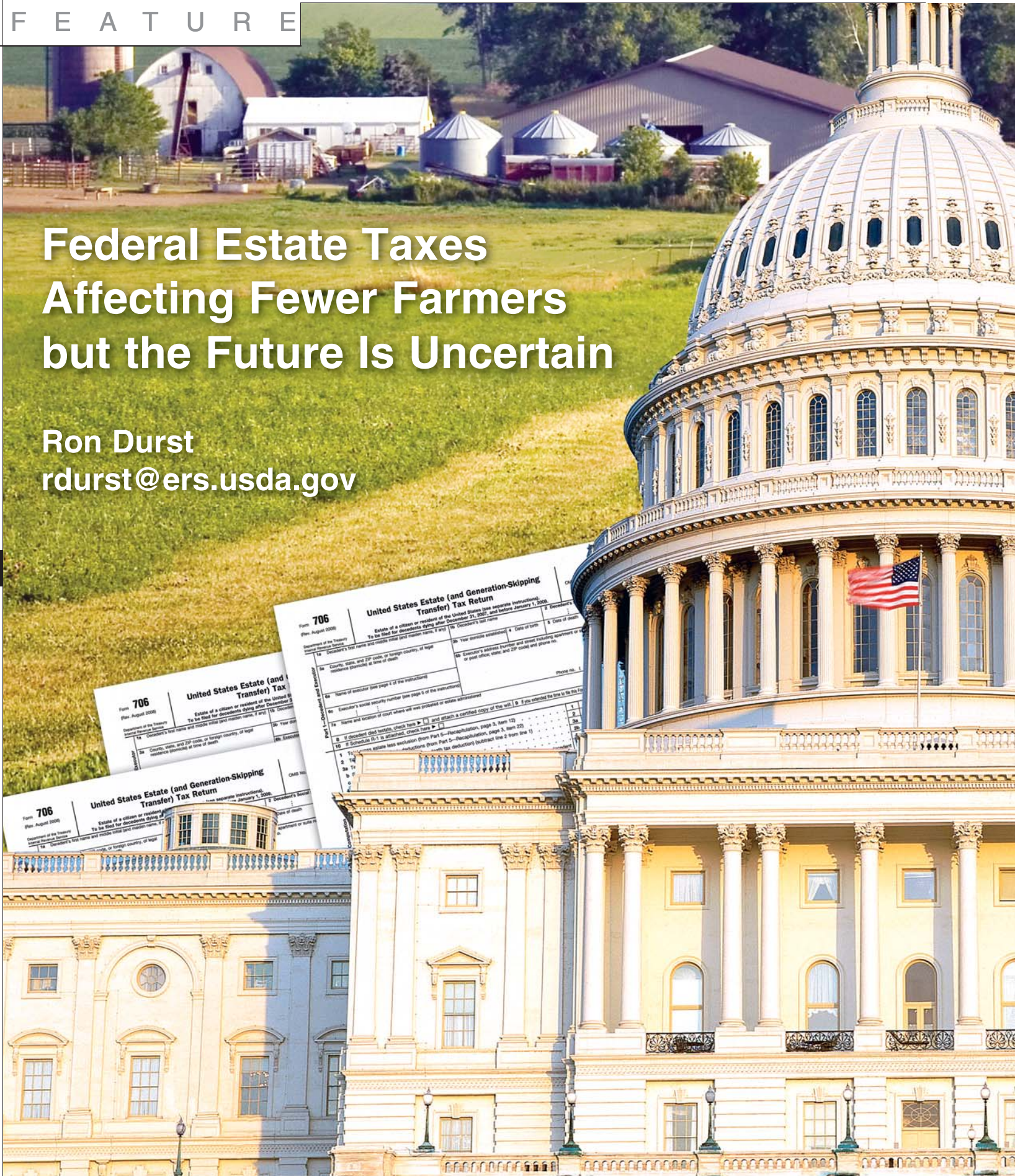


Federal Estate Taxes Affecting Fewer Farmers but the Future Is Uncertain

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Capitol (Eyewire); Farm (Shutterstock)

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- The Federal estate tax affects relatively few estates and accounts for only a small share of total Federal tax receipts.
 - Though special provisions have been enacted to limit the impact of the tax on farmers and small business owners, these groups are still more likely than the general public to owe Federal estate taxes.
 - A larger share of farm estates could be subject to estate taxes if legislation enacted in 2001 is allowed to expire at the end of 2010.
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In 2009, Federal estate and gift tax revenues are estimated at about \$26 billion, accounting for only about 1 percent of total Federal tax revenue. While the aggregate importance of Federal estate and gift taxes is relatively small, their potential effect on farmers and other small business owners has been a major concern among policymakers. These groups are more likely than the general public to owe estate taxes, and much of the concern focuses on the ability of the next generation to continue operating and investing in these family-owned businesses. For many farms, business assets account for a large share of the owner's estate. In such instances, estate tax liabilities not only drain the business of funds that might otherwise be reinvested, but could also force the liquidation of business assets.

