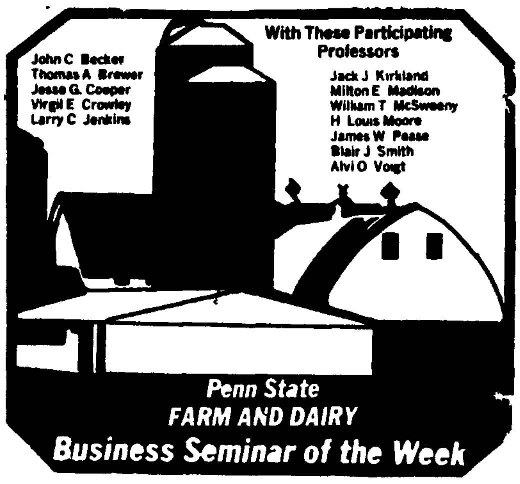

Commodity Certificates have been a source of much discussion among farmers and tax preparers in recent months. The questions being asked relate to when the certificate value must be reported as income and how much should be reported. Correct answers to those questions depend on how the commodity certificates are used and the farm operator's prior action with respect to Commodity Credit Corporation (CCC) loans.

When a farm operator receives the first loan from the Commodity Credit Corporation (CCC) he or she has a choice of (1) treating the loan as income in the year received or (2) treating the loan as any other loan -- that is, not reporting income because the obligation to repay equals the amount received. If the second option is selected and if the crop is redeemed and the loan repaid, subsequent sale of the crop should be reported as income.

If the first option is selected and the loan is treated as income, the farm operator has elected a "Section 77." Section 77 is the part of the Internal Revenue Code that relates to the the tax treatment of Commodity Loans. If such an election is made, then all subsequent CCC loans must be reported as income in the year received unless the Commissioner of Revenue gives permission to withdraw the election.

Beginning in 1986, a portion of the farm program deficiency and set aside payments were made to farmers in the form of Commodity Certificates rather than cash. Commodity certificates can be sold on the open market, exchanged for cash at county ASCS offices, or used to redeem grain from the Commodity Credit Corporation that is held as security under the 9-month loan or a 3-year reserved arrangement.

As a result of the formula used by county ASCS offices, it is profitable in some instances and during some periods of time for the farmer to pay off (redeem) a CCC loan with commodity certificates. This is the so-called "PIK and Roll procedure." Generally, what occurs is the following:

1. The farmer applies for and receives a CCC loan on the crop. 2. Using purchased commodity certificates and/or issued certificates, the farmer redeems his or her grain from the CCC by repaying the loan with the commodity certificates instead of cash. 3. Based on his or her normal marketing patterns, the farmer then sells the redeemed grain.

The income tax consequences of the "PIK and Roll" relate to the option selected by the farm operator for reporting income from CCC loans. If a farmer has not elected the Internal Revenue Code Section 77 (does not treat the CCC loan as income in the year the loan is received), the following tax consequences result from receipt of a CCC loan, receipt of a commodity certificate and use of the certificate to pay off the loan.

1. Receipt of the loan is not reported as income. 2. Receipt of a commodity certificate is reported as income. This establishes a tax basis in the certificate equal to the amount of income reported. 3. The difference between the tax basis in the certificate and the loan amount is reported as income when the certificate is used to pay off the loan. 4. The farmer's tax basis in the redeemed grain is zero. Therefore, a subsequent sale of the grain will result in gross income equal to the sale price. Feeding the grain will result in no deduction.

Example 1: A farmer sealed the 1987 corn crop and received a CCC loan of $12,000. The farmer is a cash-basis taxpayer and has not elected to report CCC loans as income. In 1987, the farmer also received commodity certificates with a face value of $10,000. Under the PIK and roll rules, the farmer used the certificates to pay off the loan and still had the corn at the end of 1987.

The tax consequences are as follow. The $12,000 loan is not income. Receipt of the certificates result in $10,000 of income. Use of the certificate to pay off the loan results in another $2,000 of income. The farmer then has a zero basis in the corn. When the corn is sold, the amount received will be reported as gross income.

If a farmer has elected the Internal Revenue Code Section 77 and reports CCC loans as income in the year the loan is received, the following tax consequences result from receipt of a CCC loan, receipt of a commodity certificate and use of the certificate to pay off the loan.

1. Receipt of the CCC loan is reported as income and the farmer has a basis in the commodity equal to the amount of the loan. 2. Receipt of a commodity certificate is reported as income (the face value of the certificate is reported as income). 3. The difference between basis in the certificate and the loan amount is used to reduce the basis in the commodity. Therefore, a subsequent sale of the commodity will result in a gain or loss measured by the difference between the basis in the commodity and the sale price. Use of the commodity as feed will result in a deduction equal to the basis in the commodity.

Example 2: Assume the same facts as in the first Example above, except that the farmer has elected the Internal Revenue Code Section 77 to report CCC loans as income in the year received. In this case, the "PIK and Roll" procedure has the following tax consequences.

Upon receipt of the CCC loan, the farmer must report $12,000 of income. This results in a $12,000 tax basis in the corn. Receipt of the certificate results in another $10,000 of income. Use of the certificate to pay off the loan requires the farmer to reduce the basis in the corn by $2,000 to $10,000.

If the corn is used for feed on the farm, the farmer can deduct the $10,000 basis. If the corn is sold, the gain or loss will be calculated using this $10,000 basis.