USDA United States Department of Agriculture

ERS

Agricultural Economic Report Number 764

*An Economic Research Service Report*

# The Taxpayer Relief Act of 1997

## Provisions for Farmers and Rural Communities

James Monke and Ron Durst

**The Taxpayer Relief Act of 1997: Provisions for Farmers and Rural Communities.** By James Monke and Ron Durst. Food and Rural Economics Division, Economic Research Service, U.S. Department of Agriculture. Agricultural Economic Report No. 764.

## Abstract

Under the Taxpayer Relief Act of 1997, most farmers will pay less Federal income tax, and farm families will find it easier to transfer the family farm across generations. The new law–the tax portion of 1997 legislation to balance the Federal budget by 2002–emerges from years of debate on proposals for tax simplification, broad tax reduction, and targeted relief for capital gains and estate taxes. The legislation is expected to generate a net tax reduction of $95 billion over 5 years for all taxpayers. A number of general and targeted tax relief provisions will reduce Federal taxes significantly for farmers and other rural residents, but also will increase the complexity of both Federal income and estate taxes. Farmers are expected to save more than $1.6 billion per year in Federal income taxes and $150-200 million in Federal estate taxes.

*Keywords:* Farm taxation, Federal income taxes, family farm, capital gains, estate taxes, tax reform, tax policy, agricultural assets, farm income variability.



## Acknowledgments

The authors thank Douglas Maxwell for his help computing estimates on estate tax effects, and Robert Collender for his insight on an early draft of the capital gains section. Rick Reeder, Pat Canning, and Michael Compson provided helpful comments on the entire manuscript.

To contact the authors:

James Monke, 202-694-5358, JMONKE@econ.ag.gov

Ron Durst, 202-694-5347, RDURST@econ.ag.gov

Washington, DC 20036 July 1998

# Contents

# Summary

The Taxpayer Relief Act of 1997 significantly reduces Federal taxes for farmers and other rural residents. Farmers are expected to save more than $1.6 billion per year in Federal income taxes and over $150 million in Federal estate taxes. Based on 1994 tax filings, those savings amount to about 10 percent in Federal income taxes and 30 percent in Federal estate taxes. Although farmers are less than 2 percent of the population, they receive a disproportionate share of the tax savings, largely because they are more likely than other taxpayers to report capital gains or to owe estate taxes.

The greatest tax reduction for farmers comes from reductions in capital gains taxes; other taxpayers also share in this tax relief. Capital gains provisions are expected to expand agricultural investment and support farmland prices, although tax laws are only one of many factors in determining asset prices. Tax relief specifically designed for farmers gives them additional flexibility to deal with income fluctuations, including using deferred payment contracts, income averaging, and deferring the gain on weather-related livestock sales. Farmers who pay their own health insurance premiums will benefit from expanded self-employed health insurance deductions. A small number of large family farm corporations will face higher taxes as a result of rules governing a switch from the cash method of accounting. Most farmers will pay less Federal income tax as a result of new child tax credits, retirement accounts, and education incentives. Some rural areas will benefit from new empowerment zones created to foster economic revitalization and community development.

Federal estate tax changes are especially important for farmers and other owners of small businesses who hold significant amounts of wealth in the form of business assets. The 1997 act substantially increases the size of farms or other small businesses that can be transferred tax free and makes important changes to special valuation and installment payment provisions. These changes will make it easier to transfer the family farm to heirs by reducing the likelihood that the farm or some of its assets will need to be sold to pay estate taxes.

While farmers and other taxpayers will owe less income and estate taxes under these new provisions, they will also face more complex tax rules, since most provisions are targeted to individuals or transactions with specific characteristics. A few provisions, primarily those affecting capital gains on principal residences, the alternative minimum tax, and the unified estate tax credit, will simplify tax preparation and recordkeeping.

## Income Tax Changes

Here are the most significant income tax changes of the 1997 law affecting farmers.

***Capital gains.*** The tax rate declines from 28 percent to 20 percent for individuals in most tax brackets (from 15 percent to 10 percent for taxpayers in the 15-percent bracket), with lower rates available in the future for assets held at least 5 years. Couples can exclude up to $500,000 of the gain realized on the sale of their principal residence. Net effect: farmers' taxes reduced by an estimated $725 million annually.

***Alternative minimum tax.*** Farmers can once again use deferred payment contracts without being subject to the alternative minimum tax. Small farm corporations are exempted from the tax. Net effect: farmers' alternative minimum tax liability reduced by about $150 million annually.

***Income averaging***. For a limited time, farmers can use income averaging to shift farm income into the 3 preceding years. Net effect: farmers' taxes reduced by about $50 million per year.

***Weather-related livestock sales.*** Farmers can defer the gain on the sale of livestock due to floods and other weather-related conditions. Net effect: farmers' taxes reduced by about $2 million per year.

***Suspense accounts.*** Large family farm corporations can no longer establish suspense accounts when they are required to change from cash to accrual accounting. Existing accounts must be recognized in income over a 20-year period. Net effect: farm corporations' taxes increased by about $35 million annually.

***Health insurance deduction***. Self-employed taxpayers (farmers and others) may deduct more of their health insurance premiums. The deduction increases from 40 percent in 1997 to 100 percent by 2006. Net effect: when fully phased in, self-employed farmers' after-tax cost of health insurance will decline by about 10 percent, or over $135 million annually.

***Child tax credit***. Farmers (and other taxpayers) can take a $500 tax credit for each dependent child under age 17. Net effect: farmers' taxes reduced by an estimated $600 million per year.

***Retirement accounts.*** The new law expands the availability of individual retirement accounts and provides penalty-free distributions for education and first-time homebuyers. Net effect: farmers and other taxpayers can defer or avoid taxes on more of their long-term savings.

***Education incentives.*** Most taxpayers can use two new nonrefundable tax credits for college expenses, deduct interest payments on student loans, and establish "education" IRAs for their children. Net effect: families' after-tax cost of higher education is reduced.

***Empowerment zones.*** Five new rural empowerment zones may be created. Net effect: some rural areas and businesses will benefit from incentives to foster economic revitalization and community development.

## Estate Tax Changes

Here are the most significant estate and gift tax changes of the 1997 law affecting farmers.

***Unified credit and family business exclusion.*** Larger farms (and larger estates in general) can now be transferred tax free, as the new law raises the unified credit from $600,000 to $1 million by 2006. The expanded unified credit, in combination with a new exclusion for continuing farms and other family businesses shields estates valued at up to $1.3 million beginning in 1998. Net effect: the number of taxable farm estates declines by 40 percent and farmers' estate taxes decline by about $150 million per year.

***Installment payments.*** The new law reduces the interest rate from 4 percent to 2 percent for qualified estates and increases the amount of taxes eligible for the lower rate. Net effect: farms and other estates are less likely to be liquidated to pay estate taxes in a lump sum.

***Cash leases.*** Farm heirs can now cash-rent farms to qualified family members and still remain eligible for special use value benefits. Net effect: reduces estate taxes by about $2 million per year, and provides retroactive tax relief totaling about $25 million for 1976-97.

***Conservation easements***. The new law creates a new estate tax exclusion for the value of land subject to a conservation easement. Net effect: saves farmers and others an estimated $50 million per year in Federal taxes after the exclusion reaches its maximum amount in 2002.

# The Taxpayer Relief Act of 1997

## Provisions for Farmers and Rural Communities

James Monke and Ron Durst

### Introduction

The Taxpayer Relief Act of 1997 (H.R. 2014, P.L. 105-34; August 5, 1997) reduces the overall amount of Federal income and estate taxes paid by farmers and other taxpayers. The act is the tax portion of the legislative package to balance the Federal budget by 2002 (together with the Balanced Budget Act of 1997, H.R. 2015, P.L. 105-33; August 5, 1997). The tax act emerged from years of debate on proposals for tax simplification, broad tax reduction, and targeted capital gains and estate tax relief. The package results in a total net tax reduction of $95 billion over 5 years. A number of general and targeted tax relief provisions will significantly reduce Federal taxes for farmers and other rural residents, but will also generally increase the complexity of the tax code. As a segment of the tax-paying population, farmers are expected to receive more than their 2 percent share of the tax savings because they are more likely than other taxpayers to report capital gains or to owe estate taxes. Farmers are expected to save about 10 percent of the nearly $16 billion they pay annually in Federal income taxes on their farm and off-farm income. Capital gains provisions are expected to expand agricultural investment and support farmland prices. Farmers will also save about 30 percent of the estimated $500 million they pay in Federal estate taxes and find it easier to transfer the family farm across generations. The next section discusses several income tax provisions which are most relevant to farmers, and a later section summarizes estate tax provisions designed to help farm families transfer assets across generations. A glossary at the end of the report describes some of the terminology used throughout the text.

### Federal Income Tax Provisions

From shortly after its introduction in 1913, the Federal income tax has been the most important tax on agriculture. Farmers pay more in Federal income taxes on their combined farm and off-farm income than in social security or self-employment taxes, estate and gift taxes, State income taxes, or property taxes (Durst and Monke).

Farmers' greatest income tax reduction from the Taxpayer Relief Act of 1997 comes from reduced capital gains tax rates (which are available to all taxpayers). Farmers alone will benefit from additional flexibility to deal with income fluctuations by using deferred payment contracts, income averaging, and deferring the gain on weather-related livestock sales. Self-employed taxpayers who buy their own health insurance will pay less Federal income tax after expanded self-employed health insurance deductions. A small number of large family farm corporations will face higher taxes as a result of rules governing a switch from the cash method of accounting to an accrual method. Many farmers will pay less tax as a result of general provisions that provide new child tax credits, education incentives, and expanded retirement savings incentives. Some rural areas will benefit from new empowerment zones created to foster economic revitalization and community development.

Overall, farmers are expected to save more than $1.6 billion per year in Federal income taxes, primarily from capital gains tax reductions ($725 million) and new child tax credits ($600 million), but large savings also come from alternative minimum tax relief ($150 million), self-employed health insurance deductions ($135 million), and income averaging ($50 million). Because farmers paid nearly $16 billion in Federal income taxes on both their farm and nonfarm income in 1994, these savings represent about 10 percent of their Federal income tax burden (Durst and Monke).

Few provisions apply broadly to all taxpayers because of targeting. Yet, many farmers will benefit from provisions affecting both farm and nonfarm households, and savers and investors, as well as provisions available only to farm businesses. Most provisions become effective in 1998, although capital gains tax relief affected 1997 income, as well. Many provisions offer increased tax savings in future years.

Restricting benefits to certain individuals and gradually implementing tax relief makes the tax code more complex. Most tax relief provisions, including capital gains, income averaging, IRAs, child credits, and education incentives, will make tax compliance more time consuming and recordkeeping more burdensome. On the other hand, the exclusion of gain on the sale of a principal residence will significantly decrease recordkeeping burdens for homeowners, and changes in the alternative minimum tax will simplify tax compliance for many farm businesses.

Estimates of affected farmers and their income tax savings, unless otherwise noted, were computed by the authors using the 1993 and 1994 IRS Individual Public Use Tax Files (see Appendix A).

## Capital Gains Taxes

Capital gains are profits from selling stocks, real estate, and other assets used in a business (including farmland and breeding and dairy livestock). The taxation of long-term capital gains is especially important for farmers because farming is a capital-intensive business and many assets used in farming qualify for special tax treatment. Lower capital gains tax rates in the act have important implications for farm tax liability, agricultural output, and asset prices.

Capital gains have historically received special treatment in the tax code, but less so in recent years. Prior to the Tax Reform Act of 1986, up to 60 percent of capital gains were excluded from taxation and the remainder was taxed at ordinary tax rates. During the last 10 years, gain on the sale or exchange of capital assets was generally subject to the same tax rate as ordinary income, except that a top marginal rate of 28 percent was imposed on gains from assets held longer than a year when the ordinary rate exceeded 28 percent.

