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Implications of the 2003 Tax Act for California Farmers and Ranchers

by
Hoy Carman

The 2003 Tax Act offers significant income tax saving opportunities for California farmers and ranchers. Careful planning and development of a tax management strategy is necessary, however, because of the temporary and time-phased nature of the major provisions.

The Jobs and Growth Tax Relief Reconciliation Act of 2003, signed by President Bush on May 28, 2003, is expected to reduce taxes by some $330 billion by 2013. Described as the third largest tax cut in U.S. history, the purpose of the act is to stimulate economic growth and help fuel an economic recovery. Depending on individual circumstances, many California farmers and ranchers will be able to derive significant economic benefits from the 2003 Tax Act by carefully planning their future operating and investment decisions. Income tax rate reductions, new lower rates for capital gains and dividends, and increased deductions for Code Section 179 expensing will affect taxes, operating practices and asset values. Taxpayers with children or couples subject to the marriage penalty will see immediate benefits.

The 2003 Tax Act accelerates and expands portions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act) and the Job Creation and Worker Assistance Act of 2002. Most of the tax cuts contained in the 2003 Tax Act are accelerations of provisions in the 2001 Tax Act, and all cuts are temporary. Timing and planning will be important because some of the provisions will expire after two years, some after six years and all will expire at the end of 2010, unless Congress decides to make the changes permanent. While the 2003 Tax Act does not include provisions specifically directed to agriculture, the provisions for expensing capital expenditures, lower individual income tax rates, and reduced capital gains tax rates have important financial implications for farmers and ranchers.

Deduction of Capital Expenditures

The 2003 Tax Act increases the amount that businesses may expense (Code Section 179) for capital expenditures from $24,000 in 2002 to $100,000, and increases the investment limitation for expensing from $200,000 to $400,000 for tax years 2003 through 2005. During the same time period, small businesses may, for the first time, expense "off-the-shelf" computer software. Tangible personal property that qualifies for expensing includes machinery and equipment and livestock (horses, cattle, hogs, sheep, goats and fur bearing animals). Single-purpose agricultural (livestock) and horticultural structures also qualify for expensing. Single-purpose agricultural structures are any building or enclosure specifically designed, constructed and used to

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house, raise and feed a particular type of livestock and its produce. Single-purpose structures, for example, are qualifying property if used to breed chickens or hogs, produce milk from dairy cattle, or produce feeder cattle or pigs, broiler chickens or eggs. The facility must include, as an integral part of the structure or enclosure, equipment necessary to house, raise and feed the livestock. A greenhouse designed, constructed and used for the commercial production of plants is the most common horticultural structure. Timing is important because the limit for expensing and the investment limitation are reduced to $25,000 and $200,000, respectively, effective January 1, 2006. The act also increases the "bonus" depreciation provisions, allowing business taxpayers to expense 50 percent (up from 30 percent) of the cost of qualifying assets in the year of purchase for property placed in service after May 6, 2003, but before December 31, 2004.

New Individual Income Tax Rates

Individual income tax rate reductions scheduled by the 2001 Tax Act to have been effective in 2006 have been accelerated to January 1, 2003. Marginal tax rates for the two lowest brackets remain at 10 percent and 15 percent, but the taxable income limit for the 10 percent bracket has been increased from $12,000 for joint filers in 2002 to $14,000 in 2003 and 2004. This change yields tax savings of $200 for taxpayers in the 15 percent bracket or above who file a joint return ($100 for single filers). The taxable income limit is scheduled to drop to $12,000 for the 2005, 2006 and 2007 tax years and then increase to $14,000 on January 1, 2008. The 10 percent bracket will be eliminated in 2011. The top four 2002 marginal tax rates of 27, 30, 35 and 38.6 percent were reduced to 25, 28, 33 and 35 percent, respectively, with the changes retroactive to January 1, 2003. The top four rates are scheduled to return to 2002 levels on January 1, 2011. The alternative minimum tax (AMT) exemption amounts are increased to $58,000 and $40,250 for joint and single filers, respectively, but only for 2003 and 2004. The AMT exemption is then decreased to $45,000 and $33,750 for joint and single filers, respectively.

Capital Gains and Dividends

Effective May 6, 2003, the long term capital gains tax rate for taxpayers in the 10 percent or 15 percent tax brackets will drop to 5 percent (from 10 percent). The 5 percent rate drops to zero for 2008, and then returns to 10 percent from 2009 forward. For the four highest income brackets, the act reduces the maximum tax rate for long-term capital gains to 15 percent (from 20 percent), effective for capital gains recognized or installment payments received on or after May 6, 2003. The 15 percent rate will be in effect through the end of 2008, when it is scheduled to return to 20 percent. To qualify for capital gains tax treatment, cattle and horses used in a trade or business for draft, breeding, dairy or sporting purposes must be held for 24 months or more. Other livestock and other business property must be held for 12 months or more to qualify for long term capital gains tax treatment.

