

Market Segment Specialization Program



Tobacco Industry

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INTRODUCTION

The purpose of this text is to provide the examiner information on the operation and business practices of the tobacco industry and to recommend specific audit techniques for the examinations of tobacco farmers, dealers, and warehouses. The information presented is a product of a number of in-depth examinations performed by four experienced agents. The program is designed to supplement, not replace, the examiner's audit skills.

Raising significant issues while maintaining consistency throughout the Service is a goal of the Audit Specialization Program. Industry specialists are responsible for keeping current with changing industry practices and recognizing potential issues that may appear on future tax returns.

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Chapter 1

OVERVIEW

BACKGROUND

During the initial stages of gathering information on tobacco growers, a scheme was uncovered through contact with the U.S. Department of Agriculture (USDA). The dealers circumvented the regulatory requirements enabling the farmers to sell tobacco which exceeded their quota. It was discovered that more than 20 million pounds of tobacco (at an average price of \$1.70 per pound) were sold through the scheme in 1991 alone. Examinations of dealers in both districts have resulted in substantial adjustments. Several fraud referrals have been made and two examinations to date have resulted in jeopardy assessments.

A Compliance 2000 initiative has been developed as a result of the initial examinations, the apparent non-compliance levels by dealers, and the existence of the illegal schemes. The focus of this effort is:

1. To determine the percent of nonfilers
2. To determine the accuracy of filed returns
3. To determine the timeliness of filings and payments
4. To prepare an Audit Specialization Handbook for use by other examiners when conducting examinations involving the tobacco industry.

HISTORY OF TOBACCO

Tobacco is deeply rooted in our history. Because the export of tobacco financed shipment of essential goods from England, it became the lifeblood of the early settlers. Tobacco sales continue to play a major role in the U.S. economy.

Approximately one-third of the total annual production is exported. Leaf and manufactured product exports have grown since 1988 and now appear to be leveling off. Generally, imported tobacco is a lower grade than domestic leaf. It is used in the manufacture of generic cigarettes, which in 1992 were 30 percent of the market. American leaf is used in the brand name production.

Tobacco is the seventh largest cash crop of the 50 states. One acre produces an average yield of \$3,862. In comparison, corn, cotton, and peanuts yield \$262, \$380, and \$691 per acre, respectively. The five largest producing states of flue-cured tobacco for 1992 are:

North Carolina	583,454,564 lbs.
South Carolina	103,718,199 lbs.
Georgia	102,577,444 lbs.
Virginia	96,662,422 lbs.
Florida	18,714,463 lbs.

The tax on tobacco products is now the second largest revenue generated for the U.S. Treasury, exceeded only by the excise tax collections from gasoline. Tobacco is the most heavily taxed of any consumer product by percent of retail price. The taxes generated are not only from excise, but from income, employment, property, and sales taxes.

MARKET STRUCTURE

Before learning how the tobacco market works, one must understand the roles of the major players in the market. It is not uncommon for one person to fill more than one of the following roles. For instance, a farmer might also own a warehouse operation and have a dealer card.

The Major Players

1. USDA-ASCS, United States Department of Agriculture, Agricultural Stabilization and Conservation Service, a Federal Government agency which controls the production and marketing of agricultural commodities, including tobacco, to stabilize supply and prices. The ASCS is organized by state, with field offices in each county within the state.
2. Federal Crop Insurance Corporation (FCIC), a quasi-government entity which sells insurance policies to insure a farmer's crop against loss due to bad weather, pests, disease, etc.
3. Stabilization Cooperative (Co-op), a non-profit, producer-owned organization which stabilizes prices by purchasing tobacco from participating producers at a predetermined price when it does not receive such price at auction. The Co-op stores the tobacco for later resale.

4. Grower, the farmer who grows and cures tobacco. A farmer cannot sell controlled tobacco unless he or she has an allotment, and under ASCS rules, can only sell his or her tobacco to or through a registered dealer or warehouse.
5. Warehouse, the place where the farmers' tobacco is usually sold at auction. The warehouse has limited space and only keeps the tobacco a few days until it is sold. Warehouses can purchase tobacco for their own account for resale, however, that is a small part of their total operation. Warehouses must file transaction reports with ASCS and, should only buy and sell tobacco grown within quota limits. Each spring, a farmer must designate the warehouse(s) at which he or she will sell his or her tobacco.
6. Dealer, an individual who acts as a speculator by buying and reselling tobacco. Dealers can purchase directly from farmers, warehouses, or other dealers, at auction or nonauction, and sell to anyone who is authorized to buy. A dealer in quota controlled tobacco must have a dealer card issued by the ASCS and must file transaction reports with ASCS. In theory, the dealer would only be able to buy and sell tobacco grown within the quota limits.
7. Processor, a company which buys cured tobacco and prepares leaf for shipment to domestic or foreign manufacturers.
8. Manufacturer, generally a large corporation that purchases tobacco for manufacturing and processing into products.

How the Market Should Work

At the beginning of the tobacco season, each grower of flue-cured tobacco is notified by the ASCS of his or her acreage allotment and quota for the season. The farmer then grows and cures his or her crop. The crop is taken by truckloads to the warehouse where it is weighed and graded in smaller lots of about 300 pounds each. Since the crop does not all mature at the same time, it is taken in batches throughout the sales season, generally from late July through October in North Carolina and Virginia. The tobacco is sold at auction by the warehouse. The buyer, usually a processor or manufacturer, pays the warehouse and the warehouse pays the farmer after deducting certain fees and a commission. If the farmer still has unsold

tobacco after his or her cumulative sales for the season have reached 103 percent of his or her quota, the farmer has the choices of:

1. Destroying the excess
2. Selling the excess with a penalty, which can be 75 percent of the market price of tobacco, and reducing next year's quota, or
3. Taking the excess back to the farm to store until next year, then selling against next year's quota.

None of these alternatives are particularly good for the farmer, however, if he or she has adequate storage space, holding the excess until next year is the better choice because it can be sold for full value at that time. A fourth but illegal alternative is to sell the excess on the black market.

If the buyer is a dealer, he or she, having no ability to store tobacco, would try to resell it quickly, either at the same warehouse where it was purchased or by trucking it to another warehouse. The dealer, therefore is merely a speculator or middleman, and in legitimate transactions, his or her profit margin would probably be small.

Warehouses are required by ASCS to make payment to the seller by check on the day of the sale. Dealers are not required to pay for purchases by check and often deal in large amounts of cash.

GOVERNMENT REGULATION OF THE TOBACCO INDUSTRY

The USDA, through the ASCS, administers production and price support programs for the various kinds of tobacco. The purpose of the tobacco program is to:

1. Ensure that supply is consistent with anticipated demand
2. Provide an orderly market
3. Guarantee the farmer a fair price.

Most types of tobacco are regulated. The most common type, flue-cured, is monitored more closely than burley tobacco. Every 3 years the Secretary of Agriculture holds a national referendum of tobacco farmers to determine if most are in favor of continuing marketing quotas for the types of tobacco under marketing quotas.

If two-thirds of the eligible producers respond favorably for marketing quotas and price support, then both are in effect for the next 3 years. The secretary annually sets the quota based on expected demand and exports.

Each participant, from the field to the factory, operates under varying degrees of Government regulation. Although the crop year of a farmer runs from the spring when the plants are set out in the field, until July through October when the leaves are harvested and cured, the season starts in January when the county ASCS office notifies the farmer of the allotment and quota that has been determined for his or her land that year. Allotment runs with the land. Quota is the number of pounds that can be marketed from the tobacco grown on the designated acreage allotment. By April 15, the producer must designate the warehouse, or warehouses, where he or she will sell his or her tobacco and he or she lists the number of pounds of his or her allotment that he or she intends to sell at each designated warehouse.

Each spring the farmer must visit the county ASCS office and certify how many acres are planted. ASCS then measures the acreage on each farm to ensure compliance. In earlier years this was done by an individual actually measuring the land with chains -- presently the land is measured from aerial photographs. The ASCS office issues marketing cards (similar to a credit card) that identifies the farm, operator, and pounds available to sell. The marketing card is brought to the warehouse and presented prior to the auction. Each sales invoice is imprinted with the card at the time the tobacco is weighed. On the bill there is a record of how much tobacco was weighed in, number of pounds sold, price per pound, and the purchaser's name. If the tobacco goes to stabilization, this is likewise noted on the sales invoice. The marketing card remains in the possession of the warehouse until the farmer is issued a check for the pounds sold that day at the warehouse. The balance of pounds that can be sold at each warehouse is noted on the card after each sale. At the end of the marketing period the card is returned to the ASCS where the sales are reconciled.

The warehouse is likewise regulated by the Department of Agriculture and its agencies. Tobacco, placed on burlap sheets on the warehouse floor in piles of about 300 pounds, is graded by employees of the Agricultural Marketing Service. Graders consider the leaves' color, place on the stalk, length, and quality. The warehouse operator allocates the selling time on his or her floor

between farmers and dealers. After each day's sales he or she must report sales to the ASCS, issue checks to producers and bill the buyers. Generally the tobacco buyer is a processor or manufacturer, but it could be a dealer, another warehouse, or the stabilization cooperative.

Each year, a dealer must apply for and be issued a dealer card from ASCS. A dealer can buy tobacco from a warehouse, another dealer, or directly from the farm. The dealer is limited to selling only as many pounds as he or she has already purchased. He or she cannot sell "short" as a stockbroker can. The dealer must report his or her purchases and sales weekly to the ASCS office, using Form MQ-79. The warehouse daily sales report, Form MQ-80, is reconciled with the Form MQ-79 reports of the dealer by the ASCS office.

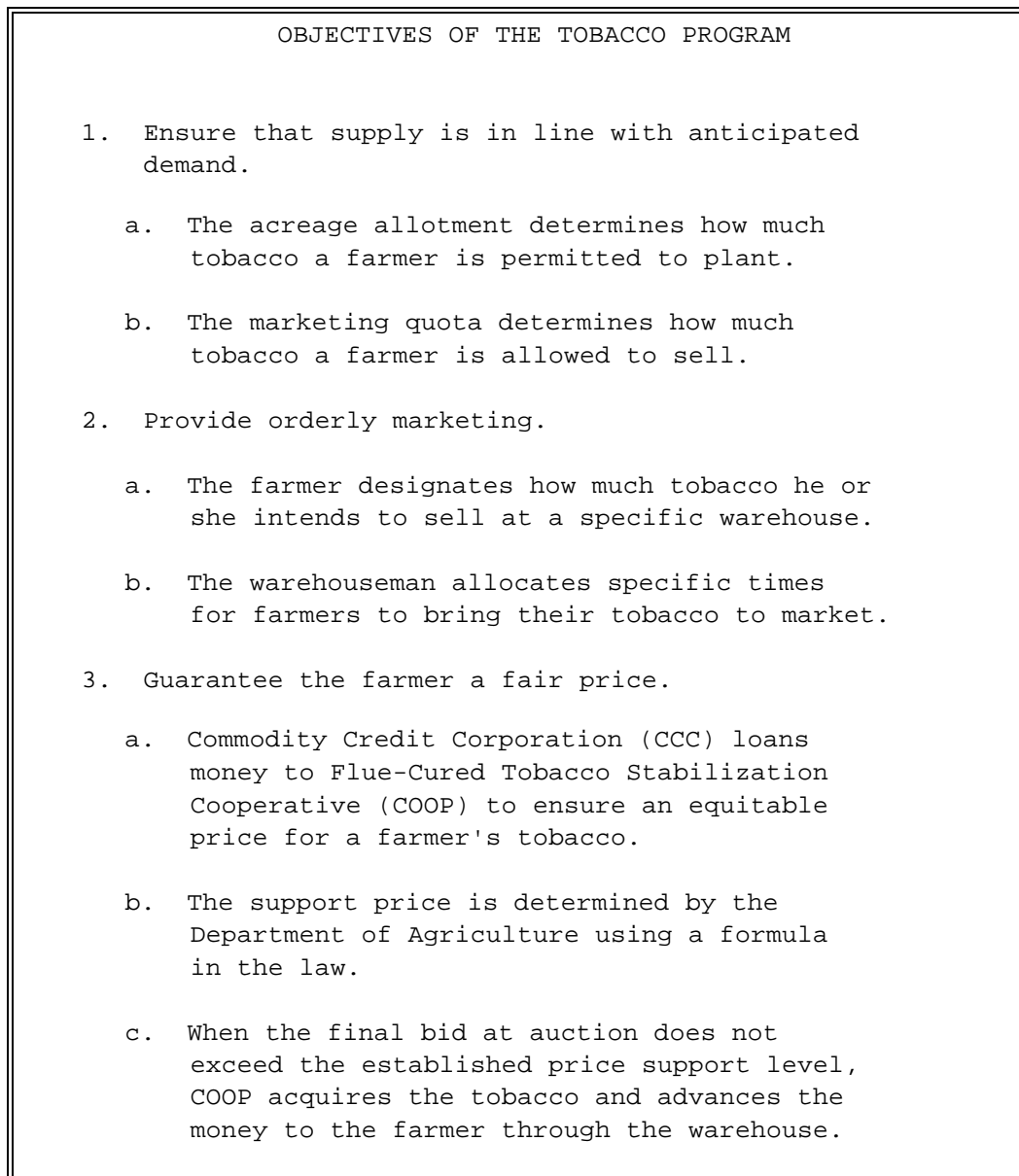
A support price is established each year by USDA based on a formula that takes into account intended purchases by manufacturers, the unmanufactured exports and the reserve stock. If tobacco does not attain the support price at auction it then goes to stabilization. This in essence means that it is being reserved for the future. However, the producer is paid on the spot by means of a loan from the Government owned and operated Commodity Credit Corporation (CCC) which loans money to farmer-owned associations. Interest is paid on the loans by the association out of fees paid by both farmers and processors into a "no net cost" account maintained by the Board of Stabilization. Legislation enacted in 1982 has effectively established the price support program with no cost to the American taxpayer. The assessment and collection of funds deposited into the no net cost account has guaranteed that there will be no net losses on the sales of tobacco held in storage by the association. To date, there has never been a loss from stored tobacco including interest paid to CCC. This aspect of the support system is generally misunderstood by the public and commonly thought to be the Government paying farmers for the production of tobacco.

