



Ag Decision Maker



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Higher guarantees available for crop insurance in 2004

by William Edwards, extension economist, 515-294-6161, wedwards@iastate.edu,

The biggest news in crop insurance for 2004 is that higher dollar values can be guaranteed. The indemnity prices for corn and soybeans for APH insurance have been announced at \$2.45 and \$5.60 per bushel, respectively. This is the rate at which any losses suffered under traditional yield insurance will be paid. Last year's APH indemnity prices were \$2.20

for corn and \$5.15 for soybeans.

The prices that will be used to calculate the guarantees for the revenue insurance products, such as Revenue Assurance and Crop Revenue Coverage, will not be announced until the end of February. However, current futures market prices are well above the averages of \$2.42 for corn and \$5.26 for soybeans that were recorded for 2003.

at 157 bushels per acre. Thus, it won't be uncommon to see proven yields for corn jump as much as 5 to 10 bushels per acre this year.

Soybeans are a different story. The average Iowa soybean yield was 31 bushels per acre in 1993, but is estimated at only one bushel above that for 2003. Of course individual farms may still have had substantially higher yields last year than a decade ago.

Let's look at an example of a farm that had an APH yield of 135 bushels per acre last year, and insured with revenue

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Handbook Updates

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

Crop Production Cost Budgets – A1-20 (13 pages)

Historic County Farm-land Values — C2-72 (10 pages)

Please add this file to your handbook and remove the out-of-date material.

Higher proven yields

This is the year that we finally get to throw yields from 1993 out of the 10-year moving average that is used to calculate most people's APH yields. The average Iowa corn yield in 1993 was 80 bushels per acre. Many farms harvested much less than that, due to prolonged floods and wet weather. The average yield for the state in 2003 is currently estimated

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insurance at the 75 percent guarantee level. The revenue guarantee was equal to 135 bu. x \$2.42 x 75 percent, or \$245. If the proven yield increases to 143 bushels this year, and the December futures price during the month of February averages \$2.80, a 75 percent guarantee will be worth \$300 per acre in 2004.

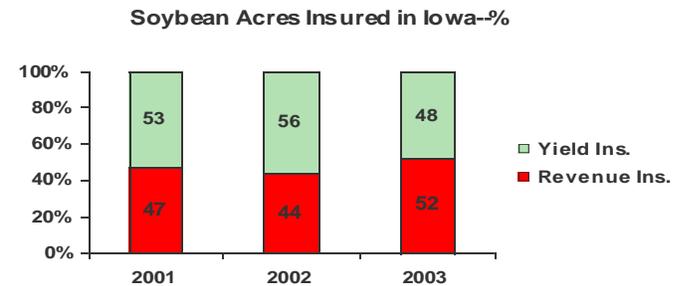
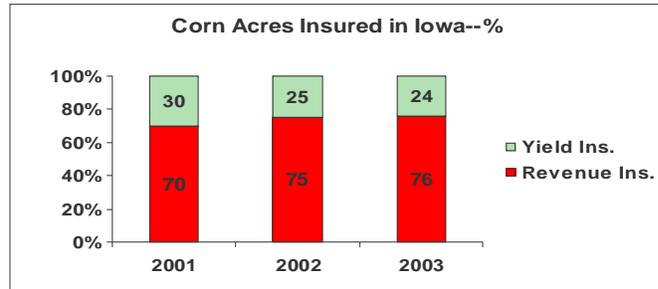
Of course, higher guarantees will also mean higher premiums, in many cases. Because insurance companies have more dollars at risk, they must collect more in premium payments. Higher APH yields may modify those increases somewhat.

Coverage choices

Producers will have a choice whether to purchase the same percent guarantee as last year, with a higher dollar value and possibly a higher premium, or to buy the same dollar guarantee as last year at a lower percent coverage. Farmers and landowners who have a fixed budget for crop insurance may opt for a lower percent coverage.

In recent years, Iowa producers have been shifting away from yield insurance toward more use of the revenue insurance products, especially for soybeans (see chart). A few years ago the insurance indemnity prices for soybeans were below the county loan rate for most producers. This meant that price risk was essentially neutralized already, and many farmers chose to insure yields, only.

