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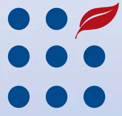

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The Potential Impact of Tax Reform on Farm Businesses and Rural Households

James M. Williamson
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Tracey Farrigan

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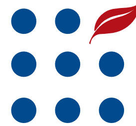

A Report from the Economic Research Service

www.ers.usda.gov

The Potential Impact of Tax Reform on Farm Businesses and Rural Households

James M. Williamson

Ron Durst

Tracey Farrigan

Abstract

Several proposals calling for fundamental reform of the Federal income tax system have been put forth, including a report by the co-chairs of the National Commission on Fiscal Responsibility. The primary elements of reform—eliminating tax preferences, restructuring capital gains and dividend tax rates, lowering rates on individual income, and reducing the number of tax brackets—could have a significant impact on the after-tax income and well-being of both farm businesses and rural households. This report uses published and special tabulation data obtained from the Internal Revenue Service, farm-level data from USDA's Agricultural Resource Management Survey, and data from the American Housing Survey to examine the current tax situation for farm households and to evaluate the importance of various Federal income tax policies. For farm households, the effect of reform will primarily depend upon changes to existing treatment of investment and business income, including several important business deductions. In contrast, changes to existing individual tax credits, especially refundable tax credits, will likely be of greater significance to nonfarm rural households.

Keywords: farm households, tax reform, income tax, tax rates, Federal tax policy, farm losses, refundable credits, tax deductions, rural households, tax preferences

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Summary

What Is the Issue?

Proposals calling for fundamental tax reform have once again called attention to a tax system that many regard as overly complex, inefficient, and inequitable. Proponents of reform see this as an opportune time for a comprehensive overhaul of the tax system because major features of the system are set to change, although some were recently made permanent by the American Taxpayer Relief Act of 2012.

Several proposals calling for fundamental reform of the Federal income tax system have been put forth, including a report by the co-chairs of the National Commission on Fiscal Responsibility (NCFRR), a bipartisan reform panel created by the President in 2010 to address the fiscal stability of the United States. The primary elements of proposed reform—eliminating tax preferences, restructuring capital gains and dividend tax rates, lowering rates on ordinary income, and reducing the number of tax brackets—could have a significant impact on the after-tax income and well-being of both farm businesses and rural households.

What Did the Study Find?

The primary goals of tax reform are to simplify the tax system, making compliance easier and reducing economic distortions induced by the system, while preserving its progressive nature. While reform may improve societal welfare, the current tax system contains features that provide substantial benefit to ***farm businesses*** in the form of reduced rates on capital gains, accelerated cost recovery provisions, and other special deductions for farm production activities. Since most farms are operated as sole proprietors, partnerships, or other noncorporate entities and taxed under the individual income tax, reform of the individual income tax structure is of greatest importance to most farmers. However, reform of the corporate income tax could also affect important business tax provisions for farmers, including those taxable under the individual income tax.

In particular, reducing or eliminating deductions for capital purchases and raising capital gains taxes could increase the farmer's tax base and raise the tax rate paid on a significant portion of their income. These effects will vary by farm size. Offsetting these effects, though, is the proposed reform of the marginal tax rate structure. A reduced number of brackets and lower rates could mitigate the effect of a potentially larger tax base for many U.S. farm households.

In 2010, about 38 percent of U.S. farmers, defined as taxpayers who filed a Schedule F with their Form 1040, reported some ***capital gains***—nearly three times the share for all other taxpayers—totaling $28.4 billion. The average amount of capital gain reported by farmers was also more than double the average capital gain reported by other taxpayers. If capital gains are taxed at rates equal to income tax rates, farmers will face higher tax liabilities on capital gains income, even if ordinary tax rates are reduced.

Farming requires large investments in machinery, equipment, and other depreciable capital. In 2010, U.S. farmers reported a total of $29 billion on capital purchases, and those making investments made an average of $32,000 in annual capital purchases. Proposed restrictions on current ***expensing and accelerated recovery of capital purchases*** could increase taxable income, especially during the early years following tax reform. Under present law, the maximum expensing amount is $500,000, but will drop to $25,000 in 2014 (as provided by the American Taxpayer Relief Act of 2012). While fewer than 20 percent of small farms (those with less than $250,000 of gross sales) invest more than $25,000, nearly 54 percent of commercial farms (farms with at least $250,000 of gross sales) invest more than that amount. Thus, investment by commercial farms will be affected the most by a substantially lower expensing amount. This could lead to increased taxable income and reduced capital investment by these farms.

Commercial farms are also the primary beneficiaries of the domestic production activities deduction for manufacturers. While only about 7 percent of farms claimed the deduction, the total amount deducted was $1.25 billion. For these farms, eliminating the deduction could add an average of about $9,000 to their taxable income.

About one out of seven farmers uses the ***self-employed health insurance deduction*** in any given year. In 2010, these farmers deducted an average of $6,173 for a total of $1.684 billion in health insurance premiums. Over 50 percent of farm households obtain their insurance through off-farm employment of the operator or spouse, which helps account for the low number of farmers claiming the deduction. Many other farmers are over age 65 and are covered by Medicare or other Government programs. Nonetheless, tax reform that eliminates the deduction for premiums on health insurance purchased by the self-employed could increase taxable income for some farmers.

Tax reform would affect rural nonfarm households differently than farm and urban households. Rural taxpayers are likely to have lower incomes and be older than urban households. Given their lower income, ***rural nonfarm households are less likely to benefit from tax deductions***, exemptions, exclusions, or deferrals, because they either lack eligible expenses to exceed the standard deduction or otherwise do not qualify for the tax exemption. Some of the most widely used deductions—for mortgage interest and real estate taxes—are related to the value of property and real property tax rates, which are generally lower in rural areas. Although rural households have higher rates of home ownership, they are less likely to have a mortgage. Thus, the typical rural homeowner may even benefit if the current mortgage interest deduction was replaced with a refundable credit for mortgage interest because the credit does not require taxpayers to itemize to receive the benefit or even have a tax liability at all.

While rural households would be less affected than other households by the elimination of itemized deductions, the restructuring of ***refundable tax credits*** could significantly lower the after-tax income of low-income rural households. Any reform that reduces the value of refundable credits—especially the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC)—is likely to reduce the well-being of low-income rural households. Overall,

one out of every three rural taxpayers receives benefits from the EITC or the CTC. In 2008, 21.6 percent of rural taxpayers received EITC benefits, compared with 16.9 percent of urban taxpayers. The earned income and child tax credits provided a total benefit of $20.6 billion to rural taxpayers in 2008.

How Was the Study Conducted?

This report uses both published and special tabulation data obtained from the Internal Revenue Service to provide an overview of the current tax situation for U.S. farm households and to evaluate the importance of various Federal income tax policies. It also uses farm-level data from USDA's Agricultural Resource Management Survey to estimate the effects of various policies on Federal income tax liabilities of farmers. The American Housing Survey is also analyzed to evaluate the relative importance of various tax provisions for rural households.

Introduction

Tax reform has once again become a topic of discussion among policymakers and the general public. Proposals calling for fundamental reform of the Federal income tax system have raised awareness of features of the system that many regard as overly complex, inefficient, or inequitable. Proponents of reform argue that the system, with its patchwork of tax preferences, is needlessly complicated and expensive to administer. Proponents also see this as an opportune time for a comprehensive overhaul of the tax system because major features of the system are set to change, although some features were recently made permanent by the American Taxpayer Relief Act of 2012.

Legislation enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) expired at the end of 2012. However, the American Taxpayer Relief Act of 2012 made permanent or extended many of the provisions in those acts important to farm businesses and rural households.[2] Under current law, the marginal tax rates on ordinary income under $400,000 ($450,000 for couples) remain at the current rates, as does the rate on capital gains and dividends; certain preferential accelerated capital cost recovery provisions also remain.

