Inconsistency in Handling Farm Income?

—by Neil E. Harl* and Roger A. McEowen**

In the arcane world of federal farm subsidies, few outside of Congressional staffs, personnel of the U.S. Department of Agriculture and those involved as program participants (and their advisors) really understand the fine points of how income is reported. The problem is complicated by three features—(1) farmers can elect to have Commodity Credit Corporation loans (which is the vehicle for two of the three ways program benefits are delivered to farmers and landowners) treated as loans or as income;1 (2) the subsidies are delivered to eligible participants in three distinctly different systems of payments; and (3) dollar limitations on payments have been imposed by the Congress2 although in recent years Congress has provided a way to avoid the payment limitations.3 The latter involves the use of a special statute-based procedure which involves what are known as commodity certificates.4 The evidence indicates that the principal use of commodity certificates is for cotton and rice with a modest use for soybeans. Relatively little use of commodity certificates has been observed for corn and wheat.

Options for receiving subsidies

As noted, federal farm subsidies involving the production of the so-called “program commodities” (those for which a payment is provided) are made available to producers under three mutually exclusive options5—

? One, the most widely used, is called a “loan deficiency payment” (LDP).6

Example: Assume the upland cotton loan rate (which is set by Congress) is 52 cents per pound. A Commodity Credit Corporation loan (CCC is a federally chartered corporation formed essentially as fiscal agent of the U.S. Department of Agriculture)7 could be obtained for 52 cents per pound of eligible cotton.

---

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University, Ames, Iowa. Member of the Iowa Bar.
** Associate Professor of Agricultural Economics and Extension Specialist, Agricultural Law and Policy, Kansas State University. Member of Kansas and Nebraska Bars.
5 A fourth option, which has rarely been used in recent years, is to forfeit the commodity under loan to the Commodity Credit Corporation. See note 7 infra.
With an LDP, however, a CCC loan is not obtained. Rather, a payment is made to the eligible participant (farm tenant, owner-operator or share-rent landowner) based upon the amount by which the loan rate exceeds the AWP (adjusted world price). 8 Assuming the AWP is 32 cents per pound of cotton, the eligible participant would receive a payment of 20 cents per pound. The eligible participant would be ineligible for either of the other two options, but would still be able to benefit from the CCC program if the crop is sold before harvest or is forward contracted. 9

The 20 cents-per-pound payment would be—(1) reported to IRS and to the taxpayer on a Form CCC-1099G, Information Return and by the taxpayer on Schedule F; and (2) subject to the payment limitation for combined marketing loan gains and LDPs. That limit is $75,000. 10

? The second option, for eligible participants, is to use a “marketing loan” which produces a “marketing loan gain.” 11

Example: Once again, assume a cotton loan rate of 52 cents per pound and an AWP of 32 cents per pound. The eligible participant would take out the loan at 52 cents per pound and could repay the loan at 32 cents per pound. That would produce a marketing loan gain of 20 cents per pound of cotton.

Again, the 20 cents-per-pound payment would be—(1) reported to IRS and to the taxpayer on a Form CCC-1099G, Information Return and by the taxpayer on Schedule F; and (2) subject to the payment limitation for marketing loan gains and LDPs of $75,000.

? The third option is to use a special procedure, the details of which were developed by the U.S. Department of Agriculture several years ago, using commodity certificates 12 (which are available for wheat, upland cotton, rice, feed grains and oilseeds). With that procedure, the eligible participant takes out a CCC loan for the commodity at the loan rate and, in essentially the same transaction, purchases a commodity certificate of a size needed to repay the loan at the AWP.

Example: Again, assume a cotton loan rate of 52 cents per pound and an AWP of 32 cents per pound. Repayment of the CCC loan at 32 cents per pound produces a loan gain of 20 cents per pound of cotton.

The 20 cents per pound gain, however—(1) is not reported to IRS under current practice of the government agency involved and (2) does not count against the payment limitation. Indeed, this third option, involving commodity certificates, is typically used when the eligible participant expects to encounter the payment limitation.

---

8 For most commodities, the reference is to the Posted County Price (PCP) on the date the loan is obtained.  
9 The LDP must be applied for between the date of harvest and the date of title transfer but not later than the final loan availability date.  
12 Federal Agriculture Improvement and Reform Act of 1996, as amended, Sec. 166(b)(3).
The fact that the 20 cent per pound gain from this option does not count against the payment limitation has been specifically authorized by Congress.\(^\text{13}\)

**To sum up**

In all three instances, if the eligible individual actually sells the upland cotton for 35 cents per pound, the eligible participant would have received a 20 cent per bushel subsidy and would have realized (and recognized) 35 cents per pound on the actual sale of the commodity for a total of 55 cents per pound of cotton. The economic benefit under the three options is comparable (other than for the relief from the payment limitations) if the taxpayer in the third option reports properly the 20 cent per pound of gain on the exchange. If the taxpayer does not report the gain under the third option, the benefit of that option is proportionately greater by the amount of the income tax benefit from not reporting the gain.

