A Panel On Tax Reform

How Will It Affect Agriculture?

The Tax Reform Act of 1986 is a major redirection in federal tax policy. In this issue we begin a three-part series of articles on its impacts on agriculture, farmers, and rural communities. The first part features a brief synopsis of those provisions of the new law specifically affecting agriculture, as well as comments from a panel of policy specialists and analysts on their impressions of the tax reform bill.

This panel was organized by Michael Boehlje and Thomas Stinson of the University of Minnesota. They are also organizing the second and third parts of the series. In the winter issue the focus will shift to the impact of the new law on decisions by farmers. Then the spring issue will include an article focused on potential aggregate effects on agriculture and rural America.

Major Provisions Related to Agriculture

Ronald Durst
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The Tax Reform Act of 1986 provides for significant reductions in marginal tax rates. A two bracket system, with rates of 15 and 28 percent replaces the previous 14 bracket system, in which rates ranged from 11 to 50 percent. The 15 percent rate and the personal exemption are phased out for upper income taxpayers, however, creating a third bracket with a marginal rate of 33 percent for joint filers with taxable incomes between approximately $72,000 and $200,000.

To pay for these rate reductions many deductions, exclusions, credits, and special provisions will be eliminated. Income averaging, the deduction for two-earner married couples, and the deduction for state and local sales taxes are among the provisions repealed. Capital gains from the sale of farm assets such as breeding and dairy livestock and farmland no longer receive special tax treatment. Instead, they are subject to the same tax rate as other sources of income.

Incentives for capital investment have been cut. Write-off periods for most farm assets are increased from the current 5-year period to 7 years, and the 10 percent investment tax credit was repealed. But, taxpayers may now currently expense up to $10,000 of investment in depreciable capital per year.

The new law also contains a number of changes aimed at restricting tax shelter opportunities in farming. These include:

—Allowing only taxpayers involved in farming on a regular, continuous, and substantial basis to use farm losses to offset other wage and salary income. Passive investors, including those renting farm land on a crop share basis, now can use such losses only to offset income from other passive investments. A special provision allows low and middle income taxpayers to deduct real estate rental losses including those from rental of farm land, of up to $25,000.

—Requiring farmers using cash accounting to deduct the costs of prepaid feed, seed, fertilizer, and similar supplies (to the extent that they exceed 50 percent of farm expenses) when they are actually used.

—Requiring capitalization of maintenance costs associated with raising a plant or animal with a preproductive period of two or more years.

—Repealing the current deduction for land clearing expenses.

Farmers with financial difficulties may also benefit from the new law. Previously, taxpayers who discharged debts by reconveying property were liable for taxes on the difference between the amount of debt written off and their basis in the property. Under the new law, "qualifying farm debt" discharged or written down by an unrelated lender will not be treated as income. In exchange for this exclusion the farmer's basis in any remaining assets, including farmland will be reduced.

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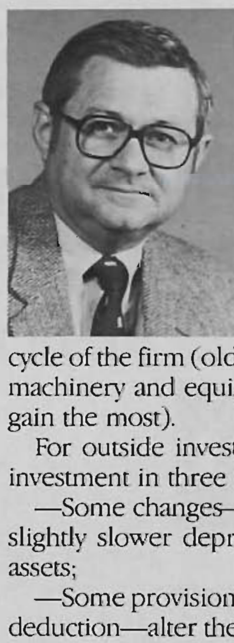
Effects Differ By Types of Farms and Farmers



Neil E. Harl
Charles F. Curtiss
Distinguished Professor Iowa State University

The short and long-term effects of the new tax law depend upon whether you're a farmer or investor, type of farming operation (whether capital gains comprise a significant part of the income stream) and the stage in the life cycle of the firm (older farmers investing relatively little in new machinery and equipment and paying tax at higher rates will gain the most).

For outside investors in agriculture, the new rules impact investment in three basic ways:

—Some changes—elimination of investment tax credit and slightly slower depreciation—discourage investment in farm assets;

—Some provisions—notably elimination of the capital gains deduction—alter the way gain is taxed on sale of farmland and increase the tax bill, and

—Other changes limit the extent to which farm losses can offset non-farm income from salaries, wages and other "active" income. This latter point may prove to be the most significant of the three although it may be possible to avoid the rules with a crop share or livestock share lease and regular and continuous involvement in the operation personally (not through an agent such as a farm manager).

