

**TEXAS & SOUTHWESTERN  
CATTLE RAISERS ASSN. INC.**

**RANCHING 101 – RANCH ACCOUNTING**

**NOVEMBER 19, 2013**

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**Ranch Accounting 101**  
**Balance Sheet**  
 As of November 19, 2013

	<u>Nov 19, 13</u>
<b>ASSETS</b>	
Current Assets	
Checking/Savings	0.00
Accounts Receivable	0.00
<b>Cattle - stocker inventory</b>	
Other Current Assets	0.00
Total Current Assets	<u>0.00</u>
Fixed Assets	
Furniture and Equipment	0.00
<b>Cows</b>	
<b>Bulls</b>	
<b>Horses</b>	
<b>Equipment &amp; fences</b>	
<b>Buildings</b>	
<b>Land</b>	
Accumulated Depreciation	0.00
Total Fixed Assets	<u>0.00</u>
Other Assets	0.00
<b>TOTAL ASSETS</b>	<u><u>0.00</u></u>
<b>LIABILITIES &amp; EQUITY</b>	
Liabilities	
Current Liabilities	
Accounts Payable	0.00
Credit Cards	0.00
Payroll Liabilities	0.00
Total Current Liabilities	<u>0.00</u>
Long Term Liabilities	
<b>Note payable to NFCC</b>	
Total Long Term Liabilities	<u>0.00</u>
Total Liabilities	<u>0.00</u>
Equity	
Opening Balance Equity	0.00
Owners Draw	0.00
Owners Equity	0.00
Net Income	0.00
Total Equity	<u>0.00</u>
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<u><u>0.00</u></u>

Ranch Accounting 101  
**Profit & Loss**  
 November 1 - 19, 2013

	<u>Nov 1 - 19, 13</u>
Ordinary Income/Expense	
Income	
<b>Sales - bought for resale</b>	
<b>Cost of sales</b>	
<b>Sales - raised</b>	
Agricultural Program Payments	0.00
Commodity Credit Loans	0.00
Cooperative Distributions	0.00
Crop Insurance Proceeds	0.00
Crop Sales	0.00
Fuel Tax Credits and Other Inc.	0.00
Total Income	0.00
Expense	
Bank Service Charges	0.00
Car and Truck Expenses	0.00
Chemicals Purchased	0.00
Computer and Internet Expenses	0.00
<b>Conservation expenses</b>	
<b>Custom hire</b>	
Depreciation Expense	0.00
<b>Dues &amp; subscriptions</b>	
<b>Farrier</b>	
<b>Feed</b>	
Fertilizers and Lime	0.00
Freight and Trucking	0.00
Gasoline, Fuel and Oil	0.00
Insurance Expense	0.00
Interest Expense	0.00
<b>Labor hired</b>	
Office Supplies	0.00
Payroll Expenses	0.00
Professional Fees	0.00
<b>Registration/transfer fees</b>	
Rent Expense	0.00
<b>Rent Expense - machinery, equip</b>	
<b>Rent Expense - land, animals</b>	
Repairs and Maintenance	0.00
Seeds and Plants Purchased	0.00
Small Tools and Equipment	0.00
Storage and Warehousing	0.00
<b>Supplies</b>	
<b>Taxes</b>	
Telephone Expense	0.00
<b>Training</b>	
<b>Utilities</b>	0.00
Veterinary, breeding, medicine	
Total Expense	0.00
Net Ordinary Income	0.00
Other Income/Expense	
Other Income	0.00
Other Expense	
Ask My Accountant	0.00
Total Other Expense	0.00
Net Other Income	0.00
Net Income	0.00

CATTLE TRANSACTIONS - 2012

FIRST-IN,  
FIRST-OUT

date	beg + bot		heifers		ending	
			cost of sales			
12/31/2011	272	185,240.90	272	185,240.90	-	-
		bot				
1/20/2012	62	52,387.56	62	52,387.56	-	-
2/10/2012	62	58,231.99	62	58,231.99	-	-
2/25/2012	64	59,433.58	64	59,433.58	-	-
3/25/2012	53	50,924.53	53	50,924.53	-	-
4/23/2012	58	53,814.93	58	53,814.93	-	-
5/20/2012	57	51,280.46	57	51,280.46	-	-
6/22/2012	60	51,208.75	60	51,208.75	-	-
7/26/2012	54	43,295.14	54	43,295.14	-	-
8/19/2012	55	46,511.52	24	20,295.94	31	26,215.58
9/15/2012	63	49,102.53		-	63	49,102.53
10/16/2012	80	61,799.76		-	80	61,799.76
11/25/2012	63	49,519.82		-	63	49,519.82
12/15/2012	60	46,707.66		-	60	46,707.66
					-	-
12/31/2012	1,063	859,459.13	766	626,113.78	297	233,345.35

date	desc	total					weaned	
			Bulls	Cows	Calves	repl h	strs	hfrs
12/31/12		404	14	194	5	-	97	94
1/10/13	sell 97 strs avg 557, 78 hfrs avg 505 at Graham						(97)	(78)
1/11/13	move 15 hfrs to R2 - left #309 at R1							(15)
2/15/13	3 calves died in snow storm (124, 267, ?)							
4/18/13	1 bull died in fight - # 106/8162		(1)					
5/9/13	work cows-shots,worm,192 cows							
5/9/13	work cows-missing tags 189, 241, 328							
5/9/13	work 177 calves - 98s, 79h				177			
5/9/13	1 calf not penned - west pasture				1			
5/11/13	tsf bull # 117/B17 to R2		(1)					
5/11/13	<b>turn bulls out</b>							
5/14/13	sold at ocw-3 open cows #120,133/168,149/119			(3)				
5/14/13	sold at ocw bull #208/7 - sterile		(1)					
5/14/13	sold at ocw-2012 late calves: 3 b, 2 h still have #309 h to feed out				(5)			
6/12/13	bot 2 bulls D freeze brand on right hip		2					
6/20/13	swapped bulls #301/7409 for 119/223							
6/25/13	sold bull # 207/597 at ocs		(1)					
8/15/13	cow #217 dead in north pasture - lightning			(1)				
9/17/13	sold at ocw bull tag# 222, frz brand 2996		(1)					
10/19/13	preg ck & worm 188 cows), 10 open							
10/19/13	of 10 open, turned 3(141,285,nt/107) back out with their late calves							
10/19/13	183 clvs thru chute-xprs5,blkleg/pnkeye/cydectrin hfrs-bangs vacc, cut 3 strs				5			
10/19/13	2 calves not penned - hfr #241, str #233				2			
10/19/13	wean 178 clvs				(178)		99	79
10/20/13	178 weighed 625 avg on 10/20/13, cut str with yellow tag #325							
		387	11	190	7	-	99	80

**SCHEDULE F  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)

**Profit or Loss From Farming**

▶ Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B.

▶ Information about Schedule F and its separate instructions is at [www.irs.gov/schedulef](http://www.irs.gov/schedulef).

OMB No. 1545-0074

**2013**

Attachment  
Sequence No. **14**

Name of proprietor

Social security number (SSN)

**A** Principal crop or activity

**B** Enter code from Part IV

**C** Accounting method:  
 Cash  Accrual

**D** Employer ID number (EIN), (see instr)

**E** Did you "materially participate" in the operation of this business during 2013? If "No," see instructions for limit on passive losses  Yes  No

**F** Did you make any payments in 2013 that would require you to file Form(s) 1099 (see instructions)?  Yes  No

**G** If "Yes," did you or will you file required Forms 1099?  Yes  No

**Part I Farm Income—Cash Method.** Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 9.)

<b>1a</b> Sales of livestock and other resale items (see instructions)	<b>1a</b>		
<b>b</b> Cost or other basis of livestock or other items reported on line 1a	<b>1b</b>		
<b>c</b> Subtract line 1b from line 1a			<b>1c</b>
<b>2</b> Sales of livestock, produce, grains, and other products you raised			<b>2</b>
<b>3a</b> Cooperative distributions (Form(s) 1099-PATR)	<b>3a</b>	<b>3b</b> Taxable amount	<b>3b</b>
<b>4a</b> Agricultural program payments (see instructions)	<b>4a</b>	<b>4b</b> Taxable amount	<b>4b</b>
<b>5a</b> Commodity Credit Corporation (CCC) loans reported under election			<b>5a</b>
<b>b</b> CCC loans forfeited	<b>5b</b>	<b>5c</b> Taxable amount	<b>5c</b>
<b>6</b> Crop insurance proceeds and federal crop disaster payments (see instructions)			
<b>a</b> Amount received in 2013	<b>6a</b>	<b>6b</b> Taxable amount	<b>6b</b>
<b>c</b> If election to defer to 2014 is attached, check here <input type="checkbox"/>		<b>6d</b> Amount deferred from 2012	<b>6d</b>
<b>7</b> Custom hire (machine work) income			<b>7</b>
<b>8</b> Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)			<b>8</b>
<b>9</b> <b>Gross income.</b> Add amounts in the right column (lines 1c, 2, 3b, 4b, 5a, 5c, 6b, 6d, 7, and 8). If you use the accrual method, enter the amount from Part III, line 50 (see instructions)			<b>9</b>

**Part II Farm Expenses—Cash and Accrual Method.** Do not include personal or living expenses (see instructions).

<b>10</b> Car and truck expenses (see instructions). Also attach Form 4562	<b>10</b>		<b>23</b> Pension and profit-sharing plans	<b>23</b>
<b>11</b> Chemicals	<b>11</b>		<b>24</b> Rent or lease (see instructions):	
<b>12</b> Conservation expenses (see instructions)	<b>12</b>		<b>a</b> Vehicles, machinery, equipment	<b>24a</b>
<b>13</b> Custom hire (machine work)	<b>13</b>		<b>b</b> Other (land, animals, etc.)	<b>24b</b>
<b>14</b> Depreciation and section 179 expense (see instructions)	<b>14</b>		<b>25</b> Repairs and maintenance	<b>25</b>
<b>15</b> Employee benefit programs other than on line 23	<b>15</b>		<b>26</b> Seeds and plants	<b>26</b>
<b>16</b> Feed	<b>16</b>		<b>27</b> Storage and warehousing	<b>27</b>
<b>17</b> Fertilizers and lime	<b>17</b>		<b>28</b> Supplies	<b>28</b>
<b>18</b> Freight and trucking	<b>18</b>		<b>29</b> Taxes	<b>29</b>
<b>19</b> Gasoline, fuel, and oil	<b>19</b>		<b>30</b> Utilities	<b>30</b>
<b>20</b> Insurance (other than health)	<b>20</b>		<b>31</b> Veterinary, breeding, and medicine	<b>31</b>
<b>21</b> Interest:			<b>32</b> Other expenses (specify):	
<b>a</b> Mortgage (paid to banks, etc.)	<b>21a</b>		<b>a</b> -----	<b>32a</b>
<b>b</b> Other	<b>21b</b>		<b>b</b> -----	<b>32b</b>
<b>22</b> Labor hired (less employment credits)	<b>22</b>		<b>c</b> -----	<b>32c</b>
			<b>d</b> -----	<b>32d</b>
			<b>e</b> -----	<b>32e</b>
			<b>f</b> -----	<b>32f</b>
<b>33</b> <b>Total expenses.</b> Add lines 10 through 32f. If line 32f is negative, see instructions				<b>33</b>
<b>34</b> <b>Net farm profit or (loss).</b> Subtract line 33 from line 9				<b>34</b>

If a profit, stop here and see instructions for where to report. If a loss, complete lines 35 and 36.

**35** Did you receive an applicable subsidy in 2013? (see instructions)  Yes  No

**36** Check the box that describes your investment in this activity and see instructions for where to report your loss.

**a**  All investment is at risk. **b**  Some investment is not at risk.

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**Part III Farm Income – Accrual Method** (see instructions).

37	Sales of livestock, produce, grains, and other products (see instructions)				37		
38a	Cooperative distributions (Form(s) 1099-PATR)	38a		38b Taxable amount	38b		
39a	Agricultural program payments	39a		39b Taxable amount	39b		
40	Commodity Credit Corporation (CCC) loans:						
a	CCC loans reported under election				40a		
b	CCC loans forfeited	40b		40c Taxable amount	40c		
41	Crop insurance proceeds				41		
42	Custom hire (machine work) income				42		
43	Other income (see instructions)				43		
44	Add amounts in the right column for lines 37 through 43 (lines 37, 38b, 39b, 40a, 40c, 41, 42, and 43)				44		
45	Inventory of livestock, produce, grains, and other products at beginning of the year. Do not include sales reported on Form 4797	45					
46	Cost of livestock, produce, grains, and other products purchased during the year	46					
47	Add lines 45 and 46	47					
48	Inventory of livestock, produce, grains, and other products at end of year	48					
49	Cost of livestock, produce, grains, and other products sold. Subtract line 48 from line 47*				49		
50	<b>Gross income.</b> Subtract line 49 from line 44. Enter the result here and on Part I, line 9				50		

\*If you use the unit-livestock-price method or the farm-price method of valuing inventory and the amount on line 48 is larger than the amount on line 47, subtract line 47 from line 48. Enter the result on line 49. Add lines 44 and 49. Enter the total on line 50 and on Part I, line 9.

**Part IV Principal Agricultural Activity Codes**



Do not file Schedule F (Form 1040) to report the following.

- Income from providing agricultural services such as soil preparation, veterinary, farm labor, horticultural, or management for a fee or on a contract basis. Instead file Schedule C (Form 1040) or Schedule C-EZ (Form 1040).
- Income from breeding, raising, or caring for dogs, cats, or other pet animals. Instead file Schedule C (Form 1040) or Schedule C-EZ (Form 1040).
- Sales of livestock held for draft, breeding, sport, or dairy purposes. Instead file Form 4797.

These codes for the Principal Agricultural Activity classify farms by their primary activity to facilitate the administration of the Internal Revenue Code. These six-digit codes are based on the North American Industry Classification System (NAICS). Select the code that best identifies your primary farming activity and enter the six-digit number on line B.

**Crop Production**

- 111100 Oilseed and grain farming
- 111210 Vegetable and melon farming

- 111300 Fruit and tree nut farming
- 111400 Greenhouse, nursery, and floriculture production
- 111900 Other crop farming

**Animal Production**

- 112111 Beef cattle ranching and farming
- 112112 Cattle feedlots
- 112120 Dairy cattle and milk production
- 112210 Hog and pig farming
- 112300 Poultry and egg production
- 112400 Sheep and goat farming
- 112510 Aquaculture
- 112900 Other animal production

**Forestry and Logging**

- 113000 Forestry and logging (including forest nurseries and timber tracts)

6



**Sales of Business Property**  
**(Also Involuntary Conversions and Recapture Amounts**  
**Under Sections 179 and 280F(b)(2))**

Department of the Treasury  
Internal Revenue Service

▶ Attach to your tax return.

▶ Information about Form 4797 and its separate instructions is at [www.irs.gov/form4797](http://www.irs.gov/form4797).

Attachment  
Sequence No. **27**

Name(s) shown on return

Identifying number

**1** Enter the gross proceeds from sales or exchanges reported to you for 2012 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) . . . . .

**1**

**Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

<b>2</b>	<b>(a)</b> Description of property	<b>(b)</b> Date acquired (mo., day, yr.)	<b>(c)</b> Date sold (mo., day, yr.)	<b>(d)</b> Gross sales price	<b>(e)</b> Depreciation allowed or allowable since acquisition	<b>(f)</b> Cost or other basis, plus improvements and expense of sale	<b>(g)</b> Gain or (loss) Subtract (f) from the sum of (d) and (e)

- 3** Gain, if any, from Form 4684, line 39 . . . . . **3**
- 4** Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . . . . **4**
- 5** Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . . . . **5**
- 6** Gain, if any, from line 32, from other than casualty or theft. . . . . **6**
- 7** Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: . . . . . **7**  
**Partnerships (except electing large partnerships) and S corporations.** Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.  
**Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.
- 8** Nonrecaptured net section 1231 losses from prior years (see instructions) . . . . . **8**
- 9** Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions) . . . . . **9**

**Part II Ordinary Gains and Losses** (see instructions)

**10** Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):


- 11** Loss, if any, from line 7 . . . . . **11** ( )
- 12** Gain, if any, from line 7 or amount from line 8, if applicable . . . . . **12**
- 13** Gain, if any, from line 31 . . . . . **13**
- 14** Net gain or (loss) from Form 4684, lines 31 and 38a . . . . . **14**
- 15** Ordinary gain from installment sales from Form 6252, line 25 or 36 . . . . . **15**
- 16** Ordinary gain or (loss) from like-kind exchanges from Form 8824. . . . . **16**
- 17** Combine lines 10 through 16 . . . . . **17**
- 18** For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:  
**a** If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions . . . . . **18a**  
**b** Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14 . . . . . **18b**

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**Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**  
(see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:		(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A			
B			
C			
D			
These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B
20	Gross sales price (Note: See line 1 before completing) . . . . .	20	
21	Cost or other basis plus expense of sale . . . . .	21	
22	Depreciation (or depletion) allowed or allowable. . . . .	22	
23	Adjusted basis. Subtract line 22 from line 21. . . . .	23	
24	Total gain. Subtract line 23 from line 20 . . . . .	24	
<b>25 If section 1245 property:</b>			
a	Depreciation allowed or allowable from line 22 . . . . .	25a	
b	Enter the <b>smaller</b> of line 24 or 25a . . . . .	25b	
<b>26 If section 1250 property:</b> If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.			
a	Additional depreciation after 1975 (see instructions) . . . . .	26a	
b	Applicable percentage multiplied by the <b>smaller</b> of line 24 or line 26a (see instructions) . . . . .	26b	
c	Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e . . . . .	26c	
d	Additional depreciation after 1969 and before 1976. . . . .	26d	
e	Enter the <b>smaller</b> of line 26c or 26d . . . . .	26e	
f	Section 291 amount (corporations only) . . . . .	26f	
g	Add lines 26b, 26e, and 26f. . . . .	26g	
<b>27 If section 1252 property:</b> Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).			
a	Soil, water, and land clearing expenses . . . . .	27a	
b	Line 27a multiplied by applicable percentage (see instructions) . . . . .	27b	
c	Enter the <b>smaller</b> of line 24 or 27b . . . . .	27c	
<b>28 If section 1254 property:</b>			
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion (see instructions) . . . . .	28a	
b	Enter the <b>smaller</b> of line 24 or 28a . . . . .	28b	
<b>29 If section 1255 property:</b>			
a	Applicable percentage of payments excluded from income under section 126 (see instructions) . . . . .	29a	
b	Enter the <b>smaller</b> of line 24 or 29a (see instructions) . . . . .	29b	
<b>Summary of Part III Gains.</b> Complete property columns A through D through line 29b before going to line 30.			
30	Total gains for all properties. Add property columns A through D, line 24 . . . . .	30	
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13 . . . . .	31	
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6 . . . . .	32	

**Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less**  
(see instructions)

	(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years. . . . .	33	
34 Recomputed depreciation (see instructions) . . . . .	34	
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report . . . . .	35	

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## Instructions for Form 4797

### Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

Section references are to the Internal Revenue Code unless otherwise noted.

#### General Instructions

##### Future Developments

For the latest information about developments related to Form 4797 and its instructions, such as legislation enacted after they were published, go to [www.irs.gov/form4797](http://www.irs.gov/form4797).

##### Purpose of Form

Use Form 4797 to report:

- The sale or exchange of:
  1. Property used in your trade or business;
  2. Depreciable and amortizable property;
  3. Oil, gas, geothermal, or other mineral properties; and
  4. Section 126 property.
- The involuntary conversion (from other than casualty or theft) of property used in your trade or business and capital assets held in connection with a trade or business or a transaction entered into for profit.
- The disposition of noncapital assets (other than inventory or property held primarily for sale to customers in the ordinary course of your trade or business).
- The disposition of capital assets not reported on Schedule D.
- The gain or loss (including any related recapture) for partners and S corporation shareholders from certain section 179 property dispositions by partnerships (other than electing large partnerships) and S corporations.
- The computation of recapture amounts under sections 179 and 280F(b)(2) when the business use of section 179 or listed property decreases to 50% or less.
- Gains or losses treated as ordinary gains or losses, if you are a trader in securities or commodities and made a mark-to-market election under Internal Revenue Code section 475(f).

#### Other Forms You May Have To File

- Use Form 4684, Casualties and Thefts, to report involuntary conversions from casualties and thefts.
- Use Form 6252, Installment Sale Income, to report the sale of property under the installment method.
- Use Form 8824, Like-Kind Exchanges, to report exchanges of qualifying business or investment property for property of a like kind. For exchanges of property used in a trade or business (and other noncapital assets), enter the gain or (loss) from Form 8824, if any, on line 5 or line 16.
- If you sold property on which you claimed investment credit, see Form

4255, Recapture of Investment Credit, to find out if you must recapture some or all of the credit.

- Individuals, corporations, and partnerships use Form 8949, Sales and Other Dispositions of Capital Assets, to report the sale or exchange of capital assets not reported on another form or schedule; gains from involuntary conversions (other than casualty or theft) of capital assets not held for business or profit; and nonbusiness bad debts. Use Schedule D for the return you are filing to figure the overall gain or loss from any transactions reported on Form 8949.

