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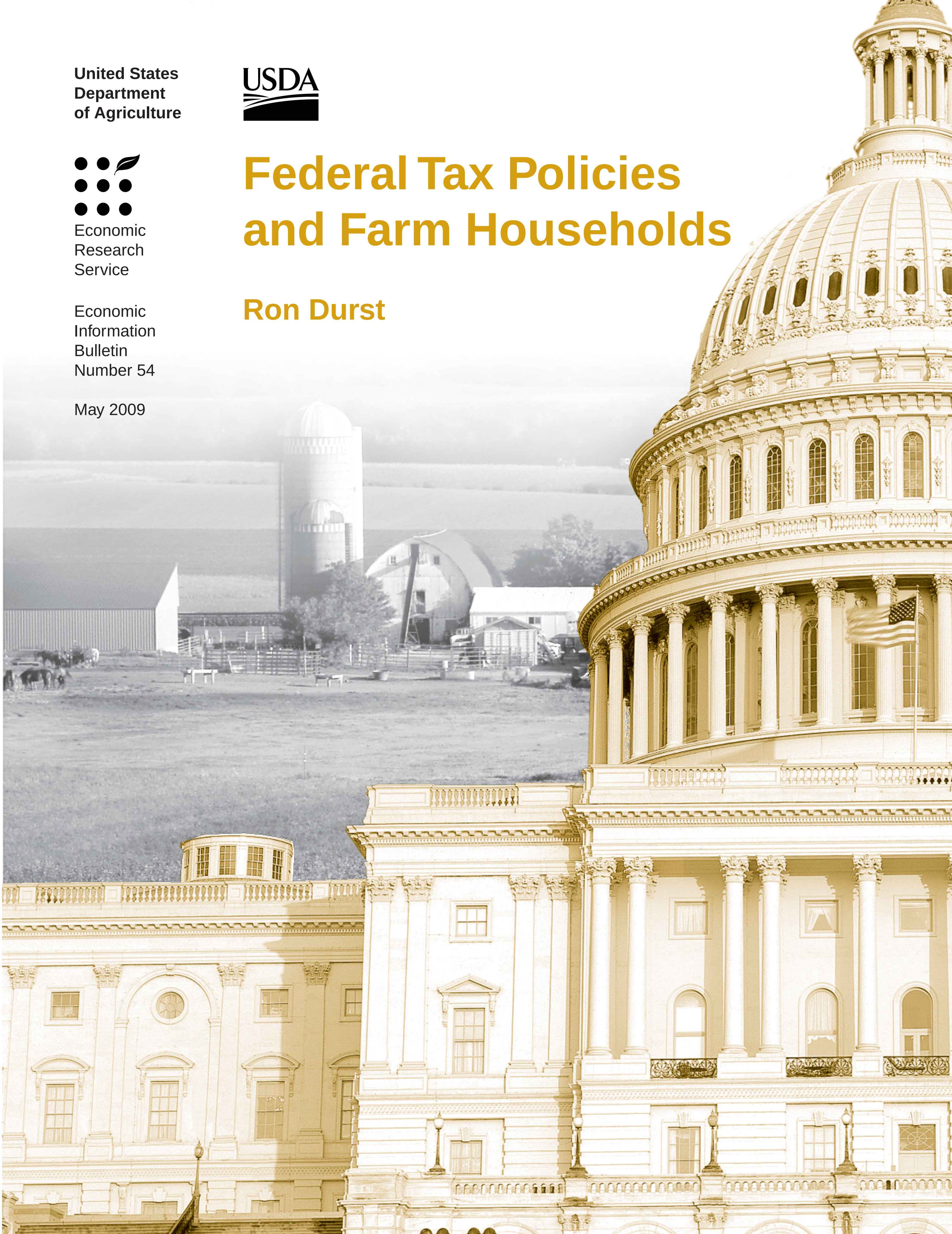
Federal Tax Policies and Farm Households

Ron Durst



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A Report from the Economic Research Service

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Federal Tax Policies and Farm Households

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Abstract

Significant changes in Federal individual income and estate tax policies have occurred over the last 10 years. Analysis suggests that changes in Federal tax provisions affecting both individual and business income taxes have reduced average tax rates for all farm households, resulting in the lowest tax burden on farm income and investment in a decade. Similarly, an analysis of the changes to Federal estate tax policies suggests that increases in the value of property that can be transferred to the next generation free of the estate tax, combined with special provisions for farmers and other small businesses, have greatly reduced the number of farm estates subject to the tax and the amount owed. While nearly 10 percent of commercial farm estates could owe tax in 2009, only 1 to 2 percent of all farm estates are estimated to be subject to the Federal estate tax this year.

Keywords: income tax, estate tax, tax rates, estate, Federal tax policy, farm losses, commercial farms

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Contents

Summary

Significant changes in Federal individual income and estate tax policies have occurred over the last 10 years. Since the Federal individual income tax affects a broad group of farmers and the Federal estate tax can affect the ability to transfer the Nation's farm businesses to the next generation, these changes are of considerable importance to the farm community. Modifications to Federal income and estate tax policies affect not only the financial well-being of farm households but also the number and size of farms, their organizational structure, and their use of land, labor, and capital inputs.

What is the issue?

A number of changes to Federal income and estate tax policies are scheduled to expire in 2010. As the expiration date approaches, the debate regarding the future of these policies is likely to intensify, especially in light of the increasingly challenging Federal budget environment. This report evaluates the impact of Federal income and estate tax policies on the tax burdens and financial well-being of farm households.