[2]Rural is defined as nonmetropolitan, which is any area that is not part of a Metropolitan Statistical Area (MSA).

This report examines recommendations put forth in a report by the co-chairs of the National Commission on Fiscal Responsibility and Reform (NCFRR) for addressing the Federal tax system. The Commission was a bipartisan reform panel created by the President in February 2010 to address the fiscal stability of the United States. This report represents common reform themes expressed by stakeholders and policymakers that will likely serve as a blueprint for future tax reform.[3] The elements of reform discussed in this report—eliminating or restructuring tax preferences such as mortgage interest deductions, restructuring capital gains and dividend tax rates, lowering marginal tax rates, and reducing the number of tax brackets—could have a significant impact on the after-tax income and well-being of farm businesses and rural households. We use tax return data from the Internal Revenue Service (IRS), income and balance sheet data from USDA's 2010 Agricultural Resource Management Survey (ARMS), and house ownership and mortgage data from the American Housing Survey to examine the size and scope of farm business and rural household activities that currently benefit from provisions identified as targets for reform (For additional information on data sources and definitions, see box).

[3]As provided by its bylaws, the Commission was required to vote on the approval of a final report. On Dec. 3, 2010, a vote was held on a plan forwarded by the panel's 2 chairs, Alan Simpson and Erskine Bowles; however, it fell short of the supermajority of 14 needed to send a proposal to Congress. This analysis examines the proposals of the Commission's co-chairs (National Commission on Fiscal Responsibility and Reform, 2010).

Data Sources and Definitions

Internal Revenue Service Income Tax Data

The Internal Revenue Service annually collects and publishes information on the operation of the Internal Revenue laws. This report uses both published and special tabulation data obtained directly from the Internal Revenue Service to evaluate the effect of various tax policies on farmers and rural America by level of adjusted gross income. *Adjusted gross income* is income from all sources, including net farm income/loss, minus certain adjustments to income. For tax purposes, a *farm* is defined as a taxpayer who has farm income or expense and files a schedule F Federal income tax return.
http://www.irs.gov/uac/Tax-Stats-2

Agricultural Resource Management Survey Data

The annual Agricultural Resource Management Survey (ARMS) is USDA's primary source of information on the financial condition, production practices, and resource use of America's farm businesses and the economic well-being of America's farm households. The report uses income and balance sheet information from the survey to evaluate various policies and to differentiate the impact by farm size based on gross sales. For purposes of the survey, a *farm* is defined as any place from which $1,000 or more of agricultural products were produced and sold, or normally would have been sold, during the year.
http://www.ers.usda.gov/data-products/arms-farm-financial-and-crop-production-practices.aspx

American Housing Survey Data

The American Housing Survey is the most comprehensive national housing survey in the United States. It provides current information on a wide range of housing subjects. The survey is used in this report to obtain information on home ownership and mortgage amounts.
http://www.census.gov/housing/ahs/

Objectives of Fundamental Tax Reform

The impetus to reform the tax system is the nearly universal desire to make the tax system simpler to administer and comply with, to improve its efficiency, and to ensure equitable treatment. To accomplish such goals, reform proponents often refer to "broadening the tax base," or amending the Internal Revenue Code (IRC) to include more income as taxable by eliminating tax expenditures or preferences.[4] Tax expenditures, the top ten by expense shown in table 1, are defined as Federal revenue losses attributable to special tax exclusions, exemptions, and deductions, as well as preferential tax rates, credits, and deferrals of tax liability (OMB, 2012). Broadening the tax base by eliminating tax expenditures can reduce complexity and computational burden, and perhaps increase efficiency and equity.

[4]Tax expenditures are sometimes known as "tax preferences," evoking an image that the benefits accrue to a small group or a narrowly defined activity. However, in some cases, an individual tax expenditure benefits a large proportion of taxpayers. The exclusion from income allowed for the employer contribution toward health insurance is one example.

Maintaining the progressive nature of the current tax system is also a stated goal of reform. Generally, progressivity is measured as a function of taxes paid relative to income. If the average tax rate increases with income, the system is said to be progressive. Progressivity can also be measured by the system's impact on the change in the relative after-tax income shares across the population of taxpaying households. A progressive system will reduce the after-tax income of taxpayers relative to their pre-tax incomes as taxpayers' incomes increase.

Table 1

Top ten individual tax expenditures, 2011

Expenditures	Estimates *($ billion)*
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	109.3
Reduced tax rates on dividends and long-term capital gains	90.5
Deduction for mortgage interest on owner-occupied residences	77.6
Earned Income Tax Credit	59.5
Child Tax Credit	56.4
Exclusion of pension contribution and earnings to defined contribution plans	48.4
Exclusion of pension contribution and earnings to defined benefit plans	42.7
Deduction of non-business State and local government income taxes, sales taxes, and personal property taxes	42.4
Exclusion of capital gains at death	38.0
Exclusion of untaxed social security and railroad retirement benefits	31.0
Exclusion of untaxed benefits provided under cafeteria plans*	31.0
Total	626.8

*A "cafeteria plan" is a type of employer-provided benefit plan that allows employees to receive certain benefits—for example, accident and health benefits, adoption assistance, or dependent care assistance—on a pretax basis, .

Source: Joint Committee on Taxation, January 2012, Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015, JCS-1-12, table 1.

Simplifying the Tax System

Complying with the tax code can be time consuming and costly if help with preparation is needed. More than three out of five U.S. taxpayers paid for tax preparation in 2006 (GAO, 2007). The need for assistance is not limited to taxpayers who would traditionally have complex tax filings, like individuals who receive income through partnerships or other pass-through entities, including a majority of farmers. Many tax credits are targeted to low-income families with children, and on average, a family receives multiple credits. Further, each credit may require a complex series of calculations, carried out through multiple forms, and guided by different eligibility rules. Filers may not be aware of the tax benefits available to them because of the labyrinth of rules, and accessing the benefits may require paying for preparation assistance. This complexity may also result in taxpayers' failure to report income or file appropriately, and in some cases failure to file altogether. The IRS estimated the tax gap—the difference between taxes owed and taxes paid—was $345 billion in 2001 (GAO, 2011).

Improving Efficiency

Taxes affect decisions about resource allocation, including the decision to participate in an activity and the level of effort of the activity for those who participate. The labor force participation decision is often cited as an example. Tax rates influence a person's decision to participate in the labor force, as well as how many hours to work, by altering the after-tax rate of pay. Proponents also suggest that the tax preferences in the current system distort such economic decisions by changing relative prices of economic activities. From the perspective of societal well-being, preferential tax treatment can cause distortions to arise when relative price differentials encourage taxpayers to consume, save, and invest differently than they would without such distortions. By removing preferential tax treatment, many of the tax-induced economic distortions can be lessened or eliminated.

Many proponents of tax reform argue that current tax rates—seven brackets ranging from a rate of 10 to 39.6 percent—are too high and discourage work and investment, leading to inefficiency. On the other hand, higher tax rates may encourage more work if taxpayers choose to maintain their current standard of living rather than trade consumption for leisure. Further, the preferential treatment of gains from capital income may encourage an inefficient allocation of resources to unearned income; in particular, higher income individuals have the ability to substitute their remuneration between ordinary income and capital income. However, the extent to which a taxpayer's labor-supply decisions are influenced by the after-tax value of earnings is an empirical question.[5] Further, many of the provisions in the IRC, such as the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC), are subject to phaseout once a taxpayer's income reaches a certain level. When the graduated tax brackets combine with the credit phaseout rates, taxpayers face even greater effective tax rates, which could lead some to work less in order to avoid the phaseout.[6]

[5]The effect of taxes on labor supply varies by demographic; the labor supply of prime-age (ages 25-54) men is estimated to be very insensitive to taxes (Hausman, 1981; MaCurdy et al., 1990), while the labor supply of women, particularly married women and women with children, is estimated to be more sensitive (Hausman. 1981; Dickert et al., 1995).