The 1997 act reduces the maximum tax rate to 20 percent on gains from assets held more than 18 months. A 10-percent rate applies to taxpayers in the 15-percent tax bracket (for example, joint returns with taxable income less than $41,200 for 1997). In addition, for assets acquired beginning in 2001 and held more than 5 years, the maximum tax rate will be reduced to 18 percent. For individuals in the 15-percent bracket, an 8-percent rate applies after 2000 regardless of the purchase date, so long as the holding period exceeds 5 years. Compared with recent years before the act, when only taxpayers above the 28-percent bracket benefited from the maximum rate on capital gains, the new array of capital gains tax rates offers all taxpayers some level of preferential treatment (table 1). Lower tax rates may be viewed as the equivalent of excluding a fraction of the gains from taxation (figure 1). Effective exclusions vary greatly, based on holding period and tax bracket, and may be lower than indicated for some taxpayers because the entire gain is actually included in AGI (adjusted gross income) and may accelerate the phaseout of some deductions or tax credits.

Individual taxpayers may also use the 10- and 20-percent capital gains tax rates when computing their alternative minimum tax (see also the section on alternative minimum tax).

**Table 1—Capital gains tax rates change after the 1997 Taxpayer Relief Act**

| Holding period | Marginal Federal tax bracket(s): 15 percent | Marginal Federal tax bracket(s): 28 percent and above |
|---|---|---|
| | Percent | |
| **Pre-1997 act** | | |
| Less than 12 months | 15 | 28-39.6[1] |
| 12 months or more | 15 | 28 |
| **1997 act** | | |
| Less than 12 months | 15 | 28-39.6[1] |
| 12-18 months | 15 | 28 |
| 18 months or more | 10 | 20 |
| 5 years or more, sold in 2001 or after | 8 | na |
| 5 years or more, bought in 2001 or after | na | 18 |

[1]For holding periods less than 1 year, gains are taxed at the same rate as ordinary income.
na: not applicable to this tax bracket(s), rate determined by other 5-year holding period category.

A 25-percent capital gains tax rate applies to recaptured depreciation on farm buildings and similar business assets. Gain from selling depreciated equipment and single-purpose agricultural structures, however, is still taxed as ordinary income.

The act also allows a taxpayer to exclude up to $250,000 of gain on the sale of a principal residence ($500,000 if married and filing a joint return). This new exclusion can be used as frequently as every 2 years, and replaced both the provision that allowed the gain to be rolled over into another residence and the $125,000 lifetime exclusion for taxpayers over age 55. Farm residences, which represent about 12 percent of the value of farms, will also qualify for the new principal residence exclusion.

Reduced capital gains tax rates are expected to save farmers an estimated $725 million each year in taxes. About one-third of this tax reduction goes to the half of all farmers who are in the 15-percent tax bracket, and two-thirds goes to the one-fourth of farmers in higher tax brackets.

The capital gains provisions are expected to expand agricultural investment in livestock and land by both farm and nonfarm investors. Owners who waited for reduced tax rates may temporarily increase the supply of land for sale, which could tend to reduce the price in the short term. But preferential tax treatment should increase the net demand for land in the long term and help to support prices. Taxes, however, are only a contributing factor determining asset prices. Many other fundamental factors such as productivity, output prices, and macroeconomic conditions are more important for determining price changes. Nonetheless, preferential capital gains tax treatment will tend to support prices above what they would be if all other factors remain constant. Without other changes, land may command a premium price because of lower capital gains taxes (Long). This competition would equalize the after-tax return with other assets for individuals facing similar marginal tax rates, even though the gross rate of return would decrease if prices rise. Some farm output prices may fall if greater investment increases production.

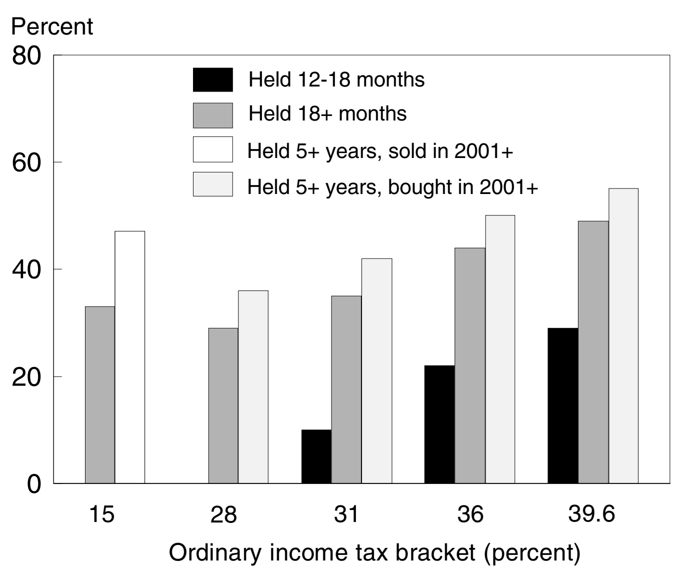
### *Important Source of Income for Farmers*

Because assets used in a trade or business, such as farmland and breeding and dairy livestock, are eligible for capital gains treatment, capital gains are an important component of total income for farmers. In 1994, the most recent year for which data are available, the total net capital gain reported by farmers was $12 billion, with nearly half of this gain from assets used in farming. About one-third of all farm sole proprietors reported capital gains. This is three times the frequency for all other taxpayers and twice that for other small businesses.

Capital gains are especially important for certain types of farms. A larger proportion of livestock farmers report capital gains than any other type of farm. Livestock qualify for capital gains treatment when they are used for breeding, dairy, or draft purposes; that is, when they are used as capital assets to produce other output. About two-thirds of all dairy farmers and about half of other livestock farmers report some capital gain income each year.

Although capital gains amounted to only 13 percent of total taxable income for farmers in 1993 and 1994, capital gains from business assets generated nearly all of the taxable farm income for most income classes (figure 2). Farm sole proprietors reported a $7.4-billion aggregate loss in 1994 from regular farm business operations (Schedule F of IRS Form 1040, which excludes capital gains), but reported about $6 billion net capital gains from the sale of farm business assets. In 1993, comparable figures were $3.7 billion aggregate loss on Schedule F and a $6 billion capital gain.

Figure 1
**Effective exclusion rates on capital gains income**



### *Reasons for Preferential Treatment*

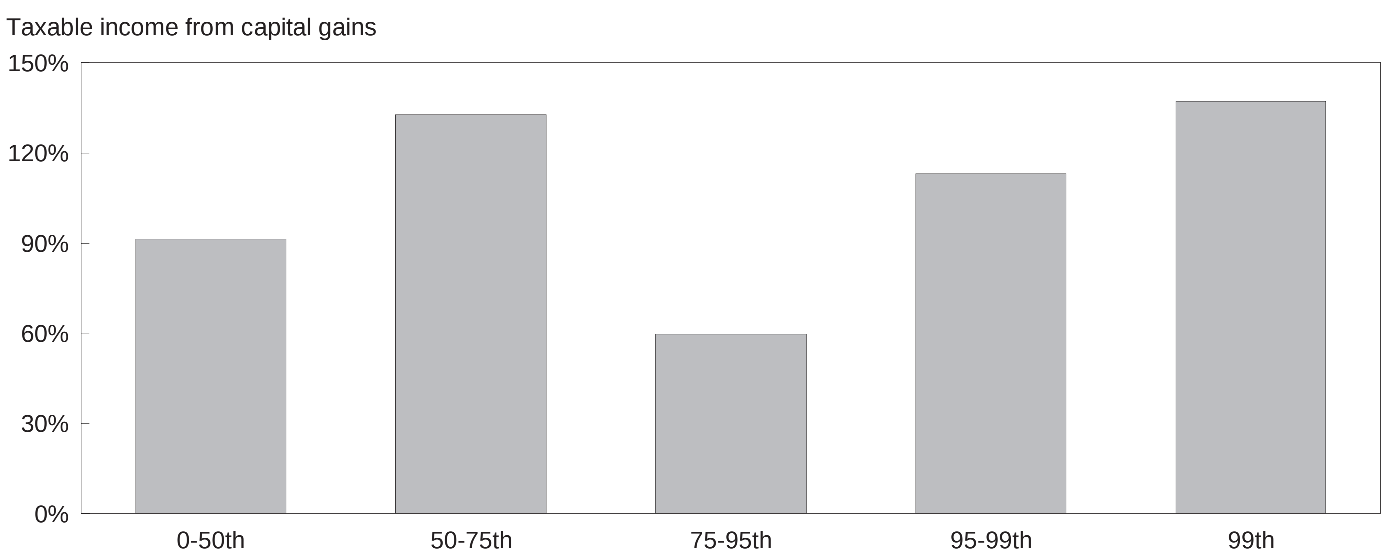
Because capital gains taxation has been widely debated over recent years and has been the focus of many proposals and justifications for reform, this section summarizes some important general issues with relevance to farm investments. This section does not, however, address specific alternatives to the 1997 act.

Proponents of reduced capital gains taxation argue that the taxation of inflationary gains, the concentration of income that occurs when capital assets are sold, and the double taxation of corporate income combine to impose a relatively higher tax rate on capital than on other income. Capital gains (especially on business assets) are also often viewed not so much as income, but rather as a byproduct of business investment — taxing the tree rather than the fruit of the tree — and therefore less deserving of taxation (David). Proponents suggest that lowering the tax rate would increase saving and investment, resulting in more efficient allocation of resources. These reasons are explored below.

Opponents of capital gains tax reduction argue that gains from capital assets are concentrated primarily among the most wealthy taxpayers and that special treatment extenuates problems in both vertical and horizontal tax equity. Horizontal equity requires that people with the same amount of income bear the same tax burden; vertical equity charges higher tax rates to those with greater ability to pay, in accord with society's consensus for progressive taxation. Some opponents also argue that capital is not taxed at a higher rate than labor when social security taxes are included. Over recent years, the increasing number of taxpayers who own stocks and mutual funds has increased the base of taxpayers who would potentially benefit from preferential treatment of capital gains.

*Effective tax rates and inflation.* Capital gains taxes are levied on nominal returns; that is, on both the return necessary to offset inflation plus the return which represents a real increase in purchasing power. Taxing inflationary gains makes the effective tax rate on the real return (the capital gains tax divided by the real capital gain) nearly always greater than the marginal tax rate. If the real rate of return is low relative to inflation, then most of the nominal capital gain is due to inflation, and the effective tax rate on the real return could exceed 100 percent (for example, after a 1-year period with 3-percent inflation and a 4-percent nominal capital gain, a 25-percent capital gains tax yields a 100-percent effective tax). Longer holding periods help reduce the effective tax rate by compounding the real rate of return, but effective tax rates often remain high relative to the marginal tax rate. While inflation also increases effective tax rates on interest and dividends, the effect on capital gains is often perceived to be greater because of the magnitude of capital sales and the proportion of the sale price that gains represent after long holding periods.

Figure 2
**Capital gains from business assets are a large part of taxable farm income**




Note: 0-50th percentile represents the bottom one-half of farmers ranked by AGI.
Share can exceed 100 percent if farm operating loss exists without capital gain.

Effective tax rates always exceed the taxpayer's marginal bracket in an inflationary environment unless part of the nominal gain is excluded from taxation. If part of the gain is excluded, then the effective rate may drop below the taxpayer's marginal rate under certain combinations of holding periods and real rates of return. For example, using hypothetical rates of return and tax law before the 1997 act, individuals in the 28-percent ordinary tax bracket faced effective capital gains tax rates on real returns of: 52 percent if real capital appreciation was 2 percent annually for 30 years and inflation was 4 percent; 39 percent if both the real gain and inflation were each 3 percent. Using the new 20-percent capital gains tax rate in the 1997 act, their effective tax rate drops to 37 percent under the former rate of return and inflation assumption, and 28 percent under the latter. Taxpayers in the 15-percent bracket fare slightly better in each scenario for the 1997 act, as do taxpayers in the 31-percent bracket or above, because their effective exclusions from taxation are greater (figure 1).

Although taxing capital gains at lower rates or excluding a portion of such gains from taxable income reduces the effect of taxing inflationary gains, they are less precise adjustments for inflation than indexing (Congressional Budget Office). In most cases, an exclusion does not fully offset the effects of inflation, but when the real increase in value is high relative to the inflation, an exclusion could overcompensate for inflation. If capital gains were indexed for inflation and there were no other exclusion, the effective tax rate would always equal the marginal rate. Indexing capital gains for inflation, however, has posed difficulties for controlling Federal budget deficits and remaining consistent with tax provisions that allow borrowers to deduct nominal interest expenses. Some officials have argued that indexing capital gains income without indexing interest deductions would provide unfair preferences to capital assets financed with debt. But reducing borrowers' interest deductions for inflation would raise tax burdens and the effective cost of borrowing.

