ECONOMIC & POLICY UPDATE
VOLUME 21, ISSUE 5
Editors: Will Snell & Nicole Atherton

Proposed Gift and Estate Tax Changes

Author(s): Laura Powers

Published: May 28th, 2021

You may have been reading in the news lately about proposed changes to various tax laws and their impact on farmers. At this time, we must emphasize the use of the word “potential.” Discussions between lawmakers and the President are ongoing. At this point, however, we would like to provide some background information as to what you may be hearing.

Elimination of Step-up in Basis

One of the potential changes is eliminating the step-up in basis on farming assets, such as equipment, buildings, and land, when those assets transfer ownership through inheritance. Eliminating step-up in basis would have a potentially drastic, and negative, impact on the capital gains tax due at the sale of those assets by the heir. Under current law, for example, when a farmer dies, the heir gets a new “stepped up” basis on assets they inherit, based on current market value of those assets. If the heir later sells the asset, any capital gains tax due by the heir is calculated on the difference between the sales price and their basis determined at acquisition.

As an example, under current law, if the decedent had an original basis of $3000 per acre on land and the market value was $10,000 per acre at death, the heir’s basis would be $10,000 per acre. If the heir sold the land for $12,000 an acre, the capital gain tax would be based on a $2000 per acre gain. Eliminating the step-up in basis would result in the heir owing capital gains tax on a $9000 per acre gain ($12,000-3,000).

An additional proposal is that there would be an immediate tax liability due at the time the heir acquires the land as a transfer of the increased basis. In other words, the heir would have to pay capital gains tax on the increased value of the asset over the decedent’s time of ownership. Thus, using the previous example, the heir would have an immediate capital gains tax liability based on a $7000 per acre gain ($10,000-3,000). The current proposal includes an exemption for family-owned and operated farms and small businesses. They are looking for an acceptable definition of family. Would “family” only be a son or daughter (the current proposal) of the decedent, or would this also include nieces, nephews or other relations? Testimony provided by the National Farm Income Tax Extension Committee is that farms are often made up of family members from multiple generations and broader relationships. Some own the land while others are involved in the operation of the farm. It is also unclear whether any transfer taxes saved by the election could be recaptured if the land is sold some time after the decedent's death, as is the case with the current Special Use Valuation.

Another question is how this applies to non-land farm assets. Raised cattle and crops and depreciated equipment and breeding stock currently receive step-up in basis. Under the American Families Act proposal, they will have no basis for the decedent's heir.

Self-Rental

Another talking point regarding tax changes is eliminating the exclusion of Net Investment Income Tax (NIIT) on self-rentals. When the NIIT passed as a part of the Affordable Care Act, it only applied to Investment Income. Many farming operations have either land or equipment in an entity separate from the operating entity. At present, when the operating entity pays the asset-owning entity the rental of those assets, there is no NIIT due on that income, regardless of total income. The Biden Administration plans to eliminate that exclusion. Currently, the NIIT applies for income higher than $200,000 (single) or $250,000 (Married Filing Jointly). Therefore, farms that have self-rental among entities will face an increased tax of 3.8% on that income.

Example

The NIIT also applies to capital gains tax at higher income levels as well. The table below displays a very simplified example of these proposed tax increases, using the earlier example.

	Basis (per ac)	Sell Price (per ac)	Gain (per ac)	Maximum Tax Rate	Tax Paid (per ac)	Tax for 100 Acre Farm
Current Law	$10,000	$12,000	$2,000	23.8%	$476	$47,600
Proposed Law	$3,000	$12,000	$9,000	43.4%	$3,906	$390,600

The Capital Gains Tax computation above is much more complicated than the table implies. The maximum rate of capital gains tax is not computed on all dollars of gain, just on the gain amount over certain thresholds of income. Length of ownership of the asset is also a factor in calculating capital gains tax. The example above is only a demonstration of the proposed tax changes. We are assuming that the overall computation of capital gains tax would remain the same and that the only changes are to the tax rates and determination of basis. For individual tax planning and estimates, seek advice from your tax advisor.

Farming is an asset-intensive, yet low-margin business. One of the barriers to entry into farming is the high cost of the assets needed to operate the business. One of the struggles that many farmers face is the availability of cash. Many farmers spend their entire careers paying off the land debt from a 30-year note. It sounds like the next generation will have to do the same. Except they will not be funding an asset, they will have to pay off a tax bill. There have been many government programs lately with the goal of helping young and socially disadvantaged farmers enter farming. Changing the stepped-up basis rules would create significant challenges in attaining these goals. It has also been pointed out that the loss of stepped-up basis, whether applied at death or sale, will increase the cost of land outside the range of farmers who operate at low returns compared to those assets. Thus land may leave agricultural production altogether or become concentrated in the hands of land trusts.

Recommended Citation Format:

Powers, L. "Proposed Gift and Estate Tax Changes" *Economic and Policy Update* (21):5, Department of Agricultural Economics, University of Kentucky, May 28th, 2021.

Author(s) Contact Information:

Laura Powers | KFBM Area Extension Specialist | laura.powers@uky.edu