[6]Eissa and Williamson-Hoynes (2004) find that married women in the phaseout range of the EITC are less likely to work.

Equity Concerns

The Federal tax system has been criticized for violating the concepts of vertical and horizontal equity. Simplifying the tax code by eliminating deductions may address some equity concerns. The principle of vertical equity requires that taxpayers across the income distribution are taxed in proportion to their ability to pay, and proponents of reform note that the system of deductions violates this principle because higher income individuals benefit more from deductions due to their higher marginal tax rates. From the standpoint of vertical equity, credits offer an advantage over itemized deductions because the tax value of each dollar of credit is equal for all taxpayers, no matter the taxpayer's marginal tax rate.

On the other hand, in many cases, the system treats similarly situated taxpayers differently—or treats taxpayers with the same income differently—violating the principle of horizontal equity. The different tax treatment of earnings and capital gains is a notable example. Under current law, a taxpayer with $50,000 of earned income from salaries, wages, or business endeavors will face a significantly higher tax burden than a taxpayer whose income consists of $50,000 of unearned income from dividends or capital gains.

Reform Proposals

The bipartisan National Commission on Fiscal Responsibility and Reform was created in February 2010 by the President to "[identify] policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run."[7] The Commission's co-chairs released a report in December 2010 entitled "The Moment of Truth," offering multiple variations of tax reform scenarios that rely on eliminating itemized deductions and restructuring or creating new credits, as well as lowering the statutory marginal rates.

[7]Created by Executive Order 13531.

Itemized deductions are targeted for reform because they add complexity to the tax system and reduce equity and progressivity. Proponents of reform argue that itemized deductions complicate the Federal tax system and create differences in tax liability between taxpayers with similar incomes and filing status—a violation of the principle of horizontal equity. Further, itemized deductions reduce the progressivity of the tax system because their value depends on the taxpayer's marginal tax rate, generally reducing tax liability more for a high-income taxpayer than for a low-income taxpayer. Thus, the impact of reducing or eliminating itemized deductions would be more keenly felt by high-income taxpayers. This is true, for example, with respect to the mortgage interest deduction, which is typically one of the largest itemized deductions for most taxpayers.

To start, the Commission's proposal would eliminate all special tax preferences and use revenue from the savings to lower tax rates and add back "small and more targeted" provisions that accomplish policy goals, such as promoting the labor force participation of low-income households, homeownership, health, charity, and retirement saving. Under the co-chairs' illustrative plan, the widely used deduction for mortgage interest would be replaced with a 12-percent nonrefundable credit applied to the annual interest on a mortgage worth no more than $500,000 in original value.[8]

[8]A nonrefundable credit is applied up to only the amount of a taxpayer's tax liability. If the value of a nonrefundable credit is more than the amount of tax, the taxpayer's tax liability is reduced to zero. In contrast, a refundable credit may entitle the individual to receive a refund for the amount in excess of tax liability.

The deduction for charitable donations would also be eliminated and replaced with a 12-percent nonrefundable credit with a 2-percent adjusted gross income (AGI) floor—that is, the credit would only apply to donations to the extent that they exceed 2 percent of a taxpayer's AGI. The NCFRR co-chairs' plan would simplify retirement saving by consolidating retirement accounts and limit the aggregate annual amount that could be contributed to the lesser of $20,000 or 20 percent of income.

Under current law, the interest income received from State and municipal bonds is not taxable and has been treated as such for nearly a century. The co-chairs' proposal would tax the interest income on all newly issued State and municipal bonds, including "Aggie Bonds" issued by States, which provide loans to beginning farmers with low equity.

The co-chairs' plan also calls for a limit or "cap" on the tax treatment of employer-sponsored health care insurance. Under current law, 100 percent of the cost of an employer's contribution for health insurance is excluded from taxation, and this represents the largest tax expenditure in terms of cost—over $109 billion a year (see table 1)—covering close to 150 million individuals in America (Kaiser Foundation, 2011). The proposal calls for the exclusion to be reduced to the 75th percentile of premium values in 2014 and kept at this level through 2018, effectively reducing the value of the exclusion, though only for beneficiaries whose plans exceed the imposed cap. By 2038, however, the proposal would completely phase out the exclusion, and tax the full extent of employers' contribution to health insurance.

The NCFRR report also proposes to reduce the statutory marginal tax rates and condense them to three brackets—the lowest rate could be as low as 8 percent and the maximum rate no higher than 29 percent.[9] Capital gains and dividends would be taxed at these new lower ordinary rates.

[9]The current maximum rate is 39.6 percent.

Two other notable tax reform plans have also been released recently (see appendix table A1). In August 2010, The President's Economic Recovery Advisory Board—an advisory panel tasked by the President with assembling options to reform the tax system—released a report with options to simplify the IRC for individual taxpayers, increase taxpayer compliance, and reform the corporate tax system. The Bipartisan Policy Center also issued a proposal by their Debt Reduction Task Force[10] entitled "Restoring America's Future." Both of these proposals share common features with the NCFRR co-chairs' report, such as lowering marginal rates on ordinary income, equalizing capital gains and ordinary income tax rates, reducing tax expenditures, reducing itemized deductions, consolidating credits, and streamlining the tax-filing process. The Bipartisan Policy Center plan proposes a national sales tax as well.

[10]Senator Pete Domenici and Dr. Alice Rivlin, co-chairs.

Taxation of Farm Income Under Proposed Reform

The Federal income tax is a progressive tax imposed on net income. It is collected annually and accounts for a substantial portion of total Federal tax revenues. Reform of the Federal income tax could have a significant effect on investment, management, and production decisions in the agricultural sector.

The individual income tax is significantly more important than the corporate income tax for understanding how taxes affect most farmers. Sole proprietorships, partnerships, and subchapter S corporations are all taxed at the individual level. The most common form of farm organization is the sole proprietorship which, according to the 2007 Census of Agriculture (USDA, National Agricultural Statistics Service), accounted for 86.5 percent of all farms and 50 percent of total sales. Partnerships comprise 7.9 percent of farms and 20 percent of sales. Income from farm partnerships and corporations taxed under subchapter S of the IRC (known as S Corporations) is also passed through to the individual partners or shareholders for taxation at the individual shareholder or partner level. Corporate farms, including C-corporations and S-corporations, in total represent 4.4 percent of U.S. farms and account for about 30 percent of sales. While census data do not separate S-corporations from other corporations, family-held corporations account for about 90 percent of all corporations, and many of these family-held corporations are S-corporations. The remaining 1.3 percent of farms includes cooperatives, estates, trusts, and institutional farms. Some of the income from these farms is also taxed under the individual tax rate structure. Therefore, more than 96 percent of all farms and over 75 percent of farm sales are taxed under the provisions of the individual income tax.

Although most family income and a large share of farm income is taxed under the individual tax structure, this does not mean that reform of the corporate tax structure would have no impact on agriculture.[11] The NCFRR co-chairs recommended replacing the graduated corporate tax rate structure with one rate; they suggested a 28-percent tax rate, depending upon the number of corporate tax expenditures that are eliminated. Since most farm corporations are relatively small, with income taxed at less than the top rate, eliminating the graduated rate structure could shift the tax burden from larger to smaller corporations.[12] For instance, the current tax rate on the first $50,000 of taxable income is 15 percent. Thus, smaller farm corporations could not only lose deductions as tax expenditures are eliminated but face higher tax rates on their expanded income tax base if the current rate structure is replaced with a single rate.

Corporate tax reform could also affect capital cost recovery and the domestic production activities deduction. Changes to these business tax provisions as part of corporate tax reform could also have a significant impact on the farm business income and tax liability of sole proprietors, partners, and other farm businesses taxed under the individual tax structure.

