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How Would Fundamental Tax Reform Affect Farmers?

Proposals to replace the existing Federal income tax with either a flat tax on income or a Federal retail sales tax would represent a dramatic shift in Federal tax policy. Following a transition period, farmers would likely experience a reduction in compliance costs due to reduced tax complexity. However, a revenue neutral, single-rate consumption tax would likely be less progressive than the current system, shifting the tax burden from higher income to middle and lower income farmers. The indirect effects of such a dramatic shift in tax policy on interest rates, asset values, and incentives to invest in farming are likely to be of greater importance than the impact on Federal tax payments for many farmers.

Proposals calling for the fundamental restructuring of the Federal income tax system have increased awareness of the complexities and inefficiencies of the current system. Promoters of such proposals suggest that the best approach to deal with these inadequacies is to completely replace the current income tax rather than to make adjustments within the existing framework. Under recent proposals, some form of consumption tax would replace both the individual and corporate income taxes, as well as the Federal estate tax. A consumption tax can be levied directly on spending or on an income base with deductions for savings and investment. This report examines two consumption tax proposals—a flat tax on income net of investment and returns to savings, and a Federal retail sales tax.

Objectives of Fundamental Tax Reform

Interest in restructuring the tax code stems from three primary objectives: simplifying tax rules, improving efficiency, and increasing the level of savings and investment.

Many Taxpayers Find Current Tax Code Too Complex. Perhaps the most compelling argument for fundamentally reforming the tax system is the complexity of the current Federal income tax. This complexity has increased over the years as the income tax has been used to support a variety of social and economic goals. Much of this complexity is due to a variety of special provisions that target benefits to specific groups or activities. One indication of the level of complexity is the number of taxpayers who hire professionals to prepare their returns. About 85 percent of farm sole proprietors used a paid preparer to file their annual Federal income tax returns in 1994, according to IRS Individual Public Use Tax File data. By contrast, 72 percent of other self-employed individuals and 45 percent of all other taxpayers used a paid preparer.

While many of the current restructuring proposals could simplify the tax system, it is not clear that they would retain the promised level of simplicity as they work their way through the legislative process or are subsequently amended. The Tax Reform Act of 1986 is a good example of how potential simplification gains can be eroded both during the legislative process and over time by subsequent amendments to the tax code. Although the reforms achieved were diluted by legislative compromise, the 1986 Act achieved some simplification by reducing the number of tax brackets and by eliminating some individual itemized and other deductions. However, over the decade following enactment, new tax brackets were introduced in 1991 and 1993 and a number of new targeted deductions and credits were added—especially in the Taxpayer Relief Act of 1997. This experience suggests that any permanent gains in simplification will require a change in attitude toward the role of the tax code in implementing social and economic policy and a commitment not only to simplify existing provisions but also to avoid reintroducing complexity over the long term.

The transition from the current income tax to a consumption tax would introduce added complexity and would require rules to avoid penalizing individuals and businesses who made long-term decisions or investments based on existing tax

rules. Depreciation of existing capital equipment and the taxation of income from existing savings are particularly important transition issues. These rules would add considerable complexity during the transition period which might extend for several years. Thus, while simplification may be the end result of restructuring the Federal income tax, it is not necessarily guaranteed—especially in the short run. Furthermore, it is not clear that the same level of simplification could not be achieved within the existing system without the added complexities associated with transition issues.

Current Tax Code Reduces Efficiency. Another argument in support of fundamental tax reform is economic efficiency. The economy could be more efficient if a new tax system causes less distortion in economic choices or if it costs less to administer. Decisions on whether to consume, save, or borrow are frequently influenced by taxes, as are choices such as whether to farm, what to produce, or when to buy inputs or sell farm products. If an alternative tax structure causes fewer distortions, yet allows the Government to raise sufficient revenue, the economy could produce more with the same level of resources.

Administrative efficiency could also be improved. Total income tax compliance costs are estimated to have exceeded $50 billion in 1989. With nearly $454 billion collected in total income tax revenue, the compliance cost was about 10 cents for every dollar collected. The compliance costs for self-employed individuals, such as farmers, are especially high. Farmers spend an estimated 60 hours per year on average on Federal income tax matters.

Savings and Investment Gains from Reform are Uncertain. A third argument for fundamental tax reform is the desire to increase the rate of savings and investment. The U.S. savings rate is lower than in many other countries. Some suggest that the Federal income tax is a contributing factor. Proponents assert that exempting savings from tax will raise the after-tax rate of return, increase total savings and investment, promote business expansion, and ultimately benefit both savers and nonsavers. Critics counter that current tax-oriented saving incentives for retirement and college have not had a clear effect on the overall savings rate, and that savings could even fall if employers dismantle some pension plans under a new tax system. In terms of capital investment, some reform proposals would allow business investments to be deducted immediately. Many small businesses, including farmers, can already immediately expense much of their capital investment. Thus, for farms and other small businesses, the gains in investment from shifting to a consumption-based tax are not clear.