The Government regulations, quota, and allotment systems create strong incentives for a farmer who has production in excess of his or her quota to dispose of this excess on the black market because the penalties are so severe. The penalty for selling excess tobacco grown over quota is 75 percent of the market price of the tobacco. For example, if a farmer has 10,000 pounds of excess tobacco and the current market price is \$1.70 per pound, the penalty for selling the excess tobacco grown is \$12,750 (10,000 x 1.70 x .75). The farmer would receive \$4,250 for the 10,000

pounds sold and would also have his or her next year's allotment reduced. Due to enhanced agricultural equipment and increased experience in harvesting tobacco, farmers are able to grow substantially more tobacco per allotted acre than the quota established by ASCS. With the excess tobacco grown, farmers may decide to store the excess for sale the next year or sell the excess at the substantial penalty. As a result, a black market emerged.

Figure 1-1 provides the objectives of the Government's tobacco program.

Figure 1-1



SCHEMES

In spite of the system of checks and balances, various schemes have developed.

Schemes to Circumvent ASCS's Quota System

Air Pounds: Paper transactions are used to create apparent inventory on a dealer's card. This is done by filing USDA reports showing dealer "B" selling (fictitious) tobacco to dealer "A," even though dealer "B" has no actual tobacco. Dealer "A" then goes to the warehouse and leaves his or her dealer card. Actual tobacco (usually a farmer's excess production) is then labeled and sold at the warehouse as if it belonged to dealer "A." The sale proceeds are split, as cash, between the farmer, warehouseman, and dealer "A." Dealer "B" is generally a low-profile individual who was paid a nominal sum to get a dealer card, has little to lose, and would not be a good target for examination.

Air Pounds: Paper transactions are used to create apparent inventory on a dealers's card, as shown above. Dealer "B" then pays cash to purchase excess tobacco from a farmer. The excess tobacco can be substituted for the air pounds and sold at a warehouse because it appears to have been purchased within quota.

Substitution by Dealer: A dealer purchases scrap tobacco, which was produced and sold within quota, at a very low price. He or she files USDA reports showing this purchase; he or she discards the scrap, then substitutes and sells better quality tobacco which he or she purchased cheaply from a farmer as excess production.

Substitution by Farmer: A farmer holding a certain amount of quota underproduces for one reason or another, either deliberately or by misfortune, then purchases another farmer's excess production, which he or she sells under his or her quota. This is illegal under USDA rules, but can be profitable because excess production generally can be bought for less than what it would cost to grow and cure the same product. This is because the penalty for selling tobacco in excess of quota is 75 percent of the market price.

Crop Insurance Schemes

Crop Shifting: A farmer has quotas on more than one farm, either by ownership or leasing. He or she insures the crop on one farm, then, at harvest, moves

some of the crop from the insured farm to the other farm for sale. The farmer then files a crop insurance claim for the "shortage" on the insured farm.

Black Market Sale: A farmer insures his or her crop, and at harvest, sells a portion of his or her crop on the black market as if excess production. The remaining crop is less than the insured amount; the farmer files an insurance claim for the "shortage." In effect, the farmer was paid twice for the claimed shortage.

Warehouse Schemes

Short Weighing: Small magnet hidden on the balance beam of tobacco scales causes the farmer's load of tobacco to weigh short. After the close of business, a few pounds are taken off the pile to bring it down to the stated weight. (see Flaking)

Flaking, Scaling, or Pinhooking: After the close of business, warehouse employees go around taking a few pounds of leaf off each farmer's piles. Enough can be accumulated to make a new pile the warehouse can sell as its own. The pounds flaked are not missed because the load was weighed short and because industry practice allows a 2 percent tolerance in the stated weight of a lot. Sometimes warehouse personnel might also lift the top layers off a pile, exchange inferior tobacco for good tobacco in the center of the pile, then replace the top layers. The good leaf which was taken is then added to the warehouse's pile for sale.

Gratuities to Buyers and Graders: Warehouses reportedly may use gifts and lavish entertainment in the form of meals, liquor, etc. to influence processors' buyers and USDA graders. The examiner should also be alert to the possibility of kickbacks between various players in the industry.

Tax Implications

Most schemes to circumvent the quota system involve payments by cash for goods or services. These payments are generally unsubstantiated by the payer and are usually unreported for tax purposes by the recipient. Dealers who participated in these schemes generally have been found to overstate their cost of goods sold to reflect what it would have been had they purchased tobacco legitimately, rather than reflecting the bargain price they paid for excess production. Dealers

also have been found to use structuring arrangements to avoid filing cash transaction reports, Form 8300 and CTR's, when cashing the checks issued by warehouses.

TYPES OF TOBACCO

The U.S. Department of Agriculture divides tobacco into seven classes based on curing method, principle use, and one specialty type.

Flue-cured -- also known as bright leaf, is carefully force dried in barns using a clean heat source and produces a golden colored leaf. It is the principle ingredient in cigarettes. North Carolina is the leading grower of flue-cured tobacco, which is also grown in Virginia, South Carolina, Georgia, Florida, and Alabama.

Burley -- Also a key ingredient in cigarettes, is grown in 14 states, with Kentucky producing the largest quantity. An air-curing process is used for Burley.

Fire-Cured -- Is used in snuff, chewing tobacco, and strong cigars.

Maryland Air-Cured -- Is used in cigarettes and as a cigar filler.

Dark Air-Cured -- Is used in chewing and smoking tobaccos, snuff, and as a cigar filler.

Cigar Types: Filler, Binder, and Wrapper -- are grown in the Northeast, Wisconsin, and Puerto Rico.

Perique -- Noted for its pleasing aroma, is used sparingly in fancy smoking tobacco blends and is grown in Louisiana in very limited quantities.

Chapter 2

FARMERS

INTRODUCTION TO TOBACCO FARMERS

Farmers who grow tobacco are different from other farmers in several ways. It is those differences that make this audit guide useful. Due to the high value of tobacco, both per acre and per pound, and the level of Government regulation of the industry, special problems and opportunities exist. A detailed paper trail is generated for legal sales of tobacco, and complex schemes have developed to facilitate illegal sales. If you have not read Chapter 1, you should consider going back and reading the parts on market structure, Government regulation, and illegal schemes before you proceed. They would give you a basic understanding of the market environment and how the farmer, dealer, warehouse, and Government agencies interact.

This chapter contains information intended to help the examiner perform a quality audit of a tobacco farmer.

AUDIT STEPS

Pre-Audit Analysis

Prior to contacting the taxpayer the agent should review the return to determine the examination potential. Items listed below are points to be considered in both the agent's audit decision and preplan.

1. Is there sufficient income to sustain the taxpayer's standard of living? Does it appear the spouse works outside the home? Does the taxpayer have any passive, investment, or other sources of income?
2. Are there any large, unusual, or questionable expenses claimed?
3. If a depreciation schedule is attached to the return, are there any acquisitions or sales of assets which should be considered?

4. If wages or contract labor are deducted, payroll tax reports, transcripts, and IRPOL for 1099 information should be requested.
5. Request prior and subsequent years RTVUEs for comparison of gross profit percentage and expenses.
6. Inspect the amount of interest expense, if any, in comparison to the total out-of-pocket expenditures.
7. If there is a clear indication that the Schedule F reports only tobacco farming, the proforma included in this section should be used to identify variances and unusual items.

Sources of Information

Internal Sources

1. RTVUE and BRTVUE of prior and subsequent years.
2. IRPs for the last 4 years.
3. Division of Motor Vehicles listings for the taxpayer.
4. Annual reports filed with the Secretary of State or State Corporation Commission.
5. CTR and Form 8300 filings.
6. Employment tax return transcripts.

External Sources

1. ASCS Office (See information in Figure 2-1 for data available at ASCS offices).
2. Cooperative Extension Service Agent
 - a. Weather conditions for a growing season
 - b. Market conditions
 - c. Information on the latest techniques used by farmers.

3. Courthouse records
 - a. Deeds
 - b. Deeds of trust
 - c. Property tax listings
 - d. Judgment and liens
 - e. Probate files.
4. Financial statements furnished to creditors.
5. Tobacco Warehouses
 - a. Checks written to farmers for tobacco sales
 - b. Sales tickets.

ASCS OFFICE

Each ASCS office maintains records of tobacco produced and sold for each farm located in their county. All farms are assigned farm numbers and detailed records are maintained by farm number. If the examiner finds it necessary to make third party contacts, the county ASCS office has the following data available:

Form 1026A

A computer printout listing the farmer's name and all farm numbers that the farmer is associated with for each year. If the farmer is tending farms in more than one county, each ASCS office will have records on all farms (including farms located in other counties).

Farm Folder

There is a farm folder for each farm number. Information located in the farm folder includes detail of all crop activity, the total allotment, and the actual measurements for that specific farm. Also found in the farm folder is the allocation of crop interests, if any, between farm operators, land owners, etc.

Detail Farm Marketing Report

A listing by year for each farm, the date, the warehouse, and number of pounds sold from each farm and any balance left on hand at the end of the season. A farmer can sell 103 percent of his or her quota legally, but the 3 percent over and above quota will be subtracted from next year's allowable quota. (See Exhibit 2-1 for an example.)

MO 108-1

A report of the carryover (stored) tobacco from the previous year.

Flue-Cured Tobacco Marketing Card

Shows the quota, and as each sale is recorded, the remaining pounds available to sell. Ideally, it would end with a zero balance. One card is issued per designated warehouse. Just above the name on the front of the card is the year and the last three digits of the designated warehouse. The large blank space above the name is to indicate any liens of the farmer to the Federal Government or Federal agency. The smaller right hand box is used to indicate a change to warehouse designation and date of change. (See Exhibit 2-2 for an example.)

Information Document Request

The following provides an example of what you need to request on an information document request.

Form 4564 Rev. Jan. 1984	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number 1
TO:	Subject 1040 Examination	
	TIN No.	Submitted to:
	Dates of Previous Requests None	

Please provide the following at our meeting on:

1. All books and records including journals, ledgers, or other documents used in the preparation of your income tax returns for the year(s) shown above.
2. Bank statements, canceled checks, check register, and savings account records (including certificates of deposit, money market accounts, etc.) covering the period December, 19__ through January, 19__, for all accounts, business and personal.
3. Records of all loan proceeds and loan repayments, including the beginning and ending balances for the year being examined.
4. Records to establish all non-taxable income received during the year(s).
5. Records of purchases, sales, and/or construction of real estate or other property during the year(s).
6. Records of business and personal assets acquired during the year(s).
7. Records to establish your gross farm income for the year(s), including sales journals, sales bills and receipts, and any other records used in determining your gross income.

From:	Name and Title of Requester Revenue Agent	Date
	Office Location	

Form 4564 Rev. Jan. 1984	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number 1
TO:	Subject 1040 Examination	
	TIN No.	Submitted to:
	Dates of Previous Requests None	

8. Copies of your prior and subsequent year tax returns.
9. A copy of any related Federal tax returns, i.e., Forms 940, 943, W-4, W-2, 1099 filed and received, excise returns, amended returns, and any related partnership and corporate returns.
10. Copies of any prior audit reports and any correspondence received from the Internal Revenue Service.
11. Complete Depreciation Schedule for the year(s) shown above.
12. Records to verify the following expenses:

13. Records to establish any tobacco allotment purchased or sold during the year(s).
14. Please furnish records to establish your total tobacco allotment and the total pounds of tobacco you produced and sold during the taxable year for all farms tended or leased.
15. Other information may be requested as necessary.

From:	Name and Title of Requester Revenue Agent	Date
	Office Location	

Initial Interview

When examining a tobacco farmer, the following questions should be used to supplement your initial interview. The questions below address both the tobacco farmer and the indirect method.

1. How did you determine Gross Income reported on Schedule F?
2. Is the income reported from more than one crop? If so, what are the gross receipts for each crop?
3. What types of records did you keep for farm income? sales journal, sales bills, receipts, etc.)
4. How did you determine your farm expenses?
5. What records did you keep for farm expenses? (Cash disbursements journal, invoices, receipts, canceled checks, etc.)
6. Who is responsible for the books and records?
7. Did you have a farm bank account?
8. Did you receive any crop insurance proceeds? If so, how much and from whom? Deposited? To which account?
9. What farm loans did you receive during the tax year? Amount received? Source of loan? Amount repaid? When? Deposited? To which account?
10. How did you handle the sales proceeds?
11. Was all income deposited? If so, to which accounts?
12. Was any other income deposited to the farm account? If so, what were the sources of other income?
13. How did you pay for your farm expenses? (Cash, check, charge, etc.)
14. Did you ever endorse sales checks over to a third party for payment of some expense or liability?

15. What crops did you raise during the tax year under examination?
16. Number of farms where tobacco was grown? Did you own all these farms? Rent?
17. What are the farm numbers for each of your farms? How many acres on each farm were used to produce tobacco?
18. Is this the same number of farms you produced tobacco on in the prior and subsequent tax years? If not, explain difference.
19. What was your total tobacco allotment and quota?
20. Did you have any carryover from the prior year's production?
21. What was your tobacco allotment and quota for each farm?
22. Did you lease any tobacco allotment? If so, from whom? Amount paid?
23. Did you buy or sell any allotment? If so, parties involved, amount paid or received? How was the value of the allotment determined?
24. How many pounds of tobacco did you produce?
25. How many pounds did you sell?
26. Did you produce your quota?
27. Did your tobacco production exceed your quota? If so, what did you do with the excess?
28. Did you farm with anyone else? If so, how were the profits and expenses shared?
29. How many barns did you use to cure your tobacco? Did you cure tobacco for anyone else? Did anyone else cure tobacco for you?
30. How many of these barns do you own? How many do you lease?
31. What types of barns did you use to cure your tobacco?
32. Who manufactured the barn?

