Tax Policy Implications

Individuals frequently change their behavior in response to economic incentives. Tax policies provide a variety of economic incentives that encourage certain activities or investments by providing more favorable tax treatment relative to other activities or investments. To the extent that tax policy and not market forces is the primary determinant of how economic resources are allocated, economic efficiency may not be optimal from the broader resource allocation perspective. In addition, tax incentives can have impacts that are unintended or counter to other government policy goals. The tax provisions outlined throughout the preceding chapters create incentives for farmers and nonfarm investors in farm assets to behave in certain ways and to create certain observable results that follow. Implications of Federal tax policies of significance to farmers are particularly notable in tax burdens, land prices and the ownership of capital assets, the cost of capital relative to labor, the size and organizational structure of farms, management and husbandry practices, and product supplies and prices.

Tax Burdens

The various special farm tax provisions affect both farmers' effective tax rates and their tax burdens relative to all other taxpayers. Research examining the effects of Federal tax policies on farmers' tax burdens prior to the 1980's concluded that special agricultural tax preferences reduced the tax burden on farm income (Davenport, Boehlje, and Martin). Individuals with substantial farm income enjoyed a substantially lower tax burden than individuals with no farm income. Furthermore, the gap between farm and nonfarm tax burdens widened with increasing levels of income. However, that research compared tax burdens of farmers with all other taxpayers and not with other business owners. Therefore, whether farm tax provisions provided more favorable treatment to farmers than other business owners who also benefit from targeted tax provisions is unclear. This research also found that the Federal income tax was less progressive than suggested by the marginal tax rate structure. For those farmers whose primary source of income was from farming, Federal income tax rates were found to be relatively flat suggesting that larger, higher income farmers were able to utilize investment incentives, capital gains, and other tax provisions to offset higher marginal income tax rates (Sisson).

The tax structure has changed substantially since this research was conducted. Tax law changes in the early 1980's reduced marginal tax rates and provided significant investment incentives, while legislation in the mid-1980's reduced marginal income tax rates and eliminated much of the preferential treatment that agriculture received, particularly for investors who utilized farm investments as a tax shelter. Nevertheless, while the average effective Federal income tax rate increased from 14 percent in 1987 to just over 15 percent in 1990, tax rates were slightly less progressive (Compson and Durst, 1992).[7] The differences in tax rates for farm and nonfarm taxpayers were also reduced by the elimination of income averaging, the capital gains exclusion, the investment tax credit, and other important farm tax provisions.

Two new tax brackets for high-income taxpayers were added in 1993, increasing the maximum marginal tax rate from 31 to 39.6 percent. This reversed the trend of lower marginal tax rates that began in 1981. For low-income households, the earned income tax credit was expanded in 1990 and 1993 by increasing the benefit levels and simplifying eligibility rules. Thus, while the overall tax rate increased from 15 percent to 16 percent between 1990 and 1994, an analysis of IRS data confirms that average effective tax rates became more progressive – increasing for high-income taxpayers because of the new tax brackets and decreasing for low-income farmers due to the expansion of the earned income tax credit (Durst and Monke, 1998).

Since 1997, farmers have benefited from a variety of new tax provisions including income averaging, an increased self-employed health insurance deduction, expanded capital expensing and reduced tax rates for capital gains. These provisions are likely to reduce the progressivity while more general tax provisions such as the new education and child tax credits should primarily benefit lower and middle income farmers. Thus, while these changes are expected to reduce the average effective tax burden of farmers by as much as 2 percentage points, the effect on progressivity and on farm tax burdens relative to other taxpayers is unclear.

[7]The average effective tax rate equals the amount of tax paid after all tax credits divided by an expanded measure of income which includes adjusted gross income plus statutory deductions, tax-exempt interest, and other variables.

Capital Investment: Capital/Labor Ratios

Agriculture is a capital-intensive industry. Throughout much of the 1970's and early 1980's, farming became increasingly capital intensive. Accompanying this increased use of capital has been a sharp, long-term decline in the use of labor. The number of farm workers has declined steadily over the last three decades. The result has been a sharp increase in capital/labor ratios in agriculture. Tax policy is one of a number of factors that may have played a role in this trend. Tax policies have historically provided incentives for investment in depreciable capital, while taxes have been imposed on the utilization of labor.

