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Tax Reform in 2017

It looks more likely each day that Congress may be coming together to get some sort of tax reform passed, so it's important to look at how the changes proposed by President Trump will impact our farmers and ranchers. Two of the main goals are to reduce the taxes for families & businesses and to simplify the tax code, which are both great for farmers.

Increased Standard Deduction

The first proposed change was to increase the standard deduction to $24,000 and eliminate the personal exemption. The standard deduction has been a set amount ($12,700 for Married Filing Joint Returns in 2017) that reduced total income before tax was calculated. Essentially, this means everyone got this much income at a 0% rate. If you itemized your deductions and they were more than the standard deduction, you could replace the $12,700 with your number. Personal Exemptions are another reduction in income and you get one for each person in the household or for a married couple, you would get two plus one for each dependent child. The personal exemption amount was $4,050 in 2017.

If we look at this to simplify a tax return, it certainly does that. One of the complex issues facing preparers is the definition of a child, especially with split and blended families where the child doesn't live with both parents all year long. By eliminating the personal exemptions, we eliminate much of this problem. We will still need to work on that definition for purposes of some credits like the Child Tax Credit or the Earned Income Credit, but those affect a smaller number of returns than the personal exemptions that were on almost all returns.

The drawbacks come for larger families. If you are married and have one child, you were getting three personal exemptions or $12,150 in personal exemptions and $12,700 in a standard deduction or $24,850 at "0% tax". If you have more children, the proposed law will actually reduce the amount of income you receive at that zero rate. There is a proposal to increase the amount of the child tax credit to help offset this difference.

The other drawback and simplification is that with a higher standard deduction, there will be fewer people who can itemize their deductions. This is a big simplification as Schedule A (the form for itemizing deductions) can be very complicated, so that's good. The drawback is that there may be less incentive to

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give to charities, own your own home, etc. if you don't get a tax deduction for those things.

Change to the Individual Tax Rate Structure

Another proposal is to reduce the number of individual income tax brackets from 7 to 3. I have always held the opinion that having 7 brackets does not complicate things as it's just a math formula to follow to calculate tax, so I don't believe this is a major simplification. Whether this creates a significant difference in the tax you will pay depends on where they set the breaks for the brackets. The proposed brackets are 12%, 25% and 35% but the breaks were not part of the proposal.

Enhanced Child Tax Credit

As I mentioned above, they are proposing that the amount of the Child Tax Credit "significantly increases" and that the phase out level is raised. The Child Tax Credit is currently set at $1,000 per child under the age of 17 on December 31st each year. The phase out of that starts at $110,000 of Adjusted Gross Income. This means that if your income is above that, the $1,000 per child is reduced. If they pass this, it will go a long way to replacing the personal exemptions as a $1,000 credit is better for most people than a $4,000 deduction, since the credit reduces tax paid and the deduction only reduces income.

Eliminating the Alternative Minimum Tax (AMT)

The AMT tax was imposed many years ago with the idea that it kept high income tax payers from taking advantage of too many tax benefits, but the limits were not indexed for inflation, so the levels where the AMT tax would kick in started to affect many taxpayers. They have raised the limit over the past few years, but elimination of this tax would greatly simplify the farm returns we prepare. It would allow for some flexibility in tax strategies, such as doubling up itemized deductions, which we have essentially quit doing due to the impacts of AMT.

Itemized Deductions

I've mentioned Itemized Deductions as an alternative to the Standard Deduction, but they are proposing major changes to this as well. There are MANY itemized deductions, including everything from out of pocket medical expenses, personal Real Estate Taxes, mortgage interest and charitable donations to lesser ones such as investment expenses, unreimbursed employee expenses, tax preparation fees, etc. The proposal eliminates most of these deductions. The ones they say will remain are home mortgage interest and charitable donations, but remember with a higher standard deduction, the number of people who will be able to itemize will be reduced. According to USA today, only 30% of Americans itemized under the current law, and they expect the higher standard deduction to significantly reduce that percentage. Remember farmers can donate grain to charities, so that may be a great practice to get back into as it will reduce farm income and you won't need to itemize to get the benefit.

