Impact of the FairTax on Agriculture and Ranching

There are now about 5 million Americans who live on farms and ranches. This is less than 25% of the number of people living on farms just a century ago.[1] However, farming and ranching remain as vital to our economy as they have been to our historic growth. With a total of 3.6 million U.S. workers employed in agriculture,[2 f] farming generated approximately $90 billion in Gross Domestic Product in 1997.[3] Agricultural products comprised 8 percent of all exports from the U.S., for a total of $51.8 billion in exported products in 1998.[4] Farms and ranches generate economic activity that transcends the rural communities in which they were produced, creating upstream jobs in manufacturing and downstream jobs in processing, distribution, retailing and advertising.

I. Farmers and Ranchers are Disadvantaged Under the Income Tax System

Some theorize that farming and ranching are subsidized under our current income tax system. The forms of these subsidies are said to be: favorable accounting[5 and] inventory methods,[6] certain income deferral provisions,[7] capital gain-ordinary loss treatment and expensing allowances.[8] However, in practice, farmers and ranchers pay a heavy price for our current tax system.

- ***Farmers and Ranchers Bear a Heavy Tax Burden***

Although the effective tax rate has been gradually declining from the stratospheric level of 1980, farmers and ranchers still bear relatively high income tax burdens on the operation of their businesses. The tax liabilities on the agricultural sector continue even in years in which there massive losses are incurred. The Chart below shows the effective tax rate on corporate farmers. Many family farms, however, are not incorporated.

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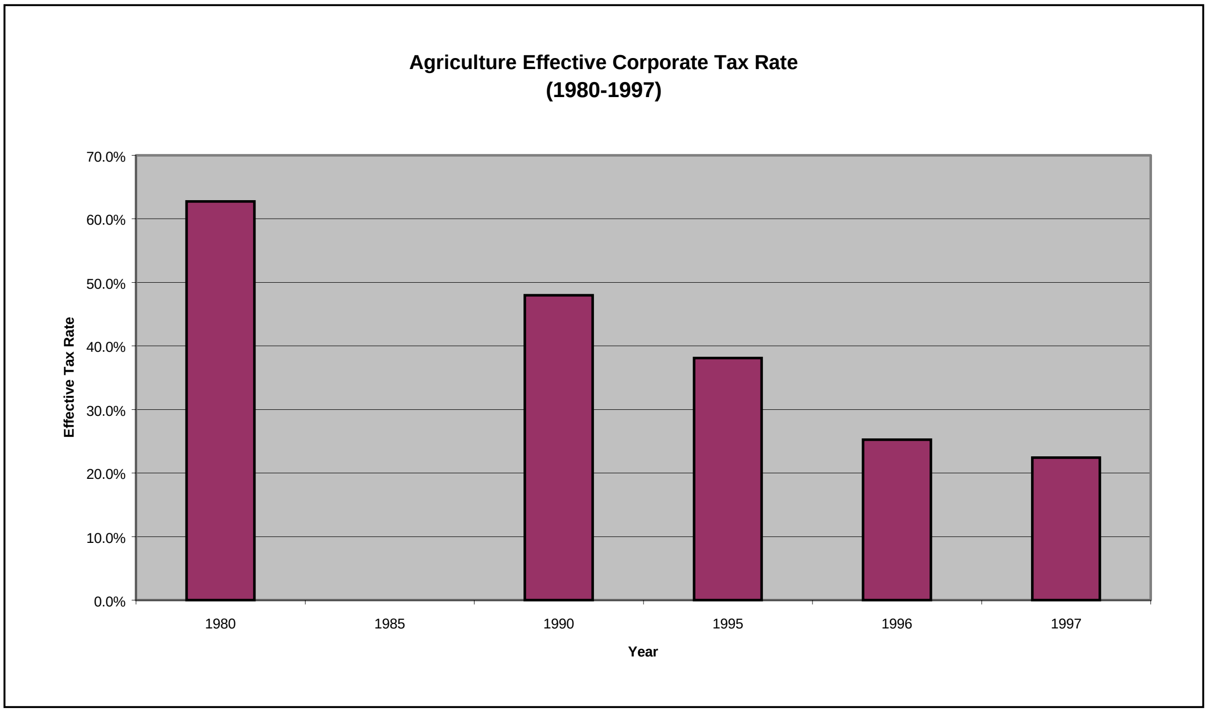
1 There are also only 2.2 million farms today, less than one-third of the number of farms in 1935.
2 Statistical Abstract of the United States, 119th Edition, 1999, Table 679.
3 To this figure we should add $38 billion in agricultural services. Statistical Abstract of the United States, 119th Edition, 1999, Table 1147.
4 Statistical Abstract of the United States, 119th Edition, 1999, Table 1121. Note: The U.S. also imported about $37.1 billion for consumption in 1998. The positive trade balance from agricultural products totals about $14.8 billion.
5 Internal Revenue Code (IRC) sections 448(b)(1) and 447. See also, IRC reg. secs. 1.61-4 and 1.471-6(a). For instance, small farmers may use the cash method of accounting, deferring items of income until actually or constructively received, except for larger farms, which must use accrual accounting.
6 IRC sec. 471 and reg. sec. 1.471-3 *et seq*.
7 An example is the like-kind exchange rules for trading of livestock. See IRS sec. 1031(e).
8 More specifically, unlike analogous expenditures for manufactures, farmers my deduct costs of operating a farm for profit, i.e., rent, labor, feed and fertilizer, which otherwise are required to be capitalized. IRC reg. sec. 1.61-4(c).



