Introduction:

Several tax law changes have occurred in the past year and those changes have an enormous effect on farmers. This information piece is designed to outline those changes so farmers can take advantage of the new tax laws. The intent is to enable farmers to minimize their tax obligation within the tax law.

Taxation of Government Program Payments:

There are a number of government programs that farmers participate in. Generally, payments are made to farmers participating in those programs. Each program payment can have a slightly different tax procedure. The various programs and the appropriate tax procedure are outlined below.

2002 Farm Bill Direct Payments: These payments are guaranteed to the farmer. The payment is split into two payments. One-half of the payment is advanced at the time of program participation sign-up. The second half of the total payment is made in the fall the covered commodity crop is harvested.

The payment income is taxable in the year received. Depending upon when the farmer signs up for the program, the payments may be received in the same year or they may be received in two different years. The farmer has the option of choosing for tax planning purposes.

2002 Farm Bill Counter-Cyclical Payments: These payments are not guaranteed to the farmer and must be “earned” based upon market price and bushels of crop sold nationally. The payments can be made to farmers at three different times over the course of a 12 month period. If earned, there are two advanced and one final payment made. These payments are taxable in the year received. The farmer does have the option of foregoing the advanced payments, if earned, until the end of the 12 month period. These payments could then be received in the same year or two different years, depending upon the tax strategy of the farmer.

Loan Deficiency Payments (LDP): LDP payments apply to covered commodity crops that have not yet been placed under CCC loan. When the Posted County Price (PCP) is above the local cash price, an LDP can be earned by the farmer. Because the PCP changes daily, the farmer will receive a different LDP rate depending upon the date selected.

LDP payments are considered ordinary income and are taxable in the year received.

Market Gain on CCC Loans: Market gain applies only to those bushels of covered commodity crop placed under CCC loan. The farmer has a choice of tax reporting of the CCC loan proceeds. They can elect either the loan method or the income method of tax reporting. The method selected will dictate the tax procedure.

Under the loan method, no income is reported when securing the CCC loan. If the loan is “bought back” at less than the loan principal and/or interest amount, there is market gain. For tax reporting, the farmer would report the loan interest and principal forgiven (gain) which is listed on IRS Form 1099. This gain would be added to the sale income of the grain to equal the total income amount for tax purposes. Caution: do not include the loan amount as income in addition to the gain and sale income – this would result in over reporting of income.

Under the income method, the farmer would report the loan amount as income. If the loan is “bought back” at less than the loan principal and/or interest amount, there is market gain. For tax reporting, the farmer would report the difference between the grain sale price and the grain basis (PCP), as gain. The loan income plus the gain would be the total for tax reporting purposes. Caution: do not include the total
grain sale amount in the total income amount for the transaction. Doing so will result in over reporting of income and an increase in tax liability.

NOTE: In 2002 the law changed regarding the selection of either the loan or income method for tax reporting. Farmers can now change their election of methods for tax reporting on CCC loans. A change from the income method to the loan method requires the completion of and filing with their tax return, IRS Form 3115. This change is considered a change in accounting method and has automatic approval from the IRS Commissioner.

Farmers can also change from the loan method to the income method. This change is called an I.R.C § 77 election and requires filing the election with the tax return.

Each method is somewhat different but both are allowed under the new tax law. These changes can be made year by year but all covered commodity crops in any given year must be treated the same. That is, if the farmer has selected the income method for tax reporting, all CCC loan crops in the same year are subject to that reporting method.

Because all crops in the same year are subject to the same tax reporting election, there is a potential tax planning problem with this issue. Assume a farmer puts 2002 corn under CCC loan on May 31, 2003. The loan will mature in January 2004. Assume further that the same farmer will place under CCC loan the 2003 corn crop in the fall of 2003. If the farmer changes the tax reporting method to accommodate the fall 2003 loan, the 2002 corn loan taken on May 31 must be changed as well. Be sure to consult your accountant if you find yourself in this situation.

Milk Income Loss Contract Payments (MILC): The MILC payments were authorized under the 2002 Farm Bill and were intended to compensate dairy farmers when the price of milk fell below a certain level. MILC payments are taxed as income in the year received, not in the year the producer first had a right to receive the payments.

Because the program allows the producer to select which month they begin receiving payments for their eligible production up to 2.4 million pounds of milk per year, there are lots of opportunities for tax planning around these payments. However, once a starting month has been chosen for a fiscal year, it can not be changed until the following year.

Conservation Reserve Program (CRP): The CRP contracts range from 10-15 years in length and are accepted as a result of a bidding and point accumulation process. Land offered to the program is usually whole complete crop fields. Payments are made annually over the life of the contract. Payments are considered income and are taxed in the year received. Also, based upon district court rulings, the payments are considered “ag program payments” not rent payments for active farmers materially participating in a trade or business (farming). That means for farmers engaged in production agriculture and receiving CRP payments, the payments are subject to Self-Employment Tax.

