The Tax Reform Act of 1986, the most comprehensive overhaul of our Federal income tax system in more than 30 years, has substantially lowered tax rates while eliminating or reducing many deductions, exclusions, and credits introduced over the years. This tax law, like those before it, affects farmland values and ownership and land use and conservation.

Land Value and Ownership Before 1986
During the 1960's and 1970's, the Federal income tax had some substantial effects on land ownership and land value resulting from different tax treatment of various types of investments and investors. Land received more favorable tax treatment than other investments. The tax incentives for land investments were greater for those in higher tax brackets, those who borrowed to buy land, and those who held their land for long periods before resale. The result was higher land values, more concentration of land ownership, more debt loads and risk for landowners, and a less active land market.

Capital Gains Exclusions. Since 1954, a portion of all long-term capital gains has been excluded from taxation. From 1978 to 1986, the exclusion was 60 percent, with only 40 percent of any gain taxable. During the 1970's, when rising farm incomes were raising the real value of land, the exclusion (and postponement of tax until sale) increased the attractiveness of land investments. Many considered farmland as a tax shelter.

Interest Rates Deduction. During the 1970’s, nominal interest rates were high as a result of inflation, but the real cost of borrowing was relatively low, primarily as a result of the tax savings from interest deductibility. In some cases, real after-tax interest rates were negative. As a result, larger profits were made by those who borrowed a larger portion of the cost of any investment. Land became an attractive investment because it was good security, and lenders were willing to finance a high portion of the investment cost.

Tax Savings in 1970’s. The capital gains exclusion and the deductibility of nominal interest provided tax savings greater for those in higher tax brackets. During the 1970’s, individuals with high incomes were encouraged to invest more of their wealth in
Our American Land

land, and less in other assets, serving to increase the rate of growth in real land values. Those with low incomes received smaller tax benefits from land ownership. They often could not afford to buy or hold land at the higher prices, which contributed to the decline in the number of farms and the increase in average farm size, and led to a greater concentration of land ownership.

Reduced Tax Benefits in 1980's. During the 1980's, the effects of tax policy on farmland were overshadowed by declines in farm income and increased farm financial stress. In 1980, when farmland values began falling, the capital gains exclusion lost much of its value as a tax incentive for land ownership. At about the same time, interest rates and inflation began to fall, further reducing the tax benefits of the deductibility of nominal interest. Farmland was no longer viewed as a tax shelter.

Land Value and Ownership Under Tax Reform

The most significant change in the 1986 tax law is the sharp decline in tax rates from a top tax rate on personal income of 50 percent to 28 percent by 1988. This reduces the overall effects of tax policy on investment decisions, and raises the after-tax return on most investments, including land. As an example, consider farm-land that rents for $100 an acre. Under old law, a high-income landowner would pay half the rent in income taxes, keeping only $50 an acre. By 1988, the same landowner will earn $72 an acre after taxes, an increase of 44 percent.

The benefits of lower tax rates are partly offset by the elimination of a number of special tax provisions. For land, the 60-percent exclusion for long-term capital gains is eliminated. This loss will gain importance when the land market stabilizes and nominal land values begin to keep pace with inflation. Under old law, with a top tax rate of 50 percent, the maximum tax on capital gains was 20 percent. Under the new law, capital gains are being taxed at the same rate as ordinary income. Those in the top tax bracket will pay a tax of 28 percent on any nominal gains in land value. Landowners, however, will continue to benefit from the postponement of the tax until the time of sale. For those who hold their land for long periods, the higher capital gains tax will be more than offset by the lower tax on current land income. The net result should be higher after-tax returns on land investments.

Land Use and Conservation Before 1986

For the past 30 years or more, the Federal income tax code has contained a number of provisions for special tax treatment of expenditures on soil and water conservation and land improvements. Farmers' decisions with regard to soil and water conservation and management have sometimes been based more on these tax benefits than on economic returns. In addition, some tax incentives for land improvements have encouraged more intensive
cropping that may have led to increased soil erosion. Consequently, the tax law has had mixed effects on farm resource management.

**Tax Deductions for Soil and Water Conservation.** Farmers have been allowed to claim immediate tax deductions for certain types of expenditures on soil and water conservation since 1954. These expenses have included the leveling, grading, and terracing of land; custom furrowing; the planting of windbreaks; and the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds. This list includes all conservation expenditures that taxpayers would normally add to the basis of land and deduct for tax purposes in the year the land was sold. Each farmer's annual conservation deductions have been limited to 25 percent of gross farm income.

The conservation practices listed are used on about one-fourth of the U.S. cropland treated with some method of erosion control. Conservation tillage is now used on about half of all treated land and is by far the most widely used method of erosion control. It normally requires special tillage equipment.