33. What was the capacity of each barn?
34. What steps did you take to cure the tobacco?
35. How long did the curing process take for each barn?
36. What type of fuel did you use to cure your tobacco?
37. How many gallons of fuel did you use to cure a barn of tobacco?
38. How many pounds of finished tobacco do you yield from each run?
39. Who were your suppliers of this fuel?
40. How did you pay for the fuel purchased? When?
41. Did you buy fuel in bulk? If so, where was it stored? Storage capacity?
42. Did you buy other fuels in bulk? If so, type (lp gas, highway diesel fuel, non-highway diesel fuel, and gasoline)?
43. Is there any personal use of this fuel? If so, how is the personal use accounted for?
44. What farm vehicles do you own? Were these vehicles used both for business and personal reasons? If so, how was the personal use accounted for?
45. Did you purchase any farm equipment or other assets during this tax year? If so, describe assets purchased? Cost of assets? Financed? Amount of payments?
46. Have you sold any farm property? If so, when? To whom? Description of property sold?
47. Did you make any major improvements or repairs to any of your farm property? If so, describe type of improvements made?
48. What type of labor costs did you incur?
49. Did you treat your farm workers as employees? (Forms 943 and W-2 filed?)

50. Did you compensate your employees in noncash media such as farm products?
51. What type of services were provided by the subcontract laborers?
If necessary, pursue employee versus independent contractor issue.

Tour of the Farm

Sometime during the early phase of the examination, the agent should request a guided tour of the farm.

Much of the information about the operation of a particular farm can be obtained at the county ASCS office. Contact prior to the first appointment is recommended. Most county agents have firsthand knowledge of the farmers in their area. The specific information available at these county offices can be found elsewhere in this handbook. A perusal of the "farm file" will reveal the acreage planted by crop and an overview of the property. Furthermore, county agents are a valuable source of information about the weather, market conditions and economy of the area. (See Exhibit 2-3 for a list of ASCS offices, primarily in North Carolina.)

Armed with the depreciation schedule, look to determine if the equipment shown is physically present, or if not, there should be a sale reported in the intervening years. All buildings shown on the schedule should be accounted for, noting improvements if a major repair is being depreciated. All vehicles on the schedule should be inspected and inquiry made regarding which vehicle is used for personal travel.

The condition of the land provides clues to the farm operation. Cutover land indicates timber sales within the relatively recent past. A large garden or presence of orchard may be indicators of excess produce that can be sold along the edge of the property. Besides tobacco, the same farmers often grow soybeans, corn, and hay.

While touring the farm, note the number of hired hands at work and quickly assess whether the most recently filed Form 943 report is reasonable in the total number of workers and wages reported.

Most tobacco farmers will have a tractor, planter, tiller, curing barns, and possibly a harvester and irrigation equipment on the fixed asset schedule. The curing barns are frequently lined up side by side. Information concerning the number of barns and capacity of each is critical when using an alternative method of determining the reasonableness of the gross receipts from the sale of tobacco.

AUDIT ISSUES/TECHNIQUES

Required Filing Checks

The inspection and discussion of the employment tax and other information returns with the farmer is a key part of the examination. It is recommended that the agent review *Publication 51, Circular A, Agricultural Employer's Tax Guide* prior to meeting with the taxpayer. The package audit procedures as required by IRM 4034 should be followed.

1. Form 943

The farmer is required to file a Form 943 to report the income tax withholding, social security tax, and Medicare tax on agricultural employees. The farmer must file a Form 943 if he or she has one or more farm workers and has paid any employee cash wages of \$150 or more during the year, or paid \$2500 or more of wages to all employees during the year. Wages of a farm worker that earns less than \$150 annually and is: 1) considered a hand harvest laborer, 2) paid piece rates, 3) commuted daily from his/her home, and 4) worked in agriculture for less than 13 weeks in the prior year, are not subject to the social security and Medicare taxes even if the total wages paid are \$2500 or more.

2. Form 940

If the farmer has paid wages of \$20,000 or more in a calendar quarter during the year under audit or the prior year, or if the farmer had 10 or more employees for some part of at least one day during 20 different calendar weeks during the year under audit or the prior year, then federal unemployment taxes are required to be paid and reported on Form 940.

3. Crew Leader

The farmer may use the services of a crew leader instead of employing the farm workers. The crew leader provides the farm labor and is considered the employer of the workers unless there is a written agreement stating the crew leader is an employee of the farmer. For the crew leader to be considered a contract laborer, they must furnish and pay the workers. To qualify as the employer for Federal unemployment tax purposes, the crew leader must also either be registered under the Migrant and Seasonal Agricultural Worker Protection Act or the majority of all crew members must operate or maintain equipment furnished by the crew leader.

4. Forms 1099

During the audit the agent should verify that all required Forms 1099 were filed. These may include information returns reporting: rents paid (for land, equipment, and allotment), nonemployee compensation, and/or the sale of allotment or some other farm asset.

To determine if the farmer has properly classified his or her farm labor, the agent must consider the 20 common law factors. If the workers were not correctly treated as employees, the agent should pursue the employment tax issue. Another area to consider in the farmer audit is the employment of resident and/or nonresident aliens. If this issue is present the examiner should refer to the Circular A for withholding requirements.

Generally, noncash remuneration for agricultural labor is excluded from "wages" for employment tax purposes but is includible in gross income and should be reported on Form W-2. Noncash compensation arrangements (for example, payments of farm products) should be examined to ensure that there has been a bona fide transfer of the noncash medium of payment. The market segment understanding of noncash remuneration for agricultural labor should be consulted in determining whether noncash payments are bona fide.

Income Probe

Tobacco growers have a wide variety of income-producing opportunities, not all involving tobacco. In examining the farmer, consider the possibilities and look for signs that one or more of the following may not be fully reported:

Regular tobacco sales (within allotment): There are various methods of verifying gross receipts from the sale of tobacco. Percentage analysis and curing cost analysis can be used to determine if all sales are reported. (See Exhibit 2-4.) Also, sales estimates based on quota poundage at average price per pound can be compared to sales per return.

Several methods rely upon records maintained by third parties. The county ASCS office can provide a copy of the tobacco card for each warehouse designated by the taxpayer. The total allotment in pounds for the growing season is listed and the remaining number of pounds is recorded after each sale. Ideally, the card would show a zero balance at the end of the market. The taxpayer will have a bill of sale for each warehouse transaction. It will list the remaining allotment before and after each sale. By lining up the farmer's retained copies, any omitted sales tickets will be apparent if the "after sale" allotment does not match the "before sale" allotment on a subsequent bill of sale.

Visit the warehouse where the taxpayer sells his or her tobacco to inspect cancelled tobacco checks issued to taxpayer. These tobacco checks should be listed and totalled, and each check should be inspected for possible third party endorsement. Any checks not deposited to the farm account should be traced to determine if they were included in income under the taxpayer's accounting practices.

Black market sales: Percentage analysis and curing cost analysis can be used to estimate the total pounds of tobacco produced. If it is determined that the pounds sold exceed the taxpayer's allotment, the excess sales would have been sold on the black market. Since black market sales are not reported on the allotment card, they will not show up in warehouse checks. The farmer would probably have been paid in cash, receiving approximately half of what it would have brought on the regular market.

Sales of seeds or plants: During the examination, look for indications of seed or plant sales, including large purchases of seeds, trays, potting medium, and related equipment and supplies. Any farmer with large greenhouses may be starting tobacco plants for sale to others.

Other crops: Many tobacco growers also produce other commodities, such as corn, soybeans, hay, or livestock. Purchases of supplies, feed, etc. may be present to alert you to the possibility of these sources. The taxpayer may also be growing melons, tomatoes, strawberries, or other fruits and vegetables for sale at local markets or roadside stands. The county ASCS office may be able to tell you of other uses taxpayer makes of his or her land.

Crop insurance proceeds: If the farmer sold less than his or her full quota, he or she may have received crop insurance proceeds to cover the balance. A Form 1099 should have been issued by the Federal Crop Insurance Corporation (FCIC), however, a written request to FCIC should get a confirmation of the amount received. Information reporting would not be required if the crop insurance proceeds represented a recovery of farming expenses that were properly capitalized under IRC section 447(b) and the farmer notified the FCIC that the expenses were capitalized. Rev. Rul. 82-93, 1982-1 C.B. 196.

Rental of farmland, tenant houses, or tobacco allotments: The county ASCS office should have information on the rentals of farmland and/or allotments by the taxpayer to other individuals. During the visual inspection of the farm, also look for outbuildings, houses, or house trailers which may have been rented out.

Rental of curing barns: Many growers have more curing barn capacity than they need. They can supplement their income by renting barns to others. When you use curing fuel costs to estimate tobacco sales, the farmer should disclose any barn rentals. Otherwise, his or her income will include the other farmer's tobacco.

Equipment sales or rentals: Some growers have been found to be buying used equipment, adding it to the depreciation schedule, then reselling it without deleting it from the depreciation schedule or reporting the sale. There is also a ready market for rental of equipment.

Sales of land or tobacco allotments: Inquiry at the county ASCS office should reveal any sales of tobacco allotments. Land sales will be on record at the county clerk's office.

Timber sales: Review disbursements for signs that timber was sold, such as expenses of timber cruises (appraisals), land clearing, grading, or replanting expenses, etc. During the onsite inspection, you might see cutover land. The county ASCS office may also have knowledge of land clearing or timber sales.

Sales of chemicals or fertilizer: Some growers are also engaged in the business of selling chemicals or fertilizer from their farms. During the onsite inspection, look for large stockpiles, advertising signs, letterhead stationery, etc., which would indicate sales activity.

Discharge of indebtedness: Determine if the farmer was discharged of any indebtedness. Income attributable to the discharge of a solvent taxpayer's debt generally is included in gross income. Under certain circumstances, however, the discharge of debt incurred in connection with the trade or business of farming is not included in income. Refer to IRC section 108 for specifics.

Traditional indirect methods may not be useful in examinations of farm returns if the taxpayer is adept at hiding assets, hoarding cash, or paying bills and loans directly with sales proceeds checks or cash. Make a decision as to whether to use a traditional indirect method or investigate the possible sources of other income to arrive at specific item adjustments. Use of curing costs to estimate gross sales may be considered to be an acceptable indirect method of computing income if used appropriately.

Using Curing Costs to Estimate Production

After harvesting, tobacco must be dried under controlled conditions (cured) before it can be sold or stored. Flue-cured tobacco is force-dried in bulk barns, using natural gas, propane, or LP gas as a heating fuel. Kerosene and diesel fuel are seldom used for drying due to their potential to give an odor to the product. Natural gas is more economical than LP or propane but is not available to most growers. A few growers may still be curing tobacco in old wooden barns; the figures discussed below may not be appropriate for determining their output, due to the relative heat inefficiency of those buildings.

Curing is one step in the process of producing tobacco where a good estimate of the actual quantity of product can be made. This is possible because the barns hold a specific quantity of tobacco, and use a specific quantity of fuel to operate for a curing cycle (about 7 days).

Bulk Barn Basics

Bulk barns come in different sizes, generally designated by the number of boxes or racks they can hold, such as 8-box, 10-box, even a 13-box size. The number of pounds of tobacco produced by each run depends on the type of leaf cured, the moisture content, and how carefully it was packed. An 8-box barn will generally produce about 2,500 to 3,000 pounds of cured tobacco per cycle. Before curing, the tobacco weighs about eight times as much. In spite of the variables in size and design, most bulk barns use about the same amount of fuel and electricity per pound of cured product.

There is a chemical (ethylene gas) which is sometimes introduced into barns during curing to accelerate the drying and coloring process. This can result in fuel and electricity savings since it shortens the time required to cure the product. One supplier, Livingston Chemicals, Inc., has developed a method under the trade name AC-CEL, applying ethylene at higher temperatures to further accelerate the curing process. The recommended application rate of ethylene is one pound of ethylene per barn per curing run.

Cost and Production Estimates

The best estimate of production can be made from gallons of curing fuel used, since this eliminates the variables of price per gallon of fuel and price per pound of tobacco.

Based on Extension Service figures, 9 pounds of cured tobacco can be produced per gallon of propane or LP gas.

Based on barn manufacturers' representatives' figures, an 8-box bulk barn will use 250 to 275 gallons to produce 2,600 to 3,000 pounds. This computes to between 9.5 and 12 pounds per gallon. One manufacturer, BulkTobac, published figures averaging 17 pounds per gallon using their barns.

Livingston Chemicals' figures for ethylene curing indicate 13 pounds per gallon of fuel, or 17 pounds per gallon using the AC-CEL method.

An estimate of production can be made from cost of fuel. Based on Extension Service and manufacturers' figures:

Extension Service	\$.095
With Ethylene	.062
With Ethylene + heat	.046

Total fuel cost divided by above cost
per pound = pounds cured

Lastly, an approximation of sales can be made from fuel costs. There is a wider variation in this method due to estimates involved.

- Based on Extension Service data, using estimates of fuel costs and tobacco selling prices:

\$.85 per gallon yields 9 lbs X \$1.70 = \$15.30 gross sales
Fuel is, therefore, 5.5 percent of tobacco sales.

- Based on Richmond District's analysis, which includes data from actual returns filed, fuel was 7.5 percent of tobacco sales.

- Based on Livingston's AC-CEL figures:

\$.85 per gallon yields 17 lbs X \$1.70 = \$28.90 gross sales
Fuel would be 2.9 percent of tobacco sales. This seems very low, and it is not recommended that this figure be used without further support.

Using these estimates for guidelines, the taxpayer should be interviewed to determine what type of barns and fuel he or she uses, whether or not ethylene gas was used, if the AC-CEL method was used, what his or her estimates of fuel use are, and records examined to determine cost and gallons of fuel purchased. Some consideration should be given to inventories of tobacco and fuel on hand at the beginning and end of the year. Farmers also sometimes pay others to cure their crop, or receive payment from others for curing others' crops. Any such arrangement should be identified. Taking all this into consideration, an estimate can be made of the number of pounds of tobacco actually produced.

Specific Expenses

Historically, farmers have kept scant accounting records. The income and expenses can be nothing more than a notation on the back of a seed catalog or the stub of the checkbook. The larger the farming operation, the greater the likelihood of detailed records and a cost accounting system. Some large farms have all the income and expenses on a computer, but the small family farm may not maintain a sophisticated accounting system. The farmer may merely enter the income and expenses on a separate page of a notebook or record income and expenses in a ledger, and balance the farm checking account. It is not uncommon for personal and farm expenses to be commingled in a single checking account.

Over the course of the year, a farmer has expenses before he or she earns income. Often the length of time between outlay and income is months. In early Spring the farmer has seed and fertilizer costs. Over the next few months there are spraying and labor costs associated with removing the seed heads, or suckering. The market for selling tobacco is July through October. Therefore, for a large part of the year the farmer is operating on savings, or more realistically, borrowed funds.

