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# Farming the Tax Code

## *Preferences Lower Taxes on Farming, But Is Farming Sector Helped?*

by Richard W. Dunford

**A**lthough the principal purpose of federal income taxes is to produce revenues for the operation of our government, taxes also have powerful impacts on economic decisions and activities. Congress has enacted numerous tax exclusions, exemptions, deductions, and credits over time to benefit certain groups of taxpayers or to encourage certain activities. Farming is one of many economic activities that gets some of these tax preferences. In fact, farm "losses" for federal income tax purposes have exceeded farm "profits" reported on tax returns for the last several years. Yet, USDA estimates net income from farming in excess of \$20 billion for these same years. This paradoxical situation is a result of tax preferences exclusively available to agriculture, on top of other tax preferences generally available to all taxpayers.

It is tempting to conclude that farm tax preferences have substantially benefited farmers through lowering their income tax liability. This is not necessarily true for several reasons.

First, a wide variety of taxpayers qualify for the farm tax preferences. Hence, many nonfarm individuals receive some of the resulting tax benefits.

Second, there are few limitations on the entry of resources into farming.

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Therefore, lower farm prices as a result of indirect supply effects may have more than offset the direct benefits of farm tax preferences.

Finally, the tax preferences for farming and other economic activities necessitate higher tax rates to raise a given amount of tax revenues. As a consequence, farmers who utilize few of the tax preferences and have a positive taxable income probably have a greater tax liability than they would have if tax rates were lower.

method, which allows farmers to deduct expenses when paid and report receipts when received. For example, expenses for seed and fertilizer purchased late in 1985 are deductible in 1985, even though the resulting crop is not grown and sold until 1986. Thus, farmers can shift expenses to high-income years and/or shift receipts to high expense years. Since income tax rates are progressive—the higher the taxable income, the higher the tax rate—farmers can lower their taxes by this shifting of

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***Two important tax preferences exclusively applicable to farming are cash accounting and the deductibility of certain capital expenditures.***

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### **Farm Tax Preferences**

Two important tax preferences exclusively applicable to farming are cash accounting and the deductibility of certain capital expenditures. They provide significant ways for people to minimize their tax liability on farm income.

#### ***Cash Accounting***

Federal income tax policies permit a mismatching of farm income and expenses in calculating net taxable income, which can result in big tax savings. This mismatching occurs primarily through the use of the cash accounting

receipts and expenses.

In contrast, nonfarm businesses cannot claim deductions for production expenses until the tax year when the resulting products are sold. This matching of expenses and receipts greatly reduces the ability of nonfarm business persons to minimize their tax liability through equalizing their taxable income from year to year.

#### ***Deducting Capital Expenditures***

Cash accounting rules apply even to some farmland improvements—capital expenditures—that contribute to pro-



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## Associates Summary of Operating Commercial Duck Farm

The primary objectives of the Partnership shall consist of the following:

1) Providing tax-free cash flow from well-managed operations

2) Appreciation in the value of the operating business and prime real estate, thereby providing long-term capital gains on sale of the project.



duction over several years. Costs of fertilizer, lime, and other materials that condition or enrich the land for more than one year, certain land clearing expenditures, and certain soil and water conservation expenditures are examples of capital expenditures that are deductible when paid. In most businesses such expenditures would have to be amortized over the useful life of the improvements.

These rules also apply to the costs of developing assets that won't produce any income for several years. Fruit and nut trees, vines, and many kinds of livestock (such as racehorses) are examples. The costs of seedlings, planting, pruning, and spraying are deductible when paid, even though the trees may not bear any fruit for five or more years. The tax benefits from these "early" deductions can be large, especially for people in high tax brackets.

### **Other Tax Preferences**

Three federal income tax preferences available to all taxpayers are especially important to farm taxpayers: preferential treatment of "long-term" capital gains, accelerated amortization schedules for depreciable property, and the investment tax credit.

### **Capital Gains Preference**

Sixty percent of the gains from the sale of "long-term" capital assets are excluded from taxation. Cattle and horses used for dairy, draft, sport, or breeding purposes qualify as long-term capital assets if they are held for at least two years. The capital gains holding period is one year for other qualifying livestock and six months for other assets (such as farmland, vines, and fruit trees).