**Additional Information.** See Pub. 544, Sales and Other Dispositions of

#### Where To Make First Entry for Certain Items Reported on This Form

	(a) Type of property	(b) Held 1 year or less	(c) Held more than 1 year
1	<b>Depreciable trade or business property:</b>		
	a Sold or exchanged at a gain . . . . .	Part II	Part III (1245, 1250)
2	<b>Depreciable residential rental property:</b>		
	a Sold or exchanged at a gain . . . . .	Part II	Part I
3	<b>Farmland held less than 10 years upon which soil, water, or land clearing expenses were deducted:</b>		
	a Sold at a gain . . . . .	Part II	Part III (1252)
4	<b>All other farmland</b>	Part II	Part I
	<b>Disposition of cost-sharing payment property described in section 126</b>	Part II	Part I
5	<b>Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:</b>	<b>Held less than 24 months</b>	<b>Held 24 months or more</b>
	a Sold at a gain . . . . .	Part II	Part III (1245)
6	b Sold at a loss . . . . .	Part II	Part I
	c Raised cattle and horses sold at a gain . . . . .	Part II	Part I
7	<b>Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:</b>	<b>Held less than 12 months</b>	<b>Held 12 months or more</b>
	a Sold at a gain . . . . .	Part II	Part III (1245)
8	b Sold at a loss . . . . .	Part II	Part I
	c Raised livestock sold at a gain . . . . .	Part II	Part I

**Table 7-1. Farm Property Recovery Periods**

Assets	Recovery Period in Years	
	GDS	ADS
Agricultural structures (single purpose)	10	15
Automobiles	5	5
Calculators and copiers	5	6
Cattle (dairy or breeding)	5	7
Communication equipment <sup>1</sup>	7	10
Computer and peripheral equipment	5	5
Drainage facilities	15	20
Farm buildings <sup>2</sup>	20	25
Farm machinery and equipment	7	10
Fences (agricultural)	7	10
Goats and sheep (breeding)	5	5
Grain bin	7	10
Hogs (breeding)	3	3
Horses (age when placed in service)		
Breeding and working (12 years or less)	7	10
Breeding and working (more than 12 years)	3	10
Racing horses	3	12
Horticultural structures (single purpose)	10	15
Logging machinery and equipment <sup>3</sup>	5	6
Nonresidential real property	39 <sup>4</sup>	40
Office furniture, fixtures, and equipment (not calculators, copiers, or typewriters)	7	10
Paved lots	15	20
Residential rental property	27.5	40
Tractor units (over-the-road)	3	4
Trees or vines bearing fruit or nuts	10	20
Truck (heavy duty, unloaded weight 13,000 lbs. or more)	5	6
Truck (actual weight less than 13,000 lbs)	5	5
Water wells	15	20

<sup>1</sup> Not including communication equipment listed in other classes.

<sup>2</sup> Not including single purpose agricultural or horticultural structures.

<sup>3</sup> Used by logging and sawmill operators for cutting of timber.

<sup>4</sup> For property placed in service after May 12, 1993; for property placed in service before May 13, 1993, the recovery period is 31.5 years.

for some commonly used assets. For a complete list of recovery periods, see the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946.

**House trailers for farm laborers.** To depreciate a house trailer you supply as housing for those who work on your farm, use one of the following recovery periods if the house trailer is mobile (it has wheels and a history of movement).

- A 7-year recovery period under GDS.
- A 10-year recovery period under ADS.

However, if the house trailer is not mobile (its wheels have been removed and permanent utilities and pipes attached to it), use one of the following recovery periods.

- A 20-year recovery period under GDS.
- A 25-year recovery period under ADS.

**Water wells.** Water wells used to provide water for raising poultry and livestock are land improvements. If they are depreciable, use one of the following recovery periods.

- A 15-year recovery period under GDS.
- A 20-year recovery period under ADS.

The types of water wells that can be depreciated were discussed earlier in *Irrigation systems and water wells* under *Property Having a Determinable Useful Life*.

### Which Convention Applies?

Under MACRS, averaging conventions establish when the recovery period begins and ends. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property. Use one of the following conventions.

- The half-year convention.
- The mid-month convention.
- The mid-quarter convention.

For a detailed explanation of each convention, see *Which Convention Applies* in chapter 4 of Publication 946. Also, see the Instructions for Form 4562.

### Which Depreciation Method Applies?

MACRS provides three depreciation methods under GDS and one depreciation method under ADS.

- The 200% declining balance method over a GDS recovery period.
- The 150% declining balance method over a GDS recovery period.
- The straight line method over a GDS recovery period.
- The straight line method over an ADS recovery period.

**Depreciation Table.** The following table lists the types of property you can depreciate under each method. The declining balance method is abbreviated as DB and the straight line method is abbreviated as SL.

### Depreciation Table

System/Method	Type of Property
GDS using 150% DB	<ul style="list-style-type: none"> <li>• All property used in a farming business (except real property)</li> <li>• All 15- and 20-year property</li> <li>• Nonfarm 3-, 5-, 7-, and 10-year property<sup>1</sup></li> </ul>
GDS using SL	<ul style="list-style-type: none"> <li>• Nonresidential real property</li> <li>• Residential rental property</li> <li>• Trees or vines bearing fruit or nuts</li> <li>• All 3-, 5-, 7-, 10-, 15-, and 20-year property<sup>1</sup></li> </ul>
ADS using SL	<ul style="list-style-type: none"> <li>• Property used predominantly outside the United States</li> <li>• Farm property used when an election not to apply the uniform capitalization rules is in effect</li> <li>• Tax-exempt property</li> <li>• Tax-exempt bond-financed property</li> <li>• Imported property<sup>2</sup></li> <li>• Any property for which you elect to use this method<sup>1</sup></li> </ul>
GDS using 200% DB	<ul style="list-style-type: none"> <li>• Nonfarm 3-, 5-, 7-, and 10-year property</li> </ul>

<sup>1</sup>Elective method

<sup>2</sup>See section 168(g)(6) of the Internal Revenue Code

**Property used in farming business.** For personal property placed in service after 1988 in a farming business, you must use the 150% declining balance method over a GDS recovery period or you can elect one of the following methods.

- The straight line method over a GDS recovery period.
- The straight line method over an ADS recovery period.



For property placed in service before 1999, you could have elected to use the 150% declining balance method using the ADS recovery periods for certain property classes. If you made this election, continue to use the same method and recovery period for that property.

## Depreciation Changes

By John Mitchell, CPA

There are three primary elements of depreciation for Federal Income Tax. The three elements are regular depreciation, Section 179 first year depreciation and Bonus Depreciation. The ordering rules are you first take the Section 179, then Bonus depreciation and lastly regular depreciation.

Section 179 deduction has been around since the investment tax credit was eliminated in 1986. The amount of allowable depreciation under Section 179 seems to change every year. For 2011 the deduction limit was \$500,000 as long as qualified purchases did not exceed \$2.0 million. For 2012 the deduction limit is \$139,000 as long as qualified purchases don't exceed \$560,000.

For 2013 the deduction limit is scheduled to drop significantly, but these amounts frequently change before the end of the year by action of Congress.

Section 179 deductions are available for new or used purchases of tangible property used in business, and can be elected in any amount between zero and the maximum limit as desired. No Section 179 or Bonus depreciation is allowed for purchases from a related party. Bonus depreciation first came in to the tax code in 2001, and has been changed several times since. For 2011 the Bonus depreciation deduction was unlimited for 100% of qualified purchases. For 2012 Bonus depreciation deduction is 50% of qualified purchases with no purchase limit. Bonus depreciation is for new assets only with a depreciable life of 20 yrs or less. Passive rental activities can use bonus depreciation but not generally the Section 179 deduction.

Unlike the Section 179 deduction, Bonus depreciation is a take it or not proposition. Meaning if you want to take Bonus depreciation you have to take it on all qualified purchases within a class life or none.

Because Bonus depreciation is allowed on new property only, it recently became important to know when a cow changed from new to used. The tax regulations specify that the day that a heifer gives birth to her first calf she becomes "used". So a bred heifer is new property eligible for either Bonus Depreciation or Section 179 deductions but a cow that has had a calf is eligible for Section 179 deductions but not Bonus Depreciation. Another regulation states that depreciable property can only be depreciated when it is "placed in service". A heifer is "placed in service" the year that she is bred. So you can depreciate bred heifers the year that you buy them but a heifer calf bought in the fall of the year that she is born is normally added to depreciation the year after she is purchased.

Depreciation lives for typical farm and ranch property is as follows:

- 1) Semi-tractor trucks 3 years.
- 2) Other vehicles and pickups 5 years.
- 3) Cows 5 years.
- 4) Most machinery 7 years.
- 5) Most horses 7 years.
- 6) Corrals, fences and grain bins 7 years.
- 7) Single purpose Ag buildings (calving sheds) 10 years.
- 8) Wells, most roads 15 years.
- 9) Machinery and shop buildings 20 years.

A series of revenue rulings indicate that earthen dams and irrigation ditches cannot be depreciated because they lack a definite life. These same earthen dams and irrigation ditches can usually be deducted in the year placed in service as a Conservation Expense. Conservation expenses are limited to those actively engaged in farming or ranching and are limited to 25% of gross income from farming and ranching and are subject to a 9 year

recapture provision if the land is sold.

Regular depreciation for farm and ranch property is 150% declining balance based on the above class lives. It does not matter for regular depreciation if the property is new or used. A 40 year old tractor is 7 year property the same as a brand new tractor. An 8 year old cow is 5 year property the same as a 2 year old cow. The tax code does make a distinction on horses, a 12 year or older horse is 5 year property rather than 7 years. You can elect to use straight line depreciation instead of the 150% declining balance if you choose. The election is simply made by the calculation used in the first year.

When depreciable property is sold, the cost is reduced by prior depreciation expense. This includes regular depreciation, Bonus depreciation and Section 179 deductions. For most personal property the gain is ordinary income rather than capital gain to the extent of prior depreciation, this includes breeding livestock, machinery, single purpose Ag buildings, fences, grain bins and vehicles. An example of this is if you bought a heifer for \$800 and took full depreciation deductions on the animal and then five years later sold her for \$1,200 you would have \$800 of ordinary income and \$400 of capital gain income.

*John Mitchell is a CPA with Casey Peterson & Associates Ltd, Rapid City, SD.*

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Farmer's Tax Guide highlights administrative and tax law changes for 2013 (10/24/2013)

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**Federal Taxes Weekly Alert,**

## **Farmer's Tax Guide highlights administrative and tax law changes for 2013**

### **IRS Publication 225, Farmer's Tax Guide**

IRS has released Publication 225, Farmer's Tax Guide, for use in preparing 2013 returns. It highlights several administrative and tax law changes for 2013.

*What's new for 2013.* Publication 225 examines these new items for 2013.

... *Standard mileage rate.* For 2013, the standard mileage rate for the cost of operating the taxpayer's car, van, pickup, or panel truck for each mile of business use is 56.5 cents (see Weekly Alert ¶ 14 11/29/2012).

... *Simplified method for business use of home deduction.* IRS has provided a simplified method to determine an individual's expenses for business use of his home (see Weekly Alert ¶ 9 01/17/2013).

... *Increased section 179 expense deduction dollar limits.* The maximum amount a taxpayer can elect to deduct for most section 179 property placed in service in 2013 is \$500,000. This limit is reduced by the amount by which the cost of the property placed in service during the tax year exceeds \$2 million (see Weekly Alert ¶ 48 08/15/2013).

... *Extension of special depreciation allowance for certain qualified property acquired after Dec. 31, 2007.* A taxpayer may be able to take a 50% special depreciation allowance for certain qualified property acquired after Dec. 31, 2007, and placed in service before Jan. 1, 2014 (see Weekly Alert ¶ 10 08/15/2013).

... *Expiration of the 3-year recovery period for certain race horses.* The 3-year recovery period for race horses two years old or younger will expire for such horses placed in service after Dec. 31, 2013.

... *Tax rates.* For tax years beginning in 2013, the social security part of the self-employment tax increases from 10.4% to 12.4%. As a result, the self-employment tax is increased from 13.3% to 15.3% (see Weekly Alert ¶ 20 10/18/2012).

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... *Maximum net earnings.* The maximum net self-employment earnings subject to the social security part (12.4%) of the self-employment tax increased to \$113,700 for 2013. There is no maximum limit on earnings subject to the Medicare part (2.9%) (see Weekly Alert ¶ 20 10/18/2012).

... *Net investment income tax (Form 8960).* For tax years beginning in 2013, individuals, estates, and trusts may be subject to the net investment income tax (see Weekly Alert ¶ 9 09/26/2013).

... *Social Security and Medicare Tax for 2013.* The employee tax rate for social security is 6.2%. The employer tax rate for social security remains unchanged at 6.2%. The social security wage base limit is \$113,700. The Medicare tax rate is 1.45% each for the employee and employer, unchanged from 2012. There is no wage base limit for Medicare tax (see Weekly Alert ¶ 20 10/18/2012). Also see "Additional Medicare Tax," below.

... *Additional Medicare Tax (Form 8959).* For tax years beginning in 2013, a 0.9% Additional Medicare Tax applies to a taxpayer's Medicare wages, Railroad Tax Act compensation, and self-employment income above a threshold amount. In addition to withholding Medicare tax at 1.45%, a taxpayer must withhold a 0.9% Additional Medicare Tax from wages the taxpayer pays to an employee in excess of \$200,000 in a calendar year. The taxpayer must begin withholding Additional Medicare Tax in the pay period in which the taxpayer pays wages in excess of \$200,000 to an employee and continue to withhold it each pay period until the end of the calendar year. Additional Medicare Tax is only imposed on the employee. There is no employer share of Additional Medicare Tax. All wages that are subject to Medicare tax are subject to Additional Medicare Tax withholding if paid in excess of the \$200,000 withholding threshold (see Weekly Alert ¶ 1 06/27/2013).

... *Leave-based donation programs to aid victims of Hurricane Sandy.* Under these programs, employees may donate their vacation, sick, or personal leave in exchange for employer cash payments made before Jan. 1, 2014, to qualified tax-exempt organizations providing relief for the victims of Hurricane Sandy. The donated leave will not be included in the income or wages of the employee. The employer may deduct the cash payments as business expenses or charitable contributions (see Weekly Alert ¶ 11 11/08/2012).

... *Work opportunity tax credit for qualified tax-exempt organizations hiring qualified veterans extended.* The work opportunity tax credit is now available for eligible unemployed veterans who begin work before Jan. 1, 2014. Qualified tax-exempt organizations that hire eligible unemployed veterans can claim the work opportunity tax credit against their payroll tax liability using Form 5884C, Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans (see Weekly Alert ¶ 2 03/14/2013).

... *Estimated tax.* For tax years beginning in 2013, the net investment income may need to be included when calculating estimated tax. Also, when figuring estimated tax, a taxpayer may need to include the 0.9% Additional Medicare Tax applicable to Medicare wages, Railroad Retirement Tax Act compensation, and self-employment income above the threshold amount. (see "Net investment income tax" and "Additional Medicare Tax," above).

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# Agricultural Law Digest

Volume 24, No. 20

October 4, 2013

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## The Long-Running Saga on Repairs v. Capitalization

-by Neil E. Harl\*

In a filing with the Federal Register on September 13, 2013,<sup>1</sup> the long-running saga on the line between repairs and capitalization for acquiring, maintaining, repairing and replacing tangible property added a new chapter. Only time will tell as to whether this will be followed by a more than temporary lull in the flow of new temporary, proposed and final regulations from the Department of the Treasury<sup>2</sup> and notices and revenue procedures<sup>3</sup> from the Internal Revenue Service on the subject.<sup>4</sup> The five sets of regulations have generally traced a path toward greater simplification and less complexity since the first set of proposed regulations was issued in 2006.<sup>5</sup>

### History of the controversy

In 2004, the Internal Revenue Service indicated that regulations would be forthcoming that would clarify the handling of repairs as well as expenditures for improving and rehabilitating property.<sup>6</sup> Proposed regulations were issued in 2006.<sup>7</sup> Those regulations focused heavily on unit-of-property determinations and a proposed repair allowance method (RAM).<sup>8</sup> Had those regulations been adopted it would have represented a significant shift in the rules governing whether those and similar types of expenditures could continue to be deducted or would have to be capitalized.

However, those regulations were withdrawn in a hail of controversy on March 10, 2008 and new regulations were proposed.<sup>9</sup> Those regulations were, in turn, withdrawn and a new set of temporary regulations was issued on December 23, 2011.<sup>10</sup> The temporary regulations were to become effective on or after January 1, 2012.<sup>11</sup> IRS announced on November 20, 2012, that the temporary repair regulations had been amended to extend the effective date to tax years beginning on or after January 1, 2014, with final regulations expected in 2013.<sup>12</sup> *Ann. 2013-7*<sup>13</sup> also stated that the effective date for *T.D. 9564*<sup>14</sup> was to be January 1, 2014.<sup>15</sup>

With considerable fanfare, the Department of the Treasury on September 13, 2013, issued *T.D. 9636*<sup>16</sup> which contained final regulations that provide guidance on the application of I.R.C. §§ 162(a) and 263(a). Those final regulations undertook to clarify and expand the standards in the current regulations under I.R.C. §§ 162(a) and 263(a), replaced and removed temporary regulations under I.R.C. §§ 162(a) and 263(a) and withdrew proposed regulations that cross referenced the text of those temporary regulations.<sup>17</sup> The final regulations do not finalize or remove the temporary regulations issued in 2011 under I.R.C. § 168 regarding

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Next issue will be published on October 25, 2013.

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general asset accounts and the disposition of property subject to I.R.C. § 168.<sup>18</sup> Rather new proposed regulations were issued.<sup>19</sup>

### The 2013 final regulations

The final regulations issued on September 13, 2013, are to be followed by all taxpayers commencing in tax years beginning on or after January 1, 2014.<sup>20</sup>

The stated objective of IRS in the final regulations is to reduce controversies with taxpayers which is to be accomplished by moving away from a “facts and circumstances” determination whenever possible as well as moving away from the subjective nature of the existing standards in general.

*Five main areas.* The final regulations make changes in each of five areas –

- Materials and supplies;<sup>21</sup>
- Repairs and maintenance;<sup>22</sup>
- Capital expenditures;<sup>23</sup>
- Amounts paid for the acquisition or production of tangible property;<sup>24</sup> and
- Amounts paid for the improvement of tangible property.<sup>25</sup>

*Reasons for changes mentioned in the Preamble to the regulations.* As stated in the Preamble to the regulations, changes to the temporary regulations issued earlier were made principally to “clarify, simplify and refine” the regulations and to create a series of new “safe harbors.” IRS specifically noted the following –

- A revised and simplified *de minimis* safe harbor permitting a taxpayer to deduct certain amounts paid for tangible property if the taxpayer had an applicable financial statement, had written accounting procedures for expensing amounts paid for the property under specified dollar amounts and treated such amounts as expenses on its applicable financial statement.<sup>26</sup>
- The extension of the safe harbor for routine maintenance of buildings which involves “. . . the recurring activities that a taxpayer expects to perform as a result of the taxpayer’s use . . . to keep the building structure or each building system in its ordinarily efficient operating condition.”<sup>27</sup>
- An annual election for buildings that cost \$1 million or less to deduct up to \$10,000 of maintenance costs or, if less, two percent of the building’s adjusted income tax basis.<sup>28</sup> The taxpayer must have average annual gross receipts of \$10 million or less during the three preceding tax years. For a lease, the unadjusted basis of the building is equal to the total amount of rent, on an undiscounted basis, paid or expected to be paid over the entire lease term, including expected renewal periods.
- A new annual election to capitalize repair costs that are capitalized on a taxpayer’s books and records.<sup>29</sup>
- The clarification of the criteria for defining betterments and restorations to tangible property.<sup>30</sup>

*Improving a unit of tangible property.* The final regulations continue the requirement of capitalization of amounts to improve a unit of tangible property.<sup>31</sup> A unit of property is considered to be improved if amounts are paid for activities performed by the taxpayer resulting in (1) a betterment to the particular unit of

property; (2) a restoration of the property; or (3) adaptation of the property to a new (or different) use.

### In conclusion

The tone and tenor of the new final regulations are significantly more friendly to taxpayers than their predecessors, dating back to 2006. That bodes well for those hoping that these regulations will mark the conclusion of the long saga on redrawing the line between repairs and expenses required to be capitalized.

### ENDNOTES

<sup>1</sup> T.D. 9636, 2013-2 C.B. \_\_\_, 78 Fed. Reg. 57686 (Sept. 19, 2013).

<sup>2</sup> See, e.g., T.D. 9564, Dec. 23, 2011 (2008 regulations withdrawn and new set of temporary regulations issued).

<sup>3</sup> See, e.g., Rev. Proc. 2012-9, 2012-1 C.B. 689; Notice 2004-6, 2004-1 C.B. 308 (warning of forthcoming regulations).

<sup>4</sup> See generally, Harl, “Temporary Regulations on Repairs, Depreciation and Capitalization,” 23 *Agric. L. Dig.* 41 (2012).

<sup>5</sup> See Mackay, Department of the Treasury, Office of Tax Policy, speaking on September 25, 2013, to KPMG, LLC tax practitioners.

<sup>6</sup> Notice 2004-6, 2004-1 C.B. 308.

<sup>7</sup> Prop. Treas. Reg. § 1.263-0, -1, -2, -3, Aug. 21, 2006. See NPRM REG 168745.

<sup>8</sup> *Id.*

<sup>9</sup> 73 Fed. Reg. 47, March 10, 2008.

<sup>10</sup> T.D. 9564, Dec. 23, 2011.

<sup>11</sup> *Id.*

<sup>12</sup> Notice 2012-73, 2012-2 C.B. 713.

<sup>13</sup> 2013-2 C.B. 308.

<sup>14</sup> Dec. 23, 2011.

<sup>15</sup> See, e.g., Temp Treas. Reg. § 1.162-4T(a) through (d) (repairs). Other sections had different effective dates).

<sup>16</sup> 78 Fed. Reg. 57686 (Sept. 19, 2013).