What did the study find?

Over the last decade, Federal income tax changes affecting both individual and business income taxes have reduced average tax rates for all farm households. While nearly all farm households have benefited from the changes, commercial farm (annual sales greater than $250,000) households are the primary beneficiaries of many of the business tax provisions, including increased expensing of capital purchases, reduced tax rates on business assets, and a new deduction for manufacturers, which is defined to include farmers.

The cumulative effect of these changes to Federal tax policy has resulted in the lowest Federal tax burden on farm income and investment in a decade. The average tax rate for farm sole proprietors was reduced from 17.1 percent in 1994 (and 17.8 percent in 2000) to about 14.8 percent in 2004. Federal income taxes paid by farm sole proprietors dropped from $24.9 billion in 2000 to $21 billion in 2004, a reduction of nearly 16 percent. Current average tax rates are estimated to be at or below the 2004 levels.

Changes to Federal estate tax policies have increased the value of property that can be transferred to the next generation free of the estate tax and have reduced tax rates on estates still subject to the tax. Special tax provisions targeted to farmers and other small business owners have provided additional benefits. Those changes have reduced the number of farm estates required to file an estate tax return as well as the number required to pay tax and the amount of Federal estate taxes owed. Based on simulations using farm-level survey data, about 2.9 percent of the 38,234 projected farm estates in 2009 are estimated to have enough assets to necessitate filing an estate tax return. After deductions, only about half of those farm estates will be taxable. The total amount of Federal estate taxes owed by farm estates in 2009 is estimated at $683 million.

The estate tax is scheduled to be repealed completely in 2010 before reverting to 2001 law in 2011. If allowed to go into effect, the reversion to 2001 law would increase the share of farm estates that owe Federal estate tax and total Federal estate tax revenues. As many as 1 of every 10 farm estates would owe estate tax in 2011, with total Federal estate taxes rising to about $2.55 billion, an increase of nearly three times the amount estimated to be owed in 2009.

How was the study conducted?

This report uses both published and special tabulation data obtained from the Internal Revenue Service to provide an overview of the current tax situation for U.S. farm households and to evaluate the importance of various Federal income and estate tax policies. It also uses farm-level data from USDA's Agricultural Resource Management Survey (ARMS) to estimate the effects of various policies on Federal income and estate tax liabilities. ARMS was also used to estimate the number of farm estates, the number of estates that would owe taxes, and total Federal estate taxes for the estates of farm operator households.

Introduction

Significant changes in Federal individual income and estate tax policies have occurred over the last decade. Since the Federal individual income tax affects a broad group of farmers and the Federal estate tax can affect the ability to transfer the farm business to the next generation, changes in these two taxes are of considerable importance to the Nation's farm community. Modifications to tax policies can affect not only the financial well-being of farm households but also the number and size of farms, their organizational structure, and their use of land, labor, and capital inputs.

Federal tax changes affecting both individual and business income taxes have reduced average tax rates for all farm households. While nearly all farm households have benefited from the changes to individual tax rates and other nonbusiness deductions and credits, commercial farm (annual sales greater than $250,000) households are the primary beneficiaries of many of the business tax provisions, including increased expensing of capital purchases, reduced tax rates on business assets, and a new deduction for manufacturers.

Changes to Federal estate tax policies have increased the value of property that can be transferred to the next generation free of the estate tax and reduced tax rates. Special tax provisions targeted to farmers and other small business owners have provided additional benefits. This has reduced the number of farm estates required to file an estate tax return and pay tax and the amount of Federal estate taxes owed.

While Federal tax policies have undergone significant change in the last several years, several factors suggest that additional changes are likely over the next couple of years:

- In both the income and estate tax area, a number of the changes enacted since 2000 are scheduled to expire in 2010. As the expiration date approaches, these policies are likely to be reexamined. Decisions regarding expiring tax provisions could affect both the tax burden and the financial well-being of farm households.

- The tax code has been increasingly viewed as a suitable vehicle to achieve a variety of social policy objectives. The first-time home buyer's tax credit is a recent example. In farming, the use of tax incentives as an alternative to cash payments for participation in various conservation programs, such as tax benefits for conservation easements, has expanded the use of the tax code to achieve conservation policy objectives.

- Tax reductions and incentives have been the focus of Federal tax policy over the last several years. However, the Federal budget deficit continues to increase at a rapid rate. In the near future, this deteriorating budget situation will likely lead to a review of the various Federal tax expenditures as potential revenue-raising options to reduce the Federal budget deficit.

All of these factors, as well as the inclusion of a tax title in the 2008 Farm Act, have raised awareness of the importance of Federal tax policies for the farm sector.

The report uses both published and special tabulation data obtained from the Internal Revenue Service (IRS) to provide an overview of the current income tax situation for farm households and to evaluate the importance of various Federal income and estate tax provisions. It also uses farm-level data from USDA's Agricultural Resource Management Survey (ARMS) to estimate the effects of various policies on Federal income and estate tax liabilities of farm households.

Federal Individual Income and Business Taxes Reduced

Since most U.S. farms are operated as sole proprietors, partnerships, or small business corporations, most farm income is taxed under the individual income tax rather than the corporate income tax. In fact, based on 2007 ARMS data, over 99 percent of all farmers are taxed under the individual rather than the corporate income tax. As a result, farmers and many other small businesses are major beneficiaries of recent changes to Federal individual income and business tax provisions.

