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FEDERAL TAX POLICY AND THE FARM SECTOR

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Farmers would be affected by a number of the proposed general tax cuts as well as several farm-specific tax provisions. This paper presents possible impacts of Farm and Ranch Risk Management (FARRM) accounts and proposed estate tax changes. FARRM accounts would be tax-deferred savings accounts to help farmers manage income variability. The accounts could allow many primary occupation farmers build a sizeable self-insurance safety net, but are not likely to reduce the need for government assistance since many small farmers will be excluded due to low taxable farm income. Estate taxes are currently paid by about 4 percent of all farmers, but a much larger number are required to file, utilize special farm provisions, alter business practices, or engage in estate planning to reduce the impact of the tax. Proposals either to repeal the tax or significantly increase the exempt amount would virtually eliminate the estate tax as a barrier to the transfer of the family farm to the next generation.

INTRODUCTION

Federal tax policies not only influence the financial well-being of the farm household but can also have important effects on the number and size of farms, their organizational structure, and their use of land, labor, and capital inputs. The most important Federal taxes for farmers are the income tax, the self-employment tax, and the estate tax. In 1996, the most recent year for which complete data are available, Federal income taxes on farm and nonfarm income comprised 48 percent of farmers' total tax burden. Social Security and self-employment taxes represented 26 percent and Federal estate taxes just over 1 percent. State and local income and property taxes accounted for the remaining 25 percent (figure 1).

Since most farms are operated as sole proprietors, partnerships or small business corporations, most farm income is taxed under the individual income tax rather than the corporate income tax. Therefore, since the household is the typical unit of taxation, farm and nonfarm income are commingled when computing income taxes. In fact, most Federal income tax can be attributed to nonfarm income.

Since 1980, IRS data indicate that farmers have reported negative aggregate net farm income for tax purposes (figure 2). These farm losses reduce taxes by offsetting taxable income from nonfarm sources. In 1996, farm sole proprietors reported over \$96 billion in taxable gross farm business income but reported a net farm operating loss of \$7.1 billion. The net loss consisted of \$8.9 billion in profits reported by about one-third of all farm sole proprietors and \$16 billion in losses reported by the remaining two-thirds. While losses are distributed similarly to the distribution of the number of farms across the farm typology,¹ 85 percent of farm profits (figure 3) are concentrated among the 26 percent of farms that are primary occupation small farms and large farms.

The Federal individual income tax imposes the largest tax burden on the broadest group of farmers in

¹ The Economic Research Service developed a new farm typology (USDA-ERS) in response to discussions by the National Commission on Small Farms. The typology defines small farms as those with sales less than \$250,000. It further divides them into mutually exclusive groups based on characteristics such as the primary occupation (farming, retirement, or lifestyle/nonfarm), and limited resource (low farm asset base, sales, and household income).

the aggregate, but the relative importance of the different taxes varies with farm size and other aspects of the farm business. Thus, the current tax debate which primarily focuses on the individual income tax and the estate and gift tax is of considerable importance to the farm community.

TAX CUT PROPOSALS

Prospects for a steadily growing budget surplus over the next decade, indications of slowing economic growth, and a Federal tax burden as a share of Gross Domestic Product (GDP) at its highest level since the end of World War II have combined to shift the focus from whether or not to cut taxes to what taxes to cut and by how much. Among the proposals likely to be considered are those passed by Congress in 1999 and 2000 but vetoed by President Clinton as well as President Bush's proposed cuts that total an estimated \$1.6 trillion over the next decade. These include:

- *Across the board reductions in individual marginal income tax rates*
The President's proposal would replace the current tax rate structure with four tax rates of 10, 15, 25 and 33 percent. Like other taxpayers, most farmers are taxed at the current 15-percent marginal tax bracket. However, tax brackets vary widely by farm type (figure 4).
- *Reduction or repeal of Federal estate and gift taxes*
Proposals include a substantial increase in the unified credit or the special deduction for qualified family-owned business interests, conversion of the credit to an exemption, a reduction in estate tax rates, and the complete repeal of the Federal estate tax within 10 years.
- *Tax cuts for married couples*
The President's proposal would provide a deduction equal to 10 percent of the lowest earning spouse's wages up to \$3,000. Other approaches include increasing the standard deduction to twice the amount for a single return, widening the 15-percent tax bracket for joint returns, and extending the phase-out range of the earned income tax credit. Allowing married couples to file as two single taxpayers has also been proposed.
- Other proposals include an increase in the expensing allowance for capital investment, alternative minimum tax relief, a reduction in capital gains tax rates, an increased child credit, and expanded tax benefits for education and retirement.

