What do the new rules on estate taxes mean for farmers?

WASHINGTON, D.C. — The new year ushered in something really new: the rules on Federal estate and gift taxes. The provisions, which are part of the Economic Recovery Tax Act of 1981, contain many changes of interest to farmers, according to USDA's Economic Research Service.

One sweeping change is in the marital deduction. Before the new law, there was a ceiling on gifts and bequests you could make to your spouse without incurring tax.

The marital deduction for bequests was limited to $250,000 or half the adjusted gross estate, whichever was greater. The marital deduction for gifts was limited to $100,000 plus 50 percent of the value in excess of $200,000.

The new law allows unlimited marital transfers without tax. That is, you can give or will your spouse any amount without paying gift or estate taxes.

In addition, the rules on property held jointly by a husband and wife are now different. In the past, the total value of such property was included in the estate of the first spouse to die, unless the surviving spouse could prove that he or she had paid for part of the property or had materially participated in the operation of the farm.

Now, however, half of joint property is assumed to belong to the surviving spouse, regardless of the amount each contributed to the purchase of the property. So, when one spouse dies, only half of the property is included in that spouse's gross estate and is thus potentially subject to estate tax.

Unified Credit Will Allow $600,000 In Tax-Free Gifts and Bequests

Besides allowing unlimited property transfers to your spouse, the new tax act substantially increases the "unified credit" (so called because it can be applied against both the gift tax and the estate tax). The unified credit establishes the amount you can will and/or give to recipients other than your spouse, free of estate and gift taxes.

Formerly, the unified credit was $47,000. This meant that you could give or will about $175,000 worth of property tax-exempt, because the credit canceled out the gift/estate tax due on that amount. The new law increases the unified credit — and so the tax-free amount — each year through 1987. For 1982, the tax-free total is $225,000. By 1987, it will be $600,000.

Annual Gift Tax Exclusion Raised

Prior to 1982, you could give away a maximum of $3,000 per recipient per year without incurring gift tax and without using up any of your tax-free total under the unified credit. Now, the maximum has been raised to $10,000 per recipient per year. (The exclusion does not apply, though, to gifts of future interests in property.)

So, for example, you and your spouse together could now give each of your children $20,000 in farm property annually, free of gift taxes. And, as in the past, these gifts do not count against the amount that you can transfer tax-free because of the unified credit.

Installment Payment Rules Liberalized

Past tax laws allowed estates consisting mainly of farms or other closely held businesses to pay estate taxes in installments. The new law broadens the conditions for installment treatment and extends the most favorable terms to more farm heirs.

In the past, a farm might qualify for installment treatment of estate taxes if it met either of two sets of conditions, the first more favorable than the second.

(1) If the farm constituted more than 65 percent of the decedent's adjusted gross estate (the gross estate minus certain expenses, debts, taxes, and losses), the estate was allowed to pay only interest for 5 years. Then, the tax due could be paid in 10 equal annual installments — thus spreading payment over a total of 15 years. Interest charged was 4 percent of taxes due on the first $1 million of the farm's value and a higher rate (periodically set by the Secretary of the Treasury) on the rest. But if a third or more of the farm was disposed of before the 15 years were up, all remaining taxes and interest came due immediately—even if the farm was "disposed of" by the original heir's dying and passing it on to another family member.

(2) If the farm constituted more than 35 percent of the decedent's gross estate (or more than 50 percent of the decedent's taxable estate), the estate tax on it could be paid in 2 to 10 equal yearly installments. But there was no 5-year deferment period before installments had to begin, and the higher rate of interest was charged on the entire amount of tax owed. If half or more of the farm was disposed of, even because of death of an heir, all taxes and interest came due immediately.

For the estate of a person dying in 1982 or after, the new tax act abolishes the second category, the 10-year treatment. Any farm that constitutes more than 35 percent of an adjusted gross estate is now eligible for the 15-year, two-level interest treatment. To lose the installment privilege, at least half (rather than a third) of the farm must be disposed of during the period. And, if an heir dies during the 15-year period and the farm passes to yet another family member, the original decedent's estate still keeps its installment-payment right.

Special Use Valuation Rules Changed

In 1976, Congress enacted to a low to value a farm, for estate tax purposes, according to its use rather than its fair market value. The change was made because many farmers feared that their land's appreciation would result in estate taxes out of line with the land's income-producing potential. The special use valuation law has been refined further under the Economic Recovery Tax Act.

