

Retirement Planning by Farmers: Opportunities in the Taxpayer Relief Act of 1997

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Abstract

Relatively few farmers regularly use tax-favored retirement accounts to diversify long-term farm assets with nonfarm savings. The Taxpayer Relief Act of 1997 creates new investment opportunities for both IRAs and regular capital assets. Complex tradeoffs exist among new tax incentives, possibly resulting in few overall gains in diversification.

* Ideas expressed in this paper are those of the author and do not necessarily reflect an official position of the Economic Research Service or the U.S. Department of Agriculture. Readers should not construe this report as personal tax advice but should consult with their own attorney.

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Introduction

The Taxpayer Relief Act of 1997 (H.R. 2014, P.L. 105-34), the most sweeping change to the tax code since 1986, creates new opportunities for farmers and others to save for retirement. Retirement planning is important for the aging farm population in the U.S. Farm households must responsibly allocate financial resources to preserve an acceptable standard of living during an increasingly long retirement. Rather than using tax-advantaged plans such as Individual Retirement Accounts (IRAs) or Keogh plans, farmers historically have focused on farm assets and relied on earnings from these assets in retirement (Hamaker and Patrick). The motive for nonfarm diversification, however, has increased due to factors such as land price volatility during the 1980s and the potential for greater farm income variability following the decoupling of price supports in the 1996 Farm Act. Furthermore, uncertainty about future social security benefits puts more responsibility on households for prudent financial planning (Mitchell and Moore).

The paper begins by assessing income sources for current farm retirees and documenting recent use of retirement tax incentives by all farmers. Another section discusses provisions in the tax act that affect retirement planning: (a) expanded opportunities to defer taxes on contributions and earnings, (b) new IRA plans that exempt account earnings from taxation, and (c) lower tax rates on capital gains. While the new type of IRA (the Roth IRA) earns tax-free income and has no mandatory distribution requirement, the optimal choice among IRAs depends more than ever on how much an investor is willing to contribute and the future tax rate. Lower capital gains taxes may increase values of farmland and buildings—important assets for farmers. Similarly, regular taxable investments in the stock market may also benefit from lower capital gains taxes.

Therefore, while new IRA opportunities encourage farmers to diversify into nonfarm retirement accounts, reduced capital gains taxes offset those incentives by continuing to emphasize long-term farm capital such as land. The paper explores these tradeoffs in the third section by comparing the after-tax returns across various IRAs and regular taxable investments. It is not intended to analyze or suggest any optimal portfolio strategy, but rather to compare the relative effects of new tax incentives on a marginal investment. The paper also argues for using the tax rate on each *component* of retirement income, rather than the overall marginal rate, when comparing with today's marginal tax rate. Implications for debt management are also discussed.

Current status of farmers' retirement planning

The long-term, retirement investment strategy of most farm sole proprietors typically focuses on investments that expand or improve the operation. Off-farm diversification has been studied by many authors, and proposed as a means of reducing risk (Hamaker and Patrick; Monke, Boehlje and Pederson; Young and Barry; Crisostomo and Featherstone). Farm resources alone may be insufficient for more than one household if retirement reduces the amount of labor available (Lee, et al.). Undiversified farm equity may be particularly at risk, as in the early 1980s (Boehlje and Pederson). Balance sheets of the farming sector, including households, suggest that diversification among broad asset classes is limited. Financial assets comprise only about 7 percent of total assets, while real estate represents about 70 percent (USDA, p. 40).

Yet, despite this apparent lack of diversification overall, farmers and landlords who are over age 65 receive many different sources of income. Social security benefits plus distributions from pension plans or IRAs comprise about one-third of total income for this group, based on the 1994 IRS Individual Public Use Tax File (table 1). Social security and defined benefit pensions

rarely are included on balance sheets, yet contribute greatly to retirement income diversification. Interest and dividend income is the single largest component, contributing over 25 percent of income spread over nearly all these taxpayers. This may suggest that by some time during retirement farmers have diversified their assets. Farm income for sole proprietors and landlords is not prominent for either group, but is more important for landlords than sole proprietors due to losses on Schedule F which are very common due to tax accounting. While fewer than two-thirds of farmers and landlords over age 65 receive social security benefits, and fewer than 60 percent receive pensions or IRA distributions, many may be deferring the date until these begin.