[11]Corporate taxes are levied on the net income of the corporation; individual taxes are based on the adjusted gross income of the individual.

[12]2008 Internal Revenue Service (IRS) data indicate that as many as 64 percent of corporate farms have business receipts of less than $250,000 (IRS, SOI Tax Stats, Table 5: Returns of Active Corporations 2008).

Most Federal Income Tax for Farm Households Is Paid on Off-Farm Income

Farm households receive income from both farm and off-farm activities, and for many, off-farm income accounts for a large share of the household's total income. In 2011, the average farm household income reported in the ARMS survey was $87,289, and off-farm sources accounted for a majority of the income (84.3 percent). In fact, since 1980, farm sole proprietors as a group have reported negative aggregate net farm income for tax purposes, and over the last decade, both the share of farmers reporting losses and the amount of losses reported have increased (fig. 1). About half of all farm partnerships and small business corporations also report losses.

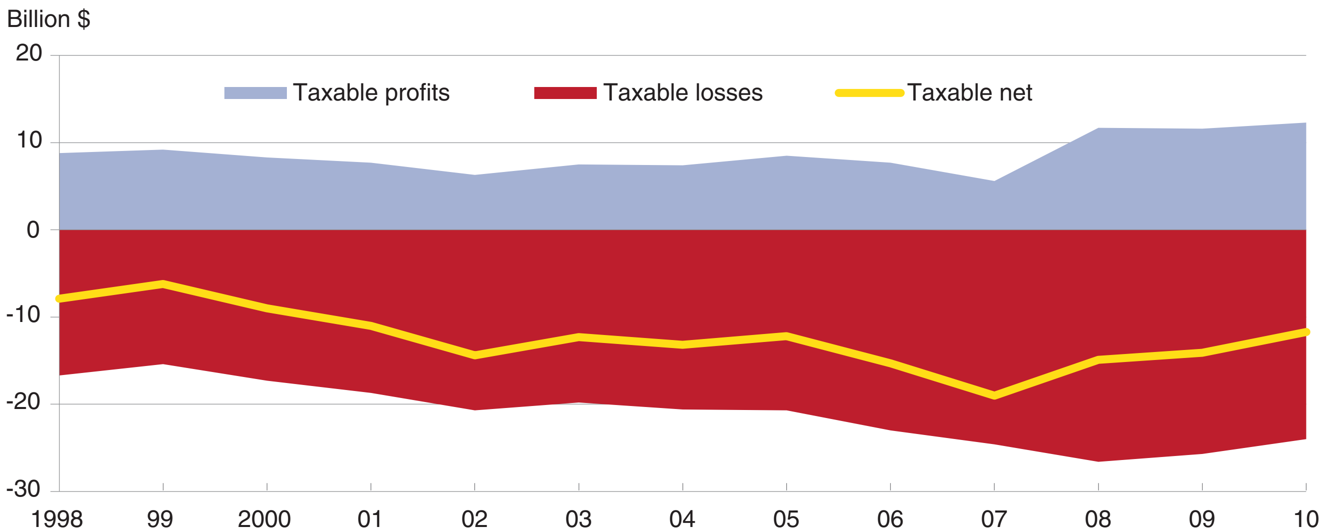
In 2010, based on IRS data, nearly three of every four farm sole proprietors reported a farm loss. For those who reported a loss, the average loss was $18,079 for a total of $24 billion. This increased reporting of losses has coincided with an increase in the amount of capital investment that can be expensed in the first year; that and other tax law changes may partially explain the trend of increasing reported farm losses.

Because the family is the typical unit of taxation for a farm business, farm and nonfarm income are combined when computing Federal income taxes for farm households. Most Federal income tax paid by farm households can be attributed to nonfarm income. With only about 30 percent of farm sole proprietors reporting a profit and with just 60 percent of those reporting a farm profit owing any Federal income taxes, only about 19 percent of farm sole proprietors paid any Federal income tax on their schedule F farm income in 2010.

Table 2 provides information on average income, farm profit/loss, and taxes by level of adjusted gross income for farm sole proprietors in 2010. While farm sole proprietors reported average adjusted gross income and taxes of

Figure 1

Total taxable net farm income/loss for farm sole proprietors reported on Form 1040 Schedule F, 1998-2010



Source: USDA, Economic Research Service; tax data are compiled from the Internal Revenue Service.

Table 2
Average farm profit/loss, income tax liability, and tax rate for farm sole proprietors by level of adjusted gross income, 2010

Level of adjusted gross income	Number of returns	Average adjusted gross income	Average farm profit/ loss	Average Federal income tax	Average effective income tax rate
		Dollars	*Dollars*	*Dollars*	*Percent*
No adjusted gross income	152,600	(115,827)	(27,746)	106	-
$1 to $10,000	155,440	5,051	(5,092)	8	.2
$10,001 to $25,000	242,271	17,285	(6,457)	116	.7
$25,001 to $50,000	413,386	37,148	(5,025)	1,067	2.9
$50,001 to $100,000	554,953	72,088	(3,181)	4,858	6.7
$100,001 to $250,000	339,874	141,398	(800)	17,376	12.3
Over $250,000	76,206	944,714	(13,488)	203,773	21.6
All	1,934,731	85,021	(6,064)	12,664	15.1

Source: USDA, Economic Research Service, based on special tabulations from 2010 Internal Revenue Service (IRS) tax data.

$85,021 and $12,664, respectively, they also reported a net farm loss of $6,064, on average. Because taxes on farm income are paid at the individual level, under the proposed changes to the individual income tax system, farm households could experience significant changes to their after-tax incomes. Proposed changes to the system of deductions and credits will expand the taxpayer's tax base, and proposed changes to tax rates on dividends and capital gains, in particular, will raise current tax rates for some farmers, even if the plan is designed to be revenue neutral.

Farmers Realize a Greater Share of Their Income From Capital Gains Than the Average Taxpayer

Reform would likely alter the tax treatment of capital gains. The Federal income tax system has historically taxed gains on the sale of assets held for investment purposes at lower rates than on other sources of income. The current tax rate on capital gains is 15 percent for taxpayers below the 39.6-percent income tax bracket and 20 percent for those in the 39.6-percent bracket (0 percent for taxpayers in the 10- or 15-percent income tax brackets; in addition, certain high-income taxpayers are assessed a 3.8 percent surtax). These reduced rates are especially significant for farmers because some assets used in farming or ranching are eligible for capital gains treatment and the amount of capital gains is increased by the ability to currently deduct certain costs (e.g., maintenance or depreciation). A primary source of such gains (or losses) is the sale of cattle used for breeding, dairy, draft, or sporting purposes; and certain other livestock.[13] Under current tax law, the IRC allows for proceeds from the disposition of such business property to be treated as a capital gain (or loss).

[13][C]attle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and (B) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry (IRC Section 1231(b)(3)).

Under the reform proposals, the preferential tax rate for capital gains would be eliminated and replaced with a rate that is equal to the rate on ordinary income. According to the IRS, in 2010 about 38 percent of all farmers reported some capital gains—more than three times the share for all other taxpayers. The average amount of capital gain reported by farmers was also more double the average capital gain reported by other taxpayers. In 2010, the last year for which complete IRS data are available, farmers reported capital gains of $28.4 billion.[14] This amount represented about 21.5 percent of total taxable income reported by farm households. The average amount for those reporting capital gains or losses was $38,921.

[14]Internal Revenue Service, Statistics of Income, Special Tabulations for *Farm Proprietorships, 2010:*

A large amount of this capital gain income was reported by high-income farmers with adjusted gross income over $250,000. Capital gains accounted for one-third of the taxable income for this group. Although high-income farmers comprised less than 4 percent of sole proprietorships filing returns, they accounted for 74.2 percent of all capital gains reported by farmers and reported average capital gains of $362,200 (table 3). On average, nearly one-third of reported gains by farm sole proprietors are attributed to the sale of assets used in farming.

