

1993 Cotton Management Economic Notes

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Production Decisions & Competitiveness

For most of Arizona, cotton is now planted and the growing season is well underway. Decisions that affect the cost of producing cotton for each farmer have been made; land preparation, pre-season fertilizer (if any) and herbicide application, pre-irrigation, and planting are completed and the cost incurred can not be recovered. These first management decisions are also the first economic decisions. **All decisions whether they are made on an economic basis or not have potential economic consequences.**

For example, this year's winter rains have caused some growers to go through extra land preparation activities because prepared land was badly washed or winter weeds became a problem. These activities had costs that add to the overall cost of production of this year's Arizona cotton crop. But if the crop was to be planted and cotton produced, the extra efforts were required. These efforts, while costing growers extra, have the benefits of getting the crop off to a good start, weather permitting. Additionally, choices of cotton variety, planting date and seeding rate also affect the crop's potential and the cost of producing the crop. But for Arizona cotton the issue of the costs of the

early season activities is greatly overshadowed by the issues of getting the crop well established and ready to perform throughout the season. Early season costs are not large compared to what is to come later in the season. As most growers fully know, it is foolish to cut cost on early crop establishment. However, it is important to make wise decisions about pre-season fertilizer application, planting date, cotton variety and growing strategy. Agronomist general concede that early planting is important in Arizona, if weather permits and if early planting dates are consistent with minimizing exposure of susceptible fruit to the emerging pink bollworms.



For Arizona cotton, the cost of preplant land preparation, pre-plant fertilizer and herbicide application is usually between \$40 and \$100 per acre while the cost of actually planting the crop is between \$10 and \$40 per acre. Generally, these costs are affected mostly by soil type and seeding rates. In the next few weeks, initial cultivations and watering back will be complete and the growing strategies of growers will be fully underway.

From an economic prospective, in-season (i.e., after planting) decision making based on costs alone is not usually wise. However, sound growing strategies for a complete season of cotton production begins early in the season, benefits from early season decisions, is carried out for an entire season, and has economic consequences that can only be measured after the season is completed.

Arizona cotton, more than most other US cotton, is facing a real challenge in the international marketplace. Foreign production and large carryover stocks are weighting down the overall cotton market as more producing countries are looking to cotton as an export to increase foreign exchange to trade for other industrial goods. **In the US, producers in the Old**

Recent Prices	April 30, 1993	
	Upland (¢/lb)	Pima (ELS) (¢/lb)
Spot	56.15	87.50
Target Price	72.90	105.80
Loan Rate	51.15	88.15
Dec '93 Futures	61.78	

Note: Upland Spot for Desert SW grade 31, staple 35;
 Pima Spot for grade 03, staple 46, 4/16/93; Phoenix Loan Rates

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Estimated To-Date Production Costs

\$/lint lb (April 30)

The following table gives estimated production costs/lb to-date. These costs include both growing and fixed or ownership costs and are based on the displayed target yields. Producers with higher yields will have lower costs/lb if input costs are the same. Growers with lower yields will have higher costs/lb.

County	Target Yield	Growing Costs		Fixed Cost	All Costs To Date
		April	To Date		
Yuma	1,300	.04	.10	.25	.35
La Paz	1,300	.04	.13	.27	.40
Mohave	1,100	.02	.13	.23	.36
Maricopa	1,250	.02	.11	.23	.34
Pinal	1,300	.04	.17	.26	.43
Pima	1,100	.06	.13	.28	.41
Cochise	700	.04	.33	.42	.76
Graham	1,050	.06	.20	.31	.51
Greenlee	850	.08	.19	.36	.55

Note: Based on Wade, et al., "1992-93 Arizona Field Crop Budgets", Various Counties, Arizona Cooperative Extension, Tucson, January 1992.

South Cotton Belt are increasing acreage in light of successful production in recent years. Arizona farmers in the mean-time are facing increased cost and the residual impacts of several years of low yields, high water costs and financial constraints. In this environment of uncertainty, growers must actively seek to remain competitive and maintain their share of an international market that looks for the best product at the lowest price. Cost control through a complete production strategy is an important part of being competitive. *Think competitively and grow quality cotton at competitive costs.*

Short Future and Option Hedge Tax Precautions

The "Corn Products Doctrine" case established by the Supreme Court in 1955 was the first case that established "ordinary loss" treatment for hedging transactions, including transactions that involving capital assets for reasons "integrally related" to business operations. In 1988 the "Corn Products Doctrine" case was re-interpreted in the *Arkansas Best* case. Arkansas Best was a holding company that acquired 65% of the stock in a Texas bank. While the stock was going up Arkansas Best was claiming capital treatment on its earnings to get the better tax rate. But when they sold the stock at a loss they claimed the loss as "ordinary" to maximize their deduction. The Court ruled that the stock purchase was not "integrally related" to busi-

ness activities or inventory of Arkansas Best since they were a holding company with no inventory. Consequently, *Arkansas Best* significantly narrowed the "Corn Products Doctrine" to require a close connection between the "asset and the taxpayer's inventory-purchase system."

As interpreted in the *Arkansas Best v. Commissioner* (485 U.S. 212 1988), section 1221 makes all assets capital assets unless they fall within an explicit provision that makes them ordinary. There is a provision that gives ordinary character to inventory like a farmer's crop but not one that explicitly covers futures or option positions with respect to inventory. It is the current litigating position of the Internal Revenue Service (i.e., *Federal National Mortgage Assoc. v. Commissioner, and Cathers v. Commissioner*) that short futures and options on short futures are capital assets even if they are used as business hedges by the taxpayers who acquire them.

Basically, the IRS's position is that short futures positions, and put options, are not hedges because they are "not substitutes or surrogates for inventory." Thus, any losses on short futures positions, put options, or other possible hedges with futures and options would be treated as capital losses. The difference in treatment of losses as ordinary versus capital are substantial. *Individuals may deduct capital losses only to the extent of their capital gains plus \$3,000 while corporations may deduct capital losses only to the extent of their capital gains.* Losses treated as ordinary income are fully deductible. Other adverse tax consequences may occur if put and call options were placed on the same underlying futures like in a "straddle" hedge — a hedge that works well if the futures price level increases or decreases substantially.

The current litigating position of the IRS is inconsistent with the examples provided on page 25 of IRS Publication 225, *Farmer's Tax Guide*. Briefs pertaining to the litigating position of the IRS were filed after the *Farmer's Tax Guide* was prepared. Thus, the outcome of these two pending cases filed by the IRS will help clarify the treatment of futures and option transactions placed as hedges. This is an important emerging issue that may have retroactive impacts if audits by the IRS are conducted. Make sure that your tax advisors and cooperative marketing personnel are aware of the current litigating position of the IRS.