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House Committee on
Agriculture

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Before the Committee on Agriculture
April 5, 2017
Hearing on
Agriculture and Tax Reform: Opportunities for Rural America

Chairman Conaway and members of the Committee, my name is James Williamson and I am an Economist at the USDA's Economic Research Service. I appreciate this opportunity to present information on the legal structure of U.S. farms as it relates to their taxation, to provide background on the economic effects of taxation, and to discuss both the individual and business provisions that are available to farmers. My remarks are based on the most recent data available from USDA's Economic Research Service (ERS) and National Agricultural Statistics Service (NASS), and publicly available data from The Internal Revenue Services' Statistics of Income.

The mission of ERS is to inform public and private decision-making on economic and policy issues related to agriculture, food, the environment, and rural development. Our efforts support the goals and objectives of USDA by providing economic statistics pertaining to agriculture.

This morning I will discuss the potential impacts of tax policy on U.S. agriculture focusing on farm structure, farm household and farm business income, and farm investment and management. The analysis is based on data from family farms, which in 2015 accounted for 99 percent of farms. A family farm is any farm where the majority of the business is owned by the operator and individuals related to the operator. A farm is defined as any place from which $1,000 or more of agricultural products were produced and sold, or normally would have been sold, during the year. I will also provide information on farms of difference sizes, as defined by their gross cash farm income.

Federal tax policy affects the economic behavior and well-being of farm households, as well as the management and profitability of farm businesses. Tax rates and tax preferences for certain activities affect the after-tax income of farm households, but they may also influence economic decisions such as labor force participation and labor allocation (hours worked on and off the farm), decisions about the

household's investment portfolio and the timing of income realization. Farm businesses are impacted both by individual income tax rates and preferences, as well as business tax preferences as provided by deductions, credits, deferrals and other provisions. Those include special provisions that allow farms to allocate net income or net losses across years to help reduce tax liabilities from characteristically volatile farm business earnings (income averaging); deductions allowing farms an extra deduction for net domestic production (Domestic Production Activities Deduction), thus potentially affecting hiring decisions; and farm capital investments subject to accelerated cost recovery provisions that effectively lower the cost of capital (Expensing and additional depreciation).

The vast majority of farms are organized as pass-through entities that are not subject to income tax themselves. Rather, the *owners* of the entities are taxed individually on their share of income. Income received from agricultural production activities, and in some cases lease payments from rented land and farm program payments—is passed through from the farm business to the individual farmers, partners, or shareholders of S corporations. The net profit or loss from agricultural production activities that is received by individuals, partners, and S corporation shareholders is reported on Schedule F of form 1040 (partners and S corporation shareholders profit or loss on Schedule E). In 2015, based on USDA Agricultural Resource Management Survey (ARMS) data, farms organized as sole proprietorships, partnerships, and Subchapter S corporations constituted about 97 percent of farms (just over 2 million farms) and about 85 percent of total agricultural production in the United States. According to the Internal Revenue Service's Statistics of Income, there were just under 1.9 million individual Form 1040 returns with a Schedule F in 2015; this represents about 1.3 percent of all individual tax filers. Thus, the individual income tax is significantly more important than the corporate income tax for understanding how taxes affect most farmers.

Farm households earn income not only from farming but from a diverse array of activities and endeavors, including off-farm work (wages and salaries), capital income (interest, rents and dividends), retirement income, Social Security benefits, and non-farm business interests. For most farms, non-farm income is combined on the owner's (or owners') Form 1040 with the farm's net profit or loss recorded on Schedule F or Schedule E. In 2015, we estimate the average farm household total income at $119,880 (the median income was $76,735) with off-farm sources accounting for 79.4 percent of total income.

Taxation of Capital Gains Income

The Federal income tax system has historically taxed gains on the sale of assets held for investment or business purposes and for more than one year at rates lower than on other sources of income. The current tax rate on long-term capital gains is 15 percent for taxpayers who are below the 39.6 percent income tax bracket, and 20 percent for those in the 39.6 percent bracket (0 percent for taxpayers in the 10 or 15 percent income tax brackets; in addition, certain high-income taxpayers are assessed a 3.8 percent surtax). These reduced rates are especially significant for farmers because farmers are more likely to realize capital gains than the average taxpayer. Under current law, many of the assets used in farming or ranching are eligible for capital gains treatment and the amount of capital gains is increased by the ability to deduct certain costs. The Internal Revenue Code currently allows for proceeds from the disposition of such business property to be treated as a capital gain (or loss).