In addition to these general tax proposals, there are a number of potential tax law changes that would be specifically targeted to farmers. These include:

- *Farm and Ranch Risk Management (FARRM) Accounts*
Allow farmers to deposit up to 20 percent of farm profit in tax-deferred accounts in order to accumulate funds that could be used in low-income years.
- *Full deductibility of health insurance premiums*
Accelerate the full deductibility of health insurance premiums that are currently 60 percent deductible and not scheduled to be fully deductible until 2003.
- *Income averaging and the alternative minimum tax*
Farmers would be able to utilize the farm income averaging provision without affecting alternative minimum tax liability.

- Other proposals include a one-time \$500,000 capital gains exclusion on the sale of a farm, the exemption of CRP payments from the self-employment tax and increased reforestation tax benefits.

While many of these tax cut proposals would provide significant tax reductions to farmers, a couple of the proposals are of special interest to the farm community. These include legislative proposals concerning FARRM accounts and reductions in Federal estate and gift taxes.

FARM AND RANCH RISK MANAGEMENT (FARRM) ACCOUNTS

A program of tax-deferred savings accounts for farmers is one alternative being considered by Congress to help farmers manage year-to-year income variability. By depositing income into Farm and Ranch Risk Management (FARRM) accounts during years of high net farm income, farmers could build a fund to draw on during low-income years. Farmers who are able to build new savings through these accounts could self-insure some of their income risk, with the additional incentive of tax deferral and possibly tax savings through bracket reduction.

How FARRM Accounts Would Work

As proposed by Congress, farmers could take a Federal income tax deduction for a FARRM deposit of up to 20 percent of eligible farm income. Eligible farm income is defined as taxable net farm income from schedule F of IRS form 1040, plus net capital gains from the sale of farm assets including livestock but not land. Deposits would be made into interest-bearing accounts, and earnings would be distributed and taxable annually. Withdrawals from principal would be at the farmer's discretion and taxable in the year withdrawn. Deposits could stay in the account for up to 5 years, with new amounts added on a first-in, first-out basis. Deposits not withdrawn after 5 years would incur a 10-percent penalty. FARRM funds would also have to be withdrawn if the participant stops farming. Deposits and withdrawals would not affect self-employment taxes.

FARRM account eligibility would be limited to individual taxpayers - that is, sole proprietors, partners, and Subchapter S shareholders - who report positive eligible farm income. To benefit from the tax deferral, the farmer must also owe Federal income tax in the year of the deposit. Using IRS data, an estimated 916,000 farmers would be eligible to contribute as much as \$2.8 billion to FARRM accounts each year. Farm sole proprietors account for over two-thirds of eligible participants and three-fourths of potential contributions.

Even though sole proprietors dominate these FARRM account estimates, significant variation exists within their ranks. Nearly 73 percent of all farm sole proprietors either report a farm loss or have no Federal income tax liability and therefore either could not participate or benefit from participating, respectively. Nearly half of the remaining 27 percent of sole proprietors who are eligible would be limited to contributing less than \$1,000 in any given year (figure 5). Only about one of every six sole proprietors could contribute more than \$1,000. Thus, while the amount of money necessary to provide risk protection - for either farm operations or household living expenses - is difficult to estimate, with over 80 percent of all farmers limited to contributions of less than \$1,000 in any given year, and with participation rates certain to be less than 100 percent of those eligible, most farmers are not likely to accumulate significant reserves.

Benefits Vary by Type of Farm

While an estimated 27 percent of all sole proprietors would be eligible for FARRM deposits in any given year and the average potential contribution for those who are eligible would be \$3,500, there

would be considerable variation among the farm types (table 1). Large family farms with sales over \$250,000 are the most likely to be eligible, at 69 percent. Their average potential contribution is \$10,800, more than twice that of the next closest group. For these large farms, and even many primary occupation small farms, FARRM accounts could offer the ability to build a sizeable and useful self-insurance safety net over several years.

At the other extreme, however, limited resource farms - farms with sales less than \$100,000 and household income less than \$10,000 for tax purposes - are the least likely to be eligible. Because of low income, most of these farms do not owe income tax and would have no incentive to participate. For the 10 percent who are eligible, their average potential deposit is only \$760. With such small amounts, FARRM accounts would be of little value to limited resource farms.

FARRM accounts will also be of relatively little benefit to other groups of small farms such as retirement and lifestyle farms. Although lifestyle farms make up the largest group by the number of farms, only 20 percent would be eligible because most lifestyle farms report taxable farm losses. On the other hand, many lifestyle farms may not need an additional risk management tool because their primary occupation and source of income is away from the farm.

