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AN UNLIMITED ESTATE TAX EXEMPTION FOR FARMLAND Unnecessary, Open to Abuse, and Likely to Hurt, Rather than Help, Family Farmers

By Aviva Aron-Dine

There is overwhelming evidence that the estate tax has never posed a significant problem for farmers. According to the Congressional Budget Office, only 1,659 farmers nationwide owed any estate tax in 2000, when the estate tax exemption stood at just *one-third* of its current level.¹ Some 1,521 of these estates — or 92 percent of them — had liquid assets that exceeded their estate tax bill, meaning they could not have needed to sell any farmland to pay the estate tax. Moreover, the remaining 138 estates had access to additional tax relief measures designed to ease estate tax burdens for farmers (see the box on page 6). Opponents of the estate tax have not been able to produce a single case in which a family farm had to be sold to pay the tax, even *before* the exemption was increased sharply in 2001.²

Nevertheless, advocates of estate tax repeal have turned the tax's impact on farms into a central issue, and many on both sides of the estate tax debate have expressed interest in modifying the tax to provide still greater protection for farmers. This desire has led some policymakers to support an unlimited estate tax exemption for all farmland. Legislation creating such an exemption has been introduced in the Senate by Senator Ken Salazar (S.

KEY FINDINGS

An unlimited estate tax exemption for farmland:

- Would likely prove extremely costly because it would create strong incentives for wealthy individuals to convert large amounts of their estates into qualifying farmland.
- Could undermine its own goals. If wealthy individuals seeking to shield assets from the estate tax bid up the price of farmland, that would make it *more* difficult for genuine family farmers to keep their farms in their families and could discourage others of ordinary means from entering farming.

In contrast, a broad-based reform like making the current (\$4 million per-couple) estate tax exemption, or the 2009 (\$7 million per-couple) estate tax exemption permanent:

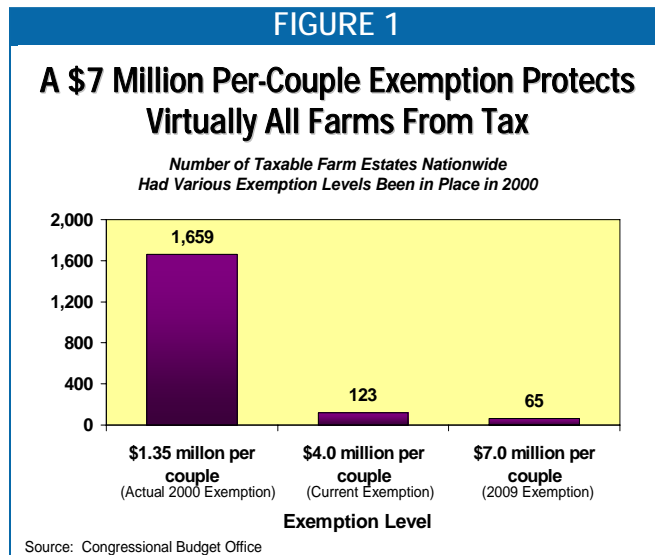
- Would protect virtually all farm estates from tax, according to Congressional Budget Office estimates.
- Would be far simpler, more administrable, and less open to abuse, and would not have unintended negative consequences for family farmers.

¹ Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses," July 2005, <http://cbo.gov/ftpdocs/65xx/doc6512/07-06-EstateTax.pdf>.

² David Cay Johnston, "Talk of Lost Farms Reflects Muddle of Estate Tax Debate," *New York Times*, April 8, 2001.

1994) and in the House by Rep. John Salazar (H.R. 1929). (Both bills have a number of cosponsors.)

However well intentioned, this approach to the issue of farms and the estate tax is misguided. An unlimited estate tax exemption for farmland could easily be abused by wealthy individuals whose primary occupation is not farming. As a result, it could lose large amounts of needed revenue. It also could have a truly perverse effect: it could *reduce* the number of family farmers and make it *more difficult* to keep farms within families.



A far better alternative would be to protect farms from the estate tax through broader estate tax reforms. For example, simply making the current estate tax exemption (a \$4 million per-couple exemption) or the scheduled 2009 estate tax exemption (a \$7 million per-couple exemption) permanent would eliminate the estate tax for virtually all farms (see Figure 1), while avoiding the problems that would accompany an unlimited estate tax exemption.

