FARM ESTATE TAX ISSUES RAISED BY THE 1976 TAX REFORM ACT

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Agricultural Economics Extension Series No. 341

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Agriculture was singled out for considerable special attention in the Tax Reform Act of 1976. Attention was drawn by Congress to a number of federal estate tax concerns that were believed to be unique to agriculture and other small firms. Legislation was enacted which provided new methods for valuing land and an expanded and more attractive installment option for paying federal estate taxes attributable to a qualifying business.

Preferential Valuation of Farm Land

The preferential or use valuation of farm land allowed by the new tax reform act can be particularly useful for reducing estate tax liabilities on farm property (Tables 1 and 2). Under this new provision, real property in an estate that is devoted to farming or other closely held businesses may be valued for estate tax purposes on the basis of its use in that capacity rather than on the basis of its fair market value. However, this special valuation cannot reduce the decedent's gross estate by more than $500,000. To qualify for this special valuation, these factors must be met:

(1) The value of the farm or other closely held business assets (both real and personal property) must comprise at least 50 percent of the decedent's adjusted gross estate.

(2) At least 25 percent of the adjusted value of the gross estate must be qualified farm or other closely held business real

Table 1. Federal Estate Tax Before and After Use Valuation on Selected Amounts of Adjusted Gross Estate with 80% Held as a Farm and Use Valued at 50% of Fair Market Value.

Adjusted Gross Estate (AGE)		Federal Estate Tax*				
		Pre-	1977		After 1980	
Before	After	1977**	Before	After	Before	After
			-Dollars-			
250,000	150,000	10,900	-	-	-	-
500,000	300,000	47,700	40,800	-	23,800	-
750,000	450,000	86,500	83,300	24,800	66,300	7,800
1 mil.	600,000	126,500	125,800	57,800	108,800	40,800
1.5 mil.	1 mil.	212,200	218,300	125,800	201,300	108,800
2 mil.	1.5 mil.	303,500	315,800	218,300	298,800	201,300

*Assumes no post-1975 taxable gifts and the full unified credit is available as an estate tax credit.

**The pre-1977 (old) estate tax results are based on a maximum 50% of AGE marital deduction plus a $60,000 specific exemption. "Pre-1977" results are based on the "Before" AGE since special valuation is a new provision in the law.

Table 2. Implications of Use Valuation for Various Estate Sizes

I. Net Worth of Decedent - $250,000

	50% Real Property		90% Real Property	
Husband's Death	Use Value	Market Value	Use Value	Market Value
Adjusted Gross Estate	$141,335	$215,971	$ 89,329	$215,971
Federal Estate Tax	0	0	0	0
Wife's Death				
Adjusted Gross Estate	150,751	225,412	95,913	224,488
Federal Estate Tax	0	1,600	0	1,330
Value of Property Received by Heirs	223,919	221,531	223,713	220,869
Percent of Parents' Estate Received by Heirs	90.13	89.22	90.35	89.31

II. Net Worth of Decedent - $500,000

	50% Real Property		90% Real Property	
Husband's Death	Use Value	Market Value	Use Value	Market Value
Adjusted Gross Estate	$285,060	$434,331	$180,848	$434,331
Federal Estate Tax	0	14,837	0	14,837
Wife's Death				
Adjusted Gross Estate	297,464	432,974	185,913	429,956
Federal Estate Tax	23,289	50,324	0	49,719
Value of Property Received by Heirs	420,536	372,640	443,864	365,745
Percent of Parents' Estate Received by Heirs	84.92	75.68	89.62	75.51

III. Net Worth of Decedent - $750,000

	50% Real Property		90% Real Property	
Husband's Death	Use Value	Market Value	Use Value	Market Value
Adjusted Gross Estate	$428,784	$652,711	$272,365	$652,711
Federal Estate Tax	13,150	58,317	0	58,317
Wife's Death				
Adjusted Gross Estate	430,830	612,746	275,046	604,771
Federal Estate Tax	51,364	63,856	16,574	63,363
Value of Property Received by Heirs	595,083	531,171	642,761	518,143
Percent of Parents' Estate Received by Heirs	80.34	72.08	86.78	71.77