The net impact for the next two to three years is expected to be negative on many farmers and most investors with further pressure on land values as potential investors assess their options. What is not known is the new equilibrium in investment patterns as the tax bill cracks down on most tax shelters.

Long term, the effects should be positive. To the extent that tax breaks and tax shelters have increased aggregate agricultural output, the result has been a disproportionate drop in price and profitability. That's because of inelastic demand for most food and fiber products.

One theme in the 1986 tax legislation is difficult to fault: moving toward economic neutrality in terms of the influence of income tax on investment decisionmaking.

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It's Not Tax Reform

Harold F. Breimyer
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Claims of tax reform are fraudulent. It's overhaul. It restores income tax accounting partway to conventional accounting practice—sufficiently so to merit adoption; but its fine print, it's anti-reform and keeps tax policy as the most pervasive regulatory instrument of government.

Instruction I to instructors: Maybe, just maybe, shoguns of the classroom will finally admit that in modern industrial economies the most crucial government fiscal issue is not how money is spent but how it is raised. The power to tax is the power to create and the power to destroy.

Instruction II: Income tax is a perfect example of fallacy of composition and should be so taught. In agriculture the more important test is not how an individual farmer is affected but the meaning for agriculture or its major industries.

Major effect on agriculture: reducing tax-code subsidization of overcapitalization and overproduction; and retracting some of the goodies enjoyed primarily by nonfarm investors.

Most revolutionary features: treating capital gains the same as earned income (packed with social philosophy); and reducing the maximum rate, all within the Reagan presidency, from 70 to 28 (or 34) percent—undermining an income-redistribution objective dating from 1913.

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Bitter-Sweet Implications for Farmers

Luther Tweeten
Regents Professor
Oklahoma State University

Selected provisions of tax reform and some "bitter-sweet implications for farmers" are noted below:

—Elimination of investment tax credit and changes in depreciation rates will increase the cost of farm capital about 10 percent. Ceteris paribus, the impact is to raise costs and reduce net farm income in the short run but to raise net farm income in the longer run. Higher effective capital prices will restrain input and output, lowering costs more than receipts because input demand is relatively more elastic than output demand. More family farms will remain.

—Reduced opportunities for tax-shelter farming will cut nonfarmers' investment in agriculture partly because of changes noted above but also because of requirements for "material participation" in management for full writeoff of losses and the taxing of capital gain as ordinary income. An advantage is less investment, less output, and higher rates of return on farm resources. A disadvantage is lower land values and less opportunity for new starts of family farmers using leased land and capital.

—Farm taxes may be higher in 1986 and 1987 but will decline slightly with time compared to current law. The 1986 legislation will reduce taxes of lower income and of very high income farmers but will raise taxes for those in between. Income taxes of family farmers on the whole have been low (removing the income tax on agriculture would have substantially added to federal revenue in the past) and the new law won't raise taxes much for them.

—Continuing to allow use of tax-free bonds to establish new farm operators seems unwise at a time when fewer, not more, operators are needed. Raising of corporate taxes will hurt job opportunities for many part-time farmers who will not obtain or will lose nonfarm jobs because many firms will not be able to raise prices (in an elastic global economy) to offset higher tax costs. Also, reducing tax writeoffs for hobby farmers will reduce the number of such farmers.

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Bill Demolishes Agricultural Tax Shelters

Hoy F. Carman
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Agriculture's popular image as "one big tax shelter" stems from tax motivated investments by nonfarm investors taking advantage of special agricultural tax provisions. The extent of the problem was revealed by Treasury Department estimates for the 1981 and 1982 tax years which indicated that total income tax collections would have increased substantially if net income from farming were not taxed and farm losses could not be used to reduce taxes on other income.

The Tax Reform Act of 1986 should effectively curtain this activity with a combination of provisions which will also be effective in reducing tax motivated investments by farmers. The sharp reduction in marginal tax rates to two brackets (15 percent and 28 percent) will remove much of the incentive for tax sheltered investments; repeal of the capital gains exclusion will suspend the incentive to convert ordinary income to capital gains through orchard and vineyard development and breeding livestock herd expansion, and, repeal of the investment tax credit removes some of the incentive to purchase livestock and perennial crop assets. New requirements to capitalize development expenditures for plants and animals with a preproductive period of more than two years effectively removes tax incentives for perennial crop development. Finally, there will be new limits on the deductibility of prepaid expenses and passive losses cannot be used to offset other income. This will effectively limit the opportunities for nonfarm investors to defer income through farming activities.

