Farm Economic Issues and Implications

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Overview

A firm understanding of the economic context within which the farmers and ranchers operate is necessary for both tax planning and financial planning. The creation and dissolution of legal entities, the restructuring of debt, and the use of various legal devices for the protection of assts from creditors and preserving inheritances cannot successfully be accomplished without knowledge of agriculture that transcends the applicable legal rules.

Crop production, energy issues, monetary policy, issues in the meat sector and unanticipated outside shocks have farm-level impacts that professional advisors and counselors need to account for when representing farm and ranch clients.

Current economic issues impacting ag – it's the topic of today's post.

Projected Plantings (and Implications)

On March 31, the USDA released its "prospective plantings" report for the 2022 crops. https://www.nass.usda.gov/Publications/Todays_Reports/reports/pspl0322.pdf The report projects farmers planting 91 million acres of soybeans and 89.5 million acres of corn. The corn planting number is down 4 percent from last year, and is the lowest acreage estimate over the last five years. The soybean projection is up four percent from 2021. Total planted acres are projected to remain about the same as 2021.

Note: The shift from corn acres to soybean acres was very predictable. Farmers have calculators and can run the numbers with higher input costs (such as fertilizer). Corn, as compared to soybeans, requires a greater amount of inputs which have risen in price substantially.

Projected wheat planted acres is up one percent from 2021, but still is projected to be the fifth lowest total wheat planted acres since 1919. Grain sorghum is projected to be down 15 percent (1.4 million acres) from 2021, with significant declines projected in Kansas and Texas. Conversely, barley and sunflower planted acres is projected to increase 11 percent and 10 percent respectively from 2021. With respect to sunflowers, however, the 2022 projection is still the fifth lowest planted area on record. Cotton acreage is projected to be up about 800,000 acres.

Implication: The projected planting numbers indicate that higher protein prices can be expected in the future.

Global Crops

The Russian war with Ukraine will have impacts on global grain trade and create additional issues for U.S. farmers and ranchers. Russia and Ukraine are leading exporters of food grains. But, Ukraine ports are closed and Russian imports are being avoided causing rising food prices. In the U.S., the rise is in addition to existing inflationary price increases for most good products. Russia and Ukraine produce 19 percent of the world's barley; 14 percent of the world's wheat; and four percent of the world's maize. They also produce 29 percent of total world wheat exports and 19 percent of total world corn exports. Those numbers are particularly important to countries that depend on imported grain from Russia and Ukraine, with a major issue being the loss of corn exports from Ukraine.

Note: U.S. corn exports are projected to rise, but U.S. wheat exports are not.

If the war triggers a global food crisis, the least developed countries that are also likely to be low-income or food-deficit countries are the most vulnerable to food shortages. This would create a surge in malnutrition in these countries. Presently, 50 countries rely on Russia and Ukraine for 30 percent of their wheat supply (combined), and 26 countries source at least 50 percent of their wheat needs from Russia/Ukraine. Egypt and Turkey get over 70 percent of their wheat from Russia/Ukraine. Russia supplies 90 percent of Lebanon's wheat and cooking oil. Grain shortages will hit the poorer African countries particularly hard. These countries rely on imported bread to feed their expanding populations. As a whole, in 2020, the continent of Africa imported $4 billion worth of ag products from Russia (which supplied the majority of the continent's wheat consumption.

This combined data indicates an escalation of global food insecurity. One estimate is that worldwide food and feed prices could rise by 22 percent which could, in turn, cause a surge in malnutrition in developing nations. Since the war started, total world food output has decreased, resulting in a sharp drop in food exports from exporting countries. Other food exporting countries have announced new limitations on food exports (or are exploring bans) to preserve domestic supplies. This will have an impact on international grain markets and will likely have serious implications for the world's wheat supply. The extent of such disruptions is unknown at the present time.

Note: Russia is also a major fertilizer exporter, supplying 21 percent of world anhydrous exports, 16 percent of world urea exports and 19 percent of world potash exports. Combined, Russia and Belarus provide 40 percent or world potash exports. The Russia/Ukraine war will likely have long term impacts on fertilizer prices in the U.S. and elsewhere. This will have impact crop planting decisions by farmers.

Energy Policy

Incomprehensible energy policy in the U.S. since late January of 2021 and in Europe have been a financial boon to Russia. The policy, largely couched in terms of ameliorating "climate change," has resulted in the U.S. from being energy independent to begging foreign countries to produce more. The restriction in U.S. production and distribution of oil has occurred at a time of increasing demand coming out of state government mandated shutdowns as a result of the China-originated virus. The resulting higher energy prices have caused the prices of many products and commodities to increase.

Monetary Policy

The U.S. economy is incurring the highest inflation in 40 years. While the employment numbers are improving coming out of virus-related shutdowns, the labor force participation rate is not. A higher rate of employment coupled with a decrease in the labor force participation rate may mean that workers are taking on multiple (lower paying) jobs in an attempt to stay even with inflation.

The last time the government attempted to dig itself out of a severe inflationary situation the Federal Reserve raised interest rates substantially to "wring inflation out of the economy." The result for agriculture was traumatic, bringing on the farm debt crisis of the 1980s. The current situation is similar with the Federal Reserve having backed itself into a corner with prolonged, historic low interest rates coupled with an outrageous increase in the money supply caused by massive government spending. If the Federal Reserve attempts to get out of the corner by just raising interest rates, the end result will likely not be good. The money supply must be reduced, or worker productivity gains must be substantial. Higher interest rates are a means to reducing the money supply.

Meat Sector

In the meat sector, the demand for beef remains strong. Beef exports are steadily growing. The current major issue in the sector is the disconnect between beef demand and the beef producer. Currently, the large meat packers are enjoying record-wide margins. Cattle producers are being signaled to decrease herd sizes because of the disconnect. Legislation is being considered in the Congress with the intent of providing more robust and transparent marketing of live cattle.

