Market Segment Specialization Program

Swine Farm Industry

Training 3123-014 (12/2001)
TPDS No. 87455Z

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.

Swine Industry

Table of Contents

Subject **page**

Introduction......ix

Chapter 1, IRC section 447 − Accrual Versus Cash......1-1
- Introduction 1-1
- Prior Law 1-1
- IRC section 447 1-1
  - Gross Receipts Test 1-2
  - Family Corporations 1-3
  - IRC section 481 1-3
- Recapture Rules ─ Suspense Account......1-5
- Audit Techniques......1-7
- Summary......1-7

Chapter 2, Farm Price Inventory......2-1
- Introduction 2-1
- Inventories 2-2
- Farm-Price Method...... 2-2
  - Farm Price Method and the Swine Industry 2-3
  - *Garth vs. Commissioner* 2-3
  - Farm Inventory 2-5
  - Market 2-5
  - Market Conversion 2-6
  - Yield 2-6
  - Record Keeping 2-7
  - Cost of Disposition 2-7
- Summary...... 2-7

Chapter 3, Unit Livestock Price 3-1
- Introduction 3-1
- General 3-1
  - Livestock 3-1
- IRC section 263A 3-3
- Audit Techniques...... 3-3
- Effective Date and Method Changes 3-6
- Resource Cites 3-7
- Transfer of Inventory...... 3-7
- Summary...... 3-7

Chapter 4, Prepaid Feed......4-1
- Introduction ─ Cash Basis Taxpayer...... 4-1
  - Revenue Ruling 79-229, 1979-2 C.B. 210 4-2
  - Payment for Feed Versus Deposit 4-3
  - Business Purpose Versus Tax Avoidance 4-3
  - Distortion of Income...... 4-4
- Internal Revenue Code section 464(f) Limitation 4-4

Case Scenario 4-4
Payment for Feed Versus Deposit 4-5
Business Purpose or Tax Avoidance 4-5
Distortion of Income 4-6
Case Law 4-6
Audit Techniques 4-7
Summary 4-7

Chapter 5, Income from Discharge of Indebtedness 5-1
Introduction 5-1
IRC section 108 5-2
Income from Discharge of Indebtedness 5-2
Definition of Farming 5-4
Qualified Farm Indebtedness 5-4
Qualified Person 5-5
Limitation 5-5
Amount and Manner of Reduction 5-6
IRC section 1017 5-6
Forgiveness of Shareholder Debt 5-7
Acquisition of Debt by Related Party 5-7
Audit Techniques 5-8
Summary 5-9

Chapter 6, Selection Fees 6-1
Introduction 6-1
Case Scenario 6-2
Related Issues 6-3
Audit Techniques 6-4
Summary 6-4

Chapter 7, Depreciation 7-1
IRC section 167(a) 7-1
IRC section 168 7-1
IRC section 168(b)(2) 7-2
Depreciation Methods Chart 7-3
IRC section 263(a) 7-4
Depreciation Accounting Method Changes 7-4
Swine Farm Components 7-6
Roads 7-6
Water Wells 7-6
Single Purpose Agriculture Structures 7-7
Other Farm Buildings 7-7
Lagoons 7-7
Certified Pollution Control Facility 7-8
Irrigation Systems 7-9
Spray Fields 7-9
Other Farm Equipment 7-9
Swine 7-10
Depreciation of Land Improvements 7-10
Summary 7-11

Chapter 8, Grower Issues 8-1
Introduction 8-1
Income 8-2
Expenses 8-3
Depreciation 8-3
Interest 8-4
Utilities 8-4
Insurance 8-4
Miscellaneous 8-5
Net Check ─ Double Deduction 8-5
IRC section 469 ─ Passive Activities 8-6
Material Participation 8-6
Recharacterization of Self-Rental Income 8-7
Alternative Minimum Tax 8-7
Corporate Minimum Tax 8-8
Income Averaging ─ IRC section 1301 8-8
Audit Techniques 8-8
Summary 8-9

Chapter 9, Penalties 9-1
Overview 9-1
Penalty Relief 9-2
Reasonable Cause 9-2
Statutory Exceptions 9-4
Administrative Waiver 9-5
Requesting Penalty Relief 9-5
Deficiency Procedures 9-6
Accuracy-Related Penalty ─ IRC section 6662 9-6
General ─ All Components of IRC section 6662 9-6
Negligence or Disregard of Rules or Regulations ─ IRC section 6662(c) 9-8
Substantial Understatement ─ IRC section 6662(d) 9-8
Substantial Valuation Misstatement ─ IRC section 6662(e) 9-9
Fraud Penalty ─ IRC section 6663 9-10
Failure to File Tax Return or to Pay Tax ─ IRC section 6651 9-11
Delinquency (Failure to File) ─ IRC section 6651(a)(1) 9-11
Failure to Pay on Notice and Demand ─ IRC section 6651(a)(2) 9-15
Fraudulent Failure to File ─ IRC section 6651(f) 9-15
Failure to File A Partnership Return Penalty ─ IRC section 6698 9-16

Chapter 10, Research Credits 10-1
Introduction 10-1
IRC section 41 10-2
Basic Research Credit 10-2
Base Amount 10-3
IRC section 174 10-5
Qualified Research 10-5
Audit Techniques 10-8
Summary 10-9

Chapter 11, Employment Taxes...11-1
Farm Workers ... 11-1
Behavioral Control ... 11-2
Financial Control ... 11-3
Relationship of the Parties ... 11-3
Withholding on Employees ... 11-3
Summary ... 11-4

Chapter 12, Excise Taxes...12-1
Gasoline Tax Credits ...12-1
Definitions ...12-1
Taking the Credit...12-3
Audit Techniques ...12-3

Glossary of Terms ...G-1

This page left intentionally blank.

Introduction

Overview of the Industry

The purpose of this guide is to identify potential issues that impact the swine industry. From the small farm operation to the largest of corporations, similar basic concepts can be encountered by examiners. The guide is designed to traverse all swine operations and to explore areas that may be pertinent to your particular case based upon type of entity and size.

The swine industry has evolved from small independent farming operations to the integrated giants that exist in many states today.

Technology has met the farming industry and hasn't ignored the swine farmer. Nutritionists and engineers are consulted in overall operation of the industry from construction of hog facilities to the management of feed consumption, temperature control, vitamin supplements and breeding processes.

The examiner may still encounter the farm consisting of a fenced pen and hutch where the animals are raised from birth to slaughter. Many of the issues prevalent with the large integrators are equally as prominent in the independent farming operation. Issues relating to independents can be found throughout the guide, such as, in chapters covering depreciation, income from discharge of indebtedness, employment taxes and miscellaneous.

The large farming corporation (Integrators) pose more significant problems to the examiner. The integrator generally supplies the pigs, feed and medication to the contract farmer; whose responsibility is to raise the animals to the specifications of the integrator. The contract grower provides the facility and labor necessary to successfully raise the animals and is compensated accordingly. The integrator and grower, therefore, are mutually dependent on each other to ensure the herds are well maintained for optimum profitability.

Generally, there are three separate stages in the process of raising pigs to desired weight.

- Sow Farm ─ Includes breeding and monitoring of sows. Records are maintained on breeding schedules, piglets per sow etc. Piglets stay approximately two or three weeks with the sow prior to transport.

- Nursery Farm ─ The pigs are transferred from the sow farm in sanitized vehicles, to spend their next several weeks at the nursery. At approximately 50 lbs. the animals again are ready to be transported to the next and last stage.

- Finishing Farm ─ The animals are then moved to the finishing farm where they will remain until they attain their market weight of 240 to 250 lbs. From the finishing farm, their last journey is to the slaughterhouse.

The rationale for this procedure is to minimize the threat to entire herds, should there be an outbreak of disease. Terminology may differ between farms or areas. For example, nursery may be designated as a weaned pig farm while a finishing farm may be referred to as a top house. Examiners will therefore need to ensure their comprehension of the taxpayer's use of terms.

The chapters that follow delve into areas that are highly technical in nature, together with more common issues confronting examiners in an industry that continues to evolve through technology and innovation.

Chapter 1

IRC section 447 − Accrual versus Cash

CONTENTS

- Introduction
- Prior Law
- IRC section 447
  - Gross Receipts Test
  - Family Corporations
  - IRC section 481
- Recapture Rules - Suspense Account
- Audit Techniques
- Summary

INTRODUCTION

Due to its dependence on nature, farming is a high-risk business that calls for extremely large capital outlays. In order to compensate for these risks, as well as to preserve this important industry, Congress has granted special status to farmers, including farm subsidy payments and 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 swine 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 pigs. 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 that 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.

IRC SECTION 447

Although IRC section 447 received several amendments over the next ten years, it was not 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. This accounts for the large number of Subchapter S farming companies.

Gross Receipts Test

Through the Omnibus Budget Reconciliation Act, Congress passed Section 447(c)(2) that set forth a gross receipts limitation for farming corporations and effectively removed the large farming companies from 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 $10,000,000. If any of the years exceeded this limit the corporation did not meet the exclusion under IRC section 447(c). A consolidated 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 major concession by providing that each corporation within a consolidated group stands alone for purposes of this limitation.

Thus, a large vertically integrated corporation which handled the farming and processing under one corporation until 1985, would stand a better chance at meeting the gross receipts test if it had spun off the farming business to a new related corporation in 1985, since it would not include the processing receipts in the computations.

Although a farming corporation may initially appear to be well under the gross receipts limitation, an error in computing the market value between related corporations could result in a substantial understatement in gross receipts for purposes of this limitation. This applies a considerable amount of pressure on the companies to hold down the selling price.

Family Corporations

There are two definitions set forth under IRC section 447(d)(2)(C) for family corporations. Either definition may be met for a company to qualify.

- At least 50 percent of all stock in a corporation may be owned by members of the same family. For the purposes of this calculation all voting stock is placed in one category and all other stock in a separate category with each category having to meet the 50-percent test.

- IRC section 447(h) provides very specific guidelines whereby companies will qualify as closely held corporations. These include minimum requirements on the percentage of stock held by family members as well as employee stock ownership. Further, it only applies to farmers 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 the individual's parents and grandparents, ancestors and lineal descendants of any of the foregoing, 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 of us have heard of or dealt with an IRC section 481(a) adjustment. Basically, 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 and the accrual methods 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 the accrual method that will result in some very large IRC section 481(a) adjustments.

Under normal circumstances, these IRC section 481(a) adjustments would be included in the income or expense for the year of change. However, Congress realized the tremendous burden this could place on taxpayers and provided some relief. IRC section 481(b) outlines allocations and tax calculations that can result in lower taxes for most taxpayers.

Suspense Account

IRC section 447 required numerous farming corporations to switch from the cash method to the accrual method for the taxable year beginning after December 31, 1987. For companies that had used the cash basis for many years and increased in size, the IRC section 481(a) net adjustments already built up by the beginning of the year of change were substantial. The affected companies lobbied strongly against bringing the entire adjustment 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) which defers a large portion of the adjustment through the use of a suspense account.

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 versus the net IRC section 481(a) adjustment calculated as of the beginning of the preceding taxable year. This prevented taxpayers from arbitrarily "beefing up" their IRC section 481(a) adjustment for the year of change.

Example 2

Farming corporation A's tax year ends on September 30 of each year. It did not meet the exceptions under IRC section 447(i) and accordingly was forced to change from the cash to the accrual method of accounting.

Its first tax year beginning after December 31, 1987, was the 8909 year that started on October 1, 1988. In setting up its suspense account it would look to the net IRC section 481(a) adjustments as of September 30, 1988 and September 30, 1987. If the September 30, 1987, is less than the September 30, 1988, (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 IRC 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 account receivables 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.

SUSPENSE ACCOUNTS CHANGES UNDER THE TAXPAYER RELIEF ACT OF 1997.

Congress believed that the previously discussed suspense account provisions were providing for an exclusion of, rather than a deferral of, the IRC section 481 amount generated when a family farm corporation was required to change its accounting method.

In accordance with this belief, Congress revised IRC section 447 with regard to the suspense accounts. IRC section 447(i)(5)(A) states that no suspense account can be established by any corporation required by IRC section 447 to change its method of accounting for any tax year ending after June 8, 1997.

Under the new law, any family farm corporation required to change to an accrual method of accounting would be required to include the IRC section 481 adjustment in gross income ratably over a period of 10 years beginning with the year of change. IRC section 447(i)(1)

RECAPTURE RULES - SUSPENSE ACCOUNT

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

The first recapture rule inspects the gross receipts of the company for the current year and matches these 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 a reduction has

occurred, the suspense account is reduced by a percentage equal to the percentage of the gross receipts reduction.

This rule was repealed by the Taxpayer Relief Act of 1997 and is effective for tax years ending after June 8, 1997.

Example 3

Current year gross receipts are $54,000,000. Gross receipts in 8806, the year proceeding the year of change, were $60,000,000. The suspense account currently stands at $25,000,000. Under IRC section 447(f)(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 the 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. Section 447(i)(5)(B) covers specific ownership transfer that will not trigger the 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.

SUSPENSE RECAPTURE CHANGES UNDER THE TAXPAYER RELIEF ACT OF 1997

Although Congress recognized the suspense accounts were creating an exclusion of, rather than deferral of, income, they also recognized the financial hardship that would be created should the family farm corporations have to recognize the suspense account balances in current year receipts. The new tax bill allows for the suspense account to be reduced over an extended period. Any reductions in the account will be included in the income of the corporation for the tax year of the reduction.

Under IRC section 447(i)(5)(B)(i), the suspense account will be reduced by an amount equal to the lesser of:

1. The applicable portion of the account, or

2. Fifty percent of the taxable income of the corporation, or the amount of the net operating loss if the corporation has no taxable income. Taxable income and the net operating loss will be calculated without regard to the suspense account recapture for the tax year.

The applicable portion, as defined by IRC section 447(i)(5)(C), is amount which would ratably reduce the amount in the account to zero over the period consisting of the tax year and the remaining tax years in the first 20 years.

Family farm corporations with existing suspense accounts that elect S-corporation status will be required to restore the suspense accounts to income in the same manner as discussed above. The net operating loss and 50 percent of taxable income limitations will take into account all items of income whether or not the items are separately stated by IRC section 1366.

If for any reason the corporation ceases to be a family corporation, the entire remaining balance in the suspense account will be included in gross income in the year of cessation.

At the time this section of the guide was written there were no regulations or examples available regarding the recapture of the suspense accounts. It is recommended that the Internal Revenue Code and Committee Reports be reviewed for any examinations involving this issue with tax years beginning after June 8, 1997.

AUDIT TECHNIQUES

1. In considering the guidelines for family farms, agents should verify the ownership status through a review of the stock book. The owners and their relationships should be analyzed. Most problems are found not in the individual ownership of the stock but in the sometimes-tangled stock ownership by various other related entities.

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

3. Review of the suspense account recapture calculations will be necessary to ensure the taxpayer is including the correct amount in income for the current year. It would appear that any exam adjustments to the taxable income of the corporation may generate an automatic adjustment to the amount of the suspense account required to be included in income for the exam year provided the taxpayer has not included the income based upon IRC section 447(i)(5)(B)(i)(1), the applicable portion of the account. Likewise, any exam adjustments to a net operating loss may change the suspense account recapture in the NOL year leaving a different balance in the account to be included in subsequent years, again provided the taxpayer has not determined the inclusion base on IRC section 447(i)(5)(B)(i)(1).

4. Review the balance sheet to ensure no family farm corporations set up suspense accounts for tax years after June 8, 1997.

SUMMARY

IRC section 447 allows the cash method of accounting to be used by specific farming corporations. The 1987 law changes affecting IRC section 447 forced many of the larger farming corporations from the cash method to the 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.

For tax years beginning after June 8, 1997, IRC section 447 provides for family farm corporations that are required to change to the accrual method of accounting to include the IRC section 481 adjustment in gross income ratably over 10 years.

Corporations that have existing suspense accounts will be required to restore the account into income over an extended period, beginning with the first taxable year beginning after June 8, 1997.

This page left intentionally blank.

Chapter 2

Farm Price Inventory

CONTENTS

Introduction
Inventories
Farm-Price Method
- Farm Price Method and The Swine Industry
- Garth vs. Commissioner
- Farm Inventory
- Market
- Market Conversion
- Yield
- Record Keeping
- Cost of Disposition

Summary

INTRODUCTION

To reduce a potentially overwhelming recordkeeping burden, Congress initially allowed most farmers to compute their tax returns under the cash method of accounting. However, items purchased for resale by a cash basis farm operation are deductible in the year of sale. Therefore livestock purchases for resale are deductible in the year of sale. The cost includes freight charges for transporting the livestock to the farm. Ordinarily, this is the only time you can deduct the purchase price.

Example 1

Farmer Sharon reports on the cash method. In 1995, she purchased 100 weaned pigs that will sell in 1996. She deducts the purchase plus any freight costs, in 1996 when the hogs are 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 little or no 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 the 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 statute 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 and the unit livestock price methods outlined in regulations are specifically designed for farmers' 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 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. 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. See Treas. Reg. section 1.471-2(a).

