The Impact of Proposed Federal Tax Reform on Farm Businesses

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Federal Tax Reform has the Potential to Affect Nearly every Aspect of the Farm Business

Recent proposals calling for fundamental reform of the Federal income tax system have raised awareness of a system that is complex, inefficient, and inequitable. Proponents of reform argue that the system with its patchwork of tax preferences is needlessly complicated and expensive to administer.

This poster examines elements put forth in a report by the co-chairs of the National Commission on Fiscal Responsibility (NCFRR) to address the Federal tax system. The Commission was a bipartisan reform panel created by the President to address fiscal stability of the United States. The report represents common reform themes that are expressed by stakeholders and policymakers and which will likely serve as a blue-print for future tax reform.[1] The elements of reform discussed in the report include:

- Eliminating many of the current tax preferences, including preferences that affect farm investment and management decisions.
- Taxing capital gains and dividends as ordinary income.
- Lowering marginal tax rates on ordinary income and reducing the number of tax brackets.

The National Commission on Fiscal Responsibility Reform Proposal

The bipartisan NCFRR was created by the President to "[identify] policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run." The Commission's co-chairs released a report in December of 2010 entitled "The Moment of Truth," offering multiple variations of tax reform scenarios that rely on eliminating itemized deductions and restructuring or creating new credits, as well as lowering the statutory marginal rates.

Table 1. Key Features of the National Commission on Fiscal Responsibility and Reform Proposal

	Current Law	**NCFRR Proposal**
Marginal Tax Rates for Individuals		
Ordinary	10, 15, 25, 28, 33, 35%[1]	Three brackets with a target of

[1] As provided by its by-laws, the Commission was required to vote on the approval of a final report. On Dec. 3, 2010, a vote was held on a plan forwarded by the panel's two chairs, Alan Simpson and Erskine Bowles; however it fell short of the supermajority of 14 needed to send a proposal to Congress. The report in this analysis is that of the Commission's co-chairs.

Income		12, 22, 29%
Capital Gains and Dividends	15%[2]	Tax at ordinary rates
Standard Deduction	$5,900 single[3] $11,900 married[3]	No change
Itemized Deductions *e.g., deductions for charitable giving, interest on state and municipal bonds, and mortgage interest*	Unlimited by AGI	Eliminate
Business Deductions	Preferences for capital expensing, depreciation, manufacturing deduction	Eliminate business preferences such as accelerated depreciation and expensing
Credits	Mix of refundable and non-refundable credits	Maintain current law EITC and Child Tax Credit; create non-refundable credits for mortgage interest, charitable giving, and retirement savings
1. Individual rates are set to return to pre-2001 levels in 2013. Those rates were 15%, 28%, 31%, 36%, 39.6%. 2. Rate on long-term gains is set to return to 20% in 2013. 3. Tax year 2012, and subject to inflation adjustment.		

Taxation of Farm Income under Proposed Reform

- The most common form of farm organization is the sole proprietorship, which accounts for 86 percent of all farms and 50 percent of total sales.
- Income from farm partnerships and corporations taxed under subchapter S of the Internal Revenue Code (known as S Corporations) is also passed through to the individual partners or shareholders for taxation at the individual shareholder or partner level.

