S. Hrg. 99-992

IMPACT OF TAX REFORM ON AGRICULTURE AND FAMILY FARMS

HEARING

BEFORE THE

SUBCOMMITTEE ON AGRICULTURE AND TRANSPORTATION

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

SECOND SESSION

APRIL 29, 1986

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

65-380 O WASHINGTON : 1987

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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[Created pursuant to sec. 5(a) of Public Law 304, 79th Congress]

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CONTENTS

WITNESSES AND STATEMENTS

TUESDAY, APRIL 29, 1986

SUBMISSIONS FOR THE RECORD

TUESDAY, APRIL 29, 1986

APPENDIX

IMPACT OF TAX REFORM ON AGRICULTURE AND FAMILY FARMS

TUESDAY, APRIL 29, 1986

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON AGRICULTURE AND TRANSPORTATION
OF THE JOINT ECONOMIC COMMITTEE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room SD-538, Dirksen Senate Office Building, Hon. James Abdnor (chairman of the subcommittee) presiding.

Present: Senators Abdnor and Boschwitz.

Also present: Robert J. Tosterud, deputy director; and Dale Jahr and Tim Bergan, professional staff members.

OPENING STATEMENT OF SENATOR ABDNOR, CHAIRMAN

Senator ABDNOR. The subcommittee will come to order.

It is a distinct pleasure for me to convene today's hearing. I want to extend to our prestigious panel of witnesses a warm welcome from me and the rest of the subcommittee. We have a lot of activity around here. Some of our members are marking up or looking at that tax reform package, the second go-around, and that ties in very closely to this hearing.

I want to welcome Senator Boschwitz as he comes in.

Anyway, one thing about our witnesses, whether Members of the Congress or whether they're in from other areas of the United States, we are here of course for our concern for agriculture and rural America. I know that is why you have agreed to appear here and share your views and we do appreciate it very much.

How taxes affect agriculture is not a new topic for me. As a matter of fact, this is the third hearing my subcommittee has held on this subject. In addition, last year we published a study that I think is an excellent background on this otherwise mystifying subject. I don't know why it is, but the subject of taxation always seems to be shrouded in misunderstanding and confusion. But for the sake of agriculture, I hope we can shed some light today.

My interest in agricultural taxation intensified a couple of years ago after I did a little research on abusive tax sheltering in agriculture. And the deeper I got into the problem, the more skeletons I found in the closet. I just want to share a few examples of what I've found or uncovered.

In 1982, over 36,000 tax returns had adjusted gross incomes exceeding $100,000, and showed farm losses. In total, these wealthy individuals took over $1.2 billion in tax deductions, or an average deduction of $34,000 a return. They took more in deductions than most Americans even earn.

And the wealthier you are, the more income you have to shelter. That same year, in 1982, farmers losing more than $200,000 had off-farm incomes averaging $568,000 and they took farm loss deductions of $410,000. Imagine that, $410,000. You just don't throw that kind of money away. People aren't stupid; they are sheltering this money from Uncle Sam.

As another example, over 100,000 tax returns reported farm losses and had farm sales exceeding $100,000. Now, these are medium-sized commercial farms or a little larger. But these so-called "farmers" reported off-farm incomes that averaged $47,000, almost twice the U.S. median household income. And their farm losses, on average, erased their income tax liability. In total, these people sheltered over $5 billion in off-farm income.

All of this evidence points to the fact that we have wealthy persons who can afford to pay taxes and who ought to pay their fair share of taxes, but yet are able to shelter significant amounts of their income from taxation. This abhorrent practice must no longer be tolerated for the sake of the entire agricultural economy and for the sake of the whole Nation as well. At a time when farmers are in the predicament that they are, to have to compete with this kind of a situation is just totally intolerable.

Ironically, the Tax Code's treatment of agriculture was intended to assist full-time farm proprietorships and to enhance food production for economic, social, and national security reasons. But instead, these provisions have attracted thousands of nonfarmer investors who are more interested in farming the Tax Code than they are in making a bona fide profit from their farming activities.

This proliferation of tax sheltered farming has three immediate effects, all of which hurt the full-time farmer directly. First, the tax shelters contribute to the overproduction of agricultural commodities. These surpluses have ruined farm prices in recent years, causing cash-flow problems for countless thousands of genuine farmers.

Second, these tax shelters drain the Treasury of badly needed revenue. By some estimates, abusive tax sheltering robs the U.S. Government of hundreds of millions of dollars annually. The Federal deficit is higher consequently, which has contributed to the high value of the dollar, making the export of food products all the more difficult.

Third, these tax sheltering schemes often take full advantage of farm programs as well, which take funding away from deserving farmers and makes the farm programs all the most costly to the taxpayers.

Now, what can be done to stop this flagrant abuse of our tax system? I have introduced legislation which limits the amount of off-farm income that can be sheltered by farm losses and deductions. Family farms would not be affected by this proposal, which sets the income limit at the national household income level, which last year was about $25,000. In fact, my legislation would put the bona fide farm on better footing to compete with large-scale and capital-intensive operations.

Above all, in this time of unwanted deficits, my legislation would save the Treasury $2.6 billion over 3 years if it was enacted. That kind of contribution to deficit reduction cannot be ignored.

I want to dismiss a myth perpetuated by my critics, who say it would ruin investment opportunities in agriculture. Well, it will eliminate destructive investment, but the tax-loss farming legislation that I introduced does not wipe out legitimate investment in agriculture. Anyone can still invest and take full deductions, so long as they are in farming to make money. My bill still exempts about 25,000 dollars' worth of losses. That amount of money is still very substantial where I come from in South Dakota. To the contrary of my critics' perspective, my legislation strengthens American agriculture by eliminating unfair competition which is hurting full-time, commercial, family farm operations.

Now I've gotten side-tracked and carried away with my pet peeve and I'm sorry, because this is a broader hearing than just the tax loss. We are here to discuss other tax issues as well and they are just as important to me. Modifying the Tax Code is sobering work and I, for one, want to proceed carefully and cautiously with these considerations. And I don't mind telling you some of the things I hear coming out of the Senate Finance Committee, Senator Grassley, hasn't exactly overwhelmed me.

I'm not going to go through them all, but I'm concerned about the investment tax credit; I'm concerned about depreciation, cash and accrual accounting—and I could go on, but I know I'm taking too much time.

The farm families are the very symbol of our Nation's agrarian heritage, free enterprise, independence and self-reliance. And they are an institution worth defending. By fixing our Tax Code, we can help out the American farmer and at the same time do the American taxpayer and consumer a favor, too.

I'm very pleased that I have a number of my Senate colleagues here who have expressed an interest in this hearing. Senator Boschwitz and Senator Grassley are here and Senator Kasten will soon be here. I'm going to call on Senator Grassley first because if I recall, you're working hard on the latest tax proposal. I just want to say that Senator Grassley brings an excellent perspective to this hearing. He's a member of the Senate Finance Committee and he's really been in the trenches of the tax reform battle. His efforts as an advocate for family farmers are well known. Not only has he been active in the farm debt crisis and reforming the Farm Credit System, but he's also been successful in correcting problems in the Tax Code for farmers who have suffered severe farm debt problems.

Earlier this year the President signed legislation that included a provision by Senator Grassley to eliminate an inequitable tax burden on farmers who deeded their land back to their lenders who had the mortgage canceled. Before Senator Grassley stepped in, farmers had to pay capital gains tax on the land because the mortgage was canceled, even though there was no cash to pay the tax. Senator Grassley corrected this problem and I want to commend you, Senator Grassley, for your efforts.

I understand that the Senate Finance Committee has also been looking at correcting a similar problem that happens to farmers when lenders cancel part of their debt when loans are restructured. I'm sure Senator Grassley has been involved in that.

I know you're busy. I know you think this is important or you wouldn't step out of the Senate Finance Committee, where you have important business going on right now, to testify. Thank you for coming and go right ahead.

STATEMENT OF HON. CHARLES GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. Well, thank you, Mr. Chairman, for your leadership in this area. Thank you for holding this hearing because this hearing is as important a part of a long-term profitability to agriculture—the perfection of the Tax Code—as any aspect that we can discuss here—the farm bill, the interest problem, and the foreign trade problem in agriculture.

And I'm not going to go into, as I do in the early part of my statement, what we all acknowledge is statistics that demonstrate the serious situation with agriculture. So I'm going to go immediately into my points about the Tax Code.

Far from helping to solve this crisis, the Tax Code as it presently exists has caused and is perpetuating many of these problems. Just about every sector of the agricultural economy has been affected by these policies that have led to what we call tax-loss farming—people that are more interested in farming the Tax Code than farming the land.

In 1978 and 1981, two changes in our Nation's tax laws were passed and hailed as major triumphs for our Nation's port producers but have turned out to be major headaches. The first change in the tax laws allowed hog buildings to be termed according to the Tax Code "unitary hog-raising facilities" and therefore were eligible for investment tax credits. The second change made in 1981 allowed for accelerated cost recovery of hog confinement facilities and although creation of these tax provisions were well-intentioned and advocated by our Nation's hog producers, now serious questions have been raised as to whether they have resulted overproduction, lower prices, and fewer farmers because the marketing system is no longer as sensitive to the law of supply and demand as it would normally be. I believe that adjustments must be made in the tax laws to correct this threat to our producers and to do away with tax-loss farmers involvement in port production especially and agriculture generally.

Through various accounting and leveraging devices cattle feeding has also become one of the most lucrative tax deferral shelters, and I see, Mr. Chairman, you have a Wall Street Journal advertisement up there that demonstrates as well as any statement I could make. These tax advantages are particularly attractive to high tax bracket investors and corporations. The net result is that more than half of our Nation's cattle are now produced by about 400 big feedlots. Some of the world's largest grain companies have also become some of our country's largest cattle feeders. This situation is not healthy for our country, for our cattlemen, for our taxpayers, or for the consumers.

Excess production exists in dairy, wheat, corn, and many other agricultural products as well because of tax laws that have enticed tax loss farmers into these businesses. Today in Georgia, for example, we have an Irish firm making a major investment in dairy operations because of tax-exempt bonds available to foreign investors. This is at a time when the 1985 farm bill has mandated a whole herd dairy buyout program to do away with excess milk production here in the United States.

And let me say parenthetically because it's not in my printed statement, but the tax advantages of that is equal to $90 per dairy cow.

The net effect of all these tax policies is that farmers with no income to shelter receive no benefits, while richer farmers and investors increase their competitive position by using shelters and writeoffs. As a result, these large investors can afford lower prices which smaller poorer family farmers cannot afford.

Until recently, the alternative minimum tax provisions of the tax laws actually punished farmers who were forced to liquidate because of adverse action by their lenders. And I appreciate the chairman giving attention to the fact that we have made changes in that law to make it easier for those farmers to settle their accounts and not end up owing a tax bill that was never intended that they owe.

We still have a ways to go, though, besides that bill that the President signed, because today the tax laws still prevent farmers and lenders from getting together to restructure and forgive debts because the farmers end up being punished by getting stuck with a big tax bill after the debt is forgiven. And, Mr. Chairman, again, you mentioned in your opening statement and in your introduction of me that I have had legislation that will solve that problem through the Senate Finance Committee. It's also part of this bill that we don't know will fly and the very discussion that we are taking this morning in the Senate Finance Committee will determine whether or not we continue down that road or change directions.

I also went to lend my support, as I did in the vote last year, to Senator Abdnor's legislation to help limit the amount of nonfarm income that can be offset by losses from farming operations. That is a bill that is very much headed in the right direction.

I am able to report that some first steps are already being taken to deal with these tax problems. One example is the deductibility of prepayment expenses. Many farmers have used this provision to get fertilizer, seed and feed in the fall when the price is lower, which is a valid business practice. But many other investors have used this provision to get an $8 deduction for an $8 investor. According to my Iowa cattlemen, this and other tax shelters have seriously hurt the cattle industry in my State and without closing these loopholes the return of legitimate family farmers to the cattle industry is doubtful. Under an amendment passed by the Senate Finance Committee taxpayers would be limited to a deduction of no more than 50 percent of their prepaid expenses as related to schedule F expenditures.

Mr. Chairman, as you know, many other issues of high priority are presently being addressed in the Finance Committee and I would hope that when we're all said and done, whether or not we take the shorter version of the tax bill just now suggested by Senator Packwood as the new direction or whether we continue to work with the tax bill that was first proposed by Senator Packwood the first week in March, I would hope that either tax approach will lead to major changes in the tax laws to discourage nonfarm interests getting into agriculture, a business that is highly capital intensive as it is, is overcapitalized to a point where the market forces aren't working, and the Tax Code is a decision for investments as opposed to the economics of it.

I thank you for the opportunity to testify and I would ask that my prepared version of my statement be printed in the record in total.

Senator ABDNOR. Without objection, it will be so printed.

[The prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF HON. CHARLES GRASSLEY

MR. CHAIRMAN, I AM VERY GRATEFUL FOR THIS OPPORTUNITY TO TESTIFY BEFORE THE JOINT ECONOMIC COMMITTEE ON THIS IMPORTANT ISSUE. THIS ISSUE IS OF PARTICULAR CONCERN TO ME AS A MEMBER OF THE FINANCE COMMITTEE AND AS A SENATOR FROM AN AGRICULTURAL STATE THAT HAS BEEN ADVERSELY AFFECTED BY TAX POLICY.

AS YOU KNOW, AGRICULTURE IS EXPERIENCING ITS WORST CRISIS SINCE THE DEPRESSION. YOU DON'T NEED TO LOOK VERY FAR TO FIND FARMERS AND FARM RELATED BUSINESSES THAT ARE EXPERIENCING SERIOUS TROUBLE. FARMERS IN MY STATE ARE FINDING THEIR SITUATION DETERIORATING AT AN ASTOUNDING RATE. A SURVEY TAKEN EARLIER THIS YEAR SHOWED THAT IOWA FARMERS HAD THE HIGHEST DEBT-TO-ASSET RATIO OF ANY OTHER STATE IN THE MIDWEST. THIS

36.9 PERCENT DEBT-TO-ASSET RATIO IS UP FROM 29.5 PERCENT JUST TWO YEARS AGO. FARM BANKRUPTCIES, FORECLOSURES AND INTEREST RATES ARE AT ALL TIME HIGHS WHILE PRICES ARE AT LOWS OR NEAR LOWS.

THIS CRISIS IN AGRICULTURE HAS CAUSED A CHAIN REACTION OF CHAOS IN OUR RURAL FINANCIAL AND BUSINESS INSTITUTIONS. NEARLY 450 BANKS IN RURAL AMERICA ARE ON THE FEDERAL DEPOSIT INSURANCE CORPORATION'S LIST OF PROBLEM BANKS, THIS IS UP FROM 370 AT THE START OF LAST YEAR. IN IOWA 18 BANKS HAVE FAILED SINCE MID 1984, WITH THE THREAT OF MORE FAILURES IN THE FUTURE. THE FARM CREDIT SYSTEM, WHICH HOLDS ABOUT ONE-THIRD OF FARM DEBT, LOST MORE MONEY LAST YEAR THAN ANY OTHER U.S. BANK OR FINANCIAL INSTITUTION IN HISTORY. THIS $2.7 BILLION LOSS DWARFS CONTINENTAL ILLINOIS'S 1984 LOSS OF $1.08 BILLION, WHICH AT THAT TIME WAS HIGH ENOUGH TO PROMPT FEDERAL INTERVENTION.

BOTH MAIN STREET FAMILY BUSINESSES AND LARGE AGRICULTURAL CORPORATIONS ARE FALLING PREY TO THIS DETERIORATING SITUATION. FOR EXAMPLE, DEERE AND CO. HAS REPORTED A LOSS OF $34 MILLION FOR THE FIRST QUARTER OF THIS YEAR. SIMILAR REPORTS HAVE BEEN

FILED BY MANY OTHER BUSINESSES WHO DEPEND ON FARMERS TO BUY THEIR PRODUCTS.

I COULD GO ON AND ON. IN A WORD THE SITUATION IS "DESPERATE"!

FAR FROM HELPING TO SOLVE THIS CRISIS, THE TAX CODE, AS IT PRESENTLY EXISTS, HAS CAUSED AND IS PERPETUATING MANY OF THESE PROBLEMS. A NEW KIND OF FARMER HAS EMERGED FROM THE PILE OF LEGISLATION AND REGULATIONS WHICH DICTATES WHO PAYS TAXES AND HOW MUCH. THIS "TAX LOSS FARMER" DOES NOT WORK THE SOIL AND HIS LIVESTOCK TO MAKE MONEY FROM THE MARKETPLACE, BUT INSTEAD HE FARMS THE TAX CODE. HIS PROFITS DON'T COME FROM SATISFYING THE NEEDS OF CONSUMERS BUT INSTEAD FROM SHORT CHANGING THE TAXPAYERS AND CONTAMINATING THE MARKETS OF OUR FARMERS. THESE FARMERS GIVE VERY LITTLE RESPECT TO THE LAND AND COULD CARE LESS ABOUT THE LONG-TERM IMPACT THEY ARE HAVING ON AGRICULTURE.

JUST ABOUT EVERY SECTOR OF THE AGRICULTURAL ECONOMY HAS BEEN AFFECTED BY THESE POLICIES.