<sup>17</sup> T.D. 9636, 78 Fed. Reg. 57686 (Sept. 19, 2013), Summary.

<sup>18</sup> *Id.*

<sup>19</sup> NPRM REG 110732-13.

<sup>20</sup> Treas. Reg. § 1.162-3(j). However, taxpayers are permitted to choose to apply the 2011 temporary regulations to taxable years beginning on or after January 1, 2012 and before the applicability date of the final regulations.

<sup>21</sup> Treas. Reg. § 1.162-3.

<sup>22</sup> Treas. Reg. § 1.162-4.

<sup>23</sup> Treas. Reg. § 1.263(a)-1.

<sup>24</sup> Treas. Reg. § 1.263(a)-2.

<sup>25</sup> Treas. Reg. § 1.263(a)-3.

<sup>26</sup> Treas. Reg. §§ 1.263(a)-1(f), 1.162-3(f).

<sup>27</sup> Treas. Reg. § 1.263(a)-3(i).

<sup>28</sup> Treas. Reg. § 1.263(a)-3(h).

<sup>29</sup> Treas. Reg. § 1.263(a)-3(n).

<sup>30</sup> Treas. Reg. § 1.263(a)-3(j).

<sup>31</sup> Treas. Reg. § 1.263(a)-(3).

# CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

## ANIMALS

**HORSES.** The plaintiff was injured while riding a horse on a trail ride on the defendant's ranch. The plaintiff was injured when the horse brushed up against a tree and the branches injured the plaintiff's leg and hip. The defendant sought summary judgment at trial on the issues of (1) lack knowledge of vicious propensity of the horse, (2) signed release of liability, and (3) assumption of risk. The defendant appealed when the trial court denied all three elements of the motion. On appeal the court affirmed, holding that there was some evidence that the defendant knew about the danger from the horse rubbing against trees in that the defendant instructed the riders to push away against the trees if the horses rubbed against the trees. The court also held that the release of liability did not cover the trail ride because the release was signed in relation to horseriding lessons. Finally, the court held that there was an issue of fact as to whether the assumption of risk doctrine applied because the plaintiff was a novice rider and the defendants fitted the horses with bitless bridles, giving the riders less control over the horses. **Vanderbrook v. Emerald Springs Ranch, LLC, 2013 N.Y. App. Div. LEXIS 6171 (N.Y. Ct. App. 2013).**

## BANKRUPTCY

### GENERAL

**AUTOMATIC STAY.** The debtor had divorced prior to filing for bankruptcy and the divorce decree required the debtor to make monthly child support payments. The Office of the Texas Attorney General filed a claim in the bankruptcy case for unpaid child support payments and notified the IRS of the unpaid obligation. The IRS took a portion of the debtor's past year overpayment of federal taxes and sent the money to the Office of the Texas Attorney General which applied the payment to the past due amounts. The bankruptcy trustee sought to recover the funds as transferred in violation of the automatic stay. The court noted that Section 362(b)(2)(F) provides an exception to the automatic stay for the "interception of a tax refund, as specified in sections 464 and 466(a)(3) of the Social Security Act or under an analogous State law." The trustee sought an interpretation of the exception that the exception did not apply to bankruptcy estate property. The court held that the tax refund was only a claim of the estate and that, once the refund became subject to an offset under state law, the estate had no claim on the offset amount; therefore, the offset of the refund did not violate the automatic stay. **In re Good, 2013-2 U.S. Tax Cas. (CCH) ¶ 50,516 (Bankr. E.D. Texas 2013).**

## FEDERAL FARM PROGRAMS

**ANIMAL WELFARE ACT.** The APHIS has adopted as final regulations revising the definition of retail pet store and related regulations to bring more pet animals sold at retail under the protection of the Animal Welfare Act (AWA). The regulations narrow the definition of retail pet store so that it means a place of business or residence that each buyer physically enters in order to personally observe the animals available for sale prior to purchase and/or to take custody of the animals after purchase, and where only certain animals are sold or offered for sale, at retail, for use as pets. Retail pet stores are not required to be licensed and inspected under the AWA. The regulations also increase from three to four the number of breeding female dogs, cats, and/or small exotic or wild mammals that a person may maintain on his or her premises and be exempt from the licensing and inspection requirements if he or she sells only the offspring of those animals born and raised on his or her premises, for pets or exhibition. This exemption would apply regardless of whether those animals are sold at retail or wholesale. **78 Fed. Reg. 57227 (Sept. 18, 2013).**

**ORGANIC FOOD.** The AMS has issued a notice which describes the sunset review and renewal process for substances on the National List of Allowed and Prohibited Substances (National List), a subpart of the USDA organic regulations. The Organic Foods Production Act of 1990 requires that the National Organic Standards Board (NOSB), a 15-member federal advisory committee, review all substances and that the Secretary of Agriculture renew these substances, within 5 years of their addition to or renewal on the National List. This action of NOSB review and USDA renewal is commonly referred to as the "Sunset Process." The notice informs stakeholders about the process that the NOSB will use to complete their responsibility to review substances under OFPA's sunset provision. **78 Fed. Reg. 56811 (Sept. 16, 2013).**

## FEDERAL ESTATE AND GIFT TAXATION

**GENERATION SKIPPING TRANSFERS.** In the first tax year, the taxpayers, husband and wife, created and transferred cash to an irrevocable trust for the benefit of their grandchildren. In each of the following three years, the taxpayers made cash gifts to the trust. The taxpayers did not report these gifts on Forms 709, *United States Gift (and Generation-Skipping Transfer) Tax Returns*. As a result, the taxpayers' GST exemption was not allocated to

these gifts. The failure to allocate GST exemption to these gifts was discovered when the taxpayers retained new counsel. It was represented that the taxpayers each had sufficient GST exemption available to allocate to these gifts. The IRS granted an extension of time to file an allocation of the GST exemption to the transfers. **Ltr. Rul. 201338013, June 5, 2013.**

In one tax year, the taxpayers each individually formed three irrevocable trusts for the benefit of their three children and each taxpayer made a gift to each of the six trusts. All of the trusts had GST potential. The taxpayers retained a tax professional to prepare their Forms 709, *United States Gift (and Generation-Skipping Transfer) Tax Returns*, reporting the gifts to the trusts. The taxpayers did not elect to treat the gifts made by each as made one-half by each taxpayer, as provided under I.R.C. § 2513. On the Forms 709, the tax professional incorrectly reported the gifts to the trusts on Part 2 of Schedule A as “Direct Skips.” In addition, on Part 1 of Schedule C, the tax professional incorrectly treated the portion of each gift equal to the gift tax annual exclusion amount as nontaxable for GST tax purposes. In the next year, the taxpayers retained a new tax professional who discovered the mistakes on the Forms 709. Shortly thereafter one of the taxpayers died. The taxpayer and the executor of the decedent’s estate represent that the taxpayers each had available GST exemption to allocate to the gifts to the trusts. The IRS noted that the returns contained sufficient information to evidence the donors’ intent to allocate their respective GST exemption to the transfers to the trusts and granted an extension of time to file an allocation of the GST exemption to the transfers. **Ltr. Rul. 201338042, June 24, 2013.**

**MARITAL DEDUCTION.** The decedent had created a revocable trust, which became irrevocable upon the decedent’s death. Under the terms of the decedent’s will, the decedent bequeathed all of the real and tangible personal property outright to the surviving spouse and bequeathed the rest and residue of any property, real or personal, to the trust. Pursuant to the terms of the trust, upon the decedent’s death, the trustee was directed to divide the trust into a marital trust and a credit shelter trust. The trustee was directed to allocate that fraction of the trust assets that would pass free of federal and state death taxes to the credit shelter trust. Under the credit shelter trust, the trustee had discretion to pay so much of the net income and principal as was necessary for the health, education, support and maintenance of the spouse and the decedent’s children. Any undistributed income was to be accumulated and added to principal. Upon the spouse’s death, the credit shelter trust was to continue for the benefit of one child. The credit shelter trust would terminate when the child reached age 35 and the trust corpus was to be distributed to the child at that time. The spouse, the executrix of the decedent’s estate, allocated all of the assets of the trust to the credit shelter trust and did not establish the marital trust. The spouse timely filed the decedent’s Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return* and listed all of the decedent’s assets that passed outright to the spouse and the credit shelter trust on Schedule M. The credit shelter trust was listed under QTIP property with the result that the decedent’s estate was deemed to have made an election under I.R.C. § 2056(b)(7)(B)(v) to treat the credit shelter trust as qualified terminable interest property. With the assistance of new

counsel, the spouse discovered that the QTIP election for the credit shelter trust was not necessary to reduce the decedent’s estate tax liability to zero. The IRS ruled that the QTIP election was null and void because it was not necessary to reduce the decedent’s estate tax; therefore, (1) the trust property would not be included in the spouse’s estate; (2) the spouse would not be treated as making a gift under I.R.C. § 2519 if the spouse disposes of the income interest with respect to the property; and (3) the surviving spouse would not be treated as the transferor of the property for GST tax purposes under I.R.C. § 2652(a). **Ltr. Rul. 201338003, June 19, 2013.**

**REFUND.** The decedent died in 2002 and during the resulting probate of the will, the estate was subject to two lawsuits, one challenging the will and one challenging the actions of the executors. The executors obtained an extension of time to file the federal estate tax return but had to file for a second extension because of the uncertainties caused by the lawsuits. The second extension filing was made in 2003 on Form 4768, *Application for Extension of Time to File a Return*, was accompanied by a check for estimated estate taxes but no designation of the payment as a “deposit” or “payment” was made. The second extension was denied by the IRS which posted the check as a payment. The lawsuits ended in 2008 and the estate filed a return with the costs of the litigation as a deduction, causing the federal estate tax owed to decrease, with a refund claim for the overpayment. The IRS denied the refund as untimely claimed. The estate argued that *Rev. Rul. 84-58, 1984-2 C.B. 501* applied to require the IRS to treat undesignated funds as deposits if made prior to any examination. The IRS argued that a facts and circumstances test applied, using factors created by courts in applying *Rosenman v. United States, 323 U.S. 658 (1945)*. The court held first that *Rev. Rul. 84-58* did not create a *per se* rule for undesignated payments; therefore, the factors of the facts and circumstances test would be used in this case. The court held that the estate check was a payment because (1) the amount was a good faith estimate of the taxes owed and was paid in an orderly fashion; (2) the estate did not contest any tax liability at the time the check was sent; (3) the check was not designated as a deposit; (4) the IRS treated the check as a payment; and (5) the check was timely sent with an extension request. **Winford v. United States, 2013-2 U.S. Tax Cas. (CCH) ¶ 60,672 (W.D. La. 2013).**

**SPECIAL USE VALUATION.** The IRS has issued the 2013 list of average annual effective interest rates charged on new loans by the Farm Credit Bank system to be used in computing the value of real property for special use valuation purposes for deaths in 2013:

District	2013 Interest Rate
AgFirst, FCB	5.49
AgriBank, FCB	5.03
CoBank, FCB	4.56
Texas, FCB	4.99

District	States
AgFirst	Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, West Virginia

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**AgriBank** Arkansas, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Tennessee, Wisconsin, Wyoming

**CoBank** Alaska, Arizona, California, Colorado, Connecticut, Hawaii, Idaho, Kansas, Maine, Massachusetts, Montana, New Hampshire, New Jersey, New Mexico, New York, Nevada, Oklahoma, Oregon, Rhode Island, Utah, Vermont, Washington

**Texas** Alabama, Louisiana, Mississippi, Texas

Note, U.S. AgBank has been merged into CoBank, effective Jan. 1, 2012.  
**Rev. Rul. 2013-19, 2013-2 C.B. 240.**

## FEDERAL INCOME TAXATION

**CHARITABLE DEDUCTIONS.** The taxpayers, husband and wife, made several donations exceeding \$5,000 of clothing and housewares to a charitable organization. The taxpayers provided only receipts from the charity which listed the claimed value and which were signed by a charity employee. The taxpayers did not obtain an independent appraisal and did not file Form 8283, *Noncash Charitable Contributions*. Although the taxpayers presented a signed Form 8283 which they claimed was filed with their return, the IRS had no record of the form being filed. The court noted that even the taxpayers' Form 8283 did not contain the appraiser's declaration and no signature from the charity. The court held that the non-cash charitable contribution deduction was properly disallowed for lack of documentation as to how the donated items were acquired, the approximate date of acquisition, and the cost or adjusted basis of the property. In addition, the court held that an employee of the charity could not be a qualified appraiser. **Haskett v. Comm'r, T.C. Summary Op. 2013-76.**

**DEPENDENTS.** During the taxable year involved, the taxpayer's parent lived in a nursing home. The parent received federal and state assistance, social security payments and Medicare assistance. The taxpayers paid a portion of the nursing home costs and some medical costs. The parent's income for the year was less than \$3,500, the applicable exemption amount for 2008. The court held that the taxpayer could not claim a dependency deduction for the parent because the parent was not a qualifying relative because the parent's income was less than the exemption amount under I.R.C. § 151(d) and the taxpayer did not pay more than one-half of the support for the parent. **Haskett v. Comm'r, T.C. Summary Op. 2013-76**

**DEPRECIATION.** The IRS has issued proposed regulations regarding dispositions of property subject to depreciation under I.R.C. § 168 (Modified Accelerated Cost Recovery System (MACRS) property). The proposed regulations also amend the general asset account regulations under Treas. Reg. § 1.168(i)-1 and the accounting for MACRS property regulations under Treas. Reg. § 1.168(i)-7. The proposed regulations will affect all taxpayers that dispose of MACRS property and are generally

proposed to apply to tax years beginning on or after January 1, 2014. Temporary Reg. §§ 1.168(i)-1T and 1.168(i)-8T provide that each structural component of a building, condominium, or cooperative is the asset for tax disposition purposes. The proposed regulations amend those regulations to provide that a building (including its structural components), a condominium (including its structural components), or a cooperative (including its structural components) is the asset for disposition purposes. This rule allows taxpayers to forgo a loss upon the disposition of a structural component of a building without making a general asset account election as required under the temporary regulations. The proposed regulations allow a taxpayer to elect to claim a loss upon the disposition of a structural component (or a portion thereof) of a building or upon the disposition of a component (or a portion thereof) of any other asset without identifying the component as an asset before the disposition event by making a partial disposition election. The election is not available for (1) a disposition of a portion of an asset as a result of a casualty event described in I.R.C. § 165; (2) a disposition of a portion of an asset for which gain (determined without regard to I.R.C. § 1245 or § 1250) is not recognized in whole or in part under I.R.C. § 1031 or I.R.C. § 1033; (3) a transfer of a portion of an asset in a "step-in-the-shoes" transaction described in I.R.C. § 168(i)(7)(B); or (4) a sale of a portion of an asset. **78 Fed. Reg. 57547 (Sept. 19, 2013).**

On a timely filed federal tax return for one taxable year, the taxpayer, an S corporation, made an election not to deduct the 50-percent additional first year depreciation under I.R.C. § 168(k)(1) for all 7-year and 15-year property placed in service during that taxable year. On its timely filed federal tax return for the next taxable year, the taxpayer made an election not to deduct the 100-percent additional first year depreciation under I.R.C. § 168(k)(5) for all 15-year property placed in service during that taxable year. At the time the taxpayer filed its federal tax returns for the two taxable years, the taxpayer was not aware that its majority shareholder needed the taxpayer to flow-through the additional first year depreciation deduction to offset other income on that individual's federal income tax returns for the two taxable years. The taxpayer claimed that, if the taxpayer had been made aware of this situation before the taxpayer filed its federal tax returns for the two taxable years, the taxpayer would have claimed the additional first year depreciation deduction for the qualified property placed in service in the two taxable years. The IRS granted an extension of time for the taxpayer to revoke both elections. **Ltr. Rul. 201337013, May 22, 2013.**

**DISASTER LOSSES.** On September 4, 2013, the President determined that certain areas in Arkansas are eligible for assistance from the government under the Disaster Relief and Emergency Assistance Act (42 U.S.C. § 5121) as a result of severe storms, tornadoes and flooding which began on August 8, 2013. **FEMA-4143-DR.** On September 6, 2013, the President determined that certain areas in Missouri are eligible for assistance from the government under the Act as a result of severe storms and flooding which began on June 26, 2013. **FEMA-4144-DR.** On September 14, 2013, the President determined that certain areas

in Colorado are eligible for assistance from the government under the Act as a result of severe storms and flooding which began on September 11, 2013. **FEMA-4145-DR**. Accordingly, taxpayers in the areas may deduct the losses on their 2012 federal income tax returns. See I.R.C. § 165(i).

**DISCHARGE OF INDEBTEDNESS.** The taxpayers, husband and wife, each received a Schedule K-1 from an LLC that showed their share of LLC discharge of indebtedness income. The Schedule K-1s also included a footnote stating that the partners may be able to exclude some or all of the cancellation of debt income pursuant to I.R.C. § 108(c)(3)(C), which relates to qualified real property business indebtedness. Prior to LLC filing its federal tax return, the taxpayers orally informed the LLC that they intended to make the I.R.C. § 108(c)(3)(C) election on their joint federal income tax return. However, the taxpayers' Form 1040 was prepared by a tax professional, who did not take into account the Schedule K-1's footnote regarding I.R.C. § 108(c), did not discuss the I.R.C. § 108(c)(3)(C) and Treas. Reg. § 1.108-5(b) election with taxpayers, and did not make the election on the taxpayers' behalf to reduce the basis of depreciable property and to exclude income resulting from the discharge of qualified real property business indebtedness. The error was not discovered until the next year's Schedule K-1s from the LLC which showed a reduced tax basis for the taxpayers' capital accounts and, pursuant to Treas. Reg. § 1.1017-1, a reduction in the taxpayers' proportionate interest in the adjusted basis of LLC's depreciable property as though the § 108(c)(3)(C) election had been made. The IRS granted the taxpayers an extension of time to make the election under I.R.C. § 108(c)(3)(C). **Ltr. Rul. 201338007, June 11, 2013.**

**HOBBY LOSSES.** The taxpayers were mother and daughter and operated a Swedish Warmblood horse breeding activity as a partnership. The court held that the activity was not entered into with the intent to make a profit because (1) although the taxpayers had a business plan, the plan did not contain sufficient specifics as to how to make the activity profitable, the taxpayer did not alter the plan to make the activity profitable and the plan did not deal with some of the difficult issues involved with horse breeding and sales; (2) the taxpayers failed to show that they maintained accurate and complete records, other than receipts, sufficient to monitor the progress of the business; (3) the taxpayers carried no business insurance; (4) although the taxpayers sought expert advice when the activity started, the taxpayers failed to seek further advice on how to change the operation to make it profitable; (5) although the taxpayers spent considerable amount of time on the activity, they failed to substantiate their claims of extensive hours, especially considering their other employment; (6) the taxpayers had no expectation of appreciation of value of the horses, particularly where they failed to sell horses at their prime value; (7) the activity had no profitable years; (8) the activity produced only minimal and sporadic revenues; and (9) the tax losses offset substantial income from other sources. **Rodriguez v. Comm'r, T.C. Memo. 2013-221.**

**INNOCENT SPOUSE RELIEF.** The IRS has issued a revenue procedure that would update *Rev. Proc. 2003-61, 2003-*

*2 C.B. 296*, which provided guidance regarding equitable relief from income tax liability under I.R.C. §§ 66(c) and 6015(f). This update to *Rev. Proc. 2003-61* addresses the criteria used in making innocent spouse relief determinations for Section 6015(f) equitable relief cases and revises the factors for granting equitable relief. The revenue procedure expands how the IRS will take into account abuse and financial control by the non-requesting spouse in determining whether equitable relief is warranted. The revenue procedure also provides for streamlined case determinations; new guidance on the potential impact of economic hardship; and the weight to be accorded to certain factual circumstances in determining equitable relief. **Rev. Proc. 2013-34, I.R.B. 2013-42.**

The taxpayer and spouse filed a joint return for 2007, and although the return showed a tax owed, no payment was made. The taxpayer signed the return knowing that no payment was to be made. The taxes were not paid because of the spouse's illness and lack of income from one of the spouse's business. The taxpayer sought innocent spouse relief based on economic hardship. However, the taxpayer did not provide sufficient information to determine the effect of the taxes on the taxpayer's finances, and the relief was denied. The court held that, even using the more relaxed criteria of *Notice 2012-8, 2012-1 C.B. 309*, the taxpayer was not entitled to relief because the taxpayer was aware that no taxes would be paid and the taxpayer failed to show that any economic hardship would result from payment of the taxes. **Wallace v. Comm'r, T.C. Memo. 2013-218.**

#### PARTNERSHIPS

**ELECTION TO ADJUST BASIS.** The taxpayer was formed as a limited liability company and elected to be taxed as a partnership. During the tax year, an interest in the taxpayer was sold to a new member; however, the taxpayer's tax advisor failed to notify the taxpayer of the election to adjust the basis of the taxpayer's assets after the transaction. The IRS granted the taxpayer an extension of time to make the election. **Ltr. Rul. 201337010, April 23, 2013.**

**REFUNDS.** The IRS has issued a notice which provides guidance for employers and employees to make claims for refund or adjustments of overpayments of Federal Insurance Contributions Act (FICA) taxes and federal income tax withholding (employment taxes) with respect to certain benefits provided to same-sex spouses and remuneration paid to same-sex spouses resulting from the United States Supreme Court decision in *United States v. Windsor, 570 U.S. \_\_\_, 133 S.Ct. 2675 (2013)* and the holdings of *Rev. Rul. 2013-17, 2013-2 C.B. 201*. **Notice 2013-61, I.R.B. 2013-42.**

