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THE SIGNIFICANCE OF CAPITAL GAINS TO FARMERS AND SOME EFFECTS OF ELIMINATING THEIR PREFERRED INCOME TAX TREATMENT*

W. Fred Woods and Charles A. Sisson

The American experience with income taxes began with the Act of 1913,¹ but it was not until 1921 that capital gains were identified separately and taxed differently from other sources of income. This fundamental revision of the income tax was justified on equity grounds; proponents of the change argued that it was unfair to tax income accrued over many years in the year that income was realized [6, p. 192].

The present capital gains provisions have been—and are now—strongly attacked alternately as being too lenient and too strict [5, p. 184]. Unfortunately, this symmetry in the opposition to present capital gains treatment does not imply the present provisions are near the optimum.

This paper investigates how the capital gains provision affects the tax position of the American farmer. Capital assets are first identified, their relationship to the present tax structure is discussed. These general statements are then specifically applied to agriculture. The study concludes with an analysis of the effect on farmers of eliminating the preferred income tax treatment of capital gains.

PRESENT TAX TREATMENT

For purposes of capital gain and loss provisions in the U.S. income tax, all property is divided into three classes: capital assets, section 1231 assets, and ordinary assets. For our purposes, we may consider capital assets to be investment property and nonbusiness property; section 1231 assets include business real property and

business depreciable property held for more than six months; and ordinary assets are inventories, stock in trade, other items held primarily for sale in the ordinary course of business, and all other assets. Section 1231 assets also include livestock held longer than twelve months for draft, breeding, dairy, and sporting purposes, except cattle and horses, which must be held more than 24 months.

Only those gains and losses resulting from sale or exchange of capital and section 1231 assets held for more than six months (longer for qualifying livestock) qualify for the special tax treatment provided by the capital gains exclusion. Gains are taxed at half the rate for ordinary income—that is, half the increase is considered non-taxable income, and the other half is taxed as ordinary income—up to a maximum rate of 35 percent.² In 1970, the year examined here, long term capital gains of individuals were subject to a maximum tax rate of 29½ percent.

CAPITAL GAINS IN AGRICULTURE

Obviously the preferred income tax treatment of capital gains is attractive in its own right. There are, however, special advantages in the treatment of capital gains that apply specifically to agriculture.

Generally, investment spending—the cost of acquiring and developing capital assets—is not deductible from income as current expense for income tax purposes. These costs are usually capitalized and recovered through depreciation over the useful life of the asset. In the case of

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¹ There was an income tax during the Civil War, but it was exclusively a war tax, short lived and largely ineffective.

² Individual taxpayers may elect the alternative, for their first \$50,000 of long term capital gains, of taxing the entire amount of gain at a 25 percent rate. The capital gains tax rate for corporations is 30 percent.

agriculture, however, certain "farmers" are allowed to deviate from the general rule. With two exceptions,³ producers of orchard, grove, and vine crops, as well as owners of breeding livestock, are allowed to charge off as current expenses the costs of developing their capital assets to the productive stage, even though little income is produced during this period. A moment's thought reveals the tangible benefits of this procedure: current income can be converted into capital gains, which are taxed at a lower rate.⁴

Other specific legislative provisions allow taxpayers reporting farm income (loss) to deduct certain expenses which, if incurred in other businesses, would be capitalized. But no other provision in the income tax law offers so great an opportunity for tax savings to "farmers"—those reporting incomes (losses) from farming operations—as Section 1231. This section gives capital gain tax benefits to gains and ordinary loss treatment to losses for specific items unique to farming; it is no mystery why this section has been called the "farmer's friend."

The friendship has cooled somewhat in recent years, however, as recapture and other provisions have been added to the basic legislation. Recapture of depreciation previously taken on personal property (1962), real estate (1964), livestock (1970), and recapture of certain conservation and land clearing expenses are now required. The holding period for cattle and horses has been extended (1970) as well. Further, farm tax shelters have been somewhat reduced through the excess deductions account (1970). However, tax benefits were only reduced, not eliminated [10, p. 28].

