



Agricultural Law Press

Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

* * * *

Issue Contents

Animals

Horses **27**

Bankruptcy

Federal taxation

Penalties **27**

Federal Agricultural Programs

Brucellosis **27**

Farm labor **27**

PACA **27**

Wheat **27**

Federal Estate and Gift Taxation

Charitable deduction **28**

Disclaimers **28**

Gift **28**

Marital deduction **28**

Statute of limitation **28**

Transferee liability **28**

Trusts **28**

Federal Income Taxation

Capital assets **29**

Cooperatives **29**

Court awards and settlements **29**

Disaster losses **29**

Employee expenses **29**

Hobby losses **30**

Like-kind exchanges **30**

Moving expenses **30**

Passive activity losses **30**

Pension plans **31**

Repairs **31**

Returns **31**

Safe harbor interest rates

March 2005 **31**

Sale of residence **31**

Transferee liability **31**

Water Law

Arkansas River Compact **32**

Ground water **32**

Agricultural Law Digest

Volume 16, No. 4

February 25, 2005

ISSN 1051-2780

Guidance on New Domestic Production Deduction

-by Neil E. Harl*

The driving force behind the bill that ultimately became the American Jobs Creation Act of 2004¹ was pressure from the World Trade Organization to repeal the Extra-Territorial Income Exclusion Act of 2000.² That Act had been branded as “inconsistent with international trade agreements” by WTO in early 2002.³ The resultant legislation contained far more than repeal of the 2000 Act, which the legislation accomplished,⁴ and included a successor to the repealed legislation which has virtually nothing to do with international trade.⁵ That provision, a deduction for “domestic production activities,” is available to taxpayers with gross receipts derived from property which was “manufactured, produced, grown, or extracted” in the United States.⁶

In mid-January 2005, the Internal Revenue Service issued interim guidance on key provisions of the domestic production deduction and announced that IRS and the Treasury Department are developing regulations regarding the deduction.⁷ The provision is first effective for tax years beginning after December 31, 2004.⁸ The interim guidance provides some assistance in planning for the deduction, first claimable on 2005 returns, but leaves several major concerns unresolved.

Overview

The deduction starts out at three percent (for 2005 and 2006), rises to six percent for 2007 – 2009) and plateaus at nine percent after 2009 of the lesser of (1) the “qualified production activities income” of the taxable year, or (2) the taxpayer’s taxable income for the year.⁹ The taxable income limitation excludes taxpayers with current year net operating losses or NOL carryovers that eliminate current year taxable income.¹⁰ For an individual, adjusted gross income is substituted for taxable income.¹¹ The deduction cannot exceed 50 percent of the W-2 wages of the employer for the taxable year.¹² The term W-2 wages includes amounts required to be included on statements under I.R.C. § 6051(a)(3), (8). That includes wages as defined in I.R.C. § 3401(a) (which does not include any remuneration, other than cash, for agricultural labor), and elective deferrals.

The term “qualified production activities income” equals the taxpayer’s “domestic production gross receipts” over the sum of the cost of goods sold, other expenses allocable to such receipts and a ratable portion of other expenses and losses not directly allocable to such receipts.¹³ A key part of the provision is the definition of “domestic production gross receipts” which includes gross receipts derived from any lease, rental, license, sale, exchange or other disposition of qualifying production property which was “manufactured, produced, grown, or extracted” by the taxpayer in whole or significant part within the United States.¹⁴ The provision makes specific reference to

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

several areas of economic activity in addition including the generation of electricity, construction performed and engineering or architectural services performed in the United States.¹⁵

The deduction is allowed for alternative minimum tax purposes¹⁶ and is available for passthrough entities and cooperatives¹⁷ as well as for individual taxpayers.¹⁸

Trade or business requirement

The statute specifically provides that “this section shall be applied by only taking into account items which are attributable to the *actual conduct of a trade or business*.”¹⁹ The interim guidance mirrors the statute in identical language.²⁰ That could well spell bad news for farm landlords who are not materially participating under a lease.²¹ However, neither the statute nor the interim guidance indicate which meaning of “trade or business” is to be used in implementing the provision. Several different definitions of the term “trade or business” are in use.

