Changing Federal Tax Policies Affect Farm Households Differently

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Significant changes in Federal individual income tax and estate and gift tax policies have occurred over the last few years. Since the Federal individual income tax imposes the largest tax burden on the broadest group of farmers and the Federal estate tax can affect the ability to transfer the farm operation to the next generation, these changes are of considerable importance to the farm community. Modifications to these tax policies can affect not only the financial well-being of farm households but also the number and size of farms, their organizational structure, and their use of land, labor, and capital inputs.

Federal tax code changes affecting both individual and business income taxes have reduced average tax rates for all farm households, but the effects of these changes vary by type of farm. Commercial farm households are the primary beneficiaries of many of the business tax provisions, including increased capital expensing and a new deduction for manufacturers, which is defined to include farmers.

Changes to Federal estate tax policies have raised the value of property that can be transferred to the next generation free of the estate tax to $1.5 million in 2005, and tax rates have been reduced. This has reduced the number of estates required to pay tax and the amount of taxes owed. Despite these changes and targeted relief to farmers and owners of small businesses, because of appreciating land values and increasing farm size, a larger share of farm estates are subject to the Federal estate tax. While about 1 percent of all estates currently owe Federal estate tax, between 3.5 and 4 percent of all farm estates and nearly 18 percent of commercial farm estates currently owe estate taxes. While existing law provides for the phase-in of additional reductions in Federal estate taxes, considerable uncertainty clouds the longrun effects of these changes due to the scheduled 1-year repeal of the tax in 2010 and a reversion to 2001 law in 2011.

The frequent revisions of the Federal tax code have added to its complexity, especially since many of the recent changes have been phased-in or are tem-


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porary. This effect has increased support for tax simplification efforts or even fundamental reform of the Federal tax system. The President has made tax reform a priority policy initiative and has appointed a commission to make recommendations for reform by November 2005. Fundamental reform could have important consequences for both the tax compliance burden and the financial well-being of farm households.

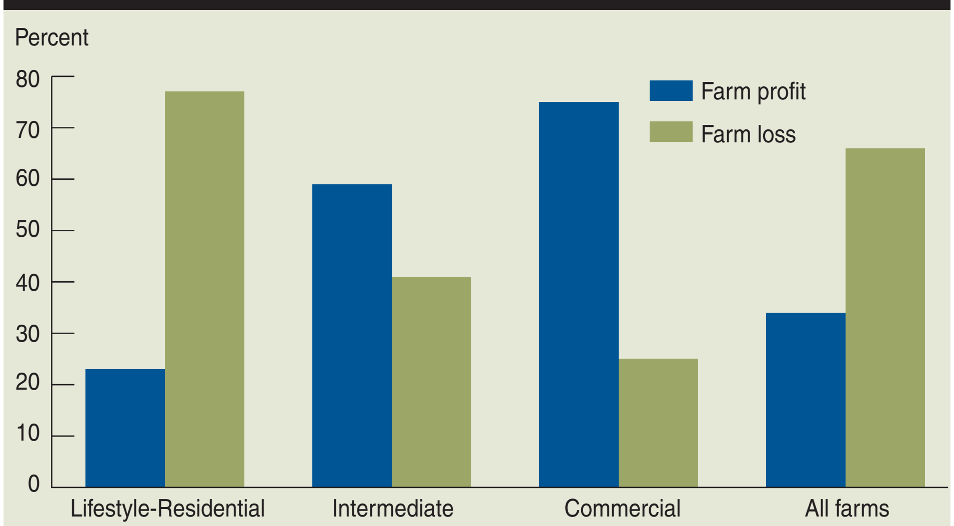
Individual Income and Business Taxes Reduced

Tax relief measures enacted in each of the last 4 years have reduced Federal income taxes for both individual and business taxpayers. For individual taxpayers, this legislation has reduced marginal income tax rates, increased standard deduction allowances, lowered tax rates on capital gains and dividends, increased savings incentives, and raised child and earned income credit amounts. Federal tax policies affecting businesses have also been modified, including reduced tax rates on business investment and manufacturing income.

