The Changing Tax Burden of Farmers

by Ron Durst and James Monke[1]

Farmers' most important tax burdens are Federal income taxes, social security taxes, State and local income and property taxes, and Federal estate taxes. Recent tax law changes have reduced farmers' overall tax burden and, consequently, have increased farmers' share of income available for debt repayment, investment, or personal consumption. Income taxes are expected to fall following Federal tax legislation enacted during 1997. Property taxes continue to rise overall, but are stable to decreasing relative to market values. Although social security taxes continue to rise, the increase is expected to be smaller than the reduction in other taxes and is slowed by continued low levels of taxable self-employment income from farming.

Introduction

Farmers, like other taxpayers, are subject to a variety of taxes at all levels of government. At the Federal level these include income taxes, social security and self-employment taxes, and estate and gift taxes. In 1994, the most recent year for which complete tax data are available, farmers paid nearly $16 billion in Federal income taxes on both their farm and nonfarm income – more than for any other type of tax (figure A-1). Social security taxes represented the second highest tax burden at $9.7 billion, which included $7.9 billion for the employer's and employee's share of the payroll tax on wages and $1.8 billion in self-employment taxes. In contrast, Federal estate and gift taxes were relatively small with taxes on farm estates estimated at only about $500 million.

At the State and local level, the most significant taxes include income taxes and farm real estate and other property taxes. Property taxes on farm real estate, dwellings, and personal property exceeded $5.1 billion in 1994. State and local income taxes were estimated to be nearly $3.9 billion.

Combined, these Federal, State, and local taxes totaled $35.2 billion on nearly $105 billion of expanded income (see box). Trends in the levels of these taxes can significantly affect the funds available for debt repayment, reinvestment in the farm business, or farm household consumption. Recent legislative and other tax developments, especially the Taxpayer Relief Act of 1997, suggest that farmers will have a larger share of their farm and other income available for such purposes. The relative importance of the various taxes may differ for individual farmers because of income levels, asset ownership, or specific State tax laws, but these taxes are clearly the most significant for farmers as a group. Farmers also pay a variety of other taxes such as excise taxes, corporate income taxes, and retail sales taxes, but these taxes are either relatively minor or not significant for the vast majority of farmers.

Federal Income Taxation

From shortly after its introduction in 1913, the Federal income tax has been the most important tax on agriculture. Throughout its history, numerous changes have affected not only the total tax burden but the distribution of the burden among various income levels.

In recent years, changing tax laws have brought about increasing rates overall but have reduced tax burdens on lower-income farmers. The average effective Federal income tax rate for all farmers was 16 percent in 1994, compared with just over 15 percent in 1990 and nearly 14 percent in 1987. Average effective tax rates equal the income tax paid divided by expanded income. Most farmers, however, have incomes that allow them to pay less in taxes than the aggregate rate suggests. About 80 percent of farmers have income of less than $60,000 and pay an average effective Federal income tax rate of less than 10 percent.

Legislation in 1986 comprehensively altered the tax structure by expanding the tax base and by eliminating many personal and business exclusions, deductions, and credits. The marginal tax rate structure was simplified from 14 brackets (ranging from 11 percent to 50 percent) to eventually only three brackets in 1991 (ranging from 15 percent to 31 percent). Farmers lost several important tax benefits because both the 60-percent exclusion for long-term capital gains and the investment tax credit were eliminated. Depreciation schedules were replaced with slower cost recovery alternatives that do not reduce taxable income as much in the early years. Analysis of IRS data indicates that Federal income taxes for farmers effectively became slightly less progressive from 1987 to 1990. Average effective tax rates for those with more than $200,000 in income decreased from about 25 percent to 21 percent, while rates for lower-income taxpayers did not change significantly (Compson and Durst, 1992).