IV. Net Worth of Decedent - $1,000,000

	50% Real Property		90% Real Property	
Husband's Death	Use Value	Market Value	Use Value	Market Value
Adjusted Gross Estate	$572,074	$871,071	$394,133	$871,071
Federal Estate Tax	45,788	91,945	2,687	91,945
Wife's Death				
Adjusted Gross Estate	545,571	801,685	390,188	794,376
Federal Estate Tax	54,890	93,498	49,155	93,583
Value of Property Received by Heirs	777,518	679,881	819,826	658,028
Percent of Parents' Estate Received by Heirs	78.80	69.32	83.49	68.71

property.

(3) The property must pass to a qualified heir (a member of the decedent's family).

(4) The real property must have been owned by the decedent and been in its present use for 5 of the last 8 years preceding the decedent's death.

(5) The decedent or a member of his family must have materially participated in the operation of the farm or other closely held business for 5 of the last 8 years immediately preceding the decedent's death.

In addition, a recapture rule affects the tax benefits provided by this special assessment if the heir subsequently sells the property to individuals outside the family or converts the use of the property from farming or other qualifying business purposes within 15 years of the decedent's death (unless the sale occurs because of the heir's death). If the sale takes place within 10 years of the decedent's death, all the tax benefits are recaptured; the amount subject to recapture is phased out during the remaining 5 years. The potential recapture is enforced by a special lien placed on the real property which heirs elect to have valued by the special valuation procedure.

The special valuation is determined by dividing the average yearly gross cash rental of comparable land, less State and local real estate taxes, by an average of the annual effective interest rates for all new Federal Land Bank Loans. (This represents a commonly accepted means of capitalizing an infinite stream of returns). These averages are computed on the basis of the most recent calendar years preceding the decedent's death.

$$\frac{\text{Per Acre Fair Rental Value (last five years) minus Real Estate Taxes}}{\text{Federal Land Bank Interest Rate (5 year average)}}$$

There are a number of special problems with use valuation. It is useful to try to determine what Congress's intentions were when they enacted this legislation. The primary intention was to remove controversy from the ways in which estate tax liabilities impinged upon family farmers and owners of other small businesses. The object of legislation was to reduce some of the problems of transfer of family business assets to succeeding generations. In terms of agricultural property, it was also Congress's intention to make it easier for heirs to be able to continue in farming. At the same time, this particular goal is not compatible with another social goal - trying to provide increased opportunities for non-farmers to enter into farming through the purchase of land.

Other special problems dealing with use valuation includes the problem of developing a list of cash rental values. Cash rental values differ widely from one area to another. In many areas we have practically no cash renting occurring. Furthermore, how are the courts and the IRS going to handle the question of what is comparable land? If a piece of land is three miles down the raod and cash rented for a certain price, how does one handle the differences of soil, productivity, rainfall and other micro-climatic factors? What is locality? How close is local? How does one determine the average effective interest rate of the Federal Land Bank loans? Is it district average interest rate over the past five years? Is it the national interest rate? At the present time, some of these questions have not been answered. There will undoubtedly be a long list of such problems developing out of the preferential valuation of farm land as well as other rather controversial and vague aspects of the 1976 Tax Reform Act.

When no comparable land is available on which average cash rents or comparable cash rents can be determined, the tax law provides for the use of the multiple factor method. This can be elected by the executor even when comparable land data is available.

Under the multiple factor method, five approaches can be used:

(1) Capitalized Earning Value - Capitalized earning value is based on the expected earnings over a reasonable period of time with prudent management.

(2) Capital Earnings Value Based on Fair Rental Value - it seems a little bit ambiguous that the Congress allowed this to be considered because if one can determine the fair rental value of land, he could use the farm method of evaluation discussed previously. Presumably the reason for going to these five factors under the multiple factor method is to provide the mechanism for evaluation in the absence of fair rental values.

