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# Ag Decision Maker

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## Using value-added agriculture to create a new rural America

by Don Hofstrand, extension value-added ag specialist, 641-423-0844, dhof@iastate.edu

When people ask "What is value-added agriculture?", the discussion usually focuses on how to define it. Most define it as adding value to the commodities and products that farmer produce. Some say that it should be called *value-retained* or *value-captured*.

Regardless of how you define it, the essence of value-added agriculture is a change in the vision for agriculture and rural America. A transformation from a vision of out-migration of people, declining standards of living and decaying infrastructure; to a vision of economic vibrancy and a growing rural America. The key to this new vision is generating economic activity, not from government programs, but from the marketplace. I am not saying government does not have a role. Government needs to play a facilitator role for this new vision.

This change in vision will not be easy, but it is doable. Below are six critical factors that need to be addressed to achieve this new vision through value-added agriculture activities.

**1. Opportunities**

Lack of market and business opportunities is the reason often given for why we cannot achieve a new vision of rural America. But careful examination shows that opportunities do exist. Examples can be seen in the food and energy industries. Granted, many of these perceived opportunities may lead to dead-ends and failures. But the point is that there are true opportunities. We need to be smart enough to find them.

**2. Leadership, Confidence, Persistence**

A critical element is identifying people with the leadership, confidence and persistence needed to find these opportunities and act on them. There is not an abundance of these people in rural America. This is the weakest link in the chain forachieving the new vision.

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### Handbook Updates

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

**Iowa Corn and Soybean County Yields** – File A1-14 (4 pages)

**Strategic Management for Farmers** – File C6-41 (3 pages)

Please add these files to your handbook and remove the out-of-date material.

### Inside . . .



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When we do find these individuals, they need to be nurtured and used as models for others to follow.

**3. Business skills**

Leadership, confidence and persistence alone will not achieve the new vision. It needs to be combined with business skills. This is the second weakest link in the chain. Business skills fall into three broad categories:

- **Idea identification and evaluation** – This involves the ability to seek out business ideas and properly evaluate their business potential. The basic premise is whether you can provide "value" for the user or consumer that is not already being provided. Value may involve better quality, lower price, better service and a whole host of other things. If you don't do this step correctly, the next two steps are irrelevant.
- **Business creation** – This involves creating a business venture that provides the value identified above and turns it into an income stream. Value-added businesses are usually quite different from traditional farm businesses. So new skill sets need to be learned.
- **Business operation** – Once a business is up and running, you need to keep it running. If you expect to continue to generate income from the marketplace, you need to adapt as market conditions change. The skills needed for business operations are quite often different from those needed for business creation. Value-added groups frequently overlook this.

**4. Capital**

Money is another critical factor for implementing a new vision for rural America. New structures need to be developed to link the financial resources currently existing in rural areas to the financing needs of rural business start-ups. Some claim that we need to attract venture capital from the financial markets. In some situations this may be true, but local investors are often willing to invest in businesses that affect their local communities.

**5. Organization and support**

Factors often overlooked are the organizational and support needs of value-added business groups. This can be as simple as the need for office, meeting room and clerical support. Extension offices and other local organizations can provide a great service to these groups with a minimal outlay of resources.

More sophisticated organizational and support services are being provided by a array of value-added alliances being created across rural America. These alliances focus on business development support by providing an organizational structure for interaction among entrepreneurs with similar interested, access to seed capital for investigating business ventures, networking opportunities with other groups and individuals, and a host of other valuable services.

**6. Rewards**

To make the new vision for rural America sustainable, we must adequately reward the individuals and groups providing the sweat and skills that go into business creation. Structures are being developed where financial rewards for the business founders are tied to the financial success of the business.

In some areas, the idea of rewards tends to go against rural culture where it is believed that these activities should be conducted as non-paid volunteers for the good of the community. However, this new vision cannot be accomplished with volunteer labor. Business creation is serious business and takes an incredible amount of time and dedication.

## Call to action

Achieving this new vision for rural America will require the involvement of individuals from all walks of life, existing rural institutions and the public sector. Examine the six factors listed above. Identify where the needs are and how you can have an impact. Get involved.

# New fifty percent special depreciation allowance

by Gary Hoff, Extension Specialist – Taxation, University of Illinois Income Tax School

When Congress enacted the Job Creation and Worker Assistance Act of 2002 (JCWAA), they made one of the largest changes to the depreciation rules since 1986. This change allowed taxpayers who purchased qualified, first-use assets to deduct 30 percent of their cost in the first year. As a part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Congress made an even larger change to the depreciation rules. JGTRRA allows taxpayers to claim a first year deduction of 50 percent of the cost of qualified assets. The basic rules governing the 30 percent/50 percent deduction are discussed in this article using primarily agricultural examples.