Prior to the Tax Reform Act of 1986 and the Social Security Reform Act of 1983, Federal tax provisions provided a number of incentives for farmers to substitute capital for labor. Accelerated depreciation and the investment tax credit greatly reduced the cost of capital while labor costs continued to rise due to increases in social security and other labor taxes. The Tax Reform Act of 1986 represented a significant shift in tax policy incentives for investment in depreciable capital. The investment tax credit was eliminated, while depreciation periods for most farm assets were lengthened. The result was a significant increase in the after-tax cost of capital. At the same time, labor taxes continued to increase primarily as a result of increases in social security taxes. The net effect of the changes is unclear. While the changes to the cost of capital were of a greater magnitude, little or no empirical evidence exists regarding current tax incentives to substitute capital for labor. Regardless, incentives for capital investment are clearly less than existed in the late 1970's and early 1980's.

A number of studies have examined the effect of tax policy on optimal equipment replacement decisions. One of the early studies found that the investment tax credit had only a minor impact on the farm machinery replacement decision (Chisholm). However, later studies found that the investment tax credit significantly reduced the replacement age of farm machinery and that this reduction resulted in the substitution of capital for labor. The effect was found to be greater for higher income taxpayers (Kay and Rister). A later study found similar results for both accelerated depreciation and the investment tax credit (Bates, Rayner, and Custance).

Studies conducted following the Tax Reform Act of 1986 are consistent with these earlier studies. The optimal replacement age for farm assets was shown to be inversely related to the amount of the investment tax credit and the present value of depreciation allowances. Therefore, these studies concluded that the abolition of the investment tax credit and reductions in the present values of tax depreciation allowances would increase optimal replacement ages and reduce optimal replacement rates (Smith). However, little or no work has been done regarding the effect of social security and other labor taxes on the cost and use of labor in agriculture. These taxes increase the cost of using labor directly and indirectly through the increased costs associated with the recordkeeping requirements necessary to comply with the taxes. Of the payroll taxes, social security is clearly the most significant. The contribution rate and amount of wages subject to the tax have increased dramatically in recent years. Unemployment insurance, on the other hand, is imposed at a much lower rate and on a smaller segment of the farm labor force. Nevertheless, the combined effect of these and related State taxes such as workers' compensation insurance is to increase the cost of farm labor.

In summary, tax incentives for capital investment in the early 1980's clearly encouraged the use of capital in agriculture, while payroll and other labor taxes discouraged the use of farm labor. However, this tax-induced substitution of capital for labor may have been relatively minor compared with other nontax factors. Tax policy merely strengthened an existing trend caused primarily by other factors such as technology developments. Therefore, while the overall reduction of investment incentives should result in reduced capital investment relative to prior laws, this clearly does not suggest a reversal of the trend to substitute capital for labor.

Land Prices and Ownership of Capital Assets

Farmland is a key asset because the supply of land available is relatively more limited than other farm assets. Low land prices facilitate entry into farming while high land prices make entry difficult. If a prospective farmer is unable to buy land or to arrange a rental agreement with a landlord, there is no way to enter land-based farming. Farmland historically has been a good tax investment during inflationary periods and has, therefore, been attractive to both farm and nonfarm investors. Its value as an inflationary hedge comes both from the deductibility of nominal interest payments on loans and the appreciation of land values on a tax-deferred basis.

Capital gains taxes are levied on nominal returns. Taxing both real and inflationary gains makes the effective tax rate on the real return (the capital gains tax divided by the real capital gain) nearly always greater than the marginal tax rate. If the real rate of return is low relative to inflation, then most of the nominal capital gain is due to inflation and the effective tax rate on the real return could exceed 100 percent.[8] Longer holding periods help reduce the effective tax rate by compounding the real rate of return, but effective tax rates often remain high relative to the marginal tax rate. Although inflation also increases effective tax rates on interest and dividends, the effect on capital gains is often perceived to be greater because of the magnitude of capital sales and the proportion of the sale price that gains represent after long holding periods.