Since most farms are operated as sole proprietorships, partnerships, or small business corporations, most farm income is taxed as individual income rather than as corporate income. As a result, farmers and many other small businesses are major beneficiaries of recent tax changes since they benefit not only from the lower individual tax rates and other changes aimed at all taxpayers but from faster writeoff of investment in machinery, equipment, and other eligible capital purchases and the newly enacted manufacturers' deduction.

The cumulative effect of these Federal tax policy changes has resulted in the lowest Federal tax burden on farm income and investment in decades. The average tax rate has been reduced from 18 percent in 2000 to about 14 percent for 2005. Like all households, about one out of every three farm households now owe no Federal income tax, with some actually receiving a refundable child or earned income credit. Nearly all farm households have realized some tax savings as a result of the changing Federal tax policy environment.

Share of farm sole proprietorships reporting farm profit and loss varies by farm type, 2000



Source: Internal Revenue Service (IRS) special tabulations, 2000.

Impact Varies by Farm Type

Since the household is the typical unit of taxation, farm and nonfarm income are combined when computing Federal income taxes for farm households. In fact, most Federal income tax paid by farm households can be attributed to nonfarm income. Since 1980, farmers have reported negative aggregate net farm income for tax purposes. In 2000, farm sole proprietorships reported total taxable gross farm business income over $91 billion but reported aggregate net farm operating losses of $9 billion. One-third of all farm sole proprietorships reported profits of $8.3 billion but the other two-thirds reported losses of $17.3 billion. About half of all partnerships and small farm business corporations also reported losses.

Examining these losses by farm type provides some additional insight on the effects of tax code changes. ERS classifies farms as rural residence farms (lifestyle, retirement, and limited resource farms), intermediate farms (sales less than $250,000 and primary occupation is farming), and commercial farms (sales greater than $250,000). Nearly $10 billion of the $17.3 billion in losses reported can be attributed to rural residence farms, with three out of four reporting a loss. Still, these farm households on average reported adjusted gross income of just over $73,000.

The fact that many rural residence and intermediate farms report losses should not suggest that changes to those tax policies affecting farm income and investment are unimportant. In most instances, losses arising as a result of these changes can be used to reduce the taxes on income from other sources. However, since rural residence and many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intermediate farm households derive most of their income from nonfarm sources, these farm households are primarily affected by the changes in individual marginal income tax rates, standard deduction and other exemption amounts, and those policies affecting the tax treatment of income from nonfarm sources.

Commercial farms account for about two-thirds of farm sales and nearly half of farm investment. These farms are the primary beneficiaries of the tax changes affecting farm business income and investment. The most significant changes over the last few years include reduced capital gains tax rates, increased capital expensing, and the new manufacturers' deduction.

The reduced tax rate of 15 percent on capital gains (5 percent for taxpayers in the 15-percent-or-lower income tax brackets) is especially significant for farmers. Capital gains are a key component of income for many farmers since assets used in farming are eligible for capital gains treatment and the amount of capital gains is increased by the ability to deduct certain costs, especially for livestock. According to the Internal Revenue Service (IRS), 40 percent of all farmers report some capital gains, nearly double the share for all taxpayers. The average amount of capital gain reported by farmers is about 50 percent higher than the average capital gain reported by other taxpayers. Over 60 percent of commercial farmers report capital gain income, and these farms account for 25 percent of all capital gains reported by farmers.

