Tax Legislation Improves Farmers' Financial Position and Access to Financing

New tax deductions for health care expenses and capital purchases reduce tax liability. Legislation expands the availability of tax-exempt financing for first-time farmers.

Federal tax legislation enacted in 1996 will improve the financial position of many farmers by reducing the after-tax cost of health insurance and medical expenses and by lowering the cost of investing in farm machinery and other depreciable capital. Banks, insurance companies, and other intermediaries may also act as trustees for newly created medical savings accounts. In addition, changes to provisions governing the use of tax-exempt bonds to provide funding to first-time farmers will expand the availability of such financing.

The Health Reform Act of 1996 gradually increases the deductibility of health insurance premiums for self-employed taxpayers over the next 10 years. Because this deduction is not subject to an income test, unlike itemized medical and dental expenses, it is accessible to a greater proportion of self-employed farmers. This deduction is especially important for farmers who must purchase insurance on their own.

Since 1988 when the self-employed health insurance deduction was introduced, nearly 40 percent of farmers whose primary source of income is from farming and 20 percent of all farmers annually used the self-employed health insurance deduction. Beginning in 1997, self-employed taxpayers will be able to deduct 40 percent of their health insurance premiums (up from 30 percent in 1996). The deduction increases to 45 percent for tax years 1998 through 2002. It increases to 50 percent in 2003, and increases 10 percent per year thereafter until it reaches 80 percent. Therefore, most self-employed individuals eligible for the deduction will be able to more than double the amount they can deduct in health insurance premiums over 1996 levels. Not everyone who currently uses the health insurance deduction will benefit, however. A small fraction of the farmers who used the health insurance deduction also itemized medical expenses and were able to deduct the remainder of their health insurance premiums. These farmers will see an offsetting reduction in their itemized deductions. Nonetheless, more than 350,000 self-employed farmers should be able to deduct an increasing amount of the $1.2 billion they pay for health insurance. As a result, farmers' Federal tax savings from this deduction will increase from approximately $60 million to over $160 million during the next 10 years (in 1996 dollars).

The average health insurance premium for farmers claiming the self-employed health insurance deduction was estimated to be about $3,300 in 1996. For a farmer in the 15-percent Federal income tax bracket (the most common tax bracket for farmers) and a 3-percent State income tax bracket, the self-employed health insurance deduction reduced tax liability by $178, on average. After the changes are fully implemented in 2006, the tax reduction will increase to $475, on average, assuming no real growth in insurance premiums.

The Health Reform Act also establishes medical savings accounts (MSAs) which will be available to all previously uninsured individuals plus an additional 750,000 taxpayers through December 31, 2000. Banks, insurance companies, and certain other intermediaries may act as trustees, and face similar regulations to those for IRAs. An individual's contributions to an MSA will be deductible for both income and social security (self-employment) taxes, and amounts withdrawn for qualified medical expenses will remain tax-free. MSAs, therefore, allow medical expenses to be paid with pre-tax income.

To open an MSA, an individual must purchase a high-deductible medical insurance plan and be self-employed or work in a firm with fewer than 50 employees. High deductible plans are defined as having $1,500-2,500 deductibles for individual coverage, or $3,000-4,000 deductibles for family coverage. Limits are also placed on total annual out-of-pocket expenses. For the self-employed, the maximum annual contribution to an MSA is limited to the smaller of (a) earned income from self-employment and (b) 65 percent of the health insurance deductible for individual coverage or 75 percent of the deductible for family coverage.

Balances in MSAs earn interest on a tax-free basis and withdrawals remain tax-exempt if they are used to pay for qualified medical expenses. Qualified medical expenses are defined by the rules identifying itemized medical expenses, but may not include regular health insurance premiums. Withdrawals from MSAs may also be used to pay for non-qualified expenses, but are subject to regular income and self-employment taxes in the year of withdrawal plus a 15-percent tax penalty. The penalty is waived, however, if the individual is age 65 or over, becomes disabled, or dies.

If actual medical expenses are low and a balance remains in the MSA, several opportunities exist. First, the balance may be sufficient for much of the following year's expected medical expenses, and only negligible additional contributions may be needed. Second, regular contributions may continue, increasing the balance in the account to cover more of the deductible or copayments. Finally, contributions may continue over a period of years and any balance not used for medical purposes may be withdrawn during retirement.

In short, MSAs may be a valuable tool allowing certain taxpayers to partially self-insure their medical expenses with pre-tax income. They may also provide additional flexibility to build a secondary retirement account, not unlike an IRA. For many farmers who already have relatively high deductible plans, an MSA used for qualified medical expenses can substantially reduce income tax liability and the effective cost of medical care. For example, a qualified farmer who purchases a family plan with a $4,000 deductible may contribute up to $3,000 per year into an MSA. If used for qualified medical expenses, the MSA results in $958 in tax savings (given a 15-percent Federal income tax, 3-percent State income tax, and self-employment taxes). As figure 11 illustrates, the combined tax savings from an MSA and the larger self-employed health insurance deduction will increase, on average, from less than $200 in 1996 to more than $1,400 by 2006.

The Small Business Job Protection Act of 1996 provides additional tax relief to farmers through accelerated recovery of capital investment costs. The cost of investment in farm machinery, equipment, and similar depreciable property must normally be depreciated over a 7-year period. However, farmers and other small businesses have been allowed to immediately deduct up to $17,500 of investment in such depreciable property each year. The ability to expense investment in depreciable property is phased out for businesses that invest over $200,000 in a year. The Act increases the amount of property that can be currently expensed from $17,500 to $25,000 by 2003. The ability to expense up to $25,000 will reduce the cost of depreciable capital and the recordkeeping requirements necessary for determining depreciation deductions for capital investments. As a result of this increase, over 60 percent of total farm investment in depreciable capital can be expensed. Most farmers will be able to expense the full amount of their investment in farm machinery, equipment, and other depreciable capital each year.

Tax-Exempt Financing for First-Time Farmers Expanded

First-time farmer bonds, tax-exempt small-issue private activity bonds on which the interest income is exempt from Federal income tax, are a popular source of funding for State-level programs aimed at providing initial long-term financing to qualified beginning farmers. State and local governments may issue tax-exempt bonds to finance loans to first-time farmers for the purchase of farmland and limited amounts of depreciable property. The amount of financing provided may not exceed $250,000 per farmer, of which no more than $62,500 can be used to purchase used farm machinery, equipment, or similar depreciable property. For this purpose, a first-time farmer is defined as an individual who has never owned farmland in excess of 15 percent of the median-sized farm in the county in which the land is located or land that exceeded $125,000 in value.

The Small Business Job Protection Act of 1996 expands the availability of first-time farmer bonds by increasing the amount of land that an individual could ever have owned and still be considered a first-time farmer from 15 percent to 30 percent of the median-sized farm in the county. The $125,000 limit remains unchanged. The Act also permits purchases from family members to qualify for this financing as long as the land is purchased at fair market value and the selling family member does not retain an interest in the farming operation. Previously, purchases from family members did not qualify. These changes will make it easier for individuals who want to enter farming, especially by purchasing an ongoing family operation, to use tax-exempt financing as the source of funds.

Figure 11

Potential individual tax savings from the Health Reform Act of 1996