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Tax planning and management considerations for farmers in 2002*

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A number of recent tax law changes are discussed in the first section of this article. These include a very brief discussion of provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 taking effect in 2002. As a result of the events of September 11, 2001, Congress enacted a provision allowing 30-percent additional first-year depreciation for acquisitions of qualifying property after September 10, 2001. The IRS will auto-

matically consent to a producer's change in accounting methods with respect to treating Commodity Credit Corporation (CCC) loans as income. Final regulations for farm income averaging were released early in 2002.

Recent Tax Law Changes

The Economic Growth and Tax Relief Reconciliation Act of 2001 had a number of provisions that took effect in 2001 and others take effect in 2002 and later years. The 10 percent tax rate becomes part of the tax schedule for 2002 and tax rates above the 15 percent rate were reduced an additional 0.5 percent for 2002. The earned income credit (EIC) is simplified for 2002 with the definition of a qualifying child being expanded to include descendants of stepchildren and foster children residing with an individual for more than one half of the year. The contribution limit for the Coverdell Educational

Savings Accounts (ESA) has been increased to \$2,000 annually per beneficiary. Multiple educational incentives for one individual, such as the HOPE Credit, Lifetime Learning Credit and tax-free distributions can now be claimed in the same year for different educational expenses. The five-year limit on the deductibility of interest on student loans is eliminated and the income limitations for deductibility are relaxed. Limitations on contributions to

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** For information on specific tax situations, consult a competent tax advisor. 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.*

Handbook Updates

For those of you subscribing to the *Ag Decision Maker Handbook*, the following updates are included.

Farm Lease Contract — File C2-06 (3 pages)

2002 Building Rental and Contracting Rates — File C2-17 (2 pages)

2002 Farmland Value Survey — File C2-70 (4 pages)

2002 Suggested Closing Inventory Prices—File C1-40 (2 pages)

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qualified retirement plans generally increase in 2002. For example, limits increase from \$2,000 to \$3,000 for both regular and Roth individual retirement accounts (IRAs) and individuals age 50 or older are permitted additional contributions.

Additional First-Year Depreciation

The Job Creation and Worker Assistance Act of 2002 allows an additional 30 percent depreciation deduction for qualifying property purchased after September 10, 2001 and before September 11, 2004. The deduction applies to the tax year in which the qualified property is placed in service.

To qualify, the property must be modified accelerated cost recovery system (MACRS) property that has an applicable recovery period of 20 years or less. Thus, in addition to livestock, machinery and equipment, single-purpose livestock/horticultural structures, field tile

and general purpose farm buildings (such as machine sheds or hay barns) would qualify.

Original use of the property must commence with the taxpayer after September 10, 2001 and before January 1, 2005. Used

machinery and equipment would not qualify. Bred heifers and gilts appear to be eligible for the additional depreciation, but not animals that have previously been used for draft, breeding, dairy or sporting purposes. Listed property, such as vehicles, which are used 50 percent or less for business, do not qualify for the additional depreciation. Producers who must use the Alternative Depreciation System (ADS) on farm assets because they elected out of the capitaliza-

tion of preproduction period expenses are not eligible for the 30 percent additional first-year depreciation.

The 30 percent additional first-year depreciation is taken after any Section 179 expensing and before regular MACRS depreciation. For example, if a farmer purchases a qualifying \$50,000 asset and elects \$10,000 Section 179 expensing, then the remaining \$40,000 would be eligible for the 30-percent additional first-year depreciation. The $\$40,000 \times 30$ percent = \$12,000 additional first-year depreciation is deducted, leaving \$28,000 for regular MACRS depreciation. With no Section 179 expensing, the entire \$50,000 would be eligible for the additional first-year depreciation. If the maximum Section 179 expensing of \$24,000 for 2002 was applied to this asset, only \$26,000 would be eligible for the additional 30 percent first-year depreciation.

For acquisitions after December 31, 2001, taxpayers are treated as claiming the 30 percent additional first-year depreciation on all qualifying property unless they elect out of the provision. To elect out of the additional depreciation, a statement indicating the MACRS classes of property for which the individual is electing not to claim the additional 30 percent first-year depreciation is attached to the income tax return. Thus, if a farmer purchased a computer (5-year MACRS property) and a tractor (7-year MACRS property), the farmer could:

- Take the 30 percent additional first-year depreciation on both assets.
- Elect not to take the additional first-year depreciation on either asset.
- Elect not to take the additional depreciation on the computer but take it on the tractor.
- Elect not to take the additional depreciation on the tractor but take it on the computer.

