INCOME TAX MANAGEMENT
FOR FARMERS IN 2005

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INCOME TAX MANAGEMENT FOR FARMERS
IN 2005*

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Congress has passed a number of major tax bills in recent years, and tax provisions have also been included in other legislation. In 2005, the Katrina Emergency Tax Relief Act extended many of the filing deadlines for those affected by the hurricane and provided favorable tax treatment for those assisting in recovery efforts. The Energy Tax Incentives Act passes in 2005 provides modest tax credits for costs incurred to improve energy in an individual’s principal residence, credits for energy saving vehicles, and credits for biodiesel and renewable diesel production. The Working Families Tax Relief Act of 2004 and the American Jobs Creation Act of 2004 were enacted in 2004. Congress also passed tax legislation in the form of the Jobs Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. These latter two acts will be referred to as the 2002 and 2003 Acts, respectively. In the Working Families Tax Relief Act of 2004, Congress extended some of the changes implemented by the 2002 and 2003 Acts. The American Jobs Creation Act of 2004 affected primarily corporations, but did eliminate the effect of the Alternative Minimum Tax (AMT) on farm income averaging, authorized a tobacco buyout program, and established the domestic production activities deduction.

The recent changes in Section 179 expensing have almost eliminated many farmers’ need to pay any federal income tax, assuming they are making capital purchases. However, reducing income tax liability may not be sufficient reason to make additional investments in depreciable assets. Furthermore, eliminating one’s tax liability for this year is not necessarily good tax planning. Good tax planning should seek to maximize after-tax wealth over time, not to minimize taxes paid in a particular year. With the changes that are occurring, farmers will need to update their tax planning techniques.

The first section of this publication briefly discusses a number of recent tax law changes affecting most individuals. Emphasis is given to those changes taking effect in 2005 or 2006. The second section emphasizes changes affecting businesses in 2005 and 2006. There is a discussion of tax-deferred exchanges of real estate and personal property like machinery and equipment in the third section. Government program payments and cost-sharing and other conservation-related payments with their reporting options are covered in the fourth section. A brief discussion of the tax implications of the tobacco buyout program is also included in that section. Farm income averaging and other recent tax developments affecting Midwestern agricultural producers are covered in the fifth section. The publication closes with a brief discussion of tax management.

* For information on specific tax situations, consult a competent tax advisor. For helpful comments on earlier versions of this publication, appreciation is expressed to Purdue colleagues Freddie Barnard, Craig Dobbins, Howard Doster, Gerry Harrison, Laura Hoelscher, Jess Lowenberg-DeBoer, Alan Miller, and Bob Taylor; and to Charles Cuykendall, Cornell University; David Frette, CPA, Washington, IN, and David Miller, Ohio State University. For a more basic discussion of income taxes and agriculture, see Patrick and Harris, *Income Tax Management for Farmers*, NCR#2, MWPS, Iowa State University, 2002.
RECENT TAX LAW CHANGES AFFECTING INDIVIDUALS

The 2003 Act reduced taxes for almost all individuals. First, expansion of the 10-percent regular tax bracket was accelerated, with an increase to $7,300 for single individuals in 2005 and to $7,550 in 2006. For married individuals filing a joint return, the 10-percent tax bracket was increased to $14,600 in 2005 and to $15,100 in 2005. The 10-percent bracket has been extended through 2010. The 15-percent tax bracket was also expanded for married couples filing joint returns. The standard deduction for a married couple, filing jointly, was increased to $10,000 for 2005, twice the standard deduction for a single individual. These changes temporarily, through 2010, continue to eliminate the so-called “marriage tax penalty” for many couples. Second, previously scheduled reductions of the regular income tax rates above the 15-percent rate were accelerated. For 2005, the maximum regular income tax rate continues at 35 percent, down from 39.6 percent in 2001.

A married couple filing jointly in 2005 has a standard deduction of $10,000 and two personal exemptions of $3,200, allowing them an adjusted gross income (AGI) of $16,400 before they incur any federal income tax liability. The next $14,600 of AGI would be taxed at a marginal rate of 10 percent, and the next $44,800 (up to an AGI of $75,800 or a taxable income of $59,400) would be taxed at the 15-percent rate. If the couple has two children, each qualifying for the $1,000 child tax credit, their AGI could be $41,000 before they would owe any federal income tax in 2005, although there would likely be some self-employment tax and state income tax liabilities at these levels of AGI. Some families may also qualify for the refundable earned income credit. Thus, these families should avoid excessively reducing their 2005 income for tax purposes.

Reduced Individual Capital Gain Rates

The tax rate on most long-term capital gains has been reduced from 20 percent to 15 percent for gains properly taken into account after May 5, 2003. For those individuals in the 15-percent or lower ordinary tax rate bracket, the reduction is from 10 percent to 5 percent. If pass-through entities (partnerships and S corporations) are involved, those capital gains are also subject to the lower tax rate. As under prior law, capital losses are generally fully deductible against capital gains. Up to $3,000 of capital losses can be deducted against ordinary income, and unused capital losses may be carried forward indefinitely. Short-term capital gains (gains on assets generally held for a year or less) are taxed at ordinary income tax rates.

Capital gain income includes the gain (or loss) from the sale of investments such as stocks and mutual funds. For cash basis farmers, capital gain income also includes the Internal Revenue Code (I.R.C.) Section 1231 gains from the disposition of raised animals used for draft, breeding, dairy, or sporting purposes if held for 12 months or more (24 months or more for cattle and horses). Gains from the disposition of depreciable personal property, like machinery and equipment, are treated as ordinary income, rather than capital gain income, to the extent of all previous depreciation and I.R.C. Section 179 allowances. For depreciable real property, gain from disposition of property is generally not treated as capital gain to the extent of depreciation allowances in excess of straight-line depreciation. Gains from the disposition of “collectibles” continue to be taxed at a maximum rate of 28 percent, while gains on depreciable real property in excess of straight-line (unrecaptured Section 1250 gain) are taxed at a maximum rate of 25 percent.
Under current law, the 5-percent rate on capital gains is scheduled to drop to zero in 2008, while the 15-percent rate will continue at the 15-percent level.

**Dividend Tax Relief**

The 2003 Act taxes dividends received by an individual after May 5, 2003 from domestic and qualified foreign corporations at the rates that apply to the individual’s capital gains. Previously, dividends were included in gross income and taxed at the ordinary income rates. For a couple filing jointly with a taxable income of $60,000 in 2005, $1,000 of qualifying dividends would be taxed at the 15-percent capital gain rate, a tax savings of $100 compared with the 25-percent ordinary income tax bracket.

I.R.C. Section 316 defines a dividend “as a distribution of property, including money, by a corporation to its shareholders that’s made out of current or accumulated earnings and profits.” Thus, farm and other cooperative patronage distributions are not eligible for the reduced rates. Dividends paid to policy holders by insurance companies and distributions from money market funds out of interest also do not qualify for the reduced rates. S corporations may make distributions to shareholders, but these distributions are not dividends and would not qualify for the reduced tax rate. But dividend distributions from farm corporations organized as C corporations do qualify.

**Other Changes Affecting Individuals**

The child tax credit was accelerated by the 2003 Act. For 2004 and 2005, the child tax credit was increased to $1,000, and this has been extended through 2009. The child tax credit generally applies to children who are eligible to be claimed as dependents and are under age 17. The child tax credit is phased out for higher income taxpayers. The phase-out starts at a modified adjusted gross income of more than $75,000 for single individuals or heads of households and $110,000 for a married couple filing jointly.

The alternative minimum tax (AMT) exemption amounts were increased from $35,750 to $40,250 for unmarried individuals and from $49,000 to $58,000 for joint filers. The AMT was established a number of years ago to ensure that individuals taking advantage of tax preferences, deductions, and tax credits would pay some income tax. However, the AMT exemption amount, unlike many tax law provisions such as the personal exemption and standard deduction, is not indexed (adjusted annually for inflation). As a result, an increasing proportion of taxpayers have become subject to the AMT. Congress has opted to increase the AMT exemption amounts year-by-year rather than index them.

