $10,000. The $10,000 may be excludable from income if Joe York meets one of the criteria under IRC section 108(e)(2).

If the debt had been "non-recourse debt" Joe would have realized a gain of $25,000 (100,000 - 75,000) and -0- income from the discharge of indebtedness. None of the gain is subject to exclusion under IRC section

108.

Under IRC section 108(e)(2), a taxpayer does not recognize income from discharge of indebtedness if the payment of the debt would have been deductible as an expense on his tax return. This can happen where interest on a loan is forgiven. Since the taxpayer could have deducted the payment of interest, he has just lost a deduction. If the Code included the forgiveness as income, it would also allow a deduction for the expense; thus, there would not be any tax affect. See also Revenue Ruling 67-200, 1967-1 C.B. 15, for the treatment of interest already deducted by an accrual basis farmer and later discharged by the creditor.

If the taxpayer owes a debt to the seller for the purchase of property any reductions in the amount owed is generally considered to be a reduction in the purchase price of the property and not as a discharge of indebtedness. The debt must arise from the purchase and the debtor may not be in bankruptcy or insolvent. The taxpayer's basis in the property should be adjusted accordingly. See, IRC section 108(e)(2).

After establishing that a taxpayer has income from the discharge of indebtedness the exclusion applicable, if any, under IRC section 108 needs to be determined. Since both the insolvency provision and the bankruptcy provision take priority over discharge from qualified farm indebtedness, only a solvent farmer who is not in bankruptcy can have qualified farm indebtedness. However, an insolvent farmer who has income from the discharge of indebtedness excluded under the insolvency exception and, thereby, becomes solvent, can then use the farm indebtedness exclusion. But who is considered a farmer and what is qualified farm indebtedness?

Definition of Farming

Most of us feel confident that we can recognize a farm when we see one. However, it is not always that simple, especially with the large integrated companies. As outlined in the general introduction, most of the poultry companies are vertically integrated from the breeder stock to the grocery store. This leaves us with the question: “Where does the farming operation stop?” IRC section 108(g) does not define the term “trade or business of farming” for purposes of this exclusion.

Over the years several court cases as well as numerous Code sections emerged during the struggle to properly define the farming business. In ***Maple Leaf Farms v. Commissioner***, 64 T.C. 438 (1975), ***acq***. 1975-2 C.B. 2, the court held that "farming" includes the operation of an integrated poultry-processing business. ***Maple Leaf Farms*** was extremely small by today's standards and did not include the tremendous extension into further processing activities engaged in by most of the current integrated companies. In many ways this has confused the issue by making it appear that today's integrated companies will qualify as farming businesses from start to finish. This is not accurate.

The Code contains numerous definitions of farming, none of which include the processing activity. IRC section 464(e) defines farming as:

> "***[T]he cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals. For purposes of this definition, trees (other than trees bearing fruit or nuts) are not treated as an agricultural or horticultural commodity."

Treas. Reg. section 1.61-4(d) provides that the term "farm" embraces the farm in the ordinarily accepted sense and includes poultry farms. It does not include processing operations.

IRC section 108(a)(1)(C) was included in the Code under the same Act in 1986 that brought in IRC section 263A. In recognition of the need for a more specific farming definition Temp. Treas. Reg. sections 1.263A-4(a)(1), 1.263A-4(a)(4)(I) and 1.263A-4(a)(4)(ii) state that the term "farming business" does not include the processing of commodities or products beyond those activities which are normally incident to the growing, raising, or harvesting of such products. This is confirmed under Treas. Reg. section 1.263A-4(a)(4)(iii) Example 3, that specifically reviews an integrated poultry operation and concludes the business of farming stops where the meat processing operation begins.

Some of the integrated companies maintain separate subsidiaries for the farming and processing operations which make it much simpler to distinguish the manufacturing activities from the farming activities. Even with separate entities, the examiner should still review the SEC filings, annual reports, and proxy statements for information which divides the total sales between farming activities and processing or manufacturing activities.

Qualified Farm Indebtedness

IRC section 108(g)(2) provides the two basic rules governing the definition of qualified farm indebtedness:

1. The indebtedness must be "incurred directly in connection with the operation by the taxpayer of the trade or business of farming.

2. 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of indebtedness occurs is attributable to the trade or business of farming.

Treas. Reg. section 1.1502-12 provides for a separate entity approach in calculating a member's separate taxable income unless provided otherwise in the consolidated return regulations. These regulations do not make any provision for a consolidated calculation under IRC section 108 and no guidance has yet been issued regarding the application of Treas. Reg. section 1.1502-12 to IRC section 108. Thus, status as a farmer for purposes of the discharge exclusion is determined separately for each member of a consolidated group.

Example 3

> A Parent Company purchases poultry from its wholly owned subsidiary and processes the birds for sale to outside third parties. The Parent Company does not receive any gross receipts from the trade or business of farming and thus probably would not qualify for the IRC section 108(a)(1)(C) exclusion.

In specifying the type of debt contemplated in this section, the Senate Finance Committee stated that:

> Qualified agricultural indebtedness is defined as debt incurred to finance the production of agricultural products * * * (including timber) or livestock in the United States, or farm business debt secured by farmland or farm machinery and equipment used in agricultural production. S. Rep. No. 99-313, 2d Sess. 272 (1986).

Qualified Person

Congress wished to ensure that only people who truly needed the special help received benefit from the discharge rules. Thus there are several limitations under IRC section 108(g)(1)(B). In order to be a qualified person:

1. The creditor must be actively and regularly engaged in the money lending business or a government agency or its agent.

2. The creditor cannot be related to the farmer.

3. The creditor cannot be the person (or a person related to such person) from whom the farmer purchased or received the property.

4. The creditor (or a person related to the creditor) cannot receive a fee with respect to the farmer's investment in the property. This limitation eliminates the possibility of profit for a shelter promoter.

itation

The exclusion for the discharge of farm indebtedness is limited by IRC section 108(g)(3) to the total of the taxpayer's adjusted tax attributes in the year the debt is cancelled plus the total adjusted basis in all qualified property held by the taxpayer as of the beginning of the tax year after the tax year in which the discharge took place. Anything over the limitation amount is recognized as taxable income.

The limitation accomplishes two purposes. It defers the recognition of income by spreading it over the depreciable lives of the farmer's remaining assets. If the tax attributes are not large enough to provide a deferral it causes the income to be

currently reported thus ensuring that the income will not be permanently deferred. Congressional intent was to allow a deferred benefit rather than a complete exclusion for solvent farmers which would, in turn, ease the credit crisis in the farming sector.

Example 4

The Farmers Home Administration (FmHA) discharged $12,000 of farm debt incurred by Ada Bullock. For the three years immediately preceding the debt discharge year, 50 percent or more of Ada's total gross receipts were attributable to farming.

The full $12,000 is excludable from Ada's income under IRC section 108(a)(1)(C) subject to the limitations in IRC section 108. The discharge was made by a qualified person and the debt was qualified farm indebtedness.

Reduction of Tax Attributes for Farmers

Earlier it was noted that the bankruptcy and insolvency exclusions take precedence over the exclusion for farmers. This is important. In addition to limitations on farm debt, the order of reduction in tax attributes differs based on the specific exclusion under which the discharge qualifies.

Under IRC section 108(g) the exclusion for qualified farm indebtedness cannot exceed the sum of (1) the adjusted tax attributes of the taxpayer **and** (2) the aggregate adjusted basis of all qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year of discharge.

The order in which of tax attributes must be reduced under the farm exclusion is:

1. Net operating losses.
2. General business credit carryovers.
3. Minimum tax credit.
4. Capital loss and capital loss carry forward.
5. Basis of qualified property.
6. Losses and credits disallowed (and suspended) under passive loss rules.
7. Foreign tax credit carryovers.

The main difference under this exclusion versus the bankruptcy and insolvency exclusion involves the reduction to asset basis. The two main exclusions allow a reduction to the basis of all assets and include this basis reduction as part of the regular tax attributes between items D and E above. The farm exclusion limits the basis reduction to qualified property but does not change the order in which the attributes are reduced. See, IRC section 1017(b)(4).

Qualifying property for farmers is property used or held for use in a trade or business or for the production of income.

Example 5

John Dade received $20,000 income from the discharge of qualified farm indebtedness. He has the following assets and basis:

- Personal Residence 50,000
- Rental Property 10,000
- Tractor -0-

If John is insolvent or under Title 11 bankruptcy he can apply the basis reduction to all assets. Under the farm exclusion, only the tractor and the rental property are qualifying property. Note: The exclusion is not limited to farm property, the rental property qualifies as income producing property.

Any reductions to basis are treated as depreciation reductions subject to recapture if the property is later sold or disposed of by the taxpayer. See, IRC section 1017(d).

Amount and Manner of Reduction

Generally, the amount of the reduction in tax attributes is one dollar for each dollar of income excluded, except for credits where the reduction is 33 1/3 cents for each dollar excluded. The reduction to the tax attributes is made after the end of the tax year. Thus, it does not affect the year of discharge.

The reductions within each category of attributes pertaining to losses and credits are made in the order in which the attribute would have been used. Thus, the current year's loss would be reduced first then any further reductions would be made to loss carryovers in the order in which they arose. This holds true for the credits and credit carryovers also.

An excess of discharge over the available tax attributes and qualifying property is gross income except for taxpayers relying on the qualified farm indebtedness exclusion of IRC section 108(a)(1)(C). Taxpayers in bankruptcy can exclude amounts in excess of their reduction in tax attributes. Insolvent taxpayers can exclude amounts in excess of their reduction in tax attributes, but only up to the amount of the insolvency.

Under IRC section 1017(b)(4)(C), an interest of a partner in a partnership, or a stock interest of a parent corporation in an 80 percent or more owned subsidiary, may be treated as depreciable property for basis reduction purposes if there is a corresponding reduction in the basis of qualifying depreciable property held by the partnership or corporation.

Example 6

Using the information from Example 5, the exclusion under qualified farm indebtedness would be $10,000, the basis in qualified property.

IRC SECTION 1017

IRC section 1017 provides the rules under which the basis in property is reduced for an IRC section 108 exclusion. It outlines the appropriate asset order for each type of exclusion.

In the case of the qualified farm indebtedness exclusion, the basis in qualified property must be reduced in the following manner as per IRC section 1017(b)(4)(A):

1.Depreciable property

2.Land used or held for use in the business of farming

3.Other qualified property

Under IRC section 108(b)(5) a taxpayer may elect to apply the tax attributes reduction first against depreciable property (land is not depreciable). The election applies only to qualified property in the case of an exclusion of qualified farm indebtedness. This is a very attractive election for a solvent taxpayer with credits or net operating losses which are usable in the next tax year. The effect of the election is that the lower depreciation is incurred ratably over the life of the asset while allowing an immediate benefit from the other tax attributes. The longer the asset life, the more attractive this election is to the taxpayer.

Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness) **must** be filed with the return for the taxable year of discharge in order to make the election to reduce basis of depreciable property under IRC section 108(b)(5).

FORGIVENESS OF SHAREHOLDER DEBT

The discharge of indebtedness of a shareholder's debt by a corporation is treated as a distribution of property and IRC section 108 does not apply. A shareholder whose debt to a corporation is forgiven realizes dividend income to the extent of the corporation's earnings and profits available for distribution.

If the shareholder's debt is canceled in connection with the complete liquidation of the corporation, the cancellation is treated as a distribution of property in exchange for the shareholder's stock. Consequently, the amount treated as received for the debt enters into the determination of the shareholder's gain or loss on the liquidation.

ACQUISITION OF DEBT BY RELATED PARTY

IRC section 108(e)(4) treats the acquisition of debt by a person related to the debtor from an unrelated creditor, as an acquisition by the debtor. This means that the debtor is seen as canceling his or her debt for the amount paid for the debt by the related party. Treas. Reg. section 1.108-2(a). The debtor's amount realized as income from discharge of indebtedness is measured by reference either to the adjusted basis of the related holder in the indebtedness on the acquisition date or to the fair market value of the indebtedness on the acquisition date, depending on whether the holder previously had acquired the indebtedness by purchase on or less than 6 months before the acquisition date. Treas. Reg. section 1.108-2(f). Income so realized is excludible from gross income to the extent provided in IRC section 108(a).

AUDIT TECHNIQUES

1. In some cases, the taxpayer will have attached a written election outlining the transaction, the qualifying exclusion, and any elections under IRC section 1017. This will normally be true for qualified farm indebtedness exclusions since these are voluntary elections. If such a statement is not attached this information should be requested.

2. A second way of locating a transaction under IRC section 108 is provided through the normal balance sheet comparative where a large decrease in payables could lead to a more in-depth review of the general entries to verify if any discharges have occurred.

   There have been several incidents in which a solvent taxpayer has claimed an exclusion under the qualified farm indebtedness even though they did not meet the rules under IRC section 108(g). Some have attached elections and others were found by analyzing the payables. Most were ineligible due to their nonfarm status.

3. For qualifying taxpayers the examiner should verify that tax for the taxable year following the year of discharge was computed after the reductions to tax attributes under IRC section 108(b) or IRC section 1017 were made. If a basis reduction was made the examiner should review IRC section 1017 and ensure the proper order of reduction was followed.

   NOTE: All reductions are made after tax is determined for the discharge year. If a discharge does not qualify for exclusion the effect on the current year will be an adjustment disallowing the exclusion of income from the discharge of indebtedness. The adjustments to future years will be in the taxpayer's favor since they deal with reinstating the tax attributes to the amounts prior to any reductions.

In most cases the agent will follow up to make sure the taxpayer has the necessary information to correctly file future returns. However, some of the larger companies prefer to handle these corrections in house.

4. Any time property is transferred in full or partial satisfaction of a debt the calculations determining the debt discharge versus the gain should be closely scrutinized. This is a very common area for mistakes. It is to the taxpayer's advantage to classify the entire gain as debt discharge so it can be excluded. For example:

   a. The gain on foreclosure sales involving non-recourse debt is often calculated using the FMV of the property instead of the full amount of the cancelled debt.

   b. The gain from the transfer of property under a non-recourse debt is sometimes incorrectly treated as income from the discharge of debt and excluded from income under the insolvency provisions.

5. The creditor should file a Form 1099-C, if it is a financial entity or a part of the Federal Government, or another entity specified in IRC section 6050P(c) any time debt has been forgiven. Many creditors are confused by the rules dividing gains and losses from debt discharge as highlighted by the numerous errors noted in the Forms 1099-C filed by FmHA. Examiner should verify the accuracy of any Form 1099-C. Also, note that a Form 1099-C only reports the amount of discharged debt. It does not indicate whether the debtor may exclude amounts from gross income under IRC section 108.

6. When corporate debt is acquired at a discount from a bank or government agency by a controlling shareholder (related party) the company should report income from discharge of indebtedness. The corporation may overlook this income.

SUMMARY

IRC section 108 provides a benefit to eligible taxpayers with some very strict rules as to who qualifies along with the order and amount affecting tax attributes. Unless a taxpayer is in bankruptcy or insolvency, any discharge of indebtedness will be offset equally by either a reduction to a tax attribute or inclusion in taxable income. Taxpayers in bankruptcy or who are insolvent are also required to reduce tax attributes, but may still exclude amounts after their tax attributes are exhausted.

The benefits of IRC section 108 are only available on discharge of indebtedness income. Thus, it is very important to correctly identify any other income involved in a transaction in which there appears to be a debt discharge.

Given all of the precautions taken by Congress to ensure only specific situations were to receive the special exclusions it is apparent that the benefits under IRC section 108 can substantially affect the amount of federal income taxes owed when a debt is discharged. Under these circumstances, it can be expected that taxpayers will strive to place themselves under its protective umbrella.

Chapter 6

"SWEETHEART DEALS"

CONTENTS

Introduction
Pre-1986 Law
Post-1986 Law
IRC section 263A
Sweetheart Deals
Audit Techniques
Summary

INTRODUCTION

A common practice in the poultry industry is the placement of chicks (broiler flocks) with independent growers to meet the company's production requirements. Each grower enters into a contractual arrangement with the poultry company. The typical contract is designed by the company and is normally limited to one year or one flock. The poultry company, also known as the integrated company, normally uses their own hatcheries in order to obtain the chicks needed for placement. These hatcheries enable them to control the quality of the birds used as well as maintaining a steady supply of chicks. The one-day-old chicks are delivered to the farms by the poultry company trucks per a pre-determined schedule. The flocks are numbered and monitored from the placement date to the completion date by technicians employed by the poultry company. The feed and medication are produced or supplied by the company with specific daily requirements for optimum weight gain.

Poultry contracts are advantageous to both the growers and the integrators. The benefits inherent in these contracts for the growers include: (1) less production and price risk, (2) insulation from price changes, (3) relatively predictable income, (4) reduction of production responsibilities, and (5) less operating capital required. The integrated companies benefit through the fixed assets provided by each grower, reduced liability for disposal of dead birds, quality management, and an increase in performance which is obtained from flocks on competitive contracts.

Per these contracts, the integrators are responsible for furnishing the growers with chicks, feed, and medication for the production of their broilers. In addition, they provide technical advice periodically during the growout period, which normally requires 4 to 6 weeks. The production weight per each bird will range from approximately 4 to 6 pounds depending on several factors. These include the birds' final destination as well as the flock mix and the company's current needs.

The grower's duties include furnishing all labor, utilities, supplies, housing, and equipment. Depending on company policy the grower may also provide the fresh sawdust or litter which is placed in the poultry houses prior to the arrival of each new flock. Under the contract, the grower agrees to care for the flocks' feed and medical needs, maintain a healthy and disease free environment, dispose of dead birds in accordance with local and state laws, and assist the catching crews in loading the flocks. All housing and equipment must be maintained according to the standards set by the companies.

As compensation under the contract, growers receive a payout or settlement after the birds are picked up and taken to be processed. The final settlement is normally less than one cent per pound and computed on the net weight gain per bird. Delivered weight is subtracted from the production weight to obtain the net gain per flock. An incentive payment is made for the growers producing above average gains compared to the other growers in the same growout complex. A growout complex is a geographical location of several growers.

Increasingly, integrators have entered into long-term contracts with the growers in order to encourage additional construction of houses. This agreement allows the grower to obtain financing for expansion needs while providing the company with houses in good locations. A pre-determined amount is paid to the grower as a "new house" fee, which is included in the growout settlement payment.

PRE-1986 LAW

Prior to 1986, the Commissioner of the Internal Revenue Service tried unsuccessfully, in numerous court cases, to challenge a taxpayer's method of accounting when using the cash method of accounting. The primary issue had been that the cash method of accounting adopted by the taxpayer did not clearly reflect income. The Commissioner relied on IRC section 446 which gives him the authority to change a taxpayer's accounting method when income is not clearly reported.

For a taxpayer to use the cash method of accounting, they had to be a farmer or rancher. IRC section 464(e) defines "farming" to mean "*** the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals."

Treas. Reg. section 1.61-4(d) definition of "farm". “As used in this section, the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms. It also includes plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers.”

