



A FairTaxSM White Paper

Land values and the federal tax system

by Ross Korves

Reports over the past few months indicate that agricultural land prices have been increasing at double-digit annual rates in some regions of the country. That is good news for many farmers and ranchers because land often serves as a retirement plan in addition to being a productive asset on working farms and ranches. With the increasing land prices also comes a potential of higher taxes if the land is sold in retirement or transferred at death.

The value of land is a key component of the financial structure of U.S. agriculture. According to U.S. Department of Agriculture (USDA) estimates for 2003, land and buildings account for about 76 percent of the total value of farm assets held by farmers and ranchers.

In 2001 Congress had its last major discussion about changing the federal tax code. The national average value of cropland was \$1,510 on January 1, 2001. By January 1, 2004, the average value had increased to \$1,780, an 18-percent increase. The national average value of cropland today is probably close to \$2,000 per acre.

How the federal government taxes farm and ranch land

The federal government's tax system gets at the value of farm and ranch land in two major ways. The federal estate tax receives most of the attention. In 2005, estates with a value after deductions of more than \$1.5 million are subject to taxation. Keep in mind that only 500 acres of cropland valued at \$3,000 per acre is worth \$1.5 million. Many farms have land valued at more than \$3,000 per acre. Under current law the estate tax disappears in 2010 only to come back again in 2011 with an exemption of \$1.0 million.

Estate taxes

Even if the repeal of the estate tax law that is set for 2010 were made permanent, inherited land that is sold at a later time would still be subject to capital gains taxes based on the value of the land at the time of purchase by the previous owner (commonly referred to as carryover basis). With land often held within a family for more than one generation, even low capital gains tax rates can still result in a substantial tax bill if land is sold. The current law for 2010 allows for up to \$3.0 million in assets going to a surviving spouse to have a stepped-up basis of the value at the time of the death of the spouse and up to \$1.3 million of other assets can also have a stepped-up basis.



Capital gains taxes

The federal capital gains tax can impact many more farmers and ranchers than the estate tax. The capital gains tax is a tax on the transfer of assets from one form to another. Active farmers and ranchers often put much of their investment capital into farmland because they believe it is a better financial use of capital than purchasing other assets. At or near retirement they often want to diversify assets to provide for a more secure, steady retirement income. Even with the lower capital gains tax rates of five percent and 15 percent that were part of the 2003 tax law changes, farmers and ranchers still pay a burdensome tax penalty for diversifying assets. These lower capital gains tax rates are only temporary. After 2008, capital gains tax rates return to ten percent and 20 percent unless Congress acts before then.

Capital gains taxes have also become a major issue in areas of the country where urban development pressures are forcing up the price of farmland. The federal tax system provides for a like-kind exchange of real estate (a Section 1031 exchange). The new property must be identified within 45 days of sale of the exchanged property and in most cases the sale must be completed within 180 days. Sellers often want to purchase land as close to their existing operations as possible and land that is similar to what they already farm. With the need to act quickly and often with only a few properties available, users of 1031 exchanges often aggressively outbid local farmers and ranchers who may want to expand existing operations.

The FairTax solution

There is a way out of the current complex, burdensome federal taxes on the transfer of farm and ranch land. It is the FairTax, a progressive national retail sales tax levied only on the final end-user of new goods and services. The FairTax is designed to replace current individual and corporate income taxes (including the alternative minimum tax), payroll taxes for Social Security and Medicare, estate and gift taxes, and corporate taxes.

The current federal tax system is cumbersome partly because it taxes income. To tax income the tax code has to define income and defining income has proven to be extremely difficult.

The FairTax taxes consumption. For most people that is easy to define. If a farmer or rancher sells some land and buys a new pleasure boat, that second transaction is taxable consumption. If he or she buys stock in Microsoft, that is not consumption. If a landowner in an urbanizing area sells land, the proceeds are not taxed unless the money is used for consumption. If the money is put in a certificate of deposit for two years while the owner waits to buy other land, the money is not taxed. When other farmland is purchased there is no tax. If he builds a new lake house, taxes do apply to that property.

Estates are not taxed at transfer; there is no consumption. There is no need to worry about original basis, carryover basis, stepped-up basis, or any other value. Death is no longer a taxable event.

Under the FairTax the federal government still needs to collect trillions of dollars of revenue just as they do today. Taxing consumption, not mislabeling the transfer of assets as income and taxing the transfer, does that.



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About Ross Korves

Ross Korves is an independent economic policy analyst.

He is a Trade Policy Analyst with Truth About Trade and Technology, a group begun and run by farmers and ranchers who believe in increased international trade and the use of biotechnology, and an Economic Policy Analyst with the ProExporter Network, a transportation and grain processing analysis firm. He also provides analysis and advice on federal tax policy for farmers and ranchers and health care policy.

Ross spent 25 years as an economist for the American Farm Bureau Federation. He is a native of southern Illinois and a graduate of Southern Illinois University.

What is the FairTax Plan?

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?

FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

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(AFFT Documents\Papers on a specific subject\Land values and the federal tax system)