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AGRICULTURE AND TAX REFORM: OPPORTUNITIES FOR RURAL AMERICA

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTEENTH CONGRESS

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AGRICULTURE AND TAX REFORM: OPPORTUNITIES FOR RURAL AMERICA

WEDNESDAY, APRIL 5, 2017

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Committee met, pursuant to call, at 10:00 a.m., in Room 1300 of the Longworth House Office Building, Hon. K. Michael Conaway [Chairman of the Committee] presiding.

Members present: Representatives Conaway, Lucas, King, Gibbs, Crawford, Davis, Yoho, Allen, Bost, Rouzer, Kelly, Comer, Marshall, Bacon, Faso, Dunn, Arrington, Peterson, Walz, Fudge, McGovern, Vela, Lujan Grisham, Kuster, Nolan, Bustos, Plaskett, Evans, O'Halleran, Panetta, Soto, and Blunt Rochester.

Staff present: Bart Fischer, Callie McAdams, Darryl Blakey, Haley Graves, Matthew S. Schertz, Paul Balzano, Stephanie Addison, Anne Simmons, Liz Friedlander, Matthew MacKenzie, Mike Stranz, Troy Phillips, Nicole Scott, and Carly Reedholm.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

The CHAIRMAN. Good morning. I call this hearing to order. And I would ask Rick Crawford to offer a quick prayer for us. Rick.

Mr. CRAWFORD. Thank you, Mr. Chairman.

Heavenly Father, we do bow humbly before you today, thankful for every blessing of life. Lord, thankful for this nation that you provided us with. Father, I would just ask that you be with each one here today, that you would give us discernment and forbearance, and a temper that reflects your grace, Father. We ask it all in Jesus' name. Amen.

The CHAIRMAN. Thank you, Rick.

The hearing of the Committee on Agriculture entitled, *Agriculture and Tax Reform: Opportunities for Rural America,* will come to order.

Good morning. I would like to welcome all of you today to today's hearing about examining how the Tax Code impacts on American agricultural producers. Much like it did in 1985 and 1986, tax reform is poised to again consume much of Washington's attention. Before that happens, today's hearing will offer Members a baseline understanding of how the current Code affects farmers, ranchers, and foresters, and how changes to the Code might affect them moving forward.

Both the Ranking Member and I are CPAs, and many of our colleagues in Congress are small business owners in their own right.

Each of us who has advised a client or managed a business is keenly aware of the day-in and day-out challenges of running a business, including the need to carefully manage cash to pay suppliers; the challenge of financing repairs, improvements, or expansion; and the relentless drive to build a business that can be transitioned to the next generation.

While there are several parallels between agriculture and other small businesses, few sectors are subject to as many unknowns as farming and ranching. Weather, pests, constantly changing consumer preferences, predatory trade practices of foreign governments, and so much more all rob certainty from producers. Agriculture is an industry of high fixed costs, lead times that last an entire growing season or longer, and highly variable returns combined with, historically, very tight margins. As a result, managing tax liability is of paramount importance.

To support producers, Congress has worked to soften the negative impacts of inflexible tax rules that do not make sense for agriculture. These changes, which often seek to align taxable events with real world activities, help producers manage their tax burden and ensure that they have the means to continue farming and ranching.

As with tax reform changes from years past, the devil is always in the details. While Chairman Brady and his colleagues at Ways and Means are hard at work, many of the details have yet to be ironed out. What we do know though is that tax reform is coming and it holds a promise of dramatically increasing economic growth for all of America in every walk of life.

Providing for a simpler, fairer Tax Code means that many parts of the Tax Code may have to change. Actually, they will have to change. While every individual component of tax reform will have its supporters and detractors, these individual proposals cannot be evaluated in a vacuum. I would ask my colleagues to listen, ask questions, and learn today, but reserve judgment on the components of tax reform until you see the entire package.

I would like to, again, welcome our witnesses and thank them for taking the time to be with here today.

[The prepared statement of Mr. Conaway follows:]

PREPARED STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

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With that, I'd like to again welcome our witnesses and thank them for taking the time to be with us here today.

With that, I now turn to the Ranking Member, Mr. Peterson, for any comments he'd like to make.

The CHAIRMAN. And with that, I will recognize the Ranking Member for any comments that he might have.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. PETERSON. Thank you, Mr. Chairman. And I want to thank the witnesses and the Members for being here today to testify.

As you said, tax reform and what happens with tax law is a very important issue for agriculture and rural America. And we need to keep in mind that beyond the farm bill, there are other aspects of Federal policy that Congress may act on, there are few others that will have the impact on producers as what we do there on land and tax policy on those issues.

Like the Chairman said, I am a CPA. And I remember the days back in the '70s when people would come by my office——

The CHAIRMAN. Which century was that?

Mr. PETERSON. That was in the 1870s.

The CHAIRMAN. 1870s.

Mr. PETERSON. And people would come in my office in December and they would ask me to figure out what their net income was, and then they would ask me how much equipment they had to buy, so they wouldn't have to pay any tax. And this is sometimes equipment they needed, but a lot of times it really wasn't what they needed, but they had a seven percent tax credit that time, tax——

The CHAIRMAN. Investment.

Mr. PETERSON. Investment tax credit. And it was part of the reason people got in trouble in the farm crisis. Unfortunately, we have something going on today that is similar, with the section 179 depreciation and the bonus depreciation, which continues on at 50 percent, and I don't know when that expires. Is that this year? It keeps going, does it?

The CHAIRMAN. It scales down.

Mr. PETERSON. What? Next year?

The CHAIRMAN. It scales down.

Mr. PETERSON. Anyway, my old partners tell me that they have the same situation going on now that we had back then, that people are buying stuff so they don't have to pay tax. And I get that, and I made a living for quite a few years helping people with that,

but, as we get into this downturn in prices and pressure on agriculture producers, you are going to see people being more in a bind than they would have been because of what they did in the tax area.

We need to be careful in what we do. Some of the ideas I have heard, getting rid of interest deductions as opposed to letting 100 percent expensing of all equipment and building, I have some real questions about that in terms of what it is going to do for agriculture, we need to be careful. This border adjustment tax sounds good, but could potentially collapse our export markets. We need to be really careful in what we do, and be mindful of how this is going to impact agriculture and our producers. Maybe we need to reenact, bring up the fair tax which eliminates the income tax altogether, and it changes the incentive from buying things to get rid of tax, to saving to get rid of tax. And that changes the whole mentality of it, I was a cosponsor of that theme for many years but it kind of died by the wayside.

The CHAIRMAN. Me too.

Mr. PETERSON. Anyway, this is an important issue. It is good that we have an opportunity to discuss it here in the Agriculture Committee, and, hopefully something will get done because the Tax Code does need to change, we do need to lower the rates, we do need to address some of the complexity in the system, and hopefully we can have some voice in that.

So thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentleman yields back.

Major tax reform hasn't been done since 1987 because it is hard. And I agree with the gentleman. I have cosponsored the fair tax each time I have been in Congress as well because I do think a dramatic change would be for the best, but you are going to have to have a President run on that issue in order to educate the people as to what is going on.

The chair requests that other Members submit their opening statements for the record so witnesses may begin their testimony to ensure there is ample time for questions.

Our first panel today is two of our fellow Members of the Ways and Means Committee. We have Ms. Kristi Noem from South Dakota, a former Member of the Agriculture Committee, much to our regret she moved over to the Ways and Means Committee. Kristi will go first, and then we have a fellow CPA, Lynn Jenkins from Kansas, who will also be testifying this morning.

So with that, Kristi, you are recognized for 5 minutes.

STATEMENT OF HON. KRISTI L. NOEM, A REPRESENTATIVE IN CONGRESS FROM SOUTH DAKOTA

Mrs. NOEM. Well, thank you, Mr. Chairman, and thank you for allowing me to appear before the Agriculture Committee today. And, Ranking Member Peterson, the concerns that you just expressed are some that we have debated in the Ways and Means meetings that we have had on tax reform as well, and that is one of the things that I have been grateful for. I have been able to bring an agriculture perspective to those discussions, talk about the industry, how it is highly leveraged at times when producers are buying land with loans, then making loans to purchase machin-

ery, then having an operating loan every year too. We have to be careful in what we do so that we keep their operations viable. I appreciate you expressing those concerns, and we will continue to work for a Tax Code that works for everybody.

It is an honor, and it always has been an honor for me to fight alongside of you for agriculture, and it was an honor for me to serve on this Committee for many years. We advocated for those who feed the world, and were able to pass a strong farm bill in 2014. We all know there were challenges in getting that legislation to the finish line, but we proved once again that there is no job too hard that farmers can't do, and no task that isn't worth doing for our agriculture industry that feeds the world.

Today, we face another significant challenge and opportunity with tax reform.

Just as the farm bill touches every single family's life, because everyone eats, tax reform will impact everyone's life because we all pay taxes in one way or another. I commend you for holding today's hearing.

I know that some of the areas of the Tax Code disproportionately and unfairly impact America's agriculture community. This includes the death tax. As many of you know, my family was hit with the death tax when my dad had an accident on our family farm at the age of 49 years old. About a month after he passed away, our family received a letter from the IRS that said we owed money on land and machinery and cattle, and we didn't have money in the bank. It was very difficult for us to keep our family operation going. We took out a massive loan, but it took me 10 years to pay off that loan. And since then I have been active in making sure that we are advocating for repealing the death tax. We weren't able to invest in our operation and make the kind of improvements that we wanted to because we had to pay on that loan every single year.

And many producers find themselves in a similar spot when tragedy strikes their family, and that is why I have sponsored legislation to repeal the death tax, and was glad that it was included in the House Ways and Means tax reform *Blueprint.* Additionally, what many don't quite realize is how highly leveraged agriculture production is. Many farmers take out loans every year only to put that money in the ground in the form of seeds and fertilizer, and hope that that fall there will be something to pick up and harvest so they can pay their bills.

It is especially true for younger farms and younger farmers who aren't established enough to cash-flow their own operations. Ensuring that there is adequate cost recovery mechanisms in the Tax Code is essential to attracting and keeping younger producers on the family farm.

Some use a combination of interest and expensing for operating notes and equipment purchases. Because land is a principle input for agriculture, ensuring there continues to be a cost recovery mechanism for land purchases remains a priority. And all this said, Mr. Chairman, there is one additional thing in common between the farm bill and tax reform: provisions cannot be looked at in isolation. And I encourage you to view tax reform as a comprehensive package that is aimed to increase opportunity and growth for Americans from all walks of life.

Mr. Chairman, nowhere in the country is the American dream more alive than within agriculture. I stand ready to work with you and Members of the Committee to make sure farmers and ranchers can continue to pursue the American dream, and in doing so, our great tradition of feeding the world.

It is great to be with all of you today. I loved serving on this Committee. It is such a bipartisan group of folks who really care about policy to secure a safety net for our farmers and ranchers, but also recognize we feed the world. God bless you for the work that you do, and use me as a resource as you go forward and look at tax reform and how it impacts the industry.

With that, Mr. Chairman, I will yield back.

The CHAIRMAN. The gentlelady yields back. We thank you, Kristi, for being here.

Ms. Jenkins, 5 minutes.

STATEMENT OF HON. LYNN JENKINS, A REPRESENTATIVE IN CONGRESS FROM KANSAS

Ms. JENKINS. Chairman Conaway, Ranking Member Peterson, and honorable Members of the House Agriculture Committee, thank you for the opportunity to testify before you this morning to discuss the important topic of tax reform, and the potential it has to help the agricultural economy and the rural way of life in America.

Mr. Chairman, as fellow CPAs, I know that we both understand the opportunity that tax reform can unlock in this space. I would also like to echo the remarks of my colleague on the House Ways and Means Committee, Congresswoman Noem, regarding the importance of eliminating the death tax and allowing interest deductibility for our farmers and ranchers.

I was raised on a dairy farm in Holton, Kansas, and so I can speak with firsthand knowledge about the challenges and rewards that come with farming. Ours was a family operation, not at all different from other small businesses across America, and as such, we had to balance work on the farm with the complicated bookkeeping that goes along with that.

To make life easier for American families and businesses, the Ways and Means Committee has embarked on an effort to accomplish comprehensive tax reform for the first time since 1986. The guiding principles of tax reform will be beneficial to the agriculture community. We plan to lower tax rates for families and businesses, simplify a complex and burdensome Code for filers, and encourage investment. We believe that these principles will unburden American taxpayers and spur economic growth.

Of particular interest to the Agriculture Committee is our effort to lower tax rates for individuals, pass-through businesses, and corporations. For individuals, this means moving from our current system of seven marginal tax brackets down to three, with rates at 12 percent, 25 percent, and 33 percent. For pass-through businesses, the rate would be 25 percent, and for corporations the rate would be 20 percent. In addition, our plan will reduce complexity by repealing the alternative minimum tax. The result here will be a significant rate cut across the board, a lower tax burden for farmers and ranchers, and simplification when filing.

The plan also provides businesses the ability of immediate expensing of their investments. For the ag community this means that purchases related to the business, like tractors, combines, and other farm equipment, will be written-off in real time for tax purposes as we move toward a cash-flow tax. This means that we are doing away with complicated depreciation schedules and uncertainty regarding extension of temporary tax provisions. Additionally, this will make sense for family farmers who already operate on a cash-flow basis by using the cash accounting system. We believe that moving toward immediate and full expensing would open greater opportunities for the cash method of accounting.

I want to thank you all again for the opportunity to be with you this morning. I look forward to working with each and every one of you on this Committee to ensure that the interests of rural America will be protected as we move forward with comprehensive tax reform.

Thank you, and I yield back.

The CHAIRMAN. Well, I thank the gentlelady for yielding back.

Agriculture is glad we have both of you on the Ways and Means Committee as that Committee begins its work. We know how much impact individual Members have on the Agriculture Committee on the farm bill, and I am looking forward to having you as advocates on behalf of ag interests on the Ways and Means Committee in whatever path we walk on tax reform. With that, thank you both for being here this morning.

And we will now transition to the second panel.

Well, we have a terrific second panel. The first panel set the table well for where we go from here, so I would like to welcome Ms. Patricia Wolff, the Senior Director for Congressional Relations, American Farm Bureau Federation here in Washington, D.C.; Mr. Doug Claussen who is a CPA and a Principal at K•Coe Isom, LLP, in Cambridge, Nebraska; Mr. Chris Hesse, CPA, Principal of CliftonLarsonAllen, LLP, Minneapolis, Minnesota; Mr. Guido van der Hoeven, Extension Specialist/Senior Lecturer, Department of Agricultural and Resource Economics, Raleigh, North Carolina; and Dr. James Williamson, Economist, United States Department of Agriculture, Economic Research Service, here in D.C.

Ms. Wolff, your 5 minutes will begin when you want to. Thank you.

STATEMENT OF PATRICIA A. WOLFF, SENIOR DIRECTOR, CONGRESSIONAL RELATIONS, AMERICAN FARM BUREAU FEDERATION, WASHINGTON, D.C.

Ms. WOLFF. Chairman Conaway, Ranking Member Peterson, and Members of the Committee, thank you for scheduling this hearing on agriculture and tax reform. This discussion of Tax Code provisions that are valuable to farmers and ranchers is important as the 115th Congress begins to rewrite our nation's Tax Code.

My name is Pat Wolff, and I serve as the American Farm Bureau Federation's tax policy specialist. Farm Bureau is a general farm organization with nearly six million families who grow, raise, or harvest all commodities commercially produced in our country. Farm Bureau appreciates the opportunity to highlight the Tax

Code provisions important to the long-term financial success of farm and ranch businesses.

Farms and ranches operate in a world of uncertainty. Each day our members face unpredictable commodity and product markets, fluctuating input prices, uncertain weather, and insect and disease outbreaks. Clearly, running a farm or ranch business is challenging under the best of circumstances, and these challenges can lead to significant financial uncertainty. Farmers and ranchers need a Tax Code that recognizes that our industry faces unique financial risks. Tax priorities and policies are needed that support high-risk, high-input, capital-intensive businesses like farms and ranches that predominantly operate as sole proprietors and pass-through entities.

Congress has acknowledged these unique business challenges by including provisions in the Tax Code to allow farmers and ranchers to handle their cash-flow challenges by leveling their incomes and matching income with expenses.

Farm Bureau has identified several of these provisions as critical components of any tax reform plan. And I will mention these in a minute, but these are a comprehensive list of provisions that help farmers. What is important to take away from today's hearing is that farmers and ranchers need financial and tax management tools to weather turbulent financial times.

Before I talk about the tax provisions that Farm Bureau has identified as priorities, I need to make an important point about effective tax rates. Lower tax rates coupled with base-broadening provisions will provide the foundation for any major tax overhaul. Unless farmers and ranchers continue to have access to a menu of tax provisions that help them deal with the cyclical and unpredictable nature of their businesses, there is a potential that even with lower tax rates, there could be an increase in taxes that farmers and ranchers pay.

Now I will turn to the items that Farm Bureau has identified as priorities. First, cost recovery. Farm and ranch businesses have high input costs. Immediate expenses reduces the taxes in the purchase year, providing readily available funds for buying production supplies, replacing livestock, upgrading equipment, and hopefully for expanding their businesses. Second, cash accounting. Cash accounting is the preferred and far-and-away the most chosen method of accounting for farmers and ranchers. It allows them to cash-flow by matching income with expenses, and aids in tax planning. Third, the interest deduction. Farmers and ranchers rely almost exclusively on borrowed money to buy production inputs, equipment, land, and buildings. The interest they pay on their loans is a legitimate business expense and should be deductible. Fourth, estate taxes. Estate taxes can disrupt the transition of farm and ranch businesses from one generation to the next. They should be repealed, and unlimited stepped-up basis, another critical element in preserving family farm operations, should continue. Fourth, capital gains taxes. Production agriculture requires large investments in land and buildings that are held for long periods of time. Lower tax rates on capital gains recognizes the risk that is involved with long-term business investments, and should continue. Fifth, like-kind exchanges. Like-kind exchanges help farmers and ranchers operate efficient businesses by deferring taxes when they sell, and

then purchase new or better land, livestock, and equipment. This allows them to improve and grow their businesses faster.

In closing, I would like to thank the Committee for holding this important hearing about agriculture and tax reform. Farm Bureau encourages the Committee to actively advocate for a Tax Code that helps farmers and ranchers navigate the uncertain and unpredictable nature of their businesses.

[The prepared statement of Ms. Wolff follows:]

PREPARED STATEMENT OF PATRICIA A. WOLFF, SENIOR DIRECTOR, CONGRESSIONAL RELATIONS, AMERICAN FARM BUREAU FEDERATION, WASHINGTON, D.C.

Chairman Conaway, Ranking Member Peterson, and Members of the Committee, thank you for scheduling this hearing on *Agricultur*[*e*] *and Tax Reform: Opportunities for Rural America.* It is important for the Committee on Agriculture to shed light on tax provisions important to farmers and ranchers as the 115th Congress begins to rewrite our nation's Tax Code.

My name is Pat Wolff and I serve as Farm Bureau's tax policy specialist. Farm Bureau is the country's largest general farm organization, with nearly six million member families and representing nearly every type of crop and livestock production across all 50 states and Puerto Rico. Farm Bureau appreciates the opportunity to highlight Tax Code provisions important to the long-term financial success of farm and ranch businesses.

Farms and ranches operate in a world of uncertainty. From unpredictable commodity and product markets to fluctuating input prices, from uncertain weather to insect or disease outbreaks, running a farm or ranch business is challenging under the best of circumstances. Farmers and ranchers need a Tax Code that recognizes the financial challenges that impact agricultural producers.

Farm Bureau supports tax laws that help the family farms and ranches that grow America's food and fiber, often for rates of return that are modest compared to other businesses['] opportunities. What is needed are tax policies that support high-risk, high-input, capital-intensive businesses like farms and ranches that predominantly operate as sole proprietors and pass-through entities.

The House of Representatives is moving forward with comprehensive tax reform designed to spur growth of our nation's economy. Many of the provisions of the tax reform *Blueprint* will be beneficial to farmers, including reduced income tax rates, reduced capital gains taxes, immediate expensing for all business inputs except land and the elimination of the estate tax. The proposed loss of the deduction for business interest expense, however, is a cause for concern. The *Blueprint* can be improved by guaranteeing the continuation of stepped-up basis, preserving cash accounting and maintaining like-kind exchanges.

The testimony that follows focuses on and provides additional commentary on the tax reform issues most important to farmers and ranchers.

Lower Effective Tax Rates Will Benefit Farm and Ranch Businesses

Farm Bureau supports reducing tax rates and views this as the most important goal of tax reform. Tax reform must be comprehensive and treat farm and ranch businesses that operate as individuals, pass-through businesses and corporations fairly. More than 94 percent of farms and ranches are taxed under IRS provisions affecting individual taxpayers. Tax reform that fails to treat sole proprietors, partnerships and S corporations fairly will not help, and could even hurt, the bulk of agricultural producers who operate outside of the corporate Tax Code.

While lower tax rates are important, the critical feature for farmers and ranchers is the effective tax rate paid by farm and ranch businesses. Tax reform that lowers rates by expanding the base should not increase the overall tax burden (combined income and self-employment taxes) of farm and ranch businesses. Because profit margins in farming and ranching are tight, farm and ranch businesses are more likely to fall into lower tax brackets. Tax reform plans that fail to factor in the impact of lost deductions for all rate brackets could result in a tax increase for agriculture.

Farming and ranching is a cyclical business where a period of prosperity can be followed by 1 or more years of low prices, poor yields or even a weather disaster. Tax Code provisions like income averaging allow farmers and ranchers to pay taxes at an effective rate equivalent to a business with the same aggregate but steady revenue stream. Farm savings accounts would accomplish the same object[ive] plus allow a fa[r]mer or rancher to reserve income in a dedicated savings account for

withdrawal during a poor financial year. Currently one of the main mechanisms farmers have to move money from one year to the next is by purchasing new equipment or other inputs. Farm savings accounts would give farmers much more flexibility in money management.

Accelerated Cost Recovery Helps Farmers Remain Efficient

Expensing allows farm and ranch business to recover the cost of business investments in the year a purchase is made. Because production agriculture has high input costs, Farm Bureau places a high value on the immediate write-off of equipment, production supplies and pre-productive costs.

The value of expensing has been widely acknowledged by Congress as recently as 2015 with passage of the PATH Act, which made permanent the $500,000 level of Sect. 179 small businesses expensing. The Tax Code also provides immediate cost recovery through bonus depreciation and through long standing provisions that allow for the expensing of soil and water conservation expenditures, expensing of the costs of raising dairy and breeding cattle and for the cost of fertilizer and soil conditioners like lime.

When farmers are not allowed immediate expensing they must capitalize purchases and deduct the expense over the life of the property. Accelerated deductions reduce taxes in the purchase year, providing readily available funds for upgrading equipment, to replace livestock, to buy production supplies for the next season and for farmers to expand their businesses.

Cash Accounting Helps Farm and Ranch Businesses to Cash-Flow

Cash accounting is the preferred method of accounting for farmers and ranchers because it allows them to match income with expenses and aids in tax planning. Farm Bureau supports the continuation of cash accounting.

Cash accounting allows farmers and ranchers to improve cash-flow by recognizing income when it is received and recording expenses when they are paid. This provides the flexibility farmers need to plan for major business investments and in many cases provides guaranteed availability of some agricultural inputs.

Under a progressive tax rate system, farmers and ranchers, whose incomes can fluctuate widely from year to year, will pay more total taxes over a period of time than taxpayers with more stable incomes. The flexibility of cash accounting also allows farmers to manage their tax burden on an annual basis by controlling the timing of revenue to balance against expenses and target an optimum level of income for tax purposes.

Loss of cash accounting would create a situation where a farmer or rancher might have to pay taxes on income before receiving payment for sold commodities. Not only would this create cash-flow problems, but it also could necessitate a loan to cover ongoing expenses until payment is received. The use of cash accounting helps to mitigate this challenge by allowing farm business owners to make tax payments after they receive payment for their commodities.

Deducting Interest Expense Is Important for Financing

Debt service is an ongoing and significant cost of doing business for farmers and ranchers who must rely on borrowed money to buy production inputs, vehicles and equipment, and land and buildings. Interest paid on these loans should be deductible because interest is a legitimate business expense.

Farm and ranch businesses are almost completely debt financed with little to no access to investment capital to finance the purchase of land and production supplies. In 2015, all but five percent of farm sector debt was held by banks, life insurance companies and government agencies. Without a deduction for interest, it would be harder to borrow money to purchase land and production inputs and the agriculture sector could stagnate.

Land has always been farmers' greatest assets, with real estate accounting for 79 percent of total farm assets in 2015. Since almost all land purchases require debt financing, the loss of the deduction for mortgage interest would make it more difficult to cash-flow loan payments and could even make it impossible for some to secure financing at all. The need for debt financing is especially critical for new and beginning farmers who need to borrow funds to start their businesses.

Repealing Estate Taxes Will Aid in Farm Trans[it]ions

Estate taxes disrupt the transition of farm and ranch businesses from one generation to the next. Farm Bureau supports estate tax repeal, opposes the collection of capital gains taxes at death and supports the continuation of unlimited stepped-up basis.

Farming and ranching is both a way of life and a way of making a living for the millions of individuals, family partnerships and family corporations that own more

than 99 percent of our nation's more than two million farms and ranches. Many farms and ranches are multi-generation businesses, with some having been in the family since the founding of our nation.

Many farmers and ranchers have benefited greatly from Congressional action that increased the estate tax exemption to $5 million indexed for inflation, provided portability between spouses, and continued the stepped-up basis. Instead of spending money on life insurance and estate planning, farmers are able to upgrade buildings and purchase equipment and livestock. And more importantly, they have been able to continue farming when a family member dies without having to sell land, livestock or equipment to pay the tax.

In spite of this much-appreciated relief, estate taxes are still a pressing problem for some agricultural producers. One reason is that the indexed estate tax exemption, now $5.49 million, is still catching up with recent increases in farmland values. While increases in cropland values have moderated over the last 3 years, cropland values remain high. On average cropland values are 62 percent higher than they were a decade ago. As a result, more farms and ranches now top the estate tax exemption. With 91 percent of farm and ranch assets illiquid, producers have few options when it comes to generating cash to pay the estate tax.

Reduced Taxation of Capital Gains Encourages Investment

The impact of capital gains taxes on farming and ranching is significant. Production agriculture requires large investments in land and buildings that are held for long periods of time during which land values can more than triple. Farm Bureau supports reducing capital gains tax rates and wants an exclusion for farm land that remains in production.

Capital gains taxes are owed when farm or ranch land, buildings, breeding livestock and timber are sold. While long-term capital gains are taxed at a lower rate than ordinary income to encourage investment and in recognition that long-term investments involve risk, the tax can still discourage property transfers or alternatively lead to a higher asking price.

Land and buildings typically account for 79 percent of farm or ranch assets. The current top capital gains tax is 20 percent. Because the capital gains tax applies to transfers, it provides an incentive to hold rather than sell land. This makes it harder for new farmers and producers who want to expand their business, say to include a child, to acquire property. It also reduces the flexibility farm and ranches need to adjust their businesses structures to maximize use of their capital.

Stepped-Up Basis Reduces Taxes for the Next Generation of Producers

There is also interplay between estate taxes and capital gains taxes: stepped-up basis. Step-up sets the starting basis (value) of land and buildings at what the property is worth when it is inherited. Capital gains taxes on inherited assets are owed only when sold and only on gains over the stepped-up value. If capital gains taxes were imposed at death or if stepped-up basis were repealed, a new capital gains tax would be created and the implications of capital gains taxes as described above would be magnified.

Stepped-up basis is also important to the financial management of farms and ranches that continue after the death of a family member. Not only are land and buildings eligible for stepped-up basis at death but so is equipment, livestock, stored grains, and stored feed. The new basis assigned to these assets resets depreciation schedules providing farmers and ranchers with an expanded depreciation deduction.

Like-Kind Exchanges Help Ag Producers Stay Competitive

Like-kind exchanges help farmers and ranchers operate more efficient businesses by allowing them to defer taxes when they sell assets and purchase replacement property of a like-kind. Farm Bureau supports the continuation of Sect. 1031 like-kind exchanges.

Like-kind exchanges have existed since 1921 and are used by farmers and ranchers to exchange land and buildings, equipment, and breeding and production livestock. Without like-kind exchanges some farmers and ranchers would need to incur debt in order to continue their farm or ranch businesses or, worse yet, delay mandatory improvements to maintain the financial viability of their farm or ranch.

The CHAIRMAN. Thank you, Pat.

Doug, 5 minutes.

STATEMENT OF DOUG CLAUSSEN, CPA, PRINCIPAL, K•COE ISOM, LLP, CAMBRIDGE, NE

Mr. CLAUSSEN. Good morning, Chairman Conaway, Ranking Member Peterson, Members of the Committee. Thank you for the opportunity to appear before you today.

My name is Doug Claussen, and I am a certified public accountant and principal at K•Coe Isom. We are a national leader in providing accounting and consulting expertise to American farmers, ranchers, and ag-related businesses. I have more than 20 years of experience working with all facets of agriculture.

I will discuss several issues with you today, focusing primarily around Tax Code provisions that are of particular importance to farmers, livestock producers, and ag-related businesses. In June of last year, House Ways and Means Committee leadership unveiled a document entitled, *Better Way for Tax Reform,* and this is commonly referred to as the *Blueprint.* This *Blueprint* lays out the Committee's tax reform priorities, which include streamlining and simplifying the existing Tax Code and the lowering of overall tax rates for individuals and businesses. K•Coe Isom supports Tax Code simplification and rate reductions. We applaud Speaker Ryan and Chairman Brady for their efforts to advance tax reform.

The process of streamlining the Code likely means the elimination of many of the provisions that farmers have used to manage their tax burden, and smooth out income volatility. I will talk about the importance of three provisions in particular; cash accounting, interest expense deductibility, and loss carryback provisions.

I begin with cash accounting. Although the elimination of cash accounting for farmers was not included in the *Blueprint,* it has been proposed by Ways and Means Committee leadership as recently as 2013, and it would generate significant tax revenues. In that earlier reform draft, the Committee proposed eliminating cash basis accounting for all entities with annual gross revenues in excess of $10 million. This would have had devastating impacts on affected farmers and livestock producers.

Under current law, there are two primary methods of accounting for tax purposes; tax and accrual. Under cash basis accounting, tax obligations are created only after cash has actually been received. Conversely, accrual basis accounting results in tax obligations as soon as the taxpayer has the right to receive payment. In short, with accrual accounting, farmers could find themselves paying taxes on income that they have not yet received. Farmers have long utilized the cash method of accounting to provide a consistent tax liability from year to year. Just to clarify, over a full economic cycle, taxes will be paid on all of a farm's income, regardless of the accounting method used. Cash accounting is a flexibility tool, not a tax avoidance tool. Fortunately, then-Chairman Camp backed away from this cash to accrual proposal for farmers. I am confident that was the right decision, and I urge you to ensure farmers continue to have access to this tool as you consider comprehensive tax reform this year.

Now to discuss the provision the *Blueprint* does contain, which is the limit on the deduction for interest payments as a business expense, except as to offset interest income. Ag operations are high-

ly dependent on credit, both for their day-to-day operations and long-term expansion. As such, most U.S. farm operations incur a substantial annual interest expense, yet are seldom structured to generate interest income to offset it. We also need to consider the purchase of farmland with debt capital. According to a 2014 survey conducted by the USDA, approximately 21 million acres of farmland are expected to be sold before 2019, virtually all of it through debt financing. The *Blueprint* recognizes that this provision will uniquely impact certain industries, and that exemptions should be made. Specifically, it states the, "Ways and Means Committee will work to develop special rules with respect to interest expense for financial services companies . . .". We believe agriculture is also uniquely impacted, and support special rules exempting farmers from this provision.

The third provision I would like to discuss is treatment of net operating losses. The *Blueprint* would prohibit carrybacks of net operating losses, and would limit net operating loss carryforwards to 90 percent of the net taxable amount for any year. As with cash accounting, carrybacks and carryforwards are tools widely utilized by farmers to stabilize their volatile revenue streams and tax liabilities. Without a loss carryback provision the volatility of the net farm income puts farmers in a position of paying tax in the highest brackets in the more profitable years, then when they suffer significant losses there is minimal tax benefit if they are forced only to carry them forward to future years.

Again, I appreciate the opportunity to testify before this panel this morning, and for your commitment to American agriculture. Comprehensive tax reform has the potential to deliver significant benefits to ag producers and to all of rural America. To date, we at K•Coe Isom have worked with several farmers and industry groups to perform a detailed analysis on the implications of tax reform, and we are preparing to dive into the Ways and Means Committee's draft proposal we expect to see in the coming weeks. We intend to be an active participant throughout this process, and I offer myself and my firm as a resource to all of you as you consider these very important tax questions in the months ahead.

I welcome any questions the Committee might have, and thank you again for this opportunity.

[The prepared statement of Mr. Claussen follows:]

PREPARED STATEMENT OF DOUG CLAUSSEN, CPA, PRINCIPAL, K•COE ISOM LLP, CAMBRIDGE, NE

Chairman Conaway, Ranking Member Peterson, Members of the Committee, thank you for the opportunity to appear before you today. My name is Doug Claussen and I am a certified public accountant and principal at K•Coe Isom, LLP. We are a national leader in providing accounting, financial, succession planning, business analysis, sustainability guidance, and government affairs consulting expertise to American farmers, ranchers, and ag-related businesses. I have more than 20 years of experience working for agribusinesses and cooperatives involved in beef production, dairy operations, grain production, and marketing.

K•Coe Isom traces its roots back more than 80 years, to rural communities in the Central Great Plains and Central California where agriculture and food production are predominant industries. Two-thirds of my firm's business derives from financial and tax accounting for agricultural producers and ag-related companies. The firm is solidly embedded throughout the food-supply chain, working with producers, input suppliers, processors, packagers, distributors, biofuel manufacturers, equipment dealerships, landowners, and lenders, and we seek to positively impact the fu-

ture of farming and food production in America. In short, we are experts in the Tax Code and how it impacts farmers, processors and related rural businesses.