**RECENT TAX LAW CHANGES AFFECTING BUSINESSES**

The 2003 Act increased the I.R.C. Section 179 deduction to $100,000 for tax years beginning in 2003, 2004, and 2005. Because of the indexing for inflation, the limit on the Section 179 expensing is increased to $105,000 for 2005 and will be $108,000 for 2006. The American Jobs Creation Act extended the $100,000 limit (before indexing) for 2006 and 2007. In 2008, the Section 179 limit is currently scheduled to revert to $25,000. The additional first-year depreciation for qualifying property purchased after September 11, 2001 and placed in service before January 1, 2005 has expired and is no longer available.
The American Jobs Creation Act of 2004 provides a new income tax deduction (Section 199) for taxpayers involved in domestic production activities. This provision is intended to create incentives for greater employment in the U.S. economy. Crops and livestock produced in the U.S. do qualify as domestic production activities. Although the deduction is limited to 3 percent of the qualifying income for tax years beginning in 2005 and 2006, it increases to 6 percent for tax years beginning in 2007, 2008, and 2009. It further increases to 9 percent for tax years beginning after 2009.

**Domestic Production Activities Deduction**

The domestic production activities deduction for tax years beginning in 2005 and 2006 is limited to the smallest of:

1. 3 percent of qualified production activity income (QPAI),
2. 3 percent of taxable income of a taxable entity or adjusted gross income of an individual taxpayer (computed without the I.R.C. Section 199 deduction), or
3. 50 percent of the Form W-2 wages paid by the taxpayer during the year.

The deduction increases to 6 percent for tax years beginning in 2007, 2008, and 2009, and it further increases to 9 percent for tax years beginning after 2009. This deduction is computed on Form 8903 and is taken on the front of the Form 1040 as an adjustment to income. Thus, the deduction is for adjusted gross income only and does not reduce earnings from self-employment.

This section explains, in a farm situation, the concepts, calculations, and terminology involved in determining this new domestic production activities deduction, that is sometimes referred to as the Section 199 deduction. The terms are explained and illustrated in situations of a sole proprietor and pass-through entities such as partnerships, S corporations, and limited liability companies taxed as partnerships.

**Qualified Production Activities Income**

Qualified production activities income, commonly referred to as QPAI, is equal to domestic production gross receipts (DPGR) minus the cost of goods sold, other deductions and expenses directly allocable to such receipts, and the share of other deductions and expenses not directly allocable to such receipts. For farmers, the qualifying activities include cultivating soil, raising livestock, and fishing as well as storage, handling, and other processing (other than transportation activities) of agricultural products.

For many farmers, their QPAI will be equal to the sum of net income reported on their Form 1040 Schedule F and net gain from the sale of raised livestock reported on Form 4797. However, there a number of possible exceptions to this as explained below.

**Domestic Production Gross Receipts**

Domestic production gross receipts (DPGR) are generally the receipts from the sale of qualified production property. For cash basis farmers, this would be the receipts from the sales of livestock, produce, grains, and other products raised by the producer. DPGR includes the full sales price of livestock (like feeder livestock) and other products purchased for resale. Gains from the sale of raised draft, breeding, and dairy livestock reported on Form 4797 also appear to qualify as DPGR. Sales proceeds from livestock purchased for draft, breeding, or dairy purposes would probably not qualify unless the taxpayer had purchased the animals as young stock and
had a significant role in raising them. Gains from the sale of land, machinery, and equipment are also excluded from DPGR. Rent received from land is specifically excluded from DPGR. Custom hire income (e.g. combining, spraying, trucking, etc.) reported on Form 1040 Schedule F is also excluded from DPGR.

If a taxpayer has less than 5 percent of their total gross receipts from items that are not DPGR, a safe harbor provision allows a taxpayer to treat all their gross receipts as DPGR. For example, a farmer has income of $5,000 from planting the neighbor’s no-till soybeans. As long as qualifying DPGR exceeds $95,000, the farmer can include the $5,000 as part of his or her DPGR. If qualifying DPGR is $95,000 or less, then $5,000 custom hire income must be kept separate and expenses allocated proportionally between DPGR and non-DPGR activities.

**Computing QPAI**

To determine QPAI, the farmer’s DPGR is reduced by the appropriate costs. If items purchased for resale (like feeder livestock) are included in DPGR, the cost of these items is deducted. Directly allocable and indirectly allocable deductions, expenses, or losses related to the items included in DPGR are deducted. For a farmer whose entire crop sales receipts qualify as DPGR, QPAI would be computed by subtracting the allowable expenses, and QPAI would be equal to net farm income on Form 1040 Schedule F. If the farmer also had gains from the sale of raised livestock on Form 4797, QPAI would be the sum of net income from Form 1040 Schedule F and the livestock gain from Form 4797.

Calculations are more complicated if total receipts are not all DPGR or do not qualify for the 5-percent safe harbor discussed above. Cash basis taxpayers and taxpayers with less than $25,000,000 of gross receipts are allowed to use simplified procedures for allocating costs. For example, assume Ima Producer has $85,000 of crop sales and $15,000 of custom work income for total Form 1040 Schedule F receipts of $100,000. Ima’s DPGR would be $85,000, 85 percent of total receipts. If Ima’s total Form 1040 Schedule F expenses were $60,000, 85 percent of the Form 1040 Schedule F deductions, or $51,000 could be allocated to qualified production activities. Ima’s QPAI would be $34,000 (her $85,000 DPGR minus the $51,000 allocated cost).

**Computation of the Deduction**

The domestic production activities deduction in 2005 and 2006 is computed as the smallest of:

1. 3 percent of QPAI,
2. 3 percent of adjusted gross income (AGI), or
3. 50 percent of Form W-2 wages paid during the year.

For an individual taxpayer, AGI would include other taxable income and deductible losses. For purposes of the 3-percent limitation, AGI is computed without the Section 199 deduction.

Example: Joe Farmer operates as a sole proprietor and has gross farm receipts of $250,000 from the sale of crops and livestock. All of Joe’s receipts qualify as DPGR, and he has Form 1040 Schedule F expenses of $200,000, including $10,000 of Form W-2 wages for part-time help. Joe has net farm income of $50,000 on Form 1040 Schedule F, and his QPAI is also $50,000. Assuming Joe’s AGI exceeds $50,000, his domestic production deduction would be the lesser of $1,500 (3 percent of $50,000 QPAI) or $5,000 (50 percent of $10,000 W-2 wages).
For some farm situations, the domestic production activities deduction can be limited by Form W-2 wages.

Example: Assume Joe’s wife, Mary, provides the part-time help on the farm and is not paid. Income and expenses, other than hired labor, are the same as Example 1. Joe’s QPAI would be $60,000, and Form W-2 wages are $0. Joe would not qualify for the domestic production deduction.

Note: Joe could reasonably compensate Mary for her work on the farm and qualify for the domestic production deduction. If Joe paid Mary $8,000, his QPAI would be $52,000, and he would qualify for a $1,560 domestic production deduction. Mary’s wages would be subject to social security taxes, but Joe’s earnings for self-employment tax would be reduced by the amount of the wages paid.

Although there are various ways of computing wages for the domestic production activities deduction limitation, wages for which withholding is not required are always excluded. Thus, wages paid in commodities, wages paid to a child (under the age of 18) of the proprietor (or a child of all of the partners), and compensation paid in nontaxable fringe benefits are not counted in determining the Form W-2 wage limitation for an employer.

