

August 2015

## Changes in Iowa's Capital Gains Tax

Dermot J. Hayes  
*Iowa State University*, [dhayes@iastate.edu](mailto:dhayes@iastate.edu)

Follow this and additional works at: <http://lib.dr.iastate.edu/iowaagreview>

---

### Recommended Citation

Hayes, Dermot J. (2015) "Changes in Iowa's Capital Gains Tax," *Iowa Ag Review*: Vol. 4 : Iss. 1 , Article 4.  
Available at: <http://lib.dr.iastate.edu/iowaagreview/vol4/iss1/4>

This Article is brought to you for free and open access by the Center for Agricultural and Rural Development at Iowa State University Digital Repository. It has been accepted for inclusion in Iowa Ag Review by an authorized editor of Iowa State University Digital Repository. For more information, please contact [digirep@iastate.edu](mailto:digirep@iastate.edu).

## Changes in Iowa's Capital Gains Tax

—By Dermot J. Hayes

Late in the 1998 Legislative session, the Iowa legislature passed and Governor Branstad signed into law a provision that eliminates state capital gains tax when a business is sold to a lineal descendant. Why did this happen, and what are the likely effects?

### WHY IT HAPPENED

The principal reason given for the cut in capital gains tax was to stimulate value-added agriculture in Iowa. At first glance it seems like a stretch to link capital gains taxes with value-added agriculture, but the link is there. Iowa AgSTATE (Agricultural Strategic Thinkers Acting Together Effectively), a group of farm leaders and commodity organizations that worked together on a strategic plan for Iowa agriculture, discovered some of these connections in a study completed in the summer of 1997.

During their study, the AgSTATE group found that Iowa family farms could minimize taxes on intra-family transfers simply by waiting until the property-owning parents die before passing the farm on to the children. This incentive exists because land that is transferred at death is assigned a new base value for capital gains purposes. For example, suppose the parents bought the land for \$100 per acre, and the land is now worth \$1,100. If the land is inherited, the children establish a new base of \$1,100 and pay no taxes. If the land is sold to the children before the parents die, then capital gains taxes must be paid on the \$1,000 by which the land appreciated. This unusual situation has caused a distortion in the tax code because this re-basing can only occur at the death of the owners. The importance of this distortion has grown as land has appreciated and inheritance taxes have been minimized.

It also became clear in the study that Iowans had responded to this distortion by ensuring that the oldest family member owned the land. For example, the average age of both landowners and land buyers had increased substantially in recent years.

A third factor was the argument that older Iowans have less incentive to farm

the land or participate in value-added agricultural activities such as building modern hog confinement buildings. In many cases the children were not interested in farming, and the crop ground was rented out while awaiting the death that would allow the land to be sold without capital gains taxes. (As much as 50 percent of the farm ground is now being farmed by someone other than the owner.) In cases where the parents remained involved in agriculture, the evidence suggested that farmers above 55 years of age were more likely to quit hog production than to modernize.

Given that modern livestock production is financially risky, socially controversial, and requires long-term access to land, this aging of land owners probably reduced livestock production among Iowa's family farmers. Note that this ownership issue is not as relevant to corporations because the firm can live forever while shares are gifted on a year-by-year basis.

This thought process helps solve the mystery of why Iowa's family farmers appeared to quit hog production even in years when it was very profitable. (Or more accurately, the mystery of why those producers who quit for age-related reasons were not replaced by younger family producers.) To the extent politicians were convinced by this line of argument, the solution seemed obvious. Those that were interested in economic development and lower taxes could push capital gains cuts as a way of stimulating value-added agriculture. In fact the data showed that a 3 percent growth in value-added livestock production would cause total tax revenues to increase as the extra economic activity offset the lost capital gains taxes. Those that were more interested in social issues saw the tax cut as a way of increasing the family owned share of livestock production at the expense of corporate agriculture.

### WILL IT WORK?

The tax change is limited to lineal descendants and changes only the state tax burden. The lineal descendant

limitation means that the change will have little effect on families where the children have no interest in returning to the farm. In families where one or more of the children plan to remain involved, it will become somewhat easier to justify the sale of land to the interested offspring.

However, the fact that the Federal tax remains in place means that this incentive will be very small. Families who sell to offspring will still be penalized by federal capital gains taxes in comparison with those who wait until a death occurs. The fact that this change occurred in Iowa and not in the competing states, may give some boost to family farm based livestock production in Iowa. Yet, this effect will be muted because some of these states did not charge any income or capital gains taxes in the first place. Also, because so many people were taking advantage of the loophole, Iowa was collecting very little tax under the old system. (Total Iowa capital gains taxes on all land sales in the state amounted to only \$10 million dollars.) And so a very minor increase in value-added agriculture would increase total tax revenues. If Iowa's leadership can someday convince the Federal Tax authorities to remove the distortion, then the state should easily recoup its dollars as U.S. value-added exports increase. ♦