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Implications of 1997 Federal Income Tax Reform for California Farmers and Ranchers

by Hoy F. Carman

THE Taxpayer Relief Act of 1997 will affect the taxes and operating practices of California farmers and ranchers. Most farm families will pay less federal income tax than would have been due under prior rules and estate tax relief will make it easier for farm families to transfer assets across generations. The U.S. Department of Agriculture estimates that U.S. farmers will save over $1.6 billion annually in federal income taxes and between $150 and $200 million in estate taxes. General income tax provisions of interest include tax relief for households with children, tax incentives for higher education and retirement savings, and changes in the health insurance deduction for the self-employed. More targeted income tax provisions, including lower capital gains taxes and income averaging, will affect taxes, operating practices, and asset values. Federal estate and gift tax law changes in the 1997 act were primarily targeted to farms and small family businesses.

Capital Gains Provisions

New capital gains tax provisions will reduce taxes paid by many farm households, and will also have significant impacts on farm management practices and investment behavior for many farmers and ranchers, as they make decisions to minimize taxes paid.

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We Want to Hear from You

This is the third quarterly issue of the UC Davis *ARE Update* published by the Department of Agricultural and Resource Economics at UC Davis. To assist in our planning for future issues, we request your input.

First, please tell us what you have liked or disliked about our first three issues. Also, tell us what you would like to see in future issues: what topics, regular sections, etc., would interest you.

Second, we are planning a "Question & Answer" page, in which ARE faculty answer questions from readers regarding economic issues related to agricultural or natural resources. Please send us questions that you would like to see addressed in either short answer form or, possibly, in a feature article.

Please direct all of your comments and questions to Julie McNamara. You can contact her at her e-mail address, telephone number or postal address listed on the last page of this *Update*. We look forward to hearing from you.

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Managing Risks in California Agriculture

by Steve Blank

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For capital assets owned at least 18 months and sold after July 28, 1997, the former 28 percent maximum rate is reduced to 20 percent and the 15 percent rate is reduced to 10 percent. For assets acquired beginning in 2001 and held at least 5 years, the maximum tax rate will be reduced to 18 percent. For individuals in the 15 percent bracket, the maximum falls to 8 percent in 2001, regardless of the purchase date.

The major impacts of new, lower capital gains tax rates will be in the livestock sector and the farmland market. Both farm and nonfarm investors will increase investment in land and livestock. Lower capital gains tax rates will likely increase the demand for farmland but the reduction 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 should increase over time in response to increased demand. Increased investment in livestock will lead to increased production and lower prices over time. Lower capital gains tax rates will also affect management decisions and operating practices. For example, the culling decision for beef cattle producers will once again be based as much on tax considerations as on cow productivity. Cows will be culled at a younger age and the availability of these young cows will contribute to expansion of the nation's cow herd and the supply of beef. The "fallacy of composition" may hold; a tax rate reduction appears to benefit the individual rancher, but it may actually work to his disadvantage when the total response is considered.

The new tax law also allows individual taxpayers to exclude up to $250,000 ($500,000 if filing a joint return) of gain on the sale or exchange of a principal residence. This replaces the provision that allowed the rollover of capital gain into the purchase of a new residence and the $125,000 exclusion for taxpayers over 55. The USDA estimates that farm residences that will qualify for the exclusion account for about 12 percent of total farm value.

General Provisions

Several provisions have widespread effects, with farm family benefits based on those households that qualify for each of the tax incentives. The tax credits for households with children and the incentives for higher education and retirement savings are reduced or eliminated for high-income taxpayers.

Tax Credit for Children

This provision permits households with children to reduce their income tax by $400 for each qualifying dependent child under the age of 17 in 1998 ($500 per child after 1998). The credit is reduced if income on joint returns exceeds $110,000. An estimated 1/3 of all farm families will qualify for the credit, with aggregate benefits of some $600 million annually.

