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Farm Estate Taxes; Philosophy, Current Policy and Economic And Social Impact of Proposed Changes[1/]

by

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Establishment and Philosophy of Estate Taxes

Estate taxes, which became a permanent part of the federal revenue system in 1916, were introduced by Congress to generate and regulate the direction of society. The goals were: 1) to prevent excessive wealth and power from being concentrated into the hands of relatively few individuals and 2) to at least partially redistribute the national wealth. Estate taxes have been justified on the basis of representing:

1) The ability to pay.
2) Unearned windfall income to heirs.
3) The equalization of opportunity via the partial correction of past unequal holdings of wealth.
4) An easily assessable and collectable source of revenue - reaching income and wealth which may have been sheltered from taxation during the owner's lifetime.

President Theodore Roosevelt, when requesting Congress to enact a progressive inheritance tax stated, "the prime objective should be to put a constantly increasing burden on the inheritance of those swollen fortunes which it is certainly of no benefit to this country to perpetuate".

Donald Pearlberg in remarks to the 1974 President's Council Conference interpreted U.S. policy as directed toward keeping "a free and open system of tenure" in our agriculture. In its early years, our nation took steps to "prevent the development of a hereditary land-owning class".

1/ Based primarily upon the North Central Regional Extension Publication #40 Death and Taxes: Policy Issues Affecting Farm Property Transfers, University of Illinois at Urbana.

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Examples are laws prohibiting primogeniture - the "bequeathing of the farm , intact, to the oldest male heir - and entailment" - specifying...that a piece of property must stay in the family through subsequent generations.

Several criteria seem to be particularly appropriate for analyzing the social and economic impact of present or future farm inheritance tax laws. These are the:

1) Promotion of efficiency in the use of resources.
2) Promotion of equity and equality of opportunity for farm operation and ownership.
3) Impact on tax revenues collected.
4) Impact on the structure and organization of agricultural production.

Efficiency in the use of resources involves the establishment and maintenance of operating units that can produce at the lowest unit costs. To encourage via tax policy the establishment of farm business which are either too large or too small for the most efficient use of land labor and capital would impact adversely upon social welfare. The decrease in production efficiency resulting from such tax policy would increase the cost of food and fiber available to consumers while increasing the degree of competitive disadvantage of the American farm product vis a vis products from other countries.

Equity and equality of opportunity tend to be inversely related to the levels of inheritance taxes levied. Death tax policies place pressure upon large estates through a tax obligation when the owner dies. Farm land and other assets which may be forced upon the market to generate the capital needed for inheritance taxes provide the opportunity for new farm owners to acquire land. Otherwise a farmer might have to be born into a landholding family to acquire land.

Tax revenues generated from the current federal estate taxes collected amount to about two percent of total federal tax receipts. Although the revenue yield is not large in relation to the federal income tax, it is an important source of revenue - about six billion dollars per year - which would have to be replaced from other sources if lost through the reduction of estate taxes. Estate taxes also raise significant revenue for most state goverments.

Estate taxes affect the ultimate structure and organization of American farm businesses. Changes in estate tax laws could affect the number of family farm owner-operators, the total number of farm units, the size of farms, the concentration of production and degree of horizontal and vertical integration. Changes in the structure of agricultural organization may impact adversely on rural towns, agribusiness firms and consumers.

Current Federal Estate Tax Policy

The first permanent estate tax in 1916 provided an exemption of $50,000 and tax rates ranged from one to 10 percent. Today's exemption of $60,000 has been in effect since 1942 and the present rate scale of three to 77 percent was adopted in 1941.

The federal gift tax, introduced in 1932, is levied at rates equal to three-fourths of those of the companion federal estate tax. The gift tax rate scale, lifetime exemption of $30,000 annual exclusion of $3,000 per person per year and 50 percent marital gift exemption have remained unchanged since 1942. Adjusting for inflation, the $60,000 personal estate exemption authorized in 1942 is worth less than $18,000 in 1976 (in terms of 1942 purchasing power). Today's exemption would have to be approximately $200,000 in order to be equivalent in purchasing power to the $60,000 of 1942. Furthermore the progressive nature of the estate tax rates has rapidly increased the tax rates has rapidly increased the tax liability of the average farm estate as farm land and equipment values have inflated at a rapid rate since 1942.

The value of the average farm in Idaho is estimated to be $228,310 whereas in 1940 the average was $7,788. Additionally many of Idaho's farms are valued well in excess of a million dollars. The impact of death taxes on these farm estates can contribute to the forced dissolution of the farm business and sale of its assets.