IN 1978 AND 1981, TWO CHANGES IN OUR NATIONS TAX LAWS WERE PASSED AND HAILED AS MAJOR TRIUMPHS FOR OUR NATIONS PORK PRODUCERS BUT LATER TURNED OUT TO BE MAJOR HEADACHES. THE FIRST CHANGE IN THE TAX LAWS ALLOWED HOG BUILDINGS TO BECOME "UNITARY HOG-RAISING FACILITIES" AND THEREFORE ELIGIBLE FOR INVESTMENT TAX CREDITS. THE SECOND CHANGE IN THE 1981 TAX BILL ALLOWED FOR ACCELERATED COST RECOVERY OF HOG-BREEDING FACILITIES. ALTHOUGH CREATION OF THESE TAX PROVISIONS WERE WELL INTENTIONED AND ADVOCATED BY OUR NATIONS HOG PRODUCERS, NOW SERIOUS QUESTIONS HAVE BEEN RAISED AS TO WHETHER THEY HAVE RESULTED IN OVERPRODUCTION, LOWER PRICES AND FEWER FARMERS BECAUSE THE MARKETING SYSTEM IS NO LONGER SENSITIVE TO SUPPLY AND DEMAND. I BELIEVE THAT ADJUSTMENTS MUST BE MADE IN THE TAX LAWS TO CORRECT THIS THREAT TO OUR PRODUCERS AND DO AWAY WITH "TAX LOSS FARMERS" INVOLVEMENT IN PORK PRODUCTION.

THROUGH VARIOUS ACCOUNTING AND LEVERAGING DEVICES CATTLE FEEDING HAS ALSO BECOME ONE OF THE MOST LUCRATIVE TAX DEFERRAL SHELTERS ~~FOR DEFERRAL OF INCOME AVAILABLE~~ AVAILABLE. THESE TAX ADVANTAGES ARE PARTICULARLY ATTRACTIVE TO HIGH TAX-BRACKET INVESTORS AND CORPORATIONS. THE NET RESULT IS THAT MORE THAN HALF OF OUR

NATION'S CATTLE ARE NOW PRODUCED BY ABOUT 400 BIG FEED LOTS. SOME OF THE WORLD'S LARGEST GRAIN COMPANIES HAVE ALSO BECOME SOME OUR COUNTRY'S LARGEST CATTLE FEEDERS. THIS SITUATION IS NOT HEALTHY FOR OUR COUNTRY, CATTLEMEN, TAXPAYERS, NOR OUR CONSUMERS.

EXCESS PRODUCTION EXISTS IN DAIRY, WHEAT, CORN, AND MANY OTHER AGRICULTURAL PRODUCTS AS WELL, BECAUSE OF TAX LAWS THAT HAVE ENTICED "TAX LOSS FARMERS" INTO THESE BUSINESSES. TODAY IN GEORGIA FOR EXAMPLE, WE HAVE AN IRISH FIRM MAKING A MAJOR INVESTMENT IN DAIRY OPERATIONS BECAUSE OF TAX EXEMPT BONDS AVAILABLE TO FOREIGN INVESTORS. THIS IS AT A TIME WHEN THE 1985 FARM BILL HAS MANDATED A WHOLE HERD DAIRY BUY OUT PROGRAM TO DO AWAY WITH EXCESS MILK PRODUCTION HERE IN THE U.S..

THE NET EFFECT OF ALL THESE TAX POLICIES IS: FARMERS WITH NO INCOME TO SHELTER RECEIVE NO BENEFITS, WHILE RICHER FARMERS AND INVESTORS INCREASE THEIR COMPETITIVE POSITION BY USING SHELTERS AND WRITE-OFFS. AS A RESULT THESE LARGE INVESTORS CAN AFFORD LOWER PRICES WHICH SMALLER POORER FAMILY FARMERS CANNOT AFFORD.

UNTIL RECENTLY THE ALTERNATIVE MINIMUM TAX PROVISIONS OF THE TAX LAWS ACTUALLY PUNISHED FARMERS WHO WERE FORCED TO LIQUIDATE BECAUSE OF ADVERSE ACTION BY THEIR LENDERS. THESE FARMERS WERE REQUIRED TO COUNT AS INCOME ANY FORGIVEN DEBT AS A RESULT OF THIS FORCED LIQUIDATION. THESE LAWS JUST ADDED INSULT TO INJURY BECAUSE THE FARMERS WHO WERE FORCED OUT OF FARMING WERE STUCK WITH A BIG TAX BILL AFTER THEY HAD GONE BROKE. FORTUNATELY, WITH THE HELP OF MY COLLEAGUES, INCLUDING MY FRIEND, JOINT ECONOMIC COMMITTEE VICE-CHAIRMAN ABDNOR, I WAS ABLE TO GET THIS ALTERNATIVE MINIMUM TAX LAW CHANGED. FARMERS TRANSFERING FARMLAND AFTER DECEMBER 31, 1981, WILL BE ELIGIBLE FOR RELIEF UNDER THIS PROVISION AND FOR THE FIRST TIME FARMERS FORCED INTO LIQUIDATION WILL BE SAVED FROM THIS ADDITIONAL BURDEN.

WE STILL HAVE A WAYS TO GO, HOWEVER, TODAY THE TAX LAWS STILL PREVENT FARMERS AND LENDERS FROM GETTING TOGETHER TO RESTRUCTURE AND FORGIVE DEBTS, BECAUSE THE FARMERS END UP BEING PUNISHED BY GETTING STUCK WITH A BIG TAX BILL AFTER THE DEBT IS FORGIVEN. THIS SITUATION MUST BE CORRECTED SO THAT OUR TAX LAWS HELP SOLVE THE SERIOUS CRISIS IN AGRICULTURE INSTEAD OF

AGGRAVATING IT. USING LEGISLATION INTRODUCED BY SENATOR KASSEBAUM AS A GUIDELINE, I PROPOSED AN AMENDMENT IN THE FINANCE COMMITTEE TO HELP THESE FARMERS AND EXEMPT THOSE WHO ARE ABLE TO RESTRUCTURE THEIR DEBT FROM THE "CANCELLATION OF INDEBTEDNESS INCOME" PROVISIONS OF THE TAX CODE. THIS PROVISION WAS ACCEPTED BY THE COMMITTEE BECAUSE THE SENATORS RECOGNIZED THAT WITHOUT IT WE WOULD BE FORCING MANY FARMERS INTO BANKRUPCY, WHICH CAUSES IRREPARABLE DAMAGE TO THE FARMER, HIS LENDER, THE TAXPAYER, OUR ECONOMY, AND WOULD ADD MUCH ADDITIONAL WORK TO AN ALREADY OVERLOADED BANKRUPTCY COURT SYSTEM.

I ALSO BELIEVE THAT SENATOR ABDNOR'S LEGISLATION TO HELP LIMIT THE AMOUNT OF NON FARM INCOME THAT CAN BE OFFSET BY LOSSES FROM FARMING OPERATIONS, IS A BILL HEADED IN THE RIGHT DIRECTION. WE MUST GET A HANDLE ON THIS PROBLEM AND TAKE THE NECESSARY STEPS TO ELIMINATE TAX BENEFITS THAT HELP "TAX LOSS FARMERS" UNFAIRLY COMPETE AGAINST BONAFIDE FAMILY FARMERS. IF LIMITATIONS ON DEDUCTABILITY OF FARM LOSES AGAINST NON FARM INCOME CANNOT BE ADDRESSED SATISFACTORILY IN THE CONTEXT OF THE

MINIMUM TAX AND PASSIVE LOSS RULES, THE ONLY ANSWER IS TO LIMIT SUCH LOSES DIRECTLY, THROUGH THE REGULAR SYSTEM.

FROM MY POSITION ON THE FINANCE COMMITTEE I HAVE PURSUED MANY CORRECTIONS IN TAX CODE TO HELP AGRICULTURE. IN 1984 I WORKED TO PASS A BILL PROVIDING SOIL AND WATER CONSERVATION CREDITS TO HELP FARMERS TRYING TO CONSERVE OUR NATURAL RESOURCES. THIS IS ESPECIALLY IMPORTANT SINCE ONE OF THE FIRST CASUALTIES OF OUR TAX LAWS IS CONSERVATION. TO OFFSET THE REVENUE LOSS FROM THESE CREDITS I ALSO SUPPORTED A PROVISION WHICH WOULD HAVE EXTENDED THE DEPRECIABLE LIFE OF SINGLE PURPOSE AGRICULTURAL STRUCTURES. UNFORTUNATELY EVEN THOUGH WE WERE ABLE TO GET THESE MEASURES PASSED BY THE SENATE, THEY WERE LATER DROPPED BY THE CONFERENCE COMMITTEE.

I AM ABLE TO REPORT, HOWEVER, THAT SOME FIRST STEPS ARE ALREADY BEING TAKEN TO DEAL WITH MANY OF THESE TAX PROBLEMS. ONE EXAMPLE IS THE DEDUCTIBILITY PREPAYMENT EXPENSES. MANY FARMERS HAVE USED THIS PROVISION TO GET FERTILIZER, SEED AND FEED IN THE FALL WHEN THE PRICE IS LOWER, WHICH IS A VALID BUSINESS PRACTICE. BUT MANY OTHER INVESTORS HAVE USED THIS

PROVISION TO GET A $8 DEDUCTION FOR A $1 INVESTMENT. ACCORDING TO MY IOWA CATTLEMEN, THIS AND OTHER TAX SHELTERS HAVE SERIOUSLY HURT THE CATTLE INDUSTRY IN MY STATE AND WITHOUT CLOSING THESE LOOP HOLES THE RETURN OF LEGITIMATE FAMILY FARMERS TO THE CATTLE INDUSTRY IS DOUBTFUL. UNDER AN AMENDMENT PASSED BY THE FINANCE COMMITTEE TAXPAYERS WOULD BE LIMITED TO A DEDUCTION OF NO MORE THAN 50% OF THEIR PREPAID EXPENSES.

MR. CHAIRMAN, AS YOU KNOW, MANY OTHER ISSUES OF HIGH PRIORITY ARE PRESENTLY BEING ADDRESSED IN THE FINANCE COMMITTEE. SUCH ISSUES INCLUDE: THE USE OF CASH ACCOUNTING FOR FAMILY FARMERS; DEPRECIATION SCHEDULES FOR SINGLE PURPOSE AGRICULTURAL STRUCTURES; CLOSING LOOP HOLES FOR FOREIGN INVESTORS IN AMERICAN AGRICULTURE; ESTATE TAX PROVISIONS; INVESTMENT TAX CREDITS; DEDUCTIBILITY OF INTEREST EXPENSES; THE LIST GOES ON AND ON. I AM VERY HOPEFUL THAT WHEN EVERYTHING IS SAID AND DONE THE TAX LAWS WILL BE MORE RESPONSIVE TO THE CONCERNS OF OUR FARMERS. I CONGRATULATE THE CHAIRMAN FOR HOLDING THIS HEARING, BECAUSE THIS HEARING AND OTHER FORUMS LIKE IT ARE SERVING AN IMPORTANT ROLE IN CONCENTRATING ATTENTION ON THE PROBLEM AND HELPING TO FIND SOLUTIONS. I WILL BE WORKING VERY

HARD TO SUPPORT PROVISIONS THAT HELP OUR SUFFERING FAMILY FARMERS AND STRONGLY ENCOURAGE BOTH HOUSES OF CONGRESS AND THE ADMINISTRATION TO FIGHT FOR A BILL THAT CONTRIBUTES TO A SOLUTION TO THE CRISIS IN RURAL AMERICA AND NOT ACCELERATE ITS DEMISE.

AGAIN, MR. CHAIRMAN, THANK YOU FOR THIS OPPORTUNITY TO TESTIFY.

Senator ABDNOR. I just want to say, Senator Grassley, how much I appreciate your leaving your committee to come down here and testify on behalf of the tax situation. Certainly you're one of Congress' leading figures in this fight and we're just thankful we have you on the side of agriculture up there representing us. Thank you very much. I know you want to get back.

Senator BOSCHWITZ. I would join in that sentiment, Senator, because being on the Finance Committee and I believe being the only farmer on that Finance Committee and having a sense of what the tax laws do in the field of agriculture is really invaluable.

I think that what you did with respect to the capital gain aspects with respect to debt and so forth that was included last year in the reconciliation bill was of great value.

Senator GRASSLEY. Well, thank you.

Mr. Chairman, before I go, on your panel later on is a constituent of mine, Mr. Neil Harl, and I would like to thank the committee for seeking out this very nationally known expert on the farm situation. He's especially a valuable resource to many committees of Congress, but he's well known in this area of reform of tax law and I only wish that we in the Congress had listened to voices like Mr. Harl probably a year to 15 months before we started listening to his demonstration and evidence of the farm situation and the downturn of the farm economy and the serious situation that faced us and that we now know about out there. If we had, we would have many more farmers in business today than what we have and I think you will find Mr. Harl's testimony very valuable to this committee.

Senator ABDNOR. Well, thank you, Senator Grassley. I agree with everything you said. Mr. Harl is known nationwide for his great ability and his views on agricultural problems. As a matter of fact, this committee has had him before us before and we're going to have him again more than just today because we highly value his views and his thoughts. We thank you for your kind words. Iowa should be very proud of him. Thank you very much.

Senator GRASSLEY. Thank you.

Senator ABDNOR. Again, thanks for coming.

You have already heard a few words out of the gentleman to my right, Senator Boschwitz, who I think is one of the real leaders in agriculture in this Congress. He serves on the Senate Agriculture Committee and he doesn't sit around and wait for someone else to come up with answers. He's always in the forefront and he's been deeply involved in every form of agricultural issues.

His efforts on the farm bill and the farm credit crisis have amply demonstrated his grasp of the issues and his commitment to agriculture. No one is working harder in that respect, and I don't know of anything the farmers need more right now than some kind of financing and restructuring of their debt situation.

In addition, I might say he's one of the true businessmen in the Senate who's actually had to deal with the bottom line of Federal taxes, which I think gives him an excellent perspective to address these issues and, Senator Boschwitz, I thank you very much, as busy as you are, to find the time to come here today.

Senator BOSCHWITZ. Well, I see our colleague, Senator Kasten, is here as well and I know he's going to testify and he has introduced a very valuable piece of legislation so that the tax-exempt IDB's can't be used by foreigners to finance domestic farming operations and then they also receive, of course, a price assurance through the whole dairy program, and that's a piece of legislation I've cosponsored so I'm pleased to see him here this morning as well.

Senator ABDNOR. I will call on Senator Kasten. I want to recognize Senator Kasten for his efforts in both the areas of tax reform and agriculture. He's been active in studying the Tax Code and knowledgeable about distortions in agriculture and the whole economy that results from tax laws that encourage choices based more on tax consequences than on the economic merits of the decision. Indeed, Senator Kasten has joined Congressman Jack Kemp in legislation to simplify and reform the Tax Code, although I don't know if you'd recognize what goes on sometimes up there with the present tax bill. But in addition, Senator Kasten has been very active in behalf of his Wisconsin dairy industry, as Senator Boschwitz has alluded to, both in farm legislation and tax policy.

As Senator Boschwitz said, he's introduced legislation to eliminate one of the most flagrant abuses in the Tax Code, foreigners using tax-exempt bonds to finance domestic farming operations. And I commend him for his efforts, and I want him to know I'm a cosponsor of his legislation, too, and want to see it progress and get passed.

Senator Kasten, we certainly welcome you to the committee.

STATEMENT OF HON. ROBERT W. KASTEN, JR., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KASTEN. Mr. Chairman, thank you very much for your kind words and also the kind words of the Senator from Minnesota.

I am pleased to be here this morning to share my thoughts with you on the important issue of how agriculture is affected by the Tax Code.

Let me first, Mr. Chairman, congratulate you for calling this hearing today. I think it's timely, I think it's important to agriculture and it's important also that this hearing be held this year as we are in the process of marking up a tax bill. This hearing is clear evidence of your commitment to the family farmers of this country and, more particularly, the family farmers of South Dakota and the upper Midwest.

Like you, Mr. Chairman, I believe that Federal policies should serve our family farmers. These farmers are the keepers of our rural heritage, and the backbone of our rural economy. Right now, the family dairy farmers of the upper Midwest, Wisconsin and Minnesota and other States, are burdened with a huge dairy surplus. For the last several years, Federal policy has been aimed at easing that burden by reducing milk production. Support prices have been tried. A diversion program was tried. We have a national dairy promotion program.

Finally, we now have the whole-herd buyout, a program that pays farmers to sell their entire herds and to leave the industry, reducing production enough to give the dairy farmers who are left a fighting chance. In a sense, this is the ultimate in programs to reduce milk production.

But Federal tax policy is undermining this effort. It has been all along. Let me explain just one of the ways in which the Tax Code works at cross-purposes with our farm policy and catches family farmers in the middle.

At the same time that the whole-herd buyout was being planned in Congress, an Irish dairy firm, Masstock International, was planning a massive investment of up to $35 million in 10 1,000-cow dairies, each 1,000-cow dairy with a capacity to add another 1,000 cows, so in effect we're talking about 10 2,000-cow dairies, along with a processing plant, in central and southern Georgia. The conflicting Federal policies and the lack of direction here in Washington are amazing—one policy saying reduce production of milk through the whole-herd buyout, and another policy saying we're going to use a taxpayer-financed subsidy in order to help establish not 1 small farm, but 10 1,000-cow farms each with the capability of going to 2,000.