Coupled with preferential treatment received by other investment expenditures in agriculture, the "farmer's friend" gives an American farmer access to two of the three most important tax advantages that tax sheltered investments offer.⁵ Cost incurred to develop future income can be deducted from current earnings, while future income itself is taxed as a capital gain. Thus, not only is the payment of income taxes delayed, but

income is converted from ordinary income, taxed at its appropriate marginal rate, to capital gains income, taxed at a maximum of only one-half the ordinary income tax rate.

CAPITAL GAINS REPORTED BY PERSONS WITH FARM INCOME

Because of favorable tax treatment accorded capital gains and the relative ease of generating capital gains in most farming operations, we would expect a large portion of farm income to be in that form. In fact, the Internal Revenue Service's 1970 Sole Proprietorship Tax Model⁶ of 2.9 million returns reporting farm earnings indicates that 935,000, or 32 percent, reported capital gains. Generally, as basic income⁷ increased, the proportion of returns with capital gains in an income class also increased (Table 1). However, in absolute terms, the number of returns reporting capital gains by income class was rather uniform (Figure 1). The ratio of capital gains to both basic income and taxable income is relatively high for those with very low and very high basic incomes, indicating that preferential capital gains tax treatment is particularly important for both groups. But it should be emphasized that the bulk of capital gains reported were realized by the higher income classes (Figure 1).

The proportion of returns reporting capital gains also increased as value of farm products sold rose, although not nearly so sharply as when basic income rose (Table 1). There was even a decline—though it was slight—for the class of returns reporting farm sales of \$100,000 or more. The ratio of capital gains to both basic and taxable incomes is remarkably constant over the range of farm sales classes. Only in the case of the highest income class did ratio of capital gains to basic income vary appreciably from the 30-35 percent range (55-60 percent for the taxable income ratio).

As for type of farming operation using the capital gains provisions, livestock farm tax returns

³ Growers of citrus and almonds, in 1969 and 1970 respectively, sought and obtained Federal legislation requiring capitalization of their development expenses incurred within four years of planting. [7, Section 278].

⁴ This aspect of the tax laws has not gone entirely unnoticed by the American businessman. The phenomenon, dubbed "tax loss" farming, has been increasing in the past few years. For a fuller exposition of the problem, see [2, 10].

⁵ In addition to income conversion and deferral of tax liability, Calkins [1, pp. 758-769] names as the third major advantage of a tax sheltered investment the assurance provided as to the deductibility of an economic loss should the investment fail. This assurance is also generally available with agricultural investments.

⁶ The 1970 Sole Proprietorship Tax Model is based on a sample of returns reporting sole proprietorship income for that year. Data contained in this report were tabulated from this source by IRS at the request of the authors. At no time did the authors have access to individual income tax returns.

⁷ Basic income is defined as adjusted gross income plus excluded capital gains, dividends and other adjustments to income. It more nearly reflects disposable income to the taxpayer than does adjusted gross income.

Table 1. DISTRIBUTION OF FARM CAPITAL GAINS BY BASIC INCOME CLASS, VALUE OF FARM PRODUCTS SOLD AND TYPE OF FARM AND RELATIONSHIP OF CAPITAL GAINS TO BASIC AND TAXABLE INCOME, 1970