Over the years, a number of targeted provisions have been enacted to reduce the burden of the estate tax on farmers and other small business owners. These include a special provision that allows farm real estate to be valued at its farm use value rather than its fair market value, an installment payment provision, and a special deduction for family-owned businesses. These provisions have increased the ability of many farmers and small business owners to transfer their businesses to the next generation.

Providing tax relief to farmers and other small business owners was also an impetus for the Economic Growth and Taxpayer Relief Reconciliation Act of 2001 (the 2001 Act). The 2001 Act reduced Federal estate and gift tax rates and substantially increased the amount of property that can be transferred to the next generation free of Federal estate tax, culminating in the complete repeal of the tax in 2010.

Coinciding with repeal of the estate tax is a modification to the "step-up" in basis provision that currently exempts unrealized capital gains earned prior to death from Federal income tax when the inherited assets are sold. The new basis provision, which takes effect in 2010, limits the step-up in basis to a specified amount, resulting in potential income tax liability when inherited assets are eventually sold. However, like many other changes in the 2001 Act, the estate tax changes and basis provisions will sunset (expire) at the end of 2010. Without further legislation, these provisions will revert to prior (pre-2001) law. As a result, interest is high among farmers, small business owners, and policymakers to enact tax legislation to address these issues before 2010.

Estate Taxes Reduced But a Relatively Larger Share of Farmers Still Owe Taxes

The Federal estate tax has applied to the transfer of property at death since 1916. While the tax has been amended many times, the estate tax has never directly affected a large percentage of taxpayers. In 2009, individuals can transfer up to \$3.5 million in money and other property without incurring Federal estate tax liability. The estate of a decedent who, at death, owns more than \$3.5 million in assets must file a Federal estate tax return. However, only those returns that have a taxable estate above the exempt amount after deductions for expenses, debts, and bequests to a surviving spouse or charity are subject to tax.

Since 2001, the amount exempted from the estate tax has gradually increased from \$675,000 to \$3.5 million, while the maximum tax rate has declined from 55 percent to 45 percent. As a result, both the number of estates required to file a tax return and the number of taxable returns have dropped dramatically. About 9,600 estates (0.4 percent of all estates) are expected to owe Federal estate

tax in 2009. The estates of small business owners are about twice as likely as the typical estate to owe tax, and farm estates are even more likely to owe tax, primarily because of their land holdings.

The median wealth of farm households is about five times that of all U.S. households. As a result, a larger share of farm estates owes Federal estate tax, largely due to appreciation in land values, increases in the average size of commercial farms, and rising investment in farm machinery and equipment.

Based on simulations using farm-level survey data (see box, "How Are Farm Estate Taxes Estimated?"), about 2.9 percent of the 38,234 farm estates projected for 2009 are estimated to have assets in excess of \$3.5 million and would be required to file an estate tax return. After deductions, about half of these farm estates would be taxable. These taxable farm estates have an average net worth of \$7.0 million, with about 85 percent of the value attributable to farm business assets, primarily farm real estate. The total amount of Federal estate taxes due from farm estates in 2009 is estimated at \$683 million, with the average taxable estate owing about \$1.1 million.

The impact of the Federal estate tax varies by farm type. Despite estate tax relief targeted to farmland, an estimated 10 percent of the estates of commercial farmers (those with annual farm sales of \$250,000 or more) are likely to owe Federal estate taxes in 2009. Commercial farms are 10 times more likely to owe Federal estate taxes than other farms.

While representing only about 6 percent of all farm estates, commercial farms account for about 40 percent of all Federal estate taxes paid by farm estates. In contrast, rural residence farms (those with annual sales below \$250,000 whose operator has a primary occupation other than farming) account for nearly three-fourths of all farm estates but only about a third of estate taxes.

How Are Farm Estate Taxes Estimated?