Taxation of Farm Income Under the Current Federal Income Tax Structure

Examining farmers' taxation under the current Federal income tax structure provides a base to compare the farm effects of tax-restructuring proposals. Under the current tax structure, income from farming is taxed more favorably than income from many other businesses. Aspects of the current Federal income tax system responsible for this reduced effective rate of taxation include the ability to use the cash method of accounting, to immediately deduct certain capital expenditures, and to report income from certain assets used in farming as a capital gain. These and other provisions, many of which are available to other businesses, reduce the farm income tax base.

This favorable tax treatment is reflected in the size of farm profits and losses reported for income tax purposes. Since 1980, aggregate farm losses have exceeded farm profits and are used to offset taxes on off-farm income. In 1996, the last year for which detailed data are available, farm sole proprietors reported over $107 billion in gross farm business receipts for tax purposes but reported a net farm operating loss of about $7.1 billion. Many of these losses are reported by smaller farms in which the operator's primary source of income is an off-farm job or other nonfarm source. In fact, 75 percent of farm sole proprietors with farm business receipts below $25,000 reported a farm loss for tax purposes, and the average loss reported was about $8,100. These farms averaged over $59,000 in off-farm income. In contrast, 62 percent of farms with farm business receipts over $25,000 reported a farm profit, and the average profit was about $21,000. Thus, while many commercial-size farmers pay taxes on their farm income, farm sole proprietors in the aggregate pay little in Federal income tax on farm income.

In most years, farm partnerships and Subchapter S[1] corporations also report low incomes for tax purposes (see table). In 1994, the most recent year with data for all types of farm organizations, farm sole proprietors reported an aggregate farm operating loss of $7.3 billion, similar to 1996. However, they also reported over $5.9 billion in gains on the sale of farm capital assets and about $600 million in farm rental income. Thus, farm sole proprietors reported $850 million in combined net farm losses in 1994. Farm partnerships were more profitable, reporting a farm profit of $1 billion, while small farm business corporations (Subchapter S) reported a net loss of about $450 million. Thus, the total amount of farm income subject to the individual income tax was a negative $250 million. Large nonfamily farm corporations taxed under the corporate income tax reported a

[1]A small business corporation whose shareholders have elected to have income and losses passed through to the shareholders rather than being taxed under the corporate income tax.

Farm profit and loss by type of organization, 1994

Over half of all farmers report a loss for Federal income tax purposes

Type of organization	Profit		Loss		Total	
	Number	Amount	Number	Amount	Number	Amount
	1,000	*$ million*	*1,000*	*$ million*	*1,000*	*$ million*
Sole proprietors [1]	876	13,097	1,389	-13,951	2,265	-853
Partnerships [2]	58	3,031	42	-1,990	100	1,041
Subchapter S [2]	17	1,046	19	-1,498	37	-453
Corporations [3]	30	2,186	19	-1,064	49	1,123
Total	981	19,360	1,469	-18,503	2,451	858

[1] Farm sole proprietors are taxpayers filing IRS Schedule F. Amounts include net Schedule F, capital gains from selling business assets (Form 4797), and farm rental net income (Form 4835). [2] Farm partnerships and subchapter S corporations include the combined net farm income reported on such returns, prior to allocation and pass-through to the individual partners or shareholders. [3] Includes net income from corporate tax returns that list farming as the primary activity.

Source: ERS estimates compiled from IRS data.

profit of $1.1 billion, resulting in total net taxable farm income of only about $860 million for 1994.

Fundamental Tax Reform Proposals

Over the years there have been a variety of proposals for replacing the current income tax. Most recently, much of the attention has focused on two types of consumption tax proposals—a flat tax based on income with preferences for investments and income from savings, and a Federal retail sales tax.

The Flat Tax

In general, a flat tax is a tax system that taxes a broad measure of income at a single tax rate. There are two main approaches to determine the tax base: a consumption approach and a comprehensive income approach. While both envision a broader base by reducing the number of targeted deductions, the consumption approach encourages saving over spending by exempting dividends and interest income from taxes. Given the often-stated objectives of reform, it is not surprising that many of the recent tax proposals adopt a broad tax base while exempting the returns to savings and investment. H.R. 1040 introduced in the 106th Congress is an example of a consumption-based flat tax proposal. Under this proposal, the current multi-rate individual income tax structure would be replaced with a flat 19-percent (17 percent after 2 years) tax on earned income. Thus, investment income such as interest, dividends, and capital gains would not be taxed at the individual level. The proposal would also include some currently untaxed employer-provided fringe benefits in income, eliminate many of the itemized deductions currently allowable, and significantly increase the standard deduction and personal exemption amounts.

