

## Federal Tax Policies Affecting Farmers

*Several provisions of the tax code are specifically aimed at lowering, or even eliminating, taxes that farm operators face. Recent changes to Federal estate tax provisions will make it easier to pass farms on to the next generation by exempting most small family farms from payment of the tax. The ability to transfer larger farms, combined with preferential treatment for farmland and other business assets, could, however, help to accelerate the trend toward fewer and larger farms.*

Federal tax policies can have important effects on the number and size of farms, their organizational structure, and the amount and relative mix of land, labor and capital inputs. The most important Federal taxes for farmers are the Federal income tax, the self-employment tax, and estate and gift taxes. In 1996, farmers paid about \$19.2 billion in Federal income taxes on their farm and off-farm income. They also paid \$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. While, in the aggregate, the Federal income tax imposes the largest tax burden on the broadest group of farmers, the relative importance of each tax varies with the size and other aspects of the farm business.

This section discusses the most important features of Federal tax law and how they affect the various farm types. The box, “[Internal Revenue Service Data and Typology](#),” highlights how the farm typology is adapted for this section of the report so that it can be used with publicly available Internal Revenue Service (IRS) data.

## **The Federal Income Tax and Self-employment Tax**

The primary Federal taxes on income are the income tax and the self-employment tax. Since most farmers operate as sole proprietors, partnerships or Subchapter S corporations, the individual income tax is more important than the corporate income tax, and is levied on income from farming, as well as on wages, interest, dividends, capital gains, and other taxable sources of income. The self-employment tax is the counterpart to the Social Security or payroll tax on wage and salary income. The self-employment tax equals both the employer’s and the employee’s share of the Social Security tax.

### ***Federal Income Tax***

In recent years, the Federal income tax has changed dramatically. While top marginal tax rates were increased, both individual and business taxpayers have been provided with several new or expanded tax credits and deductions. These include child and education tax credits; an expanded earned income tax credit; reduced capital gains taxation; and targeted tax relief for farmers, including income averaging and increased deductions for self-employed health insurance costs. The net effect is a reduced Federal income tax burden for most farmers.

**Farmers’ Tax Payments and Tax Base.** In 1996, farm sole proprietors paid \$19 billion in Federal income taxes on their farm and nonfarm incomes ([table 28](#)). Most of this amount was paid by farmers whose major occupation was something other than farming and was therefore paid mostly on nonfarm income. IRS data indicate that a majority of farmers’ incomes come from off-farm sources ([table 29](#)), similar to the results from ARMS data. The only groups of farmers receiving more than a negligible portion of their income from farming were large family farmers and those small family farmers whose major occupation was farming. Only farmers operating high-sales small farms received a majority of their income from farming.

Overall, farm sole proprietors have reported a net taxable loss from farming since 1980 (on IRS Form 1040, Schedule F), and the net loss was \$7.1 billion in 1996. This amount is composed of \$8.9 billion in profits reported by about one-third of all farm sole proprietors, and \$16 billion in losses reported by the remaining two-thirds. While a majority of farmers in the limited-resource, low-sales, high-sales, and large family farm groups reported farm profits, the total amount of farm income from Schedule F was

## Internal Revenue Service Data and Typology

Information on a variety of taxable income and other tax variables for farmers is not available from Agricultural Resource Management Study (ARMS) data. Because of tax rules such as cash accounting, capital expensing, and other deductions and tax credits, farmers' taxable income in any given year may be dramatically different from USDA's measures of farm financial performance (GAO, 1993) or USDA's measures of household income.

For tax analysis, the Internal Revenue Service (IRS) compiles an annual stratified sample of individual income tax returns. Farm observations include individual farmers and materially-participating landlords who file Schedule F (profit or loss from farming), but exclude corporate farms and partnerships. Because the IRS data do not include the partnerships and corporate farms included in ARMS, and because the IRS data may include farms with sales under \$1,000 that are excluded from ARMS, the databases are not directly comparable (Compson and Durst, 1992).

