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An Agricultural Law Research Article

Impact of Reagan's Tax Proposal on Agriculture

by

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Originally published in SOUTH DAKOTA LAW REVIEW
31 S. D. L. REV. 309 (1986)

www.NationalAgLawCenter.org

IMPACT OF REAGAN'S TAX PROPOSAL ON AGRICULTURE

The current tax system has encouraged the growth and expansion of existing farm businesses and has attracted tax-motivated investments into the sector, perhaps distorting relative input and commodity prices. The Administration's proposal treats income earned within and outside of farming more equally, which would result in shifts in ownership patterns within the sector and would alter commodity production and price levels.

INTRODUCTION

In recent months there has been considerable interest shown by politicians and businessmen regarding tax reform, a reaction to growing dissatisfaction with the federal tax system. Bradley-Gephardt, Kemp-Kasten, the Reagan Administration, and the Democratic party have all submitted tax reform proposals.

President Reagan submitted his proposal to Congress on May 29, 1985, calling on Congress to overhaul our tax code based on the principles of simplicity and fairness, opening the way to a generation of growth.[1] Many of the Administration's proposals will have an impact on both large and small South Dakota farmers. Income tax and capital gains rates, investment tax credit, and depreciation allowances all affect the amount of income tax a farmer must pay currently and in the future.

This report will examine the impact of the current tax law on agriculture, the President's proposal, and the effect of Reagan's proposal on the family farm. The scope of this article will be limited to the effect on the individual taxpayer, excluding changes proposed to the corporate tax structure. The main provisions affecting agriculture included in this article are as follows: 1) reductions in individual tax rates, with accompanying increases in the personal exemption and zero bracket amounts; 2) elimination of the investment tax credit; 3) modification of depreciation policies; 4) capitalization of preproduction expenses; 5) changes to capital gains provisions; 6) repeal of elections to deduct expenditures for soil and water conservation, fertilizer and soil conditioning, and land clearing; 7) repeal of the alcohol fuels credit; 8) repeal of income averaging; 9) repeal of state and local tax deductions; 10) repeal of the two-earner deduction; and 11) increase in the spousal individual retirement account limit. This report will conclude with a discussion of agricultural tax shelters and the effect the Reagan proposal will have on such investments.

TAX RATES, PERSONAL EXEMPTIONS, STANDARD DEDUCTION

The current tax system contains fourteen brackets ranging from 11 to

1. THE RESEARCH INST. OF AM., FEDERAL TAX GUIDE, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 1 (1985) [hereinafter cited as R.I.A.].

50%.[2] The personal exemption is scheduled to be $1080 for 1986, while the zero bracket amount is to increase to $2480 for a single taxpayer and heads of household and to $3670 for joint return filers.[3]

Reagan's proposed tax system would have only three tax brackets: 15, 25, and 35%. The personal exemption would be increased to $2000. The zero bracket amounts would rise to $2980 for the single taxpayer, $3600 for heads of household, and to $4000 for taxpayers who file joint returns.[4]

This change would reduce the tax liability for many farmers. Currently, only about one-half of all farmers are in tax brackets exceeding 15%. Under Reagan's proposal, three out of every four farmers would find themselves in the new 15% tax bracket.[5] "Less than 5 percent of all farmers would be in the top 35% bracket."[6] With the increases in the personal exemption and the zero bracket amounts, for a husband and wife with two children, the first $12,000 of net farm income would be tax exempt, net income from $12,000 to $37,000 would be taxed at 15%, net income from $37,000 to $78,000 would be taxed at 25% and net farm income over $78,000 would be taxed at 35%.[7] Under current law, the same family, in 1986, would be tax exempt only if its net income did not exceed approximately $9500.[8]

Reagan's proposal on individual tax rates would allow farmers, both in the lower and higher tax brackets, to pay less in taxes. It would allow both the poor and the rich farmers to keep more of their income, allowing them to purchase other assets. Tax liabilities of families with incomes below $10,000 would fall by an average of 35.5%, and the reduction in taxes for families with incomes below $20,000 would be 18.3%.[9]

INVESTMENT TAX CREDIT

Under current law, the investment tax credit (ITC) is a credit against tax liability for a taxpayer's investment in certain depreciable property.[10] The credit is generally equal to 10% of qualified investment in property that is placed in service during the taxable year, except for some shorter-lived prop-