Let me tell you, Mr. Chairman, the average farm in Wisconsin has 53 cows, to put this into perspective.

Masstock International is financing its pilot program for its first 1,000-cow operation with a tax-exempt industrial revenue bond issued by one Georgia county, Macon County. While neighboring farmers right there in Georgia, people right down the road, if you will, were paying 13-percent interest rates, Masstock, because of this Federal subsidy has been able to go to the market and borrow $4.5 million at an interest rate of roughly 7 percent. The taxpayers, including the dairy farmers down the road in Georgia, as well as those in South Dakota, in Minnesota, in Wisconsin, are subsidizing the difference. The subsidy turns out to be roughly $270 per cow on the initial 1,000-cow farm.

Now, this isn't merely ludicrous. I believe it represents a fundamental injustice. That's why I've introduced Senate bill 2273 that would end this abuse of industrial development bonds by barring foreign individuals from using tax-exempt financing to finance farming operations in this country.

I have also introduced a companion piece of legislation—that's Senate bill 2274—which would bar foreign interests from receiving price support or other farm program benefits.

These pieces of legislation one going to the Finance Committee, the other to the Agriculture Committee—would make it clear that while any one has the right to get into American agriculture, they do not have the right to get tax farm programs subsidies to do so.

Mr. Chairman, the Masstock project is only part of a larger problem. The Tax Code encourages excessive investment in agriculture in many ways—by allowing milking parlors and hog confinement structures to be written off in 5 years, by allowing huge corporate farms to use cash accounting, and by permitting unlimited amounts of farm losses to be deducted from off-farm income.

The charts that we have before us today are a graphic example of these kinds of issues and how important they are.

The interests of farm families in Wisconsin and across the country demand that any tax reform bill we pass this year will address these important issues. We can start by including my proposal to halt subsidies to giant foreign-owned corporations. I am grateful for your support of this proposal, Mr. Chairman, and for your cosponsorship and for your leadership, and I look forward to working with you and other members of the committee, including the Senator from Minnesota, in the weeks and months to come as we work together to preserve the family farms in the United States of America.

Mr. Chairman, I appreciate the opportunity to testify before you this morning.

Senator ABDNOR. Well, thank you, Senator Kasten. We're the ones that are grateful to have you come in. You've certainly been a leader in agricultural interests and have some real fine legislation to correct some of our problems. As both Senator Boschwitz and I said, we are cosponsors of your legislation and I don't think we realized what was going to happen when the dairy buyout program went into effect. But, you so vividly brought it to our attention, and these corrections that you're trying to implement would be a great, great assistance not only to the people in the dairy business but also to the deficit and to the overall health of agriculture.

So, we thank you. I know you're busy and I hope that, as we're all working together on these various tax problems and agricultural problems, we can come up with some badly needed solutions. Thank you very much.

Do you have a comment, Senator Boschwitz?

Senator BOSCHWITZ. No, I'm a cosponsor of the Senator's legislation and very familiar with it and I think he is quite right in the way he assesses it in his testimony.

Senator ABDNOR. Both farming and the subsidies have to be corrected and hopefully we're going to get speedy action on both. Thank you.

Senator KASTEN. Thank you both.

Senator ABDNOR. Now that the Senators have completed their testimony, we're going to hear from the various farm groups on tax legislation and we will make a panel out of Charles Swanson of the National Association of Wheat Growers from the good Senator from Minnesota's home State. We have Leverne Klemme, who is taking the place of Richard Ekstrum, who is the president of the South Dakota Farm Bureau. He couldn't be here today but he sent a very, very able replacement and we're happy to have him, from my home State of South Dakota. Michael O'Connor, who is vice president of the South Dakota Farmers Union, also from down in the southeast part of the State of South Dakota, who's here today to testify for their organization.

The suggestion is that we also bring John Urbanchuk, director of agricultural services at Wharton Econometrics in Philadelphia, PA; and Mr. Neil Harl, professor of agricultural economics at Iowa State University. Gentlemen, would you come up here to the front, too.

We will call on Mr. Swanson first. You're talking to an old wheat grower here. We're happy to have you with us. I am pleased to welcome you, coming from Hallock, MN, up near the Canadian border, is that right?

Mr. SWANSON. That's correct.

Senator ABDNOR. You're representing the wheat growers. I know the wheat growers have been following this tax reform, so their testimony is going to be very helpful. I understand that you are a farmer and an accountant, so I can't think of anyone more qualified to talk about this subject than one who has to work with those tax laws and also is involved in farming. So please go right ahead.

Senator BOSCHWITZ. I might say that I welcome Mr. Swanson. Hallock is indeed up kind of toward the end of the line. The Tax Code doesn't even apply a little further north of him. So we welcome you here today.

Senator ABDNOR. Gentlemen, I'm going to ask you to hold it to 10 minutes or less so there can be some questions asked. So go ahead.

STATEMENT OF CHARLES SWANSON, CHAIRMAN, TAX COMMITTEE, NATIONAL ASSOCIATION OF WHEAT GROWERS

Mr. SWANSON. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to appear before you today to comment on the pending tax reform proposals in the Congress, and their potential impact on wheat producers. My name is Charles Swanson and I am the chairman of the National Association of Wheat Growers Tax Committee. The National Association of Wheat Growers represents wheat producers in 17 States, including my home State of Minnesota, where I produce wheat near the town of Hallock, as the chairman mentioned.

Wheat production is a capital intensive industry, so that investment incentives in the Tax Code have been important in encouraging economic efficiencies for the industry. Maximizing efficiency is the only means of building long-term profitability in agriculture. However, the underlying philosophy of many tax reform proponents has been to remove capital formation incentives so that other types of preferences and rate reductions can be made available to targeted categories of taxpayers.

The House-passed tax reform bill would be improved a great deal by proposals under consideration in the Senate Finance Committee at this time. In particular, the investment tax credit repeal is offset for small business with the increase of investment expensing to $40,000, up from the $5,000 in current law. During years when a farmer makes a large equipment purchase, such as a tractor that can be priced at $80,000 to $100,000, the increased expensing limit will be approximately equivalent to the investment tax credit. A carry-forward provision for the deduction is beneficial for taxpayers like farmers who have fluctuating incomes, just as the ITC carryforward has provided farmers with the ability to retain this credit for use against future taxable income, when they have not been able to use that credit in prior years because of low earnings.

In the Senate, the capital expensing provision has been tied to an accelerated depreciation proposal for certain "productive property," including assets used in agriculture. The ACRS system in current law has been important for those who purchase new equipment, since the largest reduction in the market value of such equipment occurs early in the economic life of that asset. However, it is important that some flexibility be retained for the taxpayer to elect a depreciation schedule that fits the asset, as well as the financial outlook for the business. In current law, straight-line depreciation has been a useful alternative for some kinds of assets.

The Packwood proposals would also allow those with carried forward investment tax credits to redeem them at 70 percent of their value, regardless of tax liability. At the beginning of 1983, unused ITC carryover for sole proprietorship farms totaled almost $80 million. Although it is difficult to predict to what extent these credits would be utilized before the carry-forward period would expire, in the near term income prospects for agriculture as a whole are not bright. The National Association of Wheat Growers, therefore, supports the redemption proposal in the belief that it would provide cash to many farmers who may not otherwise be able to use these earned credits.

Senator BOSCHWITZ. It must be more than $80 million. That's all that's out there or is that just Minnesota?

Mr. SWANSON. That's the figure from the committee staff for 1983. Yes, we agree that the figure is undoubtedly much larger by now.

The Packwood proposals also correct an inequity placed on self-employed businessmen by allowing them to deduct half of the cost of medical insurance premiums. This is an important improvement in existing law, and serves to provide greater equity between corporations who often provide health insurance to their employees and the self-employed.

The treatment of fertilizer expensing in the Senate bill is also superior to that in the House bill. The House bill repeals section 180 of the current law, which specifies that outlays for lime and fertilizer be treated as business expenses, to be deductible in the year in which the cost was incurred. Section 180 had recognized such costs as recurring ones, with a short asset life.

Although the House repealed section 180, report language states the intent that fertilizer and lime that must be applied every year be deductible as ordinary and necessary business expenses. However, the National Association of Wheat Growers believes that considerable uncertainty would be created by replacing statutory language with report language, and we would advocate the continuation of current law, as provided in the Senate bill.

Both House and Senate bills add new restrictions to the expensing of conservation projects by requiring that deducted conservation projects must meet with the prior approval of the Soil Conservation Service, or comparable State authority. Our concern, however, is that significant Soil Conservation Service budget cutbacks will make it increasingly difficult for the agency to provide service to growers. Such a situation will discourage conservation investments, which clearly would be an unfortunate and unintended result of tax reform legislation. Consultation with Soil Conservation could be helpful in the event that IRS questioned the taxpayers's deduction, but burdensome if required in advance of the deduction.

An additional conservation provision of both the House and Senate bills provides that any gain realized on the disposition of "converted wetland" or "highly erodible cropland" will be treated as ordinary income, and any loss on the disposition of such property will be treated as long-term capital loss. However, the 1985 Food Security Act authorized the creation of a 45-million acre conservation reserve, phased in over a 5-year period. Lands going into the reserve are to be taken out of production for a 10-year period, but allowed to be counted as a commodity base at the end of the reserve contract, as long as approved conservation practices are put into place on the land.

It is important that lands placed back into production upon expiration of a conservation reserve contract not be considered "converted" erodible lands under section 923 of the House bill. Further, "erodible lands" should be specifically defined in the tax bill, rather than defined by reference to the Food Security Act, which could potentially be modified as the conservation reserve program is implemented.

Both House and Senate bills would repeal the income averaging election, which has been an important means by which farmers can even out their sometimes erratic annual incomes. Under a strict annual income-reporting system, these fluctuations can unfairly increase tax liability because, during good years, agricultural producers would be forced into higher tax brackets than their long-term earning power actually warrants.

The National Association of Wheat Growers supports continuation of current law, with some tightening of averaging rules to target taxpayers whose incomes are steadily rising.

The Senate Finance Committee took an important step in approving a provision under which income from discharged indebtedness is exempted from income taxation under certain circumstances. Under current law, if a farmer reaches agreement with his lender to restructure debt, which includes a partial loan write-down, the portion written down is treated as income to the farmer. Thus, if the farmer had a $100,000 loan and the bank is willing to write off $30,000 so that the farmer will be able to meet the remainder of his loan commitment, while avoiding total bankruptcy, the farmer is treated under the Tax Code as receiving $30,000 in taxable income.

This tax liability has the effect, however, of forcing the farmer to file for bankruptcy, rather than work with the bank to bring the loan down to a manageable level. Thus, a responsible effort by the farmer and the banker to work out a voluntary debt reduction agreement is undermined by a provision of the Tax Code.

We believe that consideration should also be given to excluding from gross income any gain realized from the sale of farm real estate or equipment, as well as excluding from the investment credit recapture any such sale, if a farmer is insolvent at the time of the sale.

I would also like to add a parenthetical note. The cash basis accounting situation that is in the law with the $10 million cap, I think should remain and to small family farmers the cash accounting basis is definitely important. It would be a nightmare to force farmers, having been involved with the cash basis type of accounting, into an accrual system based on grain inventories and so forth, and I think the cash basis is very important to small farmers.

In closing, I would like to comment that it is very difficult to draw firm conclusions regarding the overall desirability of the pending tax reform proposals for agriculture. In order to generate new revenue to offset revenue reductions created by certain provisions of the Senate tax bill, for example, Federal excise taxes no longer being deductible, the most significant impact of this provision for wheat producers would relate to higher costs for trucking wheat to grain terminals. Although the trucking industry does not expect to be able to pass the additional costs of the non-deductible-excise tax along to their shippers in highly competitive markets, it seems clear that in many instances the costs will, indeed, be passed along to shippers. This will especially be true for farmers in areas not served by rail lines, and where trucking is the only practical alternative for transporting wheat. Many farmers own their own trucks for hauling wheat to market and they will, of course, directly absorb the additional costs of the excise tax proposal. Other costs related to transportation will also rise, including fuel and tires.

Thank you for your attention, Mr. Chairman, and I will be pleased to answer any questions at the appropriate time.

Senator ABDNOR. Fine. We'll do that at the conclusion of all the testimony. I just want to say that some of the provisions of the proposed tax reform you were supporting there was based on this excise tax to make up the difference, I'm afraid, and that's some of the dilemma you get into. You wipe out the buyout of the investment tax credits, and you're going to raise that kind of money, I guess, from excise taxes and other sources. So I think we're all in a real dilemma up there and looking at a whole new proposal. But we certainly thank you and we're going to proceed.

I'm going to ask unanimous consent on my own here that Senator Boschwitz be allowed to chair this committee for a few minutes. In 5 minutes we're going to vote on my amendment to the budget bill, one that's very important to me in dealing with customs. I'm trying to take a little money out of foreign aid and put it over in customs to do the job we think they have to do. I'm going to go put a short statement in and cast my vote. I'll be right back.

Senator BOSCHWITZ. I should go down and argue against your amendment.

Senator ABDNOR. You shouldn't. No, no. He's on Foreign Relations. Let's keep him here.

We have with us two gentlemen, Mr. Klemme and Mr. O'Connor. We're happy to have you both. They both know agriculture from the inside because they've lived with it all their life. We're just grateful that you gentlemen took the time off to come but with the waters you have down there you couldn't be farming today anyway. So we're happy to have you here and I'll turn this over to Senator Boschwitz and be right back.

Senator BOSCHWITZ [presiding]. Mr. Klemme.

STATEMENT OF LEVERNE KLEMME, VICE PRESIDENT, SOUTH DAKOTA FARM BUREAU FEDERATION

Mr. KLEMME. Mr. Chairman and members of the committee, I am Leverne Klemme, vice president of the South Dakota Farm Bureau and a livestock and grain farmer from central Union County, which is in the southeastern corner of South Dakota.

We feel that the present tax system is too complicated, full of provisions that tempt business people to make decisions based on tax considerations rather than sound economic principles, and, above all, emphasizes wealth redistribution at the expense of wealth creation.

For those reasons, Farm Bureau supports tax reform. However, we oppose measures that would impose greater tax burdens on farmers and ranchers. We believe that properly drafted tax reform legislation could improve the efficiency and growth of the U.S. economy. We believe that the present tax laws have led to excess investment in agriculture to the disadvantage of full-time farmers and ranchers.

Our principal goal for tax reform is the enactment of lower rates and fewer tax brackets which will offset the elimination of certain deductions, credits, and exclusions. If rates are reduced significantly from the standpoint of farmers and ranchers, Farm Bureau will take the following positions:

1. Investment tax credit.—Support the repeal of the investment tax credit.
2. Depreciation.—Support the retention of the current accelerated cost recovery system, including the scheduled increases in expensing of certain depreciable property from the current $5,000 to $10,000.
3. Capital gains.—Support a capital gains rule that would give a taxpayer the option of excluding between 40 to 60 percent of nominal gains on assets or reporting only gains in excess of inflation as ordinary income.

   Support a change to the effect that all gains on the sales of breeding, draft and sporting livestock and dairy animals would be treated as ordinary income, not capital gains.
4. Preproduction development expenditures.—Support the current law that allows annual expensing of preproduction expenditures for livestock and horticultural crops.
5. Income averaging.—Support the repeal of income averaging.
6. Cash accounting.—Support cash accounting for taxpayers whose gross farm receipts are $5 million or less.
7. Expenditures for multiyear soil conditioners, such as fertilizers.—Support the current law that allows these expenditures to be deductible in the year paid.
8. Land clearing expenditures.—Support capitalization of land clearing expenditures.
9. Soil and water conservation expenditures.—Support a change in which long-lasting and permanent improvements would be capitalized and then depreciated or added to the basis of the land, while nonpermanent, shortrun improvements could be expensed without limit.
10. Corporate tax rates and brackets.—Support a graduated rate structure for corporations.
11. Taxation of life insurance inside buildup.—Oppose proposals to tax policy holders on the inside buildup of life insurance.
12. Alcohol fuels tax credits and exemptions.—Oppose efforts to expedite the sunset of alcohol fuels tax credits and exemptions.
13. Limitations on farm loss deductions against nonfarm income.—Oppose limitations of farm loss deductions against nonfarm income.

14. Capital gains exclusion for insolvent farmers.—Support a capital gains exclusion for insolvent farmers on liquidation of farm property.

15. Carryforwards and carrybacks.—Support the provisions of current law that allow carryforward and carryback of net operating losses and carryforward of unused capital losses.

Support the carryforward of unused tax credits earned prior to tax reform.

Farm Bureau wishes to reemphasize its policy in support of S. 419 and H.R. 11, legislation to provide a tax deduction for one-half of the health insurance premiums paid by a self-employed taxpayer. We urge you to support efforts to include this health insurance tax deduction as a part of the tax reform bill.

Farmers and ranchers are keenly aware of an inequity in the Tax Code that has become more acute in recent years of rising health insurance costs.

Self-employed sole proprietors, including 88 percent of the Nation's farmers and ranchers, cannot deduct their health insurance costs as an ordinary and necessary business expense. However, when employers furnish health insurance for their employees, the full cost of the coverage is deductible to the employer as a business expense and is tax free to the employee. This inequity in tax treatment is not justified, and we encourage you to include this change in the tax reform package.