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.

Once 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:

> The 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 normally small; there are very few court cases, revenue rulings, etc. to provide guidance.

Farm Price Method and the Swine Industry

It should be noted that the application of the Farm Price Method in the swine industry has not been the method of choice for those taxpayers required to maintain inventories. It is sufficient, for purposes of this guide, to reference the method should the exception, rather than the rule, apply. Certain cases and terms may be of value should this method be used by the taxpayer. The following case, ***Garth,*** relates to the poultry industry where the Farm Price Method is more common. It does however identify the inherent problems encountered in valuing inventory.

Garth v. Commissioner

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. 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. Two main alternate positions were also offered by the government. The first claimed that the commercial layers were capital assets subject to depreciation not inventory. The second position argued even if commercial layers were inventorible 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 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 which could 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. Rev. Rul. 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 2

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 pretty easy to identify.

Example 3

Farmer Jones purchases baby chicks, raising them for 8 weeks, and processes the birds for use in his name brand TV dinners which 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 at the TV dinner market. This would be a very difficult if not impossible undertaking.

As can be seen in the examples, 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, broiler, or 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 4

In Example 3, 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 which 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. Regulation 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 which 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 Treasury Regulation 1.263A-4(a)4(ii) and (iii), Example 3. The actual point of division is not always clear.

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 Section 263A is considered. Also, the examiner would need to make sure that farm-price inventory costs are not part of the Section 263A calculations.

Market

Large swine companies process substantial numbers of hogs 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 swine products. See below for some sources available to determine the market price for any type of swine 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.

Market Conversion

Each market is based on a particular product that must be identified before the market prices are to have any meaning. 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.

The market quote for a fully grown animal is readily available and generally follows the Chicago Board Of Trade for hogs. However, there exist animals at various stages of development that would not be quoted and may not be readily ascertainable.

These values would apply to animals raised for commercial processing or for animals that had previously been utilized as breeders. There is no differentiation between breeding stock and animals held for slaughter. Processing costs will be deducted after the reduction for yield. The best information is from the company's own records. (See section below on Yield.)

Example of Sources

The United States Department of Agriculture (USDA) maintains a website at www.usda.gov which contains a tremendous amount of information. Many State governmental agencies and county extension are also a good resource for a variety of facts and statistics related to agricultural industries within their area.

The North Carolina Livestock Market Report contains weekly pig summaries, hogs at Eastern NC auction markets, state graded feeder pig sales, daily NC hog markets, etc. The report includes weight ranges, dates, and prices per weight range.

Yield

Yield is the amount of meat left after processing versus the live weight. Generally, the hog markets are based on the live weight and therefore no allowances would be required for yield or disposition. Any costs associated to get the animal to market could be considered.

Record Keeping

Contrary to the belief stated in the regulations that detailed record keeping would be a burden to farmers, the swine industry keeps extremely thorough records outlining costs 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 which provides the answer.

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. 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.

SUMMARY

The farm-price method is available to farmers and 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.

This page left intentionally blank.

Chapter 3

Unit Livestock Price

CONTENTS

Introduction
General
Livestock
IRC section 263A
Audit Techniques
Effective Date and Method Changes
Resource Cites
Transfer of Inventory
Summary

INTRODUCTION

In 1944 the Internal Revenue Service 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 the accrual method.

GENERAL

Unlike the farm-price method which applies to all farm inventory, the Unit-Livestock-Price method is only available for the valuation of livestock. 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. Treas. Reg. section 1.471-6.

Under the ULP method a taxpayer adopts a standard unit price for each animal within a particular class. Normally, the taxpayer will identify the

different categories or classes of animals in their business based on age and kind. An observation in current cases provided the following classes: WEANED, NURSERY, AND FINISHING. Other nomenclature is possible. The unit prices and classifications are subject to the Commissioner's approval.

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

ULP applies to all raised livestock and to any livestock which 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, breeding diary or sporting purposes will be included in the ULP inventory.

All livestock purchased primarily for sale must also be included in inventory. Animals purchased for draft, breeding, diary, or sport purposes, may be included in inventory, or 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 6months of the year. Treas. Reg. section 1.471-6(g).

Example 1

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***, 60 T.C. 794, Dec. 32,103, a cattle feedlot operator 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 finding in ***Auburn Packing*** may not apply to most of the current situations. The 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 which can be a substantial benefit.

IRC SECTION 263A

The Tax Reform Act of 1986 ushered in IRC section 263A which has had a profound affect on the calculation of inventory valuations. However, IRC section 263A applies to the livestock of a farmer, but only if the farmer is organized as a corporation, partnership, or tax shelter required to use an accrual method of accounting under IRC section 447 or prohibited by IRC section 448(a)(3) from using the cash method. Under IRC section 263A the taxpayer must capitalize all direct and indirect costs allocable to the livestock. This would include costs which vary depending on the amount produced (such as feed) as well as fixed costs which generally do not change based on production (such as depreciation on machinery or swine houses).

Treas. Reg. section 1.263A-4(b)(1)(ii) sets forth a listing of costs of producing an animal typically required to be capitalized under IRC section 263A. These costs include both preparatory costs, such as the acquisition costs of the animal, and pre-productive period costs. Pre-productive period costs include management, feed (such as grain, silage, concentrates, supplements, haylage, hay, pasture and other forages), maintaining pasture or pen areas (including costs that the taxpayer has elected to deduct under IRC section 175 or 180), 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 (for example, barns, trucks, and trailers), farm overhead, taxes (except state and Federal income taxes), and interest required to be capitalized under IRC section 263A(f).

As shown above, IRC section 263A requires additional costs to be included in the standard unit calculation for taxpayers using ULP.

AUDIT TECHNIQUES

1. The categories shown under the farm price method are a good starting point for classifications under ULP.

2. The primary problem area today has been caused by the 263A regulations. Many companies have never updated their standard unit costs for the IRC section 263A costs. Request the calculation worksheets which outline how your 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. On the large integrated swine companies this can be a substantial issue.

4. The following is a list of expenses included in the unit price for weaned pigs based upon a current examination.

   - Feed – Gestation
   - Feed – Farrowing
   - Labor
   - Veterinary bills and supplies
   - Maintenance
   - Supplies

   - Truck Expense
   - Office Salaries
   - Communications
   - Depreciation
   - Rent

   - Insurance
   - Taxes and Licenses
   - Other/Miscellaneous
   - Medications
   - Uniforms and Laundry

   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 larger swine companies have inventories which include thousands of pigs. 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.

6. Examiner should ensure that all appropriate classifications and age groups were used by the taxpayer.

7. Review an on-line service for the latest administrative pronouncements covering ULP and IRC section 263A. For example, the final regulations (T.D. 8897) under IRC section 263A, providing Rules for Property Produced in a Farming Business, were published in the Federal Register August 21, 2000, and are effective August 21, 2000.

   Treas. Reg. section 1.263A-4(c)(1) provides that the costs required to be allocated to an animal in a farming business may be determined using reasonable inventory valuation methods such as the farm-price method or the unit-livestock-price method. Either of these methods of valuing inventory avoids the need to account for costs of raising animals by tracing costs to each separate animal.

   Further, under Treas. Reg. section 1.263A-4(c)(2), the farm-price methods or the unit-livestock-price method may be used by any taxpayer to allocate costs to any animal, regardless of whether the animal is treated as inventory by the taxpayer. Treas. Reg. section 1.263A-4(c)(3) provides, however, that a farmer valuing farm property, to which IRC section 263A applies, under the farm-price method is not required, solely by such use, to use the farm-price method to value farm property not subject to IRC section 263A.

Under the unit-livestock-price method, the taxpayer adopts a standard unit price for each animal within a particular class. This standard unit price is used by the taxpayer in lieu of specifically identifying and tracing the costs of raising each animal in the taxpayer's farming business. Taxpayers using the unit-livestock-price method must adopt a reasonable method of classifying animals with respect to their age and kind so that the unit prices assigned by the taxpayer to animals in each class are reasonable. Thus, taxpayers using the unit-livestock-price method typically classify livestock based on their age (for example, a separate class will typically be established for calves, yearlings, and 2-year olds).

The rule under Treas. Reg. section 1.471-6(g) that allows taxpayers that purchase immature animals in the last six months of the tax year to capitalize just the cost of the animals, rather than increasing the animals' cost in accordance with established unit prices, has been modified by the final farmers' regulations. Under Treas. Reg. section 1.263A-4(c)(1), ULP tax shelters must include in inventory the annual standard unit price for all animals acquired during the taxable year, regardless of whether the purchases are made during the last 6 months of the taxable year. Also, ULP taxpayers, required by IRC section 447 to use an accrual method or prohibited by IRC section 448(a)(3) from using the cash method, must modify the annual standard price to reasonably reflect the particular period in the taxable year in which purchases of livestock are made, if such modification is necessary in order to avoid significant distortions in income that would otherwise occur through the operation of the ULP method. No specific modification that must be made to the annual standard price is set forth in the regulations. Rather these taxpayers are given the right to make any reasonable modification to the annual standard price to avoid significant distortions in income.

In response to commentators' inquiries as to the availability of the simplified production method of computing additional section 263A costs to farmers valuing their farm inventories under ULP, Treas. Reg. section 1.263A-4(c)(1) specifically allows a ULP farmer to elect to allocate its direct and indirect costs to the property produced in the business of farming under the simplified production method. In such a situation, the taxpayer's IRC section 471 costs are the costs taken into account by the taxpayer under ULP using the taxpayer's standard unit price as modified by Treas. Reg. section 1.263A-4(c)(1).

ULP taxpayers under Treas. Reg. section 1.471-6(f) must apply ULP to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications by the taxpayer must be consistently applied in all subsequent taxable years. For taxable years beginning after August 22, 1997, a taxpayer using ULP must, however, annually reevaluate the unit livestock prices 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 annual upward adjustments. No other changes in the classification of animals or unit prices may be made by a taxpayer without the prior consent of the Commissioner.

EFFECTIVE DATE AND METHOD CHANGES

For non-inventory property in the hands of a taxpayer, the final regulations are applicable to costs incurred after August 21, 2000, in taxable years ending after such date. For inventory property in the hands of a taxpayer, the final regulations are applicable to taxable years beginning after August 21, 2000.

For non-inventory property, a taxpayer changing its method of accounting to comply with the provisions of the final regulations is granted the consent of the Commissioner to make such changes for costs incurred after August 21, 2000, provided the change is made in the taxpayer's first taxable year ending after August 21, 2000. For inventory property, a taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with the provisions of the final regulations for the first taxable year beginning after August 21, 2000. To make such a change, a taxpayer must follow the automatic consent procedures in Rev. Proc. 99-49, 1999-2 C.B. 725.

As a result of the issuance of final regulations, the following publications are obsolete as of August 22, 2000:

Notice 87-76, 1987-2 C.B. 384
Notice 88-24, 1988-1 C.B. 491
Notice 88-86, Section V, 1988-2 C.B. 401

RESOURCE CITES

The following may be helpful if an issue is raised on the application of ULP.

- ***Reynolds Cattle Co. v. Commissioner***, 31 B.T.A. 206 (1934), ***acq***. XIII-2 (1934) C.B. 16
- ***Est. of Adair v. Commissioner***, 43 B.T.A. 384 (1941), ***acq***. 1941-1 C.B. 1 T.D. 5423, 1945 C.B. 70
- Mim. 5790, 1945 C.B. 72

Also, the preamble to T.D. 8729, 1997-2 C.B. 35 (the temporary farm regulations), and the preamble to T.D. 8897 (the final farm regulations), should be reviewed carefully. Among other things, the preambles explain some of the underlying policies and principles upon which the regulations are based.

TRANSFER OF INVENTORY

Another potential issue may exist where inventoried raised animals are later classified and used for breeding purposes. The taxpayer may attempt to depreciate these animals. However, based upon Revenue Ruling 60-60,1960-1,190; once an election is made to inventory animals, they cannot subsequently be treated as depreciable assets upon reaching maturity. This issue has also been pursued in relation to transfers between related entities.

Example 2

Farm A inventories all of its swine. A decision is made to transfer selected animals as breeding stock. They are classified and depreciated over 3 years. Farm A would be precluded from taking this position by the imposition of the noted Revenue Ruling. If Farm A sells it's inventory of breeding stock to related entity, Farm B, an argument could be made that Farm B continue to inventory and also be precluded from depreciating these animals.

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.

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

Internal Revenue Code 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:

1. S Corporations

2. Corporations whose gross receipts for each tax year beginning after 1975 are $1 million or less

3. 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, and

4. 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:

    - 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.

- Corporations, if on October 4, 1976, and since then, members of two families own directly, 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.

- 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 the 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

Factual development of the issue is critical to reaching the appropriate conclusion. Items to consider include:

- Is the price fixed by contract?
- Is the amount fixed by contract?
- If there is a stated amount and price is not fixed, but based upon market price at delivery; the transaction may be a deposit.
- Can the purchase price be refunded?
- If the purchase price is refundable it may be a deposit?
- Treatment of the expenditure by the seller as a deposit.
- Right to substitute other goods or products for the feed.

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 inclusive are indicative of a deposit rather than a payment:

- The absence of a specified quantity;
- 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 as a result 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 yearend 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?
- Materiality of the expenditure to the taxpayer's income.
- Customary, legitimate business practice.
- Amount of expenditure in relation to past purchases.
- Timing of expenditure.

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

INTERNAL REVENUE CODE SECTION 464(f) LIMITATIONS

Internal Revenue Code section 464(f) provides a mechanical test for determining when prepaid farming expenses are disallowed to a cash basis farm taxpayer. Generally, the statute precludes deduction for prepaid feed expenses 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 79-229, he or she 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.

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 March. At yearend the taxpayer generally contracts 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 March.

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 year-end, any net underpayment is resolved by shipping additional product. If overshipments remain at year-end, 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.
- The 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 year-end, 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 year-end 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.

To a certain extent, the test criteria are not met since 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 ***Clement v. United States,*** 500 F.2d. 422(CT. C1.2978), 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.

Entering into a supply agreement can have a legitimate business purpose, however, there is no apparent 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.

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 example reflects the following values for the fiscal years 1990 and 1991.

- Gross income increased 18 percent or $11.4 million
- Feed consumption increased 5.2 percent or $2.6 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 $4.9 million to $12.4 million. Thus, causing the financial results for 1991 to be materially distorted. In 1992, with a 6-percent increase in gross income and 19-percent reduction in feed consumption with prepaid feed reduced from $12.4 million to $8.6 million; net income increased to $4.2 million, an increase of over 200 percent from 1991.

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 -- ***GRAGG et al, O. L. v. United States*** (1994,CAS) 74 AFTR2d 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 issues, 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 issue 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 that are farmers thus it can be a coveted title.

This page left intentionally blank.

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 a FPS to assist in identifying and working a prepaid feed case:

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

2. Who approves the transactions?

3. What are 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 product does the corporation trade and for what purpose?

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

   Request a copy of the hedge program.

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 (that is, margin accounts, hedging and non-hedging accounts, managed or discretionary accounts, etc.)?

   - Request schedules, account agreements, and margin agreements.

   - Documents which support account(s) (that is, signature cards, authorization to transfer funds, hedge letters, powers of attorney, etc.).

   - Review any hedging journal entries with the person being interviewed.

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

This page left intentionally blank.

Third Party Interview Questions Relative to Feed Purchases

Vendor/Supplier:____________________________
Date:_______________

Purchaser:__________________________________
Examiner:___________

Person Interviewed:___________________________________

I, ________________________________, state that:

I reside at ____

City _____________________ State _________

1. Did you receive any prepayments from the taxpayer during the year? If so, on what dates and amounts.

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 taxpayers? Has the taxpayer consistently made prepayments for the purchase of feed?

4. Did the taxpayer get a discount for his or her volume of purchases?

5. What was the original price of feed and what was the discounted price?

6. What volume of purchases would you have required to receive this amount of discount?

7. Was this discount given to other purchasers during that year?

8. Could the taxpayer 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 buyer?

11. What reasons were discussed for the purchases?

12. Could the taxpayer have made a similar purchase three-day 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 the rate?

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

17. Wash there a storage fee involved?

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

19. How are the picked up items determined? Are they prearranged or during normal business hours?

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

21. How long could the delivery dates be extended?

    - Review Letter of Credit.

22. Could dates be extended at either party's request?

23. Does this contract fix the maximum price of 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 "Forced Majeure". Please explain. Does this mean the taxpayer could possibly get a refund?

33. If feed ingredient costs went up could you 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 ________________________ or 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 purchased?

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

43. Does the taxpayer prepay all purchases from you?

44. Do you require that all purchases be prepaid?

45. Would you 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 accrual bases 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?

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 I review it or would you require a summons?

