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Good morning, Chairman Conaway, Ranking Member Peterson, and distinguished members of the committee. I am Chris Hesse, a CPA and principal of CliftonLarsonAllen. CLA is a professional services firm that combines wealth advisory, outsourcing, and public accounting capabilities to help clients succeed professionally and personally. I serve in the national office, delivering tax planning, education and research services throughout our firm, from Omak, Washington to Sebring, Florida and from Los Angeles to Boston, and all areas in between.

Although I come to you today from Minneapolis, my family farms in Eastern Washington. I was the first in my line to leave the farm, but today, my older son and nephew are farming over 2,000 irrigated acres and another 3,000 dryland acres. I have served on Washington State Farm Bureau boards and as a county Farm Bureau president.

Part of my work today is to prepare and deliver educational materials to agricultural CPAs and tax preparers throughout the country. Our purpose is to raise the level of awareness of the many tax provisions benefiting farmers and ranchers. Today I will highlight some of the most important provisions for you.

I'd like to thank the committee for holding this hearing to focus attention to the tax provisions important to agriculture. Special tax provisions for farmers and ranchers acknowledge the challenges they face in providing food for United States consumers and our export market. Agricultural producers are uniquely subject to fluctuations in weather, not only within the United States but also across the globe. Another country's drought may substantially reduce available supplies of commodities and foodstuffs worldwide, increasing the demand and price for United States products. Similarly, bumper crops in other parts of the world increase the supply and decrease the price for our products, oftentimes below the cost of production. Various programs help reduce the risks associated with weather events, disease, and fluctuating markets. Since the Internal Revenue Code was enacted in 1913, various tax provisions have recognized the unique risks to which farmers and ranchers are exposed.

Current agricultural tax provisions, on the income side, include the following:

<u>Installment Method</u>
The installment method allows income to be recognized for tax purposes when payment is received, rather than when the sale is made. Nonfarm businesses are not allowed to report income from the sale of products manufactured or held for sale to customers using the

installment method. Farmers and ranchers may use the installment method to report the sales of raised crops and livestock and recognize taxable income when payment is received.

Farmers and ranchers may choose not to use the installment method to “smooth” taxable income. Smoothing income is a term I use to describe tax planning which reduces reporting taxable income in high tax brackets in one year, and losing tax deductions in other years from having too low of income.

Farmers may choose to sell product in one year and contract to receive payment in a subsequent year. These deferred payment contracts add flexibility to the timing of income. In this manner, a farmer may sell or commit to sell product when she believes the market provides the best price, and not be as concerned as to the tax ramifications of having sold two crops in one tax year. By using the deferred payment contract, the 2015 crop may be sold and sales price collected in 2015, also selling the 2016 crop in 2016, but arranging for payment in 2017.

Commodity Credit Corporation (CCC)

The CCC provides loans to farmers on a nonrecourse basis. That is, the farmer may borrow from the CCC and, if the collateralized crops decrease in value, the farmer may forfeit the crop to the government. If the price for the crop is lower than the target price, the farmer may keep the loan proceeds by transferring the crop to the United States. The farmer is not required to repay the balance of the loan. The result of the CCC loan is to set a floor on the price of the crop.

The taxation of CCC loans is flexible. A farmer may choose to report loan receipts as taxable income in the year received, or treat the loans as true loans. If treated as taxable income, the repayment of the loan will provide a deduction when the crop is sold. Alternatively, if the CCC loan is treated as a true loan, the repayment of the principal does not provide a tax deduction. If the CCC loan, treated as a true loan, is forfeited (to the United States), income is recognized for tax purposes at that time.

Crop Insurance

Farmer and ranchers need flexible tax provisions to help account for the risks of unpredictable weather and uncontrollable markets. Crop insurance proceeds may be deferred. Many farmers recognize taxable income from a crop in the year after harvest. When a crop failure occurs, crop insurance may be received in the year of harvest. If this happens for the farmer whose normal marketing is to recognize taxable income in the subsequent year, more than one year’s crop is taxable in one year.

