



October 5, 2007

Finance Committee Approves Agriculture Tax Package

Paves the way for 2007 Farm Bill consideration on Oct. 23

By Sara Wyant, Agri-Pulse Editor

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After a three-hour delay during which Senate Finance Committee members huddled behind closed doors, members came back into the committee room and quickly passed the **“Heartland, Habitat, Harvest and Horticulture Act”** yesterday by a 17-4 vote. The Finance Committee also approved a measure implementing legislation for the U.S.-Peru free trade deal, S2113, by voice vote.

“This disaster assistance, tax relief, and timely energy incentives will provide a much-needed boost to American agriculture and greater security to our hardworking agricultural producers,” said Chairman Max Baucus (D-MT). The \$16 billion package includes funding for permanent disaster assistance, tax credits to pay for conservation programs, incentives for renewable energy and rural development, and dozens of other provisions. (We’ve included a summary of key provisions and offsets, starting on page 3)

The package was paid for by a series of offsets, including **over \$10 billion from the codification of “economic substance”** which Ranking minority member Sen. Charles Grassley (R-IA) hailed as a necessary clarification of a law designed to stop business from avoiding taxes on investments that do not produce any economic activity. The committee voted 13-8 on that provision, with most of the other Republicans voting against it. To offset the costs of new tax credits for renewable energy, the committee **approved a 5-cents-a-gallon reduction of the current 51-cents-a-gallon credit on ethanol blended by gasoline makers**, triggered when production reaches 7.5 billion gallons.

Approval of this funding package paves the way for the Senate Agriculture Committee to mark up the 2007 Farm Bill, which is now scheduled for Oct. 23, said Sen. Kent Conrad (D-ND). However, even with these additional funds, Conrad said the Agriculture committee **will likely make across- the-board cuts of 2-3% on all outlays**, excluding those for nutrition.

“Almost everything is going to take a haircut,” he told reporters after the Finance Committee meeting.

Conrad said Committee members **“moved a lot”** toward a new farm bill framework this week, however there are still some significant differences in areas like **“the nature of reform,”** especially as it applies to payment limits, policy issues related to conservation and the amount of resources devoted to various titles. There is general agreement on the nutrition title, which will likely mirror the House level of funding, he added.

Despite some differences, Conrad said, **“We have the potential for a strong bipartisan committee vote.”**

Finance Committee amendments

Four amendments totaling approximately \$1 billion were approved during the markup:

- An amendment by Senator Jim Bunning (R-KY) extending the alternative fuels tax credit (Section 6426) to December 31, 2010, with a 50 percent carbon capture standard on date of enactment. A 75 percent carbon capture standard may be implemented prior to December 31, 2010 subject to certification of feasibility. (After the meeting adjourned, Senator Kent Conrad said Bunning’s provision was the “basis for the delay” of the Committee’s meeting, as Senators worked out a compromise.
- An amendment by Senator Ken Salazar (D-CO) to further increase the value of the cellulosic ethanol credit from \$1.11 per gallon to \$1.28.
- An amendment by Senator Debbie Stabenow (D-MI.) to extend the length of the cellulosic ethanol credit subject to available funds.
- An amendment by Senator Blanche Lincoln (D-AK.) providing a five-year depreciation period (instead of seven years) for energy-efficient small motors used on farms.

Most of the provisions mirror those released by the Committee on Tuesday and summarized in this week’s issue of *Agri-Pulse*. However, there were some additions and modifications included in a document titled “Chairman’s modifications.” For example, **payments under the permanent disaster program were decreased from 55% to 52% of the difference** between the disaster program guarantee and the sum of total farm revenue.

One new provision **changes the depreciation schedule for farm equipment purchased before Jan. 1, 2010 from 7 years to 5 years.**

For the first time, the package includes provisions for the specialty crop industry, which **Sen. Debbie Stabenow (D-MI)** described as **“a good start.”** The disaster package would provide assistance to specialty crop farmers whose trees, bushes and vines are lost due to a natural disaster and create a new program for pest and disease management.