Unlimited Exemptions Invite Abuse

An unlimited estate tax exemption for a particular type of asset, such as farmland, creates powerful incentives for wealthy individuals to find ways to exploit the exemption. Specifically, an unlimited exemption for farmland could create strong incentives for wealthy individuals who are not farmers to convert some of their wealth into farmland, with a series of undesirable results:

- **Very high costs.** Farmland currently constitutes only a small portion of the total value of taxable estates.³ But an unlimited exemption for farmland would likely cause a very large loss of estate tax revenue.

One indication of how costly an unlimited exemption for farmland could be is found in the Joint Committee on Taxation's estimate of the cost of an unlimited exemption for family-owned farms and businesses.⁴ Congressional Research Service and Internal Revenue Service data indicate that farm and business assets constitute just 10 to 20 percent of the total value of taxable estates.⁵ Yet the Joint Committee on Taxation estimated that an unlimited exemption would cost about *85 percent as much as full estate tax repeal*, presumably because the Joint Tax

³ IRS data for 2005 show that 10 percent of the value of taxable estates consisted of "other real estate," a category that includes but is not limited to farmland. <http://www.irs.gov/pub/irs-soi/05es01fy.xls>.

⁴ The Joint Tax Committee estimate is for S. 34, the "Estate Tax Repeal Acceleration for Family-Owned Businesses and Farms Act," introduced in the 108th Congress.

⁵ The Congressional Research Service has estimated that non-land farm and business assets together account for a little over 10 percent of the total value of taxable estates; as noted, IRS data indicate that farmland represented less than 10 percent of the value of taxable estates in 2005. Jane Gravelle and Steven Maguire, "Estate Taxes and Family Businesses: Economic Issues," Congressional Research Service, September 8, 2005.

Committee projected that the wealthiest individuals would shift a large fraction of their estates into the tax-exempt assets to avoid the estate tax. In fact, Joint Tax stated, “we anticipate that for a large number of estates, the bill would effectively repeal the estate tax.”

Even if one assumes that converting assets to farmland would be more difficult than converting assets to qualifying “family-owned” businesses, and even taking into account the fact that the Salazar bill includes stronger anti-abuse measures than the legislation that the Joint Tax Committee examined, it still seems likely that an unlimited exemption for farmland would be very expensive.

- **Endangering true family farms.** Most economists discourage policymakers from attempting to preserve family farms by means of special subsidies; they argue that it is more efficient for government policy to be neutral with respect to farm ownership. But regardless of one’s stance on this question, the irony is that an unlimited estate tax exemption for farmland would likely *reduce* the number of small family farmers.

As an Urban Institute-Brookings Institution Tax Policy Center analysis explains, such an exemption “could endanger many existing small farms... as wealthy people would bid up the price of such properties to claim their tax benefits. (How much of Iowa could Bill Gates buy with his fortune?)”⁶ That is, the unlimited estate tax exemption would lead wealthy individuals to seek to convert large amounts of wealth into farmland. This increase in demand for farmland would raise its price, and those bought out would likely include many small farmers. Even though these farmers would sell their farms willingly and would benefit from the increase in the farms’ value, the result would still be the opposite of the Salazar bill’s objective: the tax subsidy would result in fewer, not more, family farms.

Moreover, higher farmland values would have other, troubling implications for farmers. As Brian Reidl of the Heritage Foundation notes in another context, “High farmland prices make starting a farm prohibitively expensive for younger people...”⁷ Higher farm values could even jeopardize the efforts of non-wealthy farm families — families that would never be subject to the estate tax under current law — to keep farms within the family. One reason that family farms are sometimes sold upon an owner’s death is that they are bequeathed to multiple heirs, and the heirs who want to continue to farm cannot afford to buy out the shares of the heirs who do not. Higher farmland values would exacerbate this problem.

Finally, higher land values generally translate into higher costs for the many small farmers who rent rather than own much or all of their farmland. Thus, an estate tax provision designed to benefit the handful of farmers with estates that are larger than the general estate tax exemption could inflict collateral damage on much larger numbers of modest family farmers.

- **Reductions in economic efficiency.** As noted, an unlimited estate tax exemption for farmland would likely lead to purely tax-motivated purchases of farms. As a Tax Policy Center

⁶ Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, “Options to Reform the Estate Tax,” Urban-Brookings Tax Policy Center, March 2005, http://www.taxpolicycenter.org/UploadedPDF/311153_IssuesOptions_10.pdf.