2. I.R.C. § 1 (West Supp. 1985).
3. R.I.A., *supra* note 1, at 9.
4. *Id.* at 1, 7.
5. ECON. RESEARCH SERVICE, U.S. DEP'T OF AGRIC., *Tax Reform: How Will Farmers Fare?*, 6 FARMLINE 4 (1985) [hereinafter cited as *Farmers Fare*].
6. ECON. RESEARCH SERVICE, U.S. DEP'T OF AGRIC., *Tax Reform: Its Impact on Agriculture*, 111 AGRIC. OUTLOOK 24, 25 (1985) [hereinafter cited as *Tax Reform*].
7. CENTER FOR RURAL AFF., THE PRESIDENT'S TAX REFORM PROPOSAL: PROVISIONS AFFECTING AGRICULTURE AND THEIR IMPACTS ON FAMILY FARM PROFITABILITY AND SURVIVAL 3 (unpublished manuscript) [hereinafter cited as CENTER].
8. R.I.A., *supra* note 1, at 10.
9. *Id.* at 2.
10. I.R.C. § 48(a) (West Supp. 1985). Property that qualifies for the investment credit includes: 1) tangible personal property (other than an air conditioning or heating unit); 2) other tangible personal property (not including a building and its structural components); 3) elevators and escalators; 4) single purpose agricultural or horizontal structures; 5) rehabilitated buildings; 6) certain timber property; and 7) storage facilities (not including a building and its structural components) used in connection with the distribution of petroleum or any primary product of petroleum. *Id.*

erty, such as cars, on which the credit is 6%.[11]

The basis of depreciable property on which investment tax credit is taken is reduced by 50% of the amount of the ITC. A taxpayer has the option of electing a 2% reduction in the investment tax credit instead of any basis reduction.[12] The investment tax credit would be repealed under the Reagan proposal.[13]

The investment tax credit was initially introduced and subsequently modified to prevent capital consumption allowances based on historical cost from being eroded by inflation and to stimulate increased levels of investment.[14] Qualifying farm property includes machinery, equipment, storage facilities, single-purpose agricultural structures, and livestock acquired for dairy, draft, or breeding purposes.[15]

The investment tax credit is a mechanism which provides an investment incentive for farmers to purchase new machinery and equipment. The ITC is a dollar for dollar reduction in tax liability. Any farmer who acquires qualified investment property can benefit from the ITC. A farmer could justify his expenditure for an asset under a tax system that allows him to reduce his tax burden. Not only can ITC eliminate any tax liability due, but it also allows a farmer to acquire new assets at a lower after-tax cost. This provides the farmer with an incentive to invest in new machinery. In eliminating the ITC, farmers would end up paying more for such investments. "Preliminary estimates indicate that the after-tax cost of farm equipment and structures could rise an average of 7.5 percent."[16]

Under President Reagan's proposal, taxpayers would be allowed to carry forward some amount of the unused credits to reduce tax in years when the lower marginal tax rates of the Administration's proposal are in effect. It is uncertain whether the credits carried forward would be adjusted so that the carryforward shields no more income from tax than it would under our present system.[17]

DEPRECIATION

The Accelerated Cost Recovery System (ACRS) was enacted as part of the Economic Recovery Act of 1981. ACRS allows certain depreciable assets to be written off at accelerated rates over periods ranging from three to eighteen years, depending upon the individual asset's classification.[18] ACRS classifies all personal property as three-year or five-year property. The majority of

11. I.R.C. § 46 (West Supp. 1985).
12. I.R.C. § 48(q) (West Supp. 1985).
13. R.I.A., *supra* note 1, at 161.
14. *Id.* at 160.
15. *Tax Reform*, *supra* note 6, at 25.
16. *Id.* at 26.
17. JOINT COMM. ON TAX'N, TAX REFORM PROPOSALS: TAXATION OF CAPITAL INCOMES, J.C.S. DOC. No. 35, 99th Cong., 1st Sess. 83 (1985) [hereinafter cited as CAPITAL INCOMES].
18. I.R.C. § 168 (West Supp. 1985).

real property is classified as eighteen-year property.[19] Current law classifies cars and light trucks as the principal three-year property items, while most other personal property, including machinery, equipment, confinement buildings, and bins, is recovered over the five-year period.[20] Currently, a special exception to ACRS allows a taxpayer to expense $5000 of property used in his trade or business in the year in which the property is placed in service. This limit is scheduled to increase to $10,000 for taxable years beginning in 1989.[21] Under ACRS, only the unadjusted original cost basis of an asset can be recovered over the class recovery period.[22]

The Administration proposes the Capital Cost Recovery System (CCRS), which would modify ACRS in several respects: "1) assets would be classified on the basis of similar actual depreciation rates (as determined by the Treasury Department), 2) the prescribed statutory percentages would be designed to produce comparable investment incentives for all depreciable assets, 3) the periods over which costs are recovered would be somewhat longer than ACRS recovery periods, and 4) the basis of depreciable property would be indexed for inflation."[23]