In response to the growing impact of estate taxes upon large numbers of small and medium sized estates which may have faced little or no tax liability 20 years ago. Congress and others have been considering numerous proposals for changes in the federal estate and gift laws.

Proposed Changes in Tax Policies

Some of the major proposals for change in the federal estate tax regulations are:

Increase the present $60,000 federal estate tax exemption.

-Recent proposals for changing the $60,000 exemption include increasing it to $100,000 to $200,000. Another proposal would leave the existing federal estate tax exemption unchanged but would reduce to zero some of the lower estate tax brackets. For example, instead of increasing the exemption to $100,000 the tax rate on a taxable estate of $40,000 and less would be reduced to zero. Tax rates on amounts over $40,000 would remain unchanged.

Increasing the exemption would exclude smaller farm estates from taxation and reduce the estate tax on larger farm estates. Zero rating the lower estate tax brackets would restrict benefits to smaller estates as no tax reduction would apply for estates falling into non-zero rate brackets. In Table 1, raising the exemption to $100,000 is compared to the current exemption and to the alternative of zero-rating estate tax brackets less than $40,000.

Table 7. Effect on Farm Estates, Present Federal Estate Tax Exemption Compared with Increasing Exemption to $100,000 and Zero-rating Estate Tax Brackets $40,000 or Less.

Taxable Estate before Exemption (dollars)	Tax with Present $60,000 Exemption[1] (dollars)	Tax with $100,000 Exemption[1] (dollars)	Tax with Present Exemption and Zero Rates for Brackets $40,000 or Less (dollars)
100,000	4,800	———	———
200,000	32,700	20,700	32,700
400,000	94,500	81,700	94,500
750,000	212,500	198,200	212,500
1,000,000	303,500	288,700	303,500

[1] Without state tax credit.

Give preferential evaluation to farm property included in a decedent's estate.

-Present law provides no preferential valuation or special exemptions for farm estates. Farm property is valued for estate tax purposes at the fair market value of the property. One proposed change is to increase the exemption for family farm estates passing to individuals closely related to the decedent or the decedent's spouse. A second proposal provides that only farm property owned and operated by the decedent for a five year period prior to death and then owned and substantially controlled and supervised by a qualified heir(s) for a similar period would qualify for the exemption.

Any change in tax regulations to give agricultural assets a preferential value for tax purposes will reduce the estate tax burden. It would, however, encourage non-farmers to invest more heavily in farm land and increase land prices. Regulations to restrict the preferential valuation only to "qualified farmers" could result in very complex and expensive administrative problems.

The effect of the uniform transfer tax would be largely dependent upon whether or not the present annual gift exclusion of $3,000 per person per year were eliminated. Over a 30 year period a farmer and his wife each transferring $3,000 per year to each of four children could transfer approximately $720,000 worth of assets without incurring gift tax liability.

Tax the appreciation in the value of assets transferred by gift or death.

-Appreciation in the value of capital assets owned by a farmer and held until death is not presently subject to income tax. At the death of the owner these assets are given a new value which becomes the heir's basis. Gift transfers by the property owner during his lifetime are also not presently subject to income tax at the time of gift transfer.

The suggested change would impose an income tax on the appreciation in value of the capital assets, whether the property was transferred during the donor's lifetime or after his death. Some minimum basis, perhaps $60,000, would not be subject to the appreciation tax providing relief to small estate owners. The gains in value of assets would generally be considered as capital gains and any tax paid would be treated as a debt of the estate.

Imposition of such a tax may in general reduce investment in assets that tend to increase in value but earn only moderate or small amounts of income. Consequently the selling price of farmland would be more in line with income generating capability than with the speculative value of the real estate.

Permit almost all transfers of property between spouses to be tax-free by increasing the marital deduction from 50 percent to 100 percent.

-The present marital deduction permitted for both estate and gift tax purposes is generally limited to one half of the amount transferred. One proposed alternative to reduce the tax burden in small and medium-sized estates and to provide more flexibility in planning transfers between spouses would be to eliminate the 50 percent limitation (Table 3). Additional tax relief would be provided by eliminating the restrictions upon the types of interests that qualify for the deduction and allowing the surviving spouse to determine the extent to which the marital deduction should apply.

Any liberalization of the marital deduction would provide the opportunity to reduce the federal estate and gift taxes paid.

