Ag Decision Maker

A Business Newsletter for Agriculture

Vol. 7, No. 5 www.extension.iastate.edu/agdm March 2003

Does the New Farm Bill Reduce Risk?

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Farm programs administered by the U.S. Department of Agriculture have had many objectives over the years. Protecting farmers from the risk of falling commodity prices has been one of the most important ones. A number of different mechanisms have been tried, including price supports, loans, supply control incentives, and various types of payments. The 2002 Farm Bill contains three different types of payments, each relates differently to commodity prices.

Handbook Updates

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

2003 Iowa Farm Custom Rate Survey — File A3-10 (4 pages)

Historic Iowa Farm Custom Rate Survey — File A3-12 (3 pages)

Farmland Value Survey (Realtors Land Institute) — File C2-75 (2 pages)

Please add these files to your handbook and remove the out-of-date material.

Direct Payments

Direct payments have replaced other farm payments received in recent years that were known variously as AMTA, Fair, Market Loss Assistance, and Oilseed Payments. Direct payments apply to all program crops, and are determined by the acres in each crop base and the program yield for that crop. A fixed rate per bushel is paid, $.28 for corn and $.44 for soybeans. However, direct payments are made on proven yields from the early 1980s and on 85 percent of the crop base acres, so based on current yields payments are only about two-thirds the stated rate.

The most important feature of direct payments is that they are fixed for the next six years once the crop bases and program yields have been established. What happens to acres, yields and prices after that will not change the value of the payments. So, direct payments have essentially no effect on price risk, except that they provide an extra cash infusion in addition to the revenue received from the market.

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Counter Cyclical Payments

The most discussed feature of the new commodity programs has been the counter cyclical payment. Counter cyclical payments are paid when the average national marketing year price is below $2.32 for corn and below $5.36 for soybeans. The yearly average price is an average of cash prices paid during September to August following harvest. It is weighted by the quantity of grain sold in each month and in each state. Yearly average cash prices in Iowa are generally about $0.10 per bushel below the national average.

Payments are made in three installments during the marketing year. Payment rates are set at the difference between the final season average price and the trigger prices mentioned above. The maximum payment rates are $0.34 per bushel for corn and $0.36 per bushel for soybeans. However, payments are based on only 85 percent of the base acres for each crop. Moreover, program yields are only 93.5 percent of recent average yields, or even less if old crop bases were retained. Thus, for each $0.10 that market prices fall below the trigger levels, the actual counter cyclical payment is about $0.08 per bushel or less.

In addition, counter cyclical payments are based on historical crop acres and yields, not current production. For example, if a farm has a 100 percent corn base but is planting 50 percent corn and 50 percent soybeans now, the counter cyclical payment provides double price risk protection for corn, but none at all for soybeans.

So, while counter cyclical payments are tied somewhat to commodity prices, it is a rather strange relationship. They do not take the place of forward pricing tools or crop revenue insurance when it comes to price risk management.

Loan Deficiency Payments

During the low grain prices of recent years, corn and soybean producers became very adept at applying for loan deficiency payments (LDPs). The new farm bill retains the same mechanism. Market loans are also available, just as before. Any time that local market prices, as measured by the posted county price in each Farm Service Agency office, fall below the county loan rate for a given commodity, a producer can apply for a loan deficiency payment equal to the difference. Payments are made on bushels that have not yet been sold or "LDPed."

Because loan deficiency payments are paid on bushels actually produced each year, they provide very direct risk protection against low prices. The average loan rates in Iowa are $1.90 for corn and $4.93 for soybeans, but they vary by county. The 2002 farm bill raised county loan rates for corn by $0.12 per bushel in Iowa, and lowered rates for soybeans by $0.26.

