January 13, 2014

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Orrin Hatch
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Senators Baucus and Hatch,

Enclosed, please find an analysis prepared by Kennedy and Coe, LLC detailing the potential impacts on agriculture from the tax reform proposals contained in the Chairman's Staff "Cost Recovery and Accounting Tax Reform Discussion Draft" dated November 21, 2013. Kennedy and Coe is a national accounting and consulting firm with over 80 years' experience working with U.S. agriculture.

We very much appreciate the opportunity you have afforded for us to comment on the cost recovery proposals. As noted in the attached analysis, we are especially concerned about the proposal to limit the use of cash accounting by certain agricultural entities. We believe that this proposal would have a significant and deleterious impact on many agricultural operations – reducing equity and increasing costs for operations that already operate with narrow margins. In the coming days, we will be submitting additional supporting materials relating specifically to our concerns with the proposal to restrict the use of cash accounting by agricultural operations.

If you have any questions about the enclosed comments, or if we can be of further service, please do not hesitate to contact me directly. We appreciate all of the work that you have put forward on the critical issue of tax reform. We look forward to working with you and your staff on these matters in the months to come.

Sincerely yours,

Brian Kuehl

Brian Kuehl
Director of Federal Affairs

6125 SKY POND DRIVE, SUITE 200, LOVELAND, CO 80538-9374 / PHONE (970) 685-3500 / FAX (970) 663-0223 / WWW.KCOE.COM
Members of American Institute of Certified Public Accountants.
GENUINE PEOPLE. CREATIVE IDEAS. VALUABLE RESULTS.

Impact on Agriculture of the 11/21/13 U.S. Senate Finance Committee Chairman's Staff Discussion Draft on Cash Recovery and Accounting

January 13, 2014

This memo analyzes the expected positive and negative impacts on U.S. agricultural operations of the tax reform proposals contained in the November 21, 2013 U.S. Senate Finance Committee Chairman's Staff Discussion Draft on Cash Recovery and Accounting.

This analysis examines selected items in the Senate discussion draft that would have the greatest impact (positive and negative) on agricultural producers and compares these impacts to current rules already in place. This analysis does not cover all of the items in the cash recovery and accounting discussion draft, but focuses on those items expected to have the largest impact on agriculture.

This analysis has been prepared by Kennedy and Coe, LLC based on our 83-year history of preparing tax filings and audits and consulting for agricultural operations nationwide.

SUMMARY

As a general principle, Kennedy and Coe strongly supports the concept of tax reform with the goals of tax-code simplification, tax-code fairness, and lower rates. Kennedy and Coe applauds the staff of the Senate Finance Committee for their work on these topics and is hopeful that Congress will enact comprehensive tax reform consistent with these goals.

We note that the agriculture industry differs greatly from other global and domestic industries. Agriculture is a commodity industry with high price volatility, high capital needs, generally low margins and low liquidity, and high risk from weather and global market conditions. Because of these differences, and because of the importance of a strong domestic agricultural industry, Congress has traditionally provided measures in the tax code, in the farm bill, and in other pieces of legislation that allow agricultural operations to mitigate risk. It is our strong belief that tax reform should not increase the already significant risk assumed by farm families and, in turn, the communities and related agricultural businesses that they support and sustain.

It is our assessment that there are some items in 11/21/13 staff discussion draft that will be beneficial for agriculture. Taken as a whole, however, we believe that the pending proposal will make the tax code more complicated for agriculture, could reduce liquidity for agricultural operations, and could lead to increased taxes on agricultural producers even if the proposals were tied to a modest reduction in overall rates. Of particular concern to us is the proposal to limit the use of cash accounting by certain agricultural entities. We believe that this change would have significant and far-reaching negative impacts on agriculture in America.

We have selected the items from the proposal that would have the greatest impact on agriculture and have created a summary for each of those items and how they would impact

producers. We have addressed our comments in the order that the provisions were compiled in the discussion draft – not in order of importance.

We would welcome the opportunity to meet with Committee staff to further discuss these comments and to work to ensure that tax reform simplifies the tax code, promotes fairness, lowers rates, and helps to strengthen agriculture in the United States.

