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The Unintended Consequences of Repealing the Federal Estate Tax and Other Legislative Moves

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[1] Federal Estate Tax

[a] Estates subject to tax

The number of estates subject to the federal estate tax has been quite modest in recent years. Of the roughly 2.5 million deaths in 2014, 5,158 incurred estate tax liability (approximately 0.21 percent of all deaths). In 2014, $16,390,024,000 was paid in federal estate tax which averaged about $3,117,590 per estate. Note: these data are *by date of reporting*.

The top 190 estates (those with taxable estates of $50,000,000 or more) paid an average of $24,935,017 each in federal estate tax in 2014. The 1,132 with taxable estates from $10,000,000 to $20,000,000 taxable estate paid an average of $2,531,305 each. The 2,401 with estates of $5,000,000 to $10,000,000 in taxable estates paid an average of $832,287 each in federal estate tax. *That is a measure of tax benefit had the federal estate tax been repealed for those filing for 2014*. It is obvious what is really driving federal estate tax repeal.

Of the total number of taxable estates (5,158), 1,674 decedents with taxable estates reported some farm property in 2014. The number of estates in each tax bracket and the average amount of farm property are shown in Table 1.

As shown in that table, the 192 estates with taxable estates of $20,000,000 or more reporting some farm property reported an average of $8,173,313 in farm assets for federal estate tax purposes. The benefit of repeal to that group would likely result in a portion of that amount going into farm assets. *Over time, this would be expected to lead to a gradual increase in farm asset ownership by the very wealthy*. The proportion of land rented would be expected to rise as farmers would have an increasingly difficult time in competing for land ownership.

Table 1. Average Value of Farm Property (Other Than Farm Real Estate) By Estate Tax

Tax Bracket	Number	Value of Farm Property	Average Value of Farm Property
Under 5,000,000	168	186,872,000	1,112,333
5,000,000-10,000,000	1,021	3,165,801,000	3,100,687
10,000,000-20,000,000	288	1,054,381,000	3,661,045
20,000,000 or more	192	8,173,313,000	4,256,933
	1,669	7,537,667,000	

IRS does not separately report farm real estate. Farm real estate is reported under the category of "Other Real Estate." A report released by the Congressional Research Service on June 9, 2003 included an estimate of the amount of farm real estate include in the "Other Real Estate" category. Approximately $1.6 billion of the assets reported in the "Other Real Estate" category was believed to be farmland at the time of that study, 2001. The conclusion by CRS was that farm real estate included in taxable estates in 2001 was estimated to total $1,582,774,000 which was approximately 1.28 percent of all taxable estate value.

The CRS conclusion was that "…farm assets and business assets represent a relatively small share of total taxable estate value. And, most of the farm and business assets in the estate tax base are concentrated in estates valued at or above $10 million."

[b] Is the federal estate tax a barrier to continuation of a farm or ranch business?

It is widely stated that the federal estate tax is an obstacle for farming and ranching operations. I disagree. As I have been quoted fairly widely, in 50 some years of working in this area of taxation, *I have never seen a farm or ranch operation that had to be sold to pay federal estate tax*. The latest quote to that effect was several weeks ago in the *London Financial Times.* An earlier quote on the front page of the *New York Times* carried the same identical message.

At present, 2017, a decedent is allowed to pass $5,490,000 in property value without triggering federal estate tax and the spouse is allowed the same amount for a total of $10,980,000. That figure is inflation adjusted. Even if the spouse without that much property dies first, the surviving spouse under the concept of "portability" can utilize the remaining allowance of the deceased spouse. Moreover, since 1976 eligible property meeting the requirements for "special use valuation" is in line for an additional amount (currently $1,120,000) which is also inflation adjusted. That provision requires that the farm remain in the family for 10-years at least and be under a share rent lease or be an operating farm or ranch.

However, many publications, including farm publications, report that farmers and ranchers support repeal. In reality, farmers and ranchers are being "used" to support repeal for the upper echelons of estates because of the higher standing, publicly, of farmers and ranchers compared with multi-billionaires. This aspect of the matter has been discussed widely in several publications.

[c] The era of income tax basis

Over the past several decades, estate planning has been dominated by the era of *federal estate tax.* However, the dramatic increase in farmland values has caused attention to be focused on *income tax basis*. That is the difference between what was paid for the land plus improvements and its current fair market value.