(3) Assessed Land Value - Assessed land value may be accepted as valuation for estate tax purposes in those states that do provide a use differential land value assessment i.e. where farm land is valued at its productivity rate which is at least somewhat lower

than its fair market value for other non-agricultural uses.

(4) Comparable Farms - Comparable farms would be those farms that are very similar in productivity but which are widely separated from urban and recreational use and which therefore, should be valued almost totally at their use value in production of agriculture.

(5) Any other method which fairly values the farm.

If use valuation is elected, there is a tax lien that attaches to the real property. This has implications concerning credit utilization and credit flows in agriculture. Some lenders have expressed reservations about advancing funds if the security already has a use valuation tax lien attached. If such a lien is attached to real property, it may reduce the possibility of using that property as the collateral for refinancing as commonly occurs during farm expansion and in periods of financial stress. Consequently, as such liens become a common occurrence, farmers may find it more difficult to use their real estate as a source of security for credit transactions.

Another important implication is that the recapture rules may result in conflicts between on-farm and off-farm heirs. If the real property ceases to be used for a qualified purpose or if it is sold outside the family, recapture of any tax benefits may occur. Conflict between the heirs can clearly occur if, because of disability or other investment opportunities (including an opportunity to purchase a more productive parcel of real estate), the on-farm heir decides to sell the qualified property and pay his portion of the recapture tax. The non-farm qualified heirs would be forced by this decision to become material participators, that is, to take an active role in the management themselves or to pay their share of the recapture tax. One would certainly expect such a conflict between the interests of the on-farm and the off-farm family to result in substantial family discord during the fifteen year period when recapture can occur - as the on-farm heir is placed in the position of qualifying for tax benefits for the off-farm heirs.

Care must also be exercised in planning for the gift or sale of property during the owner's lifetime. The sale or gift of property may be sufficient to reduce the proportion of qualified property below the 50 and 25 percent pre-death requirements discussed earlier and eligibility for use valuation could be lost.

The combination of use valuation provisions and the change in the carry-over basis rules could result in the accumulation of substantial gain in real property, particularly if real estate continues to increase in value. Thus, recipients of property transferred at death may be increasingly reluctant to sell that property because of the ever larger tax liability. This may result in reduced offerings of real estate on the market and more rental arrangements. With reduced sales of farm property, the values of property on the market may be bid up even further and different types of credit demands would arise with the emphasis on financing rental arrangements rather than on financing real estate purchases.

One might anticipate that a combination of the new carry-over basis and use valuation rules could sufficiently discourage land owners from transferring real property outside the family to the extent that a rather exclusive class of rural landholders would develop over time. Certainly the political and social implications of such a permanent group of land owners with a tax system strongly discouraging any entry are not in the best interests of equity and preservation of free entry to a family farming venture.

Unified Rate Schedule

Another important change coming out of the 1976 Tax Reform Act was the unified rate schedule for estate and gift taxes. Under the old law, estate and gift taxes were levied separately; each had its own tax rate schedule. Since the gift tax was lower than the estate tax, an individual could substantially reduce Federal taxation of intergenerational transfers by giving part of his property away during his lifetime instead of transferring all of it in a bequest. The new law eliminates this separation, and treats all transfers--whether given during one's lifetime or at death--substantially the same.

Under the previous law, there was a $60,000 exemption for the estate tax and two different kinds of exemptions for the gift tax--a once-only exemption of $30,000 and an annual exemption of $3,000 for each separate donee. The $3,000 annual gift exemption is retained in its present form; an individual may still give up to $3,000 each to other individuals every year without such gifts entering the tax base. However, the two once-only exemptions have been eliminated and replaced with a single tax credit.

For decedents dying in --	Unified credit	Equivalent Exemption 1/
1977	$30,000	$120,667
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981 and thereafter	47,000	175,625

The tax schedule itself will be progressive, increasing from a marginal rate of 30 percent (32 percent after 1980) on taxable transfers to 70 percent for cumulative taxable transfers of more than $5 million.

