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Conservation Gains in the Tax Reform Act: An Analysis of the Implications of Tax Reform for Farmers and Natural Resources in Rural America, with a Policy Agenda for the Future

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CONSERVATION GAINS IN THE TAX REFORM ACT: AN ANALYSIS OF THE IMPLICATIONS OF TAX REFORM FOR FARMERS AND NATURAL RESOURCES IN RURAL AMERICA, WITH A POLICY AGENDA FOR THE FUTURE

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I. INTRODUCTION

American agriculture evokes a variety of pleasant, pastoral images, from rolling wheat fields to seemingly endless rows of corn. The country is learning, however, that these images are deeply interlocked with complex and elusive social, political, economic, and environmental forces. Tractors plowing fields or spreading fertilizer, sprinklers cutting green circles in brown landscapes, and many other modern farming practices are as frequently born of and shaped by policymakers in Washington and state capitals as by farmers in the field or consumers in the market.

One of the most important sociopolitical forces influencing American agriculture is federal tax policy. Tax incentives have a huge impact on whether land is farmed, what commodities are grown, with what intensity, and with what consequences for the resource base. Before this year, however, the Tax Code has taken little account of its effect on the rural environment. While tax

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incentives for various forms of investment undoubtedly have contributed positively to the sheer volume of domestic agricultural production, they also have led to significant environmental damage on the nation's farms.

On October 22, 1986, President Reagan signed the Tax Reform Act of 1986, terming the measure "less a reform . . . than a revolution."[1] The Act shifts a significant portion of the federal tax burden from individuals to corporations, reduces the tax liabilities of low-income individuals, and eliminates many longstanding tax loopholes in exchange for lower and fewer tax rates.[2] Fairness and simplicity were the oft-repeated rhetorical themes espoused during the arduous reform process. Public opinion, however, remains divided over whether these broad policy objectives were achieved.[3]

One important point of consensus in the development of the reform legislation surrounded the need to make the Tax Code consistent with natural resource protection. In the past, the Internal Revenue Code has blindly subsidized soil erosion, wetland destruction, and water pollution. The 1986 reforms represent a good beginning in protecting vulnerable resources necessary for both a sustainable agriculture and a high quality rural environment. Particularly pertinent are new features that help align the Tax Code with the major soil and wetland conservation provisions of the Food Security Act of 1985 (often called the 1985 farm bill), itself a major piece of remedial conservation legislation.[4] In addition, the new reforms may eventually help alleviate certain economic distortions that are contributing to the depressed farm economy.[5]

Enactment of the Tax Reform Act is the first step in a process that will change fundamentally the relationship between taxation and agricultural resource conservation. In the short run, the Internal Revenue Service ("IRS") and the United States Department of Agriculture ("USDA") will play key roles in implementing the

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1. President Reagan, Remarks at the Signing Ceremony for the Tax Reform Act (Oct. 22, 1986) (available from White House Press Office).

2. *See generally* CONFERENCE REPORT ON THE TAX REFORM ACT OF 1986, H.R. REP. No. 841, 99th Cong., 2d Sess. (1986).

3. *See, e.g.*, Rosenbaum, *Views Split Over Effect of Tax Bill*, N.Y. Times, Sept. 29, 1986, at D5, col. 1; Aaron, *The Impossible Dream Comes True: The New Tax Reform Act*, 5 BROOKINGS REV. 3 (1987).

4. Food Security Act of 1985, 16 U.S.C. §§ 3801–3845 (Supp. III 1985).

5. *See infra* text accompanying notes 19–24.

new law.[6] Over the long run, Congress will have opportunities to build upon the 1986 reforms in creating a tax code that best promotes an environmentally sound farming future.[7]

This article considers four general topics. First, it presents an overview of what ramifications tax reform might have for economic conditions in the nation's farming regions.[8] Second, the analysis focuses on reform provisions of special significance for natural resources.[9] The third section introduces issues likely to be faced by conservationists as the new law is implemented,[10] and the article concludes with some thoughts on a future agenda for conservation tax legislation.[11]

II. Tax Reform and the Farm Economy

Any discussion of the impact of tax reform on the rural environment must be set in the context of its effect on the overall economic well-being of America's farmers. The nation's farm economy currently is plagued by a host of problems, including rising bankruptcies and foreclosures, declining export markets, massive crop surpluses, and commodity prices too low to keep pace with increasing production costs.[12] The mid-1980's present a stark reversal of fortunes from the mid-1970's, when times were much more prosperous within the American farm sector.[13]

The reasons for today's farm crisis are complex, involving myriad variables of market economics, weather and climate, technology, natural resources, and public policy. This section examines how the Tax Code has been a powerful force in shaping the structure of American agriculture, and why the 1986 reforms should ultimately prove beneficial to the slumping rural economy.

Traditionally, agriculture has enjoyed a "tax favored" status, allowing the nation's farmers to avail themselves of a host of special exclusions, deductions, and credits. Among the most pub-

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6. *See infra* text accompanying notes 84–90.
7. *See infra* text accompanying notes 91–96.
8. *See infra* text accompanying notes 12–41.
9. *See infra* text accompanying notes 42–83.
10. *See infra* text accompanying notes 84–90.
11. *See infra* text accompanying notes 91–104.
12. An excellent overview of these and related issues can be found in W. Galston, A Tough Row to Hoe: The 1985 Farm Bill and Beyond 37–41, 50–55 (1985).
13. *Id.*

licized are those benefits that have made agriculture particularly attractive as a tax shelter for investors.[14] These benefits have included accelerated depreciation deductions and investment tax credits ("ITCs") for purchases of most farm equipment.[15] In addition, income from the sale of farm assets (such as land, certain unharvested crops, horses, cattle, vines, and fruit trees) has been subject to relatively modest capital gain taxation.[16] Since the farming industry is characterized by high levels of capital investment, this tax favored status of capital assets has been especially beneficial.