For non-farmers not engaged in production agriculture, the payments are still taxed as income in the year received but are not subject to Self-Employment Tax. These individuals would report the income on IRS Form 4835.

CRP – Continuous Sign-up Enhancement: This CRP program is not accomplished through a bidding process. The land offered must meet all CRP requirements and if so, are automatically accepted into the program. The land accepted is usually small parcels of property and include areas for buffer strips, grass waterways, etc. rather than whole fields. The contract lengths vary by years depending upon which program the land owner signs up for. Included in the sign-up options are Sign-up Incentive Payments (SIP) and Practice Incentive Payments (PIP).

In addition to the regular CRP payment, a one time SIP of $100 per acre for a 10 year contract or $150 per acre for a 15 year contract is made. The CRP payment taxation rules are the same as mentioned previously. The SIP is considered an ordinary government program payment and is taxable in the year received. In addition, the SIP are not eligible for the I.R.C. § 126 exclusion for cost sharing payments for capital conservation expenditures.

The PIP is a cost sharing payment available for the installation of the conservation practice. For 2002 the PIP percentage was 50 percent of the installation cost. Like the SIP, the PIP is considered government program income and taxable in the year received. However, the farmer’s expenses of installing the practice, generally qualify for deduction as a soil and water conservation expense under I.R.C. § 175.
Conservation Reserve Enhancement Program (CREP): This program is in conjunction with the State of MN. and targets specific geographic areas of the state. The contract length is either 10 or 15 years. Included are provisions for the landowner to assign either temporary or permanent conservation easements to the enrolled land. Payments made under CREP receive the same tax treatment as the CRP payments.

Easement payments under CREP are treated differently based upon length of the easement. For easements less than 30 years, the payments are considered ordinary income and are subject to tax in the year received. Easements lasting 30 years or more are generally treated as being permanent. Payments will first be used to reduce the basis in the enrolled land. Any payment amount in excess of the basis of the land, will result in an I.R.C. § 1231 gain and is treated as capital gain.

Environmental Quality Incentive Program (EQIP): EQIP provides for the reimbursement of up to 75 percent (90 percent for limited-resource and beginning farmers and ranchers) of the cost of qualified conservation practices to enrolled farmers. In addition to the regular payments, incentive payments are also made for the adoption of certain qualifying practices. Cost sharing payments for the installation of the practices that qualify for I.R.C. § 126 requirements are eligible for partial or total exclusion from income.

The incentive payments that are designed to encourage farmers to adopt land management practices are not excludable from income and are taxed accordingly. However, the costs associated with the management practice are generally considered expenses and are currently deductible.

Wetlands Reserve Program (WRP): Under the WRP, landowners are able to apply for either a conservation easement that is permanent or 30 years in length or a cost-share restoration agreement. Ownership of the land is retained by the applicant, but future use is dictated by the easement or cost-share restoration agreement.

Payments under the permanent or 30 year easement are treated like those under the CREP program. Cost-share restoration agreement payments are subject to exclusion under I.R.C. § 126.

Wildlife Habitat Incentives Program (WHIP): The intent of this program is to assist landowners in the developing and improving wildlife habitat. Contracts are for not less than 5 years or more than 10 years. Payments under the program are cost-sharing payments. Cost-sharing payments are eligible for exclusion under I.R.C. § 126. Expenditures by the landowner are not deductible as soil and water conservation expenses under I.R.C. § 175 since the land is not being used for production agriculture.

Conservation Security Program (CSP): This program includes annual payments and cost-sharing payments. Annual payments are based upon a percentage of the “base payment” defined as the national land rental rates by land use. Landowners can participate at one of three tier levels: Tier #1 – a 5 year term, addressing at minimum of one resource concern, with an annual payment of 5 percent of the determined base payment; Tier #2 – a 10 year term, addressing a minimum of one resource concern, and an annual payment of 10 percent of the determined base payment; and Tier #3 – a 15 year term, addressing all applicable resource concerns, and an annual payment of 15 percent of the determined base payment.

The annual payments are treated the same as annual payments under the CRP program. Payments are considered ordinary income and taxed in the year received. If the landowner is actively engaged in the farm business, the payments are also subject to Self-Employment tax. If not engaged in farming, the payments are not subject to Self-Employment tax.

The cost-share payments under the program are made for: 1) adoption of new management, vegetative, and land-based structural practices; 2) maintenance of existing land management and vegetative practices; and 3) maintenance of existing land-based structural practices approved by the Secretary of Agriculture but not covered by a Federal or State maintenance requirement.