Therefore, the dispersion of income sources in retirement suggests more diversification than overall balance sheets, partly because assets rarely include the present value of social

Table 1. Frequency and importance of income sources for farmers and landlords over age 65

	Farm sole proprietors over age 65 a/		Farm landlords over age 65 a/	
	Frequency	Amount	Frequency	Amount
	<i>Percent</i>			
Total household income b/	--	100	--	100
Combined farm income c/	100	2	100	17
Interest and dividends (incl. tax-exempt)	96	30	99	26
Pensions and IRA distributions (gross)	58	17	57	17
Social security benefits (gross)	52	14	64	16
Wages and salaries	33	14	18	8
Capital gains (nonfarm)	42	10	39	5
Business income (nonfarm)	17	2	10	1
Rental income (nonfarm)	45	10	40	8

a/ Farm sole proprietors file Schedule F (farm income and loss) with their Federal individual income tax return. Farm landlords report only farm rental income (Form 4835) without Schedule F. Form 4835 does not include fixed cash rental payments; therefore, it understates the number of landlords and rental income, but does not necessarily bias the proportion of total income. As an estimate of retirees, counting all over age 65 overstates the number by including some who still work, but understates the number by excluding early retirees.

b/ The number of farm sole proprietors and landlords over 65 was 453,000 and 339,000, respectively. Total income equaled \$19.8 billion and \$14.3 billion for farm sole proprietors and landlords over age 65, respectively.

c/ Combined farm income equals the profit or loss on Schedule F plus capital gains from the sale of business assets plus farm rental net income.

Source: 1994 IRS Individual Public Use Tax File

security benefits. Yet individual retirees may not have the breadth of diversification as suggested by income, especially since interest and dividends tend to be concentrated among the wealthy.

Some taxpayers are clearly motivated by tax incentives for retirement savings, but many do not take advantage of the opportunity (Mitchell and Moore). About 42 percent of farmers in the 1995 Survey of Consumer Finances (Federal Reserve Board) reported having an IRA or Keogh account, compared with 25 percent in the nonfarm population. Two-thirds of large-scale crop farmers had a tax-deferred retirement plan (Hamaker). Yet, data from the 1994 IRS Individual Public Use Tax File indicate that only 10 percent of farm sole proprietors contributed to either an IRA or Keogh plan, compared with 6 percent of the nonfarm population. Therefore, while farmers are more likely to use IRA or Keogh plans, roughly 9 out of 10 do not contribute during any given year, and between one-third and one-half may not have any such accounts.

Opportunities in the Taxpayer Relief Act of 1997

Individual Retirement Accounts. Prior to the 1997 act, two types of IRAs existed: deductible and nondeductible. Earnings grow tax deferred in both until they are withdrawn. A deductible IRA reduces taxable income in the year the deposit is made by the amount of the contribution, but the deduction may be limited for employees covered by an employer-sponsored pension who have income above some threshold. The deductible contribution remains tax-deferred until it is withdrawn. Nondeductible IRAs are available to all taxpayers with earned income but do not reduce taxable income. An individual's total contribution to all IRAs is limited annually to the smaller of earned income or \$2,000. Distributions before age 59½ were generally subject to a 10-percent penalty in addition to the taxes due on the amount withdrawn.

The 1997 act expands upon these retirement savings incentives. Deductible IRAs become

more accessible in two ways. First, individuals who are active participants in employer-sponsored retirement plans can earn more income and still make deductible contributions. On a joint return, the AGI limit at which deductible contributions begin to be phased out rises by \$10,000 in 1998 to \$50,000, and to \$80,000 by 2007. For single taxpayers, the amount doubles from \$25,000 by 2005. Second, spouses who are not active participants in employer-sponsored retirement plans, but who are married to active participants, may fully deduct IRA contributions if household income is less than \$150,000. Previous legislation phased out a spouse's deduction concurrently with the active participant.¹

The 1997 act also creates a new, nondeductible "Roth IRA" which allows tax-free distributions of interest earnings if funds are withdrawn after 5 years and the individual has reached age 59½, died, or become disabled. Contributions to any Roth IRA are phased out for couples with AGI more than \$150,000 and individuals with more than \$95,000. Roth IRAs also have more flexible distribution requirements. Penalty-free withdrawals of contributions may be made before age 59½ or within 5 years because the contribution has already been taxed, but unqualified withdrawals of earnings are subject to penalties and taxes. Unlike other IRAs, distributions are not required after age 70½, and contributions may continue to be made. Income limits are not indexed for inflation, and total annual contributions to all IRAs remain limited to \$2,000 per individual. Special rules are available to convert existing IRAs into Roth IRAs.