Tax relief measures enacted since 2000 have significantly reduced Federal income taxes for both individual and business taxpayers. For individual taxpayers, legislation has reduced marginal income tax rates, increased standard deduction and exemption allowances, lowered tax rates on capital gains and dividends, increased savings incentives, and raised child and earned income credit amounts. Federal tax policies affecting businesses have also been modified, including reduced tax rates on business investment and manufacturing income.

As of 2008, the cumulative effect of these tax policy changes has resulted in the lowest Federal tax rate on farm income and investment in over a decade. Federal income taxes paid by farm sole proprietors dropped from $24.9 billion in 2000 to $21 billion in 2004, a reduction of nearly 16 percent. The average tax rate dropped from 17.1 percent in 1994 and 17.8 percent in 2000 to about 14.8 percent in 2004. While published data are not available for more recent years, the current average tax rate is estimated to be at or below the 2004 rate. In addition, since the average tax rate is based on adjusted gross income, it understates the actual reduction in tax rates to the extent that various changes, such as capital expensing and the deduction for manufacturers, which is defined to include farmers, have lowered the adjusted gross income base.

Like all households, about one of every three farm households now owe no Federal income tax, with some receiving a refundable child or earned income credit. Nearly all farm households have realized some tax savings as a result of the Federal tax policy environment that has existed over the last decade.

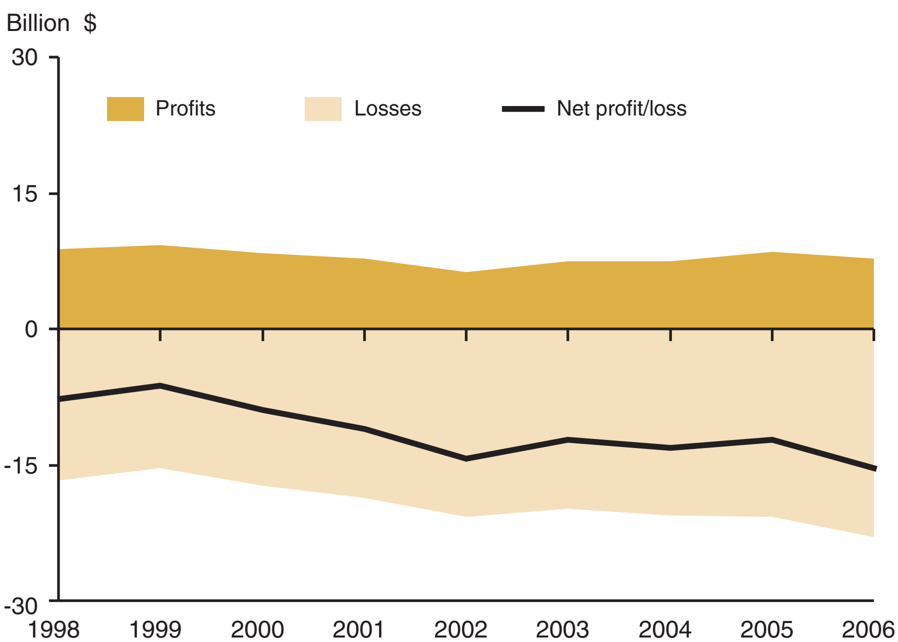
Most Federal Income Tax for Farm Households Is Paid on Off-Farm Income

Since the household is the typical unit of taxation, farm and nonfarm income are combined when computing Federal income taxes for farm households. In fact, most Federal income tax paid by farm households can be attributed to nonfarm income. Since 1980, farm sole proprietors have reported negative aggregate net farm income for tax purposes. Over the years, both the share of farmers reporting losses and the amount of losses reported have increased (fig. 1). About half of all farm partnerships and small business corporations also report losses.

In 2004, the most recent year for which detailed tax data are available, an estimated 1.4 million, or about 70 percent, of farm sole proprietors reported a net farm loss for tax purposes. The average loss was $14,380, while average adjusted gross income was $73,440. Thus, income from off-farm sources averaged $87,820. These farmers paid about $16 billion in Federal income taxes. In that same year, an estimated 589,000 farm sole proprietors reported a farm profit. The average profit reported was $12,520. This accounted for only about 20 percent of their average adjusted gross income of $62,670. These farmers paid about $5 billion in Federal income taxes.

In 2006, based on IRS data, nearly three of every four farm sole proprietors reported a farm loss. The average loss reported was $16,366, for a total of just over $23 billion. The increased reporting of losses coincided with an increase in the amount of capital investment that can be expensed in the first year and may partially explain the trend.

Figure 1
Net farm income/loss on Schedule F



Source: USDA, Economic Research Service using Internal Revenue Service Federal income tax data.

Examining losses by size of business receipts provides additional insight into the reporting of farm losses for tax purposes. Based on IRS data, farms with business receipts less than $50,000 reported an aggregate net farm loss of $13.5 billion in 2004 (table 1). Only those farms with sales in excess of $100,000 reported a small aggregate net farm profit, for a total of $1.1 billion. While accounting for only about 12 percent of farmers, these farms accounted for about 80 percent of total business receipts.

Many of those reporting farm losses are individuals whose primary occupation is something other than farming. ERS classifies farms as *rural residence farms* (lifestyle, retirement, and limited-resource farms), *intermediate farms* (annual sales less than $250,000 and primary occupation is farming), and *commercial farms* (annual sales greater than $250,000). While rural residence farms report relatively high levels of adjusted gross income, three of four typically report a farm loss, and these farms account for over half of all losses reported.

