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UNLIMITED ESTATE TAX EXEMPTION FOR FARM ESTATES IS UNNECESSARY AND LIKELY HARMFUL

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Proponents of repealing the estate tax have made farmers, along with small business, the face of their cause, driving some policymakers to push for special preferences for farms in estate tax law. One of the most radical of these proposed changes is an unlimited estate tax exemption for farmland, recently introduced by Rep. Mike Thompson (D-CA) in H.R. 5475. This approach is seriously misguided, for three basic reasons.

First, there is overwhelming evidence that the estate tax does not pose a significant problem for farmers. The Urban Institute-Brookings Institution Tax Policy Center estimates that fewer than 110 small-farm estates in the entire nation would likely face the tax in 2011 if Congress reinstated the tax at its 2009 levels, as President Obama has proposed. Moreover, estate tax opponents 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 2001 tax law began phasing down the tax significantly.[1]

Second, an unlimited exemption for farmland would promote tax sheltering by giving wealthy individuals whose primary occupation is *not* farming a strong incentive to sell financial assets and buy up large tracts of farmland in order to avoid paying the tax. In examining an earlier proposal to exempt farmland, the Tax Policy Center concluded that such an exemption "would make the estate tax essentially voluntary for the very wealthy," because of the large tax shelter that it would create.

Third, an unlimited farmland exemption could *hurt* ordinary farmers by driving up the price of farmland as wealthy individuals sought to buy farmland for use as a tax shelter. This would make it harder for young aspiring farmers to enter the farming industry and for families to hold on to true family farms.

Almost No Small Farms Would Owe Any Estate Tax Under 2009 Levels

Some proponents of weakening the estate tax beyond its 2009 parameters claim that doing so is necessary because of the impact of the tax on family-owned farms.[2] In fact, the vast majority of

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

[2] For a detailed discussion of why repealing the estate tax or weakening it beyond its current form would be unnecessary and fiscally irresponsible, see Chuck Marr and Gillian Brunet, "Stalled Proposal to Cut Estate Tax Further Is Deeply Flawed and Should Not Be Revived," Center on Budget and Policy Priorities, May 21, 2010, http://www.cbpp.org/files/5-20-10tax.pdf.

small-farm estates already are exempt from the estate tax under the 2009 rules. The Tax Policy Center estimates that only 110 small-farm *and* small-business estates nationwide will owe any estate tax in 2011 if the 2009 estate tax levels are reinstated.[3] Since that figure also includes small business estates that are *not* farms, this means that *fewer* than 110 small-farm estates are likely to face the estate tax in 2011 if the 2009 rules are reinstated.

Moreover, this handful of taxable small-farm and small-business estates would owe only 11.3 percent of the estate's value in tax, on average, according to the Tax Policy Center — well below the average effective tax rate of 18.9 percent for all taxable estates (and far below the top marginal rate for the estate tax of 45 percent under the 2009 rules).[4] One reason for the low effective tax rate is that the first $3.5 million of any estate (effectively $7 million for a couple) is entirely exempt from estate tax, and this large exemption generally protects a significant share of the value of small-business and small-farm estates from the tax. In addition, a number of special estate tax provisions targeted to small-business and small-farm estates (see page 4 for details) allow them to significantly reduce the amount of tax they owe, effectively increasing the exemption to $9 million per farming couple.

A U.S. Department of Agriculture report confirms that only a tiny percentage of farms owe any estate tax under the 2009 rules and notes that farms have benefited significantly from changes in other federal taxes over the past decade. (See box on page 3.)

Little Evidence That Taxable Small Farm and Business Estates Face Liquidity Constraints

Proponents of further weakening the estate tax often claim that it causes small businesses and farms to be liquidated. This claim is groundless.