Under CCRS, all depreciable assets would be divided into six classes with recovery periods ranging from four to twenty-eight years.[24] The proposed CCRS would place light trucks and cars into a four year category; five years for all other trucks and trailers; six years for tractors; seven years for breeding and dairy cattle, farm equipment, bins, silos, and confinement buildings; and twenty-eight years for machine sheds, houses, and general purpose structures.[25] CCRS would adjust depreciation allowances upward for inflation by means of a basis adjustment. For each recovery class, CCRS would yield the identical real present value of depreciation deductions regardless of inflation rates, whereas ACRS yields real present value deductions which decrease as inflation increases.[26] Also, the current election permitting taxpayers to expense the aggregate cost of personal property not in excess of $5000 would be retained, but the scheduled increase to $10,000 would be repealed.[27]

The proposed depreciation rules would spread the allowable depreciation deduction over a longer period of time, but these deductions would be indexed according to inflation.[28] In effect, indexing would partially compensate for the repeal of the investment tax credit and the lengthening of the depreciation period.[29] For example, a farmer who purchases machinery for $10,000 would be permitted to deduct a total of $11,190 over a six year period, assuming a

19. R.I.A., *supra* note 1, at 132.
20. *Id.*
21. *Id.* at 134.
22. *Id.* at 139.
23. CAPITAL INCOMES, *supra* note 17, at 57.
24. R.I.A., *supra* note 1, at 138.
25. *Tax Reform*, *supra* note 6, at 26.
26. R.I.A., *supra* note 1, at 148.
27. *Id.* at 143.
28. *Farmers Fare*, *supra* note 5, at 6.
29. *Id.*

5% inflation rate.[30] The proposed indexing of tax depreciation would stop effective tax rates from fluctuating with the inflation rate. At high inflation, investment incentives under ACRS decline. Under CCRS, the investment incentive would remain constant.[31]

ACRS was designed to provide an investment incentive by accelerating depreciation deductions relative to the actual decline in the value of the asset. ACRS distorts income by concentrating larger depreciation deductions in the investment's early years. This result allows the taxpayer to reduce his tax liability attributable to unrelated income. Thus, ACRS provides "a basis for tax-sheltered investments."[32]

CCRS was designed to provide neutral investment incentives. It is premised on the theory that all depreciable assets produce the same effective rate.[33] Beginning with the second year an asset is in service, after reducing its basis for the prior years' depreciation deductions, the asset's unrecovered basis would be adjusted upwards for inflation. The applicable CCRS recovery percentage would then be applied to the asset's inflation-adjusted basis. For the purposes of computing gain or loss on disposition of a depreciable asset, a pro-rata inflation adjustment to basis would be made in the year of disposition.[34]

In addition to adjusting the basis of the asset for the rate of inflation, the Reagan proposal extends the period over which an asset must be written off. Thus, with a low inflation rate, a farmer in a low tax bracket would receive little benefit under the proposed plan as the asset's depreciable basis must be recovered over a longer period of time.

The most affected assets in CCRS are the assets that fall into the twenty-eight year class. For example, a machine shed would have to be depreciated over twenty-eight years under CCRS while under ACRS the same machine shed could be written off over a period of eighteen years. Again, with a low inflation rate, investment incentive would be reduced because of the longer period over which the cost of the asset may be recovered, especially for a farmer in a lower tax bracket.

With the inflation-adjusted CCRS, the family farmer seems to be faced with a more complicated system for determining depreciation. The self-preparer would, it would seem, have to seek professional advice on how to compute the proper inflation-adjusted depreciation. This would be in direct contrast to Reagan's stated principle of simplicity.

CAPITALIZATION OF PREPRODUCTION EXPENSES

Most farmers are not required to recognize inventories for tax purposes, and consequently, do not capitalize the costs of producing crops or raising animals with the exception of the initial costs of acquiring immature animals.

30. *Id.*
31. *Tax Reform*, *supra* note 6, at 26.
32. CAPITAL INCOMES, *supra* note 17, at 54.
33. R.I.A., *supra* note 1, at 150.
34. CAPITAL INCOMES, *supra* note 17, at 62.