More often than not, the income consists of sales of more than one commodity. Rarely will a farmer raise only tobacco. The same soil is suitable for sweet potatoes, peanuts, and cotton. However, receipts of more than \$3,800 per acre of tobacco are more than six times as great as those from peanuts, the second most lucrative crop.

There are several types of expenses on a Schedule F filed by a tobacco farmer that warrant the examiner's attention. They are:

1. Curing fuel
2. Labor costs
3. Repairs
4. Insurance
5. Allotment leasing

6. Expenses that also appear on Schedule A viz. taxes and interest

Of course, any large, unusual and questionable expense that appears should be scrutinized. Besides the costs mentioned above, there will generally be fertilizer, seed, utilities, supplies, and depreciation. It is recommended that the agent inspect the farm buildings and equipment with the depreciation schedule obtained through the initial document request. If an item is not present, it may have been scrapped or sold in the intervening years. This issue may need investigating.

During the interview and tour, the agent should determine what personal vehicles the farmer owned and who drove them. Often the farm pickup truck is claimed as 100 percent business use even though there is no other means of transportation for personal travel. Pursuit of this adjustment is a judgment call depending on the materiality.

Curing fuel is an expense unique to tobacco farmers. As discussed in the income probe section, the total cost of curing fuel is a yardstick of the pounds cured when the type and capacity of the curing barns is known. The fuel of choice, or necessity, is generally propane gas. Natural gas where available is also used. It has been estimated that the combined costs for fuel and electricity are 8.3 cents per pound of dried tobacco with the fuel being 6 cents. The interview questions are designed to identify the farmer's supplier and payment history. The amount on hand at the end of the prior season should be considered. According to the proforma developed by North Carolina State University Extension System the cost of curing fuel is 7.6 percent of the gross receipts from tobacco. (See Exhibit 2-5 for a list of Cooperative Extension contacts, primarily in North Carolina.

If the farm is not highly mechanized, the single greatest variable expense will be labor. The North Carolina Extension Service estimates that 17.9 percent of receipts is given over to hired help. The Tobacco Growers Association estimates that it requires 250 man hours of labor to harvest one acre of tobacco by hand. However, utilizing a tobacco harvester brings the leaf out of the field with minimum labor expense. Tobacco is harvested in stages, starting at the bottom of the plant as it progressively ripens. The harvester can pull leaves from all but the lower fourth of the stalk and transport them along a conveyor belt. At the end of the belt, hired workers pack the leaves in a box

which is later transferred to the curing barn. The laborers are often considered to be independent contractors and not employees of the farmer. Or, in the alternative, the workers are directed by a crew leader and he or she is the person the farmer pays. In this situation, the workers are the employees of the crew leader. Migrant workers are used throughout the growing region and the agent needs to consider the Government regulations in this area. It is the farmer's responsibility to ensure that the workers have the necessary credentials for working in the United States. There is no set wage for the subcontract labor. It depends on the individual's capacity to work quickly and what living arrangements the farmer might provide. The hourly wage can range from \$4 to \$7 per hour.

Repairs are frequent with farm equipment. Like other industries, repairs are often expensed when they should be capitalized. If the repair extends the life of an asset by more than one year, or has a life itself of more than one year, then the repair should be capitalized. When inspecting for repair expense, consider all payments for major repairs which should be capitalized whether one payment or several payments were made. The total payments should be aggregated and the total expenditure capitalized and depreciation allowed. Likewise, be alert to repairs on personal equipment.

Farmers insure their buildings and equipment under a comprehensive policy and also buy crop insurance. This last type of insurance covers damage due to hail, insect, drought, and other forces of nature. If there are employees, the farmer can deduct the premium on group health and accident, workers compensation, and state unemployment insurance. If the farmer is not covered as an employee under a group policy (after December 31, 1992) then 25 percent of the health insurance premiums paid is allowed as adjustment to income on Form 1040. Agents must be alert to the taxpayer claiming insurance of a personal nature on the Schedule F, for example, life insurance premiums, family health and accident coverage, homeowner's, and automobile insurance.

Based on North Carolina Extension Service data, the average market price per pound for leasing tobacco allotment is 30-40 cents per pound. (This varies according to the location and historical yields of the county). The examiner needs to determine that it is a true lease and not a purchase, which would require

capitalization. Just as leasing costs per pound vary by location, so does the selling price of a pound of allotment. Expenses that would normally appear on Schedule A often appear on Schedule F, especially if the taxpayer does not itemize deductions. Interest and real property taxes are the two most likely to be claimed on the farm schedule in error. Real property taxes should be apportioned between farm property and the personal residence. The county tax assessor's office can provide the breakdown of assessed valuation if a tax bill is not provided to the agent. Interest on farm equipment and land will be deducted on Schedule F, but the examiner should look to see if home mortgage and consumer interest payments are deducted erroneously.

If a fuel tax credit is claimed, verify that excise taxes on off-highway business use of equipment have been paid. (When the farmer deducts the full price of the fuel, including excise taxes, he or she is allowed a credit on the amount of excise taxes). However, when the farmer has received a tax benefit from the credit, the farmer must include the amount of the credit in income on the subsequent year's tax return.

TAX LAW, REGULATIONS AND COURT CASES

Income/Reconstruction of Income

IRC section 61
Treas. Reg. section 1.61
IRC section 446
Treas. Reg. section 1.446
IRC section 108
IRC section 451

Indirect Methods

Moll v. Commissioner, 52 T.C.M. 1449, Dec. 43,650(M), Tax Ct. Mem. 1987-39. (Use of Bureau of Labor Statistics)

See the tax law cited in the Dealer Section of this manual for additional cases supporting the use of indirect methods.

Herberg v. Commissioner, 53 T.C.M. 755, Dec.43,893(M), Tax Ct. Mem. 1987-229 can be reviewed for a contrary position on indirect methods.

Expenses

Rev. Rul. 66-58, 1966-1 C.B. 186 states that an upland cotton acreage allotment qualifies as a capital asset having an indeterminate useful life. The cost of the allotment should be capitalized and it is not subject to depreciation or amortization. Since the tobacco acreage allotments are similar to the cotton acreage allotments, they would be treated in the same manner.

IRC section 162
Treas. Reg. section 1.162-12
IRC section 262
IRC section 263
IRC sections 167/168
IRC section 6001
Rev. Rul. 66-58, 1966-1 C.B. 186.

Penalties

1. ACCURACY-RELATED PENALTY - IRC section 6662
2. CIVIL FRAUD PENALTY - IRC section 6663

See the court cases cited in the Dealer Section under penalties.

3. FAILURE TO FILE INFORMATION RETURNS

Form W-2 - IRC sections 6051(d), 6052(a), 6053(c), and 6721.

Form 1099 - IRC sections 6041, 6041A, 6042, 6044, 6045, 6049, 6050A, 6050H, 6050J, 6050N, and 6721.

4. FAILURE TO FURNISH STATEMENTS

Forms W-2, 1099, 1098 - IRC sections 6041, 6042, 6044, 6045, 6049, 6051, 6052, 6053, and 6722.

5. FAILURE TO INCLUDE CORRECT INFORMATION

Forms W-2, 1099, 1098 - IRC sections 6041, 6042, 6044, 6045, 6049, 6050H, 6050J, 6050N, 6721, and 6722.

6. FAILURE TO FILE EMPLOYMENT TAX RETURNS

Forms 943 and 940 - IRC sections 3509, 3121(g) and 6151.

Treas. Reg. section 31.3121(a)(8)-1(f)
Treas. Reg. section 31.3121(g)

North Carolina Market Summary

<u>Year</u>	<u>Type</u>	<u>Aver. Yield per acre</u>	<u>Aver. Price per lb.</u>
1991	Flue cured	2,318 lbs	\$1.73
1991	Burley	2,000 lbs	\$1.77
1992	Flue cured	2,266	\$1.73
1992	Burley	1,990	\$1.75

In both years the flue cure markets opened about July 20 and closed about October 22. The burley markets run from about November 23 until January 9th.

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Flue-Cured Tobacco Marketing Card

Front of Card

A- Liens by U.S. Government or any Government agency

B- Warehouse designation, change, and date

C- Year

D- Warehouse number - Actual warehouse # = 10735 (this shows last three digits of the warehouse #)

E- Farmer's name & address

F- Quota in pounds

G- 103 percent of "F"

H- Remaining lbs. of quota that can be sold

I- Date of last sale

U.S. Dept. of Agriculture FLUE-CURED TOBACCO MKTING. CARD		
A		B
STATE 37	COUNTY 183	FARM NO. 0000000
NAME AND ADDRESS		
C ==> 93 735 <== D		
E		

Back of Card

103% of quota		Effective Quota	
G		F	
Pounds		Date	
H		I	

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**NORTH CAROLINA ASCS OFFICES
LOCATIONS & PHONE NUMBERS BY COUNTY**

COUNTY	ADDRESS	TELEPHONE
Alamance	201 W. Elm St. Graham, NC 27253	(910)228-1753
Alexander	Box 187 Taylorsville, NC 28681	(704)632-2044
Alleghany	Box 400 Sparta, NC 28675	(919)372-5590
Anson	1706 Morven Rd. Wadesboro, NC	(704)694-3516
Ashe	Box 624 Jefferson, NC 28640	(919)246-8875
Avery	Box 249 Newland, NC 28657	(704)733-2475
Beaufort	Box 999 Washington, NC 27889	(919)946-1076
Bertie	Drawer A Windsor, NC 27983	(919)794-5308
Bladen	Box 1178 Elizabethtown, NC 28337	(910)862-3179
Brunswick	Box 110 Bolivia, NC 28422	(910)253-4448
Buncombe	560 Rivrside Ashville, NC 28801	(704)254-0916
Burke	Box 658 Morganton, NC 28655	(704)433-4047
Cabarrus-Mecklenburg	Box 547 Concord, NC 28025	(704)788-2107
Caldwell	Box 1885 Lenoir, NC 28645	(704)754-9041

Exhibit 2-3 (2 of 7)

Camden-Currituck	Box 249 Camden, NC 27921 (Currituck -	(919)335-7553 (919)232-3248)
Carteret	Box 357 Beaufort, NC 28516	(919)728-3711
Caswell	Drawer A Yanceyville, NC 27379	(910)694-4162
Catawba	Box 698 Conover, NC 28613	(704)464-1382
Chatham	Box 248 Pittsboro, NC 27312	(919)542-2244
Cherokee	Box 340 Murphy, NC 28909	(704)837-2721
Chowan	510 Virginia Road Edenton, NC 27932	(919)482-3118
Clay	Box 335 Hayesville, NC 28904	(704)389-6301
Cleveland	Box 1388 Shelby, NC	(704)487-5281
Columbus	Box 459 Whiteville, NC 28472	(910)642-2196
Craven	Box 1247 New Bern, NC 28560	(919)637-3567
Cumberland	Drawer 64308 Fayetteville, NC 28306	(910)484-2138
Davidson	Box 246 Lexington, NC 27292	(704)246-2687
Davie	Box 8 Mocksville, NC 27028	(704)634-2487
Duplin	Box 248 Kenansville, NC 28349	(919)296-2193
Durham	721 Foster Street Durham, NC 27701	(919)683-8403
Edgecombe	Box 340 Tarboro, NC 27886	(919)823-8187

Exhibit 2-3 (3 of 7)

Forsyth	1450 Fairchild Drive Winston Salem 27105	(919)767-0720
Franklin	101 S. Bickett Blvd. Suite A Louisburg, NC 27549	(919)496-3121
Gaston	Box 476 Dallas, NC 28034	(704)922-3806
Gates	Box 106 Gatesville, NC 27938	(919)3570290
Graham-Swain	Box 158 Robbinsville, NC 28771 (Swain	(704)479-3329 (704)488-2684)
Granville	Box 907 Oxford, NC 27565	(919)693-7345
Greene	Box 516 Snow Hill, NC 28560	(919)747-2968
Guilford	Box 20548 Greensboro, NC 27420	(910)375-5401
Halifax	Box 250 Halifax, NC 27839	(919)583-4511
Harnett	Box 459 Lillington, NC 27546	(919)893-5101
Haywood	Box 168 Waynesville, NC 28786	(704)456-3557
Henderson	Box 568 Hendersonville, NC 28793	(704)693-1406
Hertford	Box 128 Winton, NC 27986	(919)358-7842
Hoke	Box 689 Raeford, NC	(919)875-8111
Iredell	Box 1228 Statesville, NC 28687-1228	(704)872-5061
Jackson	Box 218 Sylva, NC 28779	(704)586-2810

Exhibit 2-3 (4 of 7)

Johnston	Box 180 Smithfield, NC 27577	(919)934-7156
Jones	Box 125 Trenton, NC 28585	(919)448-2341
Lee	Drawer 1030 Sanford, NC 27330	(919)775-3407
Lenoir	Box 159 Kinston, NC 28501	(919)523-0524
Lincoln	Box 550 Lincolnton, NC 28092	(704)735-8278
McDowell	Box 987 Marion, NC 28752	(704)652-7323
Macon	5 W. Main Street Franklin, NC 28734	(704)524-6421
Madison	Box 487 Marshall, NC 28753	(704)649-2712
Martin	Box 827 Williamston, NC 27892	(919)792-7197
Mitchell	Box 7 Bakersville, NC 28705	(704)688-4451
Montgomery	227 N. Main Street Troy, NC 27371	(910)572-3677
Moore	Box 338 Carthage, NC 28327	(919)947-5104
Nash	1006 Ag. Center Dr., Rm. 103 Nashville, NC 27856	(919)459-4111
Northampton	Box 67 Jackson, NC 27845	(919)534-5331
Onslow	Drawer 1336 Jacksonville, NC 28541	(919)455-4164
Orange	306B Revere Road Hillsborough, NC 27278	(919)732-4301

Exhibit 2-3 (5 of 7)