Table 3. Comparison of Estate Taxes after 50 Percent and 100 Percent Marital Deductions.[1]

	Husband's Estate (dollars)	Wife's Estate (dollars)
Husband Dies First — 100 Percent Marital Deduction, All Property to Wife		
Gross estate	300,000	300,000
Debts and expenses	(15,000)	(15,000)
Adjusted gross estate	285,000	285,000
Marital deduction	(285,000)	———
$60,000 exemption	(60,000)	(60,000)
Taxable estate	———	225,000
Federal estate tax	———	58,200
	Combined taxes = $58,200	
Husband Dies First — 50 Percent Marital Deduction, All Property to Wife		
Gross estate	300,000	300,000
Debts and expenses	(15,000)	(15,000)
Adjusted gross estate	285,000	285,000
Marital deduction	(142,500)	———
$60,000 exemption	(60,000)	(60,000)
Taxable estate	82,500	225,000
Federal estate tax	15,800	58,200
	Combined taxes = $74,000	

[1] This tables assumes that the wife has property of her own equal to the taxes, debts, and expenses of her husband's estate, and that the wife lives for at least 10 years after her husband's death. If the husband has planned his estate and restricted the kind of interest in property transferred to his wife, then the above tax comparisons would be different.

Tax generation skipping transfers.

-A property owner may now transfer property to his children for their lifetime with the remainder interest transferred to the grandchildren and avoid a transfer tax on such property in the estate of the children. This proposal would generally prohibit such generation-skipping by imposing a substitute tax at the time of transfer. A generation-skipping transfer would, under this proposal, be a transfer to a person more than one degree (parent to child is one degree) in family relationship below the transferor. If the transfer is to a non-relative, it is generation-skipping if the transferee is more than 25 years younger than the transferor.

Relax the tax payment time schedule.

-Generally the federal estate tax must be paid within nine months of the decedent's death. The Internal Revenue Service Code presently contains three provisions that assist in solving estate tax payment problems created by this requirement.

a) The payment of estate taxes can be extended for up to 10 years in instances in which the payment in nine months would cause undue hardship. Regulations have defined one example of undue hardship as being the sale of a small business at a sacrifice price.

b) Payment of estate taxes can be extended for a period of up to 10 years when an estate contains a farm or closely held business, the value of which exceeds either 35 percent of the gross estate or 50 percent of the taxable estate. However, the executor or administrator remains liable for the taxes until paid. In addition, certain dispositions of the farm business make the deferred tax immediately due. Finally, the deferred tax is only that portion relating to the farm or closely held business.

c) Capital gains treatment is accorded certain redemptions of corporate stock, to pay death taxes and funeral and administration expenses. This only applies to a corporation whose stock comprises more than 35 percent of the value of the decedent's gross estate or more than 50 percent of the value of the taxable estate, and the time for such redemption is limited.

Proposed changes include:

a) Making it easier for estates containing farms or other closely held businesses to qualify for the installment payment of death taxes. One possibility is to reduce the percentages from 35 and 50 to 25 and 40.

b) Permitting executors and fiduciaries to obtain a discharge from personal liability for death taxes, provided adequate security is furnished.

c) Providing additional time for redeeming stock in closely held businesses, to pay taxes attributable to the inclusion of that stock in the gross estate.

It is expected that these modifications could make it much easier for the owners of any viable farming operation or closely held business to generate the resources needed to pay the transfer taxes that become due at the time of death.

Economic and Social Impact of Proposed Changes in Federal Farm Estate Taxes

The criteria for analyzing the economic and social impact of transfer tax policy have been previously listed as efficiency, equity, governmental revenue and organizational structure. The criteria can be applied to the transfer of farm and nonfarm property alike. With regard to organizational structure, for example, it is just as fitting to ask how a death tax policy affects continuity of a small nonfarm business as of a farm. These effects are summarized in Table 4.

Table 4. Effects of Proposed Property Transfer Tax Proposals.

	Efficiency	Equity			Structure	
Policy		Wealth Concentration	Farmland Buying Opportunities	Revenue Generation	Farm Size	Amount of Nonfarm Landholding and Tenancy
Changes in Estate and Gift Tax Exemptions and Rates						
(a) Increased exemption and/or decreased rates on all kinds of property[1]	No change	Increase	Decrease	Less	Larger	Increase
(b) Increased exemption and/or decreased rates on farm property only	No change	Increase	Decrease	Less	Larger	Large increase
Unified Gift and Estate Tax	No change	Decrease	Increase	More	Smaller	Less
Unlimited Marital Deduction	No change	No change	No change	Less	No change	———
Tax on Capital Gains of Gifts or at Death	No change	Decrease	Increase	More	Smaller	Less
Tax on Generation-Skipping	No change	Decrease	Increase	More	Smaller	Less
Extension of Time for Payment	No change	Increase	Decrease	No change	Slightly larger	Slightly more

[1] Decreased exemption or increased rates, or both, would have effects opposite to those shown here.