Table 1—Eligibility and size of FARRM accounts vary considerably by farm type

	Small family farms					Large family farms	All farm proprietors
	Limited resource	Retirement	Lifestyle / other	Primary occupation			
				<\$100	\$100-250		
Number of farmers	218,383	261,926	1,167,321	336,498	151,970	82,865	2,218,964
Percent with...							
...schedule F farm profit	51	26	20	51	76	77	34
...taxable household income	17	78	90	69	69	79	76
Estimated percent eligible for FARRM accounts	10	24	20	40	61	69	27
Average potential FARRM deposit for those eligible (\$)	760	2,900	1,600	3,700	4,800	10,800	3,500

Note: Actual participation and deposit amounts are affected by individual behavior and would be less than eligibility and potential deposit amounts indicated.

Source: Compiled by USDA-ERS from 1996 Internal Revenue Service data and simulations of FARRM Accounts.

Financial Incentives and Policy Considerations

Farmers clearly respond to tax incentives. But without targeting (specifying other income criteria for eligibility), a large share of the benefits could go to relatively few farmers, including some who do not rely on farming for their livelihood. Because the current proposal does not specify a maximum deposit or accumulated balance, about 0.5 percent of sole proprietors would be eligible to contribute over \$20,000 annually, representing 25 percent of total sole proprietors' potential deposits (Monke and Durst). The average off-farm income for this group exceeds \$250,000. This increases the likelihood that their contributions would be high.

To meet goals of increasing risk management and achieving program efficiency (benefits exceeding costs), FARRM accounts must create new savings rather than replace existing risk management practices (Monke). New savings must come from reduced household consumption or from funds that

would have been invested in the business. If deposits come from assets shifted from existing savings, saving that was intended for another account, or borrowing, FARRM accounts would serve more as tax-management than risk management. IRS data suggests that at least initially most farmers who are potentially eligible have ample resources to shift funds into FARRM accounts instead of creating new savings.

In summary, tax-deferred risk management accounts have the potential to encourage farmers to provide their own safety net by saving money from high-income years to withdraw during low-income years. Taxpayers could benefit if farmers' additional financial diversification and liquidity reduce the need for income support programs or ad hoc disaster relief. Nonetheless, several potential limitations to the program's effectiveness exist. These include: (1) low levels of taxable farm income that preclude most farmers from building meaningful balances, particularly those most in need of risk management tools such as limited resource and beginning farmers; (2) concentration of benefits among operators with large farms and relatively high nonfarm income; (3) the forced withdrawal of deposits after 5 years; and (4) funding of FARRM accounts with existing liquid assets instead of new saving. Given these limitations and differences within and across farm types, FARRM accounts may improve short-term cash flow for those who participate but are not likely to significantly reduce the demand for emergency relief from the Federal government.

FEDERAL ESTATE AND GIFT TAX REFORM

Estate and gift tax receipts have historically accounted for a relatively small share of total Federal revenues, accounting for a little over one percent of total revenue in 1998. Although the number of estates subject to tax has more than doubled over the last decade, only 47,483 or about 2 percent of all estates are currently taxable. Nevertheless, while the aggregate importance of Federal estate and gift taxes is small relative to other Federal government revenue sources, the potential impact of these taxes on an individual or group of individuals, such as farmers and other small business owners, can be substantial. Providing relief to farmers and other small business owners was the primary impetus for the 1997 changes to Federal estate and gift tax policies and is a major objective of the current effort to provide additional reductions or to completely repeal Federal estate and gift taxes.

Special Farm Provisions

The appreciation in land values, the increase in farm size, and the rising investment in farm machinery and equipment have increased farm estate values and taxes. Over the years, Congressional concern that the farm sector's increasing estate and gift tax liability might cause the break-up of some family farms and other small businesses has led to the enactment of a number of targeted provisions to provide tax relief to farmers and other small business owners. These targeted provisions include the special use valuation of farmland, the installment payment of estate taxes, and a new deduction for family-owned business interests.

Special Use Value. In general, the value of property for estate tax purposes is the fair market value at the date of death. However, if certain conditions are satisfied, real property included in the estate that is devoted to farming may be valued at the property's value as a farm rather than at its fair market value. In order to be considered qualified property, the property must be transferred to a qualified heir and must satisfy certain participation, use and relative value requirements. For most farms, the use valuation law can reduce the value of the real property portion of qualifying estates by 40 to 70 percent, with the largest reductions occurring for farmland which has residential or commercial development potential. The maximum reduction in value is currently limited to \$800,000 but is indexed for inflation. All or a

portion of the special use value benefits are recaptured if the property is sold to a nonfamily member or if the property ceases to be used for farming within 10 years of the decedent's death.

