Federal Income Tax Policies

The Federal income tax is a progressive tax imposed on net income. It is collected annually and accounts for a substantial portion of Federal revenues. The Federal income tax has the greatest potential impact on investment, management, and production decisions in the agricultural sector.

The individual income tax is significantly more important than the corporate income tax for understanding how taxes affect most farmers. Sole proprietorships, partnerships, and subchapter S corporations are all taxed at the individual level. The most common form of farm organization is the sole proprietorship which, according to the 1997 *Census of Agriculture* (USDA-NASS), comprises 86 percent of all farms and 52 percent of total sales (table 3). Income from farm partnerships and subchapter S corporations is passed through to the individual partners or shareholders for taxation at the individual shareholder or partner level. Partnerships comprise 9 percent of farms and 18 percent of sales. Census data do not separate subchapter S corporations from other corporations. However, family-held corporations account for about 90 percent of all corporations. Most of these corporations are subchapter S corporations. These farms represent 2 percent to 3 percent of all farms and account for about 10 percent of sales. Therefore, more than 97 percent of all farms and about 80 percent of farm sales are taxed at the individual level. This chapter primarily focuses on the most significant features of the Federal individual income tax, and how they affect taxes paid by farmers.

Individual Tax Rates and Taxable Income

Under current law, there are five marginal income tax brackets on ordinary income: 15, 28, 31, 36, and 39.6 percent. The ordinary income tax rates are progressive, with higher marginal rates applying to higher amounts of taxable income.

Taxable income is computed by subtracting allowable adjustments, deductions, and personal exemptions from total income. Total income is the sum of wages and salaries, taxable interest and dividends, capital gains, net business income, rental income, taxable social security and retirement income, and other miscellaneous income. Business income from sole proprietorships and pass-through entities, including farms, is taxed on a net basis after subtracting allowable business expenses from gross business revenue. Important statutory adjustments for farmers include subtractions for half of the self-employment tax, contributions to tax-deferred personal retirement plans, and the self-employed health insurance deduction. The standard deduction or itemized deductions (such as medical and home mortgage interest expenses, State and local income taxes, property taxes, and charitable contributions) also reduce the amount of income subject to tax. Personal exemptions provide an additional allowance against taxable income for each person in the household. Table 4 summarizes the taxable income subject to each tax bracket, and the standard deduction and personal exemption amounts.

Most farmers, like the majority of other taxpayers, are taxed at the 15-percent marginal tax bracket. However, most of the tax collected is paid by those in higher tax brackets. Table 5 illustrates the distribution of marginal tax brackets and income taxes paid by farm sole proprietors and other taxpayers. In 1995, 53 percent of farm sole proprietors were in the 15-percent tax bracket, but they paid only 20 percent of the Federal income taxes paid by farmers. In contrast, the 5 percent of farmers in the top three tax brackets paid 54 percent of the taxes paid by farm sole proprietors. The distributions are

Table 3—Most farms are organized as sole proprietorships

Type of organization	Number	Total sales	Net income
		Million dollars	
All farms[1]	1,911,859	196,865	42,557
Sole proprietor	1,643,424	102,666	21,295
Partnership	169,462	35,539	8,706
Corporation[2]	84,002	56,907	12,212
Other[3]	14,971	1,753	345

[1]Units selling $1,000 or more of agricultural products per year.
[2]Includes family and nonfamily corporations, some of which may be subchapter S corporations.
[3]Includes cooperatives, estates and trusts, institutional, and other forms of ownership.
Source: USDA-NASS, *1997 Census of Agriculture*, table 47.

Table 4—Federal income tax brackets, standard deduction, and exemption for 2001

Item	Filing status: Single	Filing status: Married (joint)
	Dollars	
Lower bound of taxable income:		
15% tax bracket	0	0
28% tax bracket	27,050	45,200
31% tax bracket	65,550	109,250
36% tax bracket	136,750	166,450
39.6% tax bracket	297,300	297,300
Standard deduction	4,550	7,600
Personal exemption	2,900	2,900

Note: An individual's taxable income equals the sum of all income subject to taxation minus the sum of adjustments to income, the standard deduction or itemized deductions, and the personal exemption multiplied by the number of allowable exemptions. Amounts are indexed for inflation annually.

similar for nonfarm taxpayers as well, with the number of both farm and nonfarm businesses being skewed toward the extreme high- and low-tax brackets and the taxes paid being skewed toward the higher brackets.

Across the farm typology, 70 percent of Federal income taxes are paid by the 53 percent of farmers in the lifestyle/other category (table 6). This category also has the greatest proportion of small family farmers paying tax rates over the 15-percent bracket (fig. 1).

The Farm Income Tax Base

Numerous provisions of Federal income tax law allow taxpayers to reduce their tax liability if they undertake certain tax-favored activities. Many of these activities are unique to particular industries. Thus, most industries receive some level of preferential tax treatment. In general, income from farming is taxed more favorably than income from many other businesses. Federal tax incentives have encouraged greater investment in the productive capacity of certain types of farming than

Table 5—Most taxpayers are in lower brackets, but those in higher brackets pay most tax

The distribution for farm sole proprietors is skewed slightly toward the extremes

Item	Farm sole proprietors	Other nonfarm sole proprietors	All other individuals	All individual taxpayers
		Number		
Taxpayers[1]	2,244,021	18,859,895	100,114,417	118,218,333
		Percent of taxpayers		
Not taxable	24.1	23.0	19.5	20.1
15%	53.1	50.2	58.7	57.4
28%	18.2	20.9	18.9	19.1
31%	2.3	3.2	1.9	2.1
36%	1.3	1.7	.6	.8
39.6%	1.0	1.0	.4	.5
All brackets	100.0	100.0	100.0	100.0
		Million dollars		
Total Federal income tax paid[2]	17,000	117,240	451,282	585,522
		Percent of tax payments		
15%	19.8	17.3	24.2	22.6
28%	25.7	29.6	37.7	35.8
31%	9.2	11.8	10.2	10.5
36%	9.2	12.3	7.6	8.6
39.6%	36.1	29.0	20.3	22.5
All brackets	100.0	100.0	100.0	100.0

[1]Farm sole proprietors file IRS schedule F; other nonfarm sole proprietors file schedule C, but not schedule F; all other individual taxpayers file neither schedule C nor F.

[2]Total income tax after credits, excluding portions of the earned income credit that are refunded or used to offset other taxes.

Source: USDA-ERS estimates from 1995 IRS Individual Public Use Tax File.

would have been warranted without tax incentives. Tax preferences also cause some farm investors to alter management practices to maximize tax benefits, sometimes to the detriment of other economic considerations.

Farmers benefit from both general tax provisions available to all taxpayers and from provisions specifically designed for farmers. Some of the provisions that are responsible for this treatment include the current deductibility of certain capital costs, capital gains treatment of proceeds from the sale of farm assets for which development costs have been deducted against regular income, cash accounting, and farm income averaging. These and other provisions reduce the farm income tax base.

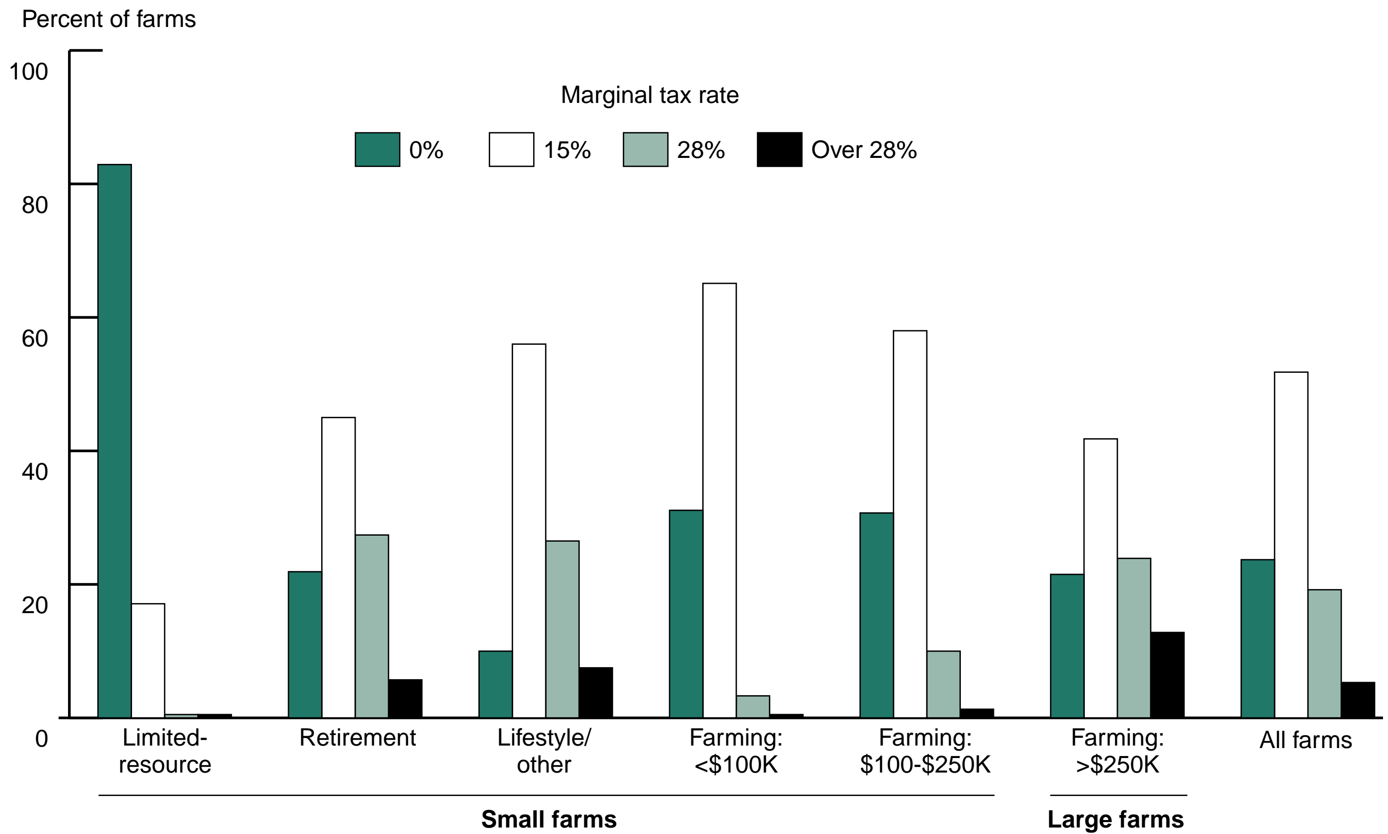
The favorable tax treatment for farm income is reflected in the size of farm profits and losses reported for income tax purposes. These tax preferences are important reasons why net farm income reported to IRS is less than that estimated by USDA to measure farm performance (GAO). Overall, farm sole proprietors have reported a net taxable loss from farming activities since 1980 based on IRS form 1040, schedule F. Aggregate annual net farm losses increased from 1990 to 1995, reversing a recovery that started in 1984 (fig. 2). The proportion of farm sole proprietors reporting a net farm loss on schedule F also has been increasing, with around 66 percent of farms reporting losses in 1996, compared with 56 percent in 1989. In 1996, farm sole proprietors reported over $102 billion in gross farm business receipts for tax purposes but reported a net farm operating loss of $7.1 billion. The net loss was the result of offsetting the $8.9 billion in profits reported by about one-third of all farm sole proprietors and $16 billion in losses reported by the remaining two-thirds (table 7).