Two new tax brackets for high-income taxpayers were added in 1993, increasing the maximum marginal tax rate from 31 percent to 39.6 percent. These higher rates affected less than 3 percent of farm sole proprietors (Compson and Durst, 1993). For low-income households, the earned income tax credit was expanded in 1990 and 1993 by increasing the benefit levels and simplifying eligibility rules. The credit provides benefits to nearly 12 percent of all farmers. Analysis of IRS data from 1990 to 1994 confirms that average effective tax rates became

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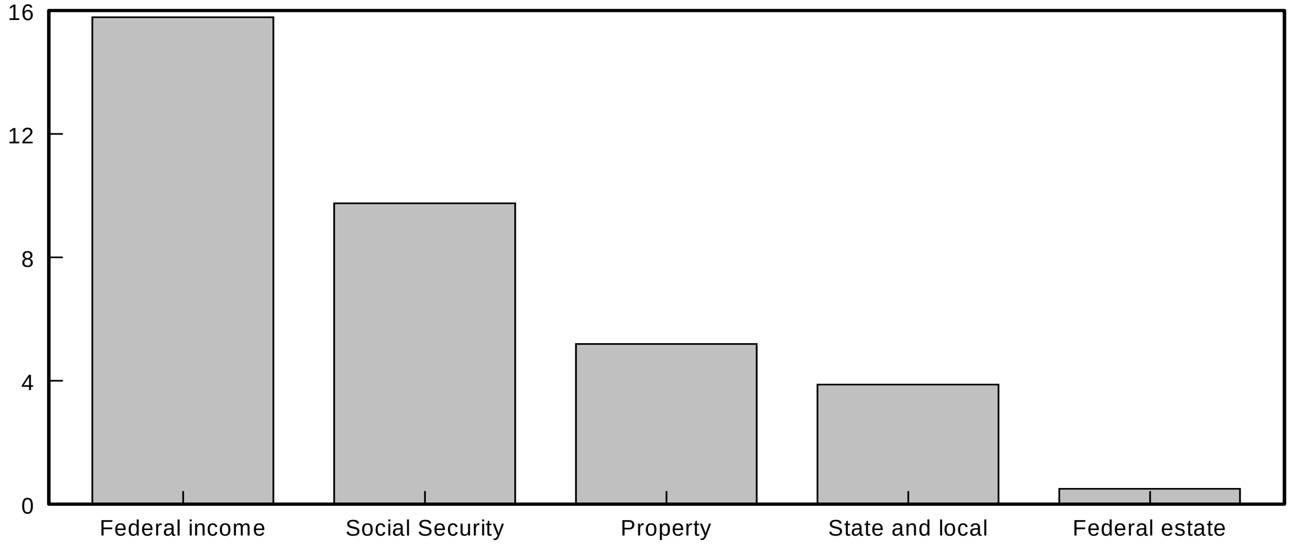
Figure A-1
Taxes paid by all farmers, 1994
$ billion



Source and definitions of tax data

Income and social security tax data were compiled from the IRS Individual Public Use Tax Files from 1987 to 1994, the most recent year available (Internal Revenue Service). The database is an annual sample of tax returns (including those from over 6,000 returns filing Schedule F and identified as farm sole proprietors), weighted to represent the aggregate population of taxpayers and stripped of any information that could be used to identify specific taxpayers. The data do not include income reported by corporate farms, but this amount is comparatively small overall. Property tax estimates are compiled from data published in *Agricultural Resources and Environmental Indicators* (USDA-ERS, 1996, 1997) and USDA's Farm Costs and Returns Survey (FCRS). Estate tax data were simulated using balance sheet information from the FCRS (Maxwell).

Federal income taxes are defined as the Federal income tax after all credits, including the earned income tax credit (EIC), are subtracted. Because the earned income tax credit is refundable, Federal income taxes may be negative. State income tax liabilities were estimated from itemized deductions claimed for Federal income taxes, adjusted for the proportion of taxpayers who itemize deductions (estimated over many intervals of income).

