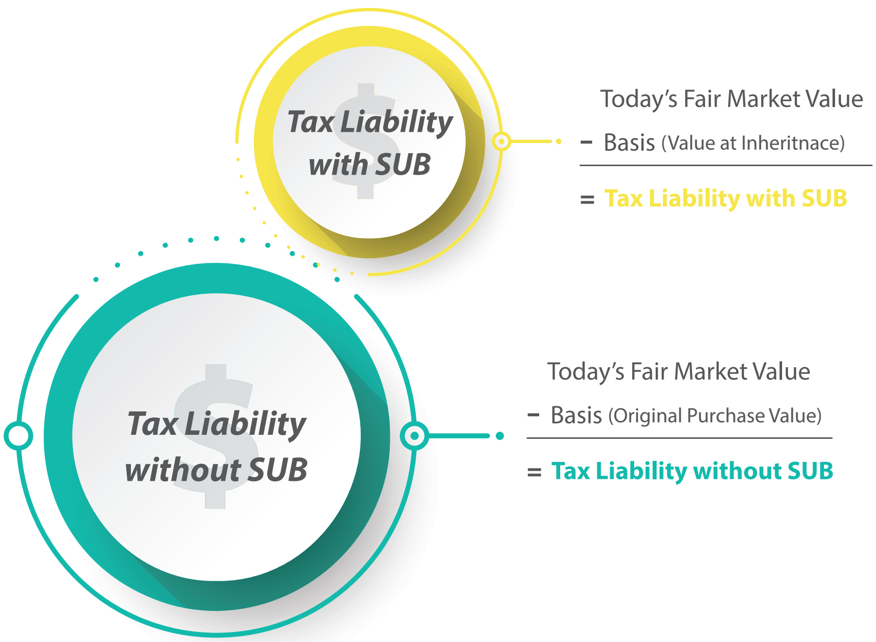
# Federal Tax Proposals:
## *What could they mean for Arkansas Farms?*

Under current law, most farms are not subject to federal estate taxes because $11.7 million per individual (or 23.4 million per couple) in assets are exempt. However, there are proposals in Congress that would significantly lower the exemption threshold. This implies that estate taxes could soon apply to many farms. This article will outline how these proposals might affect farms in Arkansas.

First, let's provide some context for how these tax laws apply. Suppose at the time of death of a farmer, a son or daughter inherits the land and other assets. At this time, the difference between what the farmer paid for it (or value at inheritance) and what its fair market value is at the time of transfer is called "capital gains." Capital gains are taxed if they are held over a year, however, these taxes can be avoided by changing the "basis" on which the assets are valued. In this scenario, the current fair market value becomes the basis, which is a "step up" from the original value or price paid for the asset. Now, should the son or daughter get out of the business and sell the assets five years later, the tax liability is a function of the new fair market value minus the fair market value at inheritance or "stepped up basis." In short, the capital gains tax provisions can be avoided at the time of inheritance as long as "stepped-up basis" is in place.




In 2017, the estate tax exemption was raised to $11.18 million (from $5.8 million.) This is indexed to inflation, so today the exemption is actually $11.7 million per person. In Arkansas, it takes about 3,457 acres of farmland or 4,021 acres of cropland to reach that exemption level. This means, at the time of inheritance, any acreage above that threshold would face the estate tax. What is important about these proposals is, when you lower the exemption level, more farms will face the estate tax because more farms will have asset values over the lower threshold.

**Specific Proposals and Importance of the Implications**

Two Acts have been proposed that will change the application of taxes at the time of death of a farmer: The Sensible Taxation and Equity Promotion (STEP) Act and the For the 99.5 Percent Act (99.5% Act.) The STEP Act would eliminate the stepped-up basis provision, and the 99.5% Act would lower the exemption level to $3.5 million where only assets above that threshold face the estate tax.

This is critical to the farming community because so much value of the asset base in farming is tied up in land, where appreciation is going to cause a dramatic increase in tax liability without the change in basis. Have you heard of the expression "asset rich, cash poor"? Whether we agree with the sentiment or not, this principle frequently applies to farm businesses. Relative to other business types, farms do not cash flow in proportion to the asset base it takes to generate an income in agriculture.

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Understanding these proposals and the agricultural business disposition are important because the conversation is not likely "going away." More and bigger government programs draw resources in the form of taxation. Also, it may not be the intention to have the agricultural community carry any more than its fair share of the tax burden, but "the voice of agriculture" must be heard to ensure farmers' representation in tax legislation. Specifically, the Arkansas agriculture community has an interest in explaining how we would be affected by these tax proposals.

**Arkansas Context Important for Understanding the Tax Situation**

Given the 2017 USDA Census of Agriculture Arkansas land values, about 3.4% of farms exceed the exemption level of $11.58 million. However, the $5.8 million exemption level is exceeded by 7.2% of farms in Arkansas. This means that lowering the exemption level from its current provision back down to $5.8 million will effectively double the amount of farms in Arkansas that will be subject to the estate tax. The proposed 99.5% Act would lower that exemption level even further though, meaning even more farms could be subject to this tax.

A row-crop farmer in the east and a livestock rancher in the west both have a stake in how the proposals will affect the tax liability generated when the transfer of assets occurs at the time of death of an operator. To demonstrate some expectations of the potential impact on Arkansas farms, some examples from a Texas A&M study are included below. Table 1 shows results directly citing the findings of their farm-policy simulation tool.

Table 1. Arkansas Representative Farms and Resulting Tax Liabilities

| Operation Type | Description | Average Annual Net Cash Farm Income | Tax Liability Under Just the STEP Act | Tax Liability Under Just the 99.5% Act | Tax Liability Under Both the STEP Act & 99.5% Act |
|---|---|---|---|---|---|
| Rice Farm | 2400 acres in NE AR | $209,290 | $880,740 | $271,001 | $899,695 |
| Cotton Farm | 2500 acres in NE AR | $1,278,995 | $1,029,805 | $2,157,625 | $2,676,174 |
| Cattle Ranch | 300 head cow-calf in SC TX* | $134,256 | $570,520 | 0 | $570,520 |

**None of the livestock "representative farms" were in Arkansas*

The rice farm, cotton farm, and cattle ranch described and summarized for their tax liabilities above would take 4.3, 2.1, and 4.2 years respectively to pay off their tax liability using only and all of their generated net farm income in the scenario that both the STEP Act and 99.5% Act apply. **One way to interpret this is the next generation cannot begin to generate income to pay themselves until after this tax liability is paid. Can you imagine a young Arkansas farmer or rancher taking over the operation working for three and half years without pay to address these tax proposals? How might that weigh in to the conversation of generational transfer?**