

How Would Proposed Changes in Federal Estate Taxes Affect Farmers?

The number of farms and other estates that must pay Federal estate taxes has increased in recent years. Concerns about this increase and its effect on farms and other small businesses have generated a number of proposals to change Federal estate tax laws. Some proposals would affect only farms and small businesses. Other proposals would lower taxes for all estates and reduce the number of estates required to file an estate tax return. Of the current proposals examined here, farm estate taxes would be reduced most by a new exclusion for family-owned businesses, including farms.

The Federal Government has levied a progressive estate tax since 1916. For most of this period, including currently, less than 2 percent of estates have been taxable. However, the number of estates subject to the tax has risen from about 19,000 in 1988 to nearly 32,000 in 1995 and Congress is actively considering a reduction in estate taxes.

Despite its relative unimportance as a revenue source, many believe that the Federal estate tax plays an important role in the overall fairness of the Federal tax system since it taxes unrealized capital gains, income that is otherwise untaxed. Although the tax primarily affects the largest estates, economists have been unable to determine if it has reduced the concentration of wealth.

Since the Federal estate tax is not levied on current economic activity but is a "lump sum" tax on the accumulated assets at death, supporters suggest that it causes less distortion in economic behavior than other methods of taxation, especially the income tax, which reduces the economic reward from current income. Opponents of the tax, however, suggest that the desire to provide an inheritance to one's heirs is an important determinant of an individual's savings behavior, and that the estate tax discourages such savings. Economists are divided on the importance of this "bequest motive."

While the impact of Federal estate taxes on either aggregate savings or the concentration of wealth is uncertain, a consensus has emerged that

the current Federal estate tax affects investment in farms and other closely held businesses. A substantial portion of a farmer's or small business owner's wealth may consist of business assets. Thus, in planning for estate taxes, owners of farms and other small businesses may divert funds from business investment to provide liquidity to pay estate taxes. In the absence of such planning, heirs may be forced to borrow or to sell business assets to pay estate taxes. Such actions may reduce the capital invested in the farm or other small business, although they should not affect most farms, which are not currently subject to the tax. Nevertheless, many of the proposed changes to current Federal estate and gift tax policies are aimed at reducing the burden of the Federal estate tax on farms and other closely held small businesses.

In the following, we have simulated the effect of current law and some proposed changes by using data from the 1994 Farm Costs and Returns Survey and applying mortality rates based on the operator's age (see box).

Overview of Current Law

The Federal estate and gift tax system applies one tax rate structure and a cumulative lifetime tax credit to both gifts and transfers at death. Under this system, each individual may transfer \$600,000 in cash and other property without Federal estate or gift tax liability. Although every estate with more than \$600,000 in gross assets must file an estate tax return, the taxable amount is reduced by deductions for funeral expenses, administrative expenses, debts, and charitable contri-

Estimating Procedures

Estimates in the report are based on simulations using data from the 1994 USDA Farm Costs and Returns Survey (FCRS). The age of the operator was used to estimate the probability that the operator would leave an estate. The FCRS is a stratified sample of farms with detailed financial information including nonfarm assets. Since the FCRS did not include questions about previous or planned future operation of the farm, the analysis only checked the relative amounts of farm real estate, other farm property, and the gross estate to determine eligibility for special use valuation and the family business exclusion. Since a few farmers may not meet the participation requirements or elect special use valuation, the benefits shown here represent the maximum benefits available.

butions. Any transfer to one's spouse is also shielded from the tax as are gifts (before death) of up to \$10,000 annually to any individual recipient. Transfers in excess of \$600,000 are taxed on a graduated scale beginning at a 37-percent rate, rising to a maximum rate of 55 percent on taxable estates above \$3 million.

Over the years, increasing farm sizes and appreciating land values have increased farm estate values and taxes. Congress, concerned that Federal estate and gift taxes might force some family farms to liquidate, has enacted two special provisions to help heirs deal with these taxes. These provisions include "special use valuation" of farmland and installment payment of estate taxes on certain small businesses.

Special Use Valuation. For tax purposes, most estate assets are valued at their fair market value at the owner's death. Farmers, however, may use special use valuation for qualified farm and ranch property if at least 50 percent of the estate is farm real estate and personal property and at least 25 percent consists of farm real estate. In addition, the property must pass to a qualified family member and both the decedent and the heir must satisfy certain business participation requirements.

While the reduction depends upon the individual property, in recent years this provision has reduced the average value of farmland and buildings for

Federal estate tax purposes by nearly 50 percent. The reduction in estate value by this provision is limited to \$750,000. According to Internal Revenue Service statistics, farm estates electing special use valuation in 1994 received an average reduction in taxable estate value of \$343,000, resulting in average tax savings of well over \$100,000. Taxable farm estates of \$1 million with typical proportions of farm real estate (68 percent) and non-farm property (18 percent) have their average estate tax rate reduced from about 15 percent to 3 percent (fig. 1).

Installment Payment of Estate Taxes.

