FARMS AND RANCHES

If you own a farm or ranch, the following is a synopsis of what to expect during an IRS audit.

Information Document Request

When initiating an audit of a farm or ranch, the examiner typically issues an Information Document Request (IDR). An IDR is a document that lists information and/or documents that the examiner is seeking from you, as part of the audit. Examples of items typically requested include: (1) copies of tax returns, including prior and subsequent years; (2) copies of shareholder or partner returns; (3) the working trial balance; (4) information about related entities, such as family members who could be considered suppliers, packers, brokers, etc.; and (5) the crop map. Typically, the examiner also requests an interview with you to discuss things such as how the business operates and how the books are kept.

Choice of Entity

Farm and ranch owners utilize many different entity types, including the following:

1. Sole Proprietorships

A sole proprietorship is simplest method of operating a business that is owned by one person. The owner of a sole proprietorship simply reports his or her gross receipts and expenses on Schedule C of the Form 1040. Since most farmers want their children to join or takeover the business, sole proprietorships are often converted to a different entity type. One of the primary weaknesses of a sole proprietorship is that it does not offer limited liability. If the farm or ranch is sued, all of the owner's personal assets could be at risk.

2. C Corporations

One of the primary strengths of a corporation is that it offers limited liability for its owner(s). However, most farmers avoid using forming a corporation, as Section 447 of the Internal Revenue Code mandates that corporations engaged in farming must utilize an accrual accounting method, rather than the cash method used by most businesses. Section 447 does not apply to S Corporations, which are discussed below. Another disadvantage of using a corporation is that the business pays income taxes at the entity level, and then the individual officers and shareholders must also pay taxes on their own tax returns.

3. **Partnerships and S Corporations**

Farmers often separate the business into multiple partnerships or S Corporations. This allows use of the cash method of accounting. Typically, the business is split into different entities based on the type of operation, such as harvesting, processing, marketing, and farming. Other times, the business is split according to ownership interest. For example, different farmers may own a percentage of each different operation.

An S Corporation typically is not an entity type that exists at the state level. Rather, it is an election that a business makes for federal tax purposes. This election can be made by a partnership or Limited Liability Company. Unlike C Corporations, S Corporations can use the cash method of accounting, and they are not taxed at the entity level. However, like a C Corporation, an S Corporation must treat its officers as employees and pay a reasonable salary, which means employment taxes must be paid.

When a partnership or S Corporation claims a loss on a tax return , the IRS may check to see if the partners and shareholders are "materially participating" in the business, as opposed to being passive investors. If the officer or shareholder is a passive investor, their ability to take losses is limited.

4. **Family Limited Partnerships**

Family Limited Partnerships (FLP) are becoming more common and are usually used for estate planning purposes, in order to transfer assets from one generation to the next. This can be done by forming a partnership to which a farmer transfers assets, including land. The farmer then gifts limited interests in the partnership to his children while he maintains a general interest. Usually the general interest that the farmer keeps is small in comparison to the limited interests that are gifted. It is important to note that the gift is an interest in the partnership itself, rather than the partnership's assets. When done correctly, the farmer can significantly reduce or avoid gift and inheritance taxes. When reviewing Family Limited Partnerships, IRS Examiners may consult with estate attorneys.

5. **Trusts**

Trusts are another form of entity generally used for estate planning purposes. When auditing a farm, the examiner will generally also audit the returns of any related farming trusts. When auditing a trust, the examiner will generally consider the following issues:

a. *Is it a Complex Trust, Simple Trust, or Grantor Trust?* Complex Trusts are taxed at a higher rate than individuals. If a taxpayer is using this type of trust, examiners will look to see if income is correctly being taxed at this higher level, or if the trust is diverting income to an entity that is taxed at a lower rate. Simple Trusts pass income to trust beneficiaries, but examiners will look to make sure that the trust does not try to pass losses to beneficiaries, as this is prohibited. Grantor Trust are an estate planning tool, more commonly referred to as a "living trust." They usually do not file returns.

b. *If trusts are established for the benefit of minor children, are the parents including distributions made to the children as income for relief of support obligations?* Parents who are obligated to support minor children cannot exclude from their own income amounts paid to support their children, simply by paying those amounts into a trust.

6. Limited Liability Partnerships (LLP) and Limited Liability Companies (LLC)

LLPs and LLCs are relatively new entity types. Like S Corporations, they shield owners from personal liability and avoid the double taxation of using a C Corporation. However, LLPs and LLCs carry certain advantages that S-Corporations do not, such as the inclusion of the entity's liabilities in basis, as well as ease of contributions and distributions of property. In farming entities, the LLP or LLC usually operates the business, but does not hold the business's assets. The assets are held by other entities, which could shield the assets from creditors of the LLP or LLC.

Here are some things IRS Examiners look for when examining a farming LLP or LLC:

a. Are assets being used by the LLP or LLC owned by a separate entity, in order to shield the assets from creditors? If so, the LLP or LLC must be paying the separate entity fair market rental value for the use.

b. Do the "at-risk rules" apply? Examiners may closely examine the liabilities portion of the balance sheet, especially when losses are claimed. The "at-risk rules" may limit the amount of losses that a particular member may claim. Losses that are allowed may have to be recaptured in later years.

c. Was the LLP or LLC previously a corporation or partnership? If so, conversion to an LLP or LLC could have triggered taxable events, such as corporate liquidations or distributions.

The Crop Map

Examiners will always request a crop map for the tax year under audit. They will want you to include how many acres of each crop were planted and/or vacant, which parcels of land are owned and which are rented, the location of each parcel compared to another, and which year trees and vines were planted.

The examiner will use the crop map to determine which areas of the farm to tour. For example, the examiner may not want to spend time touring row crop parcels that are miles away from the farm shop. On the other hand, the examiner may want to inspect vacant land owned by you that has trees and vines. Of course, the crop map for a particular tax year may not coincide with the current layout of crops, due to crop rotation.