To avoid a spike in income from receiving two years of income in one year, farmers can defer the recognition of crop insurance income to the subsequent year. If the farmer receives crop insurance on more than one crop, an election for one crop is an election for all crop insurance proceeds received in that year. The farmer does not have a choice as to the amount of crop insurance to defer. The election is “all or nothing.”

Livestock Sales, Weather, and Disease

Livestock sales are likewise provided various deferral opportunities for weather and disease.

A one-year deferral of income is available for sales of excess livestock to the extent the sale is due to drought, flood, or other weather-related conditions. The area must be designated as eligible for assistance by the United States.

Livestock available for deferral may be either raised or purchased animals, and may be held either for resale (inventory livestock) or for productive use (depreciable livestock, such as dairy, breeding, draft, or animals held for sporting purposes).

Also, a two-year deferral is available for livestock destroyed by disease, if the livestock are replaced within that two year period.

The replacement period is four years for draft, breeding, or dairy livestock sold early on account of drought, flood, or other weather-related conditions. The IRS has authority on a regional basis to extend the replacement period if the weather-related conditions continue.

Basis Upon Death

A "fresh start" applies to re-set the tax basis of assets upon the death of the taxpayer. Heirs receiving property need not search for sometimes unavailable records to determine the decedent's basis in property. As such, depreciable assets will generate depreciation deductions for the heirs who continue to operate the farm or ranch. Inventory on hand at death is also provided a basis step-up, particularly important for the farm because raised inventory has a zero tax basis.

Hedging Opportunities

Farmers may reduce price risk for both the sale of crops and livestock and for the purchase of inputs. Puts, calls, and the commodity futures markets are available to hedge prices for the inputs and sales. The hedging opportunities provide ordinary income or loss treatment upon using techniques to lock-in prices. Without this provision, a loss on a commodity futures contract would be capital gain, the deductibility of which is limited to capital gains plus $3,000.

Farmers using the commodity futures market forgo capital gains on these contracts because of the use of the contracts in hedging transactions, but this protects the availability of the ordinary loss deductions.

Tax-Deferred Exchanges (Section 1031)

Like-kind exchanges are an important tax provision for farmers and ranchers. Land is very expensive. Quality neighboring land may become available for purchase only upon a generational change. The ability to exchange, tax-free, less desirable land (perhaps land many miles or counties away) for land closer to the home base of operations, should not be a taxable event. The farmer has not cashed-out her investment. Capital gain taxes should not have to be paid because she has fully reinvested the proceeds in like-kind replacement property.

Cancellation of Debt Income

The default treatment for the discharge of indebtedness is as taxable income. However, exclusions are available if the taxpayer is in bankruptcy or insolvent. A specific provision is available for the discharge of qualified farm indebtedness. This provision applies to qualified farmers who continue to own trade or business assets or who have sufficient tax attributions (tax loss and credit carryovers). The exclusion acts as a deferral mechanism, in that the farmer isn't forced to recognize income today, but instead reduces future deductions and credits.

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On the expenditure side of the ledger, farmers use accounting method and depreciation provisions to help manage the tax liability.

Section 179

Section 179 allows farmers to expense up to $510,000 (now indexed for inflation) of the cost of equipment and other tangible assets used in production. This provides a deduction in the year of purchase, rather than depreciating the assets over several future years. Section 179 simplifies the computation of depreciation, while providing flexibility to the farmer in choosing how much Section 179 deduction to claim.

Bonus Depreciation

The farmer or rancher may choose to expense 50 percent of the cost of original use assets purchased for use on the farm. If bonus depreciation is claimed, future depreciation deductions are reduced. This is a timing issue. This is not available for used assets.

The farmer may elect not to claim bonus depreciation on a class-by-class basis. The farmer may not, however, choose a lesser percentage. In this respect, Section 179 is much more flexible.

Bonus depreciation may be claimed on most assets used on a farm, since bonus depreciation is available for assets with a cost recovery period of no greater than 20 years. Farm buildings qualify for bonus depreciation, as they have a cost recovery period of 20 years.

Under The Protecting Americans from Tax Hikes (PATH) Act enacted December 2015, bonus depreciation is available for the cost of plants or grafting for new orchards, vineyards, and other nut or fruit bearing plants. Additional bonus depreciation is not available, however, when the orchard or vineyard is placed in service (and depreciation deductions begin).