A concern with burdening the farmer with undue recordkeeping was a prime consideration in enacting the present law permitting current deductibility for most farm production costs. Certain farmers, however, such as some farming corporations and farm syndicates, are currently required to capitalize certain production costs, such as feed, seed, and fertilizer which will not be consumed until a later year.[35]

Under the Administration's proposal, farmers would not be required to recognize inventories for tax purposes unless required to do so under current law. I.R.C. section 278, which currently requires the capitalization of the development costs of fruit and nut orchards and vineyards, would be extended to apply to any plant or animal whose preproductive period was two years or longer. The preproductive period of animals would begin at the time of acquisition, breeding, or embryo implantation, and would end when the animal became ready to perform its intended function. Animals held for slaughter would not be subject to the new provisions. Farmers would be permitted to use inventory valuation methods, such as the farm-price or unit-livestock-price method, in lieu of capitalizing such expenses.[36]

Capitalization would require production costs, which are currently deductible, to be accumulated and recovered when the property is sold or through depreciation as the property is used.[37] The current law allows the deduction of such expenditures to be accelerated and, thus, does not match them to the receipt of the income which they generate.[38] The current tax deferral is, in effect, an interest-free loan from the Federal government.[39] For example, acceleration of $2000 of farm expense into the current year results in a tax savings of $1000 (assuming a 50% marginal tax rate), which can be used to finance farm operations in the coming year.[40] On the other hand, if the same farmer had to obtain a $1000 bank loan, assuming an interest rate of 15% compounded annually, he would repay $1150 at the end of one year, which would result in an after-tax cost of $1075.[41] Thus, the interest-free loan generated by the tax deferral would save him an after-tax effective interest cost of 7.5%.

Farming is one of few businesses which is not currently required to capitalize production costs. Therefore, the proposal would make the tax law more neutral in its application to various types of businesses.[42] Conversely, a review of the farm debt situation reveals that many farmers are in need of just such an interest-free loan and that to foreclose such a "loophole" could cause substan-

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35. R.I.A., *supra* note 1, at 200.
36. *Id.* at 204.
37. *Id.* at 206.
38. *Id.*
39. *Id.*
40. JOINT COMM. ON TAX'N, TAX REFORM PROPOSALS: TAX SHELTERS AND MINIMUM TAX, J.C.S. DOC. NO. 34, 99th Cong., 1st Sess. 3 (1985) [hereinafter cited as MINIMUM TAX].
41. *Id.* at 2-3.
42. R.I.A., *supra* note 1, at 207.

tial hardship by increasing their already burdensome interest cost.[43]

The proposal does circumvent the concern that the recordkeeping associated with such capitalization would be prohibitive by permitting alternative inventory methods.[44] The farm-price method provides for the valuation of inventories at market less the direct cost of disposition,[45] while the unit-livestock-price method provides for valuation of different classes of animals at a standard unit price for each animal within a class.[46] These alternatives, particularly the farm-price method, should keep this provision from being a recordkeeping nightmare.

CAPITAL GAINS

Gains or losses from the sale or exchange of capital assets[47] held for more than six months (one year for assets acquired before June 23, 1984) are treated as long-term.[48] Net long-term capital gains get preferential treatment in that 60% of the gain is excludable, making the maximum marginal rate on such gains 20%.[49] Net capital losses of up to $3000 are deductible against ordinary income, although in this case only one-half of the net long-term capital loss is useable.[50]

Subject to certain holding periods, Section 1231 affords special treatment to the following types of properties: 1) depreciable business property; 2) business realty; 3) business property or capital assets which are involuntarily converted; 4) crops sold with the land; 5) livestock; and 6) timber, domestic iron ore, or coal.[51] Section 1231 gains, which are not subject to recapture, are netted with section 1231 losses in a given year.[52] Net gains are potentially eligible for long-term capital gain treatment.[53] Net section 1231 losses are treated as ordinary losses.[54]

Three major revisions in the taxation of capital gains are proposed. First, the plan will reduce the capital gain exclusion from 60 to 50%. Second, it seeks to substantially restrict the types of section 1231 gain which are eligible for long-term capital gain treatment. Lastly, it will establish an election whereby the taxpayer, beginning in 1991, can index the basis of his capital

43. Myers, *The Outlook: Why the Farm Crisis is Likely to Worsen*, Wall St. J., Aug. 26, 1985, at 1, col. 5.

44. R.I.A., *supra* note 1, at 204.

45. JOINT COMM. ON TAX'N, TAX REFORM PROPOSALS: ACCOUNTING ISSUES, J.C.S. DOC. NO. 39, 99th Cong., 1st Sess. 52 (1985).

46. *Id.* at 53.

47. Generally, an asset will be considered a capital asset unless it falls within one of the following categories: 1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; 2) depreciable or real property used in the taxpayer's trade or business; 3) specified literary or artistic property; 4) business accounts or notes receivable; or 5) certain U.S. publications. CAPITAL INCOMES, *supra* note 17, at 25.

