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ABSTRACT

While tax reforms proposed by Bradley-Gephart, Kemp-Kasten, and the Reagan Administration differ in specifics, all three would reduce marginal tax rates and broaden the income tax base by eliminating many of the special provisions that have crept into the system over the years--agriculture benefits from a variety of these special provisions. This report focuses on the Administration's proposal, discussing in detail significant features that would affect agriculture: reductions in individual and corporate tax rates, modifications in investment tax credit and depreciation policies, changes in the current deductibility of various development costs, restrictions on property eligible for capital gains treatment, and limits on the use of the cash method of accounting. The current law and the 3 proposed tax reform laws are compared on 12 provisions--expensing, capital gains, interest, cash accounting, development expenditures, conservation and land clearing, individual tax rates, standard deduction, personal exemption, corporate tax rates, investment tax credit, and depreciation. The final section examines four types of agricultural enterprise and compares their federal tax burden in dollar amounts under current law and the Administration's proposed reform. The hypothetical cases illustrate effects of proposed reform on orchard development, a crop farm, a dairy operation, and a hog operation. (JHZ)

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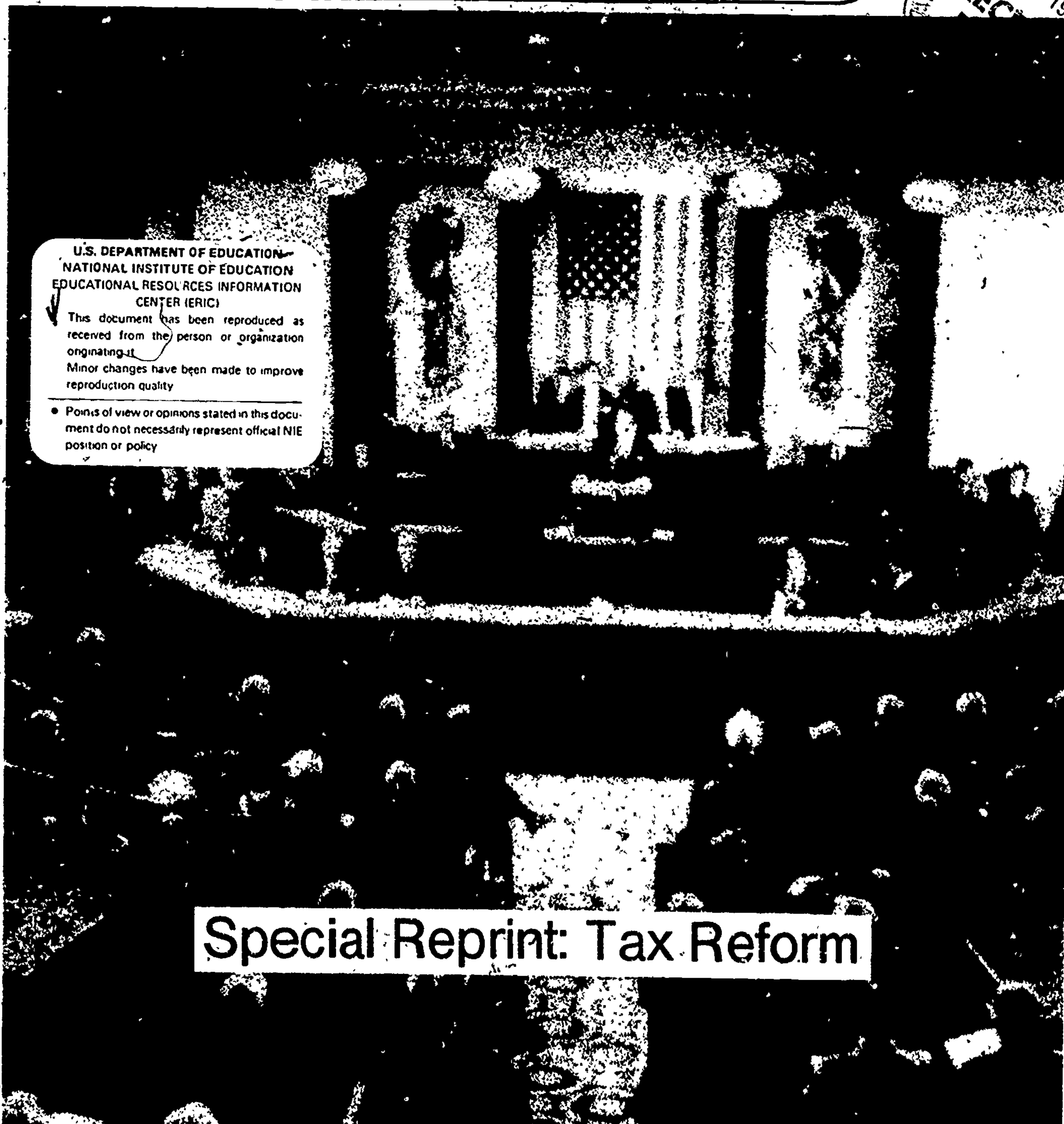


Special Reprint: Tax Reform

Tax Reform: Its Impact on Agriculture

Growing dissatisfaction with the Federal income tax system has led to a call for reform. Reforms have been laid out in proposals by Bradley Gephart, Kemp-Kasten, and more recently, the Reagan Administration.

While specifics differ in each, all three contain a common theme. Each would reduce marginal tax rates and broaden the income tax base. To do this, they would eliminate many of the special provisions that have crept into the system over the years.

