IOWA STATE UNIVERSITY
CALT
Center for Agricultural Law and Taxation

2321 N. Loop Drive, Ste 200 • Ames, Iowa 50010 www.calt.iastate.edu

Farm Bill Tax Provisions

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- by Roger A. McEowen

Overview

H.R. 2419, the Food, Conservation and Energy Security Act of 2008, better known as the 2008 Farm Bill, was passed by the House on May 14, the Senate on May 15, and vetoed by the President on May 21. On May 21, the House overrode the President's veto, and the Senate did the same on May 22. But, the version of the Farm Bill that was sent to the President and which he vetoed on May 21 did not contain Title III – the trade title. Thus, the President did not veto the entire Bill. While both the House and Senate overrode the President's veto, a Constitutional question remained as to whether the President's veto and/or the override votes had any effect.

The House passed a substantively identical Farm Bill - H.R. 6124 on May 22. The Senate passed H.R. 6124 (with the same title as H.R. 2419) on June 5. H.R. 6124 repeals H.R. 2419 in its entirety. This time, hopefully, the entire Bill will be sent to the President for his signature or veto (or the Bill could become law by the President simply not signing it by June 15). If the President vetoes the Bill, the Congress will have to undertake another override vote. At this time, however, it looks like the Congress has the votes to override any Presidential veto.

While the legislation is comprehensive and deals with numerous non-tax provisions, this is the first time that a Farm Bill has contained substantial tax legislation. In general, the Farm Bill is a net tax increase - it contains more revenue-raising offsets than tax breaks. That feature of the Bill was one factor in why the President vetoed the Bill. The article below provides a detailed discussion of the Farm Bill tax provisions, but for those readers looking for a quick "heads-up" on the tax provisions, that is provided first.

> **Note on Effective Date:** H.R. 6124 states that it is effective upon the earlier of enactment or the date of enactment of H.R. 2419. While that generally leads one to the conclusion that May 22 will be the effective date of the Farm Bill provisions that are "effective upon enactment" or "effective for tax years beginning after date of enactment", that may not be correct.
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> There still remains uncertainty as to the effective date of H.R. 2419. Because H.R. 2419 as vetoed by the President was not the Bill that Congress passed (and on which the Congress subsequently voted to override the President's veto) a question is raised as to whether H.R. 2419 was ever enacted. Congress could have easily avoided this confusion by providing a specific date for the date of enactment of H.R. 6124 - such as May 22. That way, there wouldn't be any disadvantage to someone who takes action or fails to take action between May 22 and the date the entire bill becomes law. With that much said, the commentary below assumes May 22, 2008, as the effective date of the Farm Bill.

Quick Summary

- A new category of qualified forestry conservation bonds.

- Conservation Reserve Program (CRP) payments are not subject to self-employment tax in the hands of retired or disabled farmers.

- The loan limit on Aggie Loans is increased from $250,000 to $400,000.

- The legislation includes authorization of forest conservation bonds for certain qualified projects up to a maximum of $1.5 billion.

- The cellulosic ethanol per-gallon tax credit is raised from 51 cents to $1.01 per gallon.

- A decrease in the credit for ethanol production from $.51 to $.45 per gallon.

- A uniform three-year depreciation for race horses for tax years 2009 – 2013.

- An extension of the special rules encouraging contributions of capital gain real property for conservation purposes.

- A tax deduction for endangered species recovery and restoration costs.

- A deduction for endangered species recovery expenditures.

- An exclusion for certain payments and programs relating to fish and wildlife.

- A deduction for qualified timber gains.

- An expansion of tax-deferred exchange treatment to specified property.

- A new agricultural chemicals security tax credit.

- A limitation on farming losses for certain taxpayers.

- GO-Zone-style tax breaks for specified areas in Kansas.

- A modification in the methods for computing net earnings from self-employment.

- Information reporting for CCC transactions.

Detailed Analysis

Conservation-related provisions

1. An exclusion of Conservation Reserve Program Payments from SECA tax for individuals receiving Social Security retirement or disability payments. *Sec. 15301 of the Act, amending I.R.C. §1402(a).* Effective for payments made after December 31, 2007.