Efficiency

Efficiency in production and marketing has always been esteemed in agriculture. Death tax levies have the possibility of affecting efficiency primarily through their bearing on availability and cost of liquid assets and on size of operating unit. It should be recognized that capital requirements in agriculture per worker and per dollar of sales are higher than for other industries. In general, however, it is difficult to show that modest changes in death tax rates would have much net effect on efficiency.

Modern farming indeed requires large amounts of capital, whether equity or borrowed. If transfer taxes were to be reduced, part of the tax savings would remain in agriculture. The problem of refinancing to hold estates intact would thereby be eased. It is difficult to show, nevertheless, that the present system of private and cooperative credit is inadequate for financing economically organized farms. Moreover, much of the resistance to refinancing comes from the traditional notion that farmers ought to own their farms essentially debt-free. This does not apply so generally today, nor is it usually possible.

It is sometimes argued that present death taxes force the breaking up of farms into units too small to be economic. To the extent that is true, there is some loss of efficiency. But no particular farm size is more efficient under all circumstances than all other sizes. In fact, the desirable size is governed in large measure by the managerial ability of the operator. Even if the "best size could be named, it could not be assumed that all farms subject to transfer tax are near that size.

Furthermore, if slices of a farm must be sold to pay taxes, the acreage sold may be attached to an undersized unit and add to its efficiency. Thus, for agriculture as a whole, there may be no net loss in efficiency under present or proposed transfer tax policies. In fact death taxes may occasionally lead to the breaking up of farms that have reached too large a size for best efficiency.

Do death taxes interfere with continuity in management? They probably do. However, whether an heir is a better manager than a new buyer is a debatable question. A special case arises when farm families convert to a corporate structure with several owners to circumvent death taxes. It is difficult to say whether quality of management may be improved or might be poorer.

Equity

Equity has many dimensions. Each is hard to explain, yet each is basic.

Consider equity of opportunity first. High exemption or low taxes on death transfer of farm property give an advantage to the heirs of the farmer over all other people, including young persons who would like to buy farmland. So the equality of opportunity principle is violated.

Furthermore, if it is true that young farmers can more readily enter farming on a holding somewhat smaller than many retiring farmers have built up, some division of large holdings at the time of transfer may particularly improve equality of opportunity. The aspiring young farmers would then find it easier to buy a modest-sized farm.

A second dimension of equity relates to equality of tax levies on farmers and farming compared with other taxpayers and other businesses. It is complicated by the fact that farm estates frequently have several origins. They may involve any of the following:

1) Property previously inherited and left almost unchanged. This is rare, however.

2) Accumulation of physical assets, as a farmer chose to retain them rather than convert them to current income.

3) Cumulative capital gains, on which no income tax has been paid, and which in turn may come from:

   a) General price inflation in the economy.

   b) Exceptional increases in the price of farm assets.

The principle of equity is readily applied to point three above, where it calls for the same rates on deferred as on currently paid taxes.

With respect to differences between points three-a and three-b, insofar as capital gains arise from general price inflation there is no basis for treating agriculture differently from any other industry or property holding. General price inflation results in dollar gains that have no increase in purchasing power. They extend across the economy and are no different in agriculture than in industry or trade. How to tax inflationary capital gains is a separate issue.

On the other hand, insofar as agriculture has outdistanced other sectors (due presumably, to the intrinsic scarcity of land) and thereby has yielded a special "unearned wealth", the principle of equity suggests higher taxes than those levied, for example, on the earned income represented in point two above. Capital gain in excess of general price inflation is "real" in the sense that the same quantity of farm asset now represents a greater purchasing power than before.

It hardly need be added that selective favorable treatment of agriculure in death taxes is not consistent with equity unless there is some fully counterbalancing benefit to society.

Revenue Generation

Federal property transfer taxes (estate and gift) generated $4.9 billion in 1973--about two percent of total federal tax receipts. Although they are not a major component of central government finance, any tax dollar lost to lower revenue must be replaced by some other government revenue, and any additional inheritance or other transfer tax dollar collected can reduce some other tax levy.

There is, however, an interconnection with equity. If, for example, any revenue lost through lower death taxes were to be made up by a sales tax or other "regressive" tax, the effect would be inequitable. If a replacement tax were instead to be placed on higher-bracket incomes, equity would likely be improved.

The Structure of Agriculture

Not least among the criteria for judging any proposed changes in death taxes is how they would affect the organizational structure of agriculture. Various characteristics are of interest--size of holding, financial control, marketing arrangement, and ownership and control generally. Often the question is phrased as whether the "family farm" will survive. The "dispersed" farmily farm gives proprietary status to the operating farmer and is based on access to open markets.