Thank you very much.

Senator BOSCHWITZ. Thank you very much, Mr. Klemme.

Now I will turn to Michael O'Connor, vice president of the South Dakota Farmers Union.

STATEMENT OF MICHAEL O'CONNOR, VICE PRESIDENT, SOUTH DAKOTA FARMERS UNION

Mr. O'CONNOR. Thank you, Mr. Chairman. My name is Michael O'Connor. I am vice president of the South Dakota Farmers Union, our State's largest family farm and ranch organization. My wife, Janelle, and I currently operate a diversified farm south of Alcester, SD. We raise hogs, corn, oats, soybeans and have a cow-calf operation.

Senator BOSCHWITZ. Where is Alcester?

Mr. O'CONNOR. South of Sioux Falls about 50 miles.

Senator BOSCHWITZ. You're pretty close to Mr. Klemme.

Mr. O'CONNOR. That's right.

Senator BOSCHWITZ. So you came in together?

Mr. O'CONNOR. No, I came in early.

Mr. KLEMME. We don't get along. [Laughter.]

Mr. O'CONNOR. We also have four children and no off-farm income. Farming is our only business.

I appreciate the opportunity to testify here today on the question of tax loopholes, tax abuses and their impact on agriculture. On behalf of the South Dakota Farmers Union, I want to extend wholehearted commendation to you, Senator Abdnor, for your efforts—specifically in the area of restricting the amount of farm losses that can be written off for tax purposes by high income nonfarm investors.

Mr. Chairman, it is our contention that all agriculture has been substantially damaged by a Tax Code that seems designed primarily for the benefit of large nonfarm investors. America's family farmers and ranchers are the most efficient agricultural producers in the world, but they cannot compete with investors who make money from the Tax Code by losing money on the farm.

The impact of this unjust tax system has not been limited to providing an unfair competitive advantage for nonfarm investors. It has also increased excessive agricultural production and has resulted in ever lower commodity prices and lower farm income.

During recent years, livestock producers have been especially impacted by these manipulators of the Federal Tax Code. In Georgia, a corporate-owned 20,000 cow dairy operation is now being established, thanks to tax loopholes and tax-free industrial revenue bonds. Again, I may add that this comes at a time when the 1986 farm bill calls for dairy reduction.

We have also seen an astronomical increase in the number of investor-owned hog and hog production facilities and a drastic decline in the number of cattle on feed in northern Corn Belt States and a corresponding increase in cattle numbers in investor-owned facilities in the southern Great Plains.

In my country of Union County, SD, 60 percent of the hogs held for market are investor-owned with investor facilities beginning to show up all over. Now these investors don't do much for the local feed man or the small town economy.

The following report on the state of the cattle feeding industry has been documented for us by the Center for Rural Affairs at Walthill, NE.

The cattle feeding business has largely moved out of the hands of farmer feeders into large commercial feedlots, often feeding cattle owned by tax motivated investors. In 1964, farmer feeders fed 61 percent of the cattle on feed in the 23 major cattle feeding States, according to USDA. By 1983, that share had fallen to 22 percent, with the other 78 percent fed in the large commercial lots. Livestock magazine estimated in 1979 that the largest 20 corporate feeders fed approximately one-fourth of the cattle on feed in the seven major cattle feeding States. USDA estimated that year that half the Nation's cattle were fed in 400 feedlots.

This shift is regional as well as structural, with cattle feeding moving from farm areas in the Corn Belt to the commercial feeding areas of the high plains. As of 1983, for example, Iowans were feeding the fewest cattle in 29 years. An Iowan Cattlemen's Association study indicated that the decline has cost the State's economy $2 billion and 17,000 jobs. A driving force in the change sweeping cattle feeding is custom feeding, particularly for tax motivated investors. It has changed the rules of competition in cattle feeding. Farmer feeders can compete in terms of production efficiency. However, with the advent of tax motivated custom feeding, competition is increasingly dependent on the ability to exploit the tax laws. Farmer feeders who lack high bracket incomes cannot realize the same benefit from tax shelter deductions as higher income investors. Nor can farmer feeders attract investor customers as effectively as very large feedlots, who have the volume necessary to justify the expense of marketing tax shelter offerings.

However, custom feeding is ideal for larger feedlots. According to a University of Missouri study,

> It enables feedlots to pass much of the burden of capital and risk bearing to their customers. A 25,000 head lot will require an investment in facilities of approximately $1,250,000. To own the cattle and feed would require another $10 million or more depending upon cattle and feed prices. Large size feedlots tend to depend upon custom feeding for outside investors as a method of spreading risk and utilize the feedlots' heavy investment in fixed plant and equipment.

Substantial tax benefits have brought investors flocking to custom feedlots. Half of the cattle fed on the high plains of Texas, the Nation's leading cattle feeding State, are fed for tax purposes, according to Zay Gilbreath, the head of the Cargill subsidiary Caprock Industries, the Nation's largest cattle feeder. The most publicized tax benefit of cattle feeding is use of cash accounting to defer income and taxation. Under cash accounting, an investor with a tax problem can buy feed for cattle to be sold the following year, and deduct the full cost immediately. After the corn is fed and the cattle sold the following year, the income will reappear for taxation. The investor may then choose to reinvest in more cattle or in an alternative tax shelter. Even if the investor chooses to pay the tax that year, he has accomplished the equivalent of an interest-free loan from the Internal Revenue Service, by delaying the tax for 1 year. This is particularly attractive if income can be deferred until a year in which the investor is in a lower tax bracket.

The 1984 tax law requires that certain investors consume feed within 90 days of the end of the year in which it is deducted, but that did not eliminate the tax shelter. Tax shelter feeding continues with investors modifying their practices to comply with the new rules. The result, according to Paine-Weber, has been placement of tax shelter cattle earlier in the year. Because farming is the only business with substantial inventories in which cash accounting can be used, investors seeking this break must invest in agriculture.

Additional benefits may be derived by deduction of the large interest costs of feeding cattle. Although high interest is often devastating to farmers, that's not so for everyone. Current tax law sometimes allows high bracket taxpayers to save more tax by deducting interest, than the real cost of borrowing money, resulting in a real after-tax interest rate of less than zero.

Finally, some investors have used cattle feeding to convert ordinary income to capital gain, which is 60 percent tax exempt. This involves forming a corporation to feed cattle, and taking returns in the form of capital gain when the corporation is dissolved.

Delegates attending the 1986 National Farmers Union convention in Spokane, WA, adopted proposals aimed at providing increased tax equity and justice in rural America.

We recommend:

1. The opportunity for nonfarm interests to change ordinary income into capital gains by investing in agriculture be closed.
2. Depreciation schedules for capital assets used in farming should approximate actual decline in value over the useful life of each asset.
3. Require accrual accounting for tax purposes on farming operations on publicly owned corporations and other larger than family

operations to remove the pressure which encourages farms to ever-larger units.

4. Limit current year deductions, under cash accounting, for inputs purchased for use in future years to 20 percent of the annual use of each specific input.

Mr. Chairman, in our view, House bill 3838 is a postitive step in the right direction for family agriculture. It would substantially reduce the unfair advantages now accorded to nonfarm and corporate investors and produce a more level playing field.

The House bill would increase the depreciation period for single purpose agricultural structures from the current 5 years to 13 years. We support that step.

Another section of the bill would eliminate incentives to convert wetlands and erosive land into cultivation. This provision, along with the sodbuster and swampbuster provisions of the 1985 farm bill, should get the Federal Government out of the business of encouraging poor conservation practices. Farming to Tax Code is more of an incentive than the farm program is with the special tax breaks for clearing and draining and this also comes at a time of low commodity prices and surplus.

The bill does have some flaws, which should be corrected. Specifically, it fails to deal with the question of cash accounting or limiting the deduction of farm losses from nonfarm income.

While the House bill has its problems, it is much preferable to the Packwood tax proposal.

The South Dakota Farmers Union regrets that neither of these bills has addressed the question of placing a definite limit on the amount of farm losses that can be written off against nonfarm income. Senator Abdnor, we continue to strongly support your proposal to establish a $24,000 limit on those tax writeoffs.

Oftentimes it seems like Congress takes the worst features of several different proposals and combines them to make a law. That certainly happened before in the area of tax legislation. We sincerely hope that, this time, Congress will break the pattern and will enact a genuine tax reform package.

A comment that Senator Abdnor made earlier that tax shelters add $5 billion in tax credit, that adds to the Federal debt at the expense of the family farmer.

Thank you. I am a family farmer. I make my living farming the land and raising farm commodities, not farming the Tax Code.

Senator BOSCHWITZ. Thank you very much. It's interesting to hear the different viewpoints of the three farmers who have testified.

A vote has just been called and I noticed that Mr. Urbanchuk's testimony is relatively short and so I think we'll turn to you and then we'll see if Senator Abdnor comes back.

If you don't mind, I think I will recess the hearing because I would not like to miss Mr. Harl's statement. So that perhaps the chairman will come back and start up. I will take, Mr. Urbanchuk, your statement along and read it on the way to the vote. We will take a 5- to 8-minute recess at this point. I will go and vote and come back—go and vote against Senator Abdnor's amendment. I will be right back.

[A short recess was taken at this point.]

Senator ABDNOR [presiding]. The hearing will resume. Again, I apologize for running out. They are on the last vote and I did get a chance to speak on behalf of the amendment. I'm curious to see what's going to happen. They have a tabling motion. Some people don't like taking money out of foreign aid I guess.

Mr. Urbanchuk, we're happy to have you here. Will you proceed?

STATEMENT OF JOHN M. URBANCHUK, DIRECTOR, INTERNATIONAL AGRICULTURE SERVICE, WHARTON ECONOMETRIC FORECASTING ASSOCIATES, INC.

Mr. URBANCHUK. Thank you, Mr. Chairman. I feel a little outclassed here with the people from the great States of Iowa, the Dakotas, and Minnesota, and I would like to remind people that we do farm in Pennsylvania as well.

I appreciate the opportunity to testify before the committee on the impact of various tax reform proposals on U.S. agriculture.

At present there are at least three major proposals available for consideration. These include the President's tax reform proposal, the House bill, H.R. 3838, and the proposal put forth by the chairman of the Senate Finance Committee, Mr. Packwood. Each of these proposals would have a different impact on both the U.S. economy and, in turn, the agricultural sector, if fully implemented.

As you may be aware, we at Wharton did a very substantial analysis of the impact of Treasury II, the President's tax proposal, on the American agricultural sector last July and testified before the House Committee on Ways and Means about those impacts.

Since that time we have also taken a look at specifically the Packwood bill and in less detail the House bill as well.

However, before turning to the impact of tax reform on agriculture, I would like to make several observations about the condition of and prospects for U.S. agriculture. I think these have to be kept in mind, specifically when you are considering proposals that in some form or another are going to alter the economic attractiveness of channeling investment funds into the agricultural sector.

The financial crisis in American agriculture that was very much talked about last year has not gone away. We just don't hear an awful lot about it these days. But, in fact, the situation has not gone away. All indications point to a deepening of the problem.

A recent financial survey of farmers in 10 Midwestern States conducted by the State statistical research service offices indicates a continuing deterioration in debt-to-asset ratios for most farmers. For example, in Iowa, 38.3 percent of all farmers surveyed reported a debt-to-asset ratio in excess of 40 percent. In North Dakota, 37.7 percent of farmers reported debt-to-asset ratios in excess of 40 percent. In Nebraska the ratio was 36.8 percent, and in Kansas 30.8 percent. The rest of the States report smaller numbers than that, but they are significant.

A farmer with a debt-to-asset ratio above 40 percent is very likely to have difficulty meeting debt payments with cash income and is a good candidate for financial failure. In fact, recent experience indicates that about half of these farmers are likely to experience failure.

The Food Security Act of 1985, the new farm bill, will provide farmers with some protection from sharply lower market prices that in turn are caused by the Food Security Act of 1985, specifically the drop in loan rates but moreover the weak foreign demand and weak domestic demand, particularly in the area of feed through direct Government payments—a very substantial level of direct Government payments. These payments will help hold nominal net farm income at about 1985 levels, in our opinion, probably through 1988 and into 1989. Now we're talking about nominal net farm income levels in the $29 to $30 billion range, 1985 coming in at about $31 billion and down a little bit from that.

The point is that the burden is being shifted from the marketplace in the near term to direct Government payments in order to do that.

Now what does that mean? That means that the farmers who are having financial problems aren't really going to be solved by the farm bill. The farm bill doesn't really provide any salvation for the financially troubled farmer. Really what it will do is enable farmers who are at the current time solvent or able to make a go of it to continue in operation.

In our opinion, then, considering the financial condition of American agriculture, it's very important to take a look at the health of the agricultural sectior in light of the entire economy and look very carefully at proposals that will attract capital, both equity capital as well as finance capital, into the sector.

Each of the three major tax reform proposals under consideration will increase the user cost of capital to American business, including the business of agriculture. This increase in the cost of capital can be expected to restrain growth in direct investment in plant, equipment, and structures. At least in the near term, reduced investment will offset gains in consumer income and spending that result from lower tax rates. This will lower aggregate economic output—that's real GNP, the value of all the goods and services produced in the economy—and employment as well.

The most severe impacts on both the economy and agriculture are likely to be felt under the President's proposal, Treasury II. I alluded earlier to the study that we conducted last year on the details of that and basically, by taking all of the provisions of Treasury II and putting them in, we calculated that the user cost of capital to agriculture would increase by as much as 19.8 percent.

Now clearly, the new farm bill plus some of the external environmental factors—specifically, lower interest rates and a lower dollar—have changed that outlook a bit. In fact, I suspect if we were to redo that study we would find that the impact would be slightly less than we initially expected. However, there are several key elements of the tax change that, in our feeling, will in fact increase the cost of capital not only to the entire economy but to agriculture as well.

They specifically include the treatment of the elimination of cash-basis accounting for certain agricultural enterprises, at least in Treasury II the limitation of interest expense deductions that will reduce the use of limited partnerships as a source of cost effective equity capital—and here I come back again to the need to look toward the total capital investment in agriculture and maintain that, not just finance capital but equity capital as well—the elimination of capital gains treatment upon the sale of certain breeding animals, and the elimination of the investment tax credit and revision of existing depreciation provisions.

Now both the House and the Senate bills vary from Treasury II in some of these key elements. In our analysis, we felt that the largest adverse impacts on agriculture, primarily through cost of capital and cost of operation, would occur through the restriction on the use of the cash method accounting, and in that sense we feel that it's quite important that the use use of cash method accounting for farmers under $5 million be retained.

The burden of shifting from cash method to accrual method accounting for farmers, I think that was alluded to earlier, would be a very, very substantial financial burden and administrative burden as well. From our perspective, that would, probably more than any other particular element of the Tax Code, have an adverse impact on cost of production and cost of capital as well.

There are several other aspects of the Tax Code that we feel are quite important in terms of their potential adverse impact. One is the capitalization of certain preproductive assets, which is going to come down very hard on people who are involved in orchards, vineyards, and many of the other forms of agriculture where preproductive assets are a major element as well.

We felt initially the major direct impacts of higher production costs would fall immediately on the livestock sector, primarily on livestock producers, which would prompt a cutback in herd sizes during the first 3 years following implementation of the tax reform plan. In our analysis, we assumed implementation in 1987. These reductions would reduce feed demand for corn and soybean products, and put additional pressure on prices for these commodities.

Clearly, under the environment we're operating in now, one where we have a sharp drop in loan rates and we're not seeing a tremendous increase in the export markets, at least in the near term, what we have to do from the grain and soybean side——

Senator ABDNOR. Could I get you to pull that mike just a little closer to you?

Mr. URBANCHUK. Yes, sir.

Senator ABDNOR. I want to make sure I catch everything you say.

Mr. URBANCHUK. From the perspective of the grain and livestock side, it's quite important that we look for ways to increase the base for domestic demand. And while, as was pointed out here, many of the tax provisions that are currently written into the Tax Code have had an adverse impact on the allocation of animals among various States and various sectors within agriculture, it's very important, however, to look at the total number of animals that are on feed and available for feed and increasing those numbers in order to provide a basis for growth in domestic demand for corn, for soybean meal, and other products as well.

From a macroperspective in terms of looking at the entire economy and that filters through in terms of the agricultural sector as well, we feel that the repeal of the investment tax credit, the modification of the accelerated cost recovery system, the indexing provision on depreciation, and for agricultural producers, as I indicated the uncertainty surrounding the use of cash basis accounting, would boost capital costs and restrain investment.

A recent study undertaken by our firm which analyzed the impact of implementing Chairman Packwood's tax reform plan indicated that his plan would raise the user cost of capital for the entire economy by about 250 basis points over the next 2 years, 1987 and 1988. This increase would be partially offset by a drop in the maximum corporate tax rate; however, it would still reduce fixed investment in the economy by 4.1 percent over the first 2 years following implementation. Now that's fixed investment for the entire economy, and I suspect that for fixed investment in agriculture the decline would probably be sharper than that.

This drop in investment would in turn be large enough to offset an increase in consumption that would occur from the reduction in the maximum individual tax rate, thereby dropping real gross national product, total value of goods and services, by about $9.9 billion—that's in constant 1982 dollars—over the first 2 years of the plan.