Table 6—Distribution of Federal income taxes and marginal brackets by type of farm, 1996

	Small family farms						
				Primary occupation Farm sales ($1,000)			
Item	Limited-resource	Retirement	Lifestyle/other	<$100	$100-$250	Large family farms	All farm proprietors
				Number			
All farmers	218,383	261,926	1,167,321	336,498	151,970	82,865	2,218,964
				Percent			
Share across farm types	9.8	11.8	52.6	15.2	6.8	3.7	100.0
Share by bracket within group:							
Not taxable	82.9	21.9	10.0	31.2	30.7	21.5	23.7
15%	17.1	45.0	56.1	65.2	58.0	41.8	51.9
28%	0	27.4	26.5	3.3	10.0	23.9	19.2
31%	0	3.0	4.1	.1	1.1	7.5	2.9
36%	0	1.6	1.8	.1	.1	2.9	1.2
39.6%	0	1.1	1.6	.1	0	2.4	1.1
All brackets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
				Thousand dollars			
Federal income tax paid:[1]							
Total	7,736	2,789,597	13,560,209	865,727	466,087	1,560,277	19,249,632
				Percent			
Share across farm types	0	14.5	70.4	4.5	2.4	8.1	100.0
				Dollars			
Average	35	10,650	11,617	2,573	3,067	18,829	8,675

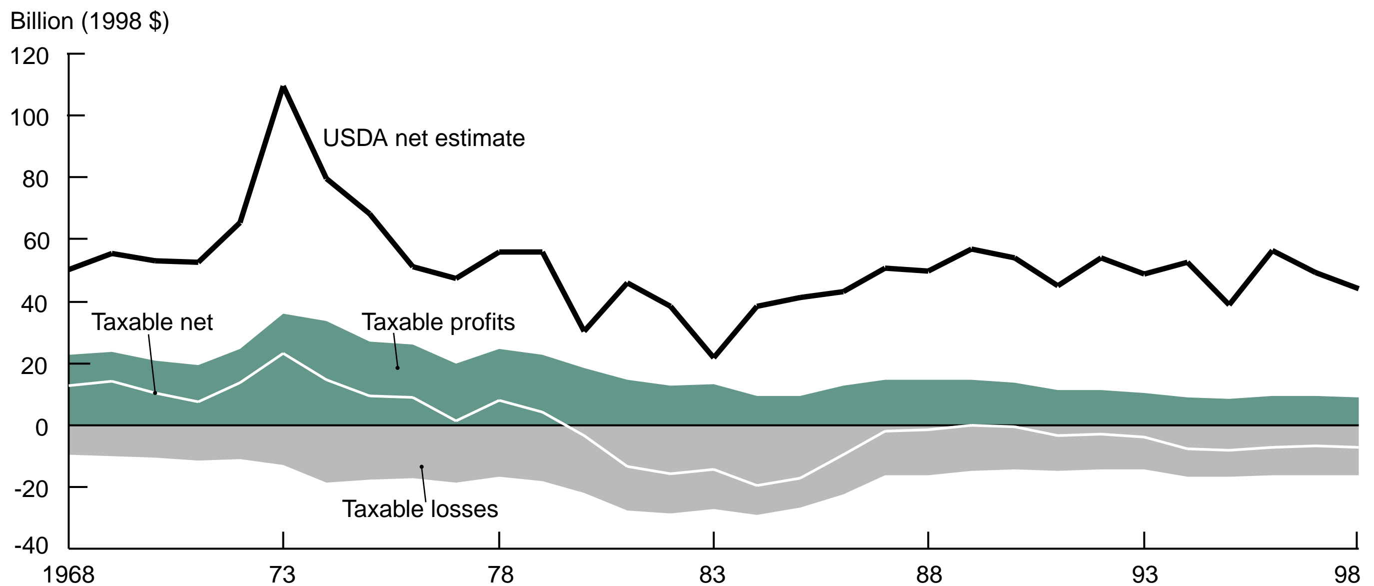
[1]Total income tax after credits, excluding portions of the earned income credit that are refunded or used to offset other taxes.
Source: Compiled by USDA-ERS from special tabulations by Internal Revenue Service.

Figure 1
Distribution of marginal brackets, 1996



Source: USDA-ERS, based on IRS data.

Figure 2
Taxable net farm income on schedule F is lower and less variable than USDA's estimate



Source: USDA-ERS; tax data are compiled from IRS.

Many of these farm 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 farm losses reduce taxes by offsetting income from nonfarm sources. 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 only 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.

By farm typology, a majority of farmers report farm profits on schedule F in the limited-resource, primary occupation, and large family farm categories (fig. 3). However, aggregate net farm income on schedule F was positive only for primary occupation farmers with gross farm sales over $50,000 – slightly broader than the two groups indicated in table 8, which include only primary occupation small farms with sales over $100,000 and large family farms (fig. 4).

Table 7—Farm profits and losses reported for taxes by sole proprietors, 1965-98

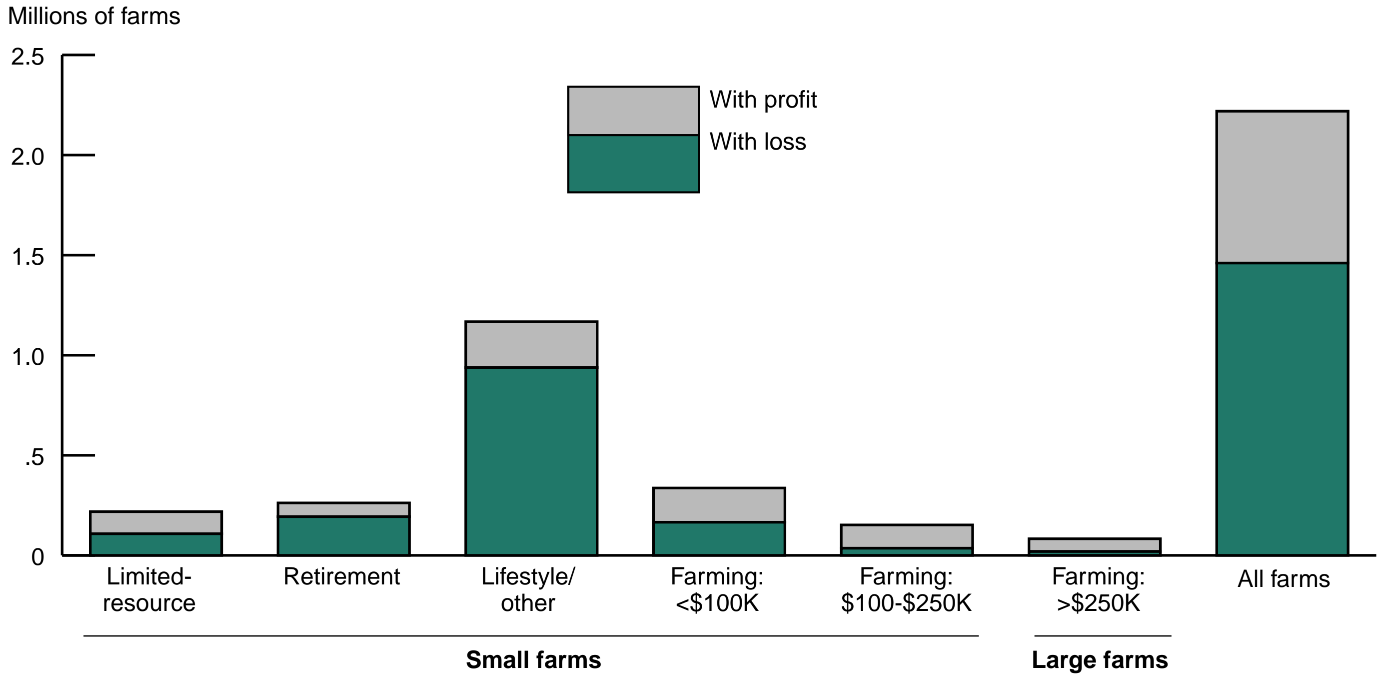
Year	Number of farm sole proprietors	Schedule F net income			Combined farm net income[1]		
			Farms with loss			Farms with loss	
		Net	Number	Losses	Net	Number	Losses
	1,000	*$million*	*1,000*	*$million*	*$million*	*1,000*	*$million*
1965	3,034	3,365	1,035	-1,852	na	na	na
1966	3,009	4,070	1,012	-1,915	na	na	na.
1967	3,012	3,353	1,125	-2,208	na	na	na
1968	3,033	3,127	1,182	-2,408	na	na	na
1969	3,092	3,578	1,155	-2,559	na	na	na
1970	3,026	2,789	1,234	-2,903	na	na	na
1971	2,775	2,188	1,290	-3,282	na	na	na
1972	2,791	4,106	1,172	-3,226	na	na	na
1973	2,866	7,228	1,219	-4,066	na	na	na
1974	2,804	4,996	1,434	-6,411	na	na	na
1975	2,755	3,563	1,415	-6,560	na	na	na
1976	2,819	3,456	1,477	-6,891	na	na	na
1977	2,487	504	1,314	-7,762	na	na	na
1978	2,705	3,565	1,386	-7,473	na	na	na
1979	2,605	2,124	1,361	-8,937	na	na	na
1980	2,608	-1,792	1,485	-11,751	na	na	na
1981	2,641	-7,812	1,657	-16,340	na	na	na
1982	2,689	-9,834	1,756	-17,828	na	na	na
1983	2,710	-9,294	1,742	-17,721	na	na	na
1984	2,694	-13,096	1,828	-19,434	na	na	na
1985	2,621	-12,005	1,730	-18,498	na	na	na
1986	2,533	-6,907	1,548	-15,902	na	na	na
1987	2,425	-1,421	1,366	-12,119	3,464	1,301	-10,934
1988	2,381	-1,175	1,375	-12,426	4,313	1,295	-11,119
1989	2,378	-210	1,332	-11,738	5,085	1,252	-10,495
1990	2,342	-411	1,325	-11,811	4,766	1,260	-10,792
1991	2,311	-3,070	1,359	-12,614	1,276	1,285	-11,346
1992	2,306	-2,620	1,392	-12,648	2,138	1,299	-11,411
1993	2,293	-3,680	1,373	-13,120	2,985	1,252	-11,353
1994	2,265	-7,335	1,485	-15,718	-853	1,389	-13,951
1995	2,244	-7,857	1,493	-16,032	-1,528	1,388	-14,330
1996	2,219	-7,112	1,461	-16,027	-247	na	na
1997	2,161	-6,847	1,439	-16,069	na	na	na
1998	2,092	-7,934	1,419	-16,743	na	na	na

na = Not available.

