Effects of Federal Tax Policy on Agriculture

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Introduction

Federal tax policies can have important effects on the number and size of farms, the organizational structure, and the amount and relative mix of land, labor, and capital inputs. The most important Federal taxes for farmers are the income tax, the self-employment tax, and the estate and gift tax. In 1996, the most recent year for which complete data are available, farmers paid about $19.2 billion in Federal income taxes on their farm and off-farm income. They also paid $1.8 billion in self-employment taxes. In contrast, Federal estate and gift taxes were relatively small with taxes on farm estates estimated at only about $735 million. While the Federal income tax imposes the largest tax burden on the broadest group of farmers in the aggregate, the relative importance of the various taxes varies for the individual farmer with the size and other aspects of the farm business.

In January 1998, the U.S. Department of Agriculture's (USDA) National Commission on Small Farms – a 30-member committee appointed by former Secretary of Agriculture Dan Glickman – released a report addressing the need for action to help small farms survive and remain competitive. In the report, the Commission identified tax policy as a contributing factor to the structure of agriculture and suggested that many tax policies favor large farms over small farms. As one of many recommendations in the report, the Commission requested that the Economic Research Service (ERS) coordinate a study to review the effects of the tax code on farming and how the tax code affects entry and exits from farming (USDA, NCSF Recommendation 5.7, p. 94). To help beginning farmers in particular, the Commission proposed (1) an exemption for the first $10,000 of income to a landlord from leasing farmland or property to a beginning farmer and (2) a revision of the depreciation recapture rules for a retiring farmer who sells equipment under an installment sale to a beginning farmer.

This report discusses the most important features of Federal tax law and how they affect agriculture. It also assesses the two tax recommendations proposed by the Commission, as well as another tax proposal regarding farm savings accounts that Congress has considered as an option to help farmers manage income variability. The report builds upon the Department's last comprehensive overview of the effects of Federal tax policy on farmers (Davenport, Boehlje, and Martin) that emerged from a 1979 initiative by former Secretary of Agriculture Bob Bergland to study the structure of agriculture.

Federal Taxes and Farmers

In the 1990's, the Federal income tax changed dramatically. While top marginal income tax rates increased, both individual and business taxpayers were provided several new or expanded tax credits and deductions. These include child and education tax credits, an expanded earned income tax credit, reduced capital gains taxation, and targeted tax relief for farmers, including income averaging and increased deductions for self-employed health insurance costs. The net effect is a reduced Federal income tax burden for most farmers.

The self-employment tax paid on earned income from business activities is comparable to the employees' and employers' share of the social security payroll tax. The amount of income subject to tax and the tax rates for the self-employment tax have increased over the past two decades, increasing the burden of this tax relative to the income tax. Overall, income taxes exceed self-employment taxes, but for lower income farmers, the self-employment tax may be more important.

Although the Federal estate tax represents a very small share of all Federal taxes paid by farmers and most farmers or their heirs never pay such taxes, the impact of Federal estate and gift taxes on the ability to transfer the family farm to the next generation has been a major concern of farmers for many years. The number of

farms subject to the Federal estate tax has increased in recent years, but Federal estate and gift taxes have had little effect on the ability of small family farms to transfer their farms to the next generation. Nevertheless, Federal estate tax provisions contained in the Taxpayer Relief Act of 1997 provide additional reductions in Federal estate taxes for farmers and other small business owners, making it easier for farmers to transfer their family farm business across generations.

Farm Typology and Data

The National Commission on Small Farms established general criteria to define small farms. The cutoff between large and small farms was set at $250,000 in gross sales. The Commission's intention was to "generally describe the farms that ... should be given priority consideration by USDA, with special emphasis on those with the greatest need to improve their net farm incomes." The result was a definition that classifies 94 percent of all U.S. farms as small farms.

A broad definition that includes so many farms may be further refined for policy discussions. Building on the Commission's definition, ERS developed a new farm typology to divide small farms into mutually exclusive, more homogeneous groups based on family, business, and occupational characteristics. The four groups are (1) limited-resource farms, (2) retirement farms, (3) lifestyle/other farms, and (4) primary occupation farms (USDA-ERS). The limited-resource group identifies farmers with low sales, income, and assets, regardless of their major occupation, and is similar to definitions used by USDA's Risk Management Agency and Natural Resources Conservation Service. Identifying this group is critical because agencies may need to develop special programs to serve limited-resource farmers. The other three groups are based on the major occupation of farmers who do not operate limited-resource farms – the occupation at which they spend more than 50 percent of their work time. This farm typology was developed primarily to be applied to the Agricultural Resource Management Study (ARMS) conducted by

Table 1—Criteria for farm typologies used with IRS and USDA data

Farm type	IRS tax file data	USDA Agricultural Resource Management Study (ARMS)
Family farm	A tax return with schedule F attached; that is, a farm sole proprietor for tax purposes.	Farm proprietorships, partnerships, and family corporations. Produce $1,000 of farm products annually.
Small family farm	Farm sales < $250,000.	Farm sales < $250,000.
• Limited-resource	Farm sales < $100,000 and household income < $10,000.	Farm sales < $100,000, farm assets < $150,000, and household income < $20,000.
• Retirement	Social security benefits > $0 and farm sales < $50,000 – regardless of age of primary taxpayer – but excluding returns when only the secondary taxpayer is over age 65.	Self-identified as retired, excluding those already identified as limited-resource.
• Primary occupation	Either combined farm income greater than nonfarm income, or farm sales > $10,000 and nonfarm income < $50,000.	Self-identified that farming was principal occupation, excluding those already identified as limited-resource.
• Lifestyle/other	A residual category for small family farms if not selected as a limited resource, retirement, or primary occupation farm.	Self-identified that principal occupation was not farming, excluding those already identified as limited-resource.
Large family farm	Farm sales > $250,000.	Farm sales > $250,000.