In ***United States v. Chemell***, 57-1 U.S.T.C. 9679, the Fifth Circuit concluded that taxpayers engaged in the business of hatching chicks and arranging for and supervising the care and growth of the chicks, were engaged in the business of "farming", even though the taxpayers were not involved in the growing of crops or the tilling of soil. The taxpayers operated a chick hatching facility and a broiler hatchery facility. They were engaged in a typical "growout" operation with chicks being placed with area farms for a period of 10 or 11 weeks. All operations were conducted under the supervision of the taxpayers and their employees. Under these circumstances, the court found that the taxpayers were "farmers" for federal income tax purposes.

The Tax Court went even further ***in Maple Leaf Farms, Inc. v. Commissioner***, 64 TC 438. Maple Leaf Farms was a small, partially integrated company involved in the meat processing business. The company grew approximately 10,000 ducks on its own property and contracted with independent growers for another 90,000 ducks each year. The company purchased one-day-old ducklings and supplied them "at a charge" to the growers. In addition, the company provided feed and medication, carried and paid insurance and taxes on the ducklings, and retained legal title to the ducklings under state law. The Tax Court held that the taxpayer was a farmer because:

(1) There was significant participation on the taxpayer's part in the growing process; and,
(2) There was a substantial risk of loss from that process.

These and other cases outlined a very broad definition of who qualifies as a farmer, which provided substantial loopholes for the tax shelters of the 1980's. Due in large part to many of the publicly marketed shelters Congress took action in 1986 to narrow this definition.

POST-1986 LAW

THE TAX REFORM ACT OF 1986 made changes to the computation of alternative minimum taxable income with respect to farm losses. IRC section 58 disallows farm losses of non-corporate taxpayers from any tax shelters farm activity. S. Rep. No 99-313, 2d Cong., 2nd Sess., at 527 (1986), 1986-3 C.B., Vol. 3, 527, states:

> "Any passive farm loss of an individual, to the extent not already denied for minimum tax purposes under the preference described above, generally is treated as a preference. A passive farm loss is defined as the taxpayer's loss for the taxable year from any tax shelter farming activity. The amount of the preference is reduced, however, by the amount, if any, of the taxpayer's insolvency, as measured using a standard similar to that set forth in IRC section 108(d)(3).
>
> For purposes of this provision, the term "tax shelter farm activity" means (1) a farming syndicate (as defined in IRC section 464(c), as modified by IRC section 461(i)(4)(A), and (2) any other activity consisting of farming unless the taxpayer materially participates in activity. A taxpayer is treated as materially participating in the activity under the material participation standard set forth for regular tax purposes in IRC section 469 (relating to passive losses), if a member of the taxpayer's family (within the meaning of IRC section 2032A(e)(2) so participates, or if the taxpayer meets the requirements of paragraph (4) or

(5) of IRC section 2032A(b) (relating to certain retired or disabled individuals and surviving spouses)."

The shelters also highlighted the problems encountered by the allowance of current year expenses for the raising of livestock. It provided opportunities for taxpayers to defer income, sometimes indefinitely, by manipulating farm expenses. Although Congress wished to maintain beneficial deductions for the true small farmers, they also wanted to stop the abuse seen in the tax shelters and by some of the large integrated companies. In pursuit of this objective, Congress passed IRC section 263A, which provides pre-productive rules outlined in the regulation below.

IRC section 263A

IRC section 263A provides that taxpayers that are required by IRC section 447 or 448 to use an accrual method of accounting or prohibited from using the cash method, respectfully, must capitalize the direct and indirect costs of producing animals. See IRC section 263A(d). The costs that are required to be capitalized include the acquisition costs of the animals, as well as the pre-productive period expenses of such animals. See Treas. Reg. section 1.263A-4(b)(2)(11).

"SWEETHEART DEALS"

The examination of poultry companies should include an analysis of the growout contracts. Most contracts are with unrelated third party growers that are arm's length transactions. However, corporate officers, majority stockholders, their family members, and close business associates, may be given access to special arrangements involving these contracts. The industry name for these special contracts with "insiders" is "Sweetheart Deals".

During the early 1980's, investment brokers sold specialized growout programs nationally. The investor was given year-end deductions for large payments that included the purchase price of the chicks, the feed and medication, technical services, the total expected growers pay, and the catch and haul expenses. The investor would not realize the income generated from these contracts until the following tax year. Due to the changes in the tax law, these types of tax shelters all but disappeared after 1986.

Following the downfall of the publicly sold tax shelters, some of the companies set up a new plan under the title "Sweetheart Deals". The corporate "insiders" needed a vehicle through which they could obtain large losses to offset their corporate salaries and other sources of income. The "Sweetheart Deals" provided just such benefits by shifting various costs from the companies records to the

insider's tax return. By devising an internal system of accounting for the "Sweetheart Deals", the stockholders and corporate employees are kept unaware of the transactions.

A company employee prepares documents that assign numerous grower contracts to selected "insiders". Amounts are designated as the separate prices covering the chicks, feed, medication, technical services, etc., which are purchased from the corporation. These arrangements always occur in the last month or two of the "insiders" tax year. The flocks are sold in the following tax year. Thus, the insider reports a large loss in the first year with all profits in the second year. At a minimum, this defers the tax due by one year. In some cases, it can even change the tax rate applicable to the deferred income.

Typically, the insider will repeat the arrangement in year two. This will push the profits into year three. In order to keep deferring income the number of birds or the costs must be increased from year to year. The decision to enter into a new year end arrangement will depend on the investor personal tax situation.

Example 1

In Year 1 Mr. Jones, a friend of the corporate CEO, was assigned contracts covering 5,000,000 broilers that were placed in grower houses during the last 2 months of Mr. Jones' tax year. Prior to his tax year-end he paid the company 10 cents for each chick, $500,000 for feed, and $50,000 for medical and technical services. In Year 2 when the birds reached maturity, Mr. Jones sold them to the company for $1.1 million. In Year 1, his tax return will show a loss of $1,050,000 on a schedule F. In Year 2, he will report a profit of $1,100,000 or he can enter into new assignments at the end of Year 2 and keep rolling the income forward.

The invoices provided to the insider supporting these transactions are not usually run through the regular corporate accounting system. The main corporate employee privy to this information maintains complete control of all the paper work, including checks written at year-end, as well as the subsequent sales proceeds. The cash, accounts receivable, and miscellaneous expense accounts are often the accounts used by the company to record the applicable journal entries. The net income or loss to the corporation may be credited or debited to the miscellaneous expense account.

The payments for chicks, feed, and medication, etc., are normally based on historical or estimated costs and not on the actual costs. In most situations, the actual costs to the corporation for feed, technical and medical services, etc. are more than the contracted amounts paid by the insider. The insider is not liable for any amounts in excess of the contracted costs.

Example 2

Under Example 1, the flocks assigned to Mr. Jones in Year 1 had actual feed costs of $650,000. Mr. Jones is not liable for the $150,000 in excess of his contracts with the company. If the actual feed costs had been $400,000, he would not have received a refund of $100,000. Mr. Jones' feed costs are set by the contract not by actual expenditures.

The corporate explanation for these favorable transactions may be the shifting of their risk of loss due to the large number of flocks in various stages of completion. By "selling" the flocks to the investors the company would not be liable for any loss if the flock is destroyed by fire, tornado, etc. In reality, the company normally absorbs the loss in these situations. A new flock may be substituted for the lost flock or the lost flock will be shown as "sold" back to the company based on estimated weights.

AUDIT TECHNIQUES

The examiner will need copies of all contracts pertaining to these arrangements as well as the accounting treatment by the company and the investor. Any departures from normal procedures should be documented. If the company issues an invoice covering the feed "sold" to the investor, yet the invoice is not included in the company's feed accounting system, this would indicate that a true sale of feed to the investor did not take place. All invoices issued to the investor should be traced through the company's accounting system.

The dates each relevant event took place and how it affects the overall transaction will need to be determined. The investor's records should include the cancelled checks to the company, bank clearance dates, contract dates, loan dates, and sale dates. These should be compared to the flock placement and settlement dates, company deposit records, and company check date, with follow up questions on any discrepancies. Exhibit 6-1 provides a good starting point when requesting information from the investor.

In-depth interviews can be the examiner's best method of establishing the facts in these cases. Probably the most important interview is with the corporate employee handling the arrangements. This individual can provide valuable information concerning the company's normal procedures, how the calculations for costs and sales are determined, as well as how any flock losses were handled. Examples of questions that can be asked during an interview are listed in Exhibit 6-2.

Calculations are a major component in these arrangements. The examiner needs to verify if the costs are based on actual expenses for the flocks under assignment or if some type of historical or estimated amounts were used. Any documents or special investor needs which were considered by the company to determine each of the cost and sale amounts should be requested and reviewed.

Other "SWEETHEART DEALS" can include the use of corporate entertainment facilities, excess rents being paid to the "insiders" for farm structures, such as hog farrowing and finishing houses, and waste water treatment facilities located near their corporate owned processing plants. Normally the amounts paid to the insiders are not comparable to a true arms length transaction.

Many of the insider transactions can be found in the company's SEC filings as well as inspection of related returns. Others are found during interviews, routine analysis of unusual journal entries, or newspaper articles. Once a special insider arrangement is identified, the examiner can look for a unique feature that may help identify any similar arrangements. For example, companies often separate the transactions relating to insider poultry contracts by running all related journal entries through a special account or cost center. Thus, by establishing which account or cost center is used the examiner can identify the individuals involved in similar arrangements.

SUMMARY

Most of these activities appear to be ordinary and necessary type business expenditures. However, the facts and circumstances may reveal various schemes structured by corporate insiders. These "Sweetheart Deals" may be reported by the insiders as farm income and expenditures that will allow them to offset other sources of income with their tax shelter farming activity. One question should come to mind, is there a valid business purpose for these arrangements? At a minimum, these are passive activities.

The exhibits include a proforma IDR that should provide some background as to the type of contracts the company has signed with insiders. This IDR can be used in conjunction with an audit of the investor.

As previously noted, Exhibit 6-2 is a sample interview directed towards the company employee who handles the records for both parties or at least for the company. This will normally be someone in the company accounting department and not an outside accountant. It will probably be the same individual who signed the contracts as the company representative.

This page left intentionally blank.

Information Document Request Items

The Information Document Request lists some of the contracts and documents that may be applicable in examining taxpayers involved in the poultry industry. The following explanations will provide the examiner with a brief overview of these documents.

The following request items (with comments) should be considered during the examination of a poultry producer/integrator.

1. ASSIGNMENT OF CONTRACT RIGHTS AND AGREEMENT FOR SERVICES (GROWERS CONTRACTS ASSIGNED).

   COMMENT: To give the appearance of an arm's length transaction, the insiders will purchase from the producer/integrator their contract rights to various independent growers. This assignment grants all the rights and privileges to the insider that the producer/integrator possesses. This would, in effect, transfer the management and control of the growers to the insiders. What has been ferreted out of these arrangements is the fact there has been no transfer of the contract rights. The independent growers are unaware that their contracts have been assigned. The producer/integrator continues to meet all obligations stipulated I the contracts.

2. GROWER'S INDIVIDUAL CONTRACTS WITH THE INTEGRATOR.

   COMMENT: Each individual grower signs a new contract each year with the producer/integrator. This contract outlines the duties and responsibilities of both parties. The grower's pay will be included as well as any incentive terms. If any grower in the grow-out complex out produces his fellow growers or exceeds some predetermined weight gain factor there will be a bonus payment. Growers are also paid a building fee (house allowance) about which is paid to encourage construction of additional houses for production purposes. Look for differences between your investor and the regular contracts.

3. AGREEMENT FOR PURCHASE OF FEED, MEDICATION, AND TECHINCAL SERVICES.

   COMMENT: This agreement will list the price to be paid by the insider for feed, medication, and technical services. All of these items will be produced or provided by the producer/integrator to each grower. Specific instructions are given to the growers by the producer/integrator. Feed ratios and amounts are given as well as the medication requirements. Technical support personnel are provided by the producer/integrator. Examiner will need to determine if the charges to the investor are actual or estimates. If they are estimates and/or the investor is not liable for any expenses over the contracted amounts the company has not shifted its risk.

4. PURCHASE AGREEMENT FOR CHICKS.

COMMENTS: The purchase agreement for chicks is a set amount per bird charged by the producer/integrator. The growers, unlike the investors, do not purchase chicks from the producer/integrator. This gives the appearance of risk being shifted from the producer/integrator to the insiders. In order for the insider to effectively achieve the tax benefit desired, the quantity of birds will probably be calculated using historical costs. The number of chicks purchased will dictate the amount of feed, medication, etc., needed to generate the loss.

5. AGENCY AGREEMENT (CORPORATE EMPLOYEE IN CHARGE OF GROWOUT PROGRAM).

COMMENT: The agency agreement provides a monetary amount to be paid to the producer/integrator employee that is in charge of the insiders' grow-out contracts.

6. TAXPAYER'S LIVE POULTRY GROWOUT SETTLEMENT STATEMENTS FOR ALL GROWOUT LOCATIONS.

COMMENT: Taxpayer's Live Poultry Grow-out Settlement Statements are provided to each insider upon the sale of their grow-out contract flocks. These statements provide a complete detailed summary of the number of chicks placed at each grower site, the final number of birds marketed, the feed and medication totals, total weight of birds placed and marketed, gross selling price, death loss, condemned bird count, grower's pay, and other pertinent information concerning the flock production. It should be noted that the actual costs for the flocks on the company books do not match the amount paid by the insiders.

7. INTEGRATOR'S FEED DELIVERY TICKETS & INVOICES FOR GROWOUT CONTRACTS.

COMMENT: Feed delivery tickets and invoices should be obtained in order to ascertain the totals delivered and billed to the insiders. Approximately 90% of the total feed required for the flocks will be delivered prior to year-end. The balance will be used to finish the flocks for the desired slaughter weight. Do these tickets match the amounts paid by the investors?

8. INVOICES FOR CHICKS PURCHASED, FEED, MEDICATION, CATCHING AND HAULING FEES, AND HOUSING FEE (GROWERS PAY).

COMMENT: Actual invoices for chicks, feed, medication, catch and hauling fees, and housing fees (grower's pay) should be reviewed in order to confirm that the prices paid by the insiders is an estimate using historical costs in lieu of actual cost. This benefits the investor by locking in production costs and making it possible to provide customized gains or losses for each investor.

The producer/integrator absorbs any loss, granting the insider another opportunity to withdraw finds without a tax burden. As long as the flocks placed in production at year-end continue to increase, the insiders have a permanent tax deferral. The risk of loss argument is seriously diluted by this arrangement.

9. DELIVERY TICKETS FOR ALL CHICKS DELIVERED BY INTEGRATOR.

COMMENT: Actual delivery tickets for chicks delivered to various growers should be analyzed to confirm the quantity, date of delivery, location of the growers, etc., per the assignment agreements. These should prove to be beneficial in confirming weights and quantities used on the settlement statements.

This page left intentionally blank.

POULTRY GROWOUT INTERVIEW

1. Which department or individual/individuals is/are responsible for the corporate accounting entries involving the poultry grow-out contracts?

2. Are any growers given preferential treatment for flock, feed, medical, etc. deliveries? If so, who determines this?

3. Are any poultry grow-out contracts offered to outsiders? If so, when and how? For what purpose are these contracts offered? Is there any risk of loss benefit to the company?

4. Are any poultry grow-out contracts offered to corporate officers, board members, family members, or close associates?

5. Are these contracts given any preferential treatment?

6. Who stands the risk of loss due to any disease, natural disaster, etc.?

7. If there is a loss, does the company stand the loss in order to protect the growers and the investors? Are the growers given equivalent pay when the flock is destroyed?

8. Are the investors, outsiders, and insiders protected by the company against such a loss? Are they given the same protection?

9. How are the poultry grow-out contracts issued to the outsiders and insiders? Are existing grower contracts transferred to the investors or are they separately negotiated?

10. Who signs the assignment contracts for the company? What is their position/title?

11. What other contracts does this individual normally sign for the company?

12. If existing contracts are assigned to the investors, do the growers know their contracts have been assigned? If not, why aren't they told?

13. Who determines the flocks, growers, etc. that will be assigned to the investors? Do the investors have the option to select flocks, growers, and location?

14. When are the flock selections made? Before or after placement.

15. Are the investors privy to information about the growers that would indicate which growers are above average producers?

16. Are the contract prices for chicks, feed, medication, and technical services actual or historical costs?

17. If the costs are actual how are the amounts determined for the contracts? Are they adjusted in the next year?

18. Does the company have the right to recoup its cost of production from the investors?

19. Are the outsiders and insiders given the same treatment on production costs? Are they responsible for all production costs? If not, why aren't they?

20. What type of accounting records and reports are maintained on all grower activities? Any differences for on the assigned flocks?

21. How and when are the investors informed about their monthly flock production costs?

22. Are the investors involved in any management decisions concerning the flocks? If so, what type of direction are they providing during the production process? Is it any different for the assigned flocks versus the regular flocks?

23. How are the transactions with the insiders recorded on the company books? What are the account numbers and cost centers used?

24. Who in the company knows the flocks have been sold? Fieldmen? Supervisors? Accounting Personal? Finance Department?

25. Who physically purchases the feed used by the flocks?

26. What type of document is provided to the investor to support a deduction for feed, medical and technical services, etc.? If an invoice is issued how is it treated in the company's accounting system?

Chapter 7

GROWERS

CONTENTS

Introduction
Expenses
  Utilities
  Insurance
  Miscellaneous
  Depreciation
Net Check — Double Deduction
Financing Arrangements
Audit Techniques
Summary

INTRODUCTION

The success of the poultry industry is very dependent on the skills, expertise, and care given by the independent growers. Since grower income is a predetermined amount based on poundage of live birds or egg hatchability, the grower must concentrate on conserving expenses and capital expenditures. Income is now reported on Forms 1099 by almost all large poultry companies, so the audit focus on the independent grower should be geared toward expenses. There is still the possibility of unreported income from sales of litter, machine hire, etc., but the primary abuse, if any, will be in the expense area.

EXPENSES

The broiler and turkey grower contracts with regard to duties and expenses will be very similar. The poultry company agrees to furnish the producer/grower with chicks, feed, and medication for the production of broilers. Services provided at no cost are technical advice, catching, loading, and transporting the flock to a place designated by the company, and delivery of feed to the grower's farm.

To give the examiner a clearer concept of the type of expenses to be incurred by the grower, the following is an outline of the duties required by the company under the contract:

1. The grower agrees at his or her own expense to furnish all labor, utilities, litter, supplies, repairs and to provide housing and equipment well maintained.

2. The grower will bear the risk of loss on his or her own property.

3. The grower shall be responsible for the removal and disposal of all dead birds

in accordance with the applicable law to their location.

4. The grower agrees to follow a current nutrient management plan by the Soil Conservation Service for the disposal of litter on his farm or for litter that is disposed of at a place other than his farm.

The standard broiler contract outlines each of these duties as shown in Exhibit 7-1A. Each poultry company varies to some degree in the duties and expenses it requires from its growers. For example, some companies pay for the litter **and it does not** affect the grower's settlement check. Other companies pay for the litter **and** collect from the grower through a reduction in the final settlement check.

This practice can vary from company to company or between broiler flocks and breeder flocks grown for the same company. It is important to read the contract. A breeder contract is shown under Exhibit 7-1B for comparison to the broiler contract.

