Farm Finance

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Farm Families To Benefit from New Tax Law

Most farmers will pay less Federal income tax, and farm families will find it easier to transfer the family farm across generations, under the Taxpayer Relief Act of 1997. The new law—the tax portion of recent legislation to balance the Federal budget by 2002—emerges from years of debate on proposals for tax simplification, broad tax reduction, and targeted capital gains and estate tax relief. The result should be a net tax reduction for all Americans of $95 billion over 5 years.

A number of general and targeted tax relief provisions will significantly reduce Federal taxes for farmers and other rural residents. Farmers are expected to save over $1.6 billion per year in Federal income taxes and between $150 and $200 million in Federal estate taxes.

New tax credits for households with children, incentives for education and retirement savings, and lower capital gains taxes will help reduce income taxes for many families—farm and nonfarm alike. Farmers will also benefit from several provisions for dealing with income fluctuations across several tax years. Capital gains provisions are expected to expand agricultural investment and increase farmland prices. Federal estate tax provisions will be especially important for farmers and other small business owners who hold significant amounts of their wealth in business assets. By substantially increasing the value of farms or other businesses that can be transferred tax free, the new tax law reduces the likelihood that a farm or its assets will need to be sold to pay estate taxes.

Provisions for Income Tax Relief

A variety of targeted income tax relief provisions included in the Taxpayer Relief Act will affect many farmers and their households. General provisions providing tax relief for households with children, education, and health insurance for the self-employed will have the most widespread effect. One-third of all farm families will qualify for a new *tax credit for households with children* that allows taxpayers to directly reduce their income tax by $500 ($400 in 1998) for each qualifying, dependent child under the age of 17. While the credit is generally nonrefundable, taxpayers with three or more children may receive a refund. On joint returns, the credit is reduced if income exceeds $110,000. In the aggregate, qualifying farm families will receive an estimated $600 million per year in benefits, about $800 per family on average.

Two new nonrefundable tax credits provide *incentives for higher education*—a Hope Scholarship Credit of up to $1,500 during each student's first 2 years of college, and a 20-percent Lifetime Learning Credit up to $2,000 annually (by 2003) for each taxpayer. Up to $2,500 of student loan interest ($1,000 in 1998) becomes deductible, and new Education IRA's will allow $500 in contributions per child. Although the contributions are nondeductible, tax-free distributions from those IRA's will be allowed for qualified education expenses.

All of these education incentives are reduced or eliminated for high-income taxpayers. But farm families with incomes under the limits, especially those with children at or near college age, will benefit along with other qualifying taxpayers.

Of particular benefit to farmers are the changes in the *health insurance deduction for the self-employed*, intended to bring small business owners into line with employees receiving employer-deductible health insurance. Nearly 40 percent of those whose primary occupation is farming, and 20 percent of *all* farmers, use the self-employed health insurance deduction.

In 1997, self-employed taxpayers may deduct 40 percent of family health insurance costs. The new law gradually increases the deduction to 100 percent by 2007, up from the 80 percent scheduled under prior law. About 400,000 farmers will be able to deduct more of the $1.2 billion they currently pay for health insurance. As a result, farmers' net annual cost of buying health insurance will eventually be reduced an additional 10 percent.

The Taxpayer Relief Act provides some new opportunities for retirement savers that may be of value to farm households, particularly those who already take advantage of *IRA provisions*. The act creates "Roth IRA's," which allow tax-free distributions after 5 years if the holder reaches age 59½, dies, or becomes disabled. Contributions to these IRA's are nondeductible and are reduced for couples with more than $150,000 in income and individuals with over $95,000. Nearly all farms will qualify under these income limits.

An estimated 300,000 more farm households will become eligible to make deductible IRA contributions, as the income limits that restrict deductible contributions by taxpayers also participating in employer-sponsored pensions will double by 2007. Income limits for spouses of active participants are even higher. The $2,000 annual contribution limit remains, but penalty-free distributions are allowed for higher education and first-time home buyers. Despite broad eligibility, however, only about 9 percent of farmers contribute annually, so these new provisions may not significantly increase retirement savings for many farm households.