On the pork side, demand is not as impressive but is improving.

For poultry, demand remains strong and flock sizes are decreasing largely because of the presence of Avian Flu.

Some states have enacted labeling laws designed to protect meat consumers from deceptive and misleading advertising of "fake meat" products. The Louisiana law has been held unconstitutional on free speech grounds. *Turtle Island Foods SPC v. Strain, No. 20-00674-BAJ-EWD, 2022 U.S. Dist. LEXIS 56208 (M.D. La. Mar. 28, 2022).* Much of the advertising of "fake meat" products is couched not in terms of health benefits, but on reducing/eliminating "climate change." Government mandates have been imposed for the sake of "climate change" – a certain amount of ethanol blend in fuel; a certain amount of "renewable" energy to generate electricity, etc.). Could that also happen to the meat industry, but in a negative way? A concern for the meat industry is whether the government will try to mandate that a certain percentage of meat cuts in a meat case consist of "fake meat" products based on a claim that doing so would further the "save the planet" effort.

Water Issues

West of the Sixth Principal Meridian, access to water is critical for the success of many farming and ranching operations. A dispute is brewing between Colorado and Nebraska over water in northeast Colorado that Nebraska lays claim to under a Compact entered into almost 100 years ago. In the fertile Northeastern Colorado area, the State Engineer has shut-in almost 4,000 wells over the past two decades to maintain streamflow and satisfy downstream priority claims. A similar number of wells have had their pumping rights limited in some way. While this is a very diverse agricultural-rich area, water is essential to maintain production. Given the rapid urban development in this area, the need for water for new subdivisions along the front range will trigger major political ramifications if there are any further reductions in agriculture's water usage.

The economic impact of water issues in Northeastern Colorado is already being felt. The Colorado-Big Thompson Project collects, stores and delivers more than 200,000 acre-feet of supplemental water annually. Melting snowpack in the Colorado River headwaters on the West Slope is diverted through a tunnel beneath the Continental Divide to approximately 1,021,000 million residents and 615,000 acres of irrigated farmland in Northeastern Colorado. A unit (acre-foot) of Colorado Big Thompson water storage is presently selling for approximately $65,000. Fifteen years ago, it was priced in the $6,000 range. All other water shares are priced accordingly. This dramatic increase in price has implications for the structure of farming operations, succession planning and estate valuation.

Water access and availability will continue to be key to profitability of farms and ranches in the Plains and the West.

Tax Policy

In late March, the White House release its proposed 2023 fiscal year budget (October 1, 2022 – September 30, 2023). At the same time, the Treasury release its "Greenbook" explanation of the tax provisions contained in the budget proposal. Many of the proposals are the same as or similar to those included in bills in 2021 that failed to become law.

Here's a brief list of some of the proposals:

- Top individual rate to 39.6 percent on income over $400,000 ($450,000 for married couples;
- Corporate rate goes to 28 percent (87 percent increase on many farm corporations);
- Raise capital gain rate to 39.6 percent on income over $1 million;
- Capital gain tax on any transfer of appreciated property either during life or at death;
- Partial elimination of stepped-up basis – if to spouse, then carryover; transfer of appreciated property to CRAT would be taxable;
- Trust assets must be "marked-to-market" every 90 years beginning with any new trust after 1940. The rule would be the same for partnerships or any other non-corporate owned entity. In addition, no valuation discount for partial interests, and a transfer from a trust would be a taxable event. Exclusion of $1 million/person would apply. Any tax on illiquid assets could be paid over 15 years or the taxpayer could elect to pay the tax when the property is sold or is no longer used as a farm (in that event, there would be no 15-year option);
- All farm income (including self-rents) would be subject to the net investment income tax of 3.8 percent;
- A minimum tax would apply to those with a net worth over $100 million;
- Grantor-Retained Annuity Trusts (GRATs) must have minimum term of 10 years. This would essentially eliminate the use of a "zeroed-out" GRAT;
- Any sale to a grantor trust is taxable and any payment of tax of the trust is a taxable gift;
- Limitation on valuation discounts (related party rules);
- R.C. §2032A maximum reduction would increase to $11.7 million
- Trust reporting of assets would be required if the trust corpus is over $300,000 (or $10,000 of income);
- Elimination of dynasty trusts;
- Carried interest income would become ordinary income;
- R.C. §1031 exchange tax deferral would be limited to $1 million;
- Depreciation recapture would be triggered on the sale of real estate, which would eliminate the maximum 25% rate.

Note: The provisions have little to no chance of becoming law, but if some or all were to become law, there would be significant implications for farm and ranch businesses. Many of those implications would be negative for farming and ranching operations.

Conclusion

Farmland values remain strong. Indeed, input, machinery costs and land values are outpacing inflation. For those farmers that were able to pre-pay input expenses in 2021 for 2022 crops, the perhaps much of the price increase of inputs will be blunted until another round of inputs are needed in late 2022 for the 2023 crop. Also, short-term loans were locked in before interest rates began rising. That story will also likely be different in early 2023 when those loans are redone.

The biggest risks to agriculture will continue to be from outside the sector. Unexpected catastrophic events such as the Russian war with Ukraine, whether (or when) China will invade Taiwan, domestic monetary and fiscal policy, political developments at home and abroad, and regulation of agricultural activities remain the biggest unknown variables to the profitability of farming and ranching operations and agribusinesses.

An awareness of the economic atmosphere in which farmers and ranchers operate is important to understand for practitioners to provide fully competent advice and counsel with respect to income tax, estate, business and succession planning for farmers and ranchers.