



Three of California's largest agricultural industries — cattle ranches, dairies, and tree and vine crops — will be among those most affected by tax reform.

Income tax reform and California farmers: Who wins and who loses?

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By placing restrictions on tax incentives, the new law may discourage tax shelter investments in agriculture. Investment decisions will be based more on economics and less on possible tax losses.

The Tax Reform Act of 1986 is the most comprehensive overhaul of the federal income tax structure to take place in over 30 years. The act, which was designed to be revenue-neutral for the total U.S. economy, favors selected economic sectors over others. Significant tax rate reductions are financed through termination of many popular investment incentives and closure of a number of tax loopholes. Some industries, including capital-intensive heavy manufacturing, real estate, and agriculture, are expected to face increased income tax liabilities. General provisions of the new law, as well as provisions specific to farm operations, will affect farm taxpayers. In this report, we discuss major tax law changes affecting agriculture, focusing on its implications for farm types and sizes prevalent in California. Both short-run and longer-run impacts and adjustments will be mentioned.

Changes in the tax law that appear to have the largest potential impact on agriculture are the reduction in marginal tax rates, restrictions on tax shelter investments (passive investors), repeal of the investment tax credit, changes in depreciation provisions (life and method), termination of capital gains exclusion, limits on farmers' use of cash accounting, restrictions on prepayments, and the requirement to capitalize preproduction expenses. Since the applicability of income tax provisions varies by type of farming operation, the impact of a change will also vary by type of operation.

Tax rate reductions

The new law collapses the previous 14 graduated tax rates ranging from 11 to 50 percent into two tax rates, 15 percent (on taxable income up to \$29,750) and 28 percent (on income above that) with a 5 percent surtax on taxable income between

\$71,900 and \$149,250, to be fully effective in 1988. The 5 percent surtax collects the difference between the 15 and 28 percent tax rates on the first \$29,750 of taxable income (\$3,867.50), resulting in a flat tax rate of 28 percent for taxpayers with incomes greater than \$149,250. The corporate tax rate is also reduced, from a maximum of 46 percent to 34 percent. These reductions in tax rates are accompanied by a broadening of the tax base through restrictions on personal deductions and termination of many investment incentives and tax expenditure items. The effect of these changes on total income taxes paid by an individual will depend on the extent to which the taxpayer had previously taken advantage of tax incentives and loopholes.

Under tax rules effective in 1986, a married couple with two children, filing a joint return and using the standard deduction, paid no income tax until adjusted gross income exceeded \$7,990. Each of the four exemptions was worth \$1,080 (total of \$4,320) and the standard deduction was \$3,670. Under the tax reform act, each of the four exemptions will be worth \$1,950 in 1988 (total of \$7,800) and the standard deduction will be \$5,000, for a total adjusted gross income of \$12,800 before any income taxes are due. Beginning in 1988, the taxpayer in this example will start enjoying reduced taxes at an adjusted gross income of \$7,990, and the reduction will increase to \$559 at an income of \$12,800. Because of rate differentials, the 1988 tax savings will decrease gradually to \$517 at an adjusted gross income of \$17,000 and then the savings will increase and continue to increase as income increases. For a married couple with two children, who use the standard deduction, the tax savings when moving from the 1986 to 1988 rate schedule increases from \$662 with an adjusted gross income of \$25,000, to \$1,441 at \$35,000, to \$2,509 at \$45,000, and to \$5,311 at \$75,000. These savings may be partially or totally offset by loss of deductions for interest, state sales taxes, and miscellaneous deductions, together with termination of the 60 percent exclusion for capital gains income and termination of the investment tax credit. However, for small farmers who have significant non-farm income, tax rate reductions will likely have a larger impact on taxes paid than will other provisions.

Tax shelter investments

Agricultural tax shelters were one of the targets of the tax reform act. Termination of a variety of agricultural income tax incentives resulted from extensive publicity concerning their use and abuse. For example, U.S. Department of Agriculture (USDA) economists estimated that the

U.S. Treasury could have collected an additional \$3.8 billion in 1982 if farm income had not been taxed and if farm losses had not been used to reduce taxes on other income. A major portion of the projected increase in taxes paid by agricultural firms as a result of the new law will be from restrictions on tax incentives that encouraged tax shelter investments in agriculture.

Tax shelter investments in agriculture by nonfarm investors, part-time farmers with significant nonfarm income, and full-time farmers will be restricted by several provisions of the tax reform act:

(1) The reduction and leveling of tax rates will reduce the incentives to shift income across periods, while lowering the value of tax losses.

