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PAYING WAGES IN KIND

— by Neil E. Harl*

In general, wages paid in kind rather than in cash to agricultural labor are not subject to FICA¹ or FUTA² taxes. In addition, agricultural labor is exempt from income tax withholding³ except as the payment constitutes "wages."⁴ Wages paid "in any medium other than cash for agricultural labor" are exempt from the term "wages."⁵

Recent rulings (and apparent Internal Revenue Service scrutiny of the practice) have focused attention on the issue although neither the practice of paying wages in kind nor the authority for unique tax treatment of such in kind payments is new.

Income to the employer

An important aspect of in-kind wage payments is that the employer must report any gain on the in-kind payment into income.⁶ Typically, the commodity used to make the wage payment has a zero income tax basis so the entire amount is reportable as income. In a late 1991 ruling, a farmer paid wages to the spouse in the form of hogs and was required to report the hogs as income.⁷ In that ruling, the IRS agreed that the wages paid in kind were considered as compensation for purposes of the spouse's contribution to an Individual Retirement Account.⁸

Deduction for employee

The employer may claim an income tax deduction for the wages paid *if income tax is withheld as required by I.R.C. § 3402.*⁹ Inasmuch as wages paid to agricultural labor are exempt from withholding if paid in kind,¹⁰ income tax is withheld as required by I.R.C. § 3402 so a wage deduction is clearly available.

Dominion and control by employer

For in-kind wage payments to be exempt from FICA, FUTA and income tax withholding, the payment must not be in a form readily converted into cash and the employee must exercise dominion and control over the payment. Several rulings have addressed those requirements —

- Payment in the form of commodity storage receipts was treated in a 1979 ruling as a payment in cash.¹¹ Thus, the wages were not considered to have been paid in kind and

the special statutory provisions applicable to agricultural labor did not apply.

- In a 1982 private letter ruling,¹² wages paid in the form of milk and other commodities by a corporation carrying on a dairy operation met the requirements for avoiding the payroll taxes. The employees were compensated with a percentage of the milk produced, a percentage of the calves and a percentage of grain production.¹³

- A 1991 private letter ruling, however, held an in-kind payment to be the equivalent of cash where a spouse was paid \$200 per month in cash and 3,000 pounds of live hogs per month.¹⁴ In that situation, title to the hogs was transferred to the spouse on delivery to the market.¹⁵ Clearly, the spouse as employee failed to exercise any meaningful dominion and control over the hogs.

The requirement that the employee exercise dominion and control over the commodity constituting payment in kind poses relatively few problems for payments in passive form such as grain or soybeans. However, the employee should either pay storage for the period after the wage payment and before sale or include the value of storage as additional income. For payment of wages in the form of livestock, the employee should be responsible for the care, feeding and management of the animals from the time of wage payment until sale.

Reporting of wage by employee

The payment of a wage in kind should be reportable as "other income" on the Form W-2 and is fully reportable as income by the employee. If the commodity increases or decreases in value after wage payment, the gain or loss should be reported on Schedule D with the wage payment amount treated as the employee's income tax basis in the commodity. Gains should not be treated as self-employment income unless the employee is considered to be engaged in the trade or business of producing the commodity.

Effect on benefits

The payment of wages in kind may threaten eligibility for disability benefits and may reduce or eliminate benefits. For that reason, some pay a portion of the wages in cash and the rest in kind.

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FOOTNOTES

- ¹ I.R.C. § 3121(a)(8).
² I.R.C. § 3306(b)(11).
³ I.R.C. § 3401(a)(2).
⁴ See I.R.C. § 3121(a).
⁵ I.R.C. § 3121(a)(8).
⁶ See Ltr. Rul. 9202003, no date given.
⁷ *Id.*
⁸ *Id.*
⁹ Treas. Reg. § 1.83-6(a)(2).
¹⁰ See I.R.C. §§ 3401(a)(2), 3121(a), 3121(a)(8).
¹¹ Rev. Rul. 79-207, 1979-2 C.B. 351.
¹² Ltr. Rul. 8252018, Sept. 17, 1982.
¹³ *Id.*
¹⁴ Ltr. Rul. 9136001, May 14, 1991.
¹⁵ *Id.*