**Land Clearing and Land Improvements.** Farmers also have been allowed to claim immediate tax deductions for most expenditures on land clearing and land improvements since 1954. Examples of land clearing include diversion of streams and eradication of trees, stumps, and brush. Each farmer's annual deductions for land clearing have been limited to the lesser of $5,000 or 25 percent of taxable farm income. Examples of land improvements include earth moving, draining, the filling of wetlands, and preparing land for center-pivot irrigation. Total land improvement and conservation deductions have been limited to 25 percent of gross farm income.

Several types of land improvements such as drainage tile and concrete dams must be depreciated. However, they have been eligible for the investment tax credit and rapid write-off periods. For some taxpayers, the tax credit and rapid write-offs have provided greater tax savings than immediate deductibility.

The immediate deductibility of land-clearing expenses has encouraged the conversion of wetlands and other land into cropland. Some of this conversion would not have been profitable in the absence of the tax savings from the immediate deductions, because the land was not well suited for crop production. In addition, a tax subsidy for land conversions may have contributed to overproduction in agriculture and lower farm product prices. Immediate tax deductions for land improvements also have been questioned. Some land improvements such as drainage and preparation for irrigation may have led to more intensive cropping that has increased soil erosion.

**Investment Tax Credit.** Since 1962 (with brief interruptions), nearly all investments in farm and nonfarm equipment have been eligible for the
Plastic drainage tubing is installed on a North Carolina farm. New tax laws have eliminated investment tax credits and extended to 15 years the write-off period for installation of land improvements such as drainage systems. (John B. Litchfield, SCS, NC-2,199)

investment tax credit and accelerated tax depreciation schedules. In addition, since 1982, each business taxpayer has been allowed to immediately deduct up to $5,000 of investment in machinery equipment. At least three-fourths of all conservation practices have benefited from some type of special tax provision.

**Land Use and Conservation Under Tax Reform.**

Some of the special tax benefits in prior law have been restricted or eliminated, including those provisions that had encouraged the conversion of marginal lands into cropland. The new law is more neutral in its treatment of the various conservation methods and should have a positive effect on resource management.

**Conservation Measures Still Deductible.** Farmers may claim immediate tax deductions for soil and water conservation only when the expenses are consistent with a conservation plan approved by the U.S. Department of Agriculture (USDA) or a comparable State agency. The plan need not be specific to the individual farm. USDA and some State agencies have developed areawide plans that indicate the types of conservation measures considered suitable. Most conservation measures will remain deductible under the new law.
Depreciable Investment Incentives Reduced. Under old law, tillage equipment, drainage tile, concrete dams, and many other farm assets were eligible for a 10-percent investment tax credit and 5-year write-off periods. The new law repeals the investment tax credit retroactive to January 1, 1986. It also lengthens write-off periods to 15 years for drainage tile, concrete dams, and similar land improvements, and to 7 years for tillage equipment and most other farm assets. However, the option to expense up to $5,000 of investment a year has been raised to $10,000.

Land Clearing and Improvement Incentives Reduced. The Tax Reform Act repealed the immediate deductibility of expenditures on land clearing and land improvements. They must now be added to the basis of land, so they are not deductible until the land is sold. This change will reduce the incentive to bring marginal land into production, and it will remove the tax incentive for the land improvements that have led to increased soil erosion. Routine brush clearing and similar activities on land already in production will continue to be currently deductible as ordinary business expenses.

Conversion of Wetlands Discouraged. The Tax Reform Act also discourages the conversion of wetland or highly erodible land to cropland. Under the new law, any gain on the sale of such land is taxed as ordinary income and any loss is treated as a long-term capital loss. Since capital gains and ordinary income are taxed at the same rate under the new law, the most significant effect of this change is that losses on the sale of such land may only be used to offset up to $3,000 of ordinary income each year. The remaining loss must be carried forward to future tax years. If ordinary income tax rates are increased or if the capital gains exclusion is restored in the future, the tax penalty for converting land would increase.

Incentives for Developing Orchards and Vineyards Reduced. Under old law, farmers could claim immediate tax deductions for such development costs. Now these costs must be capitalized, which reduces the profitability of orchard and vineyard investments and may lead to a decline in orchard and vineyard acreage.

Incentives for Forestry Retained. The major change is the loss of the capital gains exclusion, which is mitigated by the fact that the tax is not paid until trees are cut or sold. Under the new law, taxpayers may continue to claim immediate tax deductions for the costs of maintaining forests. The new law also retains the 10-percent investment tax credit and the short 7-year amortization period for reforestation expenditures.