I will discuss several issues with you today, focusing primarily around Tax Code provisions that are of particular importance to farmers, livestock producers, and ag-related businesses.

In June of last year, House Ways and Means Committee leadership unveiled a document entitled a "Better Way for Tax Reform," commonly referred to as the "*Blueprint.*" This *Blueprint* lays out the basic contours of the Committee's tax reform priorities, which includes a significant streamlining and simplification of the existing Tax Code and a lowering of overall tax rates for individuals and businesses. K•Coe Isom supports Tax Code simplification and rate reductions, provided Congress does not raise the effective burden on agriculture. We applaud Speaker Ryan and Chairman Brady for their efforts to advance tax reform and we look forward to seeing and analyzing the bill.

Of course, the process of streamlining the Code likely means the elimination of many of the provisions that farmers and ranchers have utilized over the years to manage and minimize their tax burden and smooth out income volatility. I will begin by talking about the importance of three provisions in particular: cash accounting for farmers, interest expense deductibility, and loss carryback provisions.

Cash Accounting

I will begin with cash accounting. Although the elimination of cash accounting for certain farmers and ranchers was not included in the *Blueprint,* it has been proposed by Ways and Means Committee leadership as recently as 2013—and would generate significant tax revenues—so I will address it here. In that earlier reform draft, the Committee proposed eliminating cash basis accounting for all entities, including farmers, with annual gross revenues in excess of $10 million. This would have had devastating impacts on affected farmers and livestock producers.

Under current law, there are two primary methods of accounting for tax purposes: cash and accrual. Under cash basis accounting, taxes obligations attach only after cash has actually been collected or bills have actually been paid. Conversely, accrual basis accounting results in tax obligations as soon as the taxpayer has the right to receive payment, even if that payment will not actually be received for several months or even several years. In short, under accrual accounting, farmers and ranchers could find themselves paying taxes on income they have not received, creating significant cash-flow challenges.

Farmers and ranchers have long utilized the cash method of accounting to balance out the significant price and production volatility that is inherent in agriculture. This provides them with a more consistent tax liability and cash-flow from year to year. A farm operation using cash accounting can defer income to later years which enables it to manage working capital and avoid paying significant taxes at a higher marginal tax rate in an exceptional revenue year. Given agriculture's inherent income volatility, this preserved capital is often a vital lifeline during periods of low profitability which, as we know, can last for years.

Many of my clients are cattle feeders, and I would like to put some relatable numbers on this: This change to accrual would be forced upon a cattle feeder that, in a given year, markets 6,500 head of 1,300 pound cattle at a sales price of $1.19 per pound. We can agree that this example does not represent a particularly large cattle feeder or a high fat-cattle price. And depending on the cost of feed and other inputs, this feeder may very well have finished the year in the red. If commodity prices increase, and I know we all hope they do, such a rule would become increasingly applicable and force even smaller producers into accrual accounting.

Additionally, aggregation rules extend this requirement to operations smaller than $10 million. The aggregation rules are based on the common employer rules, which determine whether multiple businesses have to provide similar benefits to all employees of the businesses. As a result, farm and ranch operations with revenues below $10 million that are aggregated with other businesses under a common employer could be required to use accrual accounting as well.

In response to this cash-to-accrual accounting proposal, K•Coe Isom created a coalition called *Farmers for Tax Fairness* to oppose such a change. Through this effort, we commissioned a study by Inform Economics to study the impacts on agriculture, and they concluded that it would:

- Reduce equity in farm and livestock operations by as much as $4.84 billion;
- Reduce working capital in agriculture by as much as $12.1 billion;
- Change the way farms are allowed to manage their capital each year, leading to increased financial volatility;
- Increase interest expenses due to higher short-term lending needs;

- Decrease after-tax purchasing capacity; and
- Increase the record-keeping burden for farm managers.

And keep in mind, over a full profitability cycle, a farmer will pay taxes on all of his farm's income regardless of the accounting method used. Cash accounting is solely a flexibility tool, not a tax avoidance tool.

Fortunately, then-Chairman Camp heard our voices and backed away from this cash-to-accrual proposal for agriculture. I am confident that was the right decision, and I urge you to ensure farmers and ranchers continue to have access to this vital tool as you consider comprehensive tax reform this year.

Interest Deduction

Now to discuss a provision the *Blueprint* does contain. Because one of its primary goals is to simplify and streamline the Code, many provisions popular with farmers and ranchers are subject to change or elimination. Among these is the provision to limit the deduction for interest payments as a business expense. The *Blueprint* advocates eliminating the tax deduction for interest expenses, except as an offset to interest income. As we know, ag operations are highly dependent on credit, both for their day-to-day operations and long-term expansion. As such, most U.S. farm operations incur a substantial annual interest expense, yet are seldom structured to generate interest income to offset it.

In addition to considering annual farm operating loans, we also need to understand the purchase of farmland with debt capital. According to a 2014 survey conducted by the USDA, ten percent of U.S. farmland is expected to change hands by 2019 and approximately 21 million acres of farmland are expected to be sold over that same time period, virtually all of it through debt financing.

Given this information, consider the following example:

A farmer purchases 160 acres of land at $10,000 per acre for a total cost of $1.6 million. (For clarity, the cost of the farmland itself is not deductible under current tax law or under the *Blueprint.*) The farmer chooses to finance $1 million of that purchase on a 20 year note at four percent interest. During the 20 year term of the loan, the farmer would pay more than $471,000 in interest expense. Assuming a 40 percent tax rate, current law allows for an income tax savings of $188,000 due to the interest expense deduction. Even assuming a *Blueprint*-lowered 33 percent income tax rate, the tax savings would still be $155,000 if he were able to deduct the interest expense as a business expense. As you can see, the virtual elimination of interest expense deductions for farmers and ranchers would have a significant negative impact on their cash-flow and on their ability to make large purchases such as land and machinery.

The *Blueprint* recognizes that this provision will uniquely impact certain industries and that targeted exemptions may be appropriate. Specifically, it states that the "Ways and Means Committee will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models." K•Coe Isom believes agriculture is as uniquely impacted as the financial services industry and supports special rules exempting it from this provision as well.

One of the motivations behind this rule is to equalize the tax treatment of debt and equity financing, but equity financing is not a realistic option for most ag operations. Very few farmers want to bring investors into their operations and investors have generally been disinterested in agriculture, given its structure and volatility. What's more, farmers with annual incomes below $500,000 already have access to immediate expensing so, for them, this interest deduction limitation would not be offset by the *Blueprint*'s immediate expensing benefit.

Loss Carryback and Carryforward Provisions

The third provision I would like to discuss is the elimination of loss carrybacks and limitation on loss carryforward. The *Blueprint* would prohibit carrybacks of net operating losses and would limit net operating loss carryforwards to 90 percent of the net taxable amount for any year. As with cash accounting, carrybacks and carryforwards are tools widely utilized by farmers and ranchers to stabilize their volatile revenue streams and tax liabilities and preserve working capital for lean economic times.

According to USDA's 2017 Farm Sector Income Forecast, net farm income is forecast at $62.3 billion for 2017, which is down 8.7 percent compared to 2016. The calendar year 2016 net farm income forecasts are $68.3 billion, which is down 15.6 percent from the 2015 levels. For comparison, the net farm income for 2013 was $123.7 billion. The 2017 forecast is essentially ½ of the net farm income from 2013, just 4 years later.

Given this volatility in net farm income, farmers should have the option to level-out tax liabilities over an extended period of time. Without a loss carryback provision, the volatility of net farm income puts farmers in a position of paying tax in the highest brackets in the more profitable years. Then when they suffer significant losses, there is minimal tax benefit because they are forced to carry them forward to future years.

Other Provisions

I'd also like to briefly point out some of the beneficial provisions in the *Blueprint* that would provide meaningful tax benefits to farm and ranch operations. The positive impacts of lower tax rates on individual, pass-through, and corporate earnings would provide a clear benefit to farmers, ranchers, and the entire economy. Also, given the capital intensity of agriculture, immediate expensing of capital purchases would be used extensively by farmers and ranchers, as well as by many other industries that sell capital goods in rural areas.

Finally, the elimination of the estate tax would make succession planning for farmers, ranchers and other rural small business owners significantly less complex and help ensure that no Federal tax liability is imposed upon death. That said, based on analysis K•Coe Isom has performed, the elimination of that Code section will likely impact and benefit very few farm operations.

This is due to several factors, the most notable of which are: (1) the sophisticated planning and business structure tools that are available to farm estates to minimize or avoid the estate tax; and (2) the recent increase in the exemption, which means that few estates are subject to it, even given today's relatively high land values. Fortunately this will continue to be true in the future, given Congress' decision to index that exemption to inflation.

In my opinion, a more important consideration is the preservation of provisions that allow the heirs of an estate to receive a step-up in the basis of the property they inherit. Discontinuing this benefit, thereby making the original purchase price of land the basis for capital gains calculations, even if it was generations ago, has the potential to create massive tax liability for the heirs when they ultimately sell the land. The tax due on the sale of farmland could discourage land sales, which would make it more difficult for young farmers to get started.

Conclusion

Again, I appreciate the opportunity to testify before this panel this morning, and for your stalwart commitment to American agriculture. Comprehensive tax reform has the potential to deliver significant benefits to ag producers and to all of rural America, but I think it is important to understand that the current Tax Code has provisions that are very beneficial to agriculture—many uniquely so. Therefore, before agriculture as an industry lends its support to any reform proposal, it should closely analyze the entire package to ensure that, taken as a whole, it works to bolster the viability and profitability within the sector.

To date, we at K•Coe Isom have worked with several farmers and industry groups to perform detailed analyses on the implications of tax reform. We are sharpening our pencils to dive into the Ways and Means Committee's draft proposal we expect to see in the coming weeks. We intend to be an active participant throughout this process, and I offer myself and my firm as a resource to all of you as you consider these very important tax questions in the months ahead.

I welcome any questions the Committee might have, and thank you again for this opportunity.

The CHAIRMAN. All right, Doug, thank you.
Chris, 5 minutes.

STATEMENT OF CHRISTOPHER W. HESSE, CPA, PRINCIPAL, CLIFTONLARSONALLEN, LLP, MINNEAPOLIS, MN

Mr. HESSE. Mr. Chairman, distinguished Members of the Committee, I am Chris Hesse, a CPA and Principal of CliftonLarsonAllen, LLP. I serve in the national office delivering tax planning and research services throughout our firm and to other CPAs, from Omak, Washington, to Sebring, Florida, and from Los Angeles to Boston. We also prepare and deliver educational materials to agricultural CPAs and tax preparers throughout the country.

My family farms in eastern Washington State. I was the first in my line to leave the farm, but my older son and nephew are today farming over 2,000 irrigated acres, and another 3,000 dryland acres. I have served on Washington State Farm Bureau Boards and as a county Farm Bureau President.

We commend the Committee for holding this hearing to focus attention to the tax provisions important to agriculture. The cash method of accounting is indeed critical for farmers and ranchers. It was our client, 20 years ago, that received a bill from the IRS for $100,000 on taxable income of $15,000, all due to the alternative minimum tax that started this. With Farm Bureau's help, we got that law changed, a 10 year retroactive repeal provision.

On the income side, agricultural tax provisions include the ability to sell product using the installment method, so as to separate the timing of the sale event and the recognition of income for tax purposes. I sell corn today when the price is high, and I agree to receive payment next year. The coordination of Commodity Credit Corporation loans with income tax is so that a farmer may choose to report loan receipts as taxable income in the year received, or to treat the loans as true loans. A farmer may defer the recognition of crop insurance income to the subsequent year. Livestock sales are likewise provided various deferral opportunities for weather and disease events. Important to the list is the Section 1031 exchange because the farmer has not cashed out her investment. There is a discharge of debt income exclusion available for farmers, and there are others.

On the expenditure side of the ledger, farmers use accounting methods and depreciation provisions to help manage the tax liability. Section 179, the expensing of equipment: the cost of one combine may exceed $400,000. Fifty percent bonus depreciation on original use farm assets: farmers may deduct the cost of raising livestock. Farmers may deduct the cost of raising crops, except for those crops such as vineyards and orchards which have a pre-productive period of more than 2 years. The domestic production ag activities deduction reduces the overall tax rate from growing and production activities. Although fertilizer and soil conditioning expenses benefit the soil over several years, a farmer may deduct those costs in the year purchased. Soil and water conservation expenditures may be deducted in the year paid, to encourage farmers to use techniques to reduce erosion and conserve moisture. Farming is capital-intensive. Interest expense deductions are important, as Mr. Claussen has testified. Farmers may deduct prepaid farm supplies, within limits. This allows farmers to ensure the supply of needed inputs, such as chemicals, fertilizers, and seeds. Farmers may deduct as a charitable contribution up to 50 percent of the value of apparently wholesome food given for the benefit of the needy.

We have covered income and expenses, and there are also tax computation provisions for which farmers qualify. Farmers need not pay estimated taxes if the individual farm return is filed by March 1. Farm income averaging allows farmers an imperfect method of reducing the effect of income spikes. Farmers have a net operating loss carryback period of 5 years, rather than the 2 year provision applicable to other taxpayers.

Last, I thank the House Agriculture Committee for contacting the USDA to clarify the income threshold for partnerships and S corporations for qualifying for various ag program payments. These subsidy programs are keyed off of adjusted gross income. That term doesn't translate well for farms which operate as corporations or other limited liability entities. Your involvement fixed an error in that guidance.

Thank you for your time, and I look forward to addressing your questions.

[The prepared statement of Mr. Hesse follows:]

PREPARED STATEMENT OF CHRISTOPHER W. HESSE, CPA, PRINCIPAL, CLIFTONLARSONALLEN, LLP, MINNEAPOLIS, MN

Good morning, Chairman Conaway, Ranking Member Peterson, and distinguished Members of the Committee. I am Chris Hesse, a CPA and principal of CliftonLarsonAllen. CLA is a professional services firm that combines wealth advisory, outsourcing, and public accounting capabilities to help clients succeed professionally and personally. I serve in the national office, delivering tax planning, education and research services throughout our firm, from Omak, Washington to Sebring, Florida and from Los Angeles to Boston, and all areas in between.

Although I come to you today from Minneapolis, my family farms in Eastern Washington. I was the first in my line to leave the farm, but today, my older son and nephew are farming over 2,000 irrigated acres and another 3,000 dryland acres. I have served on Washington State Farm Bureau boards and as a county Farm Bureau President.

Part of my work today is to prepare and deliver educational materials to agricultural CPAs and tax preparers throughout the country. Our purpose is to raise the level of awareness of the many tax provisions benefiting farmers and ranchers. Today I will highlight some of the most important provisions for you.

I'd like to thank the Committee for holding this hearing to focus attention to the tax provisions important to agriculture. Special tax provisions for farmers and ranchers acknowledge the challenges they face in providing food for United States consumers and our export market. Agricultural producers are uniquely subject to fluctuations in weather, not only within the United States but also across the globe. Another country's drought may substantially reduce available supplies of commodities and foodstuffs worldwide, increasing the demand and price for United States products. Similarly, bumper crops in other parts of the world increase the supply and decrease the price for our products, oftentimes below the cost of production. Various programs help reduce the risks associated with weather events, disease, and fluctuating markets. Since the Internal Revenue Code was enacted in 1913, various tax provisions have recognized the unique risks to which farmers and ranchers are exposed.

Current agricultural tax provisions, on the income side, include the following:

Installment Method

The installment method allows income to be recognized for tax purposes when payment is received, rather than when the sale is made. Non-farm businesses are not allowed to report income from the sale of products manufactured or held for sale to customers using the installment method. Farmers and ranchers may use the installment method to report the sales of raised crops and livestock and recognize taxable income when payment is received.

Farmers and ranchers may choose not to use the installment method to "smooth" taxable income. Smoothing income is a term I use to describe tax planning which reduces reporting taxable income in high tax brackets in 1 year, and losing tax deductions in other years from having too low of income.

Farmers may choose to sell product in 1 year and contract to receive payment in a subsequent year. These deferred payment contracts add flexibility to the timing of income. In this manner, a farmer may sell or commit to sell product when she believes the market provides the best price, and not be as concerned as to the tax ramifications of having sold two crops in 1 tax year. By using the deferred payment contract, the 2015 crop may be sold and sales price collected in 2015, also selling the 2016 crop in 2016, but arranging for payment in 2017.

Commodity Credit Corporation (CCC)

The CCC provides loans to farmers on a non-recourse basis. That is, the farmer may borrow from the CCC and, if the collateralized crops decrease in value, the farmer may forfeit the crop to the government. If the price for the crop is lower than the target price, the farmer may keep the loan proceeds by transferring the crop to the United States. The farmer is not required to repay the balance of the loan. The result of the CCC loan is to set a floor on the price of the crop.

The taxation of CCC loans is flexible. A farmer may choose to report loan receipts as taxable income in the year received, or treat the loans as true loans. If treated as taxable income, the repayment of the loan will provide a deduction when the crop is sold. Alternatively, if the CCC loan is treated as a true loan, the repayment of the principal does not provide a tax deduction. If the CCC loan, treated as a true loan, is forfeited (to the United States), income is recognized for tax purposes at that time.

Crop Insurance

Farmer and ranchers need flexible tax provisions to help account for the risks of unpredictable weather and uncontrollable markets. Crop insurance proceeds may be deferred. Many farmers recognize taxable income from a crop in the year after harvest. When a crop failure occurs, crop insurance may be received in the year of harvest. If this happens for the farmer whose normal marketing is to recognize taxable income in the subsequent year, more than one year's crop is taxable in 1 year.

To avoid a spike in income from receiving 2 years of income in 1 year, farmers can defer the recognition of crop insurance income to the subsequent year. If the farmer receives crop insurance on more than one crop, an election for one crop is an election for all crop insurance proceeds received in that year. The farmer does not have a choice as to the amount of crop insurance to defer. The election is "all or nothing."

Livestock Sales, Weather, and Disease

Livestock sales are likewise provided various deferral opportunities for weather and disease.

A 1 year deferral of income is available for sales of excess livestock to the extent the sale is due to drought, flood, or other weather-related conditions. The area must be designated as eligible for assistance by the United States.

Livestock available for deferral may be either raised or purchased animals, and may be held either for resale (inventory livestock) or for productive use (depreciable livestock, such as dairy, breeding, draft, or animals held for sporting purposes).

Also, a 2 year deferral is available for livestock destroyed by disease, if the livestock are replaced within that 2 year period.

The replacement period is 4 years for draft, breeding, or dairy livestock sold early on account of drought, flood, or other weather-related conditions. The IRS has authority on a regional basis to extend the replacement period if the weather-related conditions continue.

Basis Upon Death

A "fresh start" applies to re-set the tax basis of assets upon the death of the taxpayer. Heirs receiving property need not search for sometimes unavailable records to determine the decedent's basis in property. As such, depreciable assets will generate depreciation deductions for the heirs who continue to operate the farm or ranch. Inventory on hand at death is also provided a basis step-up, particularly important for the farm because raised inventory has a zero tax basis.

Hedging Opportunities

Farmers may reduce price risk for both the sale of crops and livestock and for the purchase of inputs. Puts, calls, and the commodity futures markets are available to hedge prices for the inputs and sales. The hedging opportunities provide ordinary income or loss treatment upon using techniques to lock-in prices. Without this provision, a loss on a commodity futures contract would be capital gain, the deductibility of which is limited to capital gains plus $3,000.

Farmers using the commodity futures market forgo capital gains on these contracts because of the use of the contracts in hedging transactions, but this protects the availability of the ordinary loss deductions.

Tax-Deferred Exchanges (Section 1031)

Like-kind exchanges are an important tax provision for farmers and ranchers. Land is very expensive. Quality neighboring land may become available for purchase only upon a generational change. The ability to exchange, tax-free, less desirable land (perhaps land many miles or counties away) for land closer to the home

base of operations, should not be a taxable event. The farmer has not cashed-out her investment. Capital gain taxes should not have to be paid because she has fully reinvested the proceeds in like-kind replacement property.

Cancellation of Debt Income

The default treatment for the discharge of indebtedness is as taxable income. However, exclusions are available if the taxpayer is in bankruptcy or insolvent. A specific provision is available for the discharge of qualified farm indebtedness. This provision applies to qualified farmers who continue to own trade or business assets or who have sufficient tax attributions (tax loss and credit carryovers). The exclusion acts as a deferral mechanism, in that the farmer isn't forced to recognize income today, but instead reduces future deductions and credits.

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On the expenditure side of the ledger, farmers use accounting method and depreciation provisions to help manage the tax liability.

Section 179

Section 179 allows farmers to expense up to $510,000 (now indexed for inflation) of the cost of equipment and other tangible assets used in production. This provides a deduction in the year of purchase, rather than depreciating the assets over several future years. Section 179 simplifies the computation of depreciation, while providing flexibility to the farmer in choosing how much Section 179 deduction to claim.

Bonus Depreciation

The farmer or rancher may choose to expense 50 percent of the cost of original use assets purchased for use on the farm. If bonus depreciation is claimed, future depreciation deductions are reduced. This is a timing issue. This is not available for used assets.

The farmer may elect not to claim bonus depreciation on a class-by-class basis. The farmer may not, however, choose a lesser percentage. In this respect, Section 179 is much more flexible.

Bonus depreciation may be claimed on most assets used on a farm, since bonus depreciation is available for assets with a cost recovery period of no greater than 20 years. Farm buildings qualify for bonus depreciation, as they have a cost recovery period of 20 years.

Under The Protecting Americans from Tax Hikes (PATH) Act enacted December 2015, bonus depreciation is available for the cost of plants or grafting for new orchards, vineyards, and other nut or fruit bearing plants. Additional bonus depreciation is not available, however, when the orchard or vineyard is placed in service (and depreciation deductions begin).

Bonus depreciation is scheduled to be reduced to 40 percent for 2018 and 30 percent for 2019, after which the provision expires.

Raising Livestock

Farmers may deduct the costs of raising livestock, even though dairy cattle, for example, otherwise have a pre-productive period of more than 2 years. Consequently, when cattle are culled from the breeding or dairy herd, the farmer recognizes Section 1231 gain, usually taxed as capital gain.

Raising Crops

Farmers may deduct the costs of raising crops, except for those crops, such as vineyards and orchards, which have a pre-productive period of more than 2 years. An election is available to deduct the costs of establishing the vineyard or orchard. If this is elected, depreciation on all farm assets must be computed using slower methods over longer cost recovery periods.

The cost of raising the crops is deductible in the year paid for the cash method farmer. Since all costs have been deducted, the entire sales price is taxable income when sold and the sales proceeds are received.

Domestic Production Activities Deduction (DPAD) or Section 199

The Domestic Production Activities Deduction reduces the overall tax rate from growing and production activities. This is only available, however, if the farmer has employees to whom wages are paid. Consequently, the sole proprietor with no employees does not receive the benefit of this deduction, except in the case of receiving an allocation of the deduction from a cooperative to which the farmer transferred his crops.

DPAD provides a deduction of nine percent of the net farm income, effectively lowering the tax rate. DPAD is not allowed, however, to reduce self-employment income on which self-employment tax is paid.

Soil and Water Conservation Expenditures

Expenditures under government programs for soil and water conservation may be deducted in the year paid, limited to 25% of gross income from farming. These include the treatment or movement of earth, such as leveling, conditioning, grading, terracing and contour furrowing. They also include the construction, control and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, water courses, outlets, and ponds. The eradication of brush and the planting of windbreaks are also includes in the Section 175 expenditures. These expenditures must be consistent with a plan approved by the Natural Resources Conservation Service (NRCS) of the USDA. If no NRCS plan exists, the expenses must be in conformity with the plan of an applicable state or local agency, comparable to an NRCS plan.

The deduction for improvements is not available if the land was not previously used in farming. Also, land clearing expenditures which prepare the land for farming must be added to the tax basis of the land. Landlords who receive a share rental or a cash rent based on farm production are considered engaged in farming, and are allowed to claim the Section 175 soil and water conservation expenditures deduction.

The amounts are subject to recapture as taxable income if the farmland is disposed within 10 years of its acquisition, based upon a sliding scale.

Fertilizer and Soil Conditioning Expenditures

Although fertilizer and soil conditioning expenses benefit the soil over several years, a farmer may deduct the fertilizer in the year purchased. This is important for farmer, in that if the amounts are not deducted in the year purchased, the expenses must be claimed over the period in which the inputs benefit the soil. An agronomist would have to be hired to determine the proper period of time over which the deductions would be available.

Interest Expense

Farming is capital intensive so interest expense deductions are important. Farm land purchases do not generate depreciation deductions. The land must be paid for after income taxes are paid. To illustrate: In order to make payment of principal on debt incurred to purchase land, a farmer in the 45 percent tax bracket (25 percent income tax plus 15 percent self-employment tax, plus five percent state income tax) must generate $182 of income in order to have after-tax cash $100. In the early years of paying principal and interest on the mortgage, most of the payment is interest expense. The beginning farmer doesn't have the sufficient capital to generate the return on investment necessary to expand; the interest expense deduction to acquire the land is necessary to assure the economy of scale that could cover overhead expenses.

Farm Supplies

Farmers may deduct farm supplies in the year paid, rather than the year consumed (within limits). If certain inputs are scarce, buying early can ensure they have the chemicals, fertilizers, seeds and other supplies when they are needed.

Rent Expense

Similarly, farmers (similar to other businesses) may prepay rent, as long as the rental period expires by the end of the following year. Landlords may insist on payment in advance; the farmer may deduct this payment.

Health Insurance

As with other self-employed taxpayers, farm sole proprietors, partners, and S corporation shareholders may deduct health insurance premiums (subject to sufficient farm income).

Charitable Donation of Conservation Easement

Farmers also benefit from an enhanced limitation for the donation of a conservation easement. Rather than a 50 percent of adjusted gross limitation for non-farm taxpayers, a farmer or rancher may claim a charitable deduction up to 100 percent of adjusted gross income. If the charitable deduction is greater than the limitation, the excess charitable deduction may be carried forward for up to 15 years.

Charitable Contribution of Food

Farmers may deduct up to 50 percent of the value of apparently wholesome food given for the benefit of the needy. This is a new provision added as a result of the 2015 PATH Act. It provides the same incentive to grower/packer/shippers who own

cash basis inventory, as provided to the local grocery store that has excess food inventory nearing its expiration date.

This is a deduction particularly suited to community supported agriculture (CSA) producers and the local farmers markets.

* * * * *

Negative Tax Provisions for Farmers

The uniform capitalization rules on pre-productive expenses hurt orchardists and viticulturists. They are not able to currently deduct the costs of establishing the expensive orchards and vineyards to supply the nation with apples, oranges, grapes, and other fruits and nuts. Instead they must capitalize these costs to deduct the investment only when the orchard or vineyard becomes productive, and then over a 10 year period.

In addition, farmers and ranchers are also not allowed to use the faster depreciation methods that are available to non-farmers.

* * * * *

The unique business of farming also benefits from several distinct tax computation provisions.

Estimated Tax

Form 1040 farmers need not pay estimated taxes if the tax return is filed by March 1. Farmers who don't file by March 1 can pay one estimated tax payment on January 15. The payment of at least 100 percent of the prior year's tax or ⅔ of the current year's tax on January 15 allows the filing of the Form 1040 by April 15 without underestimation penalties. This flexibility helps farmers by not having to pay income tax on expected income that doesn't arise to the risks mentioned above.

Farm Income Averaging

Farm income averaging allows farmers an imperfect method of reducing the effect of income spikes. Farm prices fluctuate greatly and sometimes the farmer can't use the other methods to arrange for the best timing for the recognition of income and payment of expenses. Sometimes 2 (or more) years of crop income is recognized in 1 year, pushing the farmer into higher than normal tax brackets.

Farm income averaging may be particularly beneficial when the farmer retires, in that the cash method farmer likely has few farm expenses in the final year, but may have 2 or more years of crop income. The spike in income would otherwise cause the farmer to pay income tax at higher than normal marginal tax rates.

Net Operating Losses

Farmers have the option of using a net operating loss carryback period of 5 years, rather than the 2 year provision applicable to non-farmers.

The net operating loss carryback rules are inflexible, however, in that the taxpayer cannot choose how much loss to apply in any 1 year. The loss must be carried back to the earliest year in the allowed carryback period, to offset all of the income in that earliest year before applying loss to the next earlier year.

Capital Gains

Farmers benefit from capital gains, often from the sale of long-held capital assets such as land and buildings. The capital gain is often illusory, however, in that inflation accounts for the higher sales price, especially for assets held since the 1970s and 1980s when annual inflation approached 13.5 percent.

Optional Self-Employment Tax

Farmers benefit from the optional self-employment tax, to earn credits toward the Social Security system even though suffering a loss in a current year. Non-farm taxpayers may elect optional self-employment tax for only 5 years. Farmers do not have a limit. In addition to earning credits toward the Social Security system, the optional self-employment tax computation might allow the taxpayer to qualify for the earned income tax credit.

Finally, I thank the House Agriculture Committee for its efforts during this last year. Various agricultural subsidy programs rely on the calculation of Adjusted Gross Income. This term doesn't translate well for farms which operate as corporations or other limited liability entities. Previous to the Committee's involvement, the USDA's handbook did not allow the up-to-$500,000 deduction for Section 179 expenses to reduce the income of the operation.

For example, a multi-member LLC with $600,000 of income (well under the $900,000 limit for an individual farmer) was forced to report its income as $1.1 mil-

lion, preventing the individual members from qualifying for the agricultural programs to which they would have been entitled had they farmed separately. The staff's involvement fixed an error in the guidance.

Thank you for your time, and I look forward to addressing your questions.

The CHAIRMAN. Thank you, Chris.

Guido, 5 minutes.

STATEMENT OF GUIDO VAN DER HOEVEN, EXTENSION SPECIALIST/SENIOR LECTURER, DEPARTMENT OF AGRICULTURAL AND RESOURCE ECONOMICS, NORTH CAROLINA STATE UNIVERSITY, RALEIGH, NC

Mr. VAN DER HOEVEN. Good morning, Chairman Conaway, Ranking Member Peterson, and Committee Members. Thank you for the invitation to testify today.

I am Guido van der Hoeven, an Extension Specialist and Senior Lecturer at North Carolina State University, with responsibilities in farm management and taxation. Additionally, I serve as President of the Land-Grant University Tax Education Foundation, and I am co-chair of the National Farm Income Tax Extension Committee which meets annually with IRS at its national office.

Today, I want to speak about the farm transition during the lifetime of a retiring farmer, and the tax impediments that exist.

These tax barriers often impact the beginning farmer as well in the form of higher down payments when purchasing a farm and improvements. Production agriculture is, and has historically been, a capital-intensive business, as others have testified. The acquisition of land, equipment, and livestock is a daunting challenge to a new generation of farmers. A barrier to transferring farm assets during an exiting farmer's lifetime is the increased income tax liability resulting from a farm sale when compared to transfers at the retiring farmer's death. Currently, if a retiring farmer sells assets to a beginning farmer, he or she must recognize and pay income tax on the gain from that sale. If the retiring farmer gives the assets to the beginning farmer, the beginning farmer receives a carryover income tax basis in these assets, and must recognize and pay tax on the donor's unrealized gain upon a subsequent sale. By contrast, if the retiring farmer holds onto the assets until he or she dies, their income tax basis in the assets is adjusted to the date of death value, and no one has to recognize and pay income tax on the difference between the retiring farmer's basis and the date of death fair market value of these assets.

Agriculture is unique in that its largest asset, land, is an asset that typically appreciates in value, resulting in large capital gains upon sale. Likewise, raised livestock have built-in gains with increase in numbers and value per head over time. Depreciated operating assets such as purchased livestock, tractors, and machinery have little to no income tax basis, as the exiting generation begins to consider retiring from the business of farming.

My written testimony discusses tax reform proposals creating tax incentives that may encourage retiring farmers to transfer farm assets during their lifetimes, rather than waiting to transfer them at death.

Allow me to tell you a story. Since mid-March, I have visited two farm families, representative of North Carolina's production agri-

culture, in the process of retiring from active farming. The task at hand is to find a way to move forward and to fund their retirement years. Farmer one is 70 years old and has no family successor, but he has identified a young farmer in the area. Initially, the plan was to sell 2016's crop and machinery line in 2017. Doing so results in $1.2 million of income, and an approximate $490,000 tax bill. Farmer one may now delay as he feels he can't afford to retire. Farmer one is considering 5 more years of farming to manage and reduce his tax bill upon retirement. Farmer two is 68 years old. He farms with two sons, using multiple entities which are part of his and his sons' estate and succession plans. While accomplishing the goals of estate planning, transition of management, as well as operating assets, the family has incurred great expense to create and operate these entities, in part to manage a tax bill. Both farmers have engaged in allowed tax deferral over a lifetime of farming. Now, a large tax bill is a barrier to exit, and preventing the younger generation to fully grasp the throttle of the farm business. The ultimate goal of my tax reform proposals, which is supported by the two farm family stories just told, is to provide incentives to allow for lifetime transfer of farmland and production assets to beginning farmers to continue working the land. Then the retiring farmer has the ability to generate a retirement income stream with a manageable income tax liability. The beginning farmer's financial requirements may be reduced when making the purchase. In the end, one might say it boils down to cash-flow problems for the farmers wanting to retire.

This concludes my oral statement. I am available for questions. Thank you.

[The prepared statement of Mr. van der Hoeven follows:]

PREPARED STATEMENT OF GUIDO VAN DER HOEVEN, EXTENSION SPECIALIST/SENIOR LECTURER, DEPARTMENT OF AGRICULTURAL AND RESOURCE ECONOMICS, NORTH CAROLINA STATE UNIVERSITY, RALEIGH, NC

Overview

Production agriculture is and has historically been a capital intensive business. The acquisition of land, equipment and livestock is a daunting challenge to a new generation of farmers. An impediment to transferring farm assets during an exiting farmer's lifetime is the increased income tax liability resulting from lifetime transfers of those assets compared to transfers after the exiting farmer's death. If an exiting farmer sells assets to a beginning fa[r]mer, he or she must recognize and pay income tax on the gain from that sale. If the exiting farmer gives the assets to the beginning farmer, the beginning farmers receives a carryover income tax basis in the assets and must recognize and pay tax on the donor's unrealized gain upon a subsequent sale. By contrast, if the exiting farmer holds on to the assets until he or she dies, the heir's income tax basis in the assets are adjusted to the date-of-death value of the assets and no one has to recognize and pay income tax on the difference between the exiting farmer's basis and the date-of-death fair market value of the assets.