Since then, however, the loan rate has been lowered (for soybeans) and prices have in-



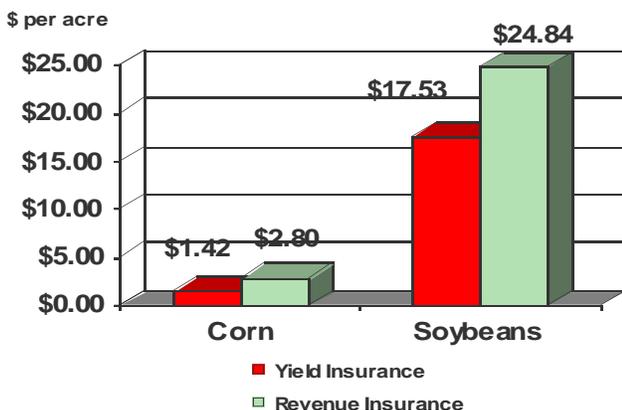
creased dramatically. Today the risk of prices dropping substantially from February to harvest is much higher, making it more important to insure revenue. Moreover, the APH indemnity prices look to be somewhat lower than those that will be used for revenue insurance this year.

Standard or Harvest Price Option?

Producers who buy revenue assurance have a choice of buying the standard version with a fixed guarantee, or the harvest price option that increases the guarantee if prices rise from February to harvest. In 2003, the RA price for soybeans rose from \$5.26 to \$7.32 by October. Producers who had significant yield losses and the harvest price option were likely to collect indemnity payments. Those who had the standard policy probably did not, because the rise in price offset the lower than expected yields. Both yield and revenue insurance paid substantial indemnities for soybeans in Iowa last year, though (see soybean acres chart).

This scenario is not likely to be repeated in 2004. Given the level of current soybean futures prices, the probability of seeing higher prices in October is much less than a year ago. Thus, producers may choose to purchase the standard RA policy, at a lower premium. However, the difference in premiums for the standard and harvest price options may also be less this year.

Indemnity Payments Made in Iowa for the 2003 Crop





Repair or capitalize expenditures?*

by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, harl@iastate.edu, 515-294-6354

The line between what is a “repair” and, therefore, is deductible, and what must be capitalized and depreciated has never provided a bright line for determining how an expense should be handled. The cases have not always been consistent which is not unexpected when the facts and circumstances of each case are controlling. Two cases, one in 2000 and another in 2003 have provided useful guidance on where the line should be drawn between repairs and expenses that must be capitalized.

The regulations

The Internal Revenue Code allows taxpayers to deduct ordinary and necessary business expenses paid or incurred during the taxable year. The regulations specify that—

“The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition, may be deducted as an expense.”

On the other hand, the regulation governing capitalization states that expenses are capital expenditures (and are to be depreciated) if the expenses—

“(1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) adapt property to a new or different use.”

The capitalization regulation goes on to state that—

“amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures”

As noted, whether an expense is capital is highly dependent on the particular circumstances of a given case and is ultimately a question of fact.

The 2003 case

The latest case, *FedEx Corp. & Subs. v. United States*, involved the deductibility of expenses incurred for aircraft maintenance. The court explained that whether an expense was a repair or a cost that had to be capitalized depended heavily upon what is the appropriate unit of property. Citing two earlier cases, the court in *FedEx Corp.* articulated four factors that a court should consider in identifying the appropriate unit of property to which to apply the factors from the repair regulations—

1. the court should consider whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management or accounting purposes;
2. the court should determine whether the economic useful life of the component part is coextensive with the economic useful life of the larger unit of property;
3. the court should determine whether the larger unit of property and the smaller unit of property can function without each other; and
4. the court should weigh whether the component part can be and is maintained while affixed to the larger unit of property.

In the *FedEx Corp.* case, the court found that the four factors favored the entire aircraft as the separate unit of property, not the engines.

The court then proceeded to examine whether the repairs in question (involving engine scheduled visits or ESVs) were “incidental repairs” as specified by the repair regulations. The court found no support in the cases for treating “incidental” as a separate capitalization requirement under the repair regulations.