When examining the crop map, the examiner will likely:

1. Compare the map to industry averages;

2. Compare the map to lease agreements to verify that income and expenses are properly allocated;

3. Determine the distances between parcels. If certain parcels are located a great distance from others, the examiner will want to know how you transport equipment from one location to another. You may be required to file a Form 2290, Heavy Highway Vehicle Use Tax Return;

4. Review the map to determine the year that trees and vines were planted to see if Uniform Capitalization of Costs (UNICAP) should be considered. When using industry averages to estimate income, the examiner will consider the year that the trees and vines were planted, as it can take years for new plantings to come into full production.

Using Industry Averages

Examiners can use industry averages to estimate both income and expenses, and the scope of the audit may be expanded or reduced depending on how much the numbers you report conflict with industry averages.

Income Averages

To determine income averages, examiners will contact the local department of agriculture. Most states publish annual crop production reports for each county. These reports may include major weather events that could have affected crop production, as well as timetables for each crop from planting to harvesting. The examiner will focus on the average production per acre and the value per crop unit. By comparing this data to the crop map you provide, the examiner can estimate the income that would be expected.

Expense Averages

Just as with income, many states often have data available that allows examiners to estimate production costs for a variety of crops. The data can be prepared by a university agricultural extension, or it may be obtained by contacting county farm advisors. This can include costs to establish permanent plantings, as well as costs to produce a crop.

These averages can be used to determine whether the expenses are reasonable and the amounts that should be capitalized under UNICAP. For example, if the farm has 100 acres of new vines and 500 acres of existing vines, only the costs associated with the 100 acres of new vines would have to be capitalized.

The Initial Interview

After requesting information and documentation through the issuance of an IDR, the examiner will generally schedule an interview with you. Many times, examiners assigned to audit farms will be familiar with farm terminology. Questions will be customized, depending on the examiner's knowledge of the particular crops or cattle at issue. Usually, the interview will include a tour of the farm and its facilities. During the interview, examiners like to ask open-ended questions, in order to get the maximum amount of information from you.

Here are some questions the examiner is likely to ask:

1. If there are young vines or trees, when were they planted?

2. If there are improvements, such as stakes, trellises, fences, or irrigation systems, when were they installed, and were costs properly capitalized?

3. If there are houses on the property, is there any rental income, or is the housing being used by employees?

4. Are there any calves at dairy, and were there any unreported calf sales? If there are calves tethered by the corrals, the examiner may wonder if they are being sold for cash, and may ask if the calves are waiting to be taken to the auction yard or to be picked-up by a buyer.

5. What kind of machinery is there? If the machinery does not match the type of crops produced, the examiner will wonder if the machinery is being rented out.

6. Are there large trucks? If so, the examiner may ask if the trucks are used during non-harvest to haul hay or other commodities for additional income.

THE AUDIT

Crop Accounting Records

Crop accounting records are generally requested in the pre-audit Information Document Request. If they are not produced, the examiner will likely ask again during the interview. These records are used by the examiner to either expand or narrow the scope of the audit, in order to focus on areas where the risk of noncompliance is highest.

At the beginning of the season, farmers typically prepare a budget for that year's crop. This may be needed for a variety of reasons, such as obtaining financing. The budget typically includes the estimated income and expenses for each crop that will be produced. In most crop accounting systems, the budgets are later compared to the actual year-end figures, and variances are noted. The examiner will focus the audit on accounts that contain significant variances from what was budgeted.

Crop Loans

Examiners will usually requests records of crop loans, including the following:

- The loan agreement, including any statement that lists collateral;

- Statements showing the loan history, including for the month following the year under audit; and

- The financial statements that were provided to the lender in order to obtain the loan.

Unrelated Third Party Financing

Examiners will look at the loan activity and trace the money. One thing they will look for is reductions in the balance of the loan that are not tied to actual payments. For example, a customer who purchases crops from you may make a payment toward the loan, rather than paying you directly. In these cases, the payment is never deposited into your account and may not have been properly included in your income.

The timing of the loan repayments may also be looked at. For example, if a loan is repaid in January of the following year, it may indicate a possible deferred payment contract.

Related Party Financing

Examiners will look to see if loans are obtained from related parties, or if the proceeds of a loan are being shared by related parties. If so, the examiner will want to trace the flow of money to determine the tax consequences for each party.

If a related entity acted as a broker for you, the examiner will look to determine when the payment for the crops was constructively received, and the loan proceeds could be considered income to you. This may require that the examiner review the books of the related party, unless you are able to provide the information. If you cannot provide the information, then the related party may also be selected for audit. Transactions between related parties will generally be reviewed to determine whether or not they are at arm's length.

Crop Contracts

Crop contracts are reviewed to determine quantity sold, payment terms, and delivery terms. The contracts typically contain some details regarding the quantity sold, whether measured in acres, bales, boxes, or pounds. The examiner will compare this quantity to industry averages, as well as the crop map you provide, to assess whether or not it seems reasonable.

The examiner will look at the payment terms to see whether or not payment is being deferred until after the close of your fiscal year. If so, the examiner will look to see if it is a valid deferred payment contract. The examiner will also look to see if there are any advance payments or crop advances, and whether they are properly accounted for.

A major consideration in determining whether a deferred payment contract is valid is the date the contract was entered into, as opposed to the delivery date. The examiner will look to compare the contract to copies of delivery tags or the dates listed on grower statements.

Grower Statements

The examiner will look at the quantity delivered and compared it to the quantity described in the contract. He or she will compare the contract number with the grower number on the statement, as you may have multiple accounts with the same purchaser. Any large variances in the quantity delivered will raise questions.