ERS researchers used data from the USDA Agricultural Resource Management Survey (ARMS) for 2000-2007 to estimate estate taxes through 2009 and the outcome of reverting to prior Federal estate tax law in 2011. The ARMS survey is a stratified sample of farms with information on farm operators and their households, including detailed financial information for both farm and nonfarm assets and debts. The number of estates was estimated based on the age of the operator and the probability that the operator would die in the current year. The estimates are for farm operator households only and do not include potential estate taxes on the transfer of farm assets by landlords and others. Estate values for future years are estimated based on ERS forecasts for the value of assets and debts.

Estate tax exemption amount has increased while graduated tax rates have declined

Year	Estate tax exemption amount	Highest marginal estate tax rate
	<i>Dollars</i>	<i>Percent</i>
2001	675,000	55
2002	1,000,000	50
2003	1,000,000	49
2004	1,500,000	48
2005	1,500,000	47
2006	2,000,000	46
2007	2,000,000	45
2008	2,000,000	45
2009	3,500,000	45
2010	Estate tax repealed	Estate tax repealed
2011 (sunset of Act)	1,000,000*	55

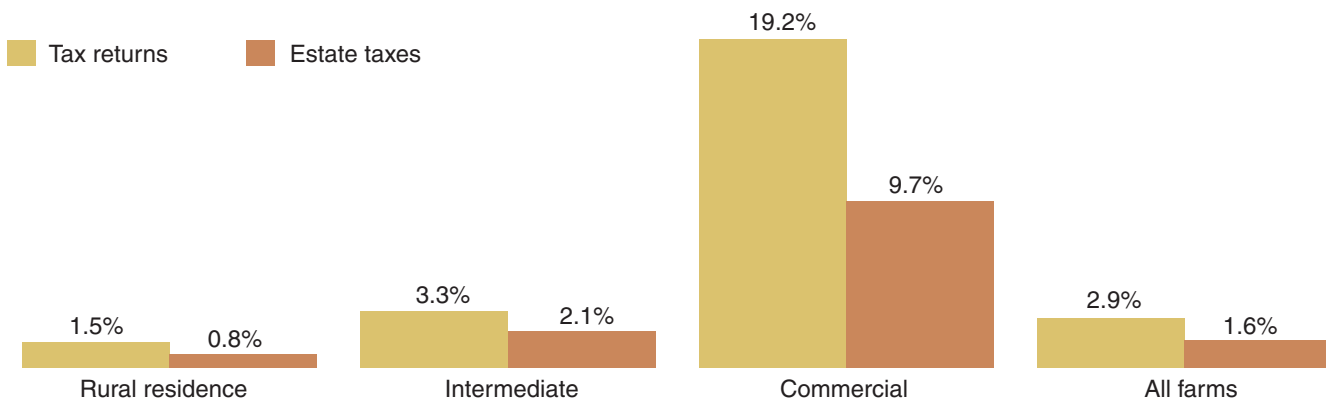
*Before being superseded by the 2001 Act, the estate tax exemption was scheduled to increase to \$1 million by 2006.

Source: USDA, Economic Research Service using data from Internal Revenue Code Section 2010.

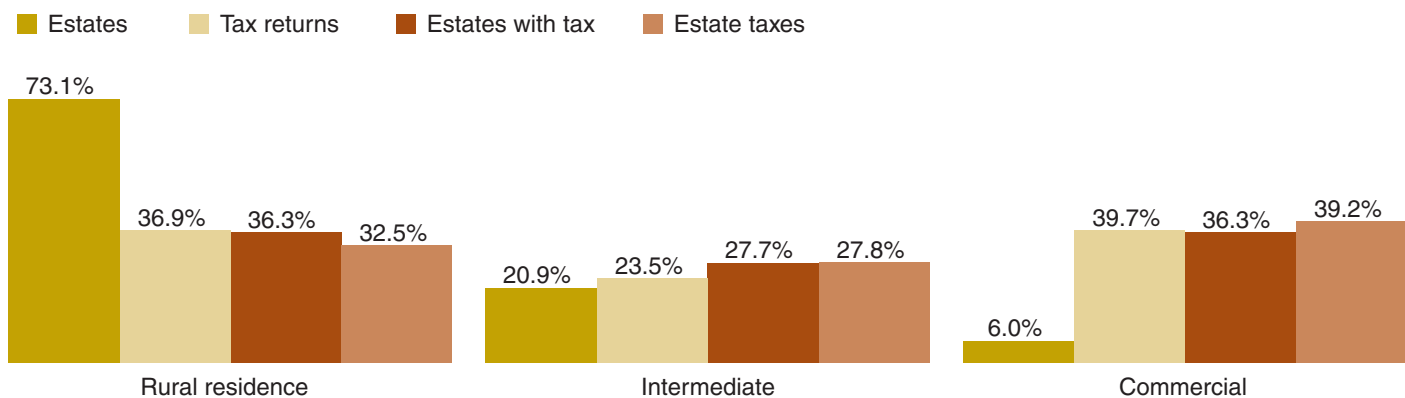


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Commercial farm estates are more likely to file a return and owe Federal estate taxes in 2009



Commercial farm estates account for only 6 percent of all farm estates but nearly 40 percent of Federal estate taxes



Note: Rural residence farms have annual sales under \$250,000 and operators whose primary occupation is other than farming; intermediate farms have annual sales under \$250,000 and operators whose primary occupation is farming; commercial farms have annual sales over \$250,000.