Note: **Household income** equals the sum of all income reported on IRS form 1040, including tax-exempt interest, social security, and pension benefits not subject to taxes, but excluding farm losses from schedule F. **Combined farm income** equals net profit or loss from schedule F, plus capital gains from the sale of business assets, plus farm rental income (crop-share only; cash rents are not listed separately for taxes). **Nonfarm income** equals household income minus combined farm income (after adjusting for schedule F losses not included in household income).

ERS and the National Agricultural Statistics Service, USDA. The annual ARMS collects financial, production, and marketing information from farmers, including the self-identified primary occupation variable which is heavily used in the farm typology.

ARMS data provide income statement and balance sheet information as well as information concerning the farm operator and household. However, tax rules such as cash accounting, capital expensing, and other deductions and tax credits frequently make farmers' taxable incomes in any given year dramatically different from the income measured by USDA to estimate financial performance (General Accounting Office). In addition, information on taxable income and many other income tax variables is not available from ARMS data.

Limited tax data are available from the Internal Revenue Service (IRS), which compiles an annual stratified probability sample of individual income tax returns that contains a large number of variables from many tax forms. IRS carefully protects the identity of individual taxpayers in the public use version by not including identification codes and by blurring other variables by averaging data with similar returns. In addition to the public use tax file, which contains separate tax records, IRS also compiles special tabulations for researchers who request information on variables that are excluded from the public use file. Within the entire annual database of about 100,000 observations representing over 118 million taxpayers, a subset of over 6,000 farm observations includes individual farmers and materially participating landlords who file schedule F, but excludes corporate farms and farm partnerships. This

Table 2—Comparison of the farm typology using ARMS and IRS data, 1996

Item	Small family farms					Large farmily farms	All farm proprietors
				Primary occupation Farm sales ($1,000)			
	Limited-resource	Retirement	Lifestyle/ other	<$100	$100-$250		
				Number			
Farmers:							
IRS data	218,383	261,926	1,167,321	336,498	151,970	82,865	2,218,964
ARMS data	291,659	261,428	537,181	524,820	192,269	154,307	1,961,664
				Percent			
Share with sales under $10,000:							
IRS data	51.9	69.8	86.6	2.6	0	0	59.3
ARMS data	87.6	78.6	74.3	42.4	0	0	55.2
				Dollars			
Average net farm income:							
IRS data	-730	783	-6,191	5,192	16,914	31,572	-111
ARMS data	d	d	-4,394	d	25,708	93,513	7,906
Average net income to household:							
IRS data [1]	-97	73,333	69,398	27,744	31,616	94,069	55,040
ARMS data	10,633	40,729	71,673	31,511	59,181	120,703	50,361
				Percent			
Share of net income to household from nonfarm source: [2]							
IRS data	[3]	98.9	108.9	81.3	46.5	66.4	100.2
ARMS data	127.8	99.7	106.1	104.1	56.6	25.2	84.3

d = data suppressed because the relative standard error for the estimate exceeds 75 percent.

[1]To be more comparable with ARMS data, includes both taxable and nontaxable sources of income reported on IRS form 1040, and allows farm losses to reduce net income.

[2]The percentage of income from nonfarm sources can be more than 100 percent if farm income is negative.

[3]Not logical to compute because net household income remains negative even though nonfarm income is positive.

Sources: IRS data compiled by USDA-ERS from special tabulations by Internal Revenue Service. ARMS data from USDA-ERS, pp. 141-43.

sample can be weighted to represent a population of about 2.2 million farm sole proprietors.

The IRS data do not allow an exact duplication of the farm typology designed for USDA data, primarily because the IRS data lack the self-identified primary occupation variable. To approximate the categories in the farm typology, different criteria were developed for IRS data. These criteria use various combinations of gross farm sales, household income, nonfarm income, and social security benefits (table 1).

With the exception of the lifestyle/other category, which contains nearly twice as many farms, the number of farms in each typology category from the IRS data is similar to the number from the ARMS data (table 2). The larger number of lifestyle/other farms reflects the fact that many households file schedule F for tax purposes but may not be considered farms under the ARMS requirement of at least $1,000 in sales. Furthermore, 42 percent of farms (220,000 farms) in the ARMS data with gross sales under $10,000 identified farming as their primary occupation. Many of these farms reported farm losses for tax purposes and were classified as lifestyle/other farms because the IRS data do not contain the self-identified primary occupation variable.

Despite the noted difference between IRS and ARMS data, both reveal that more than half of farm proprietors have sales under $10,000. Both databases also suggest that nonfarm income contributes a majority of income for farmers as a whole, and that nonfarm income is particularly important for limited-resource, retirement, lifestyle/other, and primary occupation farmers with sales under $100,000. However, net farm income reported for tax purposes is about $8,000 less, on average, than that measured by ARMS. As mentioned before, tax rules such as cash accounting, capital expensing, and other farm deductions contribute to a lower net income for tax purposes for farmers.