Also included in the agriculture tax package is legislation **Senator Pat Roberts (R-KS) authored and introduced earlier this year with Sen. Ben Nelson (D-NE)**, the Agricultural Business Security Tax Credit Act of 2007. The bill provides a tax credit to implement security measures at agricultural facilities where pesticides and fertilizers are stored.

A summary of the package, provided by the Senate Finance Committee, follows:

Disaster Assistance

Permanent Agricultural Disaster Assistance Trust Fund: Currently, farmers and ranchers may have to wait years to receive assistance from Congress for agricultural disasters. Farmers and ranchers need to know that when weather related disasters strike, a dependable safety net exists. The proposal creates a trust fund for disaster relief that would cover the “shallow losses” not covered by crop insurance. The proposal requires farmers and ranchers to purchase crop insurance in order to be eligible for disaster assistance. The trust fund will be funded through allocation of tariffs. Cost of the provision in the modification to the Chairman’s mark is \$5.1 billion over five and ten years. It will include:

Tree Assistance: Assistance to specialty crop farmers whose trees, bushes and vines are lost due to a natural disaster. Payments will help to defray the cost of reestablishing orchards and vineyards.

Pest and Disease Management and Disaster Prevention: A new program under which USDA will conduct early pest detection and surveillance activities in coordination with State departments of agriculture, will prioritize and create action plans to address pest and disease threats to specialty crops, and will create an audit based certification approach to protect against the spread of plant pests which could cause crop losses.

New Farmers

Agricultural Bond Improvements: “Aggie Bonds” are tax-exempt bonds that provide low-interest loans for first-time ranchers and farmers. Baucus’s proposal updates the structure of Aggie Bonds for the first time in 26 years. The proposal would increase the loan limit from \$250,000 to \$450,000, and index the limit amount for inflation. It would also eliminate the dollar limitation in the definition of “substantial farmland.” Cost is \$19 million over ten years.

Installment Sale Modification for Single-Purpose Agricultural Property: Single-purpose agricultural property (such as chicken barns, pig barns, and vineyard property) may be depreciated more quickly than other real estate, but this depreciation is subject to a recapture provision when the property is sold. This means that a taxpayer who has taken significant amounts of accelerated depreciation on single-purpose agricultural property may be reluctant or unable to sell or exchange the agricultural property due to the large amount of ordinary income tax due at the time of the sale or exchange. The proposal allows a taxpayer to pay recapture obligations in installments over a period of time, rather than all at once in the year of the sale. Cost is \$246 million over ten years.

Conservation

Conservation Reserve Program Tax Credits: The proposal will allow a participant in the Conservation Reserve Program (CRP) the option to choose between the regular cash payment and a tax credit. The tax credit will be equal to 100% of the value of the cash payment the

participant would have otherwise received and the credit will be excludable from both income and self-employment taxes. Cost is \$3.771 billion over ten years.

Wetlands Reserve Program and Working Grasslands Protection Program Tax Credits:

Currently, participants in the Wetlands Reserve Program and Working Grasslands Protection Program receive cash payments for easements they sell to the government. The proposal will allow a participant in the Wetlands Reserve Program and the Working Grasslands Protection Program the option to choose between the cash payment for the easement or a tax credit. A tax credit will be equal to the value of the payment they would have received after taxes were paid on the payment. Cost: \$75 million over ten years.

Tax Treatment of Conservation Reserve Program Payments: This proposal provides that CRP payments to retired or disabled individuals are to be treated as rental payments for tax purposes and are therefore excluded from self-employment taxes. Cost: \$206 million over ten years.

Rural Heritage Conservation Extension: Permanently extends the enhanced tax incentive for conservation easements included in last year's Pension Protection Act. The provision allows all taxpayers to deduct up to 50% of their adjusted gross income (AGI) for donations of conservation easements and carry forward the deduction up to 15 years. A bonus allows ranchers and farmers to deduct up to 100% of their AGI for donations of conservation easements. Cost: \$761 million over ten years.

