

Federal Estate and Gift Taxes

The current Federal estate and gift tax system applies a unified tax rate structure and a cumulative lifetime credit to gifts and transfers of money and other property at death. Under the system, individuals can transfer a specified amount (\$675,000 in 2001) in cash and other property without Federal estate or gift tax liability as a result of the unified lifetime credit. Although every estate with more than \$675,000 in gross assets must file an estate tax return, the taxable amount is reduced by deductions for funeral expenses, administrative expenses, debts, charitable contributions, and transfers to one's spouse. As a result, less than half of all estates required to file a return are actually taxable. Gifts of up to \$10,000 annually to any individual are also exempt from tax and do not count against the amount exempted from tax by the unified credit. Transfers in excess of the exempt amount are taxed at a graduated rate structure that begins at an effective rate of 37 percent, rising to a maximum rate of 55 percent on taxable estates above \$3 million (table 20).

Estate and gift tax receipts have historically accounted for a relatively small share of total annual Federal revenues. The receipts from the Federal estate and gift tax for fiscal year 1999 are estimated at \$25.9 billion, less than 2 percent of total Federal revenues. While the aggregate importance of estate and gift taxes is small relative to other Federal government revenue sources, the potential impact of these taxes on an individual or

group of individuals, such as farmers and other small business owners, can be substantial.

The impact of Federal estate and gift taxes on the farm sector was an important issue during the late 1970's. During that period, the appreciation in land values, the increase in farm size, and the rising investment in farm machinery and equipment increased estate values and taxes substantially. Congressional concern that increased estate and gift taxes might cause the break-up of some family farms and other small businesses resulted in the enactment of two special provisions in the Tax Reform Act of 1976. These provisions are the special use valuation of farmland and the installment payment of estate taxes. Concern for the effects of the Federal estate tax on farmers and other small businesses was also the primary impetus for the changes enacted as part of the Taxpayer Relief Act of 1997, which included a new deduction for qualified family-owned business interests.

Special Use Value

The value of property for estate tax purposes is generally the fair market value at the date of death. However, if certain conditions are satisfied, real property included in the estate which is devoted to farming or other closely held business use may be valued at the property's value as a farm or other closely held business rather than its fair market value. To be considered qual-

Table 20—Federal estate and gift tax rate schedule, 2001

Taxable estate	Tax liability is ¹	Plus	Of amount over
<i>Dollars</i>	<i>Dollars</i>	<i>Percent</i>	<i>Dollars</i>
10,000 and under	0	18	0
10,001- 20,000	1,800	20	10,000
20,001- 40,000	3,800	22	20,000
40,001- 60,000	8,200	24	40,000
60,001- 80,000	13,000	26	60,000
80,001- 100,000	18,200	28	80,000
100,001- 150,000	23,800	30	100,000
150,001- 250,000	38,800	32	150,000
250,001- 500,000	70,800	34	250,000
500,001- 750,000	155,800	37	500,000
750,001- 1,000,000	248,300	39	750,000
1,000,001- 1,250,000	345,800	41	1,000,000
1,250,001- 1,500,000	448,300	43	1,250,000
1,500,001- 2,000,000	555,800	45	1,500,000
2,000,001- 2,500,000	780,800	49	2,000,000
2,500,001- 3,000,000	1,025,800	53	2,500,000
3,000,001 and over	1,290,800	55	3,000,000

¹Before credits and phase-out of graduated rates for estates with taxable amount in excess of \$10,000,000.

Source: Internal Revenue Code Section 2001.

ified property, the property must be transferred to a qualified heir,⁵ must have been used as a farm for 5 years during the 8-year period ending with the decedent's death, the decedent or a member of the decedent's family must have participated in the farm business, the value of the qualified real property must equal at least 25 percent of the estate, and the combined value of the real and other business property must be at least 50 percent of the gross estate.

The method used to value farmland for use value purposes is to divide the 5-year average annual gross cash or share rental for comparable land in the area, minus State and local real estate taxes, by an average of the annual effective interest rate for all new Federal Land Bank (FLB) loans for the year of death. For most farms, the use valuation law can reduce the value of the real property portion of qualifying estates by 40 percent to 70 percent, with the largest reductions occurring for farmland which has residential or commercial development potential. All or a portion of the estate tax benefits obtained under the special use valuation provision are recaptured if the property is sold to a nonfamily member or if the property ceases to be used for farming or other closely held business purpose within 10 years of the decedent's death.