Pass-Through Entities

S corporations, partnerships, and other pass-through entities do not pay income tax, and their income and expenses flow through to the shareholders or partners. The Section 199 limitations are applied at the shareholder, partner, or similar level for both QPAI and Form W-2 wage allocation. An individual who has been allocated QPAI from a pass-through entity is also treated as having been allocated Form W-2 wages from that entity in an amount equal to the lesser of:

1. The owner’s applicable share of such wages, or
2. Two times 3 percent (for tax years beginning in 2005 and 2006) of the entity’s QPAI allocated to the owner. (The 3 percent increases to 6 percent in 2007, 2008, and 2009, and to 9 percent for tax years beginning after 2009.)

An individual may be involved in multiple entities. The second limitation restricts an individual who has a negative QPAI (a loss) and positive Form W-2 wages in one entity from taking a Section 199 deduction by combining this with another entity with a positive QPAI and little or no W-2 wages. Losses and deductions of pass-through entities may also be limited by the at-risk and passive activity rules. Income and expenses of the pass-through entities involved in qualified production activities are generally combined.

Other Situations

Taxable entities, such as regular corporations, are eligible for the domestic production activities deduction at the entity level, rather than at the owner level. Taxable income of the corporation, before any Section 199 deduction, would replace AGI as one of the three limitations on the deduction. Taxpayers who have generally reduced corporate income by making wages and rent payments to shareholders may want to consider leaving more income in the corporation to take advantage of the domestic production activities deduction.

Rent received from land is explicitly excluded from DPGR. Thus, cash rent landowners
do not qualify for the domestic production activities deduction. Share-rent landowners could argue that their receipts are from the sale of commodities they produced in a trade or business. Share-rent landowners are considered in the business of farming for soil and water conservation deductions and farm income averaging. However, it could be argued that tax law treats landowners’ receipts as rent although they are not reported as rental income on Schedule E. From a practical standpoint, few share-lease landowners will have the Form W-2 wages necessary to meet the wage limitation and thus would not qualify for the domestic production activities deduction.

Cooperatives may be engaged in manufacturing, production, growth, or extraction of agricultural or horticultural products or in the marketing of such products. Farmers receiving a patronage distribution from such a cooperative may have a domestic production activities deduction. The domestic production activities deduction amount is reported on Form 1099-PATR box 6, and the producer would include the amount on line 17 of the Form 8903.

**Depreciation and Section 179 Expensing**

Farmers and others in an active trade or business can elect to treat the cost of up to $105,000 of qualifying property purchased during 2005 as an expense (rather than as a depreciable capital expenditure). Under prior law, the annual Section 179 expensing limit was increased to $25,000 for 2003 and later years. The 2003 Act increased the Section 179 expensing deduction to $100,000, with inflation adjustments for later years. The Section 179 expensing election can be made after the close of the tax year when completing the return or on an amended return. For 2005, taxpayers no longer have the 30-percent and 50-percent additional first-year depreciation alternatives available. These provisions expired at the end of 2004 and were not extended. However, because of Section 179 expensing, farmers have considerable flexibility in managing their deductions and taxable income.

Section 179 expensing can be used for tangible personal property used in a trade or business. Farm machinery and equipment; livestock used for draft, breeding, or dairy purposes; grain storage; single purpose livestock/horticultural structures; and field tile all qualify for Section 179 expensing. General-purpose farm buildings, such as machinery sheds or hay barns, are not eligible for Section 179 expensing.

Purchased new or used property can be expensed under Section 179. Property previously used by the purchaser is not eligible for expensing. Inherited property or property acquired from a spouse, ancestors, or lineal descendants is also not eligible for Section 179 expensing. On like-kind exchanges (swaps or trades), only the boot portion paid is eligible for expensing.

The entire Section 179 expensing election can be taken on one large item, reducing the basis for cost recovery. Alternatively, several small items can be completely written off in the year of purchase. Less than the full $105,000 expensing election can also be claimed. The amountsexpensed are treated the same as depreciation when the property is sold or traded and for depreciation recapture purposes. If a Section 179 expensing election is made, notations regarding the specific allocations should be made on the depreciation schedule. If no allocations are specified, IRS prorates the expensing election among all eligible assets. Generally, it will be more advantageous to allocate the expensing deduction to longer lived assets and to assets that are likely to be kept in the business for their entire depreciable life.
The expensing election is phased out on a dollar-for-dollar basis if over $420,000 of qualified property is placed in service during 2005 ($430,000 in 2006). For example, if a farmer buys $450,000 of machinery in 2005, the maximum Section 179 expensing allowed would be reduced $30,000 ($450,000 - $420,000), making the limit $75,000. An individual is not allowed to elect the full $105,000 and carryover the $30,000 excess. Only the boot portion on like-kind trades is considered for the $420,000 limit. Thus, if the boot portion of the $450,000 purchase with a like-kind trade-in was only $175,000, then the full $105,000 expensing could be elected.

The expensing deduction is limited to the taxable income from any active trade or business before any Section 179 expensing. A farmer’s and/or spouse’s off-farm wage or business income can be combined with Form 1040 Schedule F loss so that aggregate taxable income would be positive. This would permit a Section 179 expense for an asset acquired by the farm business. Gain or loss from the sale of livestock, machinery, and other business assets reported on Form 4797 is also included in taxable income for purposes of applying this taxable income limitation. “Suspended losses" from passive activities are not considered in determining the taxable income limit.

The American Jobs Creation Act provides greater flexibility with respect to late Section 179 elections and changes in Section 179 elections. Originally, Section 179 elections could be made only on the original return for the year and could not be changed on an amended return. Thus, if a return was audited and a change proposed, the taxpayer could not make or change the Section 179 election. Currently, a taxpayer may change, make, or revoke a Section 179 election by the extended due date of the return or by filing an amended return for tax years beginning after 2002 and before 2008. If a Section 179 election is revoked, that revocation is irrevocable for that property. For example, assume a farmer elected to expense $25,000, the entire cost of a used planter in 2005, and then revoked that election in 2006. The farmer could no longer elect to expense any of the cost of the planter for 2005, but other qualifying assets could be expensed for 2005.

**Final Quarter Limitation and Mid-Quarter Convention**

The depreciation regulations generally allow one-half year’s depreciation in the year of acquisition and one-half year’s depreciation in the year of disposition. A special limitation on regular depreciation applies if more than 40 percent of the total depreciable bases of property acquired in a tax year is placed in service during the last three months of the year. Nonresidential real property and residential real property are excluded from this calculation. This “final quarter limitation" affects all assets acquired during the tax year and may substantially reduce the amount of depreciation allowed, especially on end-of-the-year purchases. The final quarter limitation is computed after the Section 179 expensing is applied.

Example: Assume a $100,000 combine (7-year MACRS property in Table 1) was the only asset acquired during 2005 and it was placed in service after September 30. Only one and one-half months of depreciation would be allowed. Instead of deducting $10,710 of the “half-year" depreciation, one could deduct depreciation for only one and one-half months or $2,680. The depreciation not allowed in the year of purchase would be taken in later years. Thus the total depreciation is not affected. For example, 20.85 percent would be allowed in the second year for the combine subject to the final quarter limitation in the year of purchase. For further details, see IRS Publication 946, “How to Depreciate Property," Table A-18, page 85.
Table 1. MACRS Depreciation Deduction Percentages for Property Used in Farming by Class-Life of MACRS Property Acquired after 1988 (150% DB)

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<td>4.461</td>
</tr>
<tr>
<td>21</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>2.231</td>
</tr>
</tbody>
</table>

Determination of whether the final quarter limitation applies is made after any Section 179 expensing. Whether Section 179 expensing is elected, which assets are selected for expensing, and whether the entire $105,000 allowance for 2005 is used may have a considerable impact on the depreciation for the year. It may be possible to avoid application of the limitation by electing to apply Section 179 expensing to depreciable assets acquired in the final quarter of the year.