The unified credit which is now available under the new 1976 Tax Reform Act is clearly different in its impact from the exemption available in pre-1977 estate tax regulations because it's worth the same amount to everyone regardless of the size of estate. As recognized in the debate concerning the 1976 Tax Reform legislation, an increase in the exemption would have been worth far more to those in the highest tax bracket. The credit thus targets the largest potential tax benefits to smaller estates as illustrated in Figure 1. Since the credit is available to each individual decedent, one would anticipate that additional gifting between spouses would be encouraged in order to obtain full utilization of credit available at the death of both the husband and the wife.

Carry-over Basis

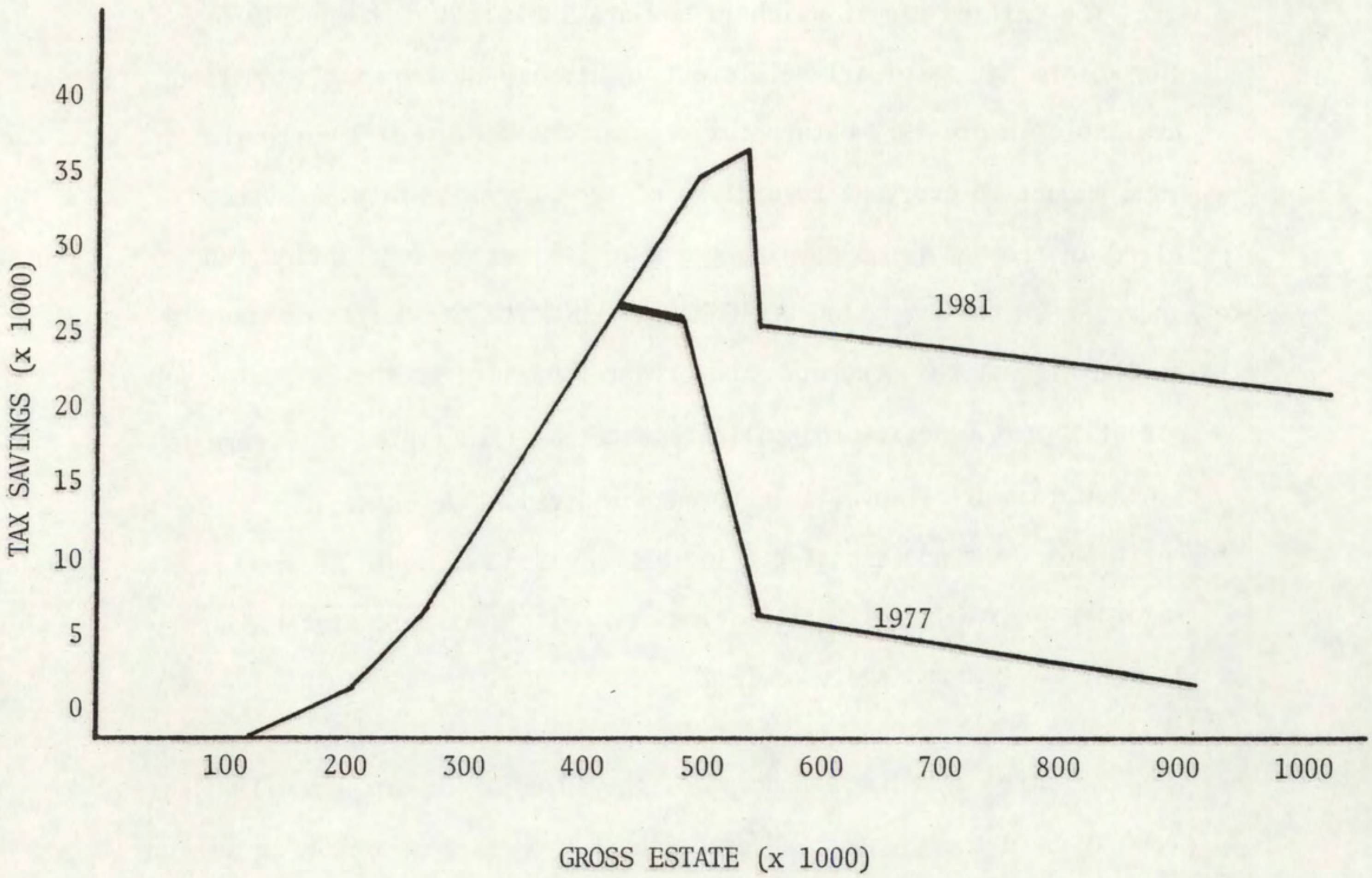
The carry-over basis concept of the 1976 Tax Reform Act will likely prove to have the greatest adverse impact upon farmers of any provision of that law. Capital gains that were unrealized during an individual's lifetime were not taxed under prior estate tax provisions. The present act will change this practice in the future.