Even though expanded access to deductible IRAs helps only those employees who are

¹ The Small Business Job Protection Act of 1996 had already expanded deductibility for nonworking spouses by allowing them to contribute up to \$2,000 annually beginning in 1997, up from \$250. Deductibility, however, continued to be reduced for both spouses based solely on one spouse's participation in an employer-sponsored retirement plan.

covered by employer-sponsored pension plans and their spouses, about 300,000 additional farm households will become eligible for deductible contributions (Monke and Durst). Nearly all farm households will qualify for the new Roth IRAs.

Lower capital gains tax rates. Because some long-term capital assets such as farmland commonly are viewed as retirement savings, but are not eligible for IRAs, capital gains tax rates (and the tax deferral until gains are realized) are an important factor in farmers' retirement plans.

Historically, capital gains have received special treatment in the tax code, but less so from 1986 to 1997. Prior to the Tax Reform Act of 1986, 60 percent of capital gains were excluded from taxation and the remainder was taxed at ordinary tax rates. After the 1986 act, gain on the sale of capital assets was generally subject to the same tax rate as ordinary income, except that a top marginal rate of 28 percent was imposed on gains from assets held longer than a year.

The 1997 act reduces the maximum tax rate to 20 percent on gains from assets held more than 18 months.² A 10-percent rate applies to taxpayers in the 15-percent tax bracket (for example, joint returns with taxable income less than \$41,200 for 1997). In addition, for assets acquired beginning in 2001 and held more than 5 years, the maximum tax rate will be reduced to 18 percent. For individuals in the 15-percent bracket, an 8-percent rate applies after 2000 regardless of the purchase date, so long as the holding period exceeds 5 years. In contrast with treatment before the act when only taxpayers above the 28-percent bracket benefited from the maximum rate on capital gains, the new array of capital gains tax rates offers all taxpayers some level of preferential treatment. A 25-percent capital gains tax rate applies to recaptured

² The IRS Restructuring Act of 1998 (H.R. 2676, P.L. 105-206, July 22, 1998) shortens the holding period requirement to 12 months, the period that was applicable before the 1997 act.

depreciation on farm buildings and similar business assets. Gain from selling depreciated equipment and single-purpose agricultural structures, however, is still taxed as ordinary income. The act also allows a taxpayer to exclude up to \$250,000 of gain on the sale of a principal residence (\$500,000 if married and filing a joint return).

Without other changes affecting prices, farmland and other capital assets may command a premium price because of lower capital gains taxes (Long). Competition should equalize the after-tax return with other assets for individuals facing similar marginal tax rates. Current owners may show greater wealth, and all investors may expect higher long-term after-tax gains.

Analysis of new retirement investment opportunities

Tax incentives of IRAs vs. capital gains. The new opportunities of Roth IRAs and reduced capital gains taxes require careful consideration. Both encourage investment, but the preferred choice varies among individuals. Some may choose the plan that yields the greatest amount in retirement after taxes, based on marginal tax rates today and in retirement. Others may prefer deductible IRAs for the current tax savings, or may select Roth IRAs because earnings are tax-free with no mandatory distributions. Some may prefer the liquidity of regular investments which qualify for lower capital gains taxes. These tradeoffs are discussed below.

The \$2,000 annual IRA contribution limit is more restrictive for deductible IRAs than for Roth IRAs (Joint Committee on Taxation, 1997). Contributions to Roth IRAs are made with after-tax dollars, allowing investors to allocate more than \$2,000 of pretax income to retirement savings. On the other hand, contributions to deductible IRAs are made with pretax dollars, limiting the total pretax retirement allocation to \$2,000. Therefore to make a fair comparison of the future after-tax balance, a \$2,000 contribution to a Roth (or nondeductible) IRA equals a

\$2,000 contribution to a deductible IRA plus a deposit to a regular taxable account equal to the tax savings from the deductible contribution.

The formulas in table 2 compare future values after taxes of a single deposit for four different types of retirement savings accounts and are presented together to facilitate comparison. Formulas for the three IRAs are adapted from the Joint Committee on Taxation; the formula for the regular taxable account was derived by the author. Interest or dividends are assumed to be reinvested, and capital gains are not realized until the end of the period. For the regular taxable account, taxes are subtracted from current dividends before the balance is reinvested.