Most dividends will be taxed at the same rate as capital gains—5 or 15 percent depending on the taxpayers' income bracket. The rule for dividends applies for the same time frame as for long term capital gains, May 6, 2003 through December 31, 2008, (with a zero rate during 2008 for the lowest two tax brackets). Taxpayers must exercise care, however, because not all dividends are covered by the new lower rates. IRS Code Sections 246(c), 404(k), 501, 521 and 591 identify the types of dividends that qualify for the lower rates.

Child Tax Credit and Marriage Penalty Relief

The child tax credit increases from $600 per year to $1,000 per year per child, retroactive to January 1, 2003, but only for 2003 and 2004. It will be reduced to $700 for the 2005 through 2008 tax years, then increase to $800 for 2009 and $1,000 for 2010. Under current "sunset" provisions, the child tax credit is scheduled to return to $500 for 2011.

Marriage penalty relief increases the basic standard deduction for joint filers to 200 percent of the single filer amount and the 15 percent bracket size for joint filers to 200 percent of the 15 percent bracket size for single filers for 2003 and 2004. The basic standard deduction for joint filers is reduced to 174 percent of the single filer amount in 2005 and will increase annually, reaching 200 percent again in 2009. The 15 percent bracket size for joint filers is reduced to 180 percent of the single filer amount in 2005 and will increase back to 200 percent in 2008.

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Some Implications of the 2003 Tax Act

While the expected impact of individual provisions on farmers and ranchers is typically straight forward, the combined effects of the total package of tax law changes can be ambiguous because of offsetting effects. For example, by reducing the after-tax cost of capital expenditures, the 2003 Tax Act can be expected to increase purchases of machinery, equipment and other items eligible for expensing. At the same time, reductions in tax rates reduce the after-tax value of the expensing provisions. Suppose, for example, that a farmer in the 30 percent tax bracket purchases and expenses a piece of equipment for $25,000. His after-tax cost of the purchase is 70 percent of the cost ($17,500), but his after-tax cost increases to 72 percent of the cost ($18,000) when his tax bracket is reduced to 28 percent. Increasing the amount of investment eligible for expensing to $100,000 will increase incentives to invest through December 31, 2005, but after that date, the reduction in tax rates will dominate.

Livestock investment and operating decisions are affected by individual and capital gains tax rates. Since the sale of raised livestock (held for more than two years) is subject to capital gains treatment, a producer can adjust taxable income by varying the replacement interval for cows. Shortening the replacement interval increases the proportion of income from cull cows that is subject to favorable capital gains treatment. Reduced capital gains tax rates, other things being equal, encourage ranchers to cull younger cows, and these younger cows tend to be sold as breeding stock rather than as slaughter cows. At the same time, reduced tax rates on ordinary income reduce the comparative advantage of capital gains and tend to increase the optimum culling age for cows. Overall, high income producers will tend to reduce the culling age for beef and dairy cattle operations, while lower income producers will tend to focus on cow productivity.

Lower capital gains tax rates will likely increase the demand for farmland but may also increase the availability and turnover of farmland as owners who had been waiting for lower tax rates put their property on the market. The short-run impact on prices is thus difficult to predict, but prices for land should increase over time in response to increased demand.

Planning Considerations

Most farm taxpayers will be able to increase their benefits from the Tax Reform Act of 2003 by planning and consulting with their tax advisors regarding the timing of machinery and equipment purchases, investments in single-purpose structures and the disposition of farm assets. Livestock producers making culling decisions will want to consider the difference in tax rates between capital gains for selling a raised cull cow versus ordinary income for selling a raised replacement heifer. The optimal decision will change as taxable income changes and as capital gains and ordinary income tax rates change. Farm taxpayers using cash accounting should continue to be careful about the timing of income and expenditures at the end of the tax year to take advantage of rate changes when they occur. Those taxpayers with estate plans and assets that are likely to appreciate will want to consider gifting or intra-family sales to take advantage of the low capital gains tax rate. It is especially important that farmers and their tax advisors keep current on "sunset" provisions in the Tax Reform Act of 2003 and changes that occur over time.

Which provisions in the 2003 Tax Act are most important to farm taxpayers? All taxpayers benefit from rate reductions, taxpayers with children will receive larger tax credits and the marriage penalty is reduced. Farmers who purchase large amounts of depreciable assets will realize important tax savings from the two-year increase in Code Section 179 expensing to $100,000. Reductions in capital gains tax rates are also important to a smaller number of farm taxpayers with livestock enterprises or land sales.

Readers interested in a comprehensive review of the effects of federal income taxes and tax law changes on agriculture may want to obtain a copy of Professor Carman's book. The reference is Hoy F. Carman. *U.S. Agricultural Response to Income Taxation.* Ames, Iowa: Iowa State University Press, September, 1997, 220 pp.

Hoy Carman is a professor in the Department of Agricultural and Resource Economics at UC Davis. His interests include agricultural marketing and the impacts of taxes on agriculture. Hoy can be contacted by telephone at (530)752-1525 or by e-mail at carman@primal.ucdavis.edu.