1/ These equivalent exemptions are not comparable with the $60,000 exemption under the previous estate tax provisions because of the different tax rate structure which prevailed.

Figure 1

Tax Savings From Unified Credit

By size of estate from
Tax Reform Act of 1976



Under the old law, the tax basis of inherited property was "stepped up" to its fair market value at the time of the decedent's death. Later, when an individual sold the inherited property, taxes were paid on the difference between the selling price and the "stepped up" value of the property. Any appreciation before the time of the inheritance was never taxed as income.

Under the new provisions, the tax basis for marketable bonds and securities will be either the originial purchase price or the appraised fair market value on December 31, 1976, whichever is greater. Farmland and other assets will be considered separately. Their appreciation will be prorated by a straight-line apportionment method based on the relative amount of time the property was owned before January 1, 1977. The less time this type of asset was owned before this provison takes effect, the greater the percentage of the appreciation will be taxable. The rule is as follows:

$$\text{Appreciation subject to taxation} = \frac{\text{Amount of time asset held after December 31, 1976}}{\text{Total amount of time asset held before sale}} \times \text{Total appreciation}$$

Thus, no appreciation attributable to an asset before January 1, 1977 will be subject to the new carryover basis rules. Executors may also elect to exclude from the taxable estate as much as \$10,000 of assets which were household or personal effects of the decedent. In addition, the basis of an estate can be stepped up to \$60,000. Thus, the new provision is not intended to apply to beneficiaries of smaller estates.

Objections to the carryover basis concept seem to fall into four categories:

(1) The extensive and time consuming calculations needed to compute the fresh-start adjustment. The adjustment for federal estate tax attributable to the net appreciation and value of carry-over basis property, the minimum of $60,000 adjustment for all carryover basis property, and the adjustment for state inheritance or similar tax attributable to the net appreciation in value of carryover basis property.

(2) The lack of records in most estates for determining for carryover basis property the holding period, original basis, depreciation claim through 1976 and substantial improvements made with information on date of the improvement, original cost or other basis and depreciation claimed before 1977.

(3) The additional income tax liability incurred on sale of carryover basis property after death.

(4) The long-run effects of no "new start" at death with the only upward adjustment in income tax basis coming from sale transactions.

Although all four areas of concern are important, the last one may eventually prove to be the most difficult to tolerate from a policy standpoint.

This fourth area of concern, the matter of long-range effects of the shift in income tax treatment of gain on property held until death, may eventually involve important questions of resource allocation and economic constraints in transfer of carryover basis assets.

If the long-term trend is an increase in the general price level, including the price of land, the amount of taxable gain per unit of land would increase. With no new basis at death, the potential income tax liability per unit of land would likewise increase over time unless the property was sold. Sale would be expected to become less likely over time as the net sale value (after payment of income tax liability) diminishes relative to fair market value. Thus, in effect, income tax liability would become a factor inhibiting sale. The result could be to lock land into families and with each passing generation the probability of taxable transfer of such assets would diminish.

A price oriented market economy, such as ours, functions best with relatively free transferability of resources. For that reason, it is doubted that the present carryover basis system can long endure without resulting in significant misallocations of resources.