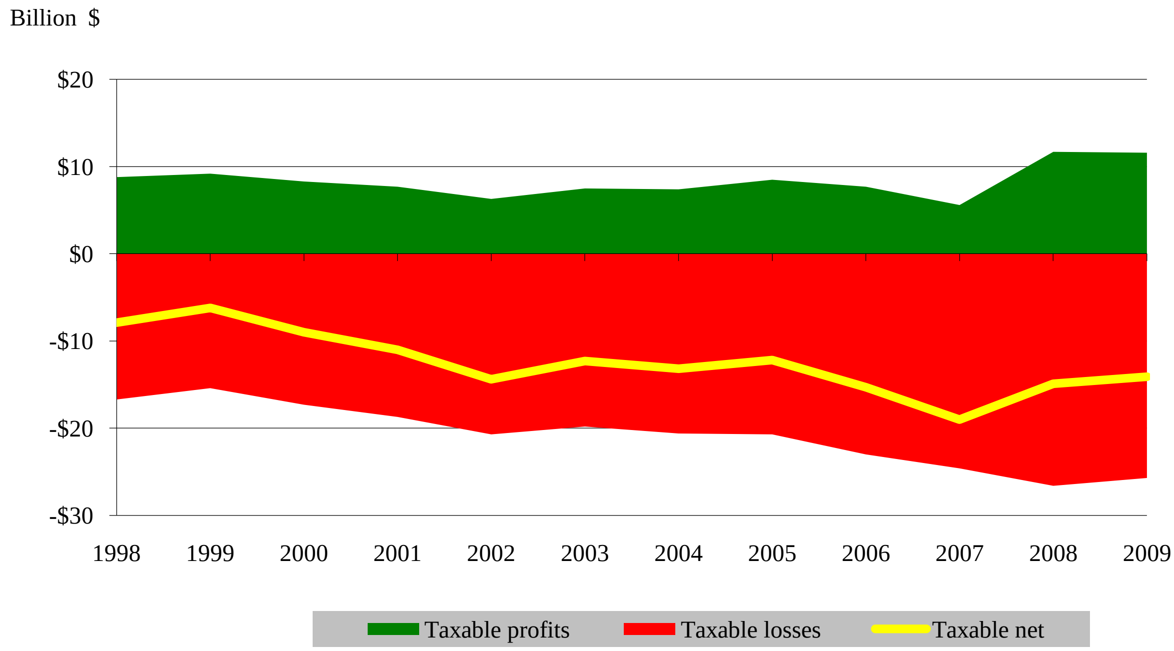
Data

We use tax return data published by the Internal Revenue Service (IRS) and income and balance sheet data from the 2010 Agricultural Resource Management Survey (ARMS) to examine the size and scope of farm business and rural household activities that currently benefit from provisions identified as targets for reform.

Most Federal Income Tax for Farm Households Is Paid on Off-Farm Income

Farms households receive income from both farm and off-farm activities, and for many, off-farm income plays a significant role in the household's total income. Because the household is the typical unit of taxation for a farm business, farm and nonfarm income are combined when computing Federal income taxes for farm households (figure 1).

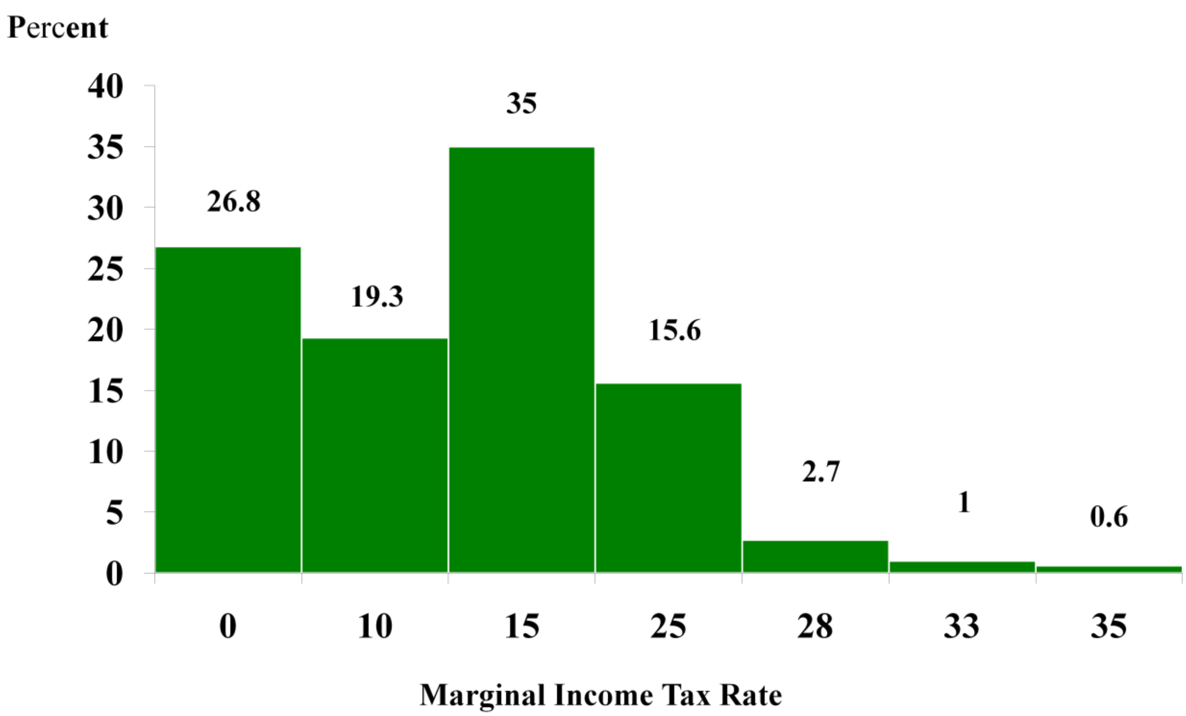
Figure 1. Total taxable net farm income/loss on Form 1040 Schedule F, 1998-2009