Chapter 5

Income from Discharge of Indebtedness

CONTENTS

Introduction
IRC section 108
- Income from Discharge of Indebtedness
- Definition of Farming
- Qualified Farm Indebtedness
- Qualified Person
- Limitation
- Amount and Manner of Reduction

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 which originally 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) which provides that gross income does not include any discharge of indebtedness if the indebtedness is from qualified farm debts.

IRC SECTION 108

Under IRC section 108 relief is provided in three main situations in addition to the discharge of 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 "insolvency" pertains to 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.

Example 1

John's liabilities are $20,000 and the fair market value of his assets is $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 precedent 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 noncash payment which can complicate the identification of discharge income.

In many cases the debtor transfers property to the creditor under an agreement which 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. (Rev. Rul. 90-16, C.B. 1990-1, 326. Treas. Reg. sections 1.166-6(a) and 1.1001-2(c), Example 8.)

What if the property is transferred to satisfy a nonrecourse debt? In that case the full amount of the cancelled debt is treated as proceeds from the sale or exchange of the transferred property. This is true even if the value of the property is less than the unpaid balance of the debt. (***J.F. Tufts***, S.Ct., 83-1 U.S.T.C. 9328.)

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 under IRC Section 108.

If the debt had been "nonrecourse 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 given rise to a deduction. This can happen where interest on a loan is forgiven. Since the taxpayer could have deducted the payment of interest he or she has really just lost a deduction. See also Rev. Rul. 67-200, 1967-1 C.B., 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 to 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 taxpayer's basis in the property should be adjusted accordingly. 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. But who is considered a farmer and what is qualified farm indebtedness.

Definition of Farming

Based on the definitions of farming provided by IRC section 464(e) and Treas. Reg. section 1.263A-4(a)(4), swine operations will qualify as a farming operation for purposes of IRC section 108. It is important to note that the temporary regulation's definition of farming does not include processing of the animals.

If an agent is examining a large vertically integrated operation, it is possible for the activity to include the processing of the hogs. If this situation exists, any debt within this portion of the operation will not qualify as farming debt.

Qualified Farm Indebtedness

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

- The indebtedness must be “incurred directly in connection with the operation by the taxpayer of the trade or business of farming.”
- Fifty (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.

For purposes of this test 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 consolidating return regulations. These regulations do not make any provision for a consolidated calculation under 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 hogs from its wholly owned subsidiary and processes the hogs for sale to outside third parties. The Parent Company does not receive any gross receipts from the trade or business of farming and thus 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 or equipment used in agricultural production. S. Rep. No. 313, 99th Cong. 2d Sess. 271 (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:

- The creditor must be actively and regularly engaged in the money lending business or a government agency or its agent.
- They cannot be related to the farmer.
- They cannot be the person (or a person related to such person) from whom the farmer purchased or received the property which secures the debt.
- The creditor (or a person related to them) cannot receive a fee with respect to the farmer's investment in the property securing the debt. This limitation eliminates the possibility of profit for a shelter promoter.

Example 4

The Farmers Home Administration (FmHA) discharged $12,000 of farm debt incurred by Ada Bullock. For the 3 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). The discharge was made by a qualified person and the debt was qualified farm indebtedness. As long as Ada has significant tax attributes to cover the $12,000 it will not be included in her income.

Limitation

The exclusion for the discharge of farm indebtedness is limited 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 gain to be currently reported thus ensuring that the gain will not be permanently deferred. Congressional intent was to allow a deferred

benefit rather than a complete tax-exempt status for solvent farmers which would in turn ease the credit crisis in the farming sector.

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.

Amount and Manner of Reduction

Generally, the amount of the reduction 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 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 taxable income except for Title 11 exclusions. For taxpayers in bankruptcy Congress allows a permanent benefit to provide the clean and fresh start intended under the bankruptcy philosophy.

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.

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). This is a very attractive election for a solvent taxpayer with credits or net operating losses which are usable in the current tax year. The effect on 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 in the taxable year of discharge in order to make the election. Only when the election to first reduce the basis of depreciable property is made, can the basis actually be reduced below the amount of the taxpayer's undischarged liabilities.

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 solvent 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 cancelled in connection with the complete liquidation of the corporation, the cancellation is treated as a distribution in exchange for the shareholder's stock. Consequently, the debt cancellation 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) considers the acquisition of debt by a person related to the debtor from an unrelated creditor, as an acquisition by the debtor. What this means is the debtor is seen as canceling his or her debt for the amount paid by the related party. Any discount is realized as income from discharge of indebtedness. Treas. Reg. section 1.108-1(F(1).

AUDIT TECHNIQUES

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.

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.

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(g) or IRC section 1017 were made. If a basis election 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 affect 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.

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: The gain on foreclosure sales involving nonrecourse debt is often calculated using the FMV of the property instead of the full amount of the cancelled debt.

or

The gain from the transfer of property under a nonrecourse debtor is sometimes incorrectly treated as income from the discharge of debt and excluded from income under the insolvency provisions.

A Form 1099-C should be filed by the creditor 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. Examiners should verify the accuracy of any Form 1099-C.

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 inadvertently 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, any discharge of indebtedness will be offset equally by either a reduction to a tax attribute or inclusion in taxable income.

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 which includes 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.

This page was left intentionally blank.

Chapter 6

Selection Fees

CONTENTS

Introduction
Case Scenario
Related Issues
Audit Techniques
Summary

INTRODUCTION

A common practice in the swine industry is purchasing genetically superior breeding stock that will ensure quality animals for consumption or breeding purposes. This method will provide for a continued high grade of breeding stock for the farming operation. Generally there is a contract with the supplier that identifies the type of animals purchased and imposes constraints on the offspring generated from these animals.

A portion of the contract will discuss the use of offspring; whether for breeding or for consumption. If they are to be used on the farm as "breeding stock", there is a cost associated with this "selection." The farm will be required to compensate the supplier for offspring selected for breeding. The contract will further delineate the method of selection and cost per animal selected.

Example 1

Farm A purchases a boar from Supplier B for $1,000. The contract states that for the first 2 boars selected from breeding, a fee of $300 per boar will be required. Any additional selections will cost $200 per boar. [This is usually based on a per sow, per year basis.]

The payment of the $300 per boar is treated as an expense by Farm A and is considered as a cost of "raising." Remember, that a cash basis farm may deduct the cost of raising the animals, as a current expense.

The position to be taken is that the "selection fee" is not a cost of raising, but rather a cost of or associated cost of the offspring. And since the animal is, by definition, to be used as "Breeding Stock," must be capitalized and depreciated over 3 years. (See DEPRECIATION CHAPTER) Depending on the size of the farm operation and extent of its involvement with these suppliers, adjustments can be significant.

CASE SCENARIO

The following arguments were successfully applied in several cases:

- Purchased Breeding Stock -- A portion of Section 1.162-12(a) Income Tax Regulations provides that "amounts expended in purchasing work, breeding, dairy or sporting animals are regarded as capital investments." Such expenditures to purchase livestock are clearly capital in nature, must be capitalized, and are not subject to the election granted for costs connected with raising livestock.

- The issue of costs associated with purchased animals versus raised animals has drawn some attention over the years generating some cases with similarities but not specifics. Costs of raising livestock were specially treated as deductions with the taxpayer maintaining an option to expense or capitalize costs under either Treas. Reg. section 1.62-12 or Treas. Reg. section 1.471-6(a) [***Welder v. United States***, (1971, DC TX) 28 AFTR 2d 71-5407, 329 F.Supp 739, 71-2 U.S.T.C. 9592].

- Treas, Reg. section 1.162-12 provides that "the purchase of feed and other costs connected with raising livestock may be treated as expense deduction in so far as such costs represent actual outlay."

- In the ***Ellis, Robert V and Betty J*** 1984 PH Memo 84-190 case, the emphasis is that a later portion of Section 1.162-12(a) Income Tax Regulations provides that "amounts expended in purchasing work, breeding, dairy or sporting animals are regarded as investments in capital." Such expenditures to purchase livestock are clearly capital in nature, must be capitalized, and are not subject to the election granted costs connected with raising livestock.

- ***Dugger v. Commissioner,*** [Dec. 35,518] 71T.C. 154, 71PH T. C. 87 is most similar to the case at hand. The petitioner subleases 40 head of cattle with the purpose of developing a herd. A fee of $100 was paid to sublease each brood cow and $300 to maintain each cow and calf until such time that the calf was weaned (8 to 9 months). The agreement stipulated that the calves born to the said cows were the property of the petitioner. The leased brood cow was returned to its owner when its calf was weaned. There was no guarantee of a calf per cow. Petitioner however did receive 20 male and 20 female calves. The cost to purchase a weaned calf, such as petitioner was to receive from the process outlined in the agreement, would have been between $250 and $350.

- It was held that those expenditures associated with the leased brood cows were non-deductible capital expenditures.

- This case cites ***Weiner v. Commissioner***, 58 T.C. 81(1972) ***aff'd*** 494 F.2d 691(9th Cir. 1974). Where the taxpayer paid $330 per animal to raise calves. Of the $330, $302 was designated as raising cost and $28 as the purchase price for each calf (Petitioner's Position).

- The cows which petitioners had "purchased" were not specifically designated as theirs until they had reached maturity and were rented to the dairy. On these facts, it was held that the entire $330 was allegedly a cost of raising the calves. Petitioner did not acquire ownership of the animals until they had become calves and were leased to the dairy. Consequently, petitioner had to capitalize the entire $330 outlay as the purchase price of the mature cows. In substance, it was a purchase of weaned calves rather than rental or care of breeding cows. The cost was necessary to the creation of the desired asset ─ ***Weiner***; a mature cow; ─ in this case; a weaned calf.

- This case hinges also on the creation of an asset. The asset is a pig to be used in the Breeding Process. In order to accomplish or meet that goal, the taxpayer must pay a fee. If not, the animal can be used for slaughter only. The purpose of the animal is for Breeding. No other animal that is non-selected incurs any costs other than what is commonly considered the "cost of raising," that is, feeding, breeding, veterinary care, supervision, and overhead charges (as identified in ***Weiner v. Commissioner***). The animal cannot be used for breeding unless selected to do so and a fee paid.

Revenue Ruling 87-105, 1987-2 CB 46, provided for the allocation of costs between cow and embryo transplant where taxpayer purchases cows that have been artificially impregnated with transplanted purebred embryos. The ruling provides, in part, that the costs allocable to the cows and the costs to the embryos must be capitalized and are not deductible currently as expenses under Section 162 of the Internal Revenue Code.

Obviously, the cost of the embryo transplant is not considered a cost of raising. Yet the ruling appears to provide for cost attributable to an unborn animal. Therefore, it is a cost associated with an asset and capitalized as such. The selected boar expense is a cost associated with an asset, although born, it is similarly segregated for treatment and is non deductible.

RELATED ISSUES

Examiners should review the taxpayers records to ensure that purchased animals (any breeding stock), includes transportation costs. Some taxpayers separate transportation from the capitalized breeding stock. In addition, taxpayers may misclassify purchased breeding stock within the

selection fee account. Also note that taxpayers may utilize other nomenclature for "selection fees" such as "boar expense" or "royalty expense."

AUDIT TECHNIQUES

Examiners should review the general ledger for the type of expenses that are stipulated above. In addition, query the taxpayer regarding their treatment of purchased hogs, both purchased for consumption and for breeding purposes. If purchased for consumption, their deduction of cost is in the year of sale, not the year of purchase. If for breeding purposes, they must be depreciated. Invoices will provide evidence of transportation cost treatment. This line of questioning should lead to discussion relative to the existence of contracts regarding the breeding stock. From there, the examiner can determine the procedures and requirements on offspring "selected" for breeding.

SUMMARY

Costs associated with selecting offspring for breeding purposes are generally deducted as a current expense of raising animals. No definition of raising will ever include a cost similar to selection costs. The expense is more appropriately categorized as an acquisition cost. The rhetoric contained within the case scenario has been successful in taxpayer concurrence with the issue.

Chapter 7

Depreciation

CONTENTS

IRC section 167(a)
IRC section 168
IRC section 168(b)(2)
Depreciation Methods Chart
IRC section 263(a)
Depreciation Accounting Method Changes
Swine Farm Components
- Roads
- Water Wells
- Single Purpose Agriculture Structures
- Other Farm Buildings
- Lagoons
- Certified Pollution Control Facility
- Irrigation Systems
- Spray Fields
- Other Farm Equipment
- Swine
- Depreciation of Land Improvements

Summary

IRC SECTION 167(a)

Currently, Internal Revenue Code section 167(a) provides an income tax deduction for property used in the taxpayer's trade or business or held by the taxpayer for the production of income, that is subject to exhaustion, wear and tear (including a reasonable allowance for obsolescence). The methodology for determining this depreciation allowance is found within IRC section 168.

IRC SECTION 168

IRC section 168 generally is applicable for tangible depreciable property placed in service after December 31, 1986. For tangible depreciable property placed in service after 1980 and before 1987, the depreciation allowance was determined under former IRC section 168 (ACRS).

IRC section 168(a)(MACRS), except as otherwise provided by IRC section 168, the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using the applicable:

1. Depreciation method,
2. Recovery period, and
3. Convention.

IRC SECTION 168(b)(2)

In 1988 Congress passed IRC section 168(b)(2) 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 property used in a farming business, except for nonresidential real property and residential rental property.

You can depreciate property placed in service after 1988 in a farming business using:

1. The 150-percent declining balance method over the GDS recovery period, which switches to the straight line method when that method provides a greater deduction,

2. The straight line method over the GDS recovery period,

3. The straight-line method over fixed ADS recovery periods, or

4. The 150-percent declining balance method over fixed ADS recovery periods, which switches to the straight line method when that method provides a greater deduction. This method does not apply to property placed in service on or after August 5, 1997.

Revenue Procedure 87-56 states that for property not described in any asset class life or used in a described activity, a 7-year class is assigned for the general MACRS method (GDS) and 12-year recovery period for ADS. See IRC section 168 (e)(3)(c), 168(c), 168(g)(2)(c)(ii).

Publication 946, titled "How to Depreciate Property" states that "MACRS" consists of two systems that determine how you depreciate your property. The main system is called the General Depreciation System (GDS) while the second system is called the Alternative Depreciation System (ADS). Unless ADS is specifically required by law or you elect it, GDS is generally used to figure your depreciation deduction.

Publication 946, under "Election of ADS" states "although your property may come under GDS, you can make an election to use ADS." ADS uses the straight-line method of depreciation over fixed ADS recovery periods.

Once the election is made for the 150-percent method under GDS or the straight-line method under GDS or ADS it is irrevocable.

DEPRECIATION ACCOUNTING METHOD CHANGES

To help you determine the method to use for a specific property class, the following depreciation methods chart is provided from Publication 946. The declining balance method is abbreviated as DB and the straight-line method is abbreviated as SL.

DEPRECIATION METHODS CHART	
3, 5, 7, 10-year (Non-Farm)	200% DB-GDS 150% DB-GDS 150% DB-AD* SL-GDS* SL-ADS*
3, 5, 7, 10-year (Farm)	150% DB-GDS 150% DB-ADS* SL-GDS* SL-ADS*
15, 20-year (Farm or Non-Farm)	150% DB-GDS SL-GDS* SL-ADS*
Nonresidential Real Property Residential Rental Property Trees or Vines Bearing Fruit or Nuts	SL-GDS SL-ADS*
Tax-Exempt Use Property Tax-Exempt Bond-Financed Property Imported Property Foreign Use Property (Outside the United States)	SL-ADS

* Does not apply to property placed in service after August 4, 1997.

IRC section 168 provides specific cost recovery rules, which 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.

Example 1

Farmer Brown owns the following assets.

- Computer
- Office Furniture
- Tractor
- Road
- Hay Baler
- Water Well
- Stock Trailer
- Lagoon
- Truck
- Underground Irrigation

He uses all of these assets in his farming business. Depreciation on each asset is limited to 150 percent declining balance under the GDS system. Under the ADS system, he would be limited to straight-line depreciation for each asset.

IRC SECTION 263(a)

IRC section 263(a) states, "No deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Related Treas. Reg. section 1.263(a)-1(b) provides that capital expenditures are:

Amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use.

Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures.

DEPRECIATION ACCOUNTING METHOD CHANGES

In swine farm examinations, the two issues covered below constitute changes in a taxpayer's method of accounting.

1. Reclassifying property on which depreciation has been claimed to nondepreciable property, and
2. Reclassification of asset recovery periods under ACRS or MACRS.
3. Change in depreciation method.

Treas. Reg. section 1.446-1(e)(2)(ii)(a) defines a change in the method of accounting to include a change in the overall plan or accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. The regulations further define a "material item" as any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Under Treas. Reg. section 1.446-1(e)(2)(ii)(b), a correction to require depreciation in lieu of a deduction for the costs of a class of depreciable assets which had been consistently treated as an expense in the year of purchase constitutes a change in method of accounting.