Augmenting this favorable taxation of capital assets, cash accounting rules have allowed most farmers to deduct the costs of inputs before income is received from the expenditures.[17] This method of bookkeeping benefits certain farmers because they can defer the payment of taxes into the future while currently deducting their expenditures.[18] For example, farmers may deduct the cost of pesticides in a given year even if the crops the chemicals are intended to protect are not sold until the following year. By "mis-matching" annual income and expenses, farmers often are able to reduce their total tax liabilities over time.

In spite of these surface appearances, however, federal tax policy has not been wholly good for the rural economy. For example, the unsustainable boom in farmland prices of the 1970's was partially caused by the Tax Code, in combination with both high inflation rates and optimistic expectations for the farm sector's continued growth and prosperity. During that decade, farmland values were bid up to record high levels, in contrast to previous trends. In addition, a majority of all returns on farm investment came not as income from actual farming operations, but as capital gains principally from land ownership transactions.[19]

Since peaking in 1981, however, farm real estate values have dropped greatly.[20] Last year's twelve percent aggregate decline in

14. *See, e.g.*, *Tax Reform Takes Final Form*, SMALL FARM ADVOCATE, Summer 1986, at 1.

15. Internal Revenue Code, 26 U.S.C. §§ 38, 46 (1982 & Supp. III 1985) [hereinafter I.R.C.] (all references to the I.R.C. are to the pre-amended statute).

16. I.R.C. § 1202 (1982); I.R.C. § 1231 (1982 & Supp. III 1985).

17. I.R.C. §§ 446, 447 (1982).

18. Dunford, *Farming the Tax Code*, CHOICES, Third Quarter 1986, at 19.

19. J. LEE, FARM SECTOR FINANCIAL PROBLEMS: ANOTHER PERSPECTIVE 11 (USDA-ERS Agriculture Information Bulletin No. 499, 1986).

20. USDA ECONOMIC RESEARCH SERVICE, NO. CD-90, AGRICULTURAL LAND VALUES AND MARKETS 1, 3 (Aug. 1985).

farmland prices represents the largest drop since the depression era of the 1930's.[21] The current trend of declining land prices is a fundamental reason why a large segment of the nation's farming population is currently plagued by unmanageable credit problems.[22]

Another example of the tax policy's ill effects on the rural economy has been the Code's bias regarding the scale of farming operations and the socioeconomic structure of the farm sector. Many economists believe the Tax Code has helped to bring about more capital-intensive agricultural practices, the concentration of land into fewer and larger farms, and large commodity surpluses.[23] The Tax Code's fostering of production far in excess of what commodity markets can bear is partially responsible for today's low prices for some agricultural products, which significantly hamper the efforts of today's farmers to make a profit.[24]

The new reform provisions will, on the whole, make the Tax Code less favorable for investments in agriculture. As mentioned above, however, by reducing speculative investments and their resultant ill effect on the rural economy, the new provisions should ultimately prove beneficial.

One significant change in the new provisions is the repeal of the ITC.[25] This section in the past has enabled farmers to reduce their tax liabilities by ten percent of the cost of a wide variety of investments ranging from tractors to livestock confinement structures.[26] The 1986 Act also extends the periods over which depreciation deductions may be taken on most farm machinery, thus reducing the amount deductible in any one year.[27] This latter change is offset somewhat, however, by increases in the percentages of investment expenditures that may be deducted in each year of the longer depreciation periods.[28]

One of the most significant changes made in the 1986 Act concerns capital gain transactions. By establishing a capital gains

21. *Id.* at 3.

22. *See, e.g.*, Galston, *supra* note 12, at 50.

23. *See, e.g.*, JOINT ECONOMIC COMMITTEE, THE EFFECTS OF FEDERAL INCOME TAX POLICY ON U.S. AGRICULTURE, S. REP. NO. 273, 98th Cong., 2d Sess. 27–29 (1984).

24. *Id.* at 30.

25. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2085 (1986) (amending I.R.C. § 49 (1982)) [hereinafter T.R.A.].

26. I.R.C. §§ 38, 46 (1982 & Supp. III 1985).

27. T.R.A., *supra* note 25, § 201 (amending I.R.C. §§ 46, 167, 168, 178, 179, 280F, 291, 461, 465, 467, 514, 751, 1245, 1250, 4162, 6111, 7701 (1982)).

28. *Id.*

rate equal to the tax rate for taxpayers' ordinary incomes, the new law ends, for the time being, preferential treatment of income from the sale of assets such as land, breeder livestock, and certain unharvested crops.[29] Nevertheless, the law retains definitions that formally distinguish between ordinary income and income from the sale of capital assets.[30] This could prove important in the event that Congress reinstates a tax exclusion for a fraction of capital gains income.[31] A similar effect could result if Congress were to confine a general tax rate hike to ordinary income while leaving rates for capital gains at levels set by the Tax Reform Act.