The quantity accepted will also be looked at, to see if only part of a delivery was accepted, or if there is an unaccounted for variance between the quantity contracted and delivered. If a large amount of the crop delivered was rejected, the examiner will want to know what happened to the rejected portion. Was it resold to a different purchaser? Was it sold in a different type of market for a lower price, such as winery, juices, or cattle feed? If it was disposed of, how was it disposed of, and was it insured?

All statements covering payments for the crop year will be reviewed, until the balance owed to the grower is reduced to zero. The method of reporting income will also be reviewed. Some farmers report net payments into income, while others report gross receipts and deduct expenses.

INCOME ISSUES

Methods of Accounting

The Internal Revenue Code allows farmers to use the cash method of accounting, which means certain expenses can be claimed in the current year, while the corresponding income is deferred until the following year. However, the cash method has certain requirements, and examiners will look to ensure you are not deferring income that you have constructively received. Under the cash method, income is included in the year that it is actually or constructively received, and expenses can be deducted in the year that they are paid. Under this method, farmers do not have to use inventories.

Farmers, like all taxpayers, must compute taxable income in the same way that books and records are maintained. Farmers must choose a method during the first year of farming, and methods can only be changed later with prior approval of the IRS. If a method is not chosen, then the IRS will impose the method that most accurately reflects income. The available methods are cash method, accrual method, and hybrid methods.

Corporations engaged in farming are required to use the accrual method. This includes partnerships that have corporations as partners. This does not include S Corporations or corporations with less than $1 million of gross receipts in each year since 1975. Family farm corporations are also exempt from these requirements, if, since December 31, 1985, the corporation has never had gross receipts of more than $25 million, and at least 50% of each class of stock is owned by members of the same family.

If a farmer uses the accrual method, an inventory must be maintained, and it must include all unsold items at the end of the year that are held for sale or for use of feed or seed. Farmers are not required to keep an inventory of growing crops, unless the crops have a pre-productive period of more than two years.

Income Deferral and Constructive Receipt

Farming entities under certain circumstances are allowed to deduct currently the expenses of growing and harvesting crops while deferring income to later years. Attempts to move income include the use of deferred income contracts and advances from packers. This can lead to potential issues involving constructive receipt.

To determine the validity of such an arrangement, examiners will first look to see if there is a written contract between you and the buyer. If not, you probably had constructive receipt of the proceeds after the crops were delivered. If there is a contract, the examiner will look to see when you received payment. In some cases, contracts provide that you are not to be paid until payment is requested. This could result in payment not being received until years after it was earned. The doctrine of constructive receipt requires that the payment be reported as income in the year when you had the right to request it.

To properly defer income, a contract providing for deferred payments must have been in place prior to the amounts being earned. If the contract was executed after the crops were already delivered, then you most likely already had the right to receive payment, but chose to defer it. Assuming the contract was in place prior to delivery; the examiner will look to ensure that the parties are following the terms of the contract. Sometimes, farmers will receive advance payments, disguised as loans. Under the "substance over form" argument, this would be considered income.

Agricultural Program Payments

Certain governmental programs provide benefits to farmers. Many of these payments provided by these programs are taxable to the farmers. The examiner may ask you to sign an authorization to enable access to government records, which could include:

- Certifications for program eligibility,
- Payment records,
- Contracts,
- Aerial photographs,
- Number of acres,
- Production data regarding disaster payments,
- Crop share arrangements,
- Cash rent arrangements, or
- Farm production reports.

Loans

The IRS reviews loans received from government agencies to see if they are taxable. The general rule is that loan proceeds are not treated as income. However, there are certain exceptions to this general rule. The IRS pays particularly close attention to loans from Commodity Credit Corporations (CCC), and Information Document Requests usually ask if such loans were obtained.

If there is a loan from a CCC, the examiner will want to determine whether an election was filed under IRC Section 77. If you do not provide this information, the examiner will request it from the local Farm Service Agency (FSA) office.

Substance over Form

Each loan is reviewed to determine whether it is a bona fide loan, rather than an attempt to defer income, distribute income to a shareholder or partner, or shift income from one entity to another. The examiner is likely to use the following techniques when reviewing loans:

- Year-end analysis of the note payable account,
- Matching product sales to income recognition, or
- Making a flowchart diagram of transactions, including product deliveries, loan executions, sale proceeds, and loan repayment.

Examiners will look for income distributions to shareholders that are disguised as loans. Due to the family nature of the agricultural industry, this is a relatively common practice. Such loans may be reclassified as constructive dividends, which are taxable. They will also look to see if legitimate loans to shareholders are later forgiven, which would give rise to cancellation of indebtedness income. As part of this analysis, examiners will generally do the following:

- Reconcile the numbers on the return with numbers from the general ledger.
- Compare the beginning balance to ending balance on the general ledger, then investigate any significant changes.
- Review the general ledger for unusual entries.
- Determine whether a bona fine creditor-debtor relationship exists.
- Review corporate minutes, promissory notes, date issues, repayment dates, and fair market interest rates.
- Trace the source of repayments to confirm that the shareholder who received the loan is actually repaying it, as opposed to a third party (e.g. customer).
- Determine whether interest has been properly charged on the loan, and whether interest income has been properly reported.

Unreported Sales and By-Product Sales

Some farming activities produce by-products that are sold. If this is the case, examiners will look to see if this income was reported on the return. Some examples include:

- Manure being sold as fertilizer,
- Corn cobs being sold to be used in the production of plastic,
- Excess grain and hay being sold,
- Untilled land being rented out for pasture,
- Selling trees for lumber or firewood,
- Renting out equipment that is not being used,
- Income from hunting privileges, or
- Orchard and vineyard pruning is shredded and sold to co-generation plants.

The types of expenses that you claim can offer clues to an examiner of types of unreported income that might exist. For example:

- If a cattle farmer claims expenses for plastic backs or packaging materials, he might also have income from fruits, vegetables, etc.
- Repair expenses on a chainsaw may indicate the sale of logs or lumber.
- Depreciation expenses on a tandem dump-truck may indicate that the farmer is selling soil.
- Fuel expenses for a tractor during the offseason may indicate additional income-generating activities.
- Machinery in excess of what is necessary for a farm of that size may indicate that the farmer does custom work.