To qualify for the 30 percent special depreciation allowance (SDA), the asset must be purchased after September 10, 2001 and before September 11, 2004. It must also be placed into service before January 1, 2005. The "placed in service" period is extended until January 1, 2006 for certain property with a longer production period. No written binding contract for the purchase of the property could have been in effect before September 11, 2001. In 2003, JGTRRA extended the deadline for purchases to January 1, 2005.

In addition JGTRRA also increased the 30 percent SDA to 50 percent for qualifying purchases after May 5, 2003 and before January 1, 2005. The 50 percent rate does not apply if there was a written binding contract in place before May 6, 2003.

## Qualifying property

To qualify, property must be new property of one of the following types:

- **Property depreciated using modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less.** Generally, every type of property except real property has a recovery period of 20 years or less. In addition, the MACRS method is used to depreciate most property.
- **Water utility property**, which is either of the following:
  - Property that is an integral part of the gathering, treatment, or commercial distribution of water, and that, without regard to this provision, would be 20-year property
  - Any municipal sewer
- **Computer software that is not an IRC §197 intangible**, which is software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified.
- **Qualified leasehold improvement property**.

The property must also meet the following tests:

- Acquisition date test.
- Placed in service date test.
- Original use test.
- The property must not be excepted property.

## Property Depreciated Under MACRS – 20 Years or Less

MACRS property includes properties which have 3-, 5-, 7-, 10-, 15-, and 20-year recovery periods. The following is not an all-inclusive list of the property falling into each class.

- **3 Year** – breeding hogs, over-the-road tractor (semi) and some horses
- **5 Year** – automobiles, general purpose trucks, and computers and typewriters, copiers, etc.

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- **7 Year** – personal property within nonresidential real estate (carpeting, movable partitions, etc.), office furniture and fixtures, breeding and dairy cattle, farm equipment, and much more.
- **10 Year** – single purpose agricultural and horticultural structures.
- **15 Year** – drainage tile
- **20 Year** – farm buildings

## Qualified leasehold improvement property

There are specific rules for certain qualified leasehold improvement property. The following three conditions must be met in order for the property to be considered qualified leasehold improvement property:

1. The improvement is made under a lease, either by the lessee, sublessee, or lessor of the building portion.
2. The portion of the building is to be occupied exclusively by the lessee (or sublessee) of that portion.
3. The improvement is placed in service more than three years after the date the building was first placed in service.

## Original use test

According to the Joint Committee's explanation, the term "original use" means the first use of the property. This is whether or not "use" corresponds to use of property by the taxpayer. When evaluating whether property qualifies as "original use," the same factors are used to determine whether property qualifies as "new IRC §38 property" for purposes of the investment tax credit. Additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) will satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer will not satisfy the "original use" requirement.

**Example 1.** Linda replaces the engine in her tractor with a new engine. If the new engine was purchased after May 6, 2003, it will qualify for the SDA. If Linda replaced the engine with a **used engine**, it would not qualify.

Unlike the IRC §179 immediate expensing rule, the special 30 percent/50 percent special depreciation allowance does not prohibit the purchase of otherwise qualifying property from a "disqualified person."

## How much can be deducted?

The special depreciation allowance for qualified property is an additional 30 percent/50 percent of the property's depreciable basis. In a fashion similar to IRC §179, the entire amount of the SDA is taken into account regardless of the date in the tax year in which the property is first placed into service (i.e., there is no pro-ration required). Unlike the IRC §179 expense election, the 30 percent/50 percent SDA has no annual expense limits or limits on total annual asset investments. In addition, IRC §179 contains a "taxable income" limit, which is not included in the 30 percent/50 percent special depreciation allowance rules. In effect, the 30 percent/50 percent provides a tax planning opportunity by creating a net operating loss to offset either prior year's or subsequent year's taxes. In short, there are no limits on the amount of either the 30 percent or 50 percent SDA. The depreciable basis is the property's cost or other basis multiplied by the percentage of business/investment use and then reduced by the following items:

- Any IRC §179 deduction taken for the property.
- Any deduction for removal of barriers to the disabled and the elderly for the property.
- Any investment credit, disabled access credit, or enhanced oil recovery credit for the property.