The new law also places limits on the tax treatment of "passive" investments in agriculture.[32] In order to benefit from the mismatch of income and expenses through cash accounting, for example, taxpayers must now demonstrate that they are "materially" participating in farm management.[33] In addition, some farm losses incurred by tax shelter farmers will be treated as "preference items" subject to the alternative minimum tax typically applied to ensure that upper income individuals and corporations eligible for multiple tax breaks do not escape taxation altogether.[34]

On the whole, the Tax Reform Act ultimately should limit the artificial skewing of some investment in agriculture, help restore balance between supply and demand in commodity markets, and promote stability in farmland values. To the extent these results occur, tax reform will foster greater income stability for farmers and contribute to an overall economic recovery in rural America.

It is likely, however, that making the transition to the new Tax Code will be painful for some farmers in the short run. A

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29. T.R.A., *supra* note 25, §§ 301 (amending I.R.C. §§ 170, 691, 1202, 1211, 1212 (1982)), 302 (amending I.R.C. § 1 (1982)), 311 (amending I.R.C. §§ 49, 631, 953, 1201, 1254 (1982)); I.R.C. § 1201 (1982 & Supp. III 1985), I.R.C. § 1202 (1982). Under the previous tax law, individuals were allowed to exclude 60 percent of income received from the sale of capital assets. Corporate capital gains were taxed at a maximum of 28 percent, significantly below the 46 percent maximum corporate rate for ordinary income.

30. T.R.A., *supra* note 25, §§ 301 (amending I.R.C. §§ 170, 691, 1202, 1211, 1212 (1982)), 302 (amending I.R.C. § 1 (1982)), 311 (amending I.R.C. §§ 49, 631, 953, 1201, 1254 (1982)).

31. Legislation introduced by Senator Boschwitz (R-Minnesota) to restore such a capital gain/ordinary income differential is currently pending. This bill would exclude from taxation 40 percent of any gains from assets held more than one year but fewer than three years. S. 444, 100th Cong., 1st Sess., 133 CONG. REC. 1616 (daily ed. Feb. 3, 1987).

32. T.R.A., *supra* note 25, § 501 (amending I.R.C. § 469 (1982)).

33. *Id.* § 801 (amending I.R.C. §§ 448, 461 (1982)).

34. *Id.* § 701 (amending I.R.C. §§ 26, 29, 38, 53, 55–59, 443, 1561, 6154, 6425, 6655 (1982)).

leading agricultural trade publication recently predicted that tax reform will hurt farmer cash flow, further decrease land values, and present a "minefield of unresolved tax questions."[35] This may well be the case for segments of the nation's farm population. Since today's agricultural operations rely so heavily on capital investment, American farmers stand to lose a relatively significant collection of special tax breaks while benefiting less than most non-agricultural taxpayers from the overall rate reductions.[36] Indeed, the average individual tax rate for farmers is expected to decrease only slightly under the new law.[37]

These negative effects will be felt principally by high-bracket agricultural taxpayers for whom available deductions and credits have been more valuable in terms of lowering taxable income than they have been for their low-bracket counterparts. The loss of many of the special tax breaks described above will be irrelevant to the most hard-pressed farmers who have been theoretically eligible for far more deductions than they could use to offset their modest gross incomes.[38]

Another potential effect of tax reform that deserves mention is a short-term increase in the federal deficit, perhaps by as much as $17 to $50 billion in 1988.[39] Economists consider today's excessive deficits a major source of the persistently high real interest rates that have elevated farmers' total operating costs while driving down their net incomes and land values.[40] An emerging consensus among agricultural policy analysts holds that deficit reduction is the most essential prescription for restoring vigor to the slumping farm economy.[41]

In sum, the nation's farmers must now adjust to an entirely new, and somewhat less favorable, set of signals from the Tax Code. This appears to portend greater economic efficiency over the long run with the possibility of some dislocation as the tran-

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35. Taylor, *Why Tax Reform Will Hurt Before it Helps*, 110 FARM J. 19 (1986).

36. *Id.*

37. *CRS: Tax Hike Greatest for Transportation, Communications, Construction*, INSIDE U.S. TAX POLICY, Sept. 5, 1986, at 9.

38. Taylor, *supra* note 35, at 19.

39. *Economists See Major Revenue Shortfall From Tax Bill; Favor '87 Tax Hike*, INSIDE U.S. TAX POLICY, Sept. 19, 1986, at 5.

40. *Taxes and Agriculture, 1984: Hearings Before the Joint Economic Committee*, 98th Cong., 2d Sess. 49–50, 59 (1984) (statement of Dr. Neil E. Harl, Professor of Agriculture and Economics, Iowa State University).

41. Galston, *supra* note 12, at 39.

sition is made. Ultimately, to the extent that it succeeds in reducing speculative investment in overproduction, tax reform should prove a positive step toward restoring long-term health to the rural economy.

III. Tax Reform and Natural Resources

Several features of the Tax Reform Act directly concerned with conservation are likely to have immediate and clearly favorable impacts on natural resources. These items were included in response to strong evidence, brought to light during the legislative debate, that federal tax policy has promoted farming practices that have harmed the environment while only exacerbating the commodity surplus problem.

In particular, conservationists can applaud: (1) the removal of a major tax incentive for converting highly erodible land or wetland to cropland,[42] (2) the addition of a new requirement that deductions for soil and water conservation be limited to expenditures likely to produce significant natural resource protection,[43] and (3) the repeal of a generous deduction for clearing previously uncultivated agricultural land.[44] In addition, there are significant resource implications of the legislative decisions to retain the deductibility of certain expenditures for fertilizer and lime applications,[45] and to preserve certain incentives for sustained forest management.[46] Each of these reform measures is discussed separately below.