(2) The new tax law distinguishes between "passive" and "active" income. Income is considered "passive" when the recipient is not involved in the income-generating activities on a "regular, continuous, and substantial" basis. Under the new law, passive losses can only be used to offset income from other passive investments, implying that farm losses can no longer be used to offset other wage and salary income unless the taxpayer is actively involved in farming. Since very little of total personal income is classified as passive, this provision will significantly limit tax shelter opportunities.

(3) Repeal of the investment tax credit eliminates a major tax benefit for purchases of equipment, orchards, and breeding livestock, all of which were sometimes shared with tax shelter investors. In addition, the new tax law increases depreciation periods for most farm assets.

(4) New requirements to capitalize development expenditures for plants and animals with a preproductive period of more than two years removes some of the tax incentive for perennial crop development and breeding livestock investments. However, the extent to which these restrictions will be effective is not clear.

(5) Capital gains will now be taxed at the same rate as ordinary income, adding to the after-tax cost of orchard and breeding livestock investments.

Repeal of investment tax credit

The investment tax credit has been used sporadically to increase investment in qualified property and stimulate economic activity. The credit was first introduced in 1962, then modified in 1964; it was suspended from October 1966 through December 1967, but then restored in March 1967; it was repealed in 1969, re-introduced in 1971, increased in 1975, liberalized in 1981 with modifications in 1982, and then terminated at the end of

1986. When last effective in 1985, the investment tax credit was 6 percent of the cost of three-year property (accelerated cost recovery system) and 10 percent of the cost of other qualifying property, primarily five-year property. The credit could be applied to either new or used property, but its application was limited to not more than \$125,000 of used property.

The investment tax credit, in combination with other tax provisions, has stimulated investment in qualifying assets. It has been an important factor in machinery and equipment purchases and construction of single-purpose structures, especially after the Economic Recovery Tax Act of 1981. USDA researchers estimated that the investment tax credit increased net investment in farm equipment by 12 percent and net investment in structures by 5 percent for the 17-year period from 1962 through 1978. U.S. Department of Treasury Statistics of Income for 1979 Sole Proprietorship Tax Returns indicate that 2.74 million farm tax returns reported gross income that year. Of those, 1.18 million returns claimed investment tax credits in the amount of \$1.2 billion. The average amount of investment tax credit increased with adjusted gross income, as did the percentage of returns claiming the credit. Only 6 percent of farmers with adjusted gross income of under \$5,000 claimed any investment tax credit and the average amount was only \$75; just over 65 percent of the farms with incomes in the range of \$50,000 to \$100,000 claimed an average credit of \$2,511; and over 90 percent of farmers with adjusted gross income above \$1 million claimed investment tax credit averaging over \$37,200 per farm. The credit resulted in an 11 percent reduction in total income tax liability for sole proprietor farms in 1979.

Repeal of the investment tax credit can be expected to slow the rate of investment in qualifying agricultural assets and may increase the amount of taxes paid by some farmers. For the individual farmer, it is a trade-off between the use of the credit and the reduction in marginal income tax rates. Because owners of small and medium sized farms infrequently purchase machinery, they will probably pay more taxes under the new law in the year of a machinery purchase than they would have previously, since the benefits of the rate reduction are less than the tax credit. In other years when machinery is not purchased, however, taxes will probably be lowered by the tax reform act.

Recently, farms with gross receipts between \$50,000 and \$500,000 have been able to claim less than half of the investment tax credit available to them, because they had no current tax liability. USDA

estimates indicate that farm sole proprietors held over \$3 billion in accumulated tax credits in 1983 and that the amount had probably increased by 1986. The tax reform act restricts the carryover of unused investment tax credit; only 65 percent of unused credit can be carried forward after 1987 (82.5 percent in 1987). This restriction could cost farmers more than \$1 billion in unused tax credits. Research on utilization of the investment tax credit indicates that the burden of the carryover restriction will fall most heavily on medium-sized farmers with substantial debt and little or no off-farm income.

Depreciation provisions

Under previous income tax law, the accelerated cost recovery system (ACRS) allowed depreciable assets to be written off at relatively fast rates over periods ranging from 3 to 18 years, depending on the asset. Most farm assets, including machinery and equipment, single-purpose buildings, and even long-lived orchards and vineyards, could be depreciated over a 5-year period. There was no distinction between new and used property, and salvage values were ignored. There was an option to treat up to \$5,000 of investment per year as a current expense.