Now in our analysis the Federal deficit is expected to decline over the next several years, primarily as a result of cuts in both defense and nondefense spending. The Packwood plan, however, ends up reducing net Federal receipts over the first 2 years of the plan by about $29.2 billion through fiscal 1989, thereby resuting in a higher deficit than we normally would have received under the existing tax legislation. So, really, instead of being revenue neutral, we end up with a higher Federal deficit than we would have otherwise had.

In our opinion, both the House bill and the Packwood bill have less severe implications for investment and output for both the entire economy and the agricultural sector. Care must be taken, however, to ensure that adequate incentives are maintained, including those provided by the tax laws, to provide the agricultural sector with a flow of both equity and finance capital needed to guarantee growth in investment, not just over the next several years but over the next decade as well.

Thank you very much.

Senator ABDNOR. Thank you, Mr. Urbanchuk. We certainly appreciate your being here and giving us your expertise. We know you have an extensive background. Being director of international agricultural services for Wharton Econometric Forecasting Associates, lends a great deal of credence to this committee and we certainly thank you for your appearance.

Mr. URBANCHUK. Thank you.

Senator ABDNOR. Now we'll hear from Mr. Harl, who is another gentleman who I greatly respect for his expertise in this field, and coming from near my home State of South Dakota he certainly understands the problem out there in the Midwest.

Mr. Harl, this is not your first appearance before this committee, nor will it be the last, and we are pleased to have you here today.

STATEMENT OF NEIL E. HARL, CHARLES F. CURTISS DISTINGUISHED PROFESSOR IN AGRICULTURE AND PROFESSOR OF ECONOMICS, IOWA STATE UNIVERSITY

Mr. HARL. Mr. Chairman, Senator Boschwitz, it's indeed a pleasure to be back before this committee and I appreciate the opportunity once again.

My testimony today is given in the context of serious problems for agriculture and I'd like to take a couple of minutes to outline my perceptions as to what those problems are.

I think there are two serious ones.

Senator BOSCHWITZ. Mr. Harl, are you going to follow your testimony along?

Mr. HARL. I will be summarizing it, Senator. It's a little longer than I thought I could cover orally.

Senator BOSCHWITZ. That's OK.

Senator ABDNOR. Go right ahead.

Mr. HARL. Do we have enough time?

Senator BOSCHWITZ. Yes.

Mr. HARL. All right. Then we will cover it a little bit more completely.

I think we have two serious problems in agriculture. As the prior individuals have indicated, we have a debt problem. It's severe. It's partly a matter of magnitude of debt. It's partly a matter of concentration of that debt. And if we're going to see agriculture reasonably stable at all in the near term it will require more intervention than we now have in place.

Second, and a longer term problem, is our persistent capacity to overproduce. That has been a problem for many years. It seems to be growing more serious and as we look ahead to the next 2 or 3 decades, particularly with the advent of biotechnologies, we think that problem will grow more serious.

Now just a word about the concentration of debt and the debt load. Those numbers are very well known to this committee. The amount of debt is over $200 billion, but the more serious statistic is the concentration of that debt among the farmers who are the most severely stressed.

Some of the State studies indicate that as much as, in North Dakota, 74 percent of the debt is held by farmers above the 40-percent debt-to-asset line; in Iowa the figure is 73 percent. We have some unpublished data indicating that it may actually be higher than any of those figures as of early 1986.

So with that concentration of debt among those who in general are unable to remain stable, it is certain we are going to have very serious problems for some time to come unless something dramatic happens, like a sharp drop in interest rates, a sharp increase in commodity prices, or they strike oil on their land, all three of which are about equally improbable. And the way oil prices are going that might be even a bigger disaster.

Senator BOSCHWITZ. I notice that your incomplete survey here didn't include Minnesota. Do you happen to know the figures?

Mr. HARL. No; Minnesota was not a participant in that State study and so I do not have comparable data from that one. However, there are some other studies that do indicate Minnesota's condition.

Senator BOSCHWITZ. I presume it would be somewhat similar. What about South Dakota?

Mr. HARL. No; South Dakota was not a participant either. We do believe, based on other sources, that the States of North Dakota, South Dakota, Minnesota, Iowa, and Nebraska are very close in terms of condition. We think that Iowa is probably a notch worse off than the others, followed closely by Nebraska and by South Dakota, and North Dakota, and the southern part of Minnesota, at least. Those are the most severely stressed areas.

Now the default figures in table 2 of my prepared statement from that same regional survey indicate that for real estate loans, a range of 6 to 17 percent for nonreal estate loans 7 to 15 percent, again an indication of the consequences of the concentration of debt.

As we know, last year the Farm Credit System lost $2.69 billion. It's continuing to lose this year. We lost 68 agricultural banks in 1985. The projections are that we'll lose even more this year.

So the short-term prospects are not very good.

Senator BOSCHWITZ. Mr. Chairman, if you don't mind, I'd like to ask questions as we go along.

Senator ABDNOR. Go right ahead.

Senator BOSCHWITZ. The status of debt on table 2 of your prepared statement indicates that 47 percent of the farmers have no real estate loans at all, and 45 percent on the average.

Mr. HARL. The top one is the percentage of farms with loans. The next one is the farms that are current on their loans, and the bottom figure is percentage of farms that are delinquent on their loans.

Senator BOSCHWITZ. Therefore, 53.2 percent of the farms have real estate loans, 46.3 percent have no loans whatsoever on real estate?

Mr. HARL. Right.

Senator BOSCHWITZ. And 45 percent of the farms have no operating loans?

Mr. HARL. Yes. Fifty-five percent of the farms did have non-real-estate loans, so we do have a significant number who are not borrowing for purposes of production credit. Even in Iowa, our latest study shows about 42 percent of the farmers were not borrowing for production credits. This again indicates the concentration of the debt problem, making the policy side of it so much more difficult because it's not spread evenly.

Senator BOSCHWITZ. One of the amazing things of the 1970's and early 1980's is that as farm land prices went up and you went down and had coffee with your neighbor in the morning and if you had 500 acres and they're worth $2,000 an acre, you suddenly become a millionaire. That's pretty heady stuff to talk about over coffee. And yet, the amazing thing is that most farmers didn't bite and didn't expand in the midst of all that. Those who did certainly are suffering.

Mr. HARL. There's an interesting relationship here to age, Senator, also. Our data show that for the people with 0- to 10-percent debt-to-asset ratios, those who are stable, the average age is about

59. Those who have 11 to 40 percent debt-to-asset ratios have an average age of 55. Those in the 41 to 70 percent range have an average age of about 48. Those 71 to 100 have an average age of 46. That's a stairstep down in age for each bracket.

Also there are interesting implications by size of farms.

Senator BOSCHWITZ. But that's not surprising, not at all.

Mr. HARL. No. They were vulnerable, partly because of age.

Senator BOSCHWITZ. You get more conservative as you get a little older.

Mr. HARL. That's right. They didn't remember the 1930's or know well anyone who was around during the 1930's.

I'd like to spend just a moment looking at four technical tax problems stemming from the concentration of debt and the short-run problem we have. These are problems that are causing difficulties as we work through the situation.

No. 1 is the problem of taxation of abandonments in bankruptcy. It is a perplexing problem and one that is most serious in every agricultural State. Unfortunately, farmers are being encouraged by circumstances to file bankruptcy and primarily to avoid income tax consequences. I would hope that we might be able some day to fashion a system that would not provide that encouragement. I think that if a farmer is insolvent, we should be able to assure about the same outcome whether they file bankruptcy or not. If they go through bankruptcy it means a lot of discharged debt.

Right now circumstances are encouraging them to go in that direction. Once they're in bankruptcy, the bankruptcy trustee often abandons property any time the value of the property as collateral is less than the loan obligation. It's done routinely. We are fearful that abandonment will return the tax consequences to the farmer as debtor. Right now, that's a most serious problem faced just about everywhere.

The next problem involves section 453B of the Internal Revenue Code, enacted as part of the Installment Sales Revision Act of 1980. The particular subsection that I'm focusing upon was enacted to discourage people from striking off payments to their children on land contracts annually and thereby passing wealth on to them. Unfortunately, the language used was so broad that if a seller under a land contract restructures the contract, it creates the prospect of construction receipt of gain for the seller.

It's most serious in the family situation because you have to take as the value of the contract the face amount. So we need, I think, to focus attention on section 453B with an appropriate amendment to assure that sellers who are willing to restructure contracts will not be greeted by additional tax liability.

I don't think it was the intent to include that amount as gain. I was involved to a degree with the fashioning of that mission. The language is too broad under the present circumstances.

Senator BOSCHWITZ. You cover that?

Mr. HARL. No; it is not covered in there. I've added that as an extra item. I'll be glad to provide; an additional supplemental statement on that point.

Senator ABDNOR. We would like to have that if you will.

Mr. HARL. Another problem involves section 7872 of the Internal Revenue Code to make it very clear that the minimum interest rules do not apply to workout arrangments.

Senator BOSCHWITZ. The what rule?

Mr. HARL. Section 7872, minimum interest rules. You remember back in 1984 as part of the 1984 legislation the Congress dealt with the problem of zero interest or low interest loans. The impetus originally came because families would make a zero interest loan to a child. The approach was to treat that as though there had been a loan with income and gift tax consequences.

Unfortunately, the fifth one of those possibilities could catch the restructuring of loans from commercial lenders. While the Treasury has not yet picked that up in regulations, they could I think do so because of the sweep of the legislation, and it's causing some concern. It is a technical point, but I think one that could be remedied and that would be helpful.

If we could return now to the prepared statement itself, I would like to talk about our second problem in agriculture, which is the problem of overproduction. It's a global problem and a serious one and I think it has important implications for tax policy.

Especially in the last 5 years we've seen an almost unprecedented increase in agricultural productivity around the world. There are several reasons for that. One major reason, I believe, is that the U.S. dollar stayed high so long that it not only caused our corn, soybeans, and wheat to be expensive in export; it also provided a strong economic inducement for people in other countries to increase their output, to increase production, to bring land into production, to increase productivity.

Senator ABDNOR. Don't you think that's probably a bigger reason even than the first?

Mr. HARL. I think it is a very substantial reason; yes. I think there have been enormous inducements to bring land into production, particularly in parts of the world like Argentina where they did indeed have land that could be brought into production with development capital.

Senator ABDNOR. Correct me if I'm wrong, but I think just the other day Secretary Baker was urging international lending institutions to loan money to Argentina or Brazil which wanted to buy down their tax on grain.

Mr. HARL. I'm well aware of that, Senator. There may be other justifications for such a move, but we have already induced a great deal of increase in productivity.

Second, they have borrowed our technology very effectively; and third, we've had unusually good weather. And those three together have meant that we've had a very, very——

Senator BOSCHWITZ. What about loan rates?

Mr. HARL. Oh, yes, that as well. We've had, as a result, a very substantial increase in agricultural productivity worldwide.

Now the long-term prospects are that if we do not increase demand for food in this country and abroad, then we're going to have to reduce supply.

What are our prospects for increasing demand? In the United States, not terribly bright. Our demand for food increases just a little faster than population and that's under 1 percent per year. That's not a terribly exciting solution to the problem.

Clearly, the last frontier for increasing demand for food is the Third World. There are about a dozen countries that would like to increase caloric intake and about three dozen that would like to improve their diets. They can't do it because they lack the means to acquire the food. It's an income problem. It's a problem of low personal productivity.

The long-term solution is to increase the level of development so that they can afford to eat better and if we do indeed continue to have a comparative advantage in food production we might sell a portion of that increased demand to the Third World countries.

The increase in demand for industrial use of agricultural commodities certainly is a possibility, but when energy prices are declining and a number of those industrial uses are substitutes for petroleum products, it is not a terribly exciting prospect.

That brings us to reducing supply. If we cannot increase demand for food, then we have a global problem of reducing supply. I think the markets are telling us that in many areas of production we have too much of society's resources involved in food production. We have too much capacity, using too many resources, and we're going to have to face that painful task of reducing our productive plant.

Senator ABDNOR. But reducing the production in this country isn't going to help if the other countries produce more, just like we observed under the PIK program. We didn't help our cause out any. Are we going to produce just for America then?

Mr. HARL. I do not believe that——

Senator BOSCHWITZ. I might say, Mr. Harl, that all the people who have testified up to this point, with the possible exception of Mr. O'Connor and to some degree Mr. Klemme, want to protect all these incentives to invest into agriculture. And I agree that it's all very nice, I mean, some of them spoke as though there were no problems in agriculture. You have to protect all these tax incentives so that there will be more investment and so forth.

Mr. HARL. What I'm leading up to is the conclusion that we do not need more capital induced into agriculture at a time when we have overproduction, at least in those areas where we have overproduction. There may be some crops and some livestock areas where that is not so true, but as we think about reducing supply we have three possibilities.

We have land; we have people; and we have capital. The number of people does not bear a very close relationship to agricultural productivity. You could remove 10 percent of the farmers and you wouldn't remove 10 percent of the production. This has been a problem of misunderstanding that we've had with some people here in Washington relative to reducing output.

Second is land. We've generally removed land by paying people for removing it. That is the least painful way. If we remove land that way, however, it creates a target in the Federal budget and this is an era when those targets are very visible and we wonder if it will be possible to maintain that kind of budget exposure. If we can't do it through that route we'll have to do it through the market.

Senator BOSCHWITZ. Do you find any evidence in decreased production when you reduce land or plant?

Mr. HARL. Do we reduce production if we remove land? Some, Senator. We never, however, remove production to the extent we remove the land because our means for reducing land generally take out the least productive and we leave the incentive to increase production on the remaining land. So we have a lot of slippage there.

If we let the market do it, then it has to squeeze price and squeeze profitability everywhere so the profitability disappears at the margin and that, of course is very painful, especially for the areas that are the least productive—the marginal areas.

Capital is the remaining factor. We don't do much about capital as a matter of policy. We assume capital will flow where the productivity is the greatest and until it's committed in the form of machinery and other capital items it does have a great deal of flexibility and will move where the return is greatest

My concern here is that we not induce capital to move where the market is telling us it shouldn't be going unduly, and I think we have the capacity to do that with the tax system. Therefore, in the interest of trying to encourage the movement of resources to an equilibrium position, we should look very, very carefully at anything that would induce capital to move in any kind of a tax shelter manner because it does not help us in terms of adjusting to our long-term problem of overproduction.

Now I have some specific comments in my prepared statement. First is expense method depreciation. Recounting, first of all, that we've gone through a history of almost 30 years with that provision, we were about to increase it to the $7,500 level and then to $10,000. I think that is, perhaps, manageable. For the life of me, I cannot understand an increase to $40,000 for a sector like agriculture. I think it would create, clearly, an attraction for outside investment because a $40,000 amount is a very significant amount for agriculture, and I do not believe that it would square with our general approach of not encouraging additional productive capacity.

In the depreciation area, my concern is twofold. One is the very short period for depreciating real property items in the 1981 legislation, the 15-year property that's been increased to 18 and now to 19 years. I think that depreciable real property should be depreciated over a much longer and all of the bills would shift to a longer period. I think that is clearly an appropriate move.

I think the 5-year property category has been a special problem for agriculture. It's the residual and because it is a residual, because of the way it's drafted, it puts in the 5-year category presently single purpose agricultural structures, which are principally livestock confinement units. It also puts in the same category silos and grain bins. These are long-lived facilities that I think are inappropriate for a 5-year depreciation period if we are trying to avoid tax sheltering.

We have some examples indicating the potential for tax shelter activity. Also, there is the fact that on depreciable real property section 1250 recapture essentially permits a taxpayer to convert deductions from ordinary income into capital gain. I think it would be advisable to consider shifting all property to section 1245 recapture to fully eliminate all of the incentive to convert ordinary income into capital gain. That has been proposed in some of the legislation. I understand that it would not be a part of some of the provisions in the Senate.

I think investment tax credit clearly has two problems. One is that ITC does have the capacity to induce investment. Second, it's a massive consumer of revenue, about $44 billion by fiscal 1989. As I point out in the conclusion of my prepared statement, I think our No. 1 tax problem in agriculture is the deficit and I think we simply somehow must close that deficit and try to get the forces neutralized that have led in the past to agriculture's No. 1 problem.

Land-clearing expense——

Senator BOSCHWITZ. I hope you have a sense that we are doing that.

Mr. HARL. Yes, sir, I do indeed. I am concerned because while Gramm-Rudman certainly possesses the capacity to do it, it forces the constitutional challenge and there are, of course, some arbitrary features about Gramm-Rudman that will impact agriculture very seriously. But I come right back and say that I think it is moving in the right direction. We must close the deficit, either through reducing spending or increasing revenue, one or the other.

Senator BOSCHWITZ. Unfortunately, if you're not arbitrary here in the Congress where you have 535 different voices and if you don't mandate what's going to happen, it ain't going to happen.

Mr. HARL. Right. Land-clearing expense, should be the No. 1 candidate for repeal. With the exception of perhaps 2 years since enactment of that section, we've been in surplus production on many of our basic commodities, and I do not believe that it's justifiable to encourage the clearing of land to create more productive capacity at a time when we consistently have been running on the negative side of the ledger budget issue?

In soil and water conservation expense, we have a clear commitment to cleaning up the environment and I would be concerned were it totally repealed. I do believe that tightening down as has been proposed makes sense so that the thrust of that deduction is limited.