Estate and Generation-Skipping Taxes

The proposal is set to eliminate the "death" tax and the generation-skipping transfer taxes. Any proposal in the past to eliminate this tax also eliminated the step-up in basis. This will affect every farm, instead of just those whose net worth exceeds $11 million (for a married couple). Whether elimination is better than keeping the tax depends on the farm. The heirs of an active farmer who passes away will almost always receive better tax treatment from the step-up in basis than elimination of the estate tax, but a retired landowner with significant assets may be better off forfeiting the step-up.

The other challenge that producers will face is proving basis if the step up is eliminated. The way it is now, we have a basis "reset" every generation, so the farthest we must look back to determine basis is "when Dad died". If we don't get that reset, we will have to find what Grandpa paid for that ground 70 years ago if we need to sell it. That will create a recordkeeping nightmare for accountants and attorneys to try and put that information together when everyone who had firsthand knowledge of the event has passed away.

New Tax Rate for Small Businesses

Sole proprietorship (you file a Schedule F), partnerships and S corporations will have a maximum tax rate of 25% on their business income. This means that even if you are in the top bracket of 35% for ordinary income, your farm income will only be taxed at 25%. This doesn't simplify the tax calculation, but it will reduce the taxes paid by farmers. This could be a significant impact for high income producers. This would also reduce the incentives for creating entities, which would go back to simplifying the process for producers.

New Tax Rate for Corporations

The corporate tax rate (for C-corporations) would be limited to 20%. It doesn't say in the proposal if the 15% bracket would stay a part of the structure and the max would be 20%, or if all income recognized would be paid at 20%. This will be an interesting detail to get as it could raise taxes for those producers who are using the 15% tax bracket in a C-Corp.

There is also mention of "reducing the double taxation of corporate earnings." Without more details, it's hard to know what that means or how it will impact farmers, but reducing that tax would be a huge benefit to those operations with a significate deferred tax liability.

Unlimited Section 179

The proposal includes a lift of the limit in how much you can expense for capital purchases in the year of acquisition for assets purchased after September 27th, 2017 and for at least 5 years. This would apply to all assets except structures. There was no mention if there would still be a purchase limit in place or what would happen after the 5 years. It could be that there would be no Section 179, or it could go back to the levels we have today. We would be back to the uncertainly of "what are they going to do" that we have been faced with for so many years.

While this sounds like a great deal, remember that if you are front loading deprecation on assets that you have financed, you could create a cash flow problem since you are not matching your cash outlay with a deduction on your return. It will take some discipline to use this tax benefit appropriately.

Interest Expense

There has been a lot of discussion about eliminating the deduction for interest paid. The proposal is only eliminating that deduction for C-corporations but the committee has been giving direction to consider the appropriate deduction for non-corporate taxpayers. The elimination of this deduction could be huge for highly leveraged producers. Our average producer spent $35,000 in interest last year. That, with today's brackets, would cost the producer almost $16,500 in additional taxes (assuming 15.3% self-employment taxes, 25% federal income taxes and 7% state taxes). This will be a very interesting proposal to watch.

Domestic Production Activities Deduction

The final major change for producers is a proposed elimination of the Domestic Production Activities Deduction. This deduction has been around since 2004 and now amounts to a deduction of 9% of income or 50% of wages paid whichever is less. Elimination of this would very much simplify farm tax returns since there is an impact for the cooperatives that producers work with and the calculation is complicated. The impact of this would depend on the profitability of the operation and how much they are paying in wages. For some operations, this will have no impact and for others, it could increase taxable income by more than $50,000. This deduction has always been one that has been received with no expense so while it could have a big impact, it was a "free" deduction before.

Conclusion

Tax law changes can never be all good or all bad since a budget still must be met. There are many things in here that will benefit farm tax payers, but the reality is there is a lot of compromises that needs to be made before any of these changes become law. This will certainly complicate the tax planning season as we don't know exactly how to plan what's best for producers. It will also complicate filing season since these types of sweeping changes will significantly impact the forms, calculations etc. The longer they take to pass something with retroactive provisions, the more delays you should expect in the filing season.

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