Cost-share payments will be considered as ordinary income and taxed the year received. Deductible business expenses or expenses under soil and water conservation (I.R.C. § 175) are allowed.

Grassland Reserve Program (GRP): Under the GRP, landowners can enroll contiguous parcels of land at least 40 acres in size in a 10, 15, 20 or 30 year contract or greater than 30 year permanent easement.

Annual payments under the 10 – 30 year contracts will not exceed 75 percent of the grazing rental value of the
land. The payments will be considered ordinary income and are subject to the same tax treatment as CRP annual payments. Easement payments will first be used to reduce the basis in the land. Any payments in excess of the basis in the land will result in an I.R.C. § 1231 gain and are treated as capital gain.

**Cost-Sharing Payments for Capital Expenditures (I.R.C. § 126) Provision:**

For many of the conservation programs mentioned previously, the tax treatment of the payments involves the use of I.R.C. § 126. Following is an explanation of the code and an example of how it might work.

**Eligibility:** part or all of a payment received for participation in certain cost-sharing programs for conservation, reclamation, and restoration of land may be excluded from the taxpayer participant’s income. To be eligible for the exclusion, the following three provisions must be met: 1) the payment must be a cost-sharing payment for a capital expenditure (payment included as income and expenses claimed to offset the income), 2) the capital expenditure for which the payment is made can not substantially increase the annual income of the property (defined as 10 percent of the average annual gross receipts from the property over the past three years immediately prior to the improvement or an amount equal to $2.50 times the number of affected acres); and 3) the payment must be certified by the Secretary of Agriculture as having been made primarily for soil and water conservation, environmental protection or restoration, improving forests, or providing wildlife habitat.

**Example:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Improvement</td>
<td>$60,000</td>
</tr>
<tr>
<td>Increase in Property Value</td>
<td>$50,000</td>
</tr>
<tr>
<td>Value of I.R.C. 126 Improvement</td>
<td>$50,000</td>
</tr>
<tr>
<td>Cost Share Payment</td>
<td>$45,000</td>
</tr>
<tr>
<td>Landowner Share of Cost</td>
<td>$15,000</td>
</tr>
<tr>
<td>Avg. Annual Gross Receipts</td>
<td>$27,000</td>
</tr>
<tr>
<td>Opportunity Cost of Money</td>
<td>6%</td>
</tr>
<tr>
<td>Excludable Portion:</td>
<td></td>
</tr>
<tr>
<td>10% X $27,000 ÷ .06 =</td>
<td>$45,000</td>
</tr>
<tr>
<td>Value of 126 Improvement</td>
<td>$50,000</td>
</tr>
<tr>
<td>Minus excludable amount</td>
<td>-$45,000</td>
</tr>
<tr>
<td>Minus landowner share</td>
<td>-$15,000</td>
</tr>
<tr>
<td>Taxable Amount</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

**Changes in Depreciation:**

Recent federal legislation has resulted in several changes in the tax law related to depreciation. Those changes affect Section 179 Depreciation as well as the First Year “Bonus “ Depreciation provision.

**Section 179 Depreciation: The Section 179 expensing deduction for first year depreciation increases to $100,000, beginning January 1, 2003, for the years 2003, 2004, and 2005. This is an increase from $24,000 in 2002. The new provision means that taxpayers can expense up to $100,000 of equipment purchases in the first year. Drainage tile and single-purpose farm buildings, such as hog barns and dairy barns in addition to equipment, qualify for this option.**

In the past, the Section 179 deduction started to phase out if you bought and placed into service more than $200,000 of qualifying property in one year. That threshold has been increased to $400,000. The write-off is then reduced dollar for dollar of total property placed in service if the threshold is exceeded. The write-off will phase out completely if purchases are $500,000 or more.

Vehicles with a gross vehicle weight of 6,000 pounds or more still qualify for the deduction; light trucks and smaller cars do not qualify. However, computer software now qualifies for Section 179 Depreciation allowance.

The $100,000 provision under Section 179 Depreciation allowance is due to be phased out after 2005. The Section 179 allowance will revert to an amount of $25,000.

**First Year “Bonus” Depreciation:** The bonus depreciation provision includes both a 30% and a 50% provision. Both are explained in the following sections.

1) 30% Bonus Depreciation: On March 9, 2002, President Bush signed into law the Job Creation and Worker Assistance Act of 2002. One of the provisions contained in the bill that is especially important to farmers was a 30% bonus depreciation deduction for new property. Farm property covered under this provision would include breeding stock, machinery, new drainage tile, and single or multi-purpose buildings such as machine sheds.

For property to qualify under this provision, four requirements have to be met.
Those requirements are: 1) the property must be new or original use property, 2) the property must be subject to MACRS depreciation with a useful life of 20 years or less, 3) the property must have been purchased or have a binding contract applicable after September 10, 2001 and before January 1, 2005, and 4) the property must be placed into service before January 1, 2005.

