Congress has been busy with tax changes that have impacted farming operations in recent years. The American Jobs Creation Act of 2004 eliminated the effect of the Alternative Minimum Tax on farm income averaging, authorized a tobacco buyout program, and established the domestic production activities deduction. Legislation in 2005 and 2006 extended the Section 179 expensing limits, maximum tax rate on capital gains, and also increased the age limit for taxing a minor’s unearned income at the parent’s rate. Added were modest tax credits for energy saving vehicles and credits for biodiesel and renewable diesel production. In 2006, the rules for deducting charitable contributions were also tightened.

The recent changes in Section 179 expensing have potentially eliminated federal income taxes for many farmers, assuming they are making capital purchases. However, reducing income tax liability in any one year may not be the best reason to make additional investments—maximizing after-tax wealth over the course of years is probably a better strategy. With the changes that are occurring, many farmers may need to rethink their tax strategies.

Long-time Top Farmer attendee, crop and livestock producer Michael Dora who farms with his son Drew near Rushville, Indiana has already met with his tax advisers this fall. “Like most farmers I know, I just wish this whole process could be somehow simplified. These tax credits and deductions are well intended, but I think in some cases they disadvantage the smaller farmer. Our income should come from the elevator or the livestock buyer, not the federal government.”

The domestic production activities deduction (DPAD) will double for 2007 to 2009, and then triples for 2010 and later years. Farmers qualify for this as producers of crops and livestock. DPAD is intended to create incentives for greater employment in the U.S., but it does not require taxpayers to increase the amount of labor actually hired. To qualify, a farm operation must have paid Form W-2 wages that are subject to federal income tax withholding requirements. Thus wages paid as commodities, wages to your children under age 18, and nontaxable fringe benefits are excluded.

Regarding DPAD, “This is something that we are certainly aware of, and is going to be increasingly important in the coming years,” according to Michael Dora.

**How the DPAD is Calculated**

The deduction for tax years 2005 and 2006 is limited to the smallest of:

- 3% of qualified production activity income (QPAI)
- 3% of adjusted gross income (before DPAD)
- 50% of the FormW-2 wages paid by the taxpayer during the year

The deduction increases to 6% for 2007 through 2009, then further increases to 9% in 2010. That means a farming family with qualified production activity income of $80,000 could qualify for a $2400
deduction this year, and a $4800 deduction next year. Thus, farmers want to ensure their employment and other practices are in place to take advantage of this increased deduction for the upcoming year.

This deduction is computed on Form 8903 and is taken as an adjustment to income on line 35 of Form 1040. Thus, the deduction is for income taxes only and does not reduce earnings from self-employment. Income and expenses of partnerships and S corporations pass through to the owners of the business and are included in DPAD calculations on the owner’s return. Regular or C corporations claim the DPAD on line 25 of Form 1120.

Cash rent landowners are not eligible for the deduction and share-rent landowners will generally not qualify for the deduction because of the Form W-2 wage limitation. For tax years beginning after June 1, 2006, off-farm wages are not considered in computing qualified income. Because of this, families with farm losses may find it difficult to qualify for the deduction in the coming years.

**What Qualifies as Qualified Production Activities Income**

QPAI is equal to farm gross receipts 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 such receipts such as depreciation, property taxes, and interest. Government subsidies and payments not to produce are substitutes for gross receipts and qualify, as do subsidy payments that are directly linked to production, such as the loan deficiency payments (LDPs) and countercyclical payments. For many farmers, QPAI will be equal to the sum of net income reported on their Schedule F and net gain from the sale of raised livestock reported on Form 4797.

**Implications for Top Farmers**

Many farms may find that they can make legitimate wage payments to family members (spouses and children age 18 and older) and qualify for the deduction. Or, a farming operation may decide they are financially ahead to hire employees to complete tasks instead of hiring it done as custom work, such as spraying or harvesting, for example, to ensure that 50% of W-2 wages paid at least reach 6% of the farm’s QPIA. Also, if DPAD was not a part of your 2005 taxes, it may be worthwhile to consider filing an amended return, especially when considering that DPAD for individuals is taken on Form 1040 and for 2005 and 2006 is not limited to the receipts of the business.

**For More Information**

Income Tax Management for Farmers in 2006, November 2006
http://www.agecon.purdue.edu/extension/pubs/taxplanning.asp

New Tax Deduction Plows Money Back into Farmers' Pockets, December, 2005

A Brief Overview of the New Domestic Production Activities Deduction, November 2005
http://www.irs.gov/businesses/small/article/0,,id=150439,00.html