2. An extension of the special rule encouraging contributions of capital gain real property for conservation purposes. *Sec. 15302 of the Act, amending I.R.C. §170.* Effective for contributions made in taxable years beginning after December 31, 2007 and before January 1, 2010.

3. A deduction for endangered species recovery expenditures. *Sec. 15303 of the Act, amending I.R.C. §175.* Effective for expenditures paid or incurred after May 22, 2008.

   Note: The provision applies to expenditures that are paid or incurred by a taxpayer engaged in the business of farming for the purpose of achieving site-specific management actions pursuant to the Endangered Species Act of 1973. Such expenditures are to be treated the same as expenditures for the purpose of soil and water conservation made with respect to land used in farming, or for the prevention of erosion of land used in farming. The same rules apply – i.e., I.R.C. §175 expenses may not exceed 25 percent of the taxpayer's gross income derived from farming during the tax year.

4. The Bill contains two major provisions relating to timber. A temporary reduction in the corporate tax rate for qualified timber gain, and a reduction in the holding period requirement applicable for real estate investment trusts. *Secs. 15311-15315 of the Act, amending I.R.C. §§856, 857 and 1201.*

   - For tax years ending after May 22, 2008, and beginning on or before May 23, 2009,

a 15% alternative tax applies to the portion of a corporation's taxable income that consists of qualified timber gain (or, if less, the net capital gain) for a tax year.

Note: The Act also includes detailed changes for REITs (real estate investment trusts) holding timber property. For example, timber gain is included under I.R.C. §631(a) as a category of statutorily recognized qualified real estate income of a REIT if the cutting is provided by a taxable REIT subsidiary, and also includes gain recognized under I.R.C. §631(b). The otherwise applicable one-year holding period does not apply.

- For sales to a qualified organization for conservation purposes, the bill reduces from 4 years to 2 years the holding period requirement under I.R.C. §857(b)(6)(D), which provides a safe harbor from prohibited transaction treatment for certain timber property sales. The REIT changes apply to tax years beginning after May 23, 2008, but do not apply after the last day of the first tax year beginning after May 23, 2008.

5. A new category of tax-credit bonds – qualified forestry conservation bonds. *Sec. 15316 of the Act, creating new I.R.C. §§54A and 54B.* Effective for bonds issued after May 22, 2008.

   - A qualified forestry conservation bond must be issued by a State or an I.R.C. §501(c)(3) organization, and must be used to finance a qualified forestry conservation project.

   - A "qualified forestry conservation project" means forest land where:

     - Some portion of the land acquired is adjacent to U.S. Forest Service Land;
     - At least 50 percent of the land acquired is transferred to the U.S. Forest Service at no net cost and not more than half of the land acquired may either remain with or be donated to a State;
     - All of the land must be subject to a habitat conservation plan for native fish approved by the U.S. Fish and Wildlife Service; and
     - The amount of acreage must be at least 400 acres.

   - There is a national limitation on qualified forestry conservation bonds of $500 million.

   - All of the available project proceeds must be used within the three-year period that begins on the date of issuance

   - The issuer receiving an allocation to issue qualified forestry conservation bonds may, in lieu of issuing bonds, elect to treat such allocation as a deemed payment of tax that is equal to 50 percent of the amount of the allocation.

     Observation: The provision, included in the Farm Bill by Senator Max Baucus (D-MT), appears to apply to only one private landowner in the United States – the Plum Creek Timber Company (Montana's largest private landowner). The company had planned to sell about 300,000 acres of land in the state for approximately $500 million. It is anticipated that bonds will cover about half of the purchase price. State and private money is being sought for the balance of the purchase price. The Nature Conservancy has made application for the bonds.

Energy-Related Provisions

1. Credit for the production of cellulosic biofuel. *Sec. 15321 of the Act, amending I.R.C. §40.* Effective for fuel produced after December 31, 2008, and before January 1, 2013.

   - The credit is a nonrefundable income tax credit for each gallon of qualified

cellulosic fuel production of the producer for the tax year. The amount of the credit per gallon is $1.01, except for cellulosic biofuel that is alcohol.

