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The Potential Impact of Tax Reform on Farm Businesses and Rural Households

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What Is the Issue?

Proposals calling for fundamental tax reform have once again called attention to a tax system that many regard as overly complex, inefficient, and inequitable. Proponents of reform see this as an opportune time for a comprehensive overhaul of the tax system because major features of the system are set to change, although some were recently made permanent by the American Taxpayer Relief Act of 2012.

Several proposals calling for fundamental reform of the Federal income tax system have been put forth, including a report by the co-chairs of the National Commission on Fiscal Responsibility (NCFRR), a bipartisan reform panel created by the President in 2010 to address the fiscal stability of the United States. The primary elements of proposed reform—eliminating tax preferences, restructuring capital gains and dividend tax rates, lowering rates on ordinary income, and reducing the number of tax brackets—could have a significant impact on the after-tax income and well-being of both farm businesses and rural households.

What Did the Study Find?

The primary goals of tax reform are to simplify the tax system, making compliance easier and reducing economic distortions induced by the system, while preserving its progressive nature. While reform may improve societal welfare, the current tax system contains features that provide substantial benefit to *farm businesses* in the form of reduced rates on capital gains, accelerated cost recovery provisions, and other special deductions for farm production activities. Since most farms are operated as sole proprietors, partnerships, or other noncorporate entities and taxed under the individual income tax, reform of the individual income tax structure is of greatest importance to most farmers. However, reform of the corporate income tax could also affect important business tax provisions for farmers, including those taxable under the individual income tax.

In particular, reducing or eliminating deductions for capital purchases and raising capital gains taxes could increase the farmer's tax base and raise the tax rate paid on a significant portion of their income. These effects will vary by farm size. Offsetting these effects, though, is the proposed reform of the marginal tax rate structure. A reduced number of brackets and lower rates could mitigate the effect of a potentially larger tax base for many U.S. farm households.

In 2010, about 38 percent of U.S. farmers, defined as taxpayers who filed a Schedule F with their Form 1040, reported some *capital gains*—nearly three times the share for all other taxpayers—totaling \$28.4 billion. The average amount of capital gain reported by farmers was also more than

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double the average capital gain reported by other taxpayers. If capital gains are taxed at rates equal to income tax rates, farmers will face higher tax liabilities on capital gains income, even if ordinary tax rates are reduced.

Farming requires large investments in machinery, equipment, and other depreciable capital. In 2010, U.S. farmers reported a total of \$29 billion on capital purchases, and those making investments made an average of \$32,000 in annual capital purchases. Proposed restrictions on current *expensing and accelerated recovery of capital purchases* could increase taxable income, especially during the early years following tax reform. Under present law, the maximum expensing amount is \$500,000, but will drop to \$25,000 in 2014 (as provided by the American Taxpayer Relief Act of 2012). While fewer than 20 percent of small farms (those with less than \$250,000 of gross sales) invest more than \$25,000, nearly 54 percent of commercial farms (farms with at least \$250,000 of gross sales) invest more than that amount. Thus, investment by commercial farms will be affected the most by a substantially lower expensing amount. This could lead to increased taxable income and reduced capital investment by these farms.

Commercial farms are also the primary beneficiaries of the domestic production activities deduction for manufacturers. While only about 7 percent of farms claimed the deduction, the total amount deducted was \$1.25 billion. For these farms, eliminating the deduction could add an average of about \$9,000 to their taxable income.

About one out of seven farmers uses the *self-employed health insurance deduction* in any given year. In 2010, these farmers deducted an average of \$6,173 for a total of \$1.684 billion in health insurance premiums. Over 50 percent of farm households obtain their insurance through off-farm employment of the operator or spouse, which helps account for the low number of farmers claiming the deduction. Many other farmers are over age 65 and are covered by Medicare or other Government programs. Nonetheless, tax reform that eliminates the deduction for premiums on health insurance purchased by the self-employed could increase taxable income for some farmers.

Tax reform would affect rural nonfarm households differently than farm and urban households. Rural taxpayers are likely to have lower incomes and be older than urban households. Given their lower income, *rural nonfarm households are less likely to benefit from tax deductions*, exemptions, exclusions, or deferrals, because they either lack eligible expenses to exceed the standard deduction or otherwise do not qualify for the tax exemption. Some of the most widely used deductions—for mortgage interest and real estate taxes—are related to the value of property and real property tax rates, which are generally lower in rural areas. Although rural households have higher rates of home ownership, they are less likely to have a mortgage. Thus, the typical rural homeowner may even benefit if the current mortgage interest deduction was replaced with a refundable credit for mortgage interest because the credit does not require taxpayers to itemize to receive the benefit or even have a tax liability at all.

While rural households would be less affected than other households by the elimination of itemized deductions, the restructuring of *refundable tax credits* could significantly lower the after-tax income of low-income rural households. Any reform that reduces the value of refundable credits—especially the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC)—is likely to reduce the well-being of low-income rural households. Overall, one out of every three rural taxpayers receives benefits from the EITC or the CTC. In 2008, 21.6 percent of rural taxpayers received EITC benefits, compared with 16.9 percent of urban taxpayers. The earned income and child tax credits provided a total benefit of \$20.6 billion to rural taxpayers in 2008.

How Was the Study Conducted?

This report uses both published and special tabulation data obtained from the Internal Revenue Service to provide an overview of the current tax situation for U.S. farm households and to evaluate the importance of various Federal income tax policies. It also uses farm-level data from USDA's Agricultural Resource Management Survey to estimate the effects of various policies on Federal income tax liabilities of farmers. The American Housing Survey is also analyzed to evaluate the relative importance of various tax provisions for rural households.