Endangered Species Recovery Act: This proposal establishes two new tax credits for taxpayers who take voluntary measures to aid in the recovery of species that are either listed as threatened or endangered under the Endangered Species Act (ESA) or deemed by the Secretary of Interior or Commerce to be warranted for protection under the ESA. It also establishes a tax deduction for the cost of actions to implement recovery plans under the ESA, and an exclusion from income tax obligations for payments received under various cost-share conservation programs. Cost: \$1.832 billion over ten years.

Forest Bonds: This proposal establishes a national program allowing the issuance of \$1.5 billion in tax-exempt timber conservation bonds. The bonds must be issued by a non-profit organization whose holdings consist primarily of forests and forest lands and whose board of directors includes specified representation of public officials and conservation organizations. Proceeds from the sale of bonds must be used for the acquisition of forest and forest lands that are subject to a conservation restriction, which is defined as a perpetual restriction that achieves specified conservation goals. Cost: \$257 million over ten years.

Deduction for Qualified Timber Gain and Timber REIT Rule Modifications: Under current law, gains on timber sales are eligible for capital gains tax treatment. The proposal contained in the modification to the Chairman's mark provides an election to deduct from gross income 60% of qualified timber gain. Qualified timber gain is gain from the sale or exchange of timber held for more than one year. The proposal additionally provides for modernization of timber real estate investment trusts (REIT) rules for timber property, including: (1) clarify that gains from sale of timber held less than one year is qualifying income; (2) mineral royalty income is

qualifying income; (3) conforming the taxable REIT subsidiary asset test for timber REITs; and (4) changes to the safe harbors for timber property sales. Cost: \$332 million over 10 years.

Rural Development and Other Agricultural Provisions

Rural Renaissance Bonds: The proposal creates a new category of tax credit bonds with a total allocation of \$400 million for projects such as distance learning and telemedicine programs, rural telephone, broadband access and rural community facility projects. Cost: \$168 million over ten years.

Credit for Drug Safety and Effectiveness Testing for Minor Species: To help make more medications available to veterinarians and owners of minor species (such as sheep, goats, aquaculture) this proposal provides a 50% credit for safety and effectiveness testing expenses for new animal drugs intended for these species. Cost: \$121 million over ten years.

Section 1031 Eligibility for Mutual Ditch, Reservoir, or Irrigation Company Stock: Section 1031 of the Internal Revenue Code allows the tax-free exchange of like-kind property held for productive use in a trade or business. Section 1031 may not be used to prevent recognition of gain on the exchange of stock. This provision will clarify that the exchange of ditch company stocks is effectively an exchange in real property and therefore tax free pursuant to Section 1031. Cost: \$2 million over ten years.

Agricultural Business Security Tax Credit: This proposal will allow a retailer of agricultural products and chemicals or a manufacturer, formulator, or distributor of certain pesticides a business tax credit for 30% of costs for the protection of such chemicals or pesticides, including employee security training and background checks, installation of security equipment, and computer network safeguards. The proposal in the modification to the Chairman's mark sets a \$2 million annual limit on such credit and a per facility limitation of \$100,000 (reduced by credits received for the five prior taxable years). Cost: \$14 million over ten years.

Reduce the Recovery Period for Certain Farming Machinery and Equipment: Currently, the cost of farm machinery and equipment must be recovered over seven years. The proposal in the modification to the Chairman's mark shortens the recovery period for certain farming business machinery and equipment to five years. Cost: \$1.477 billion over five years, with a negligible revenue effect over ten years.

Broadband Technology and Infrastructure Tax Incentives: The proposal in the modification to the Chairman's mark creates a two-tiered tax incentive to stimulate new investment in broadband infrastructure: 50% expensing for investment in "current-generation" broadband infrastructure (5 megabits per second download, 1 megabit per second upload) in rural and underserved areas; and full expensing for "next generation" broadband investments (100 megabits per second download, 20 megabits per second upload) in rural, underserved and other residential areas. Cost: \$72 million over ten years.