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL

AVOIDABLE TRANSFERS. The debtor made payment of a bona fide debt by a check mailed on November 18, dated November 19 and honored by the bank on November 20. For purposes of Section 547, the payment was not an avoidable transfer if made before November 20. The court held that the date of a payment for preferential transfer purposes was the date the check was honored by the bank; therefore, the payment was avoidable. **Barnhill v. Johnson, 112 S.Ct. 1386 (1992), aff'g, 931 F.2d 689 (10th Cir. 1991).**

ESTATE PROPERTY. The IRS filed a pre-petition tax lien and notice of levy against an account receivable of the debtor. The debtor sought use of the account receivable as cash collateral during the bankruptcy case but the IRS argued that the levy removed any interest of the debtor in the property. The court held that the account receivable was estate property subject to use as cash collateral until the property was sold at a tax sale. **In re Anaheim Elec. Motor, Inc., 137 B.R. 791 (Bankr. C.D. Cal. 1992).**

EXECUTORY CONTRACTS. The debtor, an agricultural equipment dealer sought to assume dealership contracts with the equipment manufacturer, under which the manufacturer provided floor plan financing and financing of purchases by customers. The manufacturer argued that Section 365(c)(2) prevented assumption of the contracts because the contracts involved financial accommodation of the debtor. The court held that the financing arrangements were only incidental to what were primarily business arrangement contracts and the debtor was allowed to assume the contracts. **In re Cole Bros., Inc., 137 B.R. 647 (Bankr. W.D. Mich. 1992).**

EXEMPTIONS.

EARNINGS. As part of its efforts to collect on a judgment, the plaintiff attached the proceeds of the sale of milk by the debtor to a dairy. The debtor objected, arguing that the milk proceeds were exempt from attachment as earnings under Ky. Rev. Stat. § 427.010. The court held that the proceeds of the sale of milk were not earnings eligible for the exemption. **Rice, Seiller, et al. v. Fitzgerald, 824 S.W.2d 435 (Ky. Ct. App. 1992).**

HOMESTEAD. The debtor claimed a residence as a homestead. The debtor had once lived in the residence fulltime but moved to two other houses which the debtor built in attempts to sell the houses. After the other houses were sold, the debtor moved back to the residence which was rented out during the debtor's absence. The court held that the debtor could claim the residence as an exempt homestead. The debtor did not abandon the residence as a homestead because the debtor always intended to move back once the other houses were sold. **In re Inmom, 137 B.R. 757 (Bankr. E.D. Ark. 1992).**

The debtors sold their Oregon homestead after moving to Colorado to obtain work. The debtors sought exemption of the proceeds under Colo. Rev. Stat. § 38-41-201 which provided for an exemption of proceeds of a homestead located in Colorado. Notwithstanding the literal language of the exemption statute, the court held that the proceeds would be exempt as fulfilling the purposes of the homestead exemption. **In re Bloedon, 137 B.R. 824 (Bankr. D. Colo. 1992).**

LIEN AVOIDANCE. The farm debtors sought to avoid a lien against the proceeds of farm machinery because the lien impaired their exemption in the farm machinery. The lien creditor argued that the exemption, under Wis. Stat. § 815.18(2)(h), was not allowed because the debtors had no equity in the machinery and the lien was consensual. The creditor also argued that because Wisconsin had not "opted out" of the federal exemptions, the Wisconsin limitations on the exemption were permissible because the debtors could elect to use the federal exemptions for lien avoidance purposes. The court held that under *Owen v. Owen, 111 S.Ct. 1833 (1991)*, a state limitation on an exemption did not affect the lien avoidance provisions of federal bankruptcy law; therefore, the lien could be avoided. **In re Wink, 137 B.R. 297 (Bankr. W.D. Wis. 1992).**

In divorce proceedings, the debtor's former husband's attorney obtained a charging interest against the former husband's interest in the marital residence. Under the divorce settlement, the debtor obtained the former husband's interest in the property subject to the charging lien. The court held that the debtor could not avoid the lien as impairing the homestead exemption because the lien attached before the debtor obtained an interest in the property. **In re Donovan, 137 B.R. 547 (Bankr. S.D. Fla. 1992).**