Source: USDA-ERS; tax data are compiled from IRS published data.

- In 2009, median farm household income was $52,000, and off-farm sources accounted for a majority of the income.
- In 2009, based on IRS data, nearly three of every four farm sole proprietors reported a farm loss. The average loss reported was $18,350, for a total of $25.7 billion.
- The bottom line is that only about 1 out of every 5 farm sole proprietors paid any Federal income tax on farm income in 2009.

Figure 2. Share of Taxpayers by Marginal Tax Rate, 2009



Source: Economic Research Service using published tax data from Internal Revenue Service, 2009.

- Reducing the tax rates will primarily benefit taxpayers who face the highest statutory marginal tax rates.
- Forty-six percent of taxpayers face marginal tax rate 10% or lower.
- Over 80% of taxpayers face a marginal rate of 15 or lower.

∆ Proposed changes to the system of deductions and credits will expand the taxpayer's tax base, and tax rates on dividends and capital gains, in particular, will raise current tax rates for some farmers. The net effect will be an increase in the farmer's tax liability.

Farmers Realize a Greater Share of their Income from Capital Gains than the Average Taxpayer

- 40 percent of all farmers report some capital gains, nearly double the share for all other taxpayers. This amount represented about 20 percent of total adjusted gross income reported by farm households.
- The average amount of capital gain reported by farmers is also about 50 percent higher than the average capital gain reported by other taxpayers.

- In 2004, the last year for which complete data are available, farmers reported net capital gains of $28.7 billion[2], and the average amount for those reporting gains was $35,900.
- On average, about one-third of reported gains are attributed to the sale of assets used in farming.

Δ Under the proposal to tax capital gains at rates equal to ordinary tax rates, farmers will face higher tax liabilities—even if ordinary tax rates are reduced. However, higher tax rates on capital gains may have other consequences. Farmers may postpone the sale of appreciated capital assets, choosing to instead pass the assets to the next generation in an estate, or they may choose to defer the realization of capital gains, for example, by holding the asset longer than otherwise planned.

Reform of Accelerated Capital Cost Recovery System Would Affect the Purchase Capital Decision

Farming requires large investments in machinery, equipment, and other depreciable capital. Under the current tax system, such costs may be treated as a current expense or capitalized and depreciated over time. The amount that can be expensed is subject to a limit, and investments above the amount must be depreciated over a specified recovery period, generally 7 years for farm machinery and equipment.

Table 2. ***Expensing Amount Limits and Additional First-Year Depreciation, 2000-2013***

Tax Year	Expensing Amount	Additional First-Year Depreciation Amount
	Dollars	*Percent*
2000	20,000	0
2001-02	24,000	30
2003	100,000	50
2004	102,000	50
2005	105,000	50
2006	108,000	0
2007	125,000	0

[2] Internal Revenue Service, Statistics of Income, *Farm Proprietorships, 1998-2004:* http://www.irs.gov/taxstats/indtaxstats/article/0,,id=129406,00.html#farm

2008	250,000	50
2009	250,000	50
2010	500,000	100 1/
2011	500,000	100
2012	139,000 2/	50
2013	25,000	0

1/ Property acquired and place in service after September 8, 2010.
2/ Indexed for inflation; Source: Rev. Proc. 2011-52.
Source: Internal Revenue Code Section 2010.