In addition to the changes in the individual income tax system, H.R. 1040 would also integrate business taxation and individual taxation by applying a consumption-based income tax to all businesses at the same 19-percent rate. All investment in capital assets could be deducted immediately as a business expense. Although integrated through the same tax rate, separate business and personal returns would be filed, as opposed to the current combined return for sole proprietors. Requiring separate returns would limit farmers' ability to use business losses to offset nonfarm wage and salary income.

Flat Tax Would Reduce Progressivity. Replacing the current multi-tier individual income tax rate structure (with marginal rates of 15 to 39.6 percent) with a flat 19-percent tax rate would result in substantial reductions in marginal tax rates for some high-income farmers. Under the current tax structure, fewer than one-fourth of all farmers have marginal tax rates exceeding 15 percent, and only about 5 percent have marginal tax rates over 28 percent. A number of lower income farmers currently in the 15-percent bracket would also experience reductions in their tax rate since the increased standard deduction ($23,200 for a joint return, up from $7,200 in 1999) and dependent exemption amount ($5,200 up from $2,750) would exceed their taxable income and result in zero tax. The remaining farmers currently in the 15-percent bracket would see a slight increase in their marginal tax rates.

If the earned income tax credit were eliminated, some low-income farmers would experience a substantial increase in their marginal tax rates. These farmers currently have a negative effective marginal tax rate as a result of the refundable earned income tax credit. While allowing a substantial exemption makes the flat tax somewhat progressive, a tax system with only one rate is likely to be less progressive than the current tax system. Unless the rate changes are offset by changes to the tax base, such a system would shift the tax burden from higher income farmers to middle and lower income farmers.

Modified Individual Tax Base Would Vary by Household. Most tax restructuring proposals substantially modify the individual income tax base. For individual taxpayers, changes in the amount and type of taxable income could more than offset any change in marginal tax rates. Under H.R. 1040, changes to the tax base include taxing certain employer-provided fringe benefits, eliminating itemized deductions, and excluding from

taxation interest income, dividends, and capital gains. Farmers receive fewer tax-free employer-provided benefits such as health insurance than other taxpayers. Also, only about 12 percent of households with a majority of income from farming currently itemize deductions compared with 30 percent for all taxpayers. Thus, these changes in the tax base would generally have a smaller impact on farmers than on other taxpayers.

Excluding interest income, dividends, and capital gains from the tax base would favor high-income farmers and other taxpayers who normally receive a much larger share of their income from such sources. Since farmers report more capital gains than other taxpayers, excluding capital gains from the individual income tax base would appear to favor farmers relative to other taxpayers. However, a large portion of farmers' capital gains are from assets used in the trade or business (such as breeding and dairy livestock), which would be subject to tax as business income and not excluded with other capital gains. In 1994, farmers reported over $12 billion in capital gains. However, nearly half of this amount represented gain from the sale of assets used in farming, such as livestock and farmland. For those whose income is primarily from farming, over 90 percent of their total capital gain income was from farm assets.