Examples: 1) dairy or beef cows that have not calved or produced milk prior to purchase, 2) new equipment that is indeed new and not overhauled, 3) leased equipment such as a tractor that has been purchased and put into use, 4) a single-use building such as a machine shed, hog, or dairy barn that is new construction, etc. First year depreciation on autos is limited to $4,600 and is in addition to the regular limits of $3,060.

Property that does not qualify for the 30% bonus depreciation include: 1) property used 50% or less in trade or business, 2) other property subject to the ADS depreciation rules and 3) property used by any other person before September 11, 2001.

Examples: 1) dairy or beef cows that have calved or produced milk prior to purchase, 2) a bull purchased for breeding but is not old enough until after January 1, 2005, 3) used buildings moved onto the farm for farming purposes, and 4) overhauled equipment etc.

2) 50% Bonus Depreciation: As part of the Jobs and Growth Relief Reconciliation Act of 2003, the first year "bonus" depreciation on new equipment increases from 30% to 50%.

Qualified property includes new or original use property just as in the 30% bonus depreciation provision. This includes machinery, breeding stock, as well as single and multi-purpose use buildings.

What is new about the 50% bonus depreciation provision is the date upon which the property must be placed into service. For the 50% bonus depreciation provision, new property must be purchased and placed in service after May 5, 2003 and before January 1, 2005.

Under the 50% bonus depreciation provision, first year depreciation of autos is increased to $7,650 and is in addition to the regular limits of $3,060.

NOTE: With the introduction of the 2003 tax law changes for depreciation, farmers now have the option of using the 30% OR the 50% bonus depreciation, depending upon when the property was purchased.

Property purchased or with a binding contract assigned dated after September 10, 2001 but prior to May 5, 2003, still qualifies for the 30% allowance only, even if the property is placed into service after May 5, 2003. Property purchased or assigned a binding contract dated after May 5, 2003 qualifies for either the 30% or the 50% allowance, depending upon the tax strategy of the tax payer.

Ordering Rules for Depreciation: Based upon the tax law changes, there are several choices for depreciation available to the farmer. That fact has necessitated the implementation of ordering rules or an order in which the different depreciation elections can be taken.

The order in which the depreciation elections can be taken are as follows: 1) any Section 179 depreciation, 2) 30% OR 50% bonus depreciation, depending upon the date of purchase (mentioned previously), and 3) regular depreciation such as MACRS.

Example:

<table>
<thead>
<tr>
<th>New combine purchase on May 6, 2003</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$200,000</td>
</tr>
<tr>
<td>Section 179 Depreciation</td>
<td>$100,000</td>
</tr>
<tr>
<td>Bonus depreciation (50%)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Straight Line MACRS, HY, 7 yrs.</td>
<td>$3,571</td>
</tr>
<tr>
<td>Total depreciation (1st Year)</td>
<td>$153,571</td>
</tr>
</tbody>
</table>

1031 Exchange Rules: On traded items of property, the 30% or 50% bonus depreciation that applies, is taken on the boot and on the remaining basis of the traded property.

Example:

<table>
<thead>
<tr>
<th>New tractor purchased on May 6, 2003</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Boot paid</td>
<td>$50,000</td>
</tr>
<tr>
<td>Old tractor trade in tax basis</td>
<td>$50,000</td>
</tr>
<tr>
<td>Total tax basis in new tractor</td>
<td>$100,000</td>
</tr>
<tr>
<td>Bonus depreciation</td>
<td>$50,000</td>
</tr>
<tr>
<td>$100,000 X .50</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

Electing Out of Bonus Depreciation: Farmers can elect not to take the bonus depreciation. In order to do so, there are three points the tax payer needs to be aware of: Those points are: 1) the tax payer must elect out for each class of property (equipment, buildings, breeding livestock, etc.), 2) property not elected out yet no bonus depreciation is taken, the property will
automatically have the basis reduced by 30% or 50%, depending upon purchase date, and 3) the tax payer can elect to take either the 30% or the 50% bonus depreciation, but not both, based upon qualification guidelines mentioned previously.

Amending Tax Returns for Bonus Depreciation: A tax payer can amend their tax return for the 2001 and 2002 tax years. This would allow them to claim the 30% bonus depreciation on the unused basis of traded items. Check with your tax accountant if this issue affects you.

Re-determined Basis: If property is sold, purchased, or involves debt discharge, the basis of the property is likely to change. Tax law changes determine how to deal with this basis re-determination.

If the basis increases and the property qualified originally for the bonus depreciation, the 30% or 50% bonus depreciation (depending upon purchase date) can be claimed.

