Testimony of Doug Claussen
Principal, K·Coe Isom LLP
U.S. House Committee on Agriculture – Public Hearing
Wednesday, April 5, 2017 – 10:00 a.m.
1300 Longworth House Office Building
Washington, D.C.

"Agriculture and Tax Reform: Opportunities for Rural America"

Chairman Conaway, Ranking Member Peterson, Members of the committee, thank you for the opportunity to appear before you today. My name is Doug Claussen and I am a certified public accountant and principal at K·Coe Isom, LLP. We are a national leader in providing accounting, financial, succession planning, business analysis, sustainability guidance, and government affairs consulting expertise to American farmers, ranchers, and ag-related businesses. I have more than 20 years of experience working for agribusinesses and cooperatives involved in beef production, dairy operations, grain production, and marketing.

K·Coe Isom traces its roots back more than 80 years, to rural communities in the Central Great Plains and Central California where agriculture and food production are predominant industries. Two-thirds of my firm's business derives from financial and tax accounting for agricultural producers and ag-related companies. The firm is solidly embedded throughout the food-supply chain, working with producers, input suppliers, processors, packagers, distributors, biofuel manufacturers, equipment dealerships, landowners, and lenders, and we seek to positively impact the future of farming and food production in America. In short, we are experts in the tax code and how it impacts farmers, processors and related rural businesses.

I will discuss several issues with you today, focusing primarily around tax code provisions that are of particular importance to farmers, livestock producers, and ag-related businesses.

In June of last year, House Ways and Means Committee leadership unveiled a document entitled a "Better Way for Tax Reform," commonly referred to as the "Blueprint." This Blueprint lays out the basic contours of the committee's tax reform priorities, which includes a significant streamlining and simplification of the existing tax code and a lowering of overall tax rates for individuals and businesses. K·Coe Isom supports tax code simplification and rate reductions, provided Congress does not raise the effective burden on agriculture. We applaud Speaker Ryan and Chairman Brady for their efforts to advance tax reform and we look forward to seeing and analyzing the bill.

Of course, the process of streamlining the code likely means the elimination of many of the provisions that farmers and ranchers have utilized over the years to manage and minimize their tax burden and smooth out income volatility. I will begin by talking about the importance of three provisions in particular: cash accounting for farmers, interest expense deductibility, and loss carryback provisions.

Cash Accounting

I will begin with cash accounting. Although the elimination of cash accounting for certain farmers and ranchers was not included in the Blueprint, it has been proposed by Ways and Means Committee leadership as recently as 2013 – and would generate significant tax revenues – so I will address it here. In that earlier reform draft, the Committee proposed eliminating cash basis accounting for all entities, including farmers, with annual gross revenues in excess of $10 million. This would have had devastating impacts on affected farmers and livestock producers.

Under current law, there are two primary methods of accounting for tax purposes: cash and accrual. Under cash basis accounting, taxes obligations attach only after cash has actually been collected or bills have actually been paid. Conversely, accrual basis accounting results in tax obligations as soon as the taxpayer has the right to receive payment, even if that payment will not actually be received for several months or even several years. In short, under accrual accounting, farmers and ranchers could find themselves paying taxes on income they have not received, creating significant cash-flow challenges.

Farmers and ranchers have long utilized the cash method of accounting to balance out the significant price and production volatility that is inherent in agriculture. This provides them with a more consistent tax liability and cash flow from year to year. A farm operation using cash accounting can defer income to later years which enables it to manage working capital and avoid paying significant taxes at a higher marginal tax rate in an exceptional revenue year. Given agriculture's inherent income volatility, this preserved capital is often a vital lifeline during periods of low profitability which, as we know, can last for years.

Many of my clients are cattle feeders, and I would like to put some relatable numbers on this: This change to accrual would be forced upon a cattle feeder that, in a given year, markets 6,500 head of 1,300 pound cattle at a sales price of $1.19 per pound. I think we can agree that this example does not represent a particularly large cattle feeder or a high fat-cattle price. And depending on the cost of feed and other inputs, this feeder may very well have finished the year in the red. If commodity prices increase, and I know we all hope they do, such a rule would become increasingly applicable and force even smaller producers into accrual accounting.

Additionally, aggregation rules extend this requirement to operations smaller than $10 million. The aggregation rules are based on the common employer rules, which determine whether multiple businesses have to provide similar benefits to all employees of the businesses. As a result, farm and ranch operations with revenues below $10 million that are aggregated with other businesses under a common employer could be required to use accrual accounting as well.

In response to this cash-to-accrual accounting proposal, K·Coe Isom created a coalition called *Farmers for Tax Fairness* to oppose such a change. Through this effort, we commissioned a study by Inform Economics to study the impacts on agriculture, and they concluded that it would:

- Reduce equity in farm and livestock operations by as much as $4.84 billion;
- Reduce working capital in agriculture by as much as $12.1 billion;

- Change the way farms are allowed to manage their capital each year, leading to increased financial volatility;
- Increase interest expenses due to higher short-term lending needs;
- Decrease after-tax purchasing capacity; and
- Increase the record-keeping burden for farm managers.

And keep in mind, over a full profitability cycle, a farmer will pay taxes on all of his farm's income regardless of the accounting method used. Cash accounting is solely a flexibility tool, not a tax avoidance tool.

Fortunately, then-Chairman Camp heard our voices and backed away from this cash-to-accrual proposal for agriculture. I am confident that was the right decision, and I urge you to ensure farmers and ranchers continue to have access to this vital tool as you consider comprehensive tax reform this year.