- In 2010 farmers reported a total of $29 billion on capital purchases, and on average those making investments made $32,000 in annual capital purchases.
- Eighty-three percent of large farms—farms with at least $500,000 in annual sales—reported they made such an investment, while only 36% of farms classified as rural residences made a capital investment. Large farms making investments averaged $97,500 in annual capital purchases.

Δ The impact of reform will depend on how the expensing and depreciation provisions change. Currently, less than 18 percent of farmers annually invest more than the $139,000 expensing amount—the limit in 2012 (See figure 3). Since investments above this limit are eligible for the bonus first-year depreciation, nearly all capital investment by farmers can be written off in the current year. Increased capital expensing allowance reduces the effective tax rate on farm capital and simplifies the recordkeeping burden associated with the depreciation of capital purchases, with commercial farmers the primary beneficiaries.

Δ Eliminating or lowering the expensing amount would raise the cost of capital purchases for some farms. This could lead to increased taxable income and reduced capital investment by these farms.

Figure 3. ***Farms with Investment Exceeding the Expensing Limit, by Business Receipts ($1,000), 2010***


70%
60%
50%
40%
30%
20%
10%
0%
< 20
20 to < 40
40 to < 100
100 to <250
250 to < 500
500 and over
Sales Class
Exceeds 2010-2011 limit ($500,000)
Exceeds 2012 limit ($139,000)
Exceeds 2013 LIMIT ($25,000)

- On average, farmers reported depreciation expenses of $21,259 in 2010. Commercial farms had substantially more depreciation expenses.
- Farms with $500,000 or more of annual sales had an average depreciation expense of $94,000.

Δ As well as raising the cost of capital investment, lowering or eliminating expensing and additional first-year depreciation, all else equal, will increase the farm's tax base and its taxable income. Farms who had previously been able to write off most or all of their capital investment in the first year due to the expensing and first-year depreciation provisions will find that their taxable incomes are higher with the elimination of these provisions.

Income Averaging

Since 1998, farmers have been eligible for income averaging. Under the current income averaging provision, a farmer can elect to shift a specified amount of farm income, including gain on the sale of farm assets other than land, to the preceding three years and to pay taxes at the rate applicable to each year. Income that is shifted back is spread equally among the three years.

- In 2004, an estimated 50,800 farmers—or about five percent of farms—saved an average of $4,434 with income averaging.
- The tax savings of sole proprietors lowered potential government tax revenues by $225.3 million. This amounted to a 23-percent reduction in Federal income taxes for those taking advantage of the provision, compared with the amount that they would have owed without income averaging.
- A large share of the total tax reduction was realized by farmers with adjusted gross income over $1 million. These farmers saved an average of $264,000, for a total savings of $82.6 million, or about 37 percent of total tax savings from the income averaging provision.

Δ While a reduction in the number and level of marginal tax rates would reduce the savings under a new system, some farmers would still face higher tax rates (and tax liability) due to income variability if the income averaging provision is eliminated.

Domestic Production Activities Deduction

One of the most important business changes in the American Jobs Creation Act of 2004 was a new deduction for U.S. manufacturers, which includes farmers. The deduction is equal to 9 percent of qualifying production income in 2010 and later years, and is based on wages paid to hired labor. It is estimated that about one in five farm households directly benefit from the new deduction.

- Farm households are expected to be eligible to deduct nearly $2.5 billion in 2010.
- Commercial farm households are the primary beneficiaries, with about two-thirds expected to benefit, compared with only about 14 percent for all other farms, due to their lack of farm income and wages paid to hired labor.
- While commercial farms account for only about 8 percent of all farms, these farms are expected to receive about 75 percent of the farm sector's total benefit from the manufacturers' deduction.

Δ Because the deduction is in effect a labor subsidy, eliminating the domestic production deduction could have an impact on farm labor. The impact is likely to be limited since a small segment of the farm sector accounts for a large majority of the deduction's use.