In 2001, the American Farm Bureau Federation acknowledged to the *New York Times* that it could not cite a single example of a farm having to be sold to pay estate taxes, and this was *before* the estate tax exemption level was more than tripled and the top rate was reduced.[5]

More recently, a Congressional Budget Office study found that of the very few farm estates that would owe any tax under the 2009 parameters, all but a handful would have sufficient liquid assets on hand (such as bank accounts, stocks, and bonds) to pay the tax without having to touch the farm or business.[6] And CBO further explained that it may have overestimated the number of small businesses and farm estates with possible liquidity constraints because it was unable to include certain assets held in trusts (such as life insurance trusts) in calculating the liquid assets available to

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[3] See Tax Policy Center, "$3.5 Million Exemption and 45 Percent Rate: Distribution of Gross Estate and Net Estate Tax by Size of Gross Estate, 2011," October 6, 2009, http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2473&DocTypeID=7. We follow the Tax Policy Center definition of a small business or farm estate as one in which more than half of the value of the estate is in a farm or business and the farm or business assets are valued at up to $5 million.

[4] *Ibid.*

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

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

USDA Study Indicates Estate Tax Cuts Are Unnecessary to Help Small Farms

A 2009 USDA study[a] based on IRS and survey data finds:

Very few farm estates[b] pay any estate tax and those that do are large.

- Only about 1.6 percent of all farm estates were subject to the estate tax in 2009, according to USDA estimates. (Fewer than 3 percent of all farm estates had to file an estate tax return, and after taking deductions and exemptions, only about half of those estates owed any estate tax.)

Farm estates have benefited significantly from recent cuts in federal taxes.

- "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," the study states. In addition, "As of 2008, the cumulative effect of … tax policy changes [over the last decade] has resulted in the lowest Federal tax rate on farm income and investment in over a decade. The average income tax rate [the percent of their income that farmers pay in tax] 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."

- Large commercial farms have benefited significantly from business tax cuts since 2001, including increased expensing of capital purchases, reduced tax rates on business assets, and new deductions for manufacturers, which farmers can also claim.

Because many farms have modest incomes, increasing refundable tax credits would help many *more* family farmers than further shrinking the estate tax.

- The study finds that tax measures that benefit low- and moderate-income households, such as permanently extending the improvements in the Child Tax Credit and Earned Income Tax Credit included in last year's Recovery Act, would likely benefit many more family-farm households than shrinking the estate tax.

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[a] Ron Durst, "Federal Tax Policies and Farm Households" Economic Information Bulletin No. (EIB-54) May 2009

[b] The report's definition of "farm estates" includes estates that have not necessarily accumulated the bulk of their assets or income from farming activity; in some cases, investments or work other than farming might be the primary activity of the decedent. The USDA figures are not comparable with the Tax Policy Center estimates for this reason, and also because the TPC estimates cover *small* farms rather than *all* farms and also include small businesses.

help pay the tax.[7]

Also, those few small businesses and farm estates that might conceivably face a liquidity problem would have other options — such as spreading their estate tax payments over a 14-year period (see below) — that would allow them to pay the tax without having to sell off any of the business or farm assets.

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[7] *Ibid.*

Farm Estates Enjoy Protections Under Estate Tax Law

Farm estates that are large enough to owe estate tax can benefit from up to four different forms of targeted estate tax relief:

- **Special-use valuation.** As noted, the $7 million per-couple estate tax exemption in effect in 2009 actually amounts to a $9 million exemption for farm couples. This is because each member of a farm couple is allowed to reduce the value of farmland and certain other assets in their estate by up to $1 million in 2010 dollars (this figure is indexed for inflation) through a provision that allows farmers to value these assets based on their *current* use (farming) rather than their most *profitable* potential use. According to a leading USDA study of this matter during the George W. Bush Administration, special-use valuation can reduce the value assigned to the component of farm estates that consists of real property (as distinguished from the part that consists of financial assets) by *40 to 70 percent* of the assets' market value.[8]

- **Extending tax payments over 14 years.** Under the 2009 estate tax rules, farm and small business estates are generally eligible to defer payment of estate tax (paying only interest) for five years and then to pay the tax in up to ten annual installments.[9] The first $1.33 million in tax is subject to a low interest rate of 2 percent; the interest rate on the remainder owed is 45 percent of the rate generally levied on late tax payments. This provision enables farmers with large estates but few liquid assets to pay the estate tax without selling their farms.