Farming requires large investments in farm machinery, equipment, and other capital. The tax treatment of these investments is of considerable importance to the farm sector, especially commercial farmers. Prior to the Economic Growth and Taxpayer Relief Reconciliation Act of 2001, capital purchases were eligible for an immediate expensing of $25,000. Investments above this amount were required to be depreciated over a specified recovery period. The 2001 Act added a temporary 30-percent first-year allowance. The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the bonus first-year depreciation from 30 to 50 percent of eligible investment and, more importantly, raised the amount of investment that can be expensed from $25,000 to $100,000. The temporary first-year bonus depreciation allowance has expired but the expensing provision was extended through 2007 by the American Jobs Creation Act of 2004. The amount is adjusted for inflation and is equal to $105,000 for 2005. Less than 10 percent of residential and intermediate farms invest more than $25,000, compared with over 40 percent of commercial farms. Most farmers will be able to deduct their entire 2005 capital investments. This increased capital expensing allowance reduces the effective tax rate on farm capital and greatly simplifies the recordkeeping burden associated with the deprecation of capital purchases, with commercial farmers the primary beneficiaries.

One of the most important business changes in the 2004 Act was the replacement of the foreign sales corporation/extraterritorial income provisions, which allowed U.S. exporters to exclude a portion of their foreign sales income, with a new deduction for U.S. manufacturers. This exclusion had been declared a prohibited export subsidy by the World Trade Organization (WTO). It was replaced to avoid retaliatory tariffs, but a recent WTO ruling regarding the phaseout of benefits under the old law raises the possibility that the tariffs could be reimposed. While few farm households directly benefited from the prior exclusion, about one out of five farm households will directly benefit from the new deduction. The deduction is equal to 3 percent of qualifying production income in 2005. It increases to 7 percent in 2007-09 and 9 percent in 2010. The deduction is limited to no more than 50 percent of wages paid to hired labor. While this limitation will reduce the deduction for many smaller farms that hire little or no labor, farm households are expected to be eligible to deduct about $800 million in 2005 and nearly $2 billion in 2010. Commercial farm households are the primary beneficiaries, with about two-thirds expected to benefit with an average deduction estimated at $6,900. While commercial farms account for only about 7 percent of all farms, they will receive about 75 percent of all benefits from the manufacturing deduction.

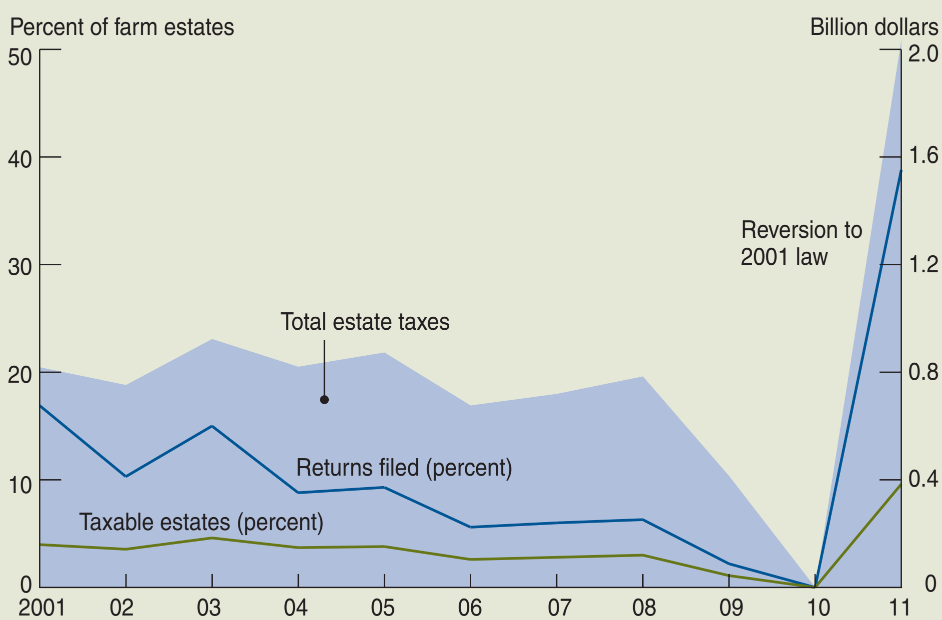
Federal Estate Taxes Lowered...

