Risk Management

Risk Management Agency

Tax-Deferred Savings Accounts For Farmers: A Potential Risk Management Tool

A program of tax-deferred savings accounts for farmers is among the alternatives currently under consideration by Congress to help farm operators manage their year-to-year income variability. Unlike the income-averaging provision for farmers included in the Taxpayer Relief Act of 1997, which allows farmers to spread above-average income to prior tax years and avoid being pushed into a higher tax bracket, tax-deferred savings accounts would build a cash reserve to be available for risk management. By depositing income into special Farm and Ranch Risk Management (FARRM) accounts during years of high net farm income, farmers could build a fund to draw on during years with abnormally low income. Federal income taxes on eligible contributions would be deferred until withdrawal.

Proposals for tax-deferred risk management savings accounts originally surfaced after passage of the 1996 Farm Act, as a mechanism to encourage farmers to save a portion of the 7-year transition payments. In 1998, as Congress sought to expand the farm safety net and ease stress from recent low prices and regional disasters, it again considered FARRM accounts. A bill to authorize FARRM accounts has now been introduced in the 1999 Congressional session (H.R. 957, S. 642), and is likely to generate more debate.

How FARRM Accounts Would Work

Under the current FARRM account proposal, farmers could take a Federal income tax deduction for FARRM deposits of no more than 20 percent of *eligible farm income*—taxable net farm income from IRS Form 1040, Schedule F, plus net capital gains from sale of business assets including livestock but not land. Deposits would be made into interest-bearing accounts at approved financial institutions, and interest earnings would be distributed and taxable to the farmer annually. Withdrawals from principal would be at the farmer's discretion (no price or income triggers for withdrawal), and taxable in the year withdrawn. Meaningful income triggers would be difficult to determine given the nature of taxable farm income and the fact that price levels do not necessarily correlate with farm-level yield or income variability.

Deposits could stay in the account for up to 5 years, with new amounts added on a first-in first-out basis. Deposits not withdrawn after 5 years would incur a 10-percent penalty. FARRM funds would have to be withdrawn if the account holder were disqualified from participating by not farming for 2 consecutive years. Deposits and withdrawals would not affect self-employment taxes.

FARRM account eligibility would be limited to individual taxpayers—sole proprietors, partners in farm partnerships, and shareholders in Subchapter S farm corporations—who report positive net farm income and owe Federal income tax. The program should be relatively easy to administer through the use of existing income tax forms, with reporting requirements similar to those of individual retirement accounts (IRA's). Contributions and distributions from the accounts could be verified by matching income tax returns with records from banks or other financial institutions where the accounts are held.

Although farm sole proprietors make up the largest share of potentially eligible individuals, over two-thirds either report a farm loss or have no Federal income tax liability and therefore could neither participate nor benefit from participation. And actual participation could be significantly less than the number eligible.

Using 1994 Internal Revenue Service (IRS) data, USDA's Economic Research Service estimates that 916,000 farmers would be eligible to contribute as much as $2.8 billion to FARRM accounts each year. Farm sole proprietors account for over two-thirds of eligible participants and three-fourths of potential contributions. But about half of eligible farm sole proprietors would be limited to contributing less than $1,000. Thus, each year only about one of every six sole proprietors could contribute more than $1,000. Contributions for farm partners would also be small—averaging below $2,000—but subchapter S shareholders' contributions could average $4,355.

Basing eligibility for contributions on positive net farm income would direct

This article continues the series on risk management.

much of the benefit of FARRM accounts to those relying on farming for more than half their income. About two-thirds of potential contributions by sole proprietors would be concentrated among the one-third of eligible sole proprietors who derive over half their income from farming. A very small share of limited resource farmers—gross farm sales under $100,000 and household income less than $10,000—would be eligible, and their contributions would be rather small.

The amount of money that would be deposited into FARRM accounts and a minimum account balance that would be sufficient to provide risk protection for either farm operations or household living expenses are difficult to estimate. But with over 80 percent of all farmers limited to contributions of less than $1,000 in any given year, and with participation rates expected to be less than 100 percent, most farmers are not likely to accumulate significant reserves. Some producers with low contribution limits may be able to deposit larger amounts in years when farm income is higher. But the 5-year window for building reserves and the generally low level of taxable net farm income combine to reduce the likelihood that most farmers would be able to build balances adequate to self-insure risk exposure.