Installment Payment of Estate Tax. A second special provision currently available to farmers and other small business owners is aimed at the liquidity problem that these businesses can face as a result of having a large portion of the estate in land and other relatively illiquid business assets. While Federal estate and gift taxes generally must be paid within 9 months of the date of death, if at least 35 percent of an estate's value is a farm or closely held business, estate taxes on these assets can be paid over a 14-year period. The interest rate on the first \$1 million in taxable value (above amounts exempted by the unified credit) of the farm or other closely-held business is 2 percent with the rate on amounts above \$1 million equal to 45 percent of the normal rate applicable to underpayments of tax.

Deduction for Qualified Family-Owned Business. Beginning in 1998, a new deduction for qualified family-owned business interests was enacted. This \$675,000 deduction is in addition to any benefits from special use valuation and the unified credit. However, the deduction combined with the amount exempted by the unified credit is limited to \$1.3 million. Participation and recapture provisions similar to those applicable to the special use value provision also apply to this new deduction.

Current Impact of Federal Estate Taxes on Farmers

The changes enacted in 1997 reduced the number of farm estates that will be subject to tax primarily by increasing the amount exempted by the unified credit from \$600,000 to \$1,000,000 by 2006 and by increasing the favored treatment of farm and other business assets over other assets for estate tax purposes. Despite this favorable treatment, nearly twice as many farm estates are taxable than all other estates. Based on simulations using 1998 farm-level survey data, an estimated 4 percent of all farm estates would owe Federal estate and gift taxes, compared to just about 2 percent of all estates. Of the 31,161 estimated farm estates for 1998, about one out of every 6 estates had assets in excess of \$625,000 and would be required to file an estate tax return (fig. 6). After deductions, special use value and the family business deduction, only about 4 percent of farm estates would be taxable. The total amount of Federal estate taxes owed by these farmers was estimated at \$735 million. The average tax due for those who owed tax was about \$600,000 on an average net worth of \$2.8 million.

The Federal estate tax burden can be further analyzed by the size and type of farm. Using the new ERS farm typology, it is clear that the Federal estate tax should not be of major concern to most small farms (farms with sales under \$250,000). Only about 3.5 percent of all small farms owe any Federal estate taxes (fig. 7, 8). Compared to small farms, the share of large and very large farms that owe taxes is significantly greater with 10 percent and 17 percent respectively owing Federal estate taxes. In most instances, the tax owed is also greater with the very large farms on average owing over \$1 million in Federal estate taxes.

Without the special provisions, the Federal estate tax would impose a much greater burden on farmers. The potential for savings from these provisions is highlighted by the fact that the special use valuation and the family business deduction reduced both the number of taxable estates and total Federal estate taxes for all farm estates by about half (fig. 9). The largest percentage reductions occurred for primary occupation farms with sales of between \$100,000 and \$250,000. Federal estate taxes for this category of farms was cut by nearly 75 percent. Reductions for retirement farms were substantially less with such farms experiencing only about a one-third reduction in taxes. This reflects the inability of a larger share of retirement farms to qualify for the family business deduction due to the relatively large value of nonfarm assets in the estate. This may reflect the disposition of farm assets in anticipation of or during retirement. Reductions as a percentage of tax were also smaller for very large farms. This can be

attributed to the cap on the reduction in value under the special use value provision and the fixed deduction amount under the new deduction for family-owned business interests.

The installment payment provision further reduced the estate tax burden by providing below market interest rates over an extended repayment period. Over half of all taxable farm estates were eligible for installment payment. These estates owed much higher taxes on average and accounted for over 87 percent of total Federal estate taxes owed by farmers. The present value of Federal estate tax payments for these farm estates was reduced by about one-third.

Who Would Benefit from Repeal or the Alternative Proposals?

While only about 4 percent of all farmers owe Federal estate tax, a much larger number of farmers are required to file, utilize special farm provisions, alter business practices or engage in estate planning to reduce the impact of the tax on their farm business. Thus, while the majority of the benefits would accrue to the 4 percent of farm estates that owe taxes, the repeal of the Federal estate tax would affect a much broader group of farmers.

About 1 out of every 6 farm estates must file an estate tax return. This group of farmers would be relieved of the administrative burden of filing. Also, those required to file but who owe no tax due to special provisions, including special use valuation and the deduction for family-held business interests, may be subject to the recapture of estate tax benefits and may face increased income tax liability due to a lower carryover basis associated with special use valuation provision. The number of farm estates that must file but owe no tax due to these special provisions is estimated at nearly double the number of estates that actually owe Federal estate taxes. As a result of the repeal of the Federal estate tax, these individuals would realize income tax savings and could avoid potential estate tax recapture liability. Finally, those farmers with assets near the filing threshold would no longer need to alter their business plans or engage in other estate planning techniques to avoid the estate tax.