48. I.R.C. § 1222(3) (West Supp. 1985).

49. I.R.C. § 1202(a) (West Supp. 1985).

50. I.R.C. § 1211(b) (West Supp. 1985).

51. R.I.A., *supra* note 1, at 165.

52. I.R.C. § 1231(a) (West Supp. 1985).

53. I.R.C. § 1231(a)(1) (West Supp. 1985).

54. I.R.C. § 1231(a)(2) (West Supp. 1985).

assets for inflation in lieu of taking the capital gain deduction.[55]

The proposed law retains the current definition of capital asset, but only land used in a trade or business, such as farmland, would continue to be treated as section 1231 property. Gain from the sale of depreciable business property, including recognized gain from involuntary conversions, would be treated as ordinary income. Interests in timber, coal, iron ore, livestock, and unharvested crops, would not be treated as capital assets if they were used in a trade or business or otherwise held as income producing property.[56]

The proposed reduction in the capital gain exclusion must be analyzed in relation to the proposed decrease in the progressive rate structure. Viewed in this light, capital gains will receive more preferential treatment under Reagan's proposal than under the current law, for the maximum marginal rate on long-term capital gain income would be 17.5%.[57]

One reason for the preferential treatment afforded to capital gains is to offset the phantom gain generated by inflation.[58] Reagan's proposal further recognizes this trade-off by making available an election, beginning in 1991,[59] whereby a taxpayer can elect to index the basis of the asset sold for inflation in lieu of taking the capital gain deduction.[60] Farmers, particularly retiring farmers, justifiably benefit from the capital gain deduction on the sale of assets, such as farmland, which they have utilized over a substantial period of time. Generally, the monetary value of such assets has increased due to inflation, while in real terms little or no gain may have resulted. Thus, the farmer selling appreciated farmland will benefit from the President's proposal due to the overall reduction in the capital gain tax rate.

One criticism this rate preference draws relative to agriculture is that the rate reduction for capital assets tends to increase their value relative to other assets.[61] This favorable tax treatment was partially blamed for the rapid increase in land prices in years past. Thus, a farmer who planned to personally use the land for farming often encountered difficulty in financing the acquisition.[62] The proposal somewhat alleviates this problem by decreasing the value of the capital gain preference relative to the tax rate on ordinary income. Under current law the capital gain preference reduces the marginal tax rate by up to 30%, representing the difference between 50%, the highest marginal rate on ordinary income, and 20%, the highest marginal rate on capital gains.[63] The reduction in the same marginal rates under the Reagan proposal

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55. R.I.A., *supra* note 1, at 168-69.

56. *Id.*

57. *Id.* at 168.

58. *Id.* at 170.

59. One has to question the propriety of enacting tax legislation, keyed to inflation, five years before its effective date.

60. R.I.A., *supra* note 1, at 169.

61. *Taxes and Agriculture: Hearings Before the Joint Economic Comm.*, 98th Cong., 2nd Sess. 8 (1984) (testimony of Prof. Hoy F. Carman) [hereinafter cited as *Hearings*].

62. CENTER, *supra* note 7, at 8.

63. R.I.A., *supra* note 1, at 164.

is only 17.5%, the difference between 35% and 17.5%, respectively.[64]

The proposed change relative to section 1231 property would not significantly affect a farmer's tax liability arising from the sale of machinery or equipment. Current recapture provisions make it necessary for the sales price of such property to exceed the original purchase price before long-term capital gain treatment is available, an uncommon situation.[65] This portion of the proposal would obviate the need for the complex recapture provisions of the current law and, thus, would promote the President's goal of simplification.[66] The major impact of this provision falls on the gain recognized on the sale of raised breeding stock, the entire amount of which is potentially eligible for long-term capital gain treatment under the current law.[67] Reagan's proposal would characterize the entire gain as ordinary income,[68] thereby increasing the maximum marginal tax rate on the sale of raised breeding stock by 15%.[69]

DEDUCTIONS FOR CONSERVATION AND LAND CLEARING

Current law allows farmers to deduct various expenditures that would otherwise be capitalized or inventoried. I.R.C. section 175 allows farmers to deduct current soil and water conservation expenditures that do not increase the basis of depreciable assets. The deduction is limited to 25% of the taxpayer's gross income from farming.[70] Qualified expenditures include leveling, grading, terracing; construction and control of ditches, dams, waterways and ponds; the planting of windbreaks and the elimination of brush. I.R.C. section 180 grants farmers a deduction for fertilizer or other material used to enrich, neutralize or condition farmland.[71] I.R.C. section 182 permits farmers to deduct expenditures incurred to clear land and make it suitable for farming. Land clearing expenditures include the eradiction of trees, stumps, and brush; the treatment or moving of earth; and the diversion of streams and watercourses.[72] The deduction under I.R.C. section 182 is limited to the lessor of $5000 or 25% of the taxpayer's taxable income from farming.[73]

The elections to deduct expenditures for soil and water conservation, fertilizer and soil conditioning, and land clearing would be repealed.[74] Rather, these costs have to be capitalized and depreciated.