IRC section 162 and Treas. Reg. section 1.162-12 provide for deduction of expenses paid or incurred in connection with the operation and maintenance of a farm. The requirements that the expense be "ordinary and necessary" are applicable to a farm just as they are to any other business venture. In this section, we will discuss some of the expenses peculiar to growers.

Utilities

The largest expense for the grower other than capital expenditures will be utilities. Baby chicks and turkeys have to be maintained at 80 to 90 degrees until they reach at least 6 weeks. Even after this age, they need heat through the cold winter months. Utilities will encompass natural gas or propane for the stoves, water for the waterers and cleaning, electricity for the automatic feeding equipment, and telephone for long distance calls to the company and suppliers. The propane and electric companies usually give the farmers a business rate, but this will also usually include the personal residence. An allocation must be made for the personal usage based on individual facts and circumstances.

It is not unusual for utilities to run around 25 percent of the gross receipts. This expense rate can be higher or lower depending on whether the grower uses natural gas versus propane and whether a flock was grown during the coldest winter months.

Utilities for a layer or breeder operation are less expensive and will average around 7 percent to 10 percent. Propane or natural gas is the largest expense of broiler growers while heating is not required as much on the full-grown layers and breeders.

Insurance

Growers can generally deduct the ordinary and necessary cost of insurance for the following types:

1. Fire, storm, theft, liability and other insurance on farm business assets.

2. Premiums for health and accident insurance on bona-fide employees.

3. Self-employed health insurance deduction as an adjustment to income on Form 1040. This amount is 30 percent of the amount paid for health insurance coverage for self, spouse, and dependents beginning in 1995. Prior to 1995, the deduction was 25 percent. The deduction cannot be more than the net profit from the business.

Many growers acquire all of their insurance through one farm affiliated insurance agency to take advantage of lower farm premiums. These types of agencies usually charge approximately $8.00 per $1,000 for insurance coverage and policies will breakdown the amount of insurance coverage on each asset, so a personal allocation can be easily done. Even small growers have a lot of capital tied up in buildings and equipment and insurance expense can seem rather high in relation to their income.

Miscellaneous

The grower has several types of expenses that are peculiar to their business only. One of these expenses is the purchase of litter for the buildings that house their birds. Each company may have a different requirement as to the type of litter, but generally, pine shavings or rice hulls are the two most commonly used. All floors of poultry buildings must be completely covered with 2 to 4 inches of litter for both warmth and disease control.

Companies usually require that the used litter be cleaned out of broiler houses at least once a year. This is usually completed in March or April as the buildup of the used litter provides additional warmth throughout the winter months. Also, this goes in hand with the spreading of litter on the fields before the summer hay crops. Some growers may also take out the buildup of hard cake after each flock is removed or completely cleaned out at other times depending on bug or disease control problems. This clean up can be done by the growers if they have the proper equipment or they may need to hire a third party who provides all the necessary equipment as well as labor.

Many growers do not have enough land to accommodate all of the litter so they hire someone to clean out their houses and haul off the used litter. They usually will not have to pay for this service and will generally receive some boot in addition to the clean out services, as the litter is very valuable as a fertilizer. If the grower has enough land to spread the litter per an approved plan, he or she can also have expenses under machine hire or labor for having the litter hauled and spread on his or her own fields. The grower will deduct these expenses under fertilizer, miscellaneous, or sometimes as supplies.

Exhibit 7-2 is a copy of poultry litter management information provided to growers by some companies.

Turkey growers do not clean their litter out as often as broiler farmers do and the turkey litter is not as valuable as the broiler litter. The reason for this pertains to the type of feed given to the flocks, as well as the efficiency of the bird's digestive system, which affects the nitrogen content of the litter. Turkey growers still work on the same principle as the broiler farmer, but they reuse a lot of their litter from their brooder houses in their growout houses through the use of a caking machine. They also purchase pine shavings or rice hulls for their beginning foundation in their brooder houses and replace most of this with every new flock.

Another expense the growers incur is for the spraying of their poultry houses. The popularity of spraying is currently declining, due to the lack of proof that it helps contain disease and bug problems as originally thought. To prepare for spraying the grower has to clean all the houses down to the bare dirt or floor and hire someone to come in and spray a light mist of diesel or a special spray to destroy bugs and deter health problems in the birds. These expenses will generally be deducted under machine hire or labor.

Depreciation

Depreciation for growers is computed in the same manner as it is for other farm businesses. If they depreciate the property using MACRS and use the declining balance method, they must use the 150 percent declining balance for all assets placed in service after December 31, 1988. Farm assets are limited to a maximum of 150 percent declining balance. Except for residential rental property and nonresidential real property, tangible assets used in a farming business are considered farm assets.

Growers receive special treatment if their building structures qualify as single-purpose agricultural structures as defined in IRC section 168(i)(13):

1. An enclosure or structure specifically designed, constructed, and used for housing, raising, and feeding a particular type of livestock and their produce (including poultry).

2. For housing the equipment necessary for the housing, raising, and feeding of the above livestock.

The types of structures that qualify as livestock structures include those that are used to breed chickens or hogs, to produce milk from dairy cattle, or to produce feeder cattle or pigs, broiler chickens, or eggs.

Conference Report No. 95-1800 of the Revenue Act of 1978, which defined single purpose agricultural structures, provides --

> "In order to be included under this provision, a livestock structure must be specifically designed, constructed, and used for housing, raising, and feeding of livestock and their produce. The full range of livestock breeding, raising, and production activities is

> intended to be included so that special purpose structures will qualify for credit if used, for example, to breed chickens or hogs, to produce milk from dairy cattle, or to produce feeder cattle or pigs, broiler chickens, or eggs. In addition, the structure or enclosure must be designed and used to house equipment necessary to feed and care for the livestock. As a result, such facilities must include, as an integral part of the structure or enclosure, equipment to contain the livestock and to provide water, feed, and temperature control, if necessary."

In addition, working space is permitted within an eligible structure. Under this latter rule, the property will be eligible even if working space is provided for caring for the livestock or plants or for gathering their produce such as eggs. In addition, working space may be provided to maintain the structure and to maintain or replace the equipment within the structure.

It should be emphasized that the structure must be used exclusively for the purpose for which it was specifically designed and constructed. As a result of this requirement, a hog structure will not be eligible property, for example, if it is used for the housing and feeding of poultry or if more than incidental use of a structure is made to store feed or machinery.

The Senate Report (S. Rept. No. 95-1263, 1978-3 C.B. 315, 414) states further, "It is intended that this provision be broadly construed to apply to all types of special purpose structures and enclosures used to breed, raise, and feed livestock and poultry (including the production of eggs and milk), and for the cultivation of plants. Thus, this provision will cover unitary hog, poultry, and cattle-raising systems, milking parlors, and greenhouses used to produce either plants or plants products."

Treas. Reg. section 1.48-10(b) further defines that a structure qualifies as a single purpose agricultural structure only if it is specifically designed, constructed, and used exclusively for permissible purposes with respect to on particular type of livestock. For purposes of this section, each species is a different type except that all species of poultry are consider to be of a single type.

A structure specifically designed, constructed, and used to raise poultry may house, raise, and feed both chickens and turkeys.

A single purpose agricultural structure must also house equipment necessary to house, raise, and feed the livestock. Required equipment must be an integral part of the structure, and includes, but is not limited to, equipment necessary to contain the livestock, to provide them with water or feed, and to control the temperature, lighting, and humidity of the interior of the structure. For purposes of this section, equipment is an integral part of the structure if it is physically attached to or a part of the structure. The useful life of the structure, however, need not be contemporaneous with the life of the equipment it houses. A structure without the required equipment is not a single purpose agricultural structure.

This designation is significant because single purpose agricultural structures placed in service after 1988 are assigned a 10-year MACRS recovery period and a 15-year alternate MACRS recovery period. In comparison, a general-purpose farm building is

depreciated over a 20-year MACRS recovery period and a 25-year alternate MACRS recovery period. In addition, single purpose agricultural structures constitute property eligible for IRC section 179 expensing. Also, the equipment in the structure houses is assigned a 7-year MACRS recovery period and a 10-year alternate MACRS recovery period. See IRC sections 168(b)(2)(B), 168(e)(2)(D), and 168(I)(13).

Example 1

In 1994, Farmer F had constructed, by an independent contractor, a 40' by 400' steel truss broiler house to be used in his contract poultry growing operation. The cost of the facility was $100,000 of which $65,000 was allocated for the structure and $35,000 was allocated for the equipment that is an integral part of the facility.

The cost of the structure ($65,000) will be depreciated over a 10-year MACRS recovery period, using 150 percent declining balance depreciation since the poultry house qualifies as a single purpose agricultural structure. The equipment can be depreciated over its usual recovery period of 7 years, using 150 percent declining balance depreciation.

A change to correct a taxpayer's consistently used improper depreciation method, recovery period, or convention for computing its depreciation deduction is a change to the taxpayer's method of accounting, subject to IRC sections 446 and 481.

NET CHECK – DOUBLE DEDUCTION

Many times the proceeds from the sale of various poultry products are received in the form of a "net" check. Some of the items deducted from the gross sales price to arrive at the "net" are: personal health or life insurance, propane, farm supplies, spraying expense, rice hulls, shavings, repair expenses, personal purchases, and assignments for loan repayments. The company usually records this as an accounts receivable from the grower. See Exhibit 7-3A for an example of a broiler grower check that reduces earnings by the amount of the grower's outstanding account receivables.

Exhibit 7-3B outlines the expenses paid by the company which are part of the account receivables. Many of the large poultry companies maintain a propane division that sells gas to its growers as well as outside third parties. Instead of requiring the grower to pay each time the propane is delivered, it is easier to deduct the propane bill from the growers' check.

NOTE: Although the gas may all be charged at the lower "chicken house" rate most companies will fill the grower's personal residence tank for this lower price. Check to make sure any personal expense is not deducted on the return.

Exhibit 7-3C is a settlement statement for a breeder flock. As shown, the breeder grower's pay is based on several factors:

1. The number of eggs that hatch versus the number sent to the hatchery.

2. A flock maintenance fee for the first 5 weeks when the birds aren't laying.

3. A feed bonus if the feed used versus eggs laid is above a set minimum.

In unusual situations, the grower may have a feed penalty instead of a bonus, if feed usage is excessive.

The deductions shown on Exhibit 7-3C include fly control that the company paid for and is collecting from the grower. The 5-week maintenance fee that was paid at the end of the first 5 weeks and the egg guarantee that is paid each week during the laying period are also deducted. The weekly payments are based on the number of eggs collected from the farm and hatched in the hatcheries. The payments are normally delayed 3 to 4 weeks after the eggs are picked up from the farm due to the incubation period. No other deductions were made to this grower's final settlement check.

Under "Duration of Contract" the breeder settlement sheet (Exhibit 7-3C) shows 65.7 weeks, which is deceptive. The 65.7 weeks refers to the total age of the flock and not the time spent in the breeder house. Typically, a different farmer raises the pullets until they are 20 weeks of age at which time they are moved to the breeder house. The actual date the birds were placed in the breeder house is shown under date moved as April 7, 1992. This is the date the breeder farmer received the flock.

The breeder flock is normally sold or processed when it is picked up from the farm. The flock shown in Exhibit 7-3B was sold on February 14, 1993, however, the actual settlement date is March 17, 1993. This delay is necessary to allow time for all of the flocks' eggs to hatch. The total hatchability of the flock is not known until the final batches of eggs come out of the incubators.

Some growers will record the "net" check as their gross receipts. Generally, the farmers and accountants have learned that they need to report the total gross receipts amounts so it will tie to the Form 1099 being issued by the poultry grower. However, there are still some growers who will report only their "net" check and take their deductions.

FINANCING ARRANGEMENTS

Finance leasing rules were in effect for up to $150,000 of farm property placed in service before 1988. This applied to certain leases of farm property entered into before January 1, 1988, but after July 1, 1982. Under the finance leasing rules, the fact that the lessee had an option to purchase property at a fixed price that was at least 10 percent of the lessor's original cost of the property, or that only the lessee could readily use the property was not taken into account in determining whether the agreement was a lease for federal tax purposes per IRC section 168(f)(8)(A).

Example 2

On January 1, 1987, Farmer F leased four poultry houses to be used on his farm for farming purposes. The lessor's cost basis for the poultry houses were $100,000. Under the lease, Farmer F had an option to buy the poultry houses at the end of the 7-year lease for $10,000. This lease would meet the requirements of this provision for treatment as a valid finance lease for federal tax purposes.

The benefit of these poultry house leases, under the special provision described above, was that they were not subject to the limitation applicable to other finance leases. Under the limitation, a lessor could not reduce its income tax liability for any taxable year by more than 50 percent and they were also exempt from the 40-percent ceiling limitation for leases. This did not apply to the poultry house leases.

Some of these leases will still be around on 1994 and 1995 tax returns. Generally, the grower gave a $10,000 deposit up front, which accrued interest through the term of the lease. If the grower fulfilled all of the terms of the lease, the deposit was turned over to the lessor at the completion of the lease term for the purchase of the poultry houses. Most of the growers were also required to deed five acres to the lessor which was deeded back on completion of the lease or kept by the lessor in case of default.

As a prerequisite for obtaining this type of financing, the grower entered into a leasing contract with a large poultry company for the life of the loan with lease payments for at least the amount of the loan payments. These payments are usually deducted from the grower's payment and forwarded to the financing entity. The grower is the owner of the poultry houses and should be depreciating these assets in lieu of deducting lease payments as in the previous examples. See Exhibit 7-4 for an example of one of these leasing arrangements.

As fewer companies dominate the poultry industry, independent farmers have been less willing to provide the substantial investment risk entailed in building new poultry houses. Each geographical area is likely to have only one potential "buyer" for the grower's services. Each contract normally covers only one flock or one year at a time; thus, the chance of empty poultry houses is a real threat. The new financing arrangements guarantee the grower enough contracts to at least pay off their poultry houses while ensuring available growers for the poultry companies.

AUDIT TECHNIQUES

1. It is particularly true that when the grower lives on his or her farm, many of the

bills paid for gasoline, fuel, utilities, truck expenses, insurance, interest, and taxes will also include personal amounts. One of the best sources of information for making a reasonable allocation for the personal deduction is the taxpayer. Also, inspection of insurance policies, utility bills, loan documents, and property tax assessments can provide valuable information to arrive at an equitable allocation.

2. When examining a grower that has constructed new poultry houses, it is easy to determine the cost of the equipment and the cost of the structure for depreciation purposes from paid invoices or contracts. The problem arises when a grower purchases a farm with these assets already constructed. To determine the cost between land, personal residence, poultry structures, and other farm buildings, an allocation can be made based on the assessed valuation from the County Assessor's office. In this valuation method, the equipment will not be separated from the poultry structure, so a safe rule of thumb would be 45/55 prior to 1990 and 35/65 from 1990 and forward.

3. Check to see if insurance proceeds have been received for property damage to poultry houses as growers may deduct repairs, but not include insurance proceeds as income. Poultry houses are very susceptible to various types of insurance claims due to the nature of their structures, particularly wind and ice damage.

4. Always verify any Forms 1099 issued to growers to their gross receipts on return. If they are not using the Form 1099 amount, verify from their settlement statements that they are not reporting their net check and taking their deductions.

5. In any financing arrangement, always inspect a copy of the contract to see what type of an arrangement has been made. Verify both ends of the contract to make sure both parties are treating it the same, either as a lease or a purchase. In the earlier leasing arrangements allowed, verify that the grower is including the interest income from the deposit and that he or she does not deduct the deposit twice.

6. Many of the insurance premiums may be partly for personal assets or personal benefits such as life insurance, disability, etc. and a disallowance for the personal portion will have to be made. This usually can be done by a visual inspection of the insurance policy.

SUMMARY

Growers are farmers under the Internal Revenue Code thus they are governed by the same restrictions and benefits as any other farmer. The contract between the grower and the poultry company is the pivotal piece of documentation in determining who pays which expenses and how the transactions should be reported for tax purposes.

BROILER CONTRACT-11/92
XYZ FOODS, INC.

THIS CONTRACT, entered in to by and between XYZ FOODS. INC. Whose address is ______________(hereinafter referred to as the "Company") and ______________whose address is _________________ (hereinafter referred to as the "Producer")

WITNESSITH

In consideration of the mutual covenants of the Company and the Producer as set forth below, the parties agree as follows:

1. Duties of the Company:

A **Property Provided by Company.** The Company agrees to furnish the Producer with chicks, feed, medication for the production of broilers Title to chicks, feed, and medication shall remain in the Company.

B. **Services Provided by Company.** The Company agrees to provide the following services at no cost to the Producer.

1. **Technical Advice.** The Company advisers shall visit the Producer periodically to give advice and assistance as required.
2. **Catching and Marketing.** The Company or its designees at its sole discretion shall have the right to market the broilers at any time. The Company shall catch, load, and transport the flock to a place designated by the Company.
3. **Feed Delivery.** The Company will deliver feed to the Producer's farm.

2. Duties of the Producer.

A The Producer agrees at his own expenses to furnish all labor, utilities, litter and supplies and to provide housing and equipment well maintained and fully equipped as required by Company specifications.

B. The Producer agrees to cooperate with the Company in adopting and/or installing new proven management practices and equipment.

C. The Producer warrants that he will not use or allow to be used during the period of the Contract any feed, medication, herbicides, pesticides, rodenticide, insecticides or any other item except as supplied or approved in writing by Company IN NO WAY LIMITING ANY DEFAULT PROVISION HEREIN PRODUCER AGREES THAT ANY BREACH OF THIS SECTION WILL RESULT IN IMMEDIATE DEFAULT BY PRODUCER OF THIS CONTRACT AND COMPANY MAY TAKE ACTION SO PROVIDED FOR IN PARAGRAPH 13 HEREIN.

D. The Producer will bear the risk of loss of his own property and his compensation in the event of fire or other Catastrophe while birds are in his possession.

E. The Producer will supply sufficient help at the time of delivery to assist in the expeditious unloading and placement of new chicks. When the Poultry is caught the Producer or his agent shall be present and have prepared each house for the catching crews in accordance with the schedule provided by the Company.

F. The Producer will maintain All-Weather Roads to poultry houses and keep feed bins free of my overhanging wires or other obstacles and with adequate space to turn vehicles where necessary. Failure to provide such roads and turning area will make Producer liable for wrecker or towing charges in addition to any other damages the Company may sustain. Producer must provide approved pads for mechanical loading and unloading equipment.

G. In order to insure that all dead birds have been removed from the house, the Producer or his authorized agent agrees to walk- through the houses with the catching foreman before catching of chickens begins. All chickens smothered during catching will be loaded on the truck and weighed as provided in Paragraph 9 below. In the event the Producer or his authorized agent is not present, the Producer agrees *to* accept the determination of the catching foreman between dead and smothered chickens.