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Repair or capitalize expenditures?, continued from page 3

The court next considered whether the expenditure returned the property to the state it was in before the situation prompting the expenditure arose, an expenditure intended to correct a situation, or whether the expenditure was a more permanent increment in the longevity, utility or worth of the property. The court determined that the appropriate test to apply was the corrective test, that the expenditure returned the property to the state it was in before the situation prompting the expenditure arose. Accordingly, the expenditures were all allowable as repairs.

In conclusion

The reasoning of the court in *FedEx Corp. & Subs. v. United States* and *Ingram Industries,*

Inc. & Subs. v. Commissioner is highly relevant to the question of whether a major repair on a combine or tractor engine or transmission should be considered a repair or whether the expenditure would have to be capitalized. Both cases provide useful authority for arguing that even major engine or transmission overhauls should be deductible as repairs. In general, engines and transmissions are treated as part of the larger machine, the economic life of the engine or transmission is typically considered as co-extensive with the economic life of the tractor or combine, a tractor or combine cannot function without an engine or transmission and the engine or transmission can be and generally are maintained while affixed to the tractor or combine, as the case may be.



Depreciation on listed property vehicles*

by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, harl@iastate.edu, 515-294-6354

The enactment of depreciation rules for “listed property” in 1984 marked a new era in recovering investment in business assets. For property with both business and personal use, the income tax basis for depreciation purposes is determined, as always, by applying the fraction of business use to total use. But listed property assets are further limited in terms of the amount of depreciation claimable.

The enactment of bonus depreciation rules has focused additional attention on passenger automobiles, one of the important components of listed property.

Passenger automobiles

While all vehicles used for transportation purposes are considered “listed property,” automobiles and pickups of 6,000 pounds unloaded gross vehicle weight or less (GVW for trucks and vans) are subjected to dollar limits on depreciation claimable. Property must be used “predominantly” in a qualified business use in order to be eligible for the regular amount of depreciation deduction. Predomi-

nantly means more than 50 percent in a qualified business use. The proportion of a vehicle’s basis that can be depreciated depends upon substantiation of business use. If the qualified business use is 50 percent or less, expense method depreciation may not be claimed, the 30 percent and 50 percent bonus depreciation allowances cannot be claimed, and depreciation deductions must be calculated using the alternative depreciation method.

In 2002, Congress passed legislation providing for a 30 percent extra depreciation allowance on new vehicles which provided specifically for an increase of \$4,600 in the first year depreciation allowance for passenger automobiles. In 2003, the Congress boosted the extra depreciation allowance to 50 percent for property acquired after May 5, 2003, and placed in service before January 1, 2005, if there was no binding con-

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Depreciation on listed property vehicles, continued from page 4

tract in effect before May 6, 2003. The 2003 legislation increased the first year depreciation allowance for new passenger automobiles by \$7650 to \$10,710.

The 2003 limits for passenger automobiles are as follows

	Zero Bonus	30% Bonus (new)	50% Bonus (new)
First year	3,060	7,660	10,710
Second year	4,900	4,900	4,900
Third year	2,950	2,950	2,950
Each succeeding year	1,775	1,775	1,775

The maximum allowable depreciation amounts for 2003 are:

Zero bonus	30% bonus	50% bonus (new)	50% bonus (new)
First year	9,080	22,880	32,030
Second year	14,600	14,600	14,600
Third year	8,750	8,750	8,750
Each succeeding year	5,225	5,225	5,225

The maximum allowable depreciation for 2003 is:

	Zero bonus	30% bonus (new)	50% bonus (new)
First year	3,360	7,960	11,010
Second year	5,400	5,400	5,400
Third year	3,250	3,250	3,250
Each succeeding year	1,975	1,975	1,975

Trucks and vans as non-personal use vehicles

Temporary regulations effective July 3, 2003, exclude from the definition of passenger automobiles any truck or van that is a “qualified nonpersonal use vehicle” as defined under I.R.C. • 274 which applies to vehicles not likely to be used more than a de minimis amount for personal purposes. These vehicles are subject to the limits for listed property but not the dollar limits for passenger automobiles.

Other trucks and vans

For other trucks and vans, placed in service in 2003, a higher inflation adjustment factor has been approved.

Electric automobiles

A 1998 amendment specifies that the maximum depreciation amounts that may be claimed for electric vehicles are tripled through 2004.

A deduction of \$2,000 is available for electric vehicles certified under the clean fuel provision of federal law.