Tax timing issues also benefit the investor. Deductible interest expenses reduce tax liability during the current year, while capital gains taxes are deferred until the asset is sold. Deferring capital gains taxes slightly increases the implicit after-tax rate of return. This increases with longer holding periods and can be especially important for those who intend to hold assets indefinitely.

*Accumulated income.* Deferring capital gains until an asset is sold can create problems at the time of sale because unusually large gains may push the taxpayer into a higher marginal tax bracket. In farming, this is especially a problem regarding sales of farmland and some sales of breeding and dairy livestock due to weather-related conditions. However, the potential for higher taxes can be reduced somewhat by making land sales on the installment method or by selling the land in smaller parcels over time. Based on 1993 and 1994 tax data, however, the concentration of capital gains income in a single year may not be a widespread problem. Only about 5 percent of farmers were taxed at higher marginal rates because of reporting capital gains.

*Double taxation.* The double taxation of corporate earnings, first at the corporate level and then at the shareholder level, is another justification for reduced tax rates for individuals. However, although farmers who own corporate stock are affected by this double tax, the double taxation of corporate earnings is not a significant issue for the farm sector. Most farms are sole proprietorships, partnerships, or Subchapter S corporations, which are taxed only once at the individual, partner or shareholder level. Thus, only a relatively small amount of farm business income is subject to two levels of taxation.

***Concentration of Benefits***

One argument against reducing capital gains taxes is that the primary beneficiaries are high-income individuals. Although capital gains are heavily concentrated among the most wealthy taxpayers, the distribution is less concentrated in agriculture. Farmers in the top 5 percent of the AGI distribution reported 57 percent of all capital gains reported by farmers in 1994, whereas the same proportion of the nonfarm population reported 73 percent of the total gains. One reason for this more even distribution is that farmers are more likely to report capital gains from the sale of business assets, rather than as a direct result of financial wealth. About one-fifth of all farmers report capital gains from the sale of business assets, compared with less than 1 percent of the nonfarm population. Capital gains from business assets are also more evenly distributed across income categories, although the wealthiest 5 percent of farmers still reported about 40 percent of farm business capital gains (figure 3).

Within the farm population, high-income farmers are more likely to realize capital gains than lower-income farmers, and the amount they realize is many times the typical capital gain realized by all farmers. In 1994, three-fifths of farmers with AGI over $200,000 realized a capital gain, compared with one-third of farmers with AGI under $200,000. The average gain for such high-income farmers who realized a gain was about $230,000 compared with an average of about $9,000 for those with AGI under $200,000. Capital gains are also a much larger share of income for farmers with over $200,000 income, with about 22 percent of their income coming from capital gains. Capital gains constituted only 9 percent of total income for farmers with AGI under $200,000. These differences may be overstated slightly because some of the 2 percent of farmers with AGI over $200,000 may temporarily have such income only because of one-time gains (Burman and Ricoy), possibly from the sale of nonfarm assets.

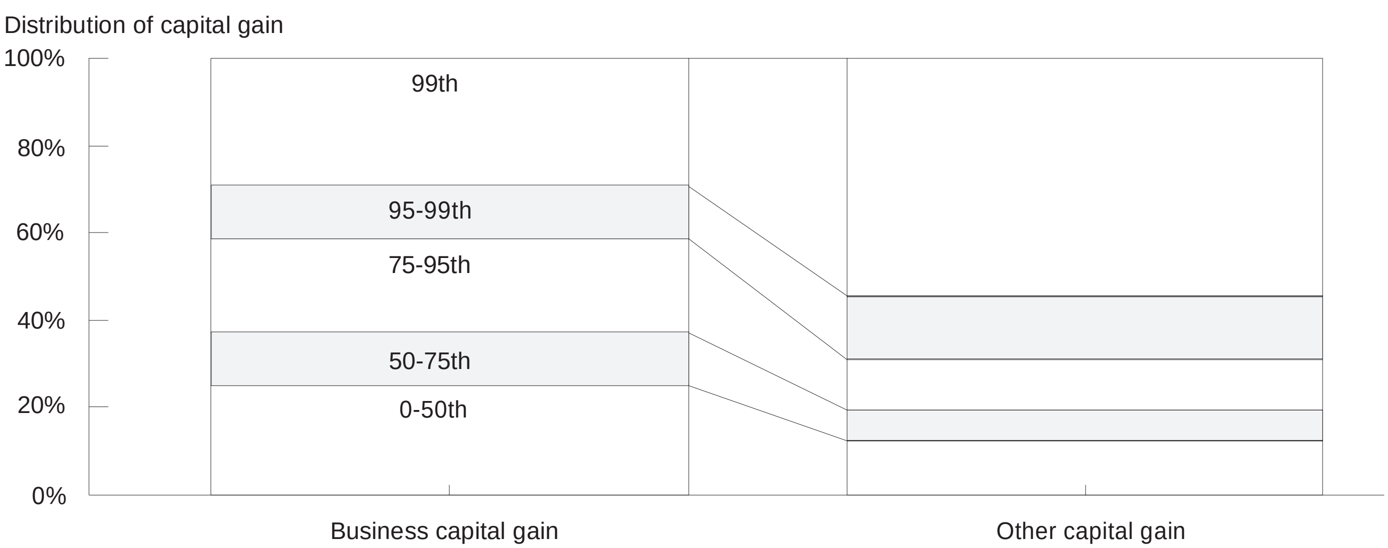
Supporters of lower capital gains taxes claim that the aggregate effects of a tax cut are more evenly distributed than capital income because people with lower incomes may benefit from higher wages in an economy that expands from increased capital investment. This effect might be mitigated in farming, however, because many owners of farm capital also provide much of the farm labor. It also assumes that capital complements labor in production, rather than replacing it.

### *Effects on Farm Assets and Ownership*

Although reduced capital gains tax rates will decrease tax liabilities for farmers who realize capital gains, two additional factors may mitigate the benefits that all farmers receive. First, tax shelter investors may expand in agriculture because of the special capital gains treatment given to agricultural assets. The net effect, however, is expected to be smaller than before 1986 because of other tax laws enacted in recent years. Second, capital gains tax rates may not be sufficiently low to encourage many farmland owners to sell assets because of large accrued gains and the ability to transfer assets across generations after death without paying any capital gains tax.

*Tax shelter opportunities.* Lower capital gains tax rates increase incentives to invest in assets that generate capital gains and to alter management practices to maximize such income. The likely result of lower rates will be increased farm investment especially in livestock and farmland. Preferential capital gains treatment may accelerate the growth in the number of large, investor-owned farms and make obtaining or controlling the means of production (primarily farmland and production facilities) more difficult for some smaller family farms. However, tax shelter opportunities are more constrained now than they were before the Tax Reform Act of 1986.

Figure 3
**For farmers, business capital gains are somewhat more evenly distributed than total gains**




Note: Bar segments represent percentiles of AGI.
Source: USDA-ERS, based on IRS Individual Public Use Tax File, 1993.

The use and abuse of tax provisions available in farming before the Tax Reform Act of 1986 is well documented (Long; Davenport, Boehlje, and Martin). Before the 1986 act, both farm and nonfarm investors were encouraged to invest more in favored activities. Increased investment expanded productive capacity and contributed to lower prices for some farm products. Capital gains provisions complemented other farm tax preferences such as the cash method of accounting and the ability to deduct development costs. Investments to develop future income could be deducted from current earnings, while future income could be converted into capital gains. Not only were income taxes delayed and reduced, but capital gains were also not subject to self-employment taxes. The combined effect of these preferences could convert a before-tax loss into an after-tax profit.

Several provisions enacted in recent years, including those contained in the Tax Reform Act of 1986, restrict such investments. These include limits on the ability to use the cash method of accounting, limits on the current deductibility of development costs, restrictions on prepaid expenses, and passive loss rules that limit the ability of some individuals to deduct losses. While these changes and lower marginal tax rates have reduced both the incentive and the opportunity to make tax-shelter investments in farming, they have not eliminated such opportunities.

*Lock-in effect.* Capital gains taxes are deferred until assets are sold and gains are realized. As gains accumulate, potential tax liabilities increase and give taxpayers a growing incentive to hold onto assets rather than selling and reallocating funds. This lock-in effect is compounded by estate planning. At death, unrealized capital gains escape income taxation because heirs generally inherit assets with a basis equal to the fair market value at the date of death. As a result, appreciation that occurred during the owner's life is not subject to the income tax. The lock-in effect encourages owners to continue to hold assets that may even earn below-average risk-adjusted returns, because they believe that tax deferral with a substandard return is better than realizing gains and paying taxes in order to reallocate funds.

In farming, the lock-in effect is easily illustrated using land. The average capital gain on farmland purchased in 1966 and held for 30 years equals about four-fifths of the value of the land. As a result, capital gains taxes had approached nearly one-fourth of the sale price before the 1997 act. The effect was to reduce the land available for purchase and to increase land for rent. Because economic rents accrue to asset owners, this is important for the distribution of returns from farming.

Reducing the capital gains tax rate decreases, but does not eliminate, the lock-in effect. Farmers and farm assets may be less responsive because capital assets that are part of an ongoing farm business may be difficult to sell without disrupting production. Farm businesses are also not very mobile, reflected in part by the low turnover of farmland; only about 3 percent is traded at market prices each year (Rogers and Wunderlich). Sellers also face much higher transaction costs than with corporate stock or more liquid assets. Furthermore, about 40 percent of farmland is owned by individuals 65 or older who are consequently better able (and increasingly motivated) to avoid capital gains taxes completely by holding their land until they die. Estate tax provisions that require significant business ownership, such as special use valuation and the new family business exclusion, discourage current owners from selling business assets. Owners with equity can easily access unrealized gains without incurring a tax liability by borrowing against the property.

Nonetheless, a smaller lock-in effect will encourage at least some farmland sales, increasing the supply of land for sale in the short run, as some locked-in assets are sold. While an increasing supply of land could depress prices, increased demand fueled by capital gains incentives will likely more than offset any supply increase. Without changes in other variables that influence land prices, preferential capital gains tax treatment will tend to support farmland prices above what they would have been.

The degree to which lower capital gains tax rates reduce the lock-in effect may be measured by computing the additional rate of return a new investment needs to earn to compensate for realizing capital gains taxes today (Minarik). The premium increases the longer an asset has been owned, the shorter the funds are expected to be reinvested, the higher the income tax rate or the asset's growth rate, and the more likely the asset is to become part of an estate. Premiums drop by more than a fourth (and up to half) in many cases after the 1997 act, but the rate of return required on an alternative investment must still often be more than 1 percentage point greater than the existing return (figure 4).

For many investors, such additional returns may be difficult to achieve in the same asset risk class, although specific parcels or stocks may offer opportunities. Consequently, many long-term landowners will continue to hold land rather than sell, even after the tax reduction offered by the 1997 act.