Note: The effective tax rate in 1985 would be effectively infinite since farmers paid $345 million in taxes on a net loss of $74 million. Source: Statistic of Income Bulletin, Spring 2000, Table 14.

- ***The Nature of Farming Creates Unique Problems Under Current Tax Law***

Apart from the high effective tax rate, our current tax regime poses additional problems for farmers and ranchers. Farming and ranching are unique for several reasons: they involve long-term effort and are high risk, are family-owned and operated and involve an investment of capital in assets that are mostly illiquid. Approximately, individuals, family partnerships or corporations today own 99 percent of U.S. farms and ranches with fewer than 10 stockholders. Non-family corporations own only 0.4 percent of farms and ranches.[9] Farmers and ranchers are often correctly characterized as asset rich and cash poor because almost all their resources are concentrated in one of the most illiquid of assets – the family enterprise. These special problems fall into three categories: (1) the confiscatory tax imposed on the sale, exchange, gift or bequest of the farm or ranch, (2) the increasing application of the alternative minimum tax to farming and ranching (which will become a huge problem over the next decade), and (3) the failure of the current tax code to take into consideration fluctuations in year-to-year income.

The concentration of wealth and savings in these illiquid assets conflicts with the capital gains tax regime. The current capital gains tax structure imposes a tax of as much as 30 percent on the sale or exchange of farms and ranches.[10] Indeed, it often makes little economic sense for the farmer or rancher to get out of the business of farming or ranching with such an extraordinarily high exit toll.

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[9] American Farm Bureau Federation, Website: www.fb.com/ffindex.htm.

[10] Additionally, the current capital gains tax structure acts as a disincentive to investment in many farmer-owned cooperatives, since many cooperatives have established a value-added operation within their co-op structure, which is funded by a class of equity stock.

Moreover, since the capital gains tax on the transfer of farmland or rangeland is not adjusted for inflation, much of the real wealth gains are lost at transfer due to the capital gains tax on "phantom" profits. In fact, land values have seen only modest real gains over the last three decades. If it were not for inflation, the price of much of this nation's farmland would be about the same as it was in the late 1960's.[11]

The problem is magnified when the farmer or rancher attempts to pass the enterprise to succeeding generations. Since the estate tax imposes steeply graduated taxes on the value of assets, heirs are often forced to sell the farm out of the family to pay death transfer taxes that can range from 15 to 55 percent. Moreover, when they do sell the farm, they still must endure capital gains taxes. The net effects of transferring a farm from one generation to another are taxes that can range between 70 to 75 percent of the value of the farm. These taxes often prevent the transfer of family farms from generation to generation, and amount instead to a leveraged buy-out of the family farm by the Federal government.[12]

The current tax regime also conflicts with the high-risk nature of the industry. Because farming and ranching income levels fluctuate with the triple threat of uncertainty of unpredictable risk, steeply graduated income tax rates, and the year-to-year system of income taxation, farmers and ranchers pay a higher tax rate than if their income were averaged over the course of many years.