Example: Assume a farmer acquired a $25,000 machine in the first quarter, a $30,000 machine in the second quarter, and a $45,000 machine in the last quarter of the year. If there was no Section 179 expensing, the final quarter limitation would apply, and a “mid-quarter convention” would apply to all assets purchased that year. Each asset is treated as if it had been acquired on the mid-point of the quarter in which it was placed in service. Depreciation for this seven-year property would be computed, using percentages from IRS Pub. 946 Tables A-15, A-16 and A-17 as:

$25,000 x 18.75 percent = $4,687.50
$30,000 x 13.39 percent = $4,017.00
$45,000 x 2.68 percent = $1,206.00
$100,000 TOTAL $9,910.50

Example: Assume the farmer elected $20,000 Section 179 expensing on the $45,000 machine acquired in the last quarter. Then only $80,000 of qualifying property would have been acquired during the year with less than one-third acquired during the fourth quarter. The 40-percent test would not be satisfied, and the half-year convention would apply to all of the purchases. Depreciation would be computed using the percentages from Table 1 above as:

$25,000 x 10.71 percent = $2,677.50
$30,000 x 10.71 percent = $3,213.00
$25,000 x 10.71 percent = $2,677.50
$80,000 TOTAL $8,568.00

In this instance, the combined depreciation and expensing deduction would total $28,568.00. This is about $18,658 more than if the final quarter limit applied.

For assets subject to the mid-quarter convention as a result of the final quarter limitation, depreciation in the year of disposition would be allowed through the mid-point of the quarter of disposition. However, the regulations indicate that if one purchases and disposes of an asset within a tax year, the transaction is assumed to occur on the same day, and one receives NO depreciation on that asset. Only those assets that were acquired during the year and are “on hand” at the end of the year are considered for the 40-percent test and are eligible for depreciation.

Alternative Depreciation Methods

Producers have considerable initial flexibility with respect to depreciation. Once a producer begins deprecating an asset using a particular method, that method must be continued for the life of the asset. However, decisions with respect to methods can be made when the asset is placed in service. Table 2 compares the annual depreciation deductions for Section 179 expensing with seven-year MACRS, the regular seven-year MACRS method, and the straight-line method over the alternative 10-year life (Alternative MACRS). These represent the range of
the fastest to the slowest depreciation methods available. Using some of the $105,000 Section 179 expensing results in much or all of the cost recovered in the year of purchase. Under regular MACRS, nearly 60 percent of cost recovery occurs within the first four years. In contrast, with alternative MACRS, 65 percent of cost recovery is left after four years.

Section 179 expensing and use of the MACRS table result in a producer recovering the cost of the depreciable assets as rapidly as possible. However, if taxable income is low or negative, the tax saving effect of this depreciation may be largely “wasted.” For example, if taxable income is low, the income tax savings on another dollar of depreciation may be 10 or 15 percent or nothing. However, if the depreciation deduction were postponed until a year when income was higher, the savings could be 25 percent or more.

Table 2. Depreciation Alternatives for $100,000 7-Year Property Acquired in 2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Expensing, $50,000</th>
<th>Regular MACRS</th>
<th>Alternative MACRS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1st Year</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Regular MACRS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>55,355</td>
<td>10,710</td>
<td>5,000</td>
</tr>
<tr>
<td>2006</td>
<td>9,565</td>
<td>19,130</td>
<td>10,000</td>
</tr>
<tr>
<td>2007</td>
<td>7,515</td>
<td>15,030</td>
<td>10,000</td>
</tr>
<tr>
<td>2008</td>
<td>6,125</td>
<td>12,250</td>
<td>10,000</td>
</tr>
<tr>
<td>2009</td>
<td>6,125</td>
<td>12,250</td>
<td>10,000</td>
</tr>
<tr>
<td>2010</td>
<td>6,125</td>
<td>12,250</td>
<td>10,000</td>
</tr>
<tr>
<td>2011</td>
<td>6,125</td>
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<td>10,000</td>
</tr>
<tr>
<td>2012</td>
<td>3,065</td>
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<td>15,000</td>
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<tr>
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<td></td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td>2015</td>
<td></td>
<td>5,000</td>
<td>0</td>
</tr>
</tbody>
</table>

Which of the possible options for Section 179 expensing and depreciation should be taken by individual producers will depend on both their overall 2005 tax situation as well as their expected tax situation in future years. There are trade-offs between the value of tax-savings of deductions for income and self-employment tax purposes in one year versus those deductions being spread over several future years. Both time value of money considerations (a dollar to be received in 2010 is not worth as much as a dollar in hand today) and expected future income are important in making these decisions. If the farmer’s marginal tax rate or tax bracket is unchanged, then tax benefits from Section 179 expensing and additional first-year depreciation are higher for MACRS assets with longer class lives. In general, the expensing election and additional first-year depreciation are applied to the qualifying property with the longest lives and those assets that are the least likely to be resold or traded. If the current marginal tax rate is low, relative to the anticipated tax rate for future years, then slower methods of depreciation are likely to result in greater tax savings.
Fuel Excise Taxes

The Transportation Act (Public Law 109-50) changes farm diesel fuel tax refund procedures for sales after September 30, 2005. Under prior law, if previously taxed diesel fuel was used in a nontaxable use, a refund of the tax paid was payable to the ultimate purchaser; however, only the ultimate vendor could make the claim. The new law allows the ultimate user to file Form 8849 for an annual claim or Form 8894 for a quarterly claim of at least $750. Previously, aerial applicators were allowed to claim refunds of tax on aviation gas only with written consent of the farmer/customer. The new law allows the aerial applicator to claim the exemption without written consent of the farmer. The exemption is expanded to include fuel consumed flying between farms where chemical are applied and the airport used by the applicator.

LIKE-KIND EXCHANGES

I.R.C. Section 1031 requires taxpayers to postpone reporting of gain or loss on property they give up if they trade that property for like-kind property. These like-kind exchanges are also referred to as “swaps,” trades, tax-deferred exchanges, or 1031 exchanges. Sometimes they are erroneously referred to as tax-free exchanges. These exchanges are not tax-free; rather, the reporting of gains or losses is postponed by adjustments of the tax basis of the asset acquired. Many like-kind exchanges involve farm real estate (real property), but most trade-ins of machinery and equipment (personal property) also qualify as like-kind exchanges. Recent IRS regulations again allow the taxpayer to transfer the remaining tax basis in the personal property given up to the like-kind property acquired.

Like-Kind Exchanges of Personal Property

Determining whether property is like-kind property can be difficult. Depreciable personal property can satisfy the like-kind exchange requirement if the properties are “like-class” and are either in the same General Asset Class (which does not include agricultural items) or the same Product Class. The IRS proposes using the North American Industry Classification System (NAICS) to replace the discontinued Standard Industrial Classification (SIC) for Product Class. Under the SIC classification, Farm Machinery and Equipment was Class 3523. Under the NAICS classification, Farm Machinery and Equipment becomes Class 333111. Among the many items listed in this category are combines, tractors, planters, tillage equipment, manure spreaders, livestock equipment, and haying machinery. Thus, essentially any machinery or equipment manufactured by a farm machinery and equipment manufacturer would meet the like-kind test. Different sex livestock are specifically defined as not being like-kind property. Different species of animals are defined as being in different classes and thus do not meet the like-kind test. Dairy and beef cattle are arguably like-kind, but there is no clear authority. Because of this industry-based approach, the definition of like-kind property is very broad for agriculture.

In a like-kind exchange, the farmer typically trades in the old asset for the asset to be acquired and pays additional money. For example, a farmer trades an old combine with a tax basis of $30,000 and $60,000 additional money for a replacement combine (new or used) selling for $100,000. The dealer gave a trade-in allowance of $40,000 for the old combine. If the farmer had sold the combine for $40,000, there would have been a gain of $10,000 to be reported (recognized) for tax purposes. However, because this qualifies as a like-kind exchange, the gain is not recognized, and the tax basis of the replacement combine is $90,000, the $30,000 adjusted
tax basis of the combine traded in plus the $60,000 cash boot. Under IRS Notice 2000-4, the taxpayer would have continued to depreciate the $30,000 adjusted basis of the combine that was traded in as if it had not been traded. Only the $60,000 cash boot would have been depreciated as the new asset.

