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# 1986 Tax

## Its Effects on

### Tax Act Signal to Commercial Farmers

#### "Get Larger or Get Out"

by Clair J. Nixon  
and James W. Richardson

The 1986 Tax Reform Act (TR86) gives commercial crop farmers a new signal from the federal government—"get larger or get out." Crop farmers who normally have taxable incomes greater than \$40,000 likely will find their federal income tax liabilities reduced. But those with incomes less than \$40,000 will pay more.

These findings come from an analysis of different size representative crop farms in four regions of the country under the provisions of the 1984 and 1986 Tax Acts. A similar study for livestock producers (dairy, beef, and hogs) show that TR86 will increase the income tax burden for profitable livestock operators. Percentage increases in income taxes are greater for smaller livestock operations than for large operations. Additional detail is provided below.

#### Impacts of TR86 on Representative Farms

TR86 will affect each farmer differently. Because it is not possible to evaluate the impact of changes on all types of agricultural firms in all regions of the country, our analysis is limited to several representative crop and livestock firms in selected regions. Both crop and livestock farms were included in the study because changes in the tax treatment of capital gains will be much more important for those operators raising livestock. FLIPSIM, a model developed at Texas A&M University, was used to simulate each representative farm under the 1984 and 1986 income tax acts.

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Twelve representative crop farms in four regions were used to demonstrate the first-round effects of the changed tax law. Small, medium, and large farms in each region were simulated. Farms raising corn and soybeans; rice, cotton, soybeans, and wheat; irrigated and dryland cotton; and wheat and grain sorghum were included as were eight representative livestock farms.

#### Crop Farm Results

Crop farms with average annual taxable income less than \$40,000 (under 1984 tax laws), generally will pay more according to our simulations. The increases ranged from a high of \$2,070 for a Southern Plains wheat and sorghum operation to \$540 for a rice and cotton farm in Mississippi. In contrast, farm operators with taxable incomes greater than \$40,000 will pay less in federal income taxes, as much as \$12,710 for the largest cotton farm simulated. This result holds even though calculated taxable income for all crop farms, regardless of size, will be lower.

These seemingly contradictory results are obtained because the benefits of the lower tax rates in TR86 for upper income farmers outweigh the cost to them of the elimination of the investment tax credit and the change in depreciation rules. For low and middle income farmers the opposite is true. Smaller scale farmers have a proportionally greater investment in machinery per dollar of output. That, coupled with the fact that the investment credit under the prior law provided everyone with the same amount of tax reduction from a dollar of investment no matter what the scale of their operation, will lead to higher tax bills on those with lower incomes.

In most representative crop farms, taxable income declines under TR86's new expensing and depreciation provisions. The use of the 200 percent declining balance method depreciation typically produces greater deductions in the first few years of the asset's life than were possible under the previous depreciation rules. This benefit is, of course, partially offset by less depreciation being available in the remaining years of the asset's life. There is, in addition, a clear incentive to elect to expense assets since the expensing allowance has been dou-

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*In his article, "Farming The Tax Code" (CHOICES, No. 3, 1986) Richard Dunford discussed rules that lowered farmers' taxes. Dunford argued that while many of these benefits were favored by farmers, "indirect supply effects may have more than offset the direct benefits of farm tax preferences."*

*The following presentation brings us up to date on tax rules as they apply to farming after the 1986 Tax*

### Tax Changes

#### Lower Rates And Fewer Brackets.

TR86 reduced a system which had 14 tax brackets and rates ranging up to 50 percent, to one where only two rates—15 and 28 percent—apply. But, because the law decreases both the income eligible for the 15 percent rate and the personal and dependency exemptions for upper income individuals, there is a hidden, third bracket with a marginal tax rate of 33 percent. For married individuals that bracket covers incomes between \$80,000 and \$190,000. Those with incomes in excess of \$190,000 again face marginal tax rates of 28 percent.

*Special Capital Gains Rate Eliminated.* The 60 percent exclusion for long term capital gains no longer applies. Beginning in 1988 long term capital gains will be taxed the same as ordinary income.

*New Depreciation Rules Change.* Once again, 200 percent declining balance depreciation can be used for most farm assets. Asset lives were lengthened slightly, in most instances, but there is no requirement to include salvage values. Multi-purpose farm structures can be written off over 20 years using 150 percent declining balance methods. In addition, taxpayers investing less than \$200,000 per year will be allowed to expense up to \$10,000 of qualified depreciable property each year.