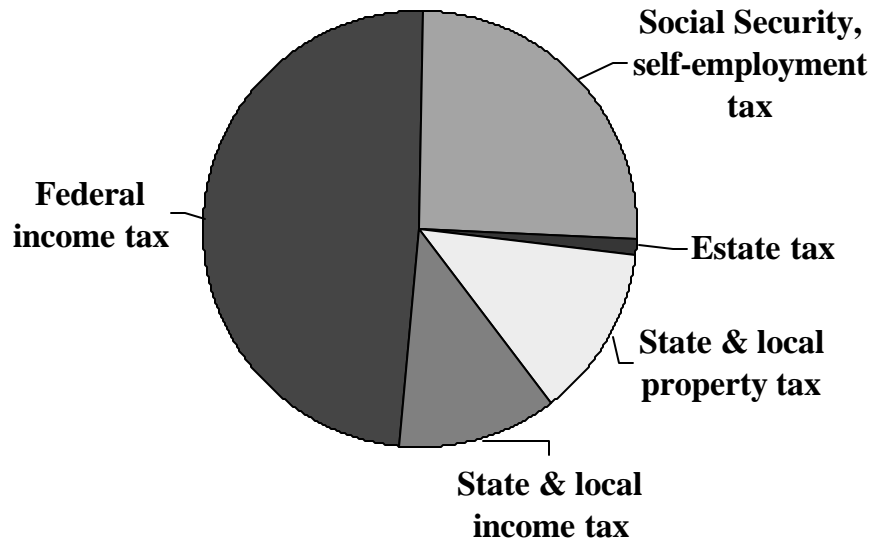
While there is considerable Congressional support for repeal, alternatives such as a significant increase in the unified credit or the value of special provisions for farmers and other small business owners are also under consideration. Due to concerns regarding the cost of eliminating the estate tax, repeal is likely to be phased in over several years and may also involve some limitations on the step-up in basis rules that currently exempt unrealized gains on inherited property from the income tax. Since a large share of the tax is paid by estates over \$5 million, an immediate significant increase in the exempt amount could sharply reduce the number of estates required to file a return and pay taxes while continuing to collect substantial estate tax revenue (fig. 10). As a result, this alternative may provide a greater reduction in taxes to a larger number of farm estates over the next decade. In any event, whether it is a phased-in repeal or a significant increase in the exempt amount, it seems likely that Federal estate taxes will be eliminated as a factor affecting the transfer of the family farm to the next generation.

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- Monke, J. June 1997. "Do Farmers Need Tax-Deferred Savings Accounts to Help Manage Income Risk?" AIB 724-07, <www.ers.usda.gov/publications/AIB724/Aib72407.pdf>
- U.S. Department of Agriculture, Economic Research Service. 2001. Farm Structure Briefing Room: Questions and Answers. <www.ers.usda.gov/briefing/FarmStructure/Questions/smallfar.htm>

Figure 1.

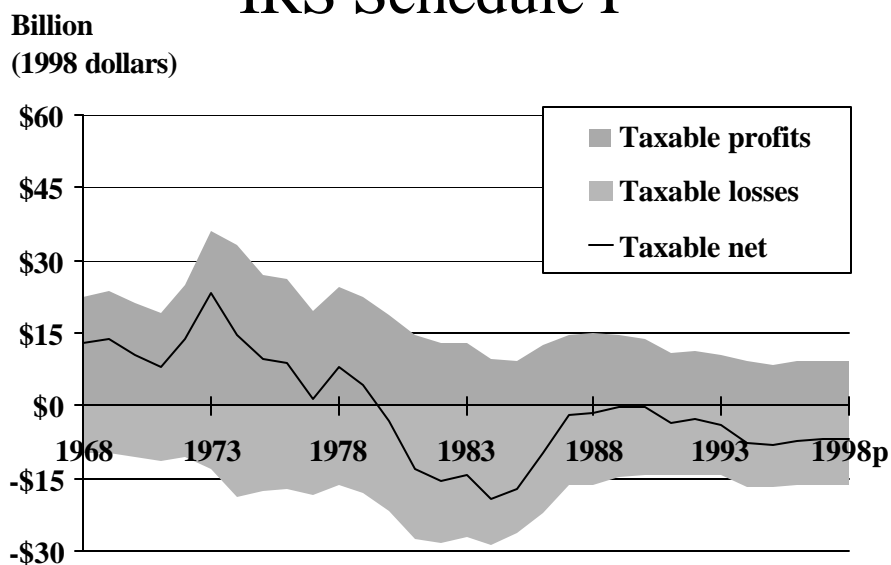
Taxes paid by farm sole proprietors (includes nonfarm income)



Source: USDA-ERS estimates based on IRS Public Use File and USDA data, 1996.