## Alternative Minimum Tax

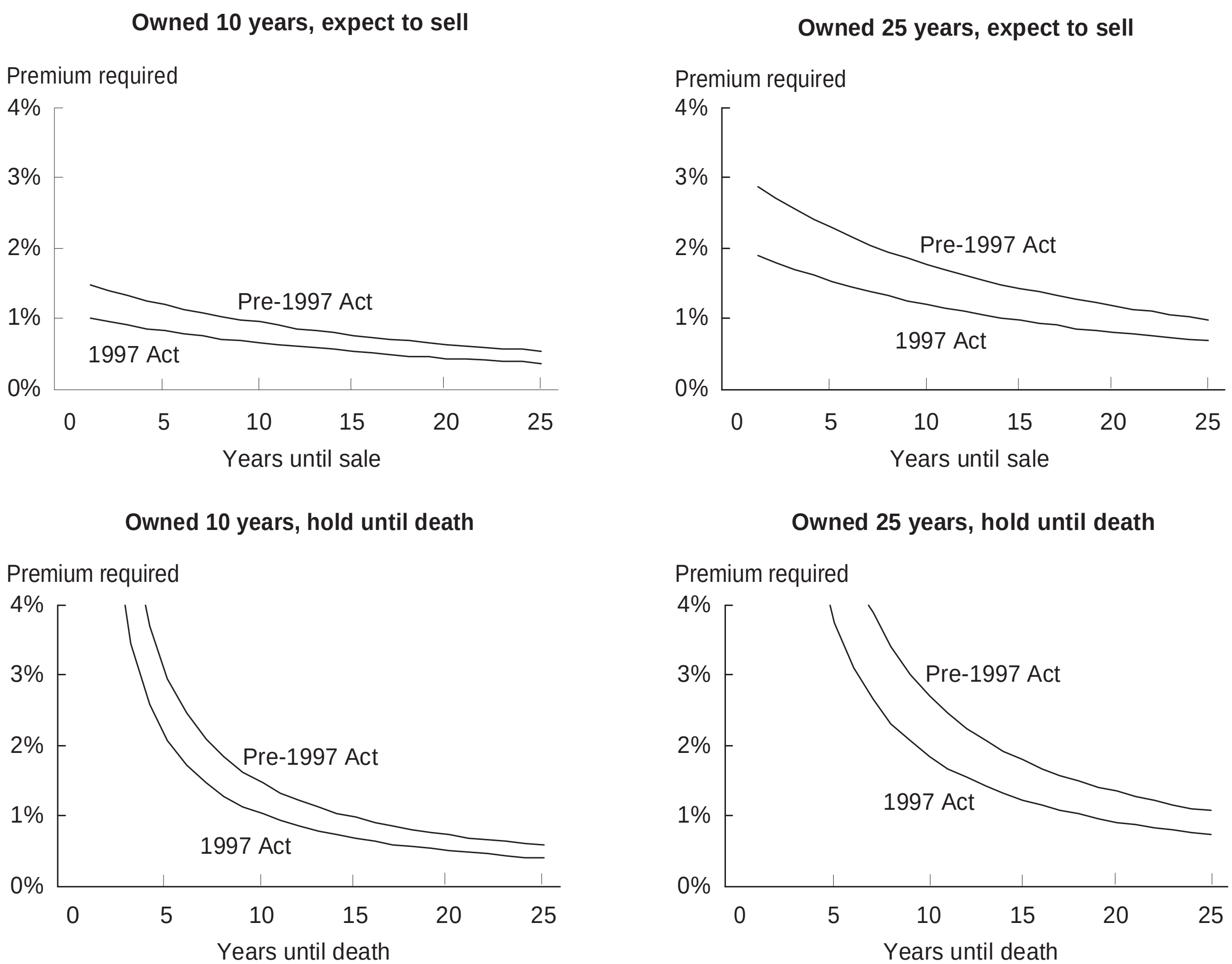
The alternative minimum tax (AMT) is designed to ensure that some Federal income tax is paid by individual and corporate taxpayers who could otherwise use numerous tax deductions or exemptions to reduce substantially or even eliminate their regular income tax. In 1994, 0.6 percent of farm sole proprietors actually paid AMT, although about 10 percent filed the form used to compute the tax. By comparison, only 0.3 percent of nonfarm taxpayers paid AMT in 1994, and only 3 percent filed the AMT form. Over time, AMT has become an increasingly important tax for many taxpayers. The ratio of farmers who paid AMT nearly doubled between 1990 and 1994, although the proportion of farmers filing the AMT form has not changed very much.

The number of taxpayers (including farmers) who pay AMT is projected to increase steadily over the next sev-

Figure 4

**Lowering the capital gains tax rates reduces the premium needed to offset the lock-in effect**

*The premium needed to offset the lock-in effect increases the longer an asset has been owned, especially with plans to hold the asset until death, but decreases into the future.*




Note: the lock-in effect is represented by the premium over the existing return which is required to compensate for realizing capital gains taxes when selling and reinvesting funds in a new asset. Illustrations represent a 28-percent captial gains tax rate before the 1997 act, and a 20-percent rate after the act. The existing asset annually yields a 6 percent capital gain and a 10.5 percent total return, generally representative of average U.S. farmland. For taxpayers in the 15-percent bracket, premiums are roughly half those of taxpayers in the 28-percent bracket.
Source: USDA-ERS simulation.

eral years. This is primarily because the exemption allowed for AMT has not changed over time while other provisions in the tax code are indexed for inflation. As regular tax deductions increase relative to the fixed exemption for AMT, more taxpayers begin to owe AMT depending on their base income, tax bracket, and other deductions.

Several provisions in the 1997 act reduce the effect of the AMT on farmers, small corporations, and other businesses, and prevent the number of affected taxpayers from increasing more than expected because of interactions with other provisions in the act. The act does not address, however, the more fundamental rules in the AMT, which have caused the ratio of affected taxpayers to increase.

### *Deferred Payment Contracts for Farmers*

The 1997 act restores farmers' ability to use deferred payment contracts without being subject to the AMT. Deferred payment contracts allow farmers to deliver farm commodities for sale at a specified price, usually in autumn, with payment deferred until the following year.

Most farmers use the cash method of accounting and have used deferred payment contracts to delay paying income taxes until the following year when payment is actually received. A 1996 IRS ruling which interpreted installment payment provisions in the 1986 Tax Reform Act required that such payments be recognized in the year of sale for AMT purposes. Nearly 10 percent of all farm operators used deferred payment contracts at the end of 1995, deferring an estimated $8.7 billion of income (USDA Farm Costs and Returns Survey). The number of farms potentially subject to the AMT, however, was much smaller. Fewer than 5 percent of all farms, possibly as low as 2 percent, would have been subject to the AMT because of deferred payment contracts. Nonetheless, this would have been a sizeable increase in the number of farmers affected by AMT. Farms using deferred payment contracts are often larger than average and more frequently cash grain farms. Most farms with deferred sales large enough to trigger AMT would have been cash grain farms and moderate-sized farms (as measured by gross receipts, see table 2).

The 1997 act allows farmers to use deferred payment contracts for both regular income tax and AMT purposes. The change is retroactive and applies to deferred sales for taxable years beginning in 1987 and thereafter.

**Table 2—Farms with deferred payment contracts**

| Characteristic | All farms | | Farms with deferred sales[1] | | Possibly subject to AMT prior to the 1997 act[2] | |
|---|---|---|---|---|---|---|
| | *1,000* | *Percent* | *1,000* | *Percent* | *1,000* | *Percent* |
| Number of farms | 2,068 | 100 | 183 | 100 | 34 | 100 |
| Farm type: | | | | | | |
| Cash grain | 389 | 19 | 67 | 37 | 19 | 55 |
| Livestock | 1,193 | 58 | 62 | 34 | 4 | 13 |
| Misc. (cotton, fruit, veg.) | 486 | 23 | 54 | 29 | 11 | 32 |
| Farm business receipts: | | | | | | |
| Under $40,000 | 1,466 | 71 | 60 | 33 | 4 | 12 |
| $40,000 - 250,000 | 479 | 23 | 89 | 49 | 19 | 56 |
| $250,000 and above | 123 | 6 | 34 | 18 | 11 | 32 |
| Farm net worth: | | | | | | |
| < $100,000 | 521 | 25 | 22 | 12 | 2 | 7 |
| $100,000 - 250,000 | 746 | 36 | 51 | 28 | 6 | 18 |
| $250,000 and above | 801 | 39 | 110 | 60 | 26 | 75 |

[1]Presence of positive year-end receivables in deferred sales contracts.

[2]Based on annual net increase in deferred sales exceeding $20,000, derived from preferences and adjustments necessary for typical farm family of four to become subject to AMT.

Source: USDA-ERS Farm Costs and Returns Survey, 1995.

This provision is expected to save farmers an estimated $150 million each year and reduce tax preparation complexities for up to 200,000 farms.

### *General AMT Relief for Businesses*

The act repeals the alternative minimum tax for small corporations for tax years beginning after 1997. A small corporation is defined as one with 3-year average annual gross receipts less than $5 million for the first taxable year after 1996 and with 3-year average gross receipts less than $7.5 million for any subsequent year. This change will allow most farm corporations to avoid the complexities of the alternative minimum tax.

The act also simplifies the AMT depreciation adjustment by eliminating the requirement to use longer recovery periods than are allowed for regular income tax purposes. This provision applies only to property placed in service during 1999 and thereafter. Before the act, the AMT required depreciation to be computed both over a longer period of years and at the slower 150-percent declining balance rate (rather than the faster 200-percent declining balance rate allowed for many other tax computations on nonfarm assets). However, because the regular income tax already requires farm property to be depreciated at the 150-percent declining balance rate, eliminating longer recovery periods for the AMT completely relieves farmers from separately computing depreciation for the regular income tax and the AMT. This will eventually reduce the recordkeeping burden and the number of farms subject to the alternative minimum tax.

### *Adjustment for Capital Gains*

For alternative minimum tax purposes, the capital gains income of individual taxpayers will be taxed at the same rates that apply for regular income tax purposes. Rather than the normal alternative minimum tax rate of 26 percent, capital gain income taxed at 10 percent for regular income tax purposes will be taxed at 10 percent for the AMT, and gains regularly taxed at the 20-percent rate will be taxed at a 20-percent rate. This change is especially important for farmers who report a significant amount of capital gain income. Without this change, the number of farmers subject to the alternative minimum tax would have increased substantially because of the new lower tax rates on capital gains for regular income tax purposes.

## Income Averaging for Farmers

Under a progressive tax rate system, taxpayers whose annual income fluctuates widely may pay higher total taxes over a multiyear period than other taxpayers with similar yet more stable income. This situation poses difficulty for tax equity. Income averaging can mitigate this effect by allowing taxpayers with variable incomes to pay a more constant income tax rate over time. The Tax Reform Act of 1986 eliminated income averaging for all taxpayers. The 1997 act offers farmers another method of income averaging during tax years 1998, 1999 and 2000.

Several recent developments increased the likelihood that many farmers would pay more tax because of income variability. The 1993 introduction of additional, higher tax brackets to the simplified tax structure of the 1986 act increased the potential for some moderate-income taxpayers to pay higher marginal tax rates. Some farmers may also experience more income variability following the decoupling and scheduled phase-out of farm program payments under the 1996 Farm Act. Nonetheless, other existing provisions for farmers reduced the effect of losing income averaging in 1986. Many farmers use cash accounting to prepay business expenses, defer farm income through installment sales, time the rate of capital expense depreciation (including expensing), and delay taxation of income due to weather-related disaster sales of crops or livestock.

Before its repeal in 1986, income averaging was available to both farmers and all other taxpayers who satisfied certain basic requirements. An individual's income must have exceeded 140 percent of the average income in the preceding 3 years. Any excess over $3,000 was taxed at a lower marginal rate. However, because not all of the above-average income was eligible for lower rates, income averaging before 1986 reduced, but did not eliminate, additional taxes.

The new income averaging provision is more restrictive and is available only for farm income. However, it may allow some farmers to avoid higher tax brackets resulting from variable income. Under the 1997 act, a farmer can elect to shift a specified amount of farm income, including gain on the sale of farm assets except land, to the preceding 3 years and pay tax at the rate applicable to each year. The current income shifted back is spread equally among the 3 years. If the marginal tax rate was lower during one or more of the preceding years, a farmer may pay less tax than without income averaging. The election is not restricted to an increase in farm income over previous years, however, and allows a constant or even smaller level of farm income to be shifted even if it is nonfarm income that varies or pushes the farmer into a higher tax bracket. Nonetheless, the new income-averaging provision restricts tax relief primarily to those who rely on farming as their primary source of income and is expected to save farmers about $50 million per year (Joint Committee on Taxation, 1997b).

Compared with tax brackets before the 1986 Tax Reform Act, today's flatter tax rate structure and lower marginal rates require larger changes in income to benefit from income averaging. Restricting income averaging to farm income also reduces the number of farmers who will benefit and the tax savings. Before the 1986 act, about 10 percent of farmers used income averaging and saved, on average, an estimated $800 each. A time series of individual farmers' taxable incomes was not available to evaluate the 1997 act, but a simulation of income variability revealed that only about 7 percent of farmers would benefit from an average tax reduction of about $400 if farm income increased by 50 percent in the short term.