H. The Producer shall be responsible for the removal of all dead birds and shall dispose of dead birds in accordance with the law applicable to this location,

I. The Producer agrees to have, and to follow as soon as practicable, a current nutrient management plan for the disposal of litter on his farm or in the event that his litter is disposed of at a place other than his farm. This plan should be provided by the Sod Conservation Service or local water conservation district and should at least include such items as the volume of litter produced, number of acres available for spreading, types of soil, nutrient requirements, litter storage arrangement if needed and pertinent information. Until Producer has a nutrient management plan developed for his farm Producer agrees to follow the Dry Poultry Litter Handling Best Management Guidelines, a copy has been provided, unless said guidelines conflict with the law of this location.

3. **Payments**. The Producer agrees to accept as compensation for this Agreement and the Company agrees to pay compensation to the Producer as determined by Schedule A attached hereto. Payments will be made to Producer no later than 15 days following the week of slaughter unless circumstances beyond the control of the Company involved.
4. **Best Efforts.** The Producer and the Company agree to use their best efforts in maintaining the broiler flock in such a manner that maximum performance will result.
5. **Farm Sale.** If the Producer's farm is sold while a flock is in the Producer's houses, consent to assignment of this agreement must be obtained from the Company and/or payments to be made at the end of the flock will be paid to the new owner/assignee.
6. **Independent Contractor.** It is understood that the Producer is engaged in and is exercising independent employment. Producer is an independent contractor and is not a partner, agent, or employee of the Company.
7. **Right of Access.** The Company shall have the right of access at all times to the premises in which the poultry is grown for the purpose of inspecting birds, delivering feed, chicks, or supplies and removal of birds.
8. **Condemnation.** Condemnation charged to the Producer shall consist of birds condemned for the following causes Tuberculosis, Leukoala, Septicemia, Toxemia, Synovitis, Tumors, Plant Rejects, Airsacculitis, Inflammatory Process, Non-salvageable Air Sac Parts and Non-Salvageable inflammatory Process Parts. Condemned weight will equal number of head condemned times average live weight of flock plus all non-salvageable air sac parts and all non-salvageable inflammatory process parts Condemnation due to plant causes shall consist of birds condemned for the following causes and will not be charges against Producers farm weight Cadavers, Ovarscale, No Viscera, Contamination, and other plant caused condemnation.
9. **Farm Weight.** The farm weight is the net difference between gross and tare weight. Gross weight will be determined on the scale normally used for such purpose as promptly as possible after the poultry is loaded on the vehicle.
10. **Number and Type of Broilers.** The Company reserves the right to determine the number, frequency and type of broiler chicks to be placed in the Producer's house.
11. **No Warranty of Property.** THE COMPANY DOES NOT WARRANT QUALITY, MERCHANTABILITY, FITNESS FOR PURPOSE OR OTHERWISE WARRANT PROPERTY DELIVERED OR RECOMMENDED BY IT TO THE PRODUCER
12. **Events of Default.** Any of the following events or occurrences shall constitute a default by the Producer under this Agreement:
    A Default under any separate but farm related financing agreement with a lending institution.
    B. Actual or attempted levy, seizure, or attachment of any of the Company's property,
    C. Use of abusive language, threat of physical harm or in any way impeding the Company or its authorized representatives from inspecting or examining the Producer's facilities and flocks.
    D. Insolvency or bankruptcy of the Producer.
    E. Failure of the Producer to properly care for and protect any of the Company's property.
    F. The occurrence of any event which in the opinion of the Company endangers or impairs the Company's property.
    G. Failure of the Producer to comply with any provision of this contract.
    H. Failure of the Producer to consistently produce broilers in an efficient competitive manner.
13. **Remedies of Company on Default of Producer.** Upon default or breach of any of the Producer's obligations under this Agreement, the Company may immediately cancel this Agreement by giving notice in writing and Company may, without further notice, delay or legal process, take possession of poultry, feed or other property owned by the Company. The Company shall have the right to utilize, without cost, the Producer's poultry facilities until the flock reaches marketable weight. The Company may also pursue any other remedies at law or equity.
14. **Waiver of Default.** No waiver by the Company of any default shall operate as a waiver of any other subsequent default and the rights and remedies reserved to the Company shall be deemed cumulative and not exclusive of any other rights provided by law or equity.
15. **Reimbursement of Company.** At its option, the Company may discharge taxes, liens, or other encumbrances at any time levied or placed on the poultry, and pay such other charges as may be incurred by the Producer in maintaining and preserving the poultry. Producer agrees to reimburse Company for any payments made or any expense incurred by Company, pursuant to this authorization.
16. **Term of Contract.** It is expressly understood and agreed between the parties hereto that the terms and conditions of this Agreement shall remain in effect unless terminated as herein provided. Either party may terminate this Agreement only at the time a particular flock of broilers is delivered to the Company and prior to the Company's placement of broilers with the Producer by delivering notice of termination, by certified mail or personal delivery. Producer understands and agrees that no agent, servant, or employee of the Company has authority to make any oral modification to this Agreement. Modification of this Agreement may only be accomplished by written instrument fully executed by the Producer and an authorized representative of the Company.
17. **Assignment.** The Company may assign this contract at my time. Producer may assign this contract only with written consent of the Company.
18. **Prior Agreement.** This contract supersedes all prior Agreements between the parties hereto.

EXECUTED THI S _____DAY OF ________, 200x

Producer:	XYZ FOODS, INC.
_________________	_______________________
Social Security #:_____________	Technical Advisor
County:____________________	_______________________
TELEPHONE: ________________	Live Production on Manager

SCHEDULE A

A. The term "net pound" used in the following formulas means farm weight less the farm caused condemnation which is chargeable to a Producer as provided in Paragraph 8. First, an average cost per pound shall be computed for all Producers of like broilers who process birds during the same week. The Producer who sells birds in more than one (1) calendar week will have his payment calculated in the week of his final processing. The "cost" for all like class Producers' flocks which are processed in the week is determined by adding the cost of the chicks placed with these Producers prices at ten cents (10) each, feed priced at ten (10) cents each, feed priced at ten (10) cents per pound, and the medication priced at the Company's cost. This total "cost" is then divided by the net pounds produced by the same Producers to arrive at an average net pound cost for the class.

B. Second, each such Producer's individual net pound cost is calculated in the same manner and using the same "cost" factors as above.

C. Each Producer in the class whose net pound cost as so calculated is two and one-half (2.5) cents more or less than the average net pound cost of the class as arrived at in subparagraph A, shall be removed from the average. The average net pound cost for the remaining Producers in the class, calculated in the same manner set forth in subparagraph A, shall constitute the "adjusted average net pound cost" for the Producers in the class processing birds for the week.

D. Each Producer processing broilers (in a like class) during the week whose net pound cost is equal to the adjusted average net pound cost will be paid the *Base Pay per net pound per the pay scale below according to the Producers average weight per bird. Each Producer whose net pound cost is less than the adjusted average net pound cost will be paid the *Base Pay per net pound according to the Producer's average weight per bird plus 75% of the difference between his net pound cost and the adjusted average net pound cost per net pound. Each Producer whose net pound cost is greater than the adjusted average net pound cost will be paid the *Base Pay per net pound according to the Producer's average weight per bird less 75% of the difference between his net pound cost and the adjusted average net pound cost per net pound. No Producer shall receive less than the **Minimum Pay according to the Producer's classification of birds.

E. Each Producer shall be paid a Fuel Bonus of (***See Below) per net pound for chicks placed with a Producer from the first accounting week of November through the last accounting week of March. This may apply to more than two (2) growing cycles only if at least one growing cycle is Class 77 or Class 78 birds.

All birds processed will be divided into five classes.

Description	Average Weight/Bird	Weight Class	***Fuel Bonus
A. Cornish	2.29 and less	Class 77	$0.95/net lb.
B. Small Broilers	2.30 - 3.00	Class 78	$0.80/net lb.
C. Broilers (Female)	3.01 and greater	Class 79	$0.50/net lb.
D. Broilers (Straight Run)	3.01 and greater	Class 80	$0.50/net lb.
E. Broilers (Male)	3.01 and greater	Class 81	$0.40/net lb.

BASE PAY SCALE - 11-82
GREEN FOREST
SCHEDULE A

Av. Wt/ Bird	*Base Pay/ Cents/Lb	**Min/Pay/ Cents/Lb	Av.Wt/ Bird	*Base Pay/ Cents/Lb	**Min/Pay Cents/Lb
Class 77			2.20	4.450	3.30
1.88 and less	4.810	3.30	2.21	4.441	3.30
1.81	4.801	3.30	2.22	4.432	3.30
1.82	4.792	3.30	2.23	4.423	3.30
1.83	4.783	3.30	2.24	4.414	3.30
1.84	4.774	3.30	2.25	4.405	3.30
1.85	4.765	3.30	2.26	4.396	3.30
1.86	4.756	3.30	2.27	4.387	3.30
1.87	4.747	3.30	2.28	4.378	3.30
1.88	4.738	3.30	2.29	4.369	3.30
1.89	4.729	3.30	Class 78		
1.90	4.720	3.30	2.30-2.35	4.360	3.00
1.91	4.711	3.30	2.36-2.40	4.352	3.00
1.92	4.702	3.30	2.41-2.45	4.344	3.00
1.93	4.693	3.30	2.46-2.50	4.338	3.00
1.94	4.684	3.30	2.51-2.55	4.328	3.00
1.95	4.675	3.30	2.56-2.60	4.320	3.00
1.96	4.656	3.30	2.61-2.65	4.312	3.00
1.97	4.657	3.30	2.66-2.70	4.304	3.00
1.98	4.648	3.30	2.71-2.75	4.296	3.00
1.99	4.639	3.30	2.76-2.80	4.288	3.00
2.00	4.630	3.30	2.81-2.85	4.280	3.00
2.01	4.621	3.30	2.86-2.90	4.272	3.00
2.02	4.612	3.30	2.91-2.95	4.264	3.00
2.03	4.603	3.30	2.96-3.00	4.256	3.00
2.04	4.594	3.30	Class 79		
2.05	4.585	3.30	---------	4.20	3.00
2.06	4.576	3.30	Class 80		
2.07	4.567	3.30	---------	4.20	3.00
2.08	4.558	3.30	Class 81		
2.09	4.549	3.30	---------	4.20	3.00
2.10	4.540	3.30			
2.11	4.531	3.30			
2.12	4.522	3.30			
2.13	4.513	3.30			
2.14	4.504	3.30			
2.15	4.495	3.30			
2.16	4.486	3.30			

____
Producer

____
Date

____
Poultry Company 2.17 4.477

Exhibit 7-1B (1 of 2)

EGGS FOR HATCHING CONTRACT

Date:____

Buyer:____ Address:____

Grower:_______________________________________ Address:____

Location of Grower's Farm:____

Birds: Pullets ___________________________ Cockerels_____________________________
(Number) (Number)

Delivery Point: Grower's Farm

---

1. FLOCK: Grower has received the above-described types and numbers of birds which will remain Buyer's property. Such birds, as their numbers may be reduced from time to time by death, disease, deformation and other normal causes, and as also reduced a result of Buyer's selection described in the next sentence, are hereinafter referred to as the "Flock". At Grower's Farm, apart from other poultry, Grower will grow the Flock for 26 weeks when Buyer will select from among them the good breeding stock to produce eggs under this Contract. Grower will follow good husbandry practices and keep detailed Flock records, with due regard to Buyer's recommendation, and Grower will notify Buyer at once of any sickness or any other problem which affects or may affect the Flock. Grower has the right to obtain form Buyer the units of feed, medicinals, egg cases, egg cleaning supplies, litter and spraying as required according to Buyer's specifications as needed for Grower's performance. To the extent Buyer has them available for Grower, and if Buyer does not have available for Grower any particular items which Grower and Buyer agree are needed, Buyer will reimburse Grower for Grower's cost of purchasing them provided Buyer's reimbursements shall not exceed the prevailing market price for the item. Grower will care for everything furnished by Buyer as Buyer's exclusive property, and if anything furnished by Buyer is lost, destroyed, damaged, wasted or misappropriated while in Grower's care or custody whether by reason of Grower's failure to follow good husbandry practices or otherwise, Grower will pay or reimburse Buyer for it. Buyer does not have any responsibility for the care of the Flock.

2. EGGS: Grower will deliver to Buyer at the Delivery Point, on each day specified by Buyer, all eggs produced by the Flock. From the time eggs are laid until they are delivered at the Delivery Point, Grower will maintain the eggs at constant temperature between 60°F. And 65°F. And at a relative humidity of 75% - 80% by appropriate heating, cooling, air-conditioning, and insulating of Grower's egg holding room. All eggs (including cull eggs) when delivered must be clean, and all eggs (except cull eggs) must weigh at least 22 oz. per dozen. Grower will case in separate containers those eggs (cull eggs) which are cracked or stained or irregularly shaped, or are undersize.

3. BUYER WILL PAY: Buyer will pay Grower a fee of $0.02 per bird for each weeks before the end of the 25th week based on the number of birds remaining at 26 weeks. After 25 weeks the Buyer will then pay the Grower fees in accordance with the Fee Schedule on the back of this Contract. The amount listed on all the Fee Schedule will be credited to the Grower's account upon hatching and at that time, will be paid 0.245 per dozen for all eggs (including cull eggs) accepted. All remaining money owing to Grower, less amounts due and to become due Buyer, will be due 10 days after termination of this Contract.

4. MINIMUM PAYMENT: Buyer guarantees that, if Grower has fully performed all Grower obligations under this Contract, Grower's receipts under this Contract will equal to at least (1) $0.02 per bird per week for each weeks before the end of the 25th week based on the number of birds remaining at 26 weeks, plus (2) a minimum of 0.252 per dozen for all eggs hatched (including cull eggs) accepted.

5. DURATION: This Contract will begin on the date hereof and will continue until terminated on one day's notice (a) by either Buyer or Grower at any time after fees based on percentage of hatch under the Fee Schedule have averaged less than $0.42 per day per 100 birds in the Flock for 14 consecutive days, or (b) by Buyer at any time after Grower has been delivering eggs under this Contract for 28 weeks. Upon termination, Grower shall deliver to Buyer all the birds remaining in the Flock except Birds determined by Buyer to be unfit for processing or for introducing into interstate commerce as food for human consumption; all such unfit birds will be disposed of by Grower as recommended by Buyer.

6. ENTIRE CONTRACT: THIS CONTRACT IS SUBJECT TO THE TERMS AND CONDITIONS ON THE FRONT AND BACK AND CONTAINS THE ENTIRE AGREEMENT BETWEEN THE PARTIES. IT CANNOT BE CHANGED OR ADDED TO EXCEPT IN WRITING SIGNED BY GROWER AND BY BUYER'S PRESIDENT OR VICE PRESIDENT. THIS PARAGRAPH IS SEPARATELY SIGNED BY GROWER HERE:

____
(Signature)

ABC, Inc.

By ____ ____
(Grower's Signature)

____
(Tenant)

I, the owner/tenant of the Grower's Farm, consent to this Contract, to delivery of the eggs to Buyer free of all liens and to payment to Grower.

Date:__________________________________ ____
(Signature)

White - Original Canary - Accounting Pink - Grower

Fee Schedule

Buyer will pay Grower the following per dozen fee for all acceptable eggs delivered by Grower (including the accompanying cull eggs):

If the percentage of all acceptable eggs from the Flock that actually hatch is:	The fee per dozen eggs delivered will be:	If the percentage of all acceptable eggs from the Flock that actually hatch is:	The fee per dozen eggs delivered will be:	If the percentage of all acceptable eggs from the Flock that actually hatch is:	The fee per dozen eggs Delivered will be:
Below 65%	25.2	75-75.9%	27.4	86-86.9%	29.6
65-65.9%	25.4	76-76.9%	27.6	87-87.9%	29.8
66-66.9%	25.6	77-77.9%	27.8	88-88.9%	30.0
67-67.9%	25.8	78-78.9%	28.0	89-89.9%	30.2
68-68.69%	26.0	79-79.9%	28.2	90-90.9%	30.4
69-69.9%	26.2	80-80.9%	28.4	91-91.9%	30.6
70-70.9%	26.4	81-81.9%	28.6	92-92.9%	30.8
71-71.9%	26.6	82-82.9%	28.8	93-93.9%	31.0
72-72.9%	26.8	83-83.9%	29.0	94-94.9%	31.2
73-73.9%	27.0	84-84.9%	29.2	95% & above	31.4
74-74.9%	27.2	85-85.9%	29.4		

II. In addition, Grower will receive credit for economical use of feed, or will be penalized for excessive use of feed, per dozen eggs produced by the Flock (not counting cull eggs), beginning after the Flock reached 10% production of hatching eggs, as follows:

Pounds of feed fed to the Flock per dozen Hatching eggs since flock reached 10% production of hatching eggs:	Bonus, to be paid, or penalty, to be suffered, per dozen hatching eggs:
9.25 & above	$0.0150 penalty
8.75 to 9.24	0.0100 penalty
7.45 to 8.74	no bonus or penalty
7.35 to 7.44	0.0155 bonus
7.25 to 7.34	0.0175 bonus
7.15 to 7.24	0.0200 bonus
7.05 to 7.14	0.0225 bonus
6.95 to 7.04	0.0250 bonus
6.85 to 6.94	0.0275 bonus
6.75 to 6.84	0.0300 bonus
6.65 to 6.74	0.0325 bonus
6.64 & below	0.0350 bonus

If when this Contract is terminated, the Flock has been producing hatchable eggs for less than 40 weeks, there will be added to the applicable "Pounds of feed fed to the Flock..." Figure in the Flock the following Bonus Amount:

Weeks of Hatching Egg Production:	Bonus Amount:
28	.15
29	.15
30	.15
31	.14
32	.14
33	.13
34	.12
35	.11
36	.09
37	.07
38	.05
39	.03

ADDITIONAL TERMS AND CONDITIONS OF THIS CONTRACT:

a. GUARANTEES, PRACTICES: Grower guarantees that the eggs will be produced in compliance with Sections 6, 7, and 12 of the Fair Labor Standards Act, as amended, and of the regulations and orders of the U.S. Department of Labor issued under Section 14 thereof. Grower agrees that the provisions (a) through (g) of the attached sheet entitled "Equal Opportunity", are binding upon the Grower during the performance of this Contract. Grower also guarantees that the Flock and eggs, when delivered, will not be adulterated under the provisions of the Food, Drug, and Cosmetic Act including its pesticide chemical provisions and will give an additional written guarantee at time of delivery that the delivered Flock and eggs are not so adulterated. Grower will not use any drug on the Flock or eggs or anything coming into contact with the Flock or eggs nor any substance or mixture intended to control growth, disease, insects, rodents, fungi, or the like, except those specifically approved by Buyer. With approved substances and mixtures, Grower will use only concentrations, timing and methods approved by Buyer. Grower will keep complete records of drugs, substances and mixtures used and will make the records available to Buyer at reasonable times.

Dry Poultry Litter Handling

Best Management Guidelines

It is recommended that each farm have a waste management plan. These are interim recommended guidelines to be used until waste management plans can be prepared for each farm.

1. Poultry litter should not be stored outside unless proper runoff controls are provided for collection and containment of rainwater that comes in contact with piles of litter.

2. Poultry litter should be evenly distributed over application sites at a rate not to exceed 5 tons per acre per year, or according to a site-specific land management plan, with no more than 2.5 tons/acre in each application. (As a rule of thumb, 30 acres for one 16,000 sq. Ft. house per year).