The IRS data do not allow an exact duplication of the ERS farm typology, primarily because the IRS data lack the major occupation variable. To approximate the categories in the farm typology, different criteria were developed for IRS data. These criteria use various combinations of gross farm sales, household income, nonfarm income and social security benefits. Large and very large farms were combined into a single category, due to sample size considerations.

With the exception of the residential/lifestyle category, which contains nearly twice as many farms, the number of farms in each category is very similar to the 1996 count of farms by the ERS typology. The large number of residential/lifestyle farms reflects the fact that many households file Schedule F for tax purposes but may not be considered farms by the USDA. Furthermore, about 220,000 farms with gross sales under \$10,000 identified farming as their major occupation in the ARMS data. Many of these farms probably reported farm losses for tax purposes and were classified as residential/lifestyle farms because the IRS data do not contain the major occupation variable.

### Typology for IRS Data

**Farm.** Any individual tax return with Schedule F.

**Small family farms.** Farms with farm sales less than \$250,000.

- **Limited-resource farms.** Small family farms with (1) sales less than \$100,000 and (2) household income less than \$10,000.
- **Retirement farms.** Small family farms with (1) gross social security benefits, (2) farm sales less than \$50,000, and (3) the secondary taxpayer not the only person over age 65.
- **Farming-occupation farms.** Small family farms with (a) combined farm income greater than nonfarm income, or (b) farm sales greater than \$10,000 and nonfarm income less than \$50,000.
  - **Low-sales.** Sales less than \$100,000.
  - **High-sales.** Sales between 100,000 and \$249,999.
- **Residential/lifestyle farms.** A residual category for small family farms if not selected as a limited-resource, retirement, or farming-occupation farm.

**Large family farms.** Farms with farm sales of \$250,000 or more.

**Table 28—Farmers’ Federal income taxes, self-employment taxes, and earned income credit, by farm typology group, 1996**

| Item                                              | Small family farms |             |                           |                    |            | Large family farms | All family farms |
|---------------------------------------------------|--------------------|-------------|---------------------------|--------------------|------------|--------------------|------------------|
|                                                   | Limited-resource   | Retire-ment | Residential/<br>lifestyle | Farming-occupation |            |                    |                  |
|                                                   |                    |             |                           | Low-sales          | High-sales |                    |                  |
| Number of farmers <sup>1</sup>                    | 218,383            | 261,926     | 1,167,321                 | 336,498            | 151,970    | 82,865             | 2,218,964        |
| Percent of farmers                                | 9.8                | 11.8        | 52.6                      | 15.2               | 6.8        | 3.7                | 100.0            |
| Income taxes after credits: <sup>2</sup>          |                    |             |                           |                    |            |                    |                  |
| Percent of group                                  | 13.7               | 77.6        | 88.4                      | 65.3               | 62.4       | 74.5               | 74.0             |
| Amount (mil. dol.)                                | 7.7                | 2,789.6     | 13,560.2                  | 865.7              | 466.1      | 1,560.3            | 19,249.6         |
| Average per farmer (dol.)                         | 35                 | 10,650      | 11,617                    | 2,573              | 3,067      | 18,829             | 8,675            |
| Self-employment taxes after credits: <sup>3</sup> |                    |             |                           |                    |            |                    |                  |
| Percent of group                                  | 40.0               | 22.4        | 24.9                      | 50.5               | 78.1       | 81.3               | 35.7             |
| Amount (mil. dols.)                               | 29.7               | 102.2       | 682.7                     | 251.7              | 336.3      | 350.2              | 1,752.8          |
| Average per farmer (dol.)                         | 136                | 390         | 585                       | 748                | 2,213      | 4,226              | 790              |
| Earned income credit: <sup>4</sup>                |                    |             |                           |                    |            |                    |                  |
| Total credit:                                     |                    |             |                           |                    |            |                    |                  |
| Percent of group                                  | 22.3               | --          | 5.9                       | 12.8               | 21.6       | 9.5                | 9.3              |
| Amount (mil. dols.)                               | 61.6               | --          | 85.3                      | 61.9               | 42.4       | 10.4               | 266.6            |
| Refundable portion:                               |                    |             |                           |                    |            |                    |                  |
| Percent of group                                  | 15.2               | --          | 4.0                       | 9.4                | 8.4        | 3.9                | 5.9              |
| Amount (mil. dols.)                               | 43.9               | --          | 58.7                      | 37.0               | 15.1       | 3.3                | 161.8            |
| Average per farmer (dol.)                         | 201                | --          | 50                        | 110                | 99         | 40                 | 73               |