### Livestock Sales Due to Weather-Related Conditions

Selling livestock because of weather-related disasters can also create tax timing problems because unusually large sales may cause marginal tax rates to increase. A special rule has allowed farmers who are forced to sell livestock due to drought to defer recognizing that income until the following year. The 1997 act expands this special treatment to include floods and other weather-related conditions in addition to drought. The change is retroactive to the beginning of 1997 and will therefore be available to farmers who were affected by severe flooding early in the year.

To qualify, the farmer must show that, under normal business practices, the sale would not have occurred during the current tax year and that weather conditions caused the area to become eligible for Federal assistance. The gains realized from selling more breeding or dairy livestock than would normally have been sold can also be deferred by purchasing similar livestock within 2 years.

Farmers' tax savings from this provision, about $2 million annually, are relatively small overall and are highly dependent on the location and severity of weather-related disasters. The small percentage of farmers who qualify, however, may save a relatively large amount of their individual tax burden in any given year. Because the law retroactively applies to floods in early 1997, farmers' tax savings are especially high during fiscal year 1998 and are estimated to be about $12 million (Joint Committee on Taxation, 1997b).

### Suspense Accounts for Large Farm Corporations

Some large family farm corporations may pay higher taxes because they may no longer defer taxes after switching from the cash method of accounting. Family farm corporations are required to change to accrual accounting if their gross receipts exceeded $25 million anytime after 1985. A family farm corporation is one with at least 50 percent of stock held by one family (or, sometimes, by two or three families). Under prior rules, affected corporations were allowed to create suspense accounts, which allowed them to defer taxes on income arising from this accounting change. By deferring taxes, income from the accounting change could remain untaxed until the corporation ceased to be a family corporation or until gross receipts from farming declined. Thus, the tax could be postponed indefinitely.

The act eliminates the ability to establish suspense accounts and requires existing accounts to be systematically added to income over 20 years, but only to the extent of net operating losses or 50 percent of net income. The act also eliminates the requirement that part of the suspense account be added to income if the corporation's gross receipts decline.

This provision affects a small number of very large family farm corporations mostly raising livestock, but also fruit, vegetables, and other crops. Income in existing suspense accounts is estimated to represent a potential tax liability of about $700 million or about $35 million per year over the 20-year period (Joint Committee on Taxation, 1997b). This represents less than 1 percent of gross sales of the affected corporations. Furthermore, since the amount to be included in income each year is limited to the net operating loss of the corporation or one-half of the corporation's net income, the provision should not have a significant impact on the operations of most affected corporations.

## Self-Employed Health Insurance Deduction

The self-employed health insurance deduction is intended to give small business owners, including many farmers, tax benefits similar to employees receiving employer-deductible health insurance. It is especially important for farmers who must purchase insurance on their own. Ever since the deduction was introduced in 1988, nearly two out of every five taxpayers who receive a majority of their income from farming have annually used the self-employed health insurance deduction. One-fifth of taxpayers receiving any income from farming annually use the deduction. This deduction is easier to use than the alternative of deducting health insurance premiums with itemized medical expenses. Itemized medical expenses must exceed 7.5 percent of AGI before becoming deductible – a test that is difficult for many taxpayers to meet. Self-employed health insurance premiums directly reduce AGI at any income level.

In 1997, farmers and other self-employed taxpayers were allowed to deduct 40 percent of the cost of providing health insurance for themselves and their families. Under 1996 legislation, this amount was scheduled to increase to 80 percent by 2006. The 1997 act accelerates the schedule after 1999 and increases the deduction to 100 percent by 2007 (table 3). However, a small fraction of farmers who claim the deduction, about 13 percent, will benefit less because they also itemize medical expenses and will see an offsetting reduction in their itemized deductions.

**Table 3—Self-employed health insurance deduction percentage increases**

| Tax year | Percent of health insurance premium deductible by the self-employed: Pre-1997 act | 1997 act |
|---|---|---|
| | *Percent* | |
| 1997 | 40 | 40 |
| 1998 | 45 | 45 |
| 1999 | 45 | 45 |
| 2000 | 45 | 50 |
| 2001 | 45 | 50 |
| 2002 | 45 | 60 |
| 2003 | 50 | 80 |
| 2004 | 60 | 80 |
| 2005 | 70 | 80 |
| 2006 | 80 | 90 |
| 2007 and thereafter | 80 | 100 |

Source: USDA-ERS, based on Research Institute of America.

The average health insurance premium for farmers claiming the deduction was estimated to be $3,400 in 1997. Therefore, increasing the deduction from 40 percent to 100 percent of the premium will eventually save farmers in the 15-percent bracket about $300 per year in 1997 dollars (or about 9 percent of the premium), assuming no real growth in insurance premiums (an additional 60 percent of $3,400 becomes deductible in the 15-percent bracket). In the 28-percent tax bracket, additional tax savings amount to $570 (or about 17 percent of the premium). Nearly 400,000 self-employed farmers should be able to deduct an increasing amount of the estimated $1.35 billion they pay for health insurance. Combined over all tax brackets, farmers' net cost of buying health insurance will eventually decrease by about $135 million per year in 1997 dollars, or about 10 percent. About one-third of these savings are due explicitly to the 1997 act, with the remainder attributed to scheduled increases in the deduction under prior legislation.

## Net Operating Losses

A net operating loss occurs when business expenses exceed gross income. Before the 1997 act, net operating losses could offset income in other tax years by being carried back 3 years and forward 15 years. The act reduces the carryback period to 2 years and increases the carry-forward period to 20 years for losses arising in tax years beginning after August 1997. Many farmers report losses each year. In 1994 two-thirds of all farm sole proprietors reported a net farm loss (table 4). Some farmers will face a delay until they can use the tax benefit of their net operating losses because they will be carrying losses forward, rather than carrying them back and receiving a refund of taxes already paid. However, the 3-year carryback period is retained for losses in Presidentially declared disaster areas for farmers and other small businesses and for individual casualty losses.

## Child Tax Credit

For many years, taxpayers have been allowed a fixed tax deduction for each dependent, including children. The act increases tax benefits for dependent children by providing a $500 ($400 for 1998) tax credit for each qualifying child under the age of 17. A qualifying child is an individual for whom the taxpayer can claim the dependency exemption and who is a son or daughter of the taxpayer, a stepson or stepdaughter, or an eligible foster child. The amount of the credit is generally limited to the taxpayer's regular income tax liability. However, an additional refundable credit is allowed for taxpayers with 3 or more children. After these taxpayers apply the child credit to regular income tax liability, they may receive the remainder of the credit as a refund to offset other taxes. These other taxes include the total of the employee's share of Social Security taxes plus one-half of the self-employment tax minus any earned income tax credit they receive. The child credit is phased out at a rate of $50 for each $1,000 of modified adjusted gross income greater than $110,000 for married taxpayers filing a joint return and $75,000 for taxpayers filing as single or head of household. The amounts are not indexed for inflation.

The new child tax credit is expected to benefit about one-third of all farmers and their families. The total credit for farmers is estimated to be about $600 million each year, with an average tax credit of about $800. The credit will eliminate Federal income tax liabilities for nearly 20 percent of eligible farm households with children, and reduce or eliminate the employee's share of Social Security/self-employment taxes for about 10 percent of farm recipients.

### *Replacement for Disqualified Earned Income Credits*

The earned income tax credit (EIC) is a refundable tax credit available to low-income workers who satisfy income and other eligibility criteria. Some farm households are disqualified because they receive more investment income than allowed. Individuals are not eligible for the EIC if they report more than $2,200 of "disqualified income," including interest, dividends, and capital gains.

The disqualified income test was enacted in 1996 to deny benefits to families with moderate amounts of investment income. The effect, however, was to disqualify many farmers with capital gains from the routine sale of business assets, especially breeding and dairy livestock that are systematically sold because of old age and low productivity. IRS data suggest that farmers in the Corn Belt, Lake States, and Northeast regions of the U.S. are the most likely to lose EIC benefits. About one-fourth of the farmers who formerly received the EIC are estimated to be disqualified, nearly 10 times the estimated disqualification rate for all recipients. A legislative proposal to allow farmers to sell some business assets without being disqualified did not survive final negotiations over the 1997 act.

Because the refundable child tax credit for families with 3 or more children is reduced by the EIC, some households will receive a greater child tax credit if they lose their EIC due to the disqualified income test. Greater child tax credit refunds will allow more than 11,000 farm households (about one-fourth of EIC-disqualified farmers) to recoup nearly $10 million of the EIC benefits lost because of disqualified income. This is about 15 percent of the total EIC lost by all farmers due to the disqualified income test.

## Individual Retirement Accounts

An Individual Retirement Account (IRA) is a personal investment plan that offers tax advantages to individuals who save for retirement. Prior to the 1997 act, two types of plans were available: deductible and nondeductible. Earnings grow tax deferred in both plans until they are withdrawn. A deductible IRA reduces taxable income in the year the deposit is made by the amount of the contribution, but the deduction may be limited for employees covered by an employer-sponsored pension who have income above some threshold. The deductible contribution remains tax-deferred until it is withdrawn. Nondeductible IRAs are available to all taxpayers with earned income, but do not reduce taxable income. An individual's total contribution to all IRAs is limited annually to the smaller of earned income or $2,000. Distributions before age 59½ are

**Table 4—Farm profits and losses for taxes (1975-94)**

| | Number of farms | | Net farm income[1] | |
|---|---|---|---|---|
| Tax year | Loss | Profit | Loss | Profit |
| | *- Thousands -* | | *- - - $ million - - -* | |
| 1975 | 1,415 | 1,340 | (6,549) | 10,112 |
| 1980 | 1,485 | 1,123 | (11,731) | 9,939 |
| 1985 | 1,729 | 892 | (18,499) | 6,493 |
| 1990 | 1,325 | 996 | (11,829) | 11,395 |
| 1991 | 1,357 | 934 | (12,397) | 9,544 |
| 1992 | 1,392 | 896 | (12,578) | 10,042 |
| 1993 | 1,373 | 899 | (13,141) | 9,474 |
| 1994 | 1,485 | 758 | (15,775) | 8,397 |

[1]For Federal income tax purposes, Schedule F (Profit or Loss from Farming) only. Excludes capital gains and farm rental income by landlords.
Source: USDA-ERS, based on IRS Statistics of Income Bulletin, 1995, 1997.

generally subject to a 10-percent penalty in addition to the taxes due on the amount withdrawn.

The act expands upon these retirement savings incentives. Deductible IRAs become more accessible in two ways. First, individuals who are active participants in employer-sponsored retirement plans can earn more income and still make deductible contributions. The limits increase gradually and eventually double by 2007 for joint returns and by 2005 for individuals (table 5). Second, spouses who are not active participants in employer-sponsored retirement plans, but who are married to active participants, may fully deduct IRA contributions if household income is less than $150,000. Previous legislation phased out a spouse's deduction concurrently with the active participant.

The 1997 act also creates a new, nondeductible "Roth IRA" from which tax-free distributions of earnings may be made if funds are withdrawn after 5 years and the individual has reached age 59½, died, or become disabled. Contributions to any Roth IRA are phased out for couples with AGI more than $150,000 and individuals with more than $95,000. Roth IRAs also have more flexible distribution requirements. Penalty-free withdrawals of contributions may be made before age 59½ or within 5 years because the contribution has already been taxed, but unqualified withdrawals of earnings may be subject to both penalties and taxes. Unlike other IRAs, distributions are not required after age 70½, and contributions may continue to be made.

Taxpayers with AGI less than $100,000 may transfer existing IRAs to Roth IRAs by paying taxes on the taxable rollover value. No penalty is imposed if the entire withdrawal is transferred to the Roth IRA, but this requires paying taxes from another account or from current income. The act, however, allows taxes on transfers made during 1998 to be paid in installments over 4 years.

Income limits are not indexed for inflation, and annual contributions to all IRAs remain limited to a total of $2,000 per individual. (Contribution limits for nonworking spouses increased from $250 to $2,000 in the Small Business Job Protection Act of 1996.) The 1997 act also permits penalty-free distributions from any IRA for higher education expenses and a lifetime limit up to $10,000 of first-time homebuyer expenses. First-time homebuyers are those who have not owned a principal residence for at least 2 years.