ANALYSIS

Part I. Section 01. Modification and Extension of Section 179 Rules

The 2013 rules for section 179 expensing set a $500,000 expense limit that is phased out as total purchases exceed $2 million. Current law sets the expensing limit for 2014 at $25,000 with the phase out starting as purchases exceed $200,000.

The pending proposal would set the 2014 limits at the same amounts as 2013: $500,000 expense limit with phase out starting at $2 million of purchases. For tax years 2015 and after, the expensing limit would be increased to $1 million with the phase out starting at $2 million of purchases. After 2015, the limits will be indexed for inflation and rounded to the nearest $100,000 increment.

This provision would be favorable to agriculture. It allows for flexibility in determining the amount of fixed-asset purchases to be expensed or to be capitalized. It sets the expensing limit at an amount that has been in effect for several years and is high enough to be a benefit to taxpayers purchasing fixed assets. We will discuss proposed changes to depreciation rules later, but due to the proposed depreciation changes, there could be more incentive to use section 179 in future years versus capitalizing the assets and taking depreciation expense over the asset's life.

Part I. Section 03. Repeal of certain other deductions.

Present law under section 180 allows expenditures for fertilizer, lime, ground limestone, marl or other materials that enrich, neutralize or condition land used in farming to be treated as a deduction during the taxable year that the expenses are paid or incurred.

The pending proposal would not allow a deduction to be taken when the fertilizer expense is paid or incurred. The cost of the fertilizer would be treated as an inventory item under section 471 and 263A, capitalized as a cost of the growing crop, and not expensed until the crop is deemed to be sold. It may be necessary to clarify how this provision will be used by cash-basis producers who do not maintain inventories for tax purposes.

This provision could lead to some fertilizer, but more likely lime and other less frequently applied products, to be expensed over several years rather than in the year paid for and/or incurred. It would also require fertilizer applied to be carried as an inventory item until the crop that the fertilizer is intended for is sold.

This proposal could lead to cash out-flow in one year by increasing a producer's tax bill (compared to current law) when the farmer locks in supply or price of fertilizer for the next year's crop. Because the cash out-flow would not create a deduction, the cash flow needs for farmers could increase and would include the need for cash for fertilizer, other deductible expenses, and also for the increased tax payment.

Part II. Section 11 Pooled asset cost recovery system and depreciation of real property.

Present law allows for depreciation of certain property used in trade or business to be deducted under the modified accelerated cost recovery system (MACRS). The amount of the depreciation deduction is determined by the applicable depreciation method, recovery period and convention. The current recovery periods range from 3-20 years for tangible personal property while most real property uses either a 39 or 27.5 year recovery period.

Farmers track assets individually under present law. Additions or disposals are added each year, with any resulting gains or losses from disposed assets being recorded in the year of disposal.

The pending proposal would replace the current cost recovery system with a pooled property cost recovery system for tangible personal property and with a straight-line cost recovery method for real property:

> **Pool 1** under the pending proposal includes automobiles and computer software. Pool 1 has a 38-percent recovery rate.
>
> **Pool 2** includes light and heavy general purpose trucks, tractor and trailer units, agriculture equipment, cotton ginning assets, breeding and dairy cattle, breeding and work horses, breeding hogs, breeding sheep and goats, trees and/or vine bearing fruit or nuts. Pool 2 has an 18-percent recovery rate.
>
> **Pool 3** includes office furniture and equipment, and airplanes. Pool 3 has a 12-percent recovery rate.
>
> **Pool 4** includes land improvements, railroad tracks, and water transportation. Pool 4 has a 5-percent recovery rate.

The amount of depreciation under the pooled asset cost recovery method is calculated by taking the total net book value of the assets in the pool and multiplying that by the Pool's recovery rate. For the following year, the net book value of the pool is the starting point. Additions and proceeds from dispositions are added or subtracted from the pool. The resulting new pool balance is multiplied by the recovery rate to determine the deduction.

The following is an example of the two depreciation methods on a sample of assets. This example assumes these assets are all purchased in the same year and are the only assets that are owned.

MACRS (current) Method.