Agriculture, like other sectors of the economy, benefits from a variety of these special provisions. The impact of tax reform on agriculture would vary, depending upon which exclusions, deductions, and credits would be eliminated or modified and the extent to which marginal tax rates would be reduced.

We will focus here on the Administration's proposal, because it is the one likely to receive the most attention over the next several months. It contains several significant features that affect agriculture, including

- reductions in individual and corporate tax rates
- modifications in investment tax credit and depreciation policies
- changes in the current deductibility of various development costs
- restrictions on property eligible for capital gains treatment
- limits on the use of the cash method of accounting.

Individual Tax Rates and Deductions

The current tax system contains 14 brackets with tax rates ranging from 11 to 50 percent. The personal exemption is now $1,040 and the standard deduction is $3,540 on a joint tax return. Rate brackets, personal exemptions, and standard deductions are indexed for inflation. The proposed tax system would have only three tax brackets. 15, 25, and 35 percent. The personal exemption would be increased to $2,000, and the standard deduction to $4,000 on a joint return. All three would continue to be indexed for inflation.

To broaden the income tax base, some deductions would be eliminated and some fringe benefits taxed. The main nonbusiness deductions include the two-earner deduction for married couples and the itemized deduction for State and local taxes. The taxed fringe benefits include a portion of health and life insurance provided by an employer.

Now, more than half of all farmers are in tax brackets over 15 percent. Under the proposal, three out of every four farmers would be in the new, 15-percent tax bracket. Less than 5 percent of all farmers would be in the top 35-percent bracket.

Taxes for most farmers would be about the same or less. The higher personal exemptions, standard deductions, and lower tax rates would offset losing some deductions and credits. In fact, the increase in the personal exemption to $2,000 will reduce farmer's taxable income about $8.4 billion. This would reduce farm taxes about $1.3 billion. The increase in the standard deduction would result in an additional tax reduction of about $100 million.

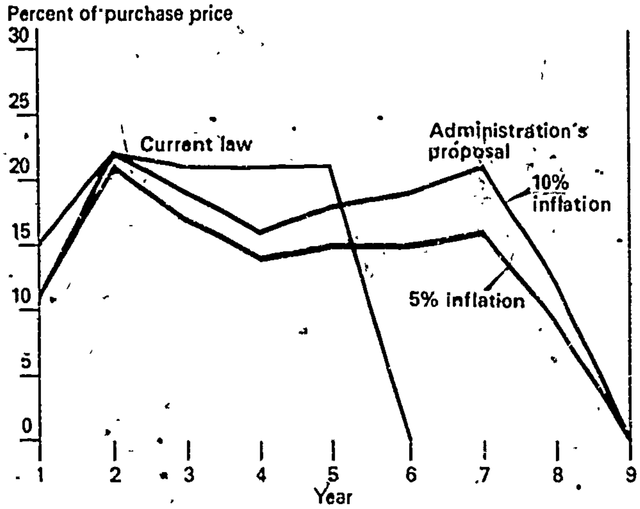
Some farmers, particularly livestock farmers, would face higher Federal income taxes. Also, since net farm profit is the base on which Social Security (self employment) taxes are levied, many farmers would pay higher Social Security taxes initially due to the expansion of the income tax base. However, these tax liabilities should decrease as the indexing of depreciation deductions is reflected in tax returns over time.

Corporate Tax Rates

Between 1974 and 1982, the number of corporate farms increased from 28,442 to 59,792. This growth came almost entirely from an increase in family and other closely held farming corporations Much of the growth in family farm corporations can be attributed to Federal tax policies. For example, lower and less progressive tax rates than the individual rate have encouraged family farms to incorporate.

Under the Administration's tax proposal, the top corporate tax rate would be reduced from 46 to 33 percent. The graduated corporate tax rate structure would be retained for corporations with taxable incomes of $360,000 or less. Thus, most small family farm corporations would continue to benefit. The tax rate on the first $50,000 of taxable income woud remain the same. However, between $50,000 and $75,000, the tax rate would drop from 30 to 25 percent, and between $75,000 and $100,000, it would fall from 40 to 33 percent. This means the average tax rate on the first $100,000 of taxable corporate income would fall from about 26 to 23 percent.

Tax Depreciation Deductions*



*For long-lived equipment.

Depreciation and the Investment Tax Credit

The Accelerated Cost Recovery System (ACRS) enacted in 1981 allows depreciable assets to be written off at accelerated rates over periods of 3 to 18 years, depending upon asset type. Most farm assets can be written off over 5 years. Tax depreciation deductions are based on the historical cost of assets and, thus, are not indexed for inflation. Each taxpayer may immediately deduct up to $5,000 of investment each year. This is scheduled to increase to $10,000 by 1989.

Most depreciable farm property also qualifies for the 6 or 10-percent investment tax credit. Qualifying farm property includes machinery, equipment, livestock purchased for dairy, draft, breeding, or sporting purposes, storage facilities, and single-purpose agricultural structures. For farmers and others who plant trees for timber, up to $10,000 a year of reforestation expenditures are eligible for the investment tax credit. These may also be amortized over 7 years.

Now, if the full tax credit is claimed, the basis for depreciation (cost of the asset) must be reduced by 50 percent of the investment tax credit. Alternatively, the taxpayer may reduce the tax credit 2 percentage points, resulting in either a 4- or 8-percent credit. For example, the purchaser of a farm tractor may claim the full 10-percent tax credit and depreciate only 95 percent of the tractor's cost, or take an 8-percent tax credit and depreciate its full cost.