Note: Typology groups used for Internal Revenue Service (IRS) data differ from those used for Agricultural Resource Management Study (ARMS) data. For more information, see the box “Internal Revenue Service Data and Typology.”

<sup>1</sup>Includes farm sole proprietors, but excludes farms organized as partnerships or Subchapter S corporations.

<sup>2</sup>Income taxes remaining after the child and dependent care tax credit, foreign tax credit, and the portion of the earned income credit used to offset Federal income taxes.

<sup>3</sup>Self-employment taxes remaining after the portion of the earned income credit used to offset other Federal taxes.

<sup>4</sup>These figures understate the current situation because of a change in 1999 that restored an estimated \$70 million in total credits to about 50,000 farm households that were previously disqualified due to selling breeding and dairy livestock.

Source: Compiled by USDA, Economic Research Service from special tabulations by Department of Treasury, Internal Revenue Service.

positive only for the high-sales and large family farm groups. Farm income was also positive for low-sales farms with gross sales over \$50,000, a subgroup not shown in the table. Thus, while some typology groups (or a majority within those groups) may report net profits, losses in the residential/lifestyle group, containing more than half the farms, make the total income for all farms negative.

Because net farm profit or loss on Schedule F does not include some farm income reported on other tax forms, a more complete measure combines capital gains from selling business assets (such as culled livestock and land) and farm rental income. The combined measure of farm income reveals an

**Table 29—Income reported for Federal income taxes by farm proprietors, by farm typology group, 1996**

| Item                                            | Small family farms |             |                       |                    | Large family farms | All family farms |            |
|-------------------------------------------------|--------------------|-------------|-----------------------|--------------------|--------------------|------------------|------------|
|                                                 | Limited-resource   | Retire-ment | Residential/lifestyle | Farming-occupation |                    |                  |            |
|                                                 |                    |             |                       | Low-sales          |                    |                  | High-sales |
| Schedule F (farm operations):                   |                    |             |                       |                    |                    |                  |            |
| Profit:                                         |                    |             |                       |                    |                    |                  |            |
| Percent of group                                | 50.6               | 26.1        | 19.6                  | 50.8               | 76.5               | 76.6             | 34.2       |
| Amount (mil. dol.)                              | 338.9              | 302.0       | 681.0                 | 1,752.6            | 2,542.6            | 3,298.2          | 8,915.2    |
| Loss:                                           |                    |             |                       |                    |                    |                  |            |
| Percent of group                                | 49.4               | 73.9        | 80.4                  | 49.2               | 23.5               | 23.4             | 65.8       |
| Amount (mil. dol.)                              | -660.2             | -1,601.3    | -9,420.1              | -2,135.4           | -727.8             | -1,482.5         | -16,027.2  |
| Total:                                          |                    |             |                       |                    |                    |                  |            |
| Amount (mil. dol.)                              | -321.3             | -1,299.3    | -8,739.1              | -382.8             | 1,814.8            | 1,815.6          | -7,112.0   |
| Capital gains from business assets:             |                    |             |                       |                    |                    |                  |            |
| Percent of group                                | 18.7               | 25.4        | 12.3                  | 23.5               | 40.2               | 32.3             | 18.8       |
| Amount (mil. dol.)                              | 156.8              | 1,271.3     | 1,399.8               | 1,946.4            | 727.7              | 748.7            | 6,250.7    |
| Farm rental income: <sup>1</sup>                |                    |             |                       |                    |                    |                  |            |
| Percent of group                                | 1.2                | 7.5         | 2.0                   | 2.3                | 0.8                | 3.4              | 2.6        |
| Amount (mil. dol.)                              | *5.1               | 233.1       | 112.7                 | 183.4              | *27.9              | 51.9             | 614.2      |
| Combined farm income (mil. dol.) <sup>2</sup>   | -159.4             | 205.1       | -7,226.5              | 1,747.0            | 2,570.4            | 2,616.2          | -247.1     |
| Off-farm income (mil. dol.) <sup>3</sup>        | 138.2              | 19,002.7    | 88,236.6              | 7,588.7            | 2,234.3            | 5,178.9          | 122,379.3  |
| Total household income (mil. dol.) <sup>4</sup> | -21.2              | 19,207.8    | 81,010.1              | 9,335.7            | 4,804.7            | 7,795.1          | 122,132.2  |
| Percent from off-farm <sup>5</sup>              | 100.0              | 98.9        | 100.0                 | 81.3               | 46.5               | 66.4             | 100.0      |