Source: USDA, Economic Research Service using data from USDA's 2007 Agricultural Resource Management Survey.

Special Provisions Benefit Farmers

Concerns that estate taxes might cause the breakup of some family-owned farms and small businesses led Congress to include two special provisions in the Tax Reform Act of 1976. These targeted provisions—the special-use valuation and the installment payment of estate taxes—have reduced the impact of Federal estate taxes on farms with estates valued above the basic exemption.

Special-Use Valuation

The value of property for Federal estate tax purposes is generally the fair market value on the date of the property owner's death. However, if certain conditions are satisfied, the estate's real property that is used solely for farming or another closely held business may be valued at the property's value as a farm or business rather than at its fair market value.

For those farms that qualify, special-use valuation can reduce the value of the real property portion of qualifying estates by 40 to 70 percent, with the largest reductions occurring for farmland having residential or commercial development potential. Based on information published by the Internal Revenue Service, the average reduction in value for qualifying estates in 2001 was 50 percent. The maximum reduction in value for estates of those dying in 2009 is \$1 mil-

lion. At current Federal estate tax rates, the potential estate tax savings available under special-use value could be as much as \$450,000. However, all or a portion of the estate tax benefits obtained under the special-use valuation provision must be repaid if the property is sold to a nonfamily member or if the property ceases to be used for farming within 10 years of the decedent's death.

Installment Payment of Estate Taxes

Federal estate taxes generally must be paid within 9 months of the date of the property owner's death. The installment payment provision was enacted out of concern that the heirs of family farmers and small business owners might have difficulty paying taxes on land and other relatively illiquid business assets. Under the provision, if at least 35 percent of an estate's value is a farm or closely-held business, estate taxes may be paid over 14 years and 9 months, with interest due only for the first 5 years. In 2009, the interest rate on the first \$1.33 million in taxable value (above the basic exemption and other exclusions) of the farm is 2 percent, with slightly higher rates owed on amounts above \$1.33 million. This installment payment provision, combined with the increase in the amount of property that can be transferred tax free, greatly reduces the liquidity problem that some farm heirs might otherwise experience as a result of Federal estate taxes.

Other Special Provisions

The Taxpayer Relief Act of 1997 (1997 Act) provided farmers and other landowners the opportunity to exclude 40 percent of the value of land subject to a qualified conservation easement for estate tax purposes. To qualify for the exclusion, the decedent or a family member must have owned the land for at least 3 years prior to the decedent's death. They also must have made a qualified conservation contribution, such as a perpetual restriction or easement on the use of real property for conservation purposes, to a charity or other qualifying organization.

The maximum estate tax exclusion for qualified landowners is \$500,000. This is in addition to the reduction in the land's value resulting from the easement itself. Thus, if the value of the easement represents a large share of the land's market value, the total reduction in value for estate tax purposes can be significantly higher than \$500,000. Donating a conservation easement may be an especially attractive option for farmers near urban areas who want to keep their land in farming. In 2005, landowners made 2,307 charitable donations of conservation easements. While the value of the estate tax benefits from these contributions is unclear, the total value of the easements was \$1.8 billion.

The 1997 Act also included a special deduction for farmers and other small business owners that will come back into effect should the current law be allowed to expire at the end of 2010. This provision allows for the deduction of the first \$675,000 of value for qualified family-owned businesses. The deduction is in addition to the basic exemption and any benefits from special-use valuation. However, the total amount excludable under this provision and the basic exemption is limited to \$1.3 million. Since the basic exemption was raised to \$1.5 million in 2004, the special deduction was effectively repealed that year. If the estate tax



provisions are allowed to expire and revert to pre-2001 law, the family business deduction will apply since the basic exemption would once again be below \$1.3 million.