In ***Diebold, Inc. v. United States***, 16 Ct. Cl.193 (1989); 89-1 U.S.T.C. 9141, ***aff'd***, 891 F.2d 1579 (Fed. Cir. 1989); 90-1 U.S.T.C. 50,003, the Claims Court found the taxpayer had improperly changed its method of accounting by changing the treatment of certain spare service parts from inventory to depreciable property.

The taxpayer in ***Diebold*** manufactured and sold automated teller machines (ATMs). Originally, the taxpayer considered its spare rotatable ATMs as nondepreciable inventory. However, 5 years later the taxpayer filed amended returns changing the treatment of the spare ATMs from inventory to depreciable property. The Service disallowed the claims

based on the premise the taxpayer changed its method of accounting without seeking the Commissioner's approval.

In agreeing with the Service, the court stated "In this case, the plaintiff's attempt to claim depreciation (over a 5-year useful life) on rotatable spare parts involves the proper time for the taking of a deduction. ***Diebold*** initially treated its spare modules as inventory, a method that permits the cost of acquiring inventory to be deducted in a single year. ***Diebold'***s amended returns, in contrast, seek to recover the cost of the spares ratably over their useful life."

The court went on to cite numerous cases in which depreciation and/or inventory deductions were issues. In reference to the cases, the court remarked "These cases establish that changes within inventory or depreciation techniques, let alone a change from inventory to depreciation, involve the timing of deductions."

In affirming the Claims Court decision, the Court of Appeals noted:

First of all, there is no question that a change from treating the replacement modules as nondepreciable inventory, where there is no deduction until the modules are removed from service, to treating them as capital assets, where there is a depreciation deduction in each year of useful life, raises the question of the taxable year in which income is reduced by the cost or a portion of the cost of manufacturing the replacement modules, that is, a question of timing.

Treas. Reg. section 1.446-1(e)(2)(b) provides that a change in the method of accounting does not include an adjustment to the useful life of a depreciable asset. The regulations also state "for the treatment of a change in the useful life of a depreciable asset, see the regulations under section 167(b) of the Code."

P.L. 97-34, Sec. 201(a), modified IRC section 168 for property placed in service after December 31, 1986. This modified section provided the rules under which depreciation deductions would be calculated based upon asset "recovery periods" not useful lives.

An examination adjustment made to correct an asset's recovery period is considered a change in method of accounting. The correction of a recovery period is not a correction of a useful life. Such a misclassification of property should be treated as a method of accounting, rather than as an error in reporting, since it only affects the timing, and not the total amount of depreciation.

A change in depreciation method under IRC section 168 is a change in method of accounting. Adjustments made to capitalize costs, which have

been currently deducted, are also considered changes in accounting methods.

Thus, for the year of change, two adjustments will be necessary:

1. The IRC section 481 adjustment for the correction of prior years, and
2. The current year adjustment.

SWINE FARM COMPONENTS

To analyze the tax law relating to depreciation with respect to a swine farm, one must first develop an understanding of the unique functional components of a farm. A typical farm includes roads, wells, single-purpose agriculture buildings, other farm buildings, lagoons, above ground and underground irrigation equipment, and other farm equipment. These elements are combined in different ways to form each swine farm. One of the common issues found with swine farm examinations is the use of improper recovery periods for certain assets. The following is a brief description of these assets, followed by a discussion of their tax treatment.

Roads

Each swine farm is located off the public road as far as feasibly possible. The road is required to meet specific compaction requirements to be able to hold concrete trucks necessary to construct the buildings needed to confine the swine. The roads are classified as "Land Improvements" in "Asset Class " 00.3 with a class life of 20 years, a GDS life of 15 years and ADS life of 20 years. The farmers usually do not separate out the road cost, but include it in the shorter class life as equipment or single purpose agriculture structures.

Water Wells

Publication 225, Farmer's Tax Guide, states "The cost of drilling water wells for irrigation and other agricultural purposes is a capital expense and not deductible as a soil and water conservation expense. You recover your cost through depreciation. You must capitalize your cost for drilling test holes. If the test holes produce no water and you continue drilling, the cost of the test holes is added to the cost of the producing well. You can recover the total cost through depreciation deductions.

If a test hole, dry hole, or dried-up well (resulting from prolonged lack of rain, for instance) is abandoned, you can deduct your unrecovered cost in the year of abandonment."

Water is necessary for not only for swine consumption, but also for the cleanliness of the building and the workers. A large swine farm usually has more than one well. Wells are classified as "Land Improvements" in "Asset Class " 00.3 with a class life of 20 years, a GDS life of 15 years and ADS life of 20 years. The farmers usually do not separate out the cost of the wells, but include it in the shorter class life as equipment or single purpose agriculture structures.

Single Purpose Agriculture Structures

A single purpose agriculture structure must be specifically designed, constructed, and used for the housing, raising, and feeding of a particular type of livestock and the produce of such livestock (IRC section. 168(i)(13)). Equipment to contain the livestock and to provide water, feed and temperature control, if necessary, must be included as an integral part of the structure or enclosure. Single purpose agricultural structures are in "Asset Class " 01.4 with a class life of 15 years, a GDS life of 10 years and ADS life of 15 years.

Other Farm Buildings

Swine farms may have a variety of ancillary structures and facilities. Most will have at least a maintenance facility or an equipment shed, a generator shed, and an office space or separate office building. These structures will be used to complete the necessary paperwork for the farm, for the workers to eat lunch and for workers to "shower in and out" from the facility. Washers, dryers, televisions, microwaves and refrigerators are common appliances found in these structure for the employees to use. These structures are classified as "Other Farm Buildings" in "Asset Class " 01.3 with a class life of 25 years, a GDS life of 20 years and ADS life of 25 years. The farmers usually classify all farm building as single purpose agriculture structures and depreciate them on the shorter life.

Lagoons

Lagoons are open-air septic tanks for swine waste disposal. Lagoons are usually constructed with clay bottoms to help prevent seepage. Lagoons are classified as "Land Improvements" in "Asset Class " 00.3 with a class life of 20 years, a GDS life of 15 years and ADS life of 20 years. The farmers may err by not separating out the cost of the lagoons, but may include it in the shorter class life as equipment or single purpose agriculture structures.

Technical Advice Request

The following is a technical advice request from Appeals to National Office and the response. This supports the Service's position taken on the lagoons.

Facts: The taxpayer is a hog farmer. In late 1992 he started construction of a hog raising operation which was completed during the summer of 1993. In connection with the hog operation, the taxpayer constructed a hog lagoon for disposal of the waste from the animals. Essentially, the lagoon is a shallow artificial pond into which the waste is pumped.

Certain chemicals are added to the water that causes the water to separate from the solid waste. The water is pumped off and sprayed over the farmer's land as fertilizer while the solid waste sinks to the bottom of the lagoon. The taxpayer uses no lining or insulating materials other than the surrounding soil although the lagoon is dug to a depth that reaches the hard pack clay which is supposed to prevent the waste products from leaking.

The taxpayer treated the lagoon as 10-year property on the return but is now claiming that it is 7-year property because it is property without a class. The revenue agent argues that the lagoon is properly classified as a land improvement with a 15-year recovery period. It has also been suggested that the lagoon be classified in Asset Guideline class 50. (Municipal wastewater treatment plant or Asset Guideline Class 51. (Municipal Sewer)"

Response: "We agree with the revenue agent that the lagoon is a land improvement described in asset guideline class 00.3 with a 15-year recovery period. Asset guideline class 00.3 includes, "canals, waterways, drainage facilities, sewers" which essentially describes the lagoon.

Certified Pollution Control Facility

You have also asked about the possibility of treating the lagoon as a "certified pollution control facility" qualifying for 60-month amortization pursuant to IRC section 169. IRC section 169 requires:

1. An election by the taxpayer,
2. Certification by a state or federal authority, and
3. Use in connection with a plant or property placed in service prior to January 1, 1976.

In the absence of facts indicating that these criteria are met, it does not appear that the property qualifies for an IRC section 169 amortization.

Publication 225, ***The Farmer's Tax Guide***, and IRC section 169 state that, "You can elect to amortize over 60 months the cost of a certified pollution facility used with a plant (or other property) that was in operation before 1976."

A certified pollution control facility is a new identifiable treatment facility used to reduce or control water or atmospheric pollution or contamination. The facility must do so by removing, changing, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. The state and federal certifying authorities must certify the facility. Examples of such a facility include septic tanks and manure-control facilities.

Example 2

This year, you purchase a new $7,500 manure control facility (lagoon) for use on your swine farm. The farm has been in operation since you bought it in 1976 and all the swine facility was in operation before that date. You have no intention of recovering the cost of the facility through sale of the waste and a federal certifying authority has so certified.

Your lagoon qualifies for amortization. You can choose to amortize its costs over 60 months. Otherwise, you can capitalize the cost and depreciate the facility over a 15-year GDS life.

Irrigation Systems

Irrigation systems are similar to watering systems in our yards or on golf courses. You can have above ground systems, underground systems or hybrids. Farmers usually have a portion of their systems underground and hoses and hose reels above the ground. The above ground equipment qualifies for a 7-year GDS life or a 10-year ADS life. However, the underground pipe is classified as "Land Improvements" in "Asset Class " 57.1 with a class life of 20 years, a GDS life of 15 years and ADS life of 20 years. The farmers may erroneously classify all irrigation equipment as regular equipment and depreciate it on the shorter life.

Spray Fields

Swine waste is high in nitrates. When lagoons become filled it is necessary to pump the liquid waste on a nitrogen consuming plant. This can be a vegetable (that is, corn, beans or peas), it could be trees (this has been approved by certain states on an experimental basis) but coastal bermuda grass is very common in areas where it will grow. State regulation govern how large spray fields must be and how often nitrates may be pumped on them. The cost of "establishing" spray fields is not a currently deductible expense. It should be capitalized and added to the basis of the land. You will find that farmers commonly deduct this expense when incurred.

The Service has ruled that "expenditures incurred by a taxpayer in the original construction of greens on a golf course constitute capital expenditures to be added to the original cost of the land and are not subject to an allowance for depreciation." Rev. Rul. 55-290, 1955-1 C.B. 320. This is similar to the permanent spray fields (that is, coastal bermuda) sprigged by the farmers.

Other Farm Equipment

This includes machinery and equipment, grain bins, and fences but not other land improvements, that are used in the production of livestock. Farm equipment is in "Asset Class " 01.1 with a class life of 10 years, a GDS life of 7 years and ADS life of 10 years. The farmers may include in this category any of the other components of the swine farm due to its short depreciable life. This classification requires close scrutiny by the examiner.

Swine

Swine purchased for breeding that are not kept in an inventory account may be depreciated. Swine that you raise usually has no depreciable basis because the costs of raising it are deducted and are not added to the basis. This may not be the case if "Selection or Royalty fees" are paid. (See the chapter on selection fees) Breeding swine are listed in "Asset Class " 01.23 with a class life of 3 years, a GDS life of 3 years and ADS life of 3 years. Immature livestock acquired for breeding purposes is eligible for depreciation when it reaches maturity. This means depreciation begins when it reaches the age when it can be bred. When this occurs, basis for depreciation is the initial cost for the immature livestock plus freight and other costs related to the acquisition.

Depreciation of Land Improvements

Under Rev. Proc. 87-56, land improvements, asset class 00.3, have a class life of 20 years and a recovery period for general depreciation purposes of 15 years (20 years for the alternative depreciation system). Under this asset class, land improvements include improvements directly to or added to land, whether such improvements are IRC section 1245 property or IRC section 1250 property, provided such improvements are depreciable. Examples include sidewalks, roads, waterways, drainage facilities, sewers, docks, bridges, fences, etc. However, this class does not include improvements that are explicitly included in any other class, and buildings and structural components.

Although certain land improvements and land have been held to be nondepreciable by the Service, some land improvements may be depreciated if they are associated with a depreciable asset.

Per Rev. Rul. 65-265, 1965-2 C.B. 52, land-moving costs (excavation, grading, soil removal, etc.) are depreciable costs to the extent they are necessary for the proper setting of buildings and paving of roadways. However, the taxpayer has to prove the costs allocable for such purposes. ***Aurora Village Shopping Center, Inc. v. Commissioner***, T.C. Memo 1970-39, 29 T.C.M. (CCH) 126 (1970).

Although earlier decisions of the Tax Court held that landscaping items were nondepreciable because they were more closely associated with the land than with depreciable buildings ***Shainberg v. Commissioner***, 33 TC 241, ***acq***., 1960-1 C.B. 5, and ***Algernon Blair, Inc. v. Commissioner***, 29 TC 1205 (1958), ***acq***., 1958-2 C.B. 4], the Commissioner has ruled that perennial shrubbery and ornamental trees immediately adjacent to an apartment complex were depreciable over the life of the building since the replacement of the buildings at the end of their useful lives would destroy the shrubbery and trees. Rev. Rul. 74-265, 1974-1 C.B. 56. However, this

ruling concluded that other landscaping on the grounds, "including perennial shrubbery and ornamental trees" around the perimeter of the tract, were inextricably associated with the land and were to be added to the basis for the land rather than the depreciable apartment complex. This also applies to the permanent pastures or spray fields used in the swine farms.

Examiners need to carefully examine the cost basis of each individual component. Usually generic terms are used because the developer has lumped all costs associated with the particular facility together in one asset account. While it will not be difficult to segregate the direct construction costs for each component, examiners will need to allocate any indirect capitalized costs, as well as capitalized interest.

Adjustments to disallow depreciation deductions taken for non-depreciable farm improvements constitute changes in methods of accounting. As such, the years of change will include two adjustments; the IRC section 481(a) adjustment and the current year adjustment. In these cases, the calculation of the IRC section 481(a) adjustment is relatively easy. It is merely the total accumulated depreciation claimed in all prior years for tax purposes. Likewise, the current year adjustment is the amount of the depreciation claimed with respect to the non-depreciable improvements.

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 swine 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 8

Grower Issues

CONTENTS

- Introduction
- Income
- Expenses
  - Depreciation
  - Interest
  - Utilities
  - Insurance
  - Miscellaneous
- Net Check - Double Deduction
- Section 469 - Passive Activities
  - Material Participation
  - Recharacterization of self-rental income
- Alternative Minimum Tax
  - Corporate Minimum Tax
- Income Averaging
- Audit Techniques
- Summary

INTRODUCTION

The larger swine integrators are dependent on contract growers to rapidly expand the integrator's production and to reduce their capital outlays. In contract situations, the integrator provides the animals, feed, veterinarian services, and technical expertise. The grower is responsible for providing the swine facility, labor, utilities, maintenance, supplies, and day to day management of the operation.

There are three swine operations a contract grower can conduct, each one requiring a facility constructed for a specific purpose. Note that a contractor is not limited to one type of operation and may operate one or all of the farms discussed below.

Sow farm

Sows are bred with boars or are artificially inseminated. The pregnant sows are moved to gestation houses and then to a farrowing house just prior to giving birth. The litter of pigs will stay with the sow for approximately 2 to 3 weeks until they are weaned at which time the pigs will be transferred to a nursery farm.

Sow contracts are generally based on production with quarterly bonuses paid for exceeding target production levels.

Nursery farm

The piglets remain in the nursery until they weigh 40 to 50 pounds. They are then transferred to a finishing farm.

Nursery contracts are generally based on the number of pigs transferred to the finishing operation with a quarterly bonus for exceeding target amounts.

Finishing farm

The pigs are received from the nursery and will remain at the finishing farm until they weigh about 240 pounds. The animals next stop will be the processing plant.

Finishing contracts are usually based on a combination of production, weight gain, and feed conversion ratios. Quarterly bonuses are paid for exceeding target levels.

It is important to note that all contracts are not the same and the organizational structure of the farms may differ. This chapter was included to give the examiner a basic understanding of the contract grower but was not meant to replace the interview with the grower or the review of the actual contract.

The grower issues discussed below are issues that have been encountered on examinations of swine facilities. While some of these issues may be unique to the industry, others will be consistent with any farm/business audit. Swine farming, like most industries, is dynamic and new examination issues will arise with new technology advancements and innovations in the way the basic operation is managed. Again, this guide will not replace the interview, which is the basic tool for gaining an understanding of the swine operation, but will provide guidance toward some examination areas that my be productive.

INCOME

Income is normally not an area that a swine farmer can understate because the amounts are easily verifiable. However, certain situations may occur that can generate examination issues and adjustments.

Usually, the income deposited into the growers bank account will be significantly less than the amount reported on the Form 1099 issued by the

integrator. This is due to financing assignments and amounts withheld by the integrator for expenses the grower purchased from the integrator. For each "sale" the grower will receive a settlement sheet from the integrator. Although most large integrators properly issue correct Forms 1099 and the accountants and taxpayers have learned to use the Form 1099 amount as gross receipts, the examiner may want to reconcile the Form 1099 amount to the settlement sheets as some examinations have revealed errors in the amounts reported on the Forms 1099. In situations where a Form 1099 is not required or not issued, the settlement sheets can be used to determine income.

