Federal Tax Developments Affect Farms and Other Rural Businesses

The inability to reach an agreement to balance the Federal budget prevented the enactment of the most significant tax proposals in 1996. However, important changes that will reduce the cost of capital investment, health insurance, and medical expenses for farms and other rural businesses were enacted. In addition, newly enacted targeting provisions will make many farmers ineligible for the earned income tax credit, while a new work opportunity tax credit will provide employers an incentive to hire certain disadvantaged individuals.

Despite the introduction of a number of new tax initiatives during the year, including proposals calling for the complete restructuring of the Federal tax code, the inability to reach agreement on a plan to balance the Federal budget precluded the enactment of major tax legislation during 1996. However, three bills were enacted that contain tax provisions of importance to farmers and rural America. These include the Small Business Job Protection Act, the Health Insurance Portability and Accountability Act, and the Personal Responsibility and Work Opportunity Reconciliation Act of 1996. The changes contained in these Acts will primarily benefit farmers and other small rural business owners and include increased capital expensing, an expanded deduction for self-employed health insurance costs, the introduction of medical savings accounts, and the simplification of retirement plans available to the self-employed. Significant developments also occurred with regard to the earned income tax credit and a new work opportunity tax credit.

The Earned Income Tax Credit

The earned income tax credit is a refundable tax credit available to low-income workers who satisfy certain income and eligibility criteria. Most recipients receive the credit in a lump sum at the end of the year by claiming it on their Federal income tax return. Since the credit is refundable, any amount in excess of Federal income and other tax liabilities is used to help the taxpayer offset Social Security taxes. This refundable portion of the credit is considered a program outlay, while that part used to offset Federal income taxes is considered a tax expenditure. In recent years, as the earned income credit has been expanded, the refundable portion has increased. In fiscal year 1995, about 80 percent of the total credit was refunded to taxpayers. Based on Federal funds data, the refundable portion of the credit was $16.8 billion. The total value of the credit was about $21.3 billion.

Efforts to more precisely target the credit continued in 1996. Legislation lowering the income threshold for the disqualifying income test from $2,350 to $2,200 and adding net capital gain to the type of income considered under the test was enacted. As a result, an otherwise qualifying individual will not be eligible for the earned income tax credit if the taxpayer has interest, dividend, net rent or royalty income or capital gain net income in excess of $2,200. The primary purpose of this test is to improve the targeting of benefits by denying eligibility to those individuals who may have a relatively low level of earned income but a significant amount of unearned income suggesting some wealth. Overall, only a small percentage of all recipients will be ineligible for the credit as a result of this change. However, a substantial number of farmers, especially dairy and livestock farmers, currently receiving the credit will be disqualified primarily because sales of certain farm assets are treated as capital gains.

The earned income tax credit is phased out if earned income or adjusted gross income, whichever is greater, exceeds a specific phaseout level. However, adjusted gross income does not include a variety of tax-exempt income sources and may be reduced by a variety of losses. In an effort to further improve targeting, the definition of adjusted gross income for purposes of phasing out the earned income tax credit was modified by disregarding certain losses. The losses that were disregarded include net capital losses, net losses from trusts or estates, net losses from nonbusiness rents and royalties, and half of the net losses from businesses computed separately for nonfarm sole proprietorships, sole proprietorships in farming, and other businesses. Again, farmers would be disproportionately affected because nearly half of all farmers receiving the credit in 1993 reported farm losses, with the average loss of about $10,500.

Because the credit is targeted to low-income workers, many of whom are below or near the poverty level, benefits are the largest in those States identified as persistent-poverty States (fig. 1). Residents of such States received a per capita program benefit of $85.00 in 1995. When added to the benefit provided in the form of income or other tax offsets, the per capita benefit exceeded $100. The total value of the credit increased by about one-third between fiscal years 1994 and 1995, while the refundable portion increased by about 40 percent. An estimated 4.7 million rural workers and their families, or about 1 out of every 5 rural residents, received benefits from the credit in fiscal year 1995. The total fiscal year 1995 rural share of the credit is estimated at $5.3 billion.

As the credit continues to expand under the phase-in schedule enacted in 1993, its importance relative to other programs targeted to low-income individuals continues to increase. For fiscal year 1997, the credit is expected to provide low-income workers and their families over $25 billion in benefits, with the rural share estimated at about $6.2 billion.