A. Capital Gains Benefits for "Sodbusters" and "Swampbusters"

One major incentive for expanding intensive farming operations onto highly erodible fields and wetland environments has been the taxation of income from land sales at favorable capital gains rates. In particular, speculative investors have reaped enormous financial benefits from their ability to purchase fragile rangeland or timberland at modest prices and convert it to cropland,

42. *See infra* text accompanying notes 47–53.
43. *See infra* text accompanying notes 54–60.
44. *See infra* text accompanying notes 61–64.
45. *See infra* text accompanying notes 65–70.
46. *See infra* text accompanying notes 71–83.

thereby instantly and dramatically raising the land's market value. Individual "sodbusters" and "swampbusters" have been able to classify the destructively managed land as a capital asset, and exclude from taxation sixty percent of the gain realized from sale of the land.[47] Soil, wildlife, and water quality have been the major losers of this taxation scheme.

In the case of converted wetlands, increasingly scarce and fragile environments that are essential to a healthy ecosystem are lost forever. Yet tax savings alone could offset an estimated one-third of certain farmers' conversion expenses.[48] One USDA economist has developed a model of the effect of a hypothetical large-scale conversion in the Pocosin region of North Carolina.[49] This study suggests that conversion may produce tax advantages worth $603 per acre, largely from capital gains treatment.

The Tax Reform Act's *de facto* elimination of special treatment for capital gains will eliminate an important incentive for both speculative investment in, and development of, land assets in general. This broad impact should act to reduce crop production on previously uncultivated highly erodible land or wetland.

In addition to eliminating preferred capital gains treatment, the new law contains specific language with respect to sales of highly erodible land and wetland that has been converted to crop production anytime after March 1, 1986.[50] This new provision renders income from such sales ineligible for capital gains treatment. This could prove to be an important future deterrent to sodbusting and swampbusting in the event that Congress raises tax rates for ordinary income or restores a partial exclusion for capital gains.

The sodbuster/swampbuster language in the new tax law is fully consistent with components of the 1985 farm bill that withhold federal farm program benefits from farmers who plant crops on converted wetlands or plow highly erodible land without taking soil retention precautions.[51] Like the farm bill, the Tax Act defines "highly erodible land" on the basis of land capability criteria or inherent erosion potential, and defines "wetland" by a combination

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47. I.R.C. § 1252 (1982 & Supp. III 1985).
48. Heimlich, *Economics of Wetland Conversion: Farm Programs and Income Tax*, NAT'L WETLANDS NEWSL., July-Aug. 1986, at 7, 9.
49. *Id.* at 9.
50. T.R.A., *supra* note 25, § 403 (amending I.R.C. § 1257 (1982)).
51. 16 U.S.C. §§ 3811, 3821 (Supp. III 1985).

of soil and vegetation characteristics.[52] As interpreted by an interim rule issued by the USDA under the farm bill, this language covers both approximately 227 million acres of uncultivated highly erodible land, and more than five million acres of wetland with a high or medium potential for conversion to rowcrop production.[53] Together, the tax and farm bills constitute a firm and laudable legislative statement that the federal government should not subsidize destructive crop production on marginal or ecologically sensitive rural land.

B. Deductions for Soil and Water Conservation

For more than three decades, farmers have been allowed to deduct expenditures up to 25 percent of their gross farm incomes for soil and water conservation.[54] American farmers claimed nearly $129 million in conservation deductions for the 1980 tax year. A disproportionate number of these deductions were claimed by taxpayers in the Corn Belt and the Southern Plains.[55]

Notwithstanding the obvious utility of this deduction, many of the loosely defined "conservation practices" that have qualified for the deduction in the past are of dubious value as erosion control and water-saving techniques. The conservation deduction has even been claimed for such harmful manipulations as wetland drainage and leveling of hills to facilitate irrigation installations.[56] Moreover, in the past, the Tax Code has contained no mechanism for determining whether the land involved is even in need of erosion abatement. This situation has led some USDA economists to conclude that outright repeal of the conservation deduction "would not have

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52. T.R.A., *supra* note 25, § 403 (amending I.R.C. § 1257 (1982)).

53. *See* Interim Rule, Highly Erodible Land and Wetland Conservation, 51 Fed. Reg. 23,496 (1986) (to be codified at 7 C.F.R. Part 12); *see also* U.S. DEP'T OF AGRIC., ENVIRONMENTAL ASSESSMENT FOR THE REGULATIONS IMPLEMENTING THE HIGHLY ERODIBLE LAND CONSERVATION PROVISIONS OF THE FOOD SECURITY ACT OF 1985 24 (1986); U.S. DEP'T OF AGRIC., ENVIRONMENTAL ASSESSMENT FOR THE REGULATIONS IMPLEMENTING THE WETLAND CONSERVATION PROVISIONS OF THE FOOD SECURITY ACT OF 1985 11 (1986).