The fact that many small rural residence and intermediate farms report losses should not suggest that changes in tax policies affecting farm income and investment are unimportant. In fact, the $20.6 billion in losses reported in 2004 is estimated to have reduced Federal income taxes on the off-farm income earned by farm households by over $3 billion. This return to farming through the tax code may partially explain the continued existence of many small farm operations despite the persistence of farm losses.

While there are limits on the ability to use such losses to offset income from other sources, in most instances, losses from farming are fully used to reduce taxes on other income. The 2008 Farm Act does impose an additional limitation: the amount of farm losses an individual can use to offset nonfarm income is limited to the greater of $300,000 or the total amount of net farm income the individual has reported over the last 5 years. This limitation only applies to those farmers receiving direct, counter-cyclical, or Commodity

Table 1
Farm profits and losses by size of gross farm income, 2004

	Size of annual gross farm income			
	Under $50,000	$50,000 < $100,000	$100,000 or more	All farmers
	Number			
Farmers	1,660,865	114,635	246,798	2,022,298
	Percent			
Share of total	82.1	5.7	12.2	100.0
	Billion dollars			
Schedule F income:				
Profits	1.198	.809	5.363	7.371
Losses	-14.725	-1.601	-4.284	-20.610
Net (profits less losses)	-13.527	-.792	1.079	-13.239

Source: USDA, Economic Research Service using Internal Revenue Service 2004 Federal income tax data.

Credit Corporation (CCC) loans. Losses that are beyond the limit can be carried forward to subsequent years. The annual revenue gain from this change is estimated by the Joint Committee on Taxation at less than $100 million. This suggests that most farm losses can continue to be used to offset income from other sources.

Since rural residence and many intermediate farm households derive most of their income from nonfarm sources, these farm households are primarily affected by the changes in individual marginal income tax rates, standard deduction, and other exemption amounts and those policies affecting the tax treatment of income from nonfarm sources. In contrast, commercial farms account for a disproportionate share of total U.S. farm sales and investment and report most of the farm profit. Thus, these farms are the primary beneficiaries of the tax changes affecting farm business income and investment. The most significant changes over the last decade include reduced capital gains tax rates, increased capital expensing and bonus depreciation, and the new manufacturer’s deduction. The increased deduction for self-employed health insurance and the availability of income averaging are also important changes to tax policy that affect farmers.

Reduced Capital Gains Taxes Increase Return on Farm Business Assets

The Federal income tax system has historically taxed gains on the sale of assets held for investment purposes at rates that are lower than tax rates on other sources of income. The current tax rate on capital gains is 15 percent (0 percent for taxpayers in the 15-percent-or-lower income tax brackets). This reduced rate is especially significant for farmers because some assets used in farming are eligible for capital gains treatment and the amount of capital gains is increased by the ability to currently deduct certain costs, especially for livestock. Due to the combination of current expensing and the tax rate differential, as long as the losses can be used to offset other income, a breakeven or losing investment on a before-tax basis can be converted into an after-tax profit. As a result, capital gains are a key component of income for many farmers.

According to the IRS, 40 percent of all farmers report some capital gains, nearly double the share for all taxpayers. The average amount of capital gain reported by farmers is also about 50 percent higher than the average capital gain reported by other taxpayers. In 2004, the last year for which complete data are available, farmers reported net capital gains of $28.7 billion. This amount represented about 20 percent of total adjusted gross income reported by farm households. The average amount for those reporting gains was $35,900. On average, about one-third of reported gains is attributed to the sale of assets used in farming. Over 60 percent of commercial farmers reported capital gain income, accounting for 25 percent of all capital gains reported by farmers. Farmers with adjusted gross income over $250,000 also report a large amount of capital gain income. In 2004, capital gains accounted for one-third of the total income for this group. These high-income farmers accounted for nearly 70 percent of all capital gains reported by farmers and reported average capital gains of $387,000.

The lower tax rates for capital gains are scheduled to expire in 2010. At that time, barring further legislation, they will revert to pre-2003 rates of 10 and 20 percent. This would result in an increase in Federal income taxes owed by farmers. A large share of the increase would fall on commercial farmers and those with adjusted gross income over $250,000.

Capital Cost Recovery System Allows Most Investment To Be Expensed in Year of Purchase

Farming requires large investments in machinery, equipment, and other capital. The tax treatment of these investments is of considerable importance to the farm sector, especially commercial farmers. Prior to the Economic Growth and Taxpayer Relief Reconciliation Act of 2001 (2001 Act), capital purchases were eligible for an immediate expensing of up to $25,000 per year. Investments above this amount were depreciated over a specified recovery period, generally 7 years (5 years in 2009) for most farm machinery and equipment.

The 2001 Act added a temporary 30-percent first-year allowance. The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the bonus first-year depreciation from 30 to 50 percent of eligible investment and, more importantly, raised the annual amount of investment that can be expensed from $25,000 to $100,000 (table 2). The temporary first-year bonus depreciation allowance expired, but the expensing provision was extended through 2007. The 2008 stimulus legislation increased the capital expensing amount to $250,000 per year and restored the 50-percent bonus first-year depreciation allowance for 2008. The 2009 stimulus legislation has extended the $250,000 expensing amount and the 50-percent bonus depreciation through the end of 2009. Less than 1 percent of farmers annually invest more than the $250,000 expensing amount. Since investments above this amount are eligible for the bonus first-year depreciation, nearly all capital investment by farmers can be written off in the current year. This increased capital expensing allowance reduces the effective tax rate on farm capital and simplifies the recordkeeping burden associated with the depreciation of capital purchases, with commercial farmers the primary beneficiaries.