In any year, 35 percent of all farm sole proprietors report *capital gains*, about three times the frequency for all taxpayers. Capital gains, including the profits from selling farm assets such as livestock and land, accounted for 13 percent of farmers' total taxable income in 1993. Provisions in the Taxpayer Relief Act reduce capital gains taxes.

For capital assets owned at least 18 months, the former 28-percent maximum rate is reduced to 20 percent and the 15-percent rate to 10 percent. For assets acquired beginning in 2001 and held at least 5 years, the maximum tax rate will be reduced to 18 percent. For individuals taxed in the 15-percent bracket, the maximum falls to 8 percent in 2001, regardless of the purchase date. When fully implemented, reduced capital gains tax rates are expected to save farmers an estimated $725 million each year.

The act also allows a taxpayer to exclude up to $250,000 ($500,000 if filing a joint return) of gain on the sale of a principal residence, replacing the provision that allowed the rollover of capital gain into the purchase of a new residence and the $125,000 exclusion for taxpayers over 55. Farm residences represent 12 percent of total farm value and will qualify for the principal residence exclusion.

Economic incentives to buy and manage assets that generate capital gains have important implications for asset prices and farm output. With lower capital gains tax rates, both farm and nonfarm investors will likely increase agricultural investment, especially in livestock and land. A temporary increase in the availability of land for sale may occur as owners who had been waiting for reduced capital gains tax rates release their land for sale. In the long term, farmland values are expected to increase from such additional investment, and some farm product prices may fall if greater investment increases production.

Provisions in the new tax law that reduce tax burdens when income fluctuates from year to year will benefit some farmers. The 1997 act restores farmers' ability to use *deferred payment contracts* without being subject to alternative minimum tax (AMT), a tax designed to prevent high-income taxpayers from avoiding taxes by using exclusions, deductions, and credits. Farmers are allowed to reduce current income taxes by selling assets in one year and waiting until another year to receive income. But the Tax Reform Act of 1986 did not permit farmers to defer such income when computing AMT. As a result, up to 5 percent of all farms, many of them large cash grain farms, faced higher taxes. The 1997 change relieves about 200,000 farms from tax preparation complexities involved in determining whether they were subject to the AMT, and reduces taxes by $150 million annually.

Selling livestock because of weather disasters can also create problems by inflating farm income in the current tax year. The Taxpayer Relief Act expands existing special treatment of livestock sales due to drought to include floods and other weather-related conditions. Farmers who prematurely sell livestock because of weather conditions may defer declaring such income for taxes until the following year. The farmer must show that under normal business practices the sale would not have occurred until the following tax year and that weather conditions caused the area to be eligible for Federal assistance. Gain from selling more breeding or dairy livestock than would have been sold can also be deferred by purchasing similar livestock within 2 years. Because the change is retroactive to the beginning of 1997, it will be available to farmers affected by flooding early in the year.

Income averaging for all taxpayers ended after the Tax Reform Act of 1986, but the 1997 act allows farmers to average income during tax years 1998-2000. A farmer may elect to shift an amount of farm income, including gain on the sale of farm assets except land, to the preceding 3 years, one-third to each year, and pay tax at the rate applicable in each year. If the marginal tax rate was lower during one or more of the preceding years, a farmer may pay less tax. Because the current tax rate structure is flatter and the provision applies only to income from farming, fewer farmers will benefit from this provision than from the averaging provision available prior to 1986. Farmers, mostly those who rely on farming as their primary source of income, are expected to save about $50 million per year.

Estate Tax Changes May Ease Farm Inheritance

Over the years, increasing farm size and appreciating land values have increased farm estate values and taxes. In the 1970's, Congress enacted two special provisions out of concern that Federal estate taxes might force some family farms to liquidate: *special use valuation*, which allows farmland to be valued at its farm value rather than its fair market value, and *installment payment of estate taxes*, which permits tax payments over a 14-year period rather than in full within 9 months of a death.

Despite the availability of special use valuation, a relatively large share of farmers continues to owe estate tax—an estimated 6 percent of farm estates owe Federal estate taxes compared with just over 1 percent of all estates. Changes to Federal estate and gift tax laws in the 1997 act were targeted primarily to farms and small businesses.