The key questions are—(1) why does USDA not report the gains under the third option to IRS, as is done with the other two; and (2) what are the behavioral consequences of having two options with the gain reported to the IRS and the third is not?

**Formal guidance**

The key guidance on the handling of commodity certificates appeared in Rev. Rul. 87-103.\(^\text{14}\) That revenue ruling was issued in response to questions raised about an earlier version of commodity certificates. Under the earlier program, dating from 1983, eligible participants who idled their land were issued commodity certificates in partial payment with the commodity certificates reported into income at their face value (not their fair market value).\(^\text{15}\) The commodity certificates could then be used to acquire commodity stocks held by CCC. The object was to reduce the level of CCC commodity inventory.

IRS ruled, in Rev. Rul. 87-103, that an eligible participant who had elected to treat their CCC loans as income\(^\text{16}\) could reduce the income tax basis in the commodity acquired by the gain in the commodity certificates.

**Example:** An eligible participant receives a $10,000 commodity certificate and uses it to acquire $12,000 of commodity which is reported into income. The $2,000 gain could be subtracted from the $12,000 basis in the commodity rather than being reported into income, with the result that the commodity would have an income tax basis of $10,000. The gain on the certificate would be delayed until the commodity was sold (for $13,000) in the example. The eligible participant would have total income of $10,000 + $12,000 + $3,000 = $25,000.

---


\(^{15}\) IR 86-175.

For eligible participants who were treating their CCC loans as loans, the $2,000 of gain on the commodity certificate would be taxable and the sale of the grain would produce a gain of $13,000 (zero basis on the grain). The total income would be—$10,000 + $2,000 + $13,000 = $25,000. In both situations, the ultimate amount of gain is the same but the timing may differ, depending on the date of sale of the commodity.

Implications for the commodity certificate (option 3)

Returning to the example involving the use of commodity certificates, applying Rev. Rul. 87-103\textsuperscript{17} would produce the following results—

For those treating CCC loans as income. The taking out of the CCC loan would result in 52 cents per pound of cotton reported into income in that year. Assuming IRS accepts the Rev. Rul. 87-103\textsuperscript{18} procedure for this brand of commodity certificate usage, which is likely, the 20 cents per pound of gain on loan repayment (52 – 32 = 20) could be used to reduce the basis in the cotton from 52 to 32 cents per pound. On sale the following year for 35 cents per pound, the eligible participant would have gain of 52 cents per pound in the year of the loan and 3 cents per pound in the later year of sale for a total gain of 55 cents per pound.

For those treating CCC loans as loans. For eligible participants who are treating CCC loans as loans, there is no income in the year the CCC loan is taken out. However, the participant would trigger 20 cents per pound as gain on repayment of the CCC loan in the year the CCC loan is taken out. In the later year of sale, for 35 cents per pound, with a zero basis for the cotton, the eligible participant would have gain of 35 cents per pound in that year. In total, the participant would have 20 cents plus 35 cents or 55 cents per pound of gain on the cotton.

Thus, both situations (treating CCC loans as loans or treating CCC loans as income) would be treated the same overall although, again, the timing of the gain would differ.

Consequences of not reporting gain to IRS

Aside from the obvious issue of whether reporting of gain on commodity certificates is required (the authors know of no authority to excuse reporting), the concerns are—(1) the behavioral impact on taxpayers who know gain from options 1 and 2 are reported to IRS and the gain from option 3 is not (which really relates to the rate of compliance with tax law, i.e., whether the gain is properly reported by the taxpayer to IRS even though the U.S. Department of Agriculture (through the Farm Service Agency) did not report the gain as a matter of information reporting) and (2) perceptions of unfairness by taxpayers who are treated differently for essentially the same government benefit.

\textsuperscript{17} 1987-2 C.B. 41.
\textsuperscript{18} Id.
In conclusion

Additional guidance from the Internal Revenue Service is needed—(1) to make clear the applicability of Rev. Rul. 87-103\textsuperscript{19} to the contemporary use of commodity certificates and (2) whether information reporting of gain by the government agency providing the subsidy is required. The importance of this matter is underscored by the fact that nearly $2 billion in commodity certificates were issued for use in 2001. If the IRS is unable or unwilling to address the issue, a statutory solution is urged.

\textsuperscript{19} 1987-2 C.B. 41.