Reform Act

Agriculture

Reform Act. This special report has three parts. The first by Nixon and Richardson focuses on first-round effects on individual farmers assuming they do not change their production system because of the tax rules. The second lists the changes in the tax rules particularly applicable to farmers. And the third by Tom Stinson and Michael Boehlje focuses on aggregate effects for agriculture.

For Agriculture

fertilizer, and other similar items exceed 50 percent of total deductible farming expenses, those expenses may be deducted only in the year in which the supplies are actually used.

Preproductive Expenses. Special rules restrict the deductibility of preproductive expenses in crops and livestock when the preproductive period is more than 2 years. Such expenses must be capitalized unless the farmer elects to recapture these costs as ordinary income on disposition of the product and to use straight line depreciation on all farm assets placed in service in each year the election is in effect.

Income Averaging Eliminated. Individuals with widely fluctuating incomes will no longer be able to average incomes for tax purposes. Last minute efforts to keep the income averaging provision available for farmers failed.

Passive Investor Rules Added. The loss from activities in which the investor is not actively involved in the daily business operations can no longer be deducted from wage and salary income. Such losses are deductible only from gains from other passive investments. All rental activities, including land rented on a crop share basis are defined as passive activities. A special rule for small investors who actively participate in management of the property allows deduction of up to $25,000 of losses per year by individuals with incomes of less than $125,000.

Dramatic Tax Rule Changes

Significant But Not Immediate Effects

By Thomas F. Stinson and Michael D. Boehlje

The Tax Reform Act of 1986 (TR86) included a dramatic number of specific changes in tax law. But, it is not yet clear how significant these changes will be for agriculture. The changes in investment incentives, tax sheltering and write-off provisions, and the lowering of tax rates may alter who and how much is invested in agriculture. However, the impact of these changes will be limited by the sector's current financial and economic condition. Today's excess capacity provides little incentive for capital investment or tax sheltering behavior, irrespective of tax laws.

In the short run the impacts of previous tax provisions are not readily reversable; once the fixed costs have been incurred and the excess capacity is in place, reducing the tax incentives to invest do not eliminate that excess capacity. As with most policy changes, the impacts will be felt over time (assuming the laws don't change), and may in fact be swamped by other forces.

In the longer run we expect that TR86 will make farming both riskier and more labor intensive. Much attention has been given to provisions designed to limit outside investment opportunities for "tax loss farmers." But those same provisions, plus the next lower tax rates and base broadening will provide incentives for family farmers to alter their behavior as well. While the tax reform probably will reduce agriculture's overall tax burden, key changes in the tax code also will reshape the structure of American agriculture.

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Income Volatility and Risk

TR86 modified or eliminated several sections of the tax code which had helped limit the volatility of farmers' disposable (after tax) incomes. Under the new tax law farm operators will have larger year-to-year fluctuations in after-tax income than before.

The two best known features of the tax reform bill—lower tax rates and fewer tax brackets—are major contributors to this increased volatility. Lower rates allow all taxpayers to keep a larger proportion of their pre-tax earnings than before, so in good years after-tax incomes will be higher. And, reducing the number of tax brackets reduces each taxpayer's likelihood of being pushed into the next bracket—with its higher marginal rates—in those good years. The result, assuming positive net farm incomes, is higher after-tax incomes.

Many fail to recognize though, that while a progressive income tax limits gains in good years, it also helps cushion losses in bad years. Loss carry forwards and carry backs remain in the tax code, and full time farmers will be permitted to deduct farm losses from non-farm incomes. But, by lowering tax rates, TR86 takes away some of the tax system's ability to moderate the fluctuating incomes of farm households.

For example, imagine a household that faced a marginal tax rate of 35 percent on non-farm income in 1986. Every dollar of farm loss would involve "saving" $.35 of taxes and a decline of $.65 in disposal income. Now, with TR86's new lower tax rates, that farm family would face marginal tax rates of only 28 percent, so each dollar of farm loss means $.28 "savings" on federal income taxes and a decline of $.72 in desposable income. The result—increasingly volatile farm incomes—with good years better, but bad years worse, attributable solely to tax reform. In more technical terms, TR86 has increased both the mean and the variance of the stream of disposable farm income while holding the expected value of net farm income constant.

Another tax change—elimination of income averaging—will have a similar impact on farmers. When marginal tax rates increase with income, farmers with

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Livestock Producers Pay More Taxes Under Tax Reform Act of 1986

Representative Farm	1984 Provisions Taxable Income	1984 Provisions Income Taxestc	1986 Tax Reform Act Taxable Income	1986 Tax Reform Act Income-Taxes
	(Thousand $)			
Dairy;				
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
Texas cow/calf; 230 cows	6.66	0.5	10.5	2.2
Midwest grain/hog;				
50 sows	11	0.2	9	1.6
105 sows	29	2.4	26	5.2
225sows	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 projection 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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Investment Behavior and Tax Sheltering