54. I.R.C. § 175 (1982).

55. Anderson & Bills, *Soil Conservation and Tax Policy*, J. SOIL & WATER CONSERVATION, July-Aug. 1986, at 225, 226.

56. Before enactment of the 1986 Act, deductions under I.R.C. § 175 could be claimed for such activities as stream diversions, land leveling and grading, drainage works, and "irrigation improvements." I.R.C. § 175 (1982). *See also* Anderson & Bills, *supra* note 55, at 225.

a serious adverse effect on efforts to promote soil erosion control on U.S. cropland."[57]

The new tax law should curtail the most unwarranted or harmful abuses of this deduction by limiting it to expenditures for activities taken in connection with plans approved by the USDA's Soil Conservation Service ("SCS") or a "comparable agency."[58] One aspect of the Tax Act that particularly benefits ecosystem values is the explicit denial of the deduction for any expenses associated with the draining and filling of wetlands.[59] An aspect that benefits water conservation is the Act's denial of deductions for the preparing of land for center pivot irrigation systems.[60]

C. Deductions for Land Clearing

The Tax Reform Act repeals the provision that has allowed farmers to deduct the lesser of $5,000 or 25 percent of their taxable farm incomes for expenses incurred in clearing land for farming.[61] Data from 1975 to 1977 are indicative of the potential magnitude of this deduction; during this period, the nation's farmers spent approximately $1.5 billion to clear an estimated eleven million acres of land.[62]

Whatever its benefits in past years in stimulating agricultural production, the land clearing deduction has indiscriminately rewarded sodbusters and swampbusters along with farmers cultivating land that is well suited to crop production. In the context of the current farm economy, such a deduction is an anachronism that, at best, needlessly induces expansion of the nation's cropland base and thereby exacerbates harmful commodity surpluses.

Under the new tax law, only brush clearing and ordinary maintenance on land already being farmed will remain deductible as regular business expenses.[63] Clearing expenditures incurred on previously uncultivated land after December 1985 can still be cap-

57. Anderson & Bills, *supra* note 55, at 228.
58. T.R.A., *supra* note 25, § 401 (amending I.R.C. § 175 (1982)).
59. *Id.*
60. *Id.*
61. T.R.A., *supra* note 25, § 402 (repealing I.R.C. § 182 (1982)); I.R.C. § 182 (1982).
62. D. LEWIS & T. MCDONALD, IMPROVING U.S. FARMLAND 1 (USDA-ERS Agricultural Information Bulletin No. 482, 1984).
63. T.R.A., *supra* note 25, § 402 (repealing I.R.C. § 182 (1982)); I.R.C. § 162 (1982 & Supp. III 1985).

italized, prospectively allowing tax benefits upon sale of the property.[64] This new provision should help curb unnecessary cropland expansion and its resultant commodity surpluses.

D. Deductions for Fertilizer and Lime

The Internal Revenue Code has allowed full annual deductions for farm field applications of fertilizer and lime,[65] even though some of these applications are essentially capital investments and, therefore, should be "amortized," or written off, over a number of years. The significance of this deduction is illustrated by the fact that farmers applied fifteen times more fertilizer and lime in 1982 than the amount used annually in 1930.[66]

Under the new tax law, farmers can continue to claim annual deductions for fertilizer and lime, provided the materials are used to "enrich, neutralize or condition land," and regardless of whether their soil productivity benefits last more than one year.[67] Although this new provision basically preserves existing law, it is noteworthy that the House of Representatives initially voted to deny annual expense deductions for fertilizer and lime applications with multi-year effects.[68] The report of the Ways and Means Committee offered little explanation for this proposed change, except to suggest that the existing provision "may affect prudent farming decisions adversely."[69]

Although no extensive legislative record surrounds the House's repeal initiative, the action appears to have been prompted by an economic view that multi-year land conditioning investments are no different from other long-term, non-deductible improvements to the land and, therefore, should be recouped over a number of years.[70] The House may also have been motivated by a concern that the deduction, in tandem with cash accounting

64. *Id.*

65. I.R.C. § 180 (1982).

66. U.S. Dep't of Agric., Misc. Publ. No. 1063, Fact Book of U.S. Agriculture 3 (revised ed. 1983).

67. I.R.C. § 180 (1982).

68. H.R. 3838, § 921, 99th Cong., 1st Sess., 131 Cong. Rec. 12,579, 12,659 (1985).

69. House Comm. on Ways and Means, Report on the Tax Reform Act of 1985, H.R. Rep. No. 426, 99th Cong., 1st Sess. 650 (1985).

70. *Id.*

provisions, has promoted needless and environmentally harmful "dumping" of excess fertilizer.

Whatever the House intended to accomplish through a new limitation on multi-year fertilizer deductions, the environmental dimension of the issue is complex. On the one hand, the notion of reducing tax benefits taken for the use of polluting inputs is intuitively appealing. On the other hand, restricting deductions for multi-year soil conditioning applications, as the House would have done, may discourage more widespread use of certain non-synthetic fertilizers. These fertilizers are often an environmentally preferable subsitute for annual application of anhydrous ammonia and other chemicals commonly used in modern agriculture. While potential tradeoffs such as this are not well understood or easily quantified, they should be considered to the extent possible in future deliberations on tax deductions for soil conditioning expenses.

E. Incentives for Sustained Forestry

In contrast to annual rowcrop farming and other agricultural pursuits, investments in growing and selling timber usually take decades to generate income. Recognizing the anomalous market conditions surrounding the tree-growing industry, various provisions of the Tax Code have conferred favorable treatment on forestry investments.