The tax reform act retains many of the ACRS rules with modifications. The 3-, 5-, 10-, and 15-year classes are kept and two new classes, 7- and 20-year property, are added. There is no distinction between new and used property; salvage values are still ignored; and the option to deduct investments as a current expense is increased to \$10,000 per year for businesses that invest less than \$200,000 per year. Recovery periods are generally lengthened, while depreciation rates are accelerated. For example, most farm equipment and single-purpose agricultural structures that were depreciated over 5 years are now written off over 7 years. The depreciable life for orchards and vineyards is increased from 5 years under the old law to 15 years under the tax reform act and the tax life for general-purpose farm structures is now 20 years. Personal property in the 3-, 5-, and 10-year classes was formerly depreciated by the 150 percent declining-balance method; now these classes and the 7-year class use the 200 percent declining-balance method. As a result, depreciation of farm machinery for the first three years is almost equal to that under the accelerated cost recovery system, even though the recovery period is lengthened from 5 to 7 years. For example, ignoring the immediate write-off allowance, the purchase of a tractor costing \$100,000 would previously have resulted in cumulative depreciation by tax year of: year 1, \$15,000; year 2, \$37,000;

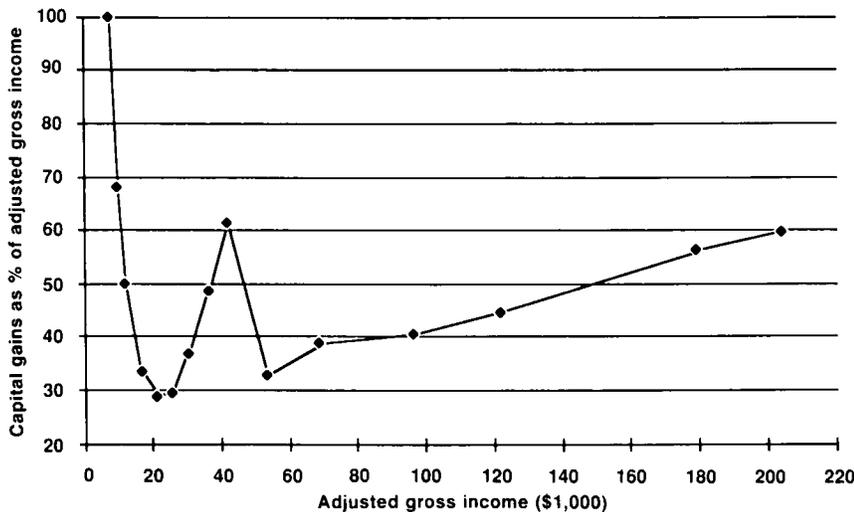


Fig. 1. Equal tax line for capital gains income as a percentage of adjusted gross income, before and after the 1986 Tax Reform Act.

year 3, \$58,000. Now the same purchase would result in cumulative depreciation by tax year of: year 1, \$14,290; year 2, \$38,786; and year 3, \$56,281.

The increase in depreciable tax life under the tax reform act will have little effect on taxable incomes for most farms; moreover, the increase in the amount of investment that can be deducted as a current expense will reduce taxable income for many farms. A clear exception will be purchased orchards and vineyards, which will have depreciation lives stretched from 5 to 15 years. This change in tax life will increase taxable income during the early years of investments in perennial crops.

Termination of capital gains exclusion

There was a 60 percent exclusion for long-term capital gains income under previous tax law; only 40 percent of the gain was subject to income taxation. The highest tax rate on long-term capital gains was thus 20 percent for taxpayers in the top 50 percent marginal tax bracket. Profits from the sale of livestock held for dairy, draft, breeding, or sporting purposes and from the sale of land were eligible for long-term capital gains treatment. The tax reform act eliminates the exclusion for long-term capital gains; these gains are now taxed at the same rate as other income. On a continuing basis, the major effect of this change will be on livestock producers whose cull sales qualifying for capital gains treatment were a significant portion of annual income. Profits from land sales will also be subject to higher taxes, but most farmland is held for long periods and future taxes on capital gains are probably not a major factor in most land purchase decisions.

