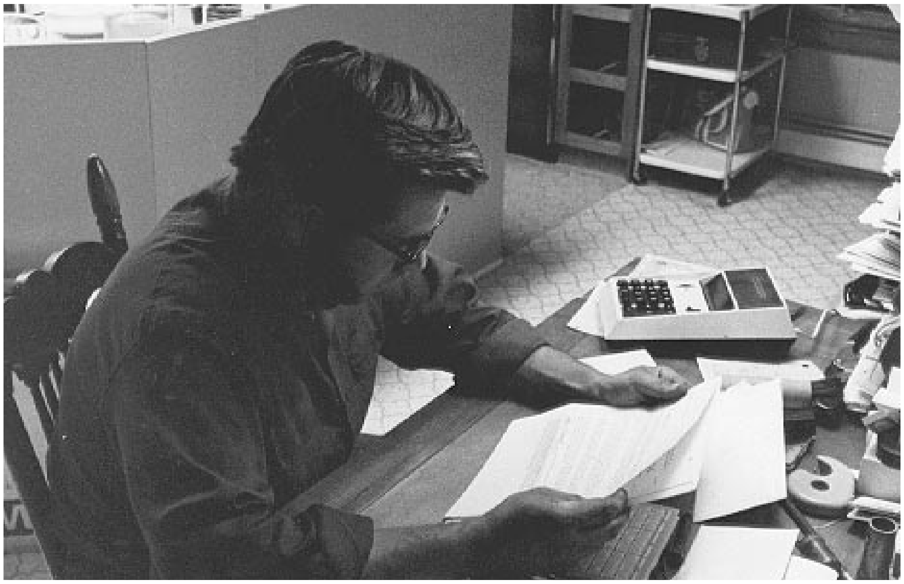
Farm Finance



The 1997 Tax Law: New Incentives for Farmers To Invest for Retirement

The investment goals of farmers increasingly include retirement planning as well as building the farm business. Good retirement planning requires allocating limited financial resources to preserve an acceptable standard of living during retirement. Farmers historically relied on farm assets to build their business *and* provide income during retirement. Tax-advantaged plans such as Individual Retirement Accounts (IRA's) or Keogh plans encourage off-farm diversification but frequently compete with farm investment decisions that promote economic viability of the farm operation.

Recent changes under the Taxpayer Relief Act of 1997 offer new opportunities at a time when farmers have several motives for diversifying total assets beyond the farm. Individual farm income may be more variable following the decoupling of farm payments from production and prices in the 1996 Farm Act. Also, income variability may contribute to land price volatility, creating more uncertainty about the future value of this major asset. Furthermore, uncertainty about the future level of Social Security benefits increases the motivation for prudent financial planning.

The tax law changes, in effect, offer conflicting incentives for farmers, perhaps more so than in the past. While plans such as IRA's offer new tax benefits, lower capital gains tax rates reaffirm farmers' inclination to reinvest in farm assets such as land and breeding or dairy livestock. The investment incentives in the new tax law are likely to increase overall investment but to generate relatively little additional diversification into off-farm assets, given the historical investment preferences of farmers.

How Farmers Have Planned

Many farmers' retirement strategies focus on investments that expand or improve the farm operation, with the intent to rely on farm assets for retirement income. Some also plan to transfer those assets to a family member who will continue to farm, or to other heirs who may be less interested in the farm business because of a nonfarm occupation. Balance sheets of the farm sector suggest that diversification among broad asset classes is limited for farm households. Financial assets comprise only about 7 percent of total assets, while real estate represents about 70 percent. This reflects the comfort level that farm assets provide many farmers.

Off-farm diversification of household assets is often recommended as a means of reducing risks and as a consideration in structuring some estates. Farm resources alone also may be insufficient for living expenses of more than one household if retirement reduces the amount of labor available to operate the farm. Farm equity may be particularly at risk, especially if it is concentrated in farmland.

Preferential capital gains tax treatment has been very important for farmers, especially given the capital-intensive nature of farming. Many farm assets qualify for capital gains treatment, including farmland and other real estate, and breeding and dairy livestock which are frequently culled to maintain a productive herd.