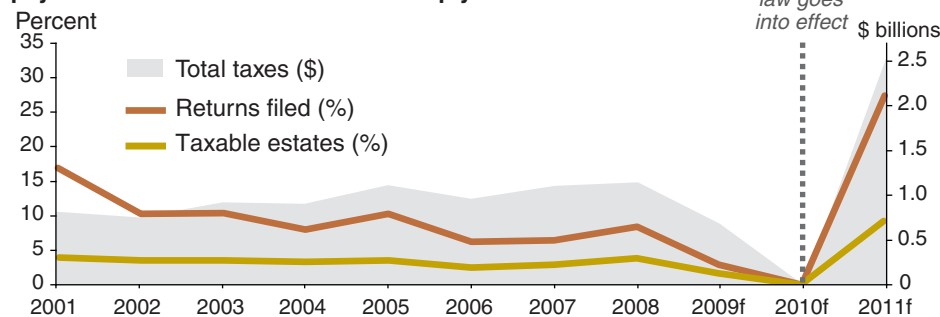
Current Law Provides for Repeal and Uncertainty

Under the 2001 Act, the estate tax is repealed completely in 2010. However, since the 2001 estate tax changes are scheduled to expire at the end of 2010, this repeal is only temporary. The resurrected tax in 2011 reverts to the law that was in place prior to the 2001 changes. As a result, the exempt amount would return to \$1 million and the top tax rate would revert to 55 percent, as established in the 1997 Act. This situation not only creates uncertainty but it also raises concerns regarding the disparate treatment of similar estates depending upon the date of death. The family of a person who dies on January 1, 2011, could owe considerably more than the heirs of a person dying a few days earlier.

The reversion to pre-2001 law will increase the share of estates that owe Federal estate tax and will result in higher Federal estate tax revenues. The share of estates that would owe tax under a reversion to pre-2001 law has been estimated to increase to about 25 percent of all estates, with total tax liability nearly doubling to over \$50 billion.

The impact on farm estates is expected to be even larger. Since 2000, farm equity has more than doubled, primarily due to the increasing value of farm real estate. Farmland values have increased by an average of 14 percent annually since 2004. As a result, under current law, it is estimated that as many as 1 out of every 10 farm estates would owe estate tax in 2011. Total payments could increase to about \$2.55 billion—nearly 300 percent more than farm estates are expected to owe in 2009.

The share of farm estates required to file a return and pay Federal estate tax could rise sharply in 2011



f: forecast based on 2007 data.

Source: USDA, Economic Research Service estimates using data from USDA's 2000-07 Agricultural Resource Management Survey.

Treatment of Gains for Inherited Assets

Under current law, the basis (which is the value used to determine gain or loss for tax purposes) of inherited assets is their fair market value at the date of death. This "step-up in basis rule" essentially eliminates the recognition of capital gains due to appreciation in the value of property occurring prior to the property owner's death. This rule is especially beneficial for assets, such as farmland, that are typically held for long periods and have appreciated considerably.

Under the 2001 Act, the step-up in basis rule is scheduled to change in 2010, limiting the amount of appreciation that would be exempt from income tax when the assets are sold. Specifically, the new basis is limited to no more than \$1.3 million (plus an additional \$3 million for transfers to a surviving spouse) over the value of the decedent's basis (e.g., the asset's purchase price). This change will add to compliance burdens since it will be necessary to determine the original cost or other basis of inherited assets. In farming, these assets may have been held for several decades with little or no documentation on their cost or other basis. The heirs of some farm estates who would owe no Federal estate or capital gains tax under current law would be faced with this compliance burden and could owe taxes when inherited assets are sold.

The number of estates with unrealized gain above the new step-up amount is estimated to exceed the current number of taxable estates. Most of these gains would be taxed at rates (15 percent on capital gains) substantially lower than estate tax rates. However, the tax would be triggered only upon the sale of the inherited assets, so some heirs would be discouraged from selling inherited assets, creating a lock-in effect.

With repeal and resurrection of the estate tax approaching, there is increasing interest in a substantial permanent increase in the exempt amount combined with the retention of the "stepped-up basis at death" treatment for inherited assets. The President's 2010 Budget would make the current \$3.5 million exemption amount and maximum 45-percent tax rate permanent and retain the stepped-up basis treatment for inherited assets. This would limit the share of estates subject to tax to less than one-half of 1 percent of all estates and between 1 and 2 percent for farm estates. It would also reduce some of the uncertainty and inequity created by the temporary repeal and sunset provisions applicable under current law. **W**

This article is drawn from . . .

Federal Tax Policies and Farm Households, by Ron Durst, EIB-54, USDA, Economic Research Service, May 2009, available at: www.ers.usda.gov/publications/eib54/