**RETURNS.** The IRS has issued a reminder to taxpayers whose tax-filing extension runs out on Oct. 15, 2013 to double check their returns for often-overlooked tax benefits and then file their returns electronically using IRS e-file or the Free File system. The IRS noted that many of the more than 12 million taxpayers who requested an automatic six-month extension this year have yet to file. Though Oct. 15 is the last day for most people, some still have more time, including members of the military and others serving in Afghanistan or other combat zone localities who typically

have until at least 180 days after they leave the combat zone to both file returns and pay any taxes due. People with extensions in parts of Colorado affected by severe storms, flooding, landslides and mudslides also have more time, until Dec. 2, 2013, to file and pay. Before filing, the IRS encourages taxpayers to take a moment to see if they qualify for these and other often-overlooked credits and deductions: (1) Benefits for low-and moderate-income workers and families, especially the Earned Income Tax Credit. The online special EITC Assistant can help taxpayers see if they're eligible (2) Savers credit, claimed on Form 8880, for low-and moderate-income workers who contributed to a retirement plan, such as an IRA or 401(k). (3) American Opportunity Tax Credit, claimed on Form 8863, and other education tax benefits for parents and college students. (4) Same-sex couples, legally married in jurisdictions that recognize their marriages, are now treated as married, regardless of where they live. This applies to any return, including 2012 returns, filed on or after Sept. 16, 2013. This means that they generally must file their returns using either the married filing jointly or married filing separately filing status. **IR-2013-77.**

**SAFE HARBOR INTEREST RATES**

	October 2013			
	Annual	Semi-annual	Quarterly	Monthly
	<b>Short-term</b>			
AFR	0.32	0.32	0.32	0.32
110 percent AFR	0.35	0.35	0.35	0.35
120 percent AFR	0.38	0.38	0.38	0.38
	<b>Mid-term</b>			
AFR	1.93	1.92	1.92	1.91
110 percent AFR	2.12	2.11	2.10	2.10
120 percent AFR	2.31	2.30	2.29	2.29
	<b>Long-term</b>			
AFR	3.50	3.47	3.46	3.45
110 percent AFR	3.86	3.82	3.80	3.79
120 percent AFR	4.20	4.16	4.14	4.12

**Rev. Rul. 2013-21, I.R.B. 2013-41.**

**S CORPORATIONS**

**SUBSIDIARIES.** The taxpayer was an S corporation which formed two subsidiaries. Although the shareholders of the three corporations treated the subsidiaries as qualified subchapter S subsidiaries, the taxpayer failed to file the election to treat the two subsidiaries as QSubs. The IRS granted an extension of time to file the elections. **Ltr. Rul. 201337004, May 14, 2013.**

The taxpayer was an S corporation which formed a subsidiary. Although the shareholders of the the corporations treated the subsidiary as a qualified subchapter S subsidiary, the taxpayer failed to file the election to treat the subsidiary as a QSubs. The IRS granted an extension of time to file the election. **Ltr. Rul. 201338039, May 20, 2013.**

**TRAVEL EXPENSES.** The IRS has issued a notice which provides the 2013-2014 special *per diem* rates for taxpayers to use in substantiating the amount of ordinary and necessary business expenses incurred while traveling away from home. The special transportation industry meal and incidental expenses (M&IE) rates are \$59 for any locality of travel in the continental United States and \$65 for any locality of travel outside the continental United States

(CONUS). The rate for the incidental expenses only deduction is \$5 per day for travel inside or outside the Continental United States. The *per diem* rates in lieu of the rates described in *Notice 2012-63, 2012-2 C.B. 496* (the *per diem* substantiation method) are \$251 for travel to any high-cost locality and \$170 for travel to any other locality within CONUS. The amount of the \$251 high rate and \$170 low rate that is treated as paid for meals for purposes of I.R.C. § 274(n) is \$65 for travel to any high-cost locality and \$52 for travel to any other locality within CONUS. The *per diem* rates in lieu of the rates described in *Notice 2012-63* (the meal and incidental expenses only substantiation method) are \$65 for travel to any high-cost locality and \$52 for travel to any other locality within CONUS. **Notice 2013-65, I.R.B. 2013-42.**

The taxpayer owned and operated a tax return preparation business out of the taxpayer's home. The taxpayer claimed deductions on Schedule C for travel, meals and lodging which were disallowed by the IRS. The taxpayer claimed that the travel, to hotels and casinos, was for the purpose of rest from the strains of business. The court agreed with the IRS that the travel expenses were personal and not related to the business. Although the taxpayer had receipts of the meals with employees, the deduction for the expenses for the meals was also denied for lack of any business purpose identified by the taxpayer. The taxpayer also claimed rent expense for the business use of the first floor of the taxpayer's home. The court disallowed the deduction for rent because the taxpayer provided no evidence showing that the first floor of the residence was used exclusively on a regular basis for a business purpose. **Linzy v. Comm'r, T.C. Memo. 2013-219.**

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The topics include:

## First day

### FARM INCOME TAX

#### New Legislation

#### Reporting Farm Income

- Constructive receipt of income
- Deferred payment and installment payment arrangements for grain and livestock sales
- Using escrow accounts
- Payments from contract production
- Development in SE tax for CRP payments
- Leasing land to family entity
- Items purchased for resale
- Items raised for sale
- Crop insurance proceeds
- Weather-related livestock sales
- Sales of diseased livestock
- Reporting federal disaster assistance benefits
- Gains and losses from commodity futures, including consequences of exceeding the \$5 million limit

#### Claiming Farm Deductions

- Soil and water conservation expenditures
- Fertilizer deduction election
- Depreciating farm tile lines
- Farm lease deductions
- Prepaid expenses
- Preproductive period expense provisions
- Regular depreciation, expense method depreciation, bonus depreciation
- Paying rental to a spouse
- Paying wages in kind
- Section 105 plans

#### Sale of Property

- Income in respect of decedent
- Sale of farm residence
- Installment sale including related party rules
- Private annuity

- Self-canceling installment notes
- Sale and gift combined.

#### Like-Kind Exchanges

- Requirements for like-kind exchanges
- "Reverse Starker" exchanges
- What is "like-kind" for realty
- Like-kind guidelines for personal property
- Partitioning property
- Exchanging partnership assets

#### Taxation of Debt

- Turnover of property to creditors
- Discharge of indebtedness
- Taxation in bankruptcy

## Second day

### FARM ESTATE AND BUSINESS PLANNING

#### New Legislation

#### Succession planning and the importance of fairness

#### The Liquidity Problem

#### Property Held in Co-ownership

- Federal estate tax treatment of joint tenancy
- Severing joint tenancies and resulting basis
- Joint tenancy and probate avoidance
- Joint tenancy ownership of personal property
- Other problems of property ownership

#### Federal Estate Tax

- The gross estate
- Special Use Valuation
- Family-owned business deduction recapture
- Property included in the gross estate
- Traps in use of successive life estates
- Basis calculations under uniform basis rules
- Valuing growing crops
- Claiming deductions from the gross estate
- Marital and charitable deductions
- Taxable estate
- The applicable exclusion amount

- Unified estate and gift tax rates
- Portability and the new regulations
- Generation-skipping transfer tax
- Importance of the Rule Against Perpetuities

#### Gifts

- Reunification of gift tax and estate tax
- Gifts of property when debt exceeds basis

#### Use of the Trust

#### The General Partnership

- Small partnership exception
- Eligibility for Section 754 elections

#### Limited Partnerships

#### Limited Liability Companies

- Developments with passive losses
- Corporate-to-LLC conversions
- Eligibility for "small partnership" exception
- New regulations for LLC and LLP losses

#### Closely Held Corporations

- State anti-corporate farming restrictions
- Developing the capitalization structure
- Tax-free exchanges
- Would incorporation trigger a gift because of severance of land held in joint tenancy?
- "Section 1244" stock

#### Status of the Corporation as a Farmer

- The regular method of income taxation
- The Subchapter S method of taxation, including the "two-year" rule for trust ownership of stock

#### Underpayment of wages and salaries

#### Financing, Estate Planning Aspects and

#### Dissolution of Corporations

- Corporate stock as a major estate asset
- Valuation discounts
- Dissolution and liquidation
- Reorganization

#### Social Security

- In-kind wages paid to agricultural labor

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## ¶ 242,705. General Rule for Deducting Payments for Materials and Supplies

Generally, amounts paid to acquire or produce nonincidental materials and supplies are deductible in the tax year in which the materials and supplies are first used or consumed in the taxpayer's operations (Reg. Sec. 1.162-3(a)(1); Reg. Sec. 1.162-3T(a)(1)).

Amounts paid to acquire or produce incidental materials and supplies that are carried on hand and for which no record of consumption is kept or of which physical inventories at the beginning and end of the tax year are not taken, are deductible in the tax year in which these amounts are paid, provided that taxable income is clearly reflected (Reg. Sec. 1.162-3(a)(2); Reg. Sec. 1.162-3T(a)(2)).

For this purpose, in the case of a taxpayer using an accrual method of accounting, the terms "amount paid" means a liability incurred. A liability cannot be taken into account before the tax year during which it is incurred (Reg. Sec. 1.162-3(c)(5); Reg. Sec. 1.162-3T(c)(4)). The term "produce" means construct, build, install, manufacture, develop, create, raise, or grow. Amounts paid to produce materials and supplies are subject to the uniform capitalization (UNICAP) rules of Code Sec. 263A (Reg. Sec. 1.162-3(c)(6); Reg. Sec. 1.162-3T(c)(5)). See ¶242,380 for a discussion of the UNICAP rules.

For purposes of the rules on the treatment of materials and supplies, the term "materials and supplies" means tangible property used or consumed in the taxpayer's operations, property that is not inventory, and property that:

- (1) is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property (Reg. Sec. 1.162-3(c)(1)(i); Reg. Sec. 1.162-3T(c)(1)(i));
- (2) consists of fuel, lubricants, water, and similar items, that are reasonably expected to be consumed in 12 months or less, beginning when used in taxpayer's operations (Reg. Sec. 1.162-3(c)(1)(ii) Reg. Sec. 1.162-3T(c)(1)(ii));
- (3) is a unit of property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations (Reg. Sec. 1.162-3(c)(1)(iii); Reg. Sec. 1.162-3T(c)(1)(iii));
- (4) is a unit of property that has an acquisition cost or production cost of \$200 or less - \$100 or less under the 2011 temporary regulations - or other amount as identified in published guidance in the Federal Register or in the Internal Revenue Bulletin (Reg. Sec. 1.162-3(c)(1)(iv); Reg. Sec. 1.162-3T(c)(1)(iv)); or
- (5) is identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as materials and supplies for which treatment is permitted under this rule (Reg. Sec. 1.162-3(c)(1)(v); Reg. Sec. 1.162-3T(c)(1)(v)).

**Example:** FleetCo, a calendar year, accrual method taxpayer, owns a fleet of aircraft that it operates in its business. In 2015, FleetCo buys a stock of spare parts, which it uses to maintain and repair its aircraft. FleetCo keeps a record of consumption of these spare parts. In 2016, FleetCo uses the spare parts for the repair and maintenance of one of its aircraft. Each aircraft constitutes a unit of property under Reg. Sec. 1.263(a)-3(e), and the spare parts do not constitute rotatable or temporary spare parts. The repair and maintenance activities do not improve the aircraft. These parts are materials and supplies because they are components acquired and used to maintain and repair FleetCo's aircraft.

Under the general rule for materials and supplies, the amounts FleetCo paid for the spare parts in 2015 are deductible in 2016, the tax year in which the spare parts are first used to repair and maintain the aircraft.

**Example:** FreightCo operates a fleet of aircraft that carries freight for its customers. FreightCo has several storage tanks on its premises, which hold jet fuel for its aircraft. Once the jet fuel is placed in FreightCo's aircraft, the jet fuel is reasonably expected to be consumed within 12 months. On December 31, 2015, FreightCo buys a two-year supply of jet fuel. In 2016, FreightCo uses a portion of the jet fuel purchased on December 31, 2015, to fuel the aircraft used in its business. The jet fuel FreightCo purchased in 2015 constitutes a material or supply because it is reasonably expected to be consumed within 12 months from the time it is placed in FreightCo's aircraft. Under the general rule for materials and supplies, FreightCo may deduct in 2016 the amounts paid for the portion of jet fuel used in the operation of its aircraft in 2016.

**Example:** RentalCo operates a business that rents out a variety of small individual items to customers (rental items). RentalCo maintains a supply of rental items on hand. In 2015, RentalCo buys a large quantity of rental items to use in its rental business. Each rental item constitutes a unit of property under Reg. Sec. 1.263(a)-3(e) and costs \$200 or less. In 2016, RentalCo begins using all the rental items purchased in 2015 by providing them to customers of its rental business. RentalCo does not sell or exchange these items on established retail markets at any time after the items are used in the rental business. The rental items constitute materials and supplies. Under the general rule for materials and supplies, the amounts RentalCo paid for the rental items in 2015 are deductible in 2016, the tax year in which the rental items are used in RentalCo's business.

**Example:** BillingCo provides billing services to its customers. In 2015, BillingCo pays amounts to buy 50 scanners to be used by its employees. Each scanner constitutes a unit of property under Reg. Sec. 1.263(a)-3(e) and costs less than \$200. In 2015, BillingCo's employees begin using 35 of the scanners, and BillingCo stores the remaining 15 scanners for use in a later tax year. The scanners constitute materials and supplies. Under the general rule for materials and supplies, the amounts BillingCo paid for 35 of the scanners are deductible in 2015, the tax year in which BillingCo first uses each of those scanners. The amounts BillingCo paid for each of the remaining 15 scanners are deductible in the tax year in which each machine is first used in BillingCo's business.

Certain safe harbor revenue procedures allow taxpayers to treat certain property as materials and supplies. For example, Rev. Proc. 2002-12 allows a taxpayer to treat smallwares as materials and supplies that are not incidental under Reg. Sec. 1.162-3. Similarly, Rev. Proc. 2002-28 allows a qualifying small business taxpayer to treat certain inventoriable items in the same manner as materials and supplies that are not incidental under Reg. Sec. 1.162-3. Neither the 2011 temporary regulations nor the 2013 final regulations supersede, obsolete, or replace these revenue procedures to the extent they deem certain property to constitute materials and supplies under Reg. Sec. 1.162-3. This designated property continues to qualify as materials and supplies under the regulations because the property is identified in published guidance as materials and supplies (T.D. 9636 (9/19/13); T.D. 9564 (12/27/11)).

In determining whether a unit of property has an economic useful life of 12 months or less, the economic useful life of a unit of property is not necessarily the useful life inherent in the property; rather, it is the period over which the property may reasonably be expected to be useful to the taxpayer or, if the taxpayer is engaged in a trade or business or an activity for the production of income, the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or for the production of income (Reg. Sec. 1.162-3T(c)(4)(i); Reg. Sec. 1.162-3T(c)(3)(i)).

For taxpayers with an "applicable financial statement," also known as AFS, the economic useful life of a unit of property is the useful life initially used by the taxpayer in determining depreciation in its applicable financial statement, regardless of any salvage value of the property. The taxpayer's applicable financial statement is the taxpayer's financial statement listed in below with the highest priority. The financial statements are, in descending priority:

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- (1) a financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);
- (2) a certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for:
  - (a) credit purposes;
  - (b) reporting to shareholders, partners, or similar persons; or
  - (c) any other substantial nontax purpose; or
- (3) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agencies (other than the SEC or the IRS) (Reg. Sec. 1.162-3(c)(4)(iii); Reg. Sec. 1.162-3T(c)(3)(iii)).

If a taxpayer treats amounts paid for a unit of property as an expense in its applicable financial statement on a basis other than the useful life of the property, or if a taxpayer does not depreciate the unit of property on its applicable financial statement, the economic useful life of the unit of property is determined under the general rule in Reg. Sec. 1.162-3(c)(4)(i) or Reg. Sec. 1.162-3T(c)(3)(i), as applicable. For example, if a taxpayer has a policy of treating as an expense on its applicable financial statement amounts paid for a unit of property costing less than a certain dollar amount, notwithstanding that the unit of property has a useful life of more than one year, the economic useful life of the unit of property must be determined under the general rule in Reg. Sec. 1.162-3(c)(4)(i) or Reg. Sec. 1.162-3T(c)(3)(i), as applicable.

If a taxpayer does not have an applicable financial statement for the tax year in which a unit of property was originally acquired or produced, the economic useful life of the unit of property must be determined under the general rule in Reg. Sec. 1.162-3T(c)(4)(i) or Reg. Sec. 1.162-3T(c)(3)(i), (Reg. Sec. 1.162-3T(c)(4)(ii); Reg. Sec. 1.162-3T(c)(3)(ii)).

**Compliance Tip:** The provisions of the 2013 final regulations relating to materials and supplies generally apply to amounts paid or incurred in tax years beginning on or after January 1, 2014 (Reg. Sec. 1.162-3(j)(1)). However, taxpayers have the option of also applying the 2013 final regulations to amounts paid or incurred in tax years beginning on or after January 1, 2012 (Reg. Sec. 1.162-3(j)(2)). As an alternative, a taxpayer may choose to apply the provisions of the 2011 temporary regulations to amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012, and before January 1, 2014.

Rev. Proc. 2012-19 provides the procedures by which taxpayers may obtain automatic IRS consent to change to their methods of accounting to comply with Reg. Sec. 1.162-3T. Taxpayers choosing to apply the provisions of Reg. Sec. 1.162-3T to tax years beginning on or after January 1, 2012, and before the applicability date of the final regulations may also obtain the automatic consent of the IRS to change their methods of accounting under Rev. Proc. 2012-19 (Notice 2012-73).

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Chapter 9: Farm Income and Expenses (Schedule F)

Key Issue 9K: Limitation on Deductibility of Farm Losses

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## Key Issue 9K: Limitation on Deductibility of Farm Losses

Effective for tax years beginning in and after 2010, individual taxpayers that receive any direct or counter-cyclical payment, any payment elected to be received in lieu of such payment, or any CCC loan are limited in terms of the deductibility of a Schedule F farming loss [IRC Sec. 461(j)(1)]. **Applicable subsidy** payments for this provision do not include CRP payments. The definition of a farming business for this provision is the same as that used for purposes of Schedule J **farm** income averaging (see Key Issue 9J), with a slightly expanded definition for specified processing activities.

### Calculating the Excess Farm Loss

The amount of **farm** loss not deductible is equal to the excess of [IRC Sec. 461(j)(4)(A)]:

1. the aggregate deductions of the farmer for the year attributable to the farming business, over
2. the sum of:
  - a. the aggregate gross income or gain of the farmer for the year attributable to farming, plus
  - b. a threshold amount for the tax year.

The *threshold amount* for any year is the greater of \$300,000 (\$150,000 for married filing separately) or the total of net **farm** income for the previous five tax years [IRC Sec. 461(j)(4)(B)].

**Preparation Pointer:** The instructions to Schedule F provide several worksheets for calculating the excess **farm** loss in different taxpayer situations. The loss limitations are included in net income for AMT purposes. Because AMT is considered in determining the threshold amount from prior year information, a taxpayer subject to AMT in a prior year must recalculate threshold amounts on the worksheets.

**Observation: Farm** losses arising by reason of fire, storm, or other casualty, or because of disease or drought are not subject to the limitations [IRC Sec. 461(j)(4)(D)].

**Example 9K-1: Previous farm income allows deductibility of farm loss.**

Kyle, a Schedule F farmer, has \$1 million of net income from farming in each of the five tax years from 2006-2010, and incurs a \$5 million Schedule F loss in 2011. The deductible farming loss in 2011 is limited to the greater of (1) \$300,000, or (2) \$5 million (total net **farm** income for the previous five tax years). Because the threshold amount equals the farming loss for 2011, the \$5 million Schedule F loss in 2011 is fully deductible by Kyle.

**Observation:** If Kyle had no other income or deductions in any of the tax years 2006-2010, the \$5 million Schedule F loss for 2011 could be carried back under the net operating loss rules to those previous five years, reducing Kyle's taxable income in each of the years 2006-2010 to zero. See Key Issue 13A.

Carryover of Disallowed Losses Any **farm** loss disallowed in a particular year will be treated as a deduction attributable to farming in the next tax year. For purposes of calculating total net **farm** income for the prior five-year period, any loss that has been limited under this provision and is carried forward is taken into account only in the year in which that loss is allowed as a deduction. No limit for the carryforward period is stated.

**Example 9K-2: Excess loss disallowed and carried forward.**

Farmer Tom has \$300,000 of net **farm** income and \$700,000 of nonfarm income in 2006. Each year from 2007-2010, he has \$1,000,000 of net **farm** income. In 2011, Tom incurs a \$7,000,000 **farm** loss. His deductible farming loss in 2011 is limited to his threshold amount, which is the greater of (1) \$300,000 or (2) \$4,300,000 (total net **farm** income for the previous five tax years). Therefore, Tom's farming loss will be limited to \$4,300,000 in 2011, and the remaining \$2,700,000 (\$7,000,000 – \$4,300,000) is disallowed as an excess **farm** loss.

The 2011 **farm** loss of \$4,300,000 is carried back under IRC Sec. 172(b)(1)(G) and allowed as a deduction in each of the five previous tax years. The loss will first offset the \$300,000 of **farm** income and \$700,000 of nonfarm income in 2006 to zero. Taxable income for 2007, 2008, and 2009 will also be reduced to zero. The remaining allowable **farm** loss of \$300,000 reduces 2010 taxable income to \$700,000.

Tom's excess **farm** loss that was disallowed in 2011 will be treated as a deduction attributable to his farming business in 2012.