Category	: Total : returns	: Returns : with : capital : gains	: Ratio of capital gains : to	
			: Basic : income	: Taxable : income
	(1,000)	Percent	Percent	Percent
Size of basic income				
Negative	133	25	---	---
\$0 - 3,499	728	12	52	920
3,500 - 4,999	317	30	29	129
5,000 - 7,999	575	33	24	63
8,000 - 9,999	325	33	21	43
10,000 - 12,499	284	34	21	38
12,500 - 14,999	180	37	21	35
15,000 - 24,999	251	44	23	35
25,000 - 49,999	88	55	28	43
50,000 - 99,999	25	62	29	43
100,000 or more	10	76	58	110
Value of farm products sold				
Less than \$25,000	1,276	21	32	56
2,500 - 4,999	414	28	30	55
5,000 - 9,999	395	36	33	64
10,000 - 19,999	380	45	30	55
20,000 - 39,999	277	53	29	52
40,000 - 99,999	132	53	35	58
100,000 or more	33	46	54	88
Type of farm				
Field crop	1,059	22	28	45
Fruit, vegetable and tree nut	129	24	39	68
Livestock	1,511	41	33	62
Animal specialty	54	17	35	62
Miscellaneous	153	26	42	71
All farms	2,906	32	32	58

SOURCE: Special tabulations by the IRS, from the 1970 Sole Proprietorship Tax Model.

showed the greatest proportion, 41 percent, while animal specialty farms (such as horse farms, mink ranches, and game farms) reported the lowest, 17 percent.

THE EFFECTS OF TAXING CAPITAL GAINS AS ORDINARY INCOME

In recent years, there has been increasingly vocal opposition to the special treatment capital gains are accorded in U.S. tax laws, with numerous

advocates of a reduction or total elimination of the tax privileges. This paper cannot hope to resolve ethical arguments underlying this controversy which, as they are based on different presumptions about what constitutes income, are irreconcilable. Instead, it addresses the issue's objective aspects and concentrates on an evaluation of its economic importance to persons reporting farming operations. If such a change were enacted, it might well have a considerable effect on the American farm sector; as the earlier section on

FIGURE 1.

DISTRIBUTION OF

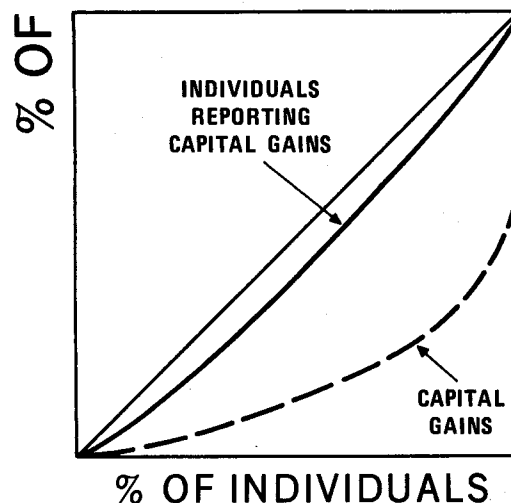
- INCOME
- CAPITAL GAINS
- TAXES

Gini Ratio:

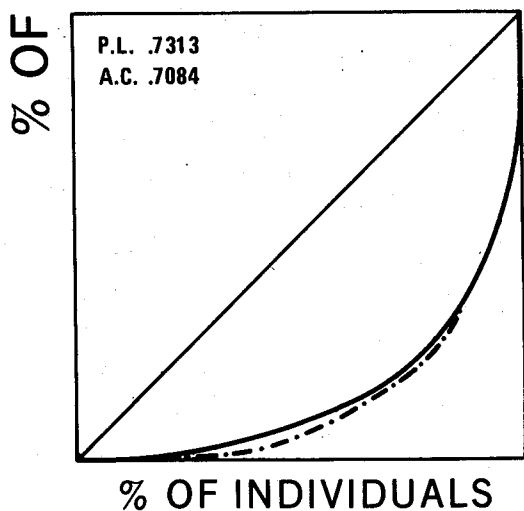
Present Law ---

* After Change —

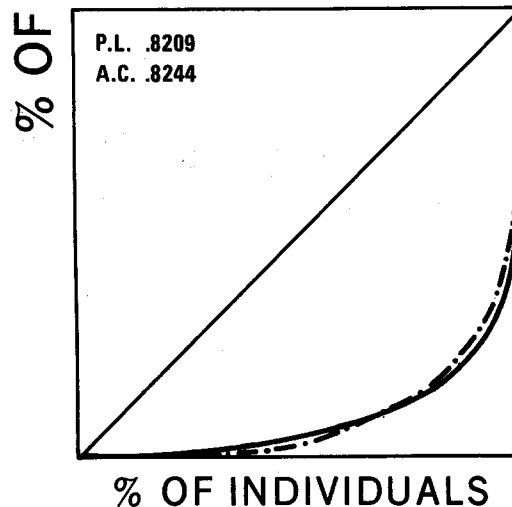
CAPITAL GAINS



TAXABLE INCOME*



TAX LIABILITY*



* PRESENT LAW AND WITH CAPITAL GAINS TAXED AS ORDINARY INCOME.

current usage of the capital gains exclusion demonstrated, farmers make extensive use of this tax provision.

This final section seeks to evaluate the first level effects of abrogating these tax advantages, at least in part, by examining data from the 1970 Sole Proprietorship Tax Model. The analysis focuses on: (1) increase in total tax revenues, (2) change in the distribution of taxable incomes, and (3) change in the distribution of income taxes paid. Results reflect changes that would have occurred in 1970 among individuals reporting a farm income or loss if capital gains had been taxed in the same manner as ordinary income.

Data from the IRS model do not permit investigation of such second-level effects as what actions farmers might have taken in light of such a change.

Results of the study indicated that aggregate tax revenues for 1970 would have increased by \$750 million, had capital gains of individuals reporting farming activities been taxed as ordinary income (Table 2). An increase was inevitable for such a simulation; what is of interest is the magnitude of the change.⁸ Average taxable incomes for the 935 thousand individuals reporting farming operations and capital gains would have increased by nearly \$2,000 and average tax liability by about \$800 each.

Table 2. INCREASE IN INCOME TAX AS A RESULT OF TAXING CAPITAL GAINS AS ORDINARY INCOME

<i>Size of basic income</i>	<i>: :</i>	<i>Amount of tax increase</i>	<i>: :</i>	<i>Percent of increase</i>
	:	<i>\$(000)</i>		
Negative	:	\$12,105		1.61
\$0 - 4,999	:	22,504		2.99
5,000 - 9,999	:	43,397		5.77
10,000 - 14,999	:	44,107		5.87
15,000 - 24,999	:	60,450		8.04
25,000 - 49,999	:	85,323		11.35
50,000 - 99,999	:	91,013		10.78
100,000 or more	:	402,790		53.58
	:			
All	:	751,689		100.00
	:			

SOURCE: Special tabulations by the Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Opponents of the capital gains exclusion have buttressed their arguments with the tenet that preferred treatment destroys the progressivity of the income tax, but this study found that eliminating the capital gains provision would have little effect on progressivity insofar as farmers are concerned. Taxable income (and consequently tax liability) rose relatively more for both those in the highest and lowest income classifications than they did for those with basic incomes between \$5,000 and \$100,000. However, redistributive effects were relatively minor, as can be seen in Figure 1. The inconsequential change in the distributions of income and tax burden is also indi-

cated by an extremely slight change in Gini ratios calculated before and after the assumed tax change. Individuals with basic incomes of \$100,000 or more would bear 54 percent of the tax increase; those with incomes over \$25,000 would bear 75 percent (Table 2).

Finally, with regard to type of farm effects, the most pronounced change would occur in fruit, vegetable, and tree nut farms; and the least in field crop farms, with changes in tax burden 60 and 38 percent, respectively (Table 3). Surprisingly, the tax burden for livestock farms increased less than for any other type except field crop farms. A far larger proportion (41 percent) of livestock

⁸ This was a static test, where income was transferred from a lower rate of taxation to a higher one. In a dynamic test, the tax increase on capital might reduce investment and hence develop economic stagnation, which could—if such an effect were indeed strong enough—actually reduce tax revenues.