About one-third of farm sole proprietors report capital gains income in any given year, three times the frequency for all other taxpayers, and twice that for other small businesses. About two-thirds of dairy farms and about half of other livestock operations report capital gains income each year. While not explicitly a retirement investment, buying additional farmland or expanding a breeding herd may serve as a de facto retirement account by dominating a farmer's asset base and by competing with alternative nonfarm uses of investment funds.

Some taxpayers are clearly motivated by tax incentives for retirement savings, but many do not take advantage of the opportunity. While farmers are more likely than other taxpayers to use IRA or Keogh plans, roughly 9 out of 10 fail to contribute during any given year, and at least one-third may not have any such accounts. Farmers use individual retirement incentives more frequently than other taxpayers because they are more likely self-employed. In a 1995 Federal Reserve survey, about 42 percent of farmers reported having an IRA or Keogh account, compared with 25 percent of the nonfarm population. Another survey

USDA does not endorse any particular retirement plan.

indicated that two out of three large-scale midwestern crop farmers had tax-deferred retirement plans. But only 10 percent of farm sole proprietors contribute to IRA or Keogh plans in any given year, according to IRS data (still higher than the 6 percent of the nonfarm population making contributions).

Despite an apparent overall lack of diversification in assets, farmers and landlords over age 65 receive many different sources of taxable income, according to IRS aggregate tax data. Social Security benefits and distributions from IRA's/pensions each comprise about one-sixth of aggregate income for these older farmers and landlords. But only a half to two-thirds receive income from these sources. Interest and dividend income is even more important for many retirees, comprising about one-fourth of the group's total income. Together, these figures suggest considerably more diversification than balance sheets, partly because the value of Social Security and some pension benefits is rarely included as an asset. Yet, individual retirees may not have the breadth of diversification as suggested by aggregate income, since interest and dividends tend to be concentrated among the wealthier farmers.

IRA's, Capital Gains, & the 1997 Tax Law

IRA's are an attractive retirement planning tool because of tax savings over the life of the investment. However, an individual's total contribution to all IRA's is limited annually to the smaller of earned income or $2,000. The "classic" deductible IRA reduces taxable income (and taxes) in the year of the deposit, but the deduction may be limited for some employees who have a retirement plan at work. Distributions before age 59½ are taxed and generally subject to a penalty. When the money is withdrawn, it is taxed as ordinary income whether it represents principal or earnings.

The 1997 tax act allows employees who have a retirement plan at work to earn more income and still qualify for deductible IRA contributions. The adjusted gross income (AGI) on a joint return that triggers limits on deductibility is raised to $50,000 in 1998 and gradually increases to $80,000 by 2007. Spouses who do not have a retirement plan at work but are married to someone who does are no longer disqualified from deductible IRA's unless AGI exceeds $150,000.

With many farm families working in off-farm jobs, these changes are increasingly important for farmers. An estimated 300,000 additional farm households became eligible for deductible contributions beginning with the 1998 tax year.

The 1997 law also created a new type of IRA–the nondeductible "Roth IRA" which allows tax-free earnings if funds are withdrawn after 5 years and the individual has reached age 59½, died, or become disabled. Contributions to Roth IRA's are phased out for couples with AGI exceeding $150,000.

Roth IRA's are also more flexible than traditional IRA's. Principal can be withdrawn without penalty before age 59½ or within 5 years, giving Roth IRA's an advantage if the farm household needs more liquidity. In addition, fund withdrawal is not required after age 70½ and contributions may continue to be made, allowing farmers to use Roth IRA's to store and build wealth for bequests. Nearly all farm households qualify for the new Roth IRAs.

Long-term capital assets such as farmland are viewed frequently as retirement savings, but are not eligible to be IRA's. However, capital gains have received special treatment in the tax code over the years, although less so from 1986 to 1997. Prior to the Tax Reform Act of 1986, 60 percent of capital gains was excluded from taxation and the remainder was taxed at ordinary tax rates. The 1986 act taxed gain on the sale of capital assets

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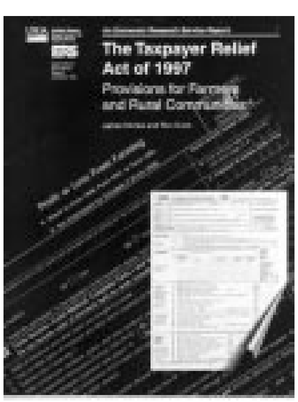

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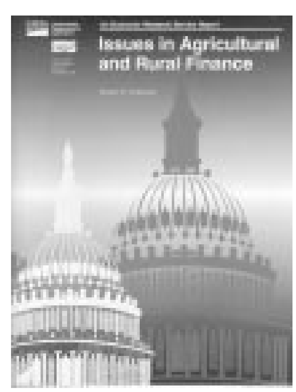

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at the same rate as ordinary income, except that a top marginal rate of 28 percent applied to gains from assets held longer than a year.

