

Proposals for Reform

The National Commission on Small Farms recommended a review of two tax reform proposals in *A Time to Act* to help “retiring farmers to assist new farmers in getting started” in farming (p. 95, Recommendation 5.7). The first proposal addresses the tax treatment of an installment sale, while the second involves the taxation of rental income from a beginning farmer. A third proposal being considered by Congress is designed to aid farmers in managing risk through farm savings accounts.

Installment Sales Reform

Installment sales of farmland and other farm property can provide benefits to both the buyer and the seller. Buyers have an alternative source of financing other than a bank or other traditional lender while the seller can realize more from the sale due to reduced tax liability. Under the current installment sale rules, taxable gain on the sale is generally recognized on a pro rata basis as the payments are received. However, there is an exception for depreciation recapture. Depreciation recapture must be fully recognized in the year of the sale even if it exceeds the amount of the payment actually received. This can cause problems for sales of an ongoing farm business with significant amounts of farm machinery and equipment or single-purpose or other farm structures. In such instances, the seller will likely require that the first-year payment be large enough to cover the tax liability associated with the depreciation recapture. Since depreciation recapture is taxed as ordinary income, this could be quite large and may make it difficult for a beginning farmer to purchase a farm business that has farm machinery, livestock, or farm buildings in addition to farmland on an installment basis. In some instances, the recapture amount may be so large that there may be little incentive to sell the farm on an installment basis and instead require that the purchaser find another source of funding for the purchase. Again, this can place the beginning farmer, who may have more difficulty in securing financing, at a disadvantage.

Allowing depreciation recapture to be recognized in the same manner as other gain in the case of an installment sale to a beginning farmer would increase the incentive for the owner to sell farm land and other farm business assets on an installment basis and should reduce the amount of money required as an initial payment. Thus, beginning farmers should be able to negotiate more favorable payment terms than under existing installment sales rules. However, the reduction in the down-

payment amount is likely to be less than the first-year tax savings. Although the additional downpayment amount goes to the Internal Revenue Service (IRS) and not the seller, reducing the amount of the downpayment increases the risk assumed by the seller should the beginning farmer default and the seller be forced to repossess and resell the property. Because sellers are likely to view an installment sale to a beginning farmer as riskier than a sale to an established farmer, there may be resistance to lowering the downpayment amount. Thus, the reduction in the downpayment amount is likely to be less than the tax savings in the year of sale.

One of the reasons for making an installment sale is to spread the gain over several years and avoid the higher tax rates that can be applicable in the case of a sale for a lump-sum payment. The reintroduction of income averaging for farmers may reduce the need to spread payments over a period of years because farm income can be spread over the 3 prior years. While averaging does not apply to land, gain from the sale of other farm business assets or other farm income is eligible for income averaging and could reduce the benefits from an installment sale.

Recent estate tax changes may also affect the willingness of retiring farmers to sell farm property under a land contract to a beginning farmer. The new family-owned business deduction currently allows as much as \$675,000 in business assets to be transferred free of tax in addition to the amount exempted by the unified credit. Because the new provision requires that the trade or business be more than 50 percent of the estate to qualify, older farmers are encouraged to remain fully invested in land and other business assets. Land sales on contract are discouraged since a land contract is not likely to be considered a business asset. Thus, modifying the installment sales rules may remove one obstacle to sales to beginning farmers. However, given the other obstacles, the change may not substantially increase the number of retiring farmers willing to sell land to a beginning farmer through a land contract.

Tax-Free Rental Income

Beginning farmers are frequently at a disadvantage in bidding for land available to rent. They may be in direct competition with established farmers who not only may be in a financial position to outbid them but also may be perceived as more creditworthy and reliable.

One of the proposals designed to make rental land available to beginning farmers is to exempt the first \$10,000 of income to a landlord who leases farmland or other property to a beginning farmer. Farm landlords, many of whom are retired, would clearly benefit from tax-free rental income, with the level of benefit depending upon the landlord's tax rate.

Exempting rental income from beginning farmers should provide beginning farmers greater access to farmland through rental arrangements. However, there may be little financial assistance provided to beginning farmers. Research has shown that similar subsidies accrue to the asset owner rather than the operator (Schertz and Johnston, 1998a,b). Thus, while the same before-tax rent from a beginning farmer would provide a higher after-tax return to the landlord, there may be little pressure to reduce the rent amount charged to the beginning farmer. Thus, the landlord could capture much of the financial benefit associated with the tax incentive. The amount of benefit, if any, captured by the beginning farmer would depend upon the local farmland rental market. Thus, the primary benefit to the beginning farmer would likely be the increased availability of farmland for rent due to the tax savings available to the landlord.

Nebraska enacted a similar policy in 1999 that provides a State income tax credit to landlords who rent property to beginning farmers (Fredrick). To qualify, a beginning farmer must have net worth under \$100,000 and provide most of the physical labor and management in the farm. The tax credit that the landlord receives is 5 percent of the gross rental income. While it is too early to evaluate the success of the Nebraska program, future analysis could indicate whether beginning farmers receive part of the benefit in the form of lower rents or whether the landlord captures most of the benefit.

Farm and Ranch Risk Management (FARRM) Accounts

A program of tax-deferred savings accounts for farmers is among the alternatives under consideration by Congress to help farm operators manage their year-to-year income variability. Unlike the income-averaging provision included in the Taxpayer Relief Act of 1997 allowing farmers to spread above-average income to prior tax years and avoid a higher tax bracket, tax-deferred savings accounts would build a cash reserve that is available for future use. By depositing income into Farm and Ranch Risk Management (FARRM) accounts during years of high net income, farmers could build a

fund to draw on during years with low income. Farmers who are able to build new savings through these accounts could be better able to smooth their household consumption over time and self-insure some of their income risk.