The Tax Reform Act of 1981 increased the maximum reduction in value under special use value from \$500,000 to \$750,000 for estates of those dying in 1983 or later. In the absence of other changes, this change would have increased the incentive to invest in farmland for estate tax purposes. However, the Economic Recovery Tax Act of 1981 made other substantial changes in estate and gift tax provisions. These included reductions in marginal estate and gift tax rates, an increase in the annual gift tax exclusion, an increase in the unified credit and the allowance of an unlimited marital deduction. The net effect of these provisions was to substantially increase the amount of property that could be transferred tax free. The cumulative effect of these changes reduced the incentive for many estates to qualify for special use value. Nevertheless, for those estates in need of additional tax saving techniques, the special use value provision continues to offer significant tax benefits. Even with reduced Federal estate tax rates, the maximum estate tax savings available under special use value is \$440,000. In addition, the liberalization of the qualification requirements

for special use value lowered the barriers which might otherwise have discouraged some investors from seeking special use value benefits. Thus, the special use value provision may have an unintended impact on the farm sector. The potential estate tax savings may have encouraged additional purchases while the recapture provisions discouraged sales. The net effect has been reduced availability but increased demand for farmland.

Installment Payment of Estate Tax for Closely Held Businesses

A second special provision for farmers and other small business owners is aimed at the liquidity problem that these businesses can face as a result of having a large portion of the estate in land and other relatively illiquid business assets. Federal estate and gift taxes generally must be paid within 9 months of the date of death. However, when at least 35 percent of an estate's value is a farm or closely held business, estate taxes may be paid over an additional 14-year period. Prior to 1998, the interest rate on taxes due on the first \$1 million in value of qualifying assets was 4 percent. For amounts above \$1 million, the rate was the normal rate applicable to underpayments of tax. Interest paid on deferred estate taxes was deductible for either estate or income tax purposes.

Beginning in 1998, the interest rate on the first \$1 million in taxable value (above amounts exempted by the unified credit) of the farm or other closely held business was reduced to 2 percent. The interest rate on amounts above \$1 million in taxable value was reduced to 45 percent of the rate applicable to underpayments of tax. However, the interest is not deductible for either estate or income tax purposes. These changes to the installment payment provision reduced both the interest expense and the administrative burden associated with installment payments. The amount of estate tax eligible for the 2-percent interest rate will increase from \$153,000 to \$435,000 by 2006. As a result, a \$2-million estate qualifying for the installment payment provision would have the present value of its tax cut in half compared with an estate required to pay Federal estate taxes in full within 9 months of death.⁶ This change combined with the increase in the amount of property that can be transferred tax free should greatly reduce the liquidity problem that some farm heirs might otherwise experience as a result of Federal estate taxes.

⁵ A qualified heir means a member of the decedent's family, including an ancestor, spouse, lineal descendants, and parents and their descendants.

⁶ Assumes a 2-percent interest rate and an 8-percent discount rate.

Indexing for Certain Estate and Gift Tax Provisions

The value of various estate tax provisions has not been changed for several years. As a result, the real value has declined significantly. Beginning in 1999, the \$10,000 annual exclusion for gifts, the \$750,000 cap on the reduction in value under special use valuation, and the \$1-million ceiling on the value of a closely held business eligible for the special low interest rate under the installment payment provision were indexed for inflation. While indexing will not restore the loss in value, it will maintain the real value at current levels in the future.

Deduction for Qualified Family-Owned Businesses

Beginning in 1998, a new deduction for the first \$675,000 of qualified family-owned business interests was enacted. The deduction is in addition to any benefits from special use valuation and the unified credit. However, the total amount excludable from this provision and the unified credit is limited to \$1.3 million. Thus, as the amount shielded from tax by the unified credit increases, the additional exempt amount for farms and closely held businesses declines to \$300,000 by 2006 and thereafter (table 21).

A qualified family-owned business interest is any stake in a business with its principal place of business in the United States in which one family owns at least 50 per-

cent of the business, two families own at least 70 percent, or three families own at least 90 percent, as long as the decedent's family owns at least 30 percent. To be eligible for the deduction, such interests must represent more than 50 percent of a decedent's estate, the decedent or a member of the family must have owned and materially participated in the business for at least 5 of the 8 years before death, and each qualified heir or a member of the heir's family must materially participate in the business for at least 5 of each 8-year period ending within 10 years after the decedent's death. The benefits from the deduction are recaptured if the qualified heir fails to meet the material participation requirements, the qualified heir disposes of the business interest other than to a family member or through a qualified conservation contribution, the principal place of business is moved outside the United States, or the heir loses U.S. citizenship.

The new exclusion for farms and other family-owned businesses combined with the increased unified credit is expected to reduce the number of taxable farm estates by nearly 50 percent. The total taxes paid are expected to drop by about one-third. This new deduction along with the other changes to the Federal estate tax provisions should reduce, if not eliminate, the need to sell farm assets to pay Federal estate taxes. Nevertheless, the targeting provisions associated with the new deduction are extremely complex and contain a number of pitfalls for the uninformed. Qualifying for the new deduction will require careful planning, further increasing the administrative burden and expense associated with the estate tax.