Income references throughout the paper use a definition of "expanded income" applicable to tax analysis. Adjusted gross income (AGI), a legal definition for taxes, does not necessarily measure economic income accurately. Expanded income is computed from AGI by adding tax-deductible contributions to retirement accounts, nontaxable pension or social security benefits, tax-exempt interest income, and the employer's share of social security taxes. An amount is also subtracted for expenses such as investment interest, moving expenses, unreimbursed employee business expenses, and passive losses that are not allowed for tax purposes. Average effective tax rates are computed by dividing the amount of tax paid by expanded income.

more progressive -- increasing for high-income taxpayers because of the new tax brackets, and decreasing for low-income taxpayers following the expansion of the earned income tax credit.

The Taxpayer Relief Act of 1997 brought about the most significant tax reforms since 1986 by providing targeted tax relief to many groups, including farmers. Overall, farmers' total Federal income tax burdens are expected to decrease about $1.6 billion per year, or about 10 percent, with benefits accruing at all income levels (Durst and Monke). Farm households will pay less tax because of provisions aimed at children, education, and retirement savings. A new child tax credit allows taxpayers to directly reduce their income tax by $500 ($400 in 1998) for each dependent under 17, or on average about $800 per eligible farm family. Higher education is also promoted by two new nonrefundable education tax credits, deductible student loan interest, and new tax-exempt savings accounts for education. Opportunities to contribute to individual retirement accounts are expanded. The Act also increases the proportion of health insurance premiums that self-employed farmers may deduct.

Capital gains tax rates were also reduced in 1997. For higher income taxpayers, the rate was reduced from 28 percent to 20 percent. Taxpayers in the 15-percent bracket now pay a 10-percent long-term capital gains tax. This provision is especially important for farmers who, according to IRS data, are three times more likely than other taxpayers to report capital gains. Farmers will also benefit from added flexibility to deal with income fluctuations by income averaging, using deferred payment contracts, or by deferring the gain on certain weather-related livestock sales. The child and education tax credits will be more beneficial to lower income households. On the other hand, most of the capital gains benefits will go to a relatively smaller group of higher income farmers.

The improving Federal budget outlook, particularly the expectation of a balanced budget or surplus, has prompted a number of proposals for further income tax reductions. Any tax increases in the near term will most likely involve narrowly targeted provisions aimed at closing tax loopholes, with little or no effect on most farmers.

Social Security and Self-employment Taxes

Social security taxes include two components: the payroll tax on wage and salary income, and self-employment taxes on the net income from sole proprietorships. Farmers pay self-employment taxes on their net farm income from Schedule F, on partnership income, and on net income from any nonfarm businesses. Farmers or spouses with off-farm employment pay payroll taxes on their wages. Social security tax burdens have risen dramatically over recent decades because of increases in both the tax rate and the amount of income subject to taxation. The most recent rate increases stem from a decade of legislation, beginning with the Social Security Amendments of 1983.

Unlike Federal income taxes which are progressive, the social security tax is a flat rate with a maximum taxable amount. In 1987, the total payroll tax on wage income was 14.3 percent and the maximum amount of earnings subject to the tax was $43,800. An income tax credit reduced the effective self-employment tax rate to 12.3 percent. By 1990, the tax rate had increased to its current level of 15.3 percent (7.65 percent for both the employer and employee), and maximum earnings subject to taxation were $51,300. The tax credit was replaced with an income tax deduction for one-half of the self-employment tax, and a 7.65-percent self-employment tax exemption made the tax more comparable to social security taxes on wage and salary income.

Social security taxes increased again in 1991 when a separate, higher earnings cap was created for the Medicare hospital insurance (HI) portion of the tax. Previously, a single earnings cap applied to both the HI portion and the old-age, survivor disability insurance (OASDI) tax. The earnings cap for the 2.9-percent HI tax (1.45 percent for both the employer and employee) more than doubled from the OASDI cap and increased from $125,000 in 1991 to $135,000 in 1993. The HI cap was removed completely in 1994, making all self-employment income subject to the 2.9-percent tax. While only about 1 percent of farm sole proprietors had wage or self-employment income above the higher HI cap, its removal exacerbated the overall increase in social security tax burdens. The earnings cap for OASDI during 1998 is $68,400.