How does all of this affect "legitimate farmers"? Cash accounting has been preserved and farmers will continue to benefit through year-end planning, but other opportunities are restricted. After-tax costs of livestock and perennial crop development will be increased, new investment should decrease and product prices should improve; repeal of the capital gains exclusion will increase taxable income for livestock producers and culling decisions will be based on productivity rather than tax rates; the demand for land should also decrease with repeal of the capital gains exclusion; and, year-end equipment purchases will offer less in the way of tax savings because of longer depreciation lives and lower tax rates.

What is the bottom line? Agriculture will realize significant long-term benefits from Tax Reform after an adjustment period which will take several years for some enterprises. In the short-run, many farmers will have increased taxable incomes and may pay more income taxes, but over time, decreased investment in agricultural enterprises will lead to improved prices and, other things equal, to increased after-tax income.

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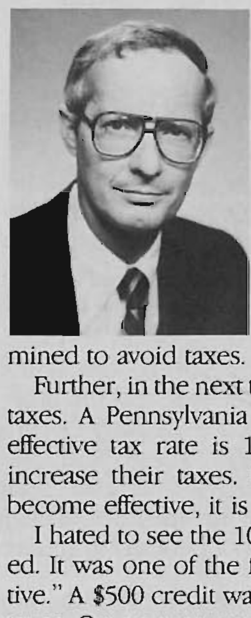
New Tax Law . . . Ho Hum!



Richard Krumme
Editor
Successful Farming

The Tax Reform Bill takes a few symbolic swipes at tax sheltering, but I expect they will be about as effective as the $50,000 payment limitation. That is to say, not very. The framers of this legislation underestimate the persistance and cunning of those determined to avoid taxes.

Further, in the next two years, farmers may actually pay more taxes. A Pennsylvania survey of 2,298 farmers showed their effective tax rate is 12.9 percent. The 15 percent rate will increase their taxes. By 1988, when the larger exemptions become effective, it is likely that the rates will be increased.

I hated to see the 10 percent investment tax credit eliminated. It was one of the few taxes which was not "bracket sensitive." A $500 credit was worth the same to everyone who paid taxes. On a percentage basis it was worth more to the lower bracket taxpayer. Further, I regarded it as an important stimulus to business.

Other negatives: Income averaging eliminated (not a big factor, but one in ten farmers uses it); capital gains exclusion puts a dent in retiring farmers' plans to draw out tax-free proceeds; carte-blanche prepayment deductions are restricted but by no means eliminated; conservation expenses are complicated by whether or not they are part of an approved "plan." (This is simplification?)

There are, of course, some positive aspects of the legislation. The "discharge of indebtedness" provision is both compassionate and suited to the times. I'm pleased to see a percentage of health insurance costs become deductible. If indeed the legislation reduces the incidence of "passive investing," and I am skeptical that it will, that would be positive for family farming.

My conclusions: There will be a slightly more negative, than positive, impact on agriculture, but on the balance it is a "ho hum" piece of legislation.

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Mixed Impacts on Rural People

Thomas F. Hady
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The summary of the Conference Committee report devotes a page and a half of its 80 pages to agriculture, and another page and a half to timber and minerals. Those provisions, plus an exemption for income from reindeer, constitute about all the new tax law has to say directly about rural concerns.

In other words, the most important thing rural people need to know is that the new tax code is important to them for the same reasons it is important to their urban cousins: it cuts rates for many, it tightens some loopholes, and it just might make the economy a little more efficient by encouraging decisions based on the economic realities and not the tax consequences. Preliminary indications are that it may also make the federal tax system less progressive.

Nevertheless, the new law will affect rural people somewhat differently because of the way they earn their livings. Roughly eight percent of nonmetro income in 1984 was from proprietorships, compared with only 4.4 percent of metro income. Hence, provisions, affecting sole proprietors are a little more important for rural people. A few examples:

—The new law allows sole proprietors to deduct 25 percent of health insurance costs, with certain restrictions, during 1987-89. That will help sole proprietors. Everyone else will find only restrictions; the new law allows medical expenses to be deducted only to the extent they exceed 7.5 percent of adjusted gross income (AGI), up from 5 percent under the old law.