After the 1997 act, the maximum capital gains tax is 20 percent for assets held more than a year. A 10-percent rate applies to taxpayers in the 15-percent tax bracket (for example, joint returns with taxable income less than $42,350 for 1998). In addition, lower rates will apply beginning in 2001 for assets held more than 5 years. In contrast with treatment 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.

Besides investing for retirement, some households intend to transfer wealth to the next generation. For these farmers, estate tax considerations are also important. If the farm business is expected to continue within the family, provisions for special valuation and the new family business exclusion under the 1997 act encourage business investment because more of an estate can be transferred tax-free. Heirs also benefit from a long-standing provision that eliminates capital gains taxes on inherited property by allowing them to use the value of the decedent's property at death for purposes of determining future gains (i.e., a step-up in basis).

Impacts of the Tax Changes

The new opportunities for IRA's and reduced capital gains taxes encourage investment and savings for retirement, but the preferred investment choice varies among individuals and depends upon the tradeoff between paying taxes now or later. An investor with a regular taxable investment such as farmland pays taxes on profit as income is generated and on the capital gain only when the asset is sold. Money in IRA's, on the other hand, is taxed only prior to investment (i.e., Roth IRA) or when redeemed (i.e., deductible IRA), with all flows treated as ordinary income.

Analyzing investment options helps identify which ones would be most beneficial to the individual investor. The following results are based on a simulation that incorporates the tax effects on alternative investments held for 15 years. Because farmland and the S&P 500 stock market index (a proxy for IRA returns) have had fairly similar total returns and risks from the early 1960's to the late 1980's, a 10-percent annual total rate of return (capital gains plus reinvested earnings) is used for both. Also, they are both investments in equity that have had cyclical periods of gains and losses. Results from this analysis are based on long-term averages and are not necessarily representative of future or short-term trends.

Compared with regular taxable investments such as farmland, Roth and deductible IRA's clearly offer greater after-tax future values, about 25 percent more. This is especially true for longer holding periods when any of the return is a currently taxable dividend or interest that can grow tax-deferred in the IRA. However, if investors are concerned about IRA restrictions or have more to invest than allowed under the program, regular taxable investments such as farmland are increasingly attractive because of lower capital gains taxes.

Choosing between the two types of IRA's depends on an individual's marginal tax bracket in retirement relative to today. That is, does the farmer expect taxable income to change enough between now and retirement to move into a different tax bracket? Based on total longrun investment value, deductible IRA's are preferred over Roth IRA's if marginal tax rates are expected to fall substantially at retirement. Roth IRA's are better if tax rates are expected to rise. If the marginal tax rate is expected to remain the same in retirement as today and the investor has less than $2,000 to invest, Roth and deductible IRAs yield the same value after taxes in the long run. However, if investors have more funds, the Roth IRA yields a greater future value, because more pre-tax income receives preferential treatment under the Roth IRA.

Overall, investment by farmers should increase as a result of the investment incentives which became effective for the first full year in 1998. Provisions for IRA's and capital gains create complex tradeoffs, but both encourage additional investment. Deductible and Roth IRA's offer the greatest after-tax return. But lower capital gains tax rates encourage more investment in regular taxable investments (e.g., land) and increase future after-tax wealth for investors who do not qualify or dislike the restrictions of an IRA.

Given the relatively low past use of IRA's by farmers, a big shift in off-farm diversification is not likely, unless investor education and advertising change individual behavior. Furthermore, while farmers may have new financial incentives to diversify away from the farm, they also have strong incentives to continue to invest in certain farm assets because of capital gains treatment and estate-tax considerations.

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