Note: Typology groups used for Internal Revenue Service (IRS) data differ from those used for Agricultural Resource Management Study (ARMS) data. For more information, see the box "Internal Revenue Service Data and Typology."

\* Estimate should be used with caution because sample contains 10 or fewer tax returns.

<sup>1</sup>Includes only crop-share farm rental income. Cash rental income is not reported separately for tax purposes.

<sup>2</sup>Net profit or loss on Schedule F plus capital gain from selling business assets, plus farm rental income.

<sup>3</sup>Household income minus combined farm income.

<sup>4</sup>The sum of all income reported on IRS Form 1040, including tax-exempt interest, social security and pension benefits not subject to taxes.

<sup>5</sup>When combined farm income is negative, the percent from off-farm sources is limited to 100 percent.

Source: Compiled by USDA, Economic Research Service from special tabulations by Department of Treasury, Internal Revenue Service.

aggregate taxable loss for all farms of \$247 million in 1996, the first loss since the mid-1980's. Most typology groups are profitable by this measure, with only residential/lifestyle and limited-resource farms reporting losses as a group.

**Important Provisions for Farmers.** Several provisions in the tax code help to reduce farmers' income tax burdens. Some provisions specifically target farmers, such as income averaging and, to a lesser extent, cash accounting. Other provisions apply to all taxpayers, such as capital gains and capital expensing provisions, but farmers may be more affected because of the nature of the farm business. Some of these provisions became effective after 1996 and are not reflected in the tables.

**Cash accounting.** Compared with other businesses, farmers' taxable incomes are more frequently reduced because of cash accounting. Under the cash method of accounting, expenses are deducted in the year they are paid and income is recognized in the year it is received. Inventories are ignored, making the cash method different from the accrual method, which is required for most businesses, including other small businesses that keep inventories. Simplified recordkeeping is the primary justification for allowing farmers to use cash accounting. Most family farmers use cash accounting and can therefore alter the timing of income and expenses, which may help minimize income subject to higher tax brackets when revenue is unusually high.

**Income averaging.** Another way that farmers avoid higher tax brackets from income variability is income averaging. Following a decade when income averaging was not available, farmers became the only taxpayers able to income average beginning with the 1998 tax year. The new income averaging provision is fundamentally simpler—but more restrictive—than the income averaging available to all taxpayers prior to 1986 because it is available only for farm income. Under the new income averaging provision, a farmer can elect to shift farm income to the preceding three years and pay tax at the rate applicable to each year. If the marginal tax rate was lower during one or more of the preceding years, the farmer will owe less tax than without income averaging.