Specifically, outlays for reforesting cutover timber stands have been eligible for a special ten percent tax credit, and are allowed to be amortized on taxes over just seven years, even though reforestation expenditures do not yield income until the trees have reached a commercially valuable size.[71] Although these reforestation expenditures, as well as any expenses incurred in establishing timber stands, must be capitalized, the Tax Code allows forest owners to deduct as business expenses the costs of maintaining the quality of the stands, notwithstanding that these maintenance expenses do not produce income until some future year.[72] More-

71. I.R.C. § 48(a) (1982 & Supp. III 1985); I.R.C. § 194 (1982).

72. I.R.C. §§ 162, 263 (1982 & Supp. III 1985); Treas. Reg. § 1.611-3(a) (1960); Rev. Rul. 75-467, 1975-2 C.B. 93; *see also* for a discussion of the tax effects of timber expenditures, Siegel, *Implications of the 1986 Federal Tax Reform Act for Forestry*, 10 NAT'L WOODLANDS 10, 18 (1987).

over, timber has been treated as a capital asset subject to the capital gain exclusion and relatively low capital gain tax rates.[73]

The nearly eight million private forest landowners in the country take advantage of this favorable tax treatment of forestry investments. Although many of these forest owners are corporations, the second largest group of owners are farmers whose property is a mixture of cropland bordered by woods.[74] Private forestry is particularly important to the rural economy of many midwestern and eastern states where public forest land is in short supply. In Illinois, for example, an estimated 96 percent of the state's total timber harvests occur on private land.[75]

In spite of the benefits of private forestry, the USDA has identified approximately 40 million acres of forest land in the United States as having a medium or high potential for conversion to intensive rowcrop production.[76] This conversion is often ill-advised. Tree cover can be an effective check against excessive soil erosion on land that is only marginal for cultivation of crops on annual rotations; erosion rates on cropland can average fifty times the rates of soil loss on similar timbered land.[77]

Not only is forest conversion frequently unwise for the environment, but management of the same land for timber production can actually have environmental benefits. For example, if sound practices are employed, timber management on private land can conserve soil, maintain recreation opportunities, and protect wildlife habitats. In addition, more intensive timber management on the country's non-industrial private forests could lessen the pressure for commercial logging of the national forests, where timber production often conflicts with amenity resources to which the public has little access on private land.[78]

The Tax Reform Act recognizes that tax policy plays an important role in enabling private forest owners to practice sustained timber management by rejecting some modifications that were

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73. I.R.C. § 631 (1982 & Supp. III 1985).

74. Kaiser, Birch & Lewis, *New Findings on Private Forest Landowners*, AM. FORESTS, July 1982, at 28, 30.

75. McCurdy & Mercker, *A Comparison of Private Forested Tracts in Southern Illinois, 1977 and 1985*, 9 NAT'L. WOODLANDS 8 (1986).

76. SOIL CONSERVATION SERVICE, U.S. DEP'T OF AGRIC., NATIONAL RESOURCES INVENTORY: NATIONAL SUMMARY, Table 32a (July 1984).

77. Bockheim, *Forest Soils*, in INTRODUCTION TO FOREST SCIENCE 108 (R. Young ed. 1982).

78. *See* AN ENVIRONMENTAL AGENDA FOR THE FUTURE 93 (R. Cahn ed. 1985).

proposed in the House bill,[79] and retaining several important incentives for forestry investment. Specifically, the new law continues to allow both the deductibility of ordinary business expenses associated with maintaining forest stands,[80] and a ten percent tax credit for, and seven year amortization of, reforestation expenses.[81] Timber's nominal status as a capital asset is also retained,[82] making income from timber sales eligible for preferential taxation in the event of a future reinstatement of a capital gain exclusion or a tax hike for ordinary income.

This favorable tax climate is clearly needed in the area of sustained private forestry. However, there is far less justification for the tax law's retention of special tax breaks for timber harvested from public land. Since public forest management decisions are mandated by law and paid for by the public,[83] economic incentives for private companies should play no role in these decisions and serve only as a subsidy for cutting timber on the national forests. This subsidy to those harvesting timber from public lands places farmers and other private timber growers at a competitive disadvantage, since they depend upon these incentives for capital to support sustainable forest practices.

IV. Implementing the Conservation Reforms

The aftermath of major amendments to the Internal Revenue Code can take a variety of procedural shapes. In the most formal manifestation of statutory implementation, the IRS publishes notices in the *Federal Register* containing proposed rules, and solicits and considers public comments on contemplated actions before making final decisions.

79. H.R. 3838, *supra* note 68, §§ 905, 911, 912, 131 Cong. Rec. at 12,657, 12,659.

80. *See* sources cited *supra* note 71.

81. I.R.C. § 48(a) (1982 & Supp. III 1985); I.R.C. § 194 (1982); T.R.A., *supra* note 25, § 1301(j)(8) (amending I.R.C. § 194 (1982)).

82. I.R.C. § 631 (1982 & Supp. III 1985); T.R.A., *supra* note 25, § 311(d)(2) (amending I.R.C. §§ 49, 953, 1254 (1982)).

83. *See generally* U.S. Forest Service, U.S. Dep't of Agric., Agricultural Handbook No. 453, The Principal Laws Relating to Forest Service Activities (1983). This volume contains the major federal statutes governing U.S. Forest Service management of the National Forest System, notably including the Multiple-Use Sustained-Yield Act of 1960 (16 U.S.C. §§ 528–531 (1960)), and the National Forest Management Act of 1976 (Pub. L. No. 94-588, 90 Stat. 2949 (1976) (codified as amended at 16 U.S.C. §§ 1600–1687 (1982)).