If the basis decreases, the tax payer recalculates the 30% or 50% bonus depreciation and pays tax on an amount equal to the additional first year depreciation claimed on the amount of the decrease.

This area of the tax law is very complex. If this issue affects you, contact your tax accountant for clarification.

Minnesota Tax Law and the Bonus Depreciation: The State of Minnesota, as well as many other states, do not allow the claiming of the total bonus depreciation in the year taken on the federal tax return. Only a percent is allowed on the state return in a given year.

For Minnesota, 80% of either the 30% or 50% bonus depreciation must be added back onto the state tax return in the year the bonus depreciation is taken. The tax payer then recovers the remaining 80% bonus depreciation by claiming equal installments over the next 5 years.

To accomplish this, the tax payer adds the 80% of the bonus depreciation to Line 4 of Schedule M1M and then writes “bonus depreciation” next to the line.

NOTE: Even though the new rules and the bonus depreciation allow for a tremendous amount of tax strategy and ability to level out income, it also causes a need for excellent records relating to depreciation. It is suggested that as many as two separate depreciation schedules are needed to insure proper compliance with the new rules. Those schedules would include: 1) a record of all property not qualifying for the bonus depreciation, and 2) a record of all property that qualifies for the bonus depreciation. This is complex so check with your tax accountant.

Self-Employment Tax Changes:

Self-Employment Tax on Land & Building Rent Received From an Entity: Until 1995, the IRS has not paid much attention to the issue of land rent or building and facility rent received from an entity – that is, as a land or building owner receiving rent from a partnership or corporation. However, since that time, there have been several circuit court rulings on this issue. The current ruling states that if a land owner rents that land to a partnership, corporation, etc., and they are a member of that entity, the land rent paid to them is not subject to self-employment tax if the rental amount is a fair rental rate.

Rent paid by an entity for buildings and facilities owned by a participant in the entity is subject to the same rules as land rent.

Be cautious with this issue. Check with your tax accountant because the rulings can change frequently.

Other Self-Employment Tax Issues: Maximum earnings subject to Self-Employment/Social Security Tax is $87,000 and a rate of 12.4%. Earnings subject to Medicare Tax is unlimited and a rate of 2.9%

Annual earning limits on Self-Employment/Social Security Tax have changed. For fully retired individuals age 65 and over, there is no limit to earnings. For individuals not fully retired and under age 65, the limit on income is $11,520.

Deferred Contract Sales and Alternative Minimum Tax (AMT) Issues:

Deferred contract sales are now allowed. A farmer can sell grain and livestock in one year, sign a deferred payment contract or an installment contract, and postpone payment and recognition of that gain into the following year. Tax on the gain will be calculated for both regular and AMT tax in the following year.

Effective in 1998, certain small corporations became
exempt from the AMT if their three prior year average annual revenues did not exceed $5 million. This amount was raised to $7.5 million in 1999 and later years.

For individuals, the AMT exemption amounts have changed. If married and filing jointly, the exemption increases to $58,000. If married filing separately, the exemption increases to $29,000. If filing single, the exemption increases to $40,250.

**Income Averaging:**

Income averaging has been reinstated, *for farmers only*. Farmers can elect an amount of their current farm income to divide equally among the previous three years. The amount applied to the previous three years is added to the previous year’s taxable income. Savings result if the previous year’s income was taxed at a lower tax rate than the current year.

This election applies to any income that is attributable to a farm business. Farm income includes items of income, deduction, gain and loss attributable to the individual’s farming business. This includes: 1) net Schedule F income, 2) an owner’s share of net income from an S corporation, partnership, or limited liability company, 3) wages received by an S corporation shareholder from the S corporation, and 4) gain from the sale of assets used in the farming business and reported on Form 4797 and/or Schedule D (Form 1040) but not gain from the sale of land or timber.

Farmers are allowed to use a negative farm income for calculations in the base year. However, this loss carried from the base year to other years in the calculation, must be removed from the base year calculation to prevent a double tax benefit.

In addition, the tax payer will lose a portion of the benefit of the income averaging if the calculation reduces the regular tax liability below that calculated using the Alternative Minimum Tax (AMT) method. Check with your tax accountant regarding this issue.

**Capital Gains Tax Changes:**

Additional changes in the capital gains tax rates were made in the 2003 tax legislation. The tax rate levels for land and stock sales were lowered substantially as follows:

- 10-15% federal tax bracket: capital gains rate of 5% (was 10% under previous law)
- 25% federal tax bracket or above: capital gains rate of 15% (was 20% under old law)


Also eliminated in the new tax law was the 5 year holding period requirement. The law also deleted the 8% and 18% capital gains tax rate brackets.

The Alternative Minimum Tax (AMT) calculation applies and the rates are the same as regular rates. There can be a reduction in the capital gains tax if a transfer is made directly to children 14 years of age and older – check with your tax accountant.