Whether an estate is required to file a return and pay Federal estate taxes is determined largely by the *unified credit provision*, which sets the basic level of estate value exempt from taxation. Prior to the 1997 act, the credit was sufficient to offset the tax on the first $600,000 of an individual's estate. Since the credit has not been changed since 1987, its real value has declined by about one-third. The 1997 act gradually increases the credit to shield $1 million from estate taxes by 2006, although most of the increase occurs in the last 3 years. Increasing the unified credit will reduce both the number of farm estates required to file an estate tax return and the number that owe Federal estate tax.

Beginning in 1998, the Taxpayer Relief Act creates an *additional exclusion for farms and other family-held businesses* that will exempt from estate taxes $675,000 of value in a qualified family-owned business. Although the exclusion is in addition to any benefits from special use valuation and the unified credit, the total amount excluded by this provision and the unified credit is limited to $1.3 million.

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The new exclusion will reduce the number of taxable farm estates by about 40 percent and reduce Federal estate taxes due on farm estates by about one-third—between $150 and $200 million. Combined with other 1997 changes to Federal estate tax provisions, the new exclusion should reduce, if not eliminate, the need to sell farm assets to pay Federal estate taxes.

The act also directly addresses the liquidity problem often faced by farms and other small businesses that hold significant amounts of their wealth in the form of business assets, by making *changes to the installment payment provision*. The installment payment provision of the tax code allows a qualifying farm or business to pay estate taxes over a period of 14 years, with only interest due for the first 4 years. The 1997 act reduces the interest rate due on the first $1 million in qualifying assets from 4 to 2 percent, and no longer includes the value of assets shielded from tax in determining the first $1 million. The act also reduces the interest due on amounts above $1 million to only 45 percent of the rate assessed for underpayments of tax. Interest is no longer deductible for either estate or income tax purposes.

Beginning in 1999, the $1 million value will be indexed for inflation. These changes, combined with the increase in the value of property that can be transferred tax-free, should greatly reduce the liquidity problem that some farm heirs might otherwise experience as a result of Federal estate taxes.

Also changed is the *special use valuation provision*. Beginning in 1999, the $750,000 cap on reduction in value for tax purposes allowed by this provision will be indexed for inflation. The cap has not been changed since 1981. Only about 10 percent of farms electing special use valuation are affected by the cap, primarily larger farms near urban areas where development pressure is greatest. Adjusting the cap for inflation will ensure that most farms continue to be unaffected by the cap.

The 1997 act also refines the requirement that farmland benefiting from the special use provision be used in farming by the heir for a period of 10 years. Under previous law, the cash rental of specially valued property other than from a surviving spouse to a family member did not qualify as continued farming by the heir since the heir no longer bore the financial risk of farming the property. Under the amended law, a lineal descendant of the decedent will be allowed to rent specially valued property for cash to a family member as long as that family member continues to operate the farm. This will provide greater flexibility for heirs under the special use value provision yet remain consistent with the objective of restricting benefits to families that continue to farm.

Finally, the act expands the estate tax benefits available to landowners who donate a *conservation easement*. A Federal estate and gift tax deduction was already allowed for the donation of a permanent restriction or easement on the use of real property to a charity or other qualifying organization exclusively for conservation purposes.

A conservation purpose includes preservation of land for the general public's outdoor recreation or education, preservation of a natural habitat, and preservation of open space for the scenic enjoyment of the general public or in support of a governmental conservation policy. The Taxpayer Relief Act allows an additional exclusion from estate and gift taxes of up to 40 percent of the value of the land on which the easement is donated if it is located within 25 miles of a metropolitan area or a national park or wilderness area, or within 10 miles of an Urban National Forest.

To qualify for the new exclusion, land must have been owned by the decedent or a member of the decedent's family for at least 3 years prior to the date of death, and the contribution must have been made by the decedent or the decedent's family. The exclusion is based on the value of the property after the conservation easement is placed and does not include any retained development rights to use the land for any commercial purpose other than farming. The maximum exclusion is limited to $100,000 in 1998 and increases to $500,000 in 2002 and thereafter.

This new exclusion will provide additional incentives for landowners to donate a conservation easement within designated areas. However, given the increase in the value of property that can be transferred tax-free to heirs under the 1997 act, the number of landowners who could benefit from the additional exclusion may be relatively small. In addition, geographic targeting that limits this benefit will also limit the pool of potential donors.

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