Pamlico	Box 307 Bayboro, NC 28515	(919)745-5064
Pasquotank	1023, Suite 4, U.S. 17 South Elizabeth City, NC 27909	(919)338-1070
Pender-New Hanover	Box 697 Burgaw, NC 28425	(910)259-9123
Perquimans	Box 1, 512 South Church Street Hertford, NC 27944	(919)426-5802
Person	Box 938 Roxboro, NC 27537	(919)599-0284
Pitt	Box 1926 Greenville, NC 27835	(919)752-6112
Polk	Box 247 Columbus, NC 28722	(704)894-8505
Randolph	Box 966 Asheboro, NC 27203	(910)629-4449
Richmond	Box 310 Rockingham, NC 28379	(910)895-3950
Robeson	Drawer 2099 Lumberton, NC 28539	(910)739-3349
Rockingham	371, NC 65, Suite 102 Reidsville, NC 27320-8815	(910)342-8252
Rowan	2727B Old Concord Road Salisbury, NC 28146	(704)637-1602
Rutherford	Box 512 Rutherfordton, NC 28139	(704)287-4220
Sampson	303A E. Rowan Street Clinton, NC 28328	(910)592-4791
Scotland	Box 567 Laurinburg, NC 28352	(910)276-2850
Stanly	26032-A Newt Road Albemarle, NC 28001	(704)982-5114

Exhibit 2-3 (6 of 7)

Stokes	Box 40 Danbury, NC 27016	(910)593-8128
Surry	Box 343 Dobson, NC 27017	(910)386-9274
Transylvania	Box 708 Brevard, NC 28712	(704)884-3222
Tyrell-Dare-Hyde	Box 418 Columbia, NC 27925	(919)796-3701 (Hyde - (919)926-3961)
Union	Box 1127 Monroe, NC 28110	(704)289-3212
Vance	Box 1149 Henderson, NC 27536	(919)438-3134
Wake	4001 Carya Drive, Suite A Raleigh, NC 27610-2914	(919)231-6126
Warren	Box 397 Warrenton, NC 27589	(919)257-4141
Washington	Box 869 Plymouth, NC 27962	(919)793-3870
Watauga	Box 632 DTS Boone, NC 28607	(704)264-3850
Wayne	Box 799 Goldsboro, NC 27533	(919)734-5281
Wilkes	Box 470 Wilksboro, NC 28697	(910)838-3622
Wilson	1806 Goldsboro St. S.W. Wilson, NC 27893	(919)237-5147
Yadkin	Box 337 Yadkinville, NC 27055	(910)679-2061
Yancey	110 Town Square, Room 14 Burnsville, NC 28714	(704)682-2516

Exhibit 2-3 (7 of 7)

For other states, you may call the state office of the United States Department of Agriculture, Agricultural Stabilization and Conservation Service (USDA-ASCS) to get a telephone number for any specific county ASCS office. For some major tobacco growing states, the numbers to call are as follows:

Alabama State ASCS Office, Montgomery, AL	(205)279-3500
Florida State ASCS Office, Gainesville, FL	(904)372-1361
Georgia State ASCS Office, Athens, GA	(404)546-2269
South Carolina State ASCS Office, Columbia, SC	(803)765-5186
Virginia State ASCS Office, Richmond, VA	(804)287-1500

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Schedule F Percentage Analysis Spreadsheet

TAXPAYER:

SCHEDULE F EXPENSES AS A PERCENTAGE OF TOBACCO SALES

	9012		9112		9212		AVERAGE
	AMOUNT	%	AMOUNT	%	AMOUNT	%	%
PRODUCE SOLD	_____	100.00%	_____	100.00%	_____	100.00%	100.0%
COOPERATIVE DIST	_____		_____		_____		
AG SUBSIDY PMNTS	_____		_____		_____		
CROP INSURANCE	_____		_____		_____		
SOIL/WATER CONS	_____		_____		_____		
FUEL CREDIT	_____		_____		_____		
OTHER INCOME	_____		_____		_____		
GROSS INCOME	_____	_____%	_____	_____%	_____	_____%	104.5%
CONSERVATION EXP	_____	_____%	_____	_____%	_____	_____%	0.3%
MACHINE HIRE	_____	_____%	_____	_____%	_____	_____%	1.0%
DEPRECIATION	_____	_____%	_____	_____%	_____	_____%	8.8%
FEED PURCHASED	_____	_____%	_____	_____%	_____	_____%	0.3%
*FERT/LIME/CHEM	_____	_____%	_____	_____%	_____	_____%	11.6%
*FREIGHT	_____	_____%	_____	_____%	_____	_____%	0.4%
FUEL:							
* MOTOR FUEL	_____	_____%	_____	_____%	_____	_____%	1.5%
* CURING FUEL	_____	_____%	_____	_____%	_____	_____%	7.6%
* OR TOTAL FUEL	_____	_____%	_____	_____%	_____	_____%	9.1%
INSURANCE	_____	_____%	_____	_____%	_____	_____%	4.8%
MORTGAGE INT	_____	_____%	_____	_____%	_____	_____%	2.9%
OTHER INTEREST	_____	_____%	_____	_____%	_____	_____%	3.7%
*LABOR	_____	_____%	_____	_____%	_____	_____%	17.6%
MACHINE RENT	_____	_____%	_____	_____%	_____	_____%	0.4%
FARM/FIELD RENT	_____	_____%	_____	_____%	_____	_____%	12.8%
*REPAIRS	_____	_____%	_____	_____%	_____	_____%	5.1%
*SEED AND PLANTS	_____	_____%	_____	_____%	_____	_____%	0.9%
STORAGE	_____	_____%	_____	_____%	_____	_____%	0.5%
*SUPPLIES	_____	_____%	_____	_____%	_____	_____%	3.7%
TAXES	_____	_____%	_____	_____%	_____	_____%	1.3%
*UTILITIES	_____	_____%	_____	_____%	_____	_____%	2.6%
*MEXICAN LABOR	_____	_____%	_____	_____%	_____	_____%	0.9%
*CONTRACT LABOR	_____	_____%	_____	_____%	_____	_____%	0.1%
OTHER EXPENSES	_____	_____%	_____	_____%	_____	_____%	1.7%
TOTAL EXPENSES	_____	_____%	_____	_____%	_____	_____%	90.5%
NET FARM PROFIT	_____	_____%	_____	_____%	_____	_____%	14.1%
TOTAL LABOR	_____	_____%	_____	_____%	_____	_____%	18.6%
*TOTAL VAR EXP	_____	_____%	_____	_____%	_____	_____%	52.1%

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Extension Personnel Working With Tobacco

For counties in North Carolina, the following are the Cooperative Extension Service personnel with tobacco responsibilities as of November 1, 1993. If a vacancy exists, the county Extension director's name is provided:

<u>County</u>	<u>Name</u>	<u>Telephone</u>
Alamance	Roger Cobb	919-570-6740
Alexander	Dan Smith	910-632-4451
Anson	Russell Sikes	910-694-2415
Beaufort	Henry Riddick	919-946-0111
Bertie	James Peele	919-794-5317
Bladen	Harvey Morris	910-862-4591
Brunswick	David Nash	910-253-4425
Caldwell	Gene Gray	704-757-1290
Carteret	Ray Harris	919-728-8421
Caswell	Ricky Williams	919-694-4158
Chatham	Richard Bradley	919-542-8202
Chowan	Mike Williams	919-482-8431
Columbus	Michael Shaw	910-642-5700
Craven	Billy Dunham	919-633-1477
Cumberland	Rick Morris	910-484-7156
Davidson	Bill Holtzmann	910-242-2081
Davie	Ronnie Thompson	910-634-6297
Duplin	Curtis Fountain	910-296-2143
Durham	Mary J. Whitmore	919-560-0525
Edgecombe	Art Bradley, Jr.	919-641-7818
Forsyth	Mark Tucker	910-767-8213
Franklin	Cedric Jones	919-496-3344
Granville	Tommy Brooks	919-693-8806
Greene	Louie Johnson	919-747-5831
Guilford	Wick Wickliffe	910-375-5876
Halifax	Douglas Phillips	919-583-5161
Harnett	Bobby Bowers	910-893-7530
Hertford	Byron Simonds	919-358-7822
Hoke	Gary Warren	910-875-3461

Exhibit 2-5 (2 of 3)

<u>County</u>	<u>Name</u>	<u>Telephone</u>
Iredell	Lyle Cassell	910-873-0507
Johnston	Kenneth Bateman	919-989-5380
Jones	Minton Small	919-448-9621
Lee	David Dycus	919-775-5624
Lenoir	Alan Harper, Jr. Mark Keene	919-527-2191
Martin	Lareo Reddick	919-792-1621
Montgomery	Bill Reece	910-576-6011
Moore	Charles Hammond	910-947-3188
Nash	Jim Stephenson	919-459-9810
Northampton	Craig Ellison	919-534-2711
Onslow	Danny Shaw	919-455-5873
Orange	Fletcher Barber, Jr.	919-732-9361
Pamlico	Fred May	919-745-4121
Pender	Sandra Maddox	910-259-1235
Person	Derek Day	910-599-1195
Pitt	Mitch Smith	919-757-2800
Randolph	Gwynn Riddick	910-318-6005
Richmond	Ben McCallum	910-997-8255
Robeson	Everette Davis	910-671-3276
Rockingham	Scott Shoulars	910-342-8230
Sampson	Bill Ellers	910-592-7161
Scotland	David Morrison	910-277-2422
Stokes	Jeff Boyles	910-593-8179
Surry	Tim Hambrick	910-386-9274
Vance	Donald Cobb	919-438-8188
Wake	Wayne Batten	919-250-1107
Warren	Philip McMillan	919-257-3640
Washington	Frank C. Winslow	919-793-2163
Wayne	Bryan Page	919-731-1520
Wilkes	Matt Miller	910-651-7331
Wilson	John Weaver	919-237-0111
Yadkin	Jack Loudermilk	910-679-2061

Exhibit 2-5 (3 of 3)

For other states, you may call the main office of the Cooperative Extension Service to get a phone number for any specific county in that state. For some major tobacco growing states, the numbers to call are as follows:

Alabama Cooperative Extension Service	334-844-4444
Florida Extension County Supervisor	904-392-1781
Georgia Extension Administration	706-542-3824
South Carolina Extension Service Administration	804-656-3298
Virginia Extension Service Administration	703-231-5299

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Chapter 3

DEALERS

INTRODUCTION TO DEALERS

A dealer is a broker of tobacco who is authorized by ASCS to buy and/or sell tobacco at either auction or nonauction. No minimum educational requirements or technical skills are necessary to become a dealer. The dealer's ability to make a profit hinges on his or her knowledge of the quality of the tobacco available. Prior to 1992, the only requirement to become a dealer of burley or flue-cured tobacco was to complete Form MQ-79-2-A, an annual Dealer Application and Agreement. As a result of significant abuses identified in the tobacco industry, the regulations were changed in 1992 to require dealers to post a bond of between \$25,000 and \$100,000.

A dealer generates income by buying tobacco from farmers or other dealers and holding it until the market price has risen or by reselling it on another market at a higher price. A dealer cannot make short sales as a stockbroker does, but can only sell tobacco which he or she already owns. The dealer can sell tobacco to other dealers, but generally sells tobacco through warehouse auctions. Dealers report their purchases and resales each week to the county ASCS offices in their dealer books, Form MQ-79. Exhibit 3-1 provides a flowchart of how a dealer buys and sells tobacco at an auction. Exhibit 3-2 provides a flowchart of how a dealer buys and sells tobacco not at an auction.

Examinations of tobacco dealers were conducted in the Greensboro and Richmond Districts which resulted in substantial proposed adjustments to income. The primary area of adjustment to dealers was in their purchases. In many cases, income was determined through the use of indirect methods. The major area of abuse was through the use of inflated and/or fictitious purchases.

AUDIT STEPS

Pre-Audit Analysis

In reviewing the tax return of a tobacco dealer there are several key areas that need to be considered in your pre-audit analysis. These are:

1. Gross Receipts

For a starting point, the number of pounds sold and reported on the Form MQ-79 should be converted to dollars using the average sale price per pound and comparing the result to the total receipts reported.

2. Cost of Goods Sold

This is the most significant area for audit. History has shown that abuses have occurred in the reporting of fictitious or overstated purchases. In these instances, purchases are often paid for with cash. Forms MQ-79 can provide the sales and purchases of the dealer that have been reported to the ASCS office. It is strongly recommended that contact be made with the ASCS office prior to the first appointment to request copies of the Forms MQ-79 for the year under examination.

3. Gross Profit Percentage

There is no industry standard and gross profit can vary widely. Do not use it as the sole criteria in determining whether the gross profit is substantially correct. A better indicator for assessing the audit potential is viewing the taxable income in light of the standard of living apparent from the return. Does the return reflect the economic reality of the taxpayer. Consider use of an indirect method.

4. Other Expenses

These may include travel and entertainment, commissions, freight, and other expenses deducted by a dealer. A close look should be given to payments for payoffs, lavish gifts, and other nondeductible items. Such expenditures are common in the industry.

5. Package Audit

Standard package audit requirements apply, however, emphasis should be on Forms 8300 and 1099. Structuring is common with the dealers. If a dealer is a corporation or partnership, the standard of living of the shareholder/partner should be considered.

6. Balance Sheet Analysis

Close scrutiny should be given to any loans. Many booked loans were found to be improper and in reality a method of laundering money. If a deposit is classified as a loan then requisition the elements of the deposit.

Sources of Information

Internal Sources

1. RTVUE and BRTVUE of prior and subsequent year and of related returns
2. IRPs for the last 4 years
3. Form 8300 filings.

External Sources

1. Form MQ-79 and Form MQ-79 summary -- from the state ASCS office.
2. Court house records:
 - a. Deeds
 - b. Deeds of Trust
 - c. Property tax listings
 - d. Judgment and liens
 - e. Probate files (in estate section of Clerk of Court office).
3. Financial statements furnished to creditors.
4. Division of Motor Vehicles listings for the taxpayer.

5. Annual reports filed with the Secretary of State or State Corporation Commission.

Note: Not all of the above sources will be utilized on every case. However, it is strongly recommended that the Forms MQ-79 be obtained as soon as possible, preferably before the initial interview.