If any of these long-term capital assets are sold for an amount greater than their purchase price, only 40 percent of the difference is reported as taxable income. Thus, the tax rate applicable to income earned through labor, for example, is more than double the tax rate applicable to income obtained due to changes in the market price of assets.

The preferential tax treatment of long-term capital gains income is especially beneficial when combined with the opportunities to mismatch income and expenses. Consider a vineyard requiring four years to mature. The owner can annually deduct the costs incurred in developing the vineyard during the ma-

turing period. These deductions will reduce the tax on other farm and nonfarm income.

If the vineyard is sold in the fourth year, only 40 percent of the appreciation in the price of the vineyard—the capital gain—will be taxed. So development expenses are deducted at the taxpayer's full tax rate in the early years, and less than half of the resulting income is taxed in the fourth year.

### **Accelerating Amortization**

A total of \$5,000 of the cost of machinery, equipment, and buildings can be expensed (deducted) in the year of purchase. The remaining cost of such property must be amortized. The rules for amortizing the remaining costs of depreciable property purchased after 1980 are specified under the Accelerated Cost Recovery System (ACRS).

Under the ACRS, depreciable property is classified into one of four recovery periods: 3 years, 5 years, 10 years, and either 15, 18, or 19 years. Cost recovery percentages are specified for each year of each recovery period. For example, 25 percent of the cost of 3-year property is deducted in the first year, 38 percent is deducted in the second year, and 37 percent in the third year.

Automobiles, farm trucks, and breeding hogs are 3-year assets. Virtually all other depreciable farm property has a 5-year depreciation period. Included are most farm machinery and equipment, livestock other than breeding hogs, farm storage facilities (such as silos and grain

whether purchased new or used, is eligible for an investment tax credit (ITC) in the acquisition year. The ITC is 6 percent of the purchase price of 3-year recovery property, and 10 percent of the purchase price of property with a 5-year recovery period. As with other tax credits, the ITC directly reduces a taxpayer's income tax liability. Thus, the ITC effectively reduces the cost of qualifying property by 6 or 10 percent.

There are some limits on the ITC claimed in any one tax year and the depreciable value of property is reduced somewhat if an ITC is taken. Nevertheless, the combination of the \$5,000 expensing option, the ACRS depreciation rules, and the ITC results in very generous tax benefits for purchases of depreciable property.

Some studies have indicated that these tax benefits for agricultural equipment and structures are comparable to the tax benefits applicable to similar property in nonfarm industries. However, the \$5,000 expensing option, the ACRS depreciation rules, and the ITC augment the value of the other agricultural tax preferences.

### **Farming As A Tax Shelter**

For income tax purposes, taxpayers are farmers or are engaged in the business of farming, if they cultivate, operate, or manage a farm with the intent to make a profit, either as an owner, a "materially participating" landlord, or a tenant. A farm is basically any area where virtually any kind of food or fiber crop is

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## ***A wide variety of taxpayers qualify as farmers for income tax purposes.***

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bins), fences, water systems, trees, vines, and single-purpose agricultural or horticultural structures (such as milking parlors and greenhouses).

This 5-year recovery period is generally shorter than the useful lives of the farm property. In some cases (such as single-purpose agricultural or horticultural buildings) the recovery period is much shorter than the useful life. This produces tax benefits for farmers to the extent that property costs are completely amortized before the property stops augmenting farm income. Hence, these short recovery periods contribute to the mismatching of income and expenses.

### **Investment Tax Credit**

Most depreciable farm property,

raised (except timber). A farmer for tax purposes does not have to live on a farm, nor depend upon farming as a livelihood to any degree.

Thus, a wide variety of taxpayers qualify as farmers for income tax purposes. For example, a stockbroker in New York City who is a limited partner in a dairy farm in New Mexico is a farmer. Physicians in Seattle, dentists in small rural towns, and retired farm operators who rent farms to farm operators on a crop-share basis are also farmers. These people, as well as farm operators, can use farm tax preferences to lower their taxable farm income and offset their non-farm income.