- For cellulosic biofuel that is alcohol, the $1.01 credit amount is reduced by: (1) the credit amount applicable for such alcohol under the alcohol mixture credit in effect at the time cellulosic biofuel is produced, and; (2) in the case of cellulosic biofuel that is ethanol, the credit amount for small ethanol producers as in effect at the time the cellulosic biofuel fuel is produced. The reduction applies regardless of whether the producer claims the alcohol mixture credit or small ethanol producer credit with respect to the cellulosic alcohol. When the alcohol mixture credit and small ethanol producer credit expire after 2010, cellulosic biofuel will receive the $1.01 without reduction.

- With respect to the small ethanol producer tax credit, the 15 million gallon limitation is waived for cellulosic biofuel that is ethanol. Thus, the small ethanol producer credit may be claimed for cellulosic ethanol in excess of 15 million gallons. The other requirements for the small ethanol producer credit continue to apply for ethanol other than cellulosic ethanol, including the 15 million gallon limitation.

- Cellulosic biofuel and alcohols cannot qualify as biodiesel, renewable diesel, or alternative fuel for purposes of the credit and payment provisions relating to those fuels

- Definitions:

  - "Qualified cellulosic biofuel is any cellulosic biofuel that the taxpayer either produces and uses in their trade or business, or produces and sells to another person for the following purposes:

    - For use by the other person in the production of a qualified biofuel mixture in such person's trade or business (other than casual off-farm production);

    - For use by the other person as a fuel in a trade or business; or

    - Who sells such biofuel at retail to another person and places the biofuel in the fuel tank of such other person

  - "Cellulosic biofuel" is any liquid fuel that:

    - Is produced in the U.S. and used as fuel in the U.S. (including possessions of the U.S.);

    - Is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis (e.g., dedicated energy crops and trees, wood and wood residues, plants, grasses, agricultural residues, animal wastes, and other waste materials and municipal solid waste); and

    - Meets the registration requirements for fuels and fuel additives established by the EPA under the Clean Air Act (i.e., it must be approved by the EPA)

      Note: Cellulosic biofuel producers must register with the IRS. The credit cannot be claimed unless the taxpayer is registered with the IRS as a producer of cellulosic biofuel.

2. Modification of the alcohol credit. *Sec. 15331 of the Act, amending I.R.C. §§40, 6426.* While the provision is effective May 22, 2008, the impact of the change is effective for calendar year 2009 and thereafter.

- The 51-cent-per-gallon incentive (credit) for ethanol is reduced to 45 cents per gallon for calendar year 2009 and

thereafter, and the low-proof blender amount is adjusted accordingly to 33.33 cents.

Note: If 7.5 billion gallons of ethanol (including cellulosic ethanol) are not produced in or imported into the U.S. in 2008, the reduction in the credit amount will be delayed. If the determination is made after the start of a calendar year, taxpayers claiming the reduced amount before the determination will be entitled to the difference between the correct credit amount for that year and the credit amount claimed (e.g., between 51 cents per gallon and 45 cents per gallon).

3. Calculation of the volume of alcohol for fuel credits. *Sec. 15332 of the Act, amending I.R.C. §40.* Effective for fuel sold or used after December 31, 2008.

   - The existing per-gallon credit for the volume of alcohol (including any denaturant) used as a fuel or in a qualified mixture is modified such that the amount of allowable denaturants cannot exceed two percent of the volume of the alcohol.

4. Extension of the ethanol tariff. *Sec. 15333 of the Act.* Effective May 22, 2008.

   - The $.54 per gallon tariff on imports of ethyl alcohol, and any mixture containing ethyl alcohol if used as a fuel or in producing a mixture to be used as a fuel that enters the U.S. is extended two years - through 2010.

Other Farm-Related Provisions

1. Qualified small-issue bonds for first-time farmers. *Act, Sec. 15341, amending I.R.C. §144.* Effective for bonds issued after May 22, 2008.

   - The Act increases the maximum amount of qualified small-issue bond proceeds available to first-time farmers to $450,000 and indexes the amount for inflation.