Expanded access to deductible IRAs helps only those employees who are covered by employer-sponsored pension plans and their spouses. Yet, about 300,000 additional farm households will become eligible for deductible contributions, based on analysis of the 1992 and 1995 Surveys of Consumer Finances (Federal Reserve Board). Nonetheless, only about 9 percent of farmers annually contribute to an IRA. Farmers, however, are more likely to contribute than nonfarmers, only about 5 percent of whom make annual contributions. Because only a small fraction of taxpayers have used existing IRA options, these new incentives may not significantly increase retirement savings for many families, unless new IRA promotions change saving behavior through investor education.

Roth IRAs and reduced capital gains taxes present new opportunities requiring careful consideration. Both encourage investment, but one may offer greater after-tax returns for different individuals. Investors may prefer particular plans based on marginal tax rates today and in retirement, expected rates of return, tax timing preferences, and withdrawal rules. One may choose the account that yields the greatest amount in retirement after taxes. Another may prefer deductible IRAs for the current tax savings, and others may select Roth IRAs because future earnings are tax-free with no mandatory distribution rules. These tradeoffs are discussed below.

**Table 5—Increased income limits allow participants to deduct more of IRA contributions**

| Tax year | AGI range for phase-out of deductible IRA contribution[1]: Joint return | Single taxpayer |
|---|---|---|
| | *Thousand dollars* | |
| 1997 | 40-50 | 25-35 |
| 1998 | 50-60 | 30-40 |
| 1999 | 51-61 | 31-41 |
| 2000 | 52-62 | 32-42 |
| 2001 | 53-63 | 33-43 |
| 2002 | 54-64 | 34-44 |
| 2003 | 60-70 | 40-50 |
| 2004 | 65-75 | 45-55 |
| 2005 | 70-80 | 50-60 |
| 2006 | 75-85 | 50-60 |
| 2007 and thereafter | 80-100 | 50-60 |

[1]Active participants in employer-sponsored retirement plans.
Source: USDA-ERS, based on Research Institute of America.

The $2,000 annual contribution limit is more restrictive for deductible IRAs than for Roth IRAs (Joint Committee on Taxation, 1997a). Contributions to Roth IRAs are made with after-tax dollars, allowing investors to allocate more than $2,000 of pretax income to retirement savings. On the other hand, contributions to deductible IRAs are made with pretax dollars, limiting the total pretax retirement allocation to $2,000. Therefore to make a fair comparison of the future after-tax balance across IRA choices, a $2,000 contribution to a Roth (or nondeductible) IRA equals a $2,000 contribution to a deductible IRA plus a deposit to a regular taxable account equal to the tax savings from the deductible contribution.

Because of the tax savings, Roth and deductible IRAs clearly offer greater after-tax returns than nondeductible IRAs and regular taxable accounts (table 6 and Appendix B). Deductible IRAs are usually preferred if marginal tax rates are expected to fall substantially in retirement. Roth IRAs are better if tax rates are expected to rise. The choice is less clear when the marginal tax rate is expected to remain the same in retirement as today. If an investor is not constrained by the $2,000 limit, Roth and deductible IRAs yield the same value after taxes. However, if the investor is constrained (can allocate more than $2,000 of pretax income), the Roth IRA yields a greater future value unless tax rates fall in retirement.

Nondeductible IRAs never return more than Roth or deductible IRAs, but they may still be preferred to a regular taxable account when investors do not qualify for any other IRA. However, if investors are concerned with an IRA's distribution restrictions, regular taxable accounts are increasingly competitive because of lower capital gains tax rates. In fact, if capital gain returns are relatively larger than current returns and no interim gains are realized, regular taxable accounts may yield more after taxes than nondeductible IRAs. Any advantage of a regular account decreases, however, with longer holding periods when any of the return is a dividend or interest which can grow tax-deferred in an IRA.

**Table 6—Future value after taxes of retirement plans under several tax scenarios**

| | Marginal tax rate scenario | | |
|---|---|---|---|
| Type of account[1] | Same today and in retirement | Higher in retirement | Lower in retirement |
| Tax rate today, $t_0$ | 28% | 15% | 28% |
| Tax rate retire, $t_W$ | 28% | 28% | 15% |
| Capital gains tax, $t_G$ | 18% | 18% | 8% |
| | | *Dollars* | |
| **Not constrained by $2,000 IRA contribution limit** ($1,000 pretax available) | | | |
| 1. Roth IRA | ***3,008*** | ***3,551*** | 3,008 |
| 2. Deductible IRA | ***3,008*** | 3,008 | ***3,551*** |
| 3. Nondeductible IRA | 2,367 | 2,794 | 2,664 |
| 4. Regular taxable account | *2,411* | *2,847* | 2,561 |
| **Constrained by $2,000 IRA contribution limit[2]** | | | |
| 1. Roth IRA | ***8,354*** | ***8,354*** | 8,354 |
| 2. Deductible IRA portfolio | 7,891 | 7,020 | ***9,093*** |
| 3. Nondeductible IRA | 6,575 | 6,575 | 7,401 |
| 4. Regular taxable account | *6,698* | *6,698* | 7,114 |

[1]Simulation assumes a 15-year investment horizon, 10-percent nominal annual total rate of return (7-percent capital gain, 3-percent current return), and reinvested dividends. Bold italics indicate the maximum of the four accounts. Italics indicate when the regular taxable account exceeds the nondeductible IRA.

[2]For a fair comparison, the $2,000 limit on a Roth (or nondeductible) account equals a $2,000 deductible IRA contribution plus a deposit to a regular taxable account equal to the tax savings. The pretax amount is $2,778 in the 28-percent tax bracket; $2,353 in the 15-percent bracket.

Source: USDA-ERS simulation.

## Education Incentives

The act creates two new nonrefundable tax credits for post-secondary education. A Hope Scholarship Credit of up to $1,500 (all of the first $1,000 and 50 percent of the next $1,000) is allowed for each student's tuition and related expenses during the first 2 years of college. A 20-percent Lifetime Learning Credit up to $1,000 annually ($2,000 after 2002) is available for a taxpayer's tuition and related expenses for an unlimited number of years. Student loan interest may also be deducted (up to $1,000 in 1998, $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001 and thereafter). The act allows nondeductible contributions of up to $500 per child to a so-called Education IRA. Distributions from such accounts for qualified higher education expenses are tax free. All education incentives are reduced for high-income taxpayers (for joint returns, phase-outs begin for the credits when AGI exceeds $80,000, interest deductions when AGI exceeds $60,000, and Education IRAs when AGI exceeds $150,000). The credits and deductions are not indexed for inflation, but phase-out triggers that are based on income will be indexed for inflation. Because college students have tended to come from households with above average incomes, these incentives will be unavailable to a higher proportion of students than aggregate income distributions would suggest. On the other hand, the incentives will tend to help more students from middle- and lower-income households to attain post-secondary education. Farmers and other rural residents, especially those with children at or near college age, will benefit along with other taxpayers.

### Earned Income Tax Credit

The earned income tax credit (EIC) is a refundable tax credit available to low-income workers who satisfy certain income and other eligibility criteria. The EIC is phased out if earned income or modified adjusted gross income exceeds a specified threshold amount. In determining modified adjusted gross income, certain losses, including a fraction of farm business losses, are disregarded.

The 1997 act adds two new nontaxable items in determining adjusted gross income used for phasing out the benefits of the earned income tax credit. These items include tax-exempt interest and the nontaxable portion of any pension, annuity, or distribution from an individual retirement account. The new law also increases the amount of business losses, including farming, that is disregarded from 50 percent to 75 percent. This change reduces EIC benefits and will have a disproportionate effect on farmers because over half of all farmers report a net loss each year.

### Welfare-to-Work and Work Opportunity Tax Credits

The act contains a new welfare-to-work tax credit to provide employers an incentive to hire long-term public assistance recipients. The credit is equal to 35 percent of qualified first-year wages and 50 percent of qualified second-year wages. Wages are broadly defined to include not only actual wages but educational assistance covered by the tax exclusion for employer-provided tuition assistance, health plan coverage, and dependent care assistance. The credit applies to the first $10,000 of wages per year, resulting in a maximum credit of $8,500 for the 2 years. An eligible employee must be certified as a long-term family assistance recipient by a State employment security agency. The new credit applies to employees who begin working after December 31, 1997, and before May 1, 1999. In addition to tax savings from the welfare-to-work credit, businesses also remain eligible for the regular tax deduction for wages paid to employees. However, no deduction is allowed for the portion of wages and salaries paid that is equal to the amount of the welfare-to-work credit for that year. For most profitable businesses hiring a targeted employee, the credit and allowable deduction will reduce the after-tax cost of the first $10,000 per year in wages to less than $4,000 on average for the two years (total wages eligible for the credit over 2 years of $20,000, less $8,500 in welfare-to-work tax credits, less the tax reduction from deducting $11,500 at a marginal tax rate of 31 percent).

The work opportunity tax credit encourages employers to hire employees from certain targeted groups. The credit was scheduled to expire on September 30, 1997, but was extended for 9 months through July 1, 1998. The act also expanded the number of target groups to eight by adding a group for qualified supplemental security income (SSI) recipients. The rate of the credit was also changed from a flat 35 percent to 25 percent of wages for employment greater than 120 hours but less than 400 hours, and to 40 percent of wages for employment over 400 hours. The credit is available on up to $6,000 of wages paid during the first year of employment. Since the credit rate is higher for wages paid for employment over 400 hours, the maximum credit under the new law may increase or decrease for individual employers depending on the proportion of wages eligible for the 40-percent rate.

### Designation of Additional Empowerment Zones

The Omnibus Budget Reconciliation Act of 1993 provided for the establishment of nine empowerment zones, including three in rural areas. These zones were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations. Eligible businesses in the zones qualified for a 20-percent wage credit, an additional $20,000 of capital expensing, and special tax-exempt financing. This first round of zones also received grant money along with the tax incentives.

The 1997 act authorizes the Secretaries of HUD (Housing and Urban Development) and Agriculture to designate an additional 20 empowerment zones — no more than 15 in urban areas and no more than 5 in rural areas. Thus, the number of rural empowerment zones will increase from three to eight. For the new zones, qualified enterprise zone businesses are eligible to receive up to $20,000 of additional expensing of capital investment and to use special tax-exempt financing. The act also makes it easier to qualify because it expands the eligibility criteria for the designation of the empowerment zones and changes the definition of a qualifying enterprise zone business. However, the businesses are not eligible for the wage credit or grant money that were available to businesses in the earlier designated empowerment zones.

New zones must satisfy different eligibility criteria than existing zones. The new poverty criteria require that the poverty rate be at least 20 percent for each population census tract within the nominated area and the poverty rate be at least 25 percent for 90 percent or more of the population census tracts. The requirement for previous zones that at least half of the tracts had 35-percent poverty rates was dropped for the new zones. A census tract with fewer than 2,000 people is treated as satisfying the 25-percent test if more than three-fourths of the tract is zoned for commercial or industrial use and the tract is adjacent to at least one tract that has a poverty rate of at least 25 percent.

Finally, the Secretary of Agriculture may designate one empowerment zone in a rural area without regard to the poverty rate, if the area satisfies emigration criteria specified by the Secretary of Agriculture. The poverty rate test also does not apply to three or more parcels that may be developed for commercial or industrial use. The total area for this exception cannot exceed 2,000 acres.

The size of a rural zone must be smaller than 1,000 square miles. However, if a population census tract in a rural area exceeds 1,000 square miles or includes a substantial amount of land owned by the Federal, State, or local government, the excess area or the government-owned land can be excluded.

The act authorizes new empowerment zone facility bonds that are not subject to the State private activity bond volume caps or the dollar limits on the amounts available to any person. The aggregate face amount of bonds that may be designated with respect to any rural empowerment zone cannot exceed $60 million. The new zones are to be designated before 1999 and will remain in effect for 10 years.

## Estate and Gift Tax Provisions

The Federal estate tax is not levied on current economic activity, but is a “lump sum” tax at death on the decedent’s accumulated wealth, including unrealized capital gains. The number of farms and other estates that paid Federal estate taxes rose from about 19,000 in 1988 to nearly 32,000 in 1995. Estate taxes are especially important for farmers and other small business owners who hold significant amounts of wealth in business assets, as they are more likely to be subject to estate taxes. In planning for estate taxes, owners of farms and other small businesses may divert funds from business investment to provide liquidity to pay estate taxes. Without such planning, heirs may need to borrow money or sell business assets to pay estate taxes.