**Lower taxes on capital gains.** Capital gains are an important source of income for many farmers. The income tax system has historically treated gain from the sale of investment assets as capital gain and taxed it at lower rates than ordinary income. During the 1986-97 period, a maximum long-term capital gains tax rate of 28 percent meant that only those high-income taxpayers in tax brackets above 28 percent paid a capital gains rate lower than their ordinary tax rates. In contrast to the earlier period, all taxpayers currently pay a lower rate on capital gains. Under current law, taxpayers in the 15-percent bracket pay a 10-percent tax on capital gains, and taxpayers in higher brackets pay a 20-percent capital gains tax.

Although assets used in the farm business are not capital (or investment) assets, gains from their sale are treated as capital gains while losses are treated as ordinary losses. Examples of such assets are farmland and livestock held for draft, breeding, or dairy purposes. Nearly two-fifths of all farmers reported capital gains in 1996, three times the average for other taxpayers. Capital gains income is distributed more evenly among farmers than other taxpayers, although half of all gains are still reported by farmers in the top 5 percent of the adjusted gross income (AGI) distribution.

Preferential capital gains treatment encourages investment in farmland and livestock by both farm and nonfarm investors. Because capital gains taxes are not paid until an asset is sold and the gain is realized, the law provides an incentive to delay some sales. In farming, this affects real estate by reducing the amount of farmland available on the market. Lower capital gains tax rates lessen this lock-in effect, but estate tax provisions continue to discourage many farmers from selling land before death. Leasing, therefore, continues to be important for many farmers because Federal tax policies contribute to low asset turnover and concentrated ownership (Monke and Durst, 1998, p. 7).

**Expensing of machinery and equipment costs.** Both the administrative burden and the cost of capital are reduced for small farm businesses by the ability to immediately deduct up to \$19,000 of investment in farm machinery and equipment in 1999. Amounts over \$19,000 must generally be depreciated over a 7-year period. While only about 10 percent of all farms invest more than \$19,000 in any year, about half of large and very large family farms invest more than the annual limit. In contrast,

95 percent of farms with business receipts less than \$100,000 invest less than the annual limit. The amount that can be expensed is scheduled to increase to \$25,000 after 2002, allowing an even greater number of small family farms to fully expense their capital investment.

**Earned Income Tax Credit.** One of the most significant tax developments for lower income farmers in recent years is the expansion of the earned income tax credit (EITC). The EITC was originally established in 1975 to help offset the self-employment or payroll tax for certain low-income taxpayers. It has since been greatly expanded so that most recipients of the credit receive a cash refund, because the amount of their credit exceeds their self-employment and income taxes owed. The EITC is phased out if earned income or modified adjusted gross income exceeds a specified threshold amount. Households with children are eligible for a larger credit. Both the number of beneficiaries and the credit amount has increased during the 1990's because of legislative changes.

The EITC provided a total benefit of \$267 million to an estimated 206,000 low-income farm households in 1996. Twenty-two percent of limited-resource farm households (and a similar percentage of low-sales households) received the EITC, compared with about 9 percent of all farm households ([table 29](#)). After using the credit to offset income and self-employment taxes, a balance of nearly \$162 million was refunded to about 130,000 farm households. Fifteen percent of limited-resource farms received EITC refunds, compared with only 6 percent of all farm households.

### **Self-employment Taxes**

In addition to income taxes, farmers also pay another Federal tax on farm net income. The self-employment tax is paid on earned income from business activities, and is comparable to the employees' and employers' share of the social security payroll tax. The tax base and tax rates for the self-employment tax have increased over the past 15 years, increasing the burden of this tax relative to the income tax, especially for lower income taxpayers who pay relatively little in Federal income taxes. Farm sole proprietors paid \$1.8 billion in self-employment taxes in 1996 ([table 28](#)). About half of this amount was paid by the one-fourth of farmers who are either farming-occupation small family farmers or large family farmers. This reflects the fact that most taxable farm profits are reported by these groups. Overall, income taxes far exceed self-employment taxes. For lower income farmers, however, the self-employment tax comprises a larger share of the Federal tax burden than the income tax. Limited-resource farmers paid four times as much self-employment tax as they paid in Federal income taxes ([fig. 26](#)).