The IRS recently issued regulations (Reg. 1.168(i)-6T(i)) that allow a taxpayer to elect out, on an asset by asset basis, of the general procedures of the new regulations. The taxpayer should enter “Election made under Section 1.168(i)-6T(i)” at the top of Form 4562 and attach a list of assets for which the election is being made. This considerably simplifies the depreciation schedule for an individual involved in a number of trades with only a small reduction in the initial depreciation deduction.

If the adjusted tax basis of the old combine had been $50,000 and the trade-in allowance was only $40,000, effectively there was a loss of $10,000 on the old combine. Because this was a like-kind exchange, rather than a sale, that loss is not recognized. The tax basis in the replacement combine would be the $50,000 basis of the old combine plus the $60,000 boot for a total of $110,000. If the trade-in value of an asset is less the asset’s adjusted basis, it would be good tax management to have the old asset sold in a separate transaction from the purchase of the new asset. Ideally, the sale of an asset at a loss and purchase of a replacement asset should involve different individuals or companies to avoid having the transactions considered as a like-kind exchange and the loss deferred by the adjustment of the basis of the replacement asset.

Like-Kind Exchanges of Real Property

For real property, like-kind is interpreted very broadly. Any real estate can be exchanged for any other real estate and qualify as like-kind as long as the property given up was, and the acquired property is, used in a trade or business or held for investment. Thus, farm land can be traded for an apartment complex or real estate with improvements can be traded for unimproved real estate. As with like-kind exchanges of personal property, the gain or loss on the relinquished property (property given up) is deferred, and the basis of the replacement property is adjusted. The basis of the replacement property is generally the basis of the relinquished property plus the value of any additional boot.

The two primary problem areas associated with like-kind exchanges of real property are the timing associated with completion of the transaction and the potential for depreciation recapture under Section 1245 and Section 1250. Farm properties that are given up can also involve recapture of soil and water conservation expenditures (Section 1252) or exclusion of conservation cost-sharing payments (Section 1255). This can result in some tax even if there is a like-kind exchange.

A like-kind exchange of real property could, but does not necessarily, involve two property owners simply swapping properties. An individual property owner relinquishing property may have a specific replacement property identified, but the owner of the replacement property may want cash rather than other property. This transaction can be handled as a like-kind exchange by the first property owner and as a sale by the second property owner. The most typical situations involve a non-simultaneous or deferred exchange. In a deferred exchange, first the relinquished property is transferred, and then the replacement property is acquired. For such a transaction to qualify as a like-kind exchange, certain rules must be followed with respect to
timing, and actual or constructive receipt of the proceeds must be avoided by the first property owner.

There are two timing issues on a deferred exchange. First, the replacement property must be identified on or before the 45th day after the taxpayer transferred the relinquished property (the day of closing). Second, the replacement property must be received (closed on) by the earlier of a) 180 days after the date the taxpayer transferred the relinquished property or b) the due date (including extensions) of the taxpayer’s tax return for the year in which the property was transferred. The identification rule has a number of specific requirements with respect to procedures that must be followed to comply with the rule. Generally, a real estate agent, qualified intermediary, or other individual who has not had any dealings with the taxpayer in the prior two years will be involved in the exchange process.

Treasury Reg. 1.1031(k)-1(g) provides four safe harbor rules to prevent the taxpayer who relinquished the property from having actual or constructive receipt of money or other property. First, the obligation of the recipient of the relinquished property to transfer replacement property can be secured or guaranteed by a mortgage, standby letter of credit, or third party guarantee. Second, a qualified escrow account or qualified trust can be used to hold the money. Third, the taxpayer can hire a qualified intermediary to handle the exchange. Fourth, an agreement can be made that provides for an increase in the amount of money or property that the taxpayer can receive based on the time between relinquishing property and receiving the replacement property. Under the last three safe harbor rules, the taxpayer cannot have the right to receive, pledge, borrow, or otherwise benefit from the proceeds before the end of the exchange period unless no replacement property is identified.

Commonly a farm involves a house, land, and some improvements such as tile drainage, grain storage, a single-purpose livestock facility (Section 1245 property), and a machine shed (Section 1250 property). These assets are grouped by class and handled individually. If the house has been owned by the taxpayer and was the principal residence of the taxpayer for at least two of the five previous years, then gain of up to $250,000 ($500,000 for a married couple if both satisfy the requirements) can be excluded from income even if cash is received. Thus, most farmers would sell their principal residence separately from the rest of the farm and exclude the gain. As long as the amounts of Section 1245 and Section 1250 property on the replacement property are at least as great as the amounts of Section 1245 and Section 1250 property, respectively, on the relinquished property, there would be no Section 1245 or Section 1250 recapture on the like-kind exchange. However, if the amounts of Section 1245 and Section 1250 property on the replacement property are less than on the relinquished property, then there would be some recapture (taxable income) to be reported by the taxpayer relinquishing property.

Like-kind exchanges offer the possibility of avoiding reporting gains on the exchange of property. These are usually quite simple and straightforward for personal property. Transactions involving real estate can be more complex, and the tax implications may be much larger. Taxpayers need to proceed carefully, usually with expert assistance, to ensure that the necessary procedures are followed.

GOVERNMENT PAYMENTS

Government payments continue to be a significant portion of farm income for many Indiana producers. Some payments are related to the farm income support program, and others
are related to producers’ participation in soil and water conservation programs. Farmers using the cash method of accounting generally report receipts as income when constructively received and deduct expenses when actually paid. However, farmers have some control over when government program payments are received and reported for income tax purposes. Special provisions allow the deduction of some conservation related expenditures, while some payments can be excluded from income. These provisions allow some additional year-end tax planning opportunities for producers.

**Government Farm Program Payments**

The Farm Security and Rural Investment Act of 2002 provides for three types of payments to crop producers: direct payments, countercyclical payments (CCPs), and marketing loans/loan deficiency payments. Producers could have requested one-half of their 2005 direct payments in December of 2004, and those payments would have been reported as 2004 income. Producers can request one-half of their 2006 payments in 2005. Although these 2006 payments are available to qualifying producers in 2005, because of a special provision enacted by Congress, these payments are not considered as income until actually received by the producer. Thus, producers with a low taxable income in 2005 may want to take the available portion or the 2006 payment on or before December 31, 2005. Producers wishing to defer income into 2006 can delay requesting payment until after December 31, 2005. The date that previous government payments have been taken does not affect when a producer’s 2006 payments can be taken.

Countercyclical payments (CCPs) replace the Market Loss Assistance (MLA) and other emergency payments under the 1996 FAIR Act. The CCPs are made only if the effective commodity price is below the target price of the commodity (net of direct payments) for the marketing year. For corn and soybeans, the marketing year runs from September in the year of harvest through the following August. However, up to 35 percent of an anticipated CCP payment can be made in October of the year of harvest. Up to 70 percent of the anticipated CCP payment can be made after February 1 of the year following harvest. The final payment is made as soon as practical following the close of the crop-marketing year. The CCPs are reported as income when received by the producer.

The marketing loan program and loan deficiency payments are continued under the 2002 Farm Bill. Producers can put their wheat, corn, and soybeans under the marketing loan program with the Commodity Credit Corporation (CCC). If market prices are above the loan rates, the CCC loans would be repaid at the loan rate, and interest would be due. The interest would be deductible when actually paid. For tax purposes, farmers can treat this loan like any other loan and not include the proceeds in income. Receipts from the sale of the crop would be reported as income when the crop is sold, and there would be no feed deduction if the crop is fed. Alternatively, producers can elect to report the CCC loan as income when received. In this case, the later redemption of the loan results in the farmer having a tax basis in the redeemed commodity equal to the amount previously reported as income. This tax basis is used in determining gain or loss when the commodity is sold. If the commodity is fed, then the producer can take a feed deduction. As discussed in a later section, the election to report CCC loans as income can be revoked by producers.