Figure 2.

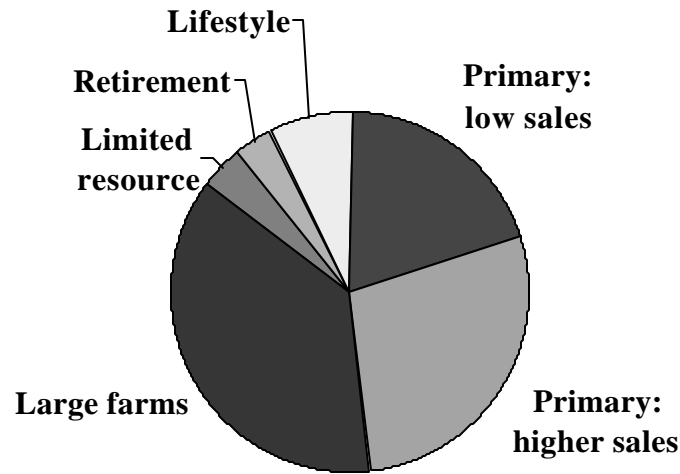
Aggregate taxable farm income IRS Schedule F



Source: IRS, Statistics of Income Bulletin.

Figure 3.

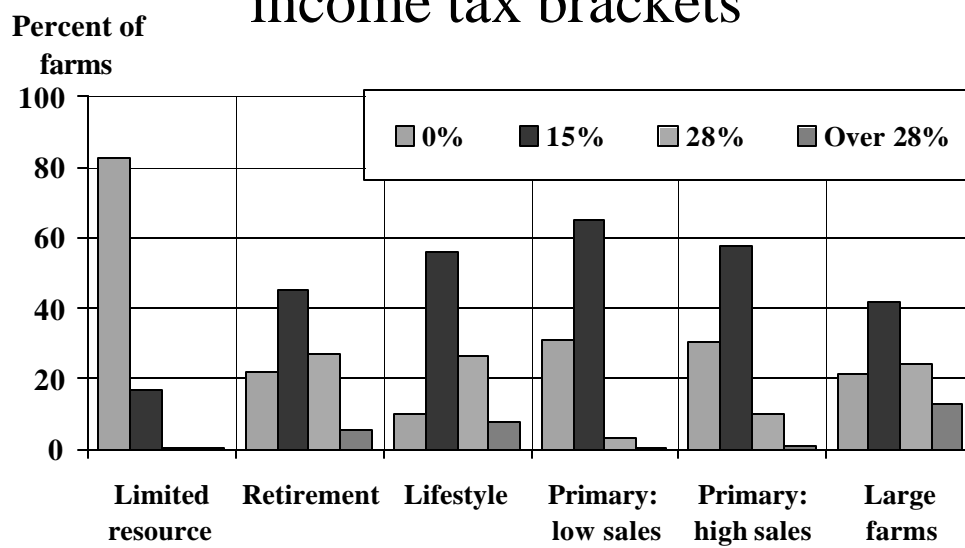
Distribution of Profits on Schedule F \$8.9 billion



Source: USDA-ERS estimates, based on IRS tabulations, 1996.

Figure 4.

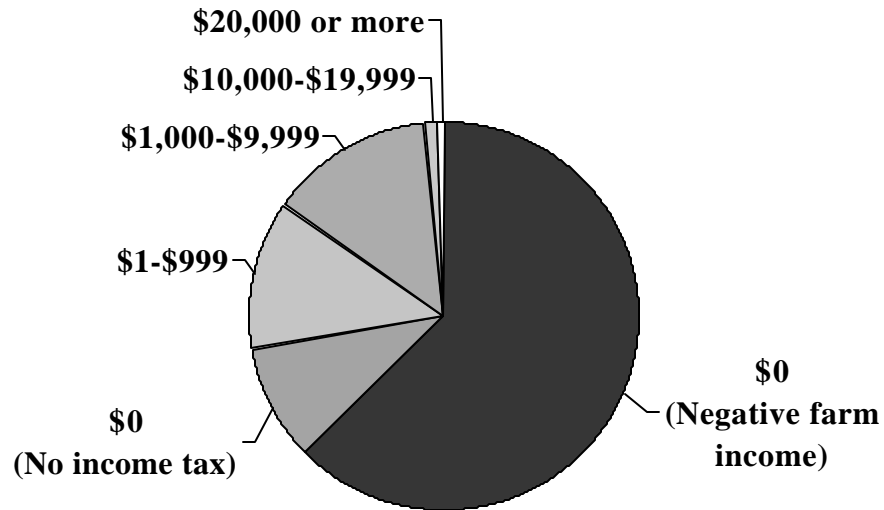
Distribution of marginal income tax brackets



Source: USDA-ERS estimates, based on IRS tabulations, 1996.

