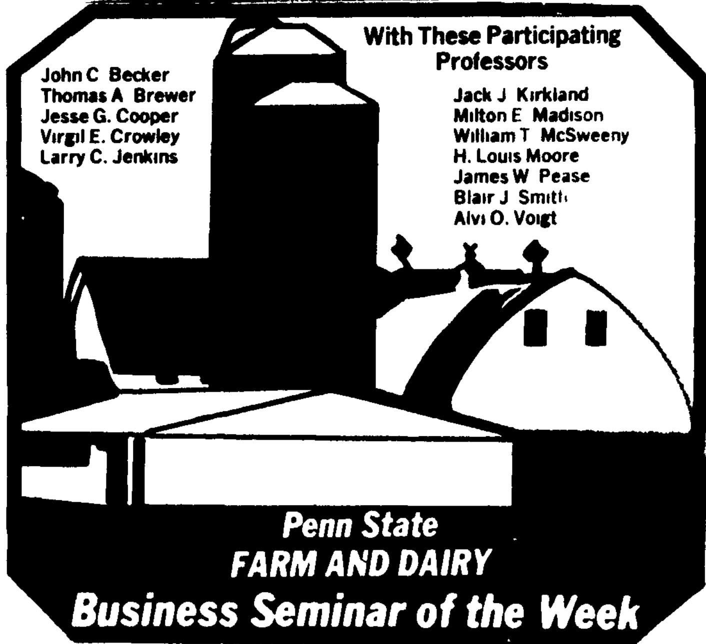

New Farm Deduction Rules Don't Permit Delays

BY LARRY C. JENKINS
Extension Economist

Farm managers who are in the habit of "delaying until tomorrow" decisions about financial matters may find themselves in a corner next March 1. That is the deadline for making a decision about capitalizing or deducting a family of expenses that the new federal tax code refers to as "preproductive costs." Unfortunately, for those individuals who tend to be procrastinators, the law provides an automatic decision for the taxpayer who fails to take action. In this respect, the new federal income tax code is very much like the rules as to estate transfer; that is, those who fail to provide a Will to guide transfer of their assets are provided one by the State.

Preproductive costs are the expenses related to support of an enterprise before that enterprise begins to produce income. Farm examples of preproductive costs are the costs of developing replacement dairy animals or the cost of growing a young orchard. Prior law permitted deducting these costs on an annual basis; that option is still open but it involves penalties to the taxpayer.

The other choice, and the one apparently preferred by drafters of the new tax law, is to capitalize the preproductive costs, rather than to deduct them each year. If costs are capitalized, they are set aside into a capital account and may then be recovered over a period of years, similar to depreciation.

The new procedures related to preproductive costs are part of the uniform capitalization rules provided by the Tax Reform Act of 1986. These rules date back several years for much of American industry but farming was generally exempt until the new tax law was passed.

The uniform capitalization rules require that both direct and indirect costs of producing property used in a trade or business are included in capital account rather than deducted each year. Direct costs that must be capitalized include cost of both materials and labor that are used in producing property; for example feed, supplies, and medicines used in growing out dairy heifers. Indirect costs that must be considered are equipment repairs, utilities, deductible taxes (except state and local income tax), and depreciation.

Breeding animals and plants, such as orchard trees and vines, are property used in a trade or business and thus are subject to the uniform capitalization rules. Those rules apply generally to property produced for use in farming if the preproductive period is more than two years. Replacement breeding animals and young fruit trees are typical examples of such property.

What Is The "Preproductive Period?"

A common question asked relative to preproductive costs is "when does the period for calculating the costs begin and end?" The new law and regulations issued by the Internal Revenue Service are relatively clear on that point.

For plants, the preproductive period begins when the plant or seed is first planted or acquired by the taxpayer and ends when a marketable crop is first produced.

The preproductive period of animals begins at the time of acquisition, breeding or embryo implantation. If the animal has more than one yield (for example, multiple lactations for a dairy cow) the preproductive period ends when the animal has its first yield. In the case of an animal that has a single yield, the preproductive period ends at the time of disposal (sale). This means that the preproductive period for a raised replacement dairy animal covers the period from conception of a female calf to the time that calf grows into a mature animal and begins the first lactation.

A second problem related to the new preproductive period rules is how to separate the "preproductive cost" from other farm costs. Most farmers do not maintain the detailed farm accounts that will permit separation of one category of cost from total farm costs. For the majority who are in that position, the rules permit using one of the simplified inventory valuation methods for determining preproductive costs. These simplified methods are the Farm-Price method and the Unit-Livestock-Price method. Regulations issued by the Internal Revenue Service describe both these in detail and permit their use in lieu of requiring the farm manager to attempt to separate costs for his/her farm.

Farmers Permitted to Continue Deducting

The Tax Reform Act of 1986 provides an exception from the generally required capitalization of preproductive costs that permits farmers to continue deducting these costs each year, rather than capitalizing them. Once made, that election is irrevocable; that is, the decision can be changed only with permission of the Commissioner of Internal Revenue.

There are two penalties if the taxpayer elects to annually deduct rather than to capitalize preproductive expense. First, if the property is disposed of (as most dairy cows will eventually be) there is a recapture as ordinary income of the amount that was deducted annually rather than capitalized. This type transaction would presumably be reported on the income tax form 4797 along with other recaptures, such as those due to depreciation.

The second, and most serious,

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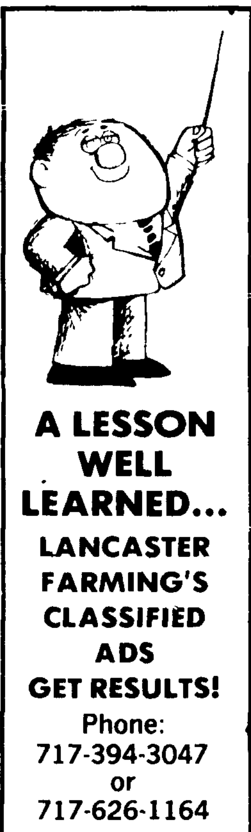

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