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INCOME TAX PLANNING FOR FARMERS*

by

Hoy F. Carman**

An assignment to discuss income tax planning for farmers at a time when major tax reforms are being considered is a difficult but, I must add, interesting task. I use the word interesting but one can rest assured that many tax advisors, management companies, and investors use stronger descriptive terms. Football coaches respond to rule changes with new or revised strategies. I expect tax reform to lengthen the working day of many tax consultants as they devise new "quick openers" and "end sweeps."

This paper will discuss some farm tax planning opportunities which have existed during the last several years. Tax provisions used in tax loss farming will be emphasized. The principal features of proposed tax reforms as applied to agriculture will be summarized and some probable effects will be discussed.

Special Farm Tax Provisions

Farmers face the same problems as do other taxpayers plus a few which are unique.[1/] But special income tax provisions applicable to farmers offer tax planning opportunities as well as problems. These favorable planning opportunities revolve primarily around the use of cash accounting. Cash accounting combined with accelerated depreciation, full deductibility of farm losses from income, timing of income and expenses, and capital gains provisions on agricultural assets have been used by farmers and ranchers as well as nonfarm investors to maximize after-tax income.

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Ordinary income can be shifted to capital gains in a fairly systematic manner with proper planning. The income shifting opportunity is afforded to farmers building up a herd of livestock, establishing an orchard or vineyard, or improving a parcel of land with soil and water conservation improvements. Most expenses, even though they add to the value of these assets, are deductible at the time incurred.[2/]

Tax Planning

I have found surprisingly little written on farm tax planning with a planning horizen of more than two tax years.[3/] Most publications dealing with farm income tax management are concerned with depreciation methods, timing receipt of income, timing of input purchases, and full deduction of expenses [8], [10], [15]. Those farmers who recognize the need for longer term tax management have typically sought out professional services from tax consultants and management companies. Most farm tax provisions have wide applicability but optimum utilization can be quite individualized.

Most farmers have benefited in one way or another from special farm income tax provisions. However, it is probably safe to say that few farmers have utilized these provisions in a systematic manner over time to convert ordinary income to capital gains.[4/] Farmers have not traditionally found themselves in the highest tax brackets where the advantage of capital gains income is greatest. Tax consultants and management firms, however, were quick to recognize the value of agricultural enterprises such as citrus and cattle for their high income clients and devised programs which exploited farm tax laws. Promotional materials of management companies and articles in business publications such as *Fortune* and

The Wall Street Journal have emphasized the tax advantages of agricultural investments [4], [3]. What high tax bracket investor can resist, for example, the detailed description of a stockbroker who realized a two-year after-tax return of 39 percent on a $35,000 investment in breeding cattle5/ [3]. The same story reported that "at least eight corporations plus dozens of individual farmers who also manage property for a fee, now handle well over $100 million of investments for more than 5,000 people." Much of the growth of these firms has occurred during the last three or four years.

Tax Loss Farming

Capital gains provisions, tax treatment of certain types of farm expenses, and cash accounting form the basis for successful "tax loss farming" or "tax sheltered investments in agriculture."6/ The incentive for tax sheltered investments is provided by the difference in tax rates between ordinary income and capital gains.

Several agricultural enterprises offer tax shelter opportunities. These include livestock, development of orchards, groves, and vineyards, and some land improvements. The method of operation is similar for each enterprise. The farmer or investor builds up a herd of breeding or dairy animals or improves land. Cash accounting is used and expenses are deducted from income, farm or nonfarm, at the time incurred. The tax basis of the raised livestock held for breeding or dairy purposes and the land improvements is zero. Thus, any gain realized from the sale of these assets is capital gains. After-tax returns for these investments increase as the marginal income tax bracket of the owner increases and as the ratio of capital gains to expenses increases.7/ Careful planning can result in an attractive return to the nonfarm investor from tax sheltered investments in agriculture. A growth-minded farmer or rancher can also use these tax provisions to build up his net worth with a minimum income tax liability.

Tax shelter investments are much more profitable for high income than for low income taxpayers. This differential in profitability permits low income farmers to execute mutually advantageous contractual arrangements with high income investors. Contractual arrangements are facilitated by management companies who for a fee (tax deductible) arrange for farmers to care for the farm property of investors. Polson found that a group of Oklahoma ranchers had higher after-tax return for each of the years 1962-1967 with cattle cared for under a contractual arrangement than with their own cattle [12]. It is important to note that the after-tax cost of establishing an orchard or improving land decreases with increases in the tax bracket of the developer. This presents interesting possibilities for orchard development. The level of taxable income of buyer and seller in seller-financed land sales is an important consideration since interest is tax deductible for the buyer but ordinary income for the seller. For a given outlay on an installment contract, the buyer will prefer the highest permissible allocation of sales price to interest. Differences in tax brackets of the buyer and seller may make adjustments in the sales price and allocation to interest profitable for both parties to the contract.

Proposed Income Tax Law Changes

Agriculture is one of the areas that has been chosen for early tax reform efforts. What started out as an effort to limit tax-loss farming by wealthy urban investors appears to have become an effort to tighten up income tax rules applicable to all farmers.