			Deductions								
Asset	Cost	Years	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	
Pickup	50,000	5	10,000	16,000	9,600	5,760	5,760	2,880	-	-	
25 Cows	50,000	5	10,000	16,000	9,600	5,760	5,760	2,880	-	-	
Tractor	175,000	7	25,008	42,858	30,608	21,858	15,628	15,610	15,628	7,805	
Feedtruck	125,000	7	17,863	30,613	21,863	15,613	11,163	11,150	11,163	5,575	
50 Breeding Swine	50,000	3	16,665	22,225	7,405	3,705	-	-	-	-	
	Total per year		79,535	127,695	79,075	52,695	38,310	32,520	26,790	13,380	450,000

Pool (proposed) Method.

		Pool	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	
Pickup	50,000	1	19,000	11,780	7,304	4,528	2,808	1,741	1,079	669	
25 Cows	50,000	2	9,000	7,380	6,052	4,962	4,069	3,337	2,736	2,244	
Tractor	175,000	2	31,500	25,830	21,181	17,368	14,242	11,678	9,576	7,852	
Feedtruck	125,000	2	22,500	18,450	15,129	12,406	10,173	8,342	6,840	5,609	
50 Breeding Swine	50,000	2	9,000	7,380	6,052	4,962	4,069	3,337	2,736	2,244	
			91,000	70,820	55,716	44,227	35,360	28,434	22,968	18,618	367,143
Deduction more than (less than) MACRS			11,465	(56,875)	(23,359)	(8,468)	(2,950)	(4,086)	(3,822)	5,238	(82,857)

After year 8, all of the items are fully depreciated under the MACRS system. Using the POOL method, after year 8, there is still an amount of $82,857 that has not been deducted.

While the pooled depreciation schedule would not include details of the assets, details on an asset-by-asset basis will still be needed in case the asset is disposed of as a gift or transferred to a related party. For tax reporting, the example used above would likely report the Pool Method as follows:

		Pool	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	
Pool 1 assets	50,000	1	19,000	11,780	7,304	4,528	2,808	1,741	1,079	669	
Pool 2 assets	400,000	2	72,000	59,040	48,413	39,698	32,553	26,693	21,888	17,949	
	Total Depreciation		91,000	70,820	55,716	44,227	35,360	28,434	22,968	18,618	367,143

In addition to assets never being fully depreciated during their useful life timeframe (5% of a pooled 2 asset remains un-depreciated after 15 years), addition and disposal of assets will be affected.

Under the existing MACRS rules, a sale of the breeding swine for a sales price of $25,000 would result in the following calculation to determine the loss of $12,310 in the year the sale occurs.

	MACRS
Sale Proceeds	25,000
Cost	50,000
Accumulated depreciation	12,690
Adjusted basis	37,310
Gain (Loss)	(12,310)

The proposed Pool Method of depreciation would not result in a loss being recorded if part of the pool assets are sold. Under the Pool Method, the sales proceeds are used to reduce the balance in the asset pool, prior to the applicable recovery rate being applied. Using the same facts in the previous example of selling the breeding swine for $25,000, the following is the resulting depreciation expense calculation using the Pool Method.

		Pool	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	
Pool 1 assets	50,000	1	19,000	11,780	7,304	4,528	2,808	1,741	1,079	669	
Pool 2 assets	375,000	2	72,000	54,540	44,723	36,673	30,072	24,659	20,220	16,581	
	Total Depreciation		91,000	66,320	52,026	41,201	32,879	26,399	21,299	17,250	348,375
	Pool Depreciation before sale		91,000	70,820	55,716	44,227	35,360	28,434	22,968	18,618	367,143
	Reduction in depreciation		-	(4,500)	(3,690)	(3,026)	(2,481)	(2,035)	(1,668)	(1,368)	(18,768)

This example shows that the $25,000 in sale proceeds reduces the balance in Pool 2. The result is that the depreciation expense is actually less in subsequent years, even though there was a loss on the sale of the breeding swine under current systems used for tax and financial statement depreciation.

Additions under the Pool Method will increase the pool balance before the applicable recovery percentage is applied to each pool.

