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FRB CHICAGO

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Implications of the new tax law

The Tax Reform Act of 1986 mandates significant changes in federal income taxes. Many of the provisions of the new law will have an effect on individual farmers and their tax liabilities. Those who benefited from certain tax breaks under the old law will lose those benefits or see them sharply curtailed. However, tax rates for both individuals and corporations will be sharply lower and future investments in agriculture will be based less on tax considerations. A recent report by the USDA summarizes many of these changes and analyzes their likely effect on farmers.

The number of tax brackets under the new system has been cut back sharply. Compared to the 14 brackets under the old law, five tax rates will apply in 1987. A final adjustment in rates will occur in 1988 when the number of brackets is reduced to two: 15 and 28 percent. For certain higher income taxpayers, however, a phaseout of the benefits from the 15 percent bracket and personal exemptions will create a third effective marginal rate of 33 percent.

Along with the reduction in marginal tax rates, the level of personal exemptions and the standard deduction will rise, tending to lower taxable income. The personal exemption will rise from the current level of $1,080 to $2,000 in 1989, while the standard deduction will rise from $3,678 to $5,000 in 1988. The repeal of some non-business deductions, however, will tend to increase taxable income. Deductions for married couples who both work and for sales taxes are no longer applicable, while deductions for contributions to individual retirement accounts have been limited.

USDA estimates suggest that most farmers will be taxed at a lower marginal rate. Previously, more than half of all farmers had marginal tax rates above 15 percent. Under the new system, however, it is estimated that 75 to 80 percent of farmers will be taxed at the 15 percent rate. Moreover, it is estimated that the higher personal exemptions and standard deduction will reduce the taxable income of individuals with farm interests by about $10 billion annually.

The corporate tax rate structure was also lowered. Under the old structure there were five brackets with a top marginal tax rate of 46 percent. The new law reduces the number of brackets to three and drops the top rate to 34 percent. It has been argued that lower marginal tax rates favored corporations over other forms of business organization and contributed to the rapid increase in incorporations of farms during the 1970s. While the new corporate rate structure will continue to provide some benefits to family farm corporations, the sharp reductions in individual tax rates will likely reduce the incentive to incorporate.

Farm business operations will also be affected by changes in the depreciation of capital items. The Accelerated Cost Recovery System (ACRS) has been modified by the new law. Under the old law most farm assets were written off over a five-year period. While some assets will continue to be depreciated over 5 years, most farm equipment will come under the new seven-year recovery period. However, accelerating depreciation rates from the old 150 percent declining balance method to a 200 percent declining balance method will be partially offsetting. In addition, businesses that invest less than $200,000 per year can immediately deduct up to $10,000, double the amount under the old tax code.

The Tax Reform Act also repealed the investment tax credit, retroactive to the beginning of 1986. Under that provision of the old tax code, investments in most farm assets qualified for a 6 percent to 10 percent tax credit. A declining proportion of unused credits, 82.5 percent in 1987 taxes and 65 percent thereafter, can be carried forward. In addition, farmers who earned half or more of their income from farming during the last 3 years will be allowed to carry unused credits of up to $750 back 15 years in recalculating past taxes owed.

USDA figures suggest that in recent years farmers have been claiming more than $1 billion in tax credits. However, many farmers have been unable to claim all the investment tax credit available to them because they had little or no taxable income. It is estimated that farm businesses organized as sole proprietorships may hold $3 billion or more in accumulated tax credits. With many of these meeting the requirement of earning at least half of their income from farming, they will be allowed to carry back credits over 15 years, limited to the extent they had taxable income. They will be able to carry forward most of any unused credits to offset future tax liabilities as well.

The new law also ends the special tax treatment of capital gains. Previously, 60 percent of any capital gain was excluded from taxation, sharply lowering the effective marginal tax rate on such income. The maximum tax on long-term capital gains under the old tax code equaled the 50 percent tax rate times the 40 percent of the gain that was taxable, or 20 percent. With capital gains to be taxed as ordinary income under the new code, the top rate will rise to 28 percent and rates under 15 percent will be no longer possible. This change in the law will result in capital gains on dairy and breeding livestock as well as farmland being treated as ordinary income for tax purposes. Dairy farmers who have contracted to liquidate their herds under the Dairy Termination Program (DTP) will continue to qualify for special capital gains treatment until September 1, 1987, the date by which all participants in the DTP must have liquidated their herds.

Farmers are still allowed to use cash accounting for income taxes. That is, expenses can be deducted in the year they are paid and income is recognized when received, while changes in the value of inventories are not considered. Concerns over taking deductions for expenses as they occur but postponing income by accumulating inventories have prompted some changes in cash accounting rules. The deductibility of expenses for most variable inputs, such as feed, seed, and fertilizer, prior to their actual use, is limited to half of total farm expenses. This change is intended to sharply limit the use of cash accounting to defer taxes.