3. Land application of poultry waste should not be undertaken when soil is saturated, frozen or covered with snow, or during rainy weather or when precipitation is in the immediate forecast.

4. Poultry waste should not be applied on slopes with a grade of more than 15% or according to a site-specific land management plan or in any manner that will allow waste to enter the waters of the state.

5. Surface and subsurface application of poultry waste should not be made within 25 feet of rock outcrops; 100 feet of streams, ponds, lakes, springs, sinkholes, wells, water supplies and dwellings, or according to a site-specific land management plan.

6. Records should be kept by the farmer of the dates, quantity, and specific sites where litter is applied; or if the litter is sold, a record should be kept of who buys the litter, the dates, quantities, and farm or sites where the litter is applied or utilized.

7. Vehicles used for transporting poultry litter on state or federally maintained roads or more than 1 mile on any other public road, should be covered or tarped.

Complied by Cooperative Committee for Poultry Farm Litter and Waste Disposal - comprised of members of the Arkansas Poultry Federation, Soil Conservation Service, Arkansas Department of Pollution Control and Ecology, Arkansas Extension Service, and Arkansas Soil & water Conservation Service.

This page left intentionally blank.

Exhibit 7-3A

__________ GROWER'S INC. GROWER PAY ACCOUNT

W/E 03/11/1996 CO-DEPT 058-405 GROWER NO. XXXXXXX

AMT. OF CHECK 477514

EARNINGS	DEDUCTIONS		NET PAY
6336780	159266	=	477514
		=	

DESCRIPTION	EARNINGS
SETTLEMENT EARNINGS	557596
10 – FUEL BONUS	.79184

DESCRIPTION	
ACCOUNTS RECEIVABLE	159266
NET POUNDS DELIVERED	143,970
PAY PER NET LB	.03873
TOTAL PAY PER NET LB	.04423
TOTAL PAY PER HEAD	.26841
MALE BROILERS	

STATEMENT OF EARNINGS AN DEDUCTIONS – DETACH AND RETAIN FOR YOUR RECORDS

No. 00725000

This page left intentionally blank.

Exhibit 7-3B

RUN ON: 03/14/1996 AT: 13:51

F O O D S, I N C.
ACCOUNTS RECEIVABLE INVOICE STATEMENT
WEEK ENDING 03/11/96

GROBR103
PAGE:

CENTER: 058405 BROILER DIVISION GROWER: FARM:

*** SOURCE OF INVOICE **	INVOICE NUMBER	INFORMATION DATE	AMOUNT **	*** ****************************** ** DESCRIPTION	PAYMENT TYPE	INFORMATION ********************************** CHECK#	DATE	AMOUNT **	INVOICE BALANCE
PROPANE SALES	2336	01/18/96	696.30	PROPANE	DEDUCT	03/11/96		696.30	
					CURRENT DEDUCTIONS & BALANCE			696.30	.00
	6936	02/06/96	841.36	PROPANE	DEDUCT	03/11/96		841.36	
					CURRENT DEDUCTIONS & BALANCE			841.36	.00
	7036	02/05/96	20.00	PROPANE	DEDUCT	03/11/96		20.00	
					CURRENT DEDUCTIONS & BALANCE			20.00	.00
WAREHOUSE SALES	27343	02/01/96	35.00	RAT BAIT	DEDUCT	03/11/96		35.00	
					CURRENT DEDUCTIONS & BALANCE			35.00	.00
			1,592.66					1,592.66	
						TOTALS FOR YOUR ACCOUNT			.00

This page left intentionally blank.

Exhibit 7-3C

BREEDER FLOCK SETTLEMENT

			DATE SETTLED		MARCH 17, 1993
GROWER NAME:			DATE PLACED		11/12/91
ACCT NO-FLOCK NO			DATE MOVED		04/07/92
			DATE 25 WEEKS AGE		05/05/92
			DATE 1ST RECEIVER		05/11/92
			DATE SOLD		02/14/93
BREED	MALES	ROSS	FEMALES	ROSS	
NO PLACED	MALES	1.018	FEMALES	6.800	
NO 25 WEEKS	MALES	673	FEMALES	6.635	
NO SOLD	MALES	510	FEMALES	3.680	

DURATION OF CONTRACT		460.0	DAYS IN PRODUCTION		279.0
	WEEKS	65.7		WEEKS	39.9

TOTAL LBS BREEDER FEED AT 10% PROD	6.31 LBS/DOZEN	595,640
TOTAL LBS FEED FROM DAY OLD	9.38 LBS/DOZEN	819,940

REVENUE:	TOTAL HATCHING EGG DOZENS	87,458	$26,154.63
	TOTAL CULL EGG DOZENS 2.986		
	AVG PAY/DZ HATCH EGGS $0.299		
	PAYMENT - BIRDS SELECTED FLOCK @ $0.02 PER BIRD - WEEK		584.64
	FEED BONUS-ADJ LBS/DOZEN	6.81	
	RATE/DOZEN HATCH EGGS	0.0300	2,623.74
	PROFIT/HEN $4.43	**TOTAL REVENUE**	$29,363.01
	LESS CHARGES TO ACCOUNT DUE FROM GROWER:		
	FLY CONTROL 90.29		90.29
	-		
	LESS GROWING GUARANTEE		584.64
	LESS EGG GUARANTEE		22,156.71
	LESS EQUIPMENT REIMBURSEMENT		0.00
	LESS ADVANCES		0.00

		AMOUNT DUE GROWER	$6,531.37
			=======

SETT EGGS/HEN HOUSED	158.18	HATCHABILITY %	81.97
PRODUCTION %	56.69	FEED LBS/DOZ-25 WKS	6.74
% QUANTITY PLACED	79.18	AVG WGT/HEN SOLD	7.86

This page left intentionally blank.

Exhibit 7-4 (1 of 3)

OPTION TO LEASE AND LEASE AGREEMENT

This agreement made and entered into this _____ day of ____, yyyy by and between __________ and _ herein designated as LESSOR and _________ hereinafter designated as LESSEE.

WITNESSETH:
LESSOR and LESSEE recite that they have entered a contract for the care of __________________poultry ("Contract") on this date. The Contract provides, among other things, that LESSEE will provide poultry to LESSOR to be cared for by LESSOR. The Contract defines instances of default by LESSOR. Also, LESSOR has executed or shall execute a Mortgage, Security Agreement and Assignment of Leases and Rents ("MSA") and Promissory Note ("Note") in favor of ___________________. If LESSOR (i) terminates the Contract and/or does not or ceases to grow poultry for ______,______ other than normal production breaks or (ii) defaults under the Contract with LESSEE or (iii) defaults under the MSA and/or Note with ____, then LESSEE shall have the option to lease LESSOR's property as provided for herein. LESSEE will exercise its option to lease by sending LESSOR the LESSEE's written notice of exercise of option. The notice will be mailed to LESSOR at the address stated in the Contract and shall be effective when mailed by LESSEE. If LESSEE exercises its option, the terms of the lease will be as follows:

1. LEASE OF PREMISES - The LESSOR, in consideration of the rents to be paid the covenants and agreements to be performed by the LESSEE, does hereby let, lease and demise unto the LESSEE the following described premises, and all improvements thereon situated in _______ county, State of ____, to-wit: ____ .

2. TERM - This lease will be for a term of 10 years, beginning mm/dd/yyyy, and ending at midnight, mm/dd/yyyy. The actual dates of the lease term shall be calculated at the beginning of the lease. The lease term shall be as long as the period of time remaining to maturity on LESSOR's promissory note to _________. If the __________ promissory note is paid in full, this lease may be immediately terminated at LESSEE's option. Notwithstanding anything to the contrary herein, the initial lease term shall be automatically extended if LESSEE's use of these premises is interrupted for whatever cause beyond the control of the LESSEE. In such instance, the initial lease term shall end on the date final payment of the MSA and Note is made.

3. OPTION TO RENEW - The LESSEE shall have an option to renew this lease on like terms and conditions, except for the amount of rent, for one period as long as the initial term of the lease. The option to renew may be exercised by LESSEE at any time before the end of the initial term of this lease. The option to renew shall be exercised by LESSEE sending written notice to LESSOR at LESSOR's address in the Broiler Contract.

4. RENT - LESSEE will pay $__________ per quarter as rent, payable as follows: ________________________.

   LESSOR hereby authorizes and directs LESSEE to pay the rental payments for the initial term of this lease agreement to _____________.

   If the option to renew is exercised, the rent shall be an amount which equals 25% of the rent paid in the initial term and LESSEE shall pay LESSOR $_____. per quarter as rent, payable as follows: ________.

5. TAXES - LESSEE will pay all real estate taxes and all other taxes of every kind and nature assessed against the above described real property.

6. MAINTENANCE - LESSEE agrees that he will not commit waste nor permit waste to be done to the above described premises. LESSOR will maintain the roof, outside walls and all structural areas around the building, and the plumbing, heating, air conditioning and electrical fixtures and equipment serving the leased premises. LESSEE, will repair any damage to any portion of the leased premises, including the roof, caused by LESSEE

or LESSEE's guests, agents, servants or employees or any guests, other than normal wear and tear. At the expiration of this lease agreement or any extension thereof, LESSEE will promptly and peacefully deliver possession of said leased premises in an good a condition as they are now, natural wear, tear and casualties beyond LESSEE's control excepted.

Exhibit 7-4 (2 of 3)

7. EASEMENTS - LESSOR agrees to grant to LESSEE all easement rights over, on or under LESSOR's adjoining property. Such easement rights shall include but not be limited to, ingress, egress, utility, etc.

8. ALTERATIONS - LESSEE shall have the right and privilege to make, at LESSEE's expense, repairs and alterations to the leased premises; provided, however, no alterations or changes of a structural nature shall be made without the prior written consent of LESSOR.

9. FIXTURES - All trade fixtures installed by LESSEE or acquired by LESSEE independently of this lease shall remain LESSEE's property and may be removed by LESSEE at the expiration of this lease; provided, however, LESSEE shall restore the leased premises and repair any damage thereto caused by such removal.

10. CASUALTY INSURANCE - LESSEE will maintain adequate fire and casualty insurances on the premises.

11. RIGHT OF INSPECTION - LESSOR or its agents, can enter the leased premises for the purpose of inspection at any reasonable time.

12. UNTENANTABILITY - Should the improvements on the leased premises, or any part thereof, be rendered unfit for occupancy for the purposes for which they are hereby let, by reason of fire, windstorm, or other act of nature or unavoidable casualty, the rentals hereinabove stipulated to be paid by the LESSEE, or such proportion thereof as is related to that portion of the improvements on the premises rendered untenantable by reason of such damage, shall be remitted and abated by LESSOR while the same remains unfit for occupancy and until the premises involved shall have been repaired or returned to tenantable condition. Provided, however, that if LESSORS shall not elect within thirty (30) days of such damage to repair or rebuild the premises then LESSEE may elect to terminate this lease. LESSOR shall in no way be liable or responsible for any damage to any property of the LESSEE in or about the leased premises by reason of flood, water, fire, windstorm or other casualty or act of nature.

13. UTILITIES - LESSEE will have completed and unrestricted access and use of all utilities located on the premises including any and all water supplies and wells.

14. SPECIAL COVENANTS OF LESSOR - LESSOR shall not sell, further encumber, or do any other act that may affect LESSEE's interest in the above property without having first obtained the express written approval of LESSEE.

15. WARRANTIES OF TITLE - LESSOR hereby warrants and covenants with and unto LESSEE that LESSOR has an absolute and indefeasible title to the leased premises, and that LESSOR will, during the term hereof and the full performance by LESSEE of LESSEE's obligation and covenants hereunder, defend the same and hold harmless the LESSEE against the lawful claims of any and all persons.

16. DEFAULT - LESSEE shall, at the option of LESSOR, be in default under the provisions of this lease agreement on the happening of any of the following events or conditions.

    a. Failure to pay the rentals provided herein within ten (10) days after the date they become due;
    b. Failure to keep or perform any of the covenants on the part of the LESSEE herein to be kept or performed, after having been given ten (10) days notice to correct same.

17. TREMEDIES IN THE EVENT OF DEFAULT - In the event of a defaultby LESSEE that continues for more than 30 days after LESSOR's written notice to LESSEE to cure such default, LESSOR may, at the LESSOR's option, declare this Lease thereupon terminated, and LESSOR shall have the right to enter upon and take possession of the leased premises, and to evict and expel LESSEE and any or all of LESSEE's property,

belongings, and effects therefrom, without legal process and without thereby being guilty of any manner of trespass either at law or in equity.

Exhibit 7-4 (3 of 3)

18. WAIVER - The LESSEE's failure to complain of any act omission on the part of the LESSOR, no matter how long the same may continue, will not be deemed a waiver by LESSEE of any breach of any provisions of this lease, or a consent to any subsequent breach of the same or any other provision.

19. NOTICES - Any notice called for or permitted under the terms hereof may be given in writing and sent by ordinary mail to the last address of the party to whom the notice is to be given and designated by such party in writing. LESSOR hereby designates its address as __________. LESSEE hereby designates its address as _____. Any notice so given shall be deemed given when posted. Designations of address may be changed by written notice given by ordinary mail from either party to the other.

20. SEVERABILITY - Each paragraph of this lease agreement is severable from all paragraphs. In the event any court of competent jurisdiction determines that any paragraph or subparagraph is invalid or unenforceable for any reason, all remaining paragraphs and subparagraphs will remain in full force and effect.

    LESSOR, or and in consideration of the agreements herein, does hereby release and relinquish unto the said LESSEE all our right of dower, curtesy and homestead in and to the said lands.

21. NUMBER AND GENDER - Whenever necessary in this lease and where the context admits, the singular term and the related pronoun shall include the plural and appropriate gender.

22. GOVERNING LAW - This lease shall be governed by the laws of the State of ______, both as to interpretation and performance.

23. BINDING EFFECT - This lease shall be binding upon and shall inure to the benefit of the parties hereto, their heirs, personal representatives, successors, and assigns.

IN WITNESS WHEREOF, the LESSOR and LESSEE have hereunto signed and sealed these presents.

_____________________ (LESSEE)

_________________ BY ________________.
(ATTEST)

_________________ ________________.
(WITNESS) (LESSOR)

_________________ ________________.
(WITNESS) (LESSOR)

This page left intentionally blank.

Chapter 9

RESEARCH CREDIT

CONTENTS

Introduction
IRC section 41
Base Amount
IRC section 174
Qualified Research
Audit Techniques
Summary

INTRODUCTION

Congress passed IRC section 41 to provide an incentive for taxpayers to increase their research and development expenditures (R&D). The congressional goal was to maintain the United States' position on the cutting edge of new technology. IRC section 41 provides a credit for qualifying research performed within the United States in all industries, including poultry farming.

The Economic Recovery Tax Act of 1981 (ERTA) first established a non-refundable credit for certain qualified research or experimental expenses in connection with a trade or business. The original credit was very broad and within a few years Congress realized that many taxpayers were stretching the definition of R&D to include expenses Congress had never intended to qualify for the credit.

In 1986 the Tax Reform Act (TRA) was passed, placing extensive limits on the type of expenditures that could qualify as research. The committee reports under Public Law 99-514 specifically put forth the congressional intent to "limit the credit to research activities designed to produce technologically new or improved business items, where substantially all the taxpayer's activities in developing or improving the item constitute elements of a process of experimentation relating to functional aspects of the business item." In pursuit of this objective Congress codified definitions for research activities, qualified services, technologically new or improved business items, process of experimentation, business components, etc. It also identified various areas not qualifying as research.

The 1998 Tax Extension Act (P.L. 105-277, section 1001) amended IRC section 41(h)(1) to further extend the termination date of the research credit to June 30,

1999. This change is effective for amounts paid or incurred after June 30, 1998. In effect, despite the lapse in tame, this change makes the credit continuous from

its previous termination date of June 30, 1998. The 1998 Act also amended the period for which the alternative credit regime will apply from 24 months to 36 months to include the 12-month extension.

The 1999 Tax Relief Extension Act (P.L. 106-170, section 502) extended the research credit through June 30, 2004. In addition, the 1999 Act increased the credit rate applicable under the alternative incremental research credit by one percentage point per step. Finally, the Act expanded the definition of qualified research to include research undertaken in Puerto Rico and U. S. possessions.

The Act creates tow suspension periods, research tax credits that are attributable to the period beginning on July 1, 1999, and ending on September 30, 2000, may not be taken into account prior to October 1, 2000, in determining any amount required to be paid under the Code. Likewise, research tax credits that are attributable tot he period beginning on October 1, 2000, and ending on September 30, 2001, may not be taken into account prior to October 1, 2001 in determining any amount required to be paid under the Code. On or after the date on which the suspension period research tax credits may be taken, a taxpayer may take the credits into account through the filing of an amended return, an application for expedited refund, and adjustment of estimated taxes, or other means allowed under the Code. However, the prohibition on taking suspended credits extends to the determination of any penalty or interest under the Code.

The following are proposed regulations issued recently by the Service. Because they are in proposed form, they do not constitute the official position of the Service and should not be cited as authority. However, they could help in reviewing a research credit issue.

Proposed Regulation 209494-90, 1997-1 C.B. 723. On January 2, 1997, the IRS and Treasury published a notice of proposed rulemaking (NPRM) in the Federal Register (62 FR 81) under section 41 describing when computer software that is developed by (or for the benefit of) a taxpayer primarily for the taxpayer's internal use can qualify for the research credit.

Proposed Regulation 105170-97, 1998-50 I.R.B. 10. On December 2, 1998, the IRS and Treasury published a NPRM in the Federal Register (63 FR 66503) under section 41 that proposes rules and provides examples relating to: (1) the definition of gross receipts for purposes of computing the base amount under section 41(c), (2) the application of the consistency rule in computing the base amount, (3) the definition of qualified research under section 41(d), (4) the application of the exclusions from the definition of qualified research, (5) the application of the shrinking-back rule, and (6) the election and the revocation of the election of the alternative incremental credit.

Proposed Regulation 105606-99, 2000-4 I.R.B. 421. On January 4, 2000, the IRS and Treasury published a new NPRM in the Federal Register (65 FR 258) under section 41 relating to the computation of the credit for increasing research activities for members of a controlled group and the allocation of the credit under section 41(f). These proposed regulations are intended to provide guidance on the proper method for computing the research credit for members of a controlled group and the proper method of allocating the group credit to members of the group.

IRC SECTION 41

Under the general rule a taxpayer is allowed a **Research Credit** based on 20 percent of the excess of qualified research expenditures for the current year over the base amount as computed under IRC section 41. By computing the credit on the excess over an established base, Congress provided an incentive for increases in R&D expenses rather than rewarding companies whose levels of R&D remained constant or decreased during the year.

Example 1

Poultry company A's current year qualified research expenses were $550,000 and its base period amount was $240,000. The company will be entitled to a research credit of $62,000 (550,000-240,000 = 310,000*.20).

Congress also wished to encourage corporations to hire universities and specific types of scientific research entities to perform company research. Effective for years beginning after December 31, 1986, amounts paid to these qualifying organizations for "basic research" are subject to a separate computation under IRC section 41(e). This is a distinct and independent credit from the general research credit with separate computations and is generally referred to as the **University Basic Research Credit.**

Basic research is defined as "any original investigation for the advancement of scientific knowledge not having a specific commercial objective". The 1986 TRA expanded the definition of basic research and increased the credit rate to the current 20 percent. Several of the large poultry companies have strong affiliations with universities, which may generate university basic research credits.