The act makes several changes to Federal estate and gift tax laws, especially for farmers. The most important changes include an increase in the unified credit, a new exclusion for farms and other family-held businesses, and reduced interest rates on the installment payment of estate taxes. While these provisions provide significant tax reductions, some changes, especially the family business exclusion, add considerable complexity to the Federal estate tax. Farm estates are expected to save over $150 million of the estimated $500 million paid annually. The number of taxable farm estates will be reduced by about 40 percent (Durst and Monke).

Estimates in the following sections of affected farmers and their estate tax savings were based primarily on simulations with the 1995 Farm Costs and Returns Survey (USDA) after applying mortality rates based on the operator’s age (see Appendix A).

### Increased Unified Credit

One of the most important factors in determining the percentage of estates subject to the Federal estate tax is the size of the unified credit, which is a tax credit applicable to both estate and gift taxes. Since 1987, the credit has remained unchanged at $192,800, which shelters an estate of $600,000. As a result, the real value of the credit has declined by about one-third, and an increasing percentage of estates have been required to file tax returns and pay taxes. This is especially important for farmers.

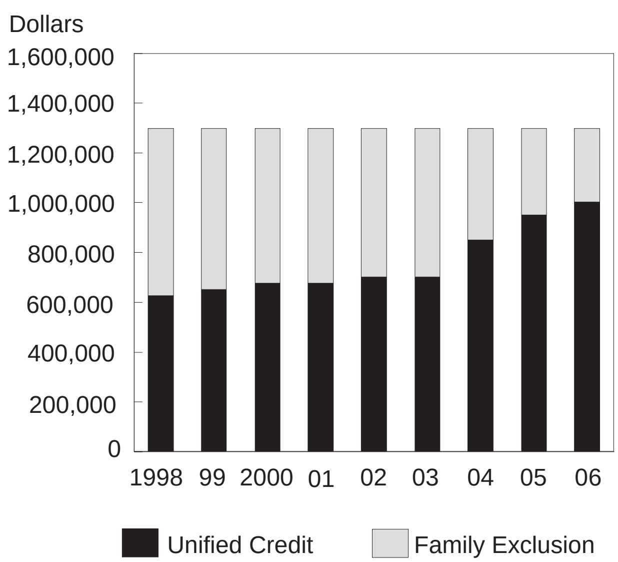
A larger share of farmers compared with other taxpayers continue to be subject to the Federal estate tax. An estimated 6 percent of farm estates currently owe Federal estate and gift taxes compared with just over 1 percent of all estates. The act gradually increases the credit to shield $1 million from estate taxes by 2006. Increasing the unified credit will reduce both the number of farmers required to file an estate tax return and those that owe Federal estate tax. However, due to the relatively slow phase-in through 2003, most of the benefits will be realized in 2004 and beyond (figure 5).

Farmers who are not eligible for the new exclusion for family-held businesses (see below) will benefit from lower taxes as a result of the increased unified credit. However, due to the combined cap of $1.3 million on benefits from the new exclusion and the unified credit, the primary benefit to farmers eligible for the exclusion will be an increase in the filing threshold. Currently, about 15 percent of all farmers are required to file a return. As a result of the increase in the unified credit and the filing threshold, that percentage should gradually decline through 2006.

### Exclusion for Qualified Family-Owned Businesses

Beginning in 1998, the act creates an exclusion for the first $675,000 of value in qualified family-owned business interests. The exclusion is in addition to any benefits from special use valuation and the unified credit. The total amount excludable from this provision and the unified credit is limited to $1.3 million. Thus, as the amount exempted by the unified credit increases, the exclusion for farms and closely-held businesses declines to $300,000 by 2006 and thereafter (figure 5).

Figure 5
**Unified credit and family business exclusion amount**




A qualified family-owned business interest is any stake in a business with its principal place of business in the United States in which one family owns at least 50 percent of the business, two families own at least 70 percent, or three families own at least 90 percent, as long as the decedent's family owns at least 30 percent. To be eligible for the exclusion, such interests must comprise more than 50 percent of a decedent's estate, the decedent or a member of the family must have owned and materially participated in the business for at least 5 of the 8 years before death, and each qualified heir or a member of the heir's family must materially participate in the business for at least 5 of each 8-year period ending within 10 years after the decedent's death. The benefits from the exclusion will be recaptured if the qualified heir ceases to meet the material participation requirements, disposes of the business interest other than to a family member or through a qualified conservation contribution, loses U.S. citizenship, or the principal place of business moves outside the United States. These targeting provisions are extremely complex and contain many pitfalls for the uninformed taxpayer. Qualifying for the new exclusion will require careful planning, further increasing the administrative burden and expense.

The number of taxable farm estates declines by about 40 percent from the combined exclusion for farms and other family-owned businesses and the increased unified credit. The total estate tax paid is expected to drop by about $150 million, or about one-third (Maxwell). This new exclusion along with the ability to continue to use special use valuation and other changes to the Federal estate tax provisions should reduce, if not eliminate, the need to sell farm assets to pay Federal estate taxes, especially for continuing businesses.

### Installment Payment for Closely Held Businesses

Federal estate and gift taxes generally must be paid within 9 months of the date of death. However, when at least 35 percent of an estate is a farm or closely held business, estate taxes could be paid over an additional 14-year period with only interest due for the first 4 years. The interest rate on taxes due on the first $1 million in value of qualifying assets was 4 percent. For amounts above $1 million, the rate was the normal rate applicable to underpayments of tax. Interest paid on deferred estate taxes was deductible for either estate or income tax purposes but when deducting for estate tax purposes, the deduction requires that the installment payments be recalculated each year.

The 1997 act lowers the interest rate on the first $1 million in taxable value (above amounts exempted by the unified credit and other exclusions) of the farm or other closely held business to 2 percent. The interest rate on amounts above $1 million in taxable value is reduced to 45 percent of the rate applicable to underpayments of tax. However, the interest will not be deductible for either estate or income tax purposes. Estates currently making payments under the installment payment provision can elect to give up future interest deductibility in exchange for the lower interest rates.

Changes to the installment payment provision will reduce both the interest expense and the administrative burden associated with installment payments. The amount of estate tax eligible for the 2-percent interest rate will increase from $153,000 to $435,000 by 2006 for an estate eligible only for the unified credit (figure 6). As a result, a $2-million estate qualifying for the installment payment provision would have the present value of its tax cut in half compared with an estate required to pay Federal estate taxes in full within 9 months of death (Maxwell). This change and the increase in property that can be transferred tax-free should greatly reduce the liquidity problem that some farm heirs might otherwise experience because of Federal estate taxes.

## Adjusting for Inflation

Beginning in 1999, the $10,000 annual exclusion for gifts, the $750,000 cap on the reduction in value under special use valuation, and the $1,000,000 ceiling on the value of a closely held business eligible for the special low interest rate under the installment payment provision will be indexed for inflation. The values of these provisions have not been changed for several years. As a result, their real value has declined significantly. While indexing will not restore the loss in value, it will maintain the real value at current levels.

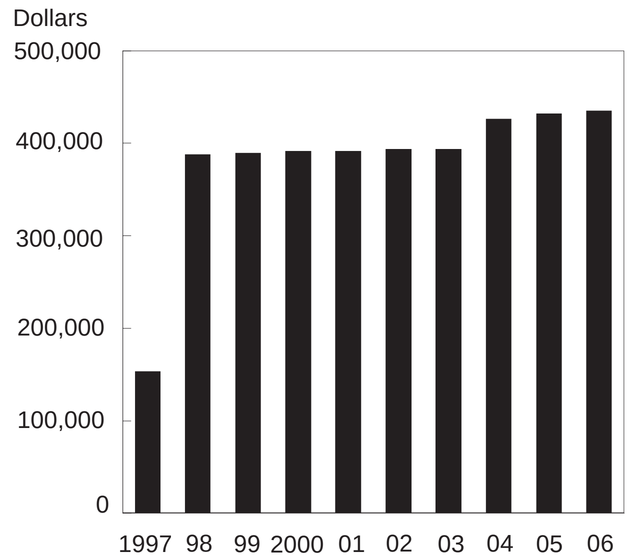
## Cash Lease of Special Use Value Property

For estate tax purposes, most assets are valued at the fair market value at the owner's death. For many years, however, farmers have used special use valuation to treat qualified farm and ranch property at its value for agricultural purposes. The reduction in value is limited to $750,000. To qualify, at least 25 percent of the estate must be farm real estate, and at least 50 percent must be farm real estate and personal property. In addition, the property must pass to a qualified family member and both the decedent and the heir must satisfy certain business participation requirements.

While the reduction depends upon the individual property, in recent years this provision has reduced the average value of eligible farmland and buildings for Federal estate tax purposes by nearly 50 percent.

Property valued under the special use valuation provision must remain in its qualified use for a period of 10 years to avoid the recapture of all or part of the estate tax savings. Some courts have held that a cash rental of specially valued property even to a family member was not a qualified use, since the heir no longer bears the financial risk of farming the property. As a result, the recapture of estate taxes was triggered. A special rule allowed a surviving spouse to cash-rent to a family member without triggering recapture.

Figure 6
**Estate tax installment payment amount eligible for low interest rate**



The act allows a lineal descendant of the decedent to cash-rent specially valued property to a family member of the lineal descendant without triggering recapture of estate tax as long as the family member continues to operate the farm. The provision is retroactive and applies to cash rentals occurring after December 31, 1976 (the effective date of special use valuation). This extends the ability to cash-rent farmland on which special use value has been elected (currently available only to surviving spouses) to other qualifying heirs. It also provides greater flexibility for certain heirs under the special use value provision, yet remains consistent with the objective of restricting benefits to those families that continue to be involved in farming. The cash lease provision reduces estate taxes by about $2 million per year; the retroactive portion of the provision allows an estimated $25 million of tax relief covering 1976-97 (Joint Committee on Taxation, 1997b).

### Exclusion for Land Subject to Conservation Easement

A deduction is currently allowed for Federal estate and gift tax purposes for a contribution of a qualified real property interest to a charity or other qualifying organization exclusively for conservation purposes. A qualifying real property interest includes a perpetual restriction or easement on the use of real property. A conservation purpose is defined as (1) the preservation of land for the general public's outdoor recreation or education, (2) the preservation of a natural habitat, and (3) the preservation of open space for the scenic enjoyment of the general public or in furtherance of a governmental conservation policy.

In addition to the current deduction for the value of the conservation easement, the act provides for an exclusion of up to 40 percent of the value of the land subject to a qualified conservation easement and located within 25 miles of a metropolitan area, a national park, or wilderness area, or within 10 miles of an Urban National Forest. The land must have been owned by the decedent or a member of the decedent's family for at least 3 years before the date of death and the contribution must have been made by the decedent or the family. Debt-financed property is eligible for the exclusion only to the extent of the net equity in the property. Granting a qualified conservation easement is not treated as a disposition that would trigger the recapture of special use valuation benefits, and the existence of a qualified conservation easement does not affect eligibility for special use valuation. The exclusion is based on the value of the property after the conservation easement is placed, and does not include any retained development rights to use the land for any commercial purpose except farming. If the value of the conservation easement is less than 30 percent of the value of the land for purposes of the exclusion, then the exclusion percentage is reduced 2 percentage points for each percentage point below 30 percent. The maximum exclusion is limited to $100,000 in 1998 and increases to $500,000 in 2002 and thereafter.

This new exclusion will provide additional incentives to donate a conservation easement within the designated areas. However, given the increase in the unified credit and the new exclusion for family-owned businesses, the number of landowners who are subject to the Federal estate tax and who would benefit from the additional exclusion may be relatively small. Geographic targeting of conservation easements will also limit the pool of potential donors. Nonetheless, farmers and other landowners are projected to save about $50 million per year after the exclusion reaches its maximum amount in 2002 (Joint Committee on Taxation, 1997b).

## Conclusions

The Taxpayer Relief Act of 1997 will allow most farmers to pay less Federal income tax and farm families to transfer farms across generations more easily. In the aggregate, farmers are expected to save about 10 percent of the $16 billion they pay in Federal income taxes each year, and over 30 percent of the $500 million they pay in estate taxes.