[1] Schedule F net income plus capital gains from selling business assets and farm rental income.

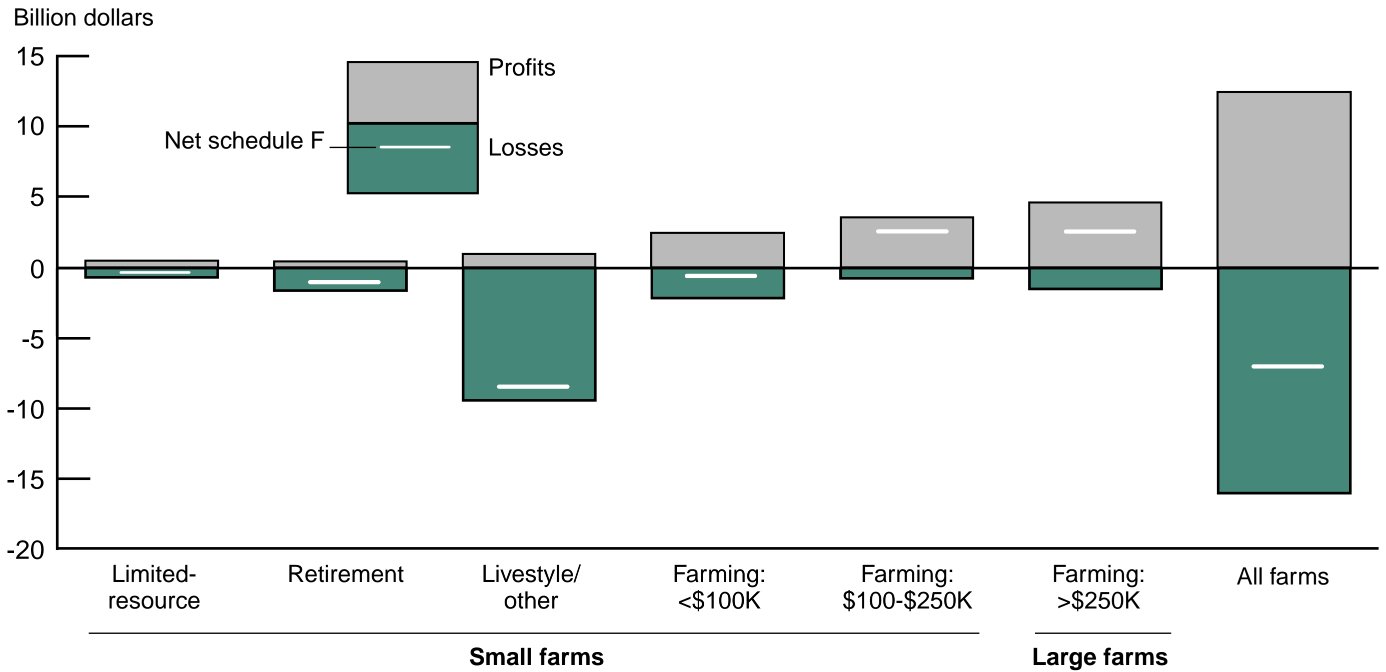
Source: 1965-86 from Long (p. 2): 1987-98 from USDA-ERS tables compiled from IRS data.

Figure 3
Number of farms with schedule F profits and losses, 1996



Source: USDA-ERS, based on IRS data.

Figure 4
Profits and losses on schedule F by farm type, 1996



Source: USDA-ERS, based on IRS data.

Table 8—Farm income reported for Federal income taxes by farm sole proprietors in 1996

Item	Small family farms					Large family farms	All farm proprietors
	Limited-resource	Retirement	Lifestyle/ other	Primary occupation Farm sales ($1,000) <$100	Primary occupation Farm sales ($1,000) $100-$250		
				Number			
Farmers[1]	218,383	261,926	1,167,321	336,498	151,970	82,865	2,218,964
				Percent			
Share across farm types	9.8	11.8	52.6	15.2	6.8	3.7	100.0
				$ 1,000			
Schedule F income:							
Gross receipts[2]	4,880,938	2,124,520	10,427,201	12,550,843	23,507,928	48,685,150	102,176,580
+ Program payments	242,497	161,492	668,529	764,664	1,415,352	1,619,994	4,872,528
- Purchased livestock[3]	18,181	-141,618	331,965	158,535	1,087,215	9,257,218	10,711,495
= Gross farm income	5,105,254	2,427,630	10,763,765	13,156,972	23,836,065	41,047,926	96,337,613
Expenses:							
Depreciation[4]	813,318	672,641	4,025,491	2,383,377	3,189,083	3,997,696	15,081,607
Mortgage, interest	438,217	194,809	1,833,096	1,170,983	1,833,607	2,710,899	8,181,611
Total expenses	5,426,513	3,726,907	19,502,838	13,539,736	22,021,309	39,232,296	103,449,598
Profits	338,896	301,989	681,002	1,752,605	2,542,569	3,298,150	8,915,212
				Percent			
Share with profit	50.6	26.1	19.6	50.8	76.5	76.6	34.2
				$1,000			
Losses	-660,155	-1,601,266	-9,420,075	-2,135,369	-727,813	-1,482,520	-16,027,197
				Percent			
Share with loss	49.4	73.9	80.4	49.2	23.5	23.4	65.8
				$1,000			
Net from schedule F	-321,259	-1,299,277	-8,739,073	-382,764	1,814,756	1,815,630	-7,111,985
+ Gain on business assets	156,800	1,271,273	1,399,832	1,946,386	727,702	748,670	6,250,661
+ Farm rental income[5]	*5,108*[6]	233,130	112,715	183,420	*27,926*[6]	51,904	614,204
= Combined farm inc.	-159,352	205,126	-7,226,527	1,747,044	2,570,384	2,616,205	-247,121
				Percent			
Percent across farm types:							
Program payments	5.0	3.3	13.7	15.7	29.0	33.2	100.0
Adjusted gross income	5.3	2.5	11.2	13.7	24.7	42.6	100.0
Depreciation[4]	5.4	4.5	26.7	15.8	21.1	26.5	100.0
Mortgage, interest	5.4	2.4	22.4	14.3	22.4	33.1	100.0
Total expenses	5.2	3.6	18.9	13.1	21.3	37.9	100.0
Profits	3.8	3.4	7.6	19.7	28.5	37.0	100.0
Losses	4.1	10.0	58.8	13.3	4.5	9.3	100.0

[1]Includes farm sole proprietors, but excludes farms organized as partnerships or subchapter S corporations.

[2]Includes gross receipts from crop and livestock sales, taxable CCC loans, crop insurance proceeds, cooperative distributions, and custom hire. Excludes income from selling farm business assets such as breeding and dairy livestock, which are reported on form 4797, and government agricultural program payments.

[3]Includes the cost or basis of livestock and other items purchased for resale, such as feeder livestock.

[4]Includes depreciation and section 179 expensing deduction for farm machinery, equipment, and buildings.

[5]Includes only crop-share farm rental income. Cash rental income is not reported separately for tax purposes.

[6]*Italics* indicate the estimate should be used with caution because the sample contained 10 or fewer returns.

Source: Compiled by USDA-ERS from special tabulations by Internal Revenue Service.

Since net farm profit or loss on schedule F does not include some farm income reported on other tax forms, a more complete measure of farm income adds capital gains from selling business assets (such as culled livestock and land) and farm rental income. For all sole proprietors, gains from selling business assets add $6.25 billion, while farm rental income adds an additional $600 million.[1] This combined measure of farm income reveals an aggregate taxable loss of $247 million in 1996, the third consecutive loss in a new trend since the mid-1980's (table 7). Combined farm income for most farm types are made positive by adding these additional variables to schedule F income, but the schedule F losses reported by lifestyle/other and limited-resource farms are sufficient to make the aggregate combined farm income for all farm sole proprietors negative (table 8).

The Farm Household Income Tax Base

In 1996, farm sole proprietors paid $19 billion in Federal income taxes on their farm and nonfarm incomes. Most of this amount was paid by farmers whose primary occupation was something other than farming and was therefore paid mostly on nonfarm income. IRS data indicate that a majority of farmers' incomes come from off-farm sources. This indication is similar to results from USDA surveys, but the divergence between farm and nonfarm income for all farm proprietors is greater in the tax data. The only farm types receiving more than a negligible portion of their income from farming were primary occupation small farms and large family farms. Only primary occupation farms with gross sales between $100,000 and $250,000 received a majority of their income from farming. All other farm types received a majority of their income from nonfarm sources (table 9).

Most of the nonfarm income comes from wages and salaries earned away from the farm by the farm operator or the operator's spouse. This is especially true for primary occupation farms and lifestyle/other farms that receive well over half of their nonfarm income from wages and salaries. Over 60 percent of primary occupation and lifestyle/other farms earn wage and salary income (table 10). Another important component is investment income which includes interest, dividends, capital gains, and rental property (other than gains from selling farm business assets or farm rental income).

[1]Includes only crop share farm rental income. Cash rental income from farm property is not reported separately from other rental income for tax purposes.

Large family farms and retirement farms receive relatively more investment income than other types of farms and are more likely to report such income. Retirement farms receive nearly as much income from social security and pensions as from investments. Nonfarm business enterprises contribute a sizeable amount of income for lifestyle/other farms, and lifestyle/other farms earn most of the nonfarm business income reported by all farm proprietors. Despite small amounts of nonfarm wages and investment income, limited-resource farms report significant losses to nonfarm businesses and to rental property (table 9). Because of these losses, limited-resource farms report only a small amount of net nonfarm income, not enough to offset their combined farm losses.

In addition to farm business deductions mentioned throughout this report, other deductions from household income include contributions to retirement accounts, expenses for self-employed health insurance and self-employment taxes, the standard or itemized deductions, and the personal exemption for each member of the household. Although relatively few farmers use retirement account deductions, such contributions are relatively more important for primary occupation farmers because they are less likely to have employer-sponsored plans at a nonfarm job.

Most farmers, like most nonfarm taxpayers, claim the standard deduction rather than itemize. Although about 30 percent of all farmers itemize their nonfarm deductions, only a negligible number of limited-resource farms itemize, and only about 16 percent of primary occupation small farms itemize. About 42 percent of lifestyle/other farm households itemize. The standard or itemized deduction and personal exemptions combine to reduce adjusted gross income (AGI) by about one-third, yielding $81 billion of taxable income for farm sole proprietor households (table 9).