This credit has several noteworthy aspects concerning the payment definition. The

credit is only available to corporations and the payments must have actually been made in order to qualify. Thus, accrual basis companies cannot claim amounts that have been incurred, but not paid. All payments must also be made to the qualifying organization pursuant to a written agreement. The agreement should be available for the examiner's review.

The examiner should be alert to the purpose of the research to ensure that it meets the rules and does not have a specific commercial objective. The major area of adjustment normally occurs with relation to the payment aspects. It is not unusual for the credit to be taken prior to actual cash payments. **Basic research** credits have also been improperly claimed for payments to third parties who used the scientific resources of a university. The payments must be to a qualified organization.

The total research credit, regular and basic, is taken as part of the general business credit on the tax return. It is subject to the limitations under IRC section 38 and the carryback and carryforward rules of IRC section 39. As with most business credits it is nonrefundable.

Similar to the Targeted Jobs Tax Credit taxpayers receive a double benefit if they are allowed to take the credit and deduct all the related expenses. In 1989, Congress passed IRC section 280C under which the taxpayer can make an annual election to either take a reduced credit under IRC section 41 or reduce their IRC section 174 deduction for the amount of credit taken. Once the election is made it can not be revoked.

Example 2

```
Company A's total research credit is $2,000 and
its IRC section 174 expenses are $500,000.  The
company elects to capitalize its IRC section
174 expenses.  Under IRC section 280C(c)(3) the
company can reduce the capitalized expenses to
$498,000 or reduce the amount of IRC section 41
credit by the amount of tax saved by not
reducing the IRC section 174 expenses.
```

As in any credit computation, the hard part of enforcing the general rule comes in providing definitions for purposes of the calculation. For example, how is the "base amount" determined and what are "qualified research expenditures"? IRC section 41 contains the explanation of base amount while IRC section 174 defines qualified research.

BASE AMOUNT

Two parts make up the base amount for the regular research credit. The *fixed-base percentage* is multiplied by the *average annual gross receipts* of the taxpayer for the four taxable years immediately prior to the credit year to determine the base amount. The fixed-base percentage is based on the qualified research expenses divided by the annual gross receipts for at least three years beginning after December 31, 1983 and before January 1, 1989. Once computed, the fixed-base percentage will not change.

Example 3

In 1991, Company A had total qualified research expenses of $100,000. The company's base amount is determined as follows:

	Qualified Research Expenses	Gross Receipts
1984	50,000	500,000
1985	70,000	600,000
1986	80,000	800,000
1987	90,000	1,000,000
1988	100,000	1,300,000
1989	0	800,000
1990	0	1,500,000

The total qualified research expenses for the 1984 through 1988 period of $390,000 are divided by the total gross receipts of $4,200,000 for a fixed-base percentage of 9.29 percent. The total receipts for 1987 through 1990 (the 4 years preceding the tax return) is $4,600,000. This amount is divided by 4 to arrive at the average annual gross receipts of $1,150,000. The $1,150,000 is multiplied by 9.29 percent for a base amount of $106,835.

NOTE: The fixed-base percentage includes all the years from 1984 to 1988. The three-year is a minimum in case the company has not been in existence all five years.

After taking all the steps to compute the base amount there is one more requirement this amount must meet each year. Under no circumstances can the base amount be less than 50 percent of the current year qualified research expenses. The excess qualifying research expenses each year will be determined by the **greater of** the base amount or 50 percent of the current year qualified research expenses. Thus, if the base amount is less than 50 percent of the current year qualified research expenses there will be no excess and no credit.

There are special rules for companies that have fewer than 3 taxable years with both gross receipts and qualified research expenses during the fixed-base years. These are called start up companies and the numerous rules covering the applicable methods for calculating their fixed-base percentage are outlined under IRC section 41(c)(3)(B). The variety of start-up company situations makes it impossible to cover in this chapter.

The base amount as well as the credit is dependent on the definition for qualified

research expenses. To lessen the impact of any variations in the interpretation of what qualifies as qualified research expenses over the year IRC section 41(c)(4)(A) requires a consistent standard definition be applied for all base years and the credit year.

Example 4

```
Company A did not include the costs associated
with its Division 12 as part of the qualified
research expenses for Base year 1.  There were
no changes in the type of activities engaged in
by Division 12 during any of the base years or
the current credit year.

In computing the current year qualified
research expenses Company A can not include any
of the Division 12 expenses. If the examiner
determines that Division 12 expenses should
have been included, the base years, as well as
the current year, must be adjusted.
```

The base amount for the basic research credit is computed in much the same manner as for the regular research credit except only the basic research expenses are included instead of all qualified research expenses.

IRC SECTION 174

Before an expenditure qualifies for the R&D credit, it must first qualify as research and experimental expenditure for purposes of section 174 of the Code. Final regulations under IRC section 174 were issued in 1957 and have been clarified or refined under proposed regulations in 1983, 1989, and 1993.

Final amendments to the IRC section 174 regulations were passed in 1994 and contain clarifications in defining research and experimental expenditures. Technically these amendments apply to returns filed after October 3, 1994. However, since the amendments simply clarify a term from the final regulations it is reasonable to allow taxpayers R&D expenses that are consistent with the final amendments regardless of the year under examination.

IRC section 174 allows the taxpayer to make an election to either deduct research or experimental expenditures paid or incurred in connection with a trade or business or the expenses can be amortized over a minimum 60 month period. The amortization period begins on the first day the taxpayer receives benefits from the R&D. This can include in-house costs as well as expenses for research conducted by another entity on behalf of the taxpayer. No matter which method is chosen the credit can be taken either way.

Qualified Research

Expenditures are termed qualified research for purposes of the credit if they meet the rules under IRC section 174. Research satisfying IRC section 174 "expensing" definition is eligible for the credit only if the research is undertaken for the purpose of discovering information that is technological in nature. Additionally, such research is eligible for the credit only if substantially all of the research activities constitute elements of a process of experimentation for a functional purpose.

IRC section 41(d) specifically excludes the following research from the term "qualified" research:

1. Quality control testing.

2. Efficiency surveys.

3. Management studies.

4. Consumer surveys.

5. Advertising or promotions.

6. The acquisition of an existing patent, model, production or process.

7. Research in connection with literary, historical, or similar projects.

For purposes of IRC section 174 eligible costs are research and developmental expenditures in the experimental or laboratory sense. Although this definition is not always completely clear, there are some obvious exclusions.

Example 5

Company B purchases breeder chicks consisting of Ross roosters and Arbor Acres hens. The company claimed a research credit on all expenses involved in raising its breeders. It was the company position that crossing one breed of male bird with a different female breed made it a researcher. It neglected to recognize that breeders are routinely crossed through out the industry and the resulting meat

producing birds are commercially marketed.

Although most cases will not be as blatantly incorrect as the "crossbreeder," it does highlight the need for the examiner to know the industry. What products have been commercially marketed as well as the different industry practices can be very important in recognizing inappropriate credit claims.

The majority of adjustments will be due to problems with the taxpayer's definition of research.

AUDIT TECHNIQUES

1. If a research credit has been claimed for the year under examination, the first step is the gathering of information. Exhibits 9-1 provide sample Information Document Requests which will be helpful in obtaining most of the background needed. Although each agent should adjust the IDR based on the case under examination, the one item that will be universally helpful is the organization chart. This one item provides an excellent tool in determining the people who should be interviewed.

2. Exhibit 9-2 is an outline of the specific steps that can be taken when auditing research credit. Both exhibits are taken from the Research Credit ISP's recommendations and include comments to ensure the agent understands the reason for each step.

3. Always double check the taxpayer's calculations even if when not auditing the research credit. This should include matching the relevant parts of the base amount to prior years. This often highlights problems with the amounts used by the taxpayer in computing the fixed-base percentage.

SUMMARY

The research credit under IRC section 41 is a temporary benefit that has been extended several times over the years since 1981. Each extension covers a specific time period and may include a change in or clarification of the tax law that affects the extension period and all subsequent extensions. The changes should be reflected under IRC section 41 as revised for the extension. Thus, the examiner needs to be careful in using the tax law write up which covers the examination period.

Research must be “qualified research” as that term is defined in IRC section 41(d)(i) and not excluded research under IRC section 41(d)(3) or (4) to be included in the research credit computation. Further, only these expenses identified in IRC section 41(b) paid or incurred in the conduct of qualified research are creditable expenses.

The committee reports on IRC section 41 are very informative in their outline of Congressional intent for each clarification, revision and extension. Many questions can be resolved by consulting the various committee reports pertaining to each of the extensions as well as the two major revisions in 1981 and 1986.

This chapter is intended to be a general review of the research credit and its relationship with the poultry industry. It does not cover the vast number of technical areas that are part of IRC section 174 and the basic research credit for third party payments. Due to the various exceptions and the numerous definitions, any claimed research credit deserves scrutiny.

Sample Items for
Information Document Requests

Five samples for Information document Requests follow.

Sample 1

Please provide me with the following information regarding your Research Credit for each year under examination.

1. All tax workpapers related to the Research Credit claimed for each year under examination. Such workpapers should be sufficient to identify all departments, cost centers or other organizational units considered to have provided qualifying research services. Likewise, the workpapers should identify each expense account utilized in the Research Credit computational structure. If any project accounting system was utilized in the formulation of the Research Credit claim, please provide a clear set of schedules to comprehensively define the components of such a system.

2. Please provide copies of any written instructions provided to the accounting and/or tax department staffs related to the preparation of the Research Credit claim. In that regard, please identify the individual(s) responsible for the analysis, organization and eventual calculation of the Research Credit claim.

3. Please provide all relevant accounting and/or financial policy manual sections related to research and development or the Research Credit.

4. Quarterly and/or yearly reports submitted by Internal Audit to the Board of Directors or management regarding research and development or the research credit.

5. Please provide all relevant portions of any Business Plan, including any subsequent revisions as they relate to research and development activity at the Company.

6. Please identify by name, title and telephone number the specific individual(s) who will work with the exam team in the audit of the research credit.

Sample 2

Please supply me with the following information regarding your Research Credit for each year under examination.

1. Corporate Organization Chart.

2. Please provide Organization Charts for each department or other organizational unit included in the Research Credit claim. Such charts should be sufficient to identify the manager, supervisor or leader of each department along with all members of the group identified by specific job function or title. The organization charts should identify the direct reporting structure for all management staff from the departmental manager to the Vice President.

3. A detailed written description of the functions performed by each department or other organizational unit included in the Research Credit claim. Such descriptions should include identification of any major development projects undertaken by the group.

4. A detailed written description of each expense account included in the Research Credit claim sufficient to define the nature of expenditures charged to that account.

5. Identify by name, wage, title and job description all personnel whose wages were included in the calculation of the research credit.

Sample 3

Please make arrangements for me to visit your research and development facility(s) for an on-site demonstration and explanation of your product development activities.

Please have available at this demonstration a responsible individual who can explain or provide the following:

1. What qualifying projects were being worked on during the years under examination.

2. The employees who worked on these projects.

3. Documentation to support and explain each project.

4. Any patents or copyrights that were granted due to the successful development of a product during the years under examination.

5. Explanation on any projects that were worked on and abandoned during the years under examination.

6. Any brochure, pamphlet or other written material that explains your research and development activities.

Sample 4

Please supply me with the following information regarding your research credit for each year under examination.

1. Do you provide a section 401(k) plan or other deferred compensation plan for your employees? If so, did you include the payments made into this plan by either the Company or the employee as qualified research wages? If so please identify the total contribution to the plan(s) paid by qualified research employees and the amount contributed by you.

2. Is all your worldwide research and development expenditures conducted inside the United States? If not, please list the locations where R&D expenses occur outside the U.S.

3. Please provide a list of all individuals and corporations who performed contract research for you. The list should include:

    a. Name, address and ID# of each contract researcher.

    b. Total amount paid each year.

    c. Description of the research performed.

    d. Does the contract researcher retained any rights to the research?

    e. Was the payment for the research contingent upon success?

Sample 5

Please supply me with the following information regarding your research credit for each year under examination.

1. Description of research performed.

2. Names and titles of individuals involved in research.

3. Research work performed by each research individual.

4. Other duties performed by each research individual.

5. New or improved business component resulting from the research.

6. Outline of the experimentation process.

7. Listing of all expenses included in the research credit calculation for the current year and base year.

8. When did the company first make the resulting new or improved business component available for sale?

9. Workpapers supporting the calculations for the current and base years.

Research Credit
Audit Plan for Examination of the Research Credit

1. Conduct a thorough, in-depth pre-audit discussion with the taxpayer. Request a explanation of the taxpayer's product research and development activities. Conduct a tour of the taxpayer's R&D facilities. Request a demonstration of the research activities. The purpose of these discussions and demonstrations is to:

   a. Identify the structure of the R&D organization and the manner in which the research credit claim was organized.

   b. Understand the taxpayer's industry and its impact on the industry for research.

   c. Understand the taxpayer's research and development function.

   d. Identify personnel whose wages were included in the credit computation, and,

   e. Identify available documentation and alternative information sources to verify R&D expenditures and qualified research activities.

   COMMENT: Having the taxpayer give an explanation and a demonstration of its research and development activities will afford the examiner an opportunity to form a natural impression as to whether the taxpayer is actually conducting research. After the demonstration, the examiner should have some basis to decide whether the expenditures incurred represent expenses incurred for research and development since this examination technique is tailored to the specific taxpayer who is conducting qualified research. Assuming that the taxpayer has convinced the examiner that qualified research is being conducted, the majority of the audit time may be spent on reviewing the expense items and the activities that they represent rather than the projects.

2. Determine how the taxpayer calculates its research credit:

   a. By cost centers, departments, and accounts taken from the taxpayer's year end adjusted trial balance.

   b. By projects.

   COMMENT: Except for certain industries where project accounting is required (for example, Aerospace, Defense), most companies calculate the research credit by totaling the costs attributable to qualified cost centers or departments and accounts"

rather than by projects. In many cases, the taxpayer has taken 100 percent of the "qualifying department, cost center and account". Often no allocation is made for unqualified expenses that may exist within those cost structures.

3. Issue an IDR requesting all workpapers calculating the research credit.

   a. Workpapers generally will show all qualifying cost centers or departments, and accounts. They should be broken down by:

      i) Wages

      ii) Supplies

      iii) Contract research

4. Issue IDR requesting the following information:

   a. Written description or profile of each qualifying cost center and/or each qualifying department. These descriptions should serve to define the function of each department included in the credit.

      COMMENT: By obtaining a written description, it is possible to eliminate the costs of certain cost centers or departments by simply reviewing what function that cost center or department performs. Interviews may be necessary to confirm what is actually done in any department where the taxpayer argues that the department description does not reflect all the functions that are performed within the department. In some cases a department may be found that performs some administrative function which would not qualify for the credit. Therefore, an allocation of that department would be warranted.

   b. Organization chart of the taxpayer. If available, request an organization chart of each qualifying cost center or department. Identify the individuals who are responsible for each cost center or department.

      COMMENT: By identifying specific individuals, it is possible to differentiate functional and managerial members of each department. Once the managerial members have been identified, the organizational structure may serve to define levels of managerial authority.

   c. The written accounting and/or financial policy and procedures manual regarding the research credit.

      COMMENT: By reviewing the taxpayer's policy, you may become familiar with the procedures used by the taxpayer to determining what qualifies for the credit.

d. Business plan prepared for each relevant department or division within the research and development structure of the company.

   COMMENT: This plan is prepared for each division showing what specific responsibilities are assigned and what accomplishments are expected of the division in the coming year.

5. For qualifying wages, employees must be engaged in qualified research, direct supervision of qualified research, and/or direct support of qualified research.

   a. Secure the taxpayer's W-2 file. This technique is especially helpful in examining taxpayers with a calendar year end, but may also be used with most fiscal year taxpayers.

      COMMENT: Utilizing a CAS, a payroll run can be requested for each qualifying department showing the employee number, name of the employee, total yearly wages, a job code number, and job title. The job code number and job title information can be useful to identify questionable job descriptions that you may want to review further.

   b. Secure a copy of the written job descriptions that appear questionable.

      COMMENT: The job descriptions will identify the specific duties and responsibilities that apply to a particular position.

   c. Request personnel evaluations of the employees in question.

      COMMENT: The personnel evaluations will give the examiner a detailed description of the assigned activities and accomplishments of the employee. They may offer a better description of the responsibilities and duties of an employee than a job description.

   d. Consider the following issues:

      i) Administrative duties ─ activities of an administrative nature may not qualify for the credit; unless such activities qualify as direct support of research activities.

      ii) Management levels ─ activities performed by managers who are above the level of first-line managers; may not qualify for the credit.

         COMMENT: It may be necessary to interview employees regarding their specific activities as the taxpayer may argue that the written job descriptions do not reflect

the true situation. To determine whether a manager's duties are above the level of a first-line manager, it might be worthwhile to interview the

employees actually conducting research for their observations concerning the activities of the managers in question. These employees may be more open than the actual manager.

iii) The duties performed by managers of direct support staff do not qualify for the credit.

iv) Non-qualified employees of all types; that is, technical writers, editors, and user manual publication staff.

v) Payments to a deferred compensation plan such as 401(k) plan. Compensation that is not subject to withholding per IRC section 3401(a) does not qualify for the credit.

vi) Research conducted in foreign countries does not qualify for the credit.

vii) Fringe benefits that are not subject to withholding under IRC section 3401(a).

viii) Activities relating to the review of a competitor's product; otherwise called reverse engineering.

6. Examination techniques used to review supplies.

COMMENT: Supplies used in qualified research in most instances do not represent a large percentage of the total qualified expenses. If supplies do represent a high percentage of the overall costs a closer review of this item would be warranted. It may indicate that the new product is beyond the research phase and in production.

a. Within the qualified cost centers or departments, specific accounts are represented to be qualified expenditures. Select those account numbers that represent supplies and obtain written descriptions of those accounts.

b. Consider the following issues:

i) Items that are by nature subject to an allowance for depreciation do not qualify for the credit. This includes items such as small tools or purchased software that are used in the research process.

ii) Utilities do not qualify; unless they are extraordinary.

7. Examination techniques used to review contract research.

COMMENT: Taxpayers determine the credit by totaling all payments made for qualified contract research and including 65 percent of this amount as a qualifying expense. Contract research is usually performed by the research and development staff of an

unrelated taxpayer. Since this other taxpayer probably computes its own research credit by totaling the expenditures of qualifying code centers and departments, its quite possible that the costs of these departments are included by both taxpayers for the credit.

a. Secure a listing of all the vendors who performed qualified contract research for the taxpayer, by amount and year.

   COMMENT: Review the list. Note all vendors (usually corporations) that would probably have research and development departments within their corporate structure. There is a good possibility that both corporations took the credit for the same research work.

b. Review the contracts or agreements with these vendors.