The share of farms reporting capital gains income also increases with farm size. Over 60 percent of commercial farmers reported capital gains income, accounting for 25 percent of all capital gains reported by farmers. However,

Table 3

Share of returns and average capital gain and income from the sale of business assets for farm sole proprietors by level of adjusted gross income, 2010

Level of adjusted gross income	Total number of returns	Share reporting capital gain/loss	Average capital gain	Share reporting sale of business assets	Average gain on business assets	Business asset share of total capital gain
		Percent	*Dollars*	*Percent*	*Dollars*	*Percent*
No adjusted gross income	152,600	47.0	21,090	28.8	10,952	31.8
$1 to $10,000	155,440	25.4	3,159	16.0	2,762	55.0
$10,001 to $25,000	242,271	27.0	3,122	16.3	3,881	75.1
$25,001 to $50,000	413,386	33.9	4,476	16.3	6,429	68.9
$50,001 to $100,000	554,953	33.6	13,518	18.7	7,985	46.0
$100,001 to $250,000	339,874	49.4	15,792	17.6	22,434	50.7
Over $250,000	76,206	77.9	362,200	31.9	204,003	23.1
All	1,934,731	37.8	38,921	18.8	22,748	29.1

Source: USDA, Economic Research Service, based on special tabulations from 2010 Internal Revenue Service tax data.

most of the capital gain is from the sale of nonfarm assets, especially for residential/lifestyle farmers (Durst and Monke, 2001).[15]

A 2007 IRS *Sales of Capital Assets* study reported that net gains from the sale of livestock were $2.2 billion, while gains from the sale of farmland were $4.6 billion. The data include farmers and nonfarmers who held the assets (many nonfarmers hold investments in agriculture but do not materially participate in farming) and demonstrate the high value that the assets generate upon their sale.

Limits on Accelerated Capital Cost Recovery Could Affect Farmers' Capital Purchase Decisions

Farming requires large investments in machinery, equipment, and other depreciable capital. Under the current tax system, such costs may be treated as a current expense or capitalized and depreciated over time. In either case, this reduces the income subject to tax. The amount that can be expensed is subject to a limit, and the investment amount above the limit must be depreciated over a specified recovery period, generally 7 years for farm machinery and equipment.

Based on 2010 ARMS data, U.S. farmers reported a total of $29 billion in capital purchases, and those making investments made $32,000, on average, in annual capital purchases.

The tax treatment of these investments is of considerable importance to the farm sector, especially to commercial farmers (farm sales above $250,000). Over the last decade, the amount that a farmer could immediately expense has changed. Beginning with the Economic Growth and Taxpayer Relief Reconciliation Act of 2001 (2001 Act), which set the expensing amount at $25,000, the amount of capital purchases eligible for immediate expensing has steadily increased (table 4). The amount was raised from $25,000 to $100,000 in 2003, and then again in 2008 to $250,000 through stimulus legislation. The Small Business Jobs Act of 2010 doubled the expensing amount to $500,000 for property placed in service in 2010 and 2011.[16] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the modified expensing amount, but the amount was lowered to $139,000 for property placed in service in tax year 2012. The American Taxpayer Relief Act of 2012 temporarily increases the amount to $500,000 for 2012 and 2013.

The ability to take an additional first-year depreciation deduction also benefits farmers making capital purchases. Combined with the expensing amount, the ability to accelerate depreciation has meant that much of the capital purchases made during the past decade have been completely deducted in the first year (table 4). For tax years 2012 and 2013, the first-year depreciation allowance is 50 percent.

In 2010, 43 percent of U.S. farms made a capital investment, but the percentage varies by farm size. In general, the greater the sales revenue of the operation, the more likely it is to make a capital investment in a given year. Based on 2010 ARMS data, 83 percent of very large commercial farms—farms with at least $500,000 in annual sales—reported they made

[15]See appendix table A2 for typologies of farms.

[16]The amount is reduced (but not below zero) by the amount by which the investment exceeds $2,000,000.

Table 4
Expensing amount limits and additional first-year depreciation, 2000-2014

Tax year	Expensing amount	Additional first-year depreciation
	Dollars	*Percent*
2000	20,000	0
2001-02	24,000	30
2003	100,000	50
2004	102,000	50
2005	105,000	50
2006	108,000	0
2007	125,000	0
2008	250,000	50
2009	250,000	50
2010	500,000	100[1]
2011	500,000	100
2012	139,000[2]	50
2013	500,000	50
2014	25,000	0

[1]Property acquired and placed in service after September 8, 2010.
[2]Indexed for inflation; Source: Revenue Procedure 2011-52. Retroactively increased to $500,000 by the American Taxpayer Relief Act of 2012.

Source: Internal Revenue Code Sections 165 and 179.

such an investment in 2010, while only 36 percent of farms classified as rural residences (less than $250,000 in sales and a reported occupation other than farming) made a capital investment.

The impact of tax reform on U.S. agricultural investment will depend on how the expensing and depreciation provisions change. Currently, fewer than 18 percent of farmers annually invest more than the prior 2012 expensing limit of $139,000 while only a little over 1 percent invest more than the revised 2012 and 2013 limit of $500,000. Investments above this amount are eligible for the 50-percent additional first-year depreciation, so nearly all capital investment by farmers can be written off in the current year. The capital expensing allowance reduces the effective tax rate on income from farm capital and simplifies the recordkeeping burden associated with the depreciation of capital purchases, with commercial farmers the primary beneficiaries.

Eliminating or lowering the expensing amount would raise the cost of capital purchases for some farms. Currently, few farms exceed the limits on the expensing provision, and as the amounts decrease, it is the farms with the largest business receipts that are constrained by the expensing amount. Under present law, the maximum expensing amount will become $25,000 in 2014. While 2010 ARMS data indicate that fewer than 20 percent of residential and intermediate farms (farms with less than $250,000 of gross sales) invest more than $25,000, nearly 54 percent of all commercial farms (farms with at least $250,000 of gross sales) invest more than that amount (fig. 2). Thus, investment by commercial farms will be affected the most by a substantially lower expensing amount. This could lead to increased taxable income and reduced capital investment by these farms.

Figure 2
Farms with agricultural investments exceeding the expensing limit, by gross farm sales, 2010

* Retroactively increased to $500,000 by the American Taxpayer Relief Act of 2012.
Source: USDA, Economic Research Service, Agricultural Resource Management Survey, 2010.

As well as raising the cost of capital investment, lowering or eliminating expensing and additional first-year depreciation could increase the farm's tax base, potentially increasing its taxable income. On average, farmers reported depreciation expenses of $21,259 in 2010. Farms with $500,000 or more of annual sales had an average depreciation expense of $94,000. Farmers that had previously been able to write off most or all of their capital investment in the first year due to the expensing and first-year depreciation provisions will find that their taxable incomes are higher with the scaling back or elimination of these provisions, whether they adjust their investment levels or not, and this could result in higher tax burdens.

Income Averaging

Under a progressive tax rate system, taxpayers whose annual income fluctuates widely may pay higher total taxes over a multiyear period (due to bouncing among tax brackets from year to year) than other taxpayers with similar yet more stable income. Farm business income is more variable than many other sources of income, such as wages and salaries. Mishra et al. (2002) estimate that farm business income accounts for 46.5 percent of the annual variation in farm household total income, while off-farm wages account for 23.2 percent. Farm business income is susceptible to commodity price volatility, which embodies the risks of weather and natural phenomena. As such, variability of farm household income generally exceeds that of all U.S. households.