Some integrators have reimbursement plans that repay the grower for qualified repairs. The grower forwards qualifying receipts to the integrator and will receive reimbursement monies for these expenses. An exam issue may occur if the grower does not include the reimbursement in income and either capitalizes or expenses the repairs. The integrator can be contacted to provide a breakdown of the amount included on the Form 1099 to determine if the reimbursement is included.

Growers recycle the animal waste by spraying the liquid waste from the waste lagoons on to pastures or spray fields. A grower may cut hay from these fields and/or have cows grazing these pastures. The examiner should look for income from these items if the interview or tour of operations indicates these issues are present.

Examiners should also be aware of timber sales during the start up period of the operation. The growers must have enough land to support the waste spraying, usually at least 20 acres. The grower may have had to clear land to satisfy this requirement and, if so, may have received timber proceeds.

If the facility is damaged the grower may make repairs prior to receiving the insurance settlement. Ensure that any repairs covered by insurance are not deducted unless the grower included the insurance proceeds in income.

EXPENSES

In contract situations, the integrator supplies the animals, feed, medication, and technical advice at no cost to the grower. In addition to providing and bearing the cost of the swine facility, the grower is usually responsible for the repairs, utilities, insurance, supplies, and labor involved in the operation.

IRC section 162 and Treas. Reg. section 1.162-12 provide for the 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. This section will discuss some of the expenses peculiar to growers.

Depreciation

Due to the large capital outlay needed to construct a modern swine facility and the availability of the 10-year life on single purpose agriculture facilities, the depreciation expense will be one of the largest expenses on the tax return. A full discussion of this expense is not warranted in this chapter as a separate chapter has been devoted to this issue to address the numerous and significant examinations issues that exist in this area.

One issue that is of relevance due to the large number of growers which have set up related corporations which they lease their swine facility to, is the IRC section 179 election. The corporation will not own any assets but is responsible for the operation of the facility. The corporation will pay the shareholder a rental fee which will be reported on Schedule E of the Form 1040. The shareholder will continue to operate the activity and purchase assets related to the operation. They may try to use IRC section 179 to expense any capital items. Examiners should disallow the IRC section 179 deduction since the activity is no longer a trade or business but exists as a rental property. The 179 election is not available to rental activities per IRC section 179(d)(1).

Interest

Although this expense will be one of the largest on the return, it is normally easy to verify through inspection of Forms 1098 or through contacts with the financing entity. The usual financing arrangement calls for an assignment of a portion of the contract proceeds to be sent directly to the financing company. The integrators will generally include the gross contract income on the Form 1099 even though the grower may actually receive only a portion of gross proceeds.

Utilities

The utility expense will vary depending on the climate of the geographical location of the swine facility. The grower maintains the facilities' temperature at a point posing the least stress on the animals. As with other farming operations the examiner can review the service location noted on the electric bills to determine if any non-farm electricity is being expensed.

If natural gas or propane is being used by the operation, the examiner can review the gas bills for delivery location to determine if personal items are being deducted.

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 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 in order to take advantage of lower farm premiums. Even the smaller growers have significant amounts of capital tied up in buildings and equipment and insurance expense can seem rather high in relation to their income. A simple review of the policy will indicate if any non-farm insurance is being deducted.

Miscellaneous

Many swine facilities will have offices attached to or located near the building housing the swine. These offices may include desk space, a kitchen, and some furniture. Because of disease transmission concerns, anyone entering the swine facility may be required to shower. The workers in the facility will have showered upon entering and are free to enter the area housing the animals without showering again. Because some workers may not leave the site during the entire work day, the grower may deduct some unusual items on the return, such as, bathroom supplies, kitchen supplies, food items, and items that would appear to be personal items. This type of activity is especially true in farrowing operations where the animals require constant attention. These expenses are usually substantiated with a cash register receipt from a discount or grocery store. A review of these tapes may determine if the grower is purchasing personal items that should not be deducted. If the grower's personal bank statements are available, review the checks to determine if there are payments made to grocery stores. If there are none, the grower may be expensing personal items through the farm activity.

Some growers have an expense account with the integrator. Supplies, repairs, and other miscellaneous items can be purchased from the integrator. If the integrator does not have a system of netting these expenses from the growers contract check, the grower will likely make a monthly payment for these supplies. The grower will usually post this check to one expense account, such as supplies expense. Examiners should review the detail of these expenses for non-deductible or personal items. Capital items, such as generators and other equipment are often included in this "supplies" account.

NET CHECK - DOUBLE DEDUCTION

Many times the proceeds from the sale of swine 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/natural

gas, farm supplies, repair expenses, personal purchases, and loan assignments. The company usually records this as an accounts receivable from the grower.

Some growers will record the "net" check as their gross receipts. This would be acceptable, except for the loan assignments, as long as the grower has not taken an additional deduction for the various expenses deducted to arrive at the "net" check and no personal items were deducted. Generally, the farmers and accountants have learned that they need to report the gross check amount so it will tie to the Form 1099 being issued by the integrator. However, there are still some growers who will report only their "net" check and also take the deductions.

The integrator generally provides the grower with a detailed list of the expenses deducted from the gross check. These expenses may or may not be separated into expense categories. The examiner will need to review these carefully for non deductible or capital items as the grower will sometimes lump all expense items withheld from their check into one line item expense on the tax return.

IRC SECTION 469 – PASSIVE ACTIVITIES

The law regarding passive losses is voluminous and complex. Only basic section 469 issues will be addressed in this guide. See the Passive Activity Losses Reference Guide, Training 3149-115 (Rev. 2/96) TPDS No. 83479V, for an in-depth review of Section 469 issues.

Material Participation

Many of the modern swine facilities may be owned by individuals outside the farming industry such as, physicians, bankers, attorneys, or other employees of the public and private sector. Large interest and depreciation deductions can generate large losses in the early years of the operation that may be subject to the passive loss limitations under IRC section 469. When the owners of a facility are not available on an everyday basis, they hire farm managers to operate the facility. When losses are incurred, the owners may not be able to resist the temptation to offset income with passive losses generated by the operation.

If the owner of a swine facility does not materially participate in the activity, then the loss is considered passive and is subject to the limitations of IRC section 469.

The Code defines material participation as participation that is regular, continuous, and substantial. The regulations have provided for seven tests for determining material participation.

This issue will normally hinge on the material participation test rules, primarily the 500 hour standard. An owner with outside employment will have to spend 1/4 of a standard work year on the activity to qualify for the 500 hour standard. Although contemporaneous record keeping of the hours a taxpayer spends in an activity is not required under the section 469 regulations, the courts have been consistent in ruling that estimates and narrative descriptions of the time spent will not qualify if the statements are self serving and uncorroborated. (***Seits v. Commissioner,*** TCM 1994-52)

While the regulations are somewhat ambivalent concerning the records to be maintained, they by no means allow the type of ballpark estimates the petitioner used." (***Goshorn v. Commissioner,*** TCM 1993-578.)

The Service has been upheld by the courts in nearly 100 percent of the court cases involving material participation. Agents do not have to accept time estimates that clear all material participation hurdles if these estimates are questionable and unverifiable. If the agent believes the estimates are unreasonable, contacts with third parties to verify these estimates are necessary.

Outside employed owners that hire farm managers and other employees to operate the farms may find it nearly impossible to prove the hour requirements of IRC section 469.

Recharacterization of Self-Rental Income

In situations where the owner of a swine facility rents the swine facility to an entity that he or she works in, any income generated by the rental will not produce passive income to be used to offset passive losses. This "self-rental" income is deemed non passive under Treas. Reg. section 1.469-2(f)(6).

Exception:

The self-rental income may be treated as passive income if a written binding lease was executed prior to February 19, 1988.

Losses from self-rented property will remain passive. Examiners should be aware of other IRC section 469 limitations that may be applicable.

ALTERNATIVE MINIMUM TAX

Farmers and their return preparers often overlook the alternative minimum tax calculation. The AMT calculation requires a depreciation adjustment

for the difference in AMT depreciation and regular depreciation. AMT depreciation is calculated using the 150-percent declining balance method. A farmers regular depreciation is usually calculated using the same method and therefore does not require an AMT adjustment. The difference in the farmers regular depreciation and AMT depreciation is the recovery period. Farmers generally use the GDS system for depreciation but the ADS system, with its extended lives is used for AMT purposes. The majority of a swine farm assets are depreciated using recovery periods of 7 or 10 years. For AMT purposes, the recovery period for these assets is 10 years and 15 years respectively. A large swine farm could generate a substantial AMT depreciation adjustment that could translate into an AMT tax liability.

The Taxpayer Relief Act of 1997 repealed the requirement that personal property be computed using the ADS system for AMT purposes. This is effective for assets placed in service after December 31, 1998. This law change will not eliminate the AMT depreciation adjustment for several more years as the assets placed in service prior to the effective date will continue to generate a difference in AMT depreciation and regular tax depreciation.

Corporate Minimum Tax

The corporate alternative minimum tax has been repealed for small corporations with tax years beginning after 1997. A small corporation is defined as a corporation having average gross receipts of less than $5 million over a three-year period. If the corporation qualifies under the $5 million test it will continue to qualify for exemption from AMT as long as average gross receipts do not exceed $7.5 million.

INCOME AVERAGING – IRC SECTION 1301

For years beginning after December 31, 1997, an individual engaged in a “farming business” may elect to average their farm income over the prior 3 years. This election would flatten out the erratic fluctuations in farm profits from year to year.

The tax imposed is equal to the current year tax computed without regard to "elected farm income" plus the increase in tax that results if the "elected farm income" is spread equally to each of the 3 prior years.

“Elected farm income" is the taxable income that is attributed to any “farming business” and is specified in an election. In some cases, “negative taxable income” in a prior year may be used to reduce the elected farm income allocated to that year. The gain from the sale or other disposition of property, other than land, regularly used in such farming

business for a substantial period shall be treated as attributable to such farming business. A "farming business" is defined by IRC section 263A(e)(4). Corporations, partnerships, S corporations, estates, and trusts cannot use farm income averaging. A partner in a partnership or a shareholder in an S corporation may use farm income averaging if the entity is engaged in a "farming business." Check the final regulations for whether the wages of an S corporation shareholder may be averaged. An individual may make a late election, or amend or revoke a previously made election, in conjunction with another adjustment that affects the taxable income of the election year or any of the base years. Without an adjustment, a late election, amendment, or revocation may be made only with the consent of the IRS.

AUDIT TECHNIQUES

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

2. Review the contract with the integrator early in the examination process. Determine if there are any special arrangements such as reimbursement plans for qualified repairs. Ensure these reimbursement amounts are included in the Form 1099 amount.

3. 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 copies of insurance policies, utility bills, loan documents, and property tax assessments can also arrive at an equitable allocation.

4. When examining a grower that has constructed new swine facilities it is simple to determine the cost of the equipment and the cost of the structure for depreciation purposes from paid invoices or contracts. Ensure that the farmer is not allocating too much of the cost to equipment in an effort to take advantage of the shorter recovery period. Review the depreciation schedule to determine if the office, roads, lagoon, and underground irrigation systems have not been lumped together with the 10 and/or 7 year property.

5. Check to see if insurance proceeds have been received for property damages to the swine facility. The growers may have deducted the repairs but not included the insurance proceeds as income.

6. In any financing arrangement, always inspect a copy of the contract to see what type of arrangements have been made.

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 integrator is the pivotal piece of documentation in determining who pays which expenses and how the transactions should be reported for tax purposes. As with all examinations, the interview is key to gaining an understanding of the details in the growers operation. Examiners should be open to developing grower issues not covered in this chapter due to the dynamics of this industry.

This page left intentionally blank.

Chapter 9

Penalties

CONTENTS

Overview
Penalty Relief
- Reasonable Cause
- Statutory Exceptions
- Administrative Waiver
- Requesting Penalty Relief
- Deficiency Procedures

Accuracy-Related Penalty ─ IRC section 6662
- General ─ All Components of IRC section 6662
- Negligence or Disregard of Rules or Regulations ─ IRC section 6662(c)
- Substantial Understatement ─ IRC section 6662(d)
- Substantial Valuation Misstatement ─ IRC section 6662(e)

Fraud Penalty ─ IRC section 6663
Failure to File Tax Return or to Pay Tax ─ IRC section 6651
- Delinquency (Failure to File) ─ IRC section 6651(a)(1)
- Failure to Pay on Notice and Demand ─ IRC section 6651(a)(2)
- Fraudulent Failure to File ─ IRC section 6651(f)

Failure to File A Partnership Return Penalty ─ IRC section 6698

OVERVIEW

Policy Statement P-1-18 states that penalties constitute one important tool of the Internal Revenue Service in pursuing its mission of collecting the proper amount of tax revenue at the least cost. In the interest of an effective tax system, the Service uses penalties to encourage voluntary compliance by:

1. Helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not;

2. Deterring noncompliance by imposing costs on it; and

3. Establishing the fairness of the tax system by justly penalizing the non-compliant taxpayer.

The penalty system is designed to:

1. Ensure consistency;

2. Ensure accuracy of results in light of the facts and law;

3. Provide methods for the taxpayer to have his or her interests heard and considered;

4. Require impartiality and a commitment to achieve the correct decision;

5. Allow for prompt reversal of initial determinations when sufficient information has been presented to indicate that the penalty is not appropriate; and

6. Ensure that penalties are used for their proper purpose and not as bargaining points in the development or processing of cases.

IRM Part XX is the resource for penalties that all examiners should be familiar with and use as they conduct the examination. With the IRM re-write the Penalty IRM will be 120.

As of January 5, 1998, penalties are no longer included in the examination results on AIMS, CEMIS, ERCS, or RGS. This does not affect the assessment of penalties. They should still be entered in Items 12 and/or 15 on Form 5344 although they will not be included in the computer generated examination results.

PENALTY RELIEF

Generally, relief from penalties falls into four separate categories:

1. Reasonable Cause;
2. Statutory Exceptions;
3. Administrative Waivers; and
4. Correction of Service Error.

The Code section for each penalty describes whether that penalty may be waived or abated for reasonable cause or other relief. IRM Exhibit 120.1-1(2), Penalty Relief - Application Chart, details when it is appropriate to grant relief under a particular Code section.

Reasonable Cause

Reasonable cause is a bona fide explanation provided by taxpayers for not complying with a tax obligation due to circumstances beyond their control. It is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligation but is unable to comply with those obligations.

Reasonable cause is based on all the facts and circumstances in each individual situation. All examiners must be consistent in applying penalties and/or practicing leniency in not assessing penalties. IRM Handbook 20.1.1.3.1 applies to all taxpayers and provides guidance regarding the non-assertion or abatement of penalties where the taxpayer can show reasonable cause. Penalties will be considered without regard to the taxpayer's financial position or ability to pay the penalty. However, a Form 911, *Application for a Taxpayer Assistance Order to relieve Hardship (ATAO)*, may be initiated by a Service employee on behalf of the taxpayer to request review of an account if: (1) The taxpayer is experiencing or about to experience a "significant hardship;" and (2) The non-Taxpayer Advocate Service (TAS) employee dealing with the problem cannot or will not relieve that hardship immediately. See, IRM Handbook 120.1.1.1.7.

At the conclusion of an examination, examiners will explain the reason penalties are being proposed and how to avoid future penalties. Examiners will inquire as to why the non-compliant behavior occurred and probe for information that will answer questions required to determine whether reasonable cause exists. Reasonable cause should be explained to the taxpayer, and an exact explanation should be provided for granting or denying a reasonable cause waiver of the penalty in question. The Service has developed standardized letters that are used by various offices; for example, IDRS Correspondex Letter 854(C), which is generally used by service centers and district offices. See, IRM Handbook 120.1.1.3.4.2(5).

IRC section 7491(c) (effective for court proceedings arising in connection with examinations commencing after July 22, 1998), provides that in the case of an individual, the Government has the burden of production with respect to liability for any penalty. However, the taxpayer has the responsibility of raising reasonable cause, substantial authority, or similar provisions. *Note to Initiator – The reasonable cause statement is from H.R. Conf. Rept. 599, 105th Congress, 2d* Sess. *(1998) 238, 241*. Each tax period and each penalty will be treated separately in making the determination. The following issues should be addressed in making a reasonable cause determination:

1. What happened and when did it happen? Was the taxpayer seriously ill, records destroyed, was erroneous advice received from the Service or a Tax Advisor, etc.? Did the taxpayer show/exercise ordinary business care and prudence including making provision for business obligations to be met when reasonably foreseeable even

occur, but nevertheless was unable to comply? In this regard, what is the taxpayer's overall compliance history? Also, is there a payment pattern in the preceding tax years (at least 2)? *Note to the Initiator – This is from IRM Handbook 120.1.1.3.1 and P-2-7.*

2. How did the taxpayer conduct other business affairs during this time? How did the conditions prevent the taxpayer's compliance?