   COMMENT: To qualify as contract research, a taxpayer must show that the research was performed only for his benefit and that he bears the economic loss if the research is not successful. Section 1.41-2(e))

c. Determine if your taxpayer does any contract research work for other taxpayers. If so, review the contracts or proposals. Also, determine what departments perform the contract research work.

   COMMENT: If these contracts, proposals, or agreements show the economic loss is with the customer; all expenses attributable to that contract do not qualify for the credit. It is important to answer the following questions:

   i) Is the contract payment contingent upon success?

   ii) Who retains all the substantial rights?

      COMMENT: In reviewing research contracts, if you identify contracts in which the risk and retention of substantial rights is with the taxpayer being examined. Please notify the research credit issue specialist of the following:

      - Name and address of vendor who performed the research.

      - Amount received from the vendor for the research work.

This page left intentionally blank.

Chapter 10

MISCELLANEOUS

CONTENTS

Introduction
Annual Accounting Periods
    52/53 Week Year
    Accruals
Depreciation
    Prior Law
    IRC section 447(i)
    IRC section 168(b)(2)
    IRC section 263A(e)(4)
    Issue
Unreported Income
Bartering
Form 1099 to Executive
Personal Expenses of Shareholders/Officers
Audit Techniques
Summary

INTRODUCTION

The poultry industry contains several issues that apply to the entire farming industry and issues that are universal. However, each industry has unique features that can have a bearing on the tax impact of a particular situation. This chapter also covers several topics that have an unusual twist because of the industry's farming connection.

ANNUAL ACCOUNTING PERIODS

52/53 Week Year

Under IRC section 441(f) specific taxpayers may elect a flexible tax year which is based on an annual period which varies from 52 to 53 weeks and always ends on the same day of the week. Section 441(f)(1) determines the actual date on which a particular 52/53-week year will "end always---

1. on whatever date such same day of the week last occurs in a calendar month, or

2.on whatever date such same day of the week falls which is nearest to the last day of a calendar month"

Example 1

Poultry, Inc. elected a taxable year ending on the last Saturday of November 1994. Its taxable year for 9411 would end on November 26, 1994 and the 9511 return would end on November 25, 1995.

If the company had made the election under IRC section 441(f)(1)(B), its 9411 return would end on December 3, 1994. The first Saturday in December is the closest Saturday to the last day of November.

Since the last day is not always in the same month from year to year, occasional problems may arise under the IRC section 441(f)(1)(B). An examiner may encounter difficulty when ordering the 9411 tax return on Poultry, Inc. if it has been entered as a 9512 return. In addition, taxpayers have used the wrong ending date, which can create problem with tax assessments.

Accruals

If the taxpayer maintains a financial year, which ends in a different month than its tax year, it may encounter unusual problems with its accruals. Under IRC section 461 the all events test requires a liability to be fixed prior to a deduction. Since some of the company's contracts are based on the financial year, they will not be fixed as of the tax year-end.

Example 2

Poultry, Inc.'s tax year ends in March and its financial year ends in September. Annual employee bonuses are based on a percentage of the annual financial profit, if any, for each financial year.

The company would not be entitled to an accrual on its 9503 tax return for the 9509 bonuses.

In Revenue Procedure 2000-22, 2000-20 I.R.B. 1008, small taxpayers are provided an expeditious procedure to change their method of accounting to the cash receipts and disbursements method. To qualify for these procedures a taxpayer must have average annual gross receipts of $1,000,000 or less and use the cash method for non-tax purposes.

DEPRECIATION

IRC section 168 provides specific cost recovery rules that are based on the type or class of income producing property. Special limitations are imposed on property used in the trade or business of farming.

Prior Law

Prior to 1989, the integrated poultry companies maintained separate entities for the farm and the processing portions of their operations to take advantage of the cash basis of accounting. Under IRC section 447 farming businesses were entitled to use the cash basis regardless of the business size as long as certain rules pertaining to corporate ownership were maintained.

Included in the farm entity were all activities prior to the actual delivery of the birds to the processing plant. For the typical company, this would include poultry growout, transportation, feed mills, and hatcheries. The processing entity included the processing operations, offal facilities, protein plants, sales, advertising, and the general administration activities.

During this time, the Internal Revenue Service made several challenges against portions of the business that the companies had included in the farming enterprise. Regardless of the Government's arguments, the courts consistently ruled that the companies farming operations included the feed mills, poultry houses, transportation, hatcheries, and feedlots. ***Burgess Poultry Market, Inc.***, 64-2 U.S.T.C. P9515; ***W. P. Garth***, 56 T.C. 610,619 (1970); ***Hi-Plains Enterprises, Inc.***, 60 T.C. 159; ***Maple Leaf Farms, Inc.***, 64 T.C. 438; and ***Rocco, Inc.,*** 72 T.C. 140.

In ***Chemell v. Commissioner***, 51 A.F.T.R. 219 the taxpayer purchased feed from third parties, including some they had contracted for prior to the planting, mixed the feed in company-owned feed mills, and delivered it to their contract growers. In finding that all of the above activities constituted farming, the courts emphasized the need to review the current industry practices in making the determination. Per their review of the poultry industry the hatchery and feeding operations were found to be "so intimately and directly connected with farming activities as to constitute one ***."

The courts also held the taxpayers to the same standard when they tried to separate portions of the farming activities in order to gain benefits. This is highlighted in ***Peterson Produce Company***, 9 A.F.T.R. 2d 1608. The taxpayer had established its feed mill and hatchery businesses under the accrual method of accounting. When they started contracting for the raising and selling of the hatchery's broiler chicks, they tried to set up a separate broiler division and use the cash method of accounting.

In ruling against the taxpayer, the court found that, "Because of the functional integration of the three departments" the broiler division was not a separate business but part of the taxpayer's established farming business. The court viewed the feed mill, hatchery, and broiler growout as so intertwined that it comprised a single trade or business. As one trade or business they were entitled to only one accounting method, inventory method, etc. Since the taxpayer was only involved in one business, it follows that all assets were either used in this one business or they were not business assets.

IRC Section 447(i)

As outlined in Chapter 1 (IRC section 447 ─ Accrual v. Cash), most of the large poultry companies were forced to change to the accrual method of accounting in their first taxable year beginning after December 31, 1987. This removed a major benefit the poultry companies had previously received under their farming umbrella. It also removed any incentive for companies to keep their farming business separated from their processing and other businesses.

IRC Section 168(b)(2)

In 1988, Congress added IRC section 168(b)(2)(B) which contains one of the few disadvantages of the farming classification. This section limits the depreciation calculation for farmers to 150 percent declining balance. It covers all tangible property used in a farming business (as defined in IRC section 263A(e)(4) except for residential rental property and nonresidential real property).

Example 3

Farmer Jones owns the following assets.

Computer
Tractor
Hay Baler
Stock Trailer
Truck
Office furniture

He uses all of these assets in his farming business. Depreciation on each asset is limited to 150 percent declining balance.

A change to correct a taxpayer's consistently used improper depreciation method, recovery period, or convention for computing its depreciation deduction is a change to the taxpayer's method of accounting, subject to IRC sections 446 and 481.

IRC Section 263A(e)(4)

In limiting the depreciation for farming businesses, IRC section 168 refers to the definition of farming as outlined under IRC section 263A(e)(4). At first glance this is not a very helpful reference. It simply defines "farming business" as the trade or business of farming. The regulations however provide more detail.

Treas. Reg. section 1.263A-4(a)(4) contains an extremely broad definition of farming which includes "the raising, shearing, feeding, caring for, training, and

management of animals." It also includes any activities which are "normally incident to the growing, raising, or harvesting" of agricultural or horticultural products. The regulations also clarify that the trade or business of merely buying and reselling plants or animals grown or raised by another is not a farming business for purposes of IRC section 263A.

The regulations clarify that a farming business does not include the processing of commodities or products beyond those activities that are normally incident to the growing, raising, or harvesting of such products. See, Treas. Reg. section 1.263A-4(a)(4)(ii). Example 3 in Treas. Reg. section 1.263A-4(a)(4)(iii) illustrates the situation where a taxpayer is in the business of raising poultry and other livestock and the taxpayer also operates a meat processing plant. Under these circumstances, the taxpayer is in the farming business with respect to the raising of the poultry and other livestock. The taxpayer is not, however, in the farming business with respect to the processing activities.

Issue

Since it is no longer advantageous to claim farm status for all of the farm activities some companies may attempt to avoid the disadvantages of the farm classification. A taxpayer may claim non-farm status for its feed trucks, cage trucks, chick buses, and feed mills to obtain 200 percent depreciation.

One argument that has been posed by integrated poultry companies is that a feed mill operator in a stand-alone business would not be considered a "farmer." Furthermore, a transportation company owning the same type of vehicles would not be considered a "farmer." Both of these statements are true, but irrelevant to an integrated poultry company.

Consider the wording of IRC section 168, "any property used in a farming business ***." Thus, a stock trailer used by a farmer in his farming business is limited to the 150 percent depreciation. A stock trailer used by an individual who hires out to haul cattle to market is not used in a farming business since the individual is not a farmer. The fact that a non-farmer can use a feed mill or a chick bus does not affect their use by a farmer.

Poultry companies have also put forth that an asset must be used in the raising, feeding, or management of the livestock before it is considered as used in the farming business. This theory is nullified by the wording of IRC section 168 which plainly states that property need only be used in a farming business. There is no requirement that it be used for a direct farming purpose. A computer used by a farmer is used in a farming business, although its purpose would be bookkeeping or accounting in nature.

As outlined in the court cases discussed earlier, the courts were united in ruling that feed mills, hatcheries, transportation, and grow out activities engaged in by the integrated poultry companies were farming businesses. Due to the intertwined nature of the activities, the courts continue to consider them as one trade or business.

The Internal Revenue Service has followed the courts' rulings. A Private Letter Ruling was issued in response to a taxpayer who was expanding its farming business to include cattle feedlots. As part of the expansion, they would be adding a feed mill that would sell 30 percent of its feed to outside third parties while using the rest for the company owned feedlot. The feed mill was ruled a part of the farming activities for purposes of the recapture tests under IRC section 447.

Although a PLR can not be cited, it does provide an indication of how the statute was interpreted in a situation that may be encountered in a poultry industry examination.

The definition for a farming business under IRC section 263A follows the findings in the above PLR. It does not allow the taxpayer or the Government to pull out segments of the farming activities. Nor does IRC section 168 narrow the depreciation limitation to "farm assets" as the taxpayer's argument indicates. Rather, it provides the broader scope covered under assets "used in a farming business."

UNREPORTED INCOME

Since most farmers are self-employed and sell a product instead of providing a service, Forms 1099 are seldom required. This had led to discrepancies between the expenses deducted and the income reported.

The assets on the depreciation schedule can provide valuable information about the farmer's activities. It can indicate when farmers own equipment to bail their own hay. Also, a farmer who does not show any hay purchases probably bails his or her own hay. Typically, a farmer can sell hay to third parties for $20 to $40 a round bale, depending on the geographical location and the size of the bale. There are several different sizes of round bales as well as at least two sizes of square bales.

If a grower has only a few acres of land, he or she will need to sell the chicken litter from his or her poultry houses. As indicated in Chapter 7 (Growers) it is illegal to stockpile chicken litter. Depending on the area, litter can be sold from $25 to $50 a load, although it is occasionally hard to find a buyer. Some of the integrated companies will buy litter from their own growers. The depreciation schedule can

indicate if the farmer needs to sell the litter based on the buyer picking it up versus the farmer delivering it to the buyer's land. This can affect the final sale price of the litter.

BARTERING

Because of its characteristics, a farming business contains more bartering opportunities than any other business, except for bartering clubs. This remains true even today because of the extremely close-knit community atmosphere that is still very much a part of the farm culture. Most independent farmers still work together to bring in hay crops, clean chicken houses, and build fences. For the most part these arrangements do not affect either farmer's taxable income. They represent equal parts income and expense.

As with any bartering, situation problems arise when a personal element is introduced. For example, if the farmer baled hay for his neighbor, a dentist, he might receive some dental care for his family. An expense may be "paid" by the rendering of services.

It is not unusual for the large integrated companies to carry on this tradition by processing birds for a competitor who finds itself overstocked. These are normally handled as arm's length transactions even when they entail a trade off of services rather than an exchange of checks.

As with the independent farmers, a personal element may cause a taxable event. The personal element could include use of the other company's plane for personal reasons, as well as use of other corporate assets. The bottom line is that although bartering is widespread in the farming industry, it seldom causes a tax problem for either party.

FORM 1099 TO EXECUTIVES

The poultry industry provides some unique opportunities for executives and shareholders to enter into business arrangements with the integrated companies. The executives and shareholders will often have various business transactions with the corporation outside of their normal duties.

Problems have been encountered in situations where the company pays a shareholder or executive taxable income other than their standard wages. These can arise from several different avenues. First, most payments made to related parties are handled manually and do not run through the company's normal account payable system. Second, many companies identify Form 1099 recipients by the vendor

codes and handwritten checks may not require a vendor code. Third, vendor codes provided to related parties are often not handled under normal company policy.

These can result in unreported rental, interest or other payments to related parties. In many cases, most of the payments will be reported. However, there may be some discrepancies between the payments shown on the corporate books and the payments shown on the payee's tax return.

PERSONAL EXPENSES OF SHAREHOLDERS/OFFICERS

The history of most integrated poultry companies is typically centered on a founding family who is still very active in the current business. Usually this family continues to own a majority or substantial minority of the corporate stock. Family members may have seats on the board of directors, hold executive offices, and/or management positions. Many of the board members and officers will be close friends of the founding family.

It is not unusual for the integrated poultry company to pay various personal expenses of different family members as well as to supply company employees to perform lawn maintenance, personal farm work, personal errands, home security, car maintenance, etc. Company employees will also run errands for the executives' family members, provide baby-sitting, and maintain personal residences.

If the shareholder or executive has outside business interests the company's accounting department or a particular company employee may provide complete bookkeeping services. These services are often extensive in nature and may include the actual management of the outside businesses.

The company should either bill the family member for the fair market value (FMV) of these services or include it in their Form W-2 or on a Form 1099. If no reporting has been made, a dividend adjustment equal to the FMV of the services is needed.

AUDIT TECHNIQUES

52/53 Week Year

Examiner should verify the beginning and ending tax year dates used by the taxpayer. If an incorrect date is used it can have an impact on any tax assessments as well as the allowable accruals.

Accruals

Inspect the contracts covering the accruals that are open to dependence on the financial period.

Depreciation

1. Review the depreciation schedule for assets claiming 200 percent depreciation. Verify the correct separation of processing versus farming.

2. There are two alternate issues which should be proposed if a taxpayer is claiming non-farm status for feed mills, transportation equipment, etc.

a. If the taxpayer has a suspense account, the tests to determine when any part of this account should be recaptured will need to be reviewed in light of the claimed non-farm status. For example, the portion of sales that are due disputed divisions will not be considered farming income. This will affect the test, which determines if the farming business has decreased and may result in a partial recapture of the suspense account.

   In the unusual case where the agent has the year in which the suspense account was created it will be necessary to remove all IRC section 481(a) adjustments arising from the disputed divisions. These will be recognized in the year of change instead of receiving a deferral in the suspense account.

b. Remember how the farm price method could only be used on farm inventory? If the feed mills are not part of the farming business, the feed must be valued under IRC section 263A. Thus, a first year 263A adjustment will be necessary.

Unreported Income

1. Bank deposit analysis of the personal account of the grower. This can identify the following sources of unreported revenues:

   a. Unreported sale of cattle and other farm products.

   b. Unreported sale of litter.

   c. Insurance payments for property losses. This can be 100 percent gain given the accelerated depreciation methods available. Insurance reimbursements in which grower did not decrease the related expenses.

   d. Unreported bonuses that the poultry company did not include on Form 1099.

   e. Unreported sale of other farm assets.

2. If the taxpayer has cattle check with local cattle auction houses for any sales in their name.

3. The company's insurance agency can be contacted (or their in-house risk department) for a complete listing of all insurance receipts. Each payment can be traced through the books for proper reporting.

4. Although the price of hay will change depending on the hay crop each year, the

examiner can get a general idea by looking for hay ads in the local paper or weekly shopper.

Bartering

Bartering arrangements that include the personal use of company assets by unrelated parties can normally be found by a thorough review of the airplane or facility logs that record usage.

Form 1099 to Executives

1. Interview a company employee familiar with the procedures that trigger the issuance of a Form_1099. Does the employee who inputs the payment information mark a box indicating a Form 1099 should be issued? Are all entries into a specific type of account automatically set up for Form 1099? Are all vendors sent Form 1099?

2. If the examiner has downloaded database records from the company it is relatively easy to separate all records containing any executives' names or vendor codes especially if the payment or vendor code columns are indexed. Vendor code listings can be requested from the taxpayer. If the agent does not have downloaded records or is unfamiliar with databases, a computer audit specialist should be consulted.

   Once the list of payments to each executive is obtained it can be matched to the executives' returns.

3. Verify if any bonuses or other payments to growers are included in their Form 1099. If the company omits any payments to the growers, it is likely that the growers will not pick up the income.

Personal Expenses of Shareholders/Officers

1. If the family member or executive is billed or charged with the services, verify the calculations used FMV and not company cost. FMV takes into consideration the employee's pension, vacation, insurance, etc. which are in excess of the actual wages paid.

2. Many entertainment facilities are listed under different titles on the depreciation schedules. It may be called a sales center, marketing facility, advertising center, or employee training facility. Review all new buildings and match to organization chart. Request building plans for any facilities that require further analysis. Visit the building if feasible. If the building is out of

town consider locating the closest IRS office and requesting information on the current usage.

3. The inspection of related returns will highlight any outside business interests. Examiner can simply ask if the company performs any bookkeeping for the related parties. If the related return will be examined, verify who set up the books on the outside businesses. Whose name is on the checks? Where are the bank statements sent? Who provided the records for the audit? Ask questions.

SUMMARY

Knowledge of an industry provides a greater ability to identify the special benefits as well as the hazards for the taxpayers in that industry. The integrated poultry companies are part of the farming industry and although they share many of the farming traits and issues, they add some unique twists of their own. By knowing the tax law history and the industry background an examiner will be able to verify the appropriate determination for their taxpayer.

This page left intentionally blank.

Chapter 11

RESOURCES

CONTENT

Introduction
Possible Avenues of Research
Magazines and Publications
Associations
Research Facilities
Market Services
State Agricultural Statistical Services
Records

INTRODUCTION

This chapter contains various sources of information to help in understanding the industry as well as providing background on a particular area. The trade publications include details on processing locations, industry trends, and the locations for suppliers. The government agencies supply market prices and statistics for different stages of growth.

The examiner should look upon the information in this chapter as a starting point rather than an all-inclusive list. As in any industry, constant changes and updates will need to be considered.

Currently, the Internal Revenue Service does not have an Industry Specialist for poultry. However, Steve Voight, the Food & Beverage ISP, has provided substantial support and coordination for several poultry examinations. His help has been invaluable. He can be reached at (630) 743-0582.

POSSIBLE AVENUES OF RESEARCH

Larger libraries, especially academic libraries, are excellent research avenues. If

they have Interlibrary Loan capabilities, articles can be ordered and received within a week.