Each formula begins with the amount of pretax income, A , needed to make the actual deposit. The annual total nominal rate of return, r , equals the current rate of return, c , plus the capital gains rate of return, g . The investment horizon ends when funds are withdrawn in n years, sometime during retirement. The marginal tax rate today is t_0 , the expected tax rate in retirement is t_w , and the capital gains tax rate in retirement is t_G . All rates of return and taxes are expressed in decimal form. The variable z equals the total annual rate of return after taxes are subtracted from current income, $z=c(1-t_0)+g$. Formulas for the Roth and deductible IRA are straightforward. In the nondeductible IRA formula, the term after t_w represents the earnings above the contribution amount which are taxed upon withdrawal in retirement. In the regular

Table 2. Formulas to compare tax incentives and after-tax returns of retirement plans

Type of account	Future value of a single deposit, after taxes	Pre-tax contribution
Roth IRA	$A (1-t_0) (1+r)^n$	$A < 2000 / (1-t_0)$
Deductible IRA	$A (1+r)^n (1-t_w)$	$A < 2000$
Nondeductible IRA	$A (1-t_0) [(1+r)^n - t_w ((1+r)^n - 1)]$	$A < 2000 / (1-t_0)$
Regular taxable account	$A (1-t_0) [(1+z)^n - t_G [((1+z)^n - 1) g / z]]$	(none)

taxable account, the term after t_G equals the capital gain on both the original investment and reinvested dividends (assuming dividends are reinvested on an after-tax basis).

When the marginal tax rate does not change ($t_0=t_w$) and the contribution is not constrained ($A<\$2,000$), the first two formulas become identical and show how a Roth IRA can yield the same amount as a deductible IRA. The formula for the nondeductible IRA incorporates tax-deferred growth with taxation on the final earnings. The regular taxable account includes ongoing taxation of current income and taxation of the capital gain only at the end of the horizon.

The following simulation assumes a 15-year investment horizon for a common asset which may be owned either as an IRA or in a regular taxable account. The asset earns a 10-percent nominal annual total rate of return (7-percent capital gain, 3-percent current return), with reinvested dividends. These rates of return are generally representative of long-term historical averages for both the U.S. stock market and farmland (Monke, Boehlje and Pederson).

Because of the tax savings, Roth and deductible IRAs clearly offer greater after-tax returns than nondeductible IRAs and regular taxable accounts (table 3). Deductible IRAs are preferred if marginal tax rates are expected to fall substantially in retirement. Roth IRAs are better if tax rates are expected to rise. The choice is less clear when the marginal tax rate is expected to remain the same in retirement as today. If an investor is not constrained by the \$2,000 limit, Roth and deductible IRAs yield the same value after taxes. However, if the investor is constrained (can allocate more than \$2,000 of pretax income), the Roth IRA yields a greater future value unless tax rates fall in retirement.

Nondeductible IRAs never return more than Roth or deductible IRAs, but they may still be preferred to a regular taxable account when investors do not qualify for any other IRA.

Table 3. Future value after taxes for different retirement plans under several tax scenarios

	Marginal tax rate scenario		
	Same today and retirement	Higher in retirement	Lower in retirement
		<i>Percent</i>	
Tax rate today, t_0	28	15	28
Tax rate retire, t_w	28	28	15
Capital gains tax, t_G	18	18	8
Type of account a/		<i>Dollars</i>	
<u>Not constrained by \$2,000 IRA contribution limit (A=\$1,000)</u>			
1. Roth IRA	3,008	3,551	3,008
2. Deductible IRA	3,008	3,008	3,551
3. Nondeductible IRA	2,367	2,794	2,664
4. Regular taxable account	<i>2,411</i>	<i>2,847</i>	<i>2,561</i>
<u>Constrained by \$2000 IRA contribution limit b/</u>			
1. Roth IRA	8,354	8,354	8,354
2. Deductible IRA portfolio	7,891	7,020	9,093
3. Nondeductible IRA	6,575	6,575	7,401
4. Regular taxable account	<i>6,698</i>	<i>6,698</i>	<i>7,114</i>

a/ Simulation assumes a 15-year investment horizon, 10-percent nominal annual total rate of return (7-percent capital gain, 3-percent current return), and reinvested dividends. **Bold** indicates the maximum of the four accounts. *Italics* indicate when the regular taxable account exceeds the nondeductible IRA.

b/ For a fair comparison, the \$2,000 limit on a Roth (or nondeductible) account equals a \$2,000 deductible IRA contribution plus a deposit to a regular taxable account equal to the tax savings. The pretax amount (A) is \$2,778 in the 28-percent tax bracket; \$2,353 in the 15-percent bracket.