If there are significant disposals from a pool that cause the balance in the pool to become negative, there is a section 1245 gain recorded in the amount needed to restore the pool balance to zero. If all the assets in a pool are disposed of and there is a balance remaining in the pool, at that time a terminal loss is taken on the remaining pool balance. This terminal loss is an ordinary loss when taken on the tax return.

The Pool Method will not simplify asset tracking or calculation of depreciation. We believe it will add another level of complexity. Financial statement accounting will still require that a depreciation schedule be kept on an asset-by-asset basis. Assets will still need to be tracked by specific asset identification for the purposes of insurance, management, and dispositions to related parties. The use of section 179 will also complicate the depreciation picture if the Pool Method is implemented. It is our assumption that records must be kept to determine which assets are part of the Pool and which assets are part of section 179 deductions.

Real property is not included in the Pool Method. Real property is depreciated using the Straight-line Method over a recovery period of 43 years. Real property includes residential rental property, farm building structures, and single-purpose agricultural or horticultural structures. Under the current MACRS system, Single-purpose agricultural structures have a 10 year recovery period, farm buildings have a 20 year recovery period, and rental residential property has a 27.5 year recovery period.

Asset	MACRS	Cost	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
Single Purpose Ag Building		75,000	7,500	13,500	10,800	8,640	6,915	5,528	4,913	4,913
Farm Building		100,000	3,750	7,219	6,677	6,177	5,713	5,285	4,888	4,522
Residential Rental Property		150,000	2,940	5,454	5,456	5,454	5,456	5,454	5,456	5,454
	POOL METHOD									
Single Purpose Ag Building		75,000	872	1,744	1,744	1,744	1,744	1,744	1,744	1,744
Farm Building		100,000	1,163	2,326	2,326	2,326	2,326	2,326	2,326	2,326
Residential Rental Property		150,000	1,744	3,488	3,488	3,488	3,488	3,488	3,488	3,488
	Difference per year per asset									
Single Purpose Ag Building			(6,628)	(11,756)	(9,056)	(6,896)	(5,171)	(3,783)	(3,168)	(3,168)
Farm Building			(2,587)	(4,893)	(4,351)	(3,851)	(3,387)	(2,959)	(2,562)	(2,196)
Residential Rental Property			(1,196)	(1,966)	(1,967)	(1,966)	(1,967)	(1,966)	(1,967)	(1,966)

The table above shows how the change in the life years and method will change the amount of depreciation expense available on an annual basis for the various types of assets. The most severe change is for single purpose agricultural structures that would shift from a 10-year to a 43-year recovery period. This long-term recovery period in many cases would be far longer than the economic life of single-purpose agricultural buildings. In addition, the transition rule requires taxpayers, beginning in 2015, to switch to this method the un-depreciated portion of all real property currently owned and purchased before January 1, 2015.

Part II. Section 12 Rules Related to Treatment of Gains from Depreciable Property.

Under current law, when assets that have been depreciated are disposed of, to the extent there is a gain on the sale, the gain is ordinary income up to the amount of depreciation previously taken on the asset. If the amount of gain exceeds the depreciation taken, the remaining gain is taxed as capital gain. If there is a loss, gains and losses are netted together. If the result is a net loss, then the loss is deductible as an ordinary loss.

The pending proposal would change current law so that all gains from 1245 property would be treated as ordinary gain regardless of the amount of depreciation previously taken on the assets. Under the Pool depreciation method, this would be mitigated by the fact that gain would only be recognized when the pool balance is decreased below zero.

The impact of this change potentially varies depending on the type of agricultural operation involved. In order to have capital gain income to report, the assets being sold would have to appreciate in value over their initial cost. This happens less frequently when machinery and equipment are involved, but depending on price cycles, could be seen more often in livestock operations when the sales price of livestock could be higher than the purchase cost.

The current year is a prime example: Cows that where purchased five years ago or more, may have only cost $700 per head. If they are being sold in the current market, they could bring over $1,000, assuming they were sold at cull prices. The $300 difference between purchase and sales price would be treated as capital gain income under existing rules and would be taxed as ordinary income under the proposal.