Related Entities

Examiners will usually create a flowchart of related entities, based on information gathered during the course of the examination, as well as from the interview with you. The flowchart will list all of the related entities, along with their ownership percentages and any major transactions. Even if an entity purports to be unrelated to you, there may be "constructive ownership" issues.

Examining Farmer Income Records

Examiners often use the following techniques to evaluate your income records:

- Reconciliation of the amounts on the return to your book, ledger, or profit and loss statement.

- Ensuring that all entries in a ledger or book are spread correctly in the various categories of income. If there is a category of nontaxable income, the Examiner will look to make sure there are no taxable items included.

- If a monthly system is used, with a year-end recap, the Examiner will look to see if the year-end recap is properly calculated and includes all of the monthly totals.

- Testing a sample for mathematical errors.

- Review of bank statements and deposit slips.

- Review of check stubs, scales tickets, and sales slips.

- Review of Forms 1099 reported to the IRS.

- Review of Form 500 for Commodity Credit Corporation loan information.

- Review of livestock sales slips.

- Loan liability ledgers from banks and other lenders. Examiners will look to see if commodity checks are used to repay loans, without being reported as income.

- Review of grain sale check stubs to see if the farmer reported the net (rather than gross) proceeds, then deduct the deduction from the check, resulting in a double-deduction.

While reviewing the records, examiners may make various inquiries of you, paying particularly close attention to farm product sales information to see that all income from farm product sales is properly included in income. The examiner will ask about any differences between the records of original entry and your records. Any unexplained differences will likely be considered unreported income.

If the tax return reports income from Agricultural Payments, the examiner will conduct pre-audit research on the Environmental Work Group website. On this site, they can search the name of each individual or business and get detailed information on payments that have been made to you by the U.S. Department of Agriculture. It also shows what counties each payments are made in. The website will also indicate whether you have received a Commodity Credit Corporation loan.

Loan Issues

The examiner will look to see if you used Commodity Certificates to repay Commodity Credit Corporation loans. If the Commodity Certificates are purchased with a check, and the certificates are immediately used to pay the Commodity Credit Corporation loans, the market gain will not be reported on the Form 1099-G. The examiner will want to review the CC Form 500, which will states the certificate numbers used to repay the loan. The examiner will also want to review your program payment history on the Environmental Working Group website, which will show "Commodity Certificates" separately from market gains.

Gross Versus Net Proceeds

Often, proceeds from the sale of farm products are paid in the form of a net check. Deductions from the gross sales price include things like hauling expenses, commissions, health or life insurance, personal purchases, assignments for loan repayments, or assignment for payment on installment sales. When you use net checks to calculate gross receipts, it may result in reducing gross income with nondeductible personal expenses. Examiners use various audit techniques to detect unreported income, including:

- Comparing sales vouchers to the farm record book.

- Reconciling loan payments to canceled checks. If the examiner finds a loan repayment with no corresponding canceled check, it may indicate that the payment was made with unreported income.

- Questioning you or the county ASCS regarding payments made to or on behalf of the farmer, including payments made from a customer to the Commodity Credit Corporation for a loan repayment.

BASIS ON FARM PROPERTY

Examiners typically review the basis of farm property, to ensure that gains and losses from the sale of assets are properly computed, and to make sure that property is properly capitalized and depreciated. Examples of issues that could arise include like kind exchanges, where two assets are exchanged, as well as gifted or inherited assets.

Like Kind Exchanges

When evaluating these exchanges, the examiner will first look to see if the assets meet the "like kind" requirements of IRS Section 1031. If so, the basis of the asset acquired is equal to the basis of the asset exchanged. If cash is also paid as part of the exchange, then the amount of cash paid is added to increase the basis. If the assets exchanged do not meet the Section 1031 requirements, then the basis of the asset received is its fair market value on the date of the exchange.

Audit Issues

Basis issues that are evaluated during the course of the audit include the following:

- A full year of depreciation being taken for an asset that was not held for a full year.

- A full year of depreciation being taken for an asset that was acquired at the end of a year.

- An unreasonably low value being placed land, when allocating costs to land and improvements. Since land is non-depreciable, farmers may try to allocate a larger portion of the costs to improvements, which can be depreciated.

- Review of cultural expenses associated with the sale of a farm, which must be capitalized in the year of purchase by the buyer. The expenses can be deducted in the year that the income from the crops is received. Examiners will look at the purchase escrow to see what the purchaser paid for the unharvested crops, to ensure proper treatment.

EXPENSES

Under the cash method, which most farmers use, expenses are deductible at the time they are paid. Under the accrual method, expenses cannot be deducted until performance occurs. Examiners key in on several issues when evaluating whether to allow expenses.

Deposits or Payments

Many farmers write a substantial number of checks at the end of the tax year to pay expenses. Examiners always review any large expenditures toward the end of the year, in order to determine whether the disbursement is a payment or a deposit.

A deposit which is to be applied toward a future expense cannot be deducted in the current year. Although a check is written, no deduction is allowable until the expense is actually incurred. Here are some factors that examiners look at in determining whether a disbursement is a payment or a deposit:

- No lack of specific quantity terms.

- The right to refund of any unapplied payment credit of the contract.

- Treatment of the expenditure as a deposit by the receiver.

- The right to substitute other goods or products.

Prepaid Expenses

The deductibility of prepaid supplies is limited if they exceed 50% of the total deductible farm expenses for the year, including the prepaid supplies. However, if the prepaid supplies are actually used or consumed during the year, they are fully deductible. For "farm related taxpayers," there are two exceptions to these limitations:

- If the prepaid farm supplies expense exceeds 50% of deductible farm expenses due to a change in the business operations caused by an extraordinary circumstance.