The federal estate tax exemption of $60,000 before 1977 for an estate with a tax rate ranging from three percent for taxable estates of $5,000 or less to a tax rate of 77 percent for estates over $10,000,000, has given way to an applicable exclusion amount of $5,490,000 for deaths in 2017 and a maximum tax rate of 40 percent. That has meant a sharp drop in the percentage of farm and ranch decedents (and of all decedents) filing a federal estate tax return and paying federal estate tax. The latest complete national data, as noted earlier, from 2014, show 5,158 estates out of approximately 2.5 million deaths actually paid federal estate tax and out of that number, 5,158, a total of 1674 decedents with taxable estates reported some farm property in 2014.

At the same time, average per acre Iowa farmland values have risen dramatically, from $88 per acre in 1941 (and $1214 in 1990) to $8,716 per acre in 2013. *Iowa Farmland Survey, Iowa State University Extension, December 2013*. However, farmland in Iowa dropped in price in 2015 to $7,633 per acre.

Many portfolios of decedents have also experienced increases in the values of other investments over the same time periods. That has meant that, for many decedents, with the income tax basis remaining relatively stable (increased by improvements made and decreased by depreciation claimed), the amount of potential gain has increased enormously in recent decades. That has meant that income tax *basis*, which determines the gain (or loss) on sale or other taxable disposition along with the selling price, has taken on much more importance and promises to figure prominently in financial planning going forward.

[d] Probable loss of new basis at death

This other dimension to the federal estate tax issue is highly significant. The unsuccessful efforts to repeal the federal estate tax in recent years (1976 and 2003) have, rather quietly, admitted that part of the strategy is to pay for the repeal, in part at least, *from reducing or eliminating the new income tax basis at death* which has been available for decades.

For many years, most assets held at death have received *a new income tax basis, generally equal to the fair market value at death*. To the extent that occurs, the gain in the eligible assets automatically takes on an income tax basis *equal to the fair market value at death*. This feature of tax policy means that virtually all farm and ranch estates end up with no gain on their assets after death of the property owner. This is enormously important *and benefits virtually every decedent and the heirs*. Thus, the irony is that, while nearly all deceased farmers and ranchers do not pay federal estate tax, they would all lose to the extent the “new basis at death” is lost. That feature of tax policy seems to lack understanding.

[e] Sell it? Gift it? Or die owning it?

The obvious decisions are to sell it, gift it, or die owning it. The relatively low income tax basis for much of the farmland (and other assets) owned by decedents, has resulted in eye-popping comparisons on how to dispose of the property. The timing and manner of how the property is disposed of affects the income tax consequences of the disposition.

Example 1. Sell the land in retirement.

Let's assume 320 acres of unimproved land was bought for $100 per acre in 1940. Today's income tax basis would be $32,000 (320 acres times $100 per acre). On a sale for $7,000 per acre, with no new basis, the income tax would be figured on the gain which would be figured at $6,900 per acre. The difference between the original cost (the basis) which would be $100 per acre and $7,000 (the selling price) would be gain on sale after the death of the owner. That difference would be 320 x $6,900 or $2,208,000. That would be the result *of no new basis at death*. Under present law, with a new basis at death based on fair market value, there would be no gain on sale and the new basis at death would be $7,000 per acre or a total of $2,240,000.

Example 2. Gift the half-section.

Gifting the half-section would result in a "carryover basis" of the original basis to the recipient of the gift of the 320 acres or $32,000 (320 acres at $100 per acre) to the recipient (or recipients) of the gift. This tends to discourage gifting if the original income tax basis is low and the gain is slated to be wiped out entirely at death.

Example 3. Die owning the half-section.

If the couple (if it is a couple) holds the half-section until death, assuming for the moment both die simultaneously, and assuming that the new basis at death continues to be in effect, the potential gain of $6,900 per acre would be eliminated and the estate of the now-deceased owners would be $7,000 per acre times 320 acres or $2,240,000 for the tract. That figure would be the new basis at the parents' deaths with no income tax due and the children could sell the property at $2,240,000 with no income tax due *because of the new basis at the parents' deaths*.