Fertilizer and lime, I do not believe, have been tax shelter items. Repeal of the deduction would return the state of the law to high uncertainty. We had rulings and cases prior to enactment of that section with the Internal Revenue Service succeeding in asserting that lime and fertilizer should be deducted over a period greater than 1 year because of a carryover effect. Were it a tax shelter, I would feel differently, but I think what repeal would do is inject enormous uncertainty into the practice of tax law and into taxpayers' positions. I do not believe that it would be wise to repeal that section.

The cash method of accounting, certainly, is at the heart of many of our tax shelter problems in agriculture. It does not appear likely that it will be altered, either administratively or by the Congress. I think the attempts to narrow its scope are appropriate. We do have some limiting rules—the farming syndicate rules are discussed in the prepared statement; also, the rules for tax shelters on the cash method of accounting were tightened up very modestly in 1984. I think the $5 million rule is, as pointed out, amply justified with further restrictions on the prepurchase of inputs because many of the tax shelters do, indeed, fall into those categories.

With respect to the section on the importance of timing, I certainly am very concerned about this aspect and, Senator, I am supportive of the limitation on offsetting farm losses against off-farm income.

I am concerned about the timing in that we have suffered massive losses of land value and if we would induce a lot of people to sell their land we might exacerbate that problem in the near term. So I would simply leave that as a point of some concern on my part.

Senator ABDNOR. You expressed that the last time you were here, too.

Mr. HARL. Yes.

Senator ABDNOR. And I think land values have plummeted a long way since that time. It is a problem. I don't know how to get around it. I'm afraid if we wait until this thing straightens itself out there's going to be a lot more outside people coming into farming. The invitation is there. They're the people who have the money and who don't mind losing it. I'm afraid they're the ones who we will be seeing taking over this land. That's all.

Mr. HARL. When I was last here, Senator, which was I believe May 10, 1984, we had lost close to 25 percent of the land value in Iowa. We've now lost almost 60 percent of the value from where we were in 1981. Every additional drop of $100 per acre cuts that much out of everybody's loan portfolio and everybody's balance sheet. We need stability, for if we cannot stabilize land values at some point, then the task of achieving a modicum of——

Senator ABDNOR. What's happening to land that has been foreclosed on? What's the picture today?

Mr. HARL. The land that is being foreclosed upon, Senator, is passing in a number of directions. The lenders are continuing to hold a great deal of it. We have some data from a study by one of my colleagues at Iowa State University indicating that about a third of the land over the last several months has ended up being held by lenders in inventory. Obviously, that isn't helpful to lenders because as land values go down their inventory value goes down and they are not earning as much as rent as they would getting interest on the funds if they were in loanable form. So lenders are hammered about the head and shoulders by holding the land in inventory. Some of it is being sold to other farmers. We have some data on that. A modest amount is going to investors, but not a great deal at this point.

The section on need for additional revenue has been touched upon. I have in prior appearances before this committee and tax writing committees always concluded my testimony since 1981 with a statement that clearly the deficit has marred the economic landscape. I consider it our No. 1 problem in agriculture. We simply must, I think, have tax policy that will contribute revenue sufficient to support politically acceptable program levels, such that the economy does not incur significant budgetary deficits in times of economic recovery. A severely and chronically unbalanced budget is a matter of national security.

I believe that, honestly. It's one of the greatest problems of security we have.

A reasonable objective guiding tax policy in agriculture should be neutrality with respect to investment and capital flow. Insofar as we can, I think our tax provisions should not induce capital flow into agriculture in preference to other investment alternatives offering comparable risks and comparable returns. Capital allocation decisions among the sectors should be made on the basis of real return, not on the basis of tax augmented return.

The persistent and chronic capacity of our agriculture to overproduce suggests that the public interest is best served by not inducing the development of additional productive capacity through tax shelter investments.

I thank you for the opportunity to appear and I would be glad to take any questions.

[The prepared statement of Mr. Harl follows:]

PREPARED STATEMENT OF NEIL E. HARL

The Impact of Tax Reform on Agriculture*

by Neil E. Harl**

Tax reform efforts in Congress and in the Administration since mid-1984 have been expended at a time when U.S. agriculture has been suffering the greatest economic trauma since the Great Depression.[1] U.S. agriculture faces two severe problems - (1) a huge debt load, concentrated heavily on about one-third of the farms,[2] that will require more intervention than is in place if the sector is to become at all stable in the near term; and (2) a persistent capacity to overproduce that has dominated U.S. agricultural policy for well over 50 years. The first problem is short-term in nature and is expected to persist for the next three to five years. The second problem is long-term and may well grow more severe as new technologies, particularly biotechnologies, are introduced which are expected to be output increasing or cost decreasing in nature or both.

I. The Debt Load in U.S. Agriculture

Data from state surveys since early 1984[3] and national studies in 1984 and 1985[4] have established that two-thirds to three-fourths of the farm debt is held by farmers with debt-to-asset ratios above 40 percent.[5] A 1985 North Dakota study showed that 74 percent of the farm debt was held by farmers with debt-to-asset ratios above 40 percent.[6]

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*Testimony prepared for the Subcommittee on Agriculture and Transportation, Joint Economic Committee, Congress of the United States, Washington, D.C., April 29, 1986.

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The latest figures from a 1986 regional survey place 38.3 percent of the Iowa farmers above a 40 percent debt-to-asset ratio, the highest of the nine states participating in the study.[7] Those states, with distribution of farmers by debt-to-asset ratio, are shown in Table 1.

Table 1: 1986 Midwest Farm Finance Survey

State	Percent of Farmers With Debt/Asset Ratios Above 40 Percent	Average Debt/Asset Ratio
Illinois	29.3	30.8
Iowa	38.3	36.9
Kansas	30.8	31.8
Michigan	23.1	28.6
Missouri	21.2	24.7
Nebraska	36.8	34.3
North Dakota	37.8	34.7
Ohio	17.2	21.2
Wisconsin	25.3	26.2

By both indicators, Iowa shows the greatest economic and financial stress of any of the states although Nebraska and North Dakota are only marginally better off than Iowa.

The default rates on real estate and non-real estate loans in the nine Midwest states are shown in Table 2.

Table 2: Status of Debt

Item	IL	IA	KS	MI	MO	NE	ND	OH	WI	Nine State
					Percent					
Real Estate Loans										
Farms with loans	53.6	56.7	51.2	54.4	46.4	59.4	63.6	45.7	57.9	53.2
Farms current on loans	88.4	88.1	82.4	90.3	90.0	91.8	88.4	93.8	93.0	89.7
Farms delinquent on loans	11.6	11.9	17.6	9.7	10.0	8.2	11.6	6.2	7.0	10.3
Non-Real Estate Loans										
Farms with loans	60.4	62.1	57.4	50.9	43.9	67.8	73.1	43.0	52.0	55.0
Farms current on loans	85.7	85.5	86.6	84.4	90.1	90.3	87.4	92.8	85.4	87.7
Farms delinquent on loans	14.3	14.5	13.4	15.6	9.9	9.7	12.5	7.2	14.6	12.3

Source: Midwest 1986 Farm Finance Report, Wisconsin Agricultural Reporting Service, Madison, Wisconsin.

In that survey, Kansas was reporting the highest default rate on real estate loans with 17.6 percent in that category. Michigan was showing the highest default rate on non-real estate loans with 15.6 percent in that classification.

The concentration of debt in the hands of farmers unable to be or become stable under the current economic environment suggests that agricultural banks, The Farm Credit System, the Farmers Home Administration and insurance companies with substantial lending with farm real estate as collateral can all expect further deterioration in terms of loan losses and defaults on obligations.

II. The Problem of Over Production

Global Perspective

No one needs to be reminded that U.S. agriculture has been "internationalized" because of the U.S. stake in international trade in agricultural products. U.S. agricultural exports reached a peak of $43.8 billion in 1981. By 1985, that figure had dropped to $31.2 billion with a decline below $29 billion expected in 1986. At the same time, imports of agricultural products have been rising and totalled almost $20 billion in 1985. Clearly, policies pursued in the early 1980's placed U.S. commodities at a competitive disadvantage in international trade.

Efforts to become more competitive internationally by lowering commodity loan rates in the Food Security Act of 1985 may discourage additional land in other countries from being brought into production and the United States may gain a larger share of new demand but the U.S. share of the international export market otherwise is unlikely to rise dramatically in the near term. Due in part to the fact that the U.S. dollar remained high for an extended period (1981 through early 1985 before commencing a decline), agricultural productivity in other countries has increased sharply in the past five years. Also during that time, a great deal of use has been made in other countries of modern technology, much from the United States, and the world has experienced unusually favorable weather conditions for grain and oil seed production in the major producing regions.

For two principal reasons, producers elsewhere are unlikely to remove land from production in the face of the new-found enthusiasm in the United States to become more competitive internationally.

- It is not rational to remove land from production until price drops below variable costs which is not a likely result considering the level of variable costs in most producing regions and the commodity loan rates possible under the Food Security Act of 1985.

• Several producing countries are sufficiently indebted to external creditors to assure that pressures to export agricultural products will be intense for some time to come. Total Third World debt at the end of 1985 was recently reported by the World Bank at nearly $950 billion and is expected to exceed $1 trillion by the end of this year. The 33 most heavily indebted Third World countries owe more than $650 billion to external creditors with 31 of the 33 projecting an increase in debt load in 1987 over 1986.

Thus the outcome internationally could well be a lowering of commodity prices, benefitting consumers and giving rise to a modest increase in the amount demanded, but with little change in market shares. Other countries may simply adjust to our lower price structure by maintaining competitive prices.

Long Term Prospects

Long-term, if exports do not rise substantially, efforts must be made to-(1) increase demand for U.S. farm products or (2) decrease supply by removing more land and capital from the sector than has been proposed, if demand and supply are to be balanced at present price levels. The markets are sending clear signals that U.S. agriculture is utilizing too many resources to produce too much food under current economic conditions.

The prospects for increasing demand are not great. The demand for food in the United States increases only a little faster than the rate of population increase--running under one percent per year. And that's not too exciting. The last frontier for increasing the demand for food is in the Third World. About a dozen countries would like to increase caloric intake and at least three dozen would like to upgrade diets. The problem is an economic one--they cannot afford to eat better and will not until economic growth lifts their country to higher levels of economic activity. It's an income problem, a poverty problem, with low personal productivity of many individuals in those countries. Quite simply, they cannot produce enough goods the rest of the world wants. The best interests of U.S. agriculture would be served by supporting an accelerated pace of development in the Third World. If we have a comparative advantage in food production--and that may be a big "if"-- we should end up supplying at least part of any increased food demand.

The possibilities for increased industrial utilization of farm commodities are uncertain. Certainly when energy prices are plummeting, there's less enthusiasm for solving agriculture's problems with that approach since many industrial uses involve petroleum substitutes.

If demand doesn't increase substantially, the only alternative to burgeoning surplus stocks is to decrease production. That means reducing the amount of land and capital devoted to agricultural production. There's very little connection between the number of people in agriculture and the level of production. Loss of 10 percent of the farmers would have very little impact on total production.

Land can be removed by paying land owners to idle part or all of their acreage. That is the least painful route but creates a highly visible target for budget cutters. If land is removed from production by market forces, it will mean that profitability everywhere must be squeezed so that profitability totally disappears for the least productive land. When commodity prices drop below the point where the revenue won't cover variable costs, land will go out of production. More precisely, the question is at what revenue level the land will shift to its next most profitable use. For some agricultural land, the next most profitable use is wasteland.

Capital is more mobile and generally flows toward the greatest profitability. That means capital isn't too likely to flow into a sector with depressed earnings unless - (1) induced by tax shelter incentives or (2) investment occurs in connection with a government public works program. The message in that respect is clear: what agriculture does not need is tax-induced investment that would have the effect of increasing aggregate output. With inelasticity of demand for farm products, increased output is rewarded with a disproportionate drop in price and profitability. For the same reason, agriculture does not need public works programs that would increase total output for commodities in surplus.

III. Implications For Tax Policy

For much of agriculture, the economic setting in which tax reform debate is taking place is one of persistent overproduction, inelastic demand for most farm commodities and depressed resource prices. As noted in the preceding section, any policy that induces capital to move into agriculture should be considered suspect if the outcome is to increase aggregate agricultural output. At a minimum, tax policy should strive for neutrality with respect to inducing capital movement into the sector.

Expense Method Depreciation

In 1981, the $5,000 allowance for "expense method depreciation" replaced the concept of "extra first year 20 percent depreciation" available since 1958.[8] The allowance is scheduled to increase to $7,500 in 1988 and to $10,000 in 1990.[9]

The proposal by the Senate Finance Committee to increase the allowance to $40,000 per year for amounts in connection with a business represents a jarring increase for the agricultural sector. As a sector of relatively small firms, a $40,000 expensing provision would - (1) induce some additional capital spending, thus inducing some increase in aggregate output, and (2) serve to attract outside investment into agriculture. It is indeed difficult to see how the provision would be in accord with policies needed to strengthen the sector.

Depreciation

The Accelerated Cost Recovery System (ACRS) in The Economic Recovery Tax Act of 1981[10] represented the greatest departure from prior law or any of the provisions except for safe harbor leasing. The most extreme of the depreciation provisions, 15-year cost recovery for depreciable real property, was corrected to a modest degree in The Tax Reform Act of 1984 by imposing an 18-year period for the fastest rate of cost recovery on real property[11] and by legislation enacted in 1985 extending the cost recovery period to 19-years.[12] The proposed legislation would lengthen substantially the period of cost recovery for depreciable real property which would be more in accord with the economic life of such property and which would discourage investors from viewing investment in depreciable real property as a tax shelter.

Of equal or greater importance in agriculture is treatment of some assets as five year property under ACRS. Because five year property is the "residual" classification category, and because most property eligible for investment tax credit is classified as five year property if not specifically made three year property, silos, corn cribs, grain bins, feeding floors, fences and tile lines are classified as five year property.[13] Likewise, single purpose agricultural and horticultural structures are specifically made five year property.[14]

Quite apart from the massive loss of revenue from ACRS, the rules have created a tax shelter opportunity. Example: On December 31, 1983, a high

tax bracket taxpayer purchased a farm for $800,000. Of the total purchase price, $300,000 was allocated to four large silos, five confinement units, fence line bunks, fences, tile lines and four large grain bins. By using accelerated cost recovery, the taxpayer could claim $45,000 in depreciation in 1983, $66,000 in 1984 and $63,000 in each of the three succeeding years. By the end of 1987, the $300,000 investment allocated to the depreciable items would be fully recovered, just over four years after the original purchase. The deductions would have offset $300,000 of non-farm income, thus saving $150,000 in federal income tax if the taxpayer was in the 50 percent federal income tax bracket. The value of state income tax deductions would increase the tax benefit. If the farm were sold in 1995, the amount allocated to those depreciable assets as Section 1245 property would, of course, be taxed as ordinary income up to a maximum of $300,000.[15]

If the purchase involved an allocation to a house, pole barn, machinery storage shed and farm shop, straight line cost recovery could have been claimed over 15 years with no depreciation recapture on later sale for such Section 1250 assets.[16] With Section 1250 assets, straight line cost recovery may be claimed with no depreciation recapture on later sale.[17] For Section 1250 property, depreciation is recaptured only to the extent depreciation claimed exceeds straight line cost recovery.[18] Thus, depreciation deductions from ordinary income can readily be converted into long-term capital gain on later sale.

Example: A high tax bracket off-farm investor on January 1, 1983, purchased a heavily improved farm for $600,000. Of the total purchase price, $100,000 was allocated to a nearly new house on the property, $80,000 to a large steel building built for machinery storage and farm shop and $20,000 for a pole barn. All of the depreciable items, totally $200,000 in value, were placed on the depreciation schedule with straight line cost recovery claimed over 15 years. By the end of 1997, the $200,000 amount would be depreciated to zero, having produced $100,000 in income tax savings for the investor who is in the 50 percent federal tax bracket (not counting the value of the deductions for state income tax purposes). If the farm were sold in 1998, with $200,000 of the sales price allocated to the house, the steel building and the pole barn, the $200,000 gain would be eligible for long-term capital gain treatment taxed at a maximum rate of 20 percent (under current law) with $40,000 in income tax due on the gain. Thus, at an eventual cost of $40,000, the taxpayer obtained tax benefits of $100,000.

The merit of extending Section 1245 recapture to all depreciable property in the interests of discouraging tax shelter activity is obvious. Likewise, longer periods of cost recovery are warranted for single purpose agricultural structures (12 to 15 years), silos (15 to 30 years), tile lines (15 to 25 years) and other depreciable realty (up to 30 years).

Investment Tax Credit

The repeal of investment tax credit is amply warranted both on grounds of generating revenue to reduce the federal deficit[19] and on grounds of discouraging tax sheltering and increased agricultural production.[20]

Land Clearing Expense

A deduction has been available up to the lesser of 25 percent of taxable income from farming or $5,000 for land clearing expense to make land suitable for use in farming.[21] Deductions from ordinary income may be obtained with eventual gain created thereby taxed as long-term capital gain if the land is held for at least 10-years.[22]

Of all the deductions uniquely available to agriculture, the land clearing expense deduction is the most difficult to justify. With the exception of a brief period in the early 1970's most farm commodities subject to price and income support programs have been in surplus since enactment of the land clearing expense deduction. Beyond a reasonable reserve in the interests of food security, the value to society of units of commodities in surplus is negative as funds must be expended to store the surplus amounts.