Additionally, the Alternative Minimum Tax (AMT) negatively affects farmers and ranchers. In recent years, the IRS has subjected farmers to AMT liability when they use deferred payment contracts in the ordinary course of business.[13]

II. The FairTax Eliminates These Disadvantages

- ***The FairTax Will Eliminate all Federal Individual and Business Taxes***

The FairTax will completely eliminate any federal taxes imposed on the production of income. Farmers will never again pay tax on the income from farming profits. Income will no longer be reported on the Schedule F, since no returns will be filed. Moreover, the FairTax applies only when a farmer purchases goods or services for personal consumption. Business to business transactions will not be taxed, and therefore, the purchase of items such as machinery, feed, fertilizer or services will not be taxed. The FairTax will eliminate more than $600 million in federal income taxes currently imposed upon the agricultural industry. It will also eliminate the self-employment tax.

[11] The high inflation rates of the 1970's added to this problem.

[12] In many parts of the U.S., the average farmer or rancher is nearly 55 years of age and has held his land for a number of years. That same farmer or rancher is concerned about retirement and would like to use the capital investments acquired through the past 30 years as the base for an adequate retirement plan.

[13] Farmers use deferred payment contracts to defer the receipt of income from a sale at the time the commodity is delivered. Historically, farmers have been able to pay taxes on income from the sale of a commodity at the time the proceeds from the sale are received. The result of the current policy forces farmers to be liable for taxes in the year the crop is sold rather than when income is received.

- ***The FairTax Will Lower the Effective Tax Rate on Farming Households***

The FairTax will favorably impact farming households by lowering the tax rates that they currently pay. Under a sales tax regime, the maximum tax rate possible will be 23 percent on purchases at the retail level. This rate is well below the average, effective tax rate now imposed on farming operations. More importantly, the actual tax rate paid by farming households will be significantly less than 23 percent, since each family is provided a tax rebate which assures their ability to spend tax free for their basic needs. In this way, the FairTax, unlike the current system, exempts from taxation the basic necessities of life. This is accomplished by providing a rebate to each family equal to the taxes paid on the purchase of essential goods and services, as determined by the Health & Human Services Poverty Level. The rebate would be paid monthly, in advance, to every family.

FairTax Monthly Rebate Chart

		Single Person	Single Person	Single Person	Married Couple	Married Couple	Married Couple
Family Size	HHS Annual Poverty Level[14]	Fair Tax Annual Consumption Allowance	Annual Rebate	Monthly Rebate	Fair Tax Annual Consumption Allowance	Annual Rebate	Monthly Rebate
1	$ 8,350	$ 8,350	$ 1,921	$ 160	$ 8,350	$ 1,921	$ 160
2	$ 11,250	$ 11,250	$ 2,588	$ 216	$ 16,700[15]	$ 3,841	$ 320
3	$ 14,150	$ 14,150	$ 3,255	$ 271	$ 19,600	$ 4,508	$ 376
4	$ 17,050	$ 17,050	$ 3,922	$ 327	$ 22,500	$ 5,175	$ 431
5	$ 19,950	$ 19,950	$ 4,589	$ 382	$ 25,400	$ 5,842	$ 487
6	$ 22,850	$ 22,850	$ 5,256	$ 438	$ 28,300	$ 6,509	$ 542
7	$ 25,750	$ 25,750	$ 5,923	$ 494	$ 31,200	$ 7,176	$ 598
8	$ 28,650	$ 28,650	$ 6,590	$ 549	$ 34,100	$ 7,843	$ 654

Table 1: This table shows the monthly rebate that families would be entitled to in 2000, under the FairTax Bill. The family allowance is based on family size and is determined by the government's Poverty Level. All lawful residents holding valid Social Security numbers would be eligible for the rebate. Monthly rebates would be sent out in advance of purchases to assure that no taxpayer pays taxes on essential goods and services.