The loss of tax deferral would reduce the attractiveness of investments in land improvement. Fewer terraces, waterways, dams and windbreaks will be constructed. This could result in long-term erosion. The loss of those deduc-

64. *Id.* at 168.
65. I.R.C. § 1245(a)(1) (West Supp. 1985).
66. R.I.A., *supra* note 1, at 172.
67. I.R.C. § 1245(a) (West Supp. 1985).
68. R.I.A., *supra* note 1, at 169.
69. This represents the difference between the 20% maximum capital gain rate under the current law and the 35% maximum rate on ordinary income under Reagan's proposal.
70. I.R.C. § 175 (1985).
71. I.R.C. § 180 (1985).
72. *Id.*
73. I.R.C. § 182 (West Supp. 1985).
74. R.I.A., *supra* note 1, at 189.

tions would curb the conversion of woodlands, wetlands, and rough rangeland. This lack of incentive, however, to the higher tax bracket farmer may encourage moderate and lower income farmers to compete for the affected land.

Proponents of President Reagan's proposal argue that the return on investments in land improvements generally is sufficient reward to induce these investments and that spending programs are preferable to tax incentives in cases where the return is insufficient. Opponents argue that the benefits of soil conservation are typically enjoyed by others as well as by the one who makes the investment. The opponents believe that the private return understates the social benefit, leading to underinvestment in the absence of public subsidies. For example, downstream users benefit from cleaner water when conservation expenditures are made upstream.[75]

ALCOHOL FUELS CREDIT

Current law allows farmers a sixty cent per gallon income tax credit for the production of alcohol used in mixtures with gasoline, diesel fuel, and special motor fuels. "A six cent per gallon exemption from the excise tax on gasoline and diesel fuel is allowed for those fuels that contain at least ten percent alcohol."[76]

Both the production tax credit and the excise tax exemption would be terminated under Reagan's proposal. The credit for alcohol fuels, however, would be available only for eligible alcohol fuels produced from facilities completed before January 1, 1986, and the fuel sold before January 1, 1993.[77]

The production credit and excise tax exemption have encouraged the production of alcohol from corn and other grain products. Eliminating these provisions would reduce the future demand for corn and other grain products used in alcohol production.

Proponents of the alcohol fuel credit and excise tax exemption argue that these incentives are necessary to encourage development of viable alternatives to petroleum fuels. They point to the United States' dependence on imported oil and to actions by other countries disrupting international markets in recent years. Proponents also believe that the development of a domestic alternative fuels industry is essential to national security.[78]

Opponents of these incentives argue that they are inefficient and are unnecessary subsidies in light of current world oil market conditions. Opponents point out that the sixty cent per gallon alcohol fuels credit and the equivalent subsidy provided by the alcohol fuels excise tax exemption amount to a federal subsidy of $25.20 per barrel of oil equivalent.[79]

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75. CAPITAL INCOMES, *supra* note 17, at 143.
76. *Tax Reform*, *supra* note 6, at 29.
77. R.I.A., *supra* note 1, at 226.
78. CAPITAL INCOMES, *supra* note 17, at 128.
79. *Id.* at 129.

INCOME AVERAGING

Due to the current progressive tax rate structure, a taxpayer whose income varies from year to year will pay more tax than a taxpayer whose income remains stable over the same number of years. Income averaging lessens this effect. It, in effect, spreads income over four years which in turn lowers the tax rate for the current taxable year.[80] The proposal repeals the income averaging provisions.[81]

Eliminating income averaging would increase the disparity in tax treatment between taxpayers with fluctuating incomes, such as farmers and taxpayers with more stable incomes.[82] This would place inequitable tax burdens on farmers. A farmer whose income varies from year to year due to asset investment, low prices, or weather conditions, could find himself paying thousands of dollars more of income tax than a person with a steady annual income over the same period. Absent income averaging, a farmer with a family of four whose income alternates between $0 and $60,000 would pay $8200 more income tax over four years than a family of four with a steady $30,000 annual income. This difference would be reduced to $6100 with income averaging.[83]

STATE AND LOCAL TAX DEDUCTION

An individual may deduct state and local taxes paid in connection with his trade or business, or property held for production of rents or royalties, from gross income to reach adjusted gross income.[84] In addition, individuals who itemize their deductions are permitted to deduct state and local real and personal property taxes, state and local income taxes, state and local general sales taxes, and windfall profit taxes in computing their taxable incomes.[85]

