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Some Farmers Entitled to New Deduction on 2005 Returns

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In an attempt to satisfy the World Trade Organization and its challenge of the Exterritorial Income Exclusion (ETI), Congress enacted Internal Revenue Code Section 199 (Domestic Production Income Deduction) as a part of the American Jobs Creation Act of 2004. At the same time, the ETI exclusion is phasing down in 2005 and 2006 and will be entirely eliminated by 2007. While ETI only applied to taxpayers who exported products outside of the United States, the new Domestic Production Activities Deduction applies to all manufacturers, including farmers.

Initially, it was thought that only farmers who could track their production directly to the export market qualified for the ETI exclusion. However, it appears if the buyer of their commodity attests they export a given percentage of their commodity, the producer who sells to the broker can use the same percentage to claim the exclusion on his income tax return. Producers may want to see their tax advisors if they have not claimed this exclusion in the past to amend their tax returns for any open years.

The new Domestic Production Income Deduction applies to all taxpayers who manufacture, produce, grow, or extract. Therefore, farm producers are entitled to the deduction if they meet the qualifications established by the temporary IRS regulations, which were released on October 20, 2005.

For 2005, the amount of the deduction is the lesser of 3% of the Qualified Production Activity Income (QPAI) or 3% of the taxpayer’s taxable income (adjusted gross income for individuals.) The deduction is limited to 50% of the W-2 wages paid by the taxpayer. Therefore, if a taxpayer does not pay W-2 wages, they are not entitled to the deduction.

Calculating the deduction is not as simple as taking 3% of the producer's net Schedule F profit. Only income from Domestic Production Gross Receipts (DPGR) qualifies. Producers must eliminate income from such non-DPGR items as earnings from performing custom harvesting. Expenses related to non-DPGR income are also eliminated before calculating the deduction. These expenses include those directly related to production of the non-DPGR income, such as fuel, repairs and depreciation on the combine used for the custom work, as well as a ratable portion of indirect expenses such as real estate taxes and depreciation on the barn used to house the combine and bookkeeping and other administrative expenses.
The regulations say the deduction is available only to the taxpayer who has the burdens and benefits of ownership of the property. It is unclear whether a taxpayer who shares crops a farm is entitled to the deduction or whether the land owner receives the deduction. Whoever gets the deduction will be able to include only their share of the production less their share of production expenses. It would seem that each would claim the deduction on their share, but this is still uncertain. Unless the landlord has wages, he will not be entitled to the deduction because of the 50% limitation.

Due to the complexity of the calculations for some types of taxpayers, there is support in Congress to repeal this deduction. The regulations released on October 20, 2005 are temporary and the IRS will release permanent regulations after receiving public comments.