[JOINT COMMITTEE PRINT]

DESCRIPTION OF MISCELLANEOUS FARM TAX PROPOSALS (S. 710, S. 887, S. 900, S. 1045, S. 1061, S. 1130, AND S. 2202)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

OF THE

SENATE COMMITTEE ON FINANCE

ON APRIL 29, 1992

PREPARED BY THE STAFF

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INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance has scheduled a public hearing on April 29, 1992, to consider various farm tax proposals. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the proposals and an analysis of issues raised by the proposals.

The first part of the pamphlet provides a summary of the bills (in numerical order) that are the subject of the hearing. The second part of the pamphlet provides a description of present law and the bills and an analysis of issues raised by the bills.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Miscellaneous Farm Tax Proposals* (JCS-10-92), April 27, 1992.

I. SUMMARY OF BILLS

A. S. 710—Senators Grassley, Dixon, Simon, and Dole

Permanent Extension of First-Time Farmer Bonds

S. 710 would permanently extend the authority of State and local governments to issue small-issue bonds for first-time farmers, which currently is scheduled to expire after June 30, 1992.

B. S. 887—Senators Jeffords, Symms, Daschle, Bumpers, Craig, and Leahy

Special Valuation of Sensitive Environmental Areas for Estate Tax Purposes

S. 887 would allow the executor of an estate to value an interest in a sensitive environmental area at its environmental use value for Federal estate tax purposes. The environmental use value would be the value of the interest in a sensitive environmental area, subject to an environment preservation easement. A sensitive environmental area would be defined as a wetlands area or other area of undeveloped natural condition or open space. An environmental preservation easement generally would be defined as a preservation easement granted for 10 years beginning from the date of death. Such easement could be granted by the decedent or executor, but would not qualify for a charitable deduction for income or estate tax purposes if granted by the latter.

S. 887 would apply to decedents dying after the date of enactment.

C. S. 900—Senators Conrad, Daschle, Burdick, Dixon, Harkin, Heflin, Kerrey, Levin and Symms

Tax Relief for Farmers Who Realize Capital Gain on the Transfer of Farm Property to Satisfy an Indebtedness

S. 900 would provide an exclusion from gross income for gain that is realized by certain farmers on the transfer of farm property in satisfaction of farm indebtedness. In addition, farmers meeting certain requirements could elect to exclude from gross income certain income from the discharge of indebtedness, subject to a lifetime limitation of $300,000.

S. 900 would apply to transfers and discharges of indebtedness occurring after December 31, 1986.

D. S. 1045—Senators Kassebaum, Dole, and Conrad

Treatment of Certain Leases to Lineal Descendants for Estate Tax Special Use Valuation Purposes

S. 1045 would provide that a cash rental of specially valued real property by a lineal descendent of the decedent to a member of the descendant's family would not result in the property failing to be treated as used in a qualified use for purposes of the special use valuation recapture tax.

S. 1045 would apply to rentals occurring, and decedents dying, after December 31, 1976.

E. S. 1061—Senators Conrad, Kassebaum, and Exon

Treatment of Certain Leases to Qualified Heirs for Estate Tax Special Use Valuation Purposes

S. 1061 would provide that a cash rental of specially valued real property by a family member receiving the property to a member of the recipient's family would not result in the property failing to be treated as used in a qualified use for purposes of the special use valuation recapture tax.

S. 1061 would apply to rentals occurring, and decedents dying, after December 31, 1976.

F. S. 1130—Senators Kasten, Shelby, and Burns

Rollover of Gain From Sale of Farm Assets into an Asset Rollover Account

S. 1130 would permit a qualified farmer to defer recognition of a limited amount of net gain from the sale of qualified farm assets to the extent the farmer contributes an amount equal to such gain to one or more asset rollover accounts ("ARAs") in the taxable year in which the sale occurs. An ARA would be an individual retirement arrangement ("IRA") that is designated at the time of establishment as an ARA. Except as provided under the bill, an ARA would be treated in the same manner as an IRA. Thus, amounts contributed to an ARA would not be includible in income until withdrawn from the ARA. However, no deduction would be allowed for contributions to an ARA, and rollover contributions to an ARA could be made only from other ARAs.