Effective tax rates always exceed the taxpayer's marginal bracket in an inflationary environment unless part of the nominal gain is excluded from taxation. If part of the gain is excluded, then the effective rate may drop below the taxpayer's marginal rate under certain combinations of holding periods and real rates of return. Since lowering capital gains tax rates below ordinary tax rates is effectively similar to providing an exclusion, current law helps to reduce the effect of taxing inflationary gains. For example, using a hypothetical 30-year holding period with 2-percent annual real capital appreciation, 4-percent inflation, and tax law from 1996, an individual in the 28-percent ordinary tax bracket faced effective capital gains tax rates on real returns of 52 percent. Under current law with the 20-percent capital gains tax rate (an effective exclusion of 29 percent), the effective tax rate in the scenario drops to 37 percent. Under pre-1986 tax law with the 60-percent exclusion, the scenario would result in a 21-percent effective tax rate on the real return.

Tax timing issues also benefit the investor who borrows. Deductible interest expenses reduce tax liability during the current year, while capital gains taxes are deferred until the asset is sold. Deferring capital gains taxes slightly increases the implicit after-tax rate of return. This increases with longer holding periods and can be especially important for those who intend to hold assets indefinitely.

Before the current policy of a maximum tax rate on capital gains, deferring capital gains until an asset was sold could create problems at the time of sale because unusually large gains may have pushed the taxpayer into a higher marginal tax bracket. In such cases, the potential for higher taxes may have been reduced somewhat by making land sales on the installment method or by selling the land in smaller parcels over time.

Farm Tax Shelter Opportunities

Lower capital gains tax rates increase incentives to invest in assets that generate capital gains and to alter management practices to maximize such income. In farming, this increases farm investment especially in livestock and farmland. Preferential capital gains treatment may accelerate the growth in the number of large, investor-owned farms and make obtaining or controlling the means of production (primarily farmland and production facilities) more difficult for some smaller family farms. However, tax shelter opportunities are more constrained now than they were before the Tax Reform Act of 1986.

The use and abuse of tax provisions available in farming before the Tax Reform Act of 1986 is well documented (Long; Davenport, Boehlje, and Martin). Before the 1986 Act, both farm and nonfarm investors were encouraged to invest more in favored activities. Several provisions enacted in recent years, including those contained in the Tax Reform Act of 1986, restrict such investments. These include limits on the ability to use the cash method of accounting, limits on the current deductibility of development costs, restrictions on prepaid expenses, and passive loss rules that limit the ability of some individuals to deduct losses. While these changes and lower marginal tax rates have reduced both the incentive and the opportunity to make tax-shelter investments in farming, they have not eliminated all such opportunities.

Tax laws encourage financing land and other assets with debt, particularly in an inflationary environment. Since nominal interest expenses for businesses are fully deductible for tax purposes, the value of the tax deduction equals the nominal interest multiplied by the tax rate. For borrowers with fixed nominal interest rate contracts, an increase in inflation reduces the effective real cost of borrowing. The real cost of borrowing is also reduced by the nominal tax benefit. Therefore, if inflation increases while a borrower holds a fixed interest rate loan, the real after-tax cost of borrowing on a fixed-rate loan will decrease and could even become negative after combining the effects of inflation and taxes. The reduction in borrowing costs is greater for

[8]For example, after a 1-year period with 3-percent inflation and a 4-percent nominal capital gain, a 25-percent capital gains tax yields a 100-percent effective tax on the real return.

individuals in higher marginal tax brackets.[9] These relationships increase the incentive to finance investments with debt, particularly for assets that generally appreciate in value during inflationary periods, and for those in higher income tax brackets.

Inflation also creates the expectation that asset values will grow over time. Economic returns become divided between current cash returns and deferred capital gains returns. When current returns are low relative to asset values and interest expenses, loan payments on debt-financed assets can exceed the cash-flow from those assets. The negative cash-flow can provide a tax shelter if the owner has other income to shield from taxes. The net effect can tend to restrict land purchases to those with sufficient outside resources to meet the negative cash-flow requirements. This creates barriers to entry and increases both the concentration of land ownership and the reliance on rented land.

Because the net tax benefits are greatest for high-bracket taxpayers who leverage their ownership with debt, they can bid substantially more for land. High-bracket taxpayers are frequently able to outbid lower bracket taxpayers when appreciation rates are high compared with annual cash returns. Furthermore, high-bracket taxpayers prefer capital gain income to ordinary income and are willing to accept low cash returns as long as the asset appreciates in value. Thus, the established farmers or nonfarm investors may be able to outbid beginning farmers in the real estate market. In contrast, the beginning farmer is normally more concerned with cash-flow than appreciation. Thus, beginning farmers have difficulty competing for real estate and obtaining ownership of farmland. The beginning farmer may, however, have the opportunity to rent farmland from owners who acquire real estate more for its appreciation than its cash-flow generating capacity.