The Flat Tax Would Affect Farm Business Income and Investment

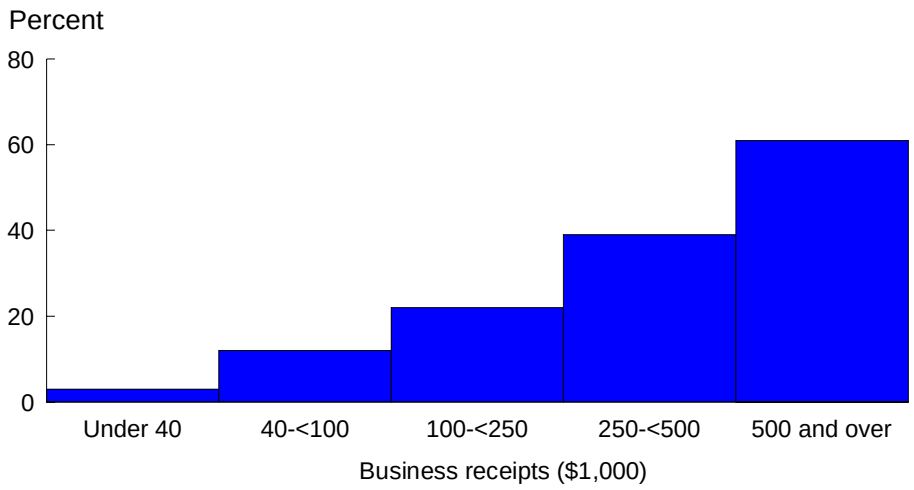
Many of the proposals for fundamental reform go beyond the individual income tax and extend the consumption tax concept to business income. These changes to the business income tax base could be of even greater significance to farmers than changes to the individual tax rates, exclusions, and deductions. Provisions governing deductions for capital investment and interest expenses are especially important to farmers. Under the current Federal income tax, expenditures to acquire or develop business assets that produce income beyond the current period generally are not immediately deductible. Businesses are allowed an annual depreciation deduction for a portion of the capital expenditure. However, the tax code began to allow small businesses to immediately expense a limited amount of capital investment in 1986. More recent legislation increased the amount of depreciable capital that can be expensed from $17,500 per year to $25,000 by 2003. Based on investment levels in recent years, this allows about two-thirds of all farm investment to be written off in the year of purchase. Only about 10 percent of all farms, primarily the largest farms, are currently unable to fully expense their investment in depreciable property (see figure). Under a consumption-based tax, the full cost of capital purchases could be expensed. The primary beneficiaries of this change would be the largest farms that frequently make capital investments in excess of the current annual expensing limit.

Deduction for Farmland Purchases Would Affect Land Market. Perhaps the most dramatic change for farm businesses in the proposed flat tax would be an immediate deduction for farmland purchases. Under the current tax system, farmland cannot be depreciated or expensed. Allowing deductions for farmland purchases would increase the demand for land by both farmers and other potential investors with sufficient resources and taxable income to use the large deductions that would be associated with such a business purchase. Under H.R. 1040, taxable losses created by such purchases could not be used to offset nonfarm wage and salary income because of separate business and personal returns, but such losses could be carried forward with an interest adjustment to offset future business income. Since the purchase could be completely expensed, the entire future sales price would be a taxable gain if sold. Assuming the step-up in basis rule continues to apply to inheritances, this would provide landowners a substantial incentive to retain ownership until death to avoid paying tax on the entire sales proceeds. The lock-in effect that already encourages farmers and others to hold assets until death would be strengthened, further reducing the supply of land available for sale.

Loss of Business Interest Deduction Would Favor Farmers with Equity. Another important issue of fundamental tax reform is the impact on the farm business' borrowing costs. H.R. 1040 would eliminate the business interest deduction. Proponents claim that interest rates would decrease because the elimination of the business interest deduction would be coupled with an exemption for interest income. The net effect on borrowing costs would depend upon whether interest rates decline enough to offset the effects of losing the deduction. Farmers currently deduct about $10 billion in business interest expenses each year, so eliminating this deduction would greatly expand the farm business tax base. However, the effect would not be uniform across the farm sector. About half of all farmers have no debt, but many of these are smaller part-time farmers. Younger, less established farmers would be especially affected by this change since over two-thirds of farmers under 35 have debt while only about one-third of all farmers over age 65 have debt.

Clearly, farmers with the highest marginal tax rates would experience the sharpest increase in after-tax borrowing costs. However, because business interest is also deductible for self-employment taxes, even a farmer in the 15-percent income tax bracket has a combined tax rate of about 30 percent. To maintain the same after-tax cost of borrowing after losing the interest expense deduction, a pre-reform interest rate of 10 percent would have to drop below 7 percent

Farmers with investment exceeding expensing limit, 1996
Larger farms would be primary beneficiaries from full expensing of capital investment



Source: Economic Research Service estimates from Agricultural Resource Management Survey, 1996.

following the enactment of a consumption tax. Given competition in international capital markets and the fact that the current tax code contains numerous underused saving incentives, few analysts expect the change in interest rates to be this large. Thus, even with lower interest rates, young farmers may be less able to compete with older farmers or other investors when buying farmland. The reliance on leased land could increase, contributing to the separation of farm ownership and operation.

The Federal Retail Sales Tax

Another reform option that has received increased attention is a Federal retail sales tax such as that contained in H.R. 2001 introduced in the 105th Congress. A retail sales tax is another form of a consumption tax. Under this type of tax, products would be taxed only once when they are purchased for final consumption at the retail level. Investment income and new savings would not be taxed until they are spent on consumption. The Federal retail sales tax would be very similar to the sales taxes which are currently levied in most States, but the Federal tax would be at a much higher rate, with estimates ranging from 15 to 23 percent. To keep the Federal tax rate as low as possible, the tax base would need to be very broad and include products often excluded from State sales taxes such as food, housing, services, and medical care.