Capital Gains Taxes

Capital gains income is the profit (or loss) realized on the sale of assets held for investment. It is based on the difference between the asset's sale price and the purchase price adjusted for depreciation or improvements (the basis). Capital gains are generally not recognized for tax purposes until the taxpayer disposes of an asset. The income tax system has historically taxed capital gains at rates that are lower than taxes on ordinary income.

Table 9—Total income reported for Federal income taxes by farm sole proprietors, 1996

	Small family farms						
				Primary occupation		Large	All
	Limited-		Lifestyle/	Farm sales ($1,000)		family	farm
Item	resource	Retirement	other	<$100	$100-$250	farms	proprietors
				Number			
All farmers	218,383	261,926	1,167,321	336,498	151,970	82,865	2,218,964
				$1,000			
Household income:[1]							
Wages and salaries	495,716	2,307,041	53,960,415	5,316,390	1,200,441	1,328,595	64,608,598
Interest income (total)	310,292	2,941,629	5,304,360	712,567	224,148	837,997	10,330,993
Dividends	61,993	1,168,483	2,411,889	99,405	102,852	474,910	4,319,531
Nonfarm business net	-140,694	491,355	5,011,164	432,494	136,561	178,808	6,109,687
Capital gains, losses	267,425	3,482,182	7,007,586	2,024,307	817,326	1,720,152	15,318,981
Gain on other property	-98,957	407,674	704,995	159,487	194,929	183,365	1,551,493
IRA distributed (taxed)	17,215	590,945	547,219	46,605	61,596	42,609	1,306,189
Pension, annuity (total)	83,597	3,702,891	4,867,831	445,856	80,639	141,331	9,322,145
Rent, royalty net income	-776,822	2,260,671	9,129,404	336,895	45,147	970,883	11,966,176
Farm profits	338,896	301,989	681,002	1,752,605	2,542,569	3,298,150	8,915,212
Social security (total)	56,574	3,113,574	216,919	77,415	108,306	73,997	3,646,783
Alimony, refund	23,765	40,658	587,352	67,065	17,986	26,780	763,608
Household income	639,000	20,809,092	90,430,136	11,471,091	5,532,500	9,277,577	138,159,396
Schedule F losses	-660,155	-1,601,266	-9,420,075	-2,135,369	-727,813	-1,482,520	-16,027,197
Net income to household	-21,155	19,207,826	81,010,061	9,335,722	4,804,687	7,795,057	122,132,199
Combined farm income[2]	-159,352	205,126	-7,226,527	1,747,044	2,570,384	2,616,205	-247,121
Nonfarm income	138,196	19,002,701	88,236,586	7,588,679	2,234,303	5,178,853	122,379,320
				Percent			
Share of net income from nonfarm[3]	[4]	98.9	108.9	81.3	46.5	66.4	100.2
				$1,000			
Selected adjustments to income:							
IRA contributions (deduct)	*7,538*[5]	45,029	205,362	56,692	38,665	44,144	397,430
Keogh/SEP contribution	*54*[5]	19,958	200,240	*5,736*	50,913	79,894	356,798
Health insurance (self-employed)	18,159	25,773	88,601	53,260	70,743	40,176	296,712
Half of self-employment tax	23,493	51,706	348,738	136,051	179,508	178,067	917,561
Adjusted gross income	-1,402,236	15,265,584	75,652,141	7,717,435	3,667,700	5,532,557	106,433,180
Less deductions	1,412,522	2,931,234	13,519,710	2,473,396	1,107,595	1,250,253	22,694,710
Less exemptions	1,039,685	1,221,622	7,893,438	2,413,408	1,253,866	669,197	14,491,217
Taxable income[6]	44,971	11,678,553	56,548,631	4,711,927	2,591,873	5,800,910	81,376,866

[1] Using data reported on form 1040, a broader measure of annual income than reported for taxes since it includes tax-exempt interest, pensions, annuities, and social security income. Does not include schedule F losses, which are added back to compute net income to household. Does not include "other income and losses," which is frequently negative because many farmers carry unused net operating losses from prior years forward into the tax year.

[2] Equals the sum of schedule F, capital gains from the sale of business assets, and farm rental income.

[3] Net income to household from nonfarm sources can exceed 100 percent if combined farm income is negative.

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

[5] *Italics* indicate the estimate should be used with caution because the sample contained 10 or fewer returns.

[6] Because taxable income cannot be less than $0, the aggregate amount exceeds adjusted gross income minus deductions and exemptions.

Source: Compiled by USDA-ERS from special tabulations by Internal Revenue Service.

Table 10—Frequency that farmers report sources of income or deductions, 1996

Item	Small family farms: Limited-resource	Retirement	Lifestyle/ other	Primary occupation, Farm sales ($1,000): <$100	$100-$250	Large family farms	All farm proprietors
				Number			
All farmers	218,383	261,926	1,167,321	336,498	151,970	82,865	2,218,964
				Percent			
Share of farmers with:							
Form 1040—							
Wages and salaries	37.1	38.6	86.7	69.5	59.9	62.7	70.8
Interest income (total)	68.5	95.7	81.9	78.9	88.9	91.1	82.6
Dividends	18.4	46.6	34.5	22.2	35.7	46.8	33.0
Nonfarm business net	22.2	17.6	28.7	23.6	22.2	19.1	25.2
Capital gains, losses	33.7	55.0	35.8	36.3	58.6	56.3	40.3
Gain on other property	14.7	14.7	14.9	23.1	34.0	40.9	18.4
IRA distributed (taxed)	3.7	26.4	4.5	2.0	3.5	2.5	6.5
Pension, annuity (total)	12.5	57.8	22.0	13.1	10.0	12.9	22.8
Rent, royalty net income	29.1	51.0	34.9	31.0	36.0	48.6	36.2
Social security (total)	4.8	100.0	1.2	2.8	6.7	6.2	14.0
IRA contributions (deductible)	*1.8*[1]	6.2	6.8	6.2	11.1	17.3	6.9
Nondeductible [2]	na	na	na	na	na	na	1.4
Keogh, self-employment pension contribution	*0*[1]	1.4	1.8	*.4*[1]	6.0	10.3	2.0
Self-employment health insurance	11.7	10.9	7.5	16.5	44.8	43.8	13.6
Half of self-employment tax	40.0	22.4	24.9	50.5	78.1	81.3	35.7
Standard deduction	67.0	69.8	56.7	75.9	71.6	58.5	63.3
Itemized deduction	3.5	28.0	41.6	16.6	16.2	28.2	30.2
Neither deduction [3]	29.5	2.2	1.6	7.5	12.2	13.2	6.5
Schedule F—							
Program payments	38.4	29.1	20.3	46.9	76.9	83.3	33.4
Depreciation [4]	69.6	67.8	74.6	91.3	97.6	98.5	78.3
Mortgage, interest	45.3	25.8	36.1	67.6	91.4	93.4	46.5
Gain on business assets	18.7	25.4	12.3	23.5	40.2	32.3	18.8
Farm rental income	*1.2*[1]	7.5	2.0	2.3	*.8*[1]	3.4	2.6
Type of tax return—[2]							
Single	na	na	na	na	na	na	16.3
Married filing jointly	na	na	na	na	na	na	80.3
Other	na	na	na	na	na	na	3.4
Tax return prepared by— [2]							
Taxpayer	na	na	na	na	na	na	15.0
Paid preparer	na	na	na	na	na	na	84.8
Other	na	na	na	na	na	na	.2

na=Not available.

[1]*Italics* indicate that estimate should be used with caution because the sample contained 10 or fewer tax returns.

[2]Data are from 1995 IRS Public Use Tax File (farm typology not available) and have varied little in recent years.

[3]May not report any deduction if adjusted gross income is negative or if taxpayer can be claimed as a dependent on another return.

[4]Includes depreciation and section 179 expensing deduction for farm machinery, equipment, and buildings.

Source: Compiled by USDA-ERS from special tabulations by Internal Revenue Service.

Because assets used in the trade or business to produce other output are eligible for capital gains treatment, capital gains are an important and frequent component of income for farmers. According to 1996 IRS tax data, about 40 percent of all farm sole proprietors reported a capital gain (table 10). This figure is three times the frequency for all other taxpayers and twice that for other small businesses. Data for most of the preceding decade also indicate similar proportions. By typology, nearly 60 percent of farms with sales over $250,000 and retirement farms reported capital gains, while about one-third of smaller sales, primary occupation farms, limited-resource farms, and lifestyle/other farms reported capital gains. About two-thirds of all dairy farmers and about half of other livestock farmers report some capital gains income each year. Of the $15 billion in net capital gains reported by farmers in 1996 (table 9), about $6.25 billion or 41 percent was attributed to assets used in a trade or business (table 8). For primary occupation small farms, over 90 percent of net capital gains were from the sale of business assets. For limited-resource and large family farms, about 60 percent and 44 percent of capital gains, respectively, were from business assets. Only 36 percent and 20 percent of capital gains were from business assets for retirement and lifestyle/other farms, respectively.

Capital gains are also heavily concentrated among the wealthiest taxpayers, although the distribution is less concentrated in farming than for all taxpayers. Farmers in the top 5 percent of the AGI distribution reported over half of the capital gains reported by farmers, while the top 5 percent of all taxpayers reported nearly three-fourths of the total capital 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.

Under current law, the maximum individual tax rate on capital gains is 20 percent for assets held longer than 1 year, and lower rates may be available for assets held over 5 years. Any capital gain which otherwise would be taxed at a 15-percent ordinary rate is taxed at a 10-percent rate. Capital gains on assets held less than 1 year are taxed as ordinary income. A special 25-percent maximum tax rate applies to gains on certain depreciable business property.

Current law also provides for lower capital gains tax rates on assets owned for more than 5 years. After December 31, 2000, gains from selling property owned for more than 5 years that would be taxed at the 10-percent rate qualifies for an 8-percent tax rate. Any gain that otherwise would be taxed at the 20-percent rate qualifies for an 18-percent tax rate if the asset was held longer than 5 years and purchased after December 31, 2000. To qualify for the 18-percent rate, taxpayers may elect to treat existing assets as having been sold for fair market value on January 1, 2001, and reacquired at that same value.

Historical Background

Beginning with the Revenue Act of 1921, which created a maximum tax rate of 12.5 percent, noncorporate capital gains have received preferential treatment. This preferential treatment has been accomplished either by providing a lower maximum tax rate on capital gains than on ordinary income or by allowing a portion of the gain to be excluded. Throughout most of the decade before the Tax Reform Act of 1986 (TRA86), a 60-percent exclusion applied. Thus, only 40-percent of long-term gains were subject to taxes. Taxpayers in all brackets benefited from the exclusion, but the exclusion was more valuable for taxpayers in the higher marginal brackets. In 1986, the last year of the exclusion, the maximum effective reduction in tax rates was from the 50-percent ordinary tax bracket to an effective 20-percent tax.