- If the total prepaid farm supplies expense for the prior 3 tax years is less than 50% of the total other deductible farm expenses for those 3 years.

A person is a "farm related taxpayer" if:

- His or her main home is on a farm;

- The principal business is farming; or

- A member of the family meets one of the first two tests. Family members can be parents, siblings, spouse, grandparents, children, grandchildren, aunts, and uncles.

There are three tests that must be met in order to deduct the cost of a supply purchased in the current taxable year which will be used in the subsequent taxable year:

- The expense must be for the purchase of supplies, rather than a deposit. It is considered a payment if made under a binding agreement to receive a specific quantity at a fixed price, and you are not able to get a refund;

- The prepayment cannot merely be for tax avoidance, but must have a specific business purpose; and

- The deduction must not result in a material distortion of income. Factors considered in making this determination include your customary business practices, the materiality of the expenditure in comparison to yearly income, the time of the year that the purchase is made, and the amount of the expenditure compared to other purchases.

Examiners will review check endorsements and check supplies to determine whether or not the expense is valid.

Related Entities

It is not uncommon for related entities to share expenses. When this happens, the IRS will take the following steps to see if expenses are properly allocated among the various entities:

1. Determine the allocation method.

2. Review a sample of checks and invoices to verify accuracy and assess the reasonability of the allocations.

3. Check for internal controls.

4. Look for unusual allocations that could have been manipulated for tax benefits.

5. Look to see if a partner who is not liable for a loan is using the loan as a basis to flow-through losses from the partnership to his personal return.

6. See if pre-productive expenses are being deducted in the current year, rather than being capitalized.

Capital vs. Reoccurring Costs

While most expenses incurred in farming activities are deductible, expenses paid for the acquisition, improvement, or restoration of an asset having a useful life of more than one year must be capitalized. Expenses pertaining to the acquisition or improvement of land are typically reviewed by examiners.

The following costs generally must be capitalized:

1. Water wells (including drilling and equipping costs).

2. Preparatory costs, including:

    a. Clearing land,

    b. Leveling and conditioning land,

    c. Purchasing and planting trees,

    d. The cost of building irrigation canals and ditches,

    e. Laying irrigation pipes and installing drain tile,

    f. Modifying channels, dams, and streams,

    g. Constructing tanks and reservoirs, or

h. Fertilizer application, if the benefits last for substantially more than a year.

Examiners use data available from the local county's Agricultural Commissioner's Office, to assess whether a particular expense is expected to provide a benefit for substantially more than one year. The examiner may also obtain data from state universities, which publish agricultural data. In trying to identify capital expenditures improperly deducted as expenses, examiners use the following techniques:

1. Look for costs that seem excessive compared to the amount of income reported.

2. If pre-productive costs are being deducted, they will check the depreciation schedule to see if the proper depreciation method is being used. If an accelerated depreciation method is being used, there is an invalid election out of Section 263A.

3. If there is an invalid election out, the examiner can either change the accounting method or change the depreciation method.

4. Use industry studies to get estimates of development costs per acre, to separate the operating costs of mature plants from the cost of pre-productive plants.

5. Take a tour of the farm and note any equipment, to see if it may have been used for activities that should be capitalized. The examiner will also note any young trees or vines.

Contract Labor

Labor is typically one of the larger expenses associated with farming. Here are some of the techniques used by examiners when evaluating labor expenses:

1. The examiner will compare the wage expense to gross receipts.

2. Verify that wages and payroll taxes were paid. The examiner will order complete microfilm transcripts of your payroll tax returns.

3. If payroll transcripts reflect an outstanding balance, the examiner will make sure you are deducting only your share of the payroll taxes, and not the employees' share.

Outside Services Informational Sources

There are a host of outside sources IRS Examiners may contact for information, both before and during an audit. These include the following:

1. Local Agriculture County Fairs – Vendors set up booths at these fairs to display their goods, and IRS examiners may attend in order to get information.

2. Gas and electric companies may provide information regarding rebates that are available to farmers who qualify for an energy efficiency program. This will also tell examiners if you have replaced or installed new pumps on water wells.

3. Examiners may call Marketing Boards, Crop Associations, and Crop Bureaus that are formed for specific commodities (e.g. Walnut Marketing Board, Sunkist Growers, Inc.), in order to get information.

4. Agricultural yellow page directories provide contacts that the examiner can contact for information.

5. Bureau of Reclamation.

6. University Cooperative Extensions.

7. National and local agricultural insurance companies can provide information about crop damages.

RAISIN GRAPES

Development of a New Vineyard

Here are some techniques used by examiners when reviewing a new vineyard:

1. If you have not properly elected out of UNICAP, look to see if all pre-productive costs have been capitalized.

2. Look to see if there is excess fertilizer, labor, or wage costs, or if there are large grape stake expenses. These are indications that a new vineyard has been developed.

3. During the interview, the examiner will likely ask about any new ranch development, and they will look for signs of it when they tour the grounds.

Method of Accounting

The spread analysis will be used to detect improper reporting of expenses and income. When large fluctuations are detected, the examiner will audit the issue more closely. The cash receipts journal will also be reviewed for large deposits in early January, which can be a sign of deferred income from the previous year. Likewise, they will look for large checks written at the end of the year, then check to see if these checks were actually paid on the date indicated.

Passive Activity Losses

If there is a loss for the year, and particularly if there is a string of losses spanning multiple years, the examiner may look to see if you are materially participating in the business. If not, the “passive loss” rules may come into play.

Raisin Receipts

If there are wide fluctuations in the spread analysis, the examiner will look to see if these are caused by decisions within your control, which may have been made tax-motivated. Here are some techniques used by examiners to review these fluctuations:

1. In the initial Information Document Request, the examiner will ask for all grower-packer contracts and the Grower Payment Reports.