If the farmer acquired multiple qualifying assets in the same MACRS class in the same tax year, all of those assets would have to be treated in the same way with respect to the 30 percent additional first-year depreciation. If an

For a further discussion of the income and estate tax changes see Patrick, "Tax Planning and Management Considerations for Farmers in 2001," Purdue University Cooperative Extension Service, CES Paper No. 338, December 2001, available at www.agecon.purdue.edu/ext/pubs/taxplan2001.pdf

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election was not attached to a timely filed return, an individual can file an amended return within 6 months of the due date of the return (excluding extensions) and make the election out.

Taxpayers filing before June 1, 2002 are treated as having elected out of the 30 percent additional first-year depreciation for acquisitions of qualifying property after September 10, 2001 and before January 1, 2002. However, these taxpayers can file an amended 2001 return by the due date of their 2002 returns (including extensions) and claim the additional depreciation for 2001. Alternatively, a taxpayer can file Form 3115 "Application for a Change in Accounting Method" with their 2002 return and take the additional first-year depreciation for 2001 as a deduction for the 2002 tax year. The taxpayer could also take the second year depreciation on the asset acquired in 2001 as a 2002 deduction.

Revoking Election to Treat CCC Loans as Income

Many producers use the Commodity Credit Corporation (CCC) loan program in which commodities are used for loans at or after harvest. Producers can treat those loans in two 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 Section 77 to treat the loan proceeds as income when received – the income method. Once the election to treat a CCC loan as income was made, it could not be revoked without the IRS Commissioner's permission. Revenue Procedure 2002-9 adds the Section 77 election to the changes in accounting methods that receive the automatic consent of the Commissioner.

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 the 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. Producers have flexibility in reporting future CCC loans. If a producer revokes the Section 77 election for 2002, nothing prevents that producer from electing to report 2003 CCC loans as income. Presumably, the new election could be revoked for the 2004 tax year.

Farm Income Averaging Regulations

Farm income averaging regulations were released in January 2002. In general, these regulations confirm most of the previous interpretations and they do provide some additional guidance. It is clear that farm income averaging does not change income in the election year or in the base years. Farm income averaging borrows the unused tax brackets from the three base years to compute the tax on one-third of the elected farm income for the election year.

The regulations clarify that landowners whose income is based on a share of farm production can treat that income as electible farm income for income averaging. Whether the landowner materially participates in the farm operation is irrelevant for income averaging. However, for 2003 and later years, to consider the farm income as electible farm income, the landowner must have a written agreement with the farm operator before the operator begins significant activities.

The regulations also indicate that farm income averaging does not apply for purposes of calculating the tentative tax for alternative minimum tax (AMT) calculations. The final regulations also allow changes in the farm income averaging election during the three-year time period for filing amended returns.



A New Brand of Agriculture? Farmer-Owned Brands Reward Innovation*

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Commodity agriculture, as currently practiced in the Midwest, is an extremely efficient way of organizing production and distribution. It allows for inexpensive production and bulk transfer of huge quantities of meat and grain and has resulted in enormous cost savings to U.S. and international consumers. This system has evolved in accordance with market forces, and we expect that these same forces will allow the current system to survive for decades.

There are aspects of the system, however, that are not desirable. For example, the commingling that occurs to take advantage of bulk handling means that signals cannot be sent from consumers to producers. Consumers might desire food products that are different from the commodity standard and they might be willing to pay a premium, but the farmer does not get this signal.

In addition, competitive pressures mean farm operations must grow larger to reduce costs. As farms have grown larger, governments throughout the world have attempted to slow the process in order to ease the transition for those who are forced out of farming and to prop up rural communities. These government protections distort markets and can lead to international tensions, as each country defends its own interventions.

Farm groups have attempted to address these issues by working together to build value-added processing facilities such as ethanol plants and to create niche products to satisfy the desire of some consumers for variety. However, whenever these efforts are successful, they are quickly imitated, and profit margins get smaller and smaller.

