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The Debate Over Repeal of the Federal Estate Tax: The Income Tax Basis Issue

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The drive to repeal the federal estate tax and the generation skipping transfer tax (GSTT) almost totally ignored the matter of income tax basis until recently. Ironically, for more than 98 percent of U.S. citizens, income basis is actually more important to them economically than either federal estate tax or GSTT. Unfortunately, many do not fully understand (1) the concept of income tax basis and (2) the long-term consequences of abandoning the commitment to a new basis at death.

This strategy includes allowing the lock-in to expire, understanding that the PCP lock-in can only be used once on the same bushels. Thus a farmer can continue to store to the end of the marketing loan and if the PCP continues to decline they can pay off the loan at that lower PCP, not the higher PCP locked in earlier. Remember that under the marketing loan program, a time frame up to 8½ months can be used for the lock-in, since it is not available within 14 days before the marketing loan expires.

Summary
There are several advantages of utilizing the marketing loan versus just claiming the LDP which include:

1) access to marketing loan proceeds represented by county loan rate rather than just the LDP that represents a fraction of the value of the crop; 2) a longer time frame up to nine months for managing price risk for stored bushels; and 3) the added benefit of a strategy to utilize the 60-day lock-in to better manage the PCP level for bushels.

The USDA Farm Service Agency website posts the latest LDPs for commodity crops covered by the government farm program. These LDPs are updated each weekday morning just after 7 am at: http://www.fsa.usda.gov/dafp/psd/default.htm.

USDA reports loan activity can be found at: www.fsa.usda.gov/dafp/psd/reports.htm.

Historical LDPs can be found at: http://www.card.iastate.edu/ag_risk_tools/ldp/.

Under the 2001 Tax Act, the new income tax basis at death is scheduled to end, for deaths after Dec. 31, 2009, with repeal of the federal estate tax. In its stead will be a one year system of “carryover basis” with the estate and $3 million for property passing to a surviving spouse. Some groups advocating for permanent repeal have claimed that this modified carry-over basis rule sufficiently protects farm and ranch families from transfer taxes at death. That claim is unfounded. The issue is critical because the Senate is scheduled to vote on repealing the federal estate tax in September.

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decedent's basis (or the fair market value of the property, whichever is less), carrying over to the estate and thus to the heir or heirs of the decedent. The executor of the estate, under rules scheduled to be in effect for deaths in 2010, would have authority to allocate up to $1.3 million per estate and an additional $3 million for property passing to a surviving spouse, to increase the income tax basis of eligible property but not above fair market value. Most property of a decedent, other than property producing income in respect of decedent, would be eligible for the adjustment in basis. However, some other categories of assets are also not eligible for the adjustment. In any event, the provision for a $3 million basis increase for a surviving spouse if there is no surviving spouse, and if the $1.3 million and $3 million allowances are exceeded, carryover basis rules apply. That is likely to occur in many farm estates.

The Reason for Congressional Action
Because of Congressional budgetary rules, the carryover basis system (along with repeal of the federal estate tax (and the generation skipping transfer tax) is scheduled to end for deaths after December 31, 2010, with the system returning to a new income tax basis at death for deaths thereafter. That result is not expected to happen and current efforts to reach an agreement in Congress over the future of the federal estate tax and generation skipping transfer tax are directed toward either repeal of the two taxes or continuation of the taxes at lower rates and with a larger exemption. The House-passed bill that the Senate will consider in September permanently repeals the federal estate tax (and GSTT), but would also make permanent the modified carryover basis rule. Thus, the discussion now occurring in Congress concerning repeal of the federal estate tax also involves the income tax basis issue.

Income tax basis is tied to the other two taxes (federal estate tax and GSTT) only because of two features of the current system –

1. the adjustment in basis occurs by reason of death and uses fair market value at death (or the value used for federal estate tax purposes if different from fair market value) and
2. repeal of the federal estate tax would result in the loss of approximately $20 billion of federal tax revenue, and a completely new basis at death would cost approximately the same amount.

The impact on the Treasury is why Congress cannot repeal the federal estate tax while at the same time retaining new basis at death. The revenue loss would be too severe unless, of course, Congress increases taxes somewhere else to make up for the shortfall. That move would be politically unpopular. However, IRS data indicates that the federal estate tax can be retained with an exemption of between $3 million and $4 million along with the longstanding rule of new basis at death, and preserve almost all of the revenue presently generated by the tax.

Conclusion
Federal estate tax is paid by estates of fewer than two percent of the decedents, and an even smaller percentage of the estates of farmers and ranchers, under current law. Yet, gain on assets held at death is ultimately taxed to everyone who inherits property, up and down the income and asset scale. Therefore, the issue is more than revenue collected or not collected. A major change in the federal estate tax and the determination of gain on property after death, as has been proposed, represents a significant shift in who bears the overall federal tax burden. The House-passed bill shifts this burden to the heirs of the relatively smaller-sized estates.

Unquestionably, agriculture (and the economy as a whole) will be better served if the Congress retains the federal estate tax (albeit with a higher exemption) and, perhaps, a lower top rate (which is currently 47 percent for taxable amounts exceeding $2,000,000) along with new basis at death.

This is an excerpt taken from the new Ag Decision Maker Information File C4-26. The full text of is available at www.extension.iastate.edu/agdm/wholefarm/html/c4-26.html.