2. If a packer is listed on Schedule B of the tax return, this is an indicator that you are deferring raisin receipts.

3. If there is nothing in writing to indicate the payment and delivery terms, the RBA Master Agreement is controlling, and the amount based on the preliminary free tonnage percentage is considered constructively received in the harvest year, regardless of when you actually received payment.

4. If there is a written agreement, but it was not executed until after delivery, you would have no bargaining power for the payment terms. As a result, it may not be a valid deferred contract for tax purposes.

5. All Grower Payment Reports (Settlement Statements) will be inspected. Examiners will look to see if you are properly treating all advances as taxable in the year received, and to ensure that expenses are not double-counted by reporting *net* proceeds and also listing the expenses on the Schedule F.

RAC Payments

Examiners will inspect RAC check stubs to determine running totals for each reserve pool. If the check stubs are not available, they may contact the local USDA field office to confirm the amounts paid to you.

Expenses and Depreciation

If you take a large deduction for the "Cost of Pulled Vines," this alerts the examiner that you may have recently purchased a ranch, and an unreasonably high percentage of the purchase price was allocated to the vines. This would result in the expense of pulling vines being overstated and the value of the land being understated.

An expense for "Cost of Purchased Crop" indicates that you have purchased an immature crop. The examiner will look to see if this purchase was an arms-length transaction with an unrelated party. He or she will inspect the purchase escrow to see how much you were charged, then compare that number with what is claimed on the tax return.

Examiners will scan the fixed asset schedule to see if any of the assets may have personal use. If so, related expenses would be limited.

Related Party Transactions

Examiners will watch for how income and expenses are allocated between and among related parties, as well as for differences in accounting methods between such parties. Examples of related party transactions include loans between growers and packers, as well as the rental or sale of equipment between the two.

LIVESTOCK

When livestock is involved, examiners look for the following:

1. The sale of livestock through unusual sources, rather than sales to buyers from packing plants or to feedlots.

2. Barter transactions.

3. The use of multiple bank accounts. If the account statements are being relied upon for tax reporting, there is a risk that some accounts were left out. Examiners will look in the available statements to see if there are transfers to or from other accounts.

4. Examiners believe that the deduction of personal expenses as farm expenses is a common problem. Examples may include insurance, gasoline, interest, taxes, utilities, and repairs. Animals may have been butchered for personal consumption.

5. Loans to family members, which are actually gifts, or which charge below market interest rates. These could either be reclassified as constructive dividends or gifts.

Cattle Industry

The IRS has identified the following as issues that commonly arise in the cattle industry:

1. Deduction of personal expenses as business expenses.

2. Cost of purchasing non-purebred cows implanted with fertilized embryos of purebred calves. When the calves are subsequently sold, the original purchase price must be allocated between the cow and the calves. The resulting gain is an *ordinary* gain, not a capital gain.

3. Transactions that do not appear in the books and bank statements, such as barter transactions.

4. Unreported by-product sales. For example, breeders with quality bulls may sell bull semen on the side.

5. Improper depreciation of steers.

6. The delegation of management decisions to managers, foremen, or other employees may indicate that you are not materially participating in the business. This could give rise to the passive loss limitations.

Dairy Cattle Industry

Unlike other farming activities, milk and cream sales can occur weekly, rather than annually. This provides a continuous cash flow. Some techniques used by examiners during an audit include the following:

1. Review detailed records provided from cooperatives.

2. Check to see if proper “first-in, first-out” accounting method is used to compute gain on sales.

3. Look for unreported sales of by-products, such as manure or bull semen.

4. See if part of the purchase price of a “quota” is properly allocated to that right.

Horse Industry

An issue that often arises during audits is the transfer of an interest percentage in an animal in exchange for training or other services. For example, a rancher may give a trainer a 10% ownership interest in a horse, in exchange for the trainer’s services. These transactions result in the recognition of gain or loss.

Sheep and Goat Industry

Examiners can obtain detailed information about various types of sheep and goats through websites run by the American Sheep Association, USDA Agricultural Research Service, and others. Some issues that will likely be examined include the following:

1. Sheep and goat products may be highly susceptible to personal use.

2. Potential sources of unreported income include stud rental, breeding stock, lamb pelts and pelt products, shearing for hire, cheese from milk, manure, soap and candles, felt making, selling wool, yard products, cottage-industry processing, incentive payments, and livestock dog breeding.

3. Breeding stock is 5-year property for depreciation purposes.

Swine Industry

In addition to being the world's most widely eaten meat, there are many other income-producing uses for hogs and pigs. The IRS uses many different online resources to research different breeds and their various uses, and they use this information to detect additional sources of unreported income during an audit.

Interview Questions

Some examples of interview questions that may be asked include the following:

Beef Interview Questions

1. How many cows did you have in the year of audit?
2. What breed is your herd?
3. Do you sell the calves from your herd or finish the feeders out?
4. Do you keep some of the heifer calves for herd replacement?
5. Do you use a bull for breeding purposes or do you use artificial insemination?
6. Do you market your cattle through any third party marketing agent? If so, who is it and where are they located?
7. Where do you market your cull cattle?
8. Do you have any arrangements with veterinarians for a regular herd health care program?
9. How many head of cattle do you market each year?
10. What is the weight of the cattle when you market them?
11. Do you sell locker beef? Number of Head? Where Slaughtered? Price Charged?
12. Does your tax return reflect an amount for personal consumption?

13. Did you buy any feeders during the year of audit? If so, how many and from whom were they acquired?

14. If the herd was purchased, how was the acquisition financed?

15. Describe the feeding program. Are the feeders finished off in a feedlot or on pasture? (What are the feeds? silage, hay, shelled corn, or some combination.)