Unless the increased expensing amount and first-year bonus depreciation are extended beyond 2009, the expensing amount will drop to $125,000 in 2010

Table 2
Amount of capital investment that can be expensed has increased

Tax year	Expensing amount
	Dollars
2000	20,000
2001-02	24,000
2003	100,000
2004	102,000
2005	105,000
2006	108,000
2007	125,000
2008	250,000
2009	250,000
2010[1]	125,000
2011	25,000

[1]The expensing amount for 2010 will be adjusted for inflation.

Source: USDA, Economic Research Service using Internal Revenue Code Section 179.

and revert to the pre-2003 amount of $25,000 per year after 2010. Less than 10 percent of residential and intermediate farms invest more than $25,000. However, over 40 percent of commercial farms invest more than $25,000. Thus, investment by commercial farmers will be affected the most by a substantially lower expensing amount. This could lead to reduced capital investment by these farmers.

Manufacturer's Deduction Provides Substantial Benefits for Commercial Farmers

One of the most important business changes in the American Jobs Creation Act of 2004 was the replacement of the foreign sales corporation/extraterritorial income provisions, which allowed U.S. exporters to exclude a portion of their foreign sales income from taxation, with a new deduction for U.S. manufacturers, which is defined to include farmers. The foreign sales corporation provision had been declared a prohibited export subsidy by the World Trade Organization, and its replacement was required to avoid retaliatory tariffs.

While few farm households directly benefited from the prior exclusion, about one in five farm households directly benefit from the new deduction. The deduction is equal to 6 percent of qualifying production income in 2009 and 9 percent in 2010 and later. The deduction is limited to no more than 50 percent of wages paid to hired labor. While this limitation will reduce the deduction for many smaller farms that hire little or no labor, farm households are expected to be eligible to deduct nearly $1.9 billion in 2009 and nearly $2.6 billion in 2010 when the deduction is increased to 9 percent. Commercial farm households are the primary beneficiaries, with about two-thirds expected to benefit, compared with about 14 percent for all other farms. While commercial farms account for only about 8 percent of all farms, they will receive about 75 percent of all the farm sector's benefits from the manufacturers' deduction. The average deduction for eligible commercial farm households is estimated at $13,300 for 2009.

Self-Employed Health Insurance Deduction Reduces Cost of Health Insurance

The self-employed health insurance deduction was created in 1988 to give small business owners, including many farmers, tax benefits similar to those of employees who receive employer-deductible health insurance. This deduction is especially important for self-employed individuals who must purchase health insurance on their own.

Since 2003, farmers and other self-employed taxpayers have been allowed to deduct 100 percent of the cost of providing health insurance for themselves and their families as long as they are not eligible for any employer-sponsored plan. The self-employed health insurance deduction is limited to the amount of the taxpayer's income from self-employment. This limitation eliminates the deduction for farmers with net farm losses.

About one of eight farmers use the self-employed health insurance deduction in any given year. In 2004, these farmers deducted an average of $4,600 for a total of $1.24 billion in health insurance premiums. Over 50 percent of farm households obtain their insurance through off-farm employment of the operator or spouse, which helps account for the low number of farmers claiming the deduction. Many other farmers are over age 65 and are covered by Medicare or other government programs.

Intermediate and commercial farmers are more likely than rural residence farmers to use the deduction. Only about 8 percent of rural residence farmers claim the deduction, primarily because these households are more likely to receive health insurance from a nonfarm job or may not qualify for the deduction given the likelihood of reporting a farm loss. The self-employed health insurance deduction allows farmers to save a portion of their premiums equal to their marginal tax rate, helping make health insurance more affordable and making the tax treatment more comparable to employer-sponsored plans.

Income Averaging Provides Reduced Tax Rates for Farmers With Variable Income

Under a progressive tax rate system, taxpayers whose annual income fluctuates widely may pay higher total taxes over a multiyear period than other taxpayers with similar yet more stable income. Farm income is more variable than many other sources of income, such as wages and salaries. Variability of farm household income far exceeds that of all U.S. households, mostly due to variability in income from farming. Variability in farm income across time is attributed to fluctuations in farm output, commodity prices, and business cycles. Farmers are allowed to use various income tax provisions to manage their tax liabilities. Cash accounting, which recognizes income and expenses when received or paid, can reduce taxable income through prepaid business expenses or deferred farm income, and well-timed capital purchases can reduce taxable income through depreciation deductions or capital expensing. While these provisions are useful in reducing income variability, they are limited by the ability of a farmer to defer sales or accelerate expenditures.

Income averaging can reduce the effect of a progressive tax rate system on taxpayers with variable income by allowing them to smooth their tax burdens over time through tax accounting methods that consider multiyear income. Since 1998, farmers have been eligible for income averaging. Under the current income averaging provision, a farmer can elect to shift a specified amount of farm income, including gain on the sale of farm assets other than land, to the preceding 3 years and pay tax at the rate applicable to each year. The current income shifted back is spread equally among the 3 years. If the marginal tax rate was lower during 1 or more of the preceding years, a farmer may pay less tax than he or she would without the option of income averaging. The provision, however, does not allow income from previous years to be brought forward. Furthermore, although the provision is designed to reduce the effect of farm income variability, as long as some farm income is available to be shifted, the source of income variability does not need to be farm income for income averaging to be beneficial. In 2004, an estimated 50,800 farmers saved an average of $4,434 with income averaging. The tax savings totaled $225.3 million and amounted to a 23-percent reduction in Federal income taxes for those taking advantage of the provision, compared with the amount that they would have owed without income averaging. A large share of the total tax reduction was realized by farmers with adjusted gross income over $1 million. These farmers saved an average of $264,000, for a total savings of $82.6 million, or about 37 percent of total tax savings from the income averaging provision.