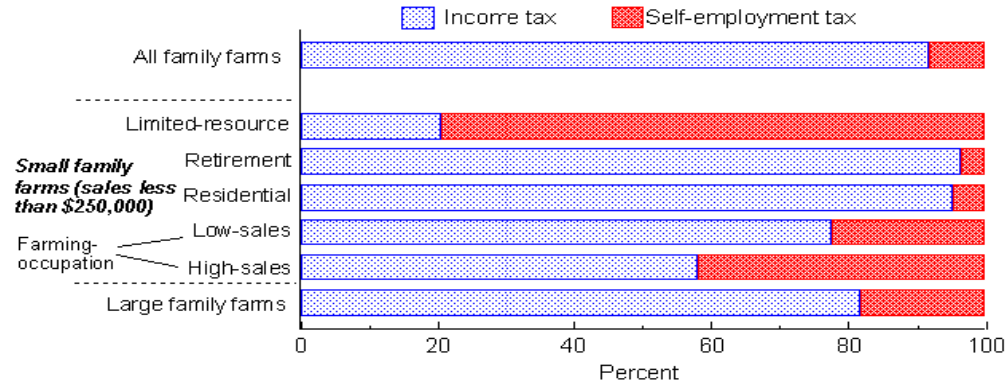
### **Federal Estate and Gift Taxation**

The current Federal estate and gift tax system applies a single tax rate structure and a cumulative lifetime credit to both gifts and transfers of money and other property at death. As a result of the unified lifetime credit, individuals can transfer a specified amount of cash and other property without Federal estate or gift tax liability. 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 rises to a maximum rate of 55 percent on taxable estates above \$3 million.

Figure 26

### Share of Federal tax burden on income, by type of tax and farm typology group, 1996

*Except for limited-resource farms, the income tax accounts for most of the Federal tax burden*



Note: Typology groups used for Internal Revenue Service (IRS) data differ from those used for Agricultural Resource Management Study (ARMS) data. For more information, see the box "Internal Revenue Service Data and Typology."

Source: Compiled by USDA, Economic Research Service from special tabulations by Department of Treasury, Internal Revenue Service.

### Farmers' Estate Tax Liabilities: Who Owes Tax and How Much

Farmers paid an estimated \$500 million in Federal estate taxes in 1996. This is a very small share of all Federal taxes paid by farmers, and most farmers or their heirs never pay such taxes. Nonetheless, the impact of Federal estate and gift taxes on the ability to transfer the family farm to the next generation has been a major concern of farmers and their representatives for many years. In the 1970's, this concern led to the enactment of two special provisions for farmers and other small business owners. The first provision permits farmland to be valued for estate tax purposes at its farm value rather than its fair market value, which might reflect the land's value for development or other uses. The second provision allows estate taxes to be paid over a 15-year period rather than within 9 months of the date of death, as required for other estates.

Despite these special provisions, over the years, increasing farm size and appreciating land values have increased farm estate values and taxes. In 1996, an estimated 6 percent of farm estates owed Federal estate taxes, compared with just over 1 percent of all other estates. However, only about 2 percent of farms with sales less than \$100,000 owed Federal estate taxes. At the same time, about one out of every 5 farms with sales over \$100,000 owed Federal estate and gift taxes.