## Application to Partnerships and S Corporations

In the case of a partnership or S corporation, the limit is applied at the partner or shareholder level. Accordingly, each partner or shareholder takes into account his or her proportionate share of the income,

gain, or deduction from the farming business of the partnership or S corporation, along with any **applicable subsidies** received by the partnership or S corporation during the tax year [IRC Sec. 461(j)(5)].

### **Coordination with Passive Activity Loss Rules**

The excess loss disallowance rule in IRC Sec. 461(j) is applied before the application of the passive loss rules of IRC Sec. 469. Accordingly, even if a **farm** loss is not disallowed as an excess **farm** loss, the passive loss rules could prevent a farmer not materially participating in the farming activity from currently deducting the **farm** loss [IRC Sec. 461(j)(7)]. The excess loss calculation worksheet should be completed before carrying the loss to Form 8582. If the taxpayer's entire investment is not at risk, and the at-risk limitations also apply, the worksheet is still prepared first, followed by the Form 6198 (At-Risk Limitations) and then Form 8582 (Passive Activity Loss Limitations).

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**Bill Stewart**

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From: johnalancohan@aol.com  
Sent: Monday, November 04, 2013 10:56 AM  
Subject: NEW ARTICLE FOR PUBLICATION

FALL 2013

FOR PUBLICATION:

**Tax Court Case Discusses “Market Study”  
By John Alan Cohan, Attorney at Law**

In the Tax Court case, *Richard H. Daley*, T.C. Memo 1996-259, an Arizona surgeon was denied deductions with respect to his cutting horse activity. The Tax Court, which in recent years has become more and more hard-nosed, concluded that the activity was not conducted for profit within the relevant IRS Regulations.

A number of facts worked against Dr. Daley: (1) He entered the activity without the aid of a written market study; (2) the evidence suggested that his motive for entering the activity was recreational; (3) he never relied on a formal profit or business plan; (4) in managing the activity he used a ledger to record various transactions and events, and had a separate “drop” file for each horse--but failed to maintain them in a completely accurate manner; (5) while he claimed to have devoted 10-12 hours per week to the horse activity, he was unable to substantiate this to the Court’s satisfaction.

The Court suggested there should have been “a formal market study prior to undertaking his horse activity.” Under this Court’s criteria, very few horse owners would pass muster. The opinion suggests that taxpayers in the horse industry are going to have to engage in a lot more of formalities insofar as documenting how they started the activity.

If you have a significant amount of losses you have a good chance of eventually being audited; it is therefore very important to document your compliance with IRS Regulations pertaining to the hobby loss rule.

Dr. Daley was unable to show that he consulted with industry experts prior to entering the activity. He testified that he had such consultations, but the judge found his testimony *lacking in credibility*. There was no documentation to back him up. This case therefore amplifies the importance of establishing groundwork documentary evidence and preserving it.

It is important to maintain inventory records on each animal, including parentage, birth date, birth weight, and registration information. There should be a chart of horses owned and sold, with details. It is important to keep separate files on each horse.

If you are audited, it is important to immediately obtain legal assistance. Evidence of your businesslike purpose should be presented to the auditor in the most favorable light. Your business



plan should be set forth in a clear and concise manner. How you eventually expect to make a profit should be made clear. If losses are due to unforeseen circumstances or setbacks, including disease or fluctuating market prices, you should maintain documentary evidence to prove these facts. The IRS also wants to see evidence that you keep abreast of industry practices and that you investigate the possibility of changing or abandoning current methods of operation in an effort to mitigate losses.

In many cases, taxpayers have convinced the Tax Court that their horse activity is a business rather than a hobby despite over two decades of losses. In those cases the taxpayers had good evidence showing the businesslike manner in which they operated their venture. The horse owners who come through well in audits usually have a working knowledge about genetic principles and other elements of animal husbandry. They usually strive to raise high quality animals, and have a plan on how to market them or otherwise make a profit.

[John Alan Cohan is a lawyer who has served the horse, livestock and farming industries since 1981. He serves can be reached by telephone at (310) 278-0203 or via e-mail at [JohnAlanCohan@aol.com](mailto:JohnAlanCohan@aol.com). His website is [www.johnalancohan.com](http://www.johnalancohan.com).]

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Reg §1.183-2 Activity not engaged in for profit defined.

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**Federal Regulations****Reg §1.183-2. Activity not engaged in for profit defined.**

 **Effective:** Reg. §1.183-2 predates P.L. 99-514, 10/22/1986, the Tax Reform Act of 1986.

**(a) In general.** For purposes of section 183 and the regulations thereunder, the term “activity not engaged in for profit” means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212. Deductions are allowable under section 162 for expenses of carrying on activities which constitute a trade or business of the taxpayer and under section 212 for expenses incurred in connection with activities engaged in for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Except as provided in section 183 and §1.183-1, no deductions are allowable for expenses incurred in connection with activities which are not engaged in for profit. Thus, for example, deductions are not allowable under section 162 or 212 for activities which are carried on primarily as a sport, hobby, or for recreation. The determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. Thus it may be found that an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit might be considered unreasonable. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

**(b) Relevant factors.** In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors

which should normally be taken into account are the following:

- (1) *Manner in which the taxpayer carries on the activity.* The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.
- (2) *The expertise of the taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.
- (3) *The time and effort expended by the taxpayer in carrying on the activity.* The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.
- (4) *Expectation that assets used in activity may appreciate in value.* The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of §1.183-1 for definition of an activity in this connection.
- (5) *The success of the taxpayer in carrying on other similar or dissimilar activities.* The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.
- (6) *The taxpayer's history of income or losses with respect to the activity.* A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not

explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

*(7) The amount of occasional profits, if any, which are earned.* The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

*(8) The financial status of the taxpayer.* The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

*(9) Elements of personal pleasure or recreation.* The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

**(c) Examples.** The provisions of this section may be illustrated by the following examples:

*Example (1).* The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer

inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.

*Example (2).* The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amount of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.

*Example (3).* The taxpayer, very successful in the business of retailing soft drinks, raise dogs and horses. He began raising a particular breed of dog many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at the "prestige" tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

*Example (4).* The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately \$8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time-to-time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting, crops, etc. The activity of farming could be found, based on all

the facts and circumstances, to be engaged in by the taxpayer for profit.

*Example (5).* A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The changes, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his oil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

*Example (6).* C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to "market" his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.

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T.D. 7198, 7/12/72.

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Alfred A. Iversen, et ux., TC Memo 2012-19, Code Sec(s). 469; 6662, 01/18/2012 **ADVANCE**

**Tax Court & Board of Tax Appeals Memorandum Decisions**

**Alfred A. Iversen, et ux. v. Commissioner, TC Memo 2012-19 , Code Sec(s) 469; 6662.**

ALFRED A. AND BRENDA C. IVERSEN, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent .

**Case Information:**

<b>Code Sec(s):</b>	469; 6662
<b>Docket:</b>	Docket No. 5300-10.
<b>Date Issued:</b>	01/18/2012
<b>Judge:</b>	Opinion by SWIFT

**HEADNOTE**

XX.

**Reference(s):** Code Sec. 469; Code Sec. 6662

**Syllabus**

**Official Tax Court Syllabus**


**Counsel**


Thomas Edward Brever, for petitioners.

John P. Healy, for respondent.

Opinion by SWIFT

## MEMORANDUM FINDINGS OF FACT AND OPINION

Respondent determined deficiencies in petitioners' 2005 and 2006 joint Federal income taxes of \$103,848 and \$70,356, respectively, and accuracy-related penalties under  section 6662. <sup>1</sup>

The issues for decision are whether petitioners' involvement in a Colorado cattle ranch constituted a passive activity under  section 469 and, if so, whether the accuracy-related penalties should be sustained.

### FINDINGS OF FACT

Some of the facts have been stipulated and are so found. At the time of filing the petition, petitioners resided in Minnesota.

Petitioner Alfred Iversen (Mr. Iversen), as a teenager, spent summers on his grandparents' 400-acre farm and ranch near Thief River Falls, Minnesota.

Mr. Iversen served in the U.S. Navy on antisubmarine warfare planes. After military service, he earned his master's degree in mechanical engineering from the University of Minnesota.

In 1979 Mr. Iversen founded PMT Corp. (PMT), which over the years has become a large and successful manufacturer and worldwide seller of surgical and medical equipment. PMT sells its medical equipment throughout the United States and in more than 30 foreign countries. PMT is a Minnesota corporation. Petitioners own a controlling interest in the stock of PMT.

In both 2005 and 2006, as president of PMT Mr. Iversen worked more than 40 hours a week, and he received from PMT a total of approximately \$6 million in salary and other income.

In 1998 petitioners formed Stirrup Ranch, LLC (Stirrup Ranch), as a limited liability company through which they purchased a 14,000-acre cattle and horse ranch (ranch) in Fremont County, Colorado, near Canon City, Colorado. Petitioners owned 100 percent of Stirrup Ranch.

The ranch is in the Colorado Rockies at an altitude of approximately 9,000 feet. The primary activity conducted by Stirrup Ranch is the commercial raising and selling of Black Angus and Hereford cattle. In addition to owning the ranch, Stirrup Ranch leases another 28,000 acres from the Bureau of Land Management. The total of the owned and leased acreage on which Stirrup Ranch grazes its cattle consists of 42,000 acres.

During 2005 and 2006 Stirrup Ranch owned approximately 300 head of cattle and 30 horses. The main ranch house on the Stirrup Ranch property is a 20,000-square-foot lodge with a log exterior and wraparound decks. The house has a large great room with vaulted ceilings, a floor to ceiling fireplace, and leather couches and chairs. The house also includes meeting rooms, office space, a conference room, a recreation room, and a number of bedrooms and bathrooms.



In 2005 and 2006 Stirrup Ranch employed full time on its property in Colorado two individuals—a ranch manager and a ranch hand. Over the course of 2005 and 2006 Stirrup Ranch employed three different ranch managers. Seasonally, Stirrup Ranch employed onsite at the ranch additional ranch hands. The Stirrup Ranch ranch manager lives on the ranch property in a house separate from the lodge.

A job description for the onsite Stirrup Ranch ranch manager, written by one of the ranch managers (and which the parties stipulate is a “description of the ranch manager’s general duties during 2005 and 2006”) states as follows:

The ranch manager is responsible for all ranching operations on the 42,000 total acres of the Stirrup Ranch. This includes but is not limited to 5 major categories: livestock management; natural resource management; maintenance and improvement projects; employee and subcontractor supervision; and working with government agencies (BLM, State Land board and US Forest Service) on our leased lands. A few of the ranch goals that [the ranch manager is] continually working toward are: maximizing hay meadow production; water development; and increasing stocking rate. Besides the year-round Stirrup Ranch head of cattle [the ranch manager] also custom graze[s] other peoples’ cattle to increase seasonal pasture utilization and cash flow. [The ranch manager’s] responsibilities require \*\*\* at least 60 hrs/week. During 2005 and 2006 petitioners spent almost all of their time in Minnesota—Mr. Iversen performing his executive responsibilities as president of PMT.

While in Minnesota Mr. Iversen also would make and receive telephone calls and send and receive emails and faxes relating to Stirrup Ranch matters. In evidence for 2005 are telephone records which indicate that Mr. Iversen made telephone calls lasting a total of 3.75 hours to locations in Colorado using PMT’s telephones. No telephone records were offered into evidence relating to 2006, and no telephone records were offered into evidence relating to petitioners’ home and mobile phones for either 2005 or 2006.

In evidence for 2005 are four emails or faxes relating to Stirrup Ranch sent to Mr. Iversen from employees working at the ranch in Colorado. For 2006 there are in evidence three emails or faxes to Mr. Iversen relating to Stirrup Ranch sent from employees working at the ranch in Colorado.

During 2005 and 2006 the onsite Stirrup Ranch ranch manager did not have general check signing authority for Stirrup Ranch; rather, Mr. Iversen retained for himself Stirrup Ranch check signing authority. Occasionally, Mr. Iversen would grant a power of attorney authorizing the ranch manager to sign Stirrup Ranch checks. The canceled checks of Stirrup Ranch that are in evidence for 2005 indicate that many of the checks signed by Mr. Iversen were routine salary checks for the ranch manager and the ranch hand. For 2006 no record of Stirrup Ranch checks is in evidence.

During 2005 and 2006, on each occasion when he traveled from Minnesota to Colorado to visit the ranch, Mr. Iversen did so on a private NetJets airplane paid for by PMT. <sup>2</sup> These flights originated from the Minneapolis-St. Paul airport and terminated at the Pueblo, Colorado, airport.

According to a NetJets airplane flight tracking record in evidence, during 2005 Mr. Iversen made 11 trips to the ranch, and (not counting outbound travel days from Minneapolis to Pueblo, Colorado, because of his late

arrival) he spent a total of 23 days onsite in Colorado at the ranch. On 19 of those days one or more of petitioners' children accompanied Mr. Iversen to the ranch on the NetJets airplane.

According to a handwritten list petitioners prepared for trial, during 2006 Mr. Iversen made 11 trips to the ranch and spent 19 days onsite at the ranch (again not counting outbound travel days).<sup>3</sup> The evidence does not indicate who traveled with Mr. Iversen to the ranch in 2006.

Occasionally in 2005 and 2006 Mr. Iversen hosted at the ranch PMT employees, sales representatives, clients, and potential clients. The PMT guests at the ranch would have meetings relating to PMT business, and they would hunt elk and other wildlife. The guests would stay overnight in the ranch lodge.

Mr. Iversen would participate in the PMT meetings conducted at the ranch, and he occasionally would hunt on the ranch with PMT employees, other guests, and family members.

While at the ranch, Mr. Iversen also would assist the ranch manager and ranch hand with various ranch chores—mending fences; rounding up cattle; branding, inoculating, and castrating cattle; and cleaning the barn.

Documents in evidence relating to Stirrup Ranch's leases of Federal grazing land designate Mr. Iversen as "permittee/ licensee" and the onsite Stirrup Ranch ranch manager as "ranch manager".

For her part, while at the ranch in 2005 and 2006 Mrs. Iversen participated in some activities relating to the family, the cattle, and the horses.

While visiting the ranch in 2005 and 2006, other Iversen family members occasionally would assist with ranch chores.

Neither Mr. Iversen nor Mrs. Iversen maintained a log, a diary, notes, or other record of the work they performed on a day-to-day basis relating to Stirrup Ranch—whether performed onsite at the ranch in Colorado or in Minnesota. //



In 2005 and 2006 neither petitioner received any salary or wages for work relating to Stirrup Ranch.


Petitioners' 2005 and 2006 joint Federal income tax returns were prepared and filed on their behalf by Martin Nergaard, who is an attorney, a certified public accountant, the director of a regional accounting firm, and a former Internal Revenue Service employee. Mr. Nergaard concluded that under the passive loss rules of section 469 Mr. Iversen in 2005 and 2006 materially participated in the activities of Stirrup Ranch, and Mr. Nergaard prepared petitioners' 2005 and 2006 joint Federal income tax returns accordingly, claiming loss deductions for Stirrup Ranch of \$288,066 for 2005 and \$197,077 for 2006.


On audit respondent concluded that Mr. Iversen did not materially participate in the activities of Stirrup Ranch, disallowed the loss deductions claimed relating to Stirrup Ranch, and determined the \$103,848 and \$70,356 deficiencies in petitioners' respective 2005 and 2006 Federal income taxes and the section 6662 accuracy-related penalties.

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## OPINION


For purposes of the limitation under  section 469 on losses from passive activities, material participation is defined as involvement in an activity on a regular, continuous, and substantial basis.  Sec. 469(h)(1)(A)-(C).


Activity performed in an individual's capacity as an investor does not qualify as participation in an activity, unless the individual is directly involved in the day-to-day management of the activity.  Sec. 1.469-5T(f)(2)(ii)(A) and (B), Temporary Income Tax Regs., 53 Fed. Reg. 5726 (Feb. 25, 1988). Investor-related activities not qualifying as material participation include: (1) Studying and reviewing financial statements or reports on operations; (2) preparing or compiling summaries or analysis of the finances or operations of the activity for the individual's own use; and (3) monitoring the finances or operations of the activity in a nonmanagerial capacity. *Id.*

Participation in an activity may be shown by any reasonable means, including calendars, appointment books, or narrative summaries identifying work performed and the approximate number of hours spent performing the work.  Sec. 1.469-5T(f)(4), Temporary Income Tax Regs., *supra*.

Contemporaneous daily time reports, logs, or similar documents are not required if other reasonable means exist of establishing a taxpayer's participation. *Id.*


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Under the 500-hour test of subparagraph (1) and under the facts and circumstances test of subparagraph (7) of  section 1.469-5T(a), Temporary Income Tax Regs., 53 Fed. Reg. 5725 (Feb. 25, 1988), petitioners contend that in 2005 and 2006 they materially participated in the management and activities of Stirrup Ranch on a regular, continuous, and substantial basis. <sup>4</sup>

Respondent emphasizes that under  section 1.469- 5726 (Feb. 25, 1988), a taxpayer's management activities under the facts and circumstances test shall not be taken into account if another person also receives compensation for management services relating to the activity or if another person performs more management services (by time) relating to the activity than the taxpayer.

Petitioners claim that in spite of the fact that a ranch manager was employed onsite at the ranch, Mr. Iversen was the real day-to-day ranch manager and he made essentially all of the significant decisions relating to the operation, activities, and management of Stirrup Ranch.

Petitioners claim that when he was at the ranch Mr. Iversen worked from dawn to dusk on Stirrup Ranch matters and that when he was in Minnesota (in order to keep up on the details of all significant aspects of Stirrup Ranch and make practically all decisions relating to the operation, activities, and management of Stirrup Ranch) Mr. Iversen spent 2 to 3 hours a day on telephone calls, emails, and fax communications with the onsite Stirrup Ranch ranch manager.

Petitioners claim that in each of 2005 and 2006, whether at the ranch in Colorado or from petitioners' home in Minnesota, Mr. Iversen spent a total of at least 400 hours working on matters relating to Stirrup Ranch, Mrs. Iversen spent at least another 100 to 150 hours working on matters relating to the horses at the ranch, and that they together meet the 500-hour test of  section 1.469-5T(a)(1), Temporary Income Tax Regs., *supra*.

<sup>5</sup>

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Mr. Iversen describes his involvement with Stirrup Ranch activities as follows: [The onsite Stirrup Ranch ranch manager and ranch hand] do nothing without telling me, and they cannot buy anything, negotiate anything, kill anything, shoot anything, and I lay down the rules as far as what they're supposed to do. Our analysis of the time and activity petitioners spent in 2005 and 2006 working on matters relating to Stirrup Ranch is made difficult by the lack of meaningful contemporaneous or other records and documentation regarding specifically what petitioners did on a day-to-day basis and how much time they spent on matters relating to Stirrup Ranch. In this case, the lack of records and documentation are not cured by estimates made years after the fact in writing or by testimony. See *Goshorn v. Commissioner*, T.C. Memo. 1993-578 [1993 RIA TC Memo ¶93,578].

Petitioners acknowledge that some portion of their time while at the ranch in Colorado (when PMT employees and clients and petitioners' family were present) was spent on activities relating to PMT and the family, not on Stirrup Ranch's cattle and horse activities.

While he was in Minnesota Mr. Iversen clearly was busy with his responsibilities as president of PMT, and the documented record in this case is particularly thin as to how much time Mr. Iversen spent on Stirrup Ranch matters—whether in Minnesota or Colorado.

The fact that the airplane flights from Minnesota to the ranch were paid for by PMT indicates to us that Mr. Iversen's time spent at the ranch often and primarily related to the affairs of PMT, not to the management and activities of Stirrup Ranch.

The airplane logs in evidence for 2005 indicate that during 4 months of 2005, Mr. Iversen made no trips to the ranch and that he was at the ranch for 1 day in each of April, June, September, and October 2005. According to the airplane flight logs, on each trip to Stirrup Ranch in 2005 on which Mr. Iversen stayed at the ranch more than 1 day, an Iversen family member went along.

The evidence does not indicate those occasions when Mr. Iversen was at the ranch without PMT employees and/or clients also being present.

Telephone records that are in evidence do not support petitioners' claim that Mr. Iversen spent frequent and numerous hours on the phone while in Minnesota talking to the Stirrup Ranch ranch manager in Colorado about Stirrup Ranch activities or any other subject.

If, in spite of the fact that there was an onsite Stirrup Ranch ranch manager, Mr. Iversen was running, supervising, managing, and involved with all significant activities of Stirrup Ranch, as petitioners seem to claim, we would expect petitioners to have offered into evidence extensive files, to-do lists, home and mobile phone records, business plans, project descriptions, instructions to employees, etc., documenting and establishing Mr. Iversen's active involvement in the regular, continuous, and substantial management and day-to-day activities of Stirrup Ranch. That documentary evidence is absent.

We do not doubt that while in Minnesota Mr. Iversen spent time on Stirrup Ranch activities—talking on the telephone to the ranch manager, reading articles on cattle ranching, receiving bills and correspondence, and writing checks in payment of ranch bills. Also, we acknowledge that while in Colorado at the ranch Mr. Iversen

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participated and assisted with the cattle operation, ranch maintenance, and improvements.

However, the weight of the evidence before us does not establish that during 2005 and 2006 petitioners spent anywhere near 500 hours on Stirrup Ranch activities, that petitioners engaged in regular, continuous, and substantial activities relating to Stirrup Ranch, or that petitioners materially participated in the activities of Stirrup Ranch as required under [§](#) section 469 and the related regulations.