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 and the companion gift tax imposed upon transfers prior to a property owner's death have never directly affected a large percentage of taxpayers. Under the current Federal estate tax system, individuals can transfer up to a specified amount in money and other property without incurring Federal estate tax liability. The estate of a decedent who, at death, owns assets in excess of the estate tax exemption amount ($3.5 million in 2009) 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 at a graduated rate, up to a current maximum of 45 percent.

In 2009, total Federal estate and gift tax revenues are estimated at about $26 billion, accounting for about 1 percent of total Federal tax revenue. While the aggregate importance of the Federal estate tax is small relative to other Federal Government revenue sources, the potential effect of the tax on farmers and other small business owners has been a major concern. Over the years, a number of targeted provisions have been enacted to reduce the burden of the estate tax on these groups. These include a special provision that allows farm real estate to be valued at its farm use value rather than at its fair market value, an installment payment provision, and a special deduction for family-owned business interests. A provision aimed at encouraging farmers and other landowners to donate an easement or other restriction on development has provided additional estate tax savings. These provisions have reduced the potential impact of estate taxes on the transfer of a farm or other small business to the next generation.

Providing tax relief to farmers and other small business owners was a primary impetus for the 2001 Act. The Act reduced Federal estate 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 tax's complete repeal in 2010. However, like many other provisions in the 2001 Act, the estate tax changes will sunset (expire) at the end of 2010.

Since passage of the legislation, the amount exempted from the estate tax has gradually increased from $675,000 in 2001 to $3.5 million in 2009 (table 3). As a result, both the number of estates required to file a tax return and the number of taxable returns have dropped dramatically. Only about 9,600 estates (0.4 percent of all estates) are expected to owe Federal estate tax in 2009, down from 51,766 in 2001. During this same period, Federal estate tax revenues have declined, but only by about 25 percent. This illustrates the fact that most of the Federal estate tax is paid by the largest estates, which continue to be taxable even at the higher exemption levels. In 2005, estates with a gross value over $5 million represented only about 14 percent of all the estates required to file a return, but they accounted for over 60 percent of Federal estate tax revenue.

Table 3
Estate tax exemption amount has increased while graduated tax rates have declined

Year	Estate tax exemption amount	Highest marginal estate tax rate
	Dollars	*Percent*
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	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 Internal Revenue Code Section 2010.

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. The median wealth of farm households is about five times that of all U.S. households.[1] 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, "Estate Tax Estimating Procedures"), 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 (fig. 2). After deductions, slightly more than half of these farm estates are likely to owe tax. 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.

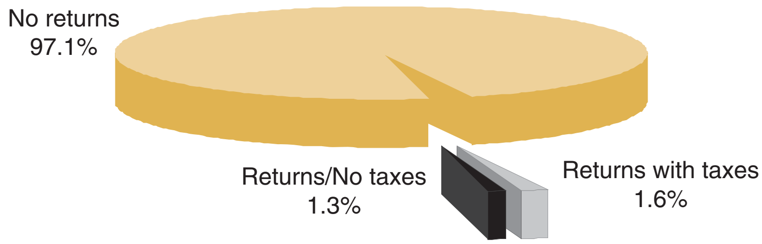
The impact of the Federal estate tax varies by farm type. A relatively larger share of commercial farms are projected to owe Federal estate taxes in 2009. The average value of farm assets for commercial farms was roughly $2.9 million in 2007, based on the most recent data available from ARMS. Thus, despite estate tax relief targeted to farmland (special-use valuation), an estimated 10 percent of all commercial farm estates are likely to owe Federal estate taxes in 2009 (fig. 3). 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 nearly 40 percent of all Federal estate taxes paid by farm estates (fig. 4). In contrast, rural residence farms account for nearly three-fourths of all farm estates but only about one-third of Federal estate taxes. These estates also tend to have a larger share of their net worth in nonfarm assets than commercial farm estates.