Under the marketing loan program, if market prices are below the loan rate, a producer may repay the CCC loan at the posted county price (PCP), and there is no interest expense. The difference between the loan rate and the PCP is referred to as the “marketing loan gain.”
Producers who treated the CCC loan as a loan must include the marketing loan gain as income when the CCC loan is repaid. The sales price would be included in income if the commodity is sold. Because no income was reported, there would be no feed deduction if the redeemed commodity were fed. Producers who reported the CCC loan as income would also report the marketing loan gain on line 6a of Form 1040 Schedule F (Form 1040), but would not include the gain as taxable income on line 6b. In this case, the PCP, rather than the loan rate, would be the farmer’s tax basis for computing gain or loss on the sale of the commodity. If the commodity is fed, the tax basis could be deducted as a feed cost.

A loan deficiency payment (LDP) can be claimed by a producer if the PCP is less than the loan rate, rather than going through the procedure of taking a CCC loan and paying it off. The LDP is reported as income when received by the producer. Producers have some control over the reporting of their activities, which influences when the LDP will be paid by the Farm Service Agency (FAS) and included as income for tax purposes. If grain is harvested and sold when delivered to the elevator, the CCC-709 form is filed with FSA. Although the LDP is based on specific delivery dates, payment will not be made until FSA receives acceptable evidence of production. For producers who store their grain, the LDP may be locked in for a 60-day period, and the producer can speculate on higher prices. If the transactions are not completed and the LDP payment made until after December 31, 2005, then the LDP income is not reported until 2006.

Conservation-Related Payments

A number of conservation-related payments may be made by the government. In general, these payments are ordinary income that is subject to income and self-employment taxes. In the case of some cost-sharing payments, there may be an offsetting deduction, or some payments may qualify to be excluded from income.

To encourage expenditures for soil and water conservation purposes, Congress has allowed a deduction of up to 25 percent of gross farm income for qualifying expenditures. To qualify, expenditures must be consistent with an approved conservation plan and involve land used in the business of farming. Land used for timber production, used in a not-for-profit (hobby) activity, or rented for a fixed amount is not considered as being used in the business of farming. Cash rent landowners who are considering making soil and water conservation expenditures may want to change the terms of their lease. Expenditures for depreciable conservation assets are not eligible for deduction as soil and water conservation expenses. Ordinary and necessary expenses that are otherwise deductible, such as periodic ditch cleaning, are also not soil and water conservation expenditures and are not subject to the 25 percent of gross income limitation.

Cost-Sharing Payments

In most counties, cost-sharing payments are available for expenditures on approved agricultural conservation practices. Establishment of grassed waterways and filter strips would be common examples. Because there is nothing to wear out, these expenditures are not eligible for depreciation and would normally be added to the basis of the property. However, to encourage conservation, Congress enacted I.R.C. Section 175, which allows a producer to elect to deduct expenditures up to 25 percent of the gross income from farming (including income from crops, livestock, fruits, and other agricultural products or livestock as well as sale of
livestock). Gains from the disposition of machinery and equipment or land are not included. If expenditures do exceed 25 percent of the gross income from farming in a year, the excess can be carried forward into future years. Alternatively, some cost-sharing payments may be eligible to be excluded from income as discussed below. Cost-sharing payments must be reported in income as government program payments on line 6a of Form 1040 Schedule F (Form 1040), but the expenditures are deducted on line 14. This reduces farm income for both income and self-employment purposes. If the land is held for five years or less, gain on the sale of land is treated as ordinary income up to the amount of previously deducted soil and water conservation expenses. If the land has been held less than 10 years but more than five years, then a declining percentage of the previously deducted soil and water conservation expenses is treated as ordinary income.

Some cost-sharing payments may involve expenditures for assets, such as metal or concrete structures, that can be depreciated. Such expenditures are not eligible for deduction as soil and water conservation expenses, but would be depreciated. If the cost-sharing payment was reported as income and depreciation was deducted, the net effect would be to increase the producer’s income for the year in which the cost-sharing payment was received. I.R.C. Section 126 allows the exclusion of the cost-sharing payment from income if the payment is from an authorized list of programs, is for a capital expenditure, does not substantially increase gross receipts from the property that was improved, and the Secretary of Agriculture certifies that the payment was made primarily for conservation purposes.

The amount that can be excluded is the present value of the greater of:
1) 10 percent of average gross receipts from the affected property for the last three years, or
2) $2.50 per acre.

Some expenditures, such as an erosion control structure, may have clearly defined areas of impact. Other expenditures, such as manure storage facilities, may have less well-defined areas of impact. Producers will want to define the area affected as being as large as possible. The present value computation involves dividing the dollar figure derived from 1 or 2 above and dividing by the relevant interest rate. Lower interest rates result in a larger present value and a larger potential amount that would be excludible. For example, assume a structure affected 100 acres, 10 percent of average gross receipts is $20 per acre, and the interest rate is 5 percent. In this instance, the present value of the amount to exclude would be calculated as:

\[(100 \times 20)/0.05 = 2,000/0.05 = 40,000\]

Thus, up to $40,000 of a cost-sharing payment could be excluded from income. If the land were sold at a gain within 10 years of receiving the cost-sharing payment, the gain, to the extent of the income exclusion, would be treated as ordinary income. This is similar to recapture of depreciation. If sold for a gain more than 10 years after the payment was received, the recapture is reduced by 10 percent for each year or part of a year that the property is held beyond 10 years.

**Conservation Reserve Program**

The Conservation Reserve Program (CRP) can involve several types of payments to producers. The annual “rent” payment is treated as ordinary income. Chief Counsel’s Office of IRS (CCA 200325002) took the position that these payments are earnings for self-employment
tax purposes for operating farmers or individuals who buy a farm with land enrolled in the CRP
and perform the contractual obligations necessary to maintain the land in the CRP program. If
the landowner did not materially participate in farming operations on the land, the IRS has
previously taken the position that these payments are not earnings for self-employment tax
purposes.

Signing incentive payments (SIP-CRP) and practice incentive payments (PIP) made to
individuals to enroll in the CRP and install certain practices are ordinary income and not eligible
for the I.R.C. Section 126 exclusion from income. Payments made as cost sharing for the
implementation of approved practices are included in income, but costs can be deducted as soil
and water conservation expenses under I.R.C. Section 175 up to 25 percent of gross income from
farming.

Other Conservation Programs

Payments can also be made under programs such as the Environmental Quality Incentives
Program (EQIP), which may affect livestock producers, the Wetlands Reserve Program (WRP),
Conservation Reserve Enhancement Program (CREP), and several others. Annual program
payments and incentive payments that are made to encourage adoption of certain production
practices are ordinary income and generally subject to self-employment tax. The cost-sharing
payments are generally handled as deductible soil and water conservation expenditures under
I.R.C. Section 175, or they may be excludible from income under I.R.C. Section 126. In some
instances, programs may involve the landowner granting 30-year or permanent easements. These
conservation-related easements are treated as other easements. The payment is first treated as a
return of basis in the property and, to the extent it exceeds the producer’s basis in the affected
property, as long-term capital gain. The payment received for granting an easement that is for
less than 30 years is treated as ordinary income.

Tobacco Quota Buyout Program

The American Jobs Creation Act of 2004 includes a tobacco quota buyout program
effective with the 2005 crop. Both quota holders (owners of the quotas) and eligible quota
growers (including owners, operators, landlords, tenants, or sharecroppers who shared in the risk
of producing tobacco in 2002, 2003 or 2004) will receive payments spread over a 10-year period
based on the size of the 2002 basic quota. Although tobacco quotas are typically discussed as
being in “pounds,” the actual quota amount can change from year-to-year. Tax treatment of
payments received by quota owners and quota growers will differ.