Further, a significant portion of the time Mr. Iversen spent on Stirrup Ranch activities appears to have been more in the capacity of an investor not involved in the day-to-day activities and which therefore would not count under the facts and circumstances test. See [§](#)sec. 1.469-5T(f)(2)(ii)(B), Temporary The presence at the ranch of a full- Income Tax Regs., supra. time paid ranch manager for most of 2005 and 2006 disqualifies much of Mr. Iversen's time working on Stirrup Ranch activities from counting under the facts and circumstances test.

We sustain respondent's deficiency determinations herein for both 2005 and 2006.

With regard to the [§](#)section 6662(a) accuracy-related penalties for 2005 and 2006 that respondent determined, we are persuaded that petitioners had good faith and reasonable cause in claiming the losses that we disallow.

Petitioners credibly testified that they believed the claimed losses qualified under the active participation rules of [§](#) section 469. Petitioners' testimony was supported by the testimony of their accountant.

Petitioners' accountant should have known better, particularly if the accountant was shown no more evidence and documentation than was shown to us. Regardless of the incorrectness of their accountant's advice, we conclude that petitioners reasonably and in good faith relied on their accountant in claiming the losses disallowed. We reject respondent's determination of the [§](#)section 6662(a) accuracy- related penalties.

*Decision will be entered under Rule 155.*

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1

All section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

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2

In August 2006 on one trip to the ranch petitioners drove a truck.

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3

For 2006 no airplane flight tracking record regarding Mr. Iversen's airplane trips to the ranch was provided to respondent, and none was offered into evidence. However, the handwritten list of Mr. Iversen's 2006 flights to the ranch was prepared by petitioners and conditionally admitted into evidence. After trial petitioners apparently provided to respondent a flight record of Mr. Iversen's flights to the ranch in 2006. Respondent

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points to a number of minor discrepancies between the handwritten list and the 2006 flight record provided after trial and objects to admission of the handwritten list on grounds of hearsay and lack of foundation. The discrepancies appear to be minor, and we overrule respondent's objection to Exhibit 13.

4

Petitioners acknowledge that they do not meet the tests relating to regular, continuous, and substantial participation set forth in subpars. (2) and (3) of § sec. 1.469-5T(a), Temporary Income Tax Regs., 53 Fed. Reg. 5725 (Feb. 25, 1988), and no evidence indicates that petitioners meet the tests set forth in subpars. (4), (5), and (6) of § sec. 1.469-5T(a), Temporary Income Tax Regs., supra.

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Under subpar. (3) of § sec. 1.469-5T(f), Temporary Income Tax Regs., 53 Fed. Reg. 5726 (Feb. 25, 1988), Mrs. Iversen's participation in the activities of Stirrup Ranch count under both the 500-hour and the facts and circumstances tests of sec. 1.469-

5T(a)(1) and (7), Temporary Income Tax Regs., 53 Fed. Reg. 5725, 5726 (Feb. 25, 1988).

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### Tax Court & Board of Tax Appeals Reported Decisions

## D. E. ALEXANDER., 22 TC 234, Code Sec(s) .

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D. E. Alexander, Petitioner, v. Commissioner of Internal Revenue, Respondent.

#### Case Information:

[pg. 234]

<b>Code Sec(s):</b>	
<b>Docket:</b>	Docket Nos. 35555, 35556.
<b>Date Issued:</b>	04/30/1954

### HEADNOTE

**1. Cost of livestock held not deductible until year livestock was sold by cattle "feeder" on cash basis.** Cost of livestock allowed in year of sale despite erroneous deduction by taxpayer in prior outlawed year.

#### Reference(s):

### Syllabus

#### Official Tax Court Syllabus

- Petitioner was engaged in the cattle business as a "cattle feeder"; he purchased calves and yearlings which he fed for 9 to 18 months and he then sold as beef cattle. He regularly kept his books and reported his income on a cash basis. Under his method of accounting, he consistently charged off and deducted as an operating expense, the cost of cattle in the year of purchase. He did not defer deduction of the cost of cattle until the year of sale. *Held*, that although the petitioner is on a cash basis, he is required, nevertheless, by Regulations 111, section 29.22(a)-7 to defer deduction of the cost of cattle until the year of sale.
- Petitioner sold cattle in 1945 and 1946 which were purchased prior to 1945, and the cost thereof deducted by the petitioner in the year of purchase. In determining deficiencies for 1945 and 1946, respondent did not include in cost of sales the cost of cattle sold in those years but purchased prior to 1945. *Held*, petitioner is entitled to include in cost of sales for 1945 and 1946, the cost of cattle which were purchased prior to 1945 and sold in 1945 and 1946, even though the cost thereof had been deducted by petitioner in determining income of a prior year.

### Counsel

Theodore R. Meyer, Esq., and Robert H. Schnacke, Esq., for the petitioners.

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*Leonard Allen Marcussen, Esq.*, for the respondent.

The Commissioner determined deficiencies in income tax for the years 1945-1948, as follows:

Docket No.	Name	Year	Amount
35555_____	D. E. Alexander_____	{1945	\$112,355.02
		{1946	29,944.20
35556_____	D. E. and Lucille D. Alexander_____	{1947	34,732.69
		{1948	<1>40,271.70

<1>The deficiency for 1948 was increased by the Commissioner from \$26,348.20 to \$40,271.70 in his amended answer which was filed at the hearing.

Income for the taxable years of the cattle business of D. E. Alexander was reported on a cash basis. The accounting records for the business were consistently kept on a cash basis, and under this method of accounting petitioner consistently charged off and deducted as an operating expense the cost of livestock, which he purchased for resale, in the year of purchase. The Commissioner has determined that deduction of the purchase cost of livestock, properly, is to be deferred until the year of sale. [pg. 235]

The chief question is whether the respondent erred in disallowing deduction for the cost of livestock which was purchased in each of the taxable years, where the livestock was not sold in the year of purchase, so as to require petitioner to defer deduction of the cost thereof until the year of sale.

If the respondent's determination is sustained under the chief issue, it will be necessary to decide whether petitioner is entitled to deduct, in each of the years 1945 and 1946, the cost of certain livestock which was sold in those years but which was purchased prior to 1945, and the cost thereof deducted by petitioner in the year of purchase.

The petitioners concede that other adjustments made by the respondent are proper.

## **FINDINGS OF FACT.**

The facts which have been stipulated are found as facts. The stipulation and the attached exhibits are incorporated herein by this reference.

The petitioners, husband and wife, are residents of Napa, California. D. E. Alexander is referred to hereinafter as the petitioner because the issues presented relate solely to his business. Petitioner kept his books and prepared his tax returns on a cash basis. The petitioners filed separate returns for 1945 and 1946; joint returns were filed for 1947 and 1948. The returns were filed with the collector for the first district of California.

During the taxable years, the petitioner was engaged in the cattle business as a cattle feeder; that is to say, he purchased calves and yearlings which he fed until they reached marketable weight, at which time he sold them as beef cattle. Petitioner conducted his business as a sole proprietor.

The petitioner has been engaged in the cattle business for over 30 years. Prior to 1934, he maintained a breeding herd and bred the cattle which he sold. Beginning in 1934, he began to sell his breeding herd in order to change his business to that of a cattle feeder. By 1939, petitioner's business was confined, exclusively, to that of a cattle feeder.

During the taxable years, petitioner carried on his cattle business in California, Oregon, and Montana. He owned and operated a 3,600-acre ranch in Napa County, California, and a 2,500-acre ranch in Oregon. In addition, he grazed cattle on leased land. The petitioner purchased most of his cattle in

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Montana. The purchases were usually made in the fall of the year, and as many as several hundred head of cattle were purchased at one time. Calves were purchased at an average weight of 400 pounds, and yearlings were purchased at an average weight of 700 pounds; they were sold when they reached a marketable weight of about 1,100 pounds. The calves were fed for [pg. 236] 15 to 18 months, and the yearlings for 9 or 10 months before they reached a marketable weight. Petitioner grazed his cattle in California in the winter, and in Oregon in the summer. He did not keep any cattle for more than 18 months.

Petitioner kept his books and reported his income on a straight cash receipts and disbursements basis. He has regularly followed that method of accounting since 1936. Petitioner did not keep an inventory of cattle and he did not use an inventory in determining his income. In accounting for and reporting his income, petitioner deducted from gross receipts in each year the cost of the cattle which he purchased in the same year; that is to say, the cost of cattle was deducted from gross receipts as an operating expense in the year in which the cattle were purchased, rather than from the proceeds of sale in the year in which the cattle were sold.

The following schedule shows the petitioner's gross receipts and net income (or loss) from his cattle business as reported in his income tax return for each of the years 1945 to 1948, inclusive. The schedule also shows the cost of the cattle purchased by the petitioner in each year and deducted from gross receipts in determining income:

Year	Gross receipts	Net income (or loss)	Cost of cattle purchased by petitioner and deducted as an expense
1945	\$209,879	\$44,453	\$125,030
1946	215,294	27,428	101,127
1947	249,565	(73,569)	207,912
1948	440,728	(1,117)	305,661

The parties have stipulated the following facts:

9. The following schedule shows the number of cattle on hand on January 1 of each year; the number purchased during the year; the number sold during the year; the number of casualties suffered in each year; and the number on hand at the end of the year for each of the years 1945 to 1949, inclusive:

	1945	1946	1947	1948	1949
On hand January 1	1,683	1,688	1,636	2,049	2,010
Purchases	1,272	978	1,685	1,772	790
Totals	2,955	2,666	3,321	3,821	2,800
Sold	1,214	988	1,206	1,737	1,269
Missing and died	53	42	66	74	82
Total deductions	1,267	1,030	1,272	1,811	1,351
On hand December 31	1,688	1,636	2,049	2,010	1,449

10. The following schedule shows an estimated breakdown of the cattle on hand on December 31 of each year from 1944 to 1949, inclusive, as between cattle purchased in each of said years and those [cattle] purchased in the preceding year, and it is stipulated that the following schedule shall be accepted as accurate for purposes of these proceedings: [pg. 237]

	1944	1945	1946	1947	1948	1949
Current year	718	1,265	968	1,181	1,262	732
Previous year	965	423	668	868	748	717
Totals	1,683	1,688	1,636	2,049	2,010	1,449

11. The average cost per head of cattle purchased in each of the years 1943 to 1949, inclusive, was as follows:

Year	Average cost
1943	\$52.90
1944	84.38
1945	98.29
1946	103.40
1947	\$123.39
1948	172.49
1949	131.68

12. The following schedule, assuming sales on a first-in, first-out basis, shows the total cost of cattle on hand on the dates indicated based upon the average unit costs set forth in paragraph 11 above and the breakdown of the cattle on hand on each of said dates as set forth in paragraph 10 above:

Dec. 31, 1944	\$111,633.34	
Dec. 31, 1945	160,029.59	
Dec. 31, 1946	165,748.92	
Dec. 31, 1947	235,474.80	
Dec. 31, 1948	309,978.10	<1>\$288,208.60
Dec. 31, 1949	220,065.09	<1>207,696.84

<1>With 1948 purchases valued at 155.24, representing market value of 1948 purchases at December 31, 1948.

The data set forth in paragraphs 9, 10, 11, and 12 of the stipulation filed herein is based on information contained in the petitioner's books and in the supporting records, including purchase invoices, bills of sales, and notebooks used by petitioner's cowhands. The petitioner and his accountant prepared and submitted the data during the course of the revenue agent's investigation, and it was used by the respondent in determining the deficiencies.

The respondent, in his notices of deficiencies, adjusted the amount of the deduction claimed by petitioner in each of the taxable years as cost of feeder cattle, so as to defer deduction of the purchase cost of the cattle until the year of sale. The respondent's notice of deficiency for the year 1947 contains the following explanation of the adjustments:

Income is increased by \$74,725.87 through adjustment of deduction allowable for costs of cattle sold in 1947, computed as follows:

1685 head of cattle purchased in 1947 by D. E. Alexander and charged to expense	\$207,912.29
Less cattle sold, died, or missing during the year from 1947 purchases--504 head	62,188.70
Remaining cost of cattle purchased in 1947 transferred to later years when sales were made	145,723.59 [pg. 238]
Less: Cost of cattle purchased in 1945	

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and sold in 1947--668 head_____	\$65,657.72	
Cost of cattle purchased in 1946 and sold in 1947--100 head_____	10,340.00	
	-----	\$75,997.72
Balance_____		-----
		69,725.87
Add for correction of costs claimed in return:		
Cost of 1947 purchases claimed in return_____	\$212,912.29	
Actual cost, as determined by audit, and as shown above_____	207,912.29	
	-----	5,000.00
Increase_____		-----
		\$74,725.87

Similar adjustments were made by the respondent for the years 1945, 1946, and 1948 with one exception. In determining the deficiency for each of the years 1945 and 1946, the respondent did not include in cost of sales the amounts of \$75,940.60 and \$35,692.74, respectively, which amounts represent the cost of cattle which were actually sold in those years but which were purchased prior to 1945, and the cost thereof deducted by the petitioner in the year of purchase.

In his notice of deficiency for 1948, the respondent erroneously determined that the cost of cattle sold in 1948, including cattle which were lost or which died in 1948, was \$252,927.24. The correct cost of cattle sold in 1948, including cattle which were lost or which died in 1948, is \$231,148.97. The respondent, by an amended answer filed at the hearing, has claimed an increased deficiency for 1948 based upon a correction of the error.

## OPINION.

HARRON, *Judge*:

The chief question is whether the petitioner, who is on a cash basis, is entitled to deduct the cost of feeder cattle in the year of purchase, as he contends, or whether the deduction of such cost must be deferred until the year in which the cattle are sold, as respondent determined.

The respondent contends that the petitioner's practice of deducting the cost of cattle as an operating expense in the year of purchase without regard to when the cattle are sold distorts income. He argues that although the petitioner is on a cash basis, petitioner is required, nevertheless, by section 29.22 (a)-7 of Regulations 111, <sup>1</sup>to compute gross income [pg. 239] by including the purchase cost of cattle in cost of sales for the year of sale; that is to say, petitioner must defer deduction of the purchase cost of cattle until the year of sale. The specific provision of the regulation upon which the respondent relies is as follows:

The profit from the sale of live stock or other items which were purchased after February 28, 1913, is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, \*\*\*

The respondent takes the position that if petitioner elects to use a cash basis in reporting income, he must do so subject to the limitation contained in the aforementioned provision of the regulations. Respondent concedes that the petitioner has an option under the applicable regulations to report income on either a cash or an inventory-accrual basis. He denies that his determination would force the petitioner to adopt an inventory-accrual method of accounting, or that it requires the use of inventories.

Petitioner contends that under the pure cash method of accounting, which he has regularly followed in keeping his books and reporting his income, it is proper for him to deduct the cost of cattle in the year

of purchase, and that his method of accounting, when consistently followed, clearly reflects his income. This is particularly true, he asserts, where, as here, a relatively constant level of operations is maintained. He contends, further, that the respondent's method of accounting for the purchase cost of cattle does not clearly reflect his income because it is a hybrid method which combines a cash basis with the use of inventories. In support of this contention, petitioner argues that the respondent actually determined the deficiencies by the use of reconstructed inventories. Finally, petitioner contends that the provision of the regulation upon which the respondent relies was not, in fact, followed by the respondent in computing the deficiencies, and that, in any event, the regulation is not applicable to the facts of this case.

Petitioner belongs to the class "farmer" under Regulations 111, section 29.22(a)-7. Farmers have an option under the regulations to report income on either a cash basis (in which no inventory to determine profits is used), or an accrual basis (in which an inventory to determine profits is used). Regs. 111, secs. 29.22(a)-7 and 29.22(c)-6. Petitioner has elected to report income on a cash basis. Section 29.22(a)-7 of Regulations 111 sets forth the manner in which the gross income of farmers who elect to report on a cash basis is to be determined. The regulation provides, in pertinent part, that a farmer who reports on a cash basis shall include in gross income for [pg. 240] the taxable year, *inter alia*, the profit from the sale of livestock or other items which were purchased, and that the profit from the sale of livestock or other items which were purchased is to be determined by deducting the cost thereof from the sales price in the year of sale. Consequently, if the regulation is valid, and if it has been correctly applied to the facts of this case, the respondent's determination must be sustained.

Treasury regulations are valid unless unreasonable or inconsistent with the statute. The Supreme Court, in *Commissioner v. South Texas Lumber Co.*, 333 U. S. 496, 501, observed that, "This Court has many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons." The regulation in question is not unreasonable and plainly inconsistent with the revenue statutes. In fact, it must be regarded as having the approval of Congress and the force of law.

The applicable provisions of section 29.22(a)-7 of Regulations 111, appeared initially in Article 38 of Regulations 45, promulgated January 28, 1921. Article 38 of Regulations 45 implemented section 213 (a) of the Revenue Act of 1918, relating to gross income. Identical provisions have appeared in the regulations promulgated to implement corresponding sections of every revenue act since the 1918 act. It is well settled that a regulation which has continued in force substantially unchanged through successive reenactments of the statutory provision to which it pertains must be regarded as having congressional approval. *Lykes v. United States*, 343 U. S. 118; *Commissioner v. Wheeler*, 324 U. S. 542; *Morrissey v. Commissioner*, 296 U. S. 344. As stated by the Supreme Court in *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U. S. 110, 116, "the legislative approval of existing regulations by reenactment of the statutory provision to which they appertain gives such regulations the force of law."

The purpose of the regulation is to prevent a shifting or postponing of income from year to year through the medium of livestock purchases. If the cost of livestock which is purchased for resale could be deducted in the year of purchase without regard to when it was sold, the income of any accounting period could be readily distorted. For example, a farmer could offset, in whole or in part, income which he receives from crops by the purchase of livestock for resale in a subsequent year or years. Or a "farmer" who deals exclusively in livestock which he purchases for resale, as does the petitioner, could shift or postpone income indefinitely simply by increasing in each year his purchases of young animals. To prevent such practices, the regulation requires a cash basis farmer who purchases livestock for resale [pg. 241] to defer deduction of the cost thereof until the year of sale. We find nothing in this requirement of the regulation which could be construed as unreasonable and plainly inconsistent with the revenue statutes. To the contrary, the regulation by preventing distortions of income is in harmony with section 41 of the Code.

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Although petitioner contends that under what may be called a pure cash method of accounting, purchases are regarded as costs chargeable against income in the period in which payment is made, the regulations do not give the petitioner an option to account for, and to report income on, a pure cash basis. If petitioner elects to report on a cash basis, he must do so in the manner prescribed by the regulations and subject to the limitations contained therein. The fact that the regulations require a departure from a pure cash basis is not significant. Farmers who with the consent of the Commissioner report income on a crop basis depart from a pure cash method of accounting. See Regs. 111, sec. 29.23 (a)-11.



Petitioner's contention that, in order to comply with the regulation, he would have to use inventories, and that the respondent, in determining the deficiencies, used reconstructed inventories, is without support in the record. As set forth in the Findings of Fact, the respondent determined the deficiencies by adjusting the amount of the deduction claimed in each of the taxable years as cost of feeder cattle. He did not compute cost of sales by using inventories. The fact that a result similar to the respondent's determination is obtained by using inventories valued at cost to compute cost of sales is not material.


We have carefully considered all of the petitioner's arguments and we find that they are without merit. The regulation upon which the respondent relies is valid and we are aware of no reason why it should not be applied in this case.

It is held that the petitioner must determine his profit from the sale of cattle by deducting the cost thereof from the sales price in the year in which the sale occurs as provided by Regulations 111, section 29.22 (a)-7.

The remaining question is whether petitioner is entitled to deduct in each of the years 1945 and 1946 the cost of the cattle which were sold in each of those years but which were purchased in prior years, such costs having been deducted by petitioner in the years of the purchase or purchases of the cattle.

As of January 1, 1945, petitioner had on hand cattle which he purchased prior to 1945, at a cost of \$111,633.34, and which he sold in 1945 and 1946. The cattle sold in 1945 cost \$75,940.60; the cattle sold in 1946 cost \$35,692.74. Under the method of accounting which petitioner followed, he deducted the cost of the cattle in the year of purchase. In determining the deficiencies for 1945 and 1946, the respondent did not [pg. 242] include such cost in the cost of the cattle sold in those years, namely \$75,940.60, and \$35,692.74, respectively, on the theory that to do so would allow the petitioner a second, or double, deduction for the identical cost.

Petitioner contends that, under the rationale of *Commissioner v. Dwyer*,  203 F. 2d 522, and *Caldwell v. Commissioner*,  202 F. 2d 112, the respondent's determination is erroneous. We agree with the petitioner. The respondent's determination presents essentially the same problem as was involved in the *Dwyer* and *Caldwell* cases. Although the respondent's determination in this proceeding did not require petitioner to change from a cash to an inventory-accrual method of accounting, and inventories or accounts receivable are not involved here, there is no distinction in principle between this case and the cited authorities.

The cost of the cattle which were purchased prior to 1945, and were sold in 1945 and 1946, was improperly deducted by the petitioner in determining income of a prior year or years. The respondent, in failing to allow deduction in 1945 and 1946 of the cost of the cattle which were sold in 1945 and in 1946, has, in effect, attempted to tax in 1945 and 1946 income of a prior taxable period or periods, the taxation of which is now barred by the statute of limitations. This he cannot do. *David W. Hughes*,  22 T. C. 1. The respondent's determinations under this issue are overruled and it is held that the petitioner is entitled to include \$75,940.60 in costs of sales for 1945 and \$35,692.74 in costs of sales for 1946.

Reviewed by the Court.

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Decisions will be entered under Rule 50.

Opper, J., dissents.