The Administration proposes the Capital Cost Recovery System (CCRS), which would divide all assets into six classes representing varying rates of economic depreciation. Tax depreciation deductions, computed with the declining-balance method,[1] would be indexed for inflation. The tax depreciation rates would range from 55 percent a year for Class 1 property to 4 percent a year for Class 6 property.

Timber and other depletable assets would not be subject to CCRS. They would be indexed for inflation. How? The cost depletion basis used to determine taxable income would be adjusted upon the sale of the asset.

The Administration's proposal would eliminate the investment tax credit. The current option to expense up to $5,000 would be retained, but the scheduled increase to $10,000 would be repealed. Amortizing of reforestation expenditures would also be repealed. By allowing a farmer to expense up to $5,000 a year, as much as 25 percent of his total farm investment could be written off in the first year.

With current inflation, effective tax rates[2] for investments in most types of depreciable farm capital are well below statutory rates. In some cases they are actually negative. Eliminating the investment tax credit and lengthening the write-off periods would increase these effective tax rates for most investors in farm machinery and equipment. Effective tax rates for investments in some farm structures would fall.

Preliminary estimates indicate that the after-tax cost of farm equipment and structures could rise an average of 7.5 percent. At current prices, overall farm investment may decline slightly.

The proposed indexing of tax depreciation would stop effective tax rates from fluctuating with the inflation rate. At high inflation, investment incentives under ACRS decline. Under CCRS, the incentive to invest would remain constant.

Indexing also eliminates the need to "front load" deductions. Front loaded deductions provide a substantial portion of total tax incentives for investment in the first or second year of the investment. This occurs now because of the investment tax credit and accelerated depreciation. Front loading is essential to many tax shelter investments.

Capital Cost Recovery System (CCRS)

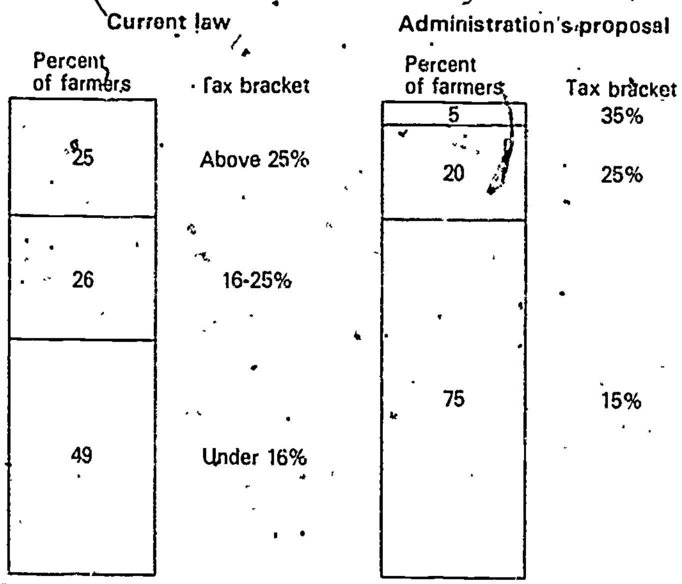
CCRS Class	Rate of depre- ciation *	Asset	Years to write-off
1	55%	Autos, light trucks & Breeding hogs	4
2	44%	Other farm trucks	5
3	33%	Farm tractors	6
4	22%	All other depreciable farm property including breeding & dairy cattle	7
5	17%	No farm assets in this class	10
6	4%	General purpose farm structures	28

* Percentage applies each year to remaining balance.

[1]Method of computing depreciation allowance by multiplying a constant rate (or percent) by the remaining (undepreciated) cost of the asset each year.

[2]Percentage amount by which the real rate of return on an investment is reduced by taxes.

Individual Tax Rates



The proposal also treats various types of farm and nonfarm capital more neutrally than the current system. This should lead to a more efficient use of capital in agriculture and in the economy as a whole.

Capital Gains
Property used for business or held as an investment generally qualifies for capital gains treatment. Now, only 40 percent of long-term capital gains are included in income. So with the current top marginal tax rate at 50 percent, the maximum tax rate on long term capital gains is 20 percent (40-percent taxable times 50-percent tax rate).

As proposed, the exclusion for long term capital gains would be reduced from 60 to 50 percent. Thus, for an investor in the proposed top 35-percent tax bracket, the tax rate on long-term capital gains would be reduced to 17 5 percent (50 percent taxable times 35-percent tax rate). Most farmers would be in the new 15-percent tax bracket and therefore pay a tax on long-term capital gains of only 7.5 percent.

The Administration proposes that beginning in 1991 taxpayers could opt to index their capital assets for inflation. However, any gain must then be fully included in income.

Preferential tax treatment under the Administration's proposal would only apply to investment assets. Thus, profits from the sale of depreciable property and livestock held for dairy, draft, breeding, or sporting purposes would be taxed as ordinary income. In contrast, profits from farmland would continue to qualify for long-term capital gains treatment.

Timber held as inventory for sale to customers or for use in a trade or business would not be eligible for long-term capital gains. Profits would be treated as capital gains only if such timber satisfied the definition of a capital asset in the hands of a particular taxpayer. The proposal would continue to qualify for capital gains timber held for investment and sold for a lump sum, or timber held by an owner who makes infrequent sales and is not in the timber business.