Soil and Water Conservation Expense

A limited opportunity exists to shelter non-farm (and farm) income by incurring expenses eligible for the soil and water conservation expenditure deduction.[23] As with land clearing expense, part or all of the deductible amount is recaptured as ordinary income if the land is held for less than 10-years.[24]

The soil and conservation expense deduction is justifiable, at least in part, on the basis of the public interest in soil and water conservation and the reduction of cost externalities in the form of water and air pollution from soil loss. Efforts to limit the soil and water conservation expense deduction to expenditures incurred in connection with programs having a demonstrable linkage to soil and water conservation are in keeping with an overall objective of not encouraging increases in aggregate agricultural output through tax inducements.

Fertilizer and Lime Deductions

Repeal of the election to deduct the cost of fertilizer and other soil amendments [25] would appear to create a problem for taxpayers of determining the appropriate time for deduction because of case law antedating enactment of the election to deduct. Before enactment of the deduction, the Internal Revenue Service had been successful in convincing the Tax Court that soil conditioning expenditures were capital in nature if the conditioning benefit lasted for more than one year.[26] IRS later ruled, however, that a deduction would be allowed even though the fertilizer, lime or other soil treatment would produce a slight benefit extending into the next year.[27]

Because the soil amendment deduction has not been a tax-shelter item, and because repeal would return taxpayers to the uncertainty of prior law, it is strongly suggested that the election to deduct not be repealed.

Cash Method of Accounting

The cash method of accounting is a factor in many, if not most, tax shelters in agriculture.[28] The opportunity to deduct expenditures in one taxable year and recognize gain in a later taxable year provides a significant economic advantage to high tax bracket taxpayers. As an example, an off-farm investor operating under a crop share lease may claim an immediate income tax deduction for all production expenses including the landowner's share of the seed, fertilizer and chemicals used as well as the annual costs associated with the land such as property taxes, interest and depreciation and repairs on farm improvements. The opportunity to defer recognition of gain on the crop until sold encourages the landowner to store the crop (often in storage facilities built or acquired with fast depreciation and investment tax credit claimed) especially if storage payments and loan funds under favorable terms (using the crop as non-recourse collateral) are available from the Commodity Credit Corporation. The economic effects of such provisions may be complex. In addition to inducing capital flows into farm assets, the tax shelter features may also influence marketing decisions of farmers and participation rates in government price and income support programs.

For more than 30 years, IRS has attempted to limit the tax-shelter features of the cash method of accounting through litigation and rulings.[29] Legislation enacted over the past two decades limits the farm deductions that may be claimed by non-farm investors under some circumstances. For "farming syndicates," deductions for feed, seed, fertilizer and other farm supplies are limited to the amounts used or consumed in the tax year.[30] A farming syndicate is a partnership, S corporation or other non-corporate enterprise engaged in farming if ownership interests have been offered for sale in an offering required to be registered with state or federal securities agencies or if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs.[31] The rules limiting the deductibility of farm supplies do not apply to amounts on hand at the end of the year because of fire, storm, flood or other casualty or because of disease or drought.[32] Several situations are identified as not being interests of a limited partner or limited entrepreneur - (1) those held by individuals who have participated for not less than five years in the management of the business of farming, (2) those held by any individuals residing on the farm, (3) those held by any individual actively participating in the farming business or in the further processing of livestock raised in the business, (4) those held by any individual whose principal business activity involves active participation in the business of farming (even though it is not in the business in question) and (5) any interest held by a member of the family (or a spouse) of a grandparent of an individual who is actively participating in the business.

Under a provision added in 1984, tax shelters on the cash method of accounting are not allowed to deduct amounts paid for farm supplies until both "economic performance" occurs and the expense is paid unless economic performance occurs within 90 days after the end of the taxable year of payment. For purposes of prepayment of farm expenses, a tax shelter has a meaning similar to that of a farming syndicate under the rules already in effect.[33] The prepaid expense provisions are intended to apply to individual taxpayers engaged in farming activities with the principal purpose of tax avoidance.

Because legislative abrogation of the administrative move to allow farmers to use the cash method of accounting is unlikely, and because significant tax shelter activity continues, further action limiting the use of cash accounting is warranted. The provision denying the cash method of accounting to those with annual gross receipts of more than $5 million is amply justified. Likewise, further and more restrictive limitations on prepayment for farm inputs would seem to be in order.

Because of the central position of the cash method of accounting to tax shelter activity, a question is raised whether an additional restrictive limitation should be imposed. A substantial proportion of the non-farm investment comes in non-corporate form and would not be significantly affected by current or proposed limitations. One possibility would be to limit the cash method of accounting, in the case of farming and ranching, to those deriving more than one-half of their adjusted gross income from farming or ranching. To avoid impacting farm and ranch families who have one or more individuals working off the farm or ranch, it is suggested that all income be deemed farm income if one or more members of the family are materially participating (personally and not through an agent or employee) in the farm or ranch operation.

IV. Importance of Timing in Enacting Additional Limiting Legislation

As discussed above, farm and ranch businesses, rural communities and the institutions serving the agricultural sector are going through the most severe financial adjustment since the Great Depression. Implementing provisions now that would have the effect of inducing investors to withdraw capital investment from agriculture could impact asset markets adversely and cause asset value to fall to levels lower than values that would otherwise occur. For that reason, care should be exercised in timing the implementation of such provisions to occur after substantial strength has been restored to farm asset markets.

V. Need for Additional Revenue

In prior appearances before this committee[34] and the tax-writing committees,[35] the massive federal budget deficits that have come to mar the economic landscape in the 1980's have been denounced in the strongest possible terms. As explained in that earlier testimony, the federal budget deficit has played a central role in contributing to agriculture's woes. At this juncture, I would like to restate two basic points - (1) it is fundamental that tax policy should be expected to contribute revenue sufficient to support politically acceptable program levels such that the economy does not incur significant budgetary deficits in times of economic recovery and (2) a severely and chronically unbalanced budget is a matter of national security.

VI. Conclusion

A reasonable objective guiding tax policy in agriculture is investment and capital flow neutrality. Insofar as possible, tax provisions should not induce capital to flow into agriculture in preference to other investment alternatives offering comparable risk and return. Intersectoral capital allocation decisions should be made on the basis of real return, not on the basis of tax-augmented return. The persistent and chronic capacity of agriculture to overproduce suggests that the public interest is best served by not inducing the development of additional productive capacity through tax-shelter investments.

FOOTNOTES

[1]See generally N. Harl, "Problems of Debt in Agriculture," 6 J. Agr. Tax. & Law 689 (1985). See also "Farm Credit Crisis: Hearings Before the Subcomm. on Conservation, Credit, and Rural Development of the House Comm. on Agriculture," 99th Cong., 1st Sess. 273-305 (1985)(statement of Neil E. Harl); "Impact on Budget Proposals on Agriculture Issues: Hearings Before the House Comm. on the Budget," 99th Cong., 1st Sess. 16-27 (1985)(statement of Neil E. Harl); "Long-Term Farm Policy to Succeed the Agriculture And Food Act of 1981 (Conservation and Credit Programs): Hearing Before the Subcomm. on Conservation, Credit, and Rural Development of the House Comm. on Agriculture," 98th Cong., 2nd Sess. 196-206 (1984)(statement of Neil E. Harl); Melichar, "A Financial Perspective on Agriculture," 70 Fed. Res. Bull. 1 (1984). See also Econ. Research Serv., U.S. Dep't of Agric., Agric. Info. Bull. No. 495, "Financial Characteristics of U.S. Farms," January 1985 [hereinafter cited as Financial Characteristics of U.S. Farms]; Econ. Research Serv., U.S. Dep't of Agric., Agric Info. Bull. No. 490, "The Current Financial Condition of Farmers and Farm Lenders," (1985); W. Dobson, F. Barnard & B. Graves, "Results of Indiana Farm Finance Survey," Purdue Agric. Econ. Rep. (July 1985); R. Hepp & S. Hardesty, "Michigan Farm Financial Situations," Ext. Bull. E-1906, Mich. State Univ. Coop. Ext. Serv. (July 1985); "Iowa Farm Finance Survey," Iowa Crop & Livestock Reporting Serv. (May 1, 1985) [hereinafter cited as 1985 Iowa Farm Finance Survey]; R. Jolly, "Farm Finance Survey: Asset and Debt Distribution," Iowa State Univ. Coop. Ext. Serv. (Mar. 28, 1984) reprinted in "Long-Term Farm Policy to Succeed the Agriculture and Food Act of 1981 (Conservation and Credit Programs): Hearings Before the Subcomm. on Conservation, Credit, and

Rural Development of the House Comm. on Agriculture," 98th Cong., 2d Sess. 207-09 (1984); A. Lines & R. Pelly, "1985 Ohio Farm Finance Survey Results," ESO-1214, Ohio State Univ. Dep't of Agric. Econ. and Rural Soc. (Sept. 1985); D. Lines & J. Scott, "Financial Condition of Illinois Agriculture," Univ. of Ill. Coop. Ext. Serv. (Jan. 1985); G. Pederson, O. Watt & H. Vreugdenhil, "Farm Financial Stress in North Dakota," N.D. Farm Research No. 4 (Jan.-Feb. 1985).

[2]See N. Harl, "The Architecture of Public Policy: The Crisis in Agriculture," ____ Kan. L. Rev. ____ (1986) (forthcoming).

[3]E.g., Farm Finance Survey, Iowa Crop and Livestock Reporting Service, March 28, 1984; R. Jolly, "Farm Finance Survey: Asset and Debt Distribution," Iowa State University Coop. Ext. Serv., June, 1984.

[4]"The Current Financial Condition of Farmers and Farm Lenders," Econ. Res. Serv., U.S. Dep't of Agriculture, Agric. Info. Bull. No. 490. March, 1985; "Financial Characteristics of U.S. Farms," January, 1985, Agric. Info. Bull. No. 495, Econ. Res. Serv., U.S. Dep't of Agriculture, July, 1985. The data used in the two U.S. Department of Agriculture publications have been severely criticized by a former USDA staff member. See R. Simunek, 2 Farm Income Letter 1, Washington D.C., February, 1986.

[5]See "Financial Characteristics of U.S. Farms," supra note 4 (66.8 percent of the debt in Cornbelt states held by farmers with debt-to-asset ratios above 40 percent). See "1985 Iowa Farm Finance Survey," Iowa Dep't of Agriculture, Iowa State University and Iowa Crop and Livestock Reporting Serv. (73 percent of the debt held by farmers with debt-to-asset ratios above 40 percent).

[6]Pederson, Watt and Vreugdenhil, "Farm Financial Stress in North Dakota," N. Dakota Farm Research No. 4, 1985.

[7]Midwest 1986 Farm Finance Report, Wisconsin Agricultural Reporting Service, Madison, Wisconsin.

[8]I.R.C. § 179, amended by Pub. L. 97-34, Sec. 202, 95 Stat. 219 (1981).

[9]I.R.C. § 179(b)(1).

[10]See I.R.C. § 168.

[11]Pub. L. 98-369, See 111(a), 98 Stat. 631 (1984).

[12]Pub. L. 99-121, 99 Stat. 505 (1985).

[13]See generally 4 Harl, Agricultural Law § 29.05[2][c][ii][B] (1986).

[14]I.R.C. § 1245(a)(3)(E).

[15]See I.R.C. § 1245.

[16]See I.R.C. § 1250.

[17]<u>Ibid</u>.

[18]See 4 Harl, <u>supra</u> note 14, § 31.03[2][b], for a discussion of the application of section 1245 recapture rules (gain is recaptured as ordinary income to the extent of depreciation claimed since 1961, since 1969 for livestock) to Section 1250 assets if 19-year accelerated cost recovery is claimed.

[19]By fiscal year 1990, the estimated revenue gain from repeal of investment tax credit would be $44.6 billion. The <u>President's Tax Proposals to the Congress for Fairness, Growth and Simplicity</u>, p. 455.

[20]See generally N. Harl, "Implications of the Administration Proposal (Treasury II) for Agriculture," testimony presented to Committee on Ways and Means, United States House of Representatives, Washington, D.C., June 24, 1985.

[21]I.R.C. § 182.

[22]See I.R.C. § 1252.

[23]I.R.C. § 175.

[24]See I.R.C. § 1252.

[25]See I.R.C. § 180.

[26]See, E. G. Sanford v. Commissioner, 2 B.T.A. 181 (1925); Swaney v. Commissioner, 5 B.T.A. 990 (1927), acq., VI-2 C.B.7.

[27]I.T. 3843, 1947-1 C.B. 12.

[28]See generally 4 Harl, Agricultural Law § 25.03 (1986).

[29]E.g., Hi-Plains Enterprises, Inc., 60 T.C. 158 (1973), aff'd, 496 F.2d 520 (10th Cir. 1974).

[30]I.R.C. § 464.

[31]I.R.C. § 464(c).

[32]I.R.C. § 464(d)(1).

[33]I.R.C. § 461(i)(3).

[34]Harl, Neil E., "Tax Policy Affecting Agriculture," in Taxes and Agriculture, S. Hearing 98-1049, Joint Economic Committee, U.S. Congress, pp. 54-71, 1984.

[35]See note 20 supra.

Senator BOSCHWITZ. Thank you, Mr. Harl. I note that we once again have a vote, and with this vote, Mr. Chairman, I am going to continue on and will not come back to the hearing.

One of the things that there's a great deal of talk about the tax laws farming—I've made the comment, Mr. Chairman, that I will review these statements once again, but some people apparently want to retain all the breaks as though the tax laws farming were not a problem at all and as though additional investment should continue to come into agriculture, and others of you have stated that certain of the advantages seem to militate against you. Which ones should be properly removed or continued, I'm going to have to study some more.

I wonder if any of you or if your organizations have put together some numbers. I can always associate well with numbers—whether or not you have put together some numbers which show how these tax laws advantages really take place.

I note that in one of your testimonies, I think the testimony of Mr. O'Connor, you said that interest—somehow you make money paying interest—additional benefits may be derived by deduction of the large interest costs, although high interest is often devastating, current tax laws sometimes allow high bracket taxpayers to save more tax by deducting interest than the real cost, whatever that means, of borrowing money resulting in real after-tax rates of less than zero.

I have never figured out exactly how to gain tax advantage by paying out a dollar and getting 50 cents back through the tax code.

I recall one winter I was going out skiing in Colorado and I was driving over the mountain and the doctor who was with me was describing how he had invested in cattle and how he was in quite a high income bracket, how he had been able to eliminate all of his taxes that year and the preceding year. The next year he couldn't come with me. The cattle market turned around and he was almost broke.

So I can't quite figure out what's the advantage and what's not the advantage. Depreciation certainly is an advantage where you don't have to take a dollar out of your pocket for the purpose of getting a dollar's worth of deductions so you can get 50 cents and make a profit. But I wonder if any of you of your organizations have put together expamples of how you can make money by getting into farming. Do you know if you have done that?

Mr. O'CONNOR. We have some. I don't have them with me.

Senator BOSCHWITZ. I would like to see them.

Mr. O'CONNOR. OK.

Senator BOSCHWITZ. Mr. Harl, have you ever put that together?

Mr. HARL. Yes, sir. Well, I was looking here—maybe I don't have it in this testimony, but we worked through a number of scenarios under which there is an advantage and one of them which I think I do have in my testimony involves the purchase of property—take a look at the example in the prepared statement. This is an illustration of both the time value of money and also the conversion of ordinary income to capital gain because usually when you find a tax shelter you can classify that tax shelter into two or three basic categories. One is the time value of money, being able to accelerate deductions and that's true with prepurchased inputs. You buy feed 1 year and you receive income the next.

Senator BOSCHWITZ. I believe Mr. O'Connor also alluded to that and that's simply a delay. It's simply a delay.

Mr. HARL. It's a delay. The advantage is measured by the time value of money. The higher your tax bracket, the greater the advantage.

Second is the conversion of ordinary income into capital gain. There's an example in my prepared statement where we talk about the fact that since we don't have full recapture of depreciation, if you buy a heavily improved farm, claim investment tax credit and take fast depreciation, and you drive down the basis on depreciable property as fast as you can, you can get capital gain on everything in excess of straight-line depreciation. That's another part of the advantage.

Senator BOSCHWITZ. Assuming, of course, that the value retains, which it doesn't always do. Assuming that the land value is at the level or above the level at which you purchased it or above the depreciable basis.

Mr. HARL. Yes, or even if it falls a little below, so long as it doesn't fall too far below. Nobody likes to lose money. So you're playing tax brackets here. The capital gain tax bracket against the bracket of ordinary income because of the depreciation you're deducting against the higher tax bracket. On sale you're getting a 60-percent deduction on the gain with 40 percent taxed as ordinary income.

Senator BOSCHWITZ. True. But if you buy it for $1,000 an acre and you sell it for $800 and you depreciated the $400 and you sell it to pay a tax, but you're out $200.

Mr. HARL. Right.

Senator BOSCHWITZ. I have to see all that stuff on paper before I really buy it. But as you see all those buzzers, that means there are 7½ minutes left to vote so I'm going to go down and vote, but I will continue this discussion later.

Senator ABDNOR. You're not coming back?

Senator BOSCHWITZ. No, I'm not.