### Recent Estate and Gift Tax Changes

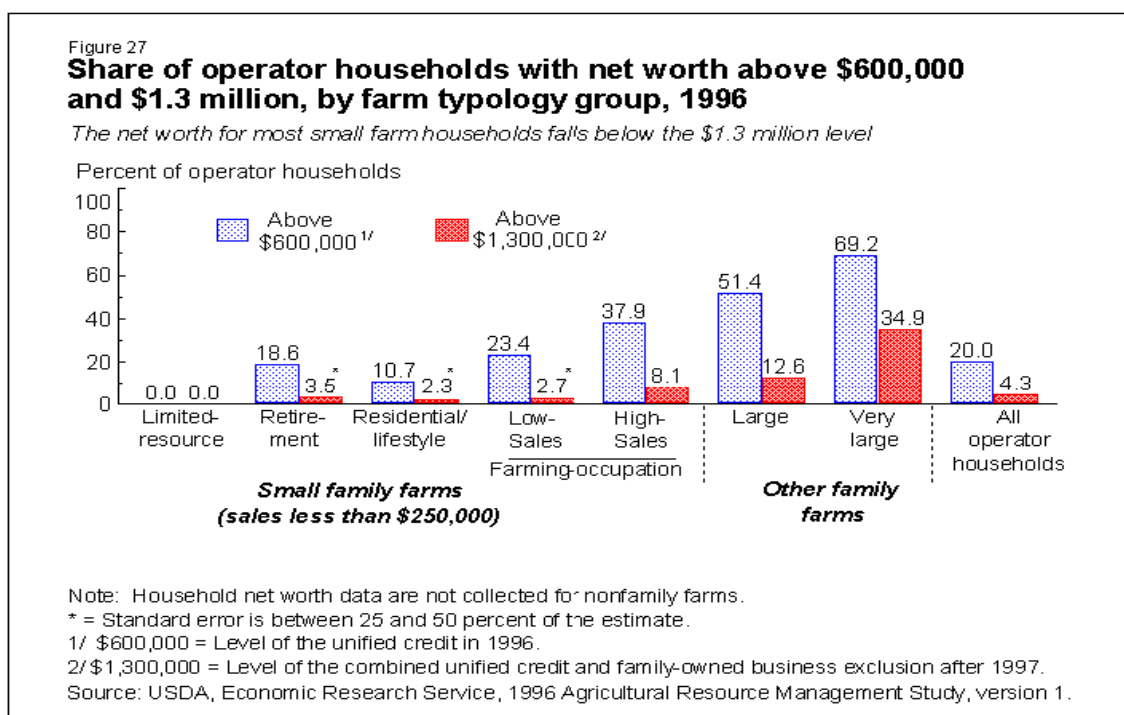
Continued concern for the effects of Federal estate taxes on family farms and small businesses was the primary impetus for the recent changes to Federal estate and gift tax laws. These changes will



significantly alter the effect of Federal estate and gift taxes on the farm sector for the next several years. These changes include an increase in the unified credit, a new family business exclusion, modifications to the installment payment provision and special use valuation, and additional estate tax benefits for the donation of a conservation easement.

**Increase in Unified Credit.** 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 from estate taxes. As a result of the recent changes, the amount of an individual's total estate exempt from tax will increase from the \$600,000 that applied between 1987 and 1997 to \$1 million by 2006. Increasing the unified credit will reduce both the number of farm estates required to file an estate tax return and the number of those that owe Federal estate tax. While households with larger farms will receive the greatest benefits from the increased credit, a number of small farm households with net worth in excess of \$600,000 will also benefit (fig. 27).

**New Family Business Exclusion.** Beginning in 1998, a new exclusion for the first \$675,000 of value in a qualified family-owned business also became available to farmers and other small business owners. The exclusion is in addition to any benefits from special use valuation and the unified credit. However, the total amount excluded by the family business exclusion and the unified credit is limited to \$1.3 million. Thus, as the unified credit increases, the exclusion for farms and other family-held businesses declines to \$300,000 by 2006. With minimal planning, the new exclusion eliminates the tax on farm estates of up to \$1.3 million. Only a small portion of operator households have a net worth above the \$1.3 million level.



**Lower Interest Rate for Installment Payments.** Since farms and other small businesses hold significant amounts of wealth in the form of business assets, those that do owe Federal estate taxes can often face a liquidity problem. The installment payment provision, which allows qualifying farms or closely held businesses to pay estate taxes over 15 years rather than within 9 months after death, directly addresses this liquidity problem. Prior to 1998, a 4 percent interest rate applied to the tax on the first \$1 million of total qualifying asset value with amounts in excess subject to the normal interest rate for underpayment of tax. Beginning in 1998, the interest rate was reduced to 2 percent on the deferred taxes on the first \$1 million in taxable value. The interest rate on amounts above \$1 million in taxable value was reduced to 45 percent of the normal rate applicable to tax underpayment. However, the existing deduction for interest costs associated with installment payments was repealed. Since only large farm estates are subject to tax, they will be the primary beneficiaries of the more favorable installment payment provisions. Beginning in 1999, the \$1 million value is indexed for inflation.