Growers will receive a transition payment of $3.00 per pound based on their effective
quota. The payment will be made in equal installments over 10 years and will be reported as
received. This payment is considered as the replacement of tobacco income and is subject to both
income tax as well as self-employment tax. Thus, a grower with a quota of 10,000 pounds would
receive $3,000 annually. This would be reported as ordinary income subject to self-employment
tax. If a grower grew tobacco only one or two years in the three-year period, the payment would
be reduced proportionally.

Quota owners will receive a total payment of $7.00 per pound in equal installments over
10 years. The tobacco quota is an interest in land and is I.R.C. Section 1231 property if held for
more than a year. The gains and losses from the tobacco quota buyout are netted with other
Section 1231 gains and losses. If there is a net Section 1231 gain, it is treated as a long-term capital gain and is not subject to self-employment tax. If the result is a net Section 1231 loss, the loss is treated as an ordinary loss and is not subject to the $3,000 limit on net capital losses.

To determine their gain or loss, quota owners must determine their adjusted tax basis in the tobacco quota. The gain or loss would be the payment to be received minus the adjusted tax basis of the quota. Purchased quota would typically have a basis equal to the amount paid for the quota. An inherited quota would generally have a value equal to the fair market value on the date of death of the decedent. A quota acquired by gift would have a basis equal to the carryover basis of the donor increased by the portion of the gift taxes attributable to appreciation of the value of the property. If there are no records of the basis, the quota owner may be able to allocate a value to the basis from historical records. For further information, see the reference by van der Hoeven.

RECENT TAX CHANGES AFFECTING PRODUCERS

The American Jobs Creation Act of 2004 provides that a farmer’s regular tax liability is used to determine the Alternative Minimum Tax (AMT). This allows a farmer to get the full effect of farm income averaging. The American Jobs Creation Act also extends the replacement period for the weather-related sale of livestock. This section reviews farm income averaging and discusses the IRS position on revoking the election to treat Commodity Credit Corporation loans as income. Finally, there is a brief review of the payment of rent by an entity in which the landowner materially participates.

Farm Income Averaging

Farm income averaging has undergone a number of changes that have been favorable to producers. The most recent change, effective for 2004 and later tax years, involves the AMT calculation. The AMT was instituted to require individuals receiving substantial tax preferences to pay some income tax. Individuals computed their regular tax and their AMT tax liability and paid the higher amount. Farmers often found that the tax reduction from farm income averaging was eliminated when the AMT was calculated. Beginning with tax year 2004, a farmer’s regular tax liability was determined without regard to farm income averaging and compared with the AMT liability. As a result, the farmer receives the full benefit of income averaging in reducing regular tax, while the AMT, if any, is unchanged.

Farm income averaging regulations were released in January 2002. The regulations clarify that landowners whose income is based on a share of production can treat that income as electible farm income for income averaging. For 2003 and later years, the landowner must have a written lease agreement with the operator before significant activities begin in order to treat that income as farm income for income averaging.

“Farm income” is based on taxable farm income. It includes all income, gains, losses, and deductions attributable to any farming business. Gain from the sale or other disposition of land is not included, nor is the sale of timber. The instructions for Schedule J indicate that farm-related items are generally reported on Form 1040 Schedule D, Form 1040 Schedule F, Form 4797, Part II of Form 1040 Schedule E (Income or Loss from Partnerships and S Corporations), and Form 4835. Thus, farm income from flow-through entities such as S corporations and partnerships does qualify. Wages and other compensation received as a shareholder in an S corporation
engaged in farming are also farm income. Farm income averaging is not available to regular corporations, trusts, or estates. Cash rent landowners are also excluded farm income averaging.

The basic concept of farm income averaging is relatively simple and uses Form 1040 Schedule J. A farmer may elect to average part or all of the farm income in the election year, e.g., 2005, and have that elected farm income treated as if it have been earned equally over the preceding three base years, 2002 to 2004, and taxed at the respective income rates for those years. Income is not carried back to prior years with income averaging. There is no change in the income reported for the base years. Rather, the unused tax brackets of the base years are used. Note that the elected income is allocated equally over the three prior or base years. If one of the three preceding years has a very low income or loss, there is no possibility of allocating more of the elected farm income to that year. Furthermore, for future income tax averaging, say in 2006, the portions of the base years’ tax brackets used with the previous income averaging in 2005 are not available for 2006. Although income averaging may reduce the income tax liability of a producer, income averaging has no effect on self-employment tax liability for the year of the election or any base year.

Farmers can elect, subject to some restrictions, the amount and type of income that they wish to average. Commonly, farmers will have ordinary income from Form 1040 Schedule F and depreciation recapture. They may also have Section 1231 gains reported on Form 4797 that are treated as long-term capital gains. In the 2000 to 2003 period, the maximum tax rate on long-term capital gains has been 20 percent and then 15 percent for dispositions after May 5, 2003. A farmer can elect to average ordinary income and allocate 2005 farm capital gain income (unless offset by non-farm capital losses) to the 2005 year. For example, assume a producer has $50,000 of Form 1040 Schedule F net income, $30,000 of farm Section 1231 gains, and no non-farm income or losses. The farmer could elect to average up to $50,000 of farm income and allocate all of the Section 1231 gain to 2005. All of the elected income would be ordinary income and allocated equally to the three prior years. However, if the farmer elected to average $60,000 of farm income, at least $10,000 would be Section 1231 gains. In this situation, one-third of the elected Section 1231 gain would be taxed according to the “rules” for each base year.

Income averaging can be used even if it does not reduce tax liability for the current year. An individual might be in a situation in which taxable incomes in the three base years were very low. If 2005 farm income were averaged, this might not reduce the 2005 tax liability. However, reducing 2005 income for future income averaging might increase potential tax savings for an individual who expected a substantially higher farm income in a future year. For example, a married individual might have taxable income of $25,000 in 2005 and very low taxable incomes in the 2002 to 2004 period. Electing to average the $25,000 of farm income in 2005 would not reduce the tax liability because the income would be taxed at the 15-percent rate for prior years. However, the taxable income for 2005 could be reduced to $0, which could benefit future income averaging. If taxable income had been negative in any of the base years, 2002-2004, then income averaging in 2005 might reduce taxes and reduce 2005 taxable income to $0.

Income averaging will have the greatest attraction for farmers whose income in one year is much higher than in the preceding three years and who have made only limited capital expenditures eligible for additional first-year depreciation or Section 179 expensing. Beginning farmers with limited income in prior years could be in this situation. Individuals do not have to have been in farming in the base years to qualify for farm income averaging. Farm families whose off-farm income has increased sharply (perhaps because of a new off-farm job) would be
eligible to average their farm income and perhaps reduce their current tax liability. Note that only farm income is eligible for income averaging.

Retiring farmers and others disposing of assets may also be able to take advantage of income averaging. Depreciation recapture on machinery, equipment, buildings, and purchased breeding stock is reported as ordinary income. The disposition of these assets in one year may result in a high marginal tax rate and benefits from income averaging. Dispositions of assets for up to a year after an individual ceases farming are presumed to be within a reasonable time and would be eligible for farm income averaging. Depending on individual circumstances, dispositions of assets over longer periods may also be acceptable for income averaging. Income averaging may also be helpful for an individual in a situation in which the usual year-end tax planning strategies do not apply. However, income averaging is not likely to substitute for regular year-end tax planning and keeping taxable income relatively stable from year-to-year.

**Weather-Related Sale of Livestock**

The gain on weather-forced sale of livestock held for draft, breeding, or dairy purposes does not need to be reported as income if the proceeds will be used to buy replacement livestock. Originally, the replacement period was two years after the end of the tax year of sale. This has now been extended to four years following the year of sale. A producer must replace the excess animals sold because of weather-related conditions with at least the same number of animals. If fewer animals are acquired or the amount invested is less than the amount received, then income must be calculated and reported. The new law also provides greater flexibility by allowing reinvestment in similar or related use property if the producer is unable to replace the livestock sold.