*Prepayment of Expenses.* New limits apply to the current deductibility of prepayments of certain expenses. If prepaid expenses for feed, seed,



## Tax Act Signal to Commercial Farmers

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bled and the investment tax credit eliminated.

The increase in average, annual depreciation/expensing deductions for the Mississippi farms demonstrates the impact on commercial operators who replace large amounts of equipment each year. Depreciation/expensing deductions increase by \$3,090, \$9,600, and \$15,110, respectively, for the small, medium, and large farms.

In contrast, depreciation/expensing deductions decrease for Midwestern grain farmers. The decrease of deductions for the 640-acre operation is \$2,810 and for the 982-acre farm it is \$5,570.

This is the case because Midwestern grain farmers are not replacing large amounts of equipment throughout the simulation period. The 640-acre operation had \$2,810 less in deductions under TR86; the 982-acre farm, \$5,570 less. The largest midwestern cash grain farm had

greater deductions under the 1986 rules because it was financially able to replace equipment each year throughout the simulation period.

Taxable income for some crop farmers also fell because of individual income tax changes such as the increase in the personal exemption from \$1,080 in 1986 to \$1,900 in 1987. Some of that benefit is offset, however, as excess itemized deductions for most farm families decline due to the increased standard deductions and the elimination of several itemized deductions.

### Livestock Farm Results

Changes in tax treatment of capital gains and repeal of investment credit creates a new environment for livestock producers. These provisions more than offset the benefit of lower tax rates, faster depreciation deductions and increased expensing and are responsible for increasing taxable income and taxes for cow/calf, swine, and dairy producers.

Under TR86, receipts from selling raised breeding stock are no longer partially sheltered and the receipts from the sale of culled cows are taxable at the same rates as other sources of income. The result is that taxable incomes from livestock sales increase dramatically. For the dairy and cow/calf farms, the increase in receipts from the sale of breeding stock outweighs the increased depreciation deduction for purchased assets available under TR86. The largest tax increase, \$4,510, was found for the large California dairy operation. The large California dairy operation would have an increase in average annual taxable income of 44 percent over that under the 1984 tax act. Similar results were found for the Southwest and New York dairies. The Upper Midwest dairy showed no increase in taxable income because capital gain income was not sufficient to offset negative net farm income.

The results for a 230 head, West Texas cow/calf ranch were similar to the dairy farms. Taxable income was increased significantly due to the elimination of capital gains treatment of proceeds from the sale of cull cows. Average annual income taxes increased \$1,760 for this operation, indicating that the overall affect of changing the depreciation/expensing provisions will not likely offset the loss of favorable capital gains treatment.

Taxable incomes declined but taxes increased for the three midwest cash grain/hog farms. Although these farms raised livestock, their depreciation deductions are largely influenced by machinery (required to farm 760 acres of corn and soybeans) and hog facilities placed in service during the mid 1970s. The change in the capital gains tax rate on income generated from the sale of raised breeding stock does not offset the increased equipment and breeding stock depreciation allowances for the smaller hog operations. The increase in depreciation allowances for the largest operation, however, just about equals the increase in income due to the capital gains treatment provisions under TR86. As a result, taxable income declines 12.5, 9.7, and .5 percent for the small, medium, and large hog operations.

### Conclusion

The bottom line for crop producers is that TR86 will cause tax liabilities to increase for small-scale farms and decrease for the large-scale farms. The lower tax rates on large taxable incomes account for lower tax liabilities for the large farms. The elimination of invest-

## Higher Taxes for Smaller Crop Farms, While Larger Crop Farms Get Tax Cut

Representative Farm	1984 Provisions		1986 Tax Reform Act	
	Taxable Income	Income Taxes	Taxable Income	Income-Taxes
(Thousand \$)				
<b>Midwest Cash Grain</b>				
640 acres	19	1.8	18	3.2
982 acres	16	1.1	15	3.0
1639 acres	58	14.3	56	11.7
<b>Texas Southern; Plains Cotton;</b>				
1088 acres	34	6.6	29	6.0
3383 acres	69	22.1	68	16.0
5570 acres	113	39.1	110	26.4
<b>Southern Great; Plains Wheat and Sorghum;</b>				
1280 acres	20	0.7	17	2.8
1920 acres	16	0.4	14	2.2
3200 acres	44	8.7	40	8.7
<b>Mississippi Delta; Rice and Cotton;</b>				
1143 acres	39	5.2	38	7.2
3119 acres	39	8.4	37	8.5
6184 acres	85	26.7	75	18.2