Since 1916, the Federal estate tax has applied to the transfer of property at death. While the tax has been amended many times, the estate tax and the companion gift tax imposed upon transfers prior to death have historically accounted for only a relatively small share of total Federal revenues. In 2005, these taxes are projected to account for less than 1 percent of total Federal tax revenue. While the aggregate importance of Federal estate and gift taxes is small relative to other Federal Government revenue sources, the potential effect of these taxes on farmers and other small business owners has been a major concern among policymakers. Over the years, this has led to the enactment of a number of targeted provisions, including a special use value provision that allows farm real estate to be valued at its farm use value rather than its fair market value. Farmers and certain other closely held businesses are also permitted to pay their taxes over a 15-year period instead of the normal 9 months following the date of death.

Providing tax relief to farmers and other small business owners was also an impetus for changes to Federal estate and gift tax policies in the Taxpayer Relief Act of 1997 and the Economic Growth and Taxpayer Relief Reconciliation Act of 2001. These changes provided a new deduction for family-owned businesses, reduced tax rates, and increased the amount of property that can be transferred to the next generation free of Federal estate tax to $1.5 million for 2005. As a result of this increase, only about 1 percent of all estates are expected to owe Federal estate tax in 2005. It has been estimated that about twice as many estates of small business owners are subject to the Federal estate tax.

An even larger share of farm estates owes Federal estate tax. The appreciation in land values, the increase in average farm size, and the rising investment in farm machinery and equipment have increased farm estate values and taxes. Based on simulations using farm-level survey data, about 9 percent of the 34,397 projected farm estates for 2005 are estimated to have assets in excess of $1.5 million and would be required to file an estate tax return. After deductions, between 3.5 and 4 percent of all farm estates would be taxable. The total amount of Federal estate taxes in 2005 is estimated at $873 million. The average tax due for those who owe is about $660,000. These taxable farm estates have an average net worth of $3.5 million, with about two-thirds of the net worth attributable to farm business assets, primarily farm real estate.

Share of farm estates owing taxes will drop over the next 5 years



Source: Estimated by USDA, Economic Research Service using data from USDA's Agricultural Resource Management Survey.

...but Larger Share of Commercial Farms Owe Federal Estate Taxes

The potential impact of the Federal estate tax varies by farm type. While only about 3 percent of all rural residence and intermediate farm estates are projected to owe any Federal estate taxes in 2005, a much larger share of commercial farm estates are projected to owe tax. Commercial farms continue to increase in size. From 1996 to 2003, during which tax code changes initiated a gradual increase in the amount of property that can be transferred free of estate tax, the average number of acres operated by commercial farms increased by about 25 percent, from just over 1,500 to nearly 1,900. This increase in size and the continued strong appreciation in land values combined to boost the average value of land and buildings for commercial farms by about two-thirds to nearly $1.3 million in 2003. These trends have continued in 2004 and 2005.