3. During what period of time did the conditions which prevented the taxpayer from complying stay in effect? Consider the duration of the conditions in relation to the return due date and to the date the taxpayer complied. Reasonable cause does not exist if, after the condition(s)which support the excuse cease to exist, the taxpayer fails to comply with the tax obligation within a reasonable time period.

The following regulations contain examples of circumstances that may be helpful in determining if a taxpayer has established reasonable cause:

1. Accuracy-Related: 1.6664-4
2. Failure to File or Pay: 301.6651-1(c)
3. Failure to Deposit: 301.6656-1(b)
4. Information Returns: 301.6724-1
5. Preparer/Promoter: 1.6694-2(d); 301.6707-1T(2&A-6,7)

The following Internal Revenue Service Policy Statements contain specific criteria that may affect the imposition of penalties:

1. P-2-4, Penalties and interest not asserted against Federal agencies;
2. P-2-7, Reasonable cause for late filing of return or failure to deposit or pay tax when due;
3. P-2-9, Timely mailed returns bearing foreign postmarks; and
4. P-2-11, Certain unsigned returns will be accepted for processing.

Statutory Exceptions

The Code and/or regulations may provide an exception to a penalty. For example:

1. IRC section 6654(e)(1), (2), or (3) - Estimated Tax Penalty.

2. IRC section 7502(a) and (e) - Timely Mailing Treated as Timely Filing and Paying.

3. IRC section 6724(a) or (c) - Waiver, Definitions and Special Rules, Information Return Penalties.

4. IRC section 6404(f) - Abatement of Penalty or Addition to Tax Attributable to Erroneous Written Advice of the IRS.

5. IRC section 7508 - Time for Performing Certain Acts Postponed by Reason of Service in Combat Zone. (Administratively, the Service has extended this relief to include erroneous oral advice when appropriate. See, IRM Handbook 120.1.3.2.4.2)

Legislation with retroactive provisions may provide guidance on associated penalties. The Service may issue a News Release or other guidance with instructions for the disposition of the related penalties.

Administrative Waiver

The Service may formally interpret or clarify a provision to provide administrative relief from a penalty that would otherwise be assessed. An administrative waiver may be addressed in a Policy Statement, News Release, or other formal communication stating that the policy of the Service is to provide relief from a penalty under specific conditions.

This may be necessary when there is a delay by the Service in printing or mailing forms, publishing guidance, or writing of regulations. An example of an administrative waiver is Notice 93-22, 1993-1 C.B. 305. This allowed individuals who requested an automatic 4-month extension of time to file an income tax return, an extension of time without remitting the unpaid amount) of any tax properly estimated to be due. (The Treas. Regs. at section 1.6081-4 have since been amended to remove the payment requirement.)

Requesting Penalty Relief

A taxpayer does not have to wait until a penalty is assessed to request relief. A request for relief may occur after an examination or with a return that is either filed or paid.

Taxpayers have the right to challenge the assertion or assessment of a penalty in an administrative appeal, and generally may do so at any stage in the penalty process. Note: <u>See</u>, IRM 120.1.1.4(2) at P1-27

Taxpayers may request:

1. Review of the penalty prior to assessment (for example, deficiency procedures),
2. Penalty abatement after it is assessed and either before or after it is paid (post-assessment review), or
3. Abatement and refund after payment (claim for refund).

Taxpayers may indicate their disagreement with the penalty in writing, verbally, or if paid, by filing a claim for refund or credit. Taxpayers should provide a written request for consideration by Appeals.

Generally, if Appeals considers a penalty before it is assessed, Appeals will not reconsider the penalty after it is assessed. Appeals will consider the following type of penalties prior to assessment:

1. Penalties which are asserted during the course of an examination of a taxpayer's INCOME tax return;

2. Penalties which are granted specific pre-assessment appeal rights such as the Trust Fund Recovery penalty (IRC section 6672) or the preparer penalties (IRC section 6694); or

3. The INTENTIONAL disregard penalty of IRC section 6721(e) when it is asserted for failures to comply with the cash reporting requirements of IRC section 6050I.

Deficiency Procedures

A penalty is subject to deficiency procedures if the related tax underpayment being assessed is subject to deficiency procedures. Penalties related to an examination of income, estate, or gift taxes are included in the deficiency procedures (notice of deficiency). The following penalties: can be assessed without providing a notice of deficiency:

1. Penalties not related to a tax (e.g. IRC sections 6700, 6701, and 6702);
2. Estimated tax penalties if a return was filed the tax year;
3. Failure to file and failure to pay (IRC section 6651) applicable to the portion of the tax liability which is not a tax deficiency; and
4. Penalties related to employment and certain excise tax.

ACCURACY-RELATED PENALTY ─ IRC SECTION 6662

General ─ All Components of IRC section 6662

Examiners are responsible for the assertion of the accuracy-related penalty. Consideration for assertion is made in all examinations and appropriate comments as to why the penalty is recommended or not is mandatory on the examiner's workpapers in cases other than the Coordinated Examination Program. Emphasis is placed on the fact that

the examiner must give a thorough explanation for assertion or non-assertion of the penalty. Reports issued to the taxpayer should contain a fully developed statement of facts, law, and argument.

Effective Date of IRC section 6662 and References to Prior Law

The accuracy-related penalty of IRC section 6662 is effective for returns due after December 31, 1989 (determined without regard to extensions). For returns due on or before December 31, 1989, refer to penalty IRC sections:

- 6653(a) for the negligence penalty;
- 6661 for the substantial understatement of tax liability penalty; and
- 6659 for the valuation overstatement penalty.

Coordination Among the Accuracy Penalties

Only one component of the accuracy-related penalty may be asserted on the same portion of the same underpayment. IRC section 6662 is not applicable if the taxpayer has not filed a tax return. A substitute for return does not constitute a return filed by the taxpayer.

IRC section 6662 shall apply to any portion of the underpayment attributable to one or more of the following:

1. Negligence or disregard of rules or regulations;
2. Any substantial understatement of income tax;
3. Any substantial valuation misstatement;
4. Any substantial overassessment of pension liabilities; or
5. Any substantial estate or gift tax valuation understatement.

IRC section 6664(a) provides the definition of an underpayment for purposes of IRC sections 6662 and 6663 as the amount by which the corrected tax exceeds the sum of the amount shown as tax by the taxpayer on his or her return plus amounts not shown as tax on the return that were previously assessed (or collected without assessment) over any rebates made.

Reasonable Cause Exception - IRC section 6664(c)(1)

If reasonable cause is proved for any underpayment, then there will no penalty under IRC section 6662 for the underpayment attributed to that underpayment.

Interest

Interest on the penalty commences with the date the return was required to be filed or to the extended due date. The examiner will ensure that the

return was filed by the extended due date (TC 460) so that interest on the penalty will be correctly computed. If an automatic extension is void, and the IDRS transcript reflects a TC 460, Form 3198 will be annotated to compute the interest from the due date of the return and not the extended due date as the automatic extension is void. The examiner will include the interest on the penalties whenever the taxpayer wants to pay the tax, penalties, and interest due in full.

The above is the rule for a FTF from IRC section 6601(e)(2)(B). The rule for a return-based penalty is at IRC section 6601(e)(2)(A).

Negligence or Disregard of Rules or Regulations ─ IRC section 6662(c)

Negligence includes:

- A failure to keep adequate books and records,
- A failure to make a reasonable inquiry into the correctness of a deduction, credit, or exclusion on a tax return that seems "too good to be true,"
- A failure to report income shown on an information return,
- A reporting by a partner or S corporation shareholder that is clearly inconsistent with the return of the respective entity.

Some indications of negligence are listed in IRN Handbook 120.1.5.7.1(3).

Disregard of rules or regulations reflects a disregard of the Code, temporary or final regulations, notices, or revenue rulings (other than notices of proposed rule making). The term "disregard" includes careless, reckless, or intentional disregard.

- Disregard is "careless" if the taxpayer does not exercise reasonable care to determine the correctness of a tax return.
- Disregard is "reckless" if the taxpayer makes little or no effort to determine if a rule or regulation exists, under circumstances demonstrating a substantial deviation from a reasonable standard of conduct.
- Disregard is "intentional" if the taxpayer knows of a rule or regulation and ignores that rule or regulation.

A taxpayer who takes a position contrary to a revenue ruling or notice has not disregarded the ruling or notice if the position has a realistic possibility of being sustained on its merits.

The amount of an underpayment due to an intentional disregard of rules and regulations is reduced by any portion of the underpayment for which the taxpayer has made an adequate disclosure. A disclosure is adequate only if it is made on Form 8275, *Disclosure Statement*, or, if the position is contrary to a regulation, on Form 8275-R. For returns due after December 31, 1991 (without regard to extensions) and before January 1, 1994, the disclosure exception does not apply if the position does not have a realistic possibility of being sustained on its merits or if the taxpayer fails to keep adequate books and records or to substantiate items properly. For returns due after December 31, 1993 (without regard to extensions) the standard is increased to a reasonable basis.

Substantial Understatement of Income Tax - IRC section 6662(d)

The substantial understatement penalty applies where:

- The understatement exceeds 10 percent of the tax required to be shown, or
- $5,000 ($10,000 for corporations).

The amount of understatement is reduced by any portion for which:

1. There was substantial authority for the position (see the items listed in IRN Handbook 120.8.4.1(3) and (4), or
2. The facts relevant to the tax treatment of an item were adequately disclosed and there was a reasonable basis for the tax position and the taxpayer kept adequate books and records and substantiated items properly. (For returns due after January 31, 1991, and before January 1, 1994, the position could not be frivolous).

The regulations define the substantial authority standard as less stringent than the "more likely than not" standard (that is, that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged), but more stringent than the "reasonable basis" standard. Authorities relevant to both sides are taken into account.

A disclosure may be made on Form 8275, *Disclosure Statement*, or, if the position is contrary to a regulation, on Form 8275-R. Also, for certain items, disclosure on the return itself is adequate; these items are listed in an annual revenue procedure.

This reduction does not apply to a corporate tax shelter. In the case of a non-corporate tax shelter, the adequate disclosure provision does not apply. In addition, the substantial authority provision only applies if in addition to having substantial authority, the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment. The definition of a tax shelter is provided in IRC section 6662(d)(2)(C)(iii). The Taxpayer Relief Act of 1997 modified the definition of tax shelters stating that a significant purpose, rather than a principle purpose, of the entity/arrangement must be the avoidance or evasion of income tax for the entity. This applies to transactions entered into after August 5, 1997.

IRC section 6662(d)(2)(D) requires the Service to publish a list of positions for which the Service believes that there is not substantial authority and which affect a significant number of taxpayers. Examiners should check this list for positions that do not have substantial authority. It will be published in the Federal Register.

Substantial Valuation Misstatement ─ IRC section 6662(e)

There is a substantial valuation misstatement if:

1. The value, or adjusted basis, of any property claimed on the return is 200 percent or more of the amount determined to be correct;

2. The price for any property or service claimed on the return in connection with any transaction between persons described in IRC section 482 is 200 percent or more or 50 percent or less of the amount determined to be correct;

3. The net IRC section 482 transfer price adjustment exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

This penalty cannot be imposed unless the underpayment attributable to the substantial valuation misstatement exceeds $5,000 ($10,000 in the case of corporations, other than an S Corporation or a personal holding company). The penalty rate is 20 percent. The rate increases to 40 percent for gross valuation misstatements described in IRC section 6662(h).

FRAUD PENALTY ─ IRC SECTION 6663

The civil fraud penalty is applied when any part of an underpayment is due to fraud with the intent to evade tax. Fraud sometimes involves false documents, and includes attempted evasion and conspiracy to defraud.

Effective Dates

The fraud penalty under IRC section 6663 is applicable to returns due (determined without regard to extensions) after December 31, 1989. For returns due on or before December 31, 1989, refer to IRC section 6653(b).

Burden of Proof and Penalty Rate

The major difference between civil and criminal fraud is the degree of proof required. Criminal fraud requires sufficient evidence to prove guilt beyond a reasonable doubt. In civil fraud, the evidence need be only clear and convincing.

Under IRC section 6663(a), if any part of the underpayment is due to fraud, there shall be added to the tax an amount equal to 75 percent of the entire underpayment, except for any portion of the underpayment which the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud.

Coordination with other Penalties

IRC section 6663 only applies in cases where a tax return is filed (other than a substitute for return under IRC section 6020(b). If the taxpayer does not file a tax return, the fraud penalty of IRC section 6663 cannot be asserted, but the fraudulent failure to file under IRC section 6651(f) can be asserted. The fraudulent failure to file penalty of IRC section 6651(f) is covered in subsequent paragraphs in this ATG chapter.

Coordination of Accuracy-related and Civil Fraud Penalties

The accuracy-related and civil fraud penalties cannot be asserted on the same portion of the same underpayment. However, the accuracy-related penalty and the civil fraud penalty may be asserted on the same return when civil fraud applies to one portion of the underpayment and the accuracy-related penalty applies to another portion of the underpayment.

The fraud penalty computation should be included on Form 4549, *Income Tax Examination Changes*, with a detailed written explanation.

Statute of Limitations

Examiners should not rely on IRC section 6501(c)(1) to keep the statute open when IRC section 6501(a) or (e)(1) can be applied. A consent should be solicited before the 3- or 6-year statute expires.

In the case of a joint return, fraud will not apply to a spouse unless some part of the underpayment is due to fraud of such spouse.

FAILURE TO FILE TAX RETURN OR TO PAY TAX ─ IRC SECTION 6651

Delinquency (Failure to File) ─ IRC section 6651(a)(1)

Assertion Criteria

IRC section 6651(a)(1) provides a penalty for failure to file a tax return, taking into consideration any extensions of time for filing, and to timely pay tax. When delinquent returns are secured by the examiner or agreed substitute for returns are submitted, it is the examiner's responsibility to determine if the delinquency penalty is applicable. The examiner should also consider the adjustment to the delinquency penalty asserted by the service center due to an examination resulting in a change to the tax due.

When a delinquent return is assigned to an examiner, that examiner is responsible for determining not only the taxpayer’s correct tax, but also the taxpayer’s liability for the FTF penalty. The examiner may find that

an asserted penalty was based on incomplete facts or on a misstatement of facts. *Note to initiator – this is from IRM Handbook 120.1.2.1.7(2)(d) at pg. 2-11.*

The examiner must consider the validity of an automatic extension. An invalid Form 4868 could result in a penalty even though the taxpayer is not liable for additional tax as a result of the examination.

Rev. Rul. 79-113, 1979-1 C.B. 389 amplifies Treas. Reg. section 1.6081-4(a)(4) guidelines on determining the validity of an automatic extension for individuals. When the amount of tax liability shown on Form 4868 is less than the amount subsequently shown on the late filed return, the extension will be considered invalid unless the taxpayer can show reasonable cause for understating the tax on Form 4868. If the taxpayer establishes reasonable cause, no penalty applies, and the Form 4868 will be accepted as valid. If the Form 4868 is determined to be invalid, the return will be considered a regular delinquent return and the penalty will be assessed from the original due date of the return on the amount of correct tax that exceeds timely payments.

To reduce rejects and delays, examiners should use the following checks to determine whether the return was filed timely prior to closing a case:

1. The received date on the face of the original return;
2. The signature date on the original return;
3. The delinquent return indicator on Form 5546, Examination Return Charge-Out; and
4. The return received date on a transcript.

When any of the above indicators indicate a late-filed return, the delinquency penalty should be considered and addressed in the workpapers.

Workpapers

Examiners will comment and explain the basis for assertion or non-assertion of the delinquency penalty on all delinquent returns in the workpapers. Statements made by the taxpayer regarding the delinquency should also be commented on.

Computation

The rate is 5 percent per month for a maximum of 25 percent and is based on the tax required to be shown on the return, reduced by any payments made on or before the due date of the return, including valid extensions.

In cases involving both the delinquency and failure to pay penalties, the delinquency rate (5 percent) will be reduced by the failure to pay penalty

rate (0.5 percent). In other words, the taxpayer will be subject to no more than a 5 percent (both penalties combined) penalty in any one month or part of a month.

Previously Assessed Delinquency Penalty

If an examiner increases the tax on a delinquent return on which the delinquency penalty has been previously assessed, the previously assessed penalty will NOT be backed out in order to compute the corrected delinquency penalty. The following formula will be used to compute the delinquency penalty on the deficiency:

- Deficiency x Penalty Rate = Delinquency Penalty on Deficiency

When the Delinquency Penalty has not previously been assessed, the following formula will be used:

- (Total Corrected Tax - Prepayment Credits) x Penalty Rate = Penalty

Carrybacks

The penalty will not be adjusted for that part of the tax liability which is decreased because of a carryback, such as a net operating loss carryback, an investment credit carryback, a foreign tax credit carryback, or a capital loss carryback (for corporations). The delinquency penalty should be computed prior to the application of the carryback.