**Revoking Election to Treat CCC Loans as Income**

Many producers use the Commodity Credit Corporation (CCC) loan program, in which commodities are used as security for loans at or after harvest. Producers can treat those loans in one of two different ways for tax purposes. Under the “loan” method, the CCC loans can be treated as other loans: loan proceeds are not treated as income, and loan repayment is not a deductible expense. Alternatively, a farmer could elect under I.R.C. Section 77 to treat the loan proceeds as income when received – the “income” method. Under previous law, once the election to treat a CCC loan as income had been made, it could not be revoked without the IRS Commissioner’s permission. Revenue Procedure 2002-9 added the Section 77 election to the changes in accounting methods that receive the automatic consent of the Commissioner for 2002 and later years. This makes revoking the election an alternative to be considered.

Farmers who have treated CCC loans as income can revoke that election by filing Form 3115, Application for a Change in Accounting Method. Because consent is automatic, Form 3115 can be filed with the tax return for the year of the change, and there is no user fee charged. The change is made on a “cut-off” basis. All CCC loans received in the year of change are treated as loans. There is no change with respect to treatment of CCC loans in prior years that have been reported as income. One copy of Form 3115 is filed with tax return, and a copy is sent to the Internal Revenue Service, Associate Chief Counsel (Domestic), Attention CC:DOM CORP:T, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. (For a completed form, see Harris, 2002 National Income Tax School Workbook, p. 473-5, or contact George Patrick.)
Producers have flexibility in reporting future CCC loans. If a producer revokes the Section 77 election for 2004 and uses the loan method, nothing prevents that producer from electing to report 2005 CCC loans as income. Presumably, this new election could be revoked for the 2006 tax year.

**Self-Employment Tax Update**

Many farmers continue to be concerned about the self-employment (SE) tax. For 2005, earnings of up to $90,000 are subject to the 12.4 percent tax for social security, and all earnings are subject to the 2.9 percent Medicare tax. For 2006, the maximum social security portion will increase to $94,200.

Farmers with SE earnings of less than $400 and gross farm income (receipts) of more than $2,400 may use the optional farm method and pay SE tax on $1,600 of earnings. However, the optional farm method provides only one quarter of coverage annually for “currently insured” status under social security. An individual must have been covered for at least six of the 12 quarters preceding the quarter of death to qualify for survivors’ benefits and at least 10 of the least 20 quarters to qualify for disability benefits. Thus, farmers who regularly rely on the optional farm method will not have or will lose their currently insured status and qualification for these benefits. Additional quarters of coverage can be obtained by those having and reporting net farm income of $1,840 or more for SE tax purposes for 2005 ($1,960 or more in 2006). Earnings of the taxpayer from non-farm employment would also provide additional quarters of social security coverage.

There has been on-going litigation on the rental of land to an entity in which the landowner materially participates. For many years, landowners would rent land to farm-operating entities (partnerships or corporations) in which they were involved. Although the rental payments were subject to income taxes, the rental payments were not included as earnings for self-employment tax. About 1995, the IRS began to challenge these arrangements with some success in Tax Court. Three cases were appealed to the 8th Circuit Court. The Court took the position that rent must include compensation for services to make the rent subject to SE tax, and sent the cases back to the Tax Court for a determination. (The 8th Circuit includes the states of Arkansas, Iowa, Minnesota, Missouri, North Dakota, and South Dakota.) The IRS apparently did not respond to the Tax Court, and the cases were decided in the taxpayers’ favor. However, the IRS has indicated that they will not follow the decision in other Circuits. One other case in New York was settled without a court hearing. Although the IRS action indicates they may challenge the traditional treatment of these payments, it is apparently has not been an audit issue.

Charitable contributions of commodities can reduce taxes for cash basis farmers, especially those who do not itemize deductions. If a farmer makes a donation of commodities in the year following the year of production, costs are deducted in the year of production, reducing income for both income and self-employment tax purposes. There is no income to report in the year of the gift. The farmer’s basis in the commodity is $0. By gifting the $0 basis commodity to a charity, the farmer gets no charitable deduction, but the farmer avoids having income for both income and self-employment tax purposes. The commodity should be transferred to the charity, rather than having the farmer sell the commodity and have the check made out to the charity. One way that this could be handled would be to write a letter to the charity informing them that
they had X bushels of commodity Y that the farmer would deliver as instructed. The charity could make arrangements for the sale and then have the farmer deliver the commodity for them.

**TAX MANAGEMENT**

Most farmers use the cash method of accounting. Farm expenditures are normally deductible when paid. Receipts are generally reported as income in the year in which they are received. As a result, farmers have the opportunity to review their year-to-date receipts and expenses, and make potentially money-saving adjustments for taxes. But that window of opportunity closes for all practical purposes with the end of a farmer's tax year. So November-December is the time to review and adjust if necessary.

One's tax management goal should be maximizing after-tax income or wealth over time, not minimizing taxes in any one year. Some people get so concerned about saving a few dollars in taxes this year that they miss the big picture. Because of the higher Section 179 expensing limits, many farmers may simply assume that they will not have a tax problem, instead of viewing each year as a tax-planning opportunity.

Keeping taxable income relatively stable year-to-year has been a key to effective income tax management in the past, because of the progressive nature of income tax rates. Recent tax law changes have “flattened” tax rates, reducing the progressiveness of income tax. Wide swings in taxable income are likely to result in higher taxes, although farm income averaging may help. The amount of income that is “tax free” because of personal exemptions and the standard deduction has increased due to law changes and inflation. One should plan to report at least this “tax-free” amount of income each year. Self-employment taxes are larger than income taxes for many farmers and may be more difficult to manage because of no exemptions and limited deductions.

As a minimum, individuals should tally their receipts and expenditures before the end of the tax year. This allows year-end tax planning. Depending on the income situation, additional sales may be made on or before December 31, 2005 or delayed into 2006. A part of the 2006 direct payments from the government for corn, soybeans, and wheat can be collected in 2005 or after December 31, 2005. The Section 179 expensing deduction can have a major impact on taxable income, and the decision can be made after the close of the tax year. However, the depreciable assets must have been placed in service before the end of the year. December purchases of feed, fertilizers, and chemicals to be used in 2006 can, up to a limit, also affect the taxable income. Although delivery of inputs purchased before January 1, 2006 is not required for a tax deduction, a purchase of specified products, rather than just a deposit, must be made in order to claim a deduction for prepaid expenses. This means that the invoice should list specific products, and quantities and the arrangement should not accrue interest to the purchaser.

Deferral of income and income taxes can still be an effective tax management strategy. If income taxes are deferred, even for a year, this is an interest-free loan from the government. Although the estimated tax payments required to avoid penalties have been increased to 90 percent of the tax liability, farmers continue to have an exception. If two-thirds or more of gross income is from farming, farmers can pay the income tax due by March 1 and avoid estimated tax penalties. Although farmers must file and pay by March 1, the due date of their return for many other purposes, such as retirement plan contributions, is April 15.
Tax implications of major decisions should still be considered before the transactions are finalized. Installment sale contracts often have tax benefits because the taxable gain on the sale is spread pro rata over the tax periods in which the contact payments are received, with certain exceptions. Tax-free or "like-kind" exchanges, such as the trade-in of machinery and equipment, may reduce taxes, but farmers need to consider both income and self-employment tax impacts. Because of the complexity of the tax laws and regulations, competent professional tax advice is generally a very worthwhile investment.
REFERENCES


Copies of IRS publications may be obtained by calling 1-800-TAX-FORM (1-800-829-3676). Tax forms and IRS publications are available at [www.irs.gov](http://www.irs.gov).