In 1994, the average effective social security tax rate for all farmers was 10 percent, up from only 7.6 percent in 1987. Effective rates continue to be regressive and range from nearly 14 percent for farmers with income less than $10,000 to only 2.6 percent for farmers with income greater than $200,000. Figure A-2 illustrates how Federal tax burdens vary with household income. Although the average effective income tax rate is fairly progressive, the regressive structure of the social security tax makes the total Federal tax essentially progressive only through $100,000 of income. This overall pattern has not changed much since 1987 because of the offsetting trends in income and social security taxes.

On average, farmers earning less than $60,000 paid more in social security taxes than in Federal income taxes. This group, which represented about 80 percent of all farmers in 1994, paid an average $3,400 in social security taxes and $1,900 in Federal income taxes. For all farmers, average Federal income taxes were $7,400 and social security taxes were $4,600. Average effective income tax rates tend to decrease over time because progressive tax brackets are indexed for inflation. But average effective social security tax rates have continued to increase because the taxable cap for OASDI rises with inflation.

Despite the increasing trend in total social security taxes paid, farmers' self-employment taxes have remained relatively flat. This is because an increasing proportion of farm households is paying payroll taxes, while fewer farms are reporting taxable farm profits. IRS data indicate that each year since 1980 farmers in the aggregate have reported negative net farm income for taxes. The total amount of net farm losses has grown annually from 1990 through 1995, reversing a recovery that started in 1984 (figure A-3). The proportion of farm sole proprietors reporting a net farm loss on Schedule F also has been increasing, with around 67 percent of farms reporting losses in 1995, compared with 56 percent in 1989.

Accelerated depreciation and other tax deductions have contributed to farmers' likelihood of reporting taxable farm losses, both during and after agriculture's poor financial performance in the mid-1980s. As a consequence, Federal taxes paid on aggregate net farm income have been low and have even decreased recently. This is reflected in the amount of self-employment taxes paid by farmers. The future trend in net farm income for tax purposes is uncertain, given the accounting differences between taxable net farm income and USDA's estimates of net income for the farming sector.

Federal Estate and Gift Taxes

The current Federal estate and gift tax system applies a unified tax rate structure and a cumulative lifetime credit to gifts and transfers of money or other property at death. Under the system, individuals can transfer a specified amount ($600,000 in 1997) in cash and other property without Federal estate or gift tax liability as a result of the unified lifetime credit. All transfers to one's spouse and gifts of up to $10,000 annually to any individual are also exempt from tax. Transfers in excess of the exempt amount are taxed on a graduated scale that begins at 37 percent, and rises to a maximum rate of 55 percent on taxable estates above $3 million.

Federal estate and gift taxes are important taxes for farmers even though they are not levied on an annual basis and most farmers never pay such taxes during their lifetime. These