- In 2015, USDA survey data suggests about 40 percent of all family farms reported some capital gains or losses, both from the sale of farm assets and non-farm assets while IRS data indicates the average individual taxpayer is far less likely to report a capital gain or loss (13.6 percent).
- For farms with capital gains, the reported average was $10,567. That amount represented 8.6 percent of total income reported by farm households. The total amount of reported capital gains was $8.7 billion.
- Overall, a majority (51.5 percent) of the capital gain income in the sector was reported by small family farms; small farms (gross cash farm income less than $350,000) account for nearly 90 percent of all farms. Total capital gains accounted for an estimated 2.2 percent of total farm household income for that group.
- Thirty-eight percent of midsized farms (farm with between $350,000 and $1 million of gross cash farm income) reported capital gains or losses, accounting for 20 percent of all capital gains reported by farms.
- Although large farms ($1 million - $4,999,999 in gross cash farm income) comprised less than 3 percent family farms, they accounted for about 22 percent of all capital gains reported by farmers and they reported average capital gains of $32,418—84 percent of which come from the sale of farm assets, with the remainder from sales of non-farm assets.
- Half of all very large farms, those with at least $5 million of gross cash farm income, reported capital gains income.

Farm Capital Investment Demand and Cost Recovery Provisions

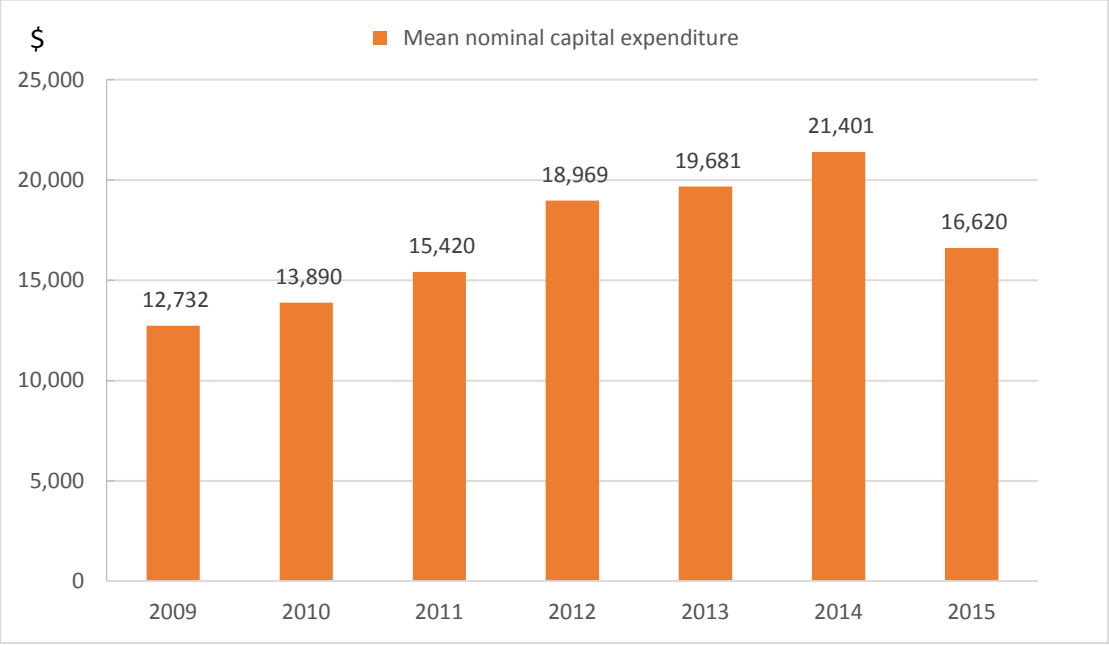
Farming requires a substantial investment in physical capital — machinery, equipment, and other depreciable property. Two provisions of the Internal Revenue Code that provide the opportunity to accelerate the recovery of such investment costs, Section 179 and Section 168(k), may benefit farm businesses that make capital investments. Section 179 allows a taxpayer to recover the cost of the investment by deducting or "expensing" the equipment in the year of the purchase, within certain limits. In addition to Section 179, Section 168(k) allows farmers to take additional depreciation or so-called "bonus depreciation" in order to accelerate the recovery of capital costs. Both of the deductions reduce the net business income of the farm, effectively reducing taxable income. The two provisions may be used in coordination, which has meant that much of the capital purchases made during the past decade were eligible to be completely deducted in the first year.

Business deductions that allow the farm to recover the cost of an investment may alter investment decisions by creating a wedge between the purchase price of capital before taxes and the after-tax cost of capital. Increases in allowable depreciation and first year investment credits shift forward the time period in which investment in capital is recovered. All else equal, the sooner the cost is recovered, the lower the user cost of capital and the greater the value of the tax recovery option. That increase in the value of the tax recovery option could lead to increases in investment.