Variability in farm income across time is attributed to fluctuations in farm output, commodity prices, and business cycles. Farmers are allowed to use various income tax provisions to manage their tax liabilities. Cash accounting, which recognizes income and expenses when received or paid, can reduce taxable income through prepaid business expenses or deferred

farm income, and, as discussed above, well-timed capital purchases can reduce taxable income through depreciation deductions or capital expensing. While these provisions are useful in reducing income variability, they are limited by the ability of a farmer to defer sales or accelerate expenditures.

Income averaging can reduce the effect of a progressive tax rate system on taxpayers with variable income by allowing them to smooth their tax burdens over time through tax accounting methods that consider multiyear income. U.S. farmers have been eligible for income averaging since 1998. Under the current income averaging provision, a farmer can elect to shift a specified amount of farm income, including gains on the sale of farm assets other than land, to the preceding 3 years and to pay taxes at the rate applicable to each year. Income that is shifted back is spread equally among the 3 years. If the marginal tax rate was lower during 1 or more of the preceding years, a farmer may pay less tax than he or she would without the option of income averaging. The provision, however, does not allow income from previous years to be brought forward. Furthermore, although the provision is designed to reduce the effect of farm income variability, as long as some farm income is available to be shifted, the source of income variability does not need to be farm income for income averaging to be beneficial.

In 2004, according to IRS tax data, 50,800 farmers—or about 2.5 percent of farms—reduced their tax liability on average by $4,434 with income averaging. The reduced liability totaled $225.3 million and amounted to a 23-percent reduction in Federal income taxes for those taking advantage of the provision, compared with the amount that they would have owed without income averaging. A large share of the total tax reduction was realized by farmers with adjusted gross income over $1 million. These farmers reduced their liability by an average of $264,000, for a total of $82.6 million.

While more recent data are not available, since farm income has trended higher in recent years the income averaging provision is likely to be of equal or greater benefit to farmers with substantial income growth. While a reduction in the number and level of marginal tax rates would reduce the savings under a new system, some farmers would still face higher tax rates due to income variability if the income averaging provision is eliminated.

Domestic Production Activities Deduction

One of the most important business changes in the American Jobs Creation Act of 2004 was the replacement of the foreign sales corporation/extraterritorial income provisions, which had allowed U.S. exporters to exclude a portion of their foreign sales income from taxation, with a new deduction for U.S. manufacturers, which includes farmers. The foreign sales corporation provision had been declared a prohibited export subsidy by the World Trade Organization, and its replacement was required to avoid retaliatory tariffs.

A domestic production activity includes an activity that involves the lease, rental, license, sale, exchange, or other disposition of tangible personal property that was manufactured, produced, grown, or extracted in whole or in significant part within the United States. It is not limited to exported goods.[17] Thus, while very few farm households directly benefited from the export provision, according to IRS tax data about 7 percent of farm households

[17]Domestic production activities income is the excess of domestic production gross receipts for the tax year minus the sum of the cost of goods sold and other expenses, losses, or deductions (other than the domestic production activities deduction) allocable to such receipts (IRC Section 199).

directly benefit from the new deduction. The deduction is limited to the lesser of 9 percent of adjusted gross income or domestic production activities income or 50 percent of wages paid to produce such income. While the wages-paid limitation reduces the deduction for many smaller farms that hire little or no labor, farm sole proprietors deducted nearly $1.25 billion in 2010. The average deduction for eligible farm households was $8,926. Among farms, commercial farm households are the primary beneficiaries since they are more likely to report positive farm income and wages paid to hired labor. Reducing or eliminating this deduction would result in a significant increase in taxable income for the beneficiaries of this deduction.

Self-Employed Health Insurance Deduction

The self-employed health insurance deduction was created in 1988 to give small business owners, including many farmers, tax benefits similar to those of employees who receive employer-deductible health insurance. This deduction is especially important for self-employed individuals who must purchase health insurance on their own.

Since 2003, farmers and other self-employed taxpayers have been allowed to deduct 100 percent of the cost of providing health insurance for themselves and their families as long as they are not eligible for any employer-sponsored plan. The self-employed health insurance deduction is limited to the amount of the taxpayer's income from self-employment. This limitation eliminates the deduction for farmers with net farm losses and no other self-employment income.

While IRS tax data indicate that only about 2.6 percent of all taxpayers utilize the self-employed health insurance deduction, about one out of seven farmers use the deduction in any given year. In 2010, these farmers deducted an average of $6,173 for a total of $1.684 billion in health insurance premiums. Over 50 percent of farm households obtain their insurance through off-farm employment of the operator or spouse, which helps account for the low number of farmers claiming the deduction. Many other farmers are over age 65 and are covered by Medicare or other Government programs (Jones et al., 2009).

Intermediate and commercial farmers are more likely than rural residence farmers to use the deduction. Only about 8 percent of rural residence farmers claim the deduction, primarily because greater proportions of these households receive health insurance from a nonfarm job or do not qualify for the deduction due to reporting a farm loss. The self-employed health insurance deduction allows farmers to save a portion of their premiums equal to their marginal tax rate, helping make health insurance more affordable and making the tax treatment more comparable to employer-sponsored plans.

Taxation of Rural Households Under Proposed Reform

Tax reform would affect rural nonfarm households differently than farm and urban households. Rural nonfarm households have lower incomes, are older, and have higher poverty rates than urban households. In 2008, the average rural taxpayer reported an adjusted gross income (AGI) of $43,616, compared with $60,841 for the average urban taxpayer (Durst and Farrigan, 2011). Given their lower income, rural nonfarm households are less likely to benefit from tax deductions, exemptions, exclusions, or deferrals because they either lack eligible expenses to exceed the standard deduction or otherwise do not qualify for the tax benefits.[18] For example, some of the most widely used deductions—the deduction for mortgage interest and real estate taxes—are related to the value of property and real property tax rates, which are generally lower in rural areas (average annual rural real property taxes in 2009 were $1,639 for rural homeowners versus $3,393 for nonrural).[19] However, rural households are more likely to own homes and pay property taxes than urban households (table 5).

[18]Standard deduction for married couples filing jointly in 2011 was $11,900.

[19]Authors' calculations from the 2009 American Housing Survey, Department of Commerce, Bureau of the Census.

The age distribution of rural America also affects the impact of tax reform. Approximately 16.4 percent of the rural population is over the age of 65 (12.9 percent of the urban population is over the age of 65) (2012 Current Population Survey), and older adults generally have lower incomes, particularly from earned income, due to lower rates of labor force participation. Older adults also are less likely to use the tax system to receive tax benefits targeted to wage earners and families with children. Therefore, they are less likely to be required to file a tax return or to apply for a refundable credit.[20]

[20]Social Security benefits are not taxed if a taxpayer's modified adjusted gross income plus one-half of their Social Security benefits are below a certain amount ($32,000 for married couples filing jointly in 2011); however, if a beneficiary's "provisional" income exceeds that amount, part of the Social Security benefit may be taxed

Because rural households are less likely to benefit from itemized deductions compared to urban households, proposals to eliminate deductions will have less effect on their well-being. On the other hand, rural nonfarm households are more likely than others to benefit from tax credits, particularly the refundable credits such as the Earned Income Tax Credit and the Child Tax Credit. The NCFRR co-chairs' report proposes to keep the current EITC and CTC intact; however, other reform plans seek to consolidate credits along the lines of work and family (appendix table A1). How rural nonfarm residents will fare under tax reform will depend in large part on how the credit system is changed.

Rural Homeowners Are Less Likely To Benefit From the Mortgage Interest Deduction

Itemized deductions are allowed for certain medical expenses, State and local taxes paid, mortgage interest paid, investment interest, charitable contributions, and a variety of miscellaneous expenses (see table 1).