⁷ Brian M. Reidl, “How Farm Subsidies Harm Taxpayers, Consumers, and Farmers, Too,” Heritage Foundation, June 20, 2007, <http://www.heritage.org/Research/Agriculture/bg2043.cfm>.

analysis explains, these “purely tax-motivated purchases could represent a serious efficiency loss to society. For example, it is unlikely that a billionaire’s heirs holding tens of thousands of acres of farmland for tax purposes would manage the resources as effectively as the professional farmers they would displace (and, because of the tax benefits, the heirs would not have to be efficient to make the investment pay off after tax).”⁸

In other words, the exemption could make it worthwhile for individuals who were neither interested in nor skilled at farming to hold large amounts of farmland.

Anti-Abuse Measures Are Not Foolproof and Could Work Poorly in This Case

The Salazar bill attempts to avert these problems through various anti-abuse measures. These provisions are intended to restrict the benefits of the farmland exemption to active farmers. However, the measures are unlikely to be fully effective at preventing wealthy non-farmers from converting their assets into qualifying farmland. Below are two examples of how the anti-abuse measures could break down; expert estate tax lawyers could almost certainly find more subtle loopholes to exploit.

- **The “material participation” test is vague.** To restrict the provision to active farmers, the Salazar legislation relies in part on a “material participation” test: in addition to owning the farm for at least five of the eight years before death, the decedent or a member of his or her family must have “materially participated” in the operation of the farmland.

The problem is that, according to the American Bar Association, “This requirement is ambiguous... The statute does not define material participation, and there are no regulations or case law under IRC Section 2057 to assist in resolving uncertainties about what constitutes material participation. Moreover, the related cases and other guidance under IRC Section 2032A, which was the model for IRC Section 2057, are not very useful, simply because the question of material participation depends heavily on the factual context of each situation.”⁹ Leaning heavily on such vague language as an anti-abuse measure seems dangerous.

- **The recapture tax may not eliminate large tax benefits.** To deter non-farmers from converting their assets into farmland, the Salazar bill includes a “recapture tax.” If at any time before the heir’s death, the heir sells the land to someone outside his or her family or ceases to use it as farmland, the estate tax avoided at the time of the decedent’s death is generally imposed (with an important caveat, discussed below).

It might seem that the recapture tax would discourage many wealthy families from converting their assets to farmland, since the heirs would need to hold onto the land until death to receive the tax benefits. But under the Salazar bill, the recapture tax is imposed *without* any adjustment for inflation and *without* any interest. As a result, the proposal could provide substantial tax benefits to the heirs of the wealthiest estates even if, in the end, they had to pay the recapture tax.

⁸ Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, “Options to Reform the Estate Tax.”

⁹ Task Force on Federal Wealth Transfer Taxes, “Report on Reform of Federal Wealth Transfer Taxes,” American Bar Association, 2004.

For example, consider the case of an heir inheriting a \$25 million estate. Under current (2007) estate tax law, such an estate could owe as much as \$10.4 million in taxes. But suppose the estate has been converted to qualifying farmland, and so the heir owes no tax on it at the time of the decedent's death. Assuming a 5 percent annual return on the farmland (for example, because the land appreciates in value), the \$25 million estate will be worth about \$40.7 million after ten years. If the heir then decides to sell and pays the \$10 million recapture tax, he or she is left with \$30.7 million. In contrast, suppose the heir had sold the estate immediately, paying the \$10 million in taxes, and then invested the remaining \$15 million in assets earning a 5 percent annual return. At the end of ten years, the heir would be left with only \$24.4 million. In other words, assuming a 5 percent annual return, a large estate owing \$10 million in taxes *would gain about \$6 million* from deferring the taxes for ten years.

- **In addition, it might be possible to reduce the recapture tax or eliminate it entirely by overvaluing the farmland.** Under the legislation, the recapture tax imposed if the farmland is eventually sold is set equal to the *lesser* of the tax avoided at the time of death and the difference between the amount for which the farmland is sold and its estimated value as farmland at the time of the decedent's death (i.e. its value assuming it is used for farming).¹⁰ If heirs can sufficiently overvalue the farm at the time of the decedent's death, then the difference between the sale value and the value at the time of death may be small, zero, or even negative (allowing the heirs to realize a capital loss).