The new law also changes the treatment of land-clearing expenses. Rather than allowing these costs to be fully deductible as business expenses, they must be capitalized. That is, such costs must be added to the cost of the land and recovered only after it is sold. This change in the code is intended to reduce the incentives under the previous code to bring additional land under cultivation. Expenses for most water and soil conservation programs will remain deductible, but expenditures for draining wetlands or preparing land for center pivot irrigation systems will not.

In addition, the new law places additional limits on the deductibility of development expenditures on investments such as orchards and raising livestock to maturity. Prior to generating any revenues, most expenses incurred in the development of such assets were deductible in the year the expense was incurred, which allowed the accumulation of losses to offset other income. The Tax Reform Act limits this activity by requiring that expenditures for animals and plants with a two year or longer development period must be capitalized. The expenses incurred can be claimed later as either depreciation deductions or subtracted from the sale price of the asset to determine the taxable gain. However, farmers have the option to currently deduct development expenditures if they also use straight line depreciation for all farm assets placed in service during the year the deduction is taken. These changes will likely raise the after-tax cost of developing farm assets such as orchards, vineyards, and cattle, and discourage new investment in such assets to shelter income. However, the provision allowing producers to deduct immediately the cost of replacing plants destroyed by natural disasters is retained for crops grown for human consumption. In addition, this exemption is expanded to include both replanting on different parcels of land and investors who acquire a minority interest in the operation.

Further changes in the tax code limit the use of losses and credits from one activity to offset income and taxes from another. To shelter income this way the taxpayer must "materially participate" in the activity that generates the loss or credit. In addition, losses of up to $25,000 from rental real estate, including farmland, can shelter income from other sources. However, this exception is phased out for taxpayers with adjusted gross incomes in excess of $100,000.

Another important change in the tax code pertains to the discharge of indebtedness. Formerly, an individual who satisfied a debt by turning over collateral or who participated in a debt-write-down program would likely pay taxes on some of the forgiven debt. There were three ways to have this income excluded from taxes: declared bankruptcy, insolvency, and qualified business indebtedness. The new code provides another exclusion for individuals who are solvent but have insufficient cash flow. If they received at least half of their gross receipts from farming in each of the last three years, discharge-of-indebtedness income is treated the same as for an insolvent taxpayer. That is, after the reduction of tax credits, operating loss carryovers, and basis in remaining farm assets, the discharge-of-indebtedness income is not taxable.

Peter J. Heffernan

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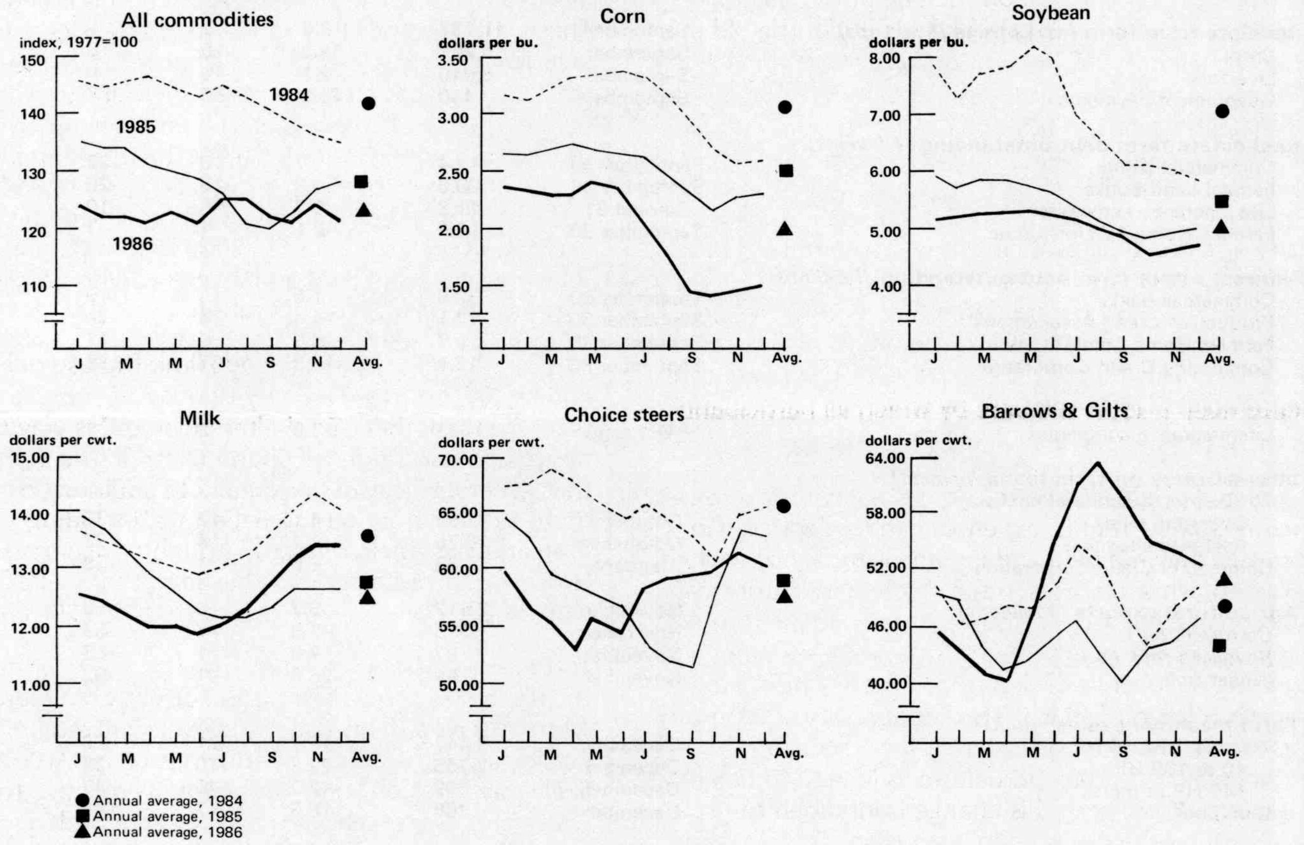
1986 in Perspective