Agriculture is unique in that its largest asset, land, is an asset that typically appreciates in value resulting in a large capital gain upon sale. Likewise raised livestock have built-in gains from the increase in numbers and value per head over time. Depreciated operating assets such as purchased livestock, tractors, and machinery have little to no income tax basis as the exiting generation begins to consider retiring from the business of farming. The current tax rules encourage farmers to hold on to these assets until they die so that the income tax basis in the assets adjusts to the date-of-death value and no one is required to recognize and pay income tax on the gain. The following proposals change the tax incentives for exiting farmers to encourage them to transfer farm assets during their lifetimes rather than waiting to transfer them at their death.

Proposed Tax Law Reforms To Facilitate Transition of Farm Assets

(1) Proposal To Create an Incentive To Sell Farming Assets Before Death

Under this proposal exiting farmers are allowed to put part or all of the proceeds from selling farm assets into a tax deferred "farm retirement account" (FRA). The gain on sale proceeds that are placed in the FRA are not taxed until they are withdrawn. At the time of the farm sale, the capital and ordinary gains on the proceeds placed in the FRA would be calculated but not recognized. As money is withdrawn from the FRA, the capital and ordinary gain from the farm sale and the income earned by the account would be recognized. The owner and beneficiaries of the FRA could be required to withdraw minimum distributions similar to current retirement accounts.

The FRA provides an income stream for the retired farmer and defers income taxes on the gain from the sale of farm assets until the exiting farmer receives sale proceeds as a FRA distribution. Ultimately, the retirement account is consumed and the income tax paid by either the retired farmer or beneficiaries.

A proposed alternative to the one described above is to allow "super funding" of an IRA through a farm sale. Under this proposal, the retiring farmer may sell a farm at fair market value, however recognize the tax consequence of the farm's sale based on the special use value under I.R.C. § 2032A rules. The exiting farmer can use the difference between the fair market sale price and the section 2032A special use value to "super fund" an IRA. The retiring farmer would withdraw distributions from this IRA under the distribution rules currently in place for IRAs. Again, this provides an incentive to transition land to beginning farmers while allowing a portion of the tax consequence of the sale to be paid over a period of time while at the same time the retired farmer has income to provide for his/her needs.

(2) Proposals Regarding Installment sales

Under current Federal income tax law, a retiring farmer can report the gain from selling farming assets as he or she receives installment payments for them. However, the seller must recognize all the depreciation recapture from the installment sale of assets in the year of the sale.

If the seller dies before the end of the installment contract, the gain from the installment sale that was not recognized by the seller before death must be recognized by the seller's estate or heirs when the remaining contract balance is paid or forgiven. By contrast, if the seller had retained ownership of the farming assets until death, the income tax basis in the assets would be adjusted to their date-of-death value and no one would recognize and pay income tax on the difference between the seller's basis in the assets and the value of the assets on the date of death.

Tax Reform might amend the installment sales rules to encourage sales of farm assets before death. Installment sales provide the dual advantage of providing retirement income to the exiting generation and allowing the entering generation to use farm profits to make payments for purchased farm assets.

Proposed changes are:

(a) Allow retiring farmers to use installment reporting for depreciation recapture on the sale of assets that were used in the farming business. This would allow the exiting farmer to sell and receive installment payments for machinery, purchased breeding, dairy or draft livestock, and buildings without triggering an acceleration of recognizing gain.

(b) Allow step-up in the basis of the installment contract for the sale of these farm assets to the value of the contract on the date of the selling farmer's death. This would allow the exiting generation to make use of installment sales without losing the full benefit of the tax-free step-up in basis at death.

(3) Proposal for Tax Reporting of Lump-Sum Sales of Farms and Equipment

Some retiring farmers may not be able to take advantage of installment reporting of their gain on sale of their farm because they do not have the means to finance the buyer's purchase of their farm. They would have a greater incentive to sell the farm to a beginning farmer if the tax law allowed them to spread their gain from the sale over the 5 tax years rather than recognizing all of it in the year of a lump-sum sale.

Under this proposal, 20% of the gain from a lump-sum sale of farming assets to a beginning farmer would be reported in each of 5 years, beginning with the year of the sale. The gain would retain its character as capital or ordinary.

(4) Proposal to retain Like-kind Exchange rules under I.R.C. § 1031

If Congress makes changes to the like-kind exchange rules, they should be retained for transfers of at least some farm real estate so that the exiting generation

can sell the buildings and some farm land to the entering generation and roll the gain into replacement farmland or other real estate. This gives the entering generation a base upon which to build its own business without the risk that the exiting generation will give or sell the farm to someone else upon death. If necessary for political or other reasons, the provision could be limited to sales under a certain limit such as $1 million or to family members who must continue farming for a period of time such as 10 years to avoid triggering recognition of the gain.

(5) Proposal for Self-Employment Tax on Rental Income

Under current law, exiting farmers who rent their farmland to entering farmers and stay active in the farming business must pay self-employment tax on their net rent. This makes it harder for exiting farmers to transfer the use of their land to entering farmers by renting it to them. By contrast, owners of other real property, such as a warehouse used in a business, are not subject to self-employment tax on the net rent they receive from the warehouse whether or not they stay active in the business that rents the warehouse from them.

This disparity can be eliminated by removing the self-employment tax on rent received by a landowner who materially participates in the production of agricultural or horticultural commodities on his or her land.

Discussion of Proposal for Self-Employment Tax on Rental Income

I.R.C. § 1401(a) imposes a 12.4% tax on up to $127,200 (for 2017) of self-employment income. This is alternatively referred to as the "old age, survivor and disability insurance" or as the "[S]ocial [S]ecurity" tax.

I.R.C. § 1401(b) imposes a 2.9% tax on all self-employment income. This is alternatively referred to as the "hospital insurance" or the "Medicare" tax.

The combination of the above two taxes is 15.3% on the first $127,200 of self-employment income in 2017 (this figure is indexed for inflation and therefore increases each year by the increase in the consumer price index.) and 2.9% on self-employment income above $127,200 (in 2017). The combination of the two taxes is often referred to as the "self-employment" tax. Note that the self-employment tax is similar to the FICA tax that is imposed on an employee's wages. The combination of the employee's (7.65%) and employer's (7.65%) shares of the FICA tax equals the 15.3% self-employment tax.

I.R.C. § 1402(b) defines "self-employment income" as "net earnings from self-employment" with some exceptions that are not important to this discussion.

I.R.C. § 1401(a) defines "net earnings from self-employment" as all income from a trade or business with several exceptions. The exception of interest to this discussion is set out in I.R.C. § 1402(a)(1). That exception excludes rent paid on real estate and on personal property rented with the real estate. However, there are two exceptions to the exception, one of which is for income derived by an owner of land if:

a. there is an arrangement under which another person will produce agricultural or horticultural commodities on the land and the owner will materially participate in the production or management of the production of the agricultural or horticultural commodities, and
b. the owner actually materially participates in the production or management of the production of the agricultural or horticultural commodity.

The effect of this provision is a disparity in the self-employment tax treatment of rent paid for farmland and rent paid for other real property.

> **Example.** *Farmer Bill owns 400 acres of farmland that he rents to his daughter under a cash lease that requires Bill to help her make management decisions. After paying property taxes, insurance and maintenance, Bill realizes $100,000 of net income from the land each year. Under current law, Bill must pay $15,300 ($100,000 × 15.3%)* of self-employment taxes on that income.
>
> *Contractor Kari owns a warehouse that she rents to her son under a cash lease. After paying property taxes, insurance and maintenance, Kari realizes $100,000 of net income from the warehouse each year. Because the rent is not from land used in farming, Kari does not have to pay self-employment tax on the rent.*
>
> *The proposed change in the law would eliminate the self-employment tax on Bill's net rental income so that he and Kari would be taxed the same.*

This provision (the farmland exception to the real estate exception) was added to the Internal Revenue Code in 1956. At that time, farmers who were at the retirement age had paid into the [S]ocial [S]ecurity system for only a short time and qualified for little or no [S]ocial [S]ecurity benefits. The provision allowed them to build up their [S]ocial [S]ecurity benefits after they quit farming by making the rent

they received subject to the self-employment tax and therefore to be counted as [S]ocial [S]ecurity earnings. Most farmers who retire today have built up [S]ocial [S]ecurity earnings that qualify them for [S]ocial [S]ecurity benefits and there is no need for them to pay [S]ocial [S]ecurity tax on their rental income after retiring from farming.

The proposed amendment will solve the self-employment tax problem not only for farmers who retire and want to participate in the production on their land but also for farmers who rent their farmland to their farming business entity. The IRS and the Tax Court think the current law requires such landowners to pay self-employment tax on the rent they receive from their business entity. *See Mizell* v. *Commissioner,* T.C. Memo 1995–571; Letter Ruling 9637004; *Bot* v. *Commissioner,* T.C. Memo 1999–256; *Hennen* v. *Commissioner,* T.C. Memo 1999–306; and *McNamara* v. *Commissioner,* T.C. Memo 1999–333.

In *McNamara* v. *Commissioner,* 236 F.3d 410 (8th Cir. 2000), the Eighth Circuit Court of Appeals disagreed with the IRS and the Tax Court and held that rent paid by the taxpayer's corporation to the taxpayer for land owned outside the corporation is not subject to self-employment tax if the rent is set at a fair rental rate. In Action on Decision 2003–003, the IRS stated that it will follow the holding of the *McNamara* case in the Eighth Circuit. However, the IRS did not acquiesce to the Eighth Circuit's decision and will continue to litigate its position in cases in other circuits. The proposed amendment would eliminate the IRS argument that rent paid from an entity for land held outside the entity is subject to self-employment tax and therefore end the disparate treatment of taxpayers inside and outside the Eighth Circuit.

(6) Proposal To Retain Step-Up in Basis to Fair Market Value at Death

If Congress repeals the Estate Tax it is proposed to keep the step-up in basis rules found in I.R.C. § 1014 similar to the rules of 2010 which allowed modified step-up on selected assets. This proposal would help to ensure the ability to settle estates where certain assets might be sold, with little to no tax consequence, to make equitable distributions amongst heirs.

(7) Proposal To Enhance Section 529 Plans To Allow Beginning Farmers To Invest in Farms

Under this proposal the Tax Code would be amended to allow contributions to and withdrawals from a 529 account to be invested in farm business capital as an alternative to investing in human capital through higher education. The beneficiary (envisioned to be young beginning farmer/rancher) as well as others can set aside funds in a tax deferred account for the express purpose of purchasing a farm (or business). Withdrawals used for disallowed purposes of the amended 529 account would follow current rules in place.

For this benefit some specific proposed rules:

(a) The beneficiary would not receive basis for the amount used in the down payment which came from this proposed account. For example: Joe Beginner used $100,000 from his special farm down payment account to buy a farm priced at $300,000. Joe's basis in the farm is $200,000 which is allocated in a *pro rata* manner to land and improvements similar to I.R.C. § 1060 rules.

([b]) If the beneficiary disposes of the property, except through a like-kind exchange with the purpose to continue farming, within a 10 year period from date of purchase, the tax deferred savings of the down payment is recaptured in full, similar to I.R.C. § 2032A rules for estate special use valuation.

(8) Replace the Income, FICA, and SECA Taxes with the FAIR Tax

The FAIR tax (H.R. 25/S. 18) would remove all the tax impediments to farm transition.

Conclusion

In conclusion, many exiting farm operators want to see the business that they have worked to create be kept together and passed to a new generation of farm operators. Current law impacts this transfer and often creates impediments to both parties and therefore these transfers do not occur. Tax reform can facilitate transfers prior to death of the exiting farmer.

The CHAIRMAN. Thank you, Guido.

Jim, 5 minutes.

STATEMENT OF JAMES M. WILLIAMSON, PH.D., ECONOMIST, ECONOMIC RESEARCH SERVICE, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, D.C.

Dr. WILLIAMSON. Chairman Conaway, and Members of the Committee, my name is James Williamson and I am an Economist from the USDA's Economic Research Service. I appreciate this opportunity to present information on tax policy in the farm sector.

This morning, I will discuss how three unique aspects of agriculture; the legal structure, the capital intensity of farming, and the volatile nature of farm earnings, are affected by current provisions of tax policy. The analysis focuses on family farms, which in 2015 accounted for 99 percent of all farms, and this analysis uses the USDA's *Agricultural Resource Management Survey* data.

To start, Federal tax policy has the potential to affect the economic behavior and well-being of farm households, and the impacts depend on their legal structure. The vast majority of farms, as has been discussed, are organized as pass-through entities that are not subject to income taxes themselves; rather, the owners of the entities are taxed individually on the share of income. Income received from farming and ranching is passed through from the farm business to the individual farmers when the farm is structured as a sole proprietorship, to partners when the farm is structured as a partnership, or to shareholders when the farm is structured as an S corporation. In 2015, farms organized as these pass-throughs constituted 97 percent of family farms, and accounted for 85 percent of the total value of agricultural production in the United States.

The more than two million family farm households earn income not only from farming, but from a diverse array of activities and endeavors, including off-farm work and non-farm business interests. And because family farms are organized as pass-throughs for the most part, when they have farm losses, these losses are able to be passed through and offset non-farm income, thus lowering their tax liability.

Farm businesses that are pass-throughs are impacted by the individual income tax rates, as well as targeted business tax provisions as provided by deductions, deferrals, and other provisions.

I would now like to talk about some main tax provisions that may affect family farms operating in a capital-intensive industry. In particular, capital gains treatment and depreciation and expensing of investment costs.

First, the tax treatment of capital gains. The Federal income tax system taxes gains on the sale of assets held for investment or business purposes, and held for more than 1 year, at rates lower than on other sources of income. Under current law, many of the assets used in farming or ranching are eligible for capital gains treatment. In terms of investment cost recovery, farming requires a substantial investment in physical capital; machinery, equipment, and other depreciable property. The Internal Revenue Code provides the opportunity to accelerate recovery of such investment costs through depreciation and expensing under Section 179, and these provisions may benefit family farm businesses that make capital investments. Additional allowable depreciation and first-year expensing shift forward the time period in which investment costs are recovered, thus lowering the cost of capital.

For the majority of family farms, investment levels are well below the $500,000 limit specified within Section 179. In 2015, the average annual investment was approximately $17,000 for a family farm. However, the average figure masks the considerable variation in investment among different types of farms, and investments generally increased with the size of the farm. We estimate that about ¼ of the 5,000 very large family farms, those with at least $5 million in sales, exceeded the $500,000 limit in 2015.

And finally, a few words on tax policy and the volatility of farm income. Under a progressive tax system, taxpayers whose annual incomes fluctuate widely may pay higher total taxes over a multiyear period than other taxpayers with similar yet more stable income. Farm business income is more variable than other types of income from other sources, such as wages and salaries. Tax provisions that allow these liabilities to be spread over multiple years are beneficial to the farm, and these include income averaging, as has been discussed, and cash accounting methods.

In summary, the Federal tax policy has the potential to affect many facets of the farm business operation and the well-being of farm households. And this is because income from farm work and off-farm income are combined for tax purposes by the vast majority of farms. The capital-intensive nature of farming means that tax policy can alter the cost of capital, and may affect investment decisions.

And finally, other tax provisions that mitigate the effects of volatile income from farming also help, but the extent to which this is the case depends on the farm's size and other factors.

Mr. Chairman, this concludes my statement. I will be happy to answer any questions that the Committee may have.

[The prepared statement of Dr. Williamson follows:]

PREPARED STATEMENT OF JAMES M. WILLIAMSON, PH.D., ECONOMIST, ECONOMIC RESEARCH SERVICE, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, D.C.

Chairman Conaway and Members of the Committee, my name is James Williamson and I am an Economist at the USDA's Economic Research Service. I appreciate this opportunity to present information on the legal structure of U.S. farms as it relates to their taxation, to provide background on the economic effects of taxation, and to discuss both the individual and business provisions that are available to farmers. My remarks are based on the most recent data available from USDA's Economic Research Service (ERS) and National Agricultural Statistics Service (NASS), and publicly available data from The Internal Revenue Services' Statistics of Income.

The mission of ERS is to inform public and private decision-making on economic and policy issues related to agriculture, food, the environment, and rural development. Our efforts support the goals and objectives of USDA by providing economic statistics pertaining to agriculture.

This morning I will discuss the potential impacts of tax policy on U.S. agriculture focusing on farm structure, farm household and farm business income, and farm investment and management. The analysis is based on data from family farms, which in 2015 accounted for 99 percent of farms. A family farm is any farm where the majority of the business is owned by the operator and individuals related to the operator. A farm is defined as any place from which $1,000 or more of agricultural products were produced and sold, or normally would have been sold, during the year. I will also provide information on farms of difference sizes, as defined by their gross cash farm income.

Federal tax policy affects the economic behavior and well-being of farm households, as well as the management and profitability of farm businesses. Tax rates and tax preferences for certain activities affect the after-tax income of farm households, but they may also influence economic decisions such as labor force participa-

tion and labor allocation (hours worked on and off the farm), decisions about the household's investment portfolio and the timing of income realization. Farm businesses are impacted both by individual income tax rates and preferences, as well as business tax preferences as provided by deductions, credits, deferrals and other provisions. Those include special provisions that allow farms to allocate net income or net losses across years to help reduce tax liabilities from characteristically volatile farm business earnings (income averaging); deductions allowing farms an extra deduction for net domestic production (Domestic Production Activities Deduction), thus potentially affecting hiring decisions; and farm capital investments subject to accelerated cost recovery provisions that effectively lower the cost of capital (Expensing and additional depreciation).

The vast majority of farms are organized as pass-through entities that are not subject to income tax themselves. Rather, the *owners* of the entities are taxed individually on their share of income. Income received from agricultural production activities, and in some cases lease payments from rented land and farm program payments—is passed through from the farm business to the individual farmers, partners, or shareholders of S corporations. The net profit or loss from agricultural production activities that is received by individuals, partners, and S corporation shareholders is reported on Schedule F of form 1040 (partners and S corporation shareholders profit or loss on Schedule E). In 2015, based on USDA *Agricultural Resource Management Survey* (ARMS) data, farms organized as sole proprietorships, partnerships, and Subchapter S corporations constituted about 97 percent of farms (just over two million farms) and about 85 percent of total agricultural production in the United States. According to the Internal Revenue Service's Statistics of Income, there were just under 1.9 million individual Form 1040 returns with a Schedule F in 2015; this represents about 1.3 percent of all individual tax filers. Thus, the individual income tax is significantly more important than the corporate income tax for understanding how taxes affect most farmers.

Farm households earn income not only from farming but from a diverse array of activities and endeavors, including off-farm work (wages and salaries), capital income (interest, rents and dividends), retirement income, Social Security benefits, and non-farm business interests. For most farms, non-farm income is combined on the owner's (or owners') Form 1040 with the farm's net profit or loss recorded on Schedule F or Schedule E. In 2015, we estimate the average farm household total income at $119,880 (the median income was $76,735) with off-farm sources accounting for 79.4 percent of total income.

Taxation of Capital Gains Income

The Federal income tax system has historically taxed gains on the sale of assets held for investment or business purposes and for more than 1 year at rates lower than on other sources of income. The current tax rate on long-term capital gains is 15 percent for taxpayers who are below the 39.6 percent income tax bracket, and 20 percent for those in the 39.6 percent bracket (0 percent for taxpayers in the 10 or 15 percent income tax brackets; in addition, certain high-income taxpayers are assessed a 3.8 percent surtax). These reduced rates are especially significant for farmers because farmers are more likely to realize capital gains than the average taxpayer. Under current law, many of the assets used in farming or ranching are eligible for capital gains treatment and the amount of capital gains is increased by the ability to deduct certain costs. The Internal Revenue Code currently allows for proceeds from the disposition of such business property to be treated as a capital gain (or loss).

- In 2015, USDA survey data suggests about 40 percent of all family farms reported some capital gains or losses, both from the sale of farm assets and non-farm assets while IRS data indicates the average individual taxpayer is far less likely to report a capital gain or loss (13.6 percent).
- For farms with capital gains, the reported average was $10,567. That amount represented 8.6 percent of total income reported by farm households. The total amount of reported capital gains was $8.7 billion.
- Overall, a majority (51.5 percent) of the capital gain income in the sector was reported by small family farms; small farms (gross cash farm income less than $350,000) account for nearly 90 percent of all farms. Total capital gains accounted for an estimated 2.2 percent of total farm household income for that group.
- Thirty-eight percent of mid-sized farms (farm with between $350,000 and $1 million of gross cash farm income) reported capital gains or losses, accounting for 20 percent of all capital gains reported by farms.

- Although large farms ($1 million–$4,999,999 in gross cash farm income) comprised less than three percent family farms, they accounted for about 22 percent of all capital gains reported by farmers and they reported average capital gains of $32,418—84 percent of which come from the sale of farm assets, with the remainder from sales of non-farm assets.
- Half of all very large farms, those with at least $5 million of gross cash farm income, reported capital gains income.

Farm Capital Investment Demand and Cost Recovery Provisions

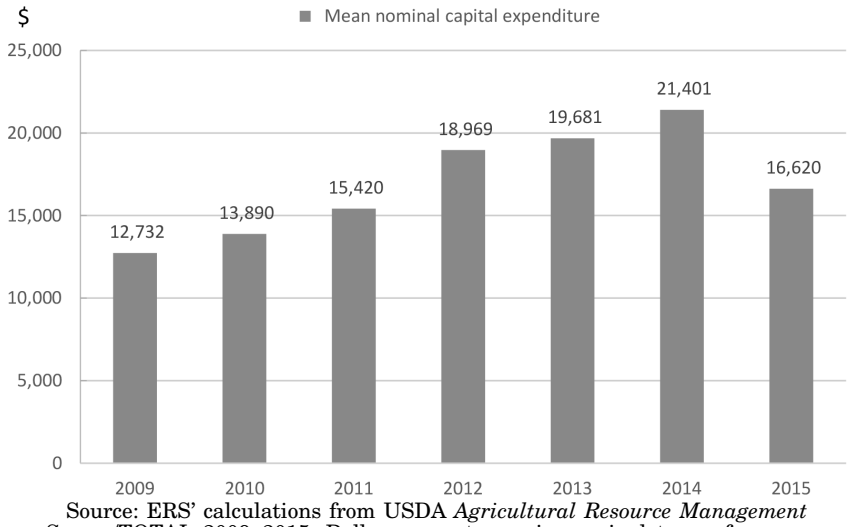
Farming requires a substantial investment in physical capital—machinery, equipment, and other depreciable property. Two provisions of the Internal Revenue Code that provide the opportunity to accelerate the recovery of such investment costs, Section 179 and Section 168(k), may benefit farm businesses that make capital investments. Section 179 allows a taxpayer to recover the cost of the investment by deducting or "expensing" the equipment in the year of the purchase, within certain limits. In addition to Section 179, Section 168(k) allows farmers to take additional depreciation or so-called "bonus depreciation" in order to accelerate the recovery of capital costs. Both of the deductions reduce the net business income of the farm, effectively reducing taxable income. The two provisions may be used in coordination, which has meant that much of the capital purchases made during the past decade were eligible to be completely deducted in the first year.

Business deductions that allow the farm to recover the cost of an investment may alter investment decisions by creating a wedge between the purchase price of capital before taxes and the after-tax cost of capital. Increases in allowable depreciation and first year investment credits shift forward the time period in which investment in capital is recovered. All else equal, the sooner the cost is recovered, the lower the user cost of capital and the greater the value of the tax recovery option. That increase in the value of the tax recovery option could lead to increases in investment.

Over the last decade, the annual maximum amount of capital expenses that a farmer could immediately deduct from their gross income under Section 179 has increased from less than $25,000 in 2000 to $500,000 in 2014, where it remains today. Any unused portion of the Section 179 deduction may be carried over to the next year. Section 179 imposes a spending cap on the total value of investments made by a taxpayer in a year before the deduction begins to phase out. In 2016 this spending cap was $2,010,000, and it is adjusted for inflation; above this amount the expensing deduction is subject to a dollar for dollar phase-out, and is fully phased out when the aggregate investment exceeds $2,510,000. The additional (bonus) depreciation allowance, which was introduced in 2001 at 30 percent of the investment cost, is currently 50 percent. The bonus depreciation provision does not place a limit on qualified investments.

Investment levels are well below the limits specified within the Section 179 provision for the over-whelming majority of farms. Average annual investment of farms has steadily increased from nearly $13,000 in 2009 to a peak of $21,401 in annual capital investments in 2014. The latest year of USDA ARMS survey data, 2015, shows a pronounced decrease in average annual investment to approximately $17,000.

Average Farm Capital Investment, 2009–2015



Source: ERS' calculations from USDA *Agricultural Resource Management Survey*/TOTAL 2009–2015. Dollar amounts are in nominal terms for comparison to their respective yearly Section 179 expensing limits.

The average figures mask the considerable variation in investment among different types of farms. Small family farms (farms such as retirement, residential or lifestyle farms, and farms with low sales) made annual capital investments of less than $10,000 on average, and only about 42 percent of them made an investment at all in 2015. Mid-sized and larger family farms were much more likely to have made a capital investment as at least 74 percent of them made an investment during the year. Large farms (gross cash farm sales of $1 million up to $5 million) are responsible for nearly 30 percent of the value of agricultural production and made annual capital investments of $129,430 on average while very large farms (gross cash farm sales of $5 million or more) made an average investment of $466,733.

Larger Family Farms Are More Likely To Have Capital Expenditures in 2015

Item	Small	Midsized	Large	Very Large
Number of family farms	1,846,954	126,331	53,268	5,747
Percent of family farms	90.9	6.2	2.6	0.3
Percent of value of production (%)	27	25	29	19
Capital expenditures:				
Mean nominal capital expenditure ($)	9,145	57,866	129,430	466,733
Percent with a capital expenditure (%)	41.5	74.8	79.5	84.8
Percent with expenditure above the Section 179 expensing limit (%)	0.04	0.53	3.49	23.9

Source: ERS' calculations from USDA Agricultural Resource Management Survey 2015. Small farms are farms with less than $350,000 gross cash income; mid-sized farms have gross cash income between $350,000 and $1 million; large farms have gross cash income between $1 million and $5 million; very large farms have gross cash income over $5 million. Note: this table excludes approximately 27,000 non-family farms.

The percent of farms that made an annual investment exceeding the limit was less than one percent during 2009–2015, but, just as in the average annual capital investment figure, this is somewhat misleading. For example, in 2015, almost ¼ of very large farms made an annual investment that exceeded the Section 179 expensing limit, whereas approximately 3.5 percent of large farms made investments exceeding the expensing limit. Together, while only representing less than four percent of all family farms, those farms account for nearly ½ of all agricultural production by family farms. Therefore, Section 179 has the potential to influence investment behavior among the farms that are producing a significant amount of the total dollar value of agricultural production.

Evidence from recent changes to cost recovery provisions suggests that deductions can have a positive effect on incremental investment. In the case of Section 179, a 2016 study in the journal *Agricultural Finance Review* found that for every $1,000 increase in the Section 179 expensing amount, farms that had been previously limited by the expensing amount made an incremental capital investment of between $320 and $1,110. The study also showed that increasing the percentage allowance of bonus depreciation, for the most part, did not have a statistically significant effect on farm capital investment. This is because the majority of farms make investments that are below the Section 179 deduction limit, and therefore the additional expensing capacity under bonus depreciation was not utilized. Taken together, the evidence suggests that farm capital investment is sensitive to the cost of capital, but at current levels of expensing and accelerated depreciation, we could expect to see incremental investment only by farms that make large capital purchases.

Domestic Production Activities

The American Jobs Creation Act of 2004 replaced the foreign sales corporation/extraterritorial income provisions, which had allowed U.S. exporters to exclude a portion of their foreign sales income from taxation, with a "domestic production activity" deduction for U.S. manufacturers, including farmers. Domestic production activities include activities that involves the lease, rental, license, sale, exchange, or other disposition of tangible personal property that was manufactured, produced, grown, or extracted in whole or in significant part within the United States. It is not limited to exported goods. While very few farms directly benefited from the export provision, an estimated seven percent of farms directly benefit from the new domestic production activity deduction. The deduction is limited to the lesser of nine percent of adjusted gross income from domestic production activities income or, 50 percent of wages paid to produce such income. While the wages-paid provision limits the applicability of the deduction for many smaller farms that hire little or no labor, larger farms do have significant labor expenses. In 2015, family farms had nearly $27 billion in labor expenses. The average deduction for eligible farm households—those with labor expenses and net income from qualified production activity—was $5,662. Among farms, commercial farm households are the primary beneficiaries since they are more likely to report both positive farm income and wages paid to hired labor.

Self-Employed Health Insurance Deduction

The self-employed health insurance deduction was created in 1988 to give small business owners, including many farmers, tax benefits similar to those of employees who receive employer-sponsored health insurance. This deduction is especially helpful for self-employed individuals who must purchase health insurance on their own. Since 2003, farmers and other self-employed taxpayers have been allowed to deduct 100 percent of the cost of providing health insurance for themselves and their families as long as they are not eligible for any employer-sponsored plan. The self-employed health insurance deduction is limited to the amount of the taxpayer's income from self-employment, thereby disqualifying the deduction for farmers with net farm losses. About one out of five farmers are eligible to use the self-employed health insurance deduction in any given year. In 2015, farmers' average cost for health insurance premiums was an estimated $5,883.

Households of small farms are less likely to be eligible to claim the deduction, primarily because higher proportions of those households receive health insurance from a non-farm job or do not qualify for the deduction due to reporting a farm loss. Households of mid-sized and large farms are more likely than those of small farms to use the deduction. Nearly one out of every two operators of mid-sized and large/very large farms are eligible to claim the deduction.

Farm Income Volatility and Tax Provisions

Under a progressive tax rate system, taxpayers whose annual income fluctuates widely may pay higher total taxes over a multiyear period than other taxpayers with similar yet more stable income. Farm business income is more variable than many other sources of income, such as wages and salaries, and transfer payments. A 2017 ERS study titled *Farm Household Income Volatility: An Analysis Using Panel Data from a National Survey* indicates that for larger scale commercial farms, those responsible for about 80 percent of the value of U.S. agricultural output, the median change in total income between years was about eight times larger than for non-farm households. The study also found that farm income (including government payments) accounted for 79.6 percent of the total income variation for the farm households studied, while 10.5 percent of income variation was from off-farm wage income and 9.9 percent of income variation was from other off-farm income.

Farmers are also allowed to use cash accounting, which recognizes income and expenses when received or paid. Cash accounting can reduce taxable income through prepaid business expenses or deferred farm income, and, as discussed above, well-timed capital purchases can reduce taxable income through depreciation deductions or capital expensing. While those provisions are useful in reducing income variability, they are limited by the ability of a farmer to defer sales or accelerate expenditures.

Income Averaging

Income averaging can reduce the effect of a progressive tax rate system on taxpayers with highly variable year-to-year income by allowing them to smooth their tax burdens over time through tax accounting methods that consider multiyear income. U.S. farmers have been eligible for income averaging since 1998. Under the current income averaging provision, a farmer can elect to shift a specified amount of farm income, including gains on the sale of farm assets other than land, to the preceding 3 years and to pay taxes at the rate applicable to each year. Income that is shifted back is spread equally across the 3 years. If the marginal tax rate was lower during 1 or more of the preceding years, a farmer may pay less tax than he or she would without the option of income averaging. The provision, however, does not allow income from previous years to be brought forward. Furthermore, although the provision is designed to reduce the effect of farm income variability, as long as some farm income is available to be shifted, the source of income variability does not need to be farm income for income averaging to be beneficial.

In 2004, an estimated 50,800 farmers—or about five percent of farms—reduced their tax liability on average by $4,434 with income averaging according to one published study (cite). The reduced liability totaled $225.3 million and amounted to a 23-percent reduction in Federal income taxes for those using the provision. A large share of the total tax reduction was realized by farmers with adjusted gross income over $1 million. These farmers reduced their liability by an average of $264,000, for a total of $82.6 million. While more recent data are not available, farm income trended higher between 2010 and 2013, so the income averaging provision is likely to be of equal or greater benefit to farmers during that period.

To conclude, Federal tax policy has the potential to affect many facets of the farm business operation and the well-being of the farm household. By altering the cost of capital, tax policy may affect investment decisions, while other provisions provide benefits linked to the volatility of farm income, but the extent to which this is the case depends on the farm's size and other factors.

Mr. Chairman, this concludes my statement. I will be happy to answer any questions that the Committee may have.

The CHAIRMAN. Well, thank you, Jim. I thank the witnesses for your succinct testimony. I think everybody came in right at or under the mark.

The chair would remind Members they will be recognized for questioning in order of seniority for Members who were here at the start of the hearing. After that, Members will be recognized in order of arrival. I appreciate Members' understanding.

With that, I recognize myself for 5 minutes.

All of you mentioned some complicating factor, or factors that complicate the preparation of a tax return and all those kind of things, some which were original with the 1986 Act, others in response to impacts that the 1986 Act had moving forward. The tax compliance costs that farmers incur, whether it is the annual compliance costs and/or the estate planning costs, nobody mentioned that in terms of an impact for simplification, can all of you speak briefly to do, in fact, we need tax reform at this juncture? Is this Code, with all of its complications and all of its factors, actually the best one to go forward with, or should we, in fact, be launching this effort to do tax reform in the agricultural arena?

So in the 4 minutes left, Ms. Wolff, do you want to start?

Ms. WOLFF. I think that we have all established that farming and ranching is a very volatile business with many challenges that other industries don't have. When you layer on top of that a very

complicated, complex Tax Code, you make the business of running a farm even harder.

We have a once-in-a-generation opportunity to rework our Tax Code. Our Tax Code hasn't, funnily, been rewritten since 1986, and we have both Congress and an Administration who has pledged to take this seriously. Farmers and ranchers very much want to lower tax rates and to make the Code simpler. Yes, I believe that there is a push among farmers and ranchers to move forward on tax reform.