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Sec. 29.22 (a)-7. Gross Income of Farmers.—A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of live stock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of live stock or other items which were purchased after February 28, 1913, is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of animals purchased as draft or work animals or solely for breeding or dairy purposes and not for resale, the profit shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation theretofore allowed (but not less than the amount allowable) in respect to such property as a deduction in computing net income. \*\*\*

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## TSCRA Cattlemen's Column: An important message regarding ag sales tax exemption

POSTED BY TSCRA ON 10-20-11

Source: [TSCRA](#)

By: Joe Parker Jr., TSCRA president

Beginning Jan. 1, 2012, a new law will require all commercial agricultural producers to have an agricultural sales tax exemption registration number to be exempt from agricultural sales tax in Texas. The exemption number is free and good for 4 years.

The agricultural sales tax exemption is important to producers and consumers alike. By exempting commercial agricultural producers from the agricultural sales tax, the cost of food is kept down for consumers. This has been the case for many years.

So why are eligible producers required to get an exemption number now?

Leading into the last legislative session, Texas was facing a large budget shortfall. There were lots of things on the table to help make up the gap, one of which included eliminating and streamlining many sales tax exemptions. Since sales tax is the primary source of revenue for the state, the legislature was looking closely at all tax exemptions, and will continue to do so as they head into the 2013 session.

While the agricultural sales tax exemption wasn't in danger of being eliminated, the process did highlight some abuses. Unfortunately, many ineligible producers have falsely claimed an agricultural sales tax exemption. What's more, retailers have had no effective way of ensuring that eligible products sold were actually used for agricultural purposes, so when they've been audited by the state, the retailer has ultimately been responsible for shouldering all of the burden rather than sharing the responsibility with the buyer.

One of the greatest attributes of the agriculture industry is its reputation as an honest industry where a person's handshake is as good as a signed contract. Because we recognized that abuse was taking place with the agricultural sales tax exemption, ag industry associations and organizations, including TSCRA, took a proactive approach to address this issue.

Working with the state legislature, the ag industry and several business associations developed and supported HB 268, introduced by Rep. Harvey Hilderbran (Kerrville) and Sen. Kel Seiger (Amarillo). The ag industry felt that HB 268 was necessary to curb abuse and demonstrate to the legislature and the Comptroller's office that we were willing to address the problem ourselves — rather than have a solution dictated to us by the state government.

It is our hope that this proactive approach will ensure the agricultural sales tax exemption stays in place for generations of Texas farmers and ranchers.

Here are some basic points about HB 268:

- The bill requires that starting Jan. 1, 2012, those wishing to get an agricultural sales tax exemption have an exemption registration number from the comptroller's office.
- This exemption number is free and is good for 4 years.
- If someone wishing to claim an agricultural sales tax exemption does not have an exemption number, they will be required to pay the sales tax, but can apply for a refund, like current law, to the comptroller's office.
- One number can be used per agricultural operation. HB 268 allows multiple people associated with that operation to use the same number.
- Retailers will have access to an online database to look up numbers if an individual cannot remember his or her number.
- HB 268 does not remove any agricultural items or production qualifications that qualify for the agricultural sales tax exemption.
- HB 268 protects confidential information such as Social Security Numbers from being shared with the comptroller's office.

Several other states, including Oklahoma, have implemented a system similar to this, and it has worked well.

Producers can register for their number online at [GetReadyTexas.com](http://GetReadyTexas.com).

You are also able to download the registration form from that page and mail the completed form to the comptroller's office, call the comptroller's Fax on Demand service at 800-531-1441 to have the paper application faxed to you, or call 800-252-5555 to request that a copy of the application be mailed to you.

As we all know, there is no perfect system to protect against all abuses. However, TSCRA felt this was a fair and economical approach to address the abuse associated with this exemption. It was also a pro-active, good faith effort by those involved in commercial agricultural production and those in the retail business to cooperatively address this problem.

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• [Preventing livestock and property theft to headline TSCRA ranch gathering in Denton](#)



Joe Parker Jr.

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## Texas Agricultural Sales and Use Tax Exemption Certification

Producers of agricultural products for sale must provide this completed form to retailers when claiming an exemption from sales and use tax on the purchase of qualifying agricultural items. The certificate may serve as a blanket certificate covering all qualifying purchases.

This form may not be used to claim exemption from tax on motor vehicles, including trailers. Motor vehicle tax exemptions must be claimed with the local County Tax Assessor-Collector at the time of registration and/or titling.

An ag/timber number is not required for the following types of agricultural items:

- horses, mules and work animals commonly used in agricultural production;
- animal life, the products of which ordinarily constitute food for human consumption, such as cows, goats, sheep, chickens, turkeys and pigs;
- feed for farm and ranch animals, including oats, corn, chicken scratch and hay; and
- seeds and annual plants, the products of which are commonly recognized as food for humans or animals (such as corn, oats and soybeans) or are usually only raised to be sold in the regular course of business (such as cotton seed).

All other agricultural items require an ag/timber number to claim a sales tax exemption. See back for qualifying and non-qualifying items.

Name of retailer
Address (Street and number, P.O. Box or route number)
City, State, ZIP code

### Important information regarding use of this certificate:


**Purchasers** issuing this certificate must be familiar with the agricultural exemptions available for the items claimed on this form. Please review Rule 3.296 at [www.salestax.tx.gov](http://www.salestax.tx.gov). Agricultural exemptions only apply if an item is purchased for **EXCLUSIVE** use in an exempt manner. Any personal or non-agricultural use disqualifies the purchase from exemption.

**Retailers** may accept this certificate as a blanket certificate covering all sales of items that can reasonably be used in the production of agricultural products for sale in the regular course of business. Retailers must collect tax on all other items such as jewelry, furniture, guns and clothing.

Name of purchaser	
Address (Street and number, P.O. Box or route number)	
City, State, ZIP code	Phone (Area code and number)
Ag/Timber number	Name of person to whom number is registered, if different than purchaser

I understand that I am required to keep records to verify eligibility for the exemption(s) and that I will be required to pay sales or use tax on purchases that do not qualify for the exemption(s), in addition to any applicable interest and penalties.

I understand that it is a criminal offense to issue an exemption certificate to the seller for taxable items that I know will be used in a manner that does not qualify for the exemptions found in Tax Code Sec. 151.316. The offense may range from a Class C misdemeanor to a felony of the second degree.

 Purchaser's signature	Purchaser's name (print or type)	Date
---	----------------------------------	------

This certificate should be furnished to the retailer. Do **not** send the completed certificate to the Comptroller of Public Accounts.



**Do Not Qualify**  
**Listed below are examples of items that do not qualify for sales and use tax exemption for agricultural production.**

- Motor vehicles and trailers\*
- Golf carts, dirt bikes, dune buggies and go-carts
- Automotive parts, such as tires, for vehicles licensed for highway use
- Clothing, including safety apparel and shoes
- Computers and computer software used for any purposes other than agricultural production
- Furniture, home furnishings and housewares
- Guns, ammunition, traps and similar items
- Items used in home gardens
- Materials used to construct roads or buildings used for shelter, housing, storage or work space (examples include general storage barns, sheds or shelters)
- Pet food
- Services such as nonresidential repair and remodeling, security and waste removal
- Work clothing

\* Motor vehicles, including trailers, are taxed under Ch. 152 of the Tax Code. Exemption must be claimed on the Application for Texas Certificate of Title/Tax Statement, Form 130-U, when filed with the local County Tax Assessor-Collector at the time of registration and/or titling. Additional information is available online at [www.window.state.tx.us/taxinfo/taxpubs/tx96\\_254.pdf](http://www.window.state.tx.us/taxinfo/taxpubs/tx96_254.pdf).

**Exempt If Used Exclusively to Produce Agricultural Products for Sale**  
**Listed below are examples of items exempt from sales and use tax if used exclusively for agricultural production and purchased by a person who holds a current ag/timber number.**

Air tanks	Farm wagons	Mowers
Augers	Farrowing houses	(hay and rotary blade)
Baler twine	(portable and crates)	Pesticides
Baler wrap	Feed carts	Pickers
Balers	Feed grinders	Planters
Binders	Feeders	Poultry feeders
Branding irons	Fertilizer	Poultry house equipment
Brush hogs	Fertilizer distributors	Pruning equipment
Bulk milk coolers	Floats for water troughs	Rollbar equipment
Bulk milk tanks	Foggers	Rollers
Calf weaners and feeders	Food for work animals	Root vegetable harvesters
Cattle currying and oiling machines	Forage boxes	Rotary hoes
Cattle feeders	Forage harvesters	Salt stands
Chainsaws used for clearing	Fruit graters	Seed cleaners
fence lines and pruning orchards	Fruit harvesters	Shellers
Choppers	Grain binders	Silo unloaders
Combines	Grain bins	Soilmovers used to grade
Conveyors	Grain drills	farmland
Corn pickers	Grain elevators	Sorters
Corral panels	(portable)	Sowers
Cotton pickers, strippers	Grain handling equipment	Sprayers
Cow stalls	Greases, lubricants and oils	Spreaders
Crawlers – tractors	Harrows	Squeeze chutes
Crushers	Head gates	Stalls
Cultipackers	Hoists	Stanchions
Discs	Husking machines	Subsoilers
Drags	Hydraulic fluid	Threshing machines
Dryers	Hydro-coolers	Tillers
Dusters	Implements of husbandry	Tires for exempt equipment
Egg handling equipment	Incubators	Troughs, feed and water
Ensilage cutters	Irrigation equipment	Vacuum coolers
Farm machinery and repair or	Manure handling equipment	Vegetable graders
replacement parts	Manure spreaders	Vegetable washers
Farm tractors	Milking equipment	Vegetable waxers

Tax Help: [tax.help@cpa.state.tx.us](mailto:tax.help@cpa.state.tx.us) • Window on State Government: [www.window.state.tx.us](http://www.window.state.tx.us)  
 Tax Assistance: 1-800-252-5555 or 512-463-4600  
 Sign up to receive email updates on the Comptroller topics of your choice at [www.window.state.tx.us/subscribe](http://www.window.state.tx.us/subscribe).

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## Texas Sales Tax on the Use of Horses

Farmers and ranchers are not exempt entities, so not all purchases that farmers and ranchers make for their use on a farm or ranch are exempt from sales tax. Some agricultural items, such as horse feed, are exempt by law, while other items, such as a saddle, are taxable unless purchased for exclusive use on a commercial farm or ranch in the production of food or other agricultural products for sale.

### New Agricultural Registration Number and Agricultural Exemption Certificate Required for Some Items Beginning in 2012

Beginning Jan. 1, 2012, purchasers of agricultural items will be required to provide sellers with a new exemption certificate (Form 01-924) or their signed confirmation letter containing their Texas Agricultural and Timber Registration Number (Ag/Timber Number) issued by the Comptroller of Public Accounts. The exemption certificate will cover purchases not already exempted by law. To qualify for the exemption, items must be used exclusively on a commercial farm or ranch in the production of agricultural products for sale. The purchaser must complete an exemption certificate to purchase these items tax-free:

- fertilizer, fungicides, insecticides, herbicides, defoliant and desiccants (drying agents) used *exclusively* in agricultural production;

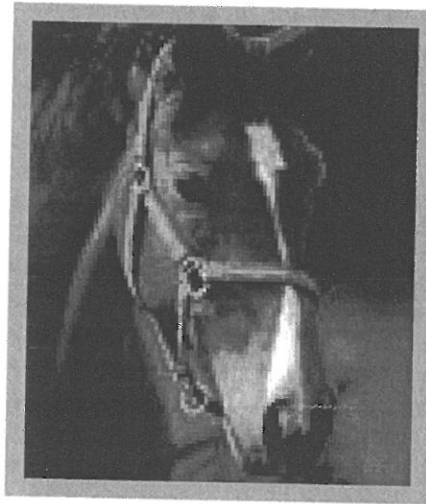
- all medications, tonics, restoratives or other therapeutic preparations (vaccines and drenches, for example) for farm and ranch animals; and
- machinery or equipment used exclusively in the production of food, grass, feed and other agricultural products or in building or maintaining farm and ranch roads and water facilities.

Under House Bill 268, passed by the Texas Legislature in 2011, commercial agriculture or timber producers will need an Ag/Timber

Number issued by the Comptroller's office to make eligible tax-exempt purchases beginning Jan. 1, 2012. The agricultural industry, including retailers and producers, felt the need to have a registration process, because many ineligible purchasers have falsely claimed an agricultural sales tax exemption. What's more, retailers have had no effective way of ensuring the eligible products they sold were actually used in an exempt agricultural manner. Retailers and producers both agreed the registration process was necessary to curb abuse and demonstrate

to the Legislature they were willing to address the problem themselves.

Blanket exemption certificates issued to suppliers on the old form must be replaced with the new certificate for purchases made on or after Jan. 1, 2012. The certificates will be good until the customer revokes the certificate in writing to the retailer or





# SALES AND USE TAX BULLETIN

Texas Sales Tax on the Use of Horses

the retailer is notified that the registration number associated with the blanket exemption certificate has expired, or been canceled or suspended.

You can apply for the Ag/Timber Number online at [www.GetReadyTexas.org](http://www.GetReadyTexas.org). By applying online you will get an Ag/Timber Number immediately upon completion. You can also print a paper application, or have one faxed to you by calling 1-800-531-1441.

### Always Exempt

The items identified below are exempt from Texas sales tax, regardless of who is buying the item or how or where it will be used. No exemption certificate or Ag/Timber Number is needed to purchase these items tax-free.

**Horses.** Sales of horses are exempt from Texas sales and use tax under Tax Code Section 151.316 (a)(1).

**Horse feed.** Sales of horse feed, including grain, hay and supplements, are exempt under Tax Code Section 151.316 (a)(3).

**Services –** the following services are not taxable:

- Horse transport;
- Horse boarding;
- Veterinary medical services;
- Farrier services (shoeing and trimming hoofs);
- Horse training; and
- Stud services.

Tax is due on all taxable items used to provide a nontaxable service unless the item is otherwise exempt, such as horse feed.

### Exempt When Used in a Qualifying Manner

Many items used with horses, such as saddles, bridles, troughs and fences, are taxable but can qualify for exemption if they are used exclusively on a farm or ranch or to produce horses for sale.

### Definition of "Farm or Ranch"

"Farm or ranch" includes one or more tracts of land used, in whole or in part, in the production of crops,

livestock or other agricultural products held for sale. See Tax Code Section 151.316(c)(1). Horses are agricultural products. The following equine businesses qualify as farms and ranches:

- Horse breeding facilities;
- Stud farms;
- Horse training facilities that train horses that will be sold; and
- Ranches that use horses in their operation.

The following activities **do not produce agricultural products for sale and do not qualify** as farms and ranches:

- Owning horses for pleasure riding, show or sport;
- Horse boarding;
- Training facilities that train horses used for sport, pleasure or show;
- Riding stables;
- Racing stables that are not horse breeders;
- Racetracks;
- Veterinary clinics;
- Commercial arena operations; and
- "Dude" ranches, lodges and hunting operations.

### Items That Can Qualify for Exemption

The items identified below qualify for exemption when used *exclusively* on a farm or ranch to produce agricultural products, including horses, which will be sold.

"Exclusively" means the item must be used 100 percent of the time on a commercial farm or ranch in the production of agricultural products for sale. An item loses its exemption if it is used off a farm or ranch, or if it is used for any purpose on a farm or ranch other than the production of agricultural products for sale.

An exemption certificate is required in order to buy or sell these products or services tax free. Purchasers claiming a sales tax exemption on the items identified in this section purchased on or after Jan. 1, 2012 must issue a Texas Agricultural Sales and Use Tax Exemption Certificate, Form 01-924 or signed confirmation letter showing a valid Ag/Timber number.

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# SALES AND USE TAX BULLETIN

Texas Sales Tax on the Use of Horses

- Fertilizers, fungicides, insecticides, herbicides, defoliants and desiccants
- Electricity used in agriculture or timber operations;
- Services performed on exempt tangible personal property identified in this list;
- Farm, timber and off-road vehicles; and
- Machinery and equipment.

The term machinery and equipment includes but is not limited to:

- Fencing material and gates used to contain agricultural livestock;
- Portable stalls, corral and gate panels;
- Working saddles and tack;
- Lunge lines, lunge whips and lead ropes;
- Stocks;
- Farrier tools;
- Hand tools, hay hooks, twitches and balling guns;
- Feeders, hay racks, water troughs and buckets;
- Tractors, loaders and implements;
- Hot walkers; and
- Manure carts, spreaders and forks.

**Note: Materials used to build barns, covered arenas and general purpose buildings do not qualify for exemption.**

## Motor Vehicles

Motor vehicles are taxed under a different tax code than the items above. As a result, motor vehicles have different standards and qualifications for exemption. The motor vehicle tax code provides exemptions for farm machines and farm trailers.

Section 152.001(12) of the Tax Code defines a “farm machine” as ‘a self-propelled motor vehicle’ specially adapted for use in the production of crops or rearing of livestock, including poultry, and use in feedlots and includes a self-propelled motor vehicle specially adapted for applying plant food materials, agricultural chemicals or feed for livestock. “Farm machine” does not include any self-propelled motor vehicle specifically designed or specially adapted for the sole purpose of transporting agricultural products, plant food materials, agricultural chemicals or feed for livestock.

Farm vehicles and trailers used *primarily* for farming or ranching are exempt from motor vehicle sales and use tax. An owner must use a farm or ranch trailer primarily in the production of food for human consumption; grass; feed for any form of animal life; or other livestock or agricultural products to be sold. *Primarily* means at least 80 percent of the operating time. If the trailer is not used primarily in an exempt manner, motor vehicle tax is due.

A standard pick-up truck is not exempt as a farm motor vehicle, even though it may have a farm registration and may be operated with farm plates. The type of cab does not determine the pick-up truck’s eligibility. For tax purposes, a farm trailer means a trailer or semitrailer (including a gooseneck trailer) designed and used primarily as a farm or ranch vehicle.

A horse trailer with sleeping quarters is not exempt, nor is any trailer used for transporting horses to and from competitions or shows.

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Independent Contractor (Self-Employed) or Employee?

Español | 中文 | Tiếng Việt | Русский

It is critical that business owners correctly determine whether the individuals providing services are employees or independent contractors.

Generally, you must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. You do not generally have to withhold or pay any taxes on payments to independent contractors.

Select the Scenario that Applies to You:

- I am an independent contractor or in business for myself
If you are a business owner or contractor who provides services to other businesses, then you are generally considered self-employed. For more information on your tax obligations if you are self-employed (an independent contractor), see our Self-Employed Tax Center.
I hire or contract with individuals to provide services to my business
If you are a business owner hiring or contracting with other individuals to provide services, you must determine whether the individuals providing services are employees or independent contractors. Follow the rest of this page to find out more about this topic and what your responsibilities are.

Determining Whether the Individuals Providing Services are Employees or Independent Contractors

Before you can determine how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be -

- An independent contractor
An employee (common-law employee)
A statutory employee
A statutory nonemployee

In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

Common Law Rules

Facts that provide evidence of the degree of control and independence fall into three categories:

- Behavioral: Does the company control or have the right to control what the worker does and how the worker does his or her job?
Financial: Are the business aspects of the worker's job controlled by the payer? (these include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
Type of Relationship: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no "magic" or set number of factors that "makes" the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another.

The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination.

Form SS-8

If, after reviewing the three categories of evidence, it is still unclear whether a worker is an employee or an independent contractor, Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding (PDF) can be filed with the IRS. The form may be filed by either the business or the worker. The IRS will review the facts and circumstances and officially determine the worker's status.

Be aware that it can take at least six months to get a determination, but a business that continually hires the same types of workers to perform particular services may want to consider filing the Form SS-8 (PDF).

Employment Tax Obligations

Once a determination is made (whether by the business or by the IRS), the next step is filing the appropriate forms and paying the associated taxes.

- Forms and associated taxes for independent contractors
Forms and associated taxes for employees

Misclassification of Employees

Consequences of Treating an Employee as an Independent Contractor

If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you may be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply). See Internal

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Revenue Code section 3509 for more information.

### Relief Provisions

If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required federal information returns on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977. See [Publication 1976, Section 530 Employment Tax Relief Requirements](#) (PDF) for more information.

### Misclassified Workers Can File Social Security Tax Form

Workers who believe they have been improperly classified as independent contractors by an employer can use Form 8919, Uncollected Social Security and Medicare Tax on Wages to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation. See the full article [Misclassified Workers to File New Social Security Tax Form](#) for more information.

### Voluntary Classification Settlement Program

The [Voluntary Classification Settlement Program \(VCSP\)](#) is a new optional program that provides taxpayers with an opportunity to reclassify their workers as employees for future tax periods for employment tax purposes with partial relief from federal employment taxes for eligible taxpayers that agree to prospectively treat their workers (or a class or group of workers) as employees. To participate in this new voluntary program, the taxpayer must meet certain eligibility requirements, apply to participate in the VCSP by filing Form 8952, Application for Voluntary Classification Settlement Program, and enter into a closing agreement with the IRS.