Table 3. CHANGE IN TAXABLE INCOME AND INCOME TAX LIABILITY AS RESULT OF TAXING CAPITAL GAINS AS ORDINARY INCOME, BY VALUE OF FARM PRODUCTS SOLD AND BY TYPE OF FARM

	: Number of :	Increase in	
	: farms :	Taxable income :	Tax liability
	: 1,000	--- Percent ---	
Value of farm products:			
sold	:		
Less than \$2,500	: 272	28	46
2,500 - 4,999	: 115	27	43
5,000 - 9,999	: 143	31	51
10,000 - 19,999	: 172	27	41
20,000 - 39,999	: 148	26	40
40,000 - 99,999	: 70	29	46
100,000 or more	: 15	43	70
	:		
Type of farm:			
Field crop	: 231	22	38
Fruit, vegetable and	:		
tree nut	: 31	34	60
Livestock	: 624	31	48
Animal specialty	: 9	30	55
Miscellaneous	: 40	35	55
	:		
All farms	: 935	29	46

SOURCE: Special tabulations by the Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

farms report capital gains than any other type, but their average capital gains exclusion was much lower. The average capital gain reported for livestock farms was \$3,290 while the average fruit, vegetable, and tree nut farms reported \$9,140. That more than compensated for the low percentage of the latter reporting capital gains (24 percent).

SUMMARY AND IMPLICATIONS

About one-third of the 2.9 million individuals filing farm income tax returns in 1970 reported capital gains. Although the proportion of individuals in a basic income class reporting capital gains increased as basic income increased, the number of individuals reporting both farm earnings and capital gains were fairly evenly distributed throughout the population. Total capital gains, however, were generally concentrated in higher income groups.

Average capital gains reported per individual, with the exception of the negative basic income group, increased sharply as basic income increas-

ed, from \$1,070 per farm taxpayer with less than \$3,500 in basic income to \$152,950 for taxpayers with basic incomes of \$100,000 or more. A similar pattern occurred when taxpayers were classified according to value of farm products sold.

As expected, livestock farms reported the largest proportion of capital gains, while crop farmers had the smallest. However, average capital gains per taxpayer were the largest for fruit, vegetable and tree nut farms; livestock farms had the smallest average capital gains, smaller even than average gains for crop farms.

Due to the combination of farm tax rules permitting current deduction of certain development expenses and preferential capital gains treatment under present U.S. income tax law, it has been generally accepted that taxation of capital gains as ordinary income would improve the progressivity of the income tax burden in agriculture. Analysis of 1970 tax returns did not support this view. Both high and low basic income groups incurred substantial increases in tax liability, with smaller increases for those in the middle income range.

The distribution of both taxable income and tax liability would have been changed little by the abolition of the preferential tax treatment for capital gains. However, the total tax bill of persons with farming activities would have increased by more than \$750 million, or an average tax increase of \$800 per taxpayer for individuals with farming activities and capital gains. Individuals with basic incomes over \$25,000 would have borne three-fourths of the tax increase, those with incomes of \$100,000 or more paying 54 percent.

Taxing capital gains as ordinary income would have increased the tax bill of those with fruit, vegetable and tree nut farms most and of those with field crop farms least. Although livestock farms reported the greatest frequency of capital

gains, their increased burden was less than for all other types except field crop farms.

The importance of farm tax shelters is a related topic to this analysis, but the data did not permit extensive investigation in this area. One may infer that a substantial part of the twelve million dollars that would have been collected in 1970 from individuals who had negative basic incomes came from this source, but it is impossible to quantify the pervasiveness of the effect.

It is evident, however, that capital gains provisions are broadly used by persons with farming activities. Furthermore, elimination of the preferred capital gains treatment would not, contrary to the conventional wisdom, lead to a more progressive distribution of income tax burdens in agriculture.

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