World Bank study: Trade liberalization would shut down two-thirds of EU’s grain and oilseed production

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In the wake of the collapse of the World Trade Organization (WTO) talks in Cancun in mid-September a number of news reports have referred to a World Bank Report that estimates that “a deal to lower global trade barriers could add more than \$500 billion a year to global incomes by 2015, lifting 144 million people out of poverty.” These results are based on a “pro-poor” scenario that is reported in 2003 *Global Economic Prospects: Realizing the Development Promise of the Doha Agenda*.

The World Bank’s “pro-poor” scenario assumes that all developed nations reduce their agricultural tariffs to a maximum of 10 percent and tariffs on other goods to 5 percent while all

developing nations reduce agricultural tariffs to a maximum of 15 percent and other goods to 10 percent. In addition, payments to producers would be decoupled from production. “The ‘decoupling’ part of the scenario is achieved by removing all domestic support in agriculture input and output subsidies and payments to land and capital. These would be replaced by direct payments to farm households.”

The prospect of a \$500 billion income gain, and the lifting of 144 million people out of poverty got me to wondering how this feat would be accomplished and what its impact would be on agricultural production in various countries of

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World Bank study: Trade liberalization would shut down two-thirds of EU's grain and oilseed production, continued from page 5

the world. Because one of the main issues at Cancun was the Agreement on Agriculture and the call for support reduction, I assumed that changes in agriculture would be a significant component of the pro-poor scenario. Indeed, \$358 billion of the gain comes from agriculture of which \$240 billion would accrue to low and middle income countries.

For a change of this magnitude to occur, significant adjustments would need to take place in the developed countries. The effect of this policy change would be felt differently in various countries and regions around the world. It appears that one of the areas that would experience the greatest change under this trade liberalization scenario is the European Union (EU).

Right now, the EU is just barely a net exporter of major field crops. Aggregating across corn, barley, wheat, soybean, rapeseed, sunflower seed, and rice, over the last five years the EU annually consumed an average of 140 million metric tons of these commodities. While she imports and exports various amounts of individual crops, in total, EU exports averaged about 4 million tons of major crops more than it imported.

The results of the study's "pro-poor" scenario show a decline in total European crop and livestock output of 30 percent below baseline projections for 2015. Break-outs of individual commodities were not published in the World Bank report but a study published by Iowa State University on a similar application of the World Bank's model does provide commodity detail.

Based on the more detailed information in the Iowa State study, we have estimated the crop-output implications from the World Bank's reported total drop in EU agricultural output of 30 percent for the pro-poor scenario. The results are staggering.

In the case of wheat, this estimation approach suggests that the "pro-poor" trade liberalization agenda would result in the loss of 26.4 (60

percent) million of Europe's 44 million wheat acres by 2015. This would transform Europe from a net wheat exporter to a significant importer.

In other grain production, Europe would lose 18.9 (70 percent) of its 27 million acres devoted to the production of other grains. With oilseeds the corresponding drop would be 6.2 million acres (59 percent) out of 10.5 million acres. In both of these cases Europe would be a significant net importer. The imports would come from lower cost producers elsewhere in the world.

According to our calculations, the World Bank study implies that the relatively self-sufficient EU would become dependent on imports for two-thirds of its grain and oilseeds. Europe would return to the same kind of ship-to-mouth existence that it experienced following WWII. It was this ship-to-mouth to existence that led to the establishment of the European Common Agricultural Policy (CAP) in 1962.

Can this be? Do we really think that the EU will reduce its total acreage of wheat, oilseeds, and other grains by 63 percent or 51.5 million acres in the next decade under this or any other trade liberalization scenario?

As one who has worked with economic simulation models for over thirty-five years, I can understand how the World Bank's model, that views the world "as one large field" to use ADM's words, would produce these results. As a policy analyst, however, I find it extremely hard to believe that the French and other Europeans would be content to sit idly by while EU's major field crop production drops by nearly two-thirds.

Again, I ask, can this be? Are we missing something here? Can the real-world adjustments that would be required to achieve a \$358 billion agriculturally based increase in global income from trade liberalization be reasonably expected to occur? Perhaps, but what a gigantic departure from previous adjustment-experience it would be.

... and justice for all

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