Ideally, from a taxpayer's viewpoint, a

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*Headlines from newspaper articles, ads, and brochures promoting tax shelters in farming.*



## How Farm Tax Preferences Are Worth More to Some Taxpayers Than to Others

In George Orwell's *Animal Farm*, the pigs took the revolutionary slogan "all animals are equal," and added "but some are more equal than others." Analogously, all livestock on U.S. farms may start out equal, but our tax code makes some livestock a lot "more equal" than others. Furthermore, some taxpayers are more equal than others in their ability to benefit from tax preferences.

First, only 40 percent of the receipts from the sale of livestock used for certain purposes is taxed, while all receipts from the sale of other livestock are taxed. Second, available tax preferences do not equally benefit all taxpayers. As shown in the example below, tax preferences generally benefit high-bracket taxpayers more than low-bracket taxpayers, due to the progressive nature of tax rates.

The table shows three different taxpayers: a farmer with no other income (in the zero tax bracket), a farmer with some other income (in the 20 percent tax bracket), and a high-income farmer or nonfarm investor (in the 50 percent tax bracket). Assume in each case it costs \$1,000 to raise a dairy cow that is sold for \$800. Thus, the before-tax return for all three taxpayers is -\$200.

Since the proceeds from the sale of

the cow qualify as a long-term capital gain, the taxable income from the sale is only \$320 (40 percent of \$800). Consequently, the tax loss from the sale would be \$680 (\$1,000 minus \$320). For the high-income farmer or nonfarm investor, this \$680 tax loss would produce \$340 of tax savings on other income (50 percent of \$680). Since this individual's tax savings are larger than the economic loss on the sale of the dairy cow, the after-tax return on the transaction is positive. The high-income individual makes money selling the cow at a loss.

For the farmer in the 20 percent tax bracket, the \$680 tax loss results in tax savings of \$136 (20 percent of \$680). This taxpayer loses \$64 on the sale of the dairy cow (\$136 minus \$200). Finally, the farmer with no other income realizes no tax savings from the \$680 tax loss. The after-tax and before-tax returns are equal in this case at -\$200.

Thus, the progressive nature of marginal tax rates makes tax preferences more valuable to some taxpayers than others. As shown in this example, some people can actually make money selling a dairy cow at a loss, while other people just experience the loss. George Orwell would understand.

### A Simple Example: Before-Tax and After-Tax Returns For Taxpayers in Different Brackets

	Farmer with no other income (zero taxes)	Farmer with some other income (20% tax bracket)	High-income farmer or nonfarm in- vestor (50% tax bracket)
Cost to raise a dairy cow	\$1,000	\$1,000	\$1,000
Proceeds from sale of dairy cow (assumed to qualify as a long-term capital gain)	\$800	\$800	\$800
Before-tax return (Line 2 minus Line 1)	-\$200	-\$200	-\$200
Tax deductible expenses	\$1,000	1,000	\$1,000
Taxable income from sale of cow (.40 times \$800)	\$320	\$320	\$320
Tax loss (line 4 minus line 5)	\$680	\$680	\$680
Tax savings on Other Income (tax percentage times line 6)	0	\$136	\$340
After-tax return (line 7 plus line 3)	-\$200	-\$64	+\$140

tax shelter contains two basic elements: large current deductions, and the deferral of income and/or its treatment as capital gains. Farming is one of several economic activities subject to the types of preferential income tax provisions that are necessary for a tax shelter. In particular, the mismatching of farm expenses and income (through cash accounting, for example) and the opportunities to get capital gains treatment on the income from the sale of many farm products and assets provide the basic elements for a tax shelter. The \$5,000 expensing option, ACRS depreciation rules, and ITC also contribute to farming tax losses that can be used to reduce taxes on other income.

The preferential tax provisions that are necessary for a tax shelter provide greater benefits to high-bracket taxpayers than low-bracket taxpayers, as shown in the accompanying table. This occurs because a given deduction, for example, produces a larger tax savings for a high-bracket individual than for a low-bracket individual. Furthermore, low-bracket individuals may not have a large enough income to fully utilize available tax preferences. In other words, tax preferences only benefit individuals who have a tax liability.