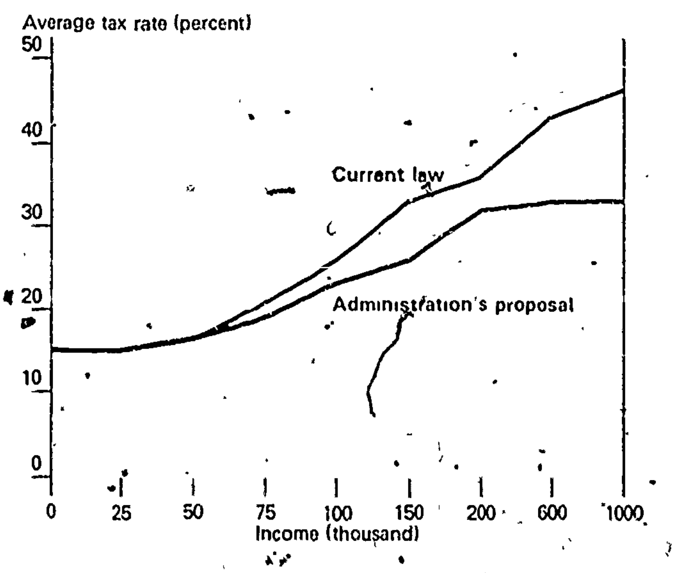
Preferential treatment for noninvestment assets, which currently are eligible for capital gains, would be repealed over 3 years. Corporations would be taxed at 30 percent in 1986. The rate would be increased 1 percent in 1987, 1988, and 1989. For individuals, the exclusion for capital gains would be reduced to 30 percent in 1986, 20 percent in 1987, 10 percent in 1988, and fully taxed thereafter.

Eliminating this provision would reduce existing incentives to adopt management practices that maximize the number of animals qualifying for capital gains. Although this would raise the tax burden on livestock farmers, reduced tax rates and increased personal exemptions could offset it for some.

Cash Accounting
Since 1915, farmers have been able to use the cash method of accounting for Federal income taxes. The continuation of this privilege has been justified on the grounds that the training or professional assistance needed to maintain the more complicated bookkeeping systems necessary for accrual accounting would impose a substantial burden on many farmers. Based on 1982 Federal income tax returns, about 98 percent of farm sole proprietors use the cash method, as well as many farm corporations and partnerships.

Under cash accounting, expenses are deducted in the year they are paid, income is recognized in the year it is received, and changes in the value of inventories are ignored. This greatly simplifies recordkeeping. However, it permits investors to mismatch income and associated expenses by generating deductions in the early years of an investment while delaying the recognition of income by building inventories that are not taxed until they are sold.

Average Corporate Tax Rates



Provision	Current law	Administration's Tax Reform Proposal
Expensing	Up to $5,000 of investment in qualifying depreciable property may be expensed, this is scheduled to increase to $10,000 by 1989	Option to expense up to $5,000 investment would be retained but the scheduled increase to $10,000 would be repealed
Capital Gains	60-percent exclusion for long-term capital gains; 20-percent maximum tax rate for top 50-percent tax bracket	50-percent exclusion for long-term capital gains; 17.5-percent tax rate for top 35-percent tax bracket; option to index for inflation beginning in 1991, limited to investment assets
Interest	Nominal interest expenses fully deductible; interest on debt-financed investment property is limited to net investment income plus $10,000	Interest deductions limited to net investment income plus $5,000, investment interest definition expanded to include all interest other than that incurred in a trade or business (except home mortgage interest), including the interest paid by limited partners and those shareholders in S corporations who do not actively take part in management
Cash Accounting	Most farmers eligible to use cash accounting, some farm corporations with gross receipts of over $1 million must use accrual accounting	Farms with gross receipts of $5 million or more required to use accrual method of accounting
Development Expenditures	Farmers allowed to claim immediate tax deductions for expenditures associated with development of certain capital assets	Expenditures capitalized for animals and plants with a reproductive period of 2 years or longer
Conservation and Land Clearing	Farmers permitted to claim immediate tax deductions for expenditures on soil and water conservation, land clearing, and for other expenditures used to enrich or condition the soil	Deductions repealed for land clearing costs, soil and water conservation, and other materials used to enrich or condition the soil
Individual Tax Rates	14 brackets with tax rates between 11 and 50 percent *	3 brackets with tax rates of 15, 25, and 35 percent * [1]
Standard Deduction	$3,540 for joint return *	$4,000 for joint return *
Personal Exemption	$1,040 personal exemption *	$2,000 personal exemption *
Corporate Tax Rates	Graduated up to 46 percent, average tax rate on first $100,000 is 26 percent	Graduated up to 33 percent; average tax on first $100,000 would be 23 percent
Investment Tax Credit	6 or 10 percent for most types of depreciable farm capital	Repealed
Depreciation	Depreciable assets may be written off over periods ranging from 3 to 18 years; most depreciable assets used in farming are written off over 5 years; depreciation deductions based on historical costs	Depreciable assets devided into six classes with tax depreciation rates ranging from 55 percent a year for class 1 property to 4 percent a year for class 6 property; most depreciable farm property would fall in class 4, written off at 22 percent over 7 years, depreciation deductions would be indexed for inflation

* Indexed for inflation.