Information Document Request

Form 4564	DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE INFORMATION DOCUMENT REQUEST	Request Number 1
To: (Name of Taxpayer and Co. Div. or Branch)		Submitted To:
Please return one copy of this form with listed documents to requester named below.		Dates of Previous Requests:

Description of Documents Requested:

- 1) BANK STATEMENTS, CANCELED CHECKS, CHECK REGISTER, AND SAVINGS ACCOUNT RECORDS (INCLUDING CERTIFICATES OF DEPOSIT, MONEY MARKET ACCOUNTS, ETC.) COVERING _____, 19__ THROUGH _____, 19__ FOR BOTH BUSINESS AND PERSONAL ACCOUNTS.
- 2) INFORMATION ON ALL TAXABLE INCOME RECEIVED IN THE TAX YEAR BEING EXAMINED. (CONTRACTS, FORMS 1099, BUSINESS RECEIPTS, TOBACCO DEALER BOOKS, FORMS MQ-79, ETC.)
- 3) RECORD OF ALL LOAN PROCEEDS AND LOAN PAYMENTS INCLUDING THE BEGINNING AND ENDING LOAN BALANCES FOR THE YEAR BEING EXAMINED.
- 4) RECORD OF PAYMENTS ON INSTALLMENT PURCHASES OF BUSINESS AND PERSONAL ASSETS, MORTGAGES, ETC. IN TAX YEAR BEING EXAMINED.
- 5) INFORMATION AND DOCUMENTATION ON NON-TAXABLE INCOME IN YEAR BEING EXAMINED (FOR EXAMPLE, INHERITANCES, INSURANCE PROCEEDS, LOANS).
- 6) PLEASE INCLUDE WITH RECORDS (IF APPLICABLE):
 - A. ACCOUNTING BOOKS AND RECORDS, SUCH AS LEDGERS AND JOURNALS, AND ALL RECORDS USED IN PREPARATION OF TAX RETURN.
 - B. ALL FORMS 940, 941, W-2, W-3, W-4, 1099, AND 8300 FOR 19__ TO THE PRESENT.
 - C. COPIES OF EXCISE TAX, HIGHWAY USE TAX, OR ANY OTHER REQUIRED RETURNS FOR 19__ TO THE PRESENT.
 - D. STATE SALES TAX REPORTS FOR YEAR BEING EXAMINED.

From:	Name and Title of Requester: TAX EXAMINER	Date
	Office Location:	

To: (Name of Taxpayer and Co. Div. or Branch)	Submitted To:
Please return one copy of this form with listed documents to requester named below.	Dates of Previous Requests:

Description of Documents Requested:

PLEASE INCLUDE WITH RECORDS (IF APPLICABLE):

- E. PURCHASE INVOICES OF BUSINESS AND PERSONAL ASSETS ACQUIRED DURING THE YEAR BEING EXAMINED, INCLUDING STOCKS, BONDS, SECURITIES, REAL ESTATE, ETC.
 - F. RECORDS OF ANY BUSINESS OR PERSONAL ASSETS SOLD DURING THE YEAR BEING EXAMINED.
 - G. COMPLETE DEPRECIATION SCHEDULE AND COMPUTATION.
 - H. PHYSICAL INVENTORY WORKPAPERS.
 - I. COPY OF ANY PRIOR AUDIT REPORTS.
 - J. COPIES OF THE PRIOR AND SUBSEQUENT YEAR TAX RETURNS.
 - K. COPIES OF ANY RELATED RETURNS FOR THE YEAR UNDER EXAMINATION.
- 7) VERIFICATION OF SPECIFIC ITEMS ON YOUR TAX RETURN AS SHOWN BELOW:
- A. COST OF GOODS SOLD, INCLUDING PURCHASES, OTHER COSTS, AND INVENTORIES.
 - B. FREIGHT: BILLS OF LADING FOR ALL TOBACCO BOUGHT AND SOLD.

From:	Name and Title of Requester: TAX EXAMINER	Date
	Office Location:	

Initial Interview

When examining a tobacco dealer, the following questions should be used to supplement your initial interview.

1. For what years have you been issued a tobacco dealer's card?
2. Did you allow any other person to use your dealer card? If yes, who used it? When? Did you receive a commission?
3. How much cash was necessary to start in the market? Where did you get that cash? How much cash do you carry over to each succeeding year to start the market season? Where is it kept? (cash-on-hand questions)
4. How were the gross receipts on the return computed?
5. Have you ever received cash proceeds for tobacco sales? If yes, was it deposited? If no, was the cash used for tobacco purchases, personal living expenses, loan repayments, etc.?
6. What costs did you incur for the tobacco sold?
7. Who did you purchase tobacco from? Where and when did these purchases take place?
8. Were the purchases paid for by cash, check, or on credit? When and how were the payments made?
9. If cash, were any cash transactions greater than \$10,000. If yes, were any Forms 8300 filed?
10. Were there any payments for purchases made to a third party and not the owner of the tobacco? If yes, provide a detailed explanation of the transactions.
11. Did you have tobacco on hand? If yes, where was it stored? Did you transport the tobacco you purchased?
12. What types of tobacco did you deal in? In what geographic areas?

In many of the examinations conducted to date, an understatement of income was determined by use of an indirect method and not an omission of specific items.

As in all interviews, it is imperative to tie down cash-on-hand and all non-taxable sources of income. Loans to and from the taxpayer have shown to be a significant area for careful scrutiny. Likewise, the taxpayer's standard of living should be considered during the initial interview in order to determine if an indirect method should be fully developed. As in all interviews, open-ended questions should be used in order to secure the most information available about the dealer.

AUDIT ISSUES/TECHNIQUES

Required Filing Checks

Since agents should already be aware of routine Required Filing Checks as required by IRM 4034, this section will pertain specifically to the examination of tobacco dealers, with an emphasis on the forms needed for audit or verification.

1. Cash Transaction Reports or Forms 8300: Because tobacco dealers often deal in large sums of cash, and have warehouse checks which need to be converted to cash quickly, they should have large numbers of cash transactions showing on the Currency and Banking Retrieval System (CBRS). See IRC section 6050I and IRM 4234, Currency and Banking Reports Handbook, for specific requirements. Any person who, in the course of carrying on a trade or business, receives cash in excess of \$10,000 in a transaction, or two or more related transactions, is required to file an information report, Form 8300, with the IRS.

The term "transaction" means the underlying event that precipitates the payer's transfer of cash to the recipient. The term transaction is defined broadly under Treas. Reg. section 1.6050I-1(c)(7) and includes, among other things, a sale of goods, payment of a debt, and reimbursement of expenses. A transaction may not be divided into multiple transactions to avoid the requirement of filing Form 8300. Thus, if a person agrees to purchase \$36,000 of tobacco from a tobacco dealer, the purchase represents a single transaction and information reporting cannot be avoided by dividing the transaction into four \$9,000 sales transactions.

The recipient must keep a copy of each Form 8300 for a period of 5 years from the date of filing. The civil penalties for violation of IRC section 6050I are provided in IRC section 6721. CTRs are also required to be filed by financial institutions which receive or pay out amounts of cash over \$10,000. Criminal penalties are covered in IRC sections 7203 and 7206. IRM 4234, text 733, requires a referral to Criminal Investigation Division when a willful failure to comply is found, including structuring of transactions to avoid the filing of reports.

2. Forms 1099 for interest, compensation, commissions, rents, etc.: It should be noted that Forms 1099 are not required to be issued to a payee in transactions involving purchases of stock-in-trade, such as tobacco purchased by a tobacco dealer for resale. See Treas. Reg. section 1.6041-3(d).
3. Forms 1040, 1065, 1120, or other required returns for any related individuals, partnerships, or corporations.
4. Forms W-2, W-4, 940, and 941 for employees, if any.

In inspecting related returns, be sure to consider how the interest in the related entity was acquired, and whether the known sources of funds are sufficient to support the acquisition. Tobacco dealers have been found to divert unreported income by purchasing an interest in corporations or partnerships which then are used to acquire real estate, businesses, or other property.

Income Probe

The first step in the examination of gross receipts should be to have the taxpayer explain how gross receipts were computed and to reconcile the books and records to the return. Then check the accuracy of the method used to be sure any reductions for warehouse fees and commissions are correctly taken without duplication.

Taxpayer should be closely questioned about his or her banking practices to determine how the warehouse checks are handled. Warehouse checks are required by USDA to be issued the day of the sale; however, the checks may be held by the payee for a period of time. In the examinations conducted, it was found that a significant number of the checks were cashed at or near the end of the marketing season, which for flue-cured, is the

month of November. Deposits should be analyzed to determine if they reconcile with known sources of income. Since the warehouse issues the dealer a net check, deposits plus checks cashed should reconcile to the sales, net of commissions and fees, not to gross sales. The agent should request source items for loans, transfers, or other claimed nontaxable deposits. Some dealers have been found to use loan schemes to launder money from tobacco sales.

ASCS records should be reconciled to gross receipts per return. USDA Forms MQ-79 or MQ-79 summaries should show gross sales before warehouse commissions and fees, however, in some cases, net sales are shown. Because the warehouse or the dealer prepares the original Form MQ-79, other evidence of gross sales, if different from the Form MQ-79 amount, should be given great weight.

Inquiry should be made of state and county ASCS offices to determine if they are aware of any allegations of illegal tobacco transactions by the taxpayer.

Cash Transaction Reports (CTR's) should be analyzed to determine if the taxpayer cashed or deposited funds in excess of known sources. In some cases, dealers use structuring to avoid issuance of CTR's. In other cases, they willingly accept issuance of CTR's.

If necessary, consider requesting the warehouses provide copies, front and back, of cancelled checks written to the dealer. These would serve to verify receipt of payment as well as providing leads as to banking or check cashing practices, second party endorsements, and other business interests.

Cost of Goods Sold

Have the taxpayer explain how cost of goods sold was determined, and what type of records were kept. In addition, have the taxpayer explain how beginning and ending inventories were determined and where they were located. It is possible that the tobacco shown in inventory is merely "air pounds" since most dealers have no place to store tobacco.

The books and records should be reconciled to the return. In many instances, the tobacco dealer will use retained carbon copies of Forms MQ-79 as a record of cost of tobacco purchases. Since the Forms MQ-79 are prepared by the taxpayer and filed with ASCS, in cases involving bargain purchases of black market tobacco, the Forms MQ-79 cannot be relied upon as an accurate

record. To avoid self-incrimination with the ASCS, the dealer would indicate the price which would have been paid for non-black market tobacco. For tax purposes, the dealer in black market tobacco usually inflates cost of goods sold to minimize net profit.

Non-auction purchases from other dealers should be scrutinized very closely. Information gathered in previous audits has shown that non-auction purchases and sales have been used by dealers to create air pounds and to transfer air pounds to other dealers. Some dealers have even gone so far as to write checks to the other dealer to give the appearance of an actual purchase, yet the first dealer would ultimately get his or her money back either as cash under the table, through a fictitious loan, or some other means. Inspection of bills of lading should be made to determine if any tobacco actually moved.

Also consider third-party contacts to verify purchases. The Form MQ-79 should show the mailing address of the person from whom each purchase was made. In most purchases of air pounds, "dead card" dealers have responded negatively to IRS inquiries, since they did not actually sell the dealer any tobacco and do not want to be charged with the phantom income from the transaction. (Dead card dealers usually receive a small fee for use of their card but do not have any tobacco to sell.)

In other instances, the dealer will use cancelled checks as a record of cost of purchases. Carefully scrutinize the records and question any unusual transactions, and request bills of lading or other corroborating evidence. Questionable purchase transactions have been noted where a check or series of checks, in even amounts under \$10,000, were written to another dealer. The endorsements on these checks frequently show them to have been cashed by the payee. In normal purchase transactions, only one check would be issued, for an odd amount, and frequently over \$10,000, and would be deposited to the payee's account. Questions arise as to why the transaction appears to be structured, was any tobacco actually purchased, and what disposition was made of proceeds? An examination of the receiving dealer may be necessary.

Non-auction purchases and sales near or after the end of the sales season should be looked at closely, since these are almost certainly transactions in air pounds. There is no sound business reason to acquire actual tobacco at that time since there is no market for it until next season.

Other Expenses

The following expenses, if material, should be considered when examining dealers for potential audit issues:

1. **Travel and Entertainment:** When buying and selling tobacco, the dealer would incur expenses traveling between farms and warehouses. Expenses would also be incurred to move tobacco from one market to another in order to secure a higher price. Conversely, lack of travel expenses may be an indicator the dealer is allowing others to sell excess tobacco pounds on his or her dealer card. As in other businesses, goodwill is generated by entertaining and providing gifts to associates. When inspecting expenses, remember the guidelines outlined in Treas. Reg. section 1.274(d). Examinations have revealed gifts given to buyers and graders, such as whiskey, golf clubs, food, and cash.
2. **Commissions:** Any payments classified as commissions should be looked at carefully to determine who they were paid to and if there was a bona fide business purpose under IRC section 162(a). The payments should be questioned to determine if they are illegal and nondeductible under IRC section 162(c). The payer-dealer may be deducting commissions paid to an individual for the use of his or her dealer card. The recipient's return should be scrutinized to determine if the income received has been properly reported.

Where Forms 1099 for these payments are warranted, they should be inspected.

Indirect Methods and Balance Sheet Approach

This section is intended to alert the reader to some of the productive areas encountered by the tobacco task force team in using indirect methods.

Consider the use of an indirect method or balance sheet audit when working tobacco dealers for the following reasons:

1. There is potential for large profits which are realized as cash or equivalent over a relatively short period of time.

2. Dealers file false reports with the ASCS to conceal their dealings in black market tobacco. When it is time to file income tax returns, they rely on the false reports submitted to ASCS to prepare their tax returns. An indirect method can be useful in showing that the records are invalid.
3. Dealers in black market tobacco cooperate extensively with each other to make their sales scheme works. They continue to cooperate to cover for each other in concealing their income and assets.
4. Some tobacco dealers have been found to be persons who have ostensibly simple life-styles. They often invest their profits in ventures and deals made without written agreements. Cars, homes, and clothing may not reflect the extent of their economic success. Profits are seldom left in bank accounts.

In examining a dealer's income by use of an indirect method, loans from third parties should be considered. Loans are reflected as a nontaxable source of funds. In reality, loans may have been created to conceal taxable income. Examinations have revealed that fictitious loans were created through the circular transfer of funds or other assets, or simply through paper transactions on the books. All purported loans between dealers and other individuals should be scrutinized to determine whether or not an actual loan existed, including sufficient inquiry to determine if the lender actually existed. "Loans" received at the beginning of the sales season may actually be a redeposit of a cash hoard from the prior year deposited in the bank to create the appearance of a loan.