**Indexed Cap on Special Use Value.** For estate tax purposes, most assets are valued at their fair market value at the owner's death. Farm estates, however, have been able to use the special use valuation provision to value qualified farm and ranch property at its value for agricultural purposes, rather than at its value for development. While the reduction from the special use value provision varies with the individual property, the provision has reduced the average value of farmland and buildings by about 50 percent in recent years. However, the maximum reduction in value has been limited to \$750,000 since 1981. Even though this cap had not been changed for nearly 20 years, only about 10 percent of farms electing special use valuation were affected by the cap. Beginning in 1999, the cap is indexed for inflation, ensuring that most farms will continue to be unaffected by the cap. Larger farms near urban areas where development pressure is the greatest will be the primary beneficiaries of the increased cap.

**Exclusion for the Donation of a Conservation Easement.** A conservation easement is a real property interest that includes a perpetual restriction on the property's use. The purpose of such an easement can include preserving land for outdoor public recreation or education, preserving natural habitat, or preserving open space. Farmers and other landowners who donate a qualifying conservation easement to a charity or other qualifying organization can realize substantial estate tax savings. In addition to the deduction for the value of the easement, an exclusion of up to 40 percent of the value of the underlying land subject to a qualified conservation easement (and located within 25 miles of a metropolitan area, a national park or wilderness area, or within 10 miles of an Urban National Forest) became available beginning in 1998.

The exclusion is based on the value of the property after the conservation easement is placed, and does not include any retained development rights to use the land for any commercial purpose except farming. The maximum exclusion was limited to \$100,000 in 1998, but increases by \$100,000 each year until it reaches \$500,000 in 2002 and thereafter. This new exclusion provides additional incentives for landowners, especially those with large farms near urban areas, to donate a conservation easement within the designated areas.

## **Summary**

In summary, while the top marginal income tax rates have increased in the 1990's, farmers continue to use several provisions to reduce their taxable income. Recent legislative changes have also created new tax benefits for capital gains income, income averaging, and capital expensing. Cash accounting is an

important benefit for farmers that reduces their recordkeeping burden and allows many farmers to reduce fluctuations in their taxable income. While a majority of limited-resource, farming-occupation, and large farms reported a net farm profit for tax purposes, only high-sales small farms and large family farms reported a net profit as a group.

As the tax base and tax rates for the self-employment tax have increased, it has become an increasing burden relative to the income tax. Overall, income taxes far exceed self-employment taxes. But for limited-resource farmers, self-employment taxes greatly exceed income taxes. The effect of both income and self-employment taxes on lower income households, however, has been reduced in recent years by the expansion of the earned income tax credit.

Although the number of farms subject to the estate tax has increased in recent years, Federal estate and gift taxes have had little negative effect on the ability of families operating small farms to transfer their farms to the next generation. Nevertheless, the recent changes to Federal estate tax provisions will make it easier to transfer the family farm business across generations by reducing the likelihood that the farm or some of its assets would need to be sold to pay Federal estate taxes. The increased unified credit exempts most small family farms from both the payment of tax and the requirement to file an estate tax return. Some small farms will also benefit from the new family business exclusion and the lower interest rate on installment payments. However, much of the benefit from the estate tax changes will be captured by the largest farm estates. Combined, these changes will allow substantially larger farm estates to be transferred to the next generation with little or no Federal estate tax. The ability to transfer larger farms, combined with the preferential treatment for farmland and other business assets and the associated pre- and post-death holding requirements, could increase competition for farmland and help to accelerate the trend toward fewer and larger farms.