     Note: Qualified small issue bonds are tax-exempt bonds issued by State and local governments to finance private business manufacturing facilities or the acquisition of land and equipment by certain first-time farmers. Concerning first-time farmers, to qualify, the individual: (1) must not have had any direct ownership interest in substantial farmland in which the individual materially participated; and (2) must not have received more than $250,000 in qualified small issue bond financing. "Substantial farmland" had been defined as any parcel of land unless the parcel is smaller than 30 percent of the median size of a farm in the county in which the parcel is located, and the fair market value of the land does not at any time while held by the individual exceed $125,000, but the Act eliminates the fair market value test from the definition.

2. Allowance of I.R.C. §1031 treatment for exchanges involving certain mutual ditch, reservoir or irrigation company stock. *Sec. 15342 of the Act, amending I.R.C. §1031.* Effective for transfers after May 22, 2008.

   - Explanation of current law: In general, I.R.C. §1031(a)(2), tax-deferred treatment does not apply to any exchange of stock in trade or other property held primarily for sale, stocks, bonds or notes, other securities or evidence of indebtedness or interest, interests in a partnership, certificate of trust or beneficial interests, or choses in action

   - Farm Bill provision: For transfers after May 22, 2008, tax-deferred treatment applies to shares in a mutual ditch, reservoir, or irrigation company, if at the time of the exchange: (1) the company is an organization described in Code

Sec. 501(c)(12)(A) (determined without regard to the percentage of its income that is collected from its members for the purpose of meeting losses and expenses); and (2) the shares in the company have been recognized by the highest court of the State in which the company was organized or by applicable State statute as constituting or representing real property or an interest in real property.

3. Creation of an agricultural chemicals security tax credit. *Act, Sec. 15343, creating I.R.C. §38(b)(1).* Effective for expenses paid or incurred after May 22, 2008, and before December 31, 2012.

   - A new 30 percent credit for qualified chemical security expenditures. The credit is a component of the general business credit and is limited to $100,000 per facility with each taxpayer's annual credit limited to $2,000,000. A taxpayer's deductible expense is reduced by the amount of the credit claimed.

   - "Qualified chemical security expenditures" incurred by an "eligible agricultural businesses" are amounts paid for:

     - Employee security training and background checks;
     - Limitation and prevention of access to controls of specific agricultural chemicals stored at a facility;
     - Tagging, locking tank valves, and chemical additives to prevent the theft of specific agricultural chemicals or to render such chemicals unfit for illegal use;
     - Protections of the perimeter of areas where specified agricultural chemicals are stored;
     - Installation of security lighting, cameras, recording equipment and intrusion detection sensors;
     - Implementation of measures to increase computer or computer network security;
     - Conducting security vulnerability assessments;
     - Implementing a site security plan; and
     - Other measures provided for by regulation

   - "Eligible agricultural businesses" are those that:

     - Sell agricultural products including specified agricultural chemicals, at retail predominantly to farmers and ranchers; or

     - Manufacture, formulate, distribute, or aerially apply "specified agricultural chemicals"

   - "Specified agricultural chemicals" is defined as:

     - Fertilizer commonly used in agricultural operations that are listed under §302(a)(2) of the Emergency Planning and Community Right-to-Know Act of 1986, section 101 or part 172 of title 49, Code of Federal Regulations, or part 126, 127 or 154 of title 33, Code of Federal Regulations; and

     - Any pesticide (as defined in section 2(u) of FIFRA, including all active and inert ingredients which are used on crops grown for food, feed or fiber.

4. Three-year depreciation for all race horses. *Sec. 15344 of the Act, amending I.R.C. §168.* Effective to any race horse that is two years old or younger at the time that it is placed in service after December 31, 2008 and before January 1, 1014.

   Note: Under prior law, a seven-year MACRS recovery period was assigned to any race horse two years old or younger at the time that it was placed in service, but a three-year MACRS recovery period was assigned to any race horse more than two years old at the time it was placed in service. The provision effectively creates a single three-year MACRS recovery period for all race horses.

5. Modification of the advanced coal project credit and the gasification project credit. *Sec. 15346 of the Act, modifying I.R.C. §§48A and 48B.* Effective for credit allocation awards issued before, on, or after May 22, 2008.

6. Limitation on farming losses of certain taxpayers. *Sec. 15351 of the Act, modifying I.R.C. 461.* Effective for taxable years beginning after December 31, 2009.

