



## FARM AND RURAL TAX POLICY

### *Background*

Federal tax policies not only influence the financial well-being of farm families but also can have important effects on the number and size of farms, their organizational structure, and their use of land, labor, and capital. The most significant Federal taxes paid by farmers are income, social security, self-employment, and estate taxes. In recent years, Federal income taxes on both farm income and income earned off the farm accounted for nearly two-thirds of farmers' total Federal tax burden.

At the State and local level, farmers are subject to a variety of taxes, including income, sales, and property taxes. Of these, the most significant are State and local real estate taxes.

Tax legislation enacted in the last 4 years has reduced Federal income taxes for both individual and business taxpayers. For individual taxpayers, this legislation has reduced marginal income tax rates, increased standard deduction allowances, lowered tax rates on capital gains and dividends, increased savings incentives, raised child and earned income credit amounts, and eliminated the marriage penalty for low-income households. Federal tax policies affecting businesses have also been modified, including reduced tax rates on business investment and manufacturing income.

### Implications for Farmers and Ranchers

Most farm income is taxed as individual income rather than as corporate income. As a result, farmers and many other small businesses are major beneficiaries of the recent tax changes since they benefit not only from the lower individual tax rates and other changes aimed at all taxpayers, but from faster write-off of investment in machinery, equipment, and other eligible capital purchases and from the newly enacted manufacturers' deduction.

The cumulative effect of these Federal income tax policy changes has been the lowest Federal income tax burden on farm income and investment in decades. Like all households, about one out of every three farm households now owes no Federal income tax, with some actually receiving a refundable child or earned income credit. The average Federal tax rate is estimated to have been reduced from 18 percent in 2000 to about 14 percent for 2005, providing farm households with an estimated \$4 billion in tax relief.

Farming requires large investments in farm machinery, equipment, and other capital purchases. The tax treatment of these investments is of considerable importance to the farm sector. The reduction in 2003 of the tax rate to 15 percent and lower on dividends and capital gains is

especially significant for farmers. Forty percent of all farmers report some capital gains, nearly double the share for all taxpayers. The average amount of capital gain reported by farmers is about 50 percent higher than the average capital gain reported by other taxpayers.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 raised the amount of investment that can be expensed from \$25,000 to \$100,000, and that was extended through 2007 by the American Jobs Creation Act of 2004, with the amount adjusted for inflation. Today, most farmers are able to deduct their entire 2005 capital investments. This increased capital expensing allowance reduces the effective tax rate on farm capital and greatly simplifies the recordkeeping burden associated with the depreciation of capital purchases.

The potential effect of Federal estate and gift taxes on farmers and other small business owners has been an important concern for farmers and policymakers. Over the years, this has led to the enactment of a number of targeted provisions, including a provision that allows farm real estate to be valued at its farm use value rather than its fair market value.

Changes have also been made to Federal estate and gift tax policies, including those contained in the Economic Growth and Taxpayer Relief Reconciliation Act of 2001. These changes reduced tax rates and raised the value of property that can be transferred to the next generation free of the estate tax to \$2 million in 2006. Despite these changes, appreciating land values and increasing farm sizes have led to a larger share of farm estates being subject to the Federal estate tax. While about 1 percent of all estates currently owe Federal estate tax, approximately 4 percent of all farm estates and nearly 18 percent of commercial farm estates currently owe estate taxes.

Under current law, the amount of property that can be transferred free of estate tax will continue to increase until it reaches \$3.5 million in 2009. The estate tax is scheduled to be repealed completely in 2010. However, since the 2001 changes are scheduled to sunset in 2011, this repeal is only temporary. The resurrected tax in 2011 reverts to the law in place prior to the 2001 changes. It is estimated that this reversion will result in as many as 10 percent of all farm estates and about 25 percent of commercial farm estates owing Federal estate tax.

### ***General Opinions Expressed***

- Many supported eliminating the estate tax and removing the capital gains tax on agricultural land to allow farming operations to be passed on to the next generation and to keep production agriculture land in production.
- Others suggested that property taxes be based on actual use, not highest and best use.
- Some suggested tax incentives to encourage retiring farmers who help out younger farmers by conveying equipment or land.
- Some suggested individual risk management savings accounts with matching USDA funds be established for farmers.
- Many commenters supported tax credits for organic farming while others encouraged tax rebates to producers for their use of fuel, herbicides, and fertilizer in the production of all crops.
- Others suggested tax credits for individuals using renewable fuels such as biodiesel and ethanol.

- Commenters called for USDA to lift the prohibition on loan guarantees used in conjunction with State-sponsored beginning-farmer “aggie” bonds.

### ***Detailed Suggestions Expressed***

- Efforts such as the New Homestead Act offer tax and other incentives to attract new rural residents. Such initiatives should be pursued by Federal policymakers in cooperation with the States.
- Inflated land prices and rental rates are financial challenges to beginning farmers. USDA should level the playing field by enacting agricultural tax reform to remove incentives that favor investors and wealthy farmers over those of more limited means.
- USDA programs should help sustain and enhance family farms by providing economic and tax incentives and credits for soil and water conservation without escalating advantages to nonfarm investors.
- The Federal Government should accelerate depreciation on farm equipment.
- Modify the Internal Revenue Code Section 1031 tax-deferred exchange rules to reduce upward spiral in land values and allow for investment in value-added processing plants.
- The Federal Government should retract the \$14 billion in tax breaks to the oil industry and give it to biofuels development.
- Develop a fuel tax credit for transportation to global markets, thereby decreasing our export price.
- All products imported into this country should be required to meet the same high standards of domestic producers. If not, levy a tax on those countries not meeting our standards.
- Farm land and structures should be exempt from school taxes on property and be replaced with a per capita or income tax so that each person pays a fair share for his or her education or children’s education.
- The Federal Government should not allow other countries to sell resources in the United States cheaper than we can produce them. Tax imports from other countries on resources already produced by the United States.