A third possible solution has recently begun to emerge that meets consumers' desire for variety and quality and allows farmers to retain profit margins for long periods. This solution would allow some smaller operations to remain in business. The solution does require cooperation between producers and government, but it also relies upon market forces. In essence, the solution is to allow farmers to own their own brands and to control production of

branded quantities, much as already occurs in other sectors of the economy. The phrase used in the European Union to describe this concept usually refers to either a "guarantee of origin" or a "guarantee of production process." (In the United States, the description will include a reference to a federal marketing order.) Neither of these phrases really captures the essence of the concept. Instead, we refer to this solution as a "farmer-owned brand."

The Economics of Farmer-Owned Brands

Some consumers are willing to pay premium prices for differentiated products, and these premiums can occasionally result in niche markets such as those that exist for organic products and local farmers markets. These consumers are essential for a successful farmer-owned brand. But producers in traditional niche markets do not attempt to control supply (that is, prevent imitation); therefore, profits for producers of organic and local products will follow the pattern described for commodity products. To be successful, branding also requires producer control over the quantity supplied, and this is the key difference between farmer-owned brands and organic products or farmers markets.

In order to assert supply control without violating price-fixing rules, farmer-owned brands must be based on some fixed attribute. For example, a particular brand might specify that the product can only come from a select area and justify this restriction based on the specific attributes of the region. Another legal way to control supply would be to limit membership in the producer group to a relatively small number of high-quality producers (or to severely restrict admission into the group). A third way would be to impose strict (for example, environmentally friendly) production and/or quality standards, possibly allowing for some flexibility over time to accommodate changes in market circumstances. A fourth way is to require the farmer-owned product to use some ingredient or process for which the pro-

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ducer group can control access, either through intellectual property rights or through trade secrets.

In all cases, a successful product will become a temptation for imitators from outside the original group and will generate attempts by members of the group to expand their individual output. If these pressures result in an expansion of supply, the brand will fail. The most obvious way to restrict this type of supply expansion is to use regulations to protect the property rights of those who own the brand. These regulations might be the same as those used to protect branded products in other sectors, with the crucial exception that they must also have the power to restrict additional production from within the group—an issue that is not faced by corporate brand owners. With this ability to restrict production comes freedom from the boom-bust price cycles associated with commodity markets.

Farmer owners will capture the benefit associated with product improvements; consequently, they can be expected to pay close attention to quality. Notice how the incentive structure for a farmer-owned brand would differ from that in a commodity system. Farmer owners would value the brand name and would therefore want to maintain high quality standards throughout the association. Further, farmers would be rewarded for innovation both in production and in marketing.

The Situation in Europe

The problems associated with agricultural commodities described earlier are in many ways of greater relevance in the European Union. Europeans tend to live closer to farm areas and they are therefore more concerned about rural vitality. Also, there is a long tradition of regional production methods, and the most successful of these are liable to be copied. Finally, E.U. agriculture is currently evolving from one based on price supports to one based on income support. This has put enormous cost pressure on farms, which, if left alone, would result in a rapid commodification of many food products.

All of the above has created a great amount of interest in the process of branding in the European Union. Dozens of individual centers are currently working on the issue, and several hundred new brands are introduced each year. The emphasis on selling the brand concept to consumers and policymakers is key to finding ways around European price-fixing laws, and any positive impact on

farm profitability is therefore viewed as a by-product of the more important goal of protecting the food supply. Nevertheless, the programs work and operate exactly as they might be expected to if they were set up to maximize farm profitability. Two of the more successful cases that we encountered on a recent study tour in Europe are Brunello di Montalcino and Parma Ham.

Brunello di Montalcino

Montalcino is a small, saucer-shaped valley in Tuscany that is said to be an ideal location for growing Sangiovese grapes (called “Brunello” in Montalcino). Producers in this area have formed an association that owns the brand called Brunello di Montalcino, and this association limits the quantity of grapes grown under this brand name. Individual vineyards have their own labels, but most of the marketing and promotion of the brand is done by the producer-owned association (about 60 percent of the association’s budget is spent on promotion). This makes a lot of economic sense, as some of the surviving vineyards harvest less than two acres. The association also suggests a minimum price for wine bearing the Brunello di Montalcino brand name. Individual vineyards are free to charge more than this suggested minimum, and virtually all of them do.