Farm Commodity Prices



	Units	1975	1980	1983	1984	1985	1986*
Production							
Corn	bil. bu.	5.84	6.64	4.17	7.67	8.87	8.22
Soybeans	bil. bu.	1.55	1.80	1.64	1.86	2.10	2.01
Wheat	bil. bu.	2.13	2.38	2.42	2.59	2.42	2.08
Beef	bil. lbs.	23.7	21.5	23.1	23.4	23.6	24.2
Pork	bil. lbs.	11.6	16.4	15.1	14.7	14.7	14.0
Milk	bil. lbs.	115.4	128.4	139.7	135.4	143.7	144.9
Farm Sector Earnings							
Gross cash income	bil. dol.	90.7	143.3	150.2	154.9	156.2	150.0
Cash receipts	bil. dol.	88.9	139.7	136.5	142.2	142.1	132.0
Government payments	bil. dol.	0.8	1.3	9.3	8.4	7.7	13.0
Total cash expenses	bil. dol.	61.1	109.1	113.0	115.6	112.1	106.0
Net cash income							
Current dollars	bil. dol.	29.6	34.2	37.1	39.3	44.0	44.0
1982 dollars	bil. dol.	49.9	39.9	35.7	36.4	39.5	38.0
Farm Sector Balance Sheet (year-end)							
Assets							
Current dollars	bil. dol.	510	1,003	957	856	771	707
1982 dollars	bil. dol.	831	1,113	902	780	682	606
Debt							
Current dollars	bil. dol.	85	170	202	199	192	186
1982 dollars	bil. dol.	139	189	191	181	170	160
Equity							
Current dollars	bil. dol.	425	833	754	657	579	520
1982 dollars	bil. dol.	693	924	711	599	512	446

*Preliminary estimates.

Selected Agricultural Economic Indicators

	Latest period	Value	Percent change from: Prior period	Year ago	Two years ago
Receipts from farm marketings *($ millions)*	September	11,737	18.6	-2	1
Crops*	September	5,257	48.3	-15	-10
Livestock	September	6,040	-2.1	10	6
Government payments	September	440	145.8	50	327
Real estate farm debt outstanding *($ billions)*					
Commercial banks	September 30	12.4	2.7†	13	22
Federal Land Banks	September 30	39.6	-4.3†	-15	-20
Life insurance companies	October 31	11.3	-0.7†	-6	-10
Farmers Home Administration	September 30	10.9	-0.1†	1	7
Nonreal estate farm debt outstanding *($ billions)*					
Commercial banks	September 30	33.6	-1.5†	-14	-19
Production Credit Associations	September 30	12.1	-4.4†	-24	-38
Farmers Home Administration	September 30	18.7	-0.3†	0	11
Commodity Credit Corporation	September 30	15.4	-14.3†	57	138
Farm loans made *($ millions)*					
Life insurance companies	October	43	-18.6	-73	1
Interest rates on farm loans *(percent)*					
7th District agricultural banks					
Operating loans	October 1	11.33	-4.1†	-12	-22
Real estate loans	October 1	10.76	-4.4†	-14	-23
Commodity Credit Corporation	January	5.88	2.6	-24	-38
Agricultural exports *($ millions)*	November	2,512	3.2	-10	-29
Corn *(mil. bu.)*	November	115	-7.9	-46	-53
Soybeans *(mil. bu.)*	November	97	7.8	21	3
Wheat *(mil. bu.)*	November	68	-26.0	-21	-32
Farm machinery sales[p] *(units)*					
Tractors, over 40 HP	December	3,447	13.7	-21	-28
40 to 139 HP	December	2,755	22.8	-10	-21
140 HP or more	December	692	-12.2	-46	-47
Combines	December	486	-18.3	-47	-45

*Includes net CCC loans.
†Prior period is three months earlier.
[p] Preliminary

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