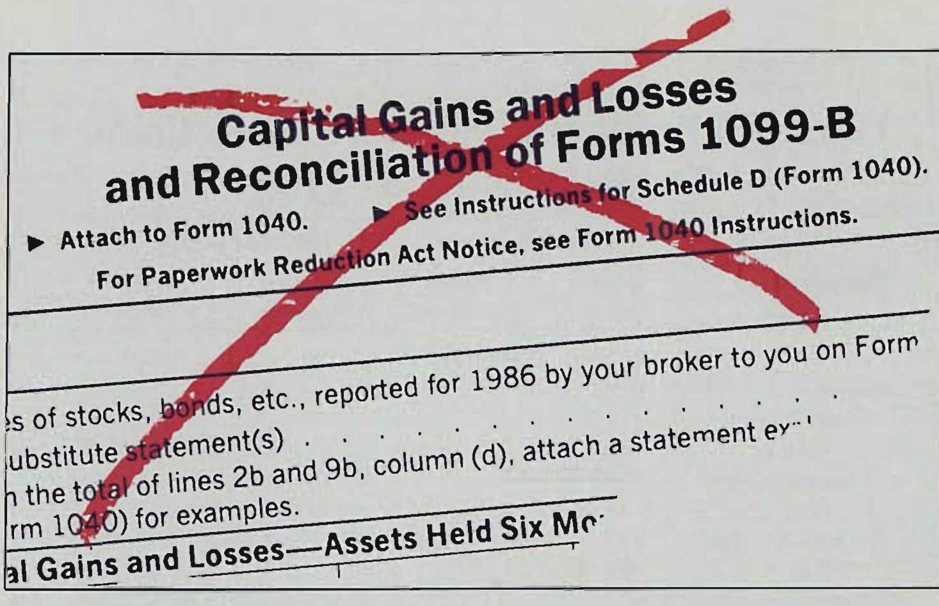
The new tax provisions, particularly limits on deductibility of passive losses and elimination of investment tax credit, will discourage tax shelter investments in agriculture and in other industries. In the past, potential tax shelter profits encouraged outside investors as well as

We expect that TR86 will make farming both riskier and more labor intensive.

farmers to expand plant capacity despite economic disincentives to do so. Although such behavior has been popularly attributed to outside investors, farmers probably made the most use of those tax shelter opportunities.

Recently, agricultural tax shelters have been—with the possible exception of cattle feeding—less attractive than those in real estate or oil and gas. As a result, the reduction in outside investment in agriculture resulting from the new tax law may be less than generally expected. Current price relationships and the lack of profitability in agriculture are likely to be more important in explaining investment behavior in the near term than tax changes.

In the longer run, TR86 may shift the mix of agricultural assets. The availability of special tax breaks for property qualifying for the investment credit (most notably specialized livestock facilities and machinery and equipment) and capital gains deductions (most applicable to breeding stock, orchards and other improved lands) encouraged investment in these items. Elimination of those tax advantages reduces their relative attractiveness, particularly in the orchard industry and in specialized livestock production. It may also lower prices of those capital assets. It appears that, in the past, investors bid up prices for those assets with



desirable tax attributes. This distorted the relative prices of these assets as well as favored ownership pattern by those in higher tax brackets.

Labor Intensity and Farm Size

TR86 does not allow the same write-offs and deductions for capital investments as provided under prior law. Thus, one incentive for capital labor substitution in agriculture has been blunted, if not eliminated. The result should be more labor intensive farming, at least for mid-size farms.

This result may not hold, however, for both large-and small-scale agriculture. For small-scale farms, the opportunity to expense up to $10,000 of capital expenditures encourages capital investment and capital labor substitution. For large-scale agriculture, the lower marginal tax rates and the new accelerated depreciation allowances more than offset the loss of investment credit, leaving a reduction in the after-tax cost of capital. TR86 is also expected to provide large-scale agriculture with more after-tax savings for potential reinvestment than moderate-size farms.

The result is an interesting mosaic of *reduced* incentives to invest and substitute capital for labor on moderate sized farms and coupled with *increased* investment incentives leading to further substitution of capital for labor in small scale and large scale agriculture. Further consequences of this phenomena are the incentive *and* the potential retained earnings for more rapid growth and expansion on the part of small and large farms in contrast to the more modest incentives and availability of retained earnings for growth on the part of moderate sized firms in agriculture.

Conclusion

The bottom line is that given the current financial and economic environment in agriculture, TR86 may not have as much impact as many have suggested. The major short run impact is likely to be distributional—TR86 will provide some, although not much, relief for farmers under severe financial stress,

The new tax provision will discourage tax shelter investments in agriculture.

but as suggested by Nixon and Richardson and others, it will significantly reduce the tax burden for those currently generating high incomes.

In the longer run, tax sheltering on the part of both farmers and non-farmers will be discouraged, risk and income volatility will increase, and passive investor rules will marginally discourage "outside investment" in agriculture. Finally, the differential incentives for and retained earnings to invest in capital assets on both small; and large farms, compared to those of moderate size, will provide further pressures for a bi-modal size distribution in agriculture. ■