The charts on this page show how the total revenue received per bushel changes as Iowa market prices move higher. Direct payments are made regardless of price. Loan deficiency payments diminish as the market price rises to the loan rate, and counter cyclical payments disappear when the national price exceeds the

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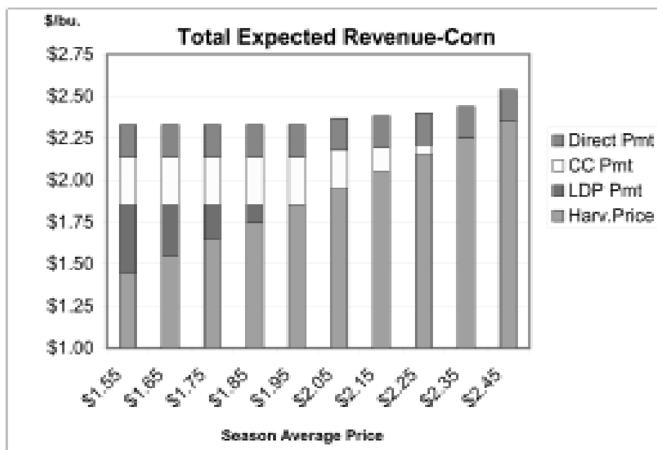

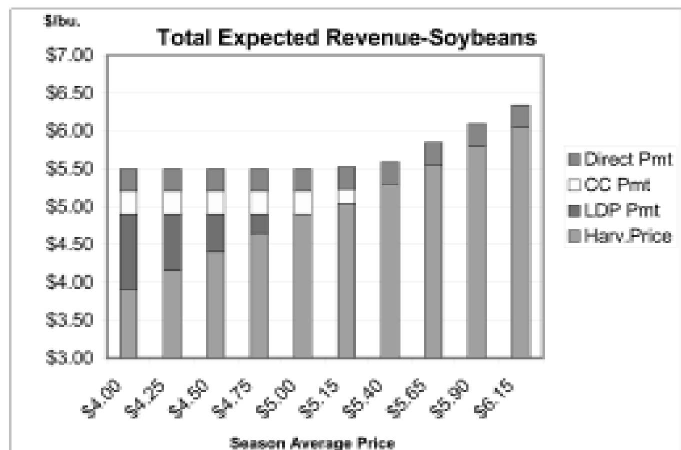

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trigger price level. Note that the minimum total revenue per bushel is around $2.33 per bushel for corn and $5.50 per bushel for soybeans. Without the direct payments the minimum revenues are $2.14 and $5.21, respectively. These values will change some if current acres and yields differ from production levels recorded from 1998 through 2001.

In summary, LDPs provide a price floor for actual production. Counter cyclical payments provide some additional price protection. Both of these are fixed through 2007, except that the loan rate for corn will drop by $0.03 in 2004. Neither of these features provides any protection against yield risk. Farmers in the Great Plains and the eastern Corn Belt found this out in 2002. Many of them suffered large yield losses due to drought, yet, since prices increased, they received only the direct payment under the new bill. As a result Congress approved emergency disaster payments for some affected areas.

Purchasing QFOBI Assets from the Estate *

by Neil Harl, Charles F. Curtiss Professor in Agriculture, professor of economics, 515-294-6354, harl@iastate.edu

Typically, assets in a qualified family-owned business interest (QFOBI) pass by inheritance to qualified heirs. The statute requires that the aggregate value of the decedent's qualified family-owned business interests exceed 50 percent of the adjusted gross estate (gross estate less allowable deductions), and that amount or more must be "acquired by any qualified heir from, or passed to any qualified heir from, the decedent…." The question is whether QFOBI assets can pass to qualified heirs by purchase with eligibility retained for the family-owned business deduction and, if so, what the income tax consequences of the sale are to a qualified heir or heirs.

Purchase of land under special use valuation from the estate

Many of the provisions of the family-owned business deduction parallel those for special use valuation. For purposes of special use valuation, the statute specified that, for eligibility for the provision, it was necessary for qualified real property to be "acquired from or passed from the decedent to a qualified heir of the decedent." Until a 1981 amendment was enacted, property was deemed to have been acquired from the decedent if so considered under I.R.C. § 1014(b) which meant that land was ineligible if purchases occurred or options were exercised before the land passed to the qualified heirs. The fact that the title to realty passed immediately to the heirs as a matter of state law subject to being retaken by the estate representative to pay debts and costs apparently was sufficient to meet the test.