- **Conservation easements.** Farmers may deduct from the value of their estate up to 40 percent of the value of land that is subject to a qualified conservation easement, up to a maximum deduction of $500,000. 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 interests 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 and small business 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.[10]

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[8] Ron Durst, James Monke, and Douglas Maxwell, "How Will the Phaseout of Federal Estate Taxes Affect Farmers?" *USDA Agriculture Information Bulletin,* No. 751-02, February 2002, http://www.ers.usda.gov/publications/aib751/aib751-02/aib751-02.pdf.

[9] Generally, estates that are required to file a return must do so within nine months of the death; this provision allows qualifying estates to spread payment of any tax owing over an *additional* 14 years. This benefit applies to the business portion of assets if at least 35 percent of the estate consists of farm or closely held business assets, in order to target those estates for which liquidity constraints are most likely.

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

Thompson Proposal Unnecessary and Likely Harmful

On May 28, Rep. Mike Thompson (D-CA) introduced a proposal (H.R. 5475) to create an unlimited estate tax exemption for the value of farmland, among other changes. Called the "Family Farm Estate Tax Relief Act of 2010," its stated intent is to protect family farms from the estate tax. As explained above, however, very few family farms would be subject to the estate tax under the 2009 rules. Instead, the main effect of the proposal would likely be to promote tax sheltering by wealthy individuals whose primary occupation is not farming. It also would be likely to adversely affect people seeking to go into farming, by driving up the price of farmland.

Unlimited Exemption for Farmland Would Promote Tax Avoidance

While the Thompson proposal includes some limits on which estates would qualify for the farmland exemption,[11] the exemption itself places no limit on the value of the farmland that can be exempted, making it particularly lucrative to the largest estates. Billionaires would have a strong incentive to sell financial assets and buy up large tracts of farmland late in life in order to avoid paying the estate tax.

Analyzing a 2007 proposal by Sen. Ken Salazar (D-CO) and Rep. John Salazar (D-CO) to create a similar unlimited exemption for farmland, the Tax Policy Center concluded:

> An unlimited exemption for farm assets would be very costly because the wealthiest people would have a strong incentive to convert most of their assets into qualifying farms, and thus skirt the estate tax. People with smaller taxable estates may decide the costs of such estate tax planning are not worth the rewards and would continue to pay the tax, but an unlimited farm exemption would make the estate tax *essentially voluntary for the very wealthy* (emphasis added).[12]

Whereas special-use valuation (see the previous page) excludes from an estate's value the difference between the land's current value and its maximum potential value, the proposed farmland exemption would apply to the *entire* value of qualifying farmland. For instance, if an estate included land that could be sold to a developer for $3 million but was worth only $2.5 million if used for farming, the $500,000 difference would be excluded from the taxable estate under special-use valuation; under the Thompson proposal, the entire $3 million would be excluded.

Proposal Could Harm Family Farms and Result in Less Efficient Use of Farmland

An unlimited exemption for farmland could also harm ordinary farmers by driving up the cost of farmland. If the wealthiest Americans began buying up farmland for tax purposes, the increased demand would lead to higher prices, making it more difficult for aspiring farmers to acquire land to begin farming and putting pressure on cash-strapped small farmers to sell. If this policy were enacted, over time, many farmers likely would end up renting the land they farm. As farm land was bid up artificially due to its estate tax advantage, farmers would be outbid for the property as wealthy

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[11] See page 6 for details.

[12] Leonard E. Burman, Katherine Lim, and Jeff Rohaly, "Back from the Grave: Revenue and Distributional Effects of Reforming the Federal Estate Tax", Urban-Brookings Tax Policy Center, October 20, 2008, pg. 32, http://www.taxpolicycenter.org/UploadedPDF/411777_back_grave.pdf. (Emphasis added.)

people from other industries that generate greater income would acquire farmland for the tax benefit. Eventually, this could squeeze out many family farms — an ironic result of a policy intended to protect them.