[1]www.ers.usda.gov/briefing/wellbeing/farmnetworth.htm

Estate Tax Estimating Procedures

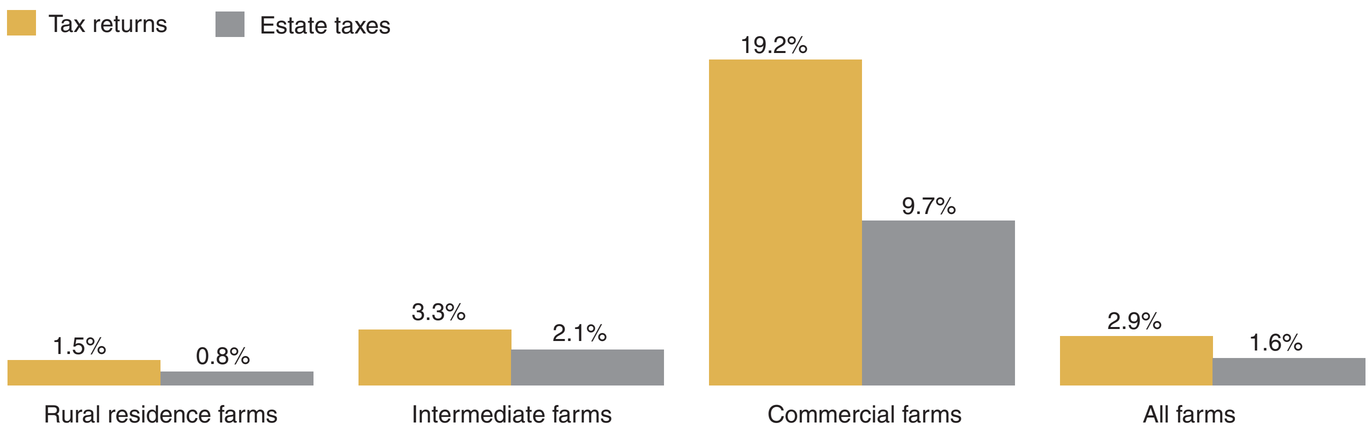
Estate tax estimates in the report are based on simulations using data from USDA's Agricultural Resource Management Survey (ARMS) for 2000-07. The ARMS survey is a stratified sample of farms with information on farm operators and their households, including detailed financial information for both farm and nonfarm assets and debts. The number of estates was estimated based on the age of the operator and mortality rates from the Social Security Administration. 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.

Figure 2
Share of farm operator estates with returns and taxes, 2009



Source: USDA, Economic Research Service estimates based on USDA's Agricultural Resource Management Survey, 2007.

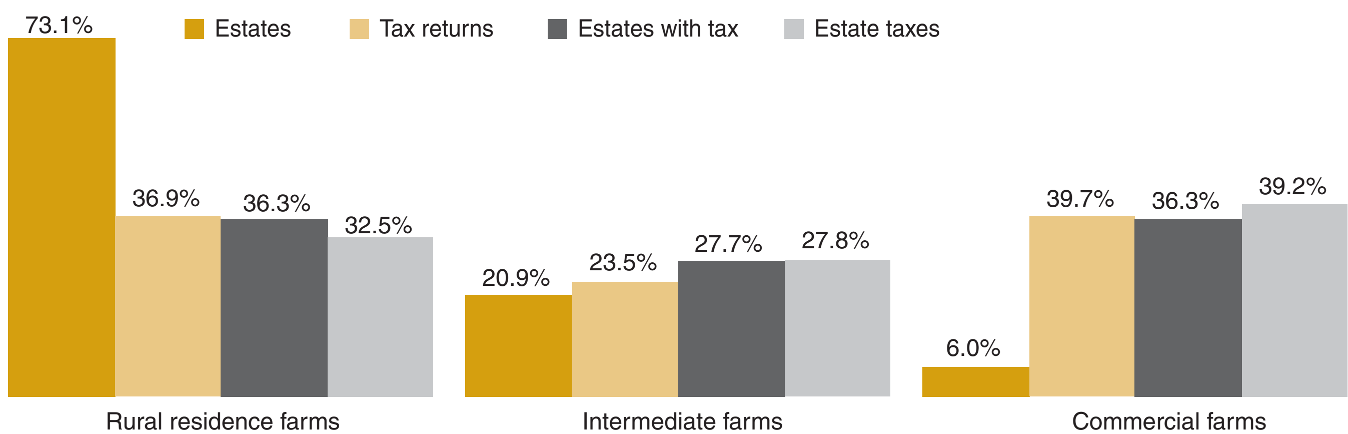
Figure 3
Share of farm estates required to file a tax return and pay estate taxes, by farm type, 2009



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 estimates using data from the Agricultural Resource Management Survey, 2007.

Figure 4
Distribution of farm estates, estate returns, taxable returns, and taxes, by farm type, 2009



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 estimates based on USDA's Agricultural Resource Management Survey, 2007.

Special Provisions Benefit Farmers

Concerns that Federal estate taxes might cause the breakup of some family-owned farms and small businesses led to the enactment of two special provisions in the Tax Reform Act of 1976. At that time, the exemption amount was only $120,000 and the top tax rate was 70 percent. These targeted provisions—the special-use valuation and the installment payment of estate taxes—reduce the impact of Federal estate taxes on farms with estates valued above the basic exemption amount.

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 other closely held business may be valued at the property's value as a farm or business rather than at its fair market value. For the property to qualify for the special-use valuation, farmland must be transferred to a qualified heir, the land must have been used as a farm for 5 years during the 8-year period ending with the decedent's death, and the decedent or a member of the decedent's family must have participated in the farm business. In addition, 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 total gross value of the estate.

For qualifying farms, special-use valuation can reduce the value of the real property portion of 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 IRS, 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 million. 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 farm or other closely held business assets 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. In 2005, only 382 estates elected to defer taxes. However, the estates that made the election held a much larger share of their estate in real estate or farm or other closely held business interests.

The Taxpayer Relief Act of 1997 provided two additional provisions that have helped to reduce the impact of the estate tax on farmers. These include an estate tax exclusion for land subject to a conservation easement and a deduction for family-owned businesses.

Exclusion for Land Subject to Conservation Easement. Under this provision, farmers and other landowners can exclude up to 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 member of his or her family must have owned the land for at least 3 years prior to the decedent's date of 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. A conservation purpose is defined as the preservation of (1) land for the general public's outdoor recreation or education; (2) a natural habitat; or (3) open space for the scenic enjoyment of the general public or in furtherance of a governmental conservation policy.