Capital Gains Tax rates for building depreciation recapture (Section 1250 property) are as follows:

- 10-15% federal tax bracket: capital gains rate of 10-15%
- 25% federal tax bracket or above: capital gains rate of 25% - maximum 25%

Capital Gains Tax rates for the sale of collectables:

- 10-15% federal tax bracket: capital gains rate of 10-15%
- 25% federal tax bracket or above: capital gains rate of 25% - maximum 28%

This is a critical issue and is complicated so check with your tax accountant for details.

**Disaster Payments and Crop Insurance Indemnity Payments:**

If crop and livestock losses have occurred due to weather conditions, there are some additional tax rules that allow preferential treatment of gains and losses realized as a result of the weather conditions.

For the farmer using the cash method of accounting, there is an exception to the general rule that states disaster and crop insurance payments must be included as income in the year received. The exception allows farmers to postpone reporting the payments by one year. However, the tax payer can not accelerate reporting the payments if the payments are received the year after the loss.
The rule applies when crops cannot be planted or are destroyed by natural disaster such as drought or flood. The rules apply to crop insurance indemnity payments as well as any disaster payments received from the federal government.

To qualify for the exemption, the taxpayer must be able to show that, under the taxpayer’s normal business practices, the income from the crop for which the payment was received would not have been reported in a year following the year of the receipt of the crop insurance or disaster payment.

The taxpayer then has the option to report the crop insurance or disaster payment as income either in the year received or the following year if that is the normal course of business.

Check with your tax accountant regarding the procedure for making this election.

**Sale of Livestock Due to Weather:**

If a farmer is forced to sell livestock because of a shortage of water, grazing, or other consequences of a weather related condition, the recognition of the sale income can be postponed.

There are two different tax treatments that apply here. The first treatment applies to draft, breeding, or dairy animals that will be replaced within a two year period. The second applies to all livestock and allows a one year postponement of the reporting of the sales proceeds.

For election to postpone gain by purchasing replacement animals, livestock (other than poultry) must have been sold due to weather conditions that otherwise would have been held for any length of time for draft, breeding, or dairy (no sporting) purposes. First, the gain does not have to be recognized if the proceeds are used to purchase replacement livestock within a two year period of the end of the tax year of the sale.

Second, the gain does not have to be recognized if the livestock purchased is to be used for the same purpose as that sold – that is, dairy cows replace dairy cows. The taxpayer must show that the weather condition caused the sale of more livestock that would normally be the case. Also, there is no requirement that the weather related conditions caused the area to declared a disaster area by the federal government.

Income can be deferred to a subsequent year but the taxpayer must use the cash method of accounting, the principal business must be farming, there must be more livestock sold than what would normally be sold, and the sale must have been caused by a weather event.

Check with your tax accountant on how this tax provision might affect your farm operation.

**Wind Easements:**

The construction of windmills for generating electricity is becoming more common. In many cases, the entity that constructs the windmill does not own the land upon which it is built. This act then results in the sale of an easement to the entity constructing the windmill. The easement gives the windmill owner the right to build the structure. The easement also prohibits the landowner from building any other structure on the land that would block the wind that drives the windmill or that would interfere with the maintenance of the windmill.

Payments are subject to the general rules for the sale of easements. The landowner compares the payment to the basis (original cost) of the land affected by the easement.

If the payments are less than the basis of the land affected, the landowner has no income to report but must reduce the basis of the land by the amount of the payments received.

If the payments exceed the basis, the basis of the property is reduced to zero and the payment portion in excess of the basis is reported as gain from the sale of an interest in the land. Generally, this gain is considered long-term capital gain because the land was not held for sale in the ordinary course of business and it was held for more than one year.

*Note:* there have been several court cases regarding the treatment of easements for purposes other than windmills. Generally, all the land involved falls under the tax treatment outlined above. Before you enter into such an easement situation, consult your tax accountant.

**Federal Individual Tax Rates:**

Due to the 2003 tax legislation, federal individual tax rates have been reduced. The reductions are in effect until the year 2010.
Changes are as follows:
28% reduced to 25% 31% reduced to 28%
36% reduced to 33% 39.6% reduced to 35%

The adjusted taxable income amounts associated with a given tax rate are as follows:

**Married filing jointly (MFJ):**
- 10% to $14,000
- 15% to $56,800
- 25% to $114,650
- 28% to $174,700
- 33% to $311,950
- 35% over $311,950

**Married filing separate MFS:**
- 10% to $7,000
- 15% to $28,400
- 25% to $57,325
- 28% to $87,350
- 33% to $155,975
- 35% over $155,975