As Brian Reidl of the Heritage Foundation has noted in another context, "High farmland prices make starting a farm prohibitively expensive for younger people."[13] Higher farm values could also jeopardize the efforts of non-wealthy farm families — families that would never be subject to the estate tax under 2009 levels— 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.

As the Tax Policy Center wrote of the 2007 Salazar proposal, "Ironically, it 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?)"

An unlimited exemption could also reduce economic efficiency, harming the broader economy. As the Tax Policy Center put it, such "purely tax-motivated purchases could represent a serious efficiency loss to society." The loss would occur because "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)."[14]

Anti-Abuse Measure Unlikely to Be Fully Effective

The Thompson proposal includes a provision intended to curb abuse of the farmland exemption, but this provision would likely be ineffective at preventing wealthy non-farmers from converting their assets into qualifying farmland.

Under a provision in the Thompson proposal, if an heir sells (or otherwise ceases to use) qualified farmland for farming, the assets that had been exempted from estate tax by the unlimited exemption for farmland would be subject to a "recapture tax." However, the wording of the recapture tax is ambiguous, and it seems likely that it would apply only if the farm were sold or changed uses within the first ten years after the estate was transferred. Under that scenario, an heir could simply hold the land for 11 years before selling and avoid the recapture tax altogether.[15]

[13] Brian M. Reidl, "How Farm Subsidies Harm Taxpayers, Consumers, and Farmers, Too," Heritage Foundation, June 20, 2007, http://www.heritage.org/Research/Reports/2007/06/How-Farm-Subsidies-Harm-Taxpayers-Consumers-and-Farmers-Too.

[14] *Ibid.*

[15] The recent Thompson bill fails to include another anti-abuse measure that was incorporated into the 2007 Salazar proposal. That proposal included a "material participation" provision requiring a family to be actively engaged in operating the farm in order for a family member's estate to qualify for the unlimited farmland exemption. That provision was vague and could likely have been skirted through careful planning.

Provision for Conservation Easements Is Unnecessarily Generous

In addition to the unlimited exemption for farmland, the Thompson bill would greatly expand estate tax benefits for conservation easements.[16]

Under the 2009 estate tax levels, farmers and other landowners may deduct from the value of their 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.) The maximum exclusion under this provision is $500,000, though the total reduction in the value of the taxable estate may be significantly greater if the donation of the easement reduces the land's market value. While the amount by which this provision reduces total estate tax collections is unclear, in 2005 landowners made $1.8 billion worth of donations of conservation easements.[17]

The Thompson proposal would increase the maximum exemption *tenfold,* to $5 million. It would also increase the percentage of land value subject to an easement that can be deducted from the value of the estate from 40 percent to 50 percent.

This proposal is unnecessary to protect small farm owners from the estate tax, for the reasons discussed previously. Also, as with other proposals that attach estate tax benefits to land ownership, it would create an incentive for wealthy taxpayers to invest in farmland in order to take advantage of the tax break, potentially driving up farm prices and endangering small farms.

Conclusion

There is no justification for creating additional preferences in the estate tax for farm estates, particularly in light of the serious fiscal problems the nation faces. If the 2009 estate tax parameters are reinstated, only a tiny number of small farm estates will face the tax at all and those that do will generally face a low effective rate. Moreover, there is no evidence that those estates would face liquidity constraints. Finally, new or enlarged special preferences for farm estates would promote tax sheltering that would make the nation's fiscal problems worse, while likely harming small farmers.

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[16] This provision was originally introduced as separate legislation (H.R. 3050) by Rep. Earl Blumenauer (D-OR).

[17] Ron Durst, "Federal Tax Policies and Farm Households", USDA Economic Research Service, May 2009, pg. 17, http://www.ers.usda.gov/Publications/EIB54/EIB54.pdf.