Business point

'Manufacturing' a new deduction

***Editor's note:** Kent Vickre and Chuck Cagley write a tax and finance column for each issue of Pioneer* GrowingPoint® *magazine. Vickre is state coordinator of the Iowa Farm Business Association. Cagley is state coordinator of Illinois Farm Business Farm Management. They address issues that influence agribusiness success.*

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If you pay wages to hired workers, you probably deduct the expenses on your income tax statement. However, you may be leaving some money on the table.

Crop and livestock producers may qualify for an additional income tax deduction for wages paid to farm workers. This is because of a law originally passed to benefit businesses selling into export markets. Here's a look at this deduction.

The tax law's history

The government intends for the American Jobs Creation Act (AJCA) of 2004 to create incentives for U.S. employment and to bring the United States in compliance with the World Trade Organization (WTO) regulations. AJCA phases out a previous law, the Extraterritorial Income Exclusion (ETI) Act of 2000. But AJCA provides an income tax deduction (Section 199) for taxpayers involved in "domestic production activities."

The ETI exclusion initially benefited manufacturers who exported products, but Section 199 of AJAC expands the benefits to a larger group of businesses, including farmers. It applies to all businesses with production income, including C corporations, S corporations, partnerships, sole proprietors, agricultural cooperatives and limited liability companies.

We can't cover all the details here, so we'll touch on some of the highlights. Check with your accountant or farm management association field staff for additional details and to see if you qualify.

New deduction limits

The domestic production activities deduction for tax years 2005 and 2006 carried a 3 percent limit, but for 2007 through 2009, the limit is the smallest of:

1. Six percent of qualified production activity income (QPAI).
2. Six percent of the taxable income of a taxable entity or adjusted gross income of an individual taxpayer (computed without the Internal Revenue Code Section 199 deduction).
3. Fifty percent of the W-2 wages paid by the taxpayer during the year – the limiting factor for many farmers.

Here's an example:

Let's assume your QPAI was $60,000. Six percent of that would be $3,600. If you paid $5,000 for part-time labor in 2007, 50 percent of the W-2 wages would be $2,500.

This would be the smaller of the two figures, assuming that the adjusted gross income was even higher than the QPAI. This $2,500 deduction, if you are in the 25 percent tax bracket, results in a $625 income tax savings.

The deduction limit increases to 9 percent for tax years beginning in 2010. You compute this deduction on Form 8903 and carry the figure to the front of Form 1040 as an adjustment to income. The deduction is from adjusted gross income only and does not reduce earnings from self-employment.

What qualifies as QPAI

Qualified production activities income is equal to domestic production gross receipts (DPGR) minus:

- The cost of goods sold.
- Other deductions and expenses directly allocable to such receipts.
- 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. Custom work is not included.

Many farmers will find their QPAI equal to the sum of net income reported on Form 1040 Schedule F and net gain from the sale of raised livestock reported on Form 4797. However, there are exceptions.