**Single filing (S):**
- 10% to $7,000
- 15% to $28,400
- 25% to $68,800
- 28% to $143,500
- 33% to $311,950
- 35% over $311,950

**Head of Household (HOH):**
- 10% to $10,000
- 15% to $38,050
- 25% to $98,250
- 28% to $159,100
- 33% to $311,950
- 35% over $311,950

**Standard Deduction & Personal Exemption:**

<table>
<thead>
<tr>
<th>Standard Deduction</th>
<th>Extra (age/blindness)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$4,750</td>
</tr>
<tr>
<td>MFJ</td>
<td>$9,500</td>
</tr>
<tr>
<td>MFS</td>
<td>$4,750</td>
</tr>
<tr>
<td>HOH</td>
<td>$6,900</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Personal Exemption:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 dependant - $3,050</td>
</tr>
<tr>
<td>2 dependants - $6,100</td>
</tr>
<tr>
<td>3 dependants - $9,150</td>
</tr>
<tr>
<td>4 dependants - $12,200</td>
</tr>
</tbody>
</table>

**Marriage Penalty Relief:**
The calculation for folks MFJ has been changed. The 15% tax bracket for MFJ has been expanded to 200% of single filers. For 2003, the top bracket goes from $47,450 (in 2002) to $56,800.
The standard deduction for MFJ is expanded to 200% of the single filer. For 2003, the standard deduction for MFJ goes from $7,950 (old law) to $9,500 (new law). The 200% standard deduction rule is for 2003 and 2004 only.

**Federal Child Tax Credit:**
Under the new tax law, the credit increases from $600 per child to $1,000 per child for 2003 and 2004.
Remember: the $400 increase in the credit was paid in advance in the form of a rebate check earlier in 2003. Therefore, you will be able to claim only the remaining $600 of the credit on your 2003 tax return.
Phase out of the child tax credit begins at $110,000 income for MFJ and $75,000 for S/HOH. The phase out lasts a bit longer at $50 reduction in the credit for every $1,000 over the limit.

**Minnesota Individual Tax Rates:**
The State of Minnesota tax rates are as follows:

<table>
<thead>
<tr>
<th>Married Filing Jointly:</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.35% to $27,780</td>
</tr>
<tr>
<td>7.05% to $110,390</td>
</tr>
<tr>
<td>7.85% over $110,390</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Single Filing:</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.35% to $19,010</td>
</tr>
<tr>
<td>7.05% to $62,440</td>
</tr>
<tr>
<td>7.85% over $62,440</td>
</tr>
</tbody>
</table>

**Corporate Tax Rates for 2003:**
The federal corporate tax rates are as follows:
- 15% to $50,000
- 25% to $75,000
- 34% to $100,000
- 39% to $335,000
- 34% to $10,000,000
- 35% to $15,000,000
- 38% to $18,333,333
The Minnesota corporate tax rate is 9.8%.

**Dividend Income Tax Procedures:**

Effective January 1, 2003 through December 31, 2008, dividend income will be taxed at capital gain rates.

The AMT calculation applies and the rates are the same as regular rates.

The new rule does not apply to dividends that are really interest or income from REITs. There is a 60 day holding period requirement. Dividends no longer offset investment interest unless election to have the income taxed at regular rates is made.

**Farm Family Tax & Retirement Provisions:**

**Qualified Higher Education Deduction:**

Beginning in 2002, an above the line deduction for up to $250 of classroom expenses is allowed for eligible educators. Eligible educators are teachers, counselors, aides or principals who work in a K-12 school at least 900 hours per year. Eligible expenses are books, supplies, and other materials used in the classroom.

**Education Expenses:**

Education IRAs have been improved. The maximum contribution increases from $500 to $2,000 in 2002. The contribution limit phase out for single individuals at $95,000 - $110,000 and for married filing jointly at $190,000 and $220,000. Contributions are treated as made in the calendar year if made by April 15 of the following year. Qualified expenses are expanded to include tuition, fees, academic tutoring, books, supplies, room and board, and computers and other equipment necessary in connection with the enrollment or attendance at a public, private or religious school. Education IRA’s can be used at nearly any school that provides elementary or secondary education (K-12) or institution or college of higher education.

The Hope Tax Credit is a non-refundable credit that reduces the taxes paid by parents of certain post high school students. The credit is 100 percent on the first $1,000 of qualified tuition and fees and 50 percent on the next $1,000 of qualified tuition and fees. The maximum credit is $1,500 in 2002. The credit can be claimed by a taxpayer for expenses incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent claimed on the tax return. To be eligible for a Hope Credit, the student must be enrolled in a degree, certificate, or other program leading to recognized educational credentialing. The student must be at least a half-time student and never have been convicted of a felony consisting of the possession or distribution of a controlled substance. The student must be in the first two years of study to be eligible for this credit. The Hope credit is phased out for single taxpayers with modified Adjusted Gross Incomes between $41,000 and $51,000 ($82,000 and $102,000 for joint tax returns).