Lock-in effect

Because increases in the value of property are not taxed until assets are sold and gains are realized, potential tax liabilities increase as gains accumulate and give taxpayers a growing incentive to hold onto assets rather than selling and reallocating funds. This incentive to continue to hold property – the lock-in effect – is compounded by estate planning. At death, unrealized capital gains that occurred during life are fully exempted from the income tax. When ownership is transferred to the heirs, the basis for determining gain upon the sale of the asset is stepped-up to the fair market value when the decedent died. The prospect of gaining tax exemption through death is an incentive not to sell the asset. From the resource allocation perspective, the lock-in effect encourages owners to continue to hold assets that may even earn below-average risk-adjusted returns, because they believe that tax deferral with a substandard return is better than realizing gains and paying taxes in order to reallocate funds. Either way, the lock-in effect reduces the land available for purchase but increases land for rent.

In farming, land is the most common asset affected by the lock-in effect. A reduced supply of land available for sale increases the price of land in the face of unchanging demand. A person expecting to hold the land until death as an investment for heirs would be able to bid even higher than a buyer who at some point expects to realize the appreciation and pay tax on it. That economic rents accrue to asset owners is important for the distribution of returns from farming. The average capital gain on farmland purchased in 1966 and held for 30 years represents about 80 percent of the value of the land.

Preferential capital gains taxes decrease, but do not eliminate, the lock-in effect. Farmers and farm assets may be less responsive to preferential tax rates because capital assets that are part of an ongoing farm business may be difficult to sell without disrupting production. Farm businesses are also not very mobile, reflected in part by the low turnover of farmland; only about 3 percent is traded at market prices each year (Rogers and Wunderlich). Sellers of farm assets also face much higher transaction costs compared with owners of corporate stock or more liquid assets. Furthermore, about 40 percent of farmland is owned by individuals age 65 or older who are consequently better able (and increasingly motivated) to avoid capital gains taxes completely by holding their land until they die. Estate tax provisions that require continued business and asset ownership, such as special use valuation and the new family business deduction, also discourage current owners from selling business assets. Owners with equity can easily access unrealized gains without incurring a tax liability by borrowing against the property.

The magnitude of the lock-in effect may be measured by computing the additional rate of return that a new investment would need to earn over the existing rate of return to compensate for realizing capital gains taxes