Use all available resources to locate any assets acquired or disposed of during the year at issue. Checks written to others also may lead to discovery of new investments. Assets representing unreported profits are sometimes hidden either in names of nominees, as a cash hoard, or by making payments to others which are promptly returned to the payer. Another way of concealing assets is to form a non-operating corporation or partnership into which the cash profits are placed to make investments in land, businesses, collectibles, and other assets. On financial statements, the dealer would understate the amount of investment in the entity. By several dealers joining in one entity, it becomes more difficult to show the sources and applications of funds attributable

to each. An examination of the entity's books may be required to determine the actual amount of funds contributed or distributed during the year by each investor.

In order for the indirect method to be successful, it is important that the agent put forth the effort to identify and verify all loans and assets, since these are the areas dealers frequently used to conceal profits.

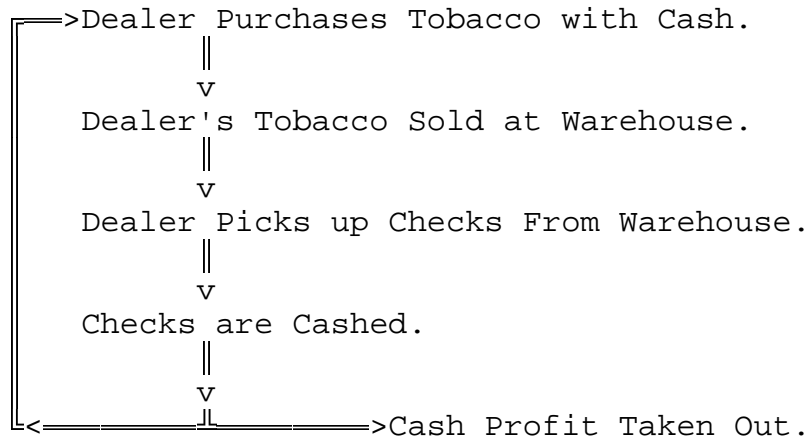
If the taxpayer is a corporation or partnership, an examination of the balance sheet should be considered, giving the same consideration to loan proceeds and assets acquired as outlined above. Any other item on the balance sheet which represents a questionable source or application of funds should also be considered, such as accounts payable or receivable, capital contributed or distributed, and investment accounts. The books and records should be reviewed for unreported distributions to the shareholder or partners, and other flows of funds out of the entity. Any adjustments to the balance sheet should result in corrections to the net income for the year, and, if appropriate, income to the shareholder or partners.

Adjustments to net profit found using indirect methods or balance sheet audits should be used, if possible, to support proposed changes to cost of goods sold or unreported gross receipts. For example, if, based on your knowledge of the tobacco industry and specific information developed from ASCS reports and other sources, you find the dealer cannot adequately verify cost of goods sold, and you know the amount shown on the return is 50 percent too high, the indirect method can serve to justify and lend credence to your proposed adjustment. It is unlikely that you will find any direct evidence as to the correct cost of goods sold since these purchases were by cash and without any paper trail which could lead the agent to potential third party contacts.

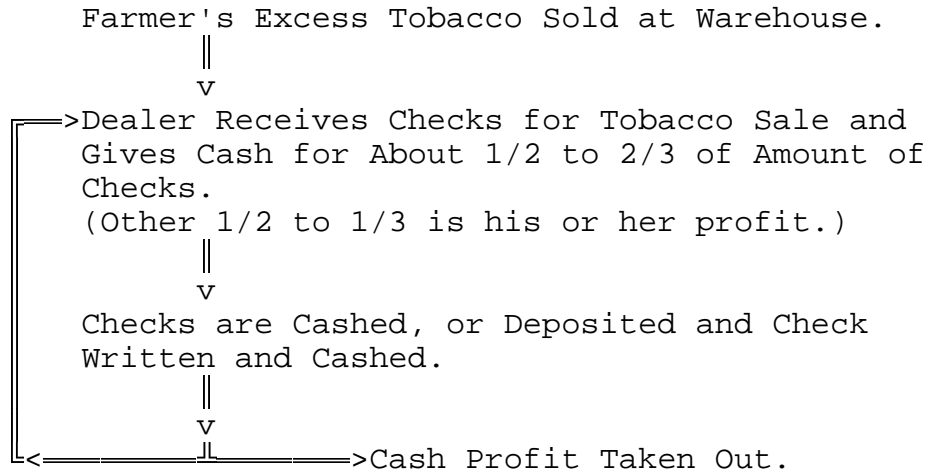
An analysis of cash flow during the tobacco season is sometimes useful to demonstrate the approximate amount of net profit generated by the dealer in the course of the tobacco season.

Dealers use a "cash cycle" to operate in the market, as follows:

1. Sale of tobacco purchased by dealer:



2. Sale of tobacco not purchased by dealer:



To maximize profits, the dealer, in either case, needs to have large cash reserves and needs to convert warehouse checks to cash quickly in order to restart the cycle and take advantage of the short tobacco season.

Later in the tobacco sales season, the cash reserves should begin to exceed cash needs. At the end of the sales season, significant amounts of cash should be apparent either on hand or in the bank; nearly the entire profit from the season's operation should be present as cash. If the bank balances and cash on hand do not approximate the expected profit, you need to question where the funds went. Large new investments or acquisitions are often made at or near the end of the tobacco sales season.

TAX LAW, REGULATIONS, AND COURT CASES

Income / Reconstruction of Income

IRC section 61
Treas. Reg. section 1.61
IRC section 446
Treas. Reg. section 1.446
IRC section 447
IRC Section 448(b)(1)

Indirect Methods

Hague Estate v. Commissioner, 30 A.F.T.R. 686, 132 F2d 775 *aff'g* 45 B.T.A. 104 (2nd Cir. 1943). (Bank deposits method)

Mauch v. Commissioner, 35 B.T.A. 617, 25 A.F.T.R. 417, 113 F2d 555, *aff'd* (3rd Cir. 1940) (Bank deposits method)

Stutts v. Commissioner, 34 T.C.M. 1303, Dec. 33,437(M), Tax Ct. Mem. 1975-298. (Source and Application approved)

Brown v. United States, (CA-9); 69-2 U.S.T.C. 9698; 418 F2d 574. (Bank deposits method approved)

Reeves v. United States, (DC) 70-1 U.S.T.C. 9314. (Bank deposits method approved)

Roberson v. Commissioner, 20 T.C.M. 1, Dec. 24,599(M), Tax Ct. Mem. 1961-1. (Net Worth)

Stafford v. Commissioner, T.C. Memo. 1992-637, 64 T.C.M. 1199 (Bureau of Labor Statistics used for reconstruction of income)

Trohimovich v. Commissioner, 62 T.C.M. 134, Dec. 47,470 (M), Tax Ct. Mem. 1991-323. (Indirect method)

Fong v. Commissioner, 61 T.C.M. 2450, Dec. 47,305(M), Tax Ct. Mem. 1991-180. (Bank Deposits method)

Risicato v. Commissioner, 48 T.C.M. 10, Dec. 41,192(M), Tax Ct. Mem. 1984-238. (Bank Deposits method)

Leong v. Commissioner, (Ct. Dec.) 78-1 U.S.T.C. 9152. (Bank Deposits method)

Greenway v. Commissioner, 52 T.C.M. 1283, Dec. 43,605(M), Tax Ct. Mem. 1987-4. (Source and Application)

Cost of Sales

IRC section 162
Treas. Reg. section 1.162
IRC section 6001
Treas. Reg. section 1.6001
Treas. Reg. section 31.6001-1

Disallowance of Cash Purchases

Sperling, Estate v. United States, (CA-2) 65-1 U.S.T.C. 9193, 341 F.2d 201. *Cert. den.*, 382 US 827.

Barnes Theatre Ticket Service v. Commissioner, 26 T.C.M. 1290, Dec. 28,705(M), Tax Ct. Mem. 1967-250.

Penalties

Accuracy-Related Penalty - IRC section 6662

Sutor v. Commissioner, 17 T.C. 64, Dec. 18,442. (Failure to keep records)

Harbin v. Commissioner, 17 T.C.M. 950, Dec.23,242(M), Tax Ct. Mem. 1952-190. (Failure to produce records)

Rutledge v. Commissioner, 63 T.C.M. 1926, Dec. 47,959(M) Tax Ct. Mem. 1992-2. (Income not reported)

Lively v. Commissioner, 63 T.C.M. 1782, Dec. 47,926(M), Tax Ct. Mem. 1992-23. (Inadequate records)

Civil Fraud Penalty - IRC section 6663

Bradford v. United States, CA-9, 86-2 U.S.T.C. 9602.

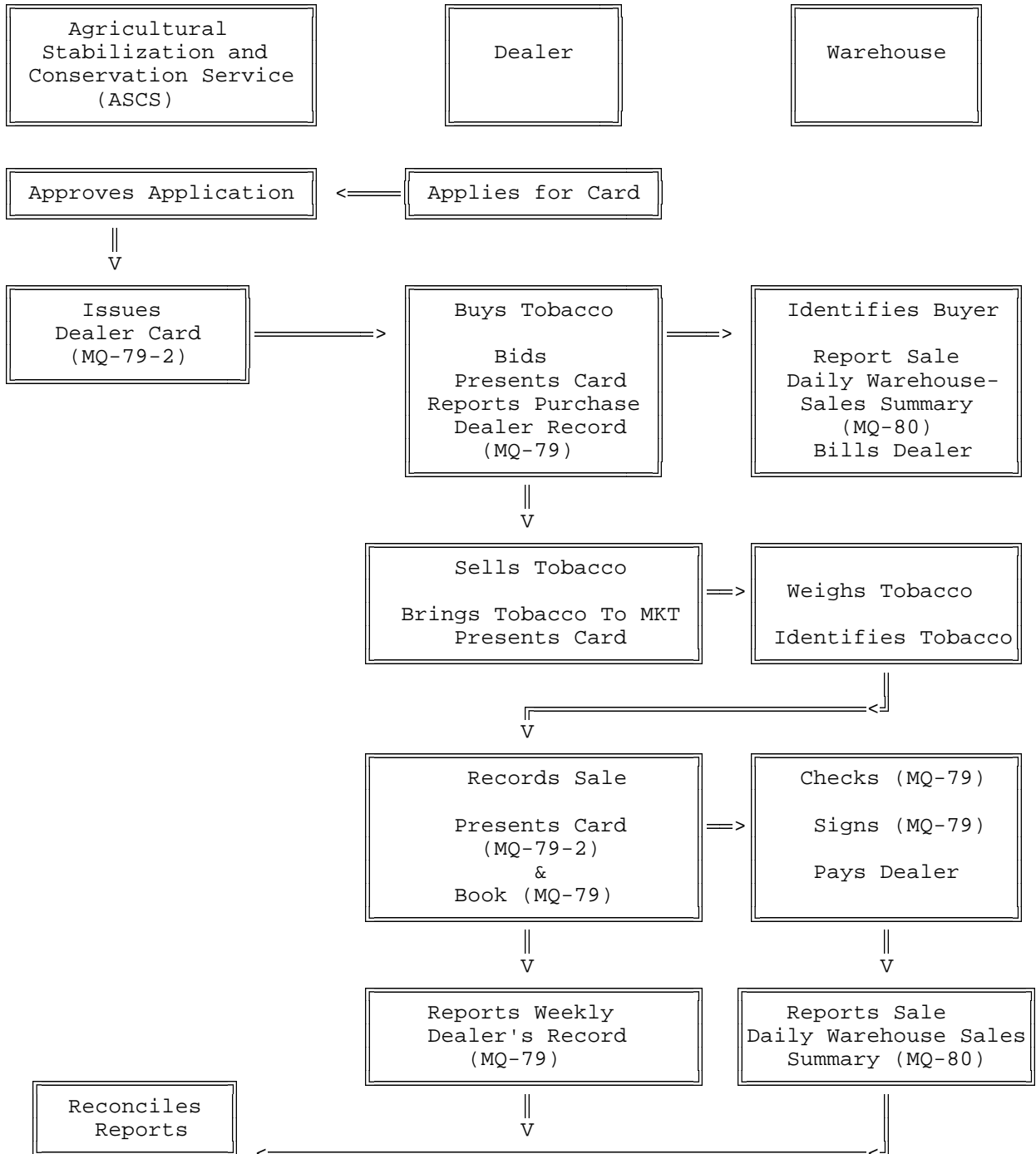
Cerilli v. Commissioner, 47 T.C.M. 757, Dec. 40,702(M), Tax Ct. Mem. 1983-773.

Resnick v. Commissioner, CA-5, 35 T.C.M. 940, Dec. 33,917(M), Tax Ct. Mem. 1976-215 *aff'd*, 575 F.2d 880 (5th Cir 1978) (unpublished opinion under CA-5 rules 66678).

