10-30-1980

Seminar On Federal Taxation And The Structure Of Agriculture

Charles Davenport
Iowa State University

Follow this and additional works at: http://lib.dr.iastate.edu/econ_las_staffpapers

Part of the Agribusiness Commons, Science and Technology Policy Commons, Taxation Commons, Taxation-State and Local Commons, and the Tax Law Commons

Recommended Citation
http://lib.dr.iastate.edu/econ_las_staffpapers/60

This Report is brought to you for free and open access by the Economics at Iowa State University Digital Repository. It has been accepted for inclusion in Economic Staff Paper Series by an authorized administrator of Iowa State University Digital Repository. For more information, please contact digirep@iastate.edu.
Abstract
Over the past half century, the structure of agriculture has been marked by change. Since little was known about these changes, Secretary Bergland initiated an inquiry into the forces that produced them. One area examined was Federal tax policy. While the theoretical and empirical tax work was not in final form by the summer of 1980, several major themes had emerged from it. They were largely consistent with prior theoretical work. To test them against practical experience, the Department of Agriculture asked five of the Nation's most prominent and skilled farm tax practitioners and commentators to prepare papers on tax policy structure.

Disciplines
Agribusiness | Science and Technology Policy | Taxation | Taxation-State and Local | Tax Law

This report is available at Iowa State University Digital Repository: http://lib.dr.iastate.edu/econ_las_staffpapers/60
SEMINAR ON
FEDERAL TAXATION AND
THE STRUCTURE OF AGRICULTURE

No. 124
Seminar on
Federal Taxation and the Structure of Agriculture*
Held October 30, 1980
at the Department of Agriculture

*This seminar was held well before the Economic Recovery Tax Act of 1981 became law. Indeed, at the time of the seminar, the proposals that eventually became law had not been suggested. Some conclusions reached at the seminar might not be appropriate under the new law. At some places in this summary, the possible relevance of the 1981 Act is raised.
INTRODUCTION

by Charles Davenport

Over the past half century, the structure of agriculture has been marked by change. Since little was known about these changes, Secretary Bergland initiated an inquiry into the forces that produced them. One area examined was Federal tax policy. While the theoretical and empirical tax work was not in final form by the summer of 1980, several major themes had emerged from it. They were largely consistent with prior theoretical work. To test them against practical experience, the Department of Agriculture asked five of the Nation's most prominent and skilled farm tax practitioners and commentators to prepare papers on tax policy structure. They were:

Philip Wile, Esq.
Thomas, Snell, Jamison,
Russell, Williamson and Asperger
Fresno, California

Prof. Neil E. Harl
Department of Economics
Iowa State University
Ames, Iowa

Philip Ridenour, Esq.
Ridenour & Knobbe
Cimmarron, Kansas

Alfred J. Olsen, Esq.
Olsen-Smith, Ltd.
Phoenix, Arizona

Prof. Roland Hjorth
School of Law
University of Washington
Seattle, Washington
These papers, reproduced after this Introduction, were prepared for use in a seminar on taxes and structure held in Washington, D.C. on October 30, 1980. At this meeting, each author summarized his views. Questions were propounded by a panel consisting of Department personnel and the outside contractors most closely involved in the tax aspects of the Structure project. Near the end of the session, some questions were asked by persons attending the seminar.

While a full transcript of these proceedings was made, it is not published. Instead, each of the prepared papers is presented with a short summary of the major points raised. The purpose here is to summarize the major conclusions that had a broad base of support. While consensus might not exist, major controversy about these points did not seem to exist.

High Level of Taxes and Special Tax Privileges

The level of Federal taxes was deemed high although the standard by which to measure the tax level was not established. It may be that present tax burdens are high compared to tax burdens of the past and that comparison is made in dollar terms without significant adjustment for inflation, progressivity arising from higher incomes (both real and inflation driven), or the larger size farm operations. Land values have outpaced inflation significantly, and the possibility of an estate tax on the death of the last of the older generation is now realistic for operations that are viewed as small although they are large by historical standards.*

While taxes are viewed as being high, there are tax preferences, some unique to agriculture and some not, that farmers may utilize to lower tax

*This seminar was held before the Economic Recovery Tax Act of 1981 became law. The Act would undoubtedly have an impact on this conclusion. Certainly, under the 1981 Act, fewer estates will have a tax imposed on them.
burdens from these high levels. Because the tax savings offered by these preferences are substantial, they justify the expenditure of considerable time and resources. They are also vital. Indeed, advantage may be lost to competitors if close attention is not paid to tax matters. This need to allow tax considerations to shape commercial and familial transactions is relatively recent on the farm scene and is generally not welcomed. There is substantial concern that tax considerations play far too large a role in farm planning but that they are inescapable so long as high taxes can be reduced by careful planning.

This planning is made difficult by at least two factors. First, the commercial needs of the farmer may conflict with forms necessary to secure tax advantage, but even where there is no conflict, commercial aspects may be difficult to fit within the tax mold. Second, the tax law is complex and frequently uncertain. Unsympathetic and technical interpretations of the law by the Internal Revenue Service exacerbates the uncertainty. As a consequence, certainty in achieving the desired and apparently permissible tax result may be elusive even where the commercial transaction can be freely shaped to satisfy the tax advisor's opinion.

Tax law thus introduces factors that have been foreign to agriculture. These factors sometimes seem to take on an importance that is greater than the many thremmatological decisions. As a result many decisions are made, almost by necessity, on the basis of alternatives laid out by expert advisers rather than by farmers. Farmers may well feel that control of their destinies has slipped from their fingers to tax professionals. While professionals do lay out alternatives, concern, worry, and the inherent risks cannot be effectively shifted from the farmer. The farmer thus is burdened with the need to deal
with unfamiliar, complex, and unproductive matters at the expense of production or leisure. Ways in which this burden could be reduced should be a high priority of policymakers in the agricultural sector.

The tax preferences arising from the use of cash accounting have another significant aspect. The tax on income can be deferred by holding the product in kind or by investing the income in farm assets for which a deduction may be taken at time of payment. In either case, there is an encouragement to hold income in the form of farm assets—that usually can be rather quickly converted to cash or used in the production of new crops. Assets so held form a kind of reserve that is available to the farmer when times are bad. This reserve is larger than other businesses might have with the same income because unlike many other businesses, these farm reserves are accumulated from income that has not borne tax. Also, because such reserves are held in the form of farm products, assets, or supplies that are readily available for farm use, there is little chance to dissipate them or to invest them in illiquid assets. The tax law thus is a positive encouragement to sound financial planning. This planning and the reserves that it produces may lead to a resiliency that will help in tiding a farm operation over difficult economic events.

High Land Prices

There was unanimity that land prices are too high. Farmers are unable to finance the purchase of land through its annual return even when the land is intensively cultivated and devoted to a high cash yielding crop. To some extent, land prices are higher with the present tax system than they would be either without any tax system or with a tax system that did not contain preferences for some kinds of farm investments.
At least three tax preferences were viewed as contributing to these higher land prices. Since 1976, the valuation for estate tax purposes of some farms is not at market value but rather at a lower "special use valuation" that was designed to reflect annual cash return rather than market values. Qualification for this provision requires that the land be held and used for farming purposes for 5 of the last 8 years before death. Disposition before 15* years after death can lead to the loss of some or all of the tax savings produced by the lower values. These provisions were seen as increasing the demand for land (in effect, capitalizing the estate tax savings into the value of the land) while at the same time lessening somewhat the supply of land offered for sale because of less need to liquidate assets to pay estate taxes and because of the restrictions on dispositions in the estate tax preference.

Another factor putting pressure on land prices was the combination of deductible carrying costs (particularly interest) and exemption from tax of much of the gain on land. Where the landowner has income that would otherwise be taxed at high rates, this combination can produce a large tax reduction on this other income while producing a much lower or perhaps no tax liability on increases in the land's value. In short, so long as there is a progressive income tax, a taxpayer in this situation in effect receives a check from Treasury. This effect is especially pronounced in times of inflation, and it makes farmland very appealing as an investment and thus produces a larger demand for the land than would exist without this particular combination. This set of preferences is not unique to agriculture.

*The Economic Recovery Tax Act of 1981 reduced the holding period to 10 years.
Essentially, the same phenomenon is produced by use of cash accounting and by the allowance as deductions of development costs of orchards, vineyards, herds, and similar assets. A tax shelter is created, and the shelter creates a higher level of demand for these assets, but particularly for land. These features then exert more upward pressures on land prices.

There was recognition that these preferences frequently confer greater benefits on taxpayers in high brackets than on taxpayers in lower brackets. Due to the tax law, higher bracket taxpayers are provided more funds with which to grow than are smaller farms.

Farmers and Tax Complexity

The highly complex nature of the tax law was alluded to above. It leads to uncertainty and excessive devotion of resources to tax planning. But, it also creates a sense of frustration and is frequently deemed unfairly arbitrary.

Much of the complexity arises from needs to define farming or farmers. This need initially arose from regulations that prescribed certain rules for the reporting of farm income. Subsequently, special legislation for declarations of estimated tax by those whose income was two-thirds farm income built that need into the statute. Later, its statutory foundation was expanded when provisions were enacted that allowed farmers to deduct expenditures made for soil and water conservation and for clearing land. Several recapture provisions contained in the 1969 legislation relied on the concept of farming and farmland. More recently, some aspects of the 1976 special use valuation provisions are limited to farmland, and in the same year, farming was defined for the purpose of limiting deductions for farming syndicates.
Generally, these definitional problems have arisen in the tax preferences that are limited to farms or farmers. Because the outlines of the target group frequently are not precise—indeed may be unknown even to the draftsman, application of unclear language to the innumerable factual patterns leads to paradoxical results. One panelist opined that intended taxpayers are sometimes excluded and that unintended taxpayers were sometimes included. As a consequence, policies that set off farmers for special tax treatment may not achieve that result. The inherent difficulty of drafting such distinctions in a coherent and rational fashion was discussed. Yet, there was unanimity that to the extent that there were special benefits for farmers, they should be limited to farmers. That sentiment can be expressed in several ways. That "tax sheltering" occurs only when "non-farmers" take advantage of farm rules. Or that "non-farmers" should be disabled from using the shelter rules.

The Corporation's Place on the Farm

The number of incorporated farm operations has increased in recent years. This trend can be expected to continue because incorporation produces tax savings and alternatives that are not available to sole proprietorships or partnerships.* These benefits are not, however, unique to farming but are generally available to all businesses.

The overall tax burden sometimes is lower when the operation is incorporated. Also, incorporation may allow owners of the farm to be provided with tax-free fringe benefits. Transmission of property to heirs can frequently be

---

*This seminar was held almost a year before the Economic Recovery Tax Act of 1981 became law. It undoubtedly would have an impact on this conclusion. It is possible that the incentives for incorporation are not so great now.
facilitated by incorporation. As a practical matter, there is little management or operational difference between incorporated and unincorporated operations.

Legislative Possibilities

Several general ideas were offered for consideration as legislative proposals. They are repeated here, not as recommendations nor as fully worked out legislative proposals, but for the purpose of reporting the proceedings, for the help they give in isolating the apparent problems, and for the purposes of making them available for discussion by the industry and policymakers. The considerations underlying them are given, but no analysis or comment is presented here.

1. Farm tax preferences should be limited to farmers.

   As noted above, there is substantial concern about the effect of farm tax rules in attracting non-farm investment. The consequence is greater production of some farm products and thus lower prices while at the same time land prices are pushed upward by tax shelter dollars. The solution proposed was to limit the use of the permissive farm tax rules to farmers.

2. Devices for lowering estate taxes, such as Section 2032A, should be in the form of a tax credit and should not be tied to specific kinds of assets.

   Section 2032A produces tax reduction by allowing an exclusion from the tax base. In a progressive tax, as the estate tax is, equal reductions in tax base produce quite different amounts of tax relief for taxpayers in different tax brackets. If the relief were converted to a credit, presumably the same tax relief would be provided for the same reduction in value.
In addition, Section 2032A is tied to providing tax relief on specific asset—farmland. When tax relief is tied to a specific asset, the relief usually is capitalized into the value of the asset and thus distorts the allocation of capital. Also, it offers no relief to those who do not own the asset although they may be equally engaged in meritorious activity (although the 1976 Act had the sole purpose of reducing estate taxes on farmland).

3. Persons other than legitimate farmers (however defined) should be required to capitalize interest paid on debt incurred or continued to finance the purchase of agricultural land.

This recommendation flowed from the discussion about farmland as an ideal tax shelter because all carrying costs are deductible while little if any of the income produced by these costs is taxed. While one approach might be to tax unrealized appreciation, that alternative was not offered because it would require an annual valuation of land.

The approach suggested would disallow carrying costs until such time as the appreciation was realized. It might not apply to many farmers because most farmers are probably in relatively low tax brackets, and thus the competitive advantage between high and low bracket taxpayers would be lessened.

4. A study be conducted for the purpose of finding an appropriate tax method for farmers.

This proposal seems grounded in the belief that the present tax laws may influence agriculture in inappropriate ways. The study would isolate the ways in which tax laws influence agriculture and then suggest an appropriate means of taxing agricultural profits. Apparently, the new method would be limited to farmers and would preserve for them the advantages now flowing from the ability to create tax-free reserves.
FEDERAL TAX LAWS AND THE
STRUCTURE OF AGRICULTURAL OPERATIONS
by Philip H. Wile*

Analyzing the effects of the Federal tax laws on the structure of agricultural operations in the United States in the year 1980 may be a little like undertaking the completion of a crossword puzzle partially done in ink by someone else who was not always correct as to those portions already completed. We cannot start at the beginning since agriculture has been operating under tax rules applied to it in various ways and under various interpretations for several decades—tax rules which at least initially were developed without too much emphasis on more sophisticated policy considerations. In light of this historical background, any attempt, at this point, to adjust the tax rules applicable to agriculture to effectuate underlying economic, social and political policy considerations may be difficult if not impossible.

The history of the applicable tax rules and principles and their effect on agricultural operations has already been well summarized. See Jamison, "Tax Planning with Livestock and Farming Operations," 1961 So. Cal. Tax Inst. 538 (1961); "Structure Issues of American Agriculture," U.S. Department of Agriculture, Economics, Statistics, and Cooperatives Service, Agricultural Economic Report 438, 152 through 160 (1979). Briefly, until 1946, the tax rules, at least the income tax rules, applicable to agricultural operations were extremely permissive as compared to the rules applied to other economic activities. From 1946 to date, those engaged in agricultural operations and

*Partner, THOMAS, SNELL, JAMISON, RUSSELL, WILLIAMSON and ASPERGER, Fresno, California.
their tax advisers have witnessed steadily increasing restrictions on these permissive rules. These restrictions came initially through actions of the Treasury Department. See, e.g., Mim. 6030, 1946-2 C.B. 45 and Mim. 6030, supp. 1, 1948-1 C.B. 42. More recently, they have come from Congress, primarily in the Revenue Acts of 1969 and 1976. Although the activities of the Treasury Department in this regard have been of more general application to all or substantially all farming operations, those of Congress have been in many cases of limited application. It would be difficult to characterize the present tax rules applicable to agricultural operations as either "permissive" or "restrictive." The application of the present rules, regardless of their characterization, suggests several concerns to one who attempts to analyze the effects of the tax law on the structure of agricultural operations.

The more permissive income tax rules applied to farmers over the years which have been most extensively used have included both (1) liberal deduction allowances with respect to expenditures which ultimately generated capital value, and (2) allowance of use of the cash method of accounting which facilitated greater control over the timing of taxable income and expenses. These rules have tended to encourage and stimulate the development of capital in farming operations. In effect, farmers have for decades been increasing the size of their holdings and the scope of their operations through the use of funds which might otherwise have been drained off in the payment of Federal income taxes. In a sense, farmers were among the first to utilize the tax shelter concepts which have more recently become so attractive to other investors in farming operations.
The use of current ordinary income deductions and tax deferrals available under these rules also enabled farmers to reduce their need for borrowed capital and to establish effective economic reserves against adverse weather, marketing or other business conditions. For example, the farmer who has developed a vineyard, a few acres at a time over a number of years, utilizing deductible development costs to offset income from the vines which are the earliest to produce and effectively timing income realization through the deferral of income at year end and the acceleration of year-end expenses, may not only have built his vineyard in large part out of capital generated from wise tax planning, but may also have established a reserve (usually in the form of income from one year’s crop deferred to be realized in the next year) against the year when weather, marketing or other conditions might make it impossible for him to realize income from all or a substantial part of the crop produced in the later year from the property. Since the expenses of each year's crop must generally be incurred before the crop is harvested and produces income or is made uneconomic to harvest by unforeseen events, these reserves have provided a valuable protection against financial ruin produced by the loss of a single crop.

Since the promulgation of MIM. 6030 in 1946, we have seen steady progress toward restricting the more permissive rules which existed prior to that time. Many of these restrictions have been applicable generally to all farmers. To the extent that they have applied or been applied to those actually engaged in productive farming operations (as well as to those who have utilized farming to provide tax shelter for income generated from other economic activity), these restrictions have tended to cut back the farmer’s opportunity
to develop capital and establish reserves out of tax savings. In formulating some of the more recent restrictive rules, Congress has attempted to apply its new restrictions only to those who might be classified as "investors" in farming rather than those directly engaged in farming. See, e.g., Internal Revenue Code Sections 278(b) and 464 as enacted in 1976 (which require capitalization of certain expenses incurred by a "farming syndicate" as defined in Section 464(c)). Congress seems to be telling us that it does not wish to withdraw the advantage offered to real farmers by some of the more permissive rules applicable to farming operations, but only to keep non-farmers from taking advantage of those rules. I believe such a policy is basically sound. However, most of the legislation which attempts to draw this line is extremely complex and has not fully achieved the desirable goal of differentiating between the "investor" and the "farmer." I have heard it said that the "investor" who wants to avoid the restrictive rules enacted to apply to him (as opposed to the "real farmer") need only acquire a pair of boots and a pickup truck for use in his occasional visits to the ranch.

The somewhat spotty effort by Congress to differentiate between the "investor" and the "farmer" has not always been successful. In some situations this legislation has the effect of classifying a family which has been engaged in agricultural operations as a primary economic activity for years as an "investor." For example, the definition of a "farming syndicate" in Section 464(c) of the Internal Revenue Code would appear to require that a farming operation conducted by the estate of a deceased spouse (or a trust established under the Will of a deceased spouse) and the surviving spouse be treated as a "farming syndicate" where the estate holds the deceased spouse's
community property one-half interest in the assets of an unincorporated farming business owned by the decedent and the surviving spouse as their community property prior to the decedent's death, at least so long as the fiduciary of the decedent's estate (or trust) does not actively participate in management of the farming operations. Obviously, such an operation should not be and never was intended by Congress to be classified as a "farming syndicate."

One of the initial efforts by Congress to reach those using the more permissive tax rules applicable to the expenses incurred in the development of agricultural properties to shelter non-farming income, is itself an example of restrictions which, because of the broad way in which they were drafted, apply to farmers engaged in that activity as a primary source of income as well as to investors. Section 278(a) of the Internal Revenue Code added in 1969 required the capitalization of development expenses (including cultural and maintenance costs incurred during the development period which would otherwise be deductible) incurred during the first four years of development of a citrus grove or almond orchard. The legislative history behind this unusual statute clearly shows that Congress was concerned about the use of citrus and almond development by high income taxpayers in the professions, the entertainment industry and other non-farming sectors of the economy. But the statute, as enacted, applies as well to the farmer who has been engaged in that activity all his life, to the extent that he elects to go into or to expand his holdings in citrus or almonds. The enactment of this statute had a significant effect on the citrus and almond businesses as well as the citrus and almond development tax shelters.
To the extent that the new restrictions on the previously favorable income tax rules applicable to farming operations have been made applicable to true farmers as well as investors, those newer, more restrictive rules tend to discourage entry into the farming business by those interested in farming as a primary earning source and to change the rules of the economic game for those already engaged in farming, frequently to their detriment. If farming operations and the production of food and fiber for national and worldwide consumption are to be encouraged for the long run by more favorable tax rules, the new restrictions on these rules, to the extent that they apply to those engaged in full time farming operations or to those who would enter this line of economic activity, operate to frustrate that broader economic policy.

Viewed in this light, the provisions of Section 278(a) discussed above would suggest that Congress has decided that the production of citrus and almonds is no longer to be encouraged while the production of other fruits and nuts is. I doubt that this is really what Congress said or even thought about in enacting that section. Of particular concern in this connection, should be the effect of new restrictions on entry into the farming business through the requirement of greater initial capital resources independent of tax savings.

Another striking example of the misdirection of restrictions placed on the established, more permissive rules which is or should be of great current concern to farmers and their tax advisers may be seen in recent developments which indicate a full-scale Treasury Department attack on use of the cash method of accounting to control the time of realization of taxable income from farming operations. This apparent Treasury Department effort is evidenced in Private Rulings Numbers 8001001 and 8004074 and in the litigation
position taken in *Griffith*, 73 T.C. No. 76 (1980) and *Watson v. Commissioner*, 613 F. 2d 594 (Fifth Cir. 1980) in which the government was successful and *Sprague v. U.S.*, 46 AFTR 2d. 80-5536 (Tenth Cir. 1980) in which the taxpayer prevailed. Although the factual situations differed, the Private Rulings and the *Griffith* case at least involved an attempt by the Internal Revenue Service to treat income from farming which would have been effectively deferred to a later year under well established applications of the cash method of accounting to be realized and taxed in the current year. To date this Treasury Department effort appears to be intended for general application to all engaged in farming operations. To the extent that this attempt to revise law settled for decades is intended to restrict the tax shelter opportunity from farming operations for those attorneys, doctors and other professionals and businessmen who have, in the past, successfully sheltered significant amounts of non-farm income from tax, it is tempting to commend it. But to the extent that the Treasury Department's attack applies to farmers generally, it should be of great concern not only to agriculture but to the public generally which depends upon agriculture for its food and fiber.

With a few notable exceptions, Congress and the Treasury Department have never been known for their prompt and expeditious attack on abuses developing under the tax laws. This is certainly true with respect to the use of farm tax shelters to protect non-farm income from tax as developed during the 1960's and 1970's. The delay by the Treasury Department and by Congress in efforts to act with respect to this serious problem of tax policy has made and is still making farming activity an attractive source of tax shelter for many investors who are not farmers. (Indeed, to a degree, the more aggressive
attack on other tax shelters has tended to encourage the use of farming as a source of shelter.) Professionals and other high income taxpayers whose income comes from sources other than farming are far better able to afford the economic losses generated from farming "tax loss" operations than can those actually engaged in the farming business who depend upon it for all or a significant part of their income. These same investors can also afford to operate farm properties at substantial economic losses indefinitely with a view toward the ultimate gain which will be realized when the property is disposed of at a significantly appreciated price. All of this has tended to depress prices for farm products and inflate the price for farm land to a point where, in the area of my practice, most agree that agricultural property can no longer be purchased at today's prices out of funds generated exclusively from farming operations. Since 1976, when Congress first attempted to restrict the use through farming syndicates of ranch development costs as a shelter for non-farm income, thus making developed, producing vineyards and orchards a better source of tax shelter than raw land, the rate of increase in the price of developed vineyards and orchards in the area of my practice has tended to be greater than the rate of increase in the price of raw land—just the opposite of the trend before 1976.

Because farmland has been priced over the price which allows it to be purchased out of operating revenue, entry into the farming business is being restricted to non-farmers who are seeking tax shelters for non-farm income or to those who are already so heavily involved in farming at a profit that they are able to derive tax shelter benefit from new farm properties equivalent to that realized by those non-farmers who are entering the field with funds
produced by their non-farm income. Initially, it is easy to characterize the problem here as one involving deficiencies in the tax rules applicable to farmers. This characterization is wrong and threatens a misdirection of corrective action. The problem is essentially one of limiting the application of the permissive or favorable tax rules established for farmers to encourage the development and operation of farmlands for the production of food and fiber to those who are economically dependent upon those operations for their livelihood. In the last analysis, it is farmers, not professionals or high income executives, who will have to satisfy this country's and perhaps the world's needs for agricultural products.

The flood of non-farmers into the farming business produced by tax shelter opportunities inherent in the permissive tax rules applied to agricultural operations has created another problem of serious magnitude for farmers. This is the problem created at death by the estate tax attributable to farm property which has appreciated in value (largely because of investment pressures from non-farmers) to a point where very substantial estate taxes may be assessed on relatively small farming operations. These taxes threaten to force the mass liquidation of farm properties now held by families which have already established their capacity as efficient producers and operators in the agricultural economy. Congress has responded in part with the legislation contained in Internal Revenue Code Section 2032A (which provides for special valuations for estate tax purposes of farmland and farming businesses, in certain very restricted circumstances) and Sections 6166 and 6166A (which provide alternative elections to pay the estate tax attributable to the decedent's interest in a farming business in installments, in certain limited cases). Although an analysis of these sections is beyond the scope of this
paper, it would not be unfair to characterize these sections generally as unduly complex and of unnecessarily limited application. Indeed, many commentators have suggested that Section 2032A may be so complex as to encourage tax professionals to avoid its use because of malpractice risks inherent in the planning work which must precede use of the section. The new Regulations recently issued under Section 2032A only serve to increase the complexities and uncertainties.

Now that Congress has seen the problem and addressed itself to it, the Treasury Department seems embarked upon a conscious program to subvert that legislation and prevent its application in many situations clearly within the scope of the Congressional intent behind enactment of the sections. An example can be found in the Treasury Department's 1975 ruling on the application of old Section 6166 (now Section 6166A) to the estate of a decedent who owns land leased to a farming business. Rev. Rul. 75-365, 1975-2 C.B. 471 (which would apparently apply as well under new Section 6166). Frequently, such a case is one which involves an individual who has devoted a lifetime to farming operations and only shortly before his death permitted operations to pass to the younger generation, retaining his land and leasing it to the new operator. The ruling holds the elections afforded by Sections 6166 and 6166A are inapplicable in this situation because the decedent was not actively engaged in the farming business at the date of his death. The Treasury Department is strictly following the literal requirements of the statute although in other situations it has recognized the need to examine the policy behind the wording of the statute in applying it. Obviously the Treasury Department is and must be concerned with its revenue sources. Where Congress has recognized policy considerations which it finds more important than
revenue, however, the Treasury Department should not be allowed to subvert that legislative decision, particularly in an area such as this where the problem can be traced directly to the inactivity of Congress and the Treasury Department in dealing with a developing problem promptly.

For many years the structure of the Federal income tax law and applicable interpretations of them have distinctly favored the incorporation of business operations which are generating significant taxable income. Effective rates on substantial income are lower; owners may avail themselves of more significant benefits as employees than as sole proprietors or partners. Other similar advantages can be documented under the present as well as prior tax rules. All of this has tended to encourage the incorporation of farming operations in the same way that it has encouraged the incorporation of other business operations. The Treasury Department itself has also encouraged farm incorporations. Until recent years, at least, significant tax savings were available through the incorporation of a farming business timed to leave the individual farmer with the use of substantial crop expenses deducted on the cash method after transferring to a new corporate operator the income (in the form of matured crops or accounts receivable from harvested crops) to be realized by the new corporation from those expenses. More recent Treasury Department interpretations and cases have substantially restricted this opportunity. Again, the courts and the Treasury Department may have closed the barn door after the economic horse has been stolen. For decades, incorporation was the key to tax savings—and hence to the generation of additional capital—in connection with farming operations. Today, many if not most significant farming operations in my area are conducted in the corporate form.
Again, we are unable to examine the policy considerations which might influence choices in this area unfettered by history.

The incorporated farmer who takes maximum advantage of the favorable rules on the taxation of income from his farming operations will, if he is successful, gradually accumulate capital in his farming corporation. Soon, under Internal Revenue Code Section 531, the corporation faces the risk of imposition of a tax on unreasonably accumulated surplus. Although the payment of dividends may constitute the theoretical answer, it is not a practical solution for most tax practitioners unless they wish to be accused of serving the Treasury Department in lieu of their clients. Under these circumstances a business use for the accumulated funds must be found. Wise counsel would probably suggest as at least one reasonable alternative the investment of these funds in additional farm properties or farming facilities. (Incidentally, the suggestion to use accumulated funds to acquire additional farming facilities may be accompanied by the suggestion that the selection of the right facilities will offer additional tax advantage in the form of Investment Tax Credits and advantageous depreciation deductions.) To the extent that increased size and increased mechanization of farming operations are economically or politically advantageous, the accumulated surplus rules are operating to serve this purpose. To the extent that increased size is not considered advantageous, the accumulated surplus rules (and, to a degree, the Investment Tax Credit and depreciation advantages offered new property) are actually stimulating the development of increasingly large corporate farming operations without underlying policy support.
When the size of farming operations is considered and farms or farming businesses are to be classified as large or small, it is important to understand the context in which these labels are applied. I practice in an area noted for its big farming operations. Many of these operations are large in terms of the number of acres farmed, the dollar volume of their sales and even their net income. But none of these big farming operations is in a position to control or even significantly influence the markets and the market prices received for its products. Farming in my area, even in its most advanced forms, is still an example of the economic market model in which the large number of producers makes the exercise of market control or influence by any one of them impossible.

It may be suggested that bigness (in the sense in which I am using that term) is not necessarily badness. In terms of solving many of the economic and social problems faced in areas of predominately agricultural economic activity, larger farming operations may offer more opportunity for solutions than small ones. Bigger farmers with somewhat greater bargaining power in purchasing and marketing and greater efficiency in operations may be more capable of dealing with problems such as seasonal labor use and labor displacement by mechanization than smaller operators who cannot generate the same efficiency because of their limited size and capital. Even if we can justify the apparently unintended effects of the tax on accumulated surplus on this basis, however, it is important to recognize that the need to use accumulated capital created by the tax on unreasonably accumulated earnings will operate like the permissive tax rules still available to investors who enter farming for the tax shelter in forcing land prices up over levels which can be justified by reference to productivity and income projections.
Generally, with certain limited exceptions, those remaining features of existing tax laws which may be considered as favorable to agriculture apply without regard to the size, nature or scope of the farming operations or the identity of those engaged in them. These rules have been developed at least in part on the basis of a general policy that agriculture should be encouraged and an historic view that the farmer should be spared the need to deal with complexities in his economic life. The farming business, like most aspects of our national economic, social and political life, has become too complex to explain the existing tax structure simply in terms of whether or not or in what form a farmer should be required to maintain a set of books and records. The existing tax law, which has grown largely without regard to more sophisticated policy considerations, offers agriculture some distinct tax advantages notwithstanding inroads made during the last ten to twelve years. At any recent point in time, these advantages are not as great as they were before—the trend is toward a more restrictive set of rules. Indeed, a long range review of the existing tax structure may lead to the conclusion that, in light of their more subtle effects, the existing rules are at least as disadvantageous to agriculture as they are advantageous. In short, we have reached a stage of pluses and minuses all developed in large part without regard for the significant policy considerations which should impact on the rules and interpretations of them. And, unfortunately, in those few areas where Congress has shown sensitivity to policy considerations, its efforts to reflect those considerations frequently have been subverted by overly restrictive Treasury Department interpretations.

The Department of Agriculture is to be commended for its attention to these matters and its concern for the "big picture." By now it should be clear
that tax legislation which affects agricultural interests is not and should not be exclusively or even primarily the concern of "tax persons." Tax factors have a significant impact on economic activity and should be of serious and constant concern to those who are responsible for the formulation of policies regarding agriculture in this country. It is hoped that the current attention being given to these matters by the Department represents a first step toward significant action in this area through which the Department of Agriculture will seek to be heard and will be listened to in the formulation of tax laws and their interpretation which can have significant positive effects on agricultural operations.
INFLUENCING THE STRUCTURE OF AGRICULTURE THROUGH TAXATION*

by Neil E. Harl**

I. Introduction

As historians write Congressional history for the Twentieth Century, a prominent place should be reserved for the discovery of taxation as a prime tool for implementation of national policy. Starting in 1962 with resort to the seven percent investment tax credit to stimulate investment and, in the words of President Kennedy, to "get the country moving again," the Congress has turned frequently to taxation where a specific change in behavioral pattern was desired. Four examples of the many specific Congressional acts—

- Investment tax credit was suspended in 1966 and again in 1969 because of inflationary pressures on the economy.
- Encouragement was provided to hire the poor, minorities and the handicapped by providing credits to employers—the Jobs Credit and the WIN Credit. The result was to reduce the payroll cost for hiring members of the targeted groups.
- In 1978, credits became one of the chief vehicles for implementing energy policy in the Energy Tax Act of 1978. Credits were provided for home insulation, installation of systems of solar and wind energy, and various business energy conservation measures.


**Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; Member of the Iowa Bar.
• A deduction was provided for land clearing expense and soil and water conservation expenditures.

There are, of course, dozens more that we could mention.

There are several reasons why Congress has turned increasingly to the tax system to implement policy—

• Taxes alter costs and returns and affect economic relationships. People are responsive to economic forces and the Congress has learned to orchestrate economic forces through taxation to achieve the desired behavioral response on the part of demanders of goods and on the part of producers. In effect, tax-oriented policy makes use of the price or market system, rather than resorting to direct governmental regulation.

• Programs can be implemented quickly if handled through taxation. It is not necessary to have long lead time to place policies in operation.

• It does not require a huge new bureaucratic force to implement new policies. The Internal Revenue Service is already in place and functioning. Especially in this era of concern about burgeoning costs for government and a general aversion to a larger governmental work force, the tax system is a particularly attractive vehicle for implementing policy.

• There is policy precision in the tax system as an implementor of policy and a uniformity of application over the target groups.

But using the tax system to implement policy is not without problems—

• It has made the federal tax structure unbelievably complex. A large proportion of the added tax law since 1962 is attributable to implementation of policies other than generation of revenue.
• There has been a tendency to implement policy that appeared sound from a micro point of view, as viewed from the standpoint of individual producers and consumers, without anticipating the macro consequences or the consequences in the aggregate. This has been especially true in the estate tax area as discussed below.

• Sectors like agriculture that differ significantly from other sectors of the economy may suffer quite different consequences when tax changes are made.

Example: During the 1960's and 1970's, several states sought to curb the use of corporations in farming. Yet in 1975 and 1978, the Congress reduced corporation income tax rates substantially more than for sole proprietorships. Thus, a decided tilt was built into the federal tax structure favoring corporations over partnerships and sole proprietorships. And this was done at a time when some states were trying to discourage use of the corporation. The Congress did more in two tax bills to influence the structure of agriculture, in terms of organizational structure at least, than the states had done in some time.

This illustrates that tax policies have tended to influence the structure of agriculture, often inadvertently. In the past couple of years, the question of structure of agriculture has moved to center stage. But it is not a new concern nor is it only recently that we have managed to influence the structure of agriculture.

The discussion following focuses attention on the structure issue and then examines key federal estate tax issues and the expected impact on the family farm.
II. The Structure of Agriculture

In the last third of the Twentieth Century, the structure of agriculture has become a matter of major concern. State legislatures in Minnesota, South Dakota, Wisconsin and Missouri have enacted statutory limits on use of the corporation since 1973 in addition to the North Dakota and Kansas limitations dating from the 1930's and Oklahoma restrictions going back to statehood. Iowa and Nebraska have imposed reporting requirements on corporations since 1975 with the Iowa legislation also including reports by limited partnerships and land ownership by nonresident aliens and imposing a ban on land acquisition by corporations with more than 25 shareholders. Iowa adopted legislation in 1977 limiting the use of the trust as a method of land ownership on farm operation.

Several states have restricted investments by nonresident aliens with some restraints enacted before the turn of the century.

In recent months, the U.S. Secretary of Agriculture has, through hearings and research programs instituted, elevated the structure of agriculture to the status of a national issue.

Some members of the United States Congress have also exhibited an interest in influencing the structure of agriculture in considering the Family Farm Act of 1972 (S. 2828), the Family Farm Antitrust Act of 1975 (S. 458), and an amendment to the Food and Agriculture Act of 1977 (S. 275) that would have limited agricultural program participation to farm operations organized in specified ways. The Congress has also indicated concern about trends in ownership of farmland through the Foreign Investment Study Act of 1974, the International Investment Survey Act of 1976 and the Foreign
Investment Disclosure Act of 1978 that requires reporting of land ownership by nonresident aliens.

In general, it is believed that discussion of the dimensions of the structure of agriculture can be subsumed under four major headings—(1) the scale or size dimension of the problem, (2) introduction of equity capital (complete with at least the right to exercise control over management) from outside agriculture, (3) vertical coordination enveloping two or more steps or stages in the production, processing and distribution processes and (4) tax motivations. The discussion following emphasizes the tax aspects.

IV. Tax Policy and Structure

Federal income tax legislation over the past decade has painted a picture of attempts by the Congress to neutralize tax-motivated resource shifts into agriculture. The income tax incentives have been largely of three types—(1) the combination of the cash method of accounting and the biological processes of agriculture that permitted (and still do to a lesser degree than formerly) conversion of deductions from ordinary income into ultimate taxation of gain as long term capital gain, (2) the availability of the cash method of accounting and deferral of recognition of gain such that expenses are incurred in one time period with income taxed in a later period, and (3) operation of tax entities with different rates of federal and state income tax ranging from zero to the highest marginal rate for individuals. As to the income tax motivations to invest in agriculture, the past several years have generally involved efforts to narrow the scope of tax motivations for nonfarm investors.
During the same period that special income tax treatment for agriculture was being contained, special federal estate tax provisions for agriculture have emerged. The remainder of this paper is devoted to a discussion of the likely effects of the changes in federal estate tax law since 1976.

It is not difficult to see why farmers and farm groups urged the Congress in 1976 to take up the subject of federal estate tax reform. In years before 1976, the reduction in number of farms and the increase in average size of farm along with sharp increases in the value of assets per farm had contributed to concern about the future of the family farm.

Table 2. Value of assets per farm, at current prices, 1940-79.

<table>
<thead>
<tr>
<th>Year</th>
<th>Real Estate &amp; Poultry</th>
<th>Machinery</th>
<th>Stored Crops</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1940</td>
<td>5,297</td>
<td>808</td>
<td>482</td>
<td>420</td>
</tr>
<tr>
<td>1950</td>
<td>13,324</td>
<td>2,283</td>
<td>2,154</td>
<td>1,344</td>
</tr>
<tr>
<td>1960</td>
<td>34,610</td>
<td>3,848</td>
<td>5,739</td>
<td>1,952</td>
</tr>
<tr>
<td>1970</td>
<td>73,172</td>
<td>7,962</td>
<td>10,952</td>
<td>3,703</td>
</tr>
<tr>
<td>1979</td>
<td>229,442</td>
<td>19,445</td>
<td>31,991</td>
<td>10,402</td>
</tr>
</tbody>
</table>


The value of assets per farm nationally had increased from $8,350 in 1940 to $311,142 in 1979. That was more than a 30-fold increase in less than 40 years.

The increase in average per acre value of farmland had added to fears that the federal estate tax burden might jeopardize the family farm.
Table 3. Increase in average value of farmland in Iowa, 1965-79.

<table>
<thead>
<tr>
<th>Year</th>
<th>Value per acre</th>
<th>Dollar change</th>
<th>Percentage change</th>
<th>Index 1967 = 100</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>320</td>
<td>29</td>
<td>10.0</td>
<td>-</td>
</tr>
<tr>
<td>1970</td>
<td>419</td>
<td>0</td>
<td>0.0</td>
<td>106</td>
</tr>
<tr>
<td>1971</td>
<td>430</td>
<td>11</td>
<td>2.6</td>
<td>108</td>
</tr>
<tr>
<td>1972</td>
<td>482</td>
<td>52</td>
<td>12.0</td>
<td>121</td>
</tr>
<tr>
<td>1973</td>
<td>635</td>
<td>154</td>
<td>31.9</td>
<td>160</td>
</tr>
<tr>
<td>1974</td>
<td>834</td>
<td>199</td>
<td>31.3</td>
<td>210</td>
</tr>
<tr>
<td>1975</td>
<td>1094</td>
<td>261</td>
<td>31.3</td>
<td>276</td>
</tr>
<tr>
<td>1976</td>
<td>1368</td>
<td>273</td>
<td>24.9</td>
<td>345</td>
</tr>
<tr>
<td>1977</td>
<td>1450</td>
<td>82</td>
<td>6.0</td>
<td>365</td>
</tr>
<tr>
<td>1978</td>
<td>1646</td>
<td>196</td>
<td>13.5</td>
<td>415</td>
</tr>
<tr>
<td>1979</td>
<td>1958</td>
<td>312</td>
<td>19.0</td>
<td>493</td>
</tr>
</tbody>
</table>

Source: Iowa Land Value Survey, Iowa State University

The Congress apparently concluded that it could be helpful in the effort to assure the survival of the farm and small business by—(1) reducing the federal estate tax burden on small estates, (2) creating a procedure for valuing land used in a farm or other business below fair market value for federal estate tax purposes under what is known as special use or "use" valuation, and (3) enacting a highly attractive installment payment provision for paying federal estate tax to the extent that a business was involved,

Congressional action in the Tax Reform Act of 1976 providing for reductions in the federal estate tax burden for farm firms seems to have taken place under the assumption that the family farm as a production entity continues (or should continue) as an economic entity through time. Pre-death and post-death requirements for installment payment of federal estate tax and "use" valuation of farmland are more difficult to meet if the farm firm ceases to function as a production entity at retirement or death even if the land is retained and rented to a tenant as noted below. Thus, the Congress appears to have
assumed that the way to assure the survival of the family farm as a concept was to work to assure the survival of family farms as economic entities.

Yet, traditionally, most farm businesses have not survived the generation of their founding. A large proportion of farm firms have been "born" and have "died" each generation with no hope that the farm firm would continue beyond the life span of the parents. In many instances, the parents have assisted some children in becoming established in farming with the farming children eventually spinning off into their own economic orbits. In other cases, the heirs are all pursuing off-farm vocations. But in both instances, the family firm does not continue to function beyond the death or retirement of the parents even though the land may continue to be owned within the family.

In recent years, a small but growing number of farm operations--referred to elsewhere as "super firms"--have pursued an objective of continuation into the next generation. In general, these are the larger operations with the most to gain economically from seeking continuity of the core family operation.

Thus, the major beneficiaries of the special steps taken to ease the federal estate tax burden have been the larger operations. Moreover, the larger the firm, the greater the tax benefit, up to a point.

Let's turn now to an examination of specific federal estate tax reforms adopted in 1976.

Increased exemption. Through 1976, each estate had been entitled to a $60,000 exemption before the federal estate tax was figured. Literally dozens of bills were introduced in Congress in 1975 and 1976 to raise that exemption. The majority of the proposals would have increased the exemption to $200,000. However, the Congress instead voted to drop the exemption.
altogether and go to a credit against the calculated federal estate tax. Much of the early work on the credit was done at Iowa State University in 1975 and early 1976.

Compared to an increased exemption, the credit resulted in less loss of federal estate tax revenue, which was significant in itself, but more importantly, the credit avoided the problem of rewarding those with the largest estates with the largest tax savings. The difference between a $200,000 exemption and a $47,000 credit (the level effective in 1981) was about $106,000 for someone with a $21 million estate. Yet the effects were the same for a $500,000 estate and almost the same even for a million dollar estate.

"Use" valuation of land. Also, as part of the 1976 reform package, the Congress created two additional procedures for valuing land for federal estate tax purposes. Under the option most likely to be used, farmland may be valued at death based on average annual gross cash rental (less property taxes) on comparable land in the locality capitalized at the average annual effective interest rate for new Federal Land Bank loans. All calculations are to use data for the last five full calendar years before death.

Example: assume average annual gross cash rents for the 1975-79 period of $74, property taxes of $4, leaving $70 to be capitalized. At an interest rate of 8-3/4 percent, the land would be valued at $800 per acre for death in 1980. And land that would have rented at that figure for the period of 1975-79 would probably sell for double that, possibly more. Our work shows land values typically running from 35 to 50 percent of fair market value under use valuation. The outcome can be sizable reductions in
federal estate tax liability up to a theoretical maximum benefit of $350,000 (70 percent maximum federal estate tax rate times a maximum reduction of $500,000 from the gross estate).¹

Reductions in tax liability of that magnitude are bound to draw the attention of investors near and far. That is why the Congress created a series of "gates" to exclude mere investors from enjoying the benefits of use valuation. To be eligible, several requirements must be met. Among them is the requirement that the decedent (or member of the decedent's family) must have participated materially in the production of income for five or more of the last eight years before death.² To avoid recapture of the tax benefit involved, a member of the qualified heir's family must continue participating materially for 15 years after death³ (unless the qualified heir dies first). It is important to note that material participation cannot be achieved by agent. That is an essential part of the gate to exclude from eligibility those who would invest in land merely to take advantage of the benefits of use valuation.

¹The Economic Recovery Tax Act of 1981 reduced the maximum federal estate tax rate to 50 percent (for deaths after 1984) and increased the maximum reduction from the gross estate (for deaths after 1982) from use valuation to $750,000. Thus, when fully phased in the theoretical maximum benefit from use valuation could be $375,000 (50 percent maximum rate times $750,000).

²For deaths after 1981, the material participation requirement can be met with material participation by the decedent or member of the decedent's family for five or more of the last eight years before the earlier of retirement, disability or death. For surviving spouses inheriting qualified real property from a deceased spouse, "active management" (which requires less involvement in decision making) substitutes for material participation.

³For deaths after 1981, the recapture period has been reduced to ten years (except where use of the ten year grace period for the qualified use test) extends the recapture period by up to two years.
The qualified use test requires the decedent or a member of the decedent's family to have had an equity interest in the farm operation—(1) at the time of death and (2) for five or more of the last eight years before death, and for the qualified heirs to each have had an equity interest in the farm operation during the recapture period after death. The practical effect of the qualified use test is to disqualify cash rented land (except that rented to a family member as tenant or to a family owned and controlled partnership or corporation from use valuation eligibility.

What are the anticipated effects of use valuation?

- For those with sizeable estates, land tends to be worth relatively more to those who can meet the eligibility requirements.

Table 4. Value of benefits from "use" valuation per acre of land.

<table>
<thead>
<tr>
<th>Net worth</th>
<th>Benefits per acre</th>
<th>Present value of benefits (8%) assuming death in</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>5 years</td>
</tr>
<tr>
<td>500,000</td>
<td>252</td>
<td>172</td>
</tr>
<tr>
<td>750,000</td>
<td>267</td>
<td>182</td>
</tr>
<tr>
<td>1,000,000</td>
<td>261</td>
<td>178</td>
</tr>
</tbody>
</table>

Thus, a person with a life expectancy of five years and a net worth of $750,000 could afford to pay $182 more per acre for land than someone not eligible for use valuation.

- In general, this situation encourages farmers—and other eligible individuals—to retain land until death and even to shift ownership toward more land and away from other investments with advancing age until the maximum reduction in gross estate is reached.

- The use value concept may, therefore, make it easier for farmers (and others who are eligible) to bid land away from nonfarmers.
• If the gate restricting the use valuation privilege is opened further to enable nonfarm investors to obtain these tax benefits, we would expect increased movement of equity capital from nonfarm investors into the farm sector. It would be expected that additional capital would flow into farmland, driving up the price, until investors were once again indifferent between investing in farmland with the benefits of "use" valuation and investing in other assets valued at death at fair market value. The expected effect would be a one-time increase in land value with subsequent purchasers paying a higher price for land. In effect, subsequent purchasers would "pay" for the one-time tax break.

• If the gate is not opened, the result would be a substantial economic advantage for those able to meet the pre- and post-death requirements. As a result, such individuals (presumably farmers and those actively involved in management under a lease) would be able to bid land away from those ineligible for use valuation (presumably nonfarm investors).

• Use valuation is also likely to discourage the sale or other disposition of land after death, at least for the duration of the recapture period. The benefits of tax deferral are substantial even for less than 10 years. After the recapture period has elapsed there is no recapture of benefits.

For nonfarmers able to meet the eligibility requirements, it will mean greater involvement in decision making at least for a potential recapture period.
A key point: the benefits go to the larger estates where the family is willing to continue to hold the land and be actively involved in the farm operation for the recapture after death. In effect, the encouragement is to continue farm operations and continue ownership of land within land-owning families.

Internal Revenue Service data indicate that the revenue loss from use valuation is greater than anticipated. The estimated loss of $15 million projected for 1976 has risen to approximately ten times that figure. Moreover, use value as a percentage of fair market value varies substantially by IRS District, ranging from a reported low of 29 percent of fair market value in the Los Angeles District to 76 percent in the Philadelphia District.

If public policy would be well served by easing the federal estate tax burden for small firms, there are ways to accomplish that result without the distortions and potential distortions in resource allocation that are inherent in use valuation as presently existing. In particular, the following are suggested:

1. In the interests of avoiding distortion in resource allocation, it is suggested that the use valuation concept be available for any assets in a closely held farm or ranch business, including machinery, livestock, equipment (as well as land), in the manner that the federal estate tax on assets in a closely held business is presently subject to installment payment. It would seem that the provision should be available to all eligible small businesses, farm and nonfarm.

---

2. Because of the difficulties inherent in valuing land by capitalizing adjusted gross cash rents, and in the interests of tax simplification and uniformity of application, it is suggested that use valuation be calculated as a statutory percentage of fair market value for the eligible assets subject to the statutory maximum limitation. At present, some agricultural areas have great difficulty in applying use valuation because of lack of cash rents on comparable land. It is not good tax policy for availability of a tax provision to be dependent upon availability of data that are related not at all to the tax in question and that vary by type of farming.

3. In order to avoid the problem inherent in deductions of making use valuation of greatest value to those with the largest estates (use value is worth $375,000 for an estate in the 50 percent tax bracket after 1982) it is suggested that the reduction in gross estate be transformed into a credit in the manner and style of the unified credit so that the value of the concept would be the same for all estates.

Installment payment of federal estate tax. Since 1958, federal law has permitted the portion of federal estate tax attributable to a business to be paid over a 10-year period. That provision was repealed as of the end of 1981. In 1976, a second installment payment provision was added. The latest provision, effective for deaths after 1976, permits payment of the federal estate tax attributable to a business to be paid over nearly 15 years after death. There is no tax due on the business part of the estate—only interest—until 69 months after death. And then the tax at one-tenth per year is paid with interest on the unpaid balance over the next nine years.
An important part of the so-called 15-year installment payment provision is the fixed 4 percent interest on the first $1 million of taxable estate. The real economic benefit of a 4 percent interest rate depends upon the alternative rate of return on funds not paid in taxes when due. Over the 15-year period, if a net of 10 percent could be earned on $100,000 not paid in federal estate tax, the earnings would total $132,225. That would cover all of the tax and all but $5,775 of the interest due.

Use of the installment payment provision also discourages sale or other disposition of land and other assets. Disposition of one-third or more of the business assets in the 15-year period after death (one-half or more for deaths after 1976) ends the installment payment privilege.

Corporate stock redemption. The third element in the trilogy of federal estate tax provisions encouraging continuation of the farm business is that, if the farm business is operated as a corporation and the requirements can be met, all death taxes and estate settlement costs can be paid by corporate purchase of stock held by the decedent. The gain, if any, would be capital gain. If installment payment of federal estate tax has been elected, stock redemption can be continued over the installment payment period—up to 177 months after death.

Essentially, that means the farm business can bear the burden for death taxes and estate settlement costs. Earnings used for that purpose have been taxed only at the corporate rate which can be as low as 17 percent (on the first $25,000 of corporate taxable income) up to a top of 46 percent on
taxable income above $100,000. These are the federal corporate income tax rates.

In summary

For farm businesses that are eligible for use valuation of land, 15-year installment payment of federal estate tax and corporate stock redemption after death, the burden of death taxes and estate settlement costs is lightened substantially. As noted earlier, the farm businesses most likely to be able to take advantage of these provisions are--(1) the larger firms (2) with an objective of continuity.

An emerging concern in the years since 1976 has been that the fact of the benefits flowing to larger firms and those continuing beyond the founding generation may be helping to transform the structure of agriculture. Without much doubt, the Congressional action in 1976 has created pressures for farm firms to continue. That encouragement could accelerate the trend toward fewer and larger farms. And it could raise the barriers to entry.

It is ironic that a policy aimed at "preserving the family farm and small business" could, at least for farm firms, have the opposite effect.

By one theory, a family owned and controlled agriculture is promoted (1) by a death tax structure that is as demanding of farm estates as those of any other sector such that investment is not unduly attracted from nonfarm investors and (2) by a death tax structure that may lead to the break up of large tracts of land. Without a doubt, entry into agriculture is inhibited if land is tied up within families for extended periods.

---

5 The corporate federal income tax rate was reduced from 17 percent to 16 percent for 1982 and to 15 percent for 1983 and later years on the first $25,000 of corporate taxable income.
The federal estate tax was apparently intended by the United States Congress to accomplish multiple objectives—(1) generate revenue, (2) redistribute wealth and (3) influence the structure of the economy. The question is whether the recent changes are consistent with those objectives.

It may be several years before clear evidence exists on the effect of the Tax Reform Act of 1976 on the structure of agriculture. One of the most difficult policy issues is the fact that what appears to be beneficial to one firm in isolation may generate quite a different outcome when the aggregate or "macro" effects are taken into account. In examining the wisdom of changes in the tax area, the changes should be evaluated not solely on the basis of the expected effects upon a particular firm but also on the basis of the expected effects in the aggregate. The aggregate effect may be surprising.
Background

Since I practice law in Southwest Kansas, this paper will naturally draw upon my experience and observations in Southwest Kansas. My law firm is a small one, consisting of three partners, two of whom devote most of their time exclusively to federal taxation matters, including income, gift, estate, and excise taxes. In the last eight or nine years, we have incorporated approximately one hundred farmers.

Without exception, each of the farm corporations which our clients have formed is a closely held family farm operation. None of the stock in any of these farm corporations is owned by anyone outside of the family, and while the entire family may not be involved on a day to day basis in the family farm operation some member or members of the family are directly and actively engaged in farming. As a practical matter, the operation and management of the farm remain the same after incorporation as they did prior to incorporation.

Our area is characterized by sandy, poor quality soil, and very low rainfall, averaging approximately twenty inches per year. The advent of the center pivot irrigation sprinkler system in the early 1960's transformed our area from predominately livestock grazing and the growing of dryland winter wheat, to the growing of irrigated crops, including wheat, milo, corn,

*Partner, Ridenour and Knobbe, Lawyers, Cimarron, Kansas
alfalfa, and soybeans. Something over 70 percent of the total area of our county is now under irrigation. While there is no "average" farm in our county, the typical farm in our county tends to consist of five or six hundred acres under irrigation and something less than that devoted to the raising of dryland wheat and milo.

With a few exceptions, the family farms which we have incorporated are larger and have greater investments in real estate and machinery than their unincorporated counterparts. The balance of this paper will explain why we think that these larger and, at least in our opinion, more efficient farmers have decided to incorporate.

Farm Corporation Tax Structure

Without exception, one of the principal reasons for incorporating every farmer which we have incorporated has been the reduction of federal income taxes. As will be seen in this section, the incorporated farm generally pays less federal income taxes than the unincorporated farm, and the tax savings increase as the farm size and income increase.

One of the easiest ways to understand how a corporate farm is taxed is to compare the corporate tax rates with the individual tax rates. Table I, below, shows the marginal tax rate for married individuals filing joint returns. The marginal tax rate is simply the rate at which the last dollar of income is taxed. As will be seen from Table I, the individual income tax rates are graduated, but they increase at a decreasing rate. That is, for taxable income between zero and $35,200, tax rates steeply increase from zero to the 43 percent marginal tax rate. However, from $35,200 through $215,400, the brackets increase only 27 percent on that $180,200 increase
in taxable income. Therefore, while the tax rate is very progressive and graduated from zero to $35,200 worth of income, it flattens out and is relatively level and unprogressive on incomes in excess of $35,200.

Table I.

Married Individuals Filing Joint Returns and Surviving Spouses

<table>
<thead>
<tr>
<th>Taxable Income over</th>
<th>Taxable Income not over</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 3,400</td>
<td>$ 3,400</td>
<td>14%</td>
</tr>
<tr>
<td>5,500</td>
<td>5,500</td>
<td>16%</td>
</tr>
<tr>
<td>7,600</td>
<td>7,600</td>
<td>18%</td>
</tr>
<tr>
<td>11,900</td>
<td>11,900</td>
<td>21%</td>
</tr>
<tr>
<td>16,000</td>
<td>16,000</td>
<td>24%</td>
</tr>
<tr>
<td>20,200</td>
<td>20,200</td>
<td>28%</td>
</tr>
<tr>
<td>24,600</td>
<td>24,600</td>
<td>31%</td>
</tr>
<tr>
<td>29,900</td>
<td>29,900</td>
<td>37%</td>
</tr>
<tr>
<td>35,200</td>
<td>35,200</td>
<td>43%</td>
</tr>
<tr>
<td>45,800</td>
<td>45,800</td>
<td>49%</td>
</tr>
<tr>
<td>60,000</td>
<td>60,000</td>
<td>54%</td>
</tr>
<tr>
<td>85,600</td>
<td>85,600</td>
<td>59%</td>
</tr>
<tr>
<td>109,400</td>
<td>109,400</td>
<td>64%</td>
</tr>
<tr>
<td>162,400</td>
<td>162,400</td>
<td>68%</td>
</tr>
<tr>
<td>215,400</td>
<td>---</td>
<td>70%</td>
</tr>
</tbody>
</table>

By comparison, present corporate federal income tax rates are shown in Table II. The corporate tax rates are steadily progressive from zero to $100,000 of income, and at the $100,000 level they flatten out at the level rate of 46 percent.
Table II
Income Taxation of Corporation

<table>
<thead>
<tr>
<th>From</th>
<th>To</th>
<th>Marginal Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ -0-</td>
<td>$ 25,000</td>
<td>17%</td>
</tr>
<tr>
<td>25,000</td>
<td>50,000</td>
<td>20%</td>
</tr>
<tr>
<td>50,000</td>
<td>75,000</td>
<td>30%</td>
</tr>
<tr>
<td>75,000</td>
<td>100,000</td>
<td>40%</td>
</tr>
<tr>
<td>Over $100,000</td>
<td></td>
<td>46%</td>
</tr>
</tbody>
</table>

By juxtaposing these two tables for various given levels of income, the difference in treatment between the corporation and the individual can readily be seen in Table III. For the first $10,000 worth of taxable income, the corporation is taxed at a higher marginal rate, but for all other levels of income the individual is taxed at a higher marginal rate, ranging from a few percentage points to the 29 percent difference between the individual and the corporation at the $50,000 taxable income level.

Table III
Marginal Tax Rates
Corporation and Individual Joint Taxpayer

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Corporation</th>
<th>Individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 10,000</td>
<td>17%</td>
<td>18%</td>
</tr>
<tr>
<td>15,000</td>
<td>17%</td>
<td>21%</td>
</tr>
<tr>
<td>20,000</td>
<td>17%</td>
<td>24%</td>
</tr>
<tr>
<td>25,000</td>
<td>17%</td>
<td>32%</td>
</tr>
<tr>
<td>30,000</td>
<td>20%</td>
<td>37%</td>
</tr>
<tr>
<td>40,000</td>
<td>20%</td>
<td>43%</td>
</tr>
<tr>
<td>50,000</td>
<td>20%</td>
<td>49%</td>
</tr>
<tr>
<td>75,000</td>
<td>30%</td>
<td>54%</td>
</tr>
<tr>
<td>100,000</td>
<td>40%</td>
<td>59%</td>
</tr>
<tr>
<td>150,000</td>
<td>46%</td>
<td>64%</td>
</tr>
<tr>
<td>200,000</td>
<td>46%</td>
<td>68%</td>
</tr>
<tr>
<td>250,000</td>
<td>46%</td>
<td>70%</td>
</tr>
</tbody>
</table>
While Table III shows the difference in tax treatment between individual and corporation, it does not show the tax savings available to the farmer who incorporates and shifts taxable income to his farm corporation, thereby having it automatically taxed at a lower rate at any given income level and simultaneously allowing him to reduce the marginal bracket in which his own income is taxed. The tax savings that can be achieved by shifting some taxable income to the corporate farm entity are shown in Table IV. As illustrated, the tax savings of the incorporated farm over the unincorporated farm range from approximately $1,000 at the $25,000 level to in excess of $20,000 at the $100,000 level.

Table IV

Comparison of Federal Income Tax Burden Between Incorporated and Unincorporated Farms

<table>
<thead>
<tr>
<th>Assume net income of</th>
<th>$25,000</th>
<th>$50,000</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary to President</td>
<td>10,000</td>
<td>15,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Retained in Corporation</td>
<td>12,000</td>
<td>38,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Tax to Individual</td>
<td>1,062</td>
<td>1,425</td>
<td>4,633</td>
</tr>
<tr>
<td>Tax to Corporation</td>
<td>2,550</td>
<td>6,850</td>
<td>16,750</td>
</tr>
<tr>
<td>Total taxes to Corporation and Individual</td>
<td>3,612</td>
<td>8,275</td>
<td>21,383</td>
</tr>
<tr>
<td>Tax to Individual without Corporation</td>
<td>4,633</td>
<td>14,778</td>
<td>41,998</td>
</tr>
<tr>
<td>Tax Savings of Incorporated Farm over Unincorporated Farm</td>
<td>1,021</td>
<td>6,503</td>
<td>20,615</td>
</tr>
</tbody>
</table>

While beyond the scope of this paper, certain other "fringe benefits" also favor the incorporated farm over the unincorporated farm. For example, the incorporated farmer can pay and deduct group term life insurance premiums on his life while the unincorporated farmer cannot. The incorporated farm
can pay and fully deduct all health and accident insurance expenses while
the unincorporated farmer can deduct only those in excess of 3 percent
of his adjusted gross income, and in most situations the incorporated farmer
can depreciate his home and deduct the expense of repairing and maintaining
it.

While Table IV shows the tax savings possible at various levels of
income that are available to the incorporated farmer, Table IV does not show
practical applications of these tax savings. The practical aspects of these
tax savings to the incorporated family farm and the heavier tax impact on
the unincorporated farmer are, in my opinion, at least some of the reasons
why larger farms may continue to get larger and smaller may either remain
the same size or sell out to larger incorporated farmers. These practical
implications and their tax impact are discussed in the next section.

Practical Implications of Tax Rate Differentials
Between Incorporated and Unincorporated Farms

At the outset it must be noted that in our opinion the difference in
tax treatment between the incorporated and the unincorporated farm has no
impact whatever on the continuation or disappearance of the "family farm" in
America. In the area of the country in which we practice law, the incor-
porated farmer is at least as much a family farmer as the unincorporated
farmer, and the fact that existing tax laws favor the incorporated farmer
over the unincorporated farmer is not to say that the tax laws discourage the
family farm. Rather, as will be discussed in this section, the present
federal income tax laws favor and encourage the larger incorporated family
farm over the smaller unincorporated family farm.
Secondly, by incorporating his farm the family farmer is simply avail-
ing himself of the same corporate tax advantages which have been utilized
for years by most other small businesses. Corporate tax advantages have
long been known and used by the corner store businessman in rural areas. I
have no idea why farmers in our area have increasingly turned to the corporate
form of business organization only in the last ten years or so, although I
suspect that farmers in our area have a growing awareness of the impact of
such things as interest rates and federal income taxes on their farm opera-
tions, factors which have long been considered by most other businessmen.

As shown in Table IV, at the $100,000 level of income the incorporated
farmer saves approximately $20,000 in federal income tax more than his
unincorporated counterpart. But, the practical implications of this tax
savings far exceed $30,000. For example, if the incorporated farmer takes
his tax savings of $20,615 and purchases a piece of depreciable farm machinery,
the tax savings are magnified as shown in Table V below:

Table V

<table>
<thead>
<tr>
<th>Purchase Price of Machinery</th>
<th>$20,615</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Tax Credit (10%)</td>
<td>$2,061</td>
</tr>
<tr>
<td>First Year Depreciation</td>
<td>$2,000</td>
</tr>
<tr>
<td>Annual Straight Line 7 Year Depreciation for 1 year</td>
<td>2,659</td>
</tr>
<tr>
<td>Total Depreciation First Year</td>
<td>$4,659</td>
</tr>
<tr>
<td>Applicable tax bracket x .30%</td>
<td>1,397</td>
</tr>
</tbody>
</table>

| Additional Tax Savings Created by Purchase | 3,458 |
| Net Tax Savings in Year of Purchase | $24,073 |
As can be seen, because of the purchase of the depreciable machinery, the incorporated farmer's total tax benefit over the unincorporated farmer is in excess of $24,000. The obvious practical tax impact of this savings is that the incorporated farmer has a $24,000 piece of farm machinery which he can use on his farm, whereas the unincorporated farmer has only a receipt for the payment of $20,000 worth of additional federal income taxes paid. Rather obviously, the farmer who has the $24,000 more to invest can easily expand his farm, hire additional labor, or purchase additional real estate since he has $24,000 more to invest than the unincorporated farmer. And, assuming that he chose to purchase the $24,000 machine with his tax savings, the additional income which his investment will produce during the following years not only magnifies the disparity in tax treatment but also increases the income of the incorporated farmer over the unincorporated farmer.

Similarly, the annual depreciation on the machine in future years will confer additional tax savings on the incorporated family farmer. However, the practical implications of the difference in tax impact can most easily be seen when comparing the after-tax cost of a tract of real estate to an unincorporated farmer and to an incorporated farmer.

For illustration purposes, assume that an incorporated farmer and an unincorporated farmer each purchase a tract of real estate and finance $150,000 of its purchase price, payable at the rate of $5,000 principal per year over a thirty year period, bearing 12 percent per annum simple interest. Assume further that each of the farmers has an annual income of $100,000, and in the case of the incorporated farmer $75,000 is retained in the corporation and $25,000 was paid as a salary to the President and sole stockholder.
of the corporation. The following table shows the difference in the after tax cost of the purchase of the real estate.

Table VI
Comparison of After-Tax Cost of $150,000 Tract of Real Estate Purchased Over Thirty Year Period at 12 Percent Annual Interest Rate

<table>
<thead>
<tr>
<th></th>
<th>Incorporated Farm</th>
<th>Unincorporated Farm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual total income required</td>
<td>$ 7,142 per yr</td>
<td>$ 12,195 per yr</td>
</tr>
<tr>
<td>to pay $5,000 annual</td>
<td>x 30 years</td>
<td>x 30 years</td>
</tr>
<tr>
<td>principal payments</td>
<td>$214,260</td>
<td>$365,850</td>
</tr>
<tr>
<td>Actual cost of annual interest payments</td>
<td>195,400</td>
<td>114,290</td>
</tr>
<tr>
<td>Total after tax cost of $150,000</td>
<td>$409,660</td>
<td>$480,140</td>
</tr>
<tr>
<td>of real estate purchased over 30 years at 12 percent interest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Savings to incorporated farmer:</td>
<td>$70,480</td>
<td></td>
</tr>
</tbody>
</table>

Therefore, as compared to the unincorporated farmer, the incorporated farmer's favored tax status saves him almost one-half of the cost of the $150,000 tract of real estate. But this is only the tip of the iceberg: Remember, the incorporated farmer has an additional $20,000 per year after-tax disposable net income more than the unincorporated farmer. If the incorporated farmer simply annually invests his tax savings in the $150,000 tract of real estate, in slightly less than 20 years he can own the $150,000 tract of real estate free and clear and paid for totally by dollars that otherwise would have been paid in taxes, while the unincorporated farmer still has an additional 10 years to pay and the net after-tax cost to him
will be $480,000 after tax dollars invested in the $150,000 tract of real
estate.

From this analysis, I believe that the following conclusions can be
drawn:

1. Graduated income tax rates encourage incorporation of the family
farm;

2. The higher the individual income tax brackets rise the more the
incorporated family farm is favored;

3. It is easier for the incorporated family farm to acquire additional
assets, and there is a distinct tax incentive for the incorporated farm to
grow larger.

Other Tax Advantages of Farm Corporations

In addition to the income tax advantages discussed above, family farm
corporations also afford various additional tax advantages to the incorporat-
ing farmer. While these miscellaneous tax advantages enjoyed by the farm
corporation are beyond the scope of this paper, a brief discussion of these
various tax advantages follows.

1. Gift Tax Advantages. From a tax standpoint, a gift of a share of
stock of a family farm corporation has many advantages. First, as long as
the donor has 51 percent or more of the stock of a corporation after the
gift, he gives up neither income nor control by making the gift. Second, as
numerous cases have pointed out, the value of a share of stock for gift tax
purposes should be discounted below the proportionate value of the underlying
assets since the gift of a minority stock interest carries with it no control
rights and is rather obviously worth less since it carries with it no control
rights, unlike a gift of the underlying assets. Similarly, a second discount
for gift tax purposes may be taken when it can be demonstrated that there is no market for the stock being given. Therefore the incorporated farmer may as a general rule annually give a larger percentage of his holdings without having to pay gift tax, by virtue of the annual exclusion, because of the applicability of these discount rules to gifts of closely held family farm corporation stock. The ease of making larger gifts of stock obviously simplifies transmitting the family farm intact to the next generation with fewer estate taxes.

2. Estate Taxes. Numerous estate tax advantages attend the incorporation of the family farm; while not an exhaustive list, the following are a few of these advantages: By incorporating his farm at or near retirement age, the incorporated farmer may be able to qualify his estate for the long term installment payment of federal estate taxes, ten years or fifteen years respectively, while the retired unincorporated farmer who does not actively farm his real estate cannot qualify but rather must have estate taxes paid within nine months from the date of death, frequently requiring the sale of farm assets to pay the taxes. Similarly, the incorporated farmer may be able to "freeze" the value of his estate and prevent inflation from adding to the value of his estate through the issuance of preferred stock, debentures, or debt obligations which will fix the value of his estate and eliminate the effects of inflation. And finally, while it is still too early to tell what impact the incorporated farm may have on new estate tax "use value" rules added by the 1976 Tax Reform Act, it appears that the incorporated farmer may have some benefits under these new valuation rules that are not available to the unincorporated farmer.
General Conclusions

Based upon the foregoing analysis and my experience in representing both incorporated and unincorporated farmers for several years in the Southwest Kansas area I believe that the following overall conclusions can be drawn:

1. The existing federal income tax structure has built-in tax incentives encouraging incorporation of the family farm.

2. The incorporated family farm enjoys numerous tax advantages which make it easier for it to expand, pay off indebtedness, and transmit the farm to the next generation.

3. A farm corporation permits dollars that would otherwise go for taxes to the federal government to be used for the reduction of debt and for farm improvements, both of which strengthen the farm's financial condition, and farm corporations have therefore had a salutary and beneficial effect on American agriculture.
TAXES AND AGRICULTURE:
SOME OBSERVATIONS!
by Alfred J. Olsen*

The following observations are based on experiences occurring during the last 14 years. The first two years involved preparing tax returns for an international C.P.A. firm in Chicago as well as reviewing the pre-1969 tax sheltered investment of individuals owning farms and breeding herds. The last 12 years have been spent as a tax attorney in Phoenix with emphasis on business and estate planning for farmers and ranchers who comprise more than 50% of such legal practice which includes 210 family farm corporations, 110 family farm partnerships and 160 living trusts. That practice involves farmers and ranchers from at least 19 different states. With all that experience, a person should possibly be able to reach conclusions, not just observations. However, conclusions indicate more finality than observations.

1. The first observations are rather redundant, but so significant that they require repeating:

(a) Agriculture is an essential industry.
(b) Agriculture requires significant capital investments and normally requires a number of years before profitable status is reached.
(c) Even when profits are earned, they produce a return on investment which is one of the lowest of all national industries.
(d) A family agricultural operation is a very high risk business with uncertain and damaging weather conditions, diseases, precipitous market fluctuations, government regulations, and ever increasing...

*Attorney, Olsen-Smith, Ltd., Phoenix, Arizona
production costs constantly threatening its economic survival.

(e) Tax and other laws should encourage the proper growth, development and continued vitality of the agricultural industry in order to insure abundant supplies of food and fiber to our nation at reasonable prices. Such growth or development does not require special incentives or "tax shelter laws."

(f) Tax laws should only be adopted or changed after long and careful consideration so that no permanent damage is done to the agriculture industry and at the same time the industry is permitted to continue to attract capital from inside and outside sources on a sound and economic basis.

2. The second observation resulting from those 14 years of experience is that taxes are too significant to the agricultural business planning process. The following are the most frequently asked questions during business meetings with agriculture clients.

(a) Will I end up with too much taxable income this year such that after paying off my crop loans there will not be sufficient cash left to pay the taxes?

(b) Why do I have to pay income tax when I still have investment credit carryover and when all of my cash has been expended for crop expenses and new equipment?

(c) If either my wife or I die, will the survivor have enough assets to pay the estate taxes and continue the family farm?

(d) If both of us die, will our son who is working with us have sufficient assets to pay the estate tax on both of our deaths and still be able to operate the family farm?
(e) Will there be sufficient assets left over after the estate taxes so that our son can continue the farm and still make a fair settlement with his brothers and sisters for their share of our assets?

(f) How can I contribute to a retirement plan for the wife and me when the cash requirements of the farm use up all of our available cash?

(g) Where do I get the cash to expand to make the farm a more efficient agricultural unit?

(h) Even if I can obtain the cash, where is there land available at an economically realistic price to make my operation large enough to be cost efficient and at the same time large enough to support all the members of my family that want to remain in agriculture?

An answer to each one of the above questions would involve a discussion of the existing income or estate tax laws. In fact, some of the questions indicate what a significant factor taxes are in the lives of farmers and ranchers. Of course, taxes generally affect all businesses, but not to the extent they affect agriculture. As stated in the first observation, the reward-risk ratio for the agriculture industry is not a balanced equation. Most farmers and ranchers realize this, but have decided through desire or necessity to accept that challenge. However, that challenge is frequently accepted without the farmer or rancher having considered that income and estate taxes have been added to the risk side of that already unbalanced equation.

Such observation does not imply that income and estate taxes should not be applicable to agriculture. It does imply, however, that if food and fiber are essential, then those tax laws must work in "harmony" with agriculture so that agriculture can pay its fair share of taxes while at the same time
sustaining the economic growth and development required to provide the amount of food and fiber desired for our nation and for export.

Harmony does not necessarily mean that the farmer and rancher require tax privileges which are not available to other taxpayers. It does mean that the tax laws should not be any more disadvantageous to the farmer and rancher than they are to any other American businessman. The following are examples where the existing tax laws appear to be inharmonious with American agriculture.

(a) The market value of real property used for agricultural purposes is often distorted by factors unrelated to its earning capacity for agricultural production. Such distortion results in gross inequities in the valuation of such property for estate tax purposes. Valuation for estate tax purposes of real property used for agricultural production should be determined on the basis of its income earning capacity for such use, subject to it being used for such purpose for a specified period of time. The 1976 Tax Reform Act, in adopting IRC § 2032A tried to alleviate such a problem. However, in attempting to limit the application of that Section, certain restrictions and limitations were adopted which detract from the practical application and use of this alternative by bona fide ranchers and farmers. The deletion of some of these restrictive provisions hopefully would facilitate the practical application and use of Section 2032A by bona fide farmers and ranchers and still avoid abuses of this valuation method by "outside" investors.
(b) The same fair market value problem exists with ad valorem, real property and personal property taxes. Agricultural land, as long as it is being used for agricultural purposes, should be assessed according to its current earning-capacity rather than to base such assessments on a sales price or a potential value as might occur for purposes other than agriculture.

(c) The laws and regulations related to Subchapter S Corporations are so complex and full of traps that the usefulness of such entities for farms and ranches is greatly diminished. Properly simplified, they would be beneficial in estate planning and operating family farms and ranches.

(d) The extraordinary risks of agriculture have fostered the common practice of deferring income each year in an amount equal to the expected costs of growing next year's crops. With many farmers and ranchers this practice has been consistently used for many years. However, any requirement that agriculture use only the accrual method of accounting or the required disallowance of deferment contracts will require agriculture to develop other methods of accomplishing this industry-wide practice or a valid substitute therefor.

(e) A common practice used for years to accomplish the necessary deferral of income was to prepay expenses such as seed, feed, interest, rent, water and fertilizer. Recently, these common practices have been attacked by alleging that such practices materially distort income. (Rev. Rul. 79-229) Such arguments may be valid against outside tax shelter investors. However, if the
farmer or rancher has been using that method consistently for many years, it is hard to see where any one of those years involves a material distortion.

(f) Until recently, most farmers operated as sole proprietors or partnerships. The tax laws for years have denied to proprietorships and partnerships most of the fringe benefits which are currently available to corporations.

(g) The tax laws as presently interpreted prevent retired farmers and ranchers from participating in the management and inspection of their rented property without having such rental income qualify as self-employment earnings thereby reducing or eliminating any Social Security benefits to which the retired farmer or rancher might be entitled.

(h) Labor taxes are an ever increasing problem for agriculture especially determining who are independent contractors and what constitutes farm labor for purposes of income tax withholding. A proper method needs to be devised to protect the collection of income and social security taxes without unduly encumbering the farmer and rancher who is already incurring greater accounting and bookkeeping expenses than the profitability of his business would warrant.

(i) The tax system is placing our farmers and ranchers in a disadvantageous position in competing for what little farm land is still available by not applying the same taxes to income from sales by foreign investors.

(j) The largest asset of any agricultural operation is usually the real property. The tax rules for depreciation and investment credit have
for many years not taken into consideration the unique character of the assets in the agricultural industry. Agriculture has significant assets which do not qualify for depreciation or investment credit such as land and marketing rights for milk base, cotton, grains, etc. These assets constitute a greater percentage of the total capital outlay required of an agricultural business than is usually required of most other types of businesses.

(k) Sections 175, 180 and 182 are no longer sufficient with their present limitations to provide agriculture with the originally desired result.

(l) The need to promote sound and economic investment in agriculture, includes a desire to eliminate tax sheltering investments. However, requiring corporations and partnerships engaged in the business of farming to use the accrual method of accounting and to capitalize preproductive period expenses causes complexities and problems inharmonious with the existing agricultural industry. Now is the time to develop an agricultural accounting method acceptable for tax purposes which will allow the legitimate use of the prevailing industry-wide practices and at the same time prevent such system from being abused by either the outside investor or the agricultural industry. Such form of accounting should allow the legitimate deferral of income in an amount not to exceed next year's growing costs. Such form of accounting is not without precedence. The insurance industry through Section 824 which provides for adjustments to provide protection against losses.
The significance of taxes to agriculture appears to be only a recent occurrence. Many of the southwestern farmers and ranchers have indicated that taxes were really a very minor consideration to their business planning even during the great cotton years of the 1950's. However, as land values increased beyond their agricultural use value and outside investors began using agriculture for tax sheltering, the tax laws as they were applied in order to eliminate the use of agriculture as a tax shelter caused the real farmer and rancher significant concerns and problems. During the last fifteen (15) years, the increased production costs, the inflated land prices and the low profit margins have made extensive income and estate tax planning extremely significant to the farmers and ranchers of the Southwest. Frequently, the proper tax planning has meant the difference between positive or negative cash flow for the operation. In some instances, it has been the difference between continued existence or liquidation of that farming operation.

3. The third observation is that since farmers and ranchers are now finding income and estate tax laws to be extremely significant in their business planning, it has become necessary for them to search the tax laws for additional tax benefits which were possibly never intended for agriculture but which through proper planning can be made available to reduce the significant impact of taxes on agribusiness. The following is a list of some of the existing tax planning presently being used by agriculturalists to reduce income and estate taxes:

(a) The incorporation of the family farm to make available the lower corporate income tax rates for better cash flow planning.

(b) The use of multiple corporations owned by the adult members of the family.
(c) The use of partnerships and multiple corporations, including Subchapter S corporations with different fiscal year ends in order to accomplish a proper business cycle for recognition of income.

(d) The adoption of pension and profit sharing plans which are designed to provide retirement benefits as well as sources of cash to be borrowed by the employees on a net economic basis more favorable than borrowing from the bank.

(e) The use of corporate benefits which are not available to a proprietorship or partnership including reimbursement for meals and lodging expenses incurred on the business premises of the employer for the convenience of the employer.

(f) The limitation of new investments to those type of investments which will qualify as trades or businesses so that practically all of the deceased farmer's assets can meet the requirements for Sections 2032A, 6166 and 6166A.

(g) The recapitalization of corporations with preferred and common stock in order to "freeze" the appreciation in the farm or ranch to a value hopefully consistent with agricultural use values.

(h) The adoption of limited partnerships with different classes of units similar to different classes of corporate stock in order to accomplish the same results as a corporate recapitalization.

(i) The use of limited partnerships to properly allocate assets and income between different generations based upon their contribution to the farming operation without the older generation losing control which may cause the farming entity to be segregated or partitioned.
(j) Gifts of limited partnership interests and minority interests in corporations to the next generation to reduce the estate tax while retaining control to avoid partitioning the farming operation. This is frequently accomplished prior to the time when the younger generation has actually "earned" such gifts.

(k) The adoption of living trusts in order to avoid the double estate taxation on the death of husband and wife while at the same time giving the surviving spouse control over the farming operation. If it were not for the estate tax laws, trusts would not be necessary since in most cases the deceased farmer would have left everything outright to the surviving spouse.

(l) The adoption of irrevocable trusts to own the life insurance on the husband and wife in amounts sufficient to pay estate taxes while at the same time avoiding estate taxes on the insurance proceeds which were acquired in order to pay estate taxes. If it sounds like a vicious circle, it is.

(m) Restructuring agreements and contracts into arrangements which now qualify for the "material participation" test under Sections 6166, 6166A and 2032A.

(n) The use of combinations of corporations and limited partnerships to qualify for Sections 2032A and 6166 without at the same time having the retired farmer's Social Security benefits either reduced or eliminated.

The above enumeration is not intended to be a blueprint of how to use the tax laws for the benefit of agriculture. However, such enumeration gives
some idea of the amount of costs which are now being incurred by agriculturalists for proper professional advice from attorneys and accountants on how to avoid the significant impact of income and estate taxes. Such costs, of course, also include the high cost of life insurance premiums incurred in order to pay the estate tax. If the income and estate tax laws were not so significant to agriculture, the above tax planning would likewise not be required. Agriculture, of course, must pay its fair share of taxes, but why must the tax laws be so complicated that the farmer has to incur the expense of professional advice in order just to help him avoid paying more than his fair share of the taxes. If the amounts now being paid for professional advice and life insurance premiums were invested in additional land, livestock and crops, there would certainly be a lot more food and fiber available for our nation as well as for exports to help the balance of payments. Additionally, if the tax laws were structured in harmony with agriculture, then agriculture could pay more taxes based upon increased profits and equity thereby shouldering more of the tax burdens presently imposed on the citizens of our nation.

Observations (Not Conclusions):

1. Income taxes and estate taxes are now too great of an economic consideration in the proper operation of agribusiness.

2. Many existing tax laws are inconsistent with the proper and sound economic growth and development of agribusiness.

3. The complex and negative aspects of taxes have caused agribusiness to expend an inordinate amount of available funds for tax planning which could have been expended more profitably for increased production and development.
4. With close cooperation between the Department of Agriculture, the Department of the Treasury, Congress and the agricultural industry associations, the tax laws as they affect agriculture can properly be structured (a) to promote sound economic growth for agriculture, (b) to prevent tax abuses, (c) to place the farmer and rancher on an equal footing with other businessmen, and (d) to allow agriculture to pay its fair share of this nation's taxes.
THE EFFECT OF THE FEDERAL TAX STRUCTURE UPON
THE ABILITY OF FARMERS TO PURCHASE AGRICULTURAL LAND
by Roland L. Hjorth*

1. Beginning Assumptions.

I start with three basic assumptions:

(1) The return on agricultural labor is too low to enable tenant farmers and other farm workers to buy land out of earnings not needed for consumption. A physician may be able to finance a farm purchase out of excess compensation, but a tenant farmer typically cannot. 1

(2) The current return on agricultural land, expressed as a percentage of value, is usually less than one third the prevailing interest rate. As a result, current return is too low to enable purchasers to buy land out of earnings from the land itself, or from a combination of land yield and farm labor. 2 In other words, bootstrap acquisitions of farm land by farmers are possible only if purchasers have other assets that generate income beyond consumption needs.

(3) Farmers who already own land may be able to add to existing holdings because they do have assets that generate excess income, but

---

*Professor of Law, University of Washington. Visiting Professor of Law, University of Michigan (1980).

1 As of late 1977, the average farm wage paid to hired workers was $2.99 per hour. Crop Reporting Board, Statistical Reporting Service, USDA, Farm Labor 12 (November 23, 1977).

increases of price in relation to current yield would make such purchases more difficult.

(4) As farmers find it more difficult to purchase land or to expand holdings, persons who have compensation or investment income in excess of current consumption needs will acquire an increasing share of the nation's agricultural land.

There exists, then, a substantial danger that those who now till the soil will lose ownership of the land. There exists a further danger that farmers who do not own all the land they farm but who are nevertheless entrepreneurs (such as tenant farmers; partners of land owners; etc.) will become mere employees of limited partnerships, corporations, or individual nonfarm investors. To some extent this danger may be attributable to the economic characteristics of farm land. But I believe that our Federal tax structure contributes significantly to the danger.

2. Economic Income Generated by Agricultural Land.

The economic income generated by any asset is the sum of current return plus capital appreciation. For example, a bond purchased at par paying 12% interest generates a 12% return. The same bond purchased at less than par generates a higher total return. An asset that pays a current yield of 5%, but that grows in value by 10%, generates a total economic return of 15%.

It is possible that in an inflationary economy both current return and

---

3. The limitation on deductibility of investment interest of I.R.C. § 163(d) might cause some absentee owners to transform landlord-tenant relationship into employer-employee relationships. The "material participation" condition to favorable estate tax treatment under I.R.C. § 2032A could have a similar effect.
capital appreciation should be discounted to reflect the inflation rate, but it would not be proper to discount capital appreciation without discounting current return. If the inflation rate is 10%, for example, it would not be proper to tax a 10% interest rate and discount a 10% capital growth rate. In sum, if interest is income in an inflationary economy, so is capital appreciation.

Current return can be expected to be high on assets that do not grow in value, and low on assets that grow in value. Bond interest is high in relation to value, presumably because a bond has no growth potential. Land rent is low in relation to value, presumably because land has a history of value appreciation. Although rates of return on agricultural land vary from locality to locality and from year to year, the average current return on agricultural land is about 3% of current value. A 3% current return may appear to be low when debt instruments pay from 10% to 20%, but the low current return has been offset by land value appreciation that is almost three times the inflation rate. Stated somewhat differently, the per acre value of farmland multiplied over thirteen times between 1942 and 1977, compared to a less than fourfold increases in prices generally.\(^4\) Agricultural investments may be sound investments for some people, but it is obvious that one cannot borrow money at 15% to buy land that generates a net rent of 3% or 4% unless one has excess income or wealth to meet the shortfall.

3. Taxation of Economic Income Generated by Farmland.

The preceding is related to our Federal tax structure in the sense that current yield is taxed currently, but capital appreciation is not. Only a small portion of the economic yield from agricultural land is subject to current taxation. Any investor knows that economic income includes capital appreciation, but our tax system does not tax capital appreciation until the appreciation is realized by means of a sale, exchange or similar disposition. Even if gain on a land disposition is realized, tax may be deferred if the land is exchanged for other land, for an interest in a partnership, or for an interest in a corporation. Appreciation accruing during a land owner's life is never taxed if the owner holds the land until he or she dies. In the unlikely event of a taxable sale, only 40% of the capital appreciation on land is included in the individual seller's taxable income. Although exceptions apply, it seems fair to conclude that the major part of income generated by farmland is not taxed, because it is unrealized appreciation type income.

The exemption of unrealized appreciation from tax obviously benefits high-bracket taxpayers more than low bracket taxpayers. As between farmers, the exemption discriminates in favor of those farmers who have substantial current return type income over those farmers who have little or no current return type income. As between farmers and all other persons, the exemption discriminates in favor of those classes of people who have high current income. If one assumes that farmers as a class do not have high current incomes, failure to tax unrealized appreciation discriminates against farmers as a class. It is, accordingly, at least arguable that the disparity in
benefit I have just described causes wealthy investors and highly compensated persons other than farmers to drive up the price of farmland to levels that are excessive in relation to current return—at least for farmers. If the tax exemption of municipal bond interest drives up the cost of bonds in relation to yield, the tax exempt feature of a major portion of economic income from farmland should have a similar effect.

It is not likely that we will ever tax unrealized appreciation. A Congress that has not been able to sustain an increase in our capital gain tax, or to abolish the rule of stepped-up basis at death, is not likely to consider taxing unrealized appreciation. But we should ask more questions about the nontax effects of the doctrine.

4. Deductibility of Interest.

We should seriously question whether interest should be currently deductible if it represents the cost of acquiring capital appreciation type property. We try to disallow the cost of indebtedness incurred or continued to purchase tax-exempt bonds. We should recognize that the realization doctrine is a form of tax exemption as well. I shall try to illustrate my argument by an example:

Taxpayer borrows $500,000 at 12% interest to buy farmland that generates no current income because property taxes and maintenance expenses equal or exceed the amount of cash rent received. The farmland grows in value at the rate of 20% per year.

In the example I have just given, the Taxpayer incurs an interest expense of $60,000 and obtains capital appreciation of $100,000. Absent the strange economics supplied by our tax laws, we would say that the Taxpayer has net
income of $40,000 under the Haig-Simons definition of income. But our tax
laws do not tax the $100,000 of unrealized appreciation. The $60,000 of
interest expense is, nevertheless, deducted from income. True income of
$40,000 is transformed into a tax loss of $60,000.

5. Repeal Interest Deduction.

I do not advocate the repeal of the doctrine of realization. But I do
believe that, in the example I have just given, the interest "expense" should
be disallowed if unrealized appreciation is not taxed. There is a certain
lack of consistency in permitting a taxpayer to deduct an interest expense
when the capital appreciation generated by the expense is not taxed. The
interest expense should, at least as to persons other than full-time farmers,
be treated as a part of the cost of acquiring the land. Treating interest as
a nondeductible capital outlay would correspond to economic reality. The
present deductibility of interest on farm acquisition indebtedness reduces
the cost of acquiring the farmland. The reduction is greatest for taxpayers
in the highest brackets and lowest for persons in the lowest brackets. If
farmers tend to fall into the lowest brackets, deductibility of acquisition
indebtedness is a form of unfair competition to farmers. As an example,
assume again a purchase of farmland at a cost of $500,000 financed by money
borrowed at 12%. A mortgage of a given duration could result in payment of
$500,000 principal and $1,000,000 interest. The after tax cost of the
interest payments (if interest is deductible) would be $300,000 for the 70%
paragraph taxpayer; $500,000 for the 50% bracket taxpayer; and $800,000 for the
20% bracket taxpayer. Total costs would be $800,000 [70% taxpayer];
$1,000,000 [50% taxpayer] and $1,300,000 [20% taxpayer]. If we assume that
farmers as a class are more likely to fall into the 20% category than into either the 50% or 70% category, then farmers pay more for farmland than do highly compensated executives in the 50% bracket or persons with unearned income that is taxed at a rate of 70%. Under the same assumption, the deduction for interest expense places farmers at a competitive disadvantage in purchasing farmland. If it is considered advantageous to encourage ownership of farm land by farmers, this competitive disadvantage should be terminated.

It is true that section 163(d) of the Code disallows the deductibility of so-called "excess investment interest." But a taxpayer may deduct "net investment interest" expense to the extent of the sum of $10,000 plus investment income. For this reason, the provision is no barrier to an investor who has substantial amounts of passive investment income. Almost by definition the taxpayer in the 70% marginal bracket is there because he or she has received substantial investment income. The investor who has $200,000 of income from stocks and bonds can deduct up to $210,000 of investment interest expense. The highly compensated executive who can afford to pay interest expense but who does not have other investment income is adversely affected by section 163 unless he can convert a farm "investment" into a farm "business" by having section 162 expenses in excess of 15 percent of rental income. Thus, by sharing costs of fertilizer, or by converting a landlord-tenant relationship into a sharecropping arrangement, the executive without substantial investment income can avoid the limitations on deductibility of investment interest.
It would seem eminently reasonable to require persons other than full-time farmers to capitalize interest expense incurred or maintained to finance the purchase of agricultural land. To prevent avoidance of this basic principle, Congress could simply enact a rule that interest expense of nonfarmers is to be disallowed in any event to the extent of 10% of the basis of such persons in the land. Thus, if a nonfarmer purchases farmland at a cost of $500,000, interest expense of any kind incurred by that person should be disallowed to the extent that it does not exceed $50,000. Any interest payment made nondeductible by this provision would be added to the owner's basis in the agricultural land. The rule could, of course, be modified to allow deductibility of a minimum amount of interest. But the proposal should be examined if it is our policy to encourage ownership of farmland by those persons who till the soil. If any such rule is adopted, it should be a rule that disallows an interest deduction generally to the extent of basis in agricultural land rather than a rule that disallows interest on indebtedness incurred or continued to acquire agricultural land, because a rule of the latter type is too easily circumvented. Full-time farmers might be given the option to deduct or capitalize interest expense. This kind of discrimination in favor of farmers would not be novel. It already exists in such provisions as I.R.C. §§ 1251 and 2032A.


I have expressed elsewhere my view that existing Federal estate tax provisions designed to save the family farm will have precisely the opposite effect. Hjorth, Special Estate Tax Valuation and the Emergence of a Land-holding Elite Class, 53 Wash. L. Rev. 609-662. I quote from that article:
"Section 2032A applies to estates whose major asset is a farm or ranch. Its principal feature is the 'productive formula' of land valuation. This formula values farmland solely by reference to current net income yield, disregarding totally any value attributable to anticipated growth in dollar value of that land. Section 2032A can reduce the value of a single estate by up to $500,000; in one husband-wife generation, the total reduction can be as much as $1 million. Maximum estate tax savings in one such generation can amount to $700,000.

Section 6166 applies to any estate in which a closely held business, including a farm or ranch, is the major asset. It allows the executor to defer payment of the entire estate tax for a period of five years and, thereafter, to pay tax in installments over the next ten years. The interest rate on the estate tax attributable to the first $1 million of farm or other closely held business property is reduced to a permanent rate of 4%. It has been observed that this provision can result in savings of from 28.5% (assuming a normal interest rate of 7%) to 47.5% (assuming a normal interest rate of 9%) of estate tax attributable to the first $1 million of farm property; in dollar terms this subsidy can range from $85,000 to $142,000.

It appears generally to be assumed that these estate tax subsidies, which benefit only the wealthiest 2% of the population, will help save the family farm. This article examines that assumption and concludes that it is unfounded. Indeed, it seems more probable that sections 2032A and 6166 will contribute to the decline and possible demise of the family farm. Several factors point to this conclusion:

(1) Sections 2032A and 6166 promise both to increase the demand and to reduce the supply of farmland in the market, with the likely result that land prices will become so high in relation to current yield that only those with substantial outside income will be able to enter the agricultural market.

(2) The subsidies benefit owner-operators of farms, but do not benefit tenant farmers, who will find it increasingly difficult to buy any of the land they till as prices rise.

(3) The subsidies grant larger benefits to wealthy owner-operators than to operators owning farms of modest size, and the small owner-operators will themselves find it increasingly difficult to buy more land if the provisions grant them only a small benefit but drive up the price of land significantly.

(4) The subsidies are unavailable to the estates of persons who have sold their farmland during their lifetimes; thus, they interfere with any desires which retiring farmers may have to sell to other farmers and further restrict the supply of land.
(5) Families that own land but have no relatives who wish to farm the land will be encouraged to transform landlord-tenant relationships into sharecropping arrangements in which decisions concerning the day-to-day operations of the farm will be made by absentee landlords.

Sections 2032A and 6166 also raise difficulties unrelated to their threat to family farms. They complicate estate planning by making it more difficult to draft marital deduction clauses in wills and by making post-mortem administration and planning extremely burdensome. Because they apply only to the estate tax, they interfere with the general policy behind the 1976 Act of treating inter vivos and testamentary transfers similarly for transfer tax purposes. Finally, because their advantages are available only to families which have a member who "participates materially" in the operation of the farm or ranch, relatives of persons who inherit or own land will find it easier to rent land than will persons who are not so related."

One redeeming feature of section 2032A was that it attempted to grant estate tax relief only to full-time farmers. But expansion of a tax concession is much easier than contraction, and we already are hearing that the "material participation" requirement is unreasonable and that a broader group of people should be able to utilize section 2032A. If section 2032A becomes available to investors generally, agricultural land will remain the income tax shelter it already is. Beyond that, it will become an estate tax shelter par excellence. As such, it could become the favored investment of the rich and our tradition of owner-occupied farms will become a relic of history.

7. The Status of Tenant Farmers.

My experience is limited to farming operations in the Midwest and in the Pacific Northwest. I have not noticed a substantial displacement of individual farmers by large corporations owned by nonfarmers. Individual farms have grown in size as technology has advanced. The farmer who farmed 160 acres 25 years ago may farm 600-1000 acres today. In many cases that
farmer will own some of the land he farms, but will rent a substantial portion from an investor. There are fewer farms, but each farm is larger. We may already have passed the point where we can expect farmers to buy the increased acreage required for an efficient farming operation, but our tax structure can have a substantial effect upon the relationship of the farmer to land he does not own. The farmer of the future may be a tenant farmer who is in charge of his farm operation, or he might be a salaried employee of an absentee owner or corporate owner. It is my belief that in the long run tenant farmers will be more productive than salaried farm workers. If I am correct, we should avoid tax rules that favor the nonfarm investor who "participates materially" over the nonfarm investor who makes no such pretense. It is a mistake, in other words, to grant a tax preference to "farmers" and then define the term so loosely that a landlord is excluded but the principal in a sharecropping arrangement is included.

If there is any merit to my earlier argument, investors may drive the price of agricultural land up to a point where current yield is negligible. If current yield becomes negligible, then a farmer who loses ownership but becomes a tenant loses little. If, on the other hand, the farmer who loses ownership becomes a salaried employee, we all lose a great deal. Provisions such as section 163(d) and section 2032A, at least to the extent they encourage employer-employee relationships over landlord-tenant relationships, should therefore be abolished.
In the mind of this observer, several important issues were raised by these proceedings. They are solely the opinion of this observer. They do not represent either the individual or the collective wisdom of the panelists. Rather they are vagrant thoughts that came to mind as the panelists discussed the issues set forth above.

1. Tax policy seems always to produce results that simply are unintended. For example, it seems unlikely that the estate tax relief offered to some farm estates through special use valuation was intended to increase farmland values. Similarly, the effect of locking heirs into the land was probably unintended. A legislative effort to deal with these unintended benefits will likely distort them from their original purpose and produce even more unintended results.

The issue is not whether these results are "good" or "bad." Presumably, high land values are good for some people (e.g. sellers) while bad for others (e.g. buyers). The lock-in effect is neutral for one who does not care to sell, but obviously will be considered undesirable by one who wants to sell and by one who wants to buy. The issue is that the desire to bestow preferences on individuals produces decidedly varying consequences. Some people will want redress from these consequences. If redress is not granted in straightforward repeal of the policy raising the ground for redress, more unintended consequences will be produced. The solution will also likely be complex and raise still another set of arbitrary and capricious qualifying standards.
Perhaps, another way of stating this conflict is that the macro effects of public policies on society frequently differ from the apparent micro effects on the individual. The consequence to any particular individual will depend on that person's situation and may appear desirable. When, however, society as a whole responds, the overall result may be quite different and at the micro level induce a second order of results. The second order effects may not be easily perceived, or perhaps not perceived at all. The legislative process focuses on the micro aspect with little attention given the macro level or second order micro results.

2. However undesirable the macro aspect may be, those who perceive a benefit at the micro level will resist change even though the macro changes may have bled away the micro benefits. For example, if the benefits of cash accounting are capitalized into the value of land, an elimination of them would, at least for some taxpayers, be beneficial. While they would pay higher taxes, their after-tax incomes would be higher than they now are. Yet gaining the market advantage is uncertain and depends on forces that few understand. It would not be considered adequate compensation for the loss of the tax benefit.

3. The changing of public policy knowing that some people will be injured by the change is obviously a serious matter, but it is commonplace. Is the argument against change made by those who rely on tax preferences stronger than the argument made by others who depend on other public policies?

4. By its very nature, a tax preference can be conferred upon only a part of the taxpayers. The intended class of beneficiaries must be defined. The drafting of definitions and qualifying criteria inevitably produces complexity. Extreme complexity will inevitably produce extreme dissatisfaction.
Some intended beneficiaries will fall outside the ambit of the preference, and some unintended will benefit. Distinctions will appear arbitrary and capricious.

But does this complexity exist except at the periphery? Is there a large segment for whom the rules are clearly applicable or inapplicable? Is the large core of beneficiaries saved more efforts than are necessary for those as to whom application is questionable? For example, if farmers were required to keep inventories, would they collectively be burdened more than those who now fight the complex rules of qualification are burdened? How does one go about answering this question? Is it a relevant question?

5. Where a large part of the financial rewards are dependent upon a complex set of tax preferences, the nature of the business is changed. Tax considerations require experts, and a failure to employ them can lead to missed opportunities without any recognition that the opportunity has been lost.

This change in business may not be recognized by the participants. How many farmers believe that the tax lawyer's opinion may reap more profits than an increase in fertilizer would? Indeed, how many farmers can be expected to know that the competitive advantage flows to high income taxpayers, and that the advantage exists whether or not the income has its source on the farm? If these matters are not understood, can we not expect dissatisfaction by those engaged in farming?

6. How important are tax considerations to farm investment? Are they strong determinants of behavior or are they relatively not very significant?