The Reagan proposal repeals the itemized deduction for state and local taxes not incurred in carrying on a trade or business or income-producing activity. Itemized state and local taxes (other than income taxes), which are incurred in carrying on an income-producing activity, i.e. real estate taxes on land held for investment, would be aggregated with employee business expenses and other miscellaneous deductions and would be deductible as itemized deductions to the extent that the total exceeded 1% of the taxpayer's adjusted gross income. State and local income taxes would not be deductible.[86]

The current state and local tax deduction disproportionately benefits high-income taxpayers residing in states having a high tax burden.[87] Therefore, since farm families are more concentrated at the lower net-income levels

80. I.R.C. §§ 1301-1304 (West Supp. 1985).
81. R.I.A., *supra* note 1, at 111.
82. CENTER, *supra* note 7, at 11.
83. *Id.*
84. I.R.C. § 164(a) (West Supp. 1985).
85. *Id.*
86. R.I.A., *supra* note 1, at 64, 105.
87. *Id.* at 62.

than are families in the general population[88] and since South Dakota has a relatively low state tax burden,[89] most South Dakota farm families do not benefit significantly from the current deduction.[90] Consequently, South Dakota farmers would not be hurt by the change, and because Reagan's tax proposal is said to be revenue neutral, the deduction's repeal would shift a portion of the tax burden away from the South Dakota farmer. The repeal of this deduction is projected to generate $33.8 billion in national tax revenues for 1988.[91]

TWO-EARNER DEDUCTION

Two-earner married couples who file a joint return can claim a deduction of an amount equal to 10% of the lesser of $30,000 or the lower earning spouse's total compensation.[92] The amount of earned income does not include amounts received for services performed by an individual in the employ of his or her spouse.[93] This deduction would be repealed by the Administration's proposal.[94]

The effect of this proposed change will vary with the farmer's individual circumstances. Since the deduction is keyed to a percentage of the lower earning spouse's total compensation, no deduction may currently be available to farm families in which either the farming spouse generates no taxable income or the non-farming spouse is engaged in no outside employment. The marriage penalty under current law is primarily attributable to the progressive rate structure and the joint return concept.[95] Since Reagan's proposal sharply curtails the progressivity of the rate structure,[96] the need for such a deduction is lessened.

SPOUSAL INDIVIDUAL RETIREMENT ACCOUNT LIMIT

An individual can deduct contributions to an individual retirement account or annuity (IRA) up to the lesser of $2000 or 100% of includible compensation.[97] Generally, no deduction is available if an individual receives no compensation during a year. If a married individual's spouse, however, earned no compensation in a year for which a joint return is filed, special "spousal IRA" limits permit the earning spouse to deduct annual IRA contributions up to the lesser of $2250 or 100% of his compensation.[98]

The Reagan proposal would increase the "spousal IRA" limits to allow a

88. Clark, *Flat Tax Rate Would Hurt Farmers*, 102 DAKOTA FARMER 31 (1984).
89. R.I.A., *supra* note 1, at 68.
90. In 1982, South Dakota ranked 50th in the tax savings per capita ($20) resulting from the itemized deduction for taxes, despite ranking 36th in income per capita. *Id.*
91. *Id.* at 63.
92. I.R.C. § 221(a)(1) (West Supp. 1985).
93. I.R.C. § 221(b)(2)(A)(v) (West Supp. 1985).
94. R.I.A., *supra* note 1, at 16.
95. *Id.* at 15.
96. *Id.* at 1.
97. I.R.C. § 219(b) (West Supp. 1985).
98. I.R.C. § 219(c) (West Supp. 1985).

married individual filing a joint return to deduct annual IRA contributions up to the lesser of $4000 or 100% of his earned income, with a maximum of $2000 allocated to either spouse. In addition, rules may be adopted to prevent the deduction of interest expense attributable to indebtedness incurred to make deductible IRA contributions.[99]

The proposed increase is intended to permit certain married couples to set aside additional amounts in IRA's for long-term savings.[100] Individual retirement accounts are of great importance to farmers who often are not participants in other qualified employee benefits plans. Seemingly, this change would be beneficial to farm families where the non-farming spouse has no outside earnings on which to base an IRA contribution. In such a case, however, the non-farming spouse often contributes her services to the farming operation without compensation. A farmer can currently compensate his wife for the fair value of her services and deduct them on their joint return. There is no effect on total income because the wife's compensation is includible in gross income. The wife's compensation from her husband is includible compensation for the purpose of computing an IRA deduction and would allow the farm couple to deduct IRA contributions up to $4000 even under the current law.[101] This arrangement yields the additional benefit of reducing the farmer's self-employment tax. Thus, in many farm situations, the continuation of such a salary arrangement would be preferable to increasing the spousal IRA deduction. Also, the proposed law may have a negative effect on farmers to the extent that they are prohibited from deducting the interest expense incurred to finance the IRA contribution.