In other contexts, the incentive to overvalue assets at death is mitigated or eliminated by the fact that the estate tax due at the time of death goes up with the valuation. But with an unlimited exemption for farmland, the incentive would be to find ways to overstate farmland values.

It should also be noted that the anti-abuse measures included in the bill, while certainly better than no anti-abuse measures at all, would likely make filing for the farmland exemption quite complex and burdensome. One could easily end up with the worst of all possible worlds: genuine family farmers unwilling or unable to make use of the provision because of its complexity, while wealthier, more sophisticated individuals with skilled estate-tax lawyers take advantage of it.

Increasing the Overall Estate Tax Exemption Would Virtually Eliminate the Estate Tax for Farmers

A far simpler approach that would avoid the problems described above would be to protect farmers from the estate tax by raising the overall estate tax exemption. For example, had this year's \$4 million per-couple estate tax exemption been in effect in 2000, the Congressional Budget Office calculates that fewer than 600 farm estate nationwide would have needed even to file an estate tax return, and of these only 123 would have owed *any* estate tax. At the \$7 million per-couple estate tax exemption level slated to take effect in 2009, fewer than 200 farm estates would have needed to file returns, and only 65 would have owed any tax.¹¹ Moreover, such farmers would also retain access to the additional targeted tax relief described in the box on page 6.

¹⁰ Technically, its "special use" value.

¹¹ Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses."

Estate Tax Protections for Farmers Under Current Law

Under current estate tax law, farm estates benefit from four forms of targeted tax relief.

- **Special use valuation.** This year's \$4 million per-couple estate tax exemption really amounts to a nearly \$6 million exemption for farm couples. Each member of a farm couple is allowed to reduce the value of farmland and certain other assets in their estate by up to \$940,000 through a provision that allows farmers to value these assets based on their current use (farming) rather than on their most profitable use.
- **Payment of tax over 15 years.** Farm estates are generally eligible to defer payment of estate tax (paying only interest) for five years and then may pay the tax in up to ten annual installments. The first \$1.25 million in estate tax is subject to an interest rate of only 2 percent. In addition, the interest rate on the remainder owed is still only 45 percent of the rate generally levied on late tax payments. This provision prevents farmers with large estates but few liquid assets from having to sell their farms to pay the estate tax.
- **Conservation easements.** Farmers may deduct from the value of the estate up to 40 percent of the value of land subject to a qualified conservation easement. (A conservation easement is essentially an enforceable promise not to develop the land for uses other than farming; typically, conservation easements are donated to environmental groups or municipalities.)
- **Minority and marketability discounts.** Estate tax law allows a lower valuation for property that is held by multiple heirs, each of whom has a minority interest, or that is otherwise difficult to sell. Farm estates are especially likely to qualify for these discounts. According to the Congressional Budget Office, minority discounts reduced the taxable value of undeveloped land and farmland for which these discounts were claimed by an average of 51 percent in 2000.*

(Prior to 2004, family farmers also benefited from a fifth targeted provision that bumped up the estate tax exemption for family-owned farms and businesses: the Qualified Family-Owned Business Interest Deduction (QFOBI). This bump-up is no longer operative because the general estate tax exemption has increased so much that it now exceeds the QFOBI exemption.)

One might wonder why, if an unlimited exemption for farmland would be subject to such abuse, other targeted provisions for farmers appear to be relatively unproblematic. The key is that an unlimited exemption creates extremely large incentives for big estates to find ways to take advantage of it. In contrast, a provision like special use valuation, the benefits of which are capped (or a provision like a 15-year payment of tax that allows deferral but not avoidance of tax) creates smaller incentives. In other words, there is less incentive to abuse these provisions, and, if the provisions are abused, the revenue loss is limited.

* Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses."

As the Tax Policy Center analysis concludes, "an across-the-board increase in the [estate tax] exclusion can effectively exempt virtually all small farms and businesses without opening the door wide for counterproductive estate tax shelters."¹² Under such an approach, the estate tax would, in effect, be repealed for nearly all farmers — without their having to cope with a complicated new set

¹² Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, "Options to Reform the Estate Tax."

of rules and without opening the door to abuse by very wealthy individuals who are not farmers and have little interest in farming.