The maximum estate tax exclusion for qualified landowners under this provision 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 estate tax benefits from these contributions is unclear, their total value was $1.8 billion.

Deduction for Qualified Family-Owned Businesses. The 1997 Act also included a special deduction for farmers and other small business owners. This provision allowed a deduction for the first $675,000 of value for qualified family-owned business interests. 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 repealed that year. If the estate tax provisions are allowed to expire and revert to pre-2001 law, the family business deduction will once again apply. However, since the basic exempt amount would be $1 million, the maximum benefit of the family business deduction would be $300,000.

Current Law Provides for Repeal and Uncertainty

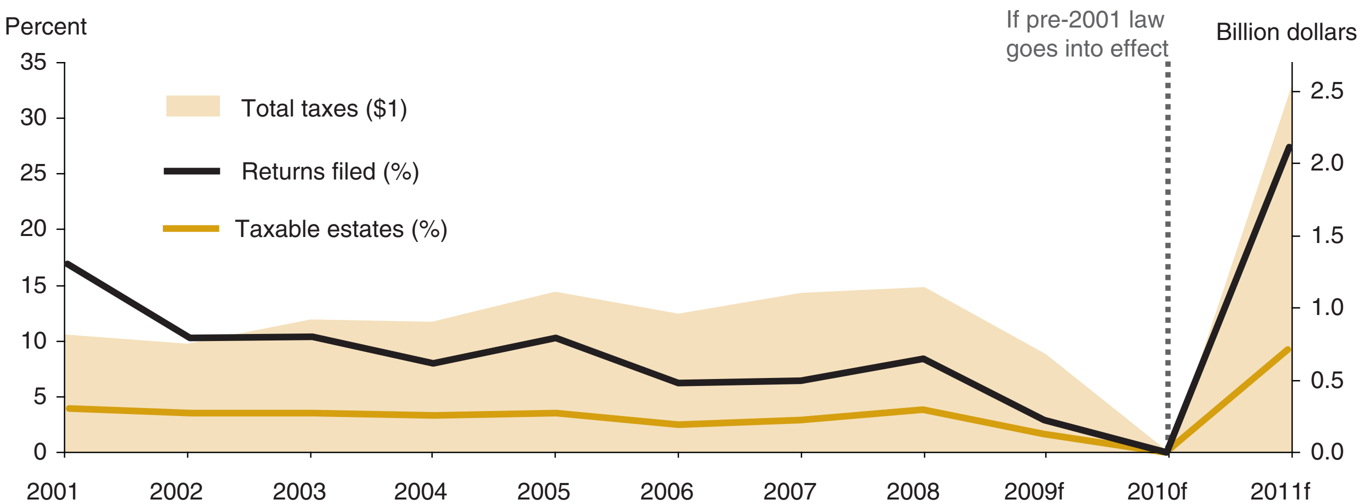
Under the 2001 Act, the Federal estate tax is repealed completely in 2010. However, since the 2001 estate tax changes are scheduled to expire at the end of 2010, this repeal is only temporary. The resurrected tax in 2011 reverts to the law in place prior to the 2001 changes. As a result, the exempt amount would return to $1 million and the top tax rate would revert to 55 percent. This situation not only creates uncertainty, but it also raises equity concerns regarding the fairness of providing such disparate treatment for similar estates depending upon the date of death, especially when they may be only days apart.

If it occurs, the reversion to pre-2001 law will increase the share of estates that owe Federal estate tax and will result in significantly higher Federal estate tax revenues. The share of estates that would owe tax under a reversion to pre-2001 law is estimated to increase to about 2.5 percent of all estates, with total tax liability more than 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 increased 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 of every 10 farm estates would owe estate tax in 2011 (fig. 5). Total estate taxes that year could increase to about $2.55 billion—nearly 300 percent more than the estimated amount owed by farm estates in 2009.

In addition to repealing the estate tax, the 2001 Act changed the treatment of unrealized gains at death, effective with estate tax repeal. Under current law, the basis (which is the value used to determine gain or loss) of assets acquired from a decedent is stepped up to the fair market value at the

Figure 5
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 2000-07 Agricultural Resource Management Survey.

date of death. This "step-up in basis rule" essentially eliminates the recognition of income on the appreciation of the property that occurred prior to the property owner's death. This change can be especially important for assets, such as farmland, that are typically held for long periods and have appreciated considerably.

Upon repeal of the estate tax in 2010, the step-up in basis rule is replaced with a carryover of the decedent's basis with an added amount of up to $1.3 million (plus an additional $3 million for transfers to a surviving spouse). This change will add to compliance burdens because it will be necessary to determine the cost or other basis of inherited assets. In farming, these assets may have been held for several decades with limited documentation on their original cost or the method in which they were acquired. The heirs of some farm estates that would owe no Federal estate tax or capital gains tax under current law would be faced with this compliance burden and could owe taxes upon the sale of the inherited assets. The number of estates with unrealized gain above the step-up amount is estimated to exceed the number of estates that currently owe estate taxes. While most of these gains would be taxed at capital gains rates that are substantially lower than estate tax rates, 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, support is growing for a substantial permanent increase in the exempt amount combined with the retention of the stepped-up basis at death treatment for inherited assets. The 2010 President's Budget would make the current $3.5 million exemption amount and tax rates 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 to between 1 and 2 percent for the estates of farmers. It would also reduce some of the uncertainty and inequity created by the temporary repeal and sunset provisions applicable under current law.

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