TAX SHELTERS AND AGRICULTURE

Investments receiving preferential tax treatment, such as the above-described rules relative to farming, invite the creation of tax shelters. This tax shelter potential attracts high-income individuals to agricultural investments because such investments allow them to report deductions as early as possible, to delay reporting of income, and to convert ordinary income to capital gains. Both farmers and non-farm investors can utilize these provisions to reduce their tax burden. A higher bracket taxpayer realizes a larger benefit from such mismatching of income and expense and, thus, will earn a higher after-tax rate of return than a lower bracket taxpayer on the same investment. Therefore, because ownership of assets will gravitate toward those who earn a greater return, investments with tax shelter characteristics will, in the long run, be concentrated in the hands of high-income taxpayers.[102]

In addition to altering the trend in farm ownership, tax shelters tend to reduce the profitability of existing family farms. Due to the inelastic demand for farm products, tax incentives producing short-term benefits may result in a

99. R.I.A., *supra* note 1, at 341.
100. *Id.* at 340.
101. I.R.C. § 219(b) (West Supp. 1985).
102. *Hearings*, *supra* note 61, at 24.

deterioration of long-run returns because of increased total production.[103] One group estimates that the higher tax costs under the President's proposal, resulting from the loss of the capital gain deduction on breeding stock, would be offset, due to decreased supply, by a 2 cent per calf price increase (assuming 15% bracket).[104]

Reagan's proposal does much to eliminate the tax shelter potential of agriculture. Required capitalization of preproduction costs, longer depreciation schedules, and the repeal of the investment tax credit significantly reduce the tax deferral incentives. The proposed changes to I.R.C. section 1231 reduce the opportunity to convert income on the sale of breeding stock from ordinary to capital gain.[105]

Other parts of the Reagan tax proposal, not discussed in length here, will also inhibit the growth of tax shelters in the agricultural area. For example, farms with gross receipts of over $5 million will be required to use the accrual method of accounting, reducing the tax deferral opportunities for large operations.[106] This threshold has been criticized as being too high and, therefore, unlikely to affect many farming businesses.[107] Investment interest expense, such as that incurred to purchase a partnership interest, will be deductible only to the extent of the sum of $5000 and the taxpayer's net investment income.[108] This is a decrease of $5000 from the current law.[109] Finally, the President proposes to extend the "at risk" limitations to real estate activities, limiting the investor's total deduction to the amount that he has directly invested, plus any additional amount for which he is personally liable.[110]

CONCLUSION

President Reagan's tax proposal no doubt contains some provisions which could adversely affect the individual farmer. Among these provisions are longer depreciation periods, repeal of the investment tax credit, changes in capital gains treatment of livestock and depreciable property, and capitalization of soil and conservation expenditures. Other provisions, such as the reduction in tax rates and the increases in the personal exemption and zero bracket amounts, are favorable to the farmer. Also, the proposal eliminates many tax preferences which have induced the formation of agricultural tax shelters. Such shelters have the effect of shifting farm ownership away from the family farmer toward the high-income taxpayer and of lowering farm profits due to overproduction.

The following table summarizes current law (1986) and the Administration's proposal:

103. *Id.* at 19.
104. CENTER, *supra* note 7, at 9.
105. *Id.* at 1.
106. R.I.A., *supra* note 1, at 213.
107. MINIMUM TAX, *supra* note 40, at 59.
108. R.I.A., *supra* note 1, at 323.
109. *Id.* at 322.
110. *Id.* at 326.

Provision	Current Law	Proposed Law
Tax Rates	15 brackets ranging from 11 to 50%	3 brackets: 15, 25, & 35%
Personal Exemptions	$1080 each	$2000 each
Standard Deduction	$3670 joint $2480 single	$4000 joint $2900 single
Spousal IRA Limit	$2250	$4000
Long-term capital gain	60% exclusion	50% exclusion
Two-earner deduction	10% of lower spouse's earnings up to $3000	None
Investment Tax Credit	6 to 10% of qualified investment	None
Depreciation	ACRS - 3, 5, and 18 year recovery periods	CCRS - indexed for inflation, 4 to 28 year recovery periods
Development Costs	Immediate deductions for conservation and land clearing	No immediate deduction, depreciation required
Cash Accounting	Cash accounting for most farmers	Accrual accounting for farms with gross receipts over $5 million
Income Averaging	Permitted	Repealed

Public enthusiam for tax reform has diminished over the past few months as great confusion exists as to the proper course of action. Nonetheless, the House Ways and Means Committee has begun drafting a new tax bill. It is already apparent that the Committee will not adopt all of the Administration's proposals. The success of the Administration's tax reform proposal will no doubt hinge on Reagan's ability to sell his ideas to the American public.

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