1 The addition of an earned-income exclusion results in actual tax rates of approximately 19, 24, and 29 percent.

Bradley-Gephardt	Kemp-Kasten	Provision
Option to expense up to $5,000 a year would be repealed	Option to expense up to $10,000 a year	Expensing
Taxed as ordinary income	40-percent exclusion for long-term capital gains; maximum tax rate of 17 percent; option to index the basis for inflation from the date of enactment	Capital Gains
Interest deductible as under current law except for limited partnership and sub-chapter S corporate investments if the taxpayer is not involved in the management of the operation, such interest could be deducted only from net investment income	Interest income and expenses treated the same as under current law	Interest
Farms with annual gross receipts of $1 million or more required to use accrual method of accounting	Farms with annual gross receipts of $1 million or more required to use accrual method of accounting	Cash Accounting
Farm syndicates and farms with annual gross receipts of $1 million or more must capitalize all preproductive expenditures	Farm syndicates and farms with annual gross receipts of $1 million or more must capitalize all preproductive expenditures	Development Expenditures
Farm syndicates and farms with annual gross receipts of $1 million or more not permitted to expense land clearing costs, soil and water conservation, and other expenditures	Deductions for land clearing costs, soil and water conservation, and other expenditures repealed	Conservation and Land Clearing
Three brackets with tax rates of 14, 26, and 30 percent	24-percent flat tax rate * 1	Individual Tax Rates
$6,000 for joint return	$3,300 for joint return *	Standard Deduction
$1,600 personal exemption	$2,000 personal exemption *	Personal Exemption
30-percent flat tax rate, average tax on first $100,000 would be 30 percent	Graduated up to 35 percent, average tax rate on first $100,000 would be 20 percent	Corporate Tax Rates
Repealed	Repealed	Investment Tax Credit
Six classes of property with write-off periods ranging from 4 to 40 years; most types of farm capital could be written off over 10 years; deductions would not be indexed for inflation	Five classes of property with write-off periods ranging from 4 to 25 years; most types of farm capital could be written off over 6 years; deductions would be indexed for inflation	Depreciation

Because of the abuses of cash accounting by tax-shelter investors, Congress has attempted to limit its application. Some nonfamily corporations with gross receipts in excess of $1 million are prohibited from using cash accounting. In addition, farm syndicates and cash basis tax shelters are required to claim tax deductions for feed, seed, fertilizer, and similar inputs in the years they are used, regardless of the years in which they were purchased.

Under the Administration's proposal, cash accounting would be restricted to farms with annual gross receipts of $5 million or less. This would affect very few farms—only about 250 sole proprietorships in 1982. According to the 1982 Census of Agriculture, about 1,000 farm corporations and partnerships would have also been required to switch.

Development Expenditures
Farmers are now allowed to claim immediate tax deductions for expenditures associated with the development of certain capital assets. For example, the costs of raising dairy, draft, breeding, and sporting livestock to maturity and the costs of caring for new orchards and vineyards until they reach bearing age may be deducted in the tax year in which such expenses are paid. Most costs of producing timber, except for planting costs and cultural practices before the seedlings are established, are also currently deductible.

The expensing of development costs distorts or mismatches the expenses and income from the developed asset. This mismatching has been used to generate losses that can be written off against income from other sources. Thus, farm assets for which development expenses may be deducted have attracted tax-motivated investment.

Concern about how such tax-motivated investments affect production and price levels prompted Congress to place restrictions on the deductibility of some development expenses. Thus, developers of citrus and almond groves, farm syndicates and some farm corporations are required to capitalize some preproduction costs.

Under the Administration's proposal, preproductive expenditures for animals and plants with a development period of 2 years or longer would be capitalized. They would be added to the cost or basis of the assets and either claimed later as tax depreciation deductions or subtracted at the time of sale from the asset price to obtain the taxable gain.

The proposal would apply to development costs paid or incurred on or after January 1, 1986. However, production costs (including interest) attributable to timber that was planted before 1986 would be capitalized under a 10 year phase-in period. Thus, 10 percent of such costs paid or incurred in 1986 and 20 percent in 1987 would have to be capitalized until 100 percent was reached in 1995.

The after tax costs of developing groves, orchards, and vineyards, raising most cattle, and producing timber would increase. New investments in these areas would be based more on prospective returns and less on tax benefits. As a consequence, tax-shelter investments in the orchard and livestock sectors would be reduced.

Capitalized development costs would be indexed for inflation. Thus, the real value of these deductions would be maintained, reducing the tax increase that would occur as a result of this proposal. However, the requirement to capitalize development expenditures would impose a significant recordkeeping burden on many farmers.

Conservation and Land Clearing Expenditures
Under current law, farmers are permitted to claim immediate tax deductions for expenditures on soil and water conservation, land clearing, and fertilizer, lime, and other materials used to enrich or condition the soil. The soil and water conservation deduction is limited to 25 percent of the taxpayer's gross income from farming. The land clearing deduction cannot exceed the smaller of $5,000 or 25 percent of net taxable income from farming. Sole proprietors now claim about $200 million for soil and water conservation and land clearing expenditures each year.

The Administration's tax proposal would repeal these deductions. Without special provisions, some of these expenditures could be recovered over the period of benefit, but others could be recovered only when the land is sold. Fertilizer that is used up in producing an annual crop would continue to be fully deductible in the first year. However, those soil conditioners with more residual benefit would have to be amortized over the benefit period.

Eliminating the option to expense these investments would increase their after-tax cost and may cause some marginally profitable conservation or land clearing projects to be shelved. Without the current deduction for land clearing, incentives to bring additional marginal land into production would be reduced.