Figure 1 illustrates combinations of taxable income and proportions of capital gains income for which a taxpayer would incur reduced or increased taxes under the new law. The line on figure 1 is an equal-tax line, which shows the various combinations of taxable income and proportions of income that were capital gains for which taxes would be the same before and after the tax reform act. For areas above the line, the taxpayer would pay more taxes under the new law than under prior tax law; for areas below the line, the taxpayer would now pay less tax. These calculations assume a married couple with two children filing a joint return and using the standard deduction. Percentages were calculated at the adjusted gross income levels where rate changes occurred under tax law effective in 1986. Two factors interact to determine the shape of the equal tax line in the graph: the decrease in tax rates between 1986 and 1988, and termination of the 60 percent capital gains exclusion in 1988. This can be illustrated with an example of one of the calculations shown in figure 1. For an adjusted gross income of \$30,870, income taxes decrease by \$1,029 between 1986 and 1988. At the 1988 tax rate of 15 percent, income would need to increase \$6,860 to make the taxes paid equal for the two years. If the 60 percent exclusion of capital gains equalled \$6,860, then capital gains income would equal \$11,433, or 37 percent of adjusted gross income.

The dollar amount of capital gains that a livestock producer with adjusted gross income in the range of \$10,000 to \$26,000 could have before incurring increased taxes under the tax reform act varies from a low of just over \$5,700 for adjusted gross income of \$17,000 to just over \$7,700 for adjusted gross income of \$26,000. The tax-

payer could have up to \$17,500 of capital gains with an adjusted gross income of \$53,700 before incurring increased taxes under the new law. Both the percentage and the dollar amount of capital gains that a producer could have before facing higher taxes increases with income for adjusted gross income above \$53,700.

Even though the capital gains exclusion has been terminated, farmers still have an incentive to receive capital gains income. Such income does not enter into computation of the Social Security self-employment tax, which for 1986 amounted to 12.3 percent of wages and self-employment earnings up to a maximum of \$42,000.

Limits on cash accounting

The use of cash accounting was the cornerstone of many agricultural tax shelters. Congress has prohibited the use of cash accounting by nonfamily farm corporations with gross receipts over \$1 million and requires farm syndicates and cash basis tax shelters to claim expenses for inputs when used, regardless of when purchased. The tax reform act retains cash accounting but with further restrictions on prepayments for inputs. Now, farmers will not be able to deduct prepaid amounts for seed, feed, fertilizer, or similar supplies beyond half of total farm expenses until the inputs are actually used. A similar rule applies to certain costs of poultry enterprises. There are no restrictions concerning the timing of the receipt of income. Farmers can thus continue to use cash accounting but with limits designed to prevent common abuses of the system to defer taxes.

Under prior tax law, farmers could immediately deduct the development costs for some capital assets, including costs of establishing perennial crops (except citrus and almonds) and costs of raising livestock. When these assets were later sold, they had a basis of zero, and all of the sales proceeds were treated as capital gains income. The tax reform act requires preproductive expenditures for plants and animals with a development period of two years or longer to be capitalized and either claimed later as depreciation deductions or subtracted from the asset price at the time of sale to compute taxable gain. There are exceptions for replanting crops lost because of casualties. In addition, farmers may elect to continue to deduct development expenditures as a current expense if they use straight-line depreciation for all farm assets placed in service during the year the development deduction is taken. The latter exception permits farmers to stagger major capital outlays and preproductive expenses so as to take the full write-off on the latter ex-

penses without compromising accelerated depreciation allowances; capital assets must simply be placed in service in years when preproductive expenses are low (or deferred by manipulation of payment timing). As a result, the impact of these capitalization requirements may be smaller than has been anticipated. Repeal of the capital gains exclusion, however, removes a great deal of the tax benefit from these preproductive expense practices.

Effects by farm type

The foregoing discussion indicates that the relative benefits and costs of the new law to any particular farmer will depend on specific attributes of the farm operation.

Vineyard and orchard developers will be hurt both directly and indirectly by several provisions of the tax reform act. Directly, they will lose both the benefits of the capital gains exclusion on orchard sales and, to some extent, the favorable tax treatment of preproductive expenses. Indirectly, tax shelter investments in these enterprises will be curtailed as investors are forced to look at economic returns rather than tax benefits; investor return requirements can therefore be expected to rise. On the other side of the coin, purchasers of bearing vineyards and orchards will lose investment tax credits from these acquisitions, as well as rapid depreciation allowances. Notably, these changes remove tax obstacles to vertical integration. Before, if a farmer developed an orchard and sold it at bearing age, the buyer received an investment tax credit while the seller's gain in orchard value was only partially taxed (as a capital gain); if integrated, both tax credit and capital gain advantages were lost. Now, there is no tax cost to integration.