Another aspect of the *loss* of "new basis at death" is that over time, with assets at death not getting a new basis, the transferability becomes increasingly limited with the heirs unwilling to pick up the income tax if and when the assets are sold. The result, without much doubt, is expected to be that economic growth would be reduced which, on a country-wide basis, could be *adverse to future economic growth*. That alone justifies a new basis at death. The economic pressures assure that assets held until death, if the basis is reasonably close to fair market value, are more likely to be sold and be generating greater value than if the land were to continue its current income-producing feature with the low basis.

Going back to the example, family heirs inherit 320 acres of land purchased in 1940 for $100 per acre or $32,000. If there is no “new basis” at the death of the immediate heirs (and later heirs for, say, 200 years), the 320 acres would have been valued at $7,000 per acre or $2,240,000 on the death of the decedent in 2017. That gain (the difference between the purchase price of $32,000 in 1940 and the date-of-death valuation of $2,240,000) in 2017 would not be eliminated as a “new basis” would do, but would continue for the years to follow *with no new basis*. That would discourage sale of the property, with the discouraging factor being to assure the land would be likely to fall into the hands of heirs that might well avoid sale to the detriment of economic growth.

Thus, any loss of new basis at death would be felt by each succeeding heir for generations to come. Although the issue of “basis” is rarely discussed, it can be highly important if there is no new basis at each death holding the ownership. Over time, and over the country, the impact would be highly negative.

In all three examples, the result would be the same—there would be no new basis at death whether the parents were considering sale, gift or holding until death.

[f] How would repeal of federal estate tax benefit farm and ranch taxpayers?

Although land values have increased in recent years, and are still at a lofty level (an average of $7,183 average per acre in Iowa in 2016, down from the peak of $8,716 per acre in 2013), relatively few estates of farmland owners at death exceed the amounts allowed by federal law to pass at death with no federal estate tax. The Internal Revenue Service publishes annually data on property values at death. While the IRS publication (*Tax Status—Estate Tax Statistics Filing*) the IRS admits in a footnote that “all figures are estimates based on a sample—money amounts are in thousands of dollars." Nonetheless, the IRS annual figures are the only on-going effort to provide a semblance of guidance on property values at death. Moreover, the IRS publication *does not include values for real estate,* only machinery, livestock and other non-real assets, under the heading of "Farm Assets." Especially for farming and ranching, where those growing older often tend to sell labor-intensive livestock ventures and concentrate on land ownership, that feature is not taken into account in the IRS publications.

Even with all of its shortcomings, the IRS publication is the major source of information. Estimates vary but it is generally believed that only two percent or less of farmers and ranchers, on average, at death are in federal estate tax territory. Even if the correct figure is five percent, it would still be a mistake to repeal the federal estate tax viewed from the standpoint of the heirs. If either number is correct, it means that 95 to 98 percent of the farmers and ranchers, to the extent of values at death, end life, if repeal of the federal estate tax occurs and becomes part of the tax law, and *there would be no new basis at death*. The heirs might enjoy some benefit but would lose the new basis at death. This could mean a much greater potential cost at death with less benefit than when federal estate tax was in force. That is, for those two or three percent or less who would benefit from repeal. On the other hand the estimated ninety-five to ninety-eight percent who do not benefit from repeal would suffer a substantial cost from the loss of "new basis at death" with no offset whatsoever.

From these perspectives, one wonders how the great bulk of farmers and ranchers and their farm publications and organizations, could come down on the side of repeal of the federal estate tax.

[g] Higher revenue from federal estate tax

Finally, the federal estate tax, admittedly, produces a modest revenue stream ($17.1 billion of revenue in 2016) but it is significant and a way for wealthy decedents to contribute to the public good.

[2] Retained Life Estate Until Death

In recent years, greater use has been made of retained life estates in farm and ranch estate planning. The procedure can, in some instances, be highly disadvantageous. With a retained life estate, property owners convey the remainder interest (all but a life estate for themselves or others). The importance of the "themselves or others" is highly important.

[a] Life estate passing to heirs of the original owner

If the owner of 640 acres of farmland sets up a transfer of ownership to an heir or heirs, for example, with a remainder interest passing to a later generation heir, it is likely that few problems will arise. Inasmuch as the implementation of such a plan triggers gift tax consequences, nothing should be included in the estate at death for the individual who previously owned the property and gave it up in the form of a life estate to one heir or set of heirs, and the remainder interest to another heir or set of heirs.