There are computer databases available at libraries that may be searched for books and journal article citations and abstracts. The main database with poultry information is called Agricola. It may be accessed through Firstsearch on the library computer. Firstsearch is also available through the World Wide Web at http://www.ref.oclc.org:2000/.

If on-the-job access is available, the Internet can be searched for further industry information. Many of the poultry associations and companies have web sites on the Internet that can be very detailed. Several of the government sites also include industry statistics.

MAGAZINES AND PUBLICATIONS

- Broiler Industry (Monthly) ─ Each January it lists the top boiler companies and provides excellent summaries of each company. It normally covers broiler production, processing, and marketing.
  Watt Publishing Co.
  (815) 734-4171

- Poultry Digest (Monthly) ─ Production information for the broiler, egg, and turkey industries. It provides a synopsis of current studies on feed, laying cycles, etc. Lists the upcoming events in the poultry field.

- Egg Industry (Monthly) ─ Current industry news and studies.
  A Watt Poultry Publication
  1-800-734-4171.

- Applied Poultry Research - Current studies on the various influences for meat yield, litter materials, copper or other minerals in the feed, manure production based on feed/breed, etc.

- British Poultry Science (Monthly) - Current research from Europe and the U. S. Examples of the type of studies: Current in-house weighing equipment for layers and its benefits. The affects of ambient temperatures, genetics traits and benefits. The affect of various temperatures at each stage of the growout.

- Turkey World (Bimonthly) - General updates on the industry.
  Watt Publishing Co.
  (815) 734-4171

- The Poultry Tribune (Monthly) - Covers the broiler, turkey, and egg industries. Focuses on breeders.
  Watt Publishing Company
  (815) 734-4171.

- Cryovac Division Offers a booklet that describes the company's packaging/ marketing systems.
  W.R. Grace & Co
  Duncan, SC
  For a copy call 800-845-3456.

  Institute of Packaging Professionals Contains the Packaging Bookstore. It can provide textbooks, monographs, packaging reference sources, etc.
  Herndon, VA
  (703) 318-8970

- Poultry Times (Weekly) - Contains market quotes.

ASSOCIATIONS

The following associations are industry supported consisting of an industry based membership.

Agriculture Council of America
Washington D.C.

Alabama Poultry & Egg Association
P.O. Box 240
Montgomery, AL 36101-0240
(324) 256-2732

Arkansas Poultry Federation
P.O. Box 1446
Little Rock, AR 72203
(501) 375-8131

Midwest Poultry Federation
2830 Wycliff Street
St. Paul, MN 44114
(612) 646-4553

National Poultry & Food
Distributors Associations
604 Green Street NE, Suite # 3
Gainesville, GA 30501
(404) 535-9901

New England Poultry Association
(207) 622-3940

Ohio Poultry Association
5930 Sharon Woods Blvd
Columbus, OH 43229
(614) 882-6111

Pacific Egg & Poultry Association
1521 I Street
Sacramento, CA 95814
(916) 441-0801

Poultry Science Association
1111 North Dunlap Avenue
Savay, IL 61874
(217) 356-3182

Southeastern Poultry & Egg Association
1530 Cooledge Road
Tucker, GA 30084
(770) 493-9401

RESEARCH FACILITIES

All of the Universities listed below have large poultry departments that normally include extensive laboratories as well as working farms. The professors/scientists have conducted numerous experiments on which papers have been written.

University of Arkansas
Fayetteville, AR 72701
(501) 575-2000
Cooperative Extension Service
(501) 575-6529
Biological & Agricultural Engineering Dept.
(501) 575-3251
Broiler Energy Unit
(501)442-8009
Poultry Farm
(501) 575-2176
Poultry Science Department
(501) 575-4952

University of Delaware
R.D. 6 Box 48
Georgetown, DE 19947
(302) 856-7303

University of Georgia
Poultry Science Dept.
Athens, GA 30602-2772

Louisiana State University
Baton Rouge, LA 70803
(504) 388-8667

Poultry Business Unit
Division of BAYER, INC.
P.O. Box 174
Watkins, GA 30677
(706) 769-1574
Email: chickenrgs @aol.com

MARKET SERVICES

Typically, the poultry company pays a fee to a market service company which supplies market information. The information supplied will depend on the needs of the poultry company. Urner Berry is very widely used and provides information on just about any poultry market from chickens to turkeys. Ask the poultry company for copies of the services they receive.

Several government agencies also offer market quotes. Most of these are free to the public and are based on industry surveys. The magazines shown below contain some of the government and industry market quotes.

- EGG CLEARINGHOUSE, INC.
  122 Broadway Street 2nd Floor
  Dover, NH 03821-0817
  (800) 829-EGGS

- GEORGIA DOCK
  Georgia Department of Agriculture
  (404) 656-3656

  Quotes are based on a whole bird with giblets. Average processed weight of 2.5 to 3 lbs. Projection for the next week. Released on Wednesdays.

- POULTRY & EGG FAX
  950 Carlisle Road

Stone Mountain, GA 30083

- POULTRY TIMES - Weekly magazine

  Contains week market prices for the broiler eggs, commercial eggs, meat turkeys, broilers and spent hens.

- URNER BERRY
  (908) 240-5330

- United States Department of Agriculture (USDA)
  Talmadge Williams
  (706) 546-2290

  Mr. Williams is involved in the gathering of statistical facts concerning the poultry industry. The USDA also prints an annual Agricultural Statistics Price Summary which includes the poultry statistics by state.

- USDA - Turkey Statistics
  Poultry & Egg Division
  Des Moines, IA
  (515) 284-4471

STATE AGRICULTURAL STATISTICAL SERVICES

Local poultry industry data can also be obtained from the following state services:

ALABAMA **ALASKA**

State Statistician
P. O. Box 240578
Montgomery, AL 36124-0578
(334) 279-3555

D. A. Brown
P. O. Box 799
Palmer, AK 99645
(907) 745-4272

ARIZONA
W. N. Sherman
3003 N. Central Ave., Suite 950
Phoenix, AZ 85012
(602) 280-8850

ARKANSAS
B. F. Klugh
P. O. Box 3197
Little Rock, AR 72203
(501) 324-5145

CALIFORNIA
H. J. Tippett
P. O. Box 1258
Sacramento, CA 95812
(916) 551-1533

COLORADO
C. A. Hudson
P. O. Box 150969
Lakewood, CO 80215-0969
(303) 236-2300

DELAWARE
T. W. Feurer
2320 S. Dupont Hwy.
Dover, DE 19901
(302) 739-4811

FLORIDA
R. L. Freie
1222 Woodward St
Orlando, FL 32803
(407) 648-6013

GEORGIA
L. E. Snipes
Stephens Fed. Bldg., Suite 320
Athens, GA 30613
(706) 546-2236

HAWAII
D. A. Martin
P. O. Box 22159
Honolulu, HI 96823-2159
(808) 973-2907

IDAHO
D. G. Gerhardt
P. O. Box 1699
Boise, ID 83701
(208) 384-1507

ILLINOIS
G. L. Clampet
P. O. Box 19283
Springfield, IL 62794-9283
(217) 492-4295

INDIANA
R. W. Gann
1148 Agad Bldg., Room 223
Purdue University
West Lafayette, IN 47907-1148
(317) 494-8371

IOWA
D. M. Skow
833 Fed. Bldg.
210 Walnut St.
Des Moines, IA 50309
(515) 284-4340

KANSAS
T. J. Byram
P. O. Box 3534
Topeka, KS 66601-3534
(913) 233-2230

KENTUCKY
D. D. Williamson
P. O. Box 1120
Louisville, KY 40201
(502) 582-5293

LOUISIANA
A. D. Frank
P. O. Box 65038
Baton Rouge, LA 70896-5038
(504) 922-1362

MARYLAND
M. B. West
50 Harry S. Truman Pkwy.,
Suite 202
Annapolis, MD 21401
(410) 841-5740

MICHIGAN
D. J. Fedewa
P. O. Box 20008
Lansing, MI 48901
(517) 377-1831

MINNESOTA
M. A. Hunst
P. O. Box 7068
St. Paul, MN 55107
(612) 296-2230

MISSISSIPPI
T. L. Gregory
P. O. Box 980
Jackson, MS 39205
(601) 965-4575

MISSOURI
R. Bellinghousen
P. O. Box L
Columbia, MO 65205
(314) 876-0950

MONTANA
J. K. Sands
P. O. Box 4369
Helena, MT 59604
(406) 449-5303

NEBRASKA
W. A. Dobbs
P. O. Box 81069
Lincoln, NE 68501
(402) 437-5541

NEVADA
M. J. Owens
P. O. Box 8880
Reno, NV 89507
(702) 784-5584

NEW HAMPSHIRE
A. R. Davis
P. O. Box 1444
Concord, NH 03302
(603) 224-9639

NEW JERSEY
R. J. Battaglia
CN-330 New Warren St.
Trenton, NJ 08625
(609) 292-6385

NEW MEXICO
C. E. Gore
P. O. Box 1809
Las Cruces, NM 88004
(505) 522-6023

NEW YORK
R. E. Schooley
1 Winners Circle
Albany, NY 12235
(518) 457-5570

NORTH CAROLINA
R. M. Murphy
P. O. Box 27767
Raleigh, NC 27611
(919) 856-4394

NORTH DAKOTA
L. W. Beard
P. O. Box 3166
Fargo, ND 58108-3166
(701) 239-5306

OHIO
J. E. Ramey
200 N. High St.
Columbus, OH 43215
(614) 469-5590

OREGON
H. K. Rowley
1735 Fed. Bldg.
Portland, OR 97204
(503) 326-2131

PENNSYLVANIA
W. C. Evans
2301 N. Cameron St., RM G-19
Harrisburg, PA 17110
(717) 787-3904

SOUTH CAROLINA
R. A. Graham
P. O. Box 1911
Columbia, SC 29202

SOUTH DAKOTA
J. C. Ranek
P. O. Box 5068
Sioux Falls, SD 57117

(803) 765-5333 (605) 330-4235

TENNESSEE
P. O. Box 41505
Nashville, TN 37204-1505
(615) 781-5300

TEXAS
D. S. Findley
P. O. Box 70
Austin, TX 78767
(512) 482-5581

UTAH
D. J. Gneiting
P. O. Box 25007
Salt Lake City, UT 84125
(801) 524-5003

VIRGINIA
R. T. Bass
P. O. Box 1659
Richmond, VA 23213
(804) 771-2493

WASHINGTON
D. A. Hassien
P. O. Box 609
Olympia, WA 98507
(206) 902-1940

WEST VIRGINIA
D. G. Loos
1900 Kanawha Blvd., E
Charleston, WV 25305
(304) 345-5958

WISCONSIN
L. H. Pratt
P. O. Box 9160
Madison, WI 53715
(608) 264-5317

WYOMING
D. W. Coulter
P. O. Box 1148
Cheyenne, WY 82003
(307) 772-2181

RECORDS

The poultry companies keep extensive records covering every aspect of their business operations. The following are some of the reports that are normally produced by the companies.

Subsidiary Ledgers

- Accounts Receivable - Trade - Home Office Accounts
- Receivable - Trade - Other Accounts
- Employee Receivables
- Grower Receivables

- Broiler Flocks Inventory
- Breeder Pullet Flocks Inventory
- Leghorn Pullet Flocks Inventory
- Leghorn Hen Flocks Inventory
- Turkey Flock Inventory

- Turkey Breeder Flock Inventory Turkey Egg Inventory

- Finished Products Inventory by Location
- Feed Ingredient Inventory by Location

- Fixed Assets by Class, Location, Owner

- Vehicle Cost

- Customer Sales/Cost
- Grower Performance

- Accounts Payable

Other

- Vouchers with Vendor Detail/Account Distribution
- Voucher Summary
- Monthly Outstanding Vouchers Payable Summary

- Daily Cash Report
- Weekly Cash Report by Deposit
- Monthly Cash Report by Deposit

- Daily Cash Disbursement Journal
- Weekly Cash Disbursement Journal
- Monthly Cash Disbursement Journal

- Weekly Payroll Journals
- Semi-Monthly Payroll Journals

- Auto Shops - Monthly Transactions (Work Orders)
- Fuel Islands - Daily, Weekly Transaction Register

- Monthly Prepaid Insurance Amortization Schedule
- Monthly Depreciation Report
- Monthly A.F.E. Status Report

Sales Divisions

- Sales Analysis
- Sales by Customer by Product for Week
- Sales by Customer by Product for Month

- Aggregate Sales by Product for Week
- Aggregate Sales by Product for Month

- Weekly Transportation Register for Dressed Poultry
- Weekly Margin Report*
- Monthly Margin Report*
  *Net Sales, Cost and Margin by Product, and Products Within Groups.

- Weekly Plant Cost Absorption to Products Produced
- Weekly Cost of Sales Determination by Product
- Weekly Valuation of Dressed Poultry Inventory by Location

Growout Divisions

- Weekly Feed Received/Purchased Journal
- Weekly Cost of Feed Manufactured
- Weekly Cost of Feed Delivered/Sold

- Grower Transaction Register - Weekly and Monthly
- (identifies feed, chicks, medication and other supplies charged to growers)
- Weekly Schedule of Broiler Chicks Delivered
- Weekly Live Broiler Movement Report by Producer
- Weekly Live Transportation Report
- Weekly Summary of Broiler Hatching Eggs Received, Set &
- Hatched by Hatchery
- Weekly Cost of Broilers Settled
- Weekly Broiler Settlement Listing Least Cost to Highest
- Weekly Servicemen's Broiler Detail Summary
- Weekly Servicemen's Summary

- Weekly Breeder Pullet Performance Report
- Weekly Breeder Hen Performance Report
- Weekly Leghorn Pullet Performance Report
- Weekly Leghorn Hen Performance Report

- Monthly Flock Amortization Schedules - Breeders
- Monthly Flock Amortization Schedules - Leghorns

- Monthly Broiler Settlement Recap Comparison
- Settlement Recap Report - each category of poultry
- Broiler Breeder Egg Production Comparison

- Monthly Capitalized Toms, Turkey Hens, etc.

- Monthly Turkey Production Reports - Year to Date

- Monthly Operating Results - Per Breeder Flock
- Sale Report - Per Flock

Sales Divisions

- Weekly Purchase Journal by Product and Vendor
- Monthly Purchase Journal by Product and Vendor

- Weekly Computation of Cost of Goods Available for sale
- Weekly Computation of Cost of Goods Sold

- Sales Analysis #1
- Sales Analysis #2

- Weekly Margin Report
- Monthly Margin Report

- Weekly Invoice Register
- Monthly Invoice Register

- Weekly Deposit Summary
- Monthly Deposit Summary

Commercial Egg Divisions

- Weekly Summary of Eggs Received and Processed
- Weekly Sales Summary of Processed Eggs by Grade and Method of Pack
- Monthly Sales Summary of Processed Eggs by Grade and Method of Pack

This Page left intentionally blank.

GLOSSARY OF TERMS

BREEDER EGGS — Eggs from the primary breeder flock that hatch into pullets.

BREEDER STOCK — Mature pullets. Hens and roosters used to produce broilers. Parent Stock.

BROILER EGGS — Eggs from the breeder flock that hatch into broilers.

BROILERS — Basic table bird. A.K.A. Fryer. Size normally ranges from 3.8 to 4.2 pounds.

BY-PRODUCTS — Products made from offal or layer spent hens (that is., dog food, fertilizer).

CHICK — The young of any bird. Normally birds are considered chicks for the first few days up to the first week of life.

COMMODITY CHICKEN — Whole or cut up bird. First processing stage.

CONTRACT GROWER — Independent farmer who is under contract to grow birds for a third party.

CORNISH HEN — Flock of hens grown to 2+ lbs. and sold as a whole bird.

CULL — Flawed egg. Broiler eggs that are cracked, oversized, etc. are culled.

DEBEAK — Clipping the chick's beaks to prevent injury to other birds.

EFFICIENT BROILER — The less feed the broiler needs to produce a pound of weight gain the more efficient the bird.

EGG BREAKING PLANT — Where cull, excess, or regular eggs are processed into a powder for cake, cookie, etc., mixes.

FAST FOOD CUTS — Product is cut-up on saws or other automatic saw-cutting machines.

FEED CONVERSION — The ratio of feed it takes for the broiler to gain one pound.

FEED MILL — Hammer and grinding mills where trainloads of grain are delivered and mixed before being taken to the farms.

FORMED — Shaped into nuggets, hot dogs, etc.

FOWL — A low quality poultry meat - Same as spent hen.

FRONTS — Front part of chicken breasts with wings.

FURTHER PROCESSED — Upgrading of the raw state (that is, deboning, cooking, breading or nuggets, etc.).

GAME HENS — Same as Cornish.

GEORGIA DOCK — Market quotes for a premium whole broiler compiled by the Georgia Department of Agriculture.

GRANDPARENT STOCK — Pedigree flocks that are the foundation of a particular genetic line.

GROW OUT HOUSE — Typically a 40' by 400' open span structure, with adjustable curtains.

HATCHERY — Environmentally controlled nurseries where eggs are hatched.

IMMATURE BREEDERS — See pullet.

INCUBATOR — Walk-in units in the hatcheries that contain egg trays on racks that rotate the eggs each hour.

IQF — Individually Quick-Frozen.

KOSHER SLAUGHTER PLANT — A processing plant which follows the Kosher guidelines.

LAYERS — Type of bird breed to produce table eggs. A fully-grown bird will weigh 2-3 lbs.

MIXED FLOCKS — Standard flocks including both males and females. Weight 3.8 to 4.2 lbs.

NEW YORK DRESSED — Whole bird, plucked, with legs and head intact. Illegal in many states.

OFFAL — Waste from the processing plants. Feathers, guts, blood, beaks, etc.

OFFAL PLANT — Where offal is separated and loaded for shipment to a protein or by-product facility.

OYSTER SHELLS — Oyster shells are sometimes fed to poultry for extra calcium. This is especially important for hens that are producing eggs.

PORTIONED — Individually sized or detailed.

POULTS — A young turkey.

PREPACK — Poultry which is prepackaged in wrapped trays.

PRIMARY BREEDER — Grandparent stock.

PRIMARY BREEDER COMPANY — Companies which invest heavily into producing a superior breeder hen and or rooster to be sold on the open market to the broiler companies.

PROCESSING — Actual killing of the bird and getting it to the raw state. Can include cutting up and packaging.

PROTEIN PLANT ─ Facility which uses the poultry offal to produce various by-products, that is, fishmeal.

PULLETS ─ An immature breeder; prior to egg production age of 26 weeks.

ROASTER ─ Broiler grown 82 to 181 days and sold for roasting.

SPENT HENS ─ Hens and roosters after a laying cycle. Laying hens are worth substantially less after a laying cycle than breeder hens due to the difference in size and the lack of meat on layers.

SPIKE ─ Adding rosters to a breeder flock during the laying cycle in order to increase hatchability.

SPURS ─ Extra "toe" on the inside of a bird's leg. These are normally removed on rooster to protect the hens.

TABLE EGG ─ Eggs from a layer flock that are sold to grocery stores. These eggs are not fertilized.

VALUE ADDED ─ A deboned product that often produces a cost-plus product for another merchandiser.

WOG ─ Whole bird without giblets and with neck removed close to body.

This page left intentionally blank.