The Lifetime Learning Credit provides a non-refundable credit against federal income taxes equal to 20 percent of qualified tuition fees incurred during a tax year. The credit can be claimed on expenses paid for education furnished after June 30, 1998. The credit can be claimed on behalf of the taxpayer, the taxpayer's spouse or any dependents.

For expenses paid between June 30, 1998 and January 1, 2003, up to $5,000 of tuition and fees per **taxpayer return** will be eligible for this credit. The maximum credit per tax return (not per student) will be $1,000. After January 1, 2003, the maximum will be $2,000. The credit is phased out for high-income tax payers. The Lifetime Learning Credit can be claimed for an unlimited number of taxable years. It can be claimed for any course of instruction at an eligible educational institution for the purpose of acquiring or improving job skills of the student.

**Student loan interest** is deductible on educational loans. Individuals who pay interest on qualified educational loans may claim a deduction for such interest expenses. The maximum deduction allowed is $2,500. The deduction is allowed on payments made on a qualified educational loan on which interest payments are required. The 60-month limitation no longer applies starting in 2002.

The deduction is an "above the line" deduction, which means that it will be a deduction on the front page of the Form 1040 and you do not have to itemize deductions to claim this credit.

This deduction is phased out for single taxpayers with modified Adjusted Gross Incomes (AGI) of over $50,000 and $100,000 for joint returns in 2002 and later. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.
Section 529 savings plans: One major enhancement is that the new law exempts earnings in Sec.529 college savings plans from federal income taxes, if used for qualified educational expenses at colleges and universities. Previously, earnings were taxed at the student’s ordinary income tax rate. The tax act allows benefactors to transfer their accounts from one state’s plan to another, tax-free, once a year. There are no earned income limits for contributing to a 529 plan.

Roth Individual Retirement Account:

The Roth IRA began in 1998. Anyone who has earned income, can contribute to a Roth Individual Retirement Account (Roth IRA). You cannot deduct Roth IRA contributions from your income. All money taken out of a Roth IRA is totally free of federal income tax, if you have held it in the Roth IRA for at least 5 years and take distributions after age 59.5, at death, disability, or for first time home buyer expense. At distribution time, the original contributions and all earnings will not be subject to any federal taxation. You do not have to draw it out at age 70 as with regular IRAs, but can leave it in the Roth IRA as long as you wish.

The maximum contribution to a Roth IRA is the same as for a regular IRA. It is $3,000 for 2002-2004, $4000 for 2005-2007 and $5,000 in 2008 and thereafter. You can contribute a total of $3,000 in 2003, it can all be put into a deductible regular IRA or all into a non-deductible Roth IRA, or you can put some in each, but the total cannot exceed the yearly limit. Also, IRA catch-ups are available to people over age 50. Starting in 2002 anyone over age 50 can contribute an additional $500 for the years 2002 through 2005 and $1,000 for the years 2006 and after.

If you have money in a regular IRA, you can convert it to a Roth IRA. You must pay the taxes on the money you take out of the old IRA. You can do this only if your adjusted gross income is under $100,000. You can convert all or a part of your regular IRA anytime by simply paying the tax on the converted amount.

IRA money can be invested nearly anywhere. Banks, life insurance companies, or brokers can set up an IRA or Roth IRA for you. You can choose between low return, low risk accounts or higher return, higher risk funds.

Consider a maximum contribution for both yourself and your spouse. If one spouse has a job and earns over $6,000 in 2003, both spouses can contribute $3,000 to their individual IRA or Roth IRA. Furthermore, a spouse who is covered by a pension plan at work does not disqualify the non-pension-covered spouse from contributing to an IRA.

Retirement Plans:

Withdrawals from retirement plans for first time home purchases are now allowed. The money must be used to purchase a first house for you or a relative. No ten percent penalty will be assessed against the money withdrawn for this purpose. Other possible penalty free uses of retirement plans include certain medical expenses, medical insurance costs, if you are disabled or if you use proceeds for qualified higher educational expenses.

Most distributions are now made by using a simplified Uniform Life Expectancy Table. Retirement plan distribution laws are very complex. However, the new tax law has made an effort to simplify the distribution rules. Secure good tax and financial planning advice when withdrawing any funds from a retirement plan.

The maximum salary reduction contribution allowed for 401(k), Simplified Employee Plans (SEP’s) and other plans increase to $11,000 in 2002, up from $10,500 in 2000. It raises $1,000 each year until reaching a maximum of $15,000 in 2006. Those age 50 or older are allowed additional “catch-up” contributions that increase annually to a maximum of $5,000 in 2006.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.