Most transfer tax policies would have only an indirect effect on certain structural characteristics such as the terms of access to markets. On the other hand, they could have a direct and significant effect on the size of farm and on ownership and operatorship structure.

Transfer tax policies with high exemptions or low rates, or both, facilitate the transfer of larger farms as a single unit. They thereby are more likely to discourage individuals from nonlandholding families from entering into farming, particularly as owners, acting instead to keep land in the same family hands from generation to generation. Low exemptions and higher rates might force splitting up of some farms, resulting in a larger quantity of real estate being forced on the market.

Likewise, selective concessions for agricultural estates could attract investments of wealthy nonfarmers in farmland and tend toward transfer of ownership and control out of the hands of operating farmers. It might be possible to enact laws to restrict these concessions to "bona fide" farmers but these would involve significant administrative costs and the potential for abuses.

Although transfer taxes could be chosen in connection with a comprehensive program to establish a specified structure such as dispersed family holdings, it is doubtful that tax policy alone can exert a controlling influence over structure.

The effect of death taxes on size of farm parallels the effect on equity examined above. Low death tax exemptions or higher tax rates tend to restrain continued growth in size of farm from generation to generation, while higher exemptions or lower rates make it easier to keep farms large. It is doubtful, however, that the actual practical effect is very great. Although heirs naturally prefer to use tax exemption to finance keeping an estate intact, in most cases sufficient credit is available for that purpose.

Death taxes can have a substantial effect on who owns and who operates farms. In a broad sense, any concession in favor of current owners works into the hands of a separate landowning class. This is likely because ownership as such then becomes particularly attractive. Consider, for instance, that portion of farm estates that is built up from deferred capital gains. If high death tax exemptions then allow sizable amounts of such capital gains to escape taxes, high-bracket taxpayers from everywhere will compete to buy farm property that offers such a tax haven.

Whether a particular kind of organization structure - family farm or any other - is preferred is a separate issue. It is not considered here. The only point to be made is that low death tax exemptions and relatively high rates have some tendency to preserve an agriculture where operators own at least part of their land. Higher exemptions and lower rates have an opposite effect. They facilitate moving toward a financially elite landholding class in agriculture, and landholding by other than farm operators.

Summary

Appreciation in value of many farm estates, due in part to accumulation of physical assets but also reflecting increased prices of these assets, has made those estates much more subject to death tax review than was true in an earlier era.

The individual farmer, like every citizen, favors easing of the amount of tax obligation. The case for such action is strengthened by the fact that the tax formulas have not been adjusted to keep pace with inflation. But the same may be said of all federal tax rates and deductions, as they have at best been adjusted only very slowly. (State tax rates have generally increased).

When six separate proposals for changes in death taxes are matched against criteria of effects on efficiency, equity, revenue generation, and structure of agriculture, the results show a mixed pattern. Some proposals that are attractive to individual farmers test out well by social criteria, but others do not. Still others are essentially neutral.

Few if any of the proposals would have a clear net general effect on the efficiency of agriculture. Various forms of organization ("structure") of agriculture have about the same operating efficiency. Hence this conclusion concerning death taxes.

Tax revenue is generated in direct proportion to the size of exemption, the tax rate, and allowable deductions. There is no mystery here. The effect any tax change would have on revenue can be readily calculated.

Equity and structure of agriculture are the crucial criteria. In general, in the American democratic tradition equity is not served by increasing the level of exemption or decreasing rates in death taxes. However, the effect on equity is complicated by the three separate sources of appreciation in value of estates. In that regard, the proposal to tax capital gains on gifts and at death could improve equity, assuming the levy were the same as in the rest of the economy. The proposal to tax generation-skipping would likewise fulfill the equity criterion - perhaps more clearly than any of the other five proposals.

If the portion of estates that represented build-up of actual physical assets could be separated out, equity would be less involved in a more liberal death tax policy applied to it than in a similar application to the unearned-income portion.

Equity is not a major consideration in proposals to unify estate and gift taxes or to change the present marital deduction.

In many respects the effect that changes in death taxes would have on the structure of agriculture runs parallel to their effect on equity. For example, a higher death tax exemption or lower rates would push toward larger farms, even perhaps a hereditary-estate agriculture. Holding the exemption relatively low, taxing capital gains at death, taxing generation-skipping, and possibily even unifying estate and gift taxes - all would act in the direction of keeping farms somewhat smaller and in more dispersed owner-operator hands.

The proposal that is most certain to move agriculture toward a system of nonfarm-landholding with more farm tenancy would be an increased death tax exemption for farm estates only. Such selective preferential treatment would also be highly inequitable.