In the last 16 years the Congress has placed a number of limitations on farm tax sheltering activities. Examples include: requiring preproduction expenses on citrus and almond groves to be capitalized rather than deducted as paid, limiting deductions for farm "syndicates," and prohibiting some farm corporations from using the cash accounting method. Farm tax sheltering is also restricted by special rules for net operating losses, at-risk limits on losses, and the alternative minimum tax. Nevertheless, many farming activities, particularly livestock activities and some perennial crops, are still effective tax shelters.

#### Impacts of Tax Policy

Many factors affect the profitability of farming. One of these is income tax rules, which play a role in profitability through effects on what portion of farm receipts are taxable and the relative after-tax costs of various inputs. Thus, income tax policies alter demands (and prices) for the factors of production and supplies (and prices) of farm commodities.

Unfortunately, it is difficult to ascertain the relative importance of income taxes in observed changes in demands for inputs and supplies of outputs.



Hence, it is not possible to measure the precise impacts of income tax policies. However, there is a consensus regarding the direction of these impacts. As demonstrated in an excellent study by Charles Davenport, Michael Boelhje, and David Martin, *The Effects of Tax Policy on American Agriculture*, federal income tax policies have:

- Exerted upward pressure on farmland prices;

- Helped concentrate farmland ownership with high-income farmers and nonfarmers, as opposed to beginning farmers;

- Encouraged the substitution of capital for labor;

- Supported growth trends in the number of very small and very large farms, at the expense of medium-sized farms;

- Reduced efficiency in some farm activities (such as pork production) through induced changes in management practices;

- Increased supplies and lowered prices for some farm commodities in particular, and possibly for all commodities in general.

The desirability of these tax impacts is generally a matter of perspective. For example, although higher land prices increase the wealth of established farmers and enhance their access to debt capital, these conditions also make it more difficult for beginning farmers to get started in agriculture. Hence, land owners may favor this impact of federal income tax policies, while those who want to start farming oppose it (at least until they buy land).

Similarly, lower prices for some farm commodities may make it difficult for some farmers to pay their bills and remain in agriculture. On the other hand, these lower prices benefit consumers of the particular commodities. Clearly, the desirability of most of these tax-induced changes differs depending upon one's perspective. **C**

*This article is based on material from a study prepared by the author—The Effects of Federal Income Tax Policy on U.S. Agriculture, Senate Print 98-273, Joint Economic Committee, U.S. Congress, Washington, DC, December 21, 1984—and a publication prepared by Jack Taylor—Farm Income Taxation, Report No. 85-13, Economics Division, Congressional Research Service, Library of Congress, Washington, DC, January 10, 1985.*

## Selected Provisions in the House and Senate Tax Reform Bills

	House Bill	Senate Bill
<b>Farm Tax Preferences</b>		
Cash Accounting	No change in current law	Prepayment deductions limited to 50% of certain costs.
Expenditures for Multi-Year Soil Conditioners	Residual value of these conditioners would be capitalized	No change in current law.
Land Clearing Expenditures	These expenditures would be capitalized	These expenditures would be capitalized.
Soil and Water Conservation Expenditures	Deductible for approved projects	Deductible for approved projects, subject to a limit.
Preproduction Development Expenditures	Deductible in year paid but all costs of raising the asset would be recaptured as ordinary income when the asset is sold, and there would be restrictions on the use of accelerated depreciation.	No change in the current law
<b>Other Tax Preferences</b>		
Treatment of Capital Gains	42% exclusion resulting in a maximum tax rate of 22% on capital gains; gains on the sale of converted wetlands or highly erodible cropland would be taxed as ordinary income.	No capital gains exclusion, resulting in a maximum tax rate of 27% on capital gains.
Expensing of Certain Depreciable Property	Up to \$10,000 of certain depreciable property could be expensed, subject to phase-out when total purchases of depreciable property exceed \$200,000.	Up to \$10,000 of certain depreciable property could be expensed, subject to phase-out when total purchases of depreciable property exceed \$200,000.
Depreciation	Generally longer recovery periods, but larger deductions in the early years (except for buildings); partial indexing for inflation after 1987.	Generally the same recovery period, but larger deductions in the early years; longer recovery period and straight line depreciation for buildings.
Investment Tax Credit	Repealed.	Repealed.

Source: Information provided by the American Farm Bureau Federation.