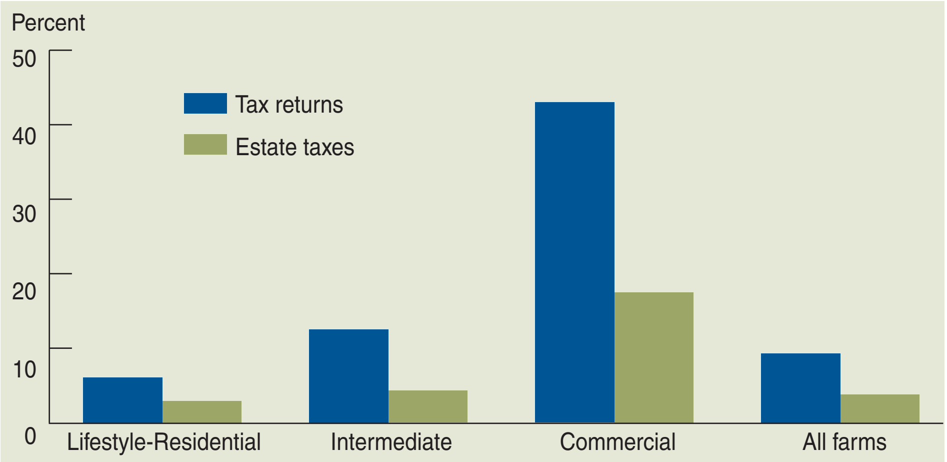
Thus, despite estate tax relief targeted to farmland (special use valuation), increasing farm size and appreciating land values continue to subject a larger share of commercial farm estates to the Federal estate tax. For 2005, an estimated 18 percent of all commercial farm estates will owe Federal estate taxes. These farms are six times more likely to owe Federal estate taxes than other farms and nonfarm small businesses. On average, commercial farm estates are expected to owe over $1.1 million in Federal estate taxes. While these farms represent only about 4 percent of all farm estates, they account for about one-third of all Federal estate taxes paid by farm estates.

Existing Law Provides for Future Tax Reductions and Uncertainty

Under the 2001 Act, the amount of property that can be transferred free of estate tax will continue to increase. The exempt amount is scheduled to increase to $2 million in 2006 and to $3.5 million in 2009. At this level, about 1 percent of farm estates will owe Federal estate tax in 2009, with total Federal estate taxes expected to be cut in half, compared with the 2005 level. Commercial farm estates will be the primary beneficiaries of these changes.

The estate tax is scheduled to be repealed completely in 2010. However, since the 2001 changes are scheduled to sunset in 2011, this repeal is only temporary. The resurrected tax in 2011 reverts to the law in place prior to the 2001 changes. As a result, the exempt amount would return to $1 million and the top tax rate would increase to 55 percent. The special deduction for qualified family-owned businesses would also be available again. This reversion is estimated to result in as many as 10 percent of all farm estates and about 25 percent of commercial farm estates owing Federal estate tax. This phase-in of the increased exempt amount and the repeal and reversion to 2001 law raises concerns regarding the equity of such disparate treatment for similar estates depending upon the date of death.

A small share of lifestyle or intermediate farm estates are taxable, 2005



Source: Estimated by USDA, Economic Research Service using data from USDA's Agricultural Resource Management Survey.

It also causes considerable uncertainty for estate planning purposes.

This uncertainty is compounded by changes in the treatment of unrealized capital gains at death that are scheduled to become effective with estate tax repeal. Under current law, the basis (which is the value used to determine gain or loss) of assets acquired from a decedent are stepped up to their fair market value at the date of death. This "step-up in basis rule" essentially eliminates the capital gains tax on increases in the value of property not realized before death. The repeal of the estate tax is coupled with the repeal of the step-up in basis rule. In 2010, the step-up in basis rule is replaced with a carryover of the decedent's basis with an added exemption of $1.3 million (plus an additional $3 million for transfers to a surviving spouse) that can be allocated among the various inherited assets with unrealized appreciation. This change will add to the compliance burden since it would be necessary to determine the cost or other basis of inherited assets. In farming, these assets may have been held for several years with limited documentation with regard to cost or even how they were acquired. Some farm estates that would owe no Federal estate tax or capital gains tax under current law would be faced with this compliance burden and could even owe capital gains taxes upon the sale of the inherited assets. The combination of no estate tax and potential capital gains taxes could increase the amount of farm assets transferred to the next generation and encourage the heirs to continue to hold the transferred assets to avoid capital gains taxes.

While repeal and resurrection of the estate tax is still several years away, there is increasing interest in either permanent repeal or a substantial permanent increase in the exempt amount combined with the retention of the stepped-up basis at death treatment for inherited assets. Addressing the issue now would reduce some of the uncertainty and inequity created by the phase-in and sunset provisions under existing law. AW

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