Generally, Federal estate taxes 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 with only interest due for the first 4 years. The interest rate on taxes due on the first \$1 million in value of qualifying assets is 4 percent. With a market interest rate of 8 percent, the 4-percent interest rate reduces the present value of the estate tax by about one-fourth, with a maximum savings of about \$33,000.

Larger Share of Farmers Currently Pay Estate Tax. Despite the availability of special use valuation, a larger share of farmers compared with other taxpayers continue to be subject to the Federal estate tax. Based on simulations using 1994 farm-level survey data, an estimated 6 percent of farm estates would owe Federal estate and

gift taxes compared with just over 1 percent of all estates. Of 29,340 estimated farm estates for the 1994 year, 4,150 would have had assets in excess of \$600,000 and would be required to file an estate tax return. However, after deductions and special use valuation, only 1,741 of the estates would be taxable. The average tax due was \$285,000 on an average net worth of \$1,587,000 for an average tax rate of 18 percent on taxable farm estates. The special use valuation provision reduced both the number of taxable estates and total Federal estate taxes for all farm estates by about a third.

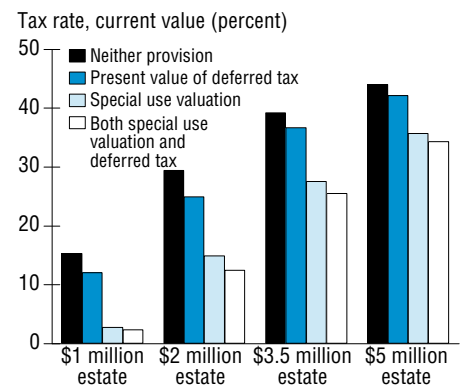
Although only about 6 percent of all farm estates currently pay estate taxes, a much higher percentage of commercial farms (those with over \$50,000 in gross cash sales) pay such taxes. The 538,000 commercial-sized farms in the Nation account for about 18 percent (5,400) of all farm estates in a given year. Over 14 percent of these farms would owe Federal estate taxes.

Proposed Changes to Federal Estate Taxes

The most important factor determining the percentage of estates subject to tax is the size of the unified credit, which

Figure 1

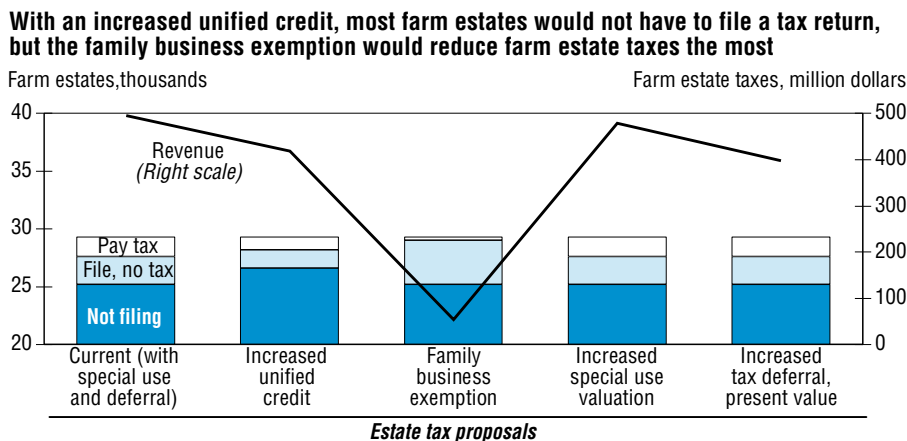
Special-use valuation and tax deferral now reduce the effective tax rate for all qualifying farm estates



Note: A farm estate is assumed to be comprised of 68 percent farm real estate, 18 percent nonfarm property, 14 percent other property.

Source: Compiled by Economic Research Service from Farm Costs and Returns Survey, 1994, and based on current law.

Figure 2



Source: Compiled by Economic Research Service from Farm Costs and Returns Survey, 1994.

is a tax credit applicable to estate and gift taxes. The amount of property shielded from tax by the unified credit was increased from \$250,000 in 1981 to \$600,000 in 1987. Since 1987, the credit has remained unchanged at \$192,800, which shelters an estate of \$600,000. As a result, an increasing percentage of estates have been required to file estate tax returns and pay taxes. This increase, and the prospects for an even larger number of estates owing taxes over the next several years, has resulted in a number of proposals to reduce Federal estate and gift taxes.

The most significant changes currently proposed for the Federal estate and gift tax laws include: (1) an increase in the unified credit to increase the amount sheltered from the current \$600,000 to \$750,000, (2) a new exclusion for farms and other closely held business interests equal to the first \$1.5 million plus half of the remainder, (3) an increase in the current cap on the reduction in estate value from special use valuation from \$750,000 to \$1 million and (4) an increase in the amount of property eligible for installment payments from \$1 million to \$2.5 million.

Simulations were done for each of these proposals. The simulated estate tax revenues raised from farm estates

and the number of farm estates filing taxable or nontaxable returns are shown in figure 2. The average tax rates for these proposals for farm estates with typical shares of property in farm real estate and nonfarm property are compared with each other and with the current average tax rate for farmers using special use valuation and deferred payments (fig. 3).