For example, under the FairTax, a family of four spending at or below the poverty level would have a negative effective tax rate, because of the rebate. This same family with expenditures of $45,000, an amount two times the poverty level, will pay an average tax of only 11½ percent. If they spend $90,000 they would pay an average tax rate of only 17¼ percent. The average income for farm-

[14] Federal Register: February 15, 2000 (Volume 65, Number 31, Pages 7555-7557).
[15] The annual consumption allowance for a married couple without children is two times the annual consumption allowance for a one-person household.

operated households in 1995 was $59,734.[16] This household under current tax law would have paid a self-employment tax alone of 15.3 percent on their income, in addition to income tax. The total tax liability for an average, farming family under current law would therefore far exceed the maximum tax rate imposed under the FairTax.

- ***The FairTax Will Eliminate All Capital Gains and Estate Taxes***

In addition to eliminating income taxes, the FairTax will eliminate both capital gains and estate and gift taxes. Unlike current law, the FairTax would not penalize capital-intensive investments, it would allow farms to be sold without imposition of a percent capital gains tax on increases in price (including those caused only by inflation), and it would not penalize transfers to succeeding generations. The FairTax would ensure that no tax would be imposed on capital purchase, sales or transfers.

III. The FairTax Will Have Other Beneficial Effects

- ***The FairTax Will Completely Eliminate Compliance Costs for Most Farmers***

Under the FairTax, there will be no more inventory capitalization requirements, no more complex rules governing employee benefits and retirement plans, no more tax depreciation schedules, no more capital gains tax, no more alternative minimum tax and no more depreciation recapture.. In place of having to comply with the complexities of the IRS system's income and payroll taxes, there will be one sales tax imposed only on new goods and services purchased for personal consumption. If the farm makes retail sales to a final consumer, the farm would simply need to collect and remit on a monthly basis a 23 percent retail sales tax. All sales to other business would not be taxable transactions.

- ***The FairTax Will Stimulate the Economy***

Farmers and ranchers will benefit from a more prosperous, growing economy. Real wages will increase,[17] and all known economic projections predict a much healthier economy. Typical estimates are that the economy will be 10 to 14 percent larger than it would have been under the income tax system within 10 years; consumption will grow very substantially. Some studies show the potential gains to be much higher.

- ***The FairTax Will Reward Savings Over Consumption***

If any businessman knows the value of savings, it is the American farmer and rancher. The FairTax will reward efforts to save by never again taxing income from savings. The only time an individual is taxed is when he or she purchases items beyond the necessities of life for his or her own personal enjoyment.

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[16] Agricultural Income and Finance Situation and Outlook, February 2000 [Table 23, Income and Net Worth of Farm Operator Households, 1998], U.S. Department of Agriculture, Economic Research Service.

[17] These studies typically do not account for the productivity gains that will be achieved due to lower compliance costs.

- ***The FairTax Will Lower Interest Rates***

One of the best attributes of the FairTax is that it will cause a drop in interest rates and reduce the carrying costs of this debt. Under the FairTax, conservative estimates predict that mortgage interest rates will fall by 25 to 30 percent, or about two points on a thirty-year conventional mortgage.[18] For example, for a $150,000 thirty-year home mortgage at an interest rate of 8 percent, the monthly mortgage payment would be $1,112.64. On that same mortgage at a 6 percent interest rate the monthly payment would be $907.64. The two-point decrease in interest rates in this instance would result in a $73,800 interest cost savings to the consumer.

- ***The FairTax Will Make American Products More Competitive Internationally***

The FairTax will improve the trade balance for agricultural and ranching products because it will not tax meat, dairy, grain or other agricultural products. Exported goods are not consumed in the U.S and are therefore, not subject to the sales tax. On the other hand, imported goods will be subject to the sales tax for the first time, taxing that property either when sold at retail in the U.S. or at the border with customs duties.[19]

[18] For an more detailed discussion of the impact a national sales tax would have on interest rates, see John E. Gobb, *Economic Review*, Federal Reserve Bank of Kansas City, “How Would Tax Reform Affect Financial Markets?” Fourth Quarter, 1995. He estimates a 25-35 percent drop (p. 27). See also, Martin Feldstein, “Effect of a Consumption Tax on the Rate of Interest,” National Bureau of Economic Research, Working Paper No. 5397 (December, 1995).

[19] The FairTax plan does not tax intermediate goods and services since those goods and services will be taxed when they are sold to the final consumer (i.e., the tax does not cascade).