Figure A-2

Effective tax rates for farmers, 1994

Percent

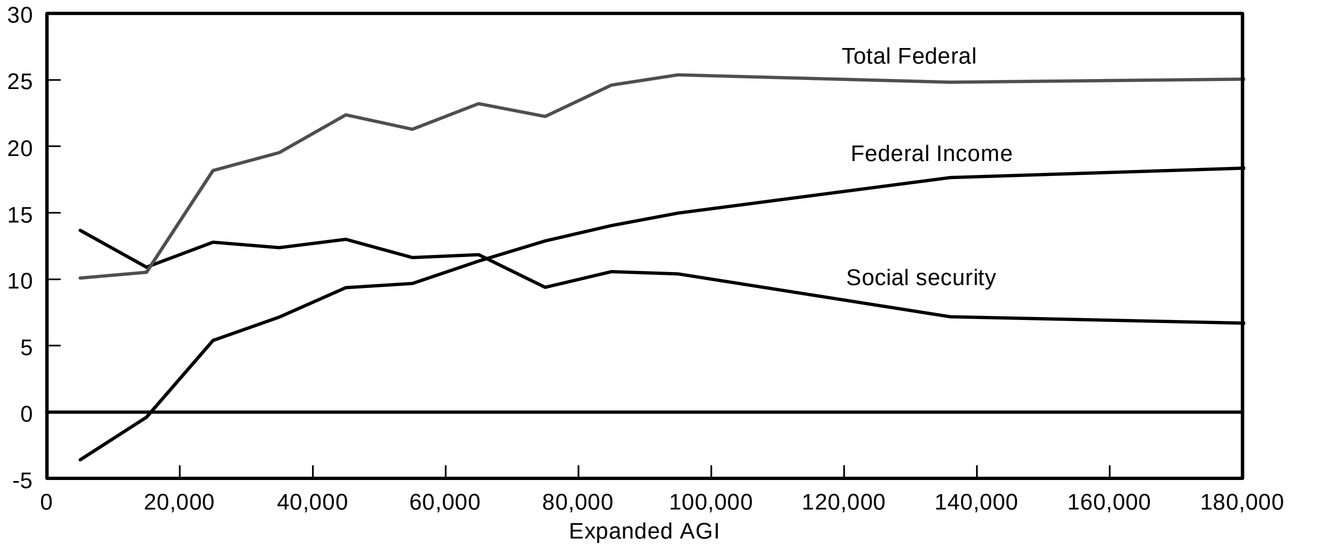
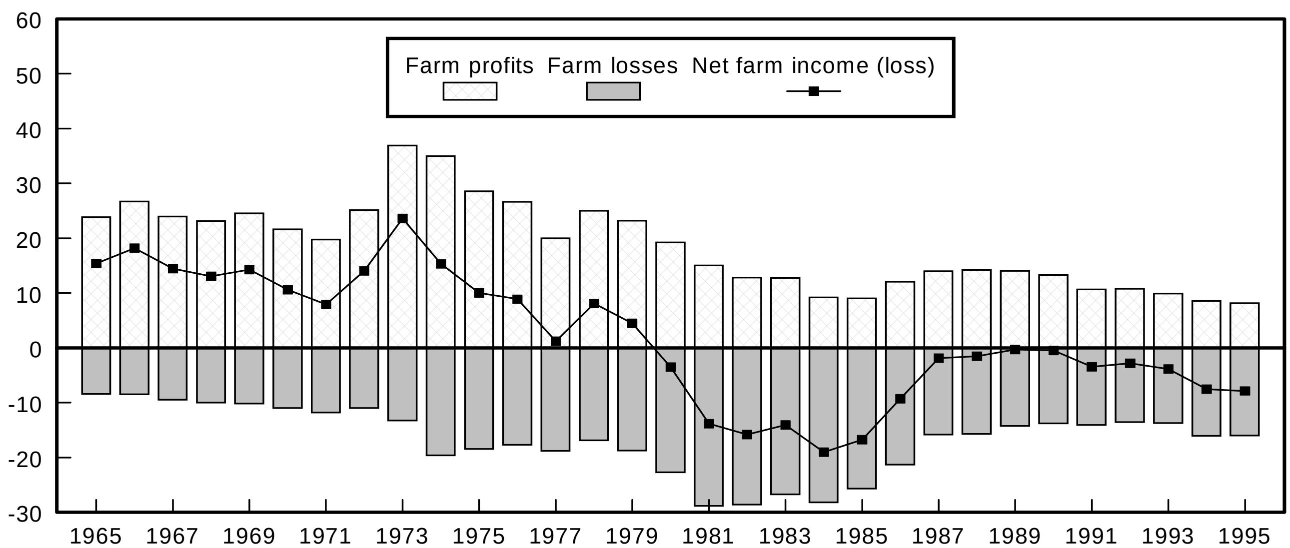


Figure A-3

Farm profits and losses on Schedule F

Billion 1995 dollars



taxes have historically represented a relatively small share of total Federal tax revenues, only about 1 percent. However, while their aggregate importance may be small relative to other Federal revenue sources, the potential impact of these taxes on an individual or group of individuals such as farmers can be substantial.