Farmers are the sole beneficiaries of several specific income tax provisions addressing income fluctuations. These provisions include preventing deferred payment contracts from causing alternative minimum tax liabilities, income averaging, and deferring the gain on weather-related livestock sales. These changes may be very valuable for individual farmers, yet the aggregate tax saving from these three provisions, just over $200 million annually, is relatively small compared with other tax law changes.

Lower capital gains tax rates provide the greatest tax savings for farmers – nearly $725 million annually. Even though taxes are only a contributing factor determining farmland prices, lower capital gains tax rates should tend to expand agricultural investment and support farmland prices. However, tax shelter opportunities are still relatively smaller and harder to achieve than before the Tax Reform Act of 1986. Lower capital gains taxes reduce the lock-in effect and encourage asset turnover, but estate planning concerns will continue to keep many assets locked in because unrealized capital gains continue not to be subject to income taxes at death.

Other provisions reduce farmers' income taxes by increasing the self-employed health insurance deduction, expanding incentives to save for retirement and education, and creating new tax credits for children and education. The new child tax credit, the provision with the greatest savings for all taxpayers, provides the second highest tax savings for farm households – about $800 on average and $600 million overall. Some rural areas will benefit from new empowerment zones.

Federal estate tax relief is especially important for farmers and other small business owners who hold significant amounts of wealth in business assets. The act substantially increases the size of farms or other small businesses that can be transferred tax free and makes important changes to special valuation and installment payment provisions. These changes will make it easier to transfer the family farm across generations by reducing the likelihood that the farm or some of its assets will need to be sold to pay estate taxes.

Because nearly all the provisions are targeted and have phase-outs for taxpayers with incomes exceeding various levels, much of the tax savings comes at the expense of added complexity in the tax code. A few provisions, however, will simplify tax preparation and recordkeeping, such as for capital gains on principal residences, the alternative minimum tax for farmers and small businesses, and the unified estate tax credit.

## References


Burman, Leonard E., and Peter D. Ricoy. "Capital Gains and the People Who Realize Them," *National Tax Journal*, Vol. 50, no. 3 (Sept. 1997): 427-451.

Congressional Budget Office. *Indexing Capital Gains.* Washington, DC: U.S. Congress, Aug. 1990.

Davenport, C., M.D. Boehlje, and D.B. Martin. *The Effects of Tax Policy on American Agriculture.* U.S. Dept. Agr., Econ. Res. Serv., AER-480, 1982.

David, Martin. *Alternative Approaches to Capital Gains Taxation.* Washington, DC: Brookings Institution, 1968.

Durst, R., and J. Monke. "The Changing Tax Burden of Farmers," in *Agricultural Income and Finance: Situation and Outlook*. U.S. Dept. Agr., Econ. Res. Serv., AIS-68, Feb. 1998, p. 33-38.

Federal Reserve Board of Governors. *Survey of Consumer Finances*. Washington, DC, various releases.

Internal Revenue Service, Statistics of Income Division. *Statistics of Income Bulletin*, 1995, 1997.

Internal Revenue Service, Statistics of Income Division. IRS Individual Public Use Tax Files, various releases.

Long, James E. "Farming the Tax Code: The Impact of High Marginal Tax Rates on Agricultural Tax Shelters," *American Journal of Agricultural Economics*. Vol. 72(1990): 1-12.

Maxwell, Douglas L. "How Would Proposed Changes in Federal Estate Taxes Affect Farmers?" in *Issues in Agricultural and Rural Finance.* U.S. Dept. Agr., Econ. Res. Serv., AIB-724-08, June 1997.

Minarik, Joseph. "Capital Gains" in *How Taxes Affect Economic Behavior*, Henry Aaron and Joseph Pechman, eds. Washington, DC: Brookings Institution, 1981.

Research Institute of America. *RIA's Complete Analysis of the Taxpayer Relief Act of 1997*. New York, 1997.

Rogers, Denise and Gene Wunderlich. *Acquiring Farmland in the United States*. U.S. Dept. Agr., Econ. Res. Serv., AIB-682, Sept. 1993.

U.S. Congress, Joint Committee on Taxation. "Description and Analysis of Tax Proposals Relating to Individual Savings and Retirement Accounts," JCS-2-97. March 1997.

U.S. Congress, Joint Committee on Taxation. "Staff Summary of the Impact of Tax Cuts and Estimated Budget Effects of Revenue Provisions in HR 2014," JCX-39-97. July 30, 1997.

U.S. Department of Agriculture, Economic Research Service. Farm Costs and Returns Survey. Washington, DC, 1995.

# Glossary

*Accrual method of accounting* - a set of rules that requires taxpayers to report inventories and consequently recognize income and expenses as production or economic performance occurs. See also cash method of accounting.

*Adjusted gross income (AGI)* - the total of all taxable sources of income, minus adjustments for contributions to tax-advantaged retirement plans or medical savings accounts, and payments for moving expenses, one-half of the self-employment tax, self-employed health insurance, and alimony.

*Alternative minimum tax (AMT)* - a tax designed to ensure that some Federal income tax is paid by both individuals and corporations who could otherwise use many tax deductions or exemptions to reduce substantially or eliminate their regular income tax.

*Capital gains* - profits from selling assets such as stocks, bonds, real estate, and certain business assets. If an asset is sold for more than its purchase price (basis), the difference is a capital gain. If the sale price is less than the purchase price, the difference is a capital loss.

*Cash method of accounting* - a set of rules that allows taxpayers to report income when revenue is actually received, and expenses when payment is actually made. Taxes may be reduced by delaying income receipts and prepaying expenses. See also accrual method of accounting.

*Depreciation* - the gradual consumption of an investment in buildings, machinery or equipment. Depreciation reduces taxable income during the recovery period by treating part of the cost of an investment as a business expense. Various tax rules have allowed several different methods to accelerate depreciation over shorter recovery periods than the actual expected life of the asset.

*Earned income credit (EIC)* - an income tax rebate program that can also provide a positive income transfer. The EIC is an incentive for low-income taxpayers to earn additional income rather than seek welfare benefits. The credit increases with income to a maximum amount based on the number of children, but is eventually phased out as the taxpayer's income becomes less likely to be considered low.

*Farm* - in this report, any establishment that for Federal income tax purposes includes Schedule F (Profit or Loss from Farming) when filing an individual income tax return as a sole proprietor, or reports gross farm income as a partnership or corporation.

*Individual retirement account (IRA)* - a personal savings plan with tax advantages designed to encourage taxpayers to save for retirement. Most individuals may contribute up to $2,000 annually. Depending on the type of account, taxes may be deferred on the contribution and earnings may accumulate either tax-deferred or tax-free.

*Marginal tax rate* - the tax rate on the highest (or last) unit of income. Under a progressive tax system, marginal tax rates increase with income. For individuals in the United States, current Federal marginal tax rates on ordinary income range from 15 percent to 39.6 percent.

*Nominal value (or nominal rate of return)* - the value (or rate of return) observed in current denominations, often reported on financial or tax records.

*Real value (or real rate of return)* - the value (or rate of return) after being adjusted for inflation; real value is used in economic analysis to measure actual purchasing power over time. Real equals nominal minus inflation.

*Special use value* - for estate tax purposes, the value of qualified farm and ranch property for an agricultural activity, rather than the property's fair market value, which may be greater because of development potential.

*Tax credit* - a dollar-for-dollar reduction in the amount of taxes owed. The value of a tax credit is the same no matter the taxpayer's income or marginal tax bracket and, therefore, contributes to the progressive tax rate structure. See also tax deduction.

*Tax deduction* - a reduction in taxable income that, in turn, reduces the amount of taxes owed. The value of a tax deduction varies with the taxpayer's marginal tax bracket and is worth more to upper-income taxpayers who are subject to higher tax rates. See also tax credit.

*Taxable income* - the amount that determines the regular income tax. It equals Adjusted Gross Income minus personal exemptions and either the standard deduction or itemized deductions.

*Unified credit* - a tax credit that shelters a fixed amount from estate and gift taxation, effectively eliminating some of the lower brackets in the estate and gift tax rate schedule.

# Appendix A

# Data and Methodology

## Income Tax Provisions

By using the IRS Individual Public Use Tax File (IRS), most income tax provisions were able to be simulated separately by modeling the effects of the new tax policy on each observation's reported income and deductions. Adjustments for inflation were made as appropriate. The estimates are considered to be additive because most changes do not create large interactions with other provisions and most taxpayers are not affected by phase-outs. Where important interactions exist, they are noted in the text (such as the interaction between the alternative minimum tax and other provisions, or the child tax credit and the earned income credit). Some estimates were also obtained from published sources such as the Statistics of Income Bulletin (IRS) and the Joint Committee on Taxation, as noted in the text. Additional information on farmers' use of deferred payment contracts was compiled from the Farm Costs and Returns Survey (USDA). Farmers' participation in retirement saving plans was supplemented by data collected in the Survey of Consumer Finances (Federal Reserve Board).

The IRS Individual Public Use Tax File is a stratified probability sample of individual income tax returns. It contains a large number of variables from various tax forms. IRS screens the data thoroughly before releasing the public use file by omitting many variables (such as any identification information) and blurring other variables by averaging data with similar returns. In recent years, the annual sample includes nearly 100,000 observations, which can be weighted to represent over 115 million tax returns. Each file contains about 6,000 farm observations, which represent the population of about 2 million farm sole proprietorships. This subset includes private farmers and materially-participating landlords who file Schedule F, but excludes corporate farms and some types of partnerships (although farms with Schedule F may also report income from farm partnerships). High-income returns (measured by adjusted gross income) are sampled more frequently (and are subsequently weighted less heavily) than low-income returns.

## Estate Tax Provisions

Estimates of the number of farmers affected by the estate tax provisions, and the change in their estate tax liabilities, were based primarily on simulations using data in the 1995 Farm Costs and Returns Survey (USDA). The probability that the operator would leave an estate was determined by applying mortality rates based on the operator's age. The survey is a stratified sample of farms with detailed financial information on both farm and nonfarm assets. Eligibility for special use valuation and the family business exclusion is based strictly on the current balance sheet because no information was available to predict the future of the farm operation. Therefore, estimates generally represent the maximum available because some farmers may not meet participation requirements or use available provisions (Maxwell). Some estimates were also drawn from reports by the Joint Committee on Taxation, as noted in the text.

# Appendix B

## Formulas for Individual Retirement Accounts

The formulas shown below compare future values after taxes of a single deposit for four different types of retirement savings accounts. These were used to compute the results presented in table 6 and may be helpful for visualizing differences among tax provisions. Formulas for the three IRAs are based on a comparison developed by the Joint Committee on Taxation (1997a) but are adapted for use in this report. Interest or dividends are assumed to be reinvested, and capital gains are not realized until the end of the period.

Each formula begins with the amount of pretax income, A, needed to make the actual deposit. The annual total nominal rate of return, r, equals the current rate of return, c, plus the capital gains rate of return, g. The investment horizon ends when funds are withdrawn in n years, sometime during retirement. The marginal tax rate today is $t_0$, the expected tax rate in retirement is $t_W$, and the capital gains tax rate in retirement is $t_G$. All rates of return and taxes are expressed in decimal form. The variable z equals the total annual rate of return after taxes are subtracted from current income, $z=c(1 - t_0)+g$.

When the marginal tax rate does not change ($t_0=t_W$) and the contribution is not constrained (A<$2,000), the first two formulas become identical and show how a Roth IRA can yield the same amount as a deductible IRA. The formula for the nondeductible IRA incorporates tax-deferred growth with taxation on the final earnings, whereas the formula for the regular taxable account includes ongoing taxation of current income and taxation of the capital gain only at the end of the horizon.

| Type of account | Future value of a single deposit, after taxes | Pre-tax contribution limit |
|---|---|---|
| Roth IRA | $A (1 - t_0) (1 + r)^n$ | $A < 2000 / (1 - t_0)$ |
| Deductible IRA | $A (1 + r)^n (1 - t_W)$ | $A < 2000$ |
| Nondeductible IRA | $A (1 - t_0) [(1 + r)^n - t_W ((1 + r)^n - 1)]$ | $A < 2000 / (1 - t_0)$ |
| Regular taxable account | $A (1 - t_0) [(1 + z)^n - t_G [((1 + z)^n - 1) g / z ]]$ | (none) |