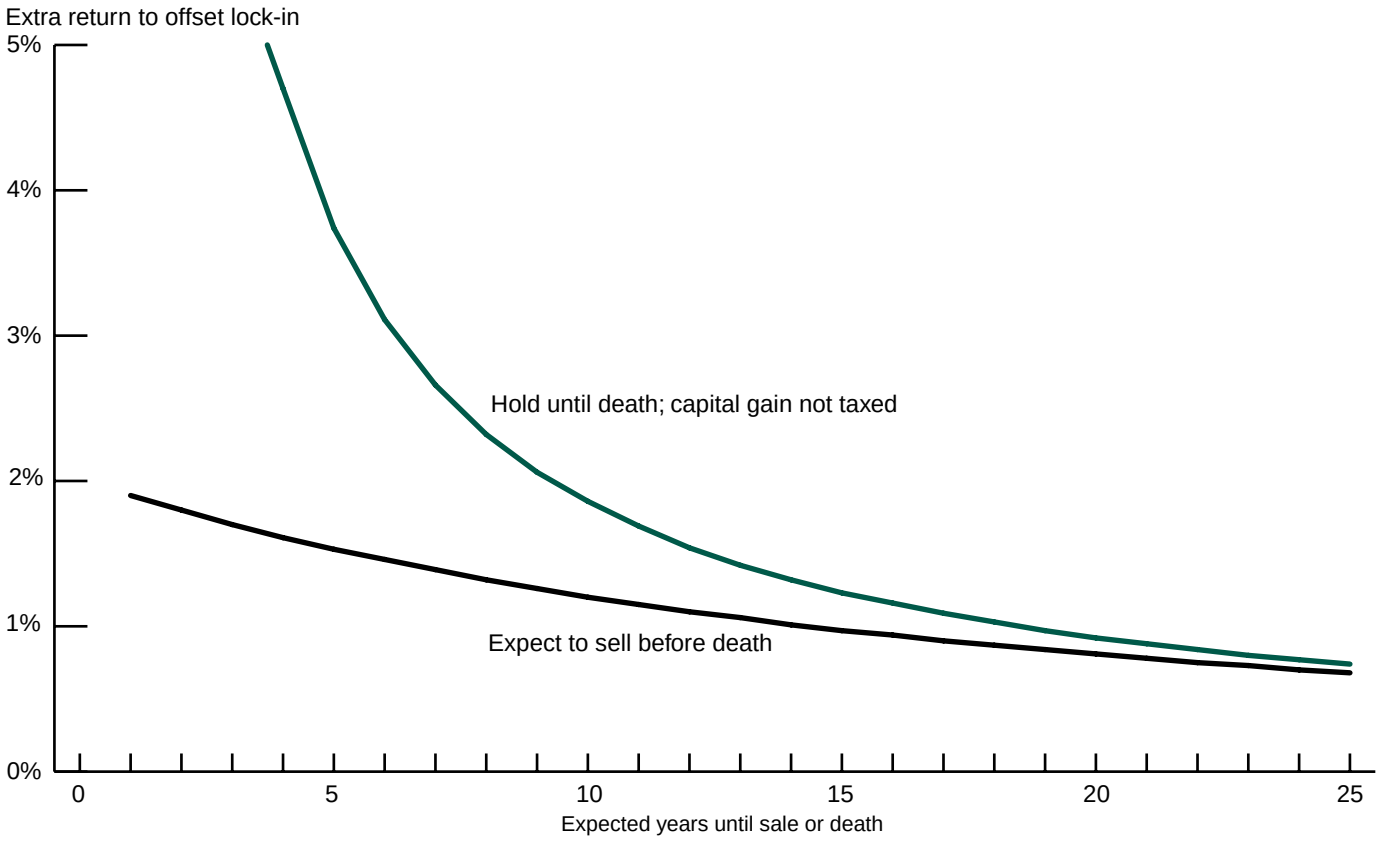
[9]For example, after a 1-year period with 3-percent inflation and a 4-percent nominal capital gain, a 25-percent capital gains tax yields a 100-percent effective tax on the real return.

today if a locked-in asset were sold (Minarik). The premium required on the new asset to make the switch increases the longer that an existing asset has been owned, the shorter the funds are expected to be reinvested, the higher the income tax rate or the asset's growth rate, and the more likely the existing asset is to become part of an estate. Under current law, and assuming the owner's life expectancy is about 10 years, the proceeds of average U.S. farmland owned for 25 years would need to earn a 2-percent bonus return to compensate for realizing capital gains taxes if it were sold and reinvested (fig. 9). If the reinvested asset was not expected to become part of an estate, the extra return needed is smaller and the difference is less noticeable as the future holding period exceeds 15-20 years. For many investors, such additional returns may be difficult to achieve in the same asset risk class, although specific parcels of land or corporate stocks may offer opportunities. Consequently, many long-term landowners will continue to hold land rather than sell, even with current preferential capital gains treatment.

Management Practices

Total returns can be characterized as coming from two sources – the agricultural product and the tax system (Davenport, Boehlje, and Martin, p. 28). Maximizing these returns requires different management skills and sometimes introduces conflicting factors into the decision making process. The return from the agricultural product depends on prices, yields, weather, technology, interest rates, and the husbandry of the farming entrepreneur. The return from the tax system depends on careful tax planning and the tax rate of the farmer. Farmers who are not able to increase their total return by managing their taxes must survive on the return from farm products alone, and they can find themselves at a competitive disadvantage to farmers who are able to earn high returns from both sources.

Figure 9
The extra return needed to offset the lock-in effect is greater if the asset can be passed through an estate, but declines the longer the new asset will be owned



Note: Figure assumes a 20-percent capital gains tax rate and that the existing asset has been owned 25 years, yielding an annual 6-percent capital gain and 10.5-percent total return (generally representative of average U.S. farmland).
Source: Simulation by the authors.