Table 21—Potential Federal estate tax exemption amount from unified credit and family-owned business deduction

Year	Unified credit exclusion amount	Family business deduction amount	Total exclusion amount ¹
<i>Dollars</i>			
1987-97	600,000	0	600,000
1998	625,000	675,000	1,300,000
1999	650,000	675,000	1,300,000
2000-01	675,000	675,000	1,300,000
2002-03	700,000	675,000	1,300,000
2004	850,000	675,000	1,300,000
2005	950,000	675,000	1,300,000
2006	1,000,000	675,000	1,300,000

¹Total amount exempted by unified credit and family business deduction cannot exceed \$1,300,000.

Source: Compiled by USDA-ERS from information contained in Internal Revenue Code Sections 2010 and 2057.

Exclusion for Land Subject to Conservation Easement

Since 1981, a deduction has been allowed for Federal income, estate, and gift tax purposes for a contribution of a qualified real property interest to a charity or other qualifying organization exclusively for conservation purposes. A qualifying real property interest includes a perpetual restriction or easement on the use of real property. A conservation purpose is defined as (1) the preservation of land for the general public's outdoor recreation or education, (2) the preservation of a natural habitat, (3) the preservation of open space for the scenic enjoyment of the general public or in furtherance of a governmental conservation policy, and (4) the preservation of historically important land or certified historic structures.

Beginning in 1998, in addition to the reduction in value for the conservation easement, an exclusion is provided for up to 40 percent of the value of land in an estate that is subject to a qualified conservation easement and located within 25 miles of a metro area, a national park or wilderness area, or within 10 miles of an urban national forest. The decedent or a member of the decedent's family must have owned the land for at least 3 years prior to the date of death and the donation must have been made by the decedent or his or her family. The exclusion is based on the value of the property after the conservation easement is placed, and does not include any retained development rights to use the land for any commercial purpose except those supportive of farming. If the value of the conservation easement is less than 30 percent of the value of the land for purposes of the exclusion, the exclusion percentage is reduced 2 percentage points for each percentage point below 30 percent. The maximum exclusion is limited to \$400,000 in 2001 but increases to \$500,000 in 2002 and thereafter.

Granting a qualified conservation easement is not treated as a disposition that would trigger the recapture of special use valuation benefits, and the existence of a qualified conservation easement does not affect eligibility for special use valuation. Thus, the exclusion can be used in combination with the special use valuation provision.

The exclusion provides an additional incentive to donate a conservation easement within the designated areas. However, given the increased unified credit, the availability of special use valuation, and the new deduction for family-owned business interests, the number of landowners who are subject to the Federal estate tax and who would benefit from the additional exclusion may be relatively small. Geographic targeting of conservation easements will also limit the pool of potential donors. Nevertheless, those farmers willing to forgo potential future development gains can transfer an additional \$500,000 in farmland to their heirs without affecting the operation of the farm business.

Implications of Federal Estate and Gift Tax Changes

The amount of property that can be transferred tax free has increased substantially since 1980. The Economic