The least demanding is the meaning of the term for purposes of income averaging for farmers and fishermen.²² For purposes of that provision, rental income under a share-rent lease is treated as income from a farming business (a requirement of eligibility for income averaging is that the individual be “engaged in a farming business”²³); whether the landlord is participating in the operation is immaterial.²⁴ Thus, a non-materially participating share rent landlord appears to be eligible.²⁵

One notch up the scale is the requirement for purposes of expense method depreciation which specifies that the taxpayer must “meaningfully participate(s) in the management or operations of the trade or business.”²⁶ The regulations make the point that it is a facts and circumstances test.²⁷

The standard test, imposed for several purposes including liability for self-employment tax,²⁸ the material participation test for special use valuation purposes²⁹ and material participation for recapture under the family-owned business deduction,³⁰ is the well-known test of “material participation.” That test is not met by non-materially participating farm landlords, who normally file on Form 4835 rather than Schedule F.

The term “active management” was created by Congress in 1981 which substitutes for material participation in the case of surviving spouses who acquire real property from a deceased spouse for purposes of special use valuation.³¹

Finally, a more demanding meaning of the term “material participation” was imposed in 1986 for purposes of determining whether an activity is considered a passive activity under the passive loss rules.³² That meaning of the term requires that the taxpayer be involved in the activity on a basis which is “regular, continuous, and substantial.”³³

In conclusion

For non-materially participating landlords, including those in retirement and those who are disabled as well as those who simply choose not to be substantially involved in the farming operation under the lease, the question of which meaning of the term “trade or business” is imposed on the provision authorizing the new deduction³⁴ takes on great importance. It should also be noted that the provision imposing the standard “material

participation” test also contains a bar on imputation of activities of an agent such as a farm manager to the land owner.³⁵

The Internal Revenue Service is urged to resolve this issue at an early date. Rendering non-material participation landlords ineligible for the deduction essentially imposes a 3 to 9 percent “tax” on the decision to operate under a non-material participation share lease.

FOOTNOTES

¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004). See Harl, “American Jobs Creation Act of 2004: Selected Provisions,” 15 *Agric. L. Dig.* 161 (2004).

² Pub. L. No. 106-519, 114 Stat. 2423 (2000).

³ See generally 4 Harl, *Agricultural Law* § 27.03 (2004); Harl, *Agricultural Law Manual* § 4.02 (2004).

⁴ American Jobs Creation Act of 2004, Sec. 101, hereinafter AJCA.

⁵ I.R.C. § 199, enacted by AJCA, Sec. 102.

⁶ I.R.C. § 199(c).

⁷ Notice 2005-14, I.R.B. 2005-7.

⁸ AJCA, Sec. 102(e).

⁹ I.R.C. § 199(a).

¹⁰ See I.R.C. §§ 63, 172.

¹¹ I.R.C. § 199(d)(2).

¹² I.R.C. § 199(b)(1).

¹³ I.R.C. § 199(c)(1).

¹⁴ I.R.C. § 199(c)(4).

¹⁵ I.R.C. § 199(c)(4)(A)(i).

¹⁶ I.R.C. § 199(d)(6).

¹⁷ I.R.C. § 199(d)(3).

¹⁸ I.R.C. § 199(d)(1), (2).

¹⁹ I.R.C. § 199(d)(5) (emphasis added).

²⁰ Notice 2005-14, I.R.B. 2005-7.

²¹ See I.R.C. § 1402(a)(1).

²² I.R.C. § 1301.

²³ I.R.C. § 1301.

²⁴ Treas. Reg. § 1.1301-1(b)(2).

²⁵ *Id.*

²⁶ Treas. Reg. § 1.179-2(c)(6)(ii).

²⁷ *Id.*

²⁸ I.R.C. 1402(a)(1).

²⁹ See I.R.C. § 2032A(e)(6).

³⁰ I.R.C. §§ 2057(b)(1)(D)(ii), 2057(f)(1)(A).

³¹ I.R.C. § 2032A(b)(5).

³² I.R.C. § 469(c)(1).

³³ I.R.C. § 469(h)(1).

³⁴ I.R.C. § 199.

³⁵ See I.R.C. § 1402(a)(1).