In the case of the 1986 law, however, there are indications that, because of the law's broad scope and the necessity of implementing the new provisions rapidly, the Treasury Department will forgo formal rulemaking procedures for many, if not most, of the new law's features.[84] There is no statutory requirement that the IRS issue rules to give the new provisions the force and effect of law. Therefore, the provisions most pertinent to agricultural conservation may receive no general interpretation by the agency. The lack of explicit rules is likely to elevate the importance of case-by-case interpretation through both advisory "letter rulings" issued by IRS staff upon taxpayer request, and more binding "revenue rulings" by the IRS Commissioner.[85]

Certain IRS rulings will undoubtedly be influenced by language of the Tax Reform Act that, in effect, calls upon the agency to defer to policies and regulations of the Department of Agriculture when implementing the new provisions affecting agricultural resource conservation.[86] Such a policy of deferral is appropriate since the USDA has the relevant technical expertise in soil science and related disciplines. As a result, the success of this year's conservation tax reforms is highly dependent on effective USDA natural resource policies and programs.

For example, the ability of the amended soil conservation deduction to encourage more effective erosion control is a function of the soundness of site-specific plans approved by the SCS.[87] Such approvals should be limited to plans designed to attain tolerable soil loss levels. This approval limitation would be consistent with the basic requirements of the USDA's interim rule for the sodbuster and conservation compliance provisions of the farm bill.[88]

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84. *First Rules From Treasury: Minimum Tax, Passive Loss, Interest Income,* INSIDE U.S. TAX POLICY, Sept. 26, 1986, at 4, 5.

85. *Id.*

86. *See, e.g.*, T.R.A., *supra* note 25, § 401 (amending I.R.C. § 175 (1982)).

87. *See supra* text accompanying notes 56–58.

88. *See* Ward & Benfield, *Comments of the NRDC on 7 C.F.R. 12, 1940, 1941, 1943, 1945 and 1980 (Highly Erodible Land and Wetland Conservation; Interim Rule),* Aug. 26, 1986, at 12. Contrary to the NRDC position, recent remarks by Department officials suggest that the USDA is prepared, in promulgating the final 7 C.F.R. Part 12, to relax the basic soil loss tolerance standard in favor of a requirement that conservation plans merely "reduce erosion to reasonable and acceptable levels based on local farming and economic considerations." Statement of Wilson Scaling, Chief, U.S. Dep't of Agric. Soil Conservation Serv., before the House Agriculture Subcomm. on Conservation, Credit and Rural Development, Mar. 10, 1987, at 7.

If a partial capital gain exclusion is reinstated in the future, and taxpayers again seek captital gains treatment for land sale profits, it is conceivable that the IRS may be faced with a determination of whether the land involved is highly erodible cropland or agriculturally converted wetland. Under such circumstances, the IRS would undoubtedly consult the technical criteria on land types developed by the USDA and expressed in the recent interim rule implementing the sodbuster and swampbuster provisions of the farm bill.[89] This hypothetical consideration makes the adequacy of the farm bill's technical definitions, as interpreted by the USDA, all the more compelling as a barrier against further tax-assisted harmful cultivation of marginal or ecologically sensitive cropland.[90]

Some agency discretion may affect even those conservation reforms that necessitate only limited interpretation by the IRS. For example, the repeal of the land clearing deduction needs little or no IRS implementation apart from deleting the line on which the deduction has previously been tabulated on farmers' tax forms. Nevertheless, the IRS should specify and adhere to standards that prevent deductible expenditures for ordinary land maintenance from being confused with non-deductible expenditures for the clearing of previously uncultivated land. Vague or ambiguous standards would enable farmers to attempt deducting as maintenance-related costs what are really clearing costs, thereby undermining the goal behind the repeal of the old provision.

The formal opportunities for public involvement in case-by-case IRS rulings are relatively limited. Nevertheless, there are ways for interested parties to influence the process. For example, submissions to the agency in advance of letter rulings can describe how the conservation intent of a specific statutory provision can best be fulfilled. In addition, in the event of an unfavorable letter ruling, parties can petition the agency for a more favorable precedent through a revenue ruling by the IRS Commissioner.

V. The Future Agenda

The Tax Reform Act of 1986 contains the most significant changes to the federal tax system in several decades. It is a rare

89. Interim Rule, *supra* note 53, at 23,502 (to be codified at 7 C.F.R. § 12.2).
90. Ward & Benfield, *supra* note 88, at 8.

event that congressional deliberations lead to such basic structural modifications.

Nevertheless, federal tax policy is in a state of constant flux, and various manipulations of the issue have already re-emerged on the congressional agenda, despite earlier legislative pronouncements that the Tax Reform Act should signal the beginning of a multi-year moratorium on future changes.[91] Agriculture figures prominently in some of the post-1986 Act reform proposals. For example, among the features of a "farm recovery tax" bill introduced this year by Senator Heflin (D-Alabama) is the restoration of an ITC for farm property.[92]

Moreover, the enactment of the 1986 law may well generate its own progeny. Lawmakers are already looking ahead to the possibility of a "technical corrections" bill to address perceived flaws in the 1986 reforms.[93] There is also growing speculation that the new reforms may prove widely unpopular and thus generate a backlash that will prompt further major legislation in the coming years. Finally, there is a rise in congressional sentiment for raising tax rates as a means of deficit reduction.[94] In sum, the 1986 Act probably represents the beginning rather than the end of the current round of major tax reform.

In any event, conservation accomplishments in the new tax law testify to the growing public sentiment favoring a sustainable farming future in rural America that does not adversely affect natural resources. If implemented effectively, the new law should significantly reduce public subsidies for destructive agricultural practices, while benefiting farmers, natural resources, and environmental quality.

To complement the valuable first step in conservation existing in the 1986 tax reforms, Congress should develop further Tax Code changes that will complete the agricultural resource mission begun by the 1985 farm bill. Three initiatives, in particular, warrant priority in the upcoming legislative debates over taxation.