Dairy Interview Questions

1. How many cows did you have in the year of audit including the dry cows?

2. What breed is your herd?

3. What is the average age of the herd?

4. To whom do you sell your milk?

5. How much do they pay you per hundred weight of milk?

6. What do you do with the calves?

7. Do you keep the heifer calves for herd replacement?

8. Do you use a bull for breeding purposes or do you use artificial insemination?

9. How many times a day do you milk?

10. Have you been on a DHIA (Dairy Herd Improvement Association) test?

11. What is your herd's average milk production?

12. Who picks up the milk at the farm and does the dairy deduct the trucking from your check?

13. Do you pay wages with commodities?

14. What commodities? Explain.

15. Do you market your milk through any third party marketing agent? If so, who is it and where are they located?

16. Where do you market your cull cattle?

17. Who are your suppliers of feed and supply items?

18. Do you have any arrangements with veterinarians for a regular herd health care program?

Swine Interview Questions

1. How many hogs did you have for breeding purposes in the year under audit?

2. What breed is your herd?

3. What is the average litter size?

4. How many litters a year do you average?

5. At what age do you wean the piglets?

6. Are you a farrow to finish, a feeder, or a farrow only operation?

7. Do you keep any gilt back for herd replacement?

8. Do you use a boar or artificial insemination for breeding purposes?

9. Do you market your hogs through any third party marketing agent? If so, who is it and where are they located?

10. Where do you market your stock?

11. Who are your suppliers of feed and supply items?

12. Do you have any arrangements with veterinarians for a regular herd health care program?

13. Do you advertise to sell breeding stock or feeder pigs?

14. Do you sell any pork directly to consumers after butchering a hog (e.g. whole hog sausage or a pig for a pig roast)?

15. Have you included an amount for your own personal consumption on your tax return?

Sheep Interview Questions

1. What is the size of your flock in the year under audit?

2. What breed is your flock?

3. What is the average number of lambs per ewe?

4. When do your sheep lamb?

5. Do you feed out the lambs or sell them as feeder lambs?

6. Do you keep any lambs back for flock replacement?

7. Do you market your sheep through any third party marketing agent? If so, who is it and where are they located?

8. Where do you market your stock?

9. Do you advertise to sell breeding stock or feeder lambs?

10. Do you sell any lambs directly to consumers for butchering?

11. Have you included an amount for your own personal consumption on your tax return?

12. When do you shear?

13. Who shears the flock?

14. Who buys the wool after the shearing?

15. Do you shear the lambs before you sell them?

16. Have you received any wool subsidy payments from the government?

Exotic Animal Interview Questions

1. What types of animals are you raising?
2. What is it that you are going to sell? Eggs? Meat? Pets? Fur?
3. How long have you been raising them?
4. What is the history of your operation (profit or loss)?
5. Do you keep any animals back for replacement purposes?
6. How and where do you market your stock?
7. Do you advertise and if so how?
8. Is there personal consumption of your stock shown on your tax return?
9. What are your plans for the future of the venture?
10. Describe any special problems or practices that I should be aware of that are unique to your industry.

LIVESTOCK MARKETING / AUCTION BARNS

Before the audit, the examiner will interview the owner of the barn, employees involved with purchases and sales of livestock, those responsible for making entries to the books and records, those controlling cash, and those responsible for transacting business at the bank. Here are some of the questions that may be asked of the owner or employees:

1. Do you go to the individual livestock producer's premises to purchase livestock rather than the producer trucking the livestock to the auction barn for sale? If so, how frequently?
2. When you go to the producer's premises to purchase livestock, do you make payments at that time or on a later date?
3. What method of payment do you use?

4. How do you determine the method of payment?

5. Does the owner of the auction barn ever purchase livestock from his/her personal account (non-business account)?

6. If so, does the owner make the check payable to the seller name, or to cash?

7. If the auction barn writes a business check to purchase livestock, what payee names may appear on the check? For example, cash, auction barn's name, or producer's name.

8. Does the auction barn ever write more than one check for the same livestock purchase?

9. Who has authority to sign checks?

10. If the auction barn uses a post office box, who has access to the box, and who normally picks up mail?

11. What individuals at the auction barn have custody over cash?

12. Who authorizes credit sales of livestock? Who makes entries to and otherwise maintains the accounts receivable record?

13. Who has authority to cash checks at the bank?

14. Is the auction barn associated with any video auction companies?

15. What records does the State require concerning livestock auctions?

16. What other services do you provide to your customers?

17. Do you charge a buyer's premium for any animals?

18. Do you accept animals with a minimum bid or reserve bid? If so, what do you charge if the reserve is not met?

GRAIN

Information Document Request (IDR)

At the beginning of the audit, the examiner will request all of the farm's records and books. The examiner will also likely schedule a tour of the facilities and an initial interview. During the tour, he or she will look to see what types of buildings, vehicles, and equipment is present. This will tip the examiner off as to what types of income and expenses could be expected.

Here are some areas that examiners inspect:

1. Is income earned by you reported by another family member, so that social security payments are not affected or reduced by earned income?

2. Use of contracts to defer income recognition.

3. Reporting patronage dividends as ordinary dividends on the first page of the 1040. By doing this, you avoid the dividends being subject to self-employment taxes.

4. Only reporting the amount of patronage dividends received in cash, rather than also including the fair market value of other property received as patronage dividends. This could include stock, qualified scrip, or amounts received in redemption of previously issued nonqualified scrip.

5. Unreported income from easements and rights-of-way.

TOBACCO

When auditing a tobacco grower, examiners usually look for unreported income. Tobacco growers often plant 5-25% more than what their contracts call for, to ensure that they make their pounds. The excess can be sold to either a co-op or an auction. The examiner will request copies of all of the contracts for the year, determine the actual production, and seek to determine what was done with any excess.

Many tobacco growers also grow other crops, such as soybeans, corn, and hay. Some raise cattle. The examiner may request a copy of FSA Form 578, which farmers provide to the local Farm Service Agency office for acreage certification. This form lists the acreage and types of crops planted.