The changes are too numerous to cover entirely here, but here are details on three of the most important...

Share Rents Now Qualify For Use In The Cash Rent Formula

The Internal Revenue Code specifies that one of two formulas has to be used to determine a farm's special use value. The first formula (given opposite) is more favorable to the estate than the second, which tends to produce a higher special use value and so a higher tax. But in the past, to use the first formula, you had to be able to factor in cash rentals for comparable farmland in the locality of the decedent's farm. Farms in areas where share rentals were the rule had to be valued according to the second, less favorable formula.

But the new law changes that situation. For the estate of a person who dies after 1981, you can now use "net share rental" to value the farm, if there is no comparable land from which the gross cash rental can be determined. The next share rental is the value of the produce received by the farm owner, minus the cash operating expenses incurred for growing the produce and paid by the owner — again, on comparable farmland in your locality. And, you factor the figure into this formula. Value of decedent's farmland, per acre = R - T/r.

"R" is the average annual cash rental per acre, or the average annual net share rental per acre for comparable farmland in the locality of the decedent's farm;

"T" is the average annual state and local real estate taxes, per acre, for comparable land; and

"r" is the average annual effective interest rate for new Federal Land Bank loans in that locality.

For all three variables, you take the annual average of the 5 most recent calendar years ended before the the date on which the decedent died.

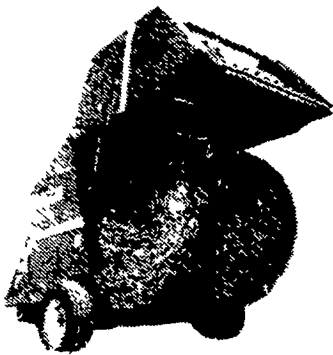
Maximum Reduction from Fair Market Value Is Now $700,000

From 1976 through 1980, $500,000 was the maximum amount by which you could reduce a farm's fair market value through special use valuation. The new tax act raises that amount in yearly increments. For the estate of a person who died in 1981, the maximum is $600,000. For the estate of a person dying in 1982, the limit will be $700,000; in 1983 and after, $750,000.

Recapture Period Shortened

For the estate of a person who died before 1982, there was a 15-year recapture period for taxes saved becasue of special use valuation. That is, during the 15 years after a decedent's death, if an heir failed to meet the special use requirements, the IRS could recapture some or all of the tax savings obtained through special use valuation. This rule still applies to estates of those who died in 1981 or before.

But, for estates of persons dying after 1981, the Economic Recovery Tax Act shortens the recapture period to 10 years. It also allows an heir 2 years' grace, from the death of the decedent, to begin using the farm for farming. And it makes the 2-year grace period retroactive to estates of farm owners who died after 1976.



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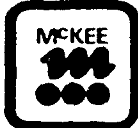

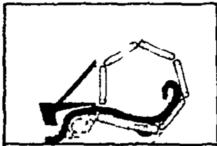

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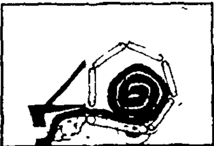

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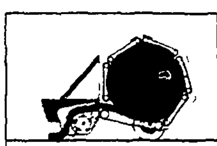

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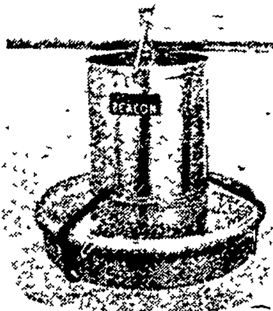

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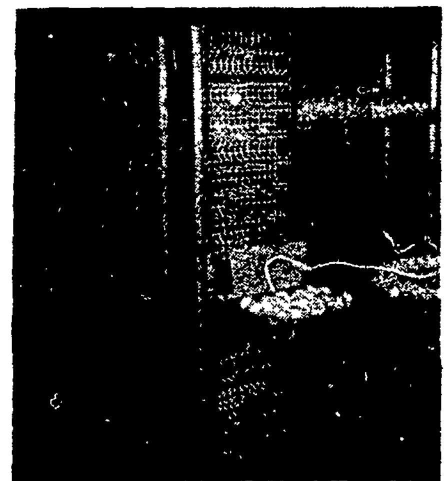

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