Figure 5.

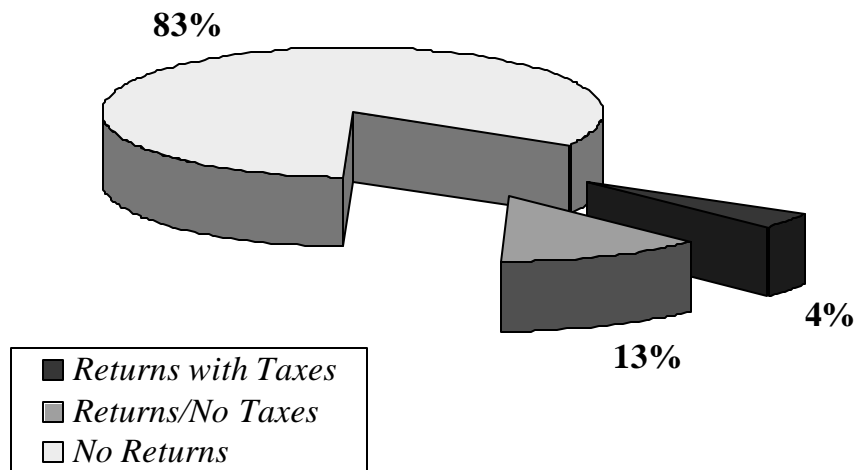
FARRM Accounts: Sole proprietors by size of potential contributions



Source: USDA-ERS simulation, based on IRS Public Use File, 1994.

Figure 6.

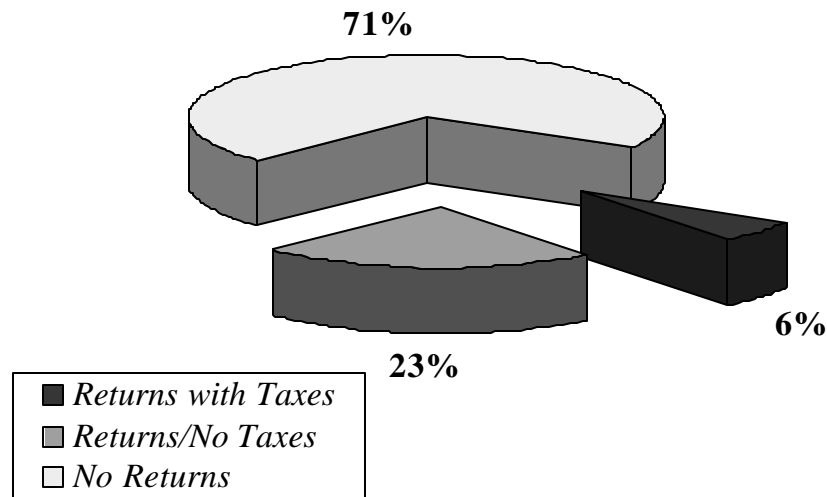
Share of Farm Estates with Returns and Taxes, 1998



Source: USDA-ERS, estimates based on ARMS data.

Figure 7.

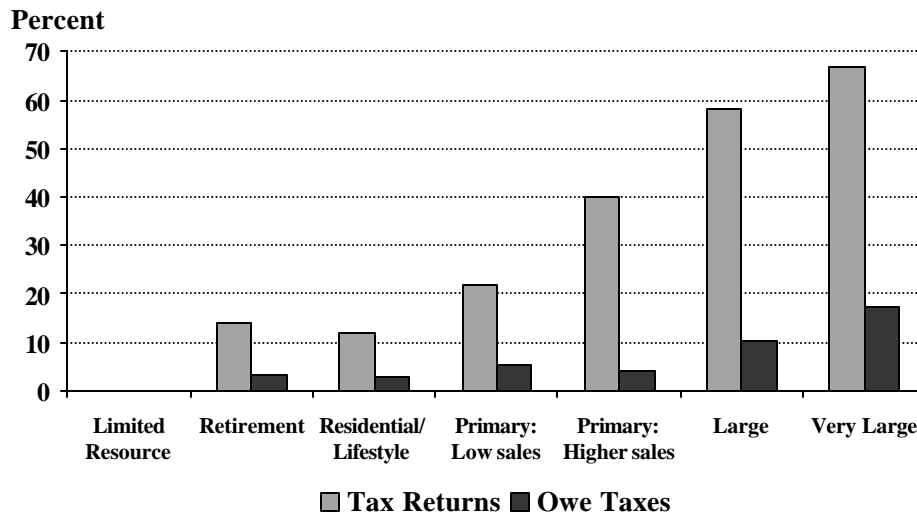
Share of Primary Occupation and Large Farm Estates with Returns and Taxes, 1998