The TRA86 maintained the distinction between capital gains and ordinary income but eliminated the 60-percent exclusion. Instead, it created a maximum capital gains tax rate of 28 percent that was equal to the maximum 28-percent ordinary tax rate under the TRA86. All taxpayers would pay the same rate on capital gains as ordinary income unless the maximum individual tax rate increased. When the top individual rate increased to 31 percent in 1991 (and to 39.6 percent in 1993), taxpayers in these upper brackets paid a lower rate on capital gains than on ordinary income. In terms of the exclusion that existed prior to TRA86, the 28-percent ceiling on capital gains tax rates created an effective exclusion of 9.7 percent for taxpayers in the 31-percent bracket, and 29 percent for taxpayers in the 39.6-percent bracket.[2]

Preferential capital gains treatment was restored to all taxpayers following the Taxpayer Relief Act of 1997

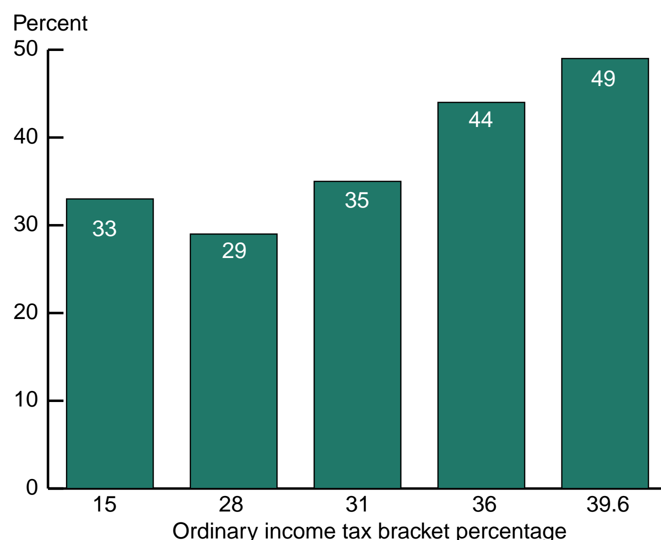
[2]While lower tax rates on capital gains may be viewed as an effective exclusion, the size of the effective exclusion may be less than indicated for some taxpayers. Under current law, the entire capital gain is included in adjusted gross income (AGI) and may therefore accelerate the phaseout of some deductions or tax credits. When this occurs, the size of the effective exclusion decreases. Such a reduction does not occur when part of the gain is directly excluded from AGI.

(TRA97). The maximum individual tax rate on long-term capital gains became 20 percent (10 percent for gains that would otherwise be taxed at the 15-percent ordinary tax bracket). To qualify for the 20-percent and 10-percent rates, the TRA97 required an 18-month holding period. The Act preserved the maximum 28-percent rate, however, for assets held between 12 and 18 months. Capital gains on assets held less than 1 year continued to be taxed as ordinary income. The IRS Restructuring Act of 1998 simplified the capital gains rate structure by shortening the holding period requirement from 18 months to 12 months. The 10- and 20-percent capital gains tax rates create five effective exclusions for capital gains income – ranging from a 29-percent effective exclusion for taxpayers in the 28-percent ordinary tax bracket, to a 49-percent effective exclusion for taxpayers in the 39.6-percent ordinary bracket (fig. 5).

Capital Gains Treatment of Farm Assets

Assets used in a trade or business (such as farming) are not capital assets under the tax law, but do receive preferential treatment. Capital assets generally include any property except business inventory held for sale or depreciable or real property used in a trade or business. Property held for personal use is a capital asset, and gains qualify for capital gains treatment, but losses are not deductible (except from casualty or theft). Stocks and bonds are also capital assets qualifying for preferential treatment, and losses may offset both capital gains and ordinary income depending on individual circumstances.

Figure 5
Effective exclusion for capital gains income



Note: Numbers within columns reflect effective exclusions percentage for capital gains income in each tax bracket.
Source: USDA-ERS.

Although assets used in a trade or business (section 1231 property) are not capital assets, gains from the sale of such assets are treated as capital gains, and losses are treated as an offset to ordinary income. Among the farm assets eligible for such treatment are farmland and livestock held for draft, dairy, breeding, or sporting purposes. The holding period requirement is generally 1 year. Cattle and horses must be held at least 2 years, however, and poultry are not eligible for capital gains treatment.

Depreciable assets used in the trade or business are treated somewhat differently. Gain from selling depreciable assets generally does not qualify for capital gains treatment to the extent of recaptured depreciation, since depreciation reduces taxable income at ordinary tax rates. For example, gain from selling depreciated equipment and single-purpose agricultural structures (section 1245 property) is taxed as ordinary income. However, under current law, farm buildings and similar depreciable business real estate (section 1250 property) receive a 25-percent capital gains tax rate on recaptured depreciation to the extent of straight-line depreciation method. Recaptured depreciation in excess of the straight-line amount is taxed at ordinary tax rates.

The capital gains treatment for farm business assets is most beneficial when combined with the ability to deduct preproductive expenses and to ignore inventories through cash accounting. This combination allows farmers to deduct development expenditures against their current income at regular tax rates and to convert income to capital gains that may be eligible for lower tax rates which are further deferred until the asset is sold.

Deducting Preproductive Capital Expenditures

Another feature of the Federal income tax that applies specifically to farmers is the ability to deduct the cost of developing certain farm assets in the tax year when the costs are incurred or paid. Examples of preproductive development costs include raising dairy, draft, breeding, or sporting livestock to their age for mature use, caring for orchards and vineyards before they are ready to produce crops, and clearing land and building long-term soil fertility by applying lime, fertilizer, and other materials.

Expensing of development costs causes a mismatching of expenses and income. This mismatching has been used to generate deductions or losses that can be written off against income from other sources. Farm assets eligible for deductible development expenses historically have attracted tax-motivated investment, sometimes to the detriment of the affected industry. For example, concern regarding the impact of tax-motivated investment on production and price levels prompted citrus and almond growers to seek legislation in 1969 requiring the capitalization of development expenses incurred within 4 years of planting.

The Tax Reform Act of 1986 placed additional restrictions on deducting preproductive development costs. Such costs for plants or animals with a development period of 2 years or longer were required to be capitalized and recovered gradually as depreciation or in lump sum at time of sale. Farmers were permitted to elect out of the capitalization requirement if they used the straight-line depreciation method for all assets placed in service during the years the election was used. Costs for land clearing and initial improvements were also required to be capitalized.

In 1988, Congress repealed the capitalization requirement for livestock out of concern over the burdensome recordkeeping requirements. Currently, therefore, only land improvements and costs related to crops with a development period of 2 years or longer are subject to the capitalization requirement.

Cash Accounting

Under the cash method of accounting, expenses are deducted in the year they are paid and income is recognized in the year it is received. Inventories of both inputs and products are ignored in determining farm income. This greatly simplifies the recordkeeping requirement for farmers. However, it also permits individuals to mismatch income and expenses by deducting expenses in the current year and recognizing income that was produced by those expenses in a later year. For some agricultural enterprises, cash accounting can allow large deductions during the early years of an investment and deferred recognition of income by building inventories of the products produced. This can cause the accumulation of larger inventories than would be justified without the tax interaction.

Farmers were originally granted the privilege of using the cash method of accounting by administrative decision in 1915. Continuation of this right has been justified on the ground that farmers have neither the expertise nor sufficient access to professional assistance to employ the more complicated bookkeeping systems necessary for accrual accounting. Based on 1982 IRS data, approximately 98 percent of farm sole proprietors used the cash method of accounting. A large number of farm partnerships and small business corporations also use the cash method. Because of abuses of the cash method of accounting, Congress has attempted to limit its use. In 1976, farm corporations and partnerships (with a corporation as a partner) with gross receipts over $1 million were required to use the accrual method of accounting – but the scope was limited by exceptions intended to avoid applying the provision to closely held family corporations. Accounting rules for family farm corporations also changed under the Tax Reform Act of 1986, which required a permanent switch to accrual accounting if 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.

The Tax Reform Act of 1986 also created additional restrictions to keep farm sole proprietors from using cash accounting to distort income. Farmers who use the cash method of accounting cannot deduct prepaid expenses for feed, seed, fertilizer, or similar supplies beyond half of their total farm expenses (excluding the prepaid amount) until the inputs are actually used. An amount is a prepaid expense if the supplies are not used or consumed during the year. Therefore, although farmers can prepay some expenses to manage their tax liability, the deductible amount of prepaid expenses is limited to half of the total of nonprepaid expenses. An exception, however, allows a taxpayer whose principal occupation is farming to exceed this limitation if (1) the prepayment limitation has been met for the 3 preceding tax years or (2) the excess prepayment is due to a business operations change caused by extraordinary circumstances such as fire, storm, casualty, disease, drought, or government crop diversion program.

Because most farmers are sole proprietors, cash accounting remains the most common method of accounting in production agriculture. This provides the vast majority of farmers some flexibility to prepay expenses and time income receipts to optimize their current-year tax burdens. A relatively small number of very large family farm corporations – mostly raising livestock, fruit, or vegetables – are required to use the accrual method of accounting which is the standard method for most nonfarm businesses with inventories.

Depreciation Allowances and Capital Expensing

Expenditures to purchase assets that will produce income over a long period of time are capital expenses and generally must be apportioned over the life that the asset is expected to produce income. This apportionment, known as depreciation, deducts only a portion of the cost each year over the life of the asset and helps match the income generated by an asset to the expense of purchasing the asset as the value of the asset decreases over its usable life. Capital expensing is a faster way of recovering costs by immediately deducting a specified dollar amount in the year an asset is purchased.

Agriculture is a capital-intensive industry. In addition to the large investment in land, farming requires substantial investments in buildings, machinery, and equipment. As a result, the system governing the recovery of these capital costs is particularly important for the agricultural economy – not only for farmers, but also for machinery manufacturers, builders, and dealers in local communities.

The capital cost recovery system has a substantial influence on the amount and composition of farm business investment. It specifies the timing of tax depreciation deductions and the levels of investment tax credits, if any. It is therefore a primary determinant of the actual tax burden on income from investment in depreciable farm capital.

Depreciation deductions under the capital cost recovery system are based on the historical cost of assets, and thus have fixed nominal values. The real values of depreciation deductions are reduced by inflation. Higher rates of inflation reduce the value of future depreciation deductions and result in higher effective tax rates and greater disincentives to invest.

Over the years, Congress has made periodic modifications in the capital cost recovery system in an effort to increase investment incentives and compensate for the effects of inflation on tax depreciation deductions. These modifications have included the allowance of accelerated tax depreciation methods, the introduction of investment tax credits, and the shortening of write-off periods.