[b] A *retained* life estate (or life estates)

But what if the life estate was a *retained* life estate where the owner of the residence (or farm) held the life estate? In that case, the *fair market value* of the property at the time of death is included in the gross estate of the deceased holder of the retained life estate. *I.R.C. § 2036(a)(1)*. See *Treas. Reg. § 20.2036-1(c)(1)(i)*.

This can be a substantial jolt if the property has increased in value after the time when the transaction to give the residence or farm to a charitable organization was finalized.

[c] A dangerous move

Three different situations in three different states used an unusual strategy to avoid probate in succeeding generations. In one of those, the Grandfather bought a tract of land in 1927 for $80,000 and to avoid probate, acquired title in an unusual manner. The title gave each of his successors (his children and grandchildren living at the time of his death) life estates and retained the remaining interest in himself. The limit of setting up life estates was intended to avoid the Rule Against

Perpetuities (which then limited life estates to a chosen group of named individuals plus 21 years).

The tract of land had declined in value to $50,000. In the years after his death, the possession of the tract of land shifted to those who had survived as one after the other died. With the increases in land values, the land was valued at just over $10,000 per acre at the death of the last survivor. The heirs of that last survivor were contemplating sale of the property but purchasers objected because of title problems. With wrangling over who held sufficient ownership to the property to claim ownership and with the holder of the retained interest long dead, it soon became clear that this was not a very good strategy to avoid probate.

[d] Exceptions

This does not occur (inclusion of the fair market value in the gross estate at the death of the holder of the retained life estate) if—the remainder interest is held by a charitable remainder annuity trust, unitrust or pooled income fund (which is unlikely for residences or farmland), or in the case of any other interest, it is in the form of a guaranteed entity or is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly). Neither is likely for a retained interest in a residence where occupancy is the "income" or for farmland where the income is in the form of crop or livestock share payments or even cash rents (which are not necessarily based on the fair market value of the property).

[e] Examples

The statutory treatment of charitable bequests or devises with a retained life estate by the property owner is confirmed by the regulations—

[i] Life estate to donor's spouse

Treas. Reg. § 20.2055-2(e)(2)(ii) deals with the gift of a residence with a life estate to the owner's wife and so there was no donor inclusion in the donor's estate at the death at the date of death value. *Id.* See *I.R.C. § 2036(a)*.

[ii] Life estate to daughter

Treas. Reg. § 20.2055-2(e)(2)(iii) involves a life estate to the daughter of the donor of the farmland in question with the same outcome. Again, there was no inclusion in the donor's estate at the date of death of value because the donor did not hold a retained life estate. *Id.* See *I.R.C. § 2036(a)*.

[iii] Life estate to donor

It is only where *the donor has a retained life estate* that inclusion in the gross estate is required at the donor's death at its date of death value. See *I.R.C. § 2036(a); Treas. Reg. § 20.2036-1(c)(1)(i)*.

[iv] No life estate

If there is no life estate involved, the fair market value at death of the property owner is in line for a charitable deduction if the property passes to a charitable organization at that time. *Treas. Reg. § 20.2055-2(e)(2)*.

[v] Application to farms as well as residences

Remember, this provision applies to farms as well as residences and farmland values have increased sharply in recent years, as much as 10 fold increases over the past 25 to 30 years. See *Duffy, "Iowa Land Value Survey," Iowa State University, December, 2014*.

For a farm or personal residence, the full benefit from the property is assured for the holder of the retained life estate for the duration of the life estate (until death occurs).

[vi] Uncertanty as to what was to be perceived by holders of retained life estate

But what if there is uncertainty as to what was to be received by the holders of the retained life estate? Regulations under I.R.C. § 2036, *Treas. Reg. § 20.2036-1(c)(2)(ii)*, govern the handling of that situation.

In an example in the regulations, the holder of the retained life estate was to receive quarterly payments of six percent of the fair market value of a trust. At the termination of the trust arrangement, the then-remaining corpus and any accrued income was to be distributed to the charitable organization.

However, at the death of the holder of the retained life estate, the calculations showed that the holder of the retained life estate had actually received over the course of the trust *more than the full amount that is statutorily required which meant that the full fair market value was included in the gross estate*.

Had the amount received been *less* than the statutory requirement, there would have been additional value passing to the charitable organization which would support a further charitable deduction.