    - Farming losses of a taxpayer (other than a C corporation) are limited, for any taxable year in which the taxpayer receives farm subsidies, to the greater of $300,000 (MFJ) or the taxpayer's total net farm income for the prior five taxable years.

    - "Total net farm income" is defined as the aggregation of all income and loss from farming businesses for the prior five taxable years.

        Note: For purposes of the provision, applicable subsidies are any direct or counter-cyclical payments under Title I of the Farm Bill or any CCC loan.

    - For purposes of calculating total net farm income for the prior five years, losses that are limited under the provision are taken into account in the year in which they are allowed as a deduction.

        Example: Frank and Mary, a farm couple, have a $500,000 excess farm loss in 2010 that is not allowed as a deduction until 2012. The calculation in 2011 of total net farm income for the prior five years does not take into account the $500,000 as a farm loss. Instead, the $500,000 loss would be included in the calculation of the prior year's total net farm income for taxable years 2013 through 2017.

    - For partnerships and S corporations, the limit is applied at the partner or shareholder level. Thus, each partner or shareholder takes into account its proportionate share of income, gain, or deduction from farming businesses of a partnership or S corporation, and any applicable subsidies received by a partnership or S corporation during the taxable year (regardless of whether such items are treated as income for Federal tax purposes).

    - "Farming business" is defined in accordance with I.R.C. §263A(e)(4), except that the processing of commodities is included in the definition.

    - As applied to cooperatives, the farming activities of a cooperative are attributed to each member for purposes of the definition of a farming business. Thus, a member of a cooperative who raises a commodity and sells it to the cooperative for processing is considered to be the processor of the commodity. Accordingly, patronage dividends received from a cooperative that is engaged in a farming business are considered to be income from a farming business.

    - Any loss that is disallowed under the provision in a particular year is carried forward to the next taxable year and treated as a deduction attributable to farming businesses in that year.

    - Farming losses resulting from fire, storm, or other casualty, or by reason of disease or drought, are disregarded for purposes of calculating the limitation.

7. An increase in and indexing of the dollar thresholds for farm optional method and nonfarm optional method for computing net earnings from self-employment. *Sec. 15352 of the Act, amending I.R.C. §1402(a).* Effective for taxable years beginning after December 31, 2007.

    - An individual may elect to use the farm optional method or the nonfarm optional method when calculating net earnings from self-employment for SECA purpose. The farm optional method allows individuals to pay SECA taxes (and secure

Social Security benefit coverage) when they have low net income or losses from farming. The nonfarm optional method is similar to the farm optional method. For tax years beginning after 2007, taxpayers electing the farm optional method are eligible to secure four credits of Social Security benefit coverage each tax year by increasing and indexing the applicable thresholds. Similar modifications are made to the nonfarm optional method.

8. GO-Zone-style tax breaks for Kiowa County, Kansas and the surrounding area. *Sec. 15345 of the Act, amending I.R.C. §1400S(b).*

   Note: For purposes of the Act, "Kansas disaster area" means an area with respect to which a major disaster has been declared by the President under Sec. 401 of the Robert T. Stafford Disaster Relief and Emergency Act (FEMA-1699-DR, as in effect on May 22, 2008) by reason of severe storms and tornados beginning on May 4, 2007, and determined by the President to warrant individual or individual and public assistance from the Federal Government under such Act with respect to damages attributable to storms and tornados.

   - Personal casualty or theft losses are deductible without regard to either the $100 limitation or the 10 percent-of-AGI limitation. Effective for losses arising after May 3, 2007.

   - An extension of the replacement period for involuntarily converted property for non-recognition of gain purposes from two to five years. Substantially all of the use of the replacement property must be in the Kansas disaster area. Effective May 22, 2008.

   - An extension of the employee retention credit (applicable to employers impacted by Hurricanes Rita, Wilma and Katrina) to the Kansas disaster area. The credit (I.R.C. §1400R) provides a 40 percent credit of the qualified wages (up to a maximum of $6,000 in qualified wages per employee) paid by an eligible employer to an eligible employee). With respect to the Kansas disaster area, the credit only applies to eligible employers who employed an average of not more than 200 employees on business days during the taxable year before May 4, 2007. Effective May 22, 2008.