Senator ABDNOR. Well, I have a 12:30 meeting and I'm afraid it won't allow us to continue. I'm sorry. We talk about all the different factors affecting agriculture. One thing I don't think we've touched much on was about GATT and all these foreign trade agreements that we have. Wouldn't you say that's quite a factor, any of you, in where agriculture is going? I realize that's off of taxation.

Mr. URBANCHUK. Clearly, if we take a look at arrangements that affect our ability to compete in world markets.

Senator ABDNOR. Yes. Last week we held a Joint Economic hearing on the European Community trade practices. We had a gentleman in front, of us, Mr. Andreas, of Archer Daniels Midland. He's the chief executive officer. One of these people we had said that the European Economic Community is putting another billion dollars into subsidizing their agricultural products over there.

Mr. URBANCHUK. That's absolutely correct and one of the biggest issues of concern right now is the trade dispute between the United States and the EC, particularly with regard to the accession of

Spain and Portugal into the Community. And you alluded earlier to Secretary Baker providing funds or incentives for South Americans to reduce their taxes in order to compete in the world markets and compete directly against us.

Now one of the things we're looking particularly now at the agricultural sector and we're looking at the tax impact in the form of agriculture—I think one of the things—and we've said this, not just myself but other people as well a number of times—we have to take a look at all of our policies, all of our economic policies in a concentrated and concerted effort as to how they impact on agriculture.

Essentially, we have the bankers, the financial industry providing incentives and encouragement for our competitors to compete against us largely because they are looking at the repayment of their loans, their debt, which only can be done on the basis of income that's brought in in hard currency to those economies.

So we have a policy over here that stimulates competition at the same time we're looking at policies here that really put us at a competitive disadvantage.

Senator ABDNOR. There are a lot of things like this that we're not really talking about that have to be considered. These all have great impacts. Right now we have the cattle coming in from Canada and the European Economic Community is shipping in more and more meat over there to Canada and the farmers up there are shipping theirs to us and this has a great impact on agriculture. We can cut back all we want to, but if we don't control some of the things that go on in the other countries of this world we defeat out purpose.

Mr. URBANCHUK. There's another good example of that and I think the wheat people are very familiar with this and that is that we're losing wheat sales to the Soviet Union, largely because the Soviets are not able to purchase under the BICEP program, the Export Incentive Enhancement Program.

Senator ABDNOR. Yes.

Mr. URBANCHUK. Basically, the Soviets will probably end up taking very little wheat from us over the next several years and and may not even include it in the next 5-year long-term grain trade agreement.

Senator ABDNOR. I wish we had more time. I gather I'm going to miss this vote. I guess I have less than 7 minutes, but this could go on and on and I wish we had more time. Maybe we'll come back to it. This fellow Andreas served on the President's Task Force on International Free Enterprise dealing with trade and aid and they made some recommendations in this group and I was very intrigued by it. I'd like to have that guy back to go through some of these things. Some things are ignored too much around Congress that should be centered on and attended to if we're really going to whip this agricultural problem.

Well, I hate to bring this to an end. This has been extremely helpful and interesting and I hope it's just the start and that we can get this input into the legislation that's coming out of this Congress.

We thank you for coming so far and participating in the hearing and making all this possible. Thank you very much.

The subcommittee stands adjourned.

[Whereupon, at 12:10 p.m., the subcommittee adjourned, subject to the call of the Chair.]

APPENDIX

Testimony on Behalf

of the

National Cattlemen's Association

on

Tax Reform

submitted to

The Honorable James Abdnor, Chairman
Agriculture and Transportation Subcommittee

of the
Joint Economic Committee

submitted by

Jimmy Powell, Chairman
NCA Tax and Credit Committee

April 29, 1986

The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry--including cattle breeders, producers and feeders. The NCA represents approximately 230,000 professional cattlemen throughout the country. Membership includes individual members as well as 49 affiliated state cattle associations and 22 affiliated national breed organizations.

Mr. Chairman, and members of the Committee, my name is Jimmie Powell. I am serving as Chairman of the National Cattlemen's Association's Tax and Credit Committee. I want to share with you our views, interests and concerns on the tax reform and its impact on the cattle industry.

As you know, agriculture and the cattle industry are currently undergoing some very difficult and trying economic times. As cattlemen and businessmen, we recognize the importance of a fair and equitable tax code, which promotes growth and good economic business decisions. We support the efforts of the Administration and Congress to attempt to bring order to the complex tax code that has evolved over the years.

Our business is capital intensive and acquisitions are primarily financed through debt. Agriculture needs equity capital, not just debt capital. This equity capital must be based on economic returns and will help all farmers and ranchers across the country. We are concerned that adequate capital be available to finance our operations. Economic growth must be a primary objective in tax reform deliberations.

Fairness is the "key" to tax reform and must govern changes in the tax code. Our membership readily accepts and desires changes which make the tax laws fairer and are aimed at treating all industries and individuals equitably. Fairness should be the number one goal of Congress.

NCA has expressed strong support for broad-based tax reform that treats all segments of our economy equally.

We urge that no particular industry be singled our and targeted for specific changes treating a perceived symptom. For example, changes which try to limit deductibility of farm losses without regard for the source or csuse of the loss do not address the provisions in our tax code that underlie the problem.

Lower marginal tax rates create an economic incentive and are a desirable result of tax reform. NCA fully supports efforts to reduce the number of tax brackets and to lower tax rates. We believe lower marginal rates will reduce the incentive for tax payers to seek out tax shelters and stimulate cattlemen to make decisions based on economic rationale.

NCA recognizes and supports efforts to address the tax shelter problems that occur in agriculture. NCA wants investment in the cattle business for economic reasons--to make a profit--and not simply based on tax considerations.

Furthermore, increasing the personal exemption level for individuals, as well as the zero bracket amount, contribute significantly to a fairer and more equitable system. Cattlemen support these efforts and hope tax reform efforts will include such provisions in a reform proposal.

NCA supports a depreciation system that accurately reflects the economic useful life of a particular asset such as a cow, pick-up or tractor.

The cattle business, and agriculture in general, is a highly volatile industry. Net income from farming and ranching can fluctuate 100% from year to year. The use of cash accounting and income averaging are very important and necessary tools for agricultural producers to moderate these peaks and valleys in income.

The cash method of accounting is used and understood by most farmers and ranchers. To change or alter this would go against one of the primary reasons for reforming the tax code--simplicity.

Early in spring of 1985, NCA organized and initiated a forum for agricultural groups to meet and discuss tax issues. This tax study group has evolved into a very useful forum of educating, discussing and planning. Obviously, all of agriculture is not affected by tax reform in the same way. This group will continue to meet as long as the reform is an issue. The working group consist of 25-30 agricultural groups.

NCA supports fair, equitable tax reform that attempts to simplify the tax code and yet maintains incentive for economic growth. Cattlemen want to work with you to ensure that our concerns are addressed.

Tax shelters have been a concern in our industry as well as other industries because of tax code problems. We feel lower marginal tax rates, repealing investment tax credit and adoption of a depreciation system that more accurately reflects useful life, removes the incentives for seeking tax shelters in agriculture. Cattlemen support those measures which are broad-based solutions to a problem and are not targeted at specific industries. We encourage you and other members of this Committee not to lose sight of a very worthwhile and desirable goal. It appears that Chairman Packwood and the Finance Committee are willing and ready to continue the process in a positive manner. NCA will be an active organization in tax reform. Afterall, a fair tax code is an achievable goal.

THE NATIONAL GRANGE

WRITTEN STATEMENT BY

THE NATIONAL GRANGE

SUBMITTED TO THE

JOINT ECONOMIC COMMITTEE

SUBCOMMITTEE ON AGRICULTURE AND TRANSPORTATION

APRIL 29, 1986

RE: TAX REFORM'S IMPACT ON AGRICULTURE

Family Farm Organization Serving Rural America

THE NATIONAL GRANGE, 1616 H STREET, N.W. WASHINGTON, D.C. 20006

Mr. Chairman, members of the Committee, The National Grange is honored to submit testimony for the record of this important hearing. We commend you, Mr. Chairman, for holding this hearing on tax reform's effect and impact on agriculture. While there are a variety of agricultural issues currently before Congress, tax reform could have the most lasting effects on the structure of agriculture in the United States.

The National Grange, founded in 1867, today represents over 400,000 members in 41 states. Our interests cover the wide cross section of agriculture as well as the quality of life in rural America.

In recent years, a concensus has developed that various tax incentives created by Congress, and supported by a wide range of agricultural interests, have had the effect of drawing excess resources into the production of food and fiber in this country, fostering overproduction and depressing farm prices and farm income. Without a doubt, the tax system has had a tremendous impact on the productivity of agriculture, encouraging farm expansion, capital-labor substitution, increased debt utilization, and outside investment.

The President's 1984 Economic Report to Congress began to explore the question of non-farm investment by stating that, "Several features of the income tax law, some of them unique to farming, may encourage greater investment in productive capacity and expanded production." Mr. Reagan's Council of Economic Advisors told the President,

> "Tax policy does not affect the profitability of all types of farms equally. The tax laws encourage the substitution of capital for labor. Larger farms, which generate higher incomes, appear to gain proportionately greater benefits than smaller farms. People in higher marginal tax brackets can benefit more from the tax provisions. This creates an incentive for higher-income people to invest in farming. In practice, losses from farm operations reduce taxes on income by more than the total federal tax revenue from farm profits, implying that total farm income for tax purposes is negative."

Let's re-examine the last statement that was made by the advisors. Studies indicate that losses from farm operations reduce taxes on non-farm income by twice the amount of total federal tax revenue from farm profits. Stated otherwise, for every one dollar that is earned in farm profits, two other non-farm dollars of income are sheltered.

With these thoughts in mind, it is obvious that the challenge for agriculture, during tax reform, is to modify those provisions whose net effects have been detrimental to agriculture while maintaining legitimate provisions that recognize unique production situations in agriculture. The National Grange does not believe there is justification for one sector of the economy, in a sense, to be able to take advantage of another sector through tax law. Therefore, we believe that prop· ·als that will restrict the opportunities to offset losses in agriculture against income that is generated from off-farm sources have significant economic benefits, significant equity benefits, and should be seriously pursued. (We should briefly note that proposals to reduce the rates of particularly the upper brackets will decrease the demand for sheltering income.)

Mr. Chairman, at this time, we would like to turn our attention to the current discussion of tax reform. In the following paragraphs, The Grange will express its concerns and share its approval with the agricultural section of H.R. 3838, the House-passed tax reform package, and the "Packwood Draft", which is currently being considered by the Senate Finance Committee.

The overusage of Investment Tax Credits (ITC) can be identified as one of the two biggest culprits contributing to overcapitalization in agriculture This dollar for dollar write-off of tax liability is a perfect mechanism for lowering tax debt. However, capital investment is needed in the agricultural industry from time to time to improve efficiency and production. To remain competitive, particularly on the world market, tax credits for prudent investments are necessary. This is why The Grange encourages the continuation of ITC; however, we recommend that a $100,000 value eligibility cap be implemented to control abusive use.

The "Packwood Draft" proposes an increase in the capital expensing provision to $50,000 to offset the loss of the ITC. The Grange vigorously opposes such action. Capital expensing is more beneficial to higher bracket taxpayers where investment tax credits treat all brackets equally. In our opinion, the increase in capital expensing does not benefit the family farmer, and we urge the Senate Panel to reduce that level to current law, $5,000, and reimplement the ITC with the cap mentioned above.

The second bandit responsible for overcapitalization is the rapid depreciation schedules established by the Accelerated Cost Recovery System (ACRS). We firmly believe that depreciation schedules must be lengthened to reflect the true economic life of farm and non-farm assets. In particular, we believe that single purpose structures must be depreciated over their useful life.

In past years, a tremendous amount of land has been brought into production that should not have been. A generous tax code and farm subsidies are the cause of this. The Food Security Act of 1985 took steps to correct one-half of the problem. Now, tax reform must correct its contributing factor so that the two policies are in harmony with one another. We generally agree with the provision in H.R. 3838, which tightens the deductions for land clearing. By repealing Section 182 expensing, the incentive to convert fragile land to cropland will be removed.

However, we advocate current law and oppose the provision in H.R. 3838 as it relates to conservation practices. The House bill creates new regulations on conservation programs. Any conservation program must be approved by the Soil Conservation Service (SCS), or comparable state authority, before the costs can be deducted as a current expense. Expenditures for soil and water conservation generate long-term social benefits for which farmers and ranchers should receive compensation. Our concern is that significant budget cuts suffered by the SCS will hamper their ability to service growers and approve conservation practices. This situation would discourage conservation investment, which is clearly not the intent of this legislation. If necessary, the SCS could be identified as the referee in any disputes between farmers and the IRS resulting from conservation investment deductions.

Similarly, The National Grange supports the continuation of fertilizer and lime expenses as being deductible as an ordinary and necessary business expense. Fertilizer and lime have a short useful life and must be applied every year. The retention of Section 180 is the simplest method by which to achieve this goal.

The alternative minimum tax should be a useful tool in forcing large corporations to pay their fair share of the tax burden. However, we must protect the insolvent farmer from this provision. The Grange believes that H.R. 3838 solves this problem by placing gain on disposition of farmland by a taxpayer who is bankrupt as a preference item under the alternative minimum tax if certain conditions are met. This is a concerted effort by Congress to correct this inequity and we applaud this provision.

Dovetailing the problem described above is the taxation of loan forgiveness. Currently, if a portion of a farmer's debt is forgiven, the gain is taxed as income. We must correct this provision, allowing bankers, farmers, and the IRS to work together in solving the current credit crunch.

The House bill acknowledges that farmers and ranchers should be able to continue the use of cash method accounting in order to avoid the complexities that are required to account for growing crops and livestock under other methods of accounting. The National Grange supports the continuation of the use of cash accounting with no limitations. We highly oppose a provision that links a percentage of prepaid expenses to the availability of cash accounting. This is simply a back door approach to the eventual elimination of cash accounting. Farmers who have access to computers will be able to circumvent this requirement while the marginal family farmer could be caught in a trap. If income averaging is eliminated, cash accounting becomes an even more important management tool.

The Grange believes that the use of income averaging is extremely important. Given the variance of weather, crop prices, and other factors beyond the control of farmers and ranchers, their incomes can fluctuate widely. These fluctuations can unfairly exaggerate tax liabilities by forcing farmers, during good years, into higher tax brackets than their long-term earning power warrants. We do believe that action must be taken to eliminate the use of income averaging for those people with continuously rising incomes and limit its use to individuals with fluctuating incomes.

We feel that the election alternative provided for in the House bill, under the preproductive period expenditures, would introduce major new complexities for ranchers in the form of both the election process and the separate depreciation schedule. To resolve this problem, we recommend a non-elective mechanism. If the farmer is producing an ordinary income product and the preproductive period is over two years, the producer would accept straight line depreciation on his/her assets. If the farmer is producing capital gain income and the preproductive period is over two years, then the producer would accept straight line depreciation on his/her assets, or he/she would realize 20 percent of the sale as ordinary income.

In addition, we believe that the preproductive period needs to be redefined to reflect the true preproductive period. H.R. 3838 defines the period for livestock from time of conception until the animal gives birth. This period, as defined by the House, actually reflects three different management periods. From conception to parturition, the management practices relate to the care of the mother (cow, sow, ewe, mare). After birth, until the female is placed in the breeding herd, is a second stage of management. The management during this period relates to the growth and development of the animal itself. When the female is placed in the breeding herd, the care of that female is a production management and is similar to the care that her mother received during gestation. Therefore, the true preproductive period for livestock is from birth until placed in the breeding herd. This should also be the definition for tax purposes.

In the "Packwood Draft", a great inequity has been recognized. Senator Packwood has proposed that self-employed taxpayers be allowed to deduct one-half of their health insurance premium as a business expense. Under current law, employees whose employers provide them with medical insurance can exclude the cost of that insurance from their gross income, but self-employed farmers and ranchers who purchase their own insurance cannot deduct the cost. We support this proposal as it will place the employed and self-employed on a level playing field.

The National Grange believes that investments should be based on economic returns rather than on the basis of how well income can be sheltered from taxation. Because of this, we applaud the restraints that are placed on passive investments deductions in H.R. 3838. In an effort to strengthen anti-sheltering in agriculture, we are pleased that a $50,000 cap is placed on tax shelter deductions. In our desire to reduce sheltering, we must be careful that we don't significantly increase the tax burden for the sector that we are trying to protect from sheltering. For that reason, we support the 2:1 ratio for those who materially participate in farming. The challenge is to accurately define material participation.

In tax reform, we must eliminate the incentive for the nonfarmer taxpayers to cultivate the Internal Revenue Code. The need to promote sound and economic investments in agriculture must be placed in the forefront of the legislative agenda. Tax laws and other laws should encourage the proper growth, development and continued viability of the agricultural industry. Such growth does not require special incentives or "tax shelter laws". If food and fiber are essential, then tax laws must work in harmony with agriculture in order to insure abundant supplies of food and fiber to our Nation at reasonable prices.

The fact is, Mr. Chairman, tax laws must be changed in order to preserve both the family farm and the current structure of rural America. Again, Mr. Chairman, I commend you for calling this hearing on this timely issue. The National Grange appreciates this opportunity to submit testimony on this vital matter.

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