Interest Deduction

Now to discuss a provision the Blueprint does contain. Because one of its primary goals is to simplify and streamline the code, many provisions popular with farmers and ranchers are subject to change or elimination. Among these is the provision to limit the deduction for interest payments as a business expense. The Blueprint advocates eliminating the tax deduction for interest expenses, except as an offset to interest income. As we know, ag operations are highly dependent on credit, both for their day-to-day operations and long-term expansion. As such, most U.S. farm operations incur a substantial annual interest expense, yet are seldom structured to generate interest income to offset it.

In addition to considering annual farm operating loans, we also need to understand the purchase of farmland with debt capital. According to a 2014 survey conducted by the USDA, 10 percent of U.S. farmland is expected to change hands by 2019 and approximately 21 million acres of farmland are expected to be sold over that same time period, virtually all of it through debt financing.

Given this information, consider the following example:

A farmer purchases 160 acres of land at $10,000 per acre for a total cost of $1.6 million. (For clarity, the cost of the farmland itself is not deductible under current tax law or under the Blueprint.) The farmer chooses to finance $1 million of that purchase on a 20 year note at 4 percent interest. During the 20 year term of the loan, the farmer would pay more than $471,000 in interest expense. Assuming a 40 percent tax rate, current law allows for an income tax savings of $188,000 due to the interest expense deduction. Even assuming a Blueprint-lowered 33 percent income tax rate, the tax savings would still be $155,000 if he were able to deduct the interest expense as a business expense. As you can see, the virtual elimination of interest expense deductions for farmers and ranchers would have a significant negative impact on their cash flow and on their ability to make large purchases such as land and machinery.

The Blueprint recognizes that this provision will uniquely impact certain industries and that targeted exemptions may be appropriate. Specifically, it states that the "Ways and Means

Committee will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models." K·Coe Isom believes agriculture is as uniquely impacted as the financial services industry and supports special rules exempting it from this provision as well.

One of the motivations behind this rule is to equalize the tax treatment of debt and equity financing, but equity financing is not a realistic option for most ag operations. Very few farmers want to bring investors into their operations and investors have generally been disinterested in agriculture, given its structure and volatility. What's more, farmers with annual incomes below $500,000 already have access to immediate expensing so, for them, this interest deduction limitation would not be offset by the Blueprint's immediate expensing benefit.

Loss Carryback and Carryforward Provisions

The third provision I would like to discuss is the elimination of loss carrybacks and limitation on loss carryforward. The Blueprint would prohibit carrybacks of net operating losses and would limit net operating loss carryforwards to 90 percent of the net taxable amount for any year. As with cash accounting, carrybacks and carryforwards are tools widely utilized by farmers and ranchers to stabilize their volatile revenue streams and tax liabilities and preserve working capital for lean economic times.

According to USDA's 2017 Farm Sector Income Forecast, net farm income is forecast at $62.3 billion for 2017, which is down 8.7 percent compared to 2016. The calendar year 2016 net farm income forecasts are $68.3 billion, which is down 15.6 percent from the 2015 levels. For comparison, the net farm income for 2013 was $123.7 billion. The 2017 forecast is essentially half of the net farm income from 2013, just four years later.

Given this volatility in net farm income, farmers should have the option to level-out tax liabilities over an extended period of time. Without a loss carryback provision, the volatility of net farm income puts farmers in a position of paying tax in the highest brackets in the more profitable years. Then when they suffer significant losses, there is minimal tax benefit because they are forced to carry them forward to future years.

Other Provisions

I'd also like to briefly point out some of the beneficial provisions in the Blueprint that would provide meaningful tax benefits to farm and ranch operations. The positive impacts of lower tax rates on individual, pass-through, and corporate earnings would provide a clear benefit to farmers, ranchers, and the entire economy. Also, given the capital intensity of agriculture, immediate expensing of capital purchases would be used extensively by farmers and ranchers, as well as by many other industries that sell capital goods in rural areas.

Finally, the elimination of the estate tax would make succession planning for farmers, ranchers and other rural small business owners significantly less complex and help ensure that no federal tax liability is imposed upon death. That said, based on analysis K·Coe Isom has performed, the elimination of that code section will likely impact and benefit very few farm operations.

This is due to several factors, the most notable of which are: (1) the sophisticated planning and business structure tools that are available to farm estates to minimize or avoid the estate tax; and (2) the recent increase in the exemption, which means that few estates are subject to it, even given today's relatively high land values. Fortunately this will continue to be true in the future, given congress' decision to index that exemption to inflation.

In my opinion, a more important consideration is the preservation of provisions that allow the heirs of an estate to receive a step-up in the basis of the property they inherit. Discontinuing this benefit, thereby making the original purchase price of land the basis for capital gains calculations, even if it was generations ago, has the potential to create massive tax liability for the heirs when they ultimately sell the land. The tax due on the sale of farmland could discourage land sales, which would make it more difficult for young farmers to get started.

Conclusion

Again, I appreciate the opportunity to testify before this panel this morning, and for your stalwart commitment to American agriculture. Comprehensive tax reform has the potential to deliver significant benefits to ag producers and to all of rural America, but I think it is important to understand that the current tax Code has provisions that are very beneficial to agriculture – many uniquely so. Therefore, before agriculture as an industry lends its support to any reform proposal, it should closely analyze the entire package to ensure that, taken as a whole, it works to bolster the viability and profitability within the sector.

To date, we at K·Coe Isom have worked with several farmers and industry groups to perform detailed analyses on the implications of tax reform. We are sharpening our pencils to dive into the Ways and Means Committee's draft proposal we expect to see in the coming weeks. We intend to be an active participant throughout this process, and I offer myself and my firm as a resource to all of you as you consider these very important tax questions in the months ahead.

I welcome any questions the committee might have, and thank you again for this opportunity.