The Economic Recovery Tax Act of 1981 introduced a new capital cost recovery system referred to as the Accelerated Cost Recovery System (ACRS). Under ACRS, depreciable assets could be written off at accelerated rates over 3 to 18 years, depending upon asset type. Most farm assets including many farm structures used in dairy, poultry, and hog production could be written off over 5 years, despite significantly longer economic lives. In addition to the shorter recovery period, each farmer could immediately deduct up to $5,000 of investment in depreciable capital each year.

Most capital assets used in farming were also eligible for a 6-percent or 10-percent investment tax credit. Qualifying property included machinery, equipment, livestock purchased for dairy, draft, breeding, or sporting purposes, crop storage facilities, and single-purpose agricultural structures. The combined effect of the investment tax credit and ACRS resulted in negative effective tax rates for investment in most types of farm machinery, equipment, and some structures[3]. This provided substantial incentive for increased investment in farm capital.

The Tax Reform Act of 1986 modified the ACRS by lengthening write-off periods and repealing the investment tax credit. However, the option to immediately deduct up to $5,000 of investment was increased to $10,000 for businesses that invest less than $200,000 per year. The net effect of these changes is a capital cost recovery system that is significantly less favorable than the system that governed investment during 1981-85. Under current policies, depreciation deductions for investment in farm property are less favorable than

[3]Negative effective tax rates occur when tax credits and deductions can offset all the income from the investment plus additional income from other sources.

Table 11—Amount of capital investment that can be expensed, 1981-2003

Tax year	Expensing amount
	Dollars
1981-86	5,000
1987-92	10,000
1993-96	17,000
1997	18,000
1998	18,500
1999	19,000
2000	20,000
2001-02	24,000
2003 and after	25,000

deductions for nonfarm property.[4] However, the increase in the amount of investment that can be immediately deducted, which is scheduled to reach $25,000 by 2003, has allowed most small farms to write-off all of their investment in depreciable capital (table 11). In fact, based on 1996 investment levels, about 90 percent of all farmers can expense their capital investment with about two-thirds of total investment in depreciable farm equipment eligible to be written off in the year the equipment is purchased. Larger farms that invest in excess of $200,000 per year either are not eligible for the deduction or are allowed to expense a reduced amount.

In 1996, farm sole proprietors reported over $15 billion in depreciation and capital expensing deductions. This represented about 15 percent of total farm business expenses reported on farm tax returns for that year. As would be expected, those farmers who receive most of their income from farming reported the bulk of these expenses. Expenses for limited-resource, retirement, and lifestyle/other farms were significantly smaller on average. In fact, in 1996 less than 1 percent of limited-resource farmers invested more than the annual expensing limit of $17,500, while nearly half of all large and nearly two-thirds of very large farms invested more than the annual expensing limit (fig. 6).

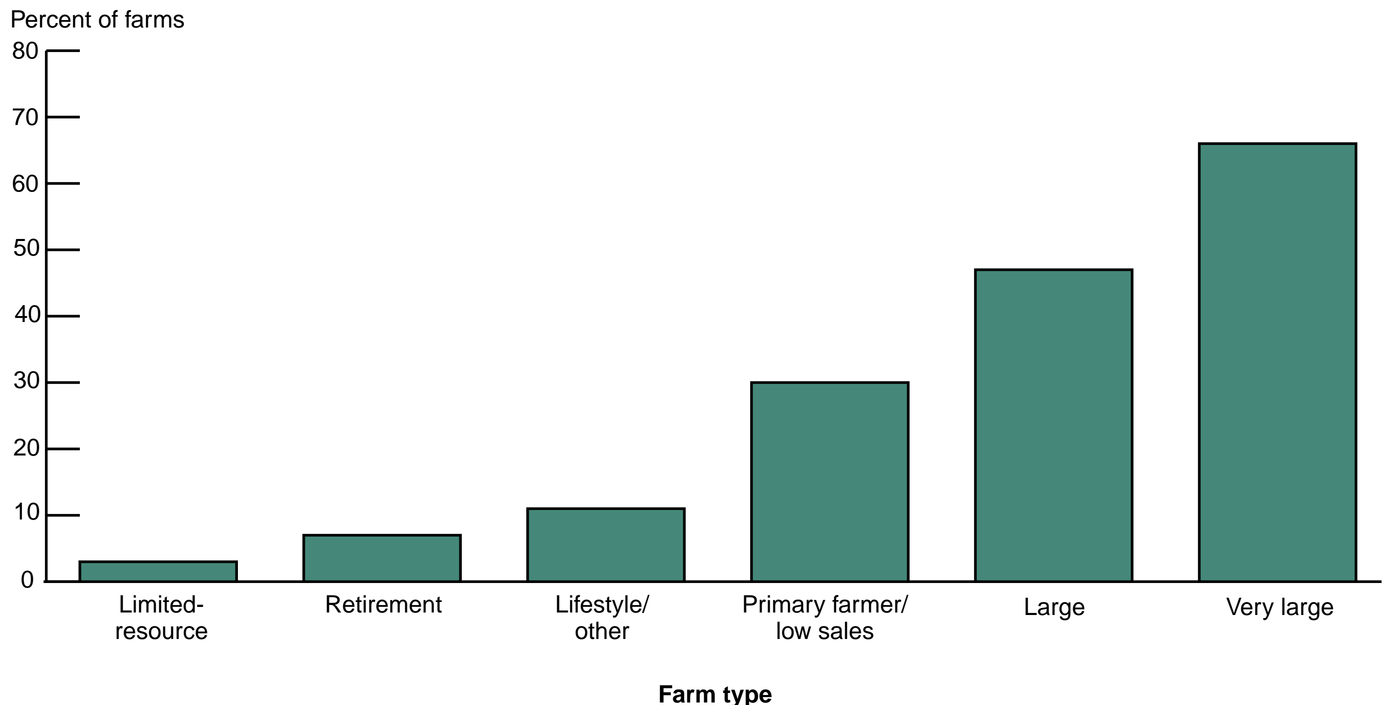
[4]Depreciation deductions were initially determined on the basis of the 200-percent declining balance method. This was changed to the 150-percent declining balance method in exchange for repealing the provision requiring the capitalization of livestock development costs.

Deductions Related to Land

Land is the primary input in farming. Thus, the tax policies that affect investment in land are particularly important for the agricultural economy. Federal income tax provisions that are most important for farmland include the deductibility of nominal interest and property tax payments, the capital gains treatment of appreciation in land values, and the deferral of capital gains until they are realized from sale or other disposition.

Interest and property tax deductions are worth more in tax reductions for taxpayers in higher tax brackets. Likewise, preferential capital gains tax rates offer greater effective tax reductions to those in higher tax brackets. These provisions have combined to make farmland, like many other real estate investments, an attractive tax-favored investment during inflationary periods.

Figure 6
Share of farmers with capital investment over the expensing limit by type of farm, 1996



Source: Estimated by ERS-USDA from ARMS data.

Soil and Water Conservation

Since 1954, farmers have been allowed to claim immediate Federal income tax deductions for certain types of expenditures on soil and water conservation or for the prevention of erosion of land used in farming. Examples of expenses have included leveling, grading, terracing, custom furrowing, planting windbreaks, and constructing, controlling, and protecting diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds. The list of potential eligible expenditures includes all conservation expenditures that taxpayers would normally add to the basis of land and deduct for tax purposes when the land was sold. Deductions are not allowed, however, for land not used in farming, for draining or filling wetlands, or for preparing land for center-pivot irrigation systems. Depreciable conservation assets such as pipes, tiles, pumps, and other nonearthen structures are also not deductible, except for some assessments by soil and water conservation districts. Each farmer's annual conservation deduction is limited to 25 percent of gross farm income, but excess amounts may be carried over to future tax years.

Since the Taxpayer Reform Act of 1986, farmers have been allowed to claim immediate deductions for soil and water conservation only when the expenses are consistent with a conservation plan approved by the USDA Natural Resources Conservation Service (NRCS) or a comparable State agency. The plan need not be specific to the individual farm, however. USDA and some State agencies have developed area-wide plans that indicate the types of conservation measures that are considered suitable.

If land is sold within 5 years of immediately deducting soil and water conservation expenses, any gain on the sale of land is treated as ordinary income up to the extent of those soil and water conservation deductions. If the sale occurs after 5 years but within 10 years, then only a certain proportion of the gain is treated as ordinary income.

Cost sharing is another method that Federal, State, and local government programs use to encourage farmers' soil and water conservation improvements. As an alternative to deducting soil and water conservation expenses, farmers may be eligible to exclude all or a portion of the government cost-share payment from their taxable income. To be eligible, the Secretary of Agriculture must determine that payments are made primarily for conservation purposes and IRS must determine that income does not substantially increase as a result of the improvement. A substantial increase in income is defined as the greater of an increase of $2.50 per acre or a 10-percent increase in the gross receipts from the affected acreage over the average gross receipts for the preceding 3 years. Government payments that are excluded from income are subject to a 20-year recapture provision which recaptures all of the exclusion if the property is sold within 10 years. The recapture percentage is reduced 10 percent per year for the following 10 years.

Livestock Sales Due to Weather-Related Conditions

Selling livestock because of weather-related disasters can create tax timing problems because unusually large sales may cause marginal income tax rates to increase. A special rule applicable to involuntary conversions allows farmers who are forced to sell livestock due to weather-related conditions (such as drought, floods, and other weather-related disasters) to defer recognizing that income until the following 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 indefinitely by purchasing similar livestock within 2 years.

Prior to the Taxpayer Relief Act of 1997, the provision applied only to sales due to drought. The 1997 Act expanded this special treatment to include floods and other weather-related conditions. Farmers' tax savings from this provision 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 realize substantial tax savings in any given year.

Income Averaging

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 creates a tax inequity because higher marginal tax rates during years with above-average income raise an individual's effective tax rate over time. Income averaging can mitigate this effect by allowing taxpayers to smooth their

tax burdens over time through tax accounting methods that consider multiyear income. Under current law, since 1998, farmers are the only taxpayers who are eligible for income averaging. Prior to the Tax Reform Act of 1986, all taxpayers were eligible for a different method of income averaging.

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 from variable income streams.

After income averaging was repealed in 1986, the simplified tax structure reduced the additional tax burden on variable income because the number of tax brackets dropped from more than a dozen to only three. Since each tax bracket was much wider, income could vary more before the taxpayer entered a higher marginal bracket. Farmers also could still use other income tax provisions to manage their tax brackets in the absence of income averaging. Cash accounting could reduce taxable income through prepaid business expenses or deferred farm income, and well-timed capital purchases could reduce taxable income through depreciation deductions or capital expensing. However, several developments in the mid-1990's increased the likelihood that some 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 higher income taxpayers to reach higher brackets. Some farmers also experienced more income variability following the decoupling and scheduled phaseout of farm program payments under the 1996 Farm Act.

The Taxpayer Relief Act of 1997 created a new method of income averaging that is more restrictive by being available only for farmers and only on farm income. Under the current law, 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 provision does not allow, however, income from previous years to be brought forward. Furthermore, as long as some farm income is available to be shifted, the source of income variability does not need to be from farm income for income averaging to be beneficial.