The mortgage interest deduction is one of the largest tax expenditures in the Federal income tax system, and it is the largest Federal tax benefit for owner-occupied housing. This deduction allows taxpayers who own a home, have a mortgage, and itemize on their tax returns to deduct interest paid on up to $1.1 million of home mortgage debt.[21] The mortgage interest deduction primarily benefits homeowners in the top fifth of the income distribution (defined as household income of at least $98,000) because they are the

[21]The provision allows for $1 million for mortgage debt plus $100,000 of home equity debt.

Table 5

Homeowners with a mortgage by income group, share by residence, 2009

	Housing and mortgage statistics					
	Household income quintile					
Rural[a]	$0-$19,299	$19,300-36,465	$36,466-59,999	$60,000-97,999	$98,000 and above	All income groups
Own (%)	62	72.8	82.1	89.7	95.0	62.1
Mortgage (%)	14.7	27.8	46.0	58.7	64.6	30.8
% population	6	5	5	4	3	22
Mortgage value ($)[b]	83,799	79,657	91,859	113,979	180,483	112,464
Urban						
Own (%)	43.5	55.6	66.2	78.2	90.1	59.5
Mortgage (%)	15.6	26.5	42.4	58.7	72.0	38.8
% population	14	15	15	15	17	78
Mortgage value ($)[b]	119,905	124,536	140,754	167,274	260,771	187,244

Notes: *Own* is the percentage who own their residence; *Mortgage* is the percentage who have a mortgage on their owned residence; *% population* is the percentage of the U.S. population.
[a]Rural is defined as living outside of a Metropolitan Statistical Area.
[b]Mean value of original mortgage or mortgages.

Source: Authors' calculations using data from the American Housing Survey, 2009.

taxpayers who are most likely to itemize. Thus, eliminating or scaling back the mortgage interest deduction would have a larger negative impact on high-income homeowners than on low- to middle-income homeowners.

Toder et al. (2010) estimated that eliminating the mortgage interest deduction without replacing it with another tax preference would raise taxes, while reducing the after-tax income of all taxpayers by less than 1 percent, on average. In fact, if the tax expenditures for the mortgage interest deduction and property tax were eliminated, the after-tax income of the lowest quintile in the income distribution would be essentially unchanged. However, these effects would vary greatly across income groups: 1 to 20 percent of taxpayers in the bottom to middle income quintiles would likely experience some increase in tax liability, compared to about 70 percent in the top income quintile. The latter group is more likely to own homes, to itemize deductions, and to face higher marginal tax rates that tend to make deductions more valuable to them than to lower income taxpayers.

Various mortgage interest deduction reform options have been considered. Under the proposal by the co-chairs of the NCFRR, the mortgage interest deduction would be eliminated and replaced with a nonrefundable mortgage interest credit that would be available to both itemizers and non-itemizers. The Debt Reduction Task Force also proposed to eliminate the mortgage interest deduction, but replace it with a refundable credit, which would benefit taxpayers with mortgages who do not itemize or who do not have a tax liability—generally, taxpayers in the bottom three income quintiles. On

the other hand, taxpayers in the fourth quintile would gain the most from a nonrefundable (NCFRR) credit because they are more likely to have a positive tax liability to be offset with the credit. With either a refundable or a nonrefundable credit, those in the top quintile would likely experience a significant increase in the amount of income subject to tax and, depending upon the tax rate structure, could face higher taxes.

In general, based on their incomes, less than a third of rural households itemize their deductions. Urban taxpayers are more likely to benefit from the mortgage interest deduction and are more likely to face reductions to after-tax income if the mortgage interest deduction is eliminated; in fact, only 3 percent of the population resides in a rural area and has income that puts them in the top fifth of the income distribution (table 5). The average mortgage value (including up to four mortgages) in 2009 was $112,464 for rural homeowners and $187,244 for urban homeowners.

On average, taxpayers in urban areas have higher incomes than their rural counterparts, and though they have lower rates of home ownership (table 5), they are more likely to have a mortgage, especially the urban residents in the top quintile of the income distribution. Further, high-income rural homeowners are less likely than high-income urban homeowners to have a mortgage, and their mortgages are of lower value. Thus, rural homeowners, especially in the lower three quintiles of the income distribution, currently receive little or no benefit from the mortgage interest deduction and may even benefit by replacing it with a refundable credit for mortgage interest.

Low-Income Rural Families Rely Heavily on Refundable Tax Credits

The major tax reform proposals each offer plans to create credits in lieu of deductions or to restructure the current credits. Although low-income families generally do not benefit from itemized deductions, they are primary beneficiaries of refundable tax credits, and how the system of credits is changed could have a substantial impact on their after-tax income. A tax credit, whether refundable or not, is applied after an individual's tax is computed.

Tax credits are an alternative to direct spending programs to accomplish specific policy objectives, and they have increasingly been used as a means to provide income support to low-income workers and families with children. Since 1980, the total cost of all tax expenditures or preferences has increased by over 250 percent and currently exceeds $1 trillion a year (The White House, 2010). Two of the most significant tax credits—the earned income tax credit (EITC) and child tax credit (CTC), which are refundable—accounted for $116 billion in tax expenditures in 2011 (table 1). In fact, the EITC has increasingly become one of the largest sources of cash assistance for low-income families. The refundable CTC also provides a significant amount of support. These two credits have significantly reduced the share of taxpayers who owe Federal income tax. For many low-income families, tax credit refunds represent a large share of their disposable income.

Both the EITC and CTC encourage work and help families with children meet basic needs. Since the EITC and CTC phase in with earnings, they encourage labor force participation among low-income single parents, to

whom the tax credits are most valuable. While a phaseout of the EITC could arguably discourage a current recipient from working, research suggests that, overall, the EITC encourages work among recipient households.[22] A growing number of families (25.7 million in 2009) receive these benefits (fig. 3). In 2010, these two refundable tax credits represented nearly 15 percent of income for low-income families and approximately 25 percent of income for low-income families with children.[23]

Rural households have historically had lower incomes and higher poverty rates than urban households. Given the income differential and the prevalence of low-wage jobs, it is not surprising that rural taxpayers benefit disproportionately from tax programs targeting low-income workers, especially the EITC.

In 2008, 21.6 percent of rural taxpayers received EITC benefits, compared with 16.9 percent of urban taxpayers. The share of rural taxpayers who received the refundable portion of the child tax credit was also slightly higher, at 13.9 percent versus 12.6 percent for urban taxpayers. The earned income and child tax credits provided a total benefit of $20.6 billion to rural taxpayers in 2008. Overall, one out of every three rural taxpayers received benefits from the EITC or the CTC.

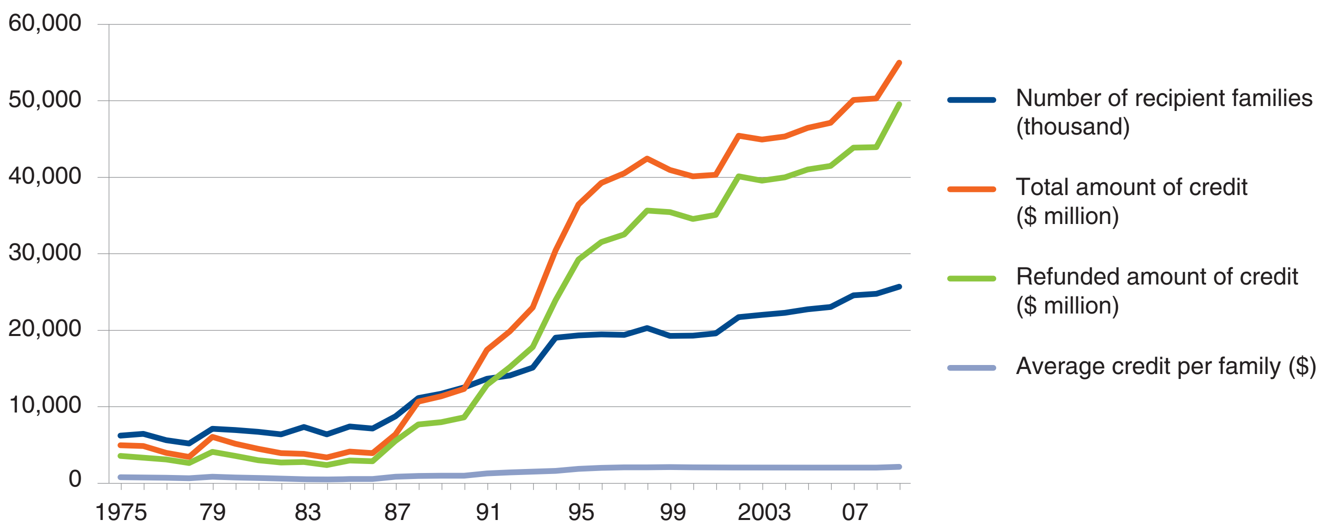
The refundable portion of the EITC and the CTC provides a significant boost ($13.7 billion in 2008) in income to rural taxpayers (table 6). For rural taxpayers with AGI under $10,000, these refundable credits were nearly one-third of AGI and averaged $1,276 in 2008. For those with income between $10,000 and $20,000, these refundable credits were nearly one-fourth of AGI and were $3,474, on average. Overall, EITC and CTC refunded tax credits provided a 13-percent increase in income to rural taxpayers receiving one or both of the credits in 2008.