However, if investors are concerned with an IRA's distribution restrictions, regular taxable accounts are increasingly competitive because of lower capital gains tax rates. In fact, if capital gain returns are relatively larger than current returns and no interim gains are realized, regular taxable accounts may yield more after taxes than nondeductible IRAs. Any advantage of a regular account decreases, however, with longer holding periods when any of the return is a currently taxable dividend or interest which can grow tax-deferred in the IRA.

Marginal tax rates today, in retirement, and on components of income. Choosing between a Roth and deductible IRA depends largely upon the current marginal tax bracket and the future tax rate. Prospective investors decide between current tax savings from deductibility versus future tax savings from tax-free earnings. As indicated above, deductible IRAs yield a

greater return than Roth IRAs only when future tax rates are expected to fall. Under a progressive tax structure, the choice becomes especially important for taxpayers in the 28 percent tax bracket or above who believe that their marginal tax bracket could fall in retirement. Some retirees experience higher incomes in retirement than planned, however, and do not drop into a lower marginal tax bracket. Although creating more wealth is a positive outcome of retirement planning, the possibility of not achieving a lower marginal tax rate affects decisionmaking.

Rather than comparing the marginal tax rate both today and in retirement, the marginal tax rate today should be compared to the future tax rate on each taxable dollar distributed from a retirement plan. In a tax accounting framework, deductible contributions are subtracted from the top of total income and reduce taxes at today's marginal tax rate. Distributions from retirement plans, however, become components of future income and contribute to filling each tax bracket. Therefore, even though total income in retirement may trigger a marginal tax rate equal to today's marginal rate, each dollar of a distribution during retirement may be taxed in whole or in part at lower tax rates than the marginal rate. This argument admittedly assumes some method of ordering income sources—an imprecise task when income is fungible. Nonetheless, the idea is simple: income in retirement, much of it from tax-deferred retirement plans, builds from zero by first offsetting the standard deduction plus personal exemptions, and then successively filling the 15 percent bracket and so on. A deductible contribution made during a high tax bracket year may be distributed in retirement so that it is taxed a lower rate, even when the marginal retirement tax rate may be no less than the pre-retirement tax rate. Furthermore, part of a deductible contribution may offset taxes from a higher bracket than the marginal rate actually paid. This approach to decisionmaking bolsters deductible IRAs, or suggests a portfolio of both Roth and

deductible IRAs, depending on the number and size of other retirement income sources.

Effect on debt management: leveraged farm investments vs. IRAs. Investments in farmland and other farm capital assets are more likely to be financed with debt than IRA contributions. Leveraging farm assets increases both the rate of return to equity and the riskiness of the return. The ability to take on additional debt will vary with individual circumstances, as will the need or appropriateness of off-farm financial investment. Furthermore, the scale of farm capital investments is often much larger than a series of IRA contributions. This affects both the feasibility of either investment alternative and the need for debt financing.

Conclusions

The Taxpayer Relief Act of 1997 created new investment opportunities for both IRAs and regular capital assets. Complex tradeoffs exist among the new tax incentives, but deductible and Roth IRAs typically offer the greatest after-tax return. The new Roth IRA has advantages for distribution requirements and for those who are constrained by the \$2,000 limit. Deductible IRAs still may be preferable for investors who expect lower tax rates in retirement. The framework in which current and future tax rates are incorporated, however, is important. Rather than using marginal tax rates, investors may want to consider average tax rates on each component of retirement income and on deductible contributions. This approach may help deductible IRAs compete with the new Roth IRAs. For investors who do not qualify for either of these IRAs or who do not like the restrictions of an IRA, lower capital gains tax rates offer new incentives to invest in regular taxable investments and still build greater future after-tax wealth. Because the new tax incentives favor both investment in farm capital assets and retirement plans, incentives for and gains in off-farm diversification may be limited.

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