The 1981 amendment, retroactive to January 1, 1977, permits property to pass by purchase and not lose eligibility for special use valuation. Under the 1981 amendment, land is considered to have been acquired from or to have passed from the decedent if:

1) the property is so considered to have passed under I.R.C. § 1014(b) relating to income tax basis of property acquired from the decedent;
2) the property is acquired by "any person" from the estate; or
3) the property was acquired by "any person" from a trust (to the extent the property was includible in the decedent's estate.)

Purchase of qualified family-owned business interests

Under the provision for a deduction for qualified family-owned business interests, the assets

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are eligible for a deduction if the qualified family-owned business interests "…are acquired by any qualified heir from, or passed to any qualified heir from, the decedent…." That statement is conditioned by the qualifying requirement that the passage must be within the meaning of I.R.C. § 2032A(e)(9). That is the passage, added in 1981, that allowed property to pass from the estate to qualified heirs by purchase from the estate for purposes of special use valuation. That assures that property can pass by purchase and not lose eligibility for purposes of the family-owned business deduction *if the purchase transaction meets any one of the three tests applicable to special use valuation purchases from the estate.*

What about the income tax basis?

I.R.C. § 1040, enacted to solve problems of income tax basis where land is purchased from the estate, assures that the only gain recognized to an estate in the event of a sale or taxable exchange by the estate is the difference between the fair market value on disposition and the federal estate tax value. That provision was needed for special use valuation because, otherwise, the difference between the special use value and the value on disposition would be taxable gain to the estate.

In the case of the family-owned business deduction, a basis is assured for the assets comprising the qualified family-owned business interest (or for the entity holding those assets) equal to the fair market value at death or the alternate valuation date. Therefore, the gain recognized on sale of qualified family-owned business interests is the difference between the federal estate tax value (fair market value at death or the alternate valuation date) and the value on sale or taxable exchange. If the purchase of assets from the estate is at the federal estate tax value (and fair market value on purchase is no greater than the federal estate tax value), there should be no gain on sale by the estate to a qualified heir or heirs.

Repeal of the family-owned business deduction

The family-owned business deduction does not apply to estates of decedents dying after December 31, 2003. Thus, it appears that the provision *will remain in effect for purposes of recapture for estates of decedents dying before January 1, 2004*, if an election was made under I.R.C. § 2057.

Income-rich Saudi Arabia Prefers Grow-Their-Own Food Security *

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Food security is a policy goal of many nations. One obvious reason a country might adopt food security as a national policy goal is to protect it against the possibility of the loss of the ability to obtain imports due to an embargo, poor crops in exporting nations and events such as war which might cut off or delay needed food imports. In addition, countries may opt for domestic food production as a means of improving their balance of payments by reducing the amount of imported food or as a means of providing employment for a portion of the population.

Given the fact that one-third if its area is the world's largest sand desert and average rainfall is four inches, one of the places one would least expect to adopt a grow-your-own food security goal is Saudi Arabia. Unlike some less developed nations, with its position over some of the world's largest oil reserves, Saudi Arabia has sufficient income to import as much food as it needs.

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Nevertheless, beginning in the early 1970s, Saudi Arabia adopted a policy with the goal of developing an agricultural sector capable of achieving food self-sufficiency. While still importing food and feed products from barley and rice to apples and bananas, Saudi agriculture has made great strides over the last 30-40 years.

Supported by policies that provide up to 1,000 acres of free land as well as machinery and equipment discounts of up to 50 percent, Saudi farmers have increased agriculture's share of GDP from 1.3 percent in 1970 to more than 7 percent in 2002. The area under cultivation has increased from under 400,000 acres in 1976 to more than 9 million acres today. Agriculture also supplies significant employment opportunities. Today 12 percent of the Saudi workforce is employed in the agricultural sector.

In addition to help with land and equipment, the Saudi government has embarked on water impoundment projects to make sure that they get full use of the four inches of rainfall they receive. Water is also obtained from deep wells and large desalinization projects. The goal of these water projects is to provide sufficient water for human as well as agricultural and industrial uses. Treated wastewater is used for industrial and agricultural purposes. As a result of these water projects, large tracts of desert have been transformed into fertile farmland.