The CHAIRMAN. Mr. Claussen?

Mr. CLAUSSEN. Thank you, Mr. Chairman. I will keep my comments brief to allow time for the other panelists to respond.

I would echo the comments that Ms. Wolff made with regard to income tax simplifications. As we think about American farmers and ranchers, they are subject to weather variability, price variability, growing condition issues, logistical issues, and all of those take a toll on their operation.

If we are able to take tax law and move it into an area that is simpler and easier for them to understand, as well as a reduction of the overall costs, that puts them in a much better position to be competitive on a global scale.

Mr. HESSE. Thank you. With regard to the variability of agriculture, weather patterns, commodity prices, it is important to recognize that there needs to be flexibility, and with flexibility comes complexity. Part of the reason for tax reform though would be to lower the top rate, flatten out the rates so that when that variability occurs, and you have the income spike or the reduction in the income, that you aren't damaged from having some of your income taxed at a higher rate in 1 year and lower rate in another year.

But I just recognize that we need the flexibility for making various decisions in the Internal Revenue Code, and with that flexibility comes the complexity.

The CHAIRMAN. Mr. van der Hoeven?

Mr. VAN DER HOEVEN. Thank you, Mr. Chairman. And just one real comment is to make definitions consistent across the Code, and I will use two examples just to illustrate. For the purposes of being a farmer so that you are exempt from the estimated tax penalty, you have to have ⅔ of your gross income from farming. That is the definition of being a *farmer*. If you want to make a conservation easement donation to qualify for 100 percent against AGI, you have to have 50 percent gross income from *farming*. Let's get consistent definitions because it is really confusing. That is just one little area, just as an explanation.

The CHAIRMAN. Thank you.

Dr. Williamson?

Dr. WILLIAMSON. The ERS, as a Federal statistical agency, doesn't have opinions on reform policies, *per se,* but I can offer some context. As a tax researcher, I can tell you that prices matter, and taxes affect prices. If you are looking at it in terms of investment, investment costs, Section 179 definitely affects the cost of investment.

And I would also like to point out, as has been mentioned, is the nature of earnings, which are very volatile, and a lot of times out of the control of the farm because of the weather, they are pro-

ducing a commodity that is sold in a global market, they don't have a lot of control over the price. And also in these recent economic conditions in agriculture, the downturn, as you have heard about, this creates a lot of liquidity issues with the farm. So meeting those liquidity issues is an important thing also.

The CHAIRMAN. All right, thank you.

Mr. Peterson, 5 minutes.

Mr. PETERSON. Thank you, Mr. Chairman.

I see a number of you commented on the section 1031 exchange situation, and you have talked about volatility. Going forward, one of the concerns farmers have is how they are going to survive this situation, but the land prices are too high, equipment prices are high, everything is high, and the commodity prices are low. Well, what I was surprised about when you had mentioned the section 1031 exchange is you say we need to keep it. And I get pushback from farmers all the time about the fact that we have expanded this section 1031 exchange, you don't have to really have like-kind for like-kind anymore. You can sell a shopping center and you can then take that money and go buy farmland. This is driving up the price of land, I will tell you, and the land is too expensive already, and it hasn't come down like it should, for a number of different reasons. I don't remember when this changed, it must have been 1986, but when I first started practicing it actually was like-kind for like-kind. You had farmland for farmland or you didn't qualify.

My question is, I would like to see us go back to like-kind; farmland for farmland. And what do you think about that, all of the members of the panel?

Ms. WOLFF. The value of like-kind exchanges for farm and ranch businesses is like-kind to like-kind. Farmers use like-kind exchanges for their equipment, for livestock, and for land. We have had our members debate about changes in the definitions. We don't have an official policy on that, but the value of the provision for farm businesses is like-kind for like-kind.

Mr. PETERSON. No, I understand that, but what about actually restricting it so it is like-kind for like-kind? That is not what it is now. You can sell an asset in the Twin Cities, an office building or whatever it is, take that capital gain and come out and buy farmland and not pay tax. They are paying more money than the farmer next door can pay for that land because of the tax advantage. Why would anybody in agriculture be opposed to keeping all that money out of our business that is driving up land prices? That is my point.

Mr. HESSE. Well, Mr. Peterson, on the other side of that too, the retiring farmer may want to go the other way in selling the farmland and arranging the sale.

Mr. PETERSON. Well, yes. No, I understand that. But the net effect of it is, it is part of what keeps the land prices high.

Mr. HESSE. Certainly, since taxes are a part of cost of an investment, the savings of tax is going to be built into the capitalization of the land. I would encourage, with respect to the equipment trades, that equipment trades where we have a $510,000 Section 179 level, perhaps the exchange of equipment, which also comes under Section 1031, is not as critical, but certainly, with respect to real estate where the farmer is looking to improve his position, sell-

ing off a lesser desirable property in order to acquire property that is nearby or of a higher quality, that, where there is not cashing out of the investment, that is really what we are concerned about.

Mr. PETERSON. Right, but that is not what the law does.

Anybody else have a comment?

Mr. CLAUSSEN. Yes, I would like to just make a comment as it relates to section 1031 on land assets. Generally, when I am having conversations with growers, with landowners, and they are considering transitioning out of a piece of land, most of the time they are looking at what are the net dollars in my pocket, or what is the net effect to me. If there is, in fact, going to be tax implications, absent a 1031 exchange, it may, in fact, cause them to say, "You know what, I don't know that I want to sell that piece of ground, I don't want to get rid of it, I will just hold onto it because I will be surrendering a significant portion as it relates to income taxation."

Mr. HESSE. For that reason, I may be willing to sell the land for a slightly lesser price to the neighbor if I can arrange a 1031 exchange and not pay tax, as opposed to having to cash-out and pay tax.

Mr. PETERSON. Well, yes, I agree with that, but in some areas, we just see too much outside money coming in, and the fact that we have kept base acres increases and that keeps the land from coming down, and that is a big part of our problem. We have a lot of things that are too expensive in agriculture, but land is way out of control.

I yield back.

The CHAIRMAN. The gentleman yields.

Mr. King, 5 minutes.

Mr. KING. Thank you, Mr. Chairman. I agree with the gentleman from Minnesota on the section 1031 exchange comments.

I would like to direct my first question to our economist on the panel, Dr. Williamson. And I want to ask you, rather than the CPAs, this question. Who invented accrual accounting? Who invented accrual accounting and what was the purpose?

Dr. WILLIAMSON. Mr. King, I do not know the answer to that.

Mr. KING. Okay, I am going to take you at your word. And then I would turn to one of our CPAs, perhaps Mr. van der Hoeven.

Mr. VAN DER HOEVEN. I am not CPA.

Mr. KING. I am sorry. Mr. Hesse. I can't see the——

Mr. HESSE. So the question regarding who invented accrual accounting?

Mr. KING. Yes.

Mr. HESSE. As an accounting profession, the accrual method is a better matching of the expense relative to the income that is earned. But taxation isn't an exercise in matching up or reporting the true economic results of an operation. Tax accounting is designed to raise tax money for funding the country. Taxable income is determined as to however Congress and the President decide that taxable income.

Mr. KING. Thank you. Mr. Claussen, do you have a different kind of an answer to that, or do you agree with Mr. Hesse?

Mr. CLAUSSEN. Well, I certainly would agree with Mr. Hesse as it relates to the origins of accrual accounting, but I would jokingly

say sometimes it is referred to as cruel accounting as well, in that there is a disconnect between the cash inflows and the cash outflows of an operation, and the operation is, in fact, trying to match up revenues when you have rights to those revenues, and expenses when the obligation is created.

Mr. KING. I would point out that my own observation on having experienced this is that it is a lot easier to pay the taxes when you actually have collected the money to pay the taxes with. And so I certainly have sympathy with all of the comments here that speak in favor of cash accounting for our agriculture businesses, and that goes for the business that I happen to start as well.

Also, the questions that I am hearing about interest expense, and I know that everybody on the panel here agrees that is an essential expense write-off, especially for our young farmers and our beginning farmers, but I just wanted to say a few words about that, and perhaps direct my question to Ms. Wolff for a response. But as I look at it, I never imagined that anybody would propose that you wouldn't be allowed to deduct your interest expense, but for my neighbors that have cash in the bank for crop inputs and everything they have is paid for, what kind of an advantage they would have over a beginning farmers. And I wonder if you would comment on that, Ms. Wolff.

Ms. WOLFF. An important thing to remember about agriculture is that it is almost completely debt financed. Over 90 percent of capital for farm business comes from loans. One important point is that farmers don't have another way to raise money to grow their businesses.

To your point about young farmers and ranchers, yes, losing the interest deduction is even worse for them than an established farmer because they have to borrow money to buy land, to buy their equipment to get started. We believe that the interest deduction should stay on the books because agriculture needs it to secure the capital that they need, and to make sure that our next generation of farmers can get started.

Mr. KING. And you can put on the books that I think it is a harebrained idea to eliminate interest deduction, especially for those reason, and especially because it is not a sound business approach and it specifically disadvantages our entry level farmers as well. Thank you, Ms. Wolff.

I would like to then turn to Dr. Williamson. The fair tax was mentioned by the Chairman and the Ranking Member, and I have long been a supporter of the fair tax. And can you think of any good reason we shouldn't adopt such a tax policy?

Dr. WILLIAMSON. Could you remind me what the fair tax is?

Mr. KING. It is a national sales tax on sales and service, and there would be sales tax on business inputs, it would be only on personal use. If you buy a combine, no sales tax, if you buy a cap for your head, which usually farmers don't do, you would pay the sales tax on that.

Dr. WILLIAMSON. Yes. Okay, again, at the ERS we do not have an opinion on issues, for example, the fair tax. What I can do is just provide you some background. Of course, as we have been talking about, the industry is capital-intensive, there are lots and lots of purchases of large machines, and again, the income is highly

volatile so there are years in which they have losses and they need to do something with that, because they also have income from off-farm work——

Mr. KING. Thank you, Dr. Williamson. My clock ran out. I appreciate your response.

I yield back.

The CHAIRMAN. The gentleman yields back.

Mr. Evans, 5 minutes.

Mr. EVANS. Thank you, Mr. Chairman.

I would like to kind of follow up a little bit on what the Chairman was raising earlier about the issue around the drive to do tax reform, if I heard that question correctly. And obviously, tax reform was done, as you indicated, about 1986, almost 40 years ago, and obviously, the market has changed completely, farming has changed completely. And I am trying to understand, even though you answered that question, like the drive to do tax reform, I am still trying to understand it in the context of how the market has changed radically since 1986. Farming is completely different from 1986 and where we are today, I am just trying to understand in the very specific way, because the title of this hearing is, *Agriculture and Tax Reform: Opportunities for Rural America.* I am just trying to get a little sense and do a little deeper dive to the question that the Chairman asked you all. Yes, we will start with the economist.

Dr. WILLIAMSON. Thank you, Mr. Evans. Compared to 1986, in general in agriculture we have seen a consolidation of larger farms now. They are farming more acres per farm. This requires more equipment. The organization of farms has changed in terms of legal structure, so we have seen more partnerships, more S corporations forming. We have recently come off of several very high years of farm income, and now farm income is down, so we are seeing debt-to-asset ratios going up, so there is growing need for liquidity. And again, as has been mentioned, they rely heavily on debt, although that has probably been the case in the past as well. So that is what I will say.

Mr. EVANS. Yes.

Mr. VAN DER HOEVEN. I would concur, and I would just say that when I started farming in 1984, corn was at $3.25 a bushel. I sold my first crop at $1.40 and was happy to get it. And we are now, in North Carolina, we are a basis positive state, we are about $3.85 to $4.00, and these are in nominal dollars. But a cotton picker is now $660,000 for one unit, tractors are $200,000, so the inputs are huge, but the output price, even though volume has gone up and we have had gains in yields, but the margins are still very, very slow.

So to your point, some things don't change, but we slide decimal points in places.

Mr. EVANS. Yes.

Mr. HESSE. Thank you for your question, Mr. Evans. Part of the issue goes back to the 1986 Act that brought a two rate structure and broadened the base, and over the last 30 years we have had various sectors of the economy, special tax provisions, whether it be tax credits, carve-outs of special deductions, or exclusions from income, which have added to the complexity, and perhaps it is time

to reset the Tax Code to get back to that more flatter structure, and eliminate some of the special tax incentives that had grown in the last 30 years.

Mr. EVANS. Yes.

Mr. CLAUSSEN. Yes, I would like to make a comment as it relates to farming operations from 30 years ago. There is a tremendous amount of sophistication in farm operations. There has been a significant amount of technological advances, whether that is on the seed genetic side, whether that is with cropping practices, whether it is sustainable practices, and then also on the equipment side. All of that technology and all that sophistication has continued to drive up the cost of doing farming, which has indirectly forced farmers to continue to get larger so that they can spread those fixed costs over more acres. That is a significant difference from farming of 30 years ago.

Ms. WOLFF. While my fellow panelists have pointed out many things that have changed, I would like to point out that many things remain the same, and that is that farmers still work on tight profit margins, they operate in a world of huge risk and volatility, and that they are price takers. As we move into tax reform, we need to know that things have changed, but some things are the same.

Mr. EVANS. Real quick, Mr. Chairman. Can I give the economists about 30 seconds?

The CHAIRMAN. Quickly.

Mr. EVANS. Any model that you know around the world that gives us a sense about a tax reform package that deals with agriculture, any example you can point out?

Dr. WILLIAMSON. You mean model?

Mr. EVANS. Any model, any country, any——

Dr. WILLIAMSON. I am not aware of other models outside the U.S. as a model for reform for agriculture.

Mr. EVANS. Okay.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentleman yields back.

Mr. Gibbs, 5 minutes.

Mr. GIBBS. Thank you, Mr. Chairman. Thank you for holding this hearing. It brings to light some of the challenges we have to get tax reform done right. And just a couple of thoughts first before I ask my question.

As we know, agriculture is a highly cyclical business, highly capital-intensive business, and this notion to do away with interest deduction is ludicrous, and the notion to force everybody to go to accrual *versus* cash accounting is ludicrous because, first of all, it is going to make people borrow more money to pay the taxes, from cash to accrual, and not have the interest deduction. And then we heard from our first panel, Ms. Kristi Noem, about the struggles her family went through and the death tax and the impact, and it is important to remember we have a generational change going on here. The average age of farmers is about 60. And you can see how important this is to be able to pass these family farms on, how the Tax Code can impact that. I want to go on record that the interest deduction, I can't understand why anybody came up with that idea to do away with it as a legitimate deduction. Obviously, they never

ran a business. So that is my comment on that, I would like to meet that person who came up with that idea.

But anyway, Ms. Wolff, one thing that has been mentioned today that is being proposed in the tax reform is the border adjustment tax, the BAT tax. What are you hearing from producers, members around the country, thoughts about the impact, positive or negative of that proposal? And then also, I guess, I also hear about, well, other countries are doing that. I don't know if you have the expertise in that, but maybe you or other panel members could expound on that a little bit.

Ms. WOLFF. Yes, first of all, I want to say that——

Mr. GIBBS. Your microphone.

Ms. WOLFF. First of all, I want to say that American Farm Bureau Federation has not taken a position on the border adjustment tax, and that is because it has positives and negatives. The concept of the tax is that income is taxed where it is consumed, rather than where it is produced. When a company sells a product overseas, that is not counted as income for tax purposes, and when a company imports a product, they cannot take that as a deduction. It changes the taxes of the company that is importing or exporting.

On the export side, certainly, the provision is designed to make our products more competitive in foreign markets. That is a huge positive for agriculture because we export so much, 25 percent of our products. On the flipside, we also rely on imported supplies; fertilizer, fuel, and that those items would increase in price, at least initially. There are positives and negatives. Different commodities have different percentages of their sales overseas, rely differently on inputs. And so we believe there are some positive things in it. We need to see how it is actually structured, how it is actually written before we can figure out whether it will be a net win for our industry.

Mr. GIBBS. Any of the CPAs want to comment? Either one of you.

Mr. CLAUSSEN. I will make my comments brief to allow time for Mr. Hesse to comment.

Your question was what are we hearing about border adjustment. We have had a number of listening sessions with growers that we work with all across the Midwest and through California, and many times we are getting more questions than we have answers. And certainly, we are not in a position to know the answers. We haven't seen a draft, we don't know all of the implications of what it would look like, but one of the challenging characteristics with regard to agriculture is the fact that we are dealing with commodities. In many cases grains, for example, are commingled from a variety of owners and shipped overseas, so we know they are being exported, but unfortunately, we are not able to identify which farmers have the grain that is being exported.

Mr. GIBBS. Yes.

Mr. CLAUSSEN. Mr. Hesse.

Mr. HESSE. Yes, and I would just echo what Mr. Claussen says. We really don't have the details to know how this might work at the agriculture or the producer level, 25 percent of our products are exported, it is not the producer usually that is doing that direct exporting yet. It will be the costs coming in, the inputs that will be built into the price, the cost structure for the input for the farmer.

Again, we don't have enough details really to even know how it would be applying.

Mr. GIBBS. I think you are all right, it raises a lot of questions about how the mechanics of it work and what the consequences might be either way.

I yield back. Thank you.

The CHAIRMAN. The gentleman yields back.

Ms. Blunt Rochester, 5 minutes.

Ms. BLUNT ROCHESTER. Thank you, Mr. Chairman, and I thank the panel.

Mr. Gibbs actually asked my question. I was really interested in the border adjustment tax because you hear a lot about it from the multinational perspective, you hear a lot about it from the retail perspective, and I was really curious about how it impacts agriculture, particularly with commodities and trade. While you don't have a lot of the details, maybe you could tell us what you think could be done to keep the agriculture industry strong should a BAT tax be in place. And I was going to start with Ms. Wolff, but I open it up to anyone.

Mr. HESSE. I really can't speculate on that, Ms. Rochester. I just don't have, either the expertise, or the knowledge to speculate on the economic consequences. I don't have any ideas to provide to you.

Ms. BLUNT ROCHESTER. Okay.

Mr. CLAUSSEN. Congresswoman, I just have a few comments as it relates to the current environment, and some of the tax provisions that are currently in place that we see with regard to exporting. There is a corporation that can be created that is called an IC–DISC, and essentially what that is doing is creating a tax advantage for the producer and exporter of those goods. It is a difference between ordinary income tax rates and dividend rates.

One of the significant challenges we have faced in agriculture as it relates to implementing an IC–DISC is strictly around this idea of whose products are being exported. As Mr. Hesse indicated, we recognize the data is available, that ag exports a significant amount of products, but it is very difficult to identify whose products are actually being exported.

We have made some inroads as it relates to the livestock sector, specifically the beef sector, but on the grain side it is almost impossible to know whose grains are being exported so that they can utilize this.

So to your question, availability of information is very difficult. The direct exporter obviously knows what is being exported, but that information is not passed back through the value chain as it relates to agriculture.

Ms. BLUNT ROCHESTER. Got you. Thank you.

Anyone else?

Mr. VAN DER HOEVEN. I would just make a comment that a few years ago I was in Fort William, Scotland, and I was having dinner and they were serving sweet potatoes. And so I asked what was the source of sweet potatoes, because North Carolina is pretty big on sweet potato production, and they came from Vick Family Farms, and Mr. Vick was a student in our program. And some of the sweet potato growers in North Carolina are very active individually,

doing the export market particularly towards Europe. Again, it is a commodity that is very narrow, very specialized and I just would bring that as just some comment.

Ms. BLUNT ROCHESTER. Got you. Great, thanks.

Dr. WILLIAMSON. Ms. Blunt Rochester, I would like to add just a few more things. Ms. Wolff laid it out beautifully the complexity of this issue. Whether agriculture benefits depends a lot on, as has been mentioned, the relationship to the importers, statutorily we know who would pay the tax, or who would benefit from a tax break, but in the end who is going to benefit in terms of the incidence of the tax, it is going to be based upon the relationship to the farmers or the cooperatives and the exporter.

And on the other side, while I am not a trade economist, but my colleagues tell me that trade relationships are dynamic, and that is the cryptic way of economists saying, well, their trade partners could raise their tax. And so there are many moving parts to this puzzle.

Ms. BLUNT ROCHESTER. Great.

Dr. WILLIAMSON. Those are my comments.

Ms. BLUNT ROCHESTER. Thank you so much.

I was going to go on to my favorite topic which is market volatility, but I don't think I have a lot of time, but I know it is a big challenge. Dr. Williamson, you mentioned, and one of my questions was about the smoothing out of it and whether tax policy actually helps that. And you mentioned something about depending on size and other factors, and I was just curious what those other factors were.

Dr. WILLIAMSON. Okay, so thank you for the question. I was speaking in terms of smoothing spikes in incomes. We have certain years where, for example, 2012–2013 we had some very good years in agriculture, now followed by depressed prices, so we have a lot of losses and lower income.

So the changes would depend on the market they are in. For example, grains, corn has been down, fruits and vegetables, has maintained a pretty steady revenue. I was speaking in terms of production commodity production and variation and commodity production. Milk, for example, might be off from grains, or fruits and vegetables productions.

Ms. BLUNT ROCHESTER. Thank you.

I yield back my time.

The CHAIRMAN. The gentlelady yields back.

Mr. Crawford, 5 minutes.

Mr. CRAWFORD. Thank you, Mr. Chairman.

Ms. Blunt Rochester brought up a good point about volatility, and I want to kind of carry on that conversation just a little bit.

Since we have so many accountants in the room, maybe I will get an answer to this. Is the premium on a put option tax deductible?

Mr. CLAUSSEN. There are a number of ways that you can handle hedging and risk management accounting. Generally, on a put option, because it is an option, when you receive that cash it is going to be taxable to you, and if you pay that cash then it is going to be a deduction for you.

Mr. CRAWFORD. The premium on the put option would then be tax deductible, and if you exercise the option and receive cash, at that point it is taxable.

Mr. CLAUSSEN. Right. Once it is no longer an open position and goes to a closed position.

Mr. CRAWFORD. Okay, that is very helpful.

Now, on the other side, call option.

Mr. CLAUSSEN. It still falls under the same——

Mr. CRAWFORD. Same deal.

Mr. CLAUSSEN. Yes.

Mr. CRAWFORD. Okay, so there is no differentiation between——

Mr. CLAUSSEN. Because they are options——

Mr. CRAWFORD. All options are the same.

Mr. CLAUSSEN. Right.

Mr. CRAWFORD. The reason I ask that is because I have had this crazy idea that if you could get farmers to, and they are already long actuals, so if they could take that short position and create more liquidity in the market, that it would reduce volatility. Would you agree? Does that make sense to you?

Mr. HESSE. Again, I am not an economist so I shouldn't speculate on that aspect.

Mr. CRAWFORD. Let me ask the economist then.

Does that make sense to you, because we have gotten the tax position fairly well clarified, so now can we see the value to a producer to use a hedge strategy that is manageable with puts and calls *versus* open futures contracts?

Dr. WILLIAMSON. The financial markets is not an area where I am really comfortable commenting on right now.

Mr. CRAWFORD. Okay. All right, well, I am going to switch gears, but that is a theory I think that——

Mr. HESSE. Mr. Crawford, if I may.

Mr. CRAWFORD. Yes.

Mr. HESSE. One of the difficulties that we do have on the tax side though is establishing whether we have a hedging arrangement or whether it is a speculating arrangement.

Mr. CRAWFORD. Sure. And they are going to be treated differently based on whether they are a *bona fide* hedge or not. And I would think for the purposes of ag producers, they would certainly qualify as *bona fide* hedgers.

Mr. HESSE. But there is also the——

Mr. CRAWFORD. There are speculators that is true, and I think that that is where we need to make some clarification to make sure that they were, in fact, *bona fide* hedgers for the purposes of hedging their crop *versus* taking a speculative position. I certainly appreciate that difference there.

Let me switch gears real quick. We had a downturn in commodity prices and it has really kind of stretched our farm bill resources to the limit. Let me ask you if you think it would be a good idea, and this is particularly true with cotton producers who didn't have title I protection, but do you think it would be a good idea if we were to implement some sort of a tax-incentivized, tax-beneficial savings account for farmers to use in conjunction with the policies that we have in place, so they could essentially effect their own disaster relief in a time when maybe there is a weather dis-

aster or in our current market scenario where prices are so low? Is that something you would support?

Mr. HESSE. Certainly, we would. The ability of managing your own money, deciding how much to set aside into a farm and ranch risk management account, for example, setting that aside, taking a deduction for placing that money into a separate account, and then deciding on when to pull that out as another technique or another tool to use for smoothing the income so you don't have the income spikes and the valleys, would be beneficial.

Mr. CRAWFORD. I am going to do a shameless plug here and say that in H.R. 1400 I would ask for you all to research that, H.R. 1400, which essentially does just that. And in the context of tax reform, I think that would be a good positive move to put one more tool in the toolbox for farmers as a risk management tool.

Finally, real quick, the preferential capital gains rate in 1986 and 1993 tax bills for some reason excluded the timber industry, and created a disadvantage for corporate holdings of timber. The 2015 PATH Act included a 1 year reprieve for C corporations harvesting timber and restored equity to the industry. Do you think it is important to preserve equity for businesses with similar assets within a similar industry so no one is at a disadvantage?

Mr. HESSE. I certainly believe in the same taxation across different entity types, and to the extent that C corporations don't have a special capital gains rate and the individuals do, that I would be in favor of having a similar type of a benefit for the C corporations.

Mr. CRAWFORD. Do you think we should probably look at that to consider that provision of the PATH Act to be made permanent?

Mr. HESSE. From a personal standpoint, I am, again, in favor of the equality so, therefore, the answer is yes.

Mr. CRAWFORD. Thank you. I appreciate it.

I yield back.

The CHAIRMAN. The gentleman yields back.

Mr. Panetta.

Mr. PANETTA. Thank you, Mr. Chairman. Gentlemen, ma'am, thank you very much for your time today, your testimony, preparation, and for being here. I appreciate that.

My questions are going to revolve around the estate tax, just to let you know.

I come from the central coast of California. Land prices there are very expensive. Just to get things clear, if I could have a show of hands, are all of you for the elimination of the estate tax?

Dr. WILLIAMSON. I don't have an opinion. ERS does not have an opinion.

Mr. PANETTA. Okay, understood. Mr. van der Hoeven?

Mr. VAN DER HOEVEN. I am on the fence because with roughly $5½ million per each, and $11 million total between the two, I think that covers over 99 percent of us. If we get rid of it completely, what does that say? I am not seeing it in the people that I talk with. Although I am working with a family where the issue relative to value is three things; location, timing, location. The family has an appraisal, 2010, $780,000. Mom died last October unexpectedly. They now have an offer on the table for 116 acres of 430

at $10.5 million. Now they are facing an estate tax issue. It is a champagne problem to have.

Mr. PANETTA. Understood. Understood. Please.

Mr. HESSE. From my viewpoint, the estate taxes doesn't raise any significant amount of money, and yet there are significant resources that go into structuring, planning over a long period of time. We generate fees from doing that, but I view it as a deadweight loss to the economy, in order to structure the arrangement such that we keep below the threshold of the $5.5 million. Therefore, since it doesn't raise that much, it seems that it would be more efficient to the economy to eliminate it, and so that we don't have the deadweight loss that is associated with planning around it.

Mr. PANETTA. Well, could you see an instance where some tweaks may help it, either raising the amount, or raising the percentage?

Mr. HESSE. I can't comment on that.

Ms. WOLFF. AFBF is committed to repealing the estate tax. When the exemption was raised to $5 million a few years ago, that was very helpful, and it does cover most farmers and ranchers but it doesn't cover all, it picks winners and losers. And farmers who come from areas of the country that have higher land values are the losers.

Second of all, as Mr. Hesse mentioned, estate planning is an expense that we believe is a waste of resources. As long as the tax is on the books, most farmers believe they have to plan for it because most farmers I know want to grow their businesses and they plan to be successful, and the $5 million sets a line where you are a winner or you are a loser. And as long as the estate tax is there, it hangs over the heads of young farmers. They know that they want to stay in the business, but they have to worry about what will happen when their farmers die. And it is a cloud hanging over our industry that we don't need, and if it is right to eliminate the tax for 99 percent of farmers, we should go the whole way.

Mr. PANETTA. Now, I was a former prosecutor, and obviously, I try to take into account the other side when I go into a case and to know their argument. And I am sure you know the argument of the other side. Give me the argument of the other side, and how do you rebut that, for keeping it?

Ms. WOLFF. Well, I don't want to assume that I am answering your question, so could you state your argument?

Mr. PANETTA. Well, obviously, there has to be some argument out there for keeping the estate tax, correct? And I would imagine being in your position, being against it, you would know that argument.

Ms. WOLFF. Well, there are philosophical arguments. To us, this is not a philosophical argument, it is a business argument; whether or not a farm and ranch can continue to the next generation. We look at this as a business issue, not a philosophical one.

Mr. PANETTA. Understood.

Mr. CLAUSSEN. I just want to make a comment as it relates to estate tax, and also the argument for current estate tax provisions, and it is the argument of stepped-up basis in the assets that are in the estate. The estate tax at current levels does not affect every-

body, and Ms. Wolff testified to that. However, stepped-up basis does affect everybody that dies with assets. If removing the estate tax also means we are removing stepped-up basis in those assets, we need to give some consideration to what are the implications as it relates to American agriculture.

Mr. PANETTA. Fair enough.

Thank you. I yield back my time.

The CHAIRMAN. Mr. Dunn, 5 minutes.

Mr. DUNN. Thank you, Mr. Chairman.

We are talking about taxes here, and sometimes it is helpful to quantify the universe we are talking about. I am wondering if any of you has ever seen or conducted a comprehensive analysis of what the farmers and ranchers of the nation generate in terms of tax revenue. And I am not talking about just the taxes they pay and their families pay, but also the taxes on all of the economic activity they generate, so taxes from manufacturers, retailers of tractors, seed, soil amendments, insurance, all of these people, the people who process and market their crops, all of that economic activity, has anybody got an eye on what the tax revenue on that economic activity is? Yes, sir.

Dr. WILLIAMSON. Mr. Dunn, well, we have not conducted an analysis on that, but we are able to maybe provide you something in writing. We do have estimates of the taxes paid on land and government fees, so we estimated that agriculture pays about $15 billion a year, and will pay in 2017.

Mr. DUNN. Real estate tax?

Dr. WILLIAMSON. And real estate taxes and fees, and property taxes.

Mr. DUNN. Okay, this is a minuscule portion of the taxes that are paid by——

Dr. WILLIAMSON. Yes.

Uunfortunately, we do not have an estimate on the total tax revenue from the economic activity of agriculture and the allied sectors.

Mr. DUNN. As we go forward and we are talking about tax reform here, enthusiastically, I think that it behooves us to understand what is the universe of economic activity that we are affecting.

Dr. WILLIAMSON. Yes.

Mr. DUNN. Also I kind of want to change back to the foresters, we touched on briefly, and I thought we were going to address this, but it actually didn't. The tree farmers actually don't have the ability to deduct or expense the reforestation expenses that they incur as they replant forest after they harvest. Of course, they almost all need to replant after they harvest. I want to ask your opinion: does this seem like a fair deduction, a business expense. Anybody?

Mr. HESSE. The timber taxation, of course, is different from agricultural farming taxation, even to the extent, for example, we may call it a Christmas tree farm, that comes under a timber taxation set of rules. But you are correct that the reforestation direct costs aren't directly deductible. After the planting, the trees are established, then all of the growing expenses from that point forward are deductible, similar to the growing costs of other farm assets.

So as to the extent of what it should be, I can't speak to that as policy.

Mr. DUNN. Well, I assure you our foresters feel like they are farmers. Yes, they don't plant quite as often or harvest as often, but they think of it like a farm.

Mr. van der Hoeven.

Mr. VAN DER HOEVEN. They are allowed to deduct $10,000 per year, per unique tract. As a management thing, they could go in and subdivide their tracts and be able to capture that. Anything over $10,000 is then amortized over 84 months. I would argue that they would be able to recover their reforestation expenses within 7 years.

Mr. DUNN. Another torturous avoidance of tax.

Thank you very much. Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman yields back.

Mr. Lawson, 5 minutes.

Mr. LAWSON. Thank you very much, Mr. Chairman. I want to thank you all for being here today.

And this question probably goes to Dr. Williamson. Dr. Williamson, given that so many small farmers have off-farm employment that often provides health insurance benefits, the percentage of farmers who use the self-employed health insurance deduction is relatively low. However, those who do are likely to choose an insurance option from the Exchange set up by the Affordable Care Act. Would repeal of ACA result in an additional burden on full-time farmers?

Dr. WILLIAMSON. Thank you for the question. You are correct that many of farmers; small, new farmers, as well as established farmers have off-farm jobs, and while some of them receive their insurance from off-farm sources, from an employer, there are many that purchase their insurance on the private market and pay out-of-pocket for that insurance. I can't answer the question of what the market would look like post-ACA if it was terminated, without knowing more information about the state, which state they are in, but I would say that, yes, many farms do choose to purchase on the market, and any reduction could make it difficult, I guess, for them to find insurance.

Mr. LAWSON. All right. Did anyone else like to comment on that? Okay, the reason why I asked that question, when I came here to Congress one of the reasons, having been in the insurance business for over 36 years, is I wanted to really work on a fix for the Affordable Care Act because we knew that there were problems, especially in Florida and some other places. And we haven't made any progress yet, but I thought that if the people who have businesses, especially some of the farmers and so forth, this would be a good time to see if we can bring out some of the information. Are they looking to lower their premiums, are they looking with prescription drugs, how does it affect the farming industry, because most of the time a lot of work that farmers are doing is so independent than everybody else, trying to get their crops to market, and at the same time providing courage and support for their families. What do most of the farming community do in terms of getting proper health insurance benefits for their families?

Mr. HESS. As a result of the legislation at the end of 2016, Congress passed H.R. 34, I believe the number was, to re-establish the ability of having health reimbursement accounts for those employers that have fewer than 50 full-time employees and full-time equivalents. I think that goes a long way to helping the small employers for agriculture to re-establish the opportunity of providing some health insurance and health and medical expense deductions against their taxes that hadn't been available under the original Affordable Care Act. And farmers do have the self-employed medical deduction available to them, to the extent that they have income from their farming operation, they can deduct the self-employed health insurance, and also health savings accounts are available to agriculture as well.