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 rather than total household income also reduces the number of farmers who will benefit and the potential tax savings. Before the 1986 Act, about 10 percent of farmers used income averaging and saved, on average, an estimated $800 each. Data on farmers' actual use of the current income averaging provision is not yet available. However, restricting income averaging to farm income may reduce the number who will benefit and the tax savings.

Self-Employed Health Insurance Deduction

The self-employed health insurance deduction was created in 1988 and is intended to give small business owners, including many farmers, tax benefits similar to employees who receive employer-deductible health insurance. It is especially important for self-employed people who must purchase health insurance on their own. It is easier to use than the alternative of deducting health insurance premiums with itemized medical expenses since itemized medical expenses are deductible only to the extent they exceed 7.5 percent of AGI – a hurdle that reduces potential deductions and is difficult for many taxpayers to meet.

In 2001, farmers and other self-employed taxpayers are allowed to deduct 60 percent of the cost of providing health insurance for themselves and their families as long as they are not eligible for an employer-sponsored

Table 12—Deductible portion of self-employed health insurance premiums since inception

Tax year	Deduction
	Percent
1988-94	25
1995-96	30
1997	40
1998	45
1999-2001[1]	60
2002[1]	70
2003 and after[1]	100

[1]Schedule to increase deductibility, part of the Tax and Trade Extension Relief Act of 1998.

plan. The deduction is allowed as long as the taxpayer's earned income from self-employment exceeds the deduction, thus eliminating the deduction for farmers with net farm losses. The remainder of their health insurance premiums may be included with itemized medical expenses and are deductible if the household is able to satisfy the itemized medical expenses threshold.

From 1988 until 1994, the self-employed health insurance deduction was limited to 25 percent of premiums (table 12). Legislation passed in 1995 increased the deduction to 30 percent. The Small Business Job Protection Act of 1996 increased the deduction to 40 percent for 1997, and established a schedule to gradually increase the deduction to 80 percent by 2006. Since then the phase-in schedule has been accelerated twice. The Taxpayer Relief Act of 1997 advanced the schedule and would have achieved full deductibility by 2007. Current rates became effective under the Tax and Trade Extension Relief Act of 1998, which accelerated the phase-in to full deductibility by 2003.

Only about 14 percent of all farmers use the self-employed health insurance deduction in any given year. However, nearly 45 percent of primary occupation farmers with gross sales over $100,000 annually use the deduction (table 13). Only about 8 percent of lifestyle/other farmers use the deduction, primarily because these households are more likely to receive health insurance from a nonfarm job or may not qualify for the deduction given the likelihood of reporting a farming loss.

A 60-percent deduction allows a farmer in the 15-percent tax bracket to save 9 percent of the cost of the premium, or $315 in reduced taxes on a $3,500 annual premium. Increasing the deduction from 60 percent to 100 percent will save an additional 6 percent of the premium. When the self-employed health insurance deduction becomes fully deductible, affected taxpayers will be able to save a portion of their premiums equal to their marginal tax bracket, helping make health insurance more affordable and make the tax treatment more comparable to employer-sponsored plans.

Net Operating Losses

A net operating loss (NOL) occurs when business expenses exceed gross income. As mentioned previously, each year about two-thirds of all farm sole proprietors report a net farm loss on schedule F. However, not all of these farms create, nor do all of their losses represent, a net operating loss. Most losses from schedule F are used to offset nonfarm income in the same tax year. Only about 10 percent of those losses become net operating losses, with nearly 100,000 farmers affected.

Under current tax law, net operating losses from farming can be carried back 5 years and forward 20 years. Carrying back a NOL creates a refund of taxes paid in previous years, while carrying forward a NOL can reduce future taxable income. Farmers receive special treatment for NOL carry-back because other taxpayers are able to carry back losses only 2 years. The 5-year carry-back period was enacted in 1998 as part of the Tax and Trade Relief Extension Act of 1998 – an

Table 13—Use of the self-employed health insurance deduction by farm proprietors, 1996

	Small family farms						
				Primary occupation		Large	All
	Limited-		Lifestyle/	Farm sales ($1,000)		family	farm
Item	resource	Retirement	other	<$100	$100-$250	farms	proprietors
				Number			
Farmers using deduction	25,502	28,588	87,840	27,696	24,054	18,846	223,023
				Percent			
Share of group	11.7	10.9	7.5	16.5	44.8	43.8	13.6
				$1,000			
Amount deducted	18,159	25,773	88,601	53,260	70,743	40,176	296,712
				Dollars			
Average deduction	712	902	1,009	959	1,039	1,108	983
Average premium[1]	2,374	3,005	3,362	3,195	3,464	3,693	3,277

[1] Premium is computed by dividing the amount deducted by the 30-percent deduction rate allowed in 1996.
Source: Compiled by USDA-ERS from special tabulations by Internal Revenue Service.

attempt to increase cash-flow for farmers temporarily suffering from losses due to low commodity prices. The longer carry-back period increases both the likelihood of a tax refund and the amount of a potential refund if the NOL is especially large. The NOL rules primarily benefit farmers with large farm losses who do not receive much nonfarm income but who have paid taxes in previous years. Generally, farms with these characteristics include primary occupation small farms and some limited-resource or retirement farms.

In 1995, about 77,000 farm sole proprietors created an estimated $1.7 billion of farm NOL's that could be carried to other tax years. Data are not available to estimate how much of these losses were carried back or forward, or to classify how the losses created were distributed across the farm typology. Historically, however, the accumulated NOL carry-forward for all farmers is quite large. An estimated 913,000 farmers carried over $7.8 billion in NOL's into tax year 1995 (table 14).

The Passive Loss Rules

One of the primary features of farm and other tax shelters that existed in the early 1980's was the generation of tax losses and credits that could be used to reduce taxes on income from other sources. The Tax Reform Act of 1986 introduced new rules aimed at limiting the availability of tax shelters throughout the economy. These new rules placed substantial restrictions on the ability of individuals, estates, trusts, personal service corporations, and closely held corporations to use losses and credits generated from a passive activity to offset other types of income. Under these rules, such losses and credits may not be used to offset income or tax from nonpassive sources such as a trade or business in which the individual materially participates. Passive activity losses and credits in excess of passive activity income are suspended and carried forward indefinitely to be used to offset future income from the same or other passive activity.

A passive activity is defined as an activity which involves the conduct of a trade or business in which the taxpayer and/or the taxpayer's spouse does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations on a regular, continual, and substantial basis. Any rental activity is treated as a passive activity, even if the taxpayer materially participates in the activity. However, a special rule allows up to $25,000 of losses and credits (deduction equivalents) from rental real estate activities in which the taxpayer actively participates to be used to offset other types of income. The active participation requirement is less stringent than the material participation requirement in that the taxpayer need not be involved in the activity on a regular, continual, and substantial basis. However, a taxpayer must participate in the making of management decisions or in arranging for others to provide services. The $25,000 exemption is phased out by 50 percent of the amount by which the taxpayer's adjusted gross income exceeds $100,000. Thus, taxpayers with adjusted gross income in excess of $150,000 are not permitted to use losses in a rental activity to offset income from other nonpassive sources.

An examination of Federal income tax return data for 1987 provides some insight into the initial impact of the passive loss rules. The percentage of individuals

Table 14—Net operating losses (NOL) reported by farm sole proprietors, 1987-95

Year	NOL carried in[1]		Total NOL created[2]		Farm NOL created[2]	
	Number	Amount	Number	Amount	Number	Amount
		$1,000		*$1,000*		*$1,000*
1987	1,069,385	-10,393,240	53,111	-2,669,295	47,783	-1,293,475
1988	877,773	-8,934,429	55,631	-2,375,248	50,840	-1,437,756
1989	900,644	-8,571,596	47,968	-2,261,914	42,722	-1,118,375
1990	864,730	-7,240,840	48,894	-2,008,501	45,012	-1,161,805
1991	901,434	-8,436,830	65,617	-3,272,532	61,551	-1,356,152
1992	809,815	-6,976,746	60,382	-1,950,676	55,234	-1,130,652
1993	887,462	-6,745,299	59,802	-2,556,630	54,454	-1,249,553
1994	872,615	-6,615,389	78,155	-2,716,738	70,333	-1,646,236
1995	913,058	-7,815,663	83,735	-2,691,232	77,490	-1,651,872

[1]NOL carried forward from previous year for both farm and nonfarm businesses. The estimate may understate the true value by the amount of other miscellaneous income reported on IRS form 1040, but the bias is expected to be small.

[2]NOL created as a result of losses in the current year, before carry-back to earlier years.

Source: USDA-ERS estimates based on IRS Individual Public Use Tax Files.

with farm income or loss reporting passive losses was over 8 percent or more than double the percentage for all other taxpayers. The average passive loss reported was also somewhat higher at about $20,000 for a total of $4.2 billion in passive losses.

The primary target of the passive loss rules was high-income taxpayers with only limited involvement in the activity generating the loss. An examination of farmers reporting passive losses by level of off-farm income indicates that the passive loss rules had the greatest impact on this target group. In fact, about half of all farmers with nonfarm income of $100,000 or more reported passive losses in 1987. These farmers reported an average of $64,300 in passive losses for a total of $2.3 billion. Thus, this relatively small group of farmers accounted for over 55 percent of all passive losses reported by farmers.

A decade after enactment, the importance of the passive loss rules has declined. For 1995, only about 4 percent of all farmers reported passive losses, with the average loss of about $12,300 for a total passive loss of $1.1 billion. This is a small share of the total farm losses reported by farm sole proprietors, and less than 10 percent of these losses were not allowed to reduce other income in the current tax year. Clearly, the level of passive losses has declined substantially since 1987, with passive losses accounting for only about 6 percent of farm losses compared with over 30 percent of farm losses in 1987. This suggests that the passive loss rules either have discouraged many nonfarm individuals from making tax-motivated investments in agriculture or have required them to increase their level of involvement in the farm operation to use these losses to offset other income.

Alternative Minimum Tax

In some cases, taxpayers can greatly reduce or even eliminate income tax liability completely by utilizing preferential income tax provisions. The alternative minimum tax (AMT) ensures that these individuals pay some Federal income tax. When the AMT was created in the 1970's, very few individuals were affected. However, the exemption amount for the AMT has not been indexed for inflation while other provisions in the tax code are indexed. As regular tax deductions increase relative to the fixed exemption amount for AMT, more taxpayers begin to owe AMT depending on combinations of base income, tax brackets, and other deductions. The number of taxpayers who pay AMT is projected to increase steadily over the next several years under the current tax structure. The compliance burden for affected taxpayers increases greatly because the AMT requires many separate calculations and tests to determine eligible deductions under AMT rules.