Bonus depreciation is scheduled to be reduced to 40 percent for 2018 and 30 percent for 2019, after which the provision expires.

Raising Livestock

Farmers may deduct the costs of raising livestock, even though dairy cattle, for example, otherwise have a preproductive period of more than two years. Consequently, when cattle are

culled from the breeding or dairy herd, the farmer recognizes Section 1231 gain, usually taxed as capital gain.

Raising Crops

Farmers may deduct the costs of raising crops, except for those crops, such as vineyards and orchards, which have a preproductive period of more than two years. An election is available to deduct the costs of establishing the vineyard or orchard. If this is elected, depreciation on all farm assets must be computed using slower methods over longer cost recovery periods.

The cost of raising the crops is deductible in the year paid for the cash method farmer. Since all costs have been deducted, the entire sales price is taxable income when sold and the sales proceeds are received.

Domestic Production Activities Deduction (DPAD) or Section 199

The Domestic Production Activities Deduction reduces the overall tax rate from growing and production activities. This is only available, however, if the farmer has employees to whom wages are paid. Consequently, the sole proprietor with no employees does not receive the benefit of this deduction, except in the case of receiving an allocation of the deduction from a cooperative to which the farmer transferred his crops.

DPAD provides a deduction of 9 percent of the net farm income, effectively lowering the tax rate. DPAD is not allowed, however, to reduce self-employment income on which self-employment tax is paid.

Soil and Water Conservation Expenditures

Expenditures under government programs for soil and water conservation may be deducted in the year paid, limited to 25% of gross income from farming. These include the treatment or movement of earth, such as leveling, conditioning, grading, terracing and contour furrowing. They also include the construction, control and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, water courses, outlets, and ponds. The eradication of brush and the planting of windbreaks are also includes in the Section 175 expenditures. These expenditures must be consistent with a plan approved by the Natural Resources Conservation Service (NRCS) of the USDA. If no NRCS plan exists, the expenses must be in conformity with the plan of an applicable state or local agency, comparable to an NRCS plan.

The deduction for improvements is not available if the land was not previously used in farming. Also, land clearing expenditures which prepare the land for farming must be added to the tax basis of the land. Landlords who receive a share rental or a cash rent based on farm production are considered engaged in farming, and are allowed to claim the Section 175 soil and water conservation expenditures deduction.

The amounts are subject to recapture as taxable income if the farmland is disposed within ten years of its acquisition, based upon a sliding scale.

Fertilizer and Soil Conditioning Expenditures

Although fertilizer and soil conditioning expenses benefit the soil over several years, a farmer may deduct the fertilizer in the year purchased. This is important for farmer, in that if the amounts are not deducted in the year purchased, the expenses must be claimed over the period in which the inputs benefit the soil. An agronomist would have to be hired to determine the proper period of time over which the deductions would be available.

Interest Expense

Farming is capital intensive so interest expense deductions are important. Farm land purchases do not generate depreciation deductions. The land must be paid for after income taxes are paid. To illustrate: In order to make payment of principal on debt incurred to purchase land, a farmer in the 45 percent tax bracket (25 percent income tax plus 15 percent self-employment tax, plus 5 percent state income tax) must generate $182 of income in order to have after-tax cash $100. In the early years of paying principal and interest on the mortgage, most of the payment is interest expense. The beginning farmer doesn't have the sufficient capital to generate the return on investment necessary to expand; the interest expense deduction to acquire the land is necessary to assure the economy of scale that could cover overhead expenses.

Farm Supplies

Farmers may deduct farm supplies in the year paid, rather than the year consumed (within limits). If certain inputs are scarce, buying early can ensure they have the chemicals, fertilizers, seeds and other supplies when they are needed.

Rent Expense

Similarly, farmers (similar to other businesses) may prepay rent, as long as the rental period expires by the end of the following year. Landlords may insist on payment in advance; the farmer may deduct this payment.

Health Insurance

As with other self-employed taxpayers, farm sole proprietors, partners, and S corporation shareholders may deduct health insurance premiums (subject to sufficient farm income).