Over the years, increasing farm size and appreciating land values have increased farm estate values and taxes. In the 1970s, Congress enacted two special provisions out of concern that Federal estate taxes might force some family farms to liquidate. The first was special use valuation which allows farmland to be valued at its farm value rather than its fair market value. The second provision was the installment payment of estate taxes, which permits payments over 14-years rather than in full within 9 months of death. Despite the availability of special use valuation, which often reduces the value of farmland for estate tax purposes by about half, a relatively large share of farmers continues to owe taxes. An estimated 6 percent of farm estates owe Federal estate taxes, compared with just over 1 percent of all estates. A higher percentage of commercial farm estates pay such taxes, with an estimated 14 percent owing Federal estate taxes in 1994. While most farm estates continue to be exempt from the tax, the average tax liability for those with sufficient net worth to be subject to the tax can be quite large. In 1994, the average Federal estate tax for all taxable farm estates was estimated at about $285,000 on an average net worth of $1,587,000 for an average tax rate of 18 percent (Maxwell).

The number of estates required to file a return and pay Federal estate taxes is largely determined by the unified credit, which provides a basic exemption. Because the credit had not been changed since 1987, its real value had declined by about one-third. As a result, the number of farmers and other taxpayers required to file a return and pay taxes had increased steadily since 1988.

Continued concern for the effects of Federal estate taxes on farms and small businesses provided the primary impetus for the changes to Federal estate and gift tax laws in the 1997 Act. The changes are especially important for farmers and other small business owners who hold significant amounts of wealth in business assets. The Act substantially increases the size of farms that can be transferred tax-free and makes important changes to the special use valuation and installment payment provisions. These changes will make it easier to transfer the family farm across generations by reducing the likelihood that the farm or some of its assets will need to be sold to pay estate taxes.

Specifically, the Act gradually increases the unified credit to shield $1 million from estate tax by 2006. Beginning in 1998, the Act also provides a new exclusion for the first $675,000 of value in a qualified family-owned business interest. The exclusion is in addition to any benefits from special use valuation and the unified credit, but the total amount excluded by this provision and the unified credit is limited to $1.3 million.

The Act also makes some important changes to the special use valuation provision. The current $750,000 cap on the reduction in value allowable under the special use value provision will be indexed for inflation beginning in 1999. Only about 10 percent of farms electing special use valuation are affected by the cap and are most likely larger farms near urban areas where development pressure is the greatest. Adjusting the cap for inflation will ensure that most farms will continue to be unaffected by the cap.

The Act also directly addresses the liquidity problem potentially faced by farms and other small businesses that hold significant amounts of wealth in the form of business assets. The Act does this by making several important changes to the installment payment provision, including lowering the interest rate on taxes due from 4 to 2 percent and raising the amount eligible for the new lower interest rate.

The overall effect of the 1997 changes to Federal estate and gift tax policies is a reduction in the number of taxable farm estates by about 40 percent. Total Federal estate taxes due are estimated to drop about one-third or between $150 and $200 million. Thus, fewer farmers will be required to file a return or to pay taxes, while those required to pay will owe less tax and many will be eligible for more favorable payment terms. The cost of this reduced tax burden is added complexity for the relatively small number of farmers that will be required to file a return and pay taxes in future years due to the eligibility requirements for the various provisions.

State and Local Taxes

State and local governments rely upon a variety of taxes for funding, including individual and corporate income taxes, sales taxes, and real estate and personal property taxes. In recent years, there has been a shift away from State and local governments' reliance on property taxes. While this has made State tax systems less regressive and has reduced the fiscal disparities among local governments, it has increased reliance on other State-level taxes such as sales and income taxes. Despite this increased reliance, these taxes remain of secondary importance to farmers. Sales tax rates vary widely from State to State. Also, purchases of farm inputs are often exempt from retail sales taxes.