Energy

Residential Wind Credit: Currently, there are no tax incentives for residential wind property. The proposal creates a new 30% personal credit for residential wind property, capped at \$4,000 per year. Cost: \$5 million over ten years.

Transmission Pole Payment Exemption: Easement payments generally must be included in a taxpayer's income for federal income tax purposes. The proposal allows taxpayers who locate an electricity transmission pole on a line of 230 kilovolts or more to exempt easement payments received from the electric utility or electric transmission company from gross income. Cost: \$179 million over ten years.

Small Producer Credit for Cellulosic Alcohol: The proposal creates a new production tax credit for cellulosic alcohol of 50 cents per gallon (in addition to the current 51 cents/gallon credit and 10 cent/gallon credit) for up to 60 million gallons of cellulosic fuel production in a taxable year. Cost: \$828 million over ten years.

Expand Expensing for Cellulosic Ethanol Facilities: The proposal expands the eligible property qualifying for the 50 percent expensing to include alcohol produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis. Cost: \$1 million over ten years.

Small Ethanol Producer Credit: The proposal extends for two years (through December 31, 2012) the 10 cent per gallon tax credit on the first 15 million gallons of ethanol production for producers with annual capacity of not more than 60 million gallons. Cost: \$172 million over ten years.

Fossil-Free Alcohol Production Credit: The proposal creates a new small producer alcohol credit of 25 cents per gallon for facilities that produce ethanol through a process that does not use a fossil-based resource available through December 31, 2012. Cost is \$278 million over ten years.

Biodiesel Tax Credits: Extends for two years (through December 31, 2010) the \$1.00 and 50 cent production tax credits for biodiesel. Extends for four years (through December 31, 2012) the 10 cent per-gallon tax credit on the first 15 million gallons of biodiesel production for producers with annual capacity of not more than 60 million gallons. Cost: \$267 million over ten years.

Renewable Diesel Incentives: Extends for two years (through December 31, 2010) the \$1 tax credit for diesel created through a thermal depolymerization process and caps, on a per facility basis, the \$1 credit at 60 million gallons per year. Cost: \$211 million over ten years.

Alternative Fuels Excise Tax Credit: The proposal modifies the credit to include biomass-gas-based versions of liquefied petroleum gas and liquefied or compressed natural gas. Cost: less than \$500,000 over 10 years.

Section 45(b)(3) Exception: Present law requires a reduction in the Section 45 production tax credit for renewable electricity for grants, tax-exempt bonds, subsidized energy financing and other credits. The proposal in the modification to the Chairman's mark provides an exception to this general rule for any financing to farmers, ranchers, or rural small businesses issued by the Secretary of Agriculture under authority granted by section 9006 of the Farm Security and Rural Investment Act of 2002. Cost: \$14 million over ten years.

Alternative Refueling Station Tax Credit: The proposal extends the 30% alternative refueling property credit (capped at \$30,000) for non-hydrogen property for one year (through December 31, 2010). Cost: \$119 million over ten years.

Offsets

A Baucus amendment providing the bulk of the bill's offset through codification of the economic substance doctrine was adopted as follows:

Clarification of the Economic Substance Doctrine and Penalty for Understatements

Attributable to Transactions Lacking Economic Substance: This proposal, added to the Chairman's mark as an amendment, clarifies the application of the economic substance doctrine but does not change current-law standards used by courts in determining when to utilize an economic substance analysis. The proposal imposes a 30% penalty on understatements attributable to a non-economic substance transaction (unless the transaction was disclosed, in which case the penalty is 20%). Under the proposal, in any case in which a court determines that the economic substance doctrine is relevant to a transaction, the economic substance doctrine would be satisfied only if (1) the transaction changes in a meaningful way (apart from federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-Federal tax purpose for entering into such transaction. The proposal becomes effective for transactions entered into after the date of enactment. This will provide \$10.012 billion over ten years.