S. 1130 would apply to sales and exchanges occurring after the date of enactment.

G. S. 2202—Senator Kassebaum

Exclusion of Gain on the Sale of Farmland With an Adjoining Principal Residence

S. 2202 would modify the $125,000 lifetime exclusion of gain that applies to the sale of a principal residence by individuals who have attained age 55. Specifically, the bill would extend the exclusion to gain derived from the sale of farmland that adjoins the land on which the principal residence is located. The exclusion would only

apply to farmland which has been actively farmed by the taxpayer and which is sold with the principal residence.

S. 2202 would apply to sales and exchanges of principal residences occurring after December 31, 1991.

II. DESCRIPTION OF BILLS

A. Qualified Small-Issue Bonds for First-Time Farmers (S. 710—Senators Grassley, Dixon, Simon, and Dole)

Present Law

Interest on certain small issues of private activity bonds is excludable from gross income if at least 95 percent of the bond proceeds is to be used to finance manufacturing facilities or certain agricultural land or equipment ("qualified small-issue bonds").

Qualified small-issue bonds are bond issues having an aggregate authorized face amount of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million.

Qualified small-issue bonds for agricultural land ("first-time farmer bonds") may be used only to provide financing to first-time farmers who will materially participate in the farming operation to be conducted on the financed land. Up to 25 percent of the proceeds of a first-time farmer bond issue ($250,000 lifetime maximum) may be used to finance farm equipment to be used on the financed land; however, no more than $62,500 of bond proceeds may be used to finance used farm equipment.

Qualified small-issue bonds, like certain other private activity bonds, are subject to annual State private activity bond volume limitations.

The authority to issue qualified small-issue bonds (including first-time farmer bonds) is scheduled to expire after June 30, 1992.

Explanation of the Bill

The bill would permanently extend the authority to issue first-time farmer bonds.

Effective date.—The bill (as introduced) is effective for bonds issued after December 31, 1991.[2]

Analysis

Overview

The purpose of the first-time farmer bond program is to increase the number of younger individuals who seek a livelihood in farming by reducing the financial burden of establishing an agricultural enterprise. Individual farmers and new farmers generally face

[2] The bill was introduced before enactment of the Tax Extension Act of 1991 and does not reflect the extension of the authority to issue qualified small-issue bonds from December 31, 1991, to June 30, 1992, that was included in that Act.

higher costs of funds than do larger, more established farming businesses because of the perceived risk of the enterprises. Some analysts believe that the private market overprices the riskiness of such enterprises. Others argue that the private market does not account for the benefits, in addition to the profits earned by farmers, which accrue to the economy from the creation and maintenance of family farms. The qualified small-issue bond program is intended to address the higher cost of capital faced by small manufacturing enterprises and first-time farmers.

Efficiency of tax-exempt bonds for funds provided to individuals

As is the case generally with tax-exempt bonds, the amount of the revenue lost to the Federal Government through the issuance of first-time farmer bonds is not completely transferred to first-time farmers as an interest rate subsidy. This occurs primarily for two reasons. First, the Federal income tax has graduated marginal tax rates. Thus, $100 of interest income forgone to a taxpayer in the 31-percent bracket costs the Federal Government $31, while the same amount of interest income forgone to a taxpayer in the 28-percent bracket costs the Federal Government $28. Generally, a taxpayer will find it attractive to buy a tax-exempt security rather than an otherwise equivalent taxable security if the interest rate paid by the tax-exempt security is greater than the after-tax yield from the taxable security, r(1-t), where t is the taxpayer's marginal tax rate and r is the yield on the taxable security. Consequently, if a taxpayer in the 28-percent bracket finds it profitable to hold a tax-exempt security, a taxpayer in the 31-percent bracket will find it even more profitable. Assuming the borrower receives the loan at the tax-exempt bond rate, this conclusion implies that the Federal Government will lose more in revenue than the first-time farmer gains in reduced interest payments.

Moