A FairTax[sm] White Paper

The FairTax benefits farmers and ranchers

by Ross Korves

About five million Americans live on the nation's 2.1 million farms and ranches. Farming and ranching remain as vital to the economy today as they have been throughout our nation's history. In 2005, farming and ranching produced crops and livestock valued at $249.2 billion and generated $109.4 billion in added value to the gross domestic product of the country.[1] These enterprises employed 3,034,000 workers, including 2,198,000 full time and part-time farm operators and 834,000 hired employees. Agricultural products comprise 7.7 percent of all exports from the U.S., for a total of $62.3 billion in exported products in fiscal year 2004. Farms and ranches generate economic activity that transcends the rural communities in which they were produced, creating upstream jobs in manufacturing and downstream jobs in processing, transportation, retailing, and exporting.

I. Farmers and ranchers are disadvantaged under the income tax system.

Some policy analysts argue that farming and ranching are subsidized under our current income tax system. These include favorable accounting and inventory methods, certain income deferral provisions, capital gain/ordinary loss treatment and expensing allowances. However, rather than being subsidies, these are simply practical accommodations in an income tax system that is overly complex for most farmers and ranchers with relatively simple business structures. Although the effective tax rate has been gradually declining from the stratospheric level of 1980, farmers and ranchers still bear high tax and compliance burdens on the operation of their businesses.

***The nature of farming creates unique problems under current tax law*.**

Farming and ranching are unique for several reasons: They involve long-term capital investment, face substantial weather and market risks, are often family owned and operated, even when incorporated, and involve assets that are mostly illiquid. According to the 2002 Census of Agriculture, individual and family farms, partnerships, and family-owned corporations account for 98.9 percent of the farms and ranches. Non-family corporations own only 0.3 percent of farms and ranches. Farmers and ranchers are often correctly characterized as being asset rich and cash poor because almost all of their resources are concentrated in one of the most illiquid of assets – the family enterprise. According to USDA estimates, over 75 percent of farm assets are in land and buildings.

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[1] United States Department of Agriculture, Economic Research Service, "2005 Forecast: Income for the Farm Sector and Farm Households," http://ers.usda.gov/features/farmincome/2005farmincome/.

Their special tax problems fall into three categories:

(1) The confiscatory tax imposed on the sale, gift, or bequest of the farm or ranch

(2) The increasing application of the alternative minimum tax to farming and ranching, which will become a huge problem over the next decade

(3) The failure of the current tax code to adequately take into consideration fluctuations in year-to-year income

Current capital gains treatment causes problems with illiquid assets.
The concentration of wealth and savings in illiquid farming and ranching assets conflicts with the capital gains tax regime. The current capital gains tax structure imposes a tax of as much as 15 percent (which will increase again to 20 percent in 2010 under current law) on the sale of farms and ranches and depreciated machinery and equipment. Since the capital gains tax on the transfer of farmland and rangeland is not adjusted for inflation, much or all of the real wealth gains are lost at transfer due to the capital gains tax on nominal increases in value. It often makes little economic sense for farmers and ranchers to exit the business with such a high exit tax.

The problem is magnified when a farmer or rancher attempts to pass the enterprise to succeeding generations. Since the estate tax imposes steeply graduated taxes on the value of assets, many farmers and ranchers must use scarce management time and capital to create estate plans to avoid estate transfer taxes that top out at 45 percent in 2007. Under the current law, aggregate gifts and bequests to grandchildren or younger beneficiaries in excess of $2,000,000 are subject to the generation-skipping transfer tax. This exemption is scheduled to increase to $3,500,000 in 2009 and become unlimited in 2010.

However, the same law that increased the exemption, lowered the tax rate, and is scheduled to eliminate the tax in 2010 is set to expire in 2011. Unless Congress takes legislative action prior to 2011, the estate tax will come back in 2011 with a $1.0 million exemption and a top rate of 55 percent. With this level of uncertainty, farmers and ranchers have little choice but to continue to update estate plans with the expectation that such taxes will be a likely reality.

According to the 2002 Census of Agriculture, the average age of the principal operator of farms and ranches is 55.3 years, with 26.2 percent of the primary operators at 65 years old or older. USDA research has shown that farmers hold land on average for about 30 years. Older farmers and ranchers are often concerned about retirement and would like to use the capital investments acquired through the past 30 years to create an adequate retirement plan.

The current tax regime also conflicts with the high-risk nature of the industry. Because the current tax system works best when incomes fluctuate little from year to year, farmers and ranchers pay a higher tax rate than if their incomes were averaged over the course of many years. While the income averaging features of the current law that were added in recent years have helped, farmers and ranchers must continue to do substantial income tax planning to avoid higher tax rates when a good income year does occur.

The best planning is often undone by the AMT.
In addition, the alternative minimum tax (AMT) negatively affects farmers and ranchers. Virtually all farm and ranch tax specialists automatically run most farm accounts through both the regular tax system and the separate AMT system to determine the total tax liability. While the AMT was designed to tax high-income individuals who did not owe taxes under the regular income tax system, it has begun to affect middle-class farmers and ranchers who use depreciation and other features of the current tax law. The best laid plans of farmers and ranchers and tax preparers can easily be undone by the complexities of the AMT.

II. The FairTax eliminates these disadvantages.

The FairTax eliminates all federal individual and business taxes.
The FairTax completely eliminates any federal taxes imposed on farm and ranch income. Farmers and ranchers never again pay taxes on farming and ranching profits. Income is no longer reported on the Schedule F, since no returns are filed. The FairTax also eliminates self-employment taxes for Social Security and Medicare.

Moreover, the FairTax applies only when goods or services are purchased for personal consumption. Business-to-business transactions are not taxed, and therefore, the purchase of items such as machinery, feed, fertilizer or services is not taxed. The USDA estimates that only two percent of farmers and ranchers sell products directly to consumers. These producers would need to collect sales taxes and remit them to the sales tax collection agency, just as many of them now do for state sales taxes.

The FairTax lowers the effective tax rate on farming households.
The FairTax favorably affects farming households by lowering the tax rates that they currently pay. Under the FairTax, the maximum tax rate possible is 30 percent on purchases at the retail level (the equivalent of 23 percent on the current payroll tax and income tax basis). This effective rate is well below the average effective combined payroll and income tax rate paid by many farmers and ranchers. More importantly, the actual sales tax rate paid by farming households is significantly less than 30 percent, since each family is provided a tax rebate which guarantees that no American household pays any FairTax on purchases of basic goods and services up to the poverty level. In this way, the FairTax, unlike the current system, exempts from taxation the basic necessities of life. This is accomplished by providing a rebate to each family equal to the taxes paid on the purchase of essential goods and services, as determined by the Department of Health and Human Services poverty level guideline. The rebate is paid monthly, in advance, to every family.

The table below shows the monthly rebate that families are entitled to in 2007, under the FairTax legislation. All lawful residents holding valid Social Security numbers are eligible for the rebate. Monthly rebates are sent out in advance of purchases to assure that no taxpayer pays taxes on essential goods and services. The annual consumption allowance for a married couple without children is two times the annual consumption allowance for a one-person household. This is part of the FairTax plan so there is no "marriage penalty" in calculating the tax rebate.

2007 FairTax prebate schedule[2]

One adult household				Two adult household			
Family Size	Annual Consumption Allowance[1]	Annual Prebate	**Monthly Prebate**	Family Size	Annual Consumption Allowance[1]	Annual Prebate	**Monthly Prebate**
1 person	$10,210	$2,348	**$196**	N/A	N/A	N/A	**N/A**
and 1 child	$13,690	$3,149	**$262**	couple	$20,420	$4,697	**$391**
and 2 children	$17,170	$3,949	**$329**	and 1 child	$23,900	$5,497	**$458**
and 3 children	$20,650	$4,750	**$396**	and 2 children	$27,380	$6,297	**$525**
and 4 children	$24,130	$5,550	**$462**	and 3 children	$30,860	$7,098	**$591**
and 5 children	$27,610	$6,350	**$529**	and 4 children	$34,340	$7,898	**$658**
and 6 children	$31,090	$7,151	**$596**	and 5 children	$37,820	$8,699	**$725**
and 7 children	$34,570	$7,951	**$663**	and 6 children	$41,300	$9,499	**$792**

For example, under the FairTax a family of four with a husband and wife, spending at or below the poverty level ($27,380) would have a zero or negative effective tax rate because of the rebate. This same family with expenditures of $54,760, an amount twice the poverty level, pays an average sales tax rate of only 13 percent on goods and services (equivalent to 11½ percent under the current income and payroll tax systems). If they spent $109,520, four times the poverty rate, they would have an average sales tax rate of 20.9 percent (equivalent to 17.3 percent under the current system). The most recent estimate for average income for farm-operator households in 2006 is $75,848.[3] If this average farm-operator household were to spend 90 percent of the money and save 10 percent, they would pay $9,629 in federal sales taxes (12.7 percent of income). Compare this to the current system where this household has to pay a self-employment tax for Social Security and Medicare of 15.3 percent in addition to income taxes, regardless of how much money they save. The total tax liability for an average farming and ranching family under current law exceeds the maximum tax rate imposed under the FairTax.

The FairTax eliminates all capital gains and estate taxes.

In addition to eliminating income taxes, the FairTax eliminates both capital gains and estate and gift taxes. Unlike current law, the FairTax does not penalize capital-intensive investments; it allows farms to be sold without imposition of a capital gains tax on increases in market value (including phantom capital gains caused only by inflation) and it does not penalize transfers to succeeding generations. The FairTax ensures that no tax would be imposed on capital purchases, sales or ownership transfers.

[2] The 2007 Department of Health and Human Services Poverty Guidelines, Federal Register: Jan. 24, 2007 (Vol. 72, No. 15, pp. 3147-3148, plus an additional amount to remove the marriage penalty. The annual consumption allowance is the amount of spending that is "untaxed" under the FairTax.
[3] United States Department of Agriculture, August, 2006.

III. The FairTax has other beneficial effects.

The FairTax eliminates compliance costs for most farmers.

Under the FairTax, there are no more inventory requirements, no complex rules governing employee benefits and retirement plans, no more depreciation schedules and depreciation recapture, no more capital gains tax, and no more alternative minimum tax. In place of having to comply with the complexities of the IRS system's income and payroll taxes, there is one national retail sales tax imposed only on new goods and services purchased for personal consumption. If the farm or ranch makes retail sales to a final consumer, the operator simply collects and remits (to state sales tax authorities) on a monthly basis a 30-percent national retail sales tax. All sales to other businesses are not taxable transactions. Farmers and ranchers report wage income for employees and self-employment income to the Social Security Administration for benefits calculation proposes. They report the income, but do not pay payroll taxes.

The FairTax stimulates the economy.

Farmers and ranchers benefit from a more prosperous, growing economy. Real wages increase and economic projections from many economists predict a much healthier economy. These studies typically do not account for the productivity gains that are achieved due to lower compliance costs. Typical estimates are that the economy will be 10 to 14 percent larger than it would have been under the income tax system within 10 years; consumption grows very substantially. Some studies show the potential gains to be much higher.[4]

The FairTax rewards savings over consumption.

U.S. farmers and ranchers know the value of saving and investing. The FairTax rewards efforts to save by never again taxing income from savings. The only time an individual is taxed is when he or she purchases new items beyond the necessities of life for his or her own personal enjoyment. Consumption is taxed and savings and the income from savings are not taxed.

The FairTax lowers interest rates.

One of the best attributes of the FairTax is that it causes a drop in interest rates and reduces the carrying costs of debt. Under the FairTax, conservative estimates predict that interest rates fall by 20 to 25 percent.[5]

The FairTax makes American products more competitive internationally.

The FairTax improves the balance of trade for agricultural products because it does not tax agricultural products that move into exports. About one acre out of every four acres of crops produced in the United States is exported. Imports of agricultural products have increased in

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[4] For a brief summary of the major findings of these studies, see "The FairTax and economic growth," Americans For Fair Taxation White Paper. Available at http://www.fairtax.org/PDF/TheFairTaxAndEconomicGrowth.pdf.

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

recent years as trade barriers have been reduced and consumers have sought a more varied diet. Under current tax laws, taxes are paid on U.S. products that are exported and imported products are untaxed on the value of the products at time of importation. Some countries provide for tax rebates for exported products. U.S. products are put at a competitive disadvantage in international trade under the current U.S. tax system.

Under the FairTax, exported goods are not consumed in the U.S and are, therefore, not subject to the sales tax. Their prices carry no burden of domestic taxation when they arrive in export markets. On the other hand, imported goods are subject to the FairTax, taxing those products when sold at retail in the U.S. The FairTax plan does not tax intermediate goods and services since those goods and services are taxed when they are sold to final consumers.

About Ross Korves

Ross Korves is an independent economic policy analyst.

He is a Trade Policy Analyst with Truth About Trade and Technology, a group begun and run by farmers and ranchers who believe in increased international trade and the use of biotechnology, and an Economic Policy Analyst with the ProExporter Network, a transportation and grain processing analysis firm. He also provides analysis and advice on federal tax policy for farmers and ranchers and health care policy.

Ross spent 25 years as an economist for the American Farm Bureau Federation. He is a native of southern Illinois and a graduate of Southern Illinois University.

What is the FairTax Plan?

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?

FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

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(AFFT Documents\Papers on a specific subject\Impact of the FairTax on farming and ranching)