Proposals for tax-deferred farm risk management accounts originally surfaced after passage of the 1996 Farm Act, as a mechanism to encourage farmers to save a portion of the 7-year transition payments. In 1998, as Congress sought to expand the farm safety net and ease stress from low commodity prices and regional disasters, it considered FARRM accounts but did not enact them. In 1999 and 2000, FARRM accounts were again included as one part of several proposed tax reduction packages that were not enacted.

As proposed, farmers could take a Federal income tax deduction for a FARRM deposit of no more than 20 percent of eligible farm income. Eligible farm income is defined as taxable net farm income from schedule F of IRS form 1040, plus net capital gains from the sale of farm assets including livestock but not land. Deposits would be made into interest-bearing accounts and earnings would be distributed and taxable annually. Withdrawals from principal would be at the farmer's discretion and taxable in the year withdrawn. Deposits could stay in the account for up to 5 years, with new amounts added on a first-in, first-out basis. Deposits not withdrawn after 5 years would incur a 10-percent penalty. FARRM funds would also have to be withdrawn if the participant stops farming. Deposits and withdrawals would not affect self-employment taxes.

FARRM account eligibility would be limited to individual taxpayers – sole proprietors, partners in farm partnerships, and shareholders in subchapter S corporations – who report positive eligible farm income. The program could be relatively easy to administer by using existing tax forms and reporting requirements similar to IRA's.

Based on 1994 IRS data, an estimated 916,000 farmers would be eligible to contribute as much as \$2.8 billion to FARRM accounts each year. Farm sole proprietors account for over two-thirds of eligible participants and three-fourths of potential contributions. Partners in farm partnerships make up about one-fourth of eligible participants and one-sixth of potential contributions.

Although farm sole proprietors make up the largest share of potentially eligible individuals, over two-thirds of all farm sole proprietors either report a farm loss or have no Federal income tax liability and therefore

could neither participate nor benefit from participation. About half of the remaining sole proprietors who are eligible would be limited to contributing less than \$1,000 in any given year. Thus, each year only about one of every six sole proprietors could contribute more than \$1,000. Actual participation rates and amounts could be significantly less than the number and amount eligible.

While an estimated 27 percent of all sole proprietors would be eligible for FARRM deposits in any given year and the average potential contribution for those who are eligible would be \$3,500, there would be considerable variation among the farm types. Large family farms with sales over \$250,000 are the most likely to be eligible, at 69 percent. Their average potential contribution is \$10,800, more than twice that of the next closest group. For these large farms, and even many primary-occupation small farms, FARRM accounts could offer the ability to build a sizeable and useful self-insurance safety net over several years.

At the other extreme, however, limited-resource farms are the least likely to be eligible. Because of low income, most of these farms do not owe income tax and would have no incentive to participate. For the 10 percent who are eligible, their average potential deposit is only \$760. With such small amounts, FARRM accounts would be of little value to limited-resource farms.

FARRM accounts will also be of relatively little benefit to other groups of small farms, such as retirement and lifestyle farms. Although lifestyle farms make up the largest group by the number of farms, only 20 percent would be eligible because most lifestyle farms report taxable farm losses. On the other hand, many lifestyle farms may not need an additional risk management tool because their primary occupation and source of income is away from the farm.

The amount of money that would actually be deposited into FARRM accounts and a minimum balance that would be necessary to provide sufficient risk protection – for either farm operations or household living expenses – are difficult to estimate. But with over 80 percent of all farmers limited to contributions of less than \$1,000 in any given year, and with participation rates certain to be less than 100 percent, most farmers are not likely to accumulate significant reserves. Some

producers with low contribution limits may be able to deposit larger amounts in years when farm income is higher. But the 5-year window for building reserves and the generally low level of taxable net farm income combine to reduce the likelihood that most farmers would be able to build balances adequate to self-insure risk exposure.

Without targeting (specifying other income criteria for those who are eligible to participate) most of the benefits would go to relatively few farmers, and some would go to individuals who do not rely on farming for their livelihood (Monke and Durst, 1999). To meet goals of program efficiency (benefits offsetting costs) and risk management, FARRM accounts must create new savings rather than shift assets or replace existing risk management practices (Monke). The primary benefits would be farmers' increased financial stability and the potential need for lower emergency aid payments.

To enhance farmers' risk management capabilities, new savings must come from reduced household consumption or from funds that would have been invested in the business, rather than from shifting existing savings, diverting future new savings, or borrowing. Available data indicate that most potentially eligible farmers have ample resources to shift funds into FARRM accounts instead of creating new savings.

In summary, tax-deferred risk management accounts have the potential to encourage farmers to provide their own safety net by saving money from high-income years to withdraw during low-income years. Taxpayers could benefit if farmers' additional financial diversification and liquidity reduce the need for income support programs or ad hoc disaster relief. Nonetheless, there are several potential limitations to the program's effectiveness. These include (1) low levels of taxable farm income that preclude most farmers from building meaningful balances, particularly those most in need of risk management tools such as limited-resource and beginning farmers; (2) concentration of benefits among operators with large farms and relatively high nonfarm income; and (3) funding of FARRM accounts with existing liquid assets instead of new savings. Given these limitations and differences within and across farm types, FARRM accounts may improve short-term cash-flow for those who participate but are not likely to significantly reduce the demand for emergency relief from the Federal government.