[22]For example, while Eissa and Williamson-Hoynes (2004) find evidence that married women reduced their labor force participation in response to an expansion of the EITC, others such as a Meyer and Rosenbaum (2001) find that single mothers work more in response to the EITC.

[23]Estimates based on 2011 Current Population Survey, tax model data for 2010.

Figure 3

Number of EITC recipient families, total amount of credit, and refunded amount of total (2009 dollars), 1975-2009



Source: USDA, Economic Research Service using data from the Internal Revenue Service.

Table 6
Refundable credits and adjusted gross income for rural taxpayers by level of adjusted gross income, 2008

	Rural taxpayers	Refundable earned income and child tax credits	Adjusted gross income	Credits as share of adjusted gross income
Adjusted gross income	*Thousand*	*$ Million*	*$ Million*	*Percent*
Under $10,000	5,148	2,026	6,442	31
$10,000 to $20,000	4,756	6,025	25,620	24
$20,001 to $25,000	1,965	2,383	16,148	15
$25,001 to $50,000	6,278	2,968	45,730	6
$50,001 to $100,000	5,352	273	12,472	2
Over $100,000	1,895	2	220	1
All	25,395	13,680	106,633	13

Source: USDA, Economic Research Service, based on special tabulations from 2008 Internal Revenue Service tax data.

Refundable tax credits, especially the EITC, have lifted a significant number of households above the poverty line. While the official measure of poverty does not include the EITC as a form of income, the Census Bureau publishes information on poverty under various alternative definitions. Comparing the poverty rate under the definition of income that includes various support programs and the EITC with the official poverty estimates for 2008 suggests a reduction in the rural poverty rate from 15.1 percent to 11.1 percent. The EITC alone was responsible for a reduction of 1.7 percentage points in the rural poverty rate. This suggests that in 2006 the EITC lifted an estimated 800,000 rural residents above the poverty line. Given expansions in the EITC that have occurred since 2006 as well as the expanded refundability of the child tax credit, the current impact on rural poverty of these tax-based policies is likely to be even greater.

The value of these credits suggests that their elimination or reduction would have a significant effect on low-income families, and rural families in particular, unless new programs were created to provide cash assistance. Most tax reform proposals would not eliminate these credits, but would consolidate them into new family and worker credits. The various options under consideration would reduce the number of credits and deductions and standardize eligibility rules. While it is suggested that this would eliminate much of the complexity, computational burden, taxpayer confusion, and difficulties with enforcement that are commonly cited by critics of the tax system, the changes could have a significant impact on the after-tax income of some rural households.

Conclusion

The primary goals of tax reform are to simplify the tax system, making it easier to comply with, and to reduce economic distortions induced by the system while preserving its progressive nature. While reform may improve societal welfare, the current tax system contains features that provide substantial benefit to farm businesses, and reform could reduce the after-tax income of many farm households. In particular, reducing or eliminating deductions for capital purchases and raising capital gains taxes could increase the farmers' tax base and raise the tax rate paid on a significant portion of their income. These effects will vary by farm size and type. Offsetting these effects, though, is the proposed reform of the marginal tax rate structure. A reduced number of brackets and lower rates will mitigate the effect of a potentially larger tax base for U.S. farm households.

Nonfarm rural households also have a major stake in tax reform. On average, rural households have lower incomes than the average U.S. household and receive significant benefits from the tax system's credits. Any reform that reduces the value of refundable credits, especially the Earned Income Tax Credit and Child Tax Credit, is likely to reduce the well-being of rural households. On the other hand, rural households are less likely to benefit from deductions and other adjustments to gross income. Therefore, eliminating or limiting these deductions will not have a large effect on most rural households. As with farmers, the net effect on Federal income tax liability and after-tax income will depend upon the specific details of tax base broadening and the restructuring of tax rates.

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Appendix table A1

Major reform proposal provisions

	Current law	NCFRR	PERAB	BPC
Tax rates for individuals				
Ordinary income	10, 15, 25, 28, 33, 35, 39.6 %	Three brackets with a target of 12, 22, 29%	N.A.	Two brackets: 15, 27%
Capital gains and dividends	0, 15, 18.8, 20, 23.8%	Tax at ordinary rates	Tax at ordinary rates with an exclusion for 50% of gains	Tax at ordinary rates (not greater than 27%), with an exclusion for first $1,000 of gain or loss
Standard deduction	$6,100 single $12,200 married	No change	Increase value	Eliminate
Itemized deductions	Limits on itemized deductions for those with adjusted gross income over $250,000 ($300,000 joint return)	Eliminate	Reduce the value of itemizing by limiting cost of expenses (<100%)	Eliminate and replace many of the deductions with a tax credit; allow deductions in excess of 5% of AGI
Credits	Mix of refundable and non-refundable credits	Maintain current law EITC and Child Tax Credit; create non-refundable credits for mortgage interest, charitable giving, and retirement savings	Consolidate common credits along the themes of work and family; simplify the eligibility rules	Create a refundable per-child tax credit of $1,600; create a 21.3% refundable earnings credit; 15% refundable credits for charitable giving and mortgage interest; 15% credits for education and retirement savings; AGI phase-outs for some credits
National sales tax	None	N.A.	N.A.	6.5% phased in over 2 years

N.A. = not applicable.

Sources: National Commission on Fiscal Responsibility and Reform (NCFRR), December 2010, “Moment of Truth”; President’s Economic Recovery Advisory Board (PERAB), August 2010, “The Report on Tax Reform Options: Simplification, Compliance and Corporate Taxation”; Bipartisan Policy Center (BPC), November 2010, “Restoring American’s Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-growth Tax System.”

Appendix table A2

Farm Typology

Farm Types	
Small family farms (gross sales less than $250,000)	**Large-scale family farms (gross sales of $250,000 or more)**
Rural-residence family farms: *Retirement farms.* Small farms whose operators report they are retired. *Residential/lifestyle farms.* Small farms whose operators report a major occupation other than farming. ***Intermediate family farms:*** Farming-occupation farms. Small family farms whose operators report farming as their major occupation. • **Low-sales farms.** Gross sales less than $100,000. • **High-sales farms.** Gross sales between $100,000 and $249,999.	***Commercial family farms:*** Large family farms. Gross sales between $250,000 and $499,999. Very large family farms. Gross sales of $500,000 or more Nonfamily farms Any farm not classified as a family farm, that is, any farm for which the majority of the farm business is not owned by individuals related by blood, marriage, or adoption.