Although 1994 is the most recent year for which complete data are available, it was not an especially good year for farm income. Examination of the most profitable year during the 1990-94 period (1990) suggests that aggregate potential contributions would have increased by about 25 percent to $3.5 billion. Thus, with 100-percent participation, potential 5-year contributions could range from $14 to $17.5 billion. The official revenue estimate by the Congressional Joint Committee on Taxation suggests that aggregate account balances would be well below this amount as a result of withdrawals and less than full participation.

Looking at data for 1996, a year when farmers benefited from both high farm prices and high government program payments, it appears that estimates of eligible participants and total potential contribution amount would not change significantly. Despite a slight increase in total taxable income from farming, the number of farmers with taxable farm income actually dropped by about 30,000. Moreover, the number of farmers and other taxpayers who owe no Federal income tax has since increased, due in large part to the new child credit and other tax relief measures enacted in 1997 and 1998. As a result, the number of farmers who would be eligible to make contributions if the program is implemented may actually be lower than 1994 data suggest.

Sole Proprietors Would Predominate Among FARRM Account Holders...

	Eligible farmers		Maximum potential FARRM deposits		
	Number (1,000)	*Percent*	*$ million*	*Percent of total*	*$ mean deposit*
All	916	100.0	2,830	100.0	3,090
Sole proprietors	626	68.3	2,138	75.5	3,415
Partners	242	26.5	483	17.1	1,995
Subchapter S shareholders	48	5.2	209	7.4	4,355

...But Nearly Three-fourths of Them Could Not Have FARRM Accounts

	Sole proprietors		Maximum potential FARRM deposits		Average income: Off-farm	Average income: Farm
	Number (1,000)	*Percent*	*$ million*	*Percent*	*$1,000*	
All sole proprietors	2,265	100.0	2,138	100.0	49	*
Ineligible to deposit, due to:						
Negative net farm income	1,422	62.8	0	0	56	-10
No Federal tax owed	217	9.6	0	0	5	8
Eligible to deposit:						
$1-$999	282	12.4	87	4.1	50	2
$1,000-$9,999	305	13.5	1,112	52.0	35	19
$10,000-$19,999	27	1.2	363	17.0	51	69
$20,000 or more	12	0.5	576	26.9	263	246

Eligible farmers are those who report a positive combination of net farm income from Form 1040, Schedule F, plus capital gains from business assets other than farmland, and who owe Federal income tax. Maximum potential deposits estimated as 20 percent of eligible farmers' total net farm income.
* Loss under $500.
Source: Compiled from 1994 IRS Individual Public Use Tax File.

Economic Research Service, USDA

Should Benefits Be Targeted?

Without a provision for targeting—specifying who is eligible to participate and where program benefits are expected to be concentrated—most of the benefits of FARRM accounts would go to relatively few farmers, and some would go to individuals who do not rely on farming for their livelihood. The FARRM account proposal currently on the table does not specify a maximum annual contribution or a limit on accumulated balances. About 0.5 percent of farm sole proprietors would be eligible to contribute over $20,000 annually, adding up to more than 25 percent of total sole proprietors' potential deposits. Off-farm income for this group exceeds $250,000, on average, and a small subset of very high-income individuals would be eligible for contributions averaging $50,000. In contrast, many farmers with persistently low farm incomes, highly vulnerable to income swings, would likely be ineligible to contribute or unable to build sufficient FARRM account balances.

Concentrating benefits for individuals at high income levels and excluding low-income farmers may raise concerns about appropriately targeting the program. Targeting could be used to reach a specific group of farmers by placing a cap on annual contributions or by limiting eligibility based on the household's adjusted gross income (AGI). For example, restricting eligibility to individuals with AGI under $100,000 would reduce potential contributions by about a third and cut the cost to taxpayers—from farmers deferring taxes—nearly in half, but would reduce the number of eligible farmers by less than 10 percent.

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The 1996 proposal for tax-deferred savings had a targeting provision—$40,000 annual contribution limit and 10-year time limit for withdrawals. A Canadian program for farmer tax-deferred savings limits its annual contributions and accumulated balances, but has no time limit.