The proposal would also change the reporting for raised livestock. Current law treats raised livestock as ordinary income if under 24 months of age, and as capital gain income if over 24 months of age. The proposal would include proceeds from raised livestock as a reduction in the respective pool. This could either limit the amount of income as it would be a basis reduction in the pool, or create income if there is a low basis or no basis in the pool. If it creates income, the income on raised livestock over 24 months of age would be ordinary income and not treated as capital gains. This would increase the tax rate on these raised sales. The dairy industry could see some of the largest impact from this if they are raising their own replacements.

Part II. Section 14 Limitation on Depreciation to Property Predominantly Used in Business.

Current law allows for business assets that are used for both business and personal use to be partially depreciated for business purposes. If an item is used less than 50% of the time for business use, it is depreciated under the alternative depreciation (straight line) method.

The proposed change would disallow any depreciation for assets used in a business less than 50% of the time. For assets that are used in between 50% and 100% of the time, depreciation

is still allowed, but the taxpayer would prorate the amount of the asset eligible for depreciation and add that prorated amount to the respective pool. Also, converting a business asset to personal use is taxable to the extent the fair market value of the asset exceeds basis at the conversion date.

This proposed change could have a negative impact on smaller agricultural operations that have assets that are for both business and personal use where the asset is not used at least 50% of the time for business.

Part II. Section 15 Repeal of Like-Kind Exchanges.

Current law allows for like-kind exchanges of property – allowing the sale of property to be offset by the acquisition of the same kind of property. Under this exchange, known as section 1031 exchanges, gains and losses are most often not reported as a result of the exchange. Basis in the new asset is the basis in the exchanged asset, adjusted for any cash or other assets received or paid in the exchange.

The pending proposal would repeal section 1031, eliminating the non-recognition of gain in the event of a like-kind exchange. This repeal makes sense for assets in a depreciation pool but does not make sense for assets not in a depreciation pool like real estate. If the pool method of depreciation was in place, it is possible that there would be quasi like-kind exchange treatment for assets that are in the same pool.

However, the section 1031 like-kind exchange provision is often used for real property and real estate transactions. The repeal of section 1031 would have substantial impact on taxpayers looking to enter into a section 1031 exchange in real estate transactions. The gain from real estate transactions would be reported as income. The amount of cash available after tax to purchase replacement property would thus be significantly less. If an agricultural operation seeks to exchange two pieces of property and the market value of the two parcels are the same, the taxpayer would have to provide additional cash or take on debt to exchange the properties. The end result would be a net decrease to the taxpayer's equity position after the exchange. Repeal of like-kind exchanges for real property would have a significant and deleterious effect on many agricultural operations.

Part III. Section 23 Treatment of Advertising Expenditures

Current law allows advertising expenses to be deducted as ordinary and necessary business expenses in the year they are paid or incurred.

The proposal would allow 50% of the expense to be deducted in the year paid or incurred. The other 50% of the expense would be amortized over a 5-year period. Advertising expenditures are defined as any message or material designed to promote or market any trade, business, service, facility or product. There are some expenses that are exceptions to the rule that include sales discounts, commissions paid to employees performing sales functions, and sample-sized goods. These items would receive a full deduction in the year paid or incurred.

This would require agricultural operations with marketing costs to incur additional record-keeping to track advertising costs and amortization expense over the 5-year amortization period. For most agricultural operations, overall advertising expenses are low compared to other expenses. The additional cost of record keeping for this proposal compared to the dollar

amount of advertising expenses would be at a high-cost to low-benefit ratio for agricultural operations.

Part III. Section 26 Amortization of Soil and Water Conservation Expenditures.

Under current law, farmers may expense amounts paid or incurred for the purpose of soil or water conservation on land used in farming. The amount of expense is limited to 25% of the gross income from farming on an annual basis. Amounts exceeding the 25% threshold in one year are eligible to be deducted in succeeding tax years.

The proposed change would require amounts paid or incurred for soil and water conservation to be amortized over a 28-year period.

Requiring these expenses to be amortized over 28 years could have a negative effect on the overall environmental picture as the level of soil and water conservation efforts could decrease. If this change were enacted into law, these types of projects would need to have a high economic and financial benefit to stand on their own as the tax benefit of the deduction over a 28-year period would be close to zero.