Enacting a retail sales tax would represent a dramatic change in Federal tax policy. Under H.R. 2001, a 15-percent retail sales tax on nearly all private consumption would replace individual and corporate income taxes as well as the Federal estate tax. Only businesses that make sales at the retail level would be required to collect and pay the tax, greatly reducing the filing burden for most taxpayers. Sales to businesses, including sales of investment goods, would generally be exempt from tax through the use of exemption certificates. A tax rebate equal to the tax rate times the poverty level would be provided to reduce regressive effects. However, the rebate would not offset the loss of the refundable portion of the earned income tax credit, which exceeded $160 million for farmers and $23 billion for all taxpayers in 1996.

For farmers, a Federal retail sales tax would exempt purchases of farm inputs such as seed, fertilizer, feed, and equipment from the tax as intermediate goods. Sales beyond the farm gate to processors would also be exempt. Therefore, a Federal retail sales tax would have little direct effect on farmers as businesses, but would affect them primarily as household consumers—the same as nonfarm households. Compliance would be simpler because the tax would be determined and collected by the retailer, eliminating individual filing burdens unless the farmer makes retail sales. However, farms with consistent operating losses may have difficulty meeting requirements for the legitimate business use of purchases and could lose their exemption certificate.

Individual farmers may also be affected by transition rules. A Federal retail sales tax would discontinue the use of existing net operating losses to offset income from both farm and nonfarm activities. Farmers carried an estimated $6.6 billion of farm net operating losses into tax year 1994. Without transition relief, some farmers could pay higher taxes under a Federal retail sales tax depending on their household consumption and the level of carryover losses. In addition, households that saved after-tax dollars under an income tax might be taxed again when those savings are spent under a Federal retail sales tax. This devalues old wealth relative to wealth created under a new tax system.

Demand for Food Could be Affected. Collectively, farmers may be affected by a Federal retail sales tax if the tax affects the demand for food. If a wide tax base is preserved to avoid a higher tax rate, and food purchased at the retail level is not exempt, the quantity of farm products demanded could fall because of higher retail food prices. Although some specialty products may benefit from greater demand by households with higher after-tax incomes, the net effect is expected to be negative. The decrease in food sales may be relatively small, however, because the quantity of food consumed is affected less by changes in price than is the case with other consumer goods

(inelastic demand). Without other structural changes, the price received by farmers should not decrease very much since most of the tax incidence will be passed on to consumers because of the inelastic demand. Nonetheless, total farm revenues could decrease slightly.

Compliance is Uncertain. Noncompliance issues are also a major concern with a Federal sales tax. Opportunities may exist for many small businesses to purchase household consumption goods tax-free by using the business exemption. The incentive to evade a Federal sales tax will be much greater than for existing State sales taxes, because of the relatively high tax rate necessary for a Federal retail sales tax to be revenue neutral. Recent studies suggest a Federal retail sales tax would need to be between 15 and 23 percent in order to raise the same Federal revenue as the current income tax. This rate would need to be even higher if certain items such as food or housing are exempted, a rebate is provided, or significant transition rules apply. Also, since a retail sales tax has only one collection point, the incentive to evade or avoid such a tax is especially high. If the tax can be avoided at that one point, no tax is collected on the product or service. High rates of noncompliance could require even higher tax rates to collect the desired amount of revenue.

Conclusions

Replacing the existing Federal income tax with a flat consumption-based income tax or a Federal retail sales tax would dramatically shift tax policy and affect farming activities. Farmers would likely benefit from reduced compliance costs due to a less complex tax system. Complexity could remain, however, during a transition period containing rules to prevent taxpayers from losing benefits from past investments. The burden of taxes under each proposal may increase or decrease depending on individual circumstances.

A revenue-neutral flat tax would likely be less progressive than the current system, shifting the tax burden from high-income to middle- and low-income farmers. Expanding the tax base by including some fringe benefits and eliminating certain itemized deductions would not significantly affect farmers whose primary source of income is farming. For most farmers, indirect effects on interest rates, asset values, and incentives to invest in farming are likely to be of greater importance than changes in Federal tax payments. Farmland may be sold less frequently, increasing the reliance on lease arrangements. Farmers using equity capital might have an advantage over those relying on debt.

A Federal retail sales tax would likely tax many items usually exempted from existing State sales taxes or require an even higher tax rate than proposed. Farmers would be affected primarily as household consumers rather than as businesses, because business inputs would be exempt from the sales tax as intermediate goods. Only the small number of farmers who make retail sales would be required to collect the tax. Farm product demand and prices could decrease slightly if retail food prices increase because of the tax.

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Further Reading

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