CENTER FOR AGRICULTURAL PROFITABILITY
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2021 Federal Estate and Transfer Tax Law Proposals

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This year has brought many proposals to Congress that would dramatically change the tax implications for many farm businesses. While I typically do not spend time researching and discussing proposals (because they rarely become law in the form they are proposed), these proposals are worth discussing and understanding the implication.

For the last 20 years, the battle over estate taxes has centered around the elimination of the estate tax (and the accompanying step up in basis) and the amount of the federal exclusion amount. There have also been small moves in the percentage of tax but that's a small consideration when compared to the other issues. This year, the focus has moved away from making changes to the federal estate taxes and has centered mostly on adding a "transfer tax" and increasing the rate of the capital gains tax.

It's important to remember that this new transfer tax does not replace the estate tax but adds to it. So, a family could end up paying both a transfer tax and then an estate tax and, with the exclusion set to return to a level somewhere around $6 or $7 million, many farms would be subject to both.

Here is what we know that's proposed:

- Capital gains tax would be increased from 20% to 39.6% for all income over $1,000,000.
- Net Investment Income Tax would be broadened to cover more income if your total income was greater than $400,000.
- Unrealized gains would be taxed when assets transfer at death or by gift as if they were sold.
    - Exemptions for transfers/gifts to spouses and charities
    - No step up in basis for spouse
    - Charitable donations would be limited to basis instead of FMV
- Each person can exclude up to $1 Million in gain.
    - Spouses' exemption can be portable
- Each person can also exclude up to $250,000 of gain on their personal residence.
- You "keep" the step up in basis, except you're paying tax to get that new basis instead of free "gift."
- The transfer tax would be a deduction on the estate tax return.
- Certain "family owned and operated businesses" would not have to make payment of the transfer tax until the business is sold or fails to be family owned and operated.

  - They will authorize a lien to be placed on property
- The minority interest discount would be eliminated.

Here's what we don't know:

- There would be no transfer tax on tangible personal property such as household items. We don't know if this would include depreciable personal property like farm equipment, buildings, etc.
- We don't know if inventory items, such as carryover grain, would be subject to the transfer tax.
- Who is family? There are many definitions that could include cousins, nieces, nephews, etc., or it could only be lineal (grandparent, parent, child).
- What does family operated mean? Do all members of the family have to materially participate?

Knowing there are many things we don't know about this proposal at this time, it's still important to look at what may be. Here are a couple examples.

Example 1: Taxable Estate of $6,894,731

As of today, an estate of less than $11.7 million can transfer to heirs tax free and it would receive a full step up in basis (assuming all assets are qualified). In other words, the heirs of this estate could sell it the day after death and pay no estate or income taxes on the recognition of the almost $6.9 million.

If the transfer tax was passed into law, a tax of $831,308, or 12% of the estate would be due, assuming the balance sheet looked something like:

	FAIR MARKET VALUE	BASIS	DEFERRED GAIN
GRAIN/PREPAIDS	$1,725,450	$0	$1,725,450
EQUIPMENT	$1,705,000	$438,000	$1,267,000
LAND	$2,670,000	$2,030,000	$640,000
BUILDINGS	$105,000	$24,200	$80,800
TOTAL	$6,205,450	$2,492,200	$3,713,250

In calculating the tax, I assumed that the carryover grain and equipment would be subject to this tax and that the tax would be calculated using capital gains rates. If they are subject to ordinary income taxes (and possibly self-employment taxes) the total tax due would be significantly higher. I also assumed that retirement accounts, which are currently not eligible for a step up in basis, would be exempt from this tax which accounts for the different between the taxable estate and total FMV.

After 2025, the estate tax exclusion is set to reduce by one-half. If this owner would pass away after that time, the heirs would also owe $85,369 in estate taxes.

Example 2: Taxable Estate of $13,489,139

An estate more than $11.7 million would also be subject to an estate tax. The transfer tax would be a deduction in calculating the estate tax, but the heirs would be liable for both. This sample balance sheet would be more like a retired farmer who no longer had carryover grain but would have accumulated a significant amount of land. The transfer tax on this estate would be $3,350,804. Together with an estate tax, over 25% of the farm's net worth would be paid in taxes.

	FAIR MARKET VALUE	BASIS	DEFERRED GAIN
EQUIPMENT	$229,500	$47,565	$181,935
LAND	$11,713,500	$2,032,200	$9,681,300
BUILDINGS	$266,000	$136,850	$129,150
STOCKS/MUTUAL FUNDS	$113,431	$77,645	$35,786
TOTAL	$12,322,431	$2,294,260	$10,028,171

After 2025, with the reduction in the estate tax exclusion, this owner's estate would owe $1,715,334 in estate taxes. Together with the transfer tax, the net worth of this estate would be reduced by almost 40% by the two taxes.

One other concern of this tax is that it is based on deferred gain and not net worth. An estate tax would never make a farm insolvent (owe more in liabilities than they have in assets) because it is a percentage of net worth. This transfer tax could realistically make many farms insolvent because the tax basis of assets, especially equipment, could be zero even though they owe considerable debt on the asset. This could also occur on land that had been refinanced making the debt owed more than the basis of the land.

As debate in Washington continues, it's important to understand that a removal of the step up in basis have a similar impact on many farm operations. It's unlikely that a proposal of this nature will make it all the way through Congress, but there will likely be a hard push to change how gifting assets will be taxed and how assets pass through an estate, so it's important to stay tuned.

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