Because most farms are operated as sole proprietors, partnerships, small business corporations (Subchapter S corporations), or limited liability companies, most farm income is taxed under the individual income tax structures rather than the corporate income tax. Forty-three States have an individual income tax. The rates vary widely and in most instances are well below Federal individual income tax rates. Nevertheless, farmers paid an estimated $3.9 billion in State and local income taxes in 1994. The effective State income tax rate for all farmers was estimated to be nearly 4 percent in 1994 and was fairly constant across all income levels.

Given the level of investment in land and other capital assets required for modern farming operations, it is not surprising that property taxes, especially real estate taxes, are the most important State and local tax paid by farmers. Farm real estate taxes are levied by local governments on farmland and improvements, including buildings. These taxes vary widely by State depending upon the degree that the local governments rely on real estate taxes as a source of revenue and the extent to which the State provides relief through preferential land-use assessment. All States currently have some form of preferential or deferred land-use assessment for farmland. State land-use laws generally provide that farmland devoted to farming be assessed on the basis of its value for farming rather than its fair market value. The laws vary in their valuation methods, their acreage requirements, the minimum number of years the land must be in farming, the percentage of annual income the landowner must receive from the land, and penalties for converting the land to a nonfarm use (USDA-ERS, 1997). Assessment on the basis of farm value is especially important in areas where urban sprawl has pushed farmland prices well above the value for farming purposes.

In recent years the trend in farm real estate taxes has been for higher total taxes. In 1996, farmers paid an estimated $4.4 billion in farm real estate taxes. This represented an average of $5.66 per acre, up nearly $1.00 since 1990. However, because of the larger increase in farmland values, the tax rate per $100 of market value actually declined slightly, with the average dropping from $0.69 in 1990 to $0.64 in 1996. This trend of increasing total taxes, increasing taxes per acre, and relatively stable or slightly decreasing taxes per $100 of market value is likely to continue as long as farmland values continue to increase and State and local governments shift away from their reliance on property taxes.

While farmers' most important property taxes are farm real estate taxes, a number of States also levy taxes on other business assets including farm machinery, equipment, livestock, and farm vehicles. Although these personal property taxes are generally based on the assets' market value, the actual value on which the tax is assessed is frequently well below the market value. Also, there are a number of States that levy no personal property taxes or exclude certain farm business assets from the tax base. As a result, personal property taxes paid on farm business assets in 1996 totaled only about $500 million.

The clear trend in State and local taxation is for further reductions in tax burdens. Some 44 States have cut taxes at least once in the last 3 years (National Conference of State Legislatures, 1997a, b). The continued strong economy in 1998 is expected to generate additional surpluses that will permit further reductions in State and local taxes. Finally, because of the 1997 Act, State taxes will automatically drop in those States that use Federal taxable income as the basis for their State income tax.

Summary and Conclusions

Farmers paid about $26 billion in Federal individual income taxes, payroll taxes, and estate and gift taxes in 1994. They paid an additional $9 billion in State and local income and property taxes. Trends in the level of these taxes are important to farmers' financial position. Recent developments suggest that most farmers will retain a larger share of both their farm and nonfarm income. The Taxpayer Relief Act of 1997 will provide significant reductions in Federal income and estate taxes. Federal income taxes are expected to fall by an estimated $1.6 billion or 10 percent, while estate and gift taxes should decrease by about one-third. While social security taxes, including self-employment taxes, are expected to continue to increase, the increase should be limited by the low level of taxable self-employment income from farming. At the State and local level, the shift away from the reliance on property taxes should limit future increases in farm real estate taxes while the continued strong economy and resulting State surpluses will permit additional reductions in both State and local income and property taxes.

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