Due to numerous tax incentives, farm management practices that maximize before-tax returns may not maximize after-tax returns. The optimal management practice to maximize after-tax returns may differ from standard management practices that are not biased by tax preferences. Economic efficiency suffers when optimal plant and animal husbandry practices are altered to maximize after-tax returns.

In the early 1880's, an often-cited example of the influence of tax incentives on farm management practices was the farrow-to-finish hog industry. Under normal production practices, a breeding sow would be used for several farrowing cycles before being culled because, after the first litter, sows usually produce larger litters and provide better care for their offspring. In such an operation, perhaps about 20-25 percent of gilts (young females) would be kept for breeding as older sows are culled, while the balance would be sold as soon as they were ready for market. Sales of breeding sows would be a fairly small percentage of total sales. However, because tax law allows breeding sows held longer than 1 year to be eligible for long-term capital gains treatment, a strong incentive existed to increase the proportion of sales eligible for preferential tax treatment by breeding all gilts at least once. While hogs raised to market weight are younger than 1 year, a one-litter sow is usually just over 1 year old and thus eligible for capital gains treatment. The practice of breeding gilts for only one litter, despite their inferior farrowing and mothering qualities, was adopted for the sole purpose of reporting more sales as capital gains rather than as ordinary income. An optimal husbandry practice is weakened by economic incentives from tax law.

In addition to the lower income tax rates available for sales of breeding livestock, another incentive exists to increase the proportion of animals that are used in the trade or business rather than being held for sale. Sales of animals used in the trade or business (for example, breeding livestock) are not included with regular farm business earnings and are therefore not subject to the self-employment tax. Thus, as self-employment tax rates have increased over the past two decades, the incentive has grown to retain livestock for breeding purposes and to cull others sooner.

In the early 1980's, favorable capital cost recovery policies (such as depreciation, expensing, and investment tax credits) stimulated investment in single-purpose agricultural buildings for dairy, poultry, and hogs and encouraged faster replacement of depreciating equipment or the acquisition of larger equipment. For the most part, these incentives were reduced by the Tax Reform Act of 1986 which eliminated the investment tax credit and lengthened depreciation periods for both machinery and single-purpose structures.

Reductions in marginal tax rates and a reduced differential between the tax rate on ordinary business income and capital gains income has reduced the incentive to adopt such practices. Incentives to invest in depreciable property near the end of a tax year to qualify for a full year's tax benefit have also been reduced. Nonetheless, capital expensing allowances may still encourage farmers to purchase or replace depreciable equipment based not only on the need for productive infrastructure but also for tax reasons.

Product Prices

Tax policies that encourage commodity production but that do not change consumer demand tend to increase supply and reduce prices in the long run. Since most agricultural products have inelastic demand, the result is lower total farm revenue for the affected commodity than if the tax policy had not affected production and prices. Consumers, however, may benefit from greater supplies and lower prices.

General equilibrium models comparing the effects of taxes across agriculture and other sectors of the economy reveal increased resource use in agriculture and greater farm output. Eliminating tax differences would raise the model's household price for food by 2 percent to 4 percent as farm output decreased, particularly shifting away from livestock and feed grains into oilseeds and other crops (Hertel and Tsigas, 1988).

Favorable tax treatment throughout the late 1970's and early 1980's stimulated investment in the agricultural sector and resulted in increased production of many commodities – especially livestock and perennial crops that benefited from rules concerning the cost of developing capital assets. The investment tax credit and accelerated depreciation deductions encouraged farmers to buy machinery and equipment and to build new farm structures. Single-purpose agricultural structures used in dairy, poultry, and hog operations were popular. The additional investment expanded production capacity, brought more acreage into production, and enhanced productivity – all increasing production and putting downward pressure on prices.

The Tax Reform Act of 1986 reduced these incentives to expand production. Repeal of the investment tax

credit and a return to slower depreciation schedules for farm machinery reduced the pace of investment. Efforts to eliminate deductions for expenses to drain or fill wetlands and to reduce incentives for center-pivot irrigation systems have slowed the conversion of marginal land into cropland.

However, the ability to immediately expense a limited amount of depreciable business property, rather than depreciate it over a specified number of years, still provides some tax benefits that promote investment and increase output, although at a much reduced rate. The return to preferential capital gains tax rates in the Taxpayer Relief Act of 1997 has increased incentives to invest in capital assets such as breeding and dairy livestock and farmland and may tend to support higher production levels that could continue to put downward pressure on prices.