## Livestock Producers Pay More Taxes Under Tax Reform Act of 1986

Representative Farm	1984 Provisions		1986 Tax Reform Act	
	Taxable Income	Income Taxes <sup>c</sup>	Taxable Income	Income-Taxes
(Thousand \$)				
<b>Dairy;</b>				
Upper Midwest—				
50 cows	0	0.0	0	0.0
New York—200 cows	0.01	0.0	0.11	.01
Arizona—350 cows	22	3.6	35	6.6
California—1450 cows	226	68.2	325	72.7
<b>Texas cow/calf;</b>				
230 cows	6.66	0.5	10.5	2.2
<b>Midwest grain/hog;</b>				
50 sows	11	0.2	9	1.6
105 sows	29	2.4	26	5.2
225 sows	50	9.0	49	9.3

ment credit causes farmers with low taxable incomes to face larger tax liabilities under TR86.

The Tax Reform Act of 1986 will cause both taxable incomes and tax liabilities for livestock operations to increase over the next few years. The increase in taxable income was substantial due to the elimination of favorable capital gain

treatment. Although the tax rates significantly declined for high income taxpayers, it is not sufficient to overcome both the elimination of capital gains and repeal of investment credit. However, percentage increases in income tax liabilities are greater for smaller livestock producers than for large commercial operators.

### Assumptions

The representative crop farms were simulated for the period 1987-1996. Livestock operations were simulated for the 1987-1991 period. Projected farm program variables assumed continuation of the 1985 Farm Bill. Average annual market prices, interest rates, and inflation rates for the 1987-90 period were projected using the Commodity Specific General Equilibrium Model (COMGEM) developed at Texas A&M University. COMGEM assumed continuation of the 1985 Farm Bill and current macroeconomic policy (high federal budget deficits and rapid expansion of the money supply).

Values beyond the 1987-90 projec-

tion period were assumed to hover around their 1990 values. All prices, interest rates, inflation rates, and farm policy variables were held constant for the 1984 and 1986 tax acts. In addition, it was assumed farm operators continued to replace equipment based on economic use and did not change their machinery replacement strategy due to the tax law changes.

Farm production and investment activities were assumed to be identical to those of the 1984-86 period. Therefore, calculated changes in "taxable income" and taxes paid are entirely linked to the changes in tax rules without consideration of changes in behavior due to the tax rules.

## Dramatic Tax Rule Changes

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uneven income streams will pay more in taxes over their lifetime than will those with a constant stream of income with the same expected value. Prior to 1987, the tax code permitted individuals to average their income, thus reducing the tax penalty on those with volatile incomes. Congress in 1986 removed that income averaging provision, bowing to the argument that the new brackets were so wide that few would be affected. Farmers whose annual incomes vary with both production and prices could well be the group most affected by this change.

TR86 may also lead landowners who rent land to farm operators to ask for cash rent rather than a share of crop thus increasing risks carried by farm operators who rent land. The new rules limiting the deduction of losses by passive investors were designed to make tax shelters unattractive. Like many other tax code changes, limiting the availability of tax writeoffs to only those involved in the day-to-day operations of the business enterprise also will affect the way future business is conducted.

Under TR86 all rental activities, including renting farmland to farm operators on a crop share basis, are considered to be passive activity of the property owner. Losses from such investments are deductible only from income from other passive investments, not from wage and salary income. Special provisions allow deduction of up to \$25,000 per year in losses when the owner actively participates in the property's management—as could be the case with a land owner leasing to a tenant on a crop share basis.

Only highly leveraged land owners are likely to generate losses when renting on either a cash or a crop share basis, and some of those—investors whose expected losses will amount to less than \$25,000—may wish to convert from cash to crop share in order to take advantage of the special \$25,000 deduction. But those whose farm losses might exceed \$25,000 and those with incomes above \$100,000—where the special deduction is phased out—may well begin to limit risk by switching to cash rent, and in turn increase the risk for farm operators who rent land.

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