Higher Education Incentives

Income tax incentives for higher education include a Hope Scholarship Credit of up to $1,500 during each student's first 2 years of college and a 20% Lifetime Learning Credit of up to $2,000 annually (by 2003) for each taxpayer. In 1998, up to $1,000 of student loan interest becomes deductible (increasing $500 per year and reaching a maximum of $2,500 for 2001 and later years), and new education IRA's will allow $500 annual nondeductible contributions per child. Tax free distributions from these IRA's will be allowed for qualified education expenses. All of these incentives are reduced or eliminated for high-income taxpayers, with restrictions varying by provision.

Health Insurance Deduction

Currently, self-employed taxpayers are allowed to deduct 40 percent of family health insurance costs. The new law has phased increases of the deduction to 100 percent in 2007, up from the 80 percent scheduled under prior law. The USDA estimates that about 400,000 farmers currently pay over $1.2 billion annually for health insurance. This change, designed to bring small business owners into line with employees receiving employer-deductible health insurance, will reduce farmers' net cost of buying health insurance.

Agricultural Provisions

Three provisions in the new tax law that apply

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mainly to farmers' problems of increased tax burdens related to fluctuating income will have relatively minor impacts in California.

Deferred Payment Contracts

The 1997 act restores farmers' ability to use deferred payment contracts without being subject to the alternative minimum tax (AMT). Farmers are allowed to defer income taxes by selling assets in one year and waiting until the next (or another) year to receive the income, but the Tax Reform Act of 1986 did not permit farmers to defer such income when computing AMT.

Disaster Livestock Sales

The 1997 act expands the existing special treatment of livestock sales due to drought to include floods and other weather-related conditions. Farmers who are forced to prematurely sell livestock because of weather conditions may defer declaring such income for taxes until the following year. The farmer must demonstrate that the sales were made earlier than usual and that he was located in an area eligible for Federal assistance due to weather conditions.

Income Averaging

The Tax Reform Act of 1986 terminated income averaging for all taxpayers, but the impact on farmers was relatively minor. Given the new rate structure effective at that time (with only two marginal tax rates, 15 and 28%), the tax impact of fluctuating income was small. With the addition of new tax rates over time (a 33% bracket was added in 1990 and 36% and 39.6% brackets were added in 1993), large year-to-year income fluctuations have become more of a tax burden. The 1997 act allows farmers to average income from farming during the tax years 1998-2000.

Estate Tax Changes

Changes to federal estate and gift tax laws in the 1997 Taxpayer Relief Act were targeted primarily to small businesses and farms. Prior to the 1997 act, the unified credit would offset the tax on the first $600,000 of an individual's estate. The 1997 act increases the credit to offset the tax on $1 million of an estate by 2006, with most of the phased increase taking place during the last three years. Beginning in 1998, the act includes an additional exclusion for farms and other family-held businesses that will exempt $675,000 of the value of a qualified family-owned business from estate taxes. However, the total amount excluded by this provision and the unified credit is limited to $1.3 million. The USDA estimates that the new exclusion will reduce the number of taxable farm estates by about 40% and reduce Federal estate taxes due on farm estates by $150 to $200 million annually. The 1997 act includes several other changes:

- It will index the $1 million value for inflation beginning in 1999
- It changes the installment payment provisions for qualifying farms or businesses
- It indexes the cap on the special use valuation provision
- It refines the requirement that farmland benefiting from the special use provision be used in farming by the heir for a period of 10 years
- It expands the estate tax benefits available to land owners who donate a qualifying conservation easement.

Concluding Comments

The Taxpayer Relief Act of 1997 may be important to farmers and ranchers. Since there is a substantial amount of "fine print" in the new tax law, the usual caveat that "farm taxpayers should consult with their accountant and/or lawyer" applies. Several of the provisions are phased-in over time and there may be income or other tests to satisfy in order to be eligible to use several of the provisions. One will find little in the way of "simplification" in the Taxpayer Relief Act of 1997.

Note:
Readers interested in the effect of Federal income taxes on agriculture can obtain a copy of Professor Carman's recently published book. The reference is Hoy F. Carman, U.S. Agricultural Response to Income Taxation, Ames, Iowa: Iowa State University Press, September, 1997, 220 pp.

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