Farm Structure

Federal tax policy can have important implications for various structural aspects of farming. These include the number and size of farms, the value and incentive to buy and sell assets, especially farmland, and the legal form in which the business is operated.

The Number and Size of Farms

Throughout the late 1970's and early 1980's, the number of very small noncommercial farms (1-49 acres) and the number of large commercial farms (500 acres or more) increased while the number of farms in the 50- to 499-acre size class decreased. Information from the 1987 *Census of Agriculture* regarding farm size distribution suggested a continuation of this trend. Between 1982 and 1987, the total number of farms declined with much of the decline concentrated in the middle of the farm size distribution. This trend has continued in the 1990's. From 1992 to 1997 the number of farms with between 50 and 499 acres declined by over 15,000 farms, while the number of farms smaller than 50 acres increased by over 10,500 farms. As a result, both small noncommercial farms and very large commercial farms continue to increase as a proportion of all farms. Factors cited for this change in the number of large farms include technology and the desire to achieve income levels and standards of living equal to those of individuals in the nonfarm sector. Personal preferences for a rural or farm lifestyle, while relying on off-farm income to support the household, contribute to the growth in the number of small farms. Tax policies also have supported this change in farm size distribution.

Federal tax policies applicable to farming tend to reinforce those factors contributing to an increase in the number of very small and large farms. These tax provisions provide the greatest benefits to those farmers with relatively high levels of farm or off-farm income. Generally, very small farms do not generate enough farm income to support a farmer and the family. These farmers frequently rely on off-farm sources of income for their support. Thus, part-time or noncommercial farms have other income that can be offset by farm losses for tax purposes. Similarly, large farm operations often generate sufficient levels of farm income to fully benefit from the various farm tax preferences. Many farmers devoting full-time to the farming operation, however, do not generate enough taxable income – either farm or nonfarm – to fully utilize the available tax benefits.

Incentive to Incorporate

A corporation is a separate taxable entity for Federal income tax purposes. While many of the rules regarding the computation of net farm income are the same for corporations and individuals, various aspects of the corporate form of business have encouraged the incorporation of farm businesses. Those aspects of the corporate income tax which have encouraged family farms to incorporate include lower and less progressive tax rates for retained earnings, the availability of business deductions for various fringe benefits not generally available to sole proprietorships or farm partnerships, and the ease of transferring the farm business and other estate planning reasons.

Between 1974 and 1997, the number of corporate farms increased from 28,442 to 84,002. This growth was almost entirely attributable to an increase in the number of family and other closely held farming corporations. In fact, only about 2 percent of all farm corporations were other than family held with 10 or more shareholders. Thus, this increase reflects a shift in the form in which family farms conducted business rather than an increase in the presence of widely held corporations in farming. A substantial portion of the growth in family farm corporations can be attributed to Federal tax policies.

In 1975 and again in 1978, tax rates for corporations were reduced. As a result, corporate rates were lower and less progressive than individual rates. This provided substantial incentive to incorporate the farm business.

Another feature associated with the corporate form of organization is the ease with which annual gifts of farm

property can be made since ownership is represented by certificates of stock. Estate and gift tax laws permit an individual to transfer $10,000 each to an unlimited number of individuals free of tax each year. This allows a married couple to make gifts of $20,000 per recipient per year free of tax. However, the transfer of the actual farm assets can cause problems due to the difficulty in partitioning the farm business. By incorporating, the transfer of the farm business can be accomplished by transferring shares of stock in the corporation. This avoids partitioning farm assets and allows the farmer to transfer a substantial amount of farm property to the next generation without losing control of the farm operation while still reserving the entire tax-exempt amount that will be allowed by the unified credit at death.

Finally, the corporate form of business organization permits a number of fringe benefits to be provided to the shareholder-employee at a lower after-tax cost. The cost of many fringe benefits, including health insurance, meals, and lodging on business premises and pension and profit sharing plans, are fully deductible to the corporation and often not included in the taxable income of the shareholder-employee.

Beginning in 1986, the incentive to incorporate was reduced somewhat by expanding the fringe benefits available to noncorporate businesses, by limiting those available to corporations, by reducing marginal income tax rates for individuals, and by strengthening the double taxation of corporate assets at the time such assets are distributed from the corporation. Despite these changes, tax savings can continue to be realized since income retained in the corporation is not subject to social security (self-employment) taxes. Nevertheless, these changes may have prompted some corporations to shift from a regular C corporation to a subchapter S corporation in which income is passed through to the shareholders and no corporate-level tax applies.