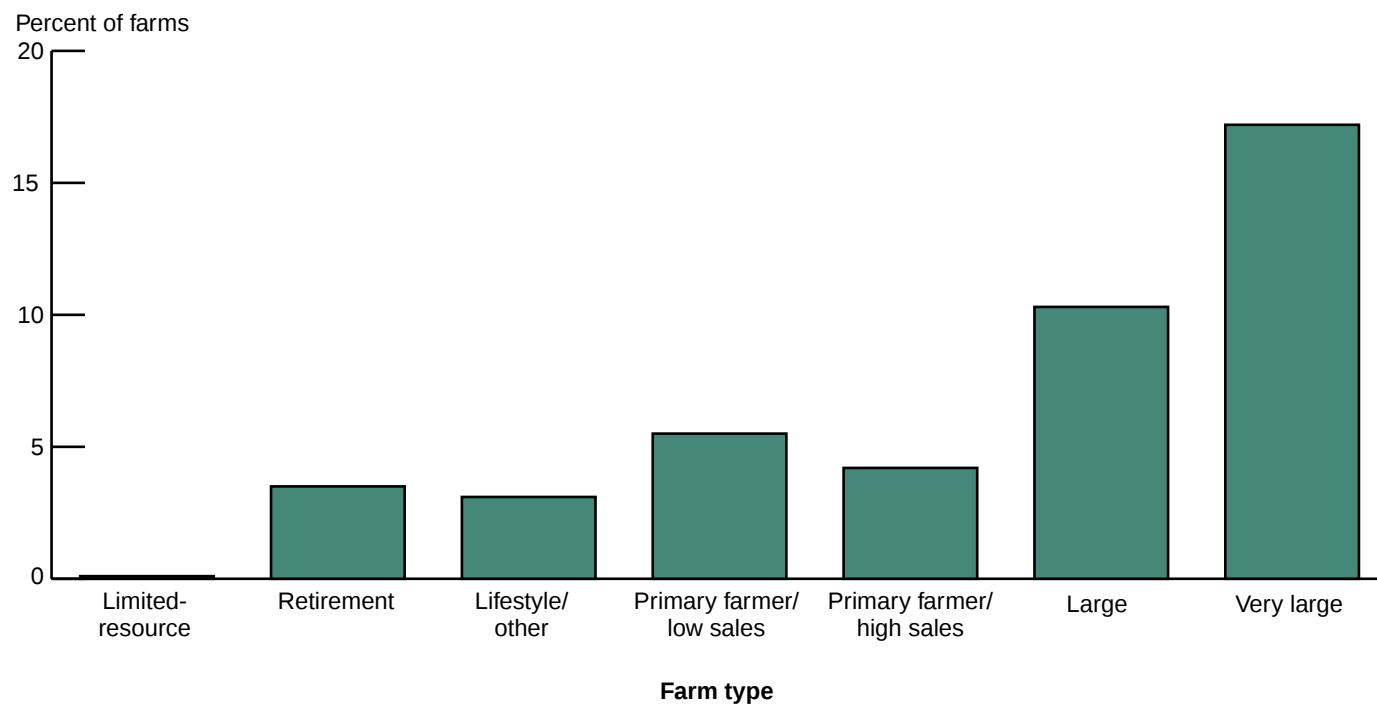
Recovery Tax Act of 1981 increased the unified credit each year from 1982 through 1987, from an effective exemption amount of \$225,000 in 1982 to \$600,000 in 1987. The exemption amount remained the same until the 1997 Act which increased it to \$1,000,000 by 2006 (table 21).

The combination of the new family business deduction and special use value will substantially reduce the number of farm estates subject to the Federal estate tax. Those that are eligible for these provisions but remain taxable are primarily farming occupation with high sales, large or very large farms (fig. 7). The majority of other farms that remain taxable are not eligible for special use valuation or the family business deduction due to the share of nonfarm assets in the estate. For lifestyle/other and retirement farms, average nonfarm net worth exceeds average farm net worth. For lifestyle/other farms, this may reflect the relative importance of the farm and nonfarm activities. For retirement farms, it may reflect the disposition of farm assets in anticipation of or during retirement.

Based on simulations using 1998 farm-level survey data, about 4 percent of all farm estates would owe Federal estate and gift taxes, slightly higher than the 2 percent of all estates. Of the 31,161 estimated farm estates for the 1998 year, only 5,394 had assets in excess of \$625,000 and would be required to file an estate tax return (fig. 8). After deductions, special use value and the family business deduction, only 1,219 of the estates would be taxable. The average tax due was estimated at \$600,000 on an average net worth of \$2,800,000 for an average tax rate of 21 percent. The special use valuation and the family business deduction reduced both the number of taxable estates and total Federal estate taxes for all farm estates by about half.

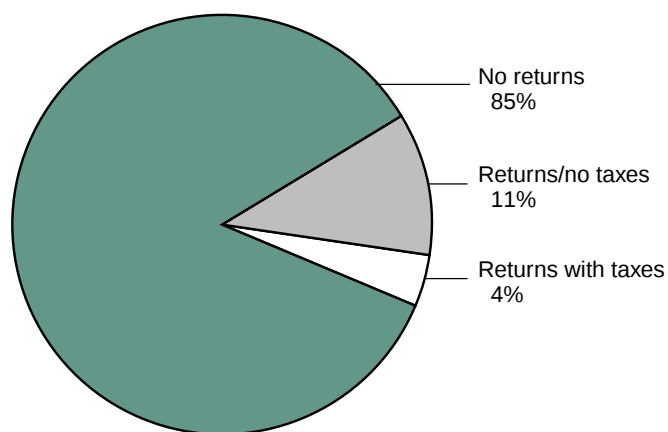
The changes enacted in 1997 reduced the number of farm estates that will be subject to tax but increased the favored treatment of farm and other business assets over other assets for estate tax purposes. Thus, the family-owned business deduction combined with other targeted provisions will encourage older farmers to retain ownership of land, livestock, machinery, and other farm assets until death. This will increase the amount of farm property transferred to heirs but may reduce opportunities for others to enter farming.

Figure 7
Share of farm estates that owe Federal estate taxes by farm typology, 1998



Source: Estimated by ERS-USDA from ARMS data.

Figure 8
Share of farm estates with returns and taxes, 1998



Source: Estimates by USDA-ERS from ARMS data.