Note that this *does not apply to vested interests where the statutory requirements are automatically met as is the case where the holder of the retained life estate is holding an interest in a farm or personal residence. Treas. Reg. § 20.2036-1(c)(2)(i).*

Where there is no life estate, retained or otherwise, the fair market value at death of the property owner is in line for a charitable deduction if the property passes to a charitable organization. *I.R.C. § 2055(d), (e).*

[f] So is a retained life estate a good idea?

In a period of rising property values (and the long-term trend is upward for most property values) the requirement that the fair market value must be included in the gross estate where a retained life estate is involved can be disadvantageous.

The transaction usually provides that the donor give up the property to the charitable organization and does not benefit from the increase in property value thereafter.

Yet the required inclusion in the gross estate of the property's fair market value at death means the increased property value is not available to defray the tax.

Careful planning is needed to avoid unexpected tax consequences at death, paying particular attention to retained life estates. See *Harl, "Charitable Gift With Retained Life Estates Can Be Troublesome," 26 Agric. L. Dig. 16 (2015).*

[3] Repeal of the Rule Against Perpetuities

[a] The origin of limits imposed on land ownership

Finally, a word or two about an ancient concept (that is, it is ancient to many of us) that had its origins in the Duke of Norfolk's Case in the late 17th Century in England. The case involved disagreements among the heirs of the Duke of Norfolk over the propriety of leaving property in successive life estates. The court agreed that it was wrong to tie up property beyond the lives of persons living at the time the property was last conveyed, although the exact time beyond which conveyances were nullified was not determined until roughly 150 years later. As a practical matter, the Rule Against Perpetuities (as it is known) places limits on how long property can be held in trust. Stated simply, property generally could not be held in trust beyond the lifetimes of a designated class of individuals plus 21 more years. As a practical matter, the Rule allows property ownership to be tied up for 100 to 125 years.

[b] The change in the Rule Against Perpetuities in 31 states

Until about 40 years ago, each of the states in this country had enacted language embodying the Rule. After South Dakota, under the leadership of their then Governor Janklow, broke ranks and repealed the Rule in that state, 30 more states had acted to repeal or modify the Rule. However, 19 states have held out with those states believing that it is not in the public interest to eliminate the Rule and allow property ownership to be tied up forever…and “forever” is a long time.

[c] Comments by legal philosophers

Professor Lewis Simes, a well-known legal scholar articulated two reasons for the Rule in contemporary society—(1) first, the Rule strikes a fair balance between the desires of the present generation, and similar desires of succeeding generations, to do what they wish with the property which they enjoy; and (2) a second and even more important reason for the Rule is that it is socially desirable that the wealth of the world be controlled by its living members and not by the dead. To those two I have added a third—it is an article of faith that economic growth is maximized if resources at our disposal are subject to the forces and pressures of the market. Prices emanating from free, open and competitive markets are the best way to allocate resources and distribute income. That feature would be minimized if the Rule Against Perpetuity were eliminated as some states have already done.

[d] The practical side of the argument

However, it is a bit sobering to envision a world economy in a couple of hundred years with the ownership of property held by a bunch of trusts physically located half a world away. Those not benefitting from ancestors who left property in trust forever would be *unable to acquire land to farm, houses in which to live or real estate for other ventures except as tenants*.

[e] The battle being fought in the remaining states

Fortunately, many of us live in a state that has, three times since 1999, voted to retain the Rule. In my view, our generation inherited the best economic system and the best legal system in the world. To repeal the Rule would be a step backward. The Administration in Washington in 2011 took steps to place a limit on how long property can be held in trust for the U.S. as a whole but it was not enacted. We would be wise to review carefully whether that limit should be imposed everywhere.

For those who would like to make a deduction to a charitable organization, the rules provided by the Congress and administered by the Internal Revenue Service can be helpful. There are two levels of benefit—one, for which Iowa State University is eligible and other is the Iowa State University Foundation which is also eligible. This allows a 50 percent deduction (figured against the donor's "adjusted gross income") on each year's tax return for the initial year and, if needed, and the requirements are met, for each of five succeeding years. For other charitable organizations, a 30 percent tax deduction is available.

Actually, the agreement permits the five-year extension (which is limited in several ways but basically allows the deduction to continue for up to five years beyond the initial year).

Example: a loyal alumnus wants to make a gift to Iowa State University for $500,000 but wants to spread it over a period of five years. That is possible if the requirements are met.