The organizational structure under which the farm business is conducted would seem to be of little significance; especially if most corporations, partnerships, or other forms of organization are closely held family operations. However, the shift to the corporate form of organization during the 1970's may have allowed these farms to expand more rapidly as a result of the reduced taxes on earnings retained in the corporation. It also may have facilitated the transfer of the farm business to the next generation resulting in the continuation of the farm business.

Land Use and Conservation

Despite tax provisions designed to encourage investments in conservation, Federal tax policies throughout the 1970's and early 1980's had a negative effect on resource conservation. Several features of the tax code promoted farming practices that exploited both soil and water resources. These features included capital gains treatment for land used in farming, the investment tax credit and accelerated depreciation, and provisions governing the deductibility of land clearing and soil and water conservation expenditures.

Throughout the 1970's and early 1980's, the immediate deductibility of land clearing and development expenditures, combined with favorable capital gains treatment, provided a major incentive to expand farming operations onto highly erodible rangelands and wetlands. Speculative investors received substantial tax benefits from the purchase of fragile rangeland, timberland, or wetland and its conversion to cropland. The costs of conversion and preparation were immediately deductible against ordinary income. Upon sale, these sodbusters and swampbusters were able to exclude 60 percent of the large increase in the land's market value. In the case of wetlands, research evaluating a large-scale conversion in the Pocosin region of North Carolina suggested that such a conversion produced tax savings worth as much as $600 per acre (Heimlich). This represented an estimated one-third of the conversion expenses. In the case of rangeland, the capital gains exemption was cited as the primary stimulus for conversion of Montana rangeland to dryland wheat production. Tax benefits were also cited as a major factor in the conversion of large areas of fragile sandy rangeland in the Nebraska Sandhills to irrigated cropland. Capital gains in combination with other available tax benefits were found to have subsidized the conversion of this rangeland to irrigated cropland by as much as $180 per acre (Laylock).

Even the deduction for soil and water conservation expenses has had a questionable impact on soil and water conservation efforts. Farmers claimed nearly $103 million in conservation deductions for the 1982 tax year. Despite the obvious positive effect of most of the expenditures eligible for this deduction, many conservation expenses that qualified were of questionable value with regard to erosion control and water conserving measures. The conservation provision allowed deductions for wetland drainage, the leveling of land to facilitate irrigation installation, and other destructive

practices on highly erodible land and wetland. Furthermore, the provision contained no explicit targeting mechanism. Utilization of the deduction was related more to income and farm size rather than the actual need for the conservation expenditures. As a result, researchers examining the effect of the proposed repeal of the soil and water conservation deduction suggested that its repeal might not have a significant adverse impact on soil erosion control practices on U.S. farmland (Anderson and Bills).

Several features of the Tax Reform Act of 1986 had a favorable impact on natural resource conservation. Many of the provisions that encouraged the conversion of rangeland and wetlands to cropland were eliminated or reduced. The remaining provisions were more effectively targeted.

Specifically, the repeal of the deduction for land-clearing expenses and the capital gains exclusion eliminated a major incentive to convert marginal land to cropland. In addition, the characterization of gains from the sale of highly erodible land and wetland converted to cropland as ordinary income rather than capital gain has been an important deterrent to sodbusting and swampbusting since preferential capital gains taxation was restored. The repeal of the investment tax credit and the lengthening of recovery periods for irrigation equipment also greatly reduced the subsidy for the capital equipment necessary for the irrigation of fragile rangeland.

In addition to modifying those provisions which had a negative impact on soil conservation efforts, the 1986 Act also improved the effectiveness of the deduction for soil and water conservation expenditures through improved targeting. The deduction can no longer be used to deduct expenses associated with the draining and filling of wetlands or for preparing land for center-pivot irrigation systems. Furthermore, only expenditures for practices taken in connection with plans approved by USDA's NRCS or a comparable State agency can be deducted under the soil and water conservation provision. Finally, more recently, the increase of tax incentives for the donation of a conservation easement should further efforts to slow the conversion of farmland to commercial or residential development uses.