Charitable Donation of Conservation Easement

Farmers also benefit from an enhanced limitation for the donation of a conservation easement. Rather than a 50 percent of adjusted gross limitation for non-farm taxpayers, a farmer or rancher may claim a charitable deduction up to 100 percent of adjusted gross income. If the charitable deduction is greater than the limitation, the excess charitable deduction may be carried forward for up to 15 years.

Charitable Contribution of Food
Farmers may deduct up to 50 percent of the value of apparently wholesome food given for the benefit of the needy. This is a new provision added as a result of the 2015 PATH Act. It provides the same incentive to grower/packer/shippers who own cash basis inventory, as provided to the local grocery store that has excess food inventory nearing its expiration date.

This is a deduction particularly suited to community supported agriculture (CSA) producers and the local farmers markets.

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Negative Tax Provisions for Farmers

The uniform capitalization rules on preproductive expenses hurt orchardists and viticulturists. They are not able to currently deduct the costs of establishing the expensive orchards and vineyards to supply the nation with apples, oranges, grapes, and other fruits and nuts. Instead they must capitalize these costs to deduct the investment only when the orchard or vineyard becomes productive, and then over a ten-year period.

In addition, farmers and ranchers are also not allowed to use the faster depreciation methods that are available to non-farmers.

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The unique business of farming also benefits from several distinct tax computation provisions.

Estimated Tax
Form 1040 farmers need not pay estimated taxes if the tax return is filed by March 1. Farmers who don’t file by March 1 can pay one estimated tax payment on January 15. The payment of at least 100 percent of the prior year’s tax or 2/3rds of the current year’s tax on January 15 allows the filing of the Form 1040 by April 15 without underestimation penalties. This flexibility helps farmers by not having to pay income tax on expected income that doesn’t arise to the risks mentioned above.

Farm Income Averaging
Farm income averaging allows farmers an imperfect method of reducing the effect of income spikes. Farm prices fluctuate greatly and sometimes the farmer can’t use the other methods to arrange for the best timing for the recognition of income and payment of expenses. Sometimes two (or more) years of crop income is recognized in one year, pushing the farmer into higher than normal tax brackets.

Farm income averaging may be particularly beneficial when the farmer retires, in that the cash method farmer likely has few farm expenses in the final year, but may have two or more years

of crop income. The spike in income would otherwise cause the farmer to pay income tax at higher than normal marginal tax rates.

Net Operating Losses

Farmers have the option of using a net operating loss carryback period of five years, rather than the two-year provision applicable to non-farmers.

The net operating loss carryback rules are inflexible, however, in that the taxpayer cannot choose how much loss to apply in any one year. The loss must be carried back to the earliest year in the allowed carryback period, to offset all of the income in that earliest year before applying loss to the next earlier year.

Capital Gains

Farmers benefit from capital gains, often from the sale of long-held capital assets such as land and buildings. The capital gain is often illusory, however, in that inflation accounts for the higher sales price, especially for assets held since the 1970s and 1980s when annual inflation approached 13.5 percent.

Optional Self-Employment Tax

Farmers benefit from the optional self-employment tax, to earn credits toward the Social Security system even though suffering a loss in a current year. Non-farm taxpayers may elect optional self-employment tax for only five years. Farmers do not have a limit. In addition to earning credits toward the Social Security system, the optional self-employment tax computation might allow the taxpayer to qualify for the earned income tax credit.

Finally, I thank the House Agriculture Committee for its efforts during this last year. Various agricultural subsidy programs rely on the calculation of Adjusted Gross Income. This term doesn't translate well for farms which operate as corporations or other limited liability entities. Previous to the Committee's involvement, the USDA's handbook did not allow the up-to-$500,000 deduction for Section 179 expenses to reduce the income of the operation.

For example, a multi-member LLC with $600,000 of income (well under the $900,000 limit for an individual farmer) was forced to report its income as $1.1 million, preventing the individual members from qualifying for the agricultural programs to which they would have been entitled had they farmed separately. The staff's involvement fixed an error in the guidance.

Thank you for your time, and I look forward to addressing your questions.