Over the last decade, the annual maximum amount of capital expenses that a farmer could immediately deduct from their gross income under Section 179 has increased from less than $25,000 in 2000 to $500,000 in 2014, where it remains today. Any unused portion of the Section 179 deduction may be carried over to the next year. Section 179 imposes a spending cap on the total value of investments made by a taxpayer in a year before the deduction begins to phase out. In 2016 this spending cap was $2,010,000, and it is adjusted for inflation; above this amount the expensing deduction is subject to a dollar for dollar phase-out, and is fully phased out when the aggregate investment exceeds $2,510,000. The additional (bonus) depreciation allowance, which was introduced in 2001 at 30 percent of the investment cost, is currently 50 percent. The bonus depreciation provision does not place a limit on qualified investments.

Investment levels are well below the limits specified within the Section 179 provision for the overwhelming majority of farms. Average annual investment of farms has steadily increased from nearly $13,000 in 2009 to a peak of $21,401 in annual capital investments in 2014. The latest year of USDA ARMS survey data, 2015, shows a pronounced decrease in average annual investment to approximately $17,000.

Average farm capital investment, 2009-2015



Source: ERS' calculations from USDA Agricultural Resource Management Survey/ TOTAL 2009-2015. Dollar amounts are in nominal terms for comparison to their respective yearly Section 179 expensing limits.

The average figures mask the considerable variation in investment among different types of farms. Small family farms (farms such as retirement, residential or lifestyle farms, and farms with low sales) made annual capital investments of less than $10,000 on average, and only about 42 percent of them made an investment at all in 2015. Mid-sized and larger family farms were much more likely to have made a capital investment as at least 74 percent of them made an investment during the year. Large farms (gross cash farm sales of $1 million up to $5 million dollars) are responsible for nearly 30 percent of the value of agricultural production and made annual capital investments of $129,430 on average while very large farms (gross cash farm sales of $5 million or more) made an average investment of $466,733.

Larger family farms are more likely to have capital expenditures in 2015

Item	Small	Midsized	Large	Very Large
Number of family farms	1,846,954	126,331	53,268	5,747
Percent of family farms	90.9	6.2	2.6	0.3
Percent of value of production (%)	27	25	29	19
Capital expenditures:				
Mean nominal capital expenditure ($)	9,145	57,866	129,430	466,733
Percent with a capital expenditure (%)	41.5	74.8	79.5	84.8
Percent with expenditure above the Section 179 expensing limit (%)	0.04	0.53	3.49	23.9

Source: ERS' calculations from USDA Agricultural Resource Management Survey 2015. Small farms are farms with less than $350,000 gross cash income; midsized farms have gross cash income between $350,000 and $1 million; large farms have gross cash income between $1 million and $5 million; very large farms have gross cash income over $5 million. Note: this table excludes approximately 27,000 non-family farms.

The percent of farms that made an annual investment exceeding the limit was less than 1 percent during 2009-2015, but, just as in the average annual capital investment figure, this is somewhat misleading. For example, in 2015, almost a quarter of very large farms made an annual investment that exceeded the Section 179 expensing limit, whereas approximately 3.5 percent of large farms made investments exceeding the expensing limit. Together, while only representing less than 4 percent of all family farms, those farms account for nearly half of all agricultural production by family farms. Therefore, Section 179 has the potential to influence investment behavior among the farms that are producing a significant amount of the total dollar value of agricultural production.

Evidence from recent changes to cost recovery provisions suggests that deductions can have a positive effect on incremental investment. In the case of Section 179, a 2016 study in the journal *Agricultural Finance Review* found that for every $1,000 increase in the Section 179 expensing amount, farms that had been previously limited by the expensing amount made an incremental capital investment of between $320 and $1,110. The study also showed that increasing the percentage allowance of bonus depreciation, for the most part, did not have a statistically significant effect on farm capital investment. This is because the majority of farms make investments that are below the Section 179 deduction limit, and therefore the additional expensing capacity under bonus depreciation was not utilized. Taken together, the evidence suggests that farm capital investment is sensitive to the cost of capital, but at current levels of expensing and accelerated depreciation, we could expect to see incremental investment only by farms that make large capital purchases.