Denial of Deduction for Interest on Underpayments Attributable to Non-Economic

Substance Transactions: This proposal denies any deduction for interest on unpaid taxes attributable to any non-economic substance transaction understatement. This proposal becomes effective for transactions entered into after the date of enactment. This will provide \$43 million over ten years.

Additional offsets are as follows:

Sale-In/Sale-Out (SILO)—Foreign: The proposal disallows future losses on foreign tax exempt use property for leases entered into on or before March 12, 2004. This will provide \$3.235 billion over ten years.

Limitation on Schedule F Loss: The proposal would limit the amount of Schedule F losses that a taxpayer may use to offset income to \$200,000 if the taxpayer receives Agriculture Program

Payments or CCC loans. Losses that are limited in a particular year may be carried forward to subsequent years. This provision will provide \$456 million over ten years.

Optional Self-Employment Tax: Qualifying for Social Security benefits can be difficult for self-employed farmers and ranchers, because they do not always have a steady income stream. When there are no earnings, no Social Security taxes are paid and no quarters are accrued. Through farm optional methods, farmers and ranchers may voluntarily pay Social Security taxes in order to earn quarters so that they can receive Social Security benefits. However, the payment thresholds are outdated and no longer allow farmers and ranchers to earn four quarters of credit per year. The proposal modifies the farm optional method so that electing taxpayers may be eligible to secure four credits of Social Security benefit coverage each taxable year. The proposal makes a similar modification to the nonfarm optional method. This provision will provide \$110 million over ten years.

Information Reporting for Commodity Credit Corporation Transactions: The Commodity Credit Corporation (“CCC”) may make market assistance loans to farmers of eligible commodities. A farmer receiving a CCC loan can use cash to repay such a loan, purchase CCC certificates for use in repayment of the loan, or deliver the pledged collateral as full payment for the loan at maturity. In IRS Notice 2007-63, the IRS held that the CCC must use Form 1099-G to report market gain associated with the repayment of a CCC loan whether the taxpayer repays the loan with cash or uses CCC certificates in repayment of the loan. This codifies that notice with no revenue effect.

Modification of Section 1031 Treatment for Certain Real Estate: An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business is exchanged for property of a “like kind”. For purposes of section 1031, the determination of “like kind” relates to the nature or character of the property and not grade or quality. Therefore, improved real estate and unimproved real estate are generally considered to be property of a “like kind” as this relates to the grade or quality of the real estate. The proposal modifies section 1031 to disallow nonrecognition treatment for exchanges of unimproved real estate for which the owner has received Agriculture Program Payments or CCC loans for improved real estate. This will provide \$27 million over ten years.

5-cent reduction in ethanol credit: This proposal reduces the 51-cent-per-gallon tax credit for ethanol by 5 cents beginning with the first calendar year after the year in which 7.5 billion gallons of ethanol has been produced. The 7.5 billion target matches the renewable fuel standard passed by Congress in the 2005 Energy Policy Act. This proposal is expected to raise \$854 million over ten years.

Extension of Tariff on Ethanol: The proposal extends the tariff on imported ethanol for two years (through December 31, 2010), and will raise \$25 million over ten years.

Elimination of Certain Refunds of Duty Imposed on Ethanol: Present law allows duties paid upon import to be reclaimed at a later date if the same or similar product is exported. Current law treats ethanol blended with gasoline the same as jet fuel. The proposal terminates that treatment.

Any drawback for ethanol blended with gasoline is still allowed. This proposal is expected to raise \$10 million over ten years.

Exclusion of denaturant from alcohol fuels credit. The proposal excludes the volume of denaturant (a substance used to render alcohol toxic or undrinkable) in the fuel for purposes of calculating the volume of alcohol eligible for the alcohol fuels credit. The proposal is estimated to raise \$284 million over ten years.

Alcohol and biodiesel as taxable fuel. The proposal in the modification to the Chairman's mark adds qualified alcohol fuel mixtures and qualified biodiesel fuel mixtures to the definition of taxable fuel and requires all producers of qualified mixtures to file information reports with the Secretary of Energy. This proposal is estimated to raise \$2 million over ten years.

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