Interest Expenses
Interest paid or incurred on indebtedness is generally fully deductible under current law. However, interest on debt incurred to acquire investment property is limited to $10,000 over net investment income. The Administration's proposal reduces this limit to $5,000 over net investment income, and expands the definition of investment interest to include all interest other than that incurred in a trade or business (except home mortgage interest).

The deductibility of interest is an important feature of some limited partnership tax-shelter investments. Since the expanded definition of investment interest would include the interest paid by limited partners and those shareholders in subchapter S corporations[3] who do not actively participate in management, this provision would tend to reduce tax shelters in agriculture and in other sectors of the economy.

Farm owner-operators, most farm landlords, general partners, and the shareholder-managers of subchapter S corporations would not be affected by this proposal. They would be able to continue claiming tax deductions for all of their business interest.

[3] A small business corporation which is treated as a sole proprietorship or partnership for Federal income tax purposes. Gains and losses are passed through to the shareholders instead of being taxed at the corporate level.

Minimum Tax
Individuals and corporations who substantially reduce their taxable incomes through preferential tax provisions are required to add back some of the excluded income and then apply the applicable minimum tax rate. For corporations, the minimum tax rate is 15 percent on tax preference items that exceed the greater of $10,000 or the regular corporate income tax. For individuals, an alternative minimum tax of 20 percent is imposed on a taxpayer's "alternative minimum taxable income" over $40,000. (Alternative minimum taxable income is essentially equal to the sum of adjusted gross income and tax preference items.) In recent years, some farmers who have sold farmland which had appreciated in value over the years have been subject to the minimum tax.

Under the Administration's proposal, an alternative minimum tax of 20 percent would apply to both individuals and corporations. Tax preference items up to $25,000 would be exempted under the proposal, and for farm sole proprietorships and partnerships would include the capital gains exclusion and depreciation deductions in excess of economic depreciation. For corporations, a portion of interest deductions would also be considered a tax preference item.

Because the tax reform proposal retains a few special provisions, a minimum tax is necessary to insure that everyone pays some tax. While the exemption level should exempt most farms from the minimum tax, some farms, particularly farm corporations with large amounts of debt financed depreciable property, will be subject to the minimum tax.

Tax Exempt Bonds
Interest on bonds issued by State and local Governments for both public and private purposes are generally tax exempt. These include industrial development or "aggie bonds" used by many States to provide low interest farm loans. While these programs have grown considerably in recent years, they have been criticized as being inefficient and poorly targeted.

The Administration's proposal would repeal the tax-exempt status for all private bonds. This would include "aggie bonds." Eliminating the tax-exempt status for these bonds would increase the cost of funding State agricultural credit programs which use these bonds.

Alcohol Fuels Credit and Excise Tax Exemption
Under current law, a 60-cent-a-gallon income tax credit is provided for the production of alcohol used in a mixture with gasoline, diesel fuel or other special motor fuels. A 6 cent-a gallon exemption from the excise tax on gasoline and diesel fuel is allowed for those fuels that contain at least 10 percent alcohol. However, if the production credit is claimed, the excise tax exemption is not allowed. Both the excise tax exemption and the production tax credit are scheduled to expire on December 31, 1992.

Under the proposal, both the production tax credit and the excise tax exemption would be terminated as of December 31, 1985. However, fuel produced in facilities completed prior to January 1, 1986, would continue to be eligible for the production tax credit until January 1, 1993. The production credit and excise tax exemption have encouraged the production of alcohol from corn and other grain products. Eliminating the tax credit and excise tax exemption may reduce the future demand for grain products used in alcohol production.

Macroeconomic and Aggregate Effects
The impact of the Administration's tax reform proposal on an individual farmer will differ with the commodity produced, the individual's tax bracket, the firm's financial structure, and many other factors. For most farmers, the tax burden would not change significantly. For these farmers the effects of the tax proposal on the farm sector as a whole are of equal or greater importance than the way it affects them individually.

These effects include the impact of tax policy changes on aggregate agricultural investment and production decisions, and the general tax policy changes as they affect the entire economy. Both have a significant impact on the economic well being of the farm sector.

The current tax system has encouraged the growth and expansion of existing farm businesses and has attracted tax motivated investments into the sector. This has distorted relative input and commodity prices. Under the Administration's proposal, income earned within and outside of farming would be treated more equally. As a result, investment decisions would be based more on economic returns and less on tax benefits. This would lead to shifts in investment patterns within the sector, and would alter production and price levels for some commodities. The magnitude of these shifts will depend on how successfully the proposal neutralizes the current impacts of tax policy on capital flows both in and out of agriculture.

The effects of the tax proposal on the overall economy are expected to be relatively small. For example, GNP would be slightly higher by 1994 under the Administration's tax proposal than under the current system. Overall investment would be slightly reduced, and inflation and interest rates would only increase by a small amount. None of these are major impacts.

Perhaps the most important change is that personal consumption expenditures would rise. This would increase domestic demand for farm products slightly. The impact on trade would be minimal, but imports would grow faster than exports. Therefore, while demand for U.S. farm products would be up, there would be a slight negative impact on our balance of trade in agricultural products.

Using these final demand estimates, GNP originating in agriculture is expected to grow somewhat faster under the Administration's proposal than under current law. Employment in agriculture would also be slightly higher.

EFFECTS ON ORCHARD DEVELOPMENT

Orchard investors have several years of costs before their trees bear fruit. Under current law, land and planting costs are capitalized. But cultural costs are tax deductible in the years in which the expenditures are made. (Citrus and almond orchards are an exception. Under current law, cultural costs for establishing these must be capitalized.)