Domestic Production Activities

The American Jobs Creation Act of 2004 replaced the foreign sales corporation/extraterritorial income provisions, which had allowed U.S. exporters to exclude a portion of their foreign sales income from taxation, with a "domestic production activity" deduction for U.S. manufacturers, including farmers. Domestic production activities include activities that involves the lease, rental, license, sale, exchange, or other disposition of tangible personal property that was manufactured, produced, grown, or extracted in whole or in significant part within the United States. It is not limited to exported goods. While very few farms directly benefited from the export provision, an estimated 7 percent of farms directly benefit from the new domestic production activity deduction. The deduction is limited to the lesser of 9 percent of adjusted gross income from domestic production activities income or, 50 percent of wages paid to produce such income. While the wages-paid provision limits the applicability of the deduction for many smaller farms that hire little or no labor, larger farms do have significant labor expenses. In 2015, family farms had nearly $27 billion in labor expenses. The average deduction for eligible farm households—those with labor expenses and net income from qualified production activity — was $5,662. Among farms, commercial farm households are the primary beneficiaries since they are more likely to report both positive farm income and wages paid to hired labor.

Self-Employed Health Insurance Deduction

The self-employed health insurance deduction was created in 1988 to give small business owners, including many farmers, tax benefits similar to those of employees who receive employer-sponsored health insurance. This deduction is especially helpful for self-employed individuals who must purchase health insurance on their own. Since 2003, farmers and other self-employed taxpayers have been allowed to deduct 100 percent of the cost of providing health insurance for themselves and their families as long as they are not eligible for any employer-sponsored plan. The self-employed health insurance deduction is limited to the amount of the taxpayer's income from self-employment, thereby disqualifying the deduction for farmers with net farm losses. About one out of five farmers are eligible to use the self-employed health insurance deduction in any given year. In 2015, farmers' average cost for health insurance premiums was an estimated $5,883.

Households of small farms are less likely to be eligible to claim the deduction, primarily because higher proportions of those households receive health insurance from a nonfarm job or do not qualify for the deduction due to reporting a farm loss. Households of midsized and large farms are more likely than those of small farms to use the deduction. Nearly one out of every two operators of midsized and large/very large farms are eligible to claim the deduction.

Farm Income Volatility and Tax Provisions

Under a progressive tax rate system, taxpayers whose annual income fluctuates widely may pay higher total taxes over a multiyear period than other taxpayers with similar yet more stable income. Farm business income is more variable than many other sources of income, such as wages and salaries, and transfer payments. A 2017 ERS study titled *Farm Household Income Volatility: An Analysis Using Panel Data from a National Survey* indicates that for larger scale commercial farms, those responsible for about 80 percent of the value of U.S. agricultural output, the median change in total income between years was about eight times larger than for nonfarm households. The study also found that farm income (including government payments) accounted for 79.6 percent of the total income variation for the farm households studied, while 10.5 percent of income variation was from off-farm wage income and 9.9 percent of income variation was from other off-farm income.

Farmers are also allowed to use cash accounting, which recognizes income and expenses when received or paid. Cash accounting can reduce taxable income through prepaid business expenses or deferred farm income, and, as discussed above, well-timed capital purchases can reduce taxable income through depreciation deductions or capital expensing. While those provisions are useful in reducing income variability, they are limited by the ability of a farmer to defer sales or accelerate expenditures.

Income Averaging

Income averaging can reduce the effect of a progressive tax rate system on taxpayers with highly variable year-to-year income by allowing them to smooth their tax burdens over time through tax accounting methods that consider multiyear income. U.S. farmers have been eligible for income averaging since 1998. Under the current income averaging provision, a farmer can elect to shift a specified amount of farm income, including gains on the sale of farm assets other than land, to the

preceding 3 years and to pay taxes at the rate applicable to each year. Income that is shifted back is spread equally across the three years. If the marginal tax rate was lower during one or more of the preceding years, a farmer may pay less tax than he or she would without the option of income averaging. The provision, however, does not allow income from previous years to be brought forward. Furthermore, although the provision is designed to reduce the effect of farm income variability, as long as some farm income is available to be shifted, the source of income variability does not need to be farm income for income averaging to be beneficial.

In 2004, an estimated 50,800 farmers —or about 5 percent of farms— reduced their tax liability on average by $4,434 with income averaging according to one published study (cite). The reduced liability totaled $225.3 million and amounted to a 23-percent reduction in Federal income taxes for those using the provision. A large share of the total tax reduction was realized by farmers with adjusted gross income over $1 million. These farmers reduced their liability by an average of $264,000, for a total of $82.6 million. While more recent data are not available, farm income trended higher between 2010 and 2013, so the income averaging provision is likely to be of equal or greater benefit to farmers during that period.

To conclude, Federal tax policy has the potential to affect many facets of the farm business operation and the well-being of the farm household. By altering the cost of capital, tax policy may affect investment decisions, while other provisions provide benefits linked to the volatility of farm income, but the extent to which this is the case depends on the farm's size and other factors.

Mr. Chairman, this concludes my statement. I will be happy to answer any questions that the Committee may have.