Minimum Penalty

A minimum delinquency penalty applies to all individual and corporate income returns (due after December 31, 1982) delinquent for more than 60 days (including extensions), except for failures shown to be due to reasonable cause and not willful neglect. In such cases, the penalty is the lessor of $100 or 100 percent of the amount of taxes required to be shown on the return.

Form 3198, Special Handling Notice

Examiners are required to provide instructions on Form 3198 regarding assertion of the delinquency penalty on ALL returns filed after the due date, even if the return has a valid extension. Negative responses are required.

Unsigned Return

It is the policy of the Service in certain circumstances (P-2-11), not to assert the delinquency penalty on a timely filed unsigned return if the criteria listed in LEM Handbook 120.1.2 is met.

Failure to Pay ─ IRC section 6651(a)(2)

For delinquent returns secured by examination, it is the examiner's responsibility to determine if the penalty should be asserted. Always give consideration to reasonable cause. The penalty applies to income, employment, gift, estate and certain excise tax returns. It does not apply to information returns, estimated tax payments, or partnership returns.

Rate

The rate is one-half of 1 percent (0.005 percent) for each month, or part of a month, during which the failure to pay continues, limited to a maximum of 25 percent of the tax shown on the return reduced by:

1. Tax paid on or before the date prescribed for the payment of the tax, and
2. Any credit against the tax which may be claimed on the return.

In cases subject to both the failure to file and pay penalties, special provisions apply. No taxpayer will be subject to more than a 5 percent penalty (both penalties combined) in any one month. Consequently, in case where both penalties apply, the failure to file penalty will be computed at 4.5 percent per month and the failure to pay penalty at 0.5 percent per month for the first 5 months, or a maximum of 25 percent for the combined penalties. If the failure to pay continues after the first 5 months, the failure to penalty of 0.5 percent per month will continue to apply subject to a maximum of 25 percent. Although each penalty applied separately could reach a maximum of 25 percent, the combined penalties will not exceed 47.5 percent.

Substitute for Return Cases

Agreed substitute for returns and returns filed under IRC section 6020(b) filed after July 30, 1996, (without regard to any extensions) unless reasonable cause has been established (IRC section 6651(g) was added by the Taxpayer Bill of Rights 2). For purposes of the failure to pay penalty a substitute return is treated as a return filed by the taxpayer. Thus, the failure to pay penalty will be computed from the original due date of the return and continue until the tax is paid or the 25 percent limitation is met. If the failure to pay penalty is applicable, the following statement will be added to the "Other Remarks" section of the RAR: "IRC section 6651 (a)(2), Failure to Pay Penalty, is applicable as allowed by law."

While the failure to pay applies to "filed returns," this procedure will ensure the failure to pay penalty ASSESSMENT is not overlooked on SFR examinations which become "filed returns" through the execution of a signed agreement. See Revenue Ruling 74-203 for a more detailed explanation of a "filed return."

Form 3198

Include a failure to pay penalty annotation in the penalties section.

Delinquent Returns

After the delinquent return has been processed by the service center and the examiner has proposed additional adjustments to the delinquent return using an examination report, examiners should not include the failure to pay penalty in the preparation of the examination report. In the RGS program, when accessing the delinquency penalty screen, the examiner is questioned whether the failure to pay penalty applies. The examiner should answer this question "no".

If the delinquent return is received from the taxpayer with remittance, the examiner will solicit payment of the failure to pay penalty when applicable. The examiner's report transmittal should explain the actions taken.

Reasonable Cause

The reasonable cause for failure to pay is the same as reasonable causes for failure to file a return within the time prescribed by law. Reasonable causes are stated in IRM Handbook section 120.1.1.3.1.

It is important that reasonable cause is addressed early in the examination process. Workpapers should contain a statement that reasonable cause was considered.

Earned Income Credit (EIC) Recapture

In examinations which involve EIC recapture, examiners should advise the taxpayer that the failure to pay penalty will be computed from the due date of the return.

Coordination with the Fraud Penalty

For returns due after December 31, 1989, the failure to pay penalty may be asserted with IRC section 6663 penalty. The failure to pay penalty will not be asserted on a case in which the IRC section 6653(b) penalty is asserted (returns due prior to January 1, 1990).

Extensions to File

Extensions do not extend the due date for payment, and generally do not affect the period for computing the penalty.

For a taxable year ending on or after December 31, 1995, reasonable cause will be presumed for the period of an automatic extension (Form 4868) if: Treas. Reg. section 1.6081-4(a) (pertaining to automatic extensions) is satisfied, the excess of the amount of tax shown on the return over certain payments is no greater than 10 percent of the amount shown, and the balance due is remitted with the return. See Treas. Reg. section 301.6651-1(c)(3).

FAILURE TO PAY ON NOTICE AND DEMAND ─ IRC SECTION 6651(a)(3)

Under IRC section 6651(a)(3), a failure to pay penalty is imposed for failure to pay tax required to be, but not, shown on the return for which the IRS has issued a notice and demand for payment. The penalty is computed from the date the tax is assessed. However, this penalty does not apply if the amount shown in the notice and demand for payment is paid within 21 days (or within 10 business days if the amount shown is $100,000 or more).

FRAUDULENT FAILURE TO FILE ─ IRC SECTION 6651(f)

Effective Dates

The fraudulent failure to file penalty is only applicable for returns due after December 31, 1989 (determined without regard to extensions).

Rate

If any failure to file any return is fraudulent, the 5 percent per month delinquency penalty rate is increased to 15 percent per month and the maximum penalty of 25 percent is increased to a maximum penalty amount of 75 percent.

Alternative Positions

When the examiner recommends the assertion of the fraudulent failure to file penalty in other than a fully agreed case, he or she will clearly reflect the assertion of the regular failure to file penalty as an alternative position in the examiner's report. This alternative position will be reflected in the examiner's report and Form 886-A, Explanation of Items.

- It is necessary to raise the regular delinquency penalty as an alternative position in the examiner's report so that if a statutory notice of deficiency is later issued, this alternative position will be included.

FAILURE TO FILE PARTNERSHIP RETURN ─ IRC SECTION 6698

IRC section 6698 imposes a penalty for a partnership's failure to file a timely or complete Form 1065, U.S. Partnership Return. This penalty applies where a partnership return is required to be filed. The penalty will not be imposed if the partnership can show reasonable cause for failure to file a complete or timely return.

Smaller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test as long as each partner fully reports their share of the income, deductions, and credits. (See Revenue Procedure 84-35, 1984-1 C.B. 509.)

Amount of the Penalty

The penalty is assessed for each month or fraction of a month, not to exceed 5 months, which the failure continues. The penalty for any month is equal to the sum of $50 times the total number of partners that are in the partnership during any part the taxable year. The penalty is imposed on the partnership rather than upon the partners for taxable years beginning

after December 31, 1978. The penalty is in addition to the criminal penalties imposed by IRC section 7203 for willful failure to file a return, supply information, or pay a tax.

Delinquent/Substitute Returns

Where an examiner secures a delinquent partnership return, or where a "substitute for return" is prepared with respect to a non-filed partnership-return, the following steps should be taken:

- Where reasonable cause exists for late or non-filing, the examiner will attach a Form 3198, Special Handling Notice, to the delinquent return or "substitute for return" at the time returns are sent to for processing. The "Other" section of Form 3198 should state that the delinquency penalty should not be assessed.

- If reasonable cause does not exist, the delinquent return or “substitute for return" should be processed using the procedures outlined in IRM 48(13)(1) section 232. The penalty will be automatically assessed by the service center. It is not necessary to issue an examination report for this penalty to be assessed.

Where an examiner is assigned to the examination of a delinquent partnership return and subsequently determines that reasonable cause for filing late exists, or that the service center's computation of the penalty is incorrect, the following will be done upon closing the case:

- If the penalty is to be abated, the examiner will prepare a Form 3198 and note: "Prepare Form 3870, Request for Adjustment - Abate Delinquency Penalty."

- If the penalty is to be increased or decreased due to an error in the computation by the service center, the examiner will prepare a Form 3198 and note: "Correct Delinquency Penalty should be $ xxx; Prepare Form 3870."

In the case of the first two situations above, ESP will prepare the Forms 3870. The examiner's workpapers should clearly document the determination with respect to the delinquency penalty.

This page left intentionally blank.

Chapter 10

Research Credits

CONTENTS

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

INTRODUCTION

Congress passed the credit for increasing research activities (research credit)[1] to provide an incentive for taxpayers to increase their research activities. The congressional goal was to maintain the United States' position on the cutting edge of new technology. The research credit covers research performed within the United States in all industries.

The Economic Recovery Tax Act of 1981 (ERTA) established a non-refundable credit for qualified research expenses paid or incurred in carrying on a trade or business of the taxpayer. As originally, enacted the research credit expired on December 31, 1985. After studying the effectiveness of the credit, Congress determined that, in practice, many taxpayers applied the credit too broadly.

In the Tax Reform Act of 1986 (the 1986 Act), Congress revised and limited the definition of the term "qualified research" by establishing additional requirements and exclusions for qualifying research. The legislative history to the 1986 Act indicates that, in amending the definition of qualified research, Congress sought to target research undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in developing a new or improved business component of the taxpayer. In addition, such research is eligible for the credit only if

[1] The research credit provisions were enacted by section 221 of the Economic Recovery Tax Act of 1981, 1981-2 C.B. 256, 293, as section 44F. Section 44F was redesignated as section 30 by section 471(c)(1) of the Deficit Reduction Act of 1984, 1984-3 (Vol. 1) C.B. 2, 334. Section 30 was redesignated as section 41 by section 231(d)(2) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 2, 95.

substantially all of the activities of the research constitute a process of experimentation for a functional purpose, that is a new or improved function, performance, or reliability or quality. The 1986 Act also sets out several additional exclusions from the definition of the term "qualified research."

IRC SECTION 41

Under the general rule, a taxpayer is allowed a research credit equal to 20 percent of the excess of its qualified research expenses for the current year over its base amount as computed under IRC section 41. By computing the research credit on the excess over an established base amount, Congress provided an incentive for increasing research expenses rather than rewarding companies with static or decreasing levels of research spending.

Basic Research Credit

Congress also wished to encourage corporations to give to universities and specific types of scientific research entities to conduct research. In the 1986 Act, Congress restructured the credit for basic research. Effective for taxable years beginning after December 31, 1986, amounts paid to these qualifying organizations for basic research are subject to a separate credit computation under IRC section 41(e). The credit for basic research is a separate component of the research credit.

Basic research is defined as "any original investigation for the advancement of scientific knowledge not having a specific commercial objective." The basic research component of the research credit has several noteworthy aspects concerning the payment definition. The credit for basic research is only available to corporations, the payments must be cash payments, and the payments must have actually been made to be considered a basic research payment eligible for the basic research credit. Thus, accrual basis companies cannot claim amounts which have been incurred yet, but not paid. All payments must also be made to the qualifying organization pursuant to a written agreement. The written 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 basic research 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.

Under IRC section 280C(c), taxpayers must reduce their IRC section 174 expenses by the amount of credit allowed under IRC section 41. In lieu of reducing their IRC section 174 expenses by the amount of credit allowed under IRC section 41, taxpayers may elect, not later than the time for filing the return of tax for the applicable year (including extensions) to take a reduced credit under IRC section 41. The election of the reduced credit under IRC section 280C(c) is an annual election. Once made, the IRC section 280C(c) election is irrevocable.

Example 1

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 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 taking the reduction to 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 expenses"? IRC section 41(c) explains the base amount computation and IRC section 41(b) defines qualified research expenses. IRC section 41(d), however, defines the term qualified research.

BASE AMOUNT

In general, under the regular research credit, the base amount is computed by multiplying the taxpayer's "fixed-base percentage" by its average annual gross receipts for the preceding 4 years.[2] In general, a taxpayer's "fixed-base percentage" is the ratio that its total qualified research expenses for the taxable years beginning after December 31, 1983, and before January 1, 1989, bears to its total gross receipts for the same period.[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

[2]Under IRC section 41(c)(2), however, the minimum base amount is 50 percent of the credit year qualified research expenses.

[3]IRC section 41(c)(3)(B) and (C) provides special rules for determining the fixed-base percentage. Under IRC section 41(c)(3)(B), the fixed-base percentage for start-up firms is 3 percent for the taxpayer's first 5 years beginning after December 31, 1993, and, under IRC section 41(c)(3)(B), the maximum fixed-base percentage is 16 percent.

- Gross Receipts:

1984	50,000	500,000
1985	70,000	600,000
1986	80,000	800,000
1987	90,000	1,000
1988	100,000	1,300,000
1989	800,000	
1990	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.

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 which 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.

A special fixed-base percentage rule for start-up companies applies, (1) if a taxpayer has fewer than 3 taxable years beginning after December 31, 1983, and before January 1, 1989, in which it had both gross receipts and qualified research expenses, and (2) for taxable years ending after June 30, 1996, if the first taxable year that the taxpayer had both qualified research expenses and gross receipts begins after December 31, 1983. See IRC section 41(c)(3)(B).

The Revenue Reconciliation Act of 1989 (the 1989 Act) added the consistency requirement to IRC section 41(c). In computing the research credit for taxable years beginning after December 31, 1989, the consistency requirement contained in IRC section 41(c)(5)(A) provides that, not withstanding whether the period for filing a claim for the credit or refund has expired for any taxable year taken into account in determining the fixed-base percentage, the qualified research expenses taken into

account in computing such percentage shall be determined on a basis consistent with the definition of qualified research expenses for the credit year. The purpose of the consistency rule is to ensure that the comparison between qualified research expenses from the credit year and qualified research expenses used to determine the fixed-base percentage for the base amount reflects an accurate measurement of any change in a taxpayer's research spending in relation to its gross receipts.

Example 2

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 credit year qualified research expenses, Company A included 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.

Final amendments to the IRC section 174 regulations were published in 1994 and contain clarifications in defining research and experimental expenditures. 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 apply 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&E. This can include in-house costs as well as expenses for research conducted by another entity on behalf of the taxpayer.

Qualified Research

Generally, the research credit is available for certain expenses incurred in the conduct of qualified research. The Tax Reform Act of 1986 (the 1986 Act) substantially amended the research credit provisions relating to the definition of "qualified research" under IRC section 41(d).[4]

> Qualified research means research-
>
> (A) For which the expenditures may be treated as expenses under section 174;
> (B) That is undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in developing a new or improved business component of the taxpayer; and
> (C) Substantially all of the activities of the research constitute a process of experimentation for a new or improved function, performance, or reliability or quality. Section 41(d)(1) and (3).

[4]See Notice of Proposed Rulemaking, Credit for Increasing Research Activities, 63 FR 66503 (December 2, 1998).

Qualified research does not include:

(i) Any research conducted after the beginning of commercial development of the business component. Section 41(d)(4)(A);

(ii) Any research related to the adaptation of an existing business component to a particular customer's requirement or need. Section 41(d)(4)(B);

(iii) Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component. Section 41(d)(4)(B);

(iv) SURVEYS, STUDIES, ETC.-Any-

(1) efficiency survey,

(2) activity relating to management function or technique,

(3) market research, testing, or development (including advertising and promotions),

(4) routine data collection, or

(5) routine or ordinary testing or inspection for quality control. Section 41(d)(4)(D).

(v) Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in-

(1) an activity which constitutes qualified research (other than the development of the internal use software itself),

(2) a production process with respect to which the requirements of Section 41(d)(1) are met, and

(3) the Service has regulatory authority to treat internal use computer software as qualified research if the software is innovative, if the development of the software involves significant economic risk and technical risk, and the software is not commercially available. Section 41(d)(4)(E) and H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-73, 1986-3 C.B. Vol. 4 73.[5]

(vi) Any research conducted outside the United States. Section 41(d)(4)(F);

(vii) Any research in the social sciences, arts or humanities. Section 41(d)(4)(G); and

(viii) Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity). Section 41(d)(4)(H).

The term "business component" as defined in IRC section 41(d)(2)(B) means any product, process, computer software, technique, formula, or invention which is to be held for sale, lease, or license, or used by the taxpayer in its trade or business. Under IRC section 41(d)(2)(C), any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component and not as part of the business component being produced.

The conference report to the 1986 Act explains that the "shrinking-back" concept is used to identify the appropriate business component for which all of the requirements of IRC section 41(d)(1) are met. Under the

[5] See Notice of Proposed Rulemaking, Credit for Increasing Research Activities, 62 FR 81 (January 2, 1997).

shrinking-back concept, the tests for determining if a particular business component satisfies the requirements of IRC section 41(d)(1) are applied first at the level of the entire product to be offered for sale or to be used by the taxpayer. If all aspects are not met at that level, the test applies at the most significant subset of elements of the product. H.R. Conf. Rep. 99-841, 99th Cong. 2nd Sess. (1986), 1986-3 C.B. (Vol. 4) 72-3.

Example 3

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 the expenses incurred in crossing one breed of male bird with a female of a different breed made the expense a qualified research expense. 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.