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91. Swardson & Dewar, *The Short-Lived "Sense" of The Congress*, Wash. Post, Mar. 20, 1987, at A4, col. 5.

92. S. 455, 100th Cong., 1st Sess., 133 CONG. REC. 1647 (daily ed. Feb. 4, 1987).

93. *Tax Chairmen Seek 'Clean' Correction Bill: To Revisit Taxes Later in Session*, INSIDE U.S. TAX POLICY, Jan. 16, 1987, at 1.

94. Rich, *Tax-Rise Campaign Intensifies*, Wash. Post, Mar. 22, 1987, at A1, col. 6.

First, all credits and deductions taken in connection with destructive sodbusting and swampbusting should be repealed. Legislation along these lines was introduced in 1985 by Senators Boren (D-Oklahoma) and Grassley (R-Iowa).[95] This legislation proposed to deny capital gains treatment to sodbusters and swampbusters. In addition, the Boren-Grassley bill would have made it difficult for those who cultivate wetland, or plow highly erodible land without taking appropriate conservation precautions to continue to profit from the full range of tax benefits. These benefits presently range from write-offs for common annual business expenses like tractor fuel and fertilizer, to accelerated depreciation deductions for machinery used for destructive land conversions.[96]

Second, a mechanism should be developed to restrict tax breaks for irrigation investments to those practices consistent with water conservation objectives. Current tax benefits for irrigation farming may be both lucrative and environmentally harmful. In Nebraska, for example, the practice of sodbusting fragile sandhill landscapes and installing center pivot irrigation systems that tap the declining Ogallala Aquifer was estimated, before the 1986 reforms, to generate as much as $175 per acre in tax benefits, aggregating to more than $28,000 per quarter section (160 acres) of irrigated land.[97]

When an irrigation system consumes water judiciously and does not contribute to runoff problems, such tax benefits may be appropriate. However, when such investments contribute to excessive aquifer depletion or pollution problems, they should not be assisted by the Tax Code.

In addition, the "water depletion" allowance, which is based on an IRS ruling, must be repealed.[98] This allowance grants farmers a deduction if they can prove that they are irreversibly depleting a ground water reserve.[99] This deduction encourages wasteful irrigation practices and penalizes farmers who practice conservation.

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95. S. 1786, 99th Cong., 1st Sess., 131 CONG. REC. 13,913 (1985).

96. *Id.* at 13,914.

97. Laycock, *Plowing of Fragile Grasslands in the Northern and Central Great Plains* (Proceedings of the Range Beef Cow Symposium VIII, Dec. 1983), at 66, 73.

98. Rev. Rul. 82-214, 1982-2 C.B. 115.

99. *Id. See also* DEP'T OF THE TREASURY, IRS PUBLICATION NO. 225, FARMERS' TAX GUIDE 26 (1984).

Finally, federal tax mechanisms could be enacted to complement present state and local efforts to protect rural open space through retention of the best farmland for agricultural uses. The irreversible loss of prime farmland to urban development is a particularly significant trend in farming areas adjacent to major metropolitan areas.[100]

A farmland protection bill introduced in 1986 by Senator Specter (R-Pennsylvania) deserves reconsideration by the current Congress.[101] This proposed legislation involves purchase of development rights ("PDR") programs where state or local governments purchase nonagricultural development rights from farmers in order to protect the farmland. The legislation would have allowed persons who transfer these nonagricultural development rights to exclude from taxation the portion of the sale income applied toward purchase or improvement of other farm property. The bill also would have allowed a taxpayer to deduct as a charitable contribution the theoretical loss in market value if they sell development rights on their farmland.[102]

These farmland protection provisions would have applied only to the relatively few places in the country where state or local governments have qualified PDR programs. For example, the legislation could have been beneficial to farmland protection efforts in North Carolina, Maryland, and Washington, where state or local PDR programs are currently in place.[103]

Senator Specter's proposed bill could be strengthened by discouraging expanded or more intensive farming operations on marginal cropland. This could be accomplished by explicitly limiting its application to "prime" farmland. This would be consistent with the federal Farmland Protection Policy Act's leading definition of

100. *See, e.g.*, AMERICAN FARMLAND TRUST, THE HIGHEST MARKET VALUE FARMING COUNTIES IN MOST STATES ARE AT THE URBANIZING METROPOLITAN FRINGE (map) (1986); S. 2549, 99th Cong., 2d Sess., 132 CONG. REC. 7335 (daily ed. June 12, 1986).

101. S. 2549, *supra* note 100, at 7335–36.

102. *Id. See also* for a discussion of similar legislation, R.W. DUNFORD, AN OVERVIEW OF FEDERAL TAX POLICIES ENCOURAGING DONATIONS OF CONSERVATION EASEMENTS TO PRESERVE NATURAL AREAS 33–37 (Congressional Research Service Report No. 84-48 ENR, 1984).

103. *See* NAT'L ASS'N OF ST. DEP'TS OF AGRIC., CURRENT STATE FARMLAND PROTECTION ACTIVITIES, (pamphlet) (Jan. 1985).

"farmland" as land with "the best combination of chemical and physical characteristics" for sustained agricultural production.[104]

In sum, the 1986 Tax Reform Act and a shifting political climate are likely to spawn considerable legislative action during the remainder of this decade. The continuing challenge will be to ensure that tax policies for agricultural resource protection are made integral parts of the Internal Revenue Code.

104. Farmland Protection Policy Act, 7 U.S.C. § 4201(c)(1)(A) (1982).