Consider an investor in the 50-percent income tax bracket who has $500-a-year cultural costs which are tax deductible. His taxes are reduced by $250 a year (per acre). When the orchard is sold, the investor's taxable profit is the $8,000 selling price minus the $3,500 basis (land and planting costs), or $4,500.

Since only 40 percent of this is taxable (capital gains rate), the capital gains tax is only $900 ($4,500 x .40 x .50), but the investor has saved $1,250 over 5 years from the tax deductions for the cultural costs. Therefore, the orchard investment actually reduces his taxes by $350. His after-tax profit is $8,000 - $6,000 (land, planting, and cultural costs) + $350 (tax savings) or $2,350 per acre. Thus, profit is greater than what it would be if the entire investment was exempt from taxation.

Federal taxes for orchard development

Item	Year 1	2	3	4	5
	Dollars per acre				
Land costs	2,000				
Planting costs	1,500				
Cultural costs	500	500	500	500	500
Selling price					8,000

Item	Current law	Proposed law
	Dollars per acre	
Deductible cultural costs	2,500	0
Tax rate	.50	.35
Tax savings	1,250	0
Selling price	8,000	8,000
Basis	3,500	6,000
Capital gain	4,500	2,000
Percent taxable	.40	.50
Taxable gain	1,800	1,000
Tax rate	.50	.35
Capital gains tax	900	350
Capital gains tax	900	350
Tax savings (cultural costs)	-1,250	-0
Net tax	-350	350
Gross profit	2,000	2,000
Income tax	+350	-350
After-tax profit	2,350	1,650

Under the tax reform plan proposed by the Administration, the costs for developing orchards would no longer be tax deductible. Instead, these costs would be capitalized by all orchard developers (similar to the current law for citrus and almond growers). In addition, 50 percent of long-term capital gains would be taxable, rather than the current 40 percent. However, tax rates would be reduced, with the top tax rate falling from 50 to 35 percent. Assume the investor is in the new 35-percent tax bracket under the proposed law. Since he is not able to deduct the cultural costs, the total cost of establishing the orchard is $6,000 an acre (the land, planting, and cultural costs). The capital gain is $2,000 an acre, and the capital gains tax is $350 (.35 x .50 x $2,000). Under the proposed law, the after-tax profit is $8,000 - $6,000 - $350, or $1,650. This is less than the before-tax profit. The effective tax rate is $350 per $2,000 or 17.5 percent. Taking account of the timing of costs and returns, the internal rate of return on this orchard investment declines from about 12 to 8 percent.

EFFECTS ON A CROP FARM

This example represents a 252-acre corn farm, the average size of all SIC (Standard Industrial Classification) corn farms. The proprietor has a spouse earning $19,670 in an off-farm job, and has two children for a total of four exemptions.

Under current law, the farmer earns $7,744 in net farm profits (Schedule F), and $600 in capital gains from breeding cattle sales (Form 4797). The family pays $3,126 in income taxes, and the farmer pays an additional $953 in self-employment taxes, for a total of $4,079.

Under the Administration's proposal, this farmer would pay less in taxes, despite the broadening of the tax base. The major tax changes for this corn farmer are as follows.

The current favorable capital gains treatment for breeding livestock sales is eliminated, and $600 of these sales would be taxed as ordinary income. Depreciation deductions rise to $8,810 because the depreciation base is indexed.

However, the investment tax credit is eliminated. The farmer continues to expense (immediately deduct) $5,000 of investment. The spousal deduction for two-earner families is eliminated, but personal exemptions are increased, and tax rates are reduced.

The net result is a decline in income tax liability of $292, from $3,126 to $2,834. In this example, there is also a decline in the self-employment tax, from $953 to $802. Thus, total taxes fall from $4,079 to $3,636, or $443.

Federal taxes for a crop farm

	Current law	Proposed law
Schedule F:		
Gross farm receipts		
Field crop sales	$72,072	$72,072
Cattle sales	4,400	4,400
Gross receipts	76,472	76,472
Farm deductions		
Production costs	56,138	56,138
Depreciation 1/	7,590	8,810
Expensing of capital	5,000	5,000
Total deductions	68,728	69,948
Net farm profit	7,744	6,524
Form 4797:		
Breeding cattle sales	600	2/ 600
Exclusion (60 percent)	360	--
Taxable gain	240	600
Form 1040:		
Wages	19,670	19,670
Interest income	4,000	4,000
Capital gains	240	0
Other farm income	0	600
Net farm profit	7,744	6,524
Total income	31,654	30,894
Spousal deduction	- 775	0
Adjusted gross income	30,879	30,894
Personal exemptions	- 4,320	- 8,000
Taxable income	26,559	22,894
Income tax 3/	3,743	2,834
Investment credit	- 617	0
Net income tax	3,126	2,834
Schedule SE:		
Self-employment income	7,744	6,524
Self-employment tax	953	802
Total Federal taxes	4,079	3,636

1/ Assumes tax plan is fully implemented. Investment of $13,810 in 1986 and same real level in previous years. 2/ Assume gain from cattle sales not part of net farm profit on schedule F. 3/ Assumes use of the standard deduction.