Mr. LAWSON. Okay, in the timber industry, which I have in between two cities, Tallahassee and Jacksonville, Florida, the timber industry it is a long-term investment, and because it is a long-term investment, the ability to deduct interest for that long-term investment. How, with what is being proposed, will this curtail or have any harm on the timber industry? Mr. Hesse, would you like to comment on that? Anyone?

Mr. CLAUSSEN. Nothing? Okay. Well, I appreciate the question about the interest deductibility. And I would say the timber industry would be in the same boat as the rest of the ag economy as it relates to interest deductibility. We have investments in long-term assets with a limited amount or no equity capital that comes into the system. Everything has to be provided from debt financing, and, therefore, the interest deductions would become a significant portion of what their operating cash-flow is, or where it goes.

Mr. LAWSON. I yield back.

The CHAIRMAN. The gentleman yields back.

Rick Allen.

Mr. ALLEN. Thank you, Mr. Chairman. And thank you, panel, for being with us today and taking your time to talk about the tax situation.

I tell you what, I know now why we haven't done tax reform in a long, long time, because it affects, it seems like we need a different Tax Code for every business.

But as far as the estate tax, obviously, it affects not only farm but construction and many, many other businesses. As far as the argument for or against the estate tax, I mean if you sell the farm, and you had a large capital gain, I mean wouldn't that come under the capital gains application?

Mr. VAN DER HOEVEN. Well——

Mr. HESSE. Generally, well, go ahead.

Mr. VAN DER HOEVEN. Go ahead.

Mr. HESSE. Well, with respect to the assets that are the long-term assets from the land, the real estate assets, certainly, those would be the capital gains. But then to the extent that there is so much in agriculture, especially depending on what period of what time of the year you die as to whether you are holding a growing crop, are you holding inventory, are you holding accounts receivable, had you sold the crop, valuation on that specific day, an unexpected day, but it would be ordinary income.

Mr. ALLEN. But you don't debate that. In other words, the IRS says you owe this much money, right, as far as estate taxes go? I mean in other words, the IRS will come in now and do a complete evaluation of the family members' assets, and the children then are required to write a check based on that evaluation.

Mr. HESSE. Yes.

Mr. ALLEN. Regardless of whether the farm is worth, right now, say, if you are growing cotton, it is not worth a lot of money, for example.

Mr. HESSE. There are provisions within the estate tax for paying of the estate tax over a 14 year period of time delay, interest-only for the first 4 years, and then 10 year payout for that portion that is associated with the farm, but still an unexpected cash-flow hit, as Representative Noem testified, as to how do we finance this, and this liability which hangs over which affects the ability of obtaining other finances.

Mr. ALLEN. Yes. And it does affect a lot of, well, mostly small businesses pretty much.

Mr. HESSE. Yes.

Mr. ALLEN. Getting back to this interest deduction, will the interest deductibility offset the gain from immediate expensing? Is it any expensing benefit?

Mr. HESSE. We don't believe so. Section 179 is at a high enough level today that, as one witness testified, the large percentage of farms are already able to deduct and expense-off their equipment purchases during the year. The tradeoff of allowing full deductibility of fixed asset purchases in exchange for interest isn't a benefit for agriculture.

Mr. ALLEN. Yes.

Ms. WOLFF. Mr. Allen, if I could add, there is no immediate expensing for land.

Mr. ALLEN. Okay.

Ms. WOLFF. When a farmer would have to take out a loan to buy land, there is no immediate expensing there. So there is certainly no tradeoff there.

Mr. ALLEN. Okay. As far as immediate expensing, is there a value to agriculture for immediate expensing *versus* the various depreciation options out there?

Mr. HESSE. Certainly, there is, with the flexibility that is available for Section 179, how much of that do I want to claim, and as a planting opportunity, another tool in the toolbox, if you will, of smoothing out the income, and expensing-off or choosing to depreciate the equipment assets or depreciable real estate assets that are required.

Mr. CLAUSSEN. And I would like to just add a comment, that immediate expensing in contrast to depreciation expense is really a timing difference, because it is not giving you the option to deduct items that you couldn't depreciate before, it is just now you are doing it on a more accelerated schedule.

Mr. ALLEN. Right. Right.

Dr. WILLIAMSON. Mr. Claussen, I would just like to add, concurring with my panelists that for the most part farmers are able to, if they have income offset, offset that income immediately with expensing and plus bonus depreciation. For the farms that do surpass

the expensing limit of $500,000 today, they still have benefitted up until that $500,000.

One thing we haven't talked about is that there is a phase-out for Section 179, but it doesn't hit until they make an aggregate investment of $2 million, and then it starts to phase-out dollar for dollar, which effectively doubles the tax rate during the phase-out period.

Mr. ALLEN. Okay. Thank you.

The CHAIRMAN. The gentleman's time has expired.

Mr. Soto.

Mr. SOTO. Thank you, Mr. Chairman.

If we had a carve-out for the estate tax simply for agriculture businesses, do you think that would satisfy what you all are concerned about, about a lot of these farmers having to divide up their land or plan for estate the whole time they are in business?

Ms. WOLFF. That has been tried once before several years back. It was called QFOBE, qualified family-owned business exemption. It was an attempt to carve-out farmers and ranchers and small businesses. It didn't work. It was very complex, it had a long set of rules, farmers were afraid to use it because it was so complex, and that they would be subject to challenge by the IRS. Certainly, a much simpler way, and a way that we believe is a better way, is to repeal the tax.

Mr. SOTO. Any other input on that?

Dr. WILLIAMSON. Well, sir, I can give you a little perspective on who would be affected by this potential carve-out. Well, based on our information we have from surveying farmers annually, well, there is a small percentage of farm estates are going to be liable for the tax, so it is less than one percent, but the liability that there is will fall mainly on mid-sized and larger farms. Just giving a little bit of a context in terms of who is affected currently, and who we potentially see as affected by any kind of provision, such as the carve-out.

Mr. HESSE. I am somewhat concerned, Mr. Soto, with regard to if we have a sector, and we will call it agriculture, that is exempt from the estate tax, and now we have what Mr. Peterson identified starting off as that you have non-agricultural interests will be flocking into agriculture to acquire those assets that might qualify for any carve-out that is there. Once we start running provisions for a carve-out of a particular sector, what are the unintended consequences from other investment money coming into that, which perhaps would drive up, again, the prices of the inputs, prices of the fixed assets and the investments in agriculture.

Mr. SOTO. The reason why I asked that is because there is a lot of sympathy for, and we have had ranches in my own district that have had to be split up just to pay the estate tax. And we know that farmers have a very unique place in America to make sure that we have an adequate food supply, but when we are lumping them in with multibillion dollar hedge fund managers that are suddenly now not paying estate tax, there is far less sympathy when you include this entire group, as opposed to these even larger Mom and Pop farms that help feed America. And so it would be much more tolerable to have an estate tax exemption for true agricultural industries. And maybe there is a way to make it less complex

and to avoid the gamesmanship, but lumping in our American farmers who have a true issue, with giant hedge fund managers and other major wealthy families that are in the billions and billions of dollars, all in this estate tax issue, is obviously a much harder lift and harder to get a lot of people onboard for.

So any particular reaction to that, I would be happy to hear.

Mr. CLAUSSEN. Yes, Mr. Soto, I really appreciate the sentiment of doing a carve-out for farmers or agriculture because there are certain provisions where that has been effective, and so I appreciate that sentiment. If there is a way to make it effective so that there isn't abuse by those that are not involved in farming, or fundamental changes in what a farmer is doing over their lifecycle, and let me give you an example. A number of farmers will spend 50 years of their life actively, day-to-day involved in the farming operation. They are on the tractor every day, so to speak. And then maybe in the sunset portion of their career, maybe they become more of a landowner that is renting their farm ground to, say, their son or nieces or nephews, so it is still farming, but would they be characterized as a *farmer* when technically they are a *landowner* that is collecting rent. Those are some of the implications that we would want to be cautious of. But I do want to commend you for your sentiment of carving-out farmers or agriculture with some of these special provisions. I appreciate that.

Mr. SOTO. I yield back. Thank you.

The CHAIRMAN. The gentleman yields back.

Mr. Marshall, 5 minutes.

Mr. MARSHALL. Thank you, Mr. Chairman. First of all, I want to compliment the Chairman and the Ranking Member for getting some great witnesses. It is very, very helpful for me to have two people from the Ways and Means Committee come over first. It was very helpful. I can't think of two better people to talk about agriculture and taxes in the same subject. Congresswoman Noem, I got to hear her very harrowing story several years ago, when I didn't know I was going to be a Congressman. Certainly, she grew up in agriculture, tragic accident, lived through the death tax issue, and ran a big farming operation. It is great to have her over on the House Ways and Means.

Congresswoman Jenkins, there is not a brighter tax mind up here. It is great that our Chairman has tax experience as well. Congresswoman Jenkins, people may know, grew up on a dairy, so she understands agriculture, and as a CPA understands tax policy.

Great to see American Farm Bureau Federation here. Certainly, the voice of agriculture. Couldn't think about doing tax issues in agriculture without talking to Farm Bureau.

Kennedy and Coe was founded in Salina, Kansas, as I recall, in my district, in the 1930s. Certainly, one of the most respected agriculture accounting firms in the country, and I appreciate your expertise.

I am sure I have talked to thousands of ag people, I represent the largest ag-producing district in the country, and they constantly tell me that without cash accounting they would go broke. There is no other way to do it. They talked about the importance of deductibility of interest, the estate tax I mentioned already, unlimited expensing and preservation of section 1031.

Ms. Wolff, is that unique to Kansas, is it unique to farming, is it unique to cattlemen and dairy as well, or does it influence one more than the other, or is it all a big priority for Farm Bureau?

Ms. WOLFF. Well, you have outlined AFBF's priorities for tax reform. It seems like a long list, but it is really not when you consider all of the things that are being discussed in tax reform. We have tried to focus on those that are most important to farmers. And being a general farm organization, they have application to all commodities, all types of farms.

So while there may be some, I would say the different commodities would put them in a different order, I believe that they all are important across the board.

Mr. MARSHALL. Okay. Mr. Claussen, I can't help but ask you, you certainly represent a very diverse group of people too. What are your thoughts? Is it going to influence dairy as well as cattle, as well as hogs, as well as other commodities?

Mr. CLAUSSEN. Mr. Marshall, I really appreciate the question, and setting the stage as it relates to who the panelists are, and your background and the district that you represent.

As I think about farm operations over the years, I think about how they have become much more specialized. It used to be that you would have a farm operation, and he would maybe have a few cows, a few hogs, he would do a little corn, a little wheat, he would even have a few chickens running around. That is not the farm economy of today. That is not the farmer of today. They have to have more specialization because of the sophistication that is required for their operation.

And as I think about things like cash accounting, that is a very reasonable and simplified method of tracking what their income is, right, cash-in and cash-out. Maybe have a few differences because of deprecation and things of that nature, but for the most part it is a very simplified method of tracking their taxable income. I appreciate the question.

Mr. MARSHALL. Yes. Yes, last, let's just talk about stepped-up basis. It is a very misconceived situation. And the other misconception is that people don't realize farming is business. And I can't emphasize that enough, farming is a small business. It has worked a lot with the community banking in the past, it is absolutely one of the most complex businesses going around right now. I want to talk about stepped-up basis just a little bit more to make sure everyone understands how important that is in the agricultural industry. Mr. Hesse, you want to grab it?

Mr. VAN DER HOEVEN. Well, I would just offer this example, Mr. Marshall, and that is let's say I inherited a tractor for $70,000, and if I got stepped-up basis then I would be able to start depreciating that on my date, which would reduce my taxable income for the 7 years. If I did not get stepped-up basis, but again, $70,000, and let's assume $10,000 over then I am going to have $10,000 more income over a 7 year period, because I don't get that depreciation.

Mr. MARSHALL. And very few farmers wouldn't have to sell a section of land just to pay some of these tax consequences if we didn't have stepped-up basis, or whatever the issue is.

Mr. VAN DER HOEVEN. Right. Possibly, yes.

Mr. MARSHALL. Okay.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentleman yields back.

Ms. Kuster.

Ms. KUSTER. Thank you very much. And thank you to the panel for being with us.

The risk of going late in the hearing is that you may have already covered this, but there is a great deal of discussion right now about a possible border adjustment tax. My district in New Hampshire, is on the northern border with Canada. We have a lot of trade back-and-forth, and including our agricultural products: cheese, dairy, fruits and vegetables, that type of thing, as well as a very big timber interest. And it would be helpful for me to understand, any of you, your perspective on the impact on the border adjustment tax both to the sort of small farm trade that we have in New Hampshire; organics, farm-to-table, that type, as well as I would be curious for Mr. Marshall's district in Kansas, with the larger operations and commodities and such.

Ms. WOLFF. The border adjustment proposal is proposing a change to our Tax Code to tax revenue where it is consumed, instead of where it is produced. And the tax benefit goes to the company that is exporting or importing. If a company produces something in the United States that is sold overseas, the revenue from that sale is not taxed as income. And if a company is importing a product, then the cost of that import is not deductible. It changes the income tax of the importing or export company.

The tax is designed to give us a competitive advantage in export sales. That is a very positive thing for any commodity that has sales overseas, which is almost all commodities, to some degree, depending on your specific commodity it may be more or less.

On the flipside then, there is an increase, or at least in the short-term until there is adjustment, an increase on supplies that we import; fertilizer, fuel, those kind of things.

So there are very positive aspects about it. There are some things that are concerning. The proposal is actually not written down yet, it is being talked about in concept, and so until we know exactly what the proposal is, it is hard to say one way or the other the impact it will have on our industry.

Ms. KUSTER. Any other members of the panel wish to comment?

Mr. CLAUSSEN. Yes, I would just like to make a comment as it relates to if we look at the umbrella of all of agriculture, it is going to be difficult to assess if a border adjustment is a positive or a negative for all of agriculture, because you point out, Congresswoman, a distinct difference in what we would call agriculture. One is you have folks that are exporting products that are right next to the border, they have an understanding of what is being exported. In fact, in many cases, the producer may be the exporter. They are able to take advantage of some of those advantages.

Now, you take Mr. Marshall in Kansas, take Hard Red Winter wheat, Hard Red Winter wheat grown in Kansas is the same kind of Hard Red Winter wheat that is grown in Nebraska or Oklahoma. It is hauled to the elevator, it is put on a train, it is hauled to the Gulf, it is hauled out to the PNW and then put on a barge and exported. There is not enough information available to say which farmer produced that grain in Kansas, and can they get that ben-

efit. The benefit would be to the direct exporter. That creates one of the challenges and one of the frustrations with border adjustment because that information doesn't get back to the actual producer and provide a direct benefit at that point.

Ms. KUSTER. That is extremely helpful. Thank you very much, in our quest to understand what the tax reform may mean to different people. Thank you very much. I appreciate it.

I yield back.

The CHAIRMAN. The gentlelady yields back.

Mr. Arrington, 5 minutes.

Mr. ARRINGTON. Thank you, Mr. Chairman. I find this hearing very helpful to me. I have a lot to learn on this subject for sure, and I do appreciate the panelists lending their expertise and their insights.

Let me start with health care, just because we are in the middle of this healthcare reform, discussion, debate. I really hope we can move that forward for all Americans, not just farmers and ranchers. But my understanding is that there are some 14 taxes that are repealed in this American Healthcare Act. This is the reform and repeal of ObamaCare. What do your clients say about this draft legislation that we have not voted on yet, but just in terms of the provisions out there specifically, repealing almost $1 trillion in taxes, 14 is the number of taxes, what are your clients saying about that, and how that would help or hurt, and support their viability and growth or inhibit it? Yes, Mr. Hesse.

Mr. HESSE. Probably the one that is most public or affects the most number of our clients may be the net investment income tax. We are still working through, quite frankly, just what is subject to the net investment income tax and what is not, what relationships, what type of income am I receiving, and is it excluded, is it included: 3.8 percent, it is one of the higher rate taxes that is part of the Affordable Care Act, and there is some hope that that would be repealed retroactively back to January 1, 2017.

The medical device excise tax is certainly important in the Minnesota region, but most of these taxes are not direct on agriculture, is really the issue, and it is the mandates that are more important.

Mr. ARRINGTON. Pardon me for interrupting, but just in terms of having small family farms and relatively small operations, and under that rubric of small businesses, *et cetera,* I mean do you generally, without getting into the details of it, because this is in the Health, Education, Labor, and Pensions Committee, do they generally favor repealing these taxes and radically departing from this current construct under Affordable Care Act, or do they want to keep Affordable Care Act? Not affordable care, the Affordable Care Act. Just generally, can anybody speak to that? Maybe the Farm Bureau members.

Ms. WOLFF. Our members have goals for healthcare reform, and they deal with two areas. One is access and one is cost. Farmers tend to live in rural areas, and that is where the access issue comes from. They need to be able to have services. They don't want to have to travel great distances to get the care they need, and so access is the first point.

The second point is then they have to be able to afford those services. And so as an overreaching goal of any healthcare reform

proposal, we are looking for things that bring healthcare costs down.

Mr. ARRINGTON. Do they generally think that a repeal of the Affordable Care Act will make headway to that end, or do they think leaving the Affordable Care Act will make headway to that end?

Ms. WOLFF. The American Farm Bureau does support repeal of the Affordable Care Act.

Mr. ARRINGTON. Thank you very much.

When I think about agriculture and farm country, like west Texas where I come from and the district I represent, we don't have the people that other communities have to support infrastructure, but what we have is product. Product the American people need, and product this country needs for economic growth, and most importantly for national security; food, fuel, and fiber, but without health care, for example, infrastructure we can't sustain that. There are unique challenges, and you all would agree with rural infrastructure. But with ObamaCare, it has brought $58 billion in additional regulatory costs, and rural hospitals, which are the center of care for rural communities, are going away, they can't handle the strain and the cost. Any comments about that in particular, anybody?

I yield back to the Chairman.

Ms. WOLFF. I can only repeat what I said before, and that is that the concern of farmers and ranchers is two-pronged. We need access, so we need a strong rural healthcare system, and we need to be able to afford it. And so any reforms that Congress enacts in health care should move us in that direction.

The CHAIRMAN. The gentleman's time has expired.

Ms. Plaskett, 5 minutes.

Ms. PLASKETT. Yes, thank you, Mr. Chairman. Good afternoon, gentlemen and ma'am.

I wanted to ask you, there has been a lot of discussion in this hearing about border adjustment taxes, and if a border adjustment tax is adopted and if the dollar appreciates, as proponents of the *Blueprint* say it will, I don't really see how this is going to help our ag exports. We know that agriculture struggles with low prices already, and the export market is one of the bright spots in agriculture. I don't believe that I am alone in this thought.

Senator Grassley told reporters this week, "You aren't going to hear anything about border adjustments in the Senate Finance Committee." I am not entirely sure if that is the same statement that we will hear here in the House. And what would the effect of removing the border adjustment tax from this plan be, where would funding come from? Wouldn't proponents need to find another source of revenue to offset the reduction rates it receives elsewhere from the plan? Do any of you have any thoughts on that? Ms. Wolff?

Ms. WOLFF. It is true that the border adjustment proposal is one of the major revenue raisers.

Ms. PLASKETT. Yes.

Ms. WOLFF. It is one of the major contributors to making the tax reform plan revenue-neutral. And there would have to be significant changes if border adjustment were not included. Either the size of the package would have to be pared-back, or other sources

of revenue would have to be found. And I don't know the answer to your question as to how that would happen, but you have certainly framed the question.

Ms. PLASKETT. Yes. I got that right, at least. I got the question right.

Mr. CLAUSSEN. Thank you for the question. I am going to speak a little bit to the pay-for provision if border adjustment is removed or scaled back. In my testimony, both in the written testimony and in the oral testimony, I talked with regard to the importance of cash accounting for farmers and ranchers. Cash accounting, back in 2013 there was a proposal to require accrual accounting for all businesses, and that provision would have generated a substantial amount of revenue.

Ms. PLASKETT. Yes.

Mr. CLAUSSEN. Now, if you take the *Blueprint* and you read through its provisions, it does not require accrual accounting. In fact, it is really an advocate for the cash basis of accounting. But one of the concerns that we have had is that as comprehensive tax reform is undertaken over the next few months and year, perhaps that question will come up, is if border adjustment is something that it is not able to be decided upon, what are some of those other provisions. And so I wanted to share testimony with regard to the importance of cash accounting, and why farmers and ranchers need to continue to be able to use that as a tool. I wanted to share that with you.

Ms. PLASKETT. Okay. The other thing when you talk about, we all know that farmers need different sorts of accounting than maybe someone in another type of business; a computer business. Thinking about investments where a farmer is making an investment every 10 years for a large piece of equipment, as opposed to a computer which would be every year or every 2 years, depending on the use of it. Can you talk to me about what would happen if the Code changes so that the amount that the business buys a product, and instead of writing off the cost over time, there has to be an immediate tax write-off on that, and it is not something that they are able to spread out over time, would that have a significant effect on farmers and how they adjust their taxes according to their investments?

Ms. WOLFF. A couple of points. First of all, it is important for farmers and ranchers to be able to match up their income and expenses.

Ms. PLASKETT. Yes.

Ms. WOLFF. Farm income fluctuates greatly. There may be 1 profitable year, followed by many that are not, and it is the matching of income expenses and leveling out that income that is important.

Ms. PLASKETT. You need time to be able to do that, right?

Ms. WOLFF. You need, well, you need flexibility to match up your income——

Ms. PLASKETT. The flexibility of——

Ms. WOLFF.—and expenses. What happens when that is not possible, as farm income spikes, if you receive all of your income over 5 years, if you have 1 year that is very profitable followed by 4 that are not, if you can't even out your income then the taxes you pay

are more than someone with a steady income, because you are realizing all of your income in 1 year, and you would be at a very high rate that year. We need provisions in the Code to help farmers even things out, and match up the income and expenses so that there is a more equitable taxation and so that they can manage their cash-flow.

Ms. PLASKETT. Okay.

The CHAIRMAN. The gentlelady's time has expired.

Ms. PLASKETT. Thank you.

The CHAIRMAN. Mr. Faso, 5 minutes.

Mr. FASO. Thank you, Mr. Chairman. Last, hopefully not least. I thank the witnesses for being here today, and I appreciate your testimony. Before the hearing today, we had a hearing in T&I for 2 hours, and I spent an hour there and come over to this one for an hour. I appreciate your indulgence.

Mr. Hesse, did I understand you to say that you didn't think there was, that you had a preference for Section 179 over the notion of 100 percent expensing?

Mr. HESSE. If the tradeoff were 100 percent expensing as a tradeoff for non-deductibility of interest. That is the proposal that we would not have deductibility of interest expense incurred by businesses, but we would allow everyone to expense-off their asset acquisitions and depreciable asset acquisitions.

Mr. FASO. Yes.

Mr. HESSE. We would not be in favor of that in the aspect because most of the farmers today are able to utilize Section 179 to expense-off the equipment purchases anyway. And so to use that as a tradeoff to satisfy or as an advantage as a tradeoff against the non-deductibility of interest is a no-go.

Mr. FASO. Got it. And that gets to what Ms. Wolff was saying in terms of the interest being so important for land purchases.

Mr. HESSE. Agriculture is so cyclical that you have all of these inputs incurred up-front, and raising of the funds, the finances in order to fund the purchases of the feed, seeds, fertilizer, *et cetera,* raising the animals, raising the crops, and not having that income for a year or 2 years later, the interest expense incurred in order to raise the funds to finance those inputs, that is what makes it an interest expense critical, just on the operational side let alone on in the acquisition of the land.

Mr. FASO. Got it.

Ms. WOLFF. And Mr. Hesse was talking about that a tradeoff is being proposed. The point that I had made earlier is that there is no immediate expensing for land.

Mr. FASO. Right.

Ms. WOLFF. Therefore, there is no tradeoff. And land is probably the biggest purchase that a farmer will make, it is the reason that they would incur the most debt, and it is that expense then would be large and would have to be something they would have to account for in their business. It would make lending money, borrowing money harder and more expensive.

Mr. FASO. Thank you, I appreciate you both clarifying that point.

And the other point that was raised by Mr. Soto relating to the estate tax, and, Mr. Hesse, you previously mentioned the compliance costs to comply with the estate tax, compared to the amount

of revenue the Federal Government derives. My recollection is it is a very small difference between what individuals and businesses pay to comply with these estate tax, *versus* what the Federal Government receives. Could you expound on that?

Mr. HESSE. I don't know the statistics as to the cost of, not only just complying with the estate tax, but also all of the planning that goes along with the desire to avoid or reduce the effects of the estate tax. I don't know, Dr. Williamson, if you have the statistics as to just what the costs are in that aspect *versus* the amount of revenue that is derived from the Federal Government.

Dr. WILLIAMSON. We do not have any information on that.

Mr. HESSE. Yes, okay.

Mr. HESSE. Sorry.

Mr. FASO. Mr. Claussen?

Mr. CLAUSSEN. Just to comment on the revenue side.

Mr. FASO. Sure.

Mr. CLAUSSEN. In 2015, Federal estate tax generated approximately $17 billion in revenue. And information was just reported the other day from the IRS that for 2016 the estate tax generated $19 billion of revenue, which is far less than even one percent.

Mr. FASO. Right. And my recollection, which is always hazardous to rely upon, but my recollection is that the compliance costs for the economy were somewhere in the neighborhood of the amount that the government raises.

Mr. CLAUSSEN. Yes, that——

Mr. FASO. What really the motivation of some in terms of, or the rationale of some, I don't want to talk about motivation, the rationale of some to justify this, they want to penalize those rich people, as they perceive it, as opposed to producing a tax exercise which is actually efficient and economical and logical for the economy. I think that is really what it comes down to; we spend as much to comply with it societally in the economy as the government collects. I appreciate your statements here.

Mr. CLAUSSEN. In 2016, the same report showed that there were 36,000 estate tax forms filed, Form 706, and for 2015 there were only 5,000 of them that actually owed any tax.

Mr. FASO. Right.

Mr. CLAUSSEN. There was a significant compliance cost with no tax due.

Mr. FASO. Thank you.

Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman's time has expired.

Mr. Thompson, 5 minutes.

Mr. THOMPSON. Thank you, Mr. Chairman. And thanks to members of the panel for being here, lending your expertise and thoughts on this important topic.

Ms. Wolff, I want to start with you. Are you familiar with the use of Section 1031, the like-kind exchanges, in the context of conservation easement transactions, and if so, can you explain how they are utilized to the benefit of the taxpayer?

Ms. WOLFF. Yes. First of all, let's establish like-kind exchange. That is a deferral of tax when a business sells an asset, real property, and purchases another similar asset. In agriculture, that is land, it is equipment, and it is animals. Like-kind exchange rules

also apply to conservation easements. If a farmer sells a conservation easement, the money that he receives from that sale is eligible for like-kind exchange treatment and can be used to purchase a like-kind asset.

Mr. THOMPSON. Okay, thank you.

Mr. van der Hoeven, much of your testimony concerns how to help older adults retire while protecting their businesses. What can we do to help younger farmers, that next generation, good succession planning, we need that next generation to make sure we are well fed and clothed, and all the good things that come off of farm and ranchland. What can we do to help younger farmers choose to enter farming, in addition to helping older farmers retire?

Mr. VAN DER HOEVEN. Well, thank you for the question. One of the things I suggest is maybe modifying Code Section 529 to allow individuals who may not desire to go on to university to develop their human capital, but to allow them, and grandparents or parents, to make an investment in a tax-deferred account to create a down payment fund, if you want to look at it that way. Capped at some value, say, $100,000, and if they bought a $300,000 farm then they could use the $100,000 as a down payment. They would not get basis for that $100,000 because they have already received a tax benefit, but it would give them some startup cash, kind of some bootstrapping, and they could start that as soon as they are born. We have parents and grandparents that establish 529s for education.

And that is one suggestion.

Mr. THOMPSON. Mr. Claussen, why is debt financing so important to the agriculture community, and what do you think happens to agricultural producers without the ability to deduct those mortgage interest costs?

Mr. CLAUSSEN. The reason that debt financing is so important because there is no other alternative. Equity capital is generally not attracted to agriculture because of volatility, low returns, it is very capital-intensive. The only way for a farmer or rancher to generate capital is either to earn it over time or to borrow it from a lender.

Specifically, if you think about land cost: land cost, if you are an ag producer and you are getting started in the operation, or in an operation, you are going to want to own some farmland, and typically, farmland is not available all the time, right? They are not making any more farmland, and so you have to be selective on when you are purchasing that ground. You have to utilize debt financing in order to acquire that ground, and then operate it. And typically, you are going to be financing 70 to 75 percent of that purchase if you are a younger farmer, and that generates a significant amount of interest expense that then would not be deductible.

Mr. THOMPSON. Mr. Claussen, just in the time I have left, you talked about net operating loss carrybacks and carryforwards, why are these provisions important to agricultural producers?

Mr. CLAUSSEN. That is a good question. I appreciate you bringing that up. I gathered just a little bit of data, this speaks to the volatility in farm income. The USDA did a 2017 Farm Sector Income Forecast and they forecast net income to be $62.3 billion for farmers. Now, if you contrast that with 2013, net farm income in 2013

was $123.7 billion. Here we are 4 years later, and net farm income is forecast to be ½ of what it was in 2013.

The rules that I believe Mr. Hesse shared in his statement with regard to farmer net operating losses, they have the ability to carry those losses back 5 years as opposed to 2 years, which would be for most other taxpayers and businesses. Because of that volatility, the 5 year carryback is critical for our ag producers.

Mr. THOMPSON. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

Mr. LaMalfa, 5 minutes.

Mr. LAMALFA. Thank you, Mr. Chairman. I appreciate, again, parachuting in from one Committee to the other, so I am sorry I didn't get to be here for the whole panel, very little of it.

But following up, Ms. Wolff, on the section 1031 situation, it can be very important for ag producers, and I am not sure what is going on, what may happen with tax reform on that being around, but obviously, it is an important tool. How unique is agriculture in its usage of that, in what is more or less a deferment of tax, it is more like basically swapping land instead of just an outright sale, the way the tax works. How unique is agriculture's usage of this type of tool compared to other industries or other property transfers that might occur in this country?

Ms. WOLFF. First of all, the tax reform *Blueprint,* the proposal, is silent on like-kind exchanges.

Mr. LAMALFA. Which makes it scary.

Ms. WOLFF. Which means we don't know how they will be treated. Certainly, like-kind exchanges are important for farmers and ranchers because, as you said, they allow a farmer to defer the tax when they are *swapping,* and that is a good word, that is a word that a farmer would use, trade equipment, upgrade their livestock, and land. If you look at the coalition that is working for like-kind exchange, it is very broad. It is very important to agriculture, but agriculture is not the only industry that is impacted. If you think about any other industry where they are trading equipment back-and-forth, it is very important to those groups too.

So certainly, it is not unique to us, but it is a very important tool for farmers to have to upgrade, keep their businesses effective, operating effectively, and up-to——

Mr. LAMALFA. Is there something more unique or more difficult, or a higher hurdle for farmers, or why it has that have even more urgency than maybe other industries or other properties? Do you see a bigger challenge?

Ms. WOLFF. I do not. Does anyone else?

Mr. LAMALFA. Others?

Mr. CLAUSSEN. Sorry, we all want to talk. I will keep mine brief so that there is time for other comments. One of the challenges that agriculture has is the fact that if you are a farming operation, you have a certain radius of land that you are going to be able to farm, and if you have the ability to reposition some of your farmland assets, maybe take a piece that is further away and move it closer, or reposition it for a higher quality piece of farm ground, you are going to do that because you are geographically limited.

Mr. LAMALFA. I get you loud and clear. We are fortunate everything is contiguous on my place, pretty much.

Mr. CLAUSSEN. Yes.

Mr. HESSE. And because agriculture is so heavily dependent upon the farmland in the first place, such a large percentage of the investment is going to be in the farmland, so it makes sense, although I don't know the statistic as to how much agriculture uses Section 1031 for real estate exchanges *versus* other industries.

Mr. LAMALFA. Okay, thank you.

I, unfortunately, got to miss most of the exchange on the border adjustment. Dr. Williamson, would you like to elaborate on any point that hasn't been made today, a little more on that? I guess where I would want to go with it is if we tailored it a little bit better to our agriculture, it could either be shielded or even benefit, what would that look like on making, if it is going to be there, what would work in order to have a coexistence?

Dr. WILLIAMSON. Well, ERS doesn't have recommendations for a policy for a border adjustment tax. It has been laid out pretty well that it the relationships are very complex, so there is a relationship with the producers, the growers, with the exporters, and the relationship with other trading partners. It is certainly unclear who is going to benefit and who is going to lose. And a lot of this has to do with the competition of the relationships between all these players.

Mr. LAMALFA. Thank you.

Others on the panel that might want to weigh in, as I am running out of time? No? No takers? Well, okay. Well, I appreciate it.

And thank you, Mr. Chairman, for the time, and I yield back.

The CHAIRMAN. The gentleman yields back.

I want to thank our witnesses, including our former Members who were here earlier to talk to us this morning. You have clearly demonstrated why tax reform is hard and why it is going to be a difficult path to walk. What I have asked my colleagues to do is to keep their powder dry until we get all of the details necessary to be able to run the kind of projections that certainly my two CPA colleagues would do for their clients in terms of what they would look like under the new scheme all-in *versus* what they looked like under the old scheme, and where the advantages and disadvantages are. Thank you for helping us point that out.

Lowering rates and spreading the base is kind of like going to heaven; everybody wants to go there, just nobody wants to die to get there. And so every one of those credits or deductions or special treatments has an advocacy group, as you have heard from this morning. Our Code is more complicated today than it was in 1986, and it is inefficient, we use it, collectively, to manipulate behavior, manipulate conduct, manipulate the economy, incentivize this activity, disincentivize that activity. All of that is inefficient in the extreme. And so if you believe that the only reason to have a Tax Code is to collect the minimum amount of money needed to fund the government, this system isn't it. But it is the system we have, and so Kevin Brady and his team are hard at work on it. The healthcare reform will take about $1 trillion of taxes out of the overall reform effort that we are going to debate later. If we don't get that done then everything you have talked about this morning

with respect to the tax reform plan will be dramatically different because we will have to fold in all those ObamaCare taxes into the new mix.