Qualified Research Expenses

ORC section 41(b) defines the term qualified research expenses to included certain in-house research expenses, contract research expenses, and amounts paid to certain research consortia.

a. In-house expenses treated as qualified research expenses include wages paid to employees or amounts paid for supplies used in the conduct of qualified research or in the direct support or supervision of the qualified research. IRC section 41(b)(2).

b. Contract research expenses treated as qualified research expenses are 65 percent of any amount paid or incurred by the taxpayer to another person (other than an employee of the taxpayer) for qualified research. IRC section 41(b)(3)(A).

c. For taxable years beginning after June 30, 1996, 75 percent of any amount paid or incurred by the taxpayer to a qualified research

d. consortium for qualified research is a qualified research expense. IRC section 41(b)(3)(C)

Election of the Alternative Incremental Research Credit

For tax years beginning after June 30, 1996, taxpayers may elect to determine their research credit under the alternate incremental research credit rules of IRC section 41(c)(4). For tax years beginning after June 30, 1996, and before July 1, 1999, the alternate incremental research credit is equal to the sum of the following amounts:

a. 1.65 percent of so much of the qualified research expenses for the taxable year as exceeds 1 percent of the average annual gross receipts for the 4 preceding tax years but does not exceed 1.5 percent of such average.

b. 2.2 percent of so much the qualified research expenses for the taxable year as exceeds 1.5 percent of the average annual gross receipts for the 4 preceding tax years but does not exceed 2 percent of such average.

c. 2.75 percent of so much of the qualified research expenses for the taxable year as exceeds 2 percent of the average annual gross receipts for the 4 preceding tax years.

For tax years beginning after June 30, 1999, the Tax Relief Extension Act of 1999, increased the percentages under the alternative incremental research credit.

Suspension of the Research Credit

The Tax Relief Extension Act of 1999 extended the research credit from June 30, 1999, to June 30, 2004, and added special rules for computing and taking into account the credit for increasing research activities for periods including July 1, 1999, through September 30, 2001. Under these special rules any research credit attributable to the period beginning on July 1, 1999, and ending on September 30, 2000, that is otherwise allowable under the Code, may not be taken into account prior to October 1, 2000. Further, any research credit attributable to the period beginning on October 1, 2000, and ending on September 30, 2001, that is otherwise allowable under the Code, may not be taken into account prior to October 1, 2001.

AUDIT TECHNIQUES

1. If a research credit has been claimed for the year under examination the first step is the gathering of information. Although each agent should adjust the IDR based on the case under examination, the one item which will be universally helpful is the organization chart. This one item provides an excellent tool in determining the people who should be interviewed.

2. 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 which 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 which 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.

The definition of R&D can be found in IRC section 174 which has received several amendments that are simply clarifications and applicable to all years. After meeting the IRC section 174 R&D definition an expenditure may still not be allowable for the research credit if it does not meet all of the special rules under IRC section 41.

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 which 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.

This page left intentionally blank.

Chapter 11

Employment Taxes

CONTENTS

Farm Workers
Behavioral Control
Financial Control
Relationship of the Parties
Withholding on Employees
Summary

FARM WORKERS

Although specific areas of noncompliance have not been identified in the swine industry, the standard determination of employee versus independent contractor is a continued requirement.

The employment tax regulations provide that an employer-employee relationship exists when the business for which the services are performed has the right to direct or control the worker who performs the service. You need to consider not only the work to be done but also how it will be done.

The determination of whether the employer has the right to direct and control is based upon the facts and circumstances of the case.

The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification--independent contractor or employee B can be valid. For an in-depth discussion, see the training material An Independent Contractor or Employee?, Training 3320-102 (Rev. 10-96) TPDS #84238I, for determining employment status. The training materials are also available on the IRS home page on the Internet at http://www.irs.ustreas.gov.

The first step in any case involving worker classification is to consider Section 530 of the Revenue Act of 1978. Before or at the beginning of an audit inquiry relating to employment status, an agent must provide the taxpayer with a written notice of the provisions of Section 530. If the requirements of Section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the employer's but not the worker's employment tax liability, including any interest or

penalties attributable to the liability for employment taxes.

In determining a worker's status, the primary inquiry is whether the worker is an independent contractor or an employee under the common law standard. Under the common law, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency B whether one party, the principal, is legally responsible for the acts or omissions of another party, the agent B and depends on the principal's right to direct and control the agent.

Guidelines for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations: sections 31.3121(d)-1, 31.3306(i)-1, and 34.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding. The regulations provide that an employer-employee relationship exists when the business for which the services are performed has the right to direct and control the worker who performs the services. This control refers not only to the result to be accomplished by the work, but also to the means and details by which that result is accomplished. In other words, a worker is subject to the will and control of the business not only as to what work shall be done but also how it shall be done. It is not necessary that the employer actually direct and control the manner in which the services are performed; it is sufficient if the employer has the right to do so. To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined.

The Service now looks at facts in the following categories when determining worker classification: behavioral control, financial control, and relationship of the parties.

BEHAVIORAL CONTROL

Facts that substantiate the right to direct or control the details and means by which the worker performs the required services are considered under behavioral control. This includes factors such as training and instructions provided by the business. Virtually every business will impose on workers, whether independent contractors or employees, some form of instruction (for example, requiring that the job be performed within specified time frames). This fact alone is not sufficient evidence to determine the worker's status. The weight of Ainstructions@ in any case depends on the degree to which instructions apply to how the job gets done rather than to the end result.

The degree of instruction depends on the scope of instructions, the extent to which the business retains the right to control the worker's compliance with the instructions, and the effect on the worker in the event of noncompliance. The more detailed the instructions that the worker is required to follow, the more control the business exercises over the worker, and the more likely the business retains the right to control the methods by which the worker performs the work. The absence of detail in instructions reflects less control.

FINANCIAL CONTROL

Facts on whether the business has the right to direct or control the economic aspects of the worker's activities should be analyzed to determine worker status. Economic aspects of a relationship between the parties illustrate who has financial control of the activities undertaken. The items that usually need to be explored are whether the worker has a significant investment, unreimbursed expenses, whether the worker's services are available to the relevant market, the method of payment and opportunity for profit or loss. The first four items are not only important in their own right but also affect whether there is an opportunity for the realization of profit or loss. All of these can be thought of as bearing on the issue of whether the recipient has the right to direct control the means and details of the business aspects of how the worker performs services.

The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of services rendered. Significant investment, unreimbursed expenses, making services available, and method of payment are all relevant in this regard. If the worker is making decisions which affect his or her bottom line, the worker likely has the ability to realize a profit or loss.

RELATIONSHIP OF THE PARTIES

The relationship of the parties is important because it reflects the parties' intent concerning control. Courts often look to the intent of the parties; this is most often embodied in contractual relationships. A written agreement describing the worker as an independent contractor is viewed as evidence of the parties' intent that a worker is an independent contractor ─ especially in close cases. However, a contractual designation, in and of itself, is not sufficient evidence for determining worker status. The facts and circumstances under which a worker performs services are determinative of a worker's status. The designation or description of the parties is immaterial. This means that the substance of the relationship governs the worker's status not the label.

WITHHOLDING ON EMPLOYEES

All cash wages paid to employees are subject to income tax withholding, social security and hospital insurance taxes, if either of the two tests below is met.

1. $150 TEST ─ Cash wages are paid to an employee of $150 or more in a year.

2. $2,500 TEST ─ Cash wages are paid to all employees of $2,500 or more during the year. The $2,500 test does not apply to an employee who

   a. Is employed as a hand-harvest laborer and is paid on a piece-rate basis; in an operation that is customarily paid on this basis;

   b. Commutes daily from his or her home to the farm; and,

   c. Was employed in agriculture less that 13 weeks in the proceeding calendar year.

Agricultural labor paid other than by cash is not subject to withholding; such as providing farm workers with housing. The value of the housing is not income to the worker, but the related costs are deductible by the employer.

SUMMARY

Farms are labor intensive providing ample opportunities for independent contractor versus employee determinations. Most independent contractors will provide their own equipment whereas an employee will normally work with the farmer's equipment and within the farm's swine houses, barns etc. The training material and Employment Tax Regulations should be consulted in the event any question arises as to the existence of an employer-employee relationship.

Chapter 12

Excise Taxes

CONTENTS

Gasoline Tax Credits
Definitions
Taking the Credit
Audit Techniques

GASOLINE TAX CREDITS

Gasoline and diesel fuels are subject to federal excise tax. However, fuel that is "used on a farm for farming purposes" is a nontaxable use of that fuel.

This section discusses the income tax credit that is allowed to farmers for gasoline used on a farm for farming purposes. Although diesel fuel is the most common fuel used for farming purposes, a farmer may not file a claim with the Government to obtain this tax benefit for this fuel. Rather, a farmer may either buy (1) dyed diesel fuel on which not tax has been imposed or (2) taxed, undyed diesel fuel (sometimes referred to as "clear fuel") from a registered ultimate vendor at a tax-excluded price; the vendor, in turn, may obtain a credit or refund from the Government.

In some cases, a farmer may be eligible for a credit or refund with respect to gasoline or undyed diesel fuel that is used in an off-highway business use (other than farming use). In such a case, consult with an excise tax agent or see Publication 378, ***Fuel Tax Credits and Refunds***. Also, see Publication 510, ***Excise Taxes for (year)***, for information about the penalty for the use of dyed fuel for taxable purposes.

Also note that a farmer may be liable for the heavy highway vehicle use tax if the farmer operates a registered highway vehicle, with a taxable gross weight of 55,000 pounds or more, on the public highways. More information concerning this tax is in the instructions for Form 2290, ***Heavy Highway Vehicle Use Tax Return.***

DEFINITIONS

Used On A Farm For Farming Purposes. Gasoline is "used on a farm for farming purposes" when the gasoline is used (1) in carrying on a trade or

business of farming, (2) on a farm in the United States, and (3) for farming purposes. Gasoline used in an aircraft will qualify if its use otherwise satisfies these requirements.

Farm. The term "farm" is used in its ordinary and accepted sense, and generally means land used for the production of crops, fruits, or other agricultural products or for the sustenance of livestock or poultry. The term "livestock" includes cattle, hogs, horses, mules, donkeys, sheep, goats, and captive fur-bearing animals.

Fuel Used For Farming Purposes. Fuel is used on a farm for farming purposes if the owner, tenant, or operator of the farm uses the fuel in any of the following ways:

1. To cultivate the soil or to raise or harvest any agricultural or horticultural commodity.

2. To raise, shear, feed, care for, train, or manage livestock, bees, poultry, fur-bearing animals, or wildlife.

3. To operate, manage, conserve, improve or maintain the farm and its tools and equipment.

4. To handle, dry, pack, grade, or store any agricultural or horticultural commodity in its raw state. For this use to qualify, the farmer must have produced more than half the commodity that was so treated during the tax year. Commodity means a single raw product. For example, apples and peaches are two separate commodities.

5. To plant, cultivate, care for, or cut trees, or to prepare (other than sawing logs into lumber, chipping or other milling) trees for market but only if the planting, etc., is incidental to the farmer's farming operation. Tree operations are incidental only if they are minor in nature when compared to the total farming operations.

The owner, tenant, or operator of a farm on which gasoline is used by any other person for the purposes described in 1 or 2 above will be treated as the ultimate purchaser who used the gasoline on the farm for farming purposes. However, an aerial applicator or other applicator is entitled to be treated as the user and ultimate purchaser of gasoline used by it on a farm for the purposes described in 1 and 2 above, but only if, under specified conditions, the owner, tenant, or operator of a farm who is otherwise entitled to treatment as the user and ultimate purchaser waives the right to the credit.

Non-Farm Use. Fuel is not used on a farm for farming purposes when it is used:

1. Off the farm, such as on the highway, even if the fuel is used in transporting livestock, feed, crops, or equipment.

2. For personal use, such as mowing the lawn.

3. In processing, packaging, freezing, or canning operations.

TAKING THE CREDIT

A farmer may obtain a gasoline tax credit if the farmer is the ultimate purchaser of gasoline used on a farm for farming purposes. A farmer makes a claim for a gasoline tax credit on Form 4136, ***Credit for Federal Tax Paid on Fuels*,** and attaches it to the farmer's income tax return. The rates for the fuel tax credit are on Form 4136. A farmer cannot claim a credit with respect to any fuel for which the farmer filed a refund claim.

A farmer may claim a gasoline tax credit on the farmer's income tax return for the year the farmer used the gasoline or the farmer may be able to amend the farmer's income tax return for that year. Generally, a farmer must file an amended return by the later of 3 years after the date the farmer filed the farmer's original return or within 2 years after the farmer paid the tax. A return filed early is considered filed on the due date. Once a farmer files Form 4136 with a claim for a gasoline tax credit, the farmer cannot file an amended return for the same year with another claim for a gasoline tax credit for farming purposes.

A farmer who claims a gasoline tax credit must include the amount of the credit in gross income if the farmer deducted the gasoline taxes as an expense and this deduction reduced the farmer's income tax liability. The year in which to include the credit in gross income depends on the farmer's method of accounting.

Cash Method ─ If a farmer uses the cash method of accounting and claims a credit on its income tax return, the farmer must include the credit in gross income for the tax year in which it files Form 4136. If a farmer files an amended return and claims a credit, the farmer must include the credit in gross income for the tax year in which the farmer receives the credit.

Accrual Method ─ If a farmer uses the accrual method of accounting and claims a credit, the farmer must include the entire credit amount in gross income for the tax year in which the qualifying use occurred.

AUDIT TECHNIQUES

During the initial interview, ask the farmer to identify the equipment that is gasoline powered. Ask the farmer how many gallons each piece of equipment uses per hour, per day, and per acre. This information may be used to compute the approximate number of gallons of gasoline used on the farm for farming purposes.

States may refund state taxes to a farmer for gasoline used on a farm. Check for any discrepancy between the gallons claimed for state and

federal tax purposes. If there is a discrepancy, determine if there is a difference between state and federal gasoline tax laws that would explain the discrepancy.

A credit is allowed only for gasoline actually used during the period covered by the claim. Therefore, a farmer may not claim a credit for unused gasoline in the fuel supply tanks of machinery.

Income tax claims for off-highway business use because these claims should be rare in the swine farm context. They also have suggested that should the issue arise, the examining agent contact an excise tax agent or refer to Pub. 378, ***Fuel Tax Credits and Refunds.***

Glossary of Terms

BARROW ─ A castrated male pig.

BOAR ─ Male pig used for breeding purposes.

BREEDING FINISHER PIG ─ A pig in the finishing production stage intended for sale or breeding purposes.

BREEDING HERD ─ Inventory of breeding females and boars in a herd.

BREEDING HERD CULL PIG SALES ─ Income from sales of breeding females and boars that were part of the breeding herd.

BREEDING NURSERY PIG ─ A pig in the nursery stage.

BREEDING WEANED PIG ─ A weaned pig intended for sale or transfer to breeding inventory.

COASTAL BERMUDA ─ A nitrogen-absorbing legume sprigged on sandy soil to absorb liquid waste sprayed from lagoons.

CONSERVATION EXPENSES ─ Expenses associated with conserving and/or protecting the environment.

CONTRACT GROWER ─ Independent farmer who is under contract to grow swine for a third party.

CRATES/PENS ─ Equipment used to confine sow movement during farrowing.

FARROWING ─ Birth of a litter of pigs.

FINISHER PIG ─ A growing pig beyond the nursery stage.

FINISHING FARM ─ Final farm stage accepting pigs from the nursery farm and raising them to market weight, usually 240 pounds.

GESTATION PERIOD ─ Period of time between conception and farrowing. Basically, three months, three weeks and three days.

GILT ─Unmated female pig.

HEDGE (GAIN OR LOSS) ─ Gain or loss from options or futures contracts.

INTEGRATOR — Generally, a large corporate entity that controls the overall production of swine. Accomplished through complete ownership of farming operations; through contract growers; or through a combination of the two. May also include ancillary operations such as feed mills and processing plants.

LITTER — Collective term for the pigs farrowed by a sow.

NURSERY FARM — Interim farm accepting sow farm piglets and raising them to an approximate weight of 40-50 pounds.

NURSERY PIG — A weaned pig in the nursery stage.

POLLUTION CONTROL FACILITY — Treatment facility used to reduce or control water or atmospheric pollution.

PREPAID EXPENSES — Expenses incurred for items which will not be used until the future. Usually the subsequent tax year.

SHOAT — Young weaned pig.

SLATS — Slotted floors of a hog facility designed to provide for ease of flushing animal waste into waste lagoon.

SOW FARM — Farming operation for breeding and farrowing processes. Piglets will remain approximately two to three weeks prior to transfer to nursery farm. Also known as a farrowing farm.

SPRAY FIELDS — Area where liquid waste from the lagoons is sprayed.

WEANED PIG — A pig that has been weaned and is ready for transfer to the nursery stage.