FARRM Accounts Are Intended To Manage Risk, Not Taxes

To meet goals of program efficiency—benefits offsetting costs—and risk management, FARRM accounts must create new savings rather than shift assets or replace existing risk management practices. The cost of the FARRM account program is primarily the decrease in government revenue associated with tax deferral. The benefits are mainly farmers' increased financial stability, and diminished need for government farm program payments or emergency aid payouts.

Creating new savings instead of shifting assets could mean a gain for taxpayers and a stronger risk position for farmers. To enhance farmers' risk management capabilities, new savings have to come from reduced household consumption or from funds that would have been invested in the business, rather than from shifting existing savings, diverting future new savings, borrowing, or depositing taxes deferred by making the contributions. But evidence indicates that most potentially eligible farmers have ample resources to shift funds into FARRM accounts instead of creating new savings.

Information on interest earnings for potentially eligible individuals suggests that contributions from existing liquid assets could fund a large portion—about three-fourths of total potential contributions—in the first year, and over half of eligible farmers have sufficient existing savings to fund FARRM account contributions for several years. Farmers with adjusted gross income above $100,000 are more likely to be able to fund a larger proportion of contributions from existing savings, while eligible farmers with AGI under $50,000 have less existing savings available and are more likely to create new savings if they decide to participate.

USDA's 1994-95 Agricultural Resource Management Study reveals that a majority of households associated with farms that have gross sales of $50,000 or more already keep liquid assets to meet unexpected expenses. If those liquid assets were moved into FARRM accounts, the household would benefit from tax deferral without incurring significant restrictions on availability of funds, but would not enhance their ability to manage risk.

Research on IRA's, similar in concept to FARRM accounts, documents a significant amount of asset shifting rather than new saving. The FARRM program provision that requires a contribution to be withdrawn within 5 years effectively limits the amount of income that can be accumulated in the account and prevents a FARRM account from becoming an additional retirement savings plan. But asset shifting could be even more prevalent for FARRM accounts than for IRA's because FARRM accounts remain liquid and, without price or income triggers that must be reached to allow withdrawals, FARRM accounts do not lock the money into long-term reserves. In addition, FARRM funds are not required to remain on deposit for a minimum time and, like IRA's, contributions prior to April 15 would apply to the preceding tax year, so depositing funds in FARRM accounts for a short period could provide a 1-year income tax deferral.

A program of tax-deferred risk management accounts has the potential to encourage farmers to provide their own safety net by saving money from high-income years to withdraw during low-income years. Taxpayers could benefit if farmers' additional financial diversification and liquidity reduce the need for continued income support programs or ad hoc farm disaster relief. Nonetheless, there are several potential limitations to the program's effectiveness. These include: 1) low levels of taxable farm income that could preclude most farmers from building meaningful account balances—particularly those most in need of risk management tools, such as limited resource and beginning farmers; 2) concentration of program benefits among operators with large farms and relatively high off-farm income; and 3) funding of FARRM accounts with farmers' existing liquid assets instead of new saving. AO

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Canada Already Has a Savings Plan for Farmers

Risk management savings accounts are not without precedent. In 1991, Canada began the Net Income Stabilization Account (NISA) program to encourage farmers to save for self-insurance (*AO* May 1995). The farmer's contribution earns a 3-percent interest rate bonus and is supplemented by a matching government contribution. Unlike the U.S. proposal, a farmer's NISA contribution is not tax-deferred, but government contributions and interest earnings are not taxed until withdrawal. Annual farm contributions are limited to 20 percent of the year's sales, and deposits eligible for government matching are limited to the smaller of $7,500 or 3 percent of eligible farm sales—gross sales of most primary commodities minus purchases of those commodities, such as seed and feed. NISA has no time limit on deposits, but account balances may not exceed 1.5 times the farm's 5-year average sales.

Analysis of the NISA provision that allows withdrawals only when income falls below an established threshold suggests that rules for withdrawal can create obstacles to effective use of funds. Administrative delays in availability of funds to farmers reduce the program's usefulness as a source of emergency funding. This partially explains why many Canadian farmers who became eligible for withdrawals did not actually take funds from their accounts.

For more information see:
Do Farmers Need Tax-deferred Savings Accounts to Help Manage Income Risk?
Call 1-800-999-6779 for a printed copy (AIB 724-07) or access it on the ERS website at www.econ.ag.gov/epubs/pdf/aib724.