Importantly, the production area is set by the association and is rarely changed. The association also limits the yield of grapes and the yield of wine from grapes (to maximums of 3.2 tons per acre and 68 percent, respectively). Production of Brunello di Montalcino is further restricted by other means, such as prohibiting irrigation. The strict rules underlying this brand are enforced using support from federal and state authorities. Attempts to use this name outside of the European Union would be opposed by the European Union in international regulatory groups such as the World Trade Organization. Vineyards that are eligible to use the Brunello di Montalcino brand command large premiums.

Parma Ham

A second successful E.U. example is “Prosciutto di Parma” or “Parma Ham,” a dry-cured ham produced in the Parma region of Italy. This brand is owned by a group of ham processors rather than by hog farmers. They maintain control over production using a regulation that specifies that all ham bearing this brand be cured in a very small area just south of the

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city of Parma. The argument used to justify this restriction is that this region has been used to dry-cure ham since at least the times of the Roman Empire, because its weather is ideally suited for that process. The wind blows into this region from nearby mountains and these climatic conditions are said to give hams a unique flavor. This is the rationale for requiring that processing facilities have windows facing the mountains to allow this "special" air through the units. Interestingly, however, with modern climate control these windows are seldom (if ever) used.

Another requirement of the "Prosciutto di Parma" brand is that the ham be produced from a pig raised in certain regions in the north of Italy. Further, only traditional Italian breeds such as Italian Landrace or Italian Large White are allowed. This creates the possibility that some of the success of the program might be transferred to Italian hog producers. Italian hog prices have averaged \$7.44 per hundred pounds higher than German hogs over this period. In this case, there is no evidence that Italian hog producers can profit from the existence of the "Prosciutto di Parma" brand because there is no restriction on the number of hogs that are grown in Italy. However, the higher prices observed in Italian hog production have probably allowed the Italian hog industry to survive in the absence of trade protections from less expensive E.U. producers in the Netherlands, Ireland and Denmark.

The Brunello di Montalcino and Prosciutto di Parma brands are only a tiny fraction of those that have succeeded in the European Union.

Example of a Successful U.S. Farmer-Owned Brand

Farmer-owned brands are relatively rare in the United States. One successful brand involves Vidalia onions, a registered trademark of the Georgia Department of Agriculture. Vidalia onions are grown only by a

see "Why Can't Vidalia Onions Be Grown in Iowa? Developing A Branded Agricultural Product" by Roxanne Clemens, MATRIC Briefing Paper 02-MBP 3, available at www.matric.iastate.edu

group of authorized farmers in the region around Vidalia in the South of Georgia. The farmers use a trademark and a federal marketing order to restrict marketing and production of these particular sweet onions.

Can the Midwest Jump on the Bandwagon?

It seems highly unlikely that the Midwest will ever create a brand of extra virgin soybean oil given current consumer preferences and production practices. But other products seem ideal for branding. For example, the Japanese beef consumer has discovered that beef originating from packing plants located along Interstate 80 has a better flavor than other U.S. beef. This is probably true because midwestern beef is typically produced from calves that are grain fed for as long as six months. Beef from other U.S. regions is typically older and less tender than the midwestern product and comes from calves fed for much shorter periods. As a result, Japanese consumers have now begun to request "I-80 beef," a brand that does not yet exist. It should be possible for a group of cattle feeders to find a suitable location for the production of this type of beef and justify why beef from this location has some special characteristics. A key element in this brand would be that state and federal regulators would agree to step in to protect this brand from overproduction from within the group and from outside competition. This latter feature has not been evident in the attempts seen with this type of product to date.

In the same way, in each county, producers could probably describe a unique way to make ice cream, cheese, sausage, or ham, or unique ways to feed and process pigs, cattle, chickens, or turkeys. These products are more likely to succeed if there is a genuine flavor difference such as might exist with range-fed poultry. Other possible brands might be based on production practices that use science to improve flavor and tenderness.

Whatever the innovation, the cases we've studied in Europe may be harbingers of a new strategy for American farmers to make the most of the unique characteristics of their products in the marketplace.

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