Source: USDA-ERS, estimates based on ARMS data.

Figure 8.

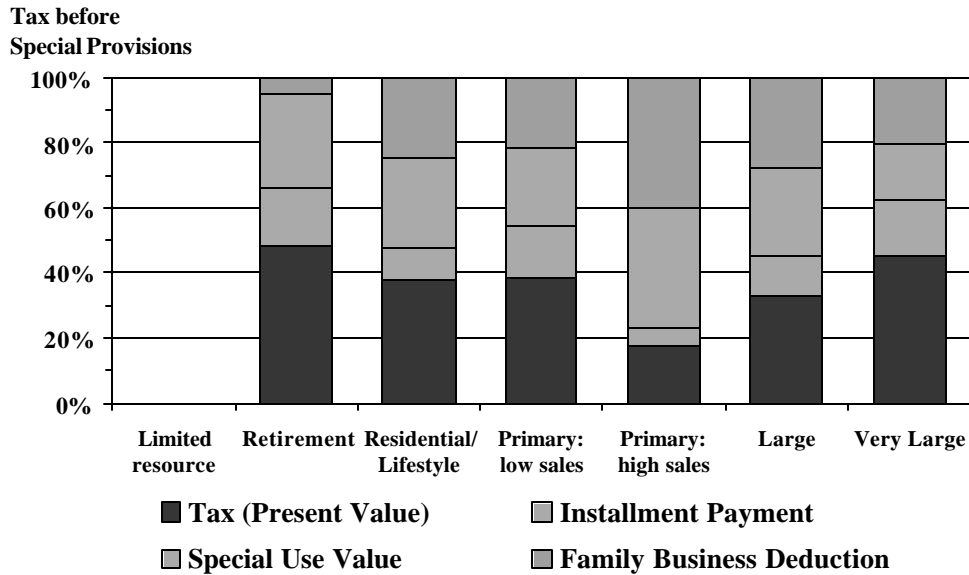
Farm Estate Returns and Taxes by Farm Type, 1998



Source: USDA-ERS, estimates based on ARMS data.

Figure 9.

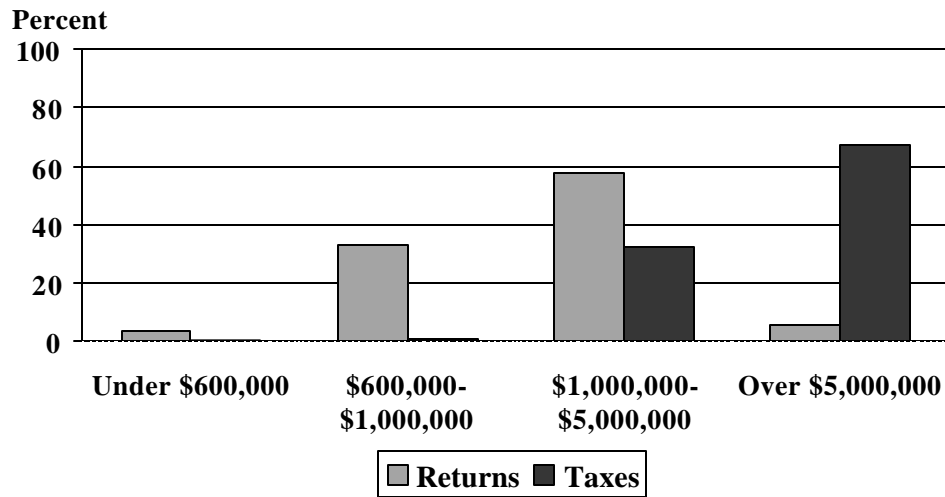
Tax and Tax Reductions from Special Farm Provisions, 1998



Source: USDA-ERS, estimates based on ARMS data.

Figure 10.

Share of Tax Returns and Taxes for Farm Estates, by Size of Net Assets, 1998



Source: USDA-ERS, estimates based on ARMS data.