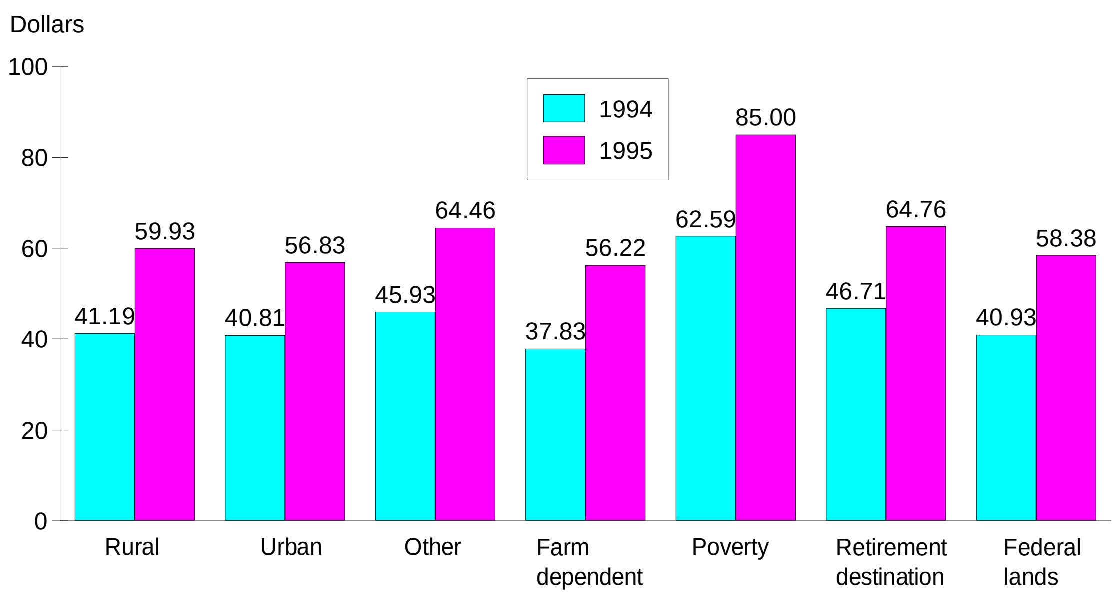
The Work Opportunity Tax Credit

The Small Business Job Protection Act of 1996 replaced the targeted jobs credit with a work opportunity credit based on a percentage of qualified wages paid to employees who begin work after September 30, 1996, and before October 1, 1997. The credit is equal to 35 percent of qualified first-year wages compared with 40 percent for the old targeted jobs tax credit. The amount of qualified wages is limited to $6,000 for each employee ($3,000 for qualified summer youth employees) during the first year of employment. Thus, the maximum credit for each employee is $2,100, except for summer youth employees, for whom the maximum credit is $1,050. To qualify for the credit, an employee must satisfy a minimum employment period test. Under the test, the employee must either be employed by the employer for at least 180 days or must perform at least 400 hours (120

Figure 1

Per capita earned income tax credit benefits by type of State, fiscal year 1994-95 1/

Benefits in 1995 increased significantly compared with those in 1994 2/



1/ Refundable portion of credit only.
2/ See data definitions for State classifications.
Source: Calculated by ERS using Federal Funds data from the Bureau of the Census.

hours for qualified summer youth employees) of service for the employer. The credit is not refundable and is thus subject to the annual tax liability limitation on the general business credit.

The credit is available to employers who hire individuals from one or more of seven targeted groups. Membership in a targeted group for the credit must be certified by the local State employment security agency. The seven targeted groups include: (1) members of a family receiving assistance under Aid to Families with Dependent Children (AFDC) or a successor program, (2) a veteran who is a member of a family either receiving AFDC assistance or assistance under a Food Stamp program, (3) an individual convicted of a felony who is hired within 1 year after conviction or release from prison and who is a member of a family whose income is 70 percent or less than the Bureau of Labor Statistics lower living standard, (4) an individual between the ages of 18 and 25 who lives within an Empowerment Zone or Enterprise Community, (5) an individual who is 16 or 17 years old who performs services for the employer between May 1 and September 15 and lives in an Empowerment Zone or Enterprise Community, (6) an individual who has a physical or mental disability that is a substantial handicap to employment, and (7) an individual between the ages of 18 and 25 who is a member of a family receiving assistance under a food stamp program.

The credit is expected to provide about $300 million in assistance to employers to hire the targeted individuals. The rural share of this amount is not clear. However, the credit will provide a substantial incentive for rural employers to hire the targeted economically disadvantaged individuals due to the nearly one-third reduction in payroll costs.

The fiscal year 1998 budget proposes to extend the credit for 1 year and to add a new targeted group for individuals 18 to 50 years old who are subject to the time limits for receipt of Food Stamps. In addition, a new welfare-to-work tax credit is proposed that would provide a 50-percent credit on the first $10,000 of wages paid to long-term recipients of assistance under AFDC or a successor program for the first and second year of employment. Thus, an employer could receive a maximum credit of $10,000 over the 2-year period.

Significant Tax Legislation Expected in 1997

Improved prospects for agreement on a plan to balance the Federal budget that would include tax cuts suggests that significant tax legislation may be enacted in 1997. While there is considerable disagreement regarding the size of the cuts, both the Administration and Congress have proposed significant tax relief, including a child tax credit, a reduction in capital gains taxes, education and savings incentives, and Federal estate and gift tax relief. While none of these changes are specifically targeted to rural areas, they would significantly benefit farmers and other rural residents. *[Ron L. Durst, 202-219-0896, rdurst@econ.ag.gov]*