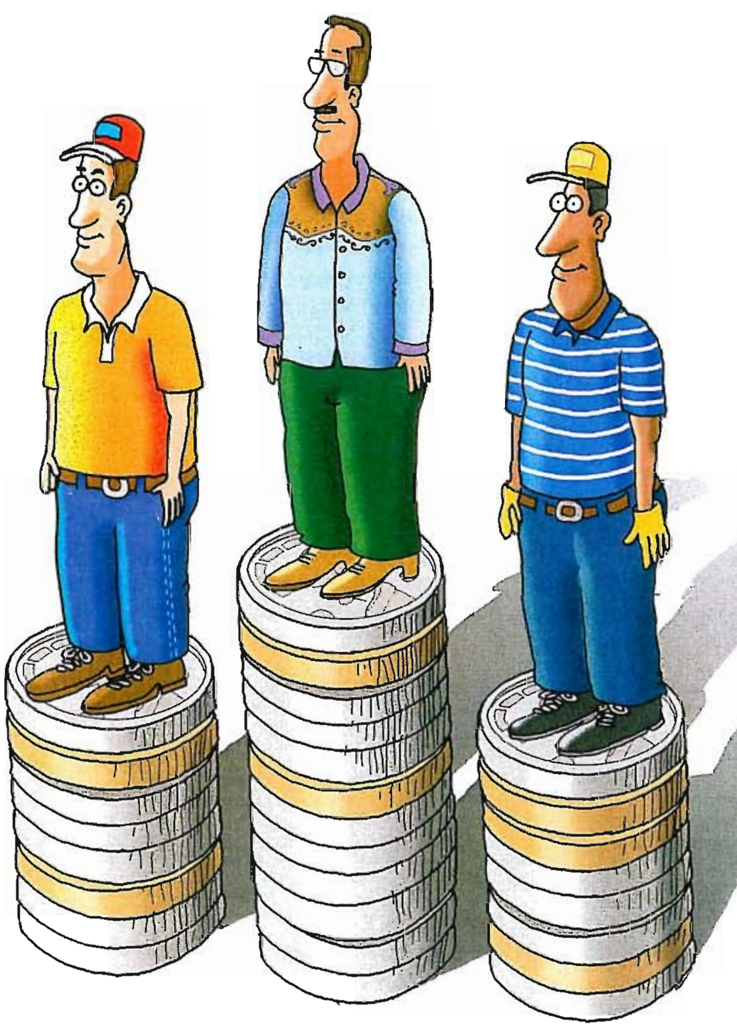
Domestic production gross receipts

Domestic production gross receipts generally are receipts from the sale of qualified production property. For cash-basis farmers, this would be receipts from the sales of livestock, produce, grains and other products raised by the producer. DPGR includes the full sales price of livestock (such as feeder cattle) and other products purchased for resale. Gains from the sale of raised draft, breeding and dairy livestock reported on Form 4797 also qualify as DPGR.

Sales proceeds from livestock purchased for draft, breeding or dairy purposes would probably not qualify unless the taxpayer purchased the animals as young stock and played a significant role in raising them.

Government subsidies and payments not to produce are substitutes for gross receipts and qualify as DPGR. Subsidy payments directly linked to production, such as the loan deficiency payments (LDPs) and countercyclical payments, would qualify. Direct payments under the 2002 Farm Bill would be classed as subsidies and would qualify. However, some authorities suggest direct payments don't quality because they are not tied directly to current production. Check with your tax adviser.

Farmers who pay wages may be eligible for a Domestic Activities Production Deduction.



CRP rewards

Payments under the Conservation Reserve Program (CRP) are related to past production and are clearly a substitute for gross receipts. Crop and revenue insurance payments received would also be included in DPGR.

Gains from the sale of land, machinery and equipment are excluded from DPGR. Land rental proceeds specifically are excluded. Custom hire income (combining, spraying, trucking, etc.) reported on Schedule F also is excluded from DPGR.

For a looking at how to claim QPAI deductions, go to Points of Internet Interest, page 17. Key code 7106

Government cost-sharing conservation payments and stewardship and incentive payments probably do not qualify. Because a custom livestock feeder does not have the benefits and burdens of ownership of the animals, these receipts would not qualify as DPGR.

Computing QPAI

If a taxpayer has less than 5 percent of his or her total gross receipts from items that are not DPGR, a safe harbor provision allows a taxpayer to treat all gross receipts as DPGR. In computing the 5 percent limit, gross receipts from the sale of assets used in a trade or business — such as machinery and equipment, livestock and other business assets — are not reduced by the adjusted basis of business property. However, for assets held for investment purposes, only the net gain is included.

To determine QPAI, you must reduce DPGR by the appropriate costs. If items purchased for resale (feeder cattle) are included in DPGR, the cost of these items is deducted. You deduct directly allocable and indirectly allocable deductions, expenses or losses related to the items included in DPGR.

For a farmer whose entire crop sales receipts qualify as DPGR, QPAI would be computed by subtracting the allowable expenses. QPAI would be equal to net farm income on Form 1040 Schedule F. If this 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.

Check with your tax consultant for ways to compute wages for the domestic production activities deduction limitation. Some of the rules are a little tricky, but this extra tax deduction is usually worth doing the extra math.

Note: *The authors would like to thank George F. Patrick, Purdue University Department of Agricultural Economics, for contributing ideas.*