   - Additional 50 percent "bonus" first-year depreciation for property that meets the following requirements:

     - The property must be property to which the general MACRS rules apply:

       - Applicable recovery period of 20 years or less;
       - Computer software other than computer software covered by I.R.C. §197;
       - Water utility property;
       - Certain leasehold improvement property; or
       - Certain nonresidential real property and residential rental property.

     - Substantially all of the use of the property must be in the Kansas disaster area and be used in the active conduct of the taxpayer's trade or business.

     - The original use of the property must commence with the taxpayer on or after May 5, 2007.

     - The property must be acquired by purchase (as defined by I.R.C. §179(d)) by the taxpayer on or after May 5, 2007 and placed in service on or before December 31, 2008 (December 31, 2009, for qualifying nonresidential real property and residential rental property).

       Note: Property does not qualify if a binding written contract for the acquisition of such property was in effect

before May 5, 2007. But, property is not precluded from qualifying for "bonus" depreciation merely because a binding written contract to acquire a component of the property is in effect before May 5, 2007.

- Property that is manufactured, constructed or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction or production of the property after May 4, 2007, and before January 1, 2009, and the property is placed in service on or before December 31, 2008 (and all other requirements are met).

- Increased expense method depreciation by the lesser of $100,000 or the cost of qualified property for the taxable year that is acquired on or after May 5, 2007, and placed in service on or before December 31, 2008. The threshold for reducing the amount expenses is the lesser of $600,000 or the cost of the qualified property placed in service during the tax year. For purposes of the provision, qualified property must:

  - Have an applicable recovery period of 20 years or less;

  - Be computer software other than computer software covered by I.R.C. §197;

  - Be water utility property; or

  - Be certain leasehold improvement property

    Also, substantially all of the use of the property must be in the Kansas disaster area and be used in the active conduct of the taxpayer's trade or business. Likewise, the original use of the property must commence with the taxpayer on or after May 5, 2007, and the taxpayer must acquire the property by purchase on or after May 5, 2007, but only if no binding contract for the acquisition was in effect before May 5, 2007, and be placed in service by the taxpayer on or before December 31, 2008.

- Enhanced expensing for certain demolition and clean-up costs of up to 50 percent of any qualified Recovery Assistance clean-up cost paid or incurred during the period beginning on May 4, 2007, and ending on December 31, 2009.

  - The remaining 50 percent is capitalized into the taxpayer's basis in the land on which the structure is located.

  - A "qualified Recovery Assistance clean-up cost" is an amount paid or incurred for the removal of debris from, or the demolition of structures on, real property located in the Kansas disaster area to the extent that the amount would otherwise be capitalized.

  - To qualify, the property must be held for use in a trade or business, for the production of income, or as inventory.

- Availability of the rule concerning special tax treatment of public utility property disaster losses.

  - Taxpayers incurring casualty losses attributable to the Kansas storms and tornados with respect to public utility property located in the Kansas disaster area may make an election to take such losses into account in the fifth taxable year (rather than the first) immediately preceding the taxable year in which the loss occurred.

    Note: If application of the election results in the creation or increase of a net operating loss for the year in which the casualty loss is taken into account, the net operating loss may be carried back or carried over subject to the

usual rules for net operating losses.

- Special treatment for net operating losses attributable to storm losses.
  - The provision mirrors the rules provided for GO-Zone losses under I.R.C. §1400N(k).
- Use of retirement funds from retirement plans.
  - The legislation provides relief similar to the relief provided in I.R.C. §1400Q with respect to use of retirement funds in connection with the tornadoes and storms occurring in the Kansas disaster area.

9. Information reporting for commodity credit corporation transactions. *Sec. 15353 of the Act, creating new I.R.C. §6039J.* Effective for loans repaid on or after January 1, 2007.

   Note: For loans repaid on or after January 1, 2007, IRS Notice 2007-63 provides that the CCC reports that the CCC reports market gain associated with the repayment of a CCC loan irrespective of whether the taxpayer repays the loan with cash or uses CCC certificates in repayment of the loan. The CCC reports the market gain on Form 1099-G.