Subtitle B. Section 51 Limitation on Use of Cash Method of Accounting.

Current law allows individuals, partnerships, s-corporations and trusts engaged in farming to use the cash method to determine their taxable income. Family C-corporations engaged in farming are allowed to use the cash method if their gross receipts are below $25 million in gross receipts.

The cash method of accounting is the simplest method of determining income and expenses. Income is recognized when the cash for the transaction is received. Expenses are deducted based on when the cash is paid.

The proposal would eliminate the cash method for any taxpayer with gross receipts over $10 million (based on a three-year average). The $10 million threshold would be subject to a cost of living adjustment beginning in 2016. The test applies at both the entity and individual partner or shareholder level. Entities and individuals would be required to aggregate gross receipts from multiple operations, if they meet common employer rules currently in place. If a taxpayer exceeds the $10 million gross receipts test, they are required to use the accrual method to determine their taxable income.

The change from cash to accrual would be treated as a change in accounting method initiated by the taxpayer. Under current rules, this type of change would require any difference in income between using the accrual method instead of the cash method to be reported as income over a 4-year period. If gross receipts decrease to below the applicable threshold, the taxpayer would still have to wait 4 years after the first change to go back to the cash method.

This proposed change would have major negative implications for many agricultural operations. The cash and equity needed to pay taxes and operate the businesses would increase as the tax consequences would not be aligned with the cash-flow of the operation. Additional cash would be needed to fund both the inputs of the business and the potential tax liability created under the accrual method of accounting. Kennedy and Coe is very concerned about this proposal and the significant impacts that it would have on U.S. agriculture. Kennedy and Coe will be submitting additional comments and analysis on the impacts of this proposal in the coming weeks.

Subtitle B. Section 52 Repeal of Special Rules for Method of Accounting for Farm Corporations.

Current law allows for family farm corporations with gross receipts under $25 million to use the cash method of accounting. This section repeals the $25 million gross receipts amount and applies the same tests mentioned in Section 51 of the proposal to determine the accounting method used for family farm corporations. This proposal would have a negative impact on family farm corporations with between $10 million and $25 million in gross receipts.

Subtitle B. Section 55 Certain Methods of Determining Inventories not Treated as Clearly Affecting Income.

Under current law, taxpayers that account for inventories have a variety of methods available to account for their inventory. The two main inventory systems are based as either LIFO (last in first out) or FIFO (first in first out). There are variations among the two systems that include dollar-value LIFO and lower of cost or market.

The pending proposal would repeal any inventory accounting method based on using the LIFO method. It would also repeal the use of lower of cost or market method, and prohibit write downs for subnormal (obsolete) inventory. Under the proposal, inventory would not be permitted to be valued below cost.

Most agricultural operations that record inventory use the FIFO method and would thus not be impacted by this proposal. However due to volatility in commodity prices, there are times when the market value of agricultural inventories are below cost and a lower of cost or market (LCM) adjustment is recorded. Financial statement accounting requires that inventory be tested for valuation adjustments whether it is due to market prices or if the inventory is below average in quality or obsolete. This proposal would not allow inventory to be valued at its true economic value for tax purposes, even though it would be adjusted downward for financial reporting.

The restriction on LCM adjustments on inventory will widen the spread between tax return and financial statement reported amounts.

CONCLUSION

Kennedy and Coe appreciates the efforts of the Finance Committee staff on tax reform and fully supports the goals of simplification, fairness, and lowering of tax rates. We are concerned, however, that many of the proposals contained in the cost recovery discussion draft will have a negative overall impact on agriculture when taken as a whole, even if coupled with modest reductions in tax rates.

Kennedy and Coe is especially concerned about the impact to agriculture of the proposed changes to the cash accounting rules. It is our belief that these changes will significantly increase complexity for affected agricultural operations and will materiality decrease the liquidity and financial flexibility that is necessary for these operations to function.

We appreciate the opportunity to submit these comments for your consideration and look forward to working with you to ensure that the final tax reform proposals will strengthen and not harm U.S. agriculture.