**Example 2.** On November 1, 2003, Chris Davis purchased and placed in service qualified property that cost $100,000. He did not elect to claim an IRC §179 deduction. He can deduct either 30 percent of the cost ($30,000) or 50 percent of the cost ($50,000) as a special depre-

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ciation allowance for 2003. He uses the remaining $70,000 (30 percent) or $50,000 (50 percent) to compute his regular MACRS depreciation deduction for 2003 and later years.

**Example 3.** Assume the same facts as **Example 2**, except Chris chooses to deduct $40,000 as an IRC §179 deduction. He uses the remaining $60,000 of cost to compute his special depreciation allowance of $18,000 (30 percent § $60,000), or $30,000 (50 percent § $60,000), Chris uses the remaining $42,000 (30 percent) or $30,000 (50 percent) of cost to compute his regular depreciation deduction for 2003 and later years.

## Electing out of the special depreciation allowance

The 30 percent/50 percent SDA is a required deduction unless the taxpayer elects not to claim the deduction. If the taxpayer does not need the large deduction that the SDA might allow, he must be careful to make a proper election on his tax return. The election must be an affirmative statement attached to or written on the return. The election must also include the classes of property on which the taxpayer wishes not to claim the SDA.

In order to manage his tax liability, a taxpayer may wish to claim the SDA on 7-year property, but not claim it on other classes of property purchased. If the taxpayer claims the SDA, he must claim it for all eligible purchases within the class for that year.

The IRS issued Rev. Proc. 2002–33 on April 29, 2002, to provide guidance about how to elect out of the special depreciation allowance, and much of this document was devoted to taxpayers who had already filed their 2000 (fiscal returns) or 2001 calendar returns prior to June 1, 2002. For taxpayers who had not filed their returns before June 1, 2002, the rules were much less complex, since specific instructions were available for the "election out" procedure. The instructions to Form 4562 (for the 2002 year) state:

For more details, see Rev. Proc. 2002-33—

**Election out**. You may elect, for any class of property, not to treat as qualified property all property in such class placed in service during the tax year. If you make the election, the property may be subject to an alternative minimum tax (AMT) adjustment for depreciation. To make the election, attach a statement to your timely filed return indicating that you are electing not to claim the additional allowance and the class of property for which you are making the election."

**Note.** If a taxpayer timely filed his return without making the election (not to claim the special depreciation allowance), he can still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Write "File pursuant to section 301.9100-2" on the amended return.

Once made, the election may not be revoked without consent from the IRS.

### Trades

If the purchase of an asset, qualifying for SDA, is a part of a like-kind exchange, the remaining basis of the traded property also qualifies for the 30 percent/50 percent SDA.

**Example 4.** John purchases a new qualifying tractor for $25,000 boot plus his old tractor. If the old tractor has a remaining basis of $15,000, both the $25,000 and the $15,000 qualify for the SDA. Therefore John can claim a $20,000 current year deduction plus the regular depreciation on the remaining basis.

**Caution**. Not all states allow full use of the SDA for purposes of calculating state income tax. Taxpayers should check their applicable state law, before deciding whether to claim the SDA on their federal tax return.

# *Ag Decision Maker* goes electronic

Like the print version, this decision-oriented agricultural business Internet site is designed for farmers, lenders, farm managers, agriculture instructors and others. It provides up-to-date information from agricultural economics at Iowa State University and other Midwest universities and institutions.

The Internet site is located at http://www.extension.iastate.edu/agdm. The new online version offers a number of interactive tools not available in the print publication. To stay current, you can request to be notified each month by email of new information that is being posted on the web site. The Internet version is free. Four types of information are offered on the site:

## Newsletter articles

This section is updated monthly and provides analysis and insight into many of the issues facing modern agriculture. Also newsletter articles published during the last three years are available.

## Decision files

More than 160 Decision Files provide information and analysis for finding solutions to many of the decisions facing farmers and agribusinesses. Each decision file can be printed or read from your computer screen.

## Decision aids

Many of the decision files have decision aids (spreadsheets) for on-line computation. Just enter your figures into the spreadsheet to analyze your individual situation and save the analysis as a file on your computer.

## Teaching activities

Many of the decision files have teaching activities for use in high school classrooms. Students can complete the teaching activity from information provided in the decision files and save or print the document and provide it to their instructor. Teachers can access a restricted area of the site to get answer keys.

The monthly print publication will still be available for a fee. Those interested in subscribing to the print publication should contact Trece Lonneman at (641) 923-2856 or via e-mail at trece@iastate.edu.



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