But I really appreciate, especially my two CPA colleagues. My license is still current, by the way. I still get the 40 hours of CPA, no exemptions. I am the most dangerous tax return preparer anywhere because I only do one, and that is the last guy you want doing your taxes is mine.

So again, I thank the folks for being here. This just sets the stage for a lot more conversations, especially as it looks at the unique aspects of agriculture, and all of the things that go on there with respect to the Tax Code and how important it is to get it right. Thank you very much for your efforts on our behalf, and I look forward to future conversations with you as the tax reform proposal begins to gain additional definition. Thank you all very much.

I have some official words to say. And they are, under the Rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional materials and supplementary written responses from our witnesses to any question posed by a Member.

This hearing of the Committee on Agriculture is adjourned. Thank you all.

[Whereupon, at 12:23 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED ARTICLE BY HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

House GOP Tax Reform Plan: A Case Study

By John L. Buckley



John L. Buckley is a former House Ways and Means Committee chief tax counsel and a former member of Tax Analysts' board of directors.

In this report, Buckley uses the farm sector of the U.S. economy as an example of how the House Republican *Blueprint* for tax reform would affect capital-intensive small businesses. He concludes that farmers could be among the large losers from the *Blueprint* plan—a result that is not positive from a political or economic perspective.

Tax Notes **Special Report**

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I. Introduction

The House Republican *Blueprint* for tax reform released before the 2016 election is a combination of tax policy ideas borrowed from prior tax restructuring proposals.[1] The changes to the personal income tax are largely drawn from the 2014 tax reform legislation introduced by former House Ways and Means Committee Chair Dave Camp. The basic structure of the proposed business tax (with expensing for capital expenditures, the disallowance of interest expense, and the continued deductibility of wages) is very similar to prior flat tax proposals, although in the *Blueprint*'s business tax, those elements are grafted onto a system of taxation that retains at least some significant accrual features. Its border adjustments are an imperfect attempt to mirror the border adjustments in VATs or retail sales taxes.

The business aspects of the *Blueprint* can be seen as a sharp departure from current law, but they are an even sharper departure from the 2014 Camp tax reform plan. His proposal was consistent with the approach taken by the 1986 Tax Reform Act—namely, a reform of our current system involving rate reductions financed by expanding the tax base with the goal of not altering levels of projected revenues or the distribution of tax burden. His proposal would have financed business rate reductions by stretching out cost recovery for tangible and intangible business investments. The *Blueprint* takes the opposite approach, providing for immediate expensing. Camp's proposal failed in the sense that it received little support from his Republican colleagues in the House or from the business community. However, it did

[1] For a description of the *Blueprint* and supporting materials, see the House Ways and Means Committee web page. This report relies on the full text of the *Blueprint,* which is part of those materials.

perform an educational function, demonstrating the difficult tradeoffs and political decisions required for such a reform, and the lack of political will to make those decisions.

I have always viewed alternatives like the *Blueprint* as an attempt to avoid the issues that condemned the Camp proposal to failure. Given our extensive debates over tax policy and reform in the context of an income tax, the winners and losers from the Camp proposal could be quickly identified, with the losers more vocal and motivated than the winners. Also, shifts in the tax burden across income categories could be quickly analyzed. That is less true for proposals like the *Blueprint.* There will be big losers and consequences that might not be readily identifiable at the outset. Shifts in the tax burden can be obscured by arguments over whether consumption-based taxes will be passed on to consumers or offset by changes in the value of the dollar. In that regard, comments made many years ago by former Senate Finance Committee Chair Daniel Moynihan, at a hearing on flat tax proposals, remain relevant today:

> The idea of a new set of simple rules is always appealing. However, any time a change of this magnitude is under consideration with huge potential risks to the economy and shifts of fortune in the balance, we must approach proponents' claims with caution and healthy skepticism.

II. Uncertain Claims of Economic Growth

Healthy skepticism is especially warranted for claims that the *Blueprint* would substantially increase economic growth. Those claims rely on macroeconomic models that are based on assumptions that are highly uncertain and in some cases even contrary to observable facts. Assumptions often reflect the modeler's view of how the economy should work rather than how it actually does.[2] Speculation on how the Federal Reserve, foreign countries or their central banks, or currency markets would respond to the *Blueprint* may be critical to the growth claims.[3]

Projections of increased growth also will depend on assumptions concerning existing law. The authors of the *Blueprint* have made it clear that the numerous temporary tax provisions routinely extended by Congress will be assumed to be permanent for purposes of budget scoring.[4] One would think that the same assumption should be followed in modeling macroeconomic growth effects, but no one should be surprised if that does not occur.[5] A November 30, 2016, Goldman Sachs report analyzed the impact of immediate expensing of capital expenditures coupled with the disallowance of net interest expense (a central component of the *Blueprint*).[6] The report concluded that if 50 percent bonus depreciation were assumed to be part of the baseline law, that component of the *Blueprint* would be neutral in the very short term and result in lower investment in the long run. In other words, simply extending bonus depreciation (and retaining interest deductibility) would be more effective in encouraging domestic investment than the *Blueprint.* A positive growth effect was projected if bonus depreciation was not part of the baseline assumption.

Finally, on the issue relevant to this report, the models make little or no attempt to analyze the effect of a proposal on the various sectors of our economy, implicitly relying on the comforting assumption that dislocations in one sector will be automatically offset by increased growth in other sectors.

There is little question that the release of the *Blueprint* in statutory form would be accompanied by claims of increased economic growth, since it appears to be designed with the relevant models in mind. But the more important question for policymakers is the proposal's effect on our complex and interrelated economy, an economy far different from the one assumed in many of the models. This report uses the farm sector as a case study to analyze the real-world impact of the *Blueprint.* There are several considerations that led to farming being chosen for the case study. For example, the impact on farming is emblematic of the adverse effects potentially

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[2] For example, some "forward looking" models assume that individuals can predict the future with 100 percent accuracy. Those models also tend to predict the most favorable growth responses.

[3] Absent an extraordinary and immediate increase in the value of the dollar, the *Blueprint*'s border adjustment on imports would create inflation in price levels, and the question of whether the Federal Reserve would accommodate that inflationary price increase will be critical to growth claims.

[4] *See Blueprint* at 16.

[5] Indeed, the Tax Foundation has criticized the Goldman Sachs report, *infra* note 6, because it assumed indefinite extension of bonus depreciation. Scott Greenberg, Kyle Pomerleau, and Stephen J. Entin, "Goldman Sachs Analysis of House GOP *Blueprint* Is Questionable" (Dec. 5, 2016).

[6] Goldman Sachs, "U.S. Daily: Corporate Tax Reform: Trading Interest Deductibility for Full Capex Expensing" (Nov. 30, 2016).

experienced by many other small businesses that rely on borrowed money to finance their operations. There is also a practical reason for the choice: the wealth of statistical information on farm income available online from the Department of Agriculture.

At the outset, I want to be clear about some of the basic assumptions underlying that analysis. First, this report assumes a current policy baseline consistent with that in the *Blueprint* description. Second, this report analyzes the *Blueprint* on a fully phased-in basis, ignoring transition rules. In my opinion, transition rules at best only delay the disruptive effects of a proposal and, in attempting to do so, can add a new set of distortions. Finally, the *Blueprint* description is expressed in very general terms, lacking many details, so some educated guesses are required. I assume that current-law accrual methods of accounting would be retained because their repeal would be a significant change and likely mentioned in the *Blueprint* description.[7] That description states that expensing will be allowed for "new investment," possibly reinstating the distinction between new and used equipment, which was a feature of the investment tax credit repealed by TRA 1986. I believe that a more likely interpretation of the term "new investment" is that both new and used property would be eligible for expensing but that there would be anti-churning rules to prevent large tax benefits from simply selling and buying equivalent pieces of property.[8] That is the interpretation followed in this report.

Even a cursory examination of the *Blueprint* leads to the inescapable conclusion that it was designed with total disregard for its effect on farming:

- Many farmers would see increases in both their income and self-employment tax liabilities. Effective tax rates (as a percentage of net income) would increase for many farmers, and that increase would be significant for farmers struggling with the impact of low crop prices or rising interest rates. The rates would approach infinity in cases in which the proposal would convert net losses into positive taxable income.
- Financial industry experts predict that the *Blueprint*'s import border adjustment would result in some appreciation in the value of the dollar and some cost inflation, since the border adjustment would increase the after-tax cost of imported items and cause domestic producers to raise their prices, as well. As a result, farmers could experience both lower crop prices because of dollar appreciation, and increases in the cost of equipment and supplies such as fuel and fertilizers.
- The border adjustments in the *Blueprint* are inconsistent with our trade agreements and invite retaliation by other countries, which could reduce access to overseas markets for our farm products.

III. Description of *Blueprint*

A. Personal Income Tax Changes

The *Blueprint*'s changes in personal income tax rules in most respects are consistent with the approach taken in the Camp tax reform plan. There would be a new rate schedule with lower rates and fewer brackets. The itemized deduction for state and local income, retail sales, and real and personal property taxes would be repealed, as would all other itemized deductions other than the deductions for home mortgage interest and charitable contributions.[9] Nominally, those two itemized deductions would be retained. However, they would be effectively repealed for all but a few upper-income taxpayers because of the effects of the repeal of the state and local tax deduction and the conversion of personal exemptions (which are currently allowed in addition to itemized deductions) into an increased standard deduction, which would be allowed *in lieu of* itemized deductions.[10]

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[7] Repeal of accrual accounting rules may appear to be a simplification, but for many corporations it would only add to overall complexity because they would have to continue reporting earnings on an accrual basis. Also, without complex transition rules, the shift from accrual accounting to cash-flow accounting could result in double taxation during the transition.

[8] In prior flat tax proposals, the anti-churning rule consisted of taxing the entire amount realized on the sale of property eligible for expensing as ordinary gain, regardless of the adjusted basis of the property.

[9] One small example of possible unintended consequences involves activities that are conducted largely for personal reasons but result in some income (such as so-called hobby farms). Section 183 allows an itemized deduction for expenses up to the amount of income. Under the *Blueprint,* the section 183 deduction would be repealed in those cases, resulting in a tax on gross income unreduced by expenses.

[10] *See* John L. Buckley, "The Hidden Repeal of the Mortgage and Charitable Deductions," *Tax Notes,* Mar. 10, 2014, p. 1103.

The plan would repeal the deduction for investment interest, a repeal that could have a significant effect on financial markets.

The main departure from the Camp plan is in the taxation of investment income. The *Blueprint* would allow a 50 percent deduction for capital gains and dividends instead of the current preferential rates. The new deduction would benefit all taxpayers other than those whose capital gains and dividend income would fall in the 10 percent or 15 percent tax brackets of current law. Those taxpayers would appear to lose the benefit of the current-law tax rate of zero percent for their capital gains and dividend income. Interest income would also be eligible for the 50 percent deduction.

B. Business Tax Changes

The new business tax contains elements that reflect a sharp departure from current law, but describing it as a "destination-based cash-flow tax" is misleading. It appears that many current-law features that depart from cash-flow treatment, such as accrual accounting and inventory rules, would be retained.[11] As discussed below, the border adjustments are flawed and would not meet the "destination-based" standard in many cases. Although perhaps over-advertised, the *Blueprint* would make significant changes.

The tax rate for non-employee business income (pass-through income) reported on an individual return would be capped at 25 percent. However, not all of that income would be eligible for the cap. The portion of the income that represents reasonable compensation for the individual's services would remain subject to the higher marginal rates. Relying on an ill-defined concept like "reasonable compensation" would introduce significant uncertainty and probably result in endless litigation as taxpayers and the IRS disagree over what is reasonable.

Capital expenditures (other than for land) would be expensed—that is, immediately deducted in the year in which the property is placed in service. The *Blueprint* description asserts that this change would "be equivalent to a zero percent marginal effective tax rate on new investments."[12] That sounds dramatic, but it is misleading. Expensing would result in a zero tax rate only for marginal investments, which are investments with an expected return slightly above the taxpayer's cost of capital. For many small businesses, the proposal would not provide greater benefits than the small business expensing provisions of current law. Taxpayers not significantly expanding their capital investments would receive a temporary increase in cost recovery allowances before returning to annual allowances comparable to those under current law.

The *Blueprint* combines expensing with the disallowance of the deduction for interest expense exceeding interest income (net interest expense). This trade-off could be harmful for many capital-intensive businesses and thus discourage investment. The *Blueprint* description justifies the disallowance by stating that it would reduce the incentive to borrow, implying that businesses could access equity markets for business capital instead of borrowing funds. This ignores the fact that equity capital is more expensive than borrowed capital even for publicly traded corporations and is simply unavailable for most small businesses.

Clearly, the most significant changes proposed by the *Blueprint* are its border adjustments. The border adjustment on imports would impose U.S. tax on imported products and services by eliminating deductions for those products and services. In most respects this border adjustment acts like an *ad valorem* tariff imposed on all imports, but with two important differences.

First, a tariff is a tax-exclusive imposition, with the amount of the tariff not included in its base. The *Blueprint*'s border adjustment on imports is a tax-inclusive system, with the tax included in its base. For example, assume the importation of an item with a value of $100. A tariff with a 20 percent rate would be $20, and the importer could recover the tariff by selling the product for $120. With the tax-inclusive border adjustment of the *Blueprint,* an importer attempting to recover the amount of that adjustment under the proposed 20 percent tax rate would have to sell the product for $125. Thus, the potential increase in prices of imported products and services (and the effective tariff) would be 25 percent, not the 20 percent tax rate.

Second, the *Blueprint*'s import border adjustment would apply only when the importer is a taxable U.S. business. Recently, I purchased an item online, not realizing that the seller was located overseas. That type of purchase would effectively be ex-

[11] The *Blueprint* description proudly states that it retains last-in, first-out accounting rules, apparently not recognizing that the border adjustment on imports would cause many to revoke LIFO elections because the basis of the most recently acquired imported property would be zero.

[12] *See Blueprint* at 23.

empt from the *Blueprint*'s border adjustment on imports. Retail stores are increasingly under pressure from online sales. In the future, domestic online sellers could be at a substantial competitive disadvantage to foreign online sellers.[13] Large governmental entities or tax-exempt entities (like tax-exempt hospitals and universities) could enjoy large cost savings by directly importing supplies and equipment rather than purchasing those items through domestic wholesalers. Even small tax-exempt hospitals could enjoy large cost savings by purchasing imported equipment and supplies through tax-exempt cooperative hospital service organizations (section 501(e)).[14]

There would also be a border adjustment for exported products and services. Unlike a VAT, the *Blueprint* would not allow rebates of taxes previously paid on exports. Instead, the amount received for the export sale would be excluded from gross income, but expenses incurred in the production of the export would continue to be deductible. Presumably, the intent is to encourage exports by providing a subsidy in the form of a negative tax that would permit exporters to provide a 20 percent reduction in the price in dollars paid by the foreign purchaser. That subsidy might be especially important as an offset to the increased dollar value and increased costs faced by U.S. manufacturers or other producers that could occur as a result of the *Blueprint*'s import border adjustment. For example, approximately 60 percent of imports are intermediate goods [15] used by U.S. businesses in the manufacture or production of goods or services. But many exporters would simply lack sufficient non-export-related taxable income to receive much benefit from the export border adjustment. Absent economic distortive transactions or mergers, for many exporters the export border adjustment would largely result in loss carryovers that would be usable only if the exporter sharply reduces its export sales in the future.[16] The *Blueprint* would increase the amount of those carryovers by interest, an adjustment that would only increase the amount of largely unusable loss carryovers.

The other significant changes in business taxation—a lower corporate tax rate and territorial system of taxation—generally would have little direct effect on the farm sector of our economy.

IV. Tax Impact on Farmers

A. Few Farmers Would Benefit

The effect of the new business tax on most farmers can be summarized simply as the combination of a largely irrelevant benefit (expensing) coupled with the detriment of a draconian disallowance of net interest expense that exceeds the benefits of the individual rate reductions.

Expensing allowed under the *Blueprint* plan is largely irrelevant for most farmers. This is because section 179 already permits expensing for tangible property used in a trade or business, subject to an annual limit of $500,000.[17] Few farmers have sufficient income to take full advantage of the $500,000 limit on section 179 expensing, much less the unlimited expensing that would be allowed under the *Blueprint.*

The following table shows the average farm cash income (projected by the USDA for 2016) for different farm sizes.[18] Farm cash income is a net income concept computed without regard to depreciation allowances—a reasonable approximation of current-law adjusted gross income from farming computed without regard to depreciation. Only the group consisting of the top four percent of farmers has an average income greater than the $500,000 limitation on section 179 expensing. Even for many in that group, the *Blueprint*'s expensing proposal would be of little if any in-

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[13] To protect its business model and obtain the same treatment as its foreign competitors, Amazon might consider moving to Vancouver so it could sell foreign-produced products directly to U.S. consumers while avoiding the border adjustment on imports.

[14] Theoretically, this problem could be solved by imposing an actual tariff on imported goods when the importer is not a taxable U.S. business. However, that tariff could be difficult to enforce, especially for Internet purchases, and could be in direct violation of our trade agreements.

[15] Robert B. Zoellick, "The Art of the Deal for Free Trade," *The Washington Post,* Jan. 6, 2017, at A14.

[16] For example, according to the March 15, 2016, edition of the *Puget Sound Business Journal,* in 2015 Boeing had export sales of approximately $51 billion. According to its 2015 annual report, Boeing's pretax income for 2015 was $7.155 billion. Thus, under the *Blueprint,* depending on the level of imported components used in its plane production, Boeing would have an NOL that could approach $44 billion.

[17] Although buildings and their structural components generally are not eligible under section 179, special rules permit many farm structures to qualify. For the definition of special purpose agricultural or horticultural structures eligible for section 179 expensing, see section 168(i)(13).

[18] USDA, "Economic Research Service, U.S. and State Farm Income and Wealth Statistics" (Nov. 30, 2016). Except when otherwise indicated, the USDA Economic Research Service is the source of the farm-related statistics used in this report.

cremental benefit compared with the current-law benefits of expensing for the first $500,000 of capital investment, coupled with the bonus and accelerated depreciation methods for investment exceeding that limitation.

Table 1

Farm Size by Gross Sales	Share of Total Number of Farmers	Average Farm Cash Income
$1 million or more	4.0%	$685,400
$500,000–$999,999	4.0%	$206,500
$250,000–$499,999	4.7%	$103,000
$100,000–$249,999	6.9%	$40,700
Less than $100,000	80.4%	–$500

The *Blueprint* would repeal the NOL carryback. As a result, farmers making equipment purchases exceeding their farm cash income would only see increases in NOL carryovers.[19] For example, if a farmer with $200,000 in annual farm cash income made equipment purchases of $500,000, under the *Blueprint,* the farmer would receive the benefit of a $200,000 deduction for the year of the purchases and $300,000 in deductions available in future years. In contrast, under current law, the farmer would see immediate benefit from the entire $500,000, in the form of a current-year deduction of $200,000 and the recovery of taxes paid in the prior 2 years through $300,000 in NOL carrybacks. Ironically, cost recovery allowances of some taxpayers would be effectively deferred under a proposal advertised as providing immediate write-offs of capital expenditures.

For the many farmers who would receive little or no benefit from the new expensing provision (because they already can fully expense under section 179), the question is whether the benefit of the rate reductions would exceed the detriment of the proposed net interest disallowance.

B. Tax Increases on Many Farmers

The AGI from farming for those who receive little or no benefit from the new expensing provision would be substantially the same as under current law, with the significant exception of the disallowance of net interest expense. Whether there will be a net increase or decrease in tax on farmers depends on levels of interest expense in the farm sector in relationship to farm net income.

The USDA publishes a financial ratio—the times interest earned ratio—to measure farmers' ability to meet their obligations to pay interest on their debts. The ratio is net farm income (increased by interest expense) divided by interest expense. It is a measure of how much pretax income farmers have to meet interest payments. Net farm income essentially is the same concept as farm cash income discussed above, but with some accrual adjustments such as cost recovery allowances. It is an imperfect but reasonable approximation of current-law AGI from farming.

The times interest earned ratio also can be used to approximate the average percentage increase in farm AGI that could result from a disallowance of interest expense. For example, the times interest earned ratio projected for 2016 is 5.4. A ratio of that size means that farm interest expense is approximately 23 percent of average net farm income, suggesting that average farm AGI would be increased by approximately 23 percent because of the disallowance of interest expense under the *Blueprint.*

Two caveats are in order concerning the 5.4 times interest earned ratio projected for 2016. First, it is an average, and the debt levels among farmers differ dramatically. A surprisingly large number of farmers have no debt. However, the percentage of farmers with debt rises significantly with farm size. Only slightly more than 20 percent of farms with gross sales less than $100,000 have debt; the percentage with debt grows steadily with farm size reaching approximately 75 percent for farms with gross sales of $500,000 or more. Because the farms with gross sales less than $100,000 have an average net loss, most farms with positive net farm income have significant levels of debt, with the exception of older farmers who acquired their land many years ago and have paid down the land acquisition debt. As a result, for farmers with debt and positive net income, the times interest earned ratio could be significantly lower than the average 5.4 figure, with the result that for them the

[19] The *Blueprint* attempts to compensate for the repeal of loss carrybacks by increasing carryovers by an interest rate factor. The interest rate used would have to match the farmer's borrowing cost to fully compensate for the loss of the carryback.

tax increase from a disallowance of net interest expense could be greater than would be suggested by the average 23 percent figure.

Second, the times interest earned ratio can vary dramatically depending on economic conditions in the farm sector and interest rates. In the 1980s the combination of high interest rates and low crop prices resulted in the times interest earned ratio dipping below 2, suggesting that disallowance of interest expense at that time could have more than doubled average farm taxable income. As recently as 2011 the combination of low interest rates and good crop prices resulted in a times interest earned ratio approaching 10. Since then, the ratio has steadily declined to 5.4, even with historically low interest rates. As a result, effective tax rates on farmers (when expressed as a percentage of net income) will be the highest during periods of farm distress. The USDA statistics suggest that many American farms operate at a loss. Under the *Blueprint,* some of those farms could face significant income and payroll tax liabilities even though they operate at an economic loss.

Farms operated as sole proprietorships or partnerships are subject to the self-employment tax, and the income subject to that tax (self-employment income) is determined under the regular income tax rules.[20] Because the *Blueprint* would not reduce self-employment tax rates, all farmers with any interest expense would experience increases in self-employment tax liability. The increase would be the greatest for farmers with income below the Social Security wage base limit ($127,200 in 2017). Using the average 23 percent increase in AGI that could result from interest disallowance, farmers with self-employment incomes less than $100,000 under current law could face self-employment tax increases of as much as $3,000.[21]

A basic assumption underlying the following analysis of the impact on income tax liabilities is that farm AGI and farm taxable income are equal. That assumption ignores non-farm-related income because the goal is to isolate farm income and analyze whether the benefits of the rate reductions for farm income exceed the detriment of interest disallowance. It also ignores both the standard deduction and itemized deductions of the very few taxpayers who would continue to itemize. That is done for purposes of simplification, with the recognition that the assumption understates the detriment of interest disallowance.[22]

Table 2 shows that even fairly modest levels of interest expense could result in net income tax increases under the *Blueprint.* The table is based on the 2016 rates for joint income tax returns. The table includes a new rate bracket to reflect the effect of the new 25 percent top rate for pass-through income, with the assumption that reasonable compensation for the farmer's work is $125,000.[23] For each rate bracket, the third column shows the percentage change in tax liability under the *Blueprint* for taxpayers with taxable income, assuming no interest expense (referred to as EBI) equal to the midpoint of the bracket. The fourth column shows the level of interest expense (as a percentage of EBI) that would result in a net tax increase—that is, the level of interest expense at which the tax under current rates on taxable income determined with the deduction for interest expense is lower than the tax at the *Blueprint* rates on taxable income not reduced by interest expense. The last column shows the tax increases under the *Blueprint* assuming that interest expense is 19 percent of EBI, the percentage consistent with the 5.4 times interest earned ratio projected for 2016.[24]

Table 2

Rate Brackets	Current Rates	*Blueprint* Rates	Percentage Change for EBI of Midpoint of Bracket	Level of Interest Expense at Which Net Tax Increase	Tax Increase With Interest at 19% of EBI
$0–$18,550	10%	12%	20% increase	N/A	$358.93
$18,551–$75,300	15%	12%	7.9% decrease	6.82% of EBI	$835.94
$75,301–$151,900	25%	25%	6.7% decrease	4.7% of EBI	$3,979.07
$151,901–$231,450	28%	25%	6.2% decrease	4.7% of EBI	$7,510.92

[20] *See* section 1402(a).

[21] The $3,000 amount is based on an average effective employment tax rate of 14.2 percent, as shown in Joint Committee on Taxation, "Overview of Federal Tax System as in Effect for 2016," at Table A–8 (May 10, 2016).

[22] The understatement is the result of the fact that an increase in AGI will translate into a larger percentage increase in taxable income.

[23] The assumption of $125,000 as reasonable compensation may seem high, but it is not, because the 25 percent cap applies only when taxable income exceeds $231,000.

[24] As discussed above, a 5.4 times interest earned ratio indicates that interest expense averages approximately 23 percent of net income, which means that interest expense would be approximately 19 percent of the sum of net income and interest expense.

Table 2—Continued

Rate Brackets	Current Rates	*Blueprint* Rates	Percentage Change for EBI of Midpoint of Bracket	Level of Interest Expense at Which Net Tax Increase	Tax Increase With Interest at 19% of EBI
$231,451–$356,413	33%	33%	5.1% decrease	3.84% of EBI	$14,419.72
$356,413–$413,350	33%	25%	5.9% decrease	4.72% of EBI	$17,754.52
$413,351–$466,950	35%	25%	9% decrease	7.11% of EBI	$17,853.61
$466,951 and above	39.6%	25%	[a] 18.04% decrease	13.91% EBI	$11,371.01

[a] The table assumes the midpoint of this bracket is $600,000.

The table also assumes that setting aside the disallowance of interest expense, taxable incomes will remain constant, since it attempts to measure the impact on the large majority of farmers who would receive little or no benefit from the *Blueprint*'s expensing proposal. That assumption also ignores changes to personal tax, an assumption that significantly overstates the benefits of the rate reductions proposed under the *Blueprint.* The *Blueprint* does not have a zero rate bracket as the *Blueprint* description suggests; it has a much larger standard deduction ($24,000) than current law ($12,000). However, that increase is accompanied by repeal of the deduction for personal exemptions.[25] For a family of four, that means that the entry point to the rate schedules begins at $24,000 rather than the existing level of approximately $28,000. Itemizers would fare much worse.[26]

The table results are not surprising given the pattern of the rate cuts proposed by the *Blueprint.* Very modest levels of interest (as a percentage of EBI) would offset the benefit of the rate reductions for most income levels simply because the benefits of the rate reductions for most income levels are fairly modest. Also, the amount of interest expense (as a percentage of EBI) required to offset the benefits of the rate reductions is always less than the percentage tax reduction from the rate cuts because of the progressive rate structure of current law. Even the large rate reductions at the top of the rate schedule would not offset the detriment of an average 23 percent increase in taxable income due to disallowance of interest expense until incomes exceed $600,000.

C. Collateral Consequences

Farming is a cyclical business largely as a result of fluctuating prices for crops and other farm products. The current income tax has a countercyclical effect: little or no tax during periods of farm distress but significant taxation during periods of farm prosperity. The *Blueprint* would reverse that impact. It would accentuate cycles in the farm sector instead of moderating them, potentially increasing risks for farm lenders and creating additional pressure for governmental farm relief during periods of low crop prices. For example, with the rate schedule proposed by the *Blueprint* and a times interest earned ratio of 2 (the level reached during the early 1980s), the effective tax rate (as a percentage of net income) could approach 50 percent, even with the 25 percent cap on rates for pass-through income.

Clearly, the disallowance of interest expense would increase the after-tax cost of interest. A farmer in the 25 percent income tax bracket could see a 33 percent increase in his after-tax interest expense.[27] There also could be an increase in rates demanded by lenders because of increased risks of default. For example, the current times interest earned ratio is 5.4, providing lenders a reasonable cushion against potentially lower income in the future. The ratio is computed on a pretax basis, which is consistent with current deductibility of interest expense. With non-deductibility of interest expense, the ratio should be calculated on an after-tax basis because the interest disallowance means that only after-tax income would be available to meet interest payments. For farmers in the 25 percent income tax bracket, interest disallowance would result in a 25 percent reduction in the income available to meet interest payments, effectively reducing the current average ratio of 5.4 to ap-

[25] The repeal of personal exemptions for dependents is accompanied by an increase in the child credit, but that increase does not alter the fact that the repeal of personal exemptions for dependents reduces the benefits of the *Blueprint*'s rate reductions by increasing the amount of income subject to higher tax rates.

[26] Many years ago at a closed bipartisan meeting on tax reform, one of the Republicans on the Ways and Means Committee described the tax reform plan then being discussed as a large tax reduction at the top coupled with small tax increases on many others, with the hope that no one would notice—not a bad description of the *Blueprint* plan.

[27] For example, assuming an interest rate of six percent and a 25 percent marginal tax rate, the after-tax cost under current law would be 4.5 percent. With the disallowance of interest expense, it would be six percent, a ⅓ increase from current law.

proximately 4. Unless lenders are willing to accept higher risks without being compensated for them, interest rates could increase.

In the 2016 farm forecast, the USDA is predicting a modest decline in farmland values because of lower projected net farm income. The increase in actual and after-tax interest rates discussed above can only place increased downward pressure on farmland values (because buyer demand would diminish). As a result, all farmers, even those with no debt, could be harmed by the *Blueprint*'s disallowance of interest expense. Transition relief, even if very generous, would probably not ease the downward pressure on farmland values.

V. Negative Effects of Import Tax

As discussed above, the border adjustment on imports could result in an effective price increase of 25 percent for imported products. Absent currency adjustments, there seems to be little doubt that the tariff equivalent would be passed on in the form of higher prices. The liability for the border adjustment would be so large that the importer could not absorb it by reducing profit margins. Most costs are fixed, with the exception of wages, but wages are considered "sticky" and thus not easily reduced. As a result, it is likely that the liability would be passed on in the form of higher prices just as VATs are passed on through higher prices.

In cases in which there is significant domestic production but not enough to meet domestic demand, the price increase on imported products could increase the price of the domestically produced product. An example is crude oil. The price of domestically produced crude oil is the world price with adjustments for transportation costs and quality differences. The increase in the cost of imported crude oil because of the border adjustment could result in higher prices for domestic production and a windfall to domestic producers.

Economists who are proponents of the *Blueprint*'s approach argue strenuously that those cost increases will not occur because of adjustments in the value of the dollar. It is an argument essentially the same as the suggestion that flexible currency exchange rates would eliminate trade imbalances—an argument unlikely to convince or calm many. First, the upward adjustment in the value of the dollar would have to be very large, 25 percent, to eliminate cost increases in the United States.[28] Second, flexible currency exchange rates were introduced for the dollar and other major currencies in the early 1970s, but the United States continues to run large trade deficits, a fact inconvenient to the theory that currency adjustments will eliminate trade imbalances. Finally, many of our imports, like oil, have a world price denominated in dollars, and upward adjustments in the value of the dollar would not shield U.S. consumers from price increases on those products.

Two prominent economists, Alan J. Auerbach and Douglas Holtz-Eakin, recently argued that the value of the dollar would increase immediately, with the result that there would be no domestic price increases or reduction of imports because of the border adjustments in the *Blueprint*.[29] Rather than engage in a long discussion of why some of their basic assumptions (such as the assumption that the import and export border adjustments are equivalent) are highly unlikely to be true in practice, I make two observations.

First, Auerbach and Holtz-Eakin present what appears to be a very rosy scenario. The Federal Government would be collecting enormous tax revenue from the border adjustment on imports, but none of that revenue would come from cost increases on U.S. consumers or businesses. Instead, the rosy scenario implicitly assumes that the burden of paying those taxes would be shifted overseas through a sharp increase in the purchasing power of the dollar with equivalent declines in the purchasing power of other currencies. The *Blueprint* business tax proposal may be destination-based since the import tax occurs only when the product enters the United States, but under the rosy scenario the liability seems to be origin-based.

Second, a report by Goldman Sachs presents a more realistic picture, suggesting that the rosy scenario is neither likely nor all that rosy. Their report concludes that an immediate adjustment in the value of the dollar of a magnitude necessary to offset potential price increases is unlikely and that if it were to occur, such a large and abrupt change in exchange rates "would deliver a sizeable hit to U.S. residents' foreign wealth and could create risks of dollar-denominated debt problems abroad."[30] The Goldman Sachs report concludes that a more likely outcome would

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[28] Goldman Sachs, "U.S. Daily: What Would the Transition to Destination-Based Taxation Look Like?" (Dec. 8, 2016).

[29] Auerbach and Holtz-Eakin, "The Role of Border Adjustments in International Taxation," American Action Forum, Nov. 30, 2016.

[30] *See* Goldman Sachs, *supra* note 28.

include higher inflation coupled with some dollar appreciation, suggesting that industries with low margins and significant import purchases would be most vulnerable.

Neither scenario would be positive for U.S. farmers. Global demand for U.S. agricultural product exports is expected to have declined in 2016 for the second straight year because of a combination of dollar appreciation and slower economic growth overseas.[31] Any future increase in the value of the dollar would put downward pressures on crop prices, and one can only speculate on the consequences of an immediate 25 percent increase in the value of the dollar.

Under the more realistic scenario, farmers could face both lower crop prices (depending on the level of actual dollar appreciation) and cost increases on any purchase of equipment or supplies when imports constitute a significant portion of the U.S. market or when imported parts are significant components of U.S. produced items. Farm equipment, fuel, and fertilizers are among the items for which cost increases could occur. Typically, farmers do not have the pricing power that would allow those costs to be passed on in higher prices for farm products.