Other sources of potential unreported income include the following:

1. Rental income, from renting out unused farmland or equipment.

2. Crop insurance proceeds.

3. Sale of tobacco seeds.

Curing Costs

The following questions may be asked during the initial interview, to determine the accuracy of claimed expenses for curing:

1. How many acres of tobacco did you grow?

2. How many barns did you use to cure your tobacco?

3. Did you cure tobacco for anyone else?

4. Did anyone else cure tobacco for you?

5. When did you purchase and install the barns?

6. How long did the curing process take for each barn?

7. How many gallons of fuel did it take to cure each barn?

8. What kind of fuel did you use?

9. Who supplied the fuel?

10. How many gallons of fuel did you purchase during the year?

11. How many gallons of fuel did you already have on hand at the start of the year?

12. Did you buy fuel in bulk? If so, how was it stored?

Other issues that will likely be explored during the course of the examination include the following:

1. Tobacco Transition Payment Program,

2. H-2A temporary agricultural program workers,

3. Imputed interest from tobacco quota contracts,

4. Capital gain reporting,

5. Farm income averaging,

6. Installment sales reporting, or

7. Like-kind exchanges.

OTHER ISSUES

A host of other issues can come up during an audit. Some of these issues are specific to the farming industry, and others are more general.

Cancellation of Indebtedness

Income from discharge of indebtedness can arise under a wide range of circumstances. These circumstances determine the tax treatment. Whenever discharge of indebtedness occurs, examiners look for the following issues:

1. Solvent partners incorrectly excluding discharged debt from income, due to the insolvency of the partnership.

2. Unreported income from debtors performing services in payment of debt.

3. Farmer incorrectly reducing attributes by the earliest year of any attribute, rather than in reducing them in the correct order.

4. The election to apply a portion of the excluded income to reduce basis in property must be made in the year of the discharge, using Form 982.

5. Incorrectly claiming depreciation deductions on land.

6. Property which is neither IRC section 1245 property nor IRC section 1250 property must be treated as IRC section 1245 property when basis was reduced due to discharge of indebtedness. Farmers fail to apply the recapture provisions to certain sales of farmland in accordance with IRC section 1017(d). Also, the installment sale provisions under IRC section 453(i) provide for recognition of recapture income in the year of disposition.

Foreclosures, Repossession, and Abandonment

When property is transferred due to foreclosure, repossession, or abandonment, the resulting gain is often incorrectly characterized as income from discharge of indebtedness. Other times, you may use the fair market value to compute gain, rather than the amount of the discharged debt. Examiners will review Form 1099-A or Form 1099-C, as well as your records, in order to determine the correct treatment.

Depreciation

Farming is a business involving large expenditures for buildings and equipment. As a result, depreciation deductions can be a major focus of an audit. There are also special rules that apply to farm property.

Here are some of the procedures used by examiners to verify claimed depreciation deductions:

1. Review the depreciation schedule to ensure that the 150% limitation was applied.

2. Consider allowed or allowable rule for basis adjustments. This rule can result in the basis being adjusted if you have used more than the 20-year recovery period assigned for farm buildings.

3. Determine whether any of the vehicles are for personal use by you or other family members.

4. Review depreciation schedules and tax returns for previous years to determine whether the Section 179 deduction was used on personal vehicles, which were then removed or never included on the detailed depreciation schedule.

Livestock Sales

When reviewing livestock sales, examiners look for the following mistakes:

1. Items purchased toward the end of the year may have been deducted on the Schedule F, even though they are on hand and not sold until the next year. When they are sold the next year, they may be deducted again, resulting in a double-deduction. To detect this, examiners will review purchases in the last six months of one year and sales in the first six months of the subsequent year.

2. Deferred payment contracts are reviewed to ensure that costs are not deducted before the corresponding income is reported.

3. Death losses on purchased livestock may be deducted at cost in the year of death. Examiners will look to ensure that the deduction is not taken again when the remaining livestock are sold. No deduction is permitted for death losses of raised livestock.

4. Sales of steers may be reported on Form 4.

5. Form 4797 as breeding livestock, when they should have been reported on Schedule F.

6. If a heifer is less than 900 pounds, it has probably been held for less than two years and probably was not held for breeding purposes. The sale of such a heifer should be reported on Schedule F, rather than Form 4797.

7. Proceeds from the sale of livestock may have been used to pay off loans. The check may have been endorsed directly to the lender and may not appear in the farmer's books or account statements.

Credits

Examiners will review credits claimed for gasoline, to see if the credits were claimed for gasoline used in highway vehicles, for custom work, for nonfarm purposes, or for diesel fuel that was purchased tax-free. Here are some ways they verify the amount of gallons allowable for the credit:

1. Several states refund the state taxes paid on gasoline used on the farm. Examiners will look for differences between the amounts claimed for state and federal purposes.

2. During the initial interview, examiners may ask which equipment is diesel powered, rather than gasoline powered. Then, the examiner will want to know how many gallons of fuel each piece of equipment uses.

3. The examiner may calculate the amount of gallons used in highway vehicles, then subtract that from the total number of gallons purchased, in order to determine the number of gallons used for farm purposes.

4. The examiner may request invoices to determine the amount of gallons purchased with tax included.

Investment Tax Credits

The examiner will determine whether you are allowed to claim any of the investment tax credits, such as the energy credit. If the energy credit is claimed, the examiner will look to see if the property is in-fact one of the types for which the credit is permitted. If the credit is permitted, the examiner will look to see if the correct reduction in basis has been made.

Credits can be carried back and carried forward, but examiners will look to make sure the credits are carried back to prior years before they are carried forward to subsequent years. If the year for which the credit should have been carried back is closed due to the statute of limitations, it will be disallowed.

Brown, PC represents farms and ranches at IRS audits throughout Texas and across the United States. If you have questions regarding an IRS Audit, please call 888-870-0025 or contact us online for a confidential consultation.