(Overstated deductions)

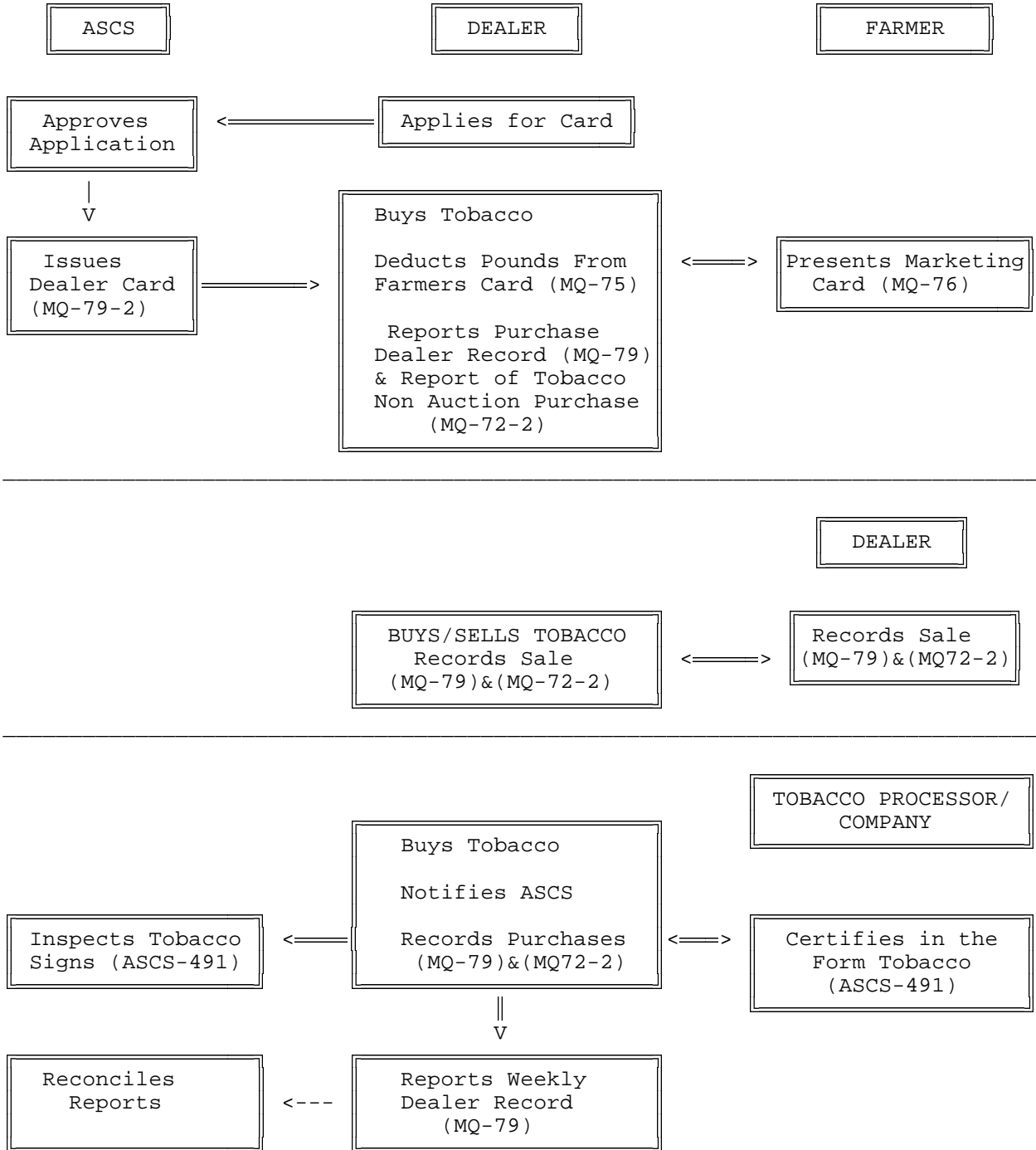
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HOW A DEALER BUYS AND SELLS TOBACCO AT AUCTION



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HOW A DEALER BUYS AND SELLS TOBACCO NOT AT AUCTION



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Chapter 4

WAREHOUSES

INTRODUCTION TO WAREHOUSES

The warehouse is the central point for moving tobacco. Its primary role is to sell the farmer's tobacco at auction to processors and manufacturers. The income it reports is the commission from those sales. Warehouse operators compete for the farmer's business in the spring, sometimes using incentives to gain and maintain their business. Farmers designate one or more warehouses for a marketing season and a designation can be changed during the season. The warehouse can also purchase and sell tobacco for its own account, referred to on the books as the "leaf account." However, this is usually only a small part of their business. A warehouse operator can simultaneously also be a farmer and tobacco dealer.

Warehouse operations are heavily regulated by the United States Department of Agriculture, and a failure to comply with those regulations can result in fines or loss of their warehouse permits.

Examinations of warehouses in the Greensboro and Richmond Districts did not produce significant audit adjustments. They were found to keep extensive books and records and generally, if diversion of income had occurred, it was more likely to be detected at the owner or operator level. Therefore, a limited discussion of audit issues and techniques follows.

WAREHOUSE OPERATIONS AND GOVERNMENT REGULATIONS

Tobacco warehouse operations are governed by regulations found in the Code of Federal Regulations, available from USDA-ASCS. Burley and flue-cured operators must register with USDA through the North Carolina ASCS office in Raleigh, NC. The warehouse operator is required to file MQ-78 annually. It lists the type of business entity, names and addresses of warehouse officials, bookkeepers, custodians of records, and the precise location of the records.

At the beginning of each marketing year, the Agricultural Marketing Service, a government agency, informs the warehouse of the number of pounds designated, the number of selling days, and the number of pounds that can be auctioned each day. The warehouse management assigns the time for farmers and dealers to sell on the floor.

When the farmer or dealer brings his or her tobacco to the warehouse on his or her assigned day, the tobacco is weighed, identified, and subsequently graded by the Agricultural Marketing Service. At the time the tobacco is weighed, the bill of sale is imprinted with the marketing card. If it is a farmer's tobacco, the warehouse maintains control of the card until after the tobacco is auctioned so that the current sale of pounds can be reflected on the back of the card. An employee of ASCS, known as the marketing recorder, is responsible for this task. If it is dealer's tobacco, the warehouse imprints the bill of sale with the dealer's card and returns the card to the dealer. The grade assigned to a sheet of tobacco establishes the price support level as well as the starting point for the bidding process.

If the final bid at auction does not exceed the established price support, the Flue-Cured Stabilization Cooperative (Coop) acquires the tobacco and advances the sale proceeds to the producer through the warehouse.

The warehouse accounts for all tobacco sold on a daily basis by filing ASCS Form MQ-80, the daily sale summary, showing sales and purchases at auction, re-sales by dealer, and the total purchases for the leaf account at auction and nonauction. This report is submitted to the ASCS.

At the end of each sale day, the warehouse operator issues checks to the farmers and dealers net of commissions, sheet charges, stabilization, other fees, and any penalties. The check and the marketing card are picked up by the farmer at the warehouse.

It is the responsibility of the warehouse operator to maintain a record of the marketing of auction and/or nonauction sales for 3 years beyond the close of the market year, or for such longer period of time as may be requested in writing by the state ASCS office.

AUDIT ISSUES AND TECHNIQUES

The warehouse examinations conducted as part of the study did not produce significant audit adjustments. Few income adjustments were identified and those found were due to misappropriation of income detected by an indirect method at the shareholder or operator level. When conducting examinations of the owners, consideration should be given to the potential for receiving proceeds from the illegal schemes outlined in Chapter 1. If the owners or operators are also tobacco farmers, they also have the potential to market their own excess tobacco through their warehouse. You might inquire at the county and state ASCS offices for a copy of Form MQ-78 which lists the names and addresses of the owners and responsible persons. The ASCS may have other useful information about allegations of activities at a particular warehouse.

The key area of noncompliance in the warehouse examinations conducted was travel and entertainment. Canceled checks for liquor, meals, sports events, and gifts did not satisfy the requirements of IRC sections 274(b) and 274(d).

In the package audit, a review of the Forms 1099 and Forms W-2 issued disclosed inconsistent classification of the same individual not performing two distinct jobs.

A potential issue in warehouse examinations is fees collected by the warehouse and submitted to other agencies. Usually, these items are accounted for as a pass-through on the books without being shown on the tax return. Verify that the fees are properly accounted as an "in and out" transaction in the warehouse books, and any net gain or loss should be shown on the return.

The warehouses will pass large sums of money through their bank account as they receive the sale proceeds from the processors and issue payments to the sellers. However, they generally only report their commissions as gross receipts on the tax return. Commissions are the largest category of income reported by warehouses. Warehouses can also have other sources of income which should be reported, including sales from the leaf account, sales of floor sweepings, interest income, vending machine sales, rents from other real estate owned, and off-season rentals of warehouse space (for tobacco storage, other storage, antiques auctions, flea markets, indoor basketball play, etc.)

While a warehouse maintains books and records similar to any other business, give close scrutiny to the following accounts which are unique to tobacco warehouses:

1. Leaf account -- The leaf account should be reviewed and close attention should be given to purchases. Examination of a sample of purchases and sales should be made to determine that correct accounting practices were used. Low-cost purchases may also be an indication that this account was used to market excess tobacco.
2. Buyers correction account -- This account should be reviewed to ensure that long and short transactions are properly reported.

Other issues identified were not specific to a warehouse examination. The examiner should address all large, questionable, or unusual items.

GLOSSARY

ACREAGE ALLOTMENT: The number of acres of tobacco that a farmer or producer is allowed to plant as determined by the Agricultural Stabilization and Conservation Service.

AGRICULTURAL ACT OF 1949: Statutory authority for administration of the price support provision of the tobacco program.

AGRICULTURAL ADJUSTMENT ACT OF 1938: Statutory authority for administration of the production tobacco program.

AGRICULTURAL STABILIZATION AND CONSERVATION SERVICE (ASCS): An agency of the U.S. Department of Agriculture (USDA), responsible for administering tobacco production and sales.

AIR POUNDS: The illegal transfer of marketing quota recorded as a sale of tobacco.

AUCTION SALE: A marketing of tobacco by a sale at public auction through a warehouse in the regular course of business.

BILLING OUT: The process of billing a tobacco company for pounds of tobacco purchased.

BUYERS CORRECTION ACCOUNT: The warehouse account of tobacco purchased at auction by the buyer but not delivered to the buyer, or any tobacco returned by the buyer, lost ticket, or any other valid reason, which is turned back to the warehouse operator and supported by an adjustment invoice from the buyer. This account shall include the pounds deducted resulting from returned lots, short lots, and short weights, and pounds added resulting from long lots and long weights, which buyers debit or credit to the warehouse operator and support with adjustment invoices.

CARRYOVER TOBACCO: Tobacco produced prior to the current calendar year which has not been marketed or otherwise disposed of prior to the beginning of the marketing year for the current crop year.

COMMODITY CREDIT CORPORATION (CCC): A government owned and operated entity that loans money to farmer owned associations (such as Flue-Cured Stabilization) to guarantee that the farmer receives a reasonable price for the tobacco.

DAMAGED TOBACCO: Any tobacco that has suffered a loss of value due to deterioration resulting from a cause such as rot, separation from stems, fire, smoke, water, or other conditions that would cause such tobacco to be distinguishably different from that normally marketed in trade channels.

DEAD CARD: A dealer card for which a Dealer Record book (Forms MQ-79) is not filed. (Usually associated with the creation of air pounds.)

DEALER: A person authorized by ASCS to buy and/or sell tobacco at auction or nonauction.

DEALER CARD: A card (ASCS Form 79) issued by ASCS to a dealer. The card is used to identify tobacco purchased or sold at either auction or nonauction.

EXCESS TOBACCO: Tobacco produced and sold above the marketing quota established by ASCS.

FALSE IDENTITY (TOBACCO): The sale of tobacco on a marketing card from a farm on which the tobacco was not produced.

FARMER, GROWER, OR PRODUCER: A person who grows tobacco.

FLAKING: The act of stealing a farmer's tobacco from the warehouse floor by warehousemen or his/her employee.

FLOOR SWEEPINGS: Scraps or leaves of tobacco which accumulate on the warehouse floor in the regular course of business.

FLUE-CURED STABILIZATION COOPERATIVE: A cooperative that purchases flue-cured tobacco which receives price support from CCC. Also referred to as "Co-op," "Stabilization," and "pool."

GREEN WEIGHT: The weight of tobacco which is in the form normally marketed by farmers prior to being redried, or processed.

IN FORM TOBACCO: Tobacco which is in the form normally marketed by farmers, That is, tobacco that has not been processed.

LEAF ACCOUNT TOBACCO: The quantity of tobacco purchased or otherwise acquired by a warehouse operator, as adjusted by the debits and credits to the buyers correction account. This account should not include tobacco in the form not normally marketed by producers, including tobacco pickings and floor sweepings.

LONG: When a tobacco warehouse sends a pile of tobacco to a tobacco company without sending the billing invoice.

MANUFACTURER: A company that purchases tobacco for manufacturing and processing into tobacco products.

MARKETING CARD: A card issued by ASCS to a farmer/producer for a farm which shows the number of pounds of tobacco that can be sold, and the remaining balance after each sale.

MARKETING QUOTA: The amount of tobacco or "pounds" established by ASCS a farmer/producer is allowed to sell.

MQ-79 DEALER'S RECORD: A form the tobacco dealer completes and submits to ASCS weekly when he or she buys or sells tobacco, which shows the pounds of tobacco purchased, sold, and the balance available.

NESTED TOBACCO: Tobacco that contains concealed foreign objects, that is, cement blocks, trash, etc. to increase the weight of the tobacco.

NONAUCTION SALE: Any marketing of tobacco other than at an auction sale.

NOT IN FORM (NIF) TOBACCO: Tobacco that has been processed by a processor or manufacturer. See Pickings.

PENALTY: Money paid to ASCS for selling tobacco in excess of the marketing quota.

PICKINGS: The residue which accumulates in the course of processing tobacco prior to redrying, consisting of scrap, stems, portions of leaves, and leaves of poor quality. Under USDA rules, pickings are considered to be "Not in Form Tobacco."

POOL: The Flue-Cured Stabilization Cooperative.

POUNDS: Pounds of tobacco.

PRICE SUPPORT: The minimum price set by ASCS for grades of tobacco.

PROCESSOR: A company that purchases tobacco for processing to be sold for manufacturing.

RESALE: The disposition by sale or otherwise of tobacco which has been marketed previously.

SALE BILL: Sales invoice of tobacco sold at auction. The sale bill shows the name and address of the warehouse; the Farm Serial Number or Dealer Number; the Tobacco Inspection Certificate Number; the grade of the tobacco; the pounds of tobacco sold; the price per pound; various warehouse expenses; the date of sale; and the amount of the check.

SCRAP TOBACCO: The residue which accumulates in the course of preparing tobacco for market, consisting chiefly of portions of tobacco leaves and leaves of poor quality.

SHEET (OF TOBACCO): A burlap cloth that flue-cured tobacco is placed on after it has been cured.

SHORT: When a tobacco warehouse sends an invoice billing the tobacco company for tobacco it has not received.

TOBACCO INSPECTION CERTIFICATE: A form that list the grade, weight, purchaser, and seller of the tobacco. The Tobacco Inspection Certificate is cross referenced to the Sale Bill. Also referred to as "Basket Tickets" and "Pink Coupons."

WAREHOUSE OPERATOR: A person who engages in the business of conducting sales of tobacco at public auction.

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