Table 15—Farm sole proprietors affected by the alternative minimum tax (AMT), 1987-96

Year	All farm sole proprietors	Share filing form 6251	Share paying AMT	Amount of AMT
	Number	*Percent*		*$1,000*
1987	2,424,528	9.5	0.55	167,729
1988	2,381,040	5.6	.46	105,070
1989	2,377,773	5.4	.32	85,782
1990	2,341,679	11.8	.35	90,365
1991	2,310,964	8.9	.45	105,728
1992	2,306,154	11.9	.38	101,493
1993	2,292,963	9.7	.62	128,037
1994	2,264,833	11.4	.63	129,172
1995	2,244,021	11.4	.69	128,074
1996	2,218,964	10.1	.78	180,883

Source: USDA-ERS estimates based on IRS Individual Public Use Tax Files.

More farmers are affected by the AMT than other taxpayers. In 1995, less than 1 percent of farm sole proprietors actually paid AMT, although about 11 percent filed the form used to compute the tax (table 15). By comparison, a similar share of nonfarm business proprietors paid AMT, but only about 8 percent filed the form. Of the remaining nonfarm, nonbusiness taxpayers, only about half as many paid AMT in 1995, and only about 2 percent filed the AMT form. More recent data indicate that an increasing proportion of farmers and other taxpayers are subject to the tax. Farm typology data from 1996 indicate that 0.78 percent of all farmers actually paid AMT, although about 10.1 percent filed the form. Large family farms are most likely to both file the form and pay the tax (23 percent and 3 percent, respectively), although small primary occupation farms with sales above $100,000 are also much more likely to be affected than the average farmer (table 16). Limited-resource farms are virtually unaffected by the AMT because of their low incomes. Farms in the lifestyle/other category may be affected by the AMT both because of tax shelter farm activities and because of other nonfarm tax preferences.

The alternative minimum tax is imposed at rates of 26 percent and 28 percent on alternative minimum taxable income in excess of a phased-out exemption amount. Alternative minimum taxable income (AMTI) is the

taxpayer's regular taxable income increased by certain itemized deductions (or the standard deduction) and other tax preferences. A relatively high exemption amount ($45,000 for joint returns) keeps most individuals from owing any AMT, although the exemption is phased out at high income levels (for joint returns, 25 cents for every $1 that AMTI exceeds $150,000). The 26-percent minimum tax rate applies to taxable income exceeding the exemption for amounts up to $175,000; income over this amount is taxed at the 28-percent rate. Capital gains income, however, is taxed under the AMT at the same preferential rates as it is under the regular income tax. If the minimum tax computed exceeds the tax owed under the regular income tax, the difference is added to the individual's tax liability.

The most important tax preference items for farmers include accelerated depreciation (for machinery placed in service before the Tax Reform Act of 1986), passive farm losses, and installment sales.

In 1997, Congress took steps to reduce the effect of the AMT on farmers, small corporations, and other businesses. Many farmers use deferred payment contracts to deliver farm commodities for sale at a specified price, usually in autumn, with payment deferred until the following year. For the majority of farmers using the cash method of accounting, deferred payment contracts allowed them to delay paying income taxes until the following tax year when payment was actually received. However, in a 1996 ruling, IRS interpreted deferred payment contracts as an installment sale that must be recognized in the year of sale for AMT purposes. The 1997 law restored farmers' ability to use deferred payment contracts to defer regular income taxes without being subject to the AMT.

The 1997 law also repealed the AMT for small corporations with 3-year average gross receipts of less than $7.5 million, beginning with the 1998 tax year. This allows most farm corporations to avoid the complexities of the AMT.

For depreciable property placed in service in 1999 or after, AMT depreciation adjustments are simplified because longer recovery periods are no longer required compared with regular income taxes. Before this simplification, 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 nonfarm assets). For farmers, eliminating longer recovery periods means no separate depreciation schedules for the AMT, because the regular income tax already required farm property to be depreciated using the 150-percent declining balance rate. As older equipment is

Table 16—Farm sole proprietors affected by the alternative minimum tax, 1996

Item	Small family farms					Large family farms	All farm proprietors
				Primary occupation			
				Farm sales ($1,000)			
	Limited-resource	Retirement	Lifestyle/ other	<$100	$100-$250		
				Number			
All filing AMT form	5,082	21,469	125,877	27,696	24,054	18,846	223,023
				Percent			
Share of group	2.3	8.2	10.8	8.2	15.8	22.7	10.1
				Number			
All paying AMT	[1]	3,970	9,178	1,124	623	2,309	17,211
				Percent			
Share of group	0	1.52	.79	.33	.41	2.79	0.78
				$1,000			
Amount paid	[1]	25,916	114,380	11,435	2,330	26,685	180,883
				Dollars			
Average, payers	[1]	6,528	12,462	10,173	3,740	11,557	10,510
Average, all farms	[1]	99	98	34	15	322	82

[1] Data unreliable because of small sample size.
Source: Compiled by USDA-ERS from special tabulations by Internal Revenue Service.

replaced or fully depreciated, this will eventually reduce the recordkeeping burden and the number of farms subject to the alternative minimum tax.

The 1997 AMT changes will reduce future AMT burdens for some farmers, but will not likely offset the rising trend in AMT affecting all taxpayers. Also, income averaging for farmers that was made available by the 1997 Act has begun to create AMT problems for some farmers because it reduces tax liability for regular tax purposes but does not affect AMT.

Earned Income Tax Credit

The earned income tax credit (EITC) is a refundable tax credit available to low-income workers who satisfy certain income and other eligibility criteria. Workers with children meeting age, relationship, and residency requirements can receive a credit of up to 40 percent of their earned income. Workers between the ages of 25 and 65 who do not have children and are not claimed as another person's dependent can receive up to a 7.65-percent credit.

The EITC was created in 1975 to reduce the burden of social security taxes on low-income workers, encouraging them to seek employment rather than welfare benefits. The program was expanded in 1990 and 1993 by increasing the amount of the credit and allowing childless workers to become eligible – making the EITC one of the largest programs targeted to low-income individuals. As an incentive to work, the EITC increases for each additional dollar of earnings until a maximum credit amount is reached. Like most other programs, the credit is reduced as earnings increase beyond another income threshold. Most taxpayers receive the EITC as a lump sum at the end of the year by claiming it on their Federal income tax return. Since the credit is

Table 17—Earned income credit received by farm households, 1996

Item	Small family farms					Large family farms	All farm proprietors
	Limited-resource	Retirement	Lifestyle/other	Primary occupation, Farm sales ($1,000): <$100	Primary occupation, Farm sales ($1,000): $100-$250		
				$1,000			
Amount of credit:							
Total[1]	61,619	5,083	85,310	61,917	42,366	10,353	266,649
Offsets income tax	*415* [2]	0	11,866	4,568	4,535	1,081	22,465
Offsets other taxes	17,328	*1,235* [2]	14,736	20,377	22,716	5,952	82,345
Refundable portion	43,875	*3,849* [2]	58,708	36,972	15,115	3,320	161,838
				Percent			
Share of credit:							
Offsets income tax	*.7* [2]	0	13.9	7.4	10.7	10.4	8.4
Offsets other taxes	28.1	*24.3* [2]	17.3	32.9	53.6	57.5	30.9
Refundable portion	71.2	*75.7* [2]	68.8	59.7	35.7	32.1	60.7
				Number			
All with credit[1]	48,670	4,020	69,000	43,170	32,900	7,890	205,650
				Percent			
Share by group:							
Total credit	22.3	1.5	5.9	12.8	21.6	9.5	9.3
Offset of income tax	*1.8* [2]	0	2.7	4.0	8.7	2.7	2.9
Offset of other taxes	16.7	*1.4* [2]	2.3	6.0	15.5	7.8	5.3
Refundable credit	15.2	*.9* [2]	4.0	9.4	8.4	3.9	5.9
				Dollars			
Average for recipients	1,266	1,264	1,236	1,434	1,288	1,312	1,297

[1]These figures may understate the current situation because of the disqualified income test enacted in 1996 which eliminated the earned income credit for many farmers because sales of breeding and dairy livestock were considered part of capital gains from investment activities. An estimated 50,000 farm households were disqualified from receiving nearly $70 million in credits. In 1999, sales of such business assets were removed from the disqualified income test, restoring the credit to many disqualified farmers.

[2]*Italics* indicate that estimate should be used with caution because the sample contained 10 or fewer tax returns.

Source: Compiled by USDA-ERS from special tabulations by Internal Revenue Service.

refundable, any amount in excess of their Federal income tax or other tax liabilities is refunded to help offset social security taxes.

Although the EITC is a general tax provision, it is important to many farm households that qualify because of low income – frequently limited-resource farms and primary occupation farms that do not have nonfarm wage income. In 1995, about 290,000 farmers – about 13 percent of all farm sole proprietors – received nearly $350 million from the earned income credit. These numbers do not reflect, however, the full phase-in of provisions enacted in 1993. Estimates for 1996 illustrate the differences by farm typology but understate the total amount of the credit and its recipients relative to current law because of an eligibility test that disqualified many farmers who routinely sold breeding and dairy livestock, as discussed below. Nonetheless, in 1996, nearly 206,000 farmers – or about 9 percent of all farm sole proprietors – received over $266 million from the credit (table 17). The average credit was $1,297, with over 60 percent of the total refunded rather than offsetting taxes. By farm typology, over 20 percent of limited resource farms and primary occupation small farms with sales over $100,000 received the credit. About 13 percent of primary occupation farms with sales less than $100,000 received the credit. For farmers who qualify, the EITC significantly reduces their effective tax burden and frequently provides additional cash-flow to meet household living expenses.

Rules for the EITC that are particularly important for farmers include the treatment of business losses and how much investment income is received. Eligibility is phased out if earned income or modified adjusted gross income exceeds a specified threshold amount. In determining modified adjusted gross income, 75 percent of business losses – including farming losses – are disregarded. Therefore, farmers cannot easily use losses on schedule F to reduce other earned income to a level that qualifies for the EITC. Disregarding 75 percent of business losses falls disproportionately on farmers because nearly two-thirds of all farmers report a net loss each year.

In an effort to better target the credit beginning in 1996 by denying benefits to those with moderate amounts of accumulated assets, taxpayers who had relatively small amounts of investment income became ineligible for the credit regardless of their other income. The investment income limit is $2,200 of interest, dividends, or net capital gains. IRS initially included the sale of business assets – including culled breeding and dairy livestock – in determining net capital gains. As a result, an estimated 50,000 farmers were disqualified for as much as $70 million in annual benefits. The disqualified income test affected farmers in the Corn Belt, Great Lakes States, and Northeast regions more than in other areas and was 10 times more likely to disqualify farmers than nonfarm taxpayers. However, IRS reversed its position in 1998 (retroactively) by indicating that sales of breeding and dairy livestock and similar business assets should not be considered net capital gains for the investment income test.