The ultimate impact of these tax law changes on the price of the orchard asset is difficult to predict. In the short run, one would expect the sales price of bearing orchards to decrease and new orchard development activity to be slowed. As productive capacity is reduced over time, however, orchard prices will increase in line with crop returns.

Cow-calf operations that raise their own replacement heifers also stand to lose from the new capital gains treatment of cull sales and new restrictions on preproduction deductions. Those that buy breeding stock will lose their investment tax credits from the purchase. These changes may be expected to change operators' problems with the raise vs. buy decision. Before the tax reform act, operators who raised their replacements could exclude 60 percent of gains on cull sales in computing taxes, while these capital

gains treatment benefits were lost if another operator raised the heifers and sold them to cow-calf operators. On the other hand, purchasing replacements gave rise to investment tax credits that were lost if operators raised their own replacements. The approach that offered the greatest benefit depended on the operator's tax status, as well as cull and heifer prices. Now, both capital gains benefits of raising and investment tax credit benefits of buying are gone, changing the choice problem in unobvious ways.

The choice of replacement interval will also be affected by the tax law changes. In this case, both capital gains tax breaks and the investment tax credit, by increasing the benefits of cull sales and lowering the costs of replacement purchases, tended to favor shorter replacement intervals. The tax reform act will favor longer intervals.

Qualitative implications of the new tax law's provisions are much the same for dairy farmers as for cow-calf operators. For other types of farmers, the biggest cost of the tax change will be the loss of investment tax credits on purchased equipment. In all cases, however, these costs must be balanced against the gains from tax rate reductions.

In summary, three of the largest agricultural industries in California, together contributing over 50 percent of agricultural sales dollars in the state, could experience significant costs due to several of the new provisions. These industries are dairies, (contributing 14.2 percent of sales), beef cattle ranches (contributing 12.2 percent), and growers of tree and vine crops (contributing 24 percent). In the latter two industries, however, it is important to note that most farms (60 percent of vineyard/orchard farms and 73 percent of cow-calf operations) have annual sales below \$20,000. Since many of these farms tend to be supported by off-farm income, the extent to which the new law's adverse effects will be offset by tax-rate reductions will depend on the size of these operators' other incomes.

Conclusion

The Tax Reform Act of 1986 reduces marginal tax rates by terminating many tax incentives and closing most income tax loopholes. Whether or not a farm taxpayer benefits from lower rates contained in the law will depend on the extent to which tax incentives and loopholes were previously utilized. The impact will probably vary by farm type, because tax incentives varied by enterprise.

Taxpayers will find that it is more difficult to deduct farm losses from nonfarm income because of limits on passive losses and on the current deduction of development expenditures. Nonfarm investors in

agricultural enterprises, as a group, thus will probably incur increased income taxes as a result of the tax reform act. Loss of tax incentives for breeding livestock and dairy operations, especially termination of the capital gains exclusion for cull sales, termination of the investment tax credit, and the requirement for capitalization of preproduction expenses, will increase income taxes for many dairies and livestock producers. Some tree crop producers, especially those who purchase or develop new acreage, will also experience higher taxes as a result of the new law because of termination of the investment tax credit, requirements for capitalization of preproduction costs, and increased depreciation lives for trees and vines (from 5 to 15 years). The average crop producer will probably enjoy reduced income taxes as a result of the tax reform act. Exceptions will be those who make large equipment expenditures no longer eligible for the investment tax credit.

Investment patterns in agricultural assets will be altered over time as a result of changes in income tax incentives. Machinery investments will be lower than they would have been when the investment tax credit was available. Significant excess capacity will be reduced as on-farm machinery inventories are adjusted to meet needs more closely. Productive capacity for livestock and perennial crops will be reduced, other things being equal, and this should lead to reduced supply and improved returns over time because the percentage increase in prices is typically greater than the percentage decrease in quantity supplied. Overall, agricultural investment decisions will be based more on economics and less on tax provisions. This change should benefit agriculture over time in both level and stability of returns.

One cannot provide a pat answer to the question of "who wins and who loses" from the tax reform act. Because of the nature of tax rate changes, the potential benefits to individual taxpayers increase as taxable income increases. The benefits of lower rates are offset, however, by termination of many tax incentives and loopholes. Potential losers from tax reform include those farmers who were best able to exploit farm tax incentives under prior rules. While there may be winners and losers among individual farmers, we expect agriculture as a whole to realize significant long-term benefits from tax reform after an adjustment period that may require several years for some enterprises.

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