The Saudi government has also established agricultural research stations as well as an extension service to help farmers figure out how to adapt their farming methods to the harsh desert climate. While Saudi Arabia once imported large amounts of wheat, today the country is nearly self-sufficient in wheat production, importing specialty flours and exporting surplus production. In comparison to the U.S. average wheat yield of 40 bu./ac., Saudi farmers reap 70 bu./ac. Of course, the larger yields do not necessarily mean that it wouldn't be cheaper overall to import the wheat. But, food security is a part of national security.

Saudi agriculture faces a number of challenges. One of the most serious challenges is the issue of water. The underground aquifers are being drawn down faster than the recharge rate. As a result, the rapidly growing population may end up competing with agriculture for scarce water resources.

When Are Livestock Exchanges "Like-Kind"?*

by Neil Harl, Charles F. Curtiss Professor in Agriculture, professor of economics, 515-294-6354, harl@iastate.edu

Although less common than like-kind exchanges of real estate or machinery, exchanges of livestock appear to be occurring more frequently in recent years. Except for the statutory bar for exchanges of livestock of different sexes, the rules governing livestock exchanges are less well known. The regulations adopted in 1991 have provided more definitive guidelines for like-kind exchanges of livestock (and other assets) than were available previously.

Regulation guidance

The regulations specify that depreciable tangible personal property can satisfy the like-kind requirement in two ways—(1) by showing that the property in question is exchanged for property that is of a *like class* or (2) by showing that the property in question is exchanged for property of a *like-kind*.

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- In determining whether property meets the test of being "like-kind," all facts and circumstances are to be considered.
- Depreciable tangible personal property can satisfy the like-kind requirement if it is exchanged for property of a like class. Depreciable tangible personal property is a "like class" to other depreciable tangible personal property if the exchanged properties are either within the same general asset class or the same product class. Livestock are not listed in the 13 general asset classes.

As for product classes, the regulations specify that a single property cannot be classified within more than one product class and that the property's product class is determined as of the date of the exchange. A product class consists of depreciable personal property that is listed in a product class in the *Standard Industrial Classification System Manual* (SIC) (1987), prepared by the Office of Management and Budget. Under the SIC system, dairy cattle are listed with a classification of 0241; beef cattle are given a classification of 0212. Therefore, an exchange of beef cows for dairy cows is not a like-kind exchange.

The SIC system has been replaced with the *North American Industrial Classification System* (NAICS); however, the Internal Revenue Service has not issued guidance on using the NAICS for federal income tax purposes and has advised that taxpayers should continue to use the four digit SIC system until guidance is published.

Other classifications under the four-digit SIC system includeæ

Property	Classification
Hogs	0213
Poultry	0259
Sheep and goats	0214
Horses	0272
Rabbits, fur-bearing animals	0271

Cases predating the regulations

In the 1967 case of *Woodbury v. Commissioner*, the parties entered into a multi-party, multi-step transaction whereby 225 cows and calves and 425 mixed yearlings were exchanged. The tax court agreed that the 225 cows with calves by side were held for breeding purposes rather than for sale but only 103 of the mixed yearlings received were held for breeding purposes; the rest of the mixed yearlings were held primarily for sale.

In the 1968 case of *Wylie v. United States*, the taxpayer traded 49 head of steer calves ranging in age from 7 to 11 months of age (which were not held for sale in the ordinary course of business) for registered Aberdeen-Angus cattle. The court held that income was not realized (or recognized) on the exchange.

In a case decided in 1978, half-blood heifers and three-quarter blood heifers were held to qualify as like-kind. In that case, the taxpayer agreed to deliver 12 three-quarter blood heifers in exchange for 12 one-half blood heifers. The three-quarter blood heifers were the offspring of artificial insemination of the 12 half-blood heifers which had been received earlier. Since the taxpayer had deducted the costs of raising the three-quarter blood heifers, giving the animals a zero basis, the half blood heifers received in exchange were ineligible for investment tax credit, despite the higher value placed on the three-quarter blood heifers. The court said the fair market value of the three-quarter blood heifers was without significance.

In conclusion

For livestock, the major concern at present is in accessing the classification reference, the *Standard Industrial Classification System Manual* (1987). After guidance is issued by IRS, the problem will be in accessing the *North American Industrial Classification System* (2002).

. . . and justice for all
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Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Stanley R. Johnson, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.

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