—The new restrictions on IRA's will affect sole proprietors less than employees with retirement plans. Further, sole proprietors have more alternatives for sheltering retirement savings.

—Employees can deduct business expenses under the new law only to the extent they exceed two percent of Adjusted Gross Income (AGI) [a provision likely to cut attendance at AAEA meetings]. Sole proprietors, on the other hand, presumably can deduct these expenses before arriving at AGI, and will not be much affected by the new provisions.

There will also be some differences as a result of differing industry mix in rural and urban areas. The depreciation changes may be especially significant. But rural America has become so diverse that it is hard to believe differences due to industry mix will be important in the aggregate.

The new tax law is very important to rural Americans. But it is important mainly because they are Americans, not because they are rural Americans.

Loan Write-Down Exemption is Key Tax Bill Feature

Senator Dave Durenberger
U.S. Senator From Minnesota
Member of the Senate Finance Committee and the Subcommittee on Energy and Agricultural Taxation.

While many farmers are disappointed with the loss of investment tax credits and income averaging, the 1986 tax reform act does include a dozen or more important provisions which should assist traditional family farming operations.

Perhaps the most important—for those farmers struggling under a heavy debt load—is the provision exempting from taxable income that portion of a loan which is forgiven in debt restructuring.

In the past, one major disincentive to farmers restructuring their loans has been the taxes due on the amount of principal which is "written-down." In fact, many farmers have been surprised when—after a grueling period of negotiations or mediation—the IRS shows up with a bill for taxes due on the amount of the loan which has been forgiven.

Debt restructuring is essential to the survival of American agriculture. By exempting principal "write-down" from taxable income, one major barrier to debt restructuring has been eliminated.

Beyond this provision, the traditional family farmer should also benefit from the tax bill's new restrictions on agricultural tax shelters. America's farmers have trouble enough these days without having to compete with doctors, dentists and lawyers who have no interest in farming other than piling up losses they can use to shelter other income. Fortunately, in restricting "passive losses," the Congress was careful not to inhibit current or retired farmers from renting land to neighbors and relatives.

Finally, the 1986 tax bill gives farmers and other small business owners who aren't incorporated access—for the first time—to deduct a portion of their health insurance premiums.

We didn't go far enough—by allowing only 25 percent of health insurance premiums paid by self-employed individuals to be deductible—but we did get our foot in the door toward treating all citizens equally in the taxation of health insurance premiums.

Most Agribusinesses Will Make Out Better

George Hoffman Director
Commodity Analysis Department
The Pillsbury Company

Agribusiness should fare well under the new tax bill. Except for heavy farm machinery manufacturing, much of agribusiness is service-oriented, with a relatively low proportion of total costs in plant and equipment. For most businesses in food processing, food service, distribution, food retailing and restaurants, the reduction in the top tax rate to 34 percent from 46 percent will more than offset the loss of investment tax credits, the scaled-back depreciation schedule and the loss of favorable treatment for capital gains.

Although total corporate taxes will rise under the new tax bill, the impacts will vary widely from industry to industry. In general, those businesses in heavy manufacturing, and others with substantial investments in plant, equipment and depreciable assets will end up paying higher taxes while companies in light manufacturing and the service sector will see their tax bills reduced. A tougher new alternative minimum tax will raise taxes for those businesses which were profitable, but paid no taxes under the old law due to various tax credits and deductions.

As the costs associated with facilities, equipment and depreciable assets become a smaller factor in the total cost structure of an agribusiness firm, the loss of tax credits and deductions associated with the purchase and sale of those assets becomes less important. For these companies, it is unlikely that the new tax code alone will result in significant long-term restructuring or redirection. For heavily capitalized industries, the loss of many tax credits and allowances will mean increased emphasis on the economics of investments and less on the tax implication. The long-term result should be improved capital efficiency in those sectors.

To the extent that the new tax bill lowers federal taxes, the level of state taxes may become an increasingly visible factor in the location of businesses. Also, a lower corporate tax rate for food processors will increase the competitive position of U.S.-based businesses relative to those based in other countries. This should be supportive for companies to locate food processing facilities in the U.S., rather than overseas, and to export more value-added food products. C