Increasing the Unified Tax Credit. Currently, each U.S. resident or citizen is allowed a unified tax credit sufficient to offset the tax on the first \$600,000 of an individual's estate. However, the real value of the credit has declined by about one-third since 1987. The proposed change would increase the unified credit enough to shield \$750,000 from estate taxes. This would lower taxes for all taxable estates and reduce the number of estates required to file an estate tax return.

Providing a New Exclusion for Family Businesses. The new family business exclusion proposal would apply to farms and other family-owned businesses and would exempt part or all of the family business. The allowable exclusion would be equal to the first \$1.5 million plus half of the value of additional business property. The new exclusion would be for estates where the business is owned by a small number of families, the business is more

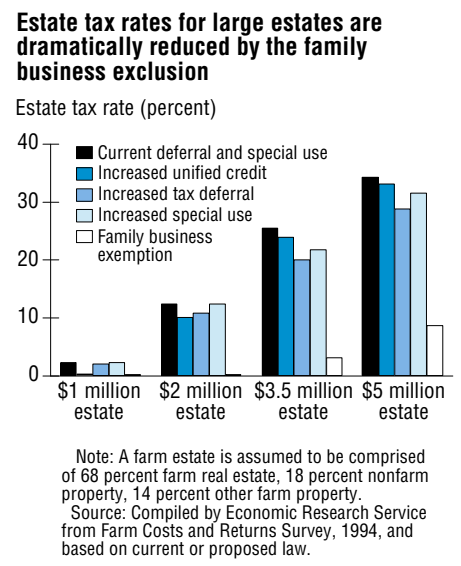
than half of the gross estate, the deceased participated in the business, and the heirs plan to continue the business. Unlike special use valuation, however, the exclusion would not favor those estates whose business assets are primarily comprised of land.

Of the proposed changes, the family business exclusion would make the most significant reduction in the number of taxable farm estates and the amount of taxes paid, with only about 1 percent of all farms owing estate taxes (fig. 2).

Increasing the Amount of Estate Tax Eligible for Deferral at Reduced Interest Rates. The average tax rate of farm estates with over \$1 million in value is estimated at about 20 percent. With up to 85 percent of net worth tied up in farmland and other essential business assets, these estates may face liquidity problems. The Administration has proposed changes to the installment payment provision to address this liquidity problem.

This proposal would increase the value of the business eligible for the special low interest rate from \$1 million to \$2.5 million. The current 4 percent interest rate would be cut to 2 percent (non-deductible) and the rate on the amount over \$2.5 million would be just 45 percent of the normal rate on tax un-

Figure 3



derpayments. The Secretary of the Treasury could also accept security arrangements in lieu of the special estate tax lien, which has made it difficult for heirs to obtain credit in some cases.

At a market interest rate of 8 percent, the present value of the tax would be lowered to about two-thirds of the original amount, resulting in savings of up to about \$255,000 for an estate in which the farm portion is valued at \$2.5 million or more. Due to the lower interest rate, even estates with \$1 million in farm property would have the present value of their tax lowered by about \$47,000, compared with about \$33,000 under current law. Thus, this proposal could significantly reduce the pressure to sell farm assets to pay estate taxes.

Increasing the Maximum Savings Under Special Use Valuation. The \$750,000 cap on the reduction in value under the special use valuation provision has been unchanged since 1981. Nevertheless, only about 10 percent of farms electing special use valuation are affected by the cap. One proposed change to the special use valuation provision would increase the cap to \$1 million.

Allowing special use valuation to reduce the value of an estate by up to \$1 million would primarily affect those farmers having more than \$1.5 million in farm real estate. Estates with net worth between \$1 million and \$5 million would only save about \$4,000 on average since many are non-taxable and most are not affected by the cap. On the other hand, estates with more than \$5 million in net assets would realize average savings of about \$137,500.

Conclusions

The number of farm estates and other estates that must pay Federal estate taxes has increased in recent years. This increase is especially important for farmers and other small business owners who hold significant amounts of wealth in the form of business assets and who are more likely to be subject to estate taxes.

Recent proposals aimed at providing tax relief to farmers and small business owners would reduce both the average tax rate and the number who owe estate taxes. For most proposals, much of the benefit would be captured by the largest estates. Modifying the installment payment provision would directly address the liquidity problem faced by heirs of some farms and small businesses. Increasing the unified credit is the only proposal that would benefit all taxable estates. It would increase the filing threshold level, lower administrative costs, and disproportionately reduce the tax and compliance costs of smaller estates, especially those that could dispense with filing or those rendered non-taxable.

Any of the proposed changes would make it easier to transfer family farm businesses across generations by reducing the likelihood that the farm or some of its assets would need to be sold to pay Federal estate taxes. However, while heirs may retain ownership of the farm business assets, only about a third of heirs in each generation choose to operate inherited family farms.

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Further Readings

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