EFFECTS ON A DAIRY OPERATION

This example assumes an 80-cow herd. Cash costs, receipts, and investment were taken from the U.S. cost-of-production budgets for 1984. This farm produces most of its forages but purchases feed concentrates. An operator and one hired worker provide labor. Substantial unpaid family labor is also needed, limiting opportunities for off-farm income. Investment is assumed to be evenly distributed over 20 years for structures and over 12 years for equipment and machinery. The farmer replaces 24 cows a year: 20 raised on the farm while only 4 are purchased.

The most significant effects on tax obligations would come from the elimination of the investment tax credit and capital gains treatment for dairy cows. Some of this increase would be offset by increased deductions for capital depreciation because the basis of assets would be indexed for inflation.

Under current law, the farmer earns $12,587 in net farm profits (Schedule F), and $4,548 in taxable gains from dairy cow sales (Form 4797). The family owes no Federal income taxes since the investment tax credit is more than sufficient to offset the full tax liability. However, the farmer must pay a self-employment tax of $1,548.

Under the Administration's proposal, this farmer would pay $1,608 in Federal income taxes. Self-employment tax liability would increase to $1,982, thus increasing total Federal taxes from $1,548 to $3,590 (see table).

Federal taxes for a dairy farm

	Current law	Proposed law
Schedule F:		
Gross farm receipts		
Milk & other receipts	$148,861	$148,861
Dairy cow sales	--	--
Gross receipts	$148,861	$148,861
Farm deductions		
Production costs	$119,365	1/ $107,365
Depreciation 2/	16,909	20,383
Expensing of capital	--	5,000
Total deductions	$136,274	$132,748
Net farm profit	$ 12,587	$ 16,113
Form 4797:		
Dairy cow sales 3/	$ 10,548	4/ $ 4,608
Exclusion (60 percent)	6,000	--
Taxable gain	$ 4,548	$ 4,608
Form 1040:		
Interest & other income	$ 2,000	$ 2,000
Capital gains	4,000	--
Other farm income	548	4,608
Net farm profit	12,587	16,113
Total income	$ 19,135	$ 22,721
Adjusted gross income	$ 19,135	$ 22,721
Personal exemptions	4,320	8,000
Taxable income	$ 14,815	$ 14,721
Income tax 5/	$ 1,487	$ 1,608
Investment tax credit	1,880	--
Net income tax	$ (393)	$ 1,608
Schedule SE:		
Self-employment income	$ 12,587	$ 16,113
Self-employment tax	1,548	1,982
Total Federal taxes	$ 1,548	$ 3,590

1/ Production costs are capitalized and recovered as depreciation deductions. 2/ Assumes tax plan is fully implemented. 3/ Dairy cow sales net of basis. 4/ Assumes dairy cow sales not part of net farm profit on schedule F. 5/ Assumes use of standard deduction.

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EFFECTS ON A HOG OPERATION

The farmer runs a 1,600-head sole proprietor hog operation and produces corn for use on the farm and for sale. The farmer also grows soybeans for sale. Unpaid family labor is needed, limiting opportunities for off-farm income. Personal exemptions are for a family of four.

Under current law, the farmer earns $32,508 in net farm profits (Schedule F), and $9,504 in capital gains from culled sow sales (Form 4797). The family pays $3,062 in income taxes and the farmer pays an additional $3.998 in self-employment taxes, for a total of $7,060.

Under the Administration's proposal, the farmer would pay a lower self-employment tax because net farm profit is lower. But overall, the farmer's total Federal taxes would increase nearly $700 to $7,773.

The most significant effects on tax obligations would come from the elimination of the investment tax credit and capital gains treatment for culled sows. Elimination of capital gains treatment results in $9,504 of such sales being taxed as ordinary income. Depreciation deductions rise by approximately $5,100 because the depreciation base is indexed. Under the Administration's proposal, the farmer is assumed to expense (immediately deduct) $5,000 of investment. [*Ron Durst and Abby Fromang-Milon (202) 447-7383. Contributions were also made by Jim Hruboucak, Ron Jeremias, John Kitchen, Ron Meekhof, Jim Miller, Leland Southard, Barbara Stucker, Dave Torgerson, and Glen Zepp*]

Federal taxes for a hog operation

	Current law	Proposed law
Schedule F:		
Gross farm receipts		
Swine receipts	$ 173,558	$ 173,558
Soybean crop sale	26,010	26,010
Corn crop sale	43,329	43,329
Sow sales	--	--
Gross receipts	242,897	242,897
Farm deductions		
Production costs	$ 175,712	$ 175,712
Depreciation 1/	34,677	34,775
Expensing of capital	--	5,000
Total deductions	210,389	215,487
Net farm profit	$ 32,508	$ 27,410
Form 4797:		
Sow sales	$ 9,504	2/ $ 9,504
Exclusion (60 percent)	5,702	--
Taxable gain	3,802	9,504
Form 1040:		
Interest & other income	$ 2,693	$ 2,693
Capital gains	3,802	--
Other farm income	--	9,504
Net farm profit	32,508	27,410
Total income	39,003	39,607
Adjusted gross income	$ 39,003	$ 39,607
Personal exemptions	- 4,320	- 8,000
Taxable income	34,683	31,607
Income tax 3/	$ 5,846	$ 4,402
Investment credit	2,784	--
Net income tax	3,062	4,402
Schedule SE:		
Self-employment income	$ 32,508	$ 27,410
Self-employment tax	3,998	3,371
Total Federal taxes	$ 7,060	$ 7,773

1/ Assumes tax plan is fully implemented.
2/ Assumes sow sales not part of net farm profit on schedule F. 3/ Assumes use of standard deduction.