### References/Related Topics

- [Proper Worker Classification \(Audio\)](#)
- [Virtual Small Business Tax Workshop - Lesson 6](#)  
The Virtual Small Business Tax Workshop is composed of nine interactive lessons designed to help new small business owners learn their tax rights and responsibilities. See Lesson 6 for information on how to identify an employee versus an independent contractor.
- [IRS Internal Training: Employee/Independent Contractor](#) (PDF)  
This manual provides you with the tools to make correct determinations of worker classifications. It discusses facts that may indicate the existence of an independent contractor or an employer-employee relationship. This training manual is a guide and is not legally binding.
- [Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding](#) (PDF)
- [Publication 15-A, The Employer's Supplemental Tax Guide](#) (PDF) has detailed guidance including information for specific industries.
- [Publication 15-B, The Employer's Tax Guide to Fringe Benefits](#) supplements Circular E (Pub. 15), Employer's Tax Guide, and Publication 15-A, Employer's Supplemental Tax Guide. It contains specialized and detailed information on the employment tax treatment of fringe benefits.
- [Businesses with Employees](#)
- [Hiring Employees](#)
- [Know Who You're Hiring - Independent Contractor \(Self-employed\) vs. Employee](#)

*Note: This page contains one or more references to the Internal Revenue Code (IRC), Treasury Regulations, court cases, or other official tax guidance. References to these legal authorities are included for the convenience of those who would like to read the technical reference material. To access the applicable IRC sections, Treasury Regulations, or other official tax guidance, visit the [Tax Code, Regulations, and Official Guidance](#) page. To access any Tax Court case opinions issued after September 24, 1995, visit the [Opinions Search](#) page of the United States Tax Court.*

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## ELECTION E102

### Deferring Income on Livestock Sold because of Drought, Floods, or Other Weather-related Conditions

A cash-basis taxpayer whose principal trade or business is farming and who is forced to sell livestock early due to drought, flood, or other weather conditions can elect to include income from the sale of the livestock in the year following the year of the sale. The weather conditions must result in the area being designated as eligible for federal assistance. The designation can be made by the President, the Department of Agriculture (or any of its agencies), or by other federal departments or agencies.

Taxpayers must establish that, under their usual business practices, the sale would not have occurred in the year of election if not for the weather-related conditions. The election applies to sales of livestock used for draft, breeding, dairy, or sporting purposes, regardless of the time period the livestock have been held. It is made separately for each generic class of animals (e.g., hogs, sheep, cattle). The deferred gain is the gain attributable to the excess of the number of livestock sold over the number that would have been sold if the weather-related conditions had not occurred. The election must be made separately for each year it is to apply. The election cannot be revoked without IRS consent.

Instead of making this election, farmers can use the involuntary conversion rules under IRC Sec. 1033(e) for certain sales of livestock (other than poultry) held for draft, breeding, or dairy purposes. Under these rules, the gain from sales of such livestock is deferred by reinvesting the sales proceeds in similar property within a certain period. The livestock subject to IRC Sec. 1033(e) treatment are those animals sold during the year that would not have been sold if there had not been a drought, flood, or other weather-related condition. (See Election E305 for more on involuntary conversions.)

#### Who Can Elect

Cash-basis taxpayers whose principle trade or business is farming. This is an entity-level election.

#### When to Elect

Generally, by the due date, including extensions, of the return for the year of sale. An amended return may be used only if it is filed by the extended due date of the return for the year of sale. However, if the sale qualifies for the four-year replacement period for involuntary conversions under IRC Sec. 1033(e)(2) (see Election E305), the election to defer income must be made by the end of the fourth year after the year the weather-related sale is made.

#### How to Elect

By attaching a statement to the return for the year of sale. If the election is made after the return for the year of sale is filed [because the sale qualified for the four-year replacement period under IRC Sec. 1033(e)(2)], the statement presumably would be attached to an amended return for the sale year. In addition, an amended return for the following year would also be required to report the gain.

**Caution:** Reg. 1.451-7 has not been amended to reflect changes by the 1988 Tax Act or American Jobs Creation Act of 2004.

#### Authorities and References

IRC Secs. 451(e) and 1033(e); Regs. 1.451-7 and 1.1033(e)-1; Notice 89-55, 1989-1 CB 696.

#### Sample Election

#### ELECTION TO DEFER INCOME FROM LIVESTOCK SOLD BECAUSE OF WEATHER-RELATED CONDITIONS

Taxpayer hereby elects under IRC Sec. 451(e) and Reg. 1.451-7 to defer income from the sale of livestock until the tax year ending \_\_\_\_ [Date] \_\_\_\_.

Taxpayer submits the following information in accordance with Reg. 1.451-7(g):

1. Evidence of weather-related conditions and date declared eligible for federal relief due to such conditions:  
\_\_\_\_\_
2. Statement explaining relationship of weather conditions to early sale of livestock: \_\_\_\_\_  
\_\_\_\_\_
3. Total number of animals sold in each of the preceding three years: \_\_\_\_\_
4. Number of animals that would have been sold in the current tax year under normal conditions: \_\_\_\_\_
5. Number of animals actually sold and number sold on account of weather-related conditions during the current year: \_\_\_\_\_
6. Computation of deferred income using the following formula: \$ \_\_\_\_\_

$$\frac{\text{Income from Sales of All Livestock}}{\text{Number of Livestock Sold}} \times \text{Excess Number Sold Due to Weather-related Conditions}$$





## Farmers ATG - Chapter Seven: General Livestock

**NOTE:** This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

**Publication Date** - July 2009

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## Introduction

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

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

## Keeping in Touch with the Industry

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

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

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

## Compliance Potential

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

Watch for the following situations during audits:

- Sales of livestock through atypical sources. Most livestock in feedlots are sold to buyers from packing plants, other ranchers or to the feedlot directly resulting in easily traced transactions. Livestock sales directly from the ranch, either before placement in feedlots or for those animals which are not normally placed in feedlots, may be to any number of sources with little or no documentation.
- Bartering may account for some sales, especially in registered or specialized livestock which have higher values. Swapping equipment or services for breeding stock or some exotic animal may be found.
- Use of multiple bank accounts with reliance on the bank records for reporting purposes lends itself to misreporting due to exclusion of some records. Funds may also be deposited or invested directly in certain types of accounts which may not be considered in the reporting process e.g. sales proceeds used to directly pay off loans. Watch for transfers to/from savings, money market, and investment accounts or certificates of deposit. Any deposits from non-taxable sources, e.g. return of previous investment, should be traced to the source of the originally invested funds.
- Personal expenses deducted as farm expenses are the most common form of misreporting among farmers and ranchers. Farming is a life-style which takes tremendous dedication and focus. All aspects of a farmer's life are centered on the crop or animal and are therefore easily considered to be financially related to the business. Customarily, you will find personal expenses in insurance, gasoline, interest, taxes, utilities, and repairs. Has

your farmer elected the 75-percent non-recordkeeping rule of Treas. Reg. section 1.274-6T(b) but failed to limit any expenses other than depreciation? What about a reversal of expenses related to animals butchered for personal consumption?

- Funding livestock activities may result in certain taxable transactions which are not properly reported. Funding transactions between individuals and related business entities may be at little or no interest and require processing as below market interest rate loans. These transactions may also be disguised dividends. Additionally, other taxable funds may be used directly for purchases or against loans without being accounted as income. Family operations may also result in loans which become gifts to other family members resulting in potential gift tax issues.

### General Livestock Risks

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

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

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

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

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

### Conclusion

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

### Industry Issues

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

### Breeder Operation

A breeder operation will generally begin with the purchase of animals proven to be able to reproduce. A single male (or small number of males) is acquired along with numerous females to which the males are bred. Control is exercised to prevent of inbreeding due to the undesirable genetic consequences. This control may take the form of limited access of the males to the females for breeding or exchange of males in breeding stock before female offspring are ready to reproduce. Stud services or invitro fertilization (artificial insemination) may also be employed.

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

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

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

### **Fattening/Feeding Operation**

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

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

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

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

### **Issues**

#### **IRC section 1231**

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

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

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

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

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

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

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

<sup>2</sup> Offspring sold as cull are generally IRC section 1231 property. See Treas. Reg. section 1.1231-2(c)(2) ex. 1. Determining when culls are IRC section 1231 property is often a factual question.

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

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

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

### IRC section 162

IRC Section 1.162-12(a) of the regulations provides that amounts expended in purchasing work, breeding, or dairy animals are regarded as investments in capital, and shall be depreciated unless such animals are included in an inventory in accordance with section 1.61-4 of the regulations. This includes, but is not limited to freight, registration fees, and health related expenses (inoculations, testing, etc.) Regarding the value of a pregnant animal and the unborn offspring or a mother/offspring pair an allocation should be made by subtracting from the purchase price the value of the mare not in foal, to arrive at the value of the unborn foal or offspring. Cf., *Gamble v. Commissioner*, 68 T.C. 800, 820-21 (1977), acq., 1986-2 C.B. 1. Although directly related to race horses, the concept is applicable to any pair purchases.

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

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

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

### **IRC section 61**

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

### **IRC section 168**

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

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

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

## **Cattle Industry**

### **Introduction**

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

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

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

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

February.

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

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

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

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

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

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

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

### Issues

- Ensure deductibility of expenses. Commonly included personal expenses include interest, fuel, insurance, supplies, repairs, utilities and taxes.
- See Rev. Rul. 86-24 (1986-8 I.R.B. 7, 1986-1 C.B. 80) and Rev. Rul. 87-105 (1987-43 I.R.B. 13, 1987-2 C.B. 46), which set forth the treatment of costs incurred to purchase non-purebred cows that are implanted with fertilized embryos of purebred calves. Rev. Rul. 86-24 contains a discussion about the subsequent treatment of sales proceeds when, after the calves are born, the cows and calves are sold separately. Essentially, there must be an allocation made in the original purchase price between the cow and the implanted embryo. The portion of the original purchase price that equals the fair market value of the cows is allocated to the cows and the remaining amount is allocated to the calves. Neither the costs attributable to the cows, nor the costs attributable to the calves are currently deductible. The cows and calves are neither capital assets nor IRC section 1231 assets. Gain or loss from the sales of the cows or the calves is ordinary.
- Many operators rely on bank records for tax reporting purposes. As a result, certain types of income may be excluded from reporting. Be aware of possible bartering with the exchange of livestock for other assets or services. Furthermore, feedlot cattle sales proceeds may be used to directly reduce cattle loans and never show up on bank records.
- By-product sales include manure either packaged or in bulk for fertilizer. Calves may be sold if not necessary

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

## Dairy Cattle Industry

### Introduction

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

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

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

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

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

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

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

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

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

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



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

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

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

### Industry Facts

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

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

### Issues

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

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

## Horse Industry

### Introduction

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

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

Training operations will take in horses and provide feed, boarding, and training appropriate to the purpose of the horse. Race horses, whether Thoroughbreds, Quarter Horses, walkers, trotters, or other types, will be provided appropriate training over a period of time. Show horses, likewise, receive extensive training and grooming. The trainers will charge fees for feed and board on a daily rate and charge out the training at flat rates, hourly rates, or may accept an interest in the horse as a fee. This type of fee requires determination of value for inclusion as income in the current year. The

amount determined as income would become the basis of the interest. The horse owner would recognize the transfer of the interest as a sale and realize a gain or loss on the transfer as it relates to the basis of the horse. See McDougal et al. 62 T.C. 720 (1974) for this court decision.

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

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

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

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

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

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

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

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

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

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

#### Issues

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

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

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

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

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

## Sheep and Goat Industry

### Sheep

From the American Sheep Association website:

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

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

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

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

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

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

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

Other than pasturing, supplement grain feeding is common during reproductive periods. Whole grains, other than

barley, and alfalfa hay are commonly used. Windfall apples, molasses, and discarded produce from grocery stores, such as lettuce, cabbage, broccoli, celery, and various fruits in limited quantities are good additives to the diet.

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

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

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

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

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

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

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

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

- [Sheep Facts 2004 \(PDF\)](#)
- [Sheep Production 2008 \(PDF\)](#)
- [Wool Facts 2008 \(PDF\)](#)

## Goats

Goats can have many purposes for the persons raising them:

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

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

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

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

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

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

Dairy goats in the United States are represented by five major breeds or their crosses. Nubian, French Alpine, Toggenburg (Toggs,) Saanen, and LaMancha are the popular breeds. As with dairy cattle, the breed choice is determined by desired production of butterfat vs. milk. Production levels are greatly affected by diet, nutrition, weather, and other factors. Production will generally be stated in pounds produced in a 305 day period (allowing for a 2-month dry period prior to breeding for rest and repair).

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

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

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

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

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

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

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

The gestation period for a doe is 145 to 155 days. A Doe generally comes into heat only in the fall and early winter. This results in spring kidding. The herd will be bred over a period of time to balance the lactation curve and provide milk at all times. Births will be twins in most cases with one to five kids possible. Separate stall facilities for birthing are recommended.

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

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

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

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

### Issues

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

### Swine Industry

See the Swine Farm Industry ATG for a detailed discussion of the swine industry.

From the National Pork Producers website:

### Facts and Figures

- Hogs are a source of nearly 40 drugs and pharmaceuticals on the market.
- Pork is the world's most widely eaten meat
- Pig skin is used to treat massive burns in humans due to its similarity to human skin
- The pig is rated the fourth most intelligent animal.
- There are more than 180 species of pigs, found on every continent except Antarctica.
- Pigs are often thought to be dirty, but actually keep themselves cleaner than most pets. They are seen lying in mud because they do not have sweat glands and constantly need water or mud to cool off.
- Swine research led to the development of the CAT scan, a technology for examining internal organs without surgery.

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

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

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

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

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

There is more than just meat produced when a pig is raised. Many of the co-products, such as replacement heart valves and skin grafts for burn victims, save lives or allow people to lead normal lives in spite of illness (insulin). Others are used in making many food and industrial products such as gelatin, plywood adhesive, glue, cosmetics and plastics. By far the largest volume co-product of pig production is manure, an effective, low-cost source of nutrients for crops and pastures. In fact, decisions regarding the type of buildings to construct frequently depend on the producer's need for and ability to efficiently use the nutrients found in pig manure. When properly handled and applied, manure can be an asset to pig operations and provide extra income to operators by reducing the need to purchase petroleum-based fertilizer."

#### Hogs and Pigs Total Hogs & Pigs for 2008

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

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

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

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

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

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

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

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

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

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

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

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

## **Ratites and Alternative Livestock**

### **Ratites (Ostrich, Emu, and Rhea)**

#### **Introduction**

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

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



## Marketing Options

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

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

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

## Industry Facts

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

## Issues

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

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

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

## Alternative Livestock

### Introduction

In addition to ratites previously discussed, there is a never ending stream of specialized animals being produced on

farms in various parts of the country. Many of the animals are marketed for pets, sport, or show animals. Some are marketed as work or food animals while others have limited marketability due to restrictions related to the classification as "endangered" species. Others are strictly raised by those interested in the animal for no economic purpose.

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

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

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

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

### Issues

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

## Appendix - A

### Interview Questions - by Type

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

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

### Beef Interview Questions

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

silage, hay, shelled corn, or some combination.)

### Dairy Interview Questions

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

### Swine Interview Questions

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

### Sheep Interview Questions

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

- Do you shear the lambs before you sell them?
- Have you received any wool subsidy payments from the government?

### Exotic Animal Interview Questions

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

## Appendix - B

### United States Department of Agriculture

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

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

## Appendix - C

### Market Segment Understanding Guidelines for Agricultural Labor — Noncash Remuneration

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- I. Introduction
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#### I. Introduction

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

Remuneration paid in any medium other than cash for agricultural labor is generally excluded from "wages" for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and federal income tax withholding

purposes. Although employers and employees may achieve tax savings through in-kind compensation under these provisions, the employees' social security benefits can be correspondingly reduced or eliminated.

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

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

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

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

## II. Background

Agricultural labor was first brought under the social security system by Public Law 734, the Social Security Amendments of 1950. Public Law 761, the Social Security Amendments of 1954, expanded coverage to self-employed farmers. Public Law 880, the Social Security Amendments of 1955, was enacted, in part, to clarify the treatment of share farming arrangements.

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

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

## III. Applicable Law

### A. Statutory Authority

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

To qualify under this provision, the services performed must be "agricultural labor" within the meaning of IRC section 3121(g) of the Code<sup>3</sup>. In general, the term includes all services performed on a farm in connection with the raising or harvesting of agricultural or horticultural commodities. Also included are services performed in connection with the operation, management, conservation, improvement, or maintenance of the farm and its tools and equipment.

<sup>3</sup>IRC sections 3306(k) and 3402(a)(2) of the Code cross-reference IRC section 3121(g) for FUTA and income tax

*withholding purposes.*

## **B. "Substance over Form" Analysis**

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

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

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

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

### **1. Exercise of Dominion and Control by the Employee**

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

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

Evidence of Transfer. Commodities typically used to compensate employees include livestock, grain, breeding rights, and milk products. Written evidence of transfer of these commodities is essential. Receipts, contracts, bills of sale, and other instruments of conveyance vary according to the type of commodity involved, but all are useful indicia of transfer. Other related documentation is also important, including sales records, weigh tickets, required veterinary inspection certificates, and maintenance receipts reflecting that recipients have incurred storage and feed costs. Breeding certificates and formal registration records are important reflections of true transfers of breeding rights and registered animals.

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

suggests that the commodities remain under the dominion and control of the employer.

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

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

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

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

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

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

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

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

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

those of the farm employer to facilitate the sale of those commodities. Such a unified arrangement creates a rebuttable presumption that suggests cash equivalency rather than a bona fide commodity transfer. Taxpayers must be able to demonstrate that there are significant objective reasons for the employee to act in concert with the employer in marketing products.

In the event an employee sells a commodity in unison or in collaboration with the employer, a single payment (i.e., a check to one payee) is strongly indicative of marketing by the employer and could be fatal to the wage exception. Furthermore, the sale of a commodity by an employee back to the employer should, under no circumstances, be considered a bona fide transfer. A purchase by the employer indicates lack of independence and would be fatal to an attempt to seek exemption.

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

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

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

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

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

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

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

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



opportunity to raise, breed, store, pledge, consume, sell, or otherwise utilize a commodity in any manner the employee deems appropriate is evidence of dominion and control.

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

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

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

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

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

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

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

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

## 2. Cash Equivalency

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

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

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

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

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

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

Payments under a deferred payment contract will, under almost all circumstances, be considered to be equivalent to cash because the sale of the underlying commodity has already occurred. Lastly, Generic Commodity Certificates<sup>4</sup> will be considered to be equivalent to cash because the employer has never owned the commodity. These certificates merely convey a transferable right to receive commodities.

<sup>4</sup>*Governed by the Agricultural Act of 1949 and its amendments.*

#### **IV. Income Tax Treatment of the Parties**

##### **A. Employer Income and Reporting**

Payment of wages in commodities is a disposition of property under IRC section 1001 of the Code. Accordingly, any gain recognized by the employer on a bona fide in-kind payment is includable in the employer's gross income under IRC section 61(a)(3). See Rev. Rul. 69-181, 1969-1 C.B. 196. An income tax deduction is allowable for wages paid if income tax is withheld as required by IRC section 3402 of the Code. Because agricultural wages paid in kind are not subject to withholding under IRC section 3402, the requirement would be met and the employer would be allowed a compensation deduction.

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

##### **B. Employee Income and Reporting**

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

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

## Appendix - D

### Suggested Web Pages For Further Research:

#### Cattle Industry:

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

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

Other cattle information:

[Cattle Today](#)

[Cattle, Ranch, and Livestock](#)

[Global Cattle Industry](#)

#### Dairy Cattle Industry:

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

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

#### Horse Industry:

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

Information [All about horses](#).

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

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

#### Sheep and Goat Industry:

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

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

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

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

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

**Swine Industry:**

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

The University of Pennsylvania School of Veterinary Medicine maintains a Web site which contains a [Swine Production Glossary](#).

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

**Ratities and Alternative Livestock:**

Oklahoma State University maintains a Web site which includes information relating to [Ostrich ranching](#).

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

*Page Last Reviewed or Updated: August 24, 2009*

## **Special Rules for Computer Records**

The definition of books and records goes beyond the typical hard copy items when you maintain all or part of your accounting records on a computer. In general, record retention periods are the same for "machine-sensible" records as they are for their hard-copy counterparts.

A machine-sensible record is data in an electronic format intended for use by a computer. Machine-sensible records do not include paper records or paper records that have been converted to an electronic storage medium, such as microfilm, microfiche, optical disk or laser disk. Retrievability is important where machine-sensible records are concerned. Not only must certain records be maintained, but the IRS must have access to those records. This becomes especially burdensome when computer systems are upgraded or converted.

If you or your business have more than \$10 million in assets and you maintain all or a portion of your accounting records on a computer, the IRS requires that your machine-sensible records be in a retrievable format and provide the information necessary to determine the correct income tax liability. This requirement applies even if your accounting system is maintained by a third-party service provider. To comply with this requirement, you must retain the following specific documentation for all data files:

Record formats (including the meaning of all the codes used to represent information)

System and program flowcharts

Label descriptions

Source program listings of programs that created the files retained

Detailed charts of accounts

Evidence that periodic tests are performed on the retained records to ensure they can produce the data stored in the records

Evidence that retained records reconcile to the taxpayer's books and the tax return

If you or your business have less than \$10 million in assets, the IRS requires you to conform to the above standards if (1) all or a portion of your books and records are only available in machine-sensible format, (2) machine-sensible records were used for complex computations (such as LIFO) or (3) you are notified by the IRS.

## **Guidelines for Paper Records**

### ***Three Years (from Date of Filing Return or Due Date of Return, Whichever Is Later)***

Auto mileage logs (three years or life of vehicle)

Bank deposit slips

Cancelled checks

Daily sales records

Entertainment records

Expense reports

Paid vendor invoices

Written acknowledgment from charity for contributions of \$250 or more

### ***Six Years***

Bank statements

Contracts (after expiration)

### ***Records to Retain Permanently***

Annual financial statements

Corporate stock records

Partnership/LLC agreement and amendments

Operating agreement and amendments

General ledger and journals

Real estate records

Tax returns

Copy C of Form W-2 (until you begin receiving Social Security benefits)

LIFO inventory records

### ***Other***

Depreciation schedules (three years after disposal of asset)

Meeting minutes (life of company)

IRA contribution and distribution records (three years after final distribution)