Let us briefly consider some tax reform proposals applicable to agriculture. A Treasury Department recommendation prepared during the Johnson Administration recommended that the amount of farm losses which could be deducted from nonfarm income be limited to $15,000 [13]. Senator Metcalf (D-Montana) introduced a bill in the Senate which would also limit the deduction of farm losses from nonfarm income, but it is more restrictive than the Treasury Department proposal. Under this bill, a taxpayer with $30,000 or more of nonfarm income could not deduct any losses from nonfarm income.[8/] The impact of these proposals on most full-time farmers and ranchers would be minimal. Tax shelter investments in agriculture would be sharply curtailed under the Treasury proposal and would no longer be profitable under Senator Metcalf's bill.

A comprehensive tax reform bill has been passed by the U.S. House of Representatives and sent to the Senate. Under its provisions, as I have seen them reported, the size of individual tax shelter investments in agriculture would be limited. In addition, the incentive for tax shelter investing would be somewhat restricted by changes in tax rates and capital gains provisions. Tax rates would be reduced, the capital gains tax rate would be half of the ordinary rate but with no maximum, and the holding period to qualify for capital gains would be lengthened.

Limitation of tax loss farming would be accomplished with the requirement for an "Excess Deductions Account." Taxpayers with nonfarm income over $50,000 would have to place farm losses above $25,000 per year in this account. The taxpayer would then have to pay ordinary tax rates on the Excess Deductions Account before claiming capital gains on breeding livestock, orchards, and land improvements. It is also reported that the definition of a "hobby farmer" (who is denied write-off of losses) would be anyone who loses $25,000 or more annually from farming for a period of three years. These provisions would not affect the profitability of tax loss farming but would limit the size of individual investments. The provision of an Excess Deductions Account should have little effect on the full-time farmer.

A change in the rules governing capital gains on livestock would increase taxes for some farmers and ranchers but would have little effect on method or size of operation. It would require that livestock be held for at least one year after first being used for draft, dairy, or breeding purposes to qualify for capital gains. Depreciation on purchased livestock would become subject to recapture provisions as ordinary income when there is a profit on subsequent sales. Each of these provisions, if enacted, would reduce the profitability of tax shelter investments in livestock enterprises.

Gains in land values which are the result of soil and water conservation expenditures would be subject to ordinary income tax rates for five years after the expense was incurred. While I have seen nothing regarding orchard establishment expenses, it is reasonable to expect similar regulations. This would lengthen the holding period of some tax shelter investments in land but would have little effect on farmers improving land or establishing orchards.

Summary

Profitable tax planning opportunities exist in agriculture, especially in the conversion of ordinary income to capital gains. Farmers have benefited from farm tax provisions but not in the spectacular manner of some wealthy urban investors. The tax reform bill passed by the U.S. House of Representatives would serve to reduce the size of tax shelter investments as well as their profitability while allowing farmers to continue their use of cash accounting. We have no way of knowing what action the Senate will take on tax reform. I feel confident, however, that even with tax reforms, farmers can profit from the type of income tax planning just described. Good financial records, familiarity with income tax law, and occasional professional advice will help score points in the tax management game.

FOOTNOTES

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**Assistant Professor of Agricultural Economics and Assistant Agricultural Economist in the Experiment Station and on the Giannini Foundation, University of California, Davis.

1/ Baker has an interesting discussion of farm tax problems with reference to court cases (see [1] and [2]). Good discussions of tax management for farmers are contained in [9] and [11].

2/ The deduction in any tax year of expenditures of a capital nature for soil and water conservation is limited to 25 percent of gross income from farming for the year. Any unused deduction can be carried over to succeeding years [15, p. 39]. Land clearing expenditures can also be deducted. The deduction in any year cannot exceed $5,000 or 25 percent of taxable income from farming, whichever is less, and the balance must be capitalized [15, p. 23].

3/ A noteworthy exception is the excellent analysis by Dean and Carter [7].

4/ I know of at least one case where a farmer has built up a substantial net worth while paying no federal income taxes.

5/ A budgeted example for a six-year investment in beef breeding cattle based on cost, price, and tax levels effective in 1967 illustrated that an investor in the 70 percent tax bracket could realize a simple after-tax return of approximately 14 percent on invested capital [6]. The rate of return decreases for investors in lower tax brackets.

6/ Other tax provisions form the basis for very popular tax sheltered investments in apartment houses and in the oil industry, e.g., liberal depreciation rules and percentage depletion allowances.

7/ For discussions of the effect of tax bracket and recovery of expenses on returns from tax shelter investments see [5] and [6].

8/ The bill (S .4059) provides that in the case of a taxpayer engaged in farming, the deductions allowable shall not exceed the sum of (1) the adjusted farm gross income for the taxable year and (2) the higher of either the amount of special deductions or $15,000 less the amount of nonfarm income over $15,000. These provisions will not apply to farmers using accrual accounting [14, pp. A-108 and A-109]. A companion bill (H.R. 19916) was introduced in the House of Representatives by Mr. Culver [14, pp. E-302 and E-303].

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