It seems unlikely that the export border adjustment could offset the negative effects of the import tax on the farm sector. Few farmers directly export their products, so they would see little direct benefit from the export border adjustment. It is unlikely that many farmers would see any indirect benefit, since when they sell their products to a process[o]r or trading company, it unclear whether the products will be consumed domestically or exported. Many of the actual exporters again may see little benefit because of insufficient taxable income from other activities.

VI. Border Adjustments Invite Trade War

According to the USDA, export markets are critically important to the health of the farm economy:

> With the productivity of U.S. agriculture growing faster than domestic food and fiber demand, U.S. farmers and agricultural firms rely heavily on export markets to sustain prices and revenues.[32]

If the *Blueprint* were enacted with its border adjustments and those adjustments were found to violate our trade agreements, U.S. farmers could suffer a double hit: the lower crop prices and cost increases discussed above, and likely retaliatory action by other countries that could threaten overseas markets for domestic agricultural products. For a foreign country, focusing retaliatory action on our farm exports would have both strategic and political benefits; it would impose pain on a politically sensitive sector of our economy while possibly protecting a politically sensitive sector of the foreign country's economy (farming) from competition from U.S. products.

Under our trade agreements, border adjustments are permitted if two requirements are satisfied. First, those adjustments are permitted for indirect taxes like VATs, excises, and retail sales taxes, but they are not permitted for direct taxes like income taxes. Second, they cannot be discriminatory, favoring domestic production over imports or subsidizing exports. The border adjustments under the *Blueprint* would violate both requirements.

It is clear that our current tax on business income (whether earned by corporate or unincorporated entities) is a direct tax. The question is whether the changes proposed by the *Blueprint* would change the nature of our business tax so that it is an indirect tax on consumption, like a VAT. Setting aside the border adjustments for a moment, the proposed tax on business income under the *Blueprint* has all the features of an income tax. As explained above, it is not a tax purely on cash-flow. It retains a deduction for labor costs and appears to retain the business deduction for state and local taxes, unlike VATs. It retains incentives like the research credit, inconsistent with the notion of a cash-flow tax. Because it is based on net income with a deduction for wages, most economists would assume that it would not increase prices on domestic production, just as they assume that the burden of the existing corporate tax is not reflected in higher prices but is borne primarily by equity owners, with a portion of that burden shifted to labor in the long run.[33] The business tax applies regardless of whether business income is saved or consumed by business owners. Indeed, one of the prominent supporters of the *Blueprint*'s approach describes it as a consumption tax except for consumption financed with wage

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[31] Congressional Research Service, "U.S. Farm Income Outlook for 2016" (Sept. 7, 2016), made publicly available by the Federation of American Scientists.

[32] USDA Economic Research Service, *U.S. Agricultural Trade Overview.*

[33] *See* J.C.T., "Modeling the Distribution of Taxes on Business Income," JCX–14–13 (Oct. 16, 2013).

income,[34] a rather large exception given that wage income is a large percentage of total national income. The border adjustment on imports has a consumption tax character, but it is a consumption tax only on imported products. I believe that most countries will accurately view the business tax proposed under the *Blueprint* as an income tax with accelerated cost recovery and non-tariff trade restrictions.

But there is little need to argue whether the new business tax is a direct or indirect tax; its border adjustment on imports discriminates against imports, and its export border adjustment attempts to subsidize exports.

It is important to recognize that the border adjustment on imports under a VAT results in equal tax burdens on both imported and domestically produced products. In both cases, the "value-added tax" is the VAT rate times the value of the product. In contrast, the tax on imported goods under the *Blueprint* would always be larger than the tax on domestically produced products, assuming there are always some labor costs, and it would be significantly higher if there are substantial labor costs. For example, assume two identical products with a value of $100 and labor costs of 60 percent, one imported and the other produced domestically. The tax on the domestically produced product would be $8 (20 percent of the value of the product minus labor costs). The border tax on the imported product would be $20.

Section 168(g)(6) authorizes the President to take limited retaliatory action against any foreign country that maintains non-tariff trade restrictions "in a manner inconsistent with provisions of trade agreements" or that engages in discriminatory or other acts or policies "unjustifiably restricting United States commerce." The import border adjustment under the *Blueprint* plan appears to be the same type of non-tariff trade restriction for which section 168(g)(6) authorizes retaliation: a restriction that at least in the past the United States would not have tolerated if implemented by a foreign country.

It also is important to recognize that the export adjustment under a VAT merely rebates VAT imposed on the product during stages of its production. The fact that the export adjustment is in the form of a rebate means that the VAT is effectively eliminated regardless of the exporter's tax situation. The rebate results in a zero tax rate, appropriately, because the intent is to tax domestic consumption not unlike a retail sales tax. Under the *Blueprint,* the amount received for the export is excluded from gross income, but the costs of production (including labor costs) remain deductible, resulting in a subsidy for exports in the form of a negative tax rate. Using the example of a product with a value of $100 and labor costs of $60, if the product were sold domestically, there would be a tax of $8. If exported, there would be a negative tax of $12 that could be used to reduce the tax on products sold domestically. As discussed above, many exporters would not receive the benefit of that subsidy, because they lack sufficient taxable income from other activities. As a result, the *Blueprint* may have a border adjustment that would violate our trade agreements even though it would provide little or no benefit in many circumstances.

The question is how countries would respond if the *Blueprint*'s business tax scheme were enacted. The process for resolving trade disputes can be lengthy and result in a delay of retaliation for years. However, companies may be unwilling to increase investments in the United States in response to the *Blueprint*'s border adjustments until it was clear that those adjustments would survive challenge. We could experience the downside of trade protectionism (higher costs to consumers and businesses, including farming) without the upside of increased domestic jobs.

Some countries might see the enactment of the *Blueprint* as a flagrant violation of trade agreements and retaliate regardless of the niceties of the trade agreements. In either event, U.S. farmers could experience reduced access to overseas markets.

VII. Conclusion

There are always winners and losers in any serious tax reform effort. In the case of the current *Blueprint* proposal for tax reform, farmers would be among the large losers.

President Truman in a fiery speech in Iowa during the 1948 campaign accused the then Republican-controlled Congress of having "stuck a pitchfork in the farmer's back."[35] It is hard to imagine what rhetorical flourish Truman might have used to condemn the "rough" treatment accorded farmers under the *Blueprint,* but I believe that he would have immediately appreciated the politics involved. And politics will

[34] PowerPoint presentation of Auerbach for conference on tax reform, Tax Policy Center (July 14, 2016).

[35] September 18, 1948, speech at Dexter, Iowa, on occasion of the National Plowing Match, available from the American Presidency Project. Truman carried Iowa.

and should play a large role in the development of tax reform legislation. Enacting a tax reform plan that is unsustainable politically serves no one's interests.

Clearly, there could be harmful economic dislocations in the farm sector of our economy: downward pressures on farmland prices, increased costs, lower crop prices because of dollar appreciation and loss of access to foreign markets, and increased farm insolvencies with risks to the farm credit system. And it may be small consolation to the farm sector, but other sectors may also face negative effects from the *Blueprint.* A research note on December 20, 2016, by JPMorgan identified the "automobile, computer, food, tobacco, petroleum, apparel, and electronic sectors as among the most at risk by the plan."[36]

Assessing the extent of those dislocations and whether they will spill over into other segments of our economy should be part of any attempt to measure the macroeconomic effects of a tax reform like the one suggested under the *Blueprint.* Instead, the current macroeconomic models simply assume that those dislocations will not occur.

SUBMITTED LETTER BY WILLIAM E. BROWN, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®

April 4, 2017

Hon. K. MICHAEL CONAWAY,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture,
Washington, D.C.

Dear Chairman Conaway and Ranking Democrat Peterson:

On behalf of the more than 1.2 million members of the National Association of REALTORS®, and of our affiliate REALTORS® Land Institute, I am writing to thank you for holding a hearing tomorrow entitled "Agriculture and Tax Reform: Opportunities for Rural America." Tax reform is a major issue affecting all real estate professionals, and there are some very specific and serious concerns about how changes to our tax system could impact agriculture, and especially agricultural land.

As I am sure you and all the Members of the Committee are aware, Section 1031 of the Internal Revenue Code provides that property held for productive use or investment may be exchanged on a tax-deferred basis for property of like-kind. This provision provides for the deferral of tax—not its forgiveness—until such time as the economic investment is ultimately disposed of or "cashed in." The like-kind exchange has been part of our tax system since 1921 and is one of many non-recognition provisions in the Code that provide for the deferral of gain.

Like-kind exchanges are integral to the efficient operation and ongoing vitality of many thousands of American farms and ranches, especially in the land real estate sector. These agribusinesses, in turn, strengthen the U.S. economy, provide jobs, and grow or raise products that feed our nation and much of the world.

For land real estate, like-kind exchanges encourage land owners, such as farmers and ranchers, to combine acreage, acquire higher-grade land, or move into another property when they are ready to retire. Moreover, section 1031 very often is the key ingredient in agreements to set aside land for preserving open space, or for scenic or environmental conservation purposes.

As you know, the House Republican tax reform "*Blueprint*" would allow for the immediate expensing of business assets *except for land.* Unfortunately, some proponents of immediate expensing believe that this feature would supplant the need for like-kind exchanges. In reality, replacing section 1031 with immediate expensing would leave land investors, including family farmers and ranchers, out in the dust by taking away their ability to do an exchange and also possibly preventing the deduction of their interest expense.

The elimination or restriction of like-kind exchanges would contract our economy by increasing the cost of capital, slowing the rate of investment, increasing asset-holding periods, and reducing transactional activity. NAR's members believe it would have a particularly catastrophic effect on land transactions since land would not be a permissible expense. Removing or inhibiting this tool would likely translate into lower land values across the country, negatively impacting rural counties' tax

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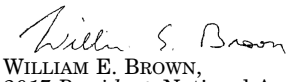
[36] Brian Faler, "Why Some Worry GOP Tax-Reform Plan Will Spark a Trade War," *Politico,* Dec. 20, 2016.

bases, and creating another real estate recession—this time specific to rural counties explicitly because of tax "reform."

In summary, there is a strong economic rationale for preserving like-kind exchanges. Limiting or repealing section 1031 would deter and, in many cases, prohibit continued and new real estate and capital investment, particularly for land. Repealing or limiting like-kind exchanges would dampen the motivation to buy, sell, and reinvest in land and real property, and would cause significant capital to flee the United States. This runs counter to the stated goals of tax reform to increase economic growth, job creation, and global competitiveness.

This hearing is aptly and optimistically entitled "Agriculture and Tax Reform: Opportunities for Rural America." NAR believes that with thoughtful leadership, tax reform *will* increase opportunities for all, including those who make their living from one of our greatest resources—the land. However, the opposite is also true, and REALTORS® urge you and the Committee to help retain the Section 1031 like-kind exchange as a vital tool for land investors, and particularly for America's family farmers and ranchers.

Sincerely,



WILLIAM E. BROWN,
2017 President, National Association of REALTORS®.

CC:

Members of the U.S. House of Representatives Committee on Agriculture.

SUBMITTED LETTER BY STEPHEN CHACON, PRESIDENT, FEDERATION OF EXCHANGE ACCOMMODATORS, *ET AL.*

April 3, 2017

Hon. K. MICHAEL CONAWAY,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture,
Washington, D.C.

Dear Chairman Conaway and Ranking Member Peterson:

We appreciate this opportunity to demonstrate the need to retain I.R.C. Section 1031, in its present form, in any tax reform bill, even if the bill includes reduced tax rates and full expensing of all investment and business assets, as proposed by the House Republican *Blueprint* for Tax Reform. Although the *Blueprint* proposes immediate expensing with unlimited loss carryforward for all tangible & depreciable personal property assets, including real estate improvements, it would not permit land to be expensed. The *Blueprint* proposals, taken as a whole, do not provide the same benefits, and are not as comprehensive, as the benefits provided to taxpayers and our economy by § 1031 like-kind exchanges. Section 1031 will still be necessary to fill in the gaps.

Like-kind exchanges benefit the agricultural sector in a myriad of ways. Farmers and ranchers use § 1031 to preserve the value of their investments and agricultural businesses while they combine acreage, acquire higher grade land, or otherwise improve the quality of their operations. They rely on § 1031 to defer depreciation recapture tax when they trade up to more efficient farm machinery and equipment. Farmers and ranchers trade dairy cows and breeding stock when they move their operations to a new location. The ability to take advantage of good business opportunities stimulates transactional activity that generates taxable revenue for land brokers, appraisers, surveyors, lenders, agricultural equipment dealers, livestock producers, manufacturers and more. Please see Appendix for examples of agricultural exchanges.

Repeal or restriction of like-kind exchanges would be especially troublesome for agricultural investments, particularly because the greatest value of agriculture operations is in the land, which often has been passed down through generations. As a result, the land generally has a very low basis and a sale would result in huge capital gains that would not be offset by a deduction for improvements that may be minimal in value, or non-existent, as in the case of raw land. Without additional cash to cover both the tax liability and the new investment, loss of § 1031 would result in a government-induced shrinkage of their agricultural business, retarding ability for growth as well as the net worth of the farmers.

Retiring farmers also benefit by exchanging their most valuable asset, their farm or ranch, for other real estate that doesn't require a 24/7/365 workday, without diminishing the value of their life savings. With a § 1031 exchange, they can downsize or divest their agricultural operation, and reinvest in other income producing real estate, such as a storage unit facility, or a triple net leased commercial property. The loss of § 1031 would result in a direct reduction of the retirement savings of these agricultural taxpayers, a severe injustice to people who worked their entire lives on the land to provide a modest living for themselves and food to feed our nation.

Most farmers, ranchers, land owners and real estate investors are not ultra-high net worth individuals or large corporations. These individual taxpayers do not have use for a large net operating loss carryforward from the unused expense deduction for real estate improvements. They do not have sufficient related income to offset the expense, thus they would realize minimal benefit. These taxpayers will face a massive amount of depreciation recapture upon sale, for which they may not have sufficient liquidity, or may not have set aside enough cash to satisfy, creating further personal challenges, locking them in, and putting other wealth building options out of reach.

Like-kind exchanges make the economics work for conservation conveyances of environmentally sensitive lands that benefit our environment, improve water quality, mitigate erosion, preserve wildlife habitats, and create recreational green spaces for all Americans. Farmers, ranchers and other landowners reinvest sale proceeds from conservation conveyances through § 11031 like-kind exchanges into more productive, less environmentally sensitive land. These socially beneficial conveyances are dependent upon the absence of negative tax consequences. Please see Appendix for examples of conservation exchanges.

Unlike the *Blueprint,* § 1031 provides a mechanism for asset sales and replacement purchases that bridge 2 tax years. Absent § 1031, taxpayers would be forced to acquire new assets prior to year-end, or be faced with recapture tax on the Year 1 sale and less equity available for the replacement purchase in Year 2. This would create a disincentive to engage in real estate and personal property transactions during the 4th quarter, resulting in tax-driven market distortions. Seasonal businesses benefit from exchanges in which assets are divested in late autumn and replaced in early spring, at the start of the new season, thereby eliminating off-season storage and debt-service expenses, without any negative tax consequences or cash-flow impairment. Like-kind exchanges take the government out of the decision-making process.

At its core, I.R.C. § 1031 is a powerful economic stimulator that is grounded in sound tax policy. The non-recognition provision is premised on the requirement that the taxpayer demonstrates continuity of investment in qualifying replacement property with no intervening receipt of cash. There is no profit-taking, and at the conclusion of the exchange the taxpayer is in the same tax position as if the relinquished asset was never sold.

Under current law, § 1031 promotes capital formation and liquidity. Two recent economic studies conclude that Section 1031 removes the tax lock-in effect, and permits taxpayers to make good business decisions without being impeded by negative tax consequences.[1] Like-kind exchanges stimulate economic activity—property improvements that benefit communities, increase property values, and generate jobs ancillary to the exchange transactions. These studies quantified that restricting or eliminating like-kind exchanges would result in a decline in GDP of up to $13.1 billion annually, reduce velocity in the economy and increase the cost of capital to taxpayers.[2] A Tax Foundation report estimated a larger economic loss, at approximately $18 billion per year.[3]

Immediate expensing does not remove the lock-in effect on a host of real estate owners. Land values represent approximately 30% of the value of commercial improved properties, and up to 100% of agricultural land investments. If these property owners are faced with reducing the value of their investments and life savings through capital gains tax, even with lower rates, they will likely hold onto these properties longer.

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[1] *Economic Impact of Repealing Like-Kind Exchange Rules,* Ernst & Young (March 2015, Revised November 2015) available at *http://www.1031taxreform.com/1031economics/;* and *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate,* David C. Ling and Milena Petrova (March 2015, revised June 22, 2015), available at *http://www.1031taxreform.com/ling-petrova/*.

[2] Ernst & Young LLP, *Economic Impact* at (v) and Ling and Petrova, *Economic Impact,* at 6.

[3] *Options for Reforming America's Tax Code,* Tax Foundation (2016), p. 79, available at *https://taxfoundation.org/options-reforming-americas-tax-code/*.

Retention of § 1031 in present form eliminates potential expensing abuse. The proposal to fully expense real estate improvements in the year of acquisition, with an unlimited carry forward, provides a tremendous incentive at acquisition for a taxpayer to inflate the value of improvements, so as to maximize the write-off. Conversely, upon sale, there is great incentive to minimize the value of the buildings and over-allocate value to the land, thus minimizing recapture tax on the improvements at ordinary income tax rates, and benefiting from lower capital gains tax rates on the land.

Appraising is not an exact science. There are different methodologies, and a considerable amount of subjectivity, particularly when there is a scarcity of market activity and relevant data upon which to rely. Given the multiple variables that can impact appraisals, land values, and structure values, appraisals can vary widely. A taxpayer with a clear incentive could easily game the system to maximize tax benefit and minimize taxes owed on disposition. Section 1031 eliminates this conflict and simply encourages reinvestment of the full value.

In summary, like-kind exchanges remove friction from business transactions and stimulate economic activity that would not otherwise benefit from the proposed *Blueprint.* Section 1031 facilitates opportunistic investment of capital and community improvement. Like-kind exchanges assist the recycling of real estate and other capital to its highest and best use in the market place thereby creating value and improving the economic conditions for local communities, rural and urban. Landowners and other businesses would be disadvantaged if they had neither the option of a tax deferred exchange nor expense deductions for land acquisition and interest on related debt.

Please feel free to contact any of us should you wish to discuss.

Sincerely,

STEPHEN CHACON, *President,* Federation of Exchange Accommodators; *Vice President,* Accruit, LLC.

SUZANNE GOLDSTEIN BAKER, *Co-Chair,* FEA Government Affairs Committee; *Executive Vice President & General Counsel* Investment Property Exchange Services, Inc.

BRENT ABRAHM, *Co-Chair,* FEA Government Affairs Committee; *President,* Accruit, LLC.

MAX A. HANSEN, *Co-Chair,* FEA Government Affairs Committee; *President,* American Equity Exchange, Inc.

APPENDIX

Examples of Agricultural and Conservation Exchanges

1. Combining Acres and/or Exchanging into Higher Grade Farms

Facts: A farmer owned two 80 acre tracts of farmland located 20 miles away from his home operation. Farmer's neighbor listed for sale a 160 acre, higher quality tract adjoining the farmer's "home farm." Through a like-kind exchange, the farmer was able to divest the two distantly located 80 acre parcels, acquire the neighboring 160 acre tract, and combine his land holdings into a larger farm of 360 contiguous acres.

Impact: The like-kind exchange allowed the farmer to exchange into the new farm without reducing his purchasing power, and provided him with the ability to combine his acres, increase operational efficiencies and add to the original family farm.

Conclusion: Section 1031 promotes reallocations of capital to higher quality assets and results in greater operational efficiencies.

2. Keeping the Farm/Ranch in the Family—The Beginning Farmer

Facts: A 65 year old Farmer owned an 80 acre farm that had been in the family for decades. When Farmer acquired the farm, land prices were much lower. Farmer's son was a beginning farmer, starting his operation. Through a like-kind exchange, Farmer sold the family farm to Son and acquired a larger, higher quality parcel located near another separate tract of farmland owned by Farmer.

Impact: The like-kind exchange allowed Farmer help his Son start his farming operation while passing the family farm on to the next generation. Farmer was able to sell the property to his son without being "tax locked" due to negative tax ramifications if gain had not been deferred.

Conclusion: Section 1031 encourages transitions of farmland assets to new and beginning farmers.

3. Keeping the Farm/Ranch in the Family—Sibling Acquisitions

Facts: Five siblings inherited an undivided ½ interest in two 600 acre tracts of ranchland (Tract A and Tract B) when their mother passed away in the 1990s, sub-

ject to a life estate with father. Father passed away in 2013 leaving the remaining undivided half to the siblings. All of the siblings were left with equivalent tax consequences in the event of a sale. Two of the siblings continued to raise cattle on the tracts while three lived in other parts of the country. The siblings decided to sell Tract A at auction with the winning bidder agreeing to lease Tract A to the rancher siblings. The three city siblings agreed to sell their interests in Tract B, the "home ranch" to their rancher brothers to keep it in the family. One of the city siblings cashed out of her interest and paid capital gains tax. The other two city siblings did like-kind exchanges into income producing properties in their cities of residence.

Impact: The like-kind exchange allowed the two rancher siblings to keep the "home ranch" in the family. At the same time Section 1031 incentivized the two city siblings to sell without fear of being "tax locked" and reinvest in assets where they live that more appropriately met their investment goals. Notwithstanding the opportunity to exchange, the third city sibling made the best decision for her, which was to liquidate the asset, pay the tax, and use the net proceeds for other purposes.

Conclusion: Section 1031 promotes and incentivizes transitions of farm and ranch assets to those who know and work the land for their livelihoods. Fifty-five percent of land in many states is owned by farmers and ranchers 65 year or older.

4. Diversification of Asset Type

Facts: Farmer built a 2,000 acre farmland asset base over the last 15 years with average values appreciating from $1,000 per acre to $8,000 per acre. With farmland values approaching all-time highs, farmer determined it was wise to diversify his portfolio and exchange into depressed commercial assets nearby. Farmer sold a portion of his farmland and exchanged into a storage unit facility, an apartment complex and a retail strip center.

Impact: Section 1031 allows for exchanges into any real property held for investment or used in a trade or business. Accordingly, farmer was able to exchange into a depressed commercial investment and hedge predicted downside risk to farmland asset values by exchanging into a more diverse real estate portfolio.

Conclusion: The like-kind exchange serves as a diversification and risk-hedging tool for all real property investors, including farmers and ranchers.

5. Relocating Farm/Ranch and Livestock Operations, Keeping Investment Dollars in the U.S.

Facts: An Amish couple owned 80 acres, a livestock operation and their homestead and were relocating to an Amish community in another state. The couple exchanged out of the land and buildings on their current farm into a comparably priced farm in the new community. Further, the couple exchanged their existing breeding stock into like-kind breeding stock on their new farm.

Impact: Section 1031 allowed the Amish couple to pursue their life plans and wholly continue their farming activities in their new community without diminishing their purchasing power or ability to earn a comparable living.

Conclusion: Like-kind exchanges enable property owners to relocate their investment assets to best suit their business and personal needs, without negative tax consequences. Section 1031 allows for exchanges of like-kind investment or business-use property. Domestic property cannot be exchanged for foreign property. Section 1031 promotes investment within the United States.

6. Improvements to the Farm/Cattle Operation

Facts: Farmer owned a 1,000 acre farm with a 500 head cattle feeding operation with buildings constructed in the 1970s. Farmer received an offer to sell the cattle feeding operation and surrounding 160 acres for $1,200,000. Farmer utilized an exchange accommodator to acquire a 160 acre tract worth $800,000, closer to his other land holdings, and construct a new cattle feeding operation, including buildings and grain storage, with a completed improvement value of $600,000. Upon completion of the improvements, the exchange accommodator transferred the $1,400,000 improved property and surrounding acres to farmer, completing the like-kind exchange.

Impact: Section 1031 allowed the farmer to exchange into land and newly constructed improvements so that he could continue farming operations in a modern and more efficient facility without eroding his investment through capital gains and recapture tax.

Conclusion: Like-kind exchanges provide maximum flexibility to taxpayers, and often result in increased capital investment. Construction of the new improvements created jobs and a stream of economic activity for machinery, equipment, and building component suppliers.

7. Conservation Conveyance—Watershed Improvement

Facts: Water quality issues have been going on for some time along the Mississippi River. Nutrient discharge from agricultural watersheds in Iowa and other states along the Mississippi watershed has resulted in a large dead zone in the Gulf of Mexico. This is a major concern for the EPA, USDA, state agencies and farm groups. The State of Iowa implemented a Nutrient Reduction Strategy to make improvements. In response to issues like this, the Iowa Department of Natural Resources (IDNR), the Natural Resources Conservation Service and other private and public organizations have implemented programs to acquire permanent conservation easements to take environmentally sensitive farm fields out of production, restore wetlands, install buffer strips, stabilize highly erodible acres and otherwise restore water quality to waterways in Iowa and other states that feed the Mississippi River.

Farmer owned 80 acres of environmentally sensitive converted wetlands that had been row cropped. A watershed improvement district purchased a permanent conservation easement from farmer whereby the land would be restored to wetlands toward the end goal of improving downstream water quality. Farmer used the sale proceeds to exchange into non-environmentally sensitive crop land.

Impact: Local concerns for drinking water, healthy fish and marine habitat, flooding impacts, and loss of recreational value are all downstream challenges that benefit from upstream solutions within watersheds. Section 1031 facilitated and promoted the farmer's participation in the conservation program and allowed an exchange into less environmentally sensitive acres, all while preserving his asset and earning base.

Conclusion: Like-kind exchanges incentivize participation in conservation programs designed to improve water quality, reduce soil erosion and bolster wildlife habitat.

8. Conservation Easement—Grazing Association and Public Recreational Benefit

Facts: A western grazing association, organized as a C corporation, could utilize additional land to enhance its operations. However, the dozen+ individual members lacked sufficient acquisition capital and did not want to encumber the association's assets or their own assets with additional debt. The USDA Natural Resources Conservation Service (NRCS) had monies available under a Grasslands Reserve Program to preserve real property in the area for wildlife, fisheries, public access, *etc.* The association conveyed a permanent conservation easement to the NRCS and used the proceeds to exchange into a number of adjacent properties that enhanced the grazing operations of the association and its members.

Impact: The members would not have undertaken this transaction if it had triggered a double taxable event to them and the association. In addition to the benefits to the association, the government and the general public now enjoy permanent access to portions of association property for fishing, hunting and other recreational pursuits that they would not have had, but for the easement and Section 1031.

Conclusion: Like-kind exchanges make the economics work to encourage participation in conservation programs that preserve our environment and create recreational spaces that benefit all Americans.

9. Upgrading Agricultural Equipment

Facts: Farmer acquired additional acres necessitating the purchase of a larger combine valued at $550,000. Farmer traded in his fully depreciated combine and was given a $250,000 trade-in credit toward the purchase.

Impact: A trade-in is a simultaneous like-kind exchange that enabled the farmer to upgrade his equipment without penalty or any reduction in purchasing power. Without a § 1031 tax deferral, the farmer's net (after tax) capital available for reinvestment into the replacement combine would have been reduced by up to $100,000 (assuming a combined Federal/state tax rate of 40% applied against the $250,000 sale price of the fully depreciated equipment).

Note that the $250,000 recapture gain (attributable to the trade-in credit) is rolled into the new combine, and cannot be depreciated. Under present MACRS depreciation rules, the replacement equipment's remaining $300,000 taxable basis would be depreciated over 7 years. Like-kind exchanges are essentially revenue neutral over the tax life of depreciable assets because the gain deferred is directly offset by a reduction in future depreciation deductions available for assets acquired through an exchange. Nevertheless, the taxpayer benefits from spreading out depreciation and softening the impact of recapture.

Conclusion: Like-kind exchanges of agricultural equipment encourage investment by farmers and ranchers in new assets that are more technologically advanced, efficient or better suited to their operations.

SUBMITTED LETTER BY ROGER JOHNSON, PRESIDENT, NATIONAL FARMERS UNION

April 5, 2017

Hon. K. MICHAEL CONAWAY,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture,
Washington, D.C.

Dear Chairman Conaway and Ranking Member Peterson:

Thank you for holding today's hearing entitled, *Agriculture and Tax Reform: Opportunities for Rural America.* As you are well aware, the farm economy is continuing to struggle as a result of low commodity prices, record harvests, and a strong U.S. dollar. Forecasts indicate that low prices will persist. In light of such challenges, National Farmers Union (NFU) believes we must pro[cee]d cautiously regarding changes that could sink an already fragile economy deeper into instability.

Like so many other organizations, NFU believes that tax reform is a necessary task for this Congress because the Tax Code has become far too complex and burdensome. NFU supports a simplified Tax Code and a more progressive tax structure.

Our members support increases to the dollar value of the gift tax to $25,000. We also support a range of tax credits including bonus depreciation, section 179, the investment and production tax credit, interest deductions, charitable deductions and the use of stepped-up basis. Our members are supportive of holding companies accountable for their full tax liabilities, especially those that use avoidance measures such as inversions, off-shoring, and highly aggressive accounting provisions.

NFU would like to distance itself from the stated position taken last week by a coalition of agricultural groups calling for the elimination of the estate tax. NFU supports increasing the estate tax limit to $10 and $20 million for individuals and couples respectively. However, the elimination of the tax altogether poses significant problems. The revenue it raises, an estimated $300 million over 10 years, would no longer flow to the treasury, even as our nation continues to face significant deficits.

The number of operations impacted by the estate tax is grossly overstated. The number of operations impacted varies from year to year, but it certainly falls below less than one percent. According to USDA, using simulations based on farm-level data from the *Agricultural Resource Management Survey* in 2014, for the 2015 tax year, it was estimated that only three percent of farm estates would be required to file an estate tax return, with about 0.8 percent owing any Federal estate tax. It is important for the Committee to remember that this data came at the height of farm values. Given the current economy, we can expect the number of farms impacted to be even lower.

Agriculture enjoys significant flexibility under the estate tax. Special use valuation, stepped-up basis, and a variety of other tools can be utilized to minimize tax liability. In fact, special use exemptions can total over a million dollars per individual and additional deductions from farm assets can send the exemptions even higher. Furthermore, the Tax Policy Center estimates, those who are required to pay the tax usually pay an average of roughly five percent, well below the 40 percent figure in statute. Abolishing the estate tax would ensure the accumulation of dynastic level wealth. Such a concept flies in the face of the very bedrock of our nation's founding.

NFU is also concerned over the current tax reform proposals being advanced in the House of Representatives. The *Blueprint,* released during the previous Congress by Chairman Brady, has a number of concerning components. While we understand that the border adjustment tax is a necessary revenue component of the plan, we are concerned over both the novelty of the approach and the negative impact it could have on agricultural trade.

The tax would likely result in appreciation of the value of the dollar, making American goods, ag exports in particular, less competitive in the international market. This could drive up already high grain stocks and reduce prices paid to producers. A significant portion of the U.S. manufacturing base imports raw materials from outside the U.S. Since there would be a 20 percent tax on these raw materials, the costs of finished products would also increase. Such goods could include tractors and other farm machinery and could easily extend to products like fertilizer, chemicals and petroleum products.

Since the tax favors domestic products over imported products, it is widely expected that such a tax would be challenged through the World Trade Organization (WTO) and also invite international retaliation, for which producers are particularly

vulnerable. Last, the tax, indirectly a subsidy to exports in the form of a negative tax, would not directly benefit agricultural producers, since it is rarely the farmers doing the exporting. Many agricultural exporters also would not have sufficient non-export related taxable income to receive much benefit from the adjustment tax.

While NFU members appreciate the goal of lower rates under the *Blueprint,* we believe the proposal would end up increasing effective rates for producers. The *Blueprint* makes significant changes in the tax framework that would have negative impacts on businesses that carry significant debt loads. These provisions would especially hurt beginning farmers and ranchers. The immediate write-off of all investments does little good for producers who already utilize section 179, currently capped at $500,000. Unlimited expensing has little value to most farmers.

The removal of net interest expensing from the Tax Code would have a significant negative impact on producers today, but also even more so in the future if interest rates increase as expected. Removing the carryback allowance for net operating losses would also have negative impacts on producers. While unlimited carry forward would be meaningful under the *Blueprint,* it does not offset the negatives of eliminating carryback. Overall, itemizers fare worse under the *Blueprint.*

NFU recognizes the challenging task tax reform represents. We appreciate that the House Ways and Means Committee is working to carry out needed reforms. Our members stand in opposition to this plan. As your Committee examines the impact of reform, we hope you will work to remedy the problems identified above. We greatly appreciate your attention in this matter.

Sincerely,



ROGER JOHNSON,
President, National Farmers Union.

SUBMITTED LETTER BY LIKE-KIND EXCHANGE STAKEHOLDER COALITION

April 7, 2017

Hon. K. MICHAEL CONAWAY,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture,
Washington, D.C.

Dear Chairman Conaway and Ranking Member Peterson:

In connection with the House Agriculture Committee's recent hearing on *Agriculture and Tax Reform: Opportunities for Rural America,* we are submitting as a statement for the record the attached letter urging you to preserve the current availability of like-kind exchange treatment as part of any business tax reform. Thank you for your consideration and your leadership on these important issues.

Sincerely,

The Like-Kind Exchange Stakeholder Coalition.

ATTACHMENT

November 29, 2016

JIM CARTER,
Tax Policy Lead,
Presidential Transition,
Washington, D.C.

Dear Mr. Carter:

As you consider ways to create jobs, grow the economy, and raise wages through tax reform, we strongly urge that current law be retained regarding like-kind exchanges under section 1031 of the Internal Revenue Code ("Code"). We further encourage retention of the current unlimited amount of gain deferral.

Like-kind exchanges are integral to the efficient operation and ongoing vitality of thousands of American businesses, which in turn strengthen the U.S. economy and create jobs. Like-kind exchanges allow taxpayers to exchange their property for more productive like-kind property, to diversify or consolidate holdings, and to transition to meet changing business needs. Specifically, section 1031 provides that tax-

payers do not immediately recognize a gain or loss when they exchange assets for "like-kind" property that will be used in their trade or business. They do immediately recognize gain, however, to the extent that cash or other "boot" is received. Importantly, like-kind exchanges are similar to other non-recognition and tax deferral provisions in the Code because they result in no change to the economic position of the taxpayer.

Since 1921, like-kind exchanges have encouraged capital investment in the U.S. by allowing funds to be reinvested back into the enterprise, which is the very reason section 1031 was enacted in the first place. This continuity of investment not only benefits the companies making the like-kind exchanges, but also suppliers, manufacturers, and others facilitating them. Like-kind exchanges ensure both the best use of real estate and a new and used personal property market that significantly benefits start-ups and small businesses. Eliminating like-kind exchanges or restricting their use would have a contraction effect on our economy by increasing the cost of capital, slowing the rate of investment, increasing asset holding periods and reducing transactional activity.

A 2015 macroeconomic analysis by Ernst & Young found that either repeal or limitation of like-kind exchanges could lead to a decline in U.S. GDP of up to $13.1 billion annually.[1] The Ernst & Young study quantified the benefit of like-kind exchanges to the U.S. economy by recognizing that the exchange transaction is a catalyst for a broad stream of economic activity involving businesses and service providers that are ancillary to the exchange transaction, such as brokers, appraisers, insurers, lenders, contractors, manufacturers, *etc.* A 2016 report by the Tax Foundation estimated even greater economic contraction—a loss of 0.10% of GDP, equivalent to $18 billion annually.[2]

Companies in a wide range of industries, business structures, and sizes rely on the like-kind exchange provision of the Code. These businesses—which include real estate, construction, agricultural, transportation, farm/heavy equipment/vehicle rental, leasing and manufacturing—provide essential products and services to U.S. consumers and are an integral part of our economy.

A microeconomic study by researchers at the University of Florida and Syracuse University, focused on commercial real estate, supports that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and other capital investments.[3] The immediate recognition of a gain upon the disposition of property being replaced would impair cash-flow and could make it uneconomical to replace that asset. This study further found that taxpayers engaged in a like-kind exchange make significantly greater investments in replacement property than non-exchanging buyers.

Both studies support that jobs are created through the greater investment, capital expenditures and transactional velocity that are associated with exchange properties. A $1 million limitation of gain deferral per year, as proposed by the Administration,[4] would be particularly harmful to the economic stream generated by like-kind exchanges of commercial real estate, agricultural land, and vehicle/equipment leasing. These properties and businesses generate substantial gains due to the size and value of the properties or the volume of depreciated assets that are exchanged. A limitation on deferral would have the same negative impacts as repeal of section 1031 on these larger exchanges. Transfers of large shopping centers, office complexes, multifamily properties or hotel properties generate economic activity and taxable revenue for architects, brokers, leasing agents, contractors, decorators, suppliers, attorneys, accountants, title and property/casualty insurers, marketing agents, appraisers, surveyors, lenders, exchange facilitators and more. Similarly, high volume equipment rental and leasing provides jobs for rental and leasing agents, dealers, manufacturers, after-market outfitters, banks, servicing agents, and

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[1] *Economic Impact of Repealing Like-Kind Exchange Rules,* ERNST & YOUNG (March 2015, Revised November 2015), at (iii), available at *http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf*.

[2] *Options for Reforming America's Tax Code,* Tax Foundation (June 2016) at p. 79, available at *http://taxfoundation.org/article/options-reforming-americas-tax-code*.

[3] David Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate* (March 2015, revised June 2015), at 5, available at *http://www.1031taxreform.com/wpcontent/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf*.

[4] *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals,* at 107, available at *https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf*.

provides inventories of affordable used assets for small businesses and taxpayers of modest means. Turnover of assets is key to all of this economic activity.

In summary, there is strong economic rationale, supported by recent analytical research, for the like-kind exchange provision's nearly 100 year existence in the Code. Limitation or repeal of section 1031 would deter and, in many cases, prohibit continued and new real estate and capital investment. These adverse effects on the U.S. economy would likely not be offset by lower tax rates. Finally, like-kind exchanges promote uniformly agreed upon tax reform goals such as economic growth, job creation and increased competitiveness.

Thank you for your consideration of this important matter.

Sincerely,

Air Conditioning Contractors of America;
American Car Rental Association;
American Rental Association;
American Seniors Housing Association;
American Truck Dealers;
American Trucking Associations;
Associated Equipment Distributors;
Associated General Contractors of America;
Avis Budget Group, Inc.;
Building Owners and Managers Association (BOMA) International;
C.R. England, Inc.;
Equipment Leasing and Finance Association;
Federation of Exchange Accommodators;
International Council of Shopping Centers;
NAIOP, the Commercial Real Estate Development Association;
National Apartment Association;
National Association of Home Builders;
National Association of Real Estate Investment Trusts;
National Association of REALTORS®;
National Automobile Dealers Association;
National Business Aviation Association;
National Multifamily Housing Council;
National Ready Mixed Concrete Association;
National Stone, Sand and Gravel Association;
Truck Renting and Leasing Association.

SUBMITTED STATEMENT BY NEIL E. HARL, PH.D., CHARLES F. CURTISS DISTINGUISHED PROFESSOR AND PROFESSOR EMERITUS OF ECONOMICS, DEPARTMENT OF ECONOMICS, IOWA STATE UNIVERSITY

First, I want to thank you, The House of Representatives Agriculture Committee, for the opportunity to provide some ideas on taxation and tax policy. My apologies for not being able to be present in Washington on March 15. My wife, Darlene, is suffering from a neurological malady that no one seems to be able to diagnose but her condition requires 24-hour care and I am the caregiver. In all of the years I have been asked to testify before Congressional Committees, this is the first occasion in which I could not be present.

I am convinced that we are facing perhaps the most important issues in the agricultural sector in recent times, at least comparing it to the past half century, perhaps the most important since the 1930's. I am reluctant to share my age but I can recall well the discussions in 1936, growing up on a rented farm in Iowa.

The political, economic and social problems we face today are daunting. I have selected seven areas for commentary.

A Rational Fiscal and Monetary Policy

Although fiscal and monetary policy does not embrace all of taxation, the policies of the 1970s demonstrated how disruptive an irrational fiscal and monetary policy can be to the agricultural sector. In Chapter 10 of my book, *The Farm Debt Crisis of the 1980s,* I list the 12 lessons we should have learned from that traumatic decade. My hope would be that we not ignore the lessons learned as we launch what may be a period of great change in economic and tax policies as well as fiscal and monetary policies. In many ways, this area of governmental involvement may be the linchpin of planning for an economically healthy agricultural sector or a time of experimentation with uncertain outcomes.

Federal Estate Tax Policy

Over the past half century, the Congress has attempted, unsuccessfully it turned out, to eliminate the Federal estate tax. The efforts in 1976 and again in 2001 were rejected (in 1980 for the 1976 attempt and 2010 for the 2001 move) although the support for repeal of the Federal estate tax has continued. In my opinion, it would be a great mistake to repeal the tax.

First, it is widely stated that the Federal estate tax is an obstacle for farming and ranching operations. I disagree. As I have been quoted fairly widely, in 50 some years of working in this area of taxation I have never seen a farm or ranch operation that had to be sold to pay Federal estate tax. The latest quote was several days ago in the *London Financial Times.*

At present, 2017, a decedent is allowed to pass $5,490,000 in property value without triggering Federal estate tax and the spouse is allowed the same amount for a total of $10,980,000. That figure is inflation adjusted. Even if the spouse without that much property dies first, the surviving spouse under the concept of "portability" can utilize the remaining allowance of the deceased spouse. Moreover, since 1976 eligible property meeting the requirements for "special valuation" is eligible for an additional amount (currently $1,120,000) which is also inflation adjusted. That pro-

vision requires that the farm remain in the family for 10 years at least and be under a share rent lease or be an operating farm or ranch.

The IRS data, published annually, do not provide data for decedents dying owning some farm property who were actively farming but it is clear that those dying whose estates reported some farm property are mostly in the upper categories of size of estate. It appears to be clear that only a small percentage of estates for active farmers (less than one percent) actually pay Federal estate tax.

However, many publications, including farm publications, report that farmers and ranchers support repeal. In reality, farmers and ranchers are being "used" to support repeal for the upper echelons of estates because of the higher standing, publicly, of farmers and ranchers compared with multi-billionaires. This aspect of the matter was discussed widely in several publications including *The London Financial Times* in recent weeks.

There is another dimension to the Federal estate tax issue. The unsuccessful efforts to repeal the Federal estate tax in recent years have, rather quietly, admitted that part of the strategy is to pay for the repeal, in part at least, from reducing or eliminating the new income tax basis at death. For many years, most assets held at death have received a new income tax basis equal to the fair market value at death. To the extent that occurs, the gain in the eligible assets takes on an income tax basis equal to the fair market value at death. This feature of tax policy means that virtually all farm and ranch estates end up with no gain on their assets. This is enormously important *and benefits virtually every decedent and the heirs.* Thus, the irony is that while nearly all deceased farmers and ranchers do not pay Federal estate tax, they would all lose to the extent the "new basis at death" is lost. That feature of tax policy seems to lack understanding. Another aspect of the loss of "new basis at death" is that over time, with assets at death not getting a new basis, the transferability becomes increasingly limited with the heirs unwilling to pick up the income tax if and when the assets are sold. The result, without much doubt, is expected to be that economic growth would be reduced. For that reason, it is my belief, held strongly, that it is in the public interest for—(1) the "new basis at death" to be continued for public policy reasons and (2) an incentive is provided for heirs to transfer assets "to the highest and best use" which encourages economic growth over time.

Finally, the Federal estate tax, admittedly, produces a modest revenue stream but it is significant and a way for very wealthy decedents to contribute to the public good.

Post Death Discrimination Against Farm Assets

For more than 40 years, an Internal Revenue ruling (Rev. Rul. 75–361, 1975–2 C.B. 344), has discriminated against livestock classified as trade or business livestock sold after death. The key statute (I.R.C. § 1223(9)) refers to the period to be eligible for long-term capital gain in the period after death as referring to property held for ". . . more than one year." As is widely known the statute is referring to property used in a trade or business, and thus eligible for long-term capital gain and ordinary loss treatment. That period is 24 months or more for cattle and horses and, for other livestock, 12 months or more. I.R.C. § 1231(b)(3). That rules out the special treatment assuring long-term capital gain treatment for the first 12 months (or 24 months) for the animals sold after death.

IRS published Rev. Rul. 75–361, 1975–2 C.B. 344, making that very point and confirming the different treatment for trade or business livestock. The facts of that ruling were that cattle and other livestock acquired from the estate produce ordinary income on sale. The ruling points out that no exception was ever made in the statute for livestock used in a trade or business with specified holding periods of 12 or 24 months. For animals not held for draft dairy, breeding or sporting purposes, the animals have a one year holding period as a capital asset rather than a "trade or business" asset and would come within the statutory rule of an automatic more-than-one-year holding period at death.

It seems inequitable for the trade or business livestock to be treated less favorably than livestock categorized as capital assets (such as held for entertainment, research or other non-business use) which come within the automatic "more-than-one-year" holding period at death.

Mergers and Acquisitions

From a policy perspective, we need to go back to the basics of antitrust, to a period more than a century ago, when the country was expressing concern about anti-competitive practices in steel, oil, rail transportation and even in agriculture. Indeed, the 1888 report to the United States Senate on anti-competitive practices con-

tributed significantly to enactment of the Sherman Antitrust Act of 1890, often referred to as the "charter of economic freedom."

In a nutshell, the three most important features of a market-oriented economy, are competition, competition and competition. We have seen the growth of rivalry in some markets but rivalry is not competition. The most critical aspects of our price and market-oriented economy are free, open and competitive markets.

In this country, in recent years, the emphasis has been on protecting the consumer. If a merger did not adversely affect consumers, the problem received little attention. I argued in a teleconference about a decade or more ago with Department of Justice lawyers and economists, about the shortcomings of that internal policy, urging a parallel emphasis on the impact of potentially competitive practices on *producers*. I got nowhere with that argument. Quite obviously, farming has so many participants that no single farmer (or rancher) can affect price with their output decisions. If one of the objectives is to foster and encourage a sector of independent entrepreneurs, rather than serfs, it is important to look at the impact on producers.

In recent years, my areas of principal concerns have been centered in six areas—(1) meat packing, including captive supplies, by highly concentrated meat packers; (2) seeds and chemicals; (3) grain handling and shipping; (4) farm equipment manufacturing; (5) fertilizer production and distribution; and (6) food retailing. However, my greatest concern in recent years has been the breathtaking increase in concentration (and influence over competitors) in the areas of seeds and chemicals. One of the major concerns has been the absence of generics at the expiration of patents (which now dominate the seed business). The patent system represents a willingness of the American people to accept a monopoly position over new and novel developments for a limited term *but not forever*.

In my view when the combined market shares reach 50 percent, a merger or acquisition should be deemed out of the question. This is a long-term issue and one of the more important in our portfolio.

The "Small Partnership" Exception

In my opinion, one of the key issues in the taxation arena is whether we are capable of simplifying the tax system. In 1967, I was asked to join a small group which was convened by the Department of the Treasury to advise the Department of how to address "tax sheltering" which was sweeping the agricultural sector. The lure of investment tax credit, fast depreciation and other more subtle practices were coming to influence economic practices, especially in livestock. Our group made several recommendations which were mostly enacted in 1969, 1976, 1981 and 1986. However, the tax committees (and IRS) in the 1970s reached the conclusion that the villain was partnerships, principally limited partnerships. Those organizational structures were present in many of the tax shelters. The outcome was that Congress became convinced that it was necessary to "get tough" with partnership taxation and weed out the unacceptable behaviors. However, a group of Senators and Members of the House of Representatives concluded that the "get tough" policy with partnerships would make life very difficult for small partnerships. That group convinced the Congress to accept an amendment to simplify tax filing for small businesses.

The amendment passed and was part of the Tax Equity and Fiscal Responsibility Act of 1982. The nine-line amendment stated, in I.R.C. § 6231(a)(1)(B)(i)—

> "The term 'partnership' shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner."

Essentially, it meant that a "small partnership" did not have to file a Form 1065 and the income, losses and credits simply flowed through to the taxpayers' Form 1040s. Moreover, the resulting entity avoided the highly complicated restrictions imposed on regular partnerships. It turned out that it was undoubtedly the most significant tax simplification move in decades.

Over the years, I covered the subject in what eventually became my 669 page seminar manual in about 3,400 seminars. I detected rumblings of resistance among some practitioners, mainly CPAs, often citing that it adversely affected "their bottom line." My response often was "a professional in practice should focus attention on what is in the best interests of the client, not on what is in the best interests of the practitioner."

However, a group of unhappy tax practitioners—principally in the Pacific Northwest and Midwest-managed to convince a Member of the House of Representatives to push through an amendment to the Bipartisan Budget Act of 2015, carefully camouflaged, repealing the "small partnership" exception effective after December 31, 2017. There were no hearings, no warnings of what was being plotted and no hint

of the fact that it would eliminate the most significant tax simplification move in decades.

The Joint Committee on Taxation proved to be the barrier to getting the 2015 amendment eliminated. The staff insisted all last year that "there is no such thing as a small partnership." We set out to prove that there was such a thing with an article in *Tax Notes,* page 1015 of the August 15, 2016 issue; the fact that IRS has embraced the small partnership with IRS Publication 541, January 2016, which details the opportunities to make use of the "small partnership" exception, at page 13; by publishing Revenue Procedure 1984–35, 1984–1 C.B. 509; by reproducing the content of that Revenue Procedure in the I.R. Manual, I.R.M. 20.1.2.3.3.1, and by litigating in more than 20 cases involving various issues with the "small partnership."

It is our belief that if the "small partnership" is reinstated, it will become the dominant entity for eligible small partnerships. Reinstatement would not affect Federal revenues (the tax rates are the same to file a Form 1040 with the information as to file a complex Form 1065). At a time when many farm and ranch operations are struggling financially because of the low market prices for many of the commodities, the savings would be welcomed. The going rate for filing a complete Form 1065 varies but runs in the vicinity of $2,000 to $2,500 or more.

What about a "flat tax"?

The idea of a "flat tax" has been around for nearly 30 years. A colleague and I wrote an article evaluating that possibility. Our conclusions were that the revenue would fall well short of the revenue needed to maintain programs at the level the public has been accustomed, it would impose a heavy tax burden on lower tax bracket taxpayers and it would distort economic decision making with full deductibility of expenditures, at least for many investments. Our conclusion was that the idea did not deserve serious attention.

Repealing the Rule Against Perpetuities

Finally . . . a word or two about an ancient concept (that is, it is ancient to many of us) that had its origins in the Duke of Norfolk's Case in the late 17th Century in England. The case involved disagreements among the heirs of the Duke of Norfolk over the propriety of leaving property in successive life estates. The court agreed that it was wrong to tie up property beyond the lives of persons living at the time the property was last conveyed, although the exact time beyond which conveyances were nullified was not determined until roughly 150 years later. As a practical matter, the Rule (as it is known) places limits on how long property can be held in trust. Stated simply, property generally could not be held in trust beyond the lifetimes of a designated class of individuals plus 21 more years. As a practical matter, the Rule allows property ownership to be tied up for 100 to 125 years

Until about 40 years ago, each of the states in this country had enacted language embodying the Rule. After South Dakota, under the leadership of their then Governor Janklow broke ranks and repealed the Rule in that state, 30 more states have acted to repeal or modify the Rule. However, 19 states have held out with those states believing that it is not in the public interest to eliminate the Rule and allow property ownership to be tied up forever.

Professor Lewis Simes, a well-known legal scholar articulated two reasons for the Rule in contemporary society—(1) first, the Rule strikes a fair balance between the desires of the present generation, and similar desires of succeeding generations, to do what they wish with the property which they enjoy; and (2) a second and even more important reason for the Rule is that it is socially desirable that the wealth of the world be controlled by its living members and not by the dead. To those two I have added a third—it is an article of faith that economic growth is maximized if resources at our disposal are subject to the forces and pressures of the market. Prices emanating from free, open and competitive markets are the best way to allocate resources and distribute income.

However, it is a bit sobering to envision a world economy in a couple of hundred years where the ownership of property is held by a bunch of trusts physically located half a world away with those not benefitting from ancestors who left property in trust forever unable to acquire land to farm, houses in which to live or real estate for other ventures except as tenants.

Fortunately, my wife and I live in a state that has three times since 1999 voted to retain the Rule. In my view, our generation inherited the best economic system and the best legal system in the world. To repeal the Rule would be a step backward. The Administration in 2011 took steps to place a limit on how long property can be held in trust. We would be wise to review carefully whether that limit should be imposed nationally.

Thank you!

NEIL E. HARL.

SUBMITTED STATEMENT BY DAVE TENNY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ALLIANCE OF FOREST OWNERS

I'd like to take this opportunity to mention the critical role that private working forests play in our rural economies. Many rural communities are located in heavily forested states where the forest products sector suffered historic economic setbacks during the Great Recession. In these communities forestry and forest products manufacturing have historically been a primary source of good paying family-waged jobs that provide lumber, paper, packaging, energy and more than 5,000 other economically valuable products.

The economic importance of these forests is evident from the 2.4 million domestic jobs supported and $280 billion in value generated across a supply chain that includes foresters, loggers, truckers, mill workers, equipment suppliers, service providers, and many others. Most working forests—over seventy percent nationally—are privately owned by families, small and large businesses and an increasingly broad array of Americans who invest in forest ownership through investment vehicles such as pension and mutual funds. The economic value derived from working forests is directly connected to a 50% increase in overall tree volume domestically over the past 60 years—because markets for forest products provide an incentive to keep working forests as forests. In turn, increased volume in forest products has enabled the United States to meet much of our domestic demand for wood products.

The economic growth and opportunity fostered by private working forests is rooted in tax policies that recognize the unique, capital-intensive, long-term nature of timberland stewardship. These tax policies encourage sound management practices and investments that keep forestlands and the economy they support productive for generations to come. By ensuring tax reform recognizes the policies that make working forests strong, we secure a bright future for the rural families, individuals, and communities that rely on them.

Timber is an attractive investment opportunity featuring a non-volatile asset, a hedge against inflation, and access to significant long-term yield. Unlike stocks, investments in forests provide unique built-in, biologic growth that is immune from market volatility. That is one reason why public and private pension funds maintain sizable investments in timberlands through timberland investment management organizations (TIMOs) and publicly traded timberland real estate investment trusts (REITs). Working forests are a part of most Americans' retirement portfolios.

We urge Congress to recognize the long-term capital investments and risks associated with forest ownership and management by ensuring the Federal Tax Code continues to encourage long-term investment in private forests. Provisions that ensure the continued capital gains treatment of timber revenue, the deductibility of timber growing and reforestation costs, and the treatment of timberland as real property are critical to the health of working forests and rural communities.

SUBMITTED JOINT LETTER BY AMERICAN FARM BUREAU FEDERATION

March 29, 2017

Hon. KEVIN BRADY,
Chairman,
House Committee on Ways and Means,
Washington, D.C.;

Hon. RICHARD NEAL,
Ranking Minority Member,
House Committee on Ways and Means,
Washington, D.C.

Dear Chairman Brady and Ranking Member Neal:

On behalf of our nation's family farmers and ranchers, we come together now to ask your support for including permanent repeal of the estate tax in any tax reform legislation moving through Congress this year. In addition, we ask your help to make sure that the benefits of repeal are not eroded by the elimination of or restrictions to the use of the stepped-up basis.

Family farmers and ranchers are not only the caretakers of our nation's rural lands but they are also small businesses. The estate tax is especially damaging to

agriculture because we are a land-based, capital-intensive industry with few options for paying estate taxes when they come due. Unfortunately, all too often at the time of death, farming and ranching families are forced to sell off land, farm equipment, parts of the operation or take out loans to pay off tax liabilities and attorney's fees.

As you know, the American Taxpayer Relief Act of 2012 (ATRA) permanently extended the estate tax exemption level to $5 million per person/$10 million per couple indexed for inflation, and maintained stepped up basis. While we are grateful for the relief provided by the ATRA, the current state of our economy, combined with the uncertain nature of our business has left many agricultural producers guessing about their ability to plan for estate tax liabilities and unable to make prudent business decisions. Until the estate tax is fully repealed it will continue to threaten the economic viability of family farms and ranches, as well as the rural communities and businesses that agriculture supports.

In addition to full repeal of the estate tax, we believe it is equally as important for Congress to preserve policies which help keep farm businesses intact and families in agriculture. As such, tax reform must maintain stepped-up basis, which limits the amount of property value appreciation that is subject to capital gains taxes if the inherited assets are sold. Because farmland typically is held by one owner for several decades, setting the basis on the value of the farm on the date of the owner's death under stepped-up basis is an important tax provision for surviving family members.

U.S. farmers and ranchers understand and appreciate the role of taxes in maintaining and improving our nation; however, the most effective Tax Code is a fair one. For this reason, we respectfully request that any tax reform legislation considered in Congress will strengthen the business climate for farm and ranch families while ensuring agricultural businesses can be passed to future generations.

Thank you for your continued efforts in support of our nation's agricultural producers. We look forward to working with you on this very important issue.

Respectfully,

Agricultural & Food Transporters Conference
Agricultural Retailers Association
American Farm Bureau Federation
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
Livestock Marketing Association
National Association of State Departments of Agriculture
National Barley Growers Association
National Cattlemen's Beef Association
National Cotton Council
National Council of Farmer Cooperatives
National Milk Producers Federation
National Peach Council
National Pork Producers Council
National Potato Council
National Renderers Association
National Sorghum Producers
National Turkey Federation
Panhandle Peanut Growers Association
South East Dairy Farmers Association
Southwest Council of Agribusiness
U.S. Apple Association
U.S. Canola Association
U.S. Rice Producers Association
U.S. Sweet Potato Council
United Egg Producers
United Fresh Produce Association
USA Rice Federation
Western Growers
Western Peanut Growers Association
Western United Dairymen

SUBMITTED STATEMENT BY AMERICAN FOREST FOUNDATION

Federal tax policy can have a significant impact on the nation's forests and rural economies. Most of America's forests are owned privately, not by government or big corporations. The 22 million family forest owners accounting for nearly 282 million acres of forestland rely on their ability to invest in their land, finance the stewardship that's needed, and afford the taxes, in order to keep the land as a forest. These family woodlands are not only important for the clean water and air, wildlife habitat, and recreational opportunities—they support more than 2.4 million jobs in rural America. These lands supply a majority of the wood consumed in forest products manufacturing too.

Currently—there are a number of tax provisions that are important to family woodland owners:

- **Capital Gains Treatment of Timber Income:** When landowners harvest timber, a long-term investment often requiring decades of expense with returns maybe once a generation, they are currently allowed to treat this income as a capital gain, just like other long-term investments.
- **Forest Management and Reforestation[:]** Currently landowners can deduct forest management and reforestation expenses, such as installing a fire break to reduce wildfire risk, installing culverts in forest roads to protect streams, paying property taxes, or replanting trees after harvest. This helps landowners afford these good land management practices that ultimately help the economy and the environment.
- **Estate Tax:** This can impact whether a landowner is able to pass their land on in their family and can also force premature or unsustainable timber harvesting.

- **Conservation Easement Tax Deductions:** Donors of qualified conservation easement can take a tax deduction that ultimately helps keep working lands intact.

These tax provisions are what help landowners continue to invest in forests and afford the good stewardship that's necessary. We understand that the tax reform discussion is about streamlining and reducing complicated tax provisions. Family woodland owners fully support this. However, we do ask that the unique nature of forestry be taken into account in these deliberations and that the Tax Code reflect this—ensuring that landowners just like any long-term investor, can treat their timber as a capital gain and ensuring landowners can deduct (or expense) their business/land management related expenses, including property taxes—so they aren't taxed twice.

SUBMITTED STATEMENT BY NATIONAL COUNCIL OF FARMER COOPERATIVES

Mr. Chairman, Ranking Member Peterson, and Members of the Committee, the National Council of Farmer Cooperatives (NCFC) appreciates the opportunity to submit testimony for the record as part of the House Agriculture Committee's hearing on agriculture and tax reform.

NCFC represents the interests of America's farmer-owned cooperatives. With nearly 3,000 farmer cooperatives across the United States, the majority of our nation's more than two million farmers and ranchers belong to one or more farmer coops. NCFC members also include twenty-one state and regional councils of cooperatives.

Farmer-owned cooperatives are central to America's abundant, safe, and affordable food, feed, fiber, and fuel supply. Through cooperatives, farmers can better manage risk, strengthen bargaining power, and improve their income from the marketplace, allowing individual producers to compete globally in a way that would be impossible to replicate as individual producers. In short, cooperatives share the financial value they create with their farmer-owners.

By pooling the buying power of hundreds or thousands of individual producers, farmer cooperatives are able to supply their members—at a competitive price—with nearly every input necessary to run a successful farming operation, including access to a dependable source of credit. Furthermore, farmer cooperative members can capitalize on new marketplace opportunities, including value-added processing to meet changing consumer demand. Cooperatives also create and sustain quality jobs, businesses, and consumer spending in their local communities.

NCFC supports pro-growth tax reform and wants to work with Congress to achieve this result. However, certain aspects of tax reform must be coordinated with the special circumstances of agriculture in general and cooperatives in particular. We applaud the Committee's invitation to provide a forum for these important issues.

Farmer cooperatives calculate their taxable income under Subchapter T of the Internal Revenue Code. Under Subchapter T, earnings from business conducted with or for a cooperative's members are subject to single tax treatment as income of farmer members, provided the cooperative pays or allocates the earnings to its members. If the earnings are used to support the cooperative's capital funding or other needs, the earnings are taxed at regular corporate rates when retained and taxed a second time when distributed to the farmer members. Additionally, earnings from sources other than business with or for the cooperative's members are taxed at corporate rates. This method of taxation has been in use for nearly a century and was codified more than 50 years ago. NCFC supports the continuation of Subchapter T and related regulations.

The House GOP *Blueprint* would reduce the top individual marginal rate from 39.6 percent to 33 percent, and it would reduce the top pass-through rate to 25 percent on non-wage income. For cooperatives to thrive, the *Blueprint* should provide that patronage distributions from cooperatives are subject to the 25 percent maximum pass-through rate. Currently, patronage distributions are subject to individual tax rates, which max out at 39.6 percent. This is the same rate that currently applies to pass-through income from partnerships, limited liability companies and S corporations. If the 25 percent rate is applied to income from these entities but not cooperatives, the maximum tax rate on patronage distributions will be 33 percent, placing cooperatives and their members at a disadvantage. It is essential that the rate on pass-through income apply to patronage distributions from cooperatives.

NCFC members are also concerned about the Border Adjustability Tax ("BAT"). The provision would make exports tax-free, a benefit to exporters. However, farmer cooperatives would need a way to pass that benefit through to their farmer members

who produce the exported goods. The BAT also would disallow the business expense deduction for imported goods, resulting in essentially a 20 percent tax on imported goods (assuming a 20 percent corporate tax rate). For agriculture, a tax on imported fertilizer, fuel, farm machinery components, and retail goods would be extremely detrimental.

Tax experts say the BAT *should* cause a rise in the dollar's value, which would offset the loss of the deduction for imports by making imported goods cheaper. However, there is no guarantee on the timing or extent of the rise in value of the dollar. Also, consideration should be given to the effects of the strengthening of the dollar, which would increase costs for U.S. trading partners and likely result in retaliatory tariffs on farm exports.

The *Blueprint* also would eliminate the deduction for net interest expense and would allow for immediate expensing of capital investments, other than land. In many cases, farmers do not have the resources to satisfy all of their cooperatives' capital needs. As a result, cooperatives often rely on debt to finance growth. The repeal of the deduction for interest on debt would cause harm to farmer cooperatives and their members by impeding business expansion, new hiring, and product development. Immediate expensing of capital investments is also a challenge for farmer cooperatives. By not spreading the cost of an investment over the life of the asset, the provision will cause net operating losses that cannot be equitably shared among current and future members.

Additionally, the *Blueprint* would repeal Section 199, the Deduction for Domestic Production Activities Income. The Section 199 deduction was enacted as a jobs creation measure in *The American Jobs Creation Act of 2004.* The deduction applies to proceeds from agricultural or horticultural products that are manufactured, produced, grown, or extracted by cooperatives, or that are marketed through cooperatives, including dairy, grains, fruits, nuts, soybeans, sugar beets, oil and gas refining, and livestock.

Cooperatives may choose to pass the Section 199 deduction through to their members or to keep it at the cooperative level, making it extremely beneficial to both. Section 199 benefits are returned to the economy through job creation, increased spending on agricultural production and increased spending in rural communities. Some have suggested lowering corporate rates to offset the impact of the loss of the deduction. However, because farmer cooperatives' income is passed through to farmer members, a corporate rate reduction would not benefit cooperatives and their members. NCFC opposes the repeal of this incentive for domestic production.

If tax reform retains the requirement to maintain inventory records for tax purposes, NCFC supports the continued viability of the last-in, first-out (LIFO) accounting method. LIFO is a widely accepted accounting method and is used by some farmer cooperatives. Taxpayers using LIFO assume for accounting purposes that inventory most recently acquired is sold first. If LIFO is repealed and replaced with the first-in, first-out (FIFO) method, farmer cooperatives and other businesses would be taxed as though they had sold all of their inventory assets, even though they would have received no cash. Obtaining the funds necessary to pay the tax on this deemed sale would cause severe strain on cooperatives' capital budgets. Taxation of LIFO reserves would be the equivalent of a retroactive tax on the savings of a cooperative.

NCFC also supports reinstating the alternative fuel mixture credit, which expired on December 31, 2016. The credit incentivizes use of propane, a clean-burning, low-carbon, domestic, and economical alternative to gasoline and diesel.

NCFC thanks this Committee for helping to ensure tax policy continues to protect and strengthen the ability of farmers and ranchers to join in cooperative efforts in order to maintain and promote the economic well-being of farmers, ensure access to competitive markets, and help capitalize on market opportunities.

SUBMITTED QUESTIONS

Response from James M. Williamson, Ph.D., Economist, Economic Research Service, U.S. Department of Agriculture

Questions Submitted by Hon. Stacey E. Plaskett, a Delegate in Congress from Virgin Islands

Question 1. This *Blueprint* would provide full expensing for all capital investments. A farm or business could buy a new product and instead of writing off the cost over time, it would be immediate. Authors of the *Blueprint* argue that this will increase investment and make businesses more productive. But there are reasons

why the Code was shaped the way that it was. The advantage of having a machine often occurs over a period of numerous years.

Assuming something like this *Blueprint* is enacted this session, what about a farmer who invested last year in a machine with a 10 year lifespan, expecting they would benefit from the 10 year write off? What about people operating businesses that do not replace equipment every 2 years, who only buy one line of equipment every 10 years or more? If they are in a business where it takes a long time to use their product and they did not plan on making another investment for another decade, wont they lose out?

Answer. With regard to the *Blueprint,* it is my understanding that the business owner/farmer would still be able to write off (deduct) the cost of the machine over a number of periods (years) if they so choose. Under current law, a business owner/farmer is not required to elect to use the Section 179 expense deduction or additional depreciation deduction (known as "Bonus Depreciation"). Rather they may elect to use the standard method for claiming depreciation allowed under Internal Revenue Code, which is currently known as the Modified Accelerated Cost Recovery System ("MACRS"). Under MACRS, all assets are divided into classes which dictate the number of years over which an asset's cost will be recovered. Each MACRS class has a predetermined schedule which determines the percentage of the asset's costs which is depreciated each year.

As well, if a business owner/farmer does elect to use the Section 179 deduction, he or she may elect to use only a portion of the cost of the machine under the provision, while the remaining cost of the equipment is depreciated under MACRS for the remaining numbers of years specified under the rules of the provision.

Under the *Blueprint,* if the farmer who wishes to spread the depreciation deduction over multiple years is still able to so—as they are able to do under current law—then they will not be made worse off.

Question 2. If tax writers change this so that a farmer could be exempted and claim expensing until the end of the depreciation life if the investment was already made at the time of enactment, is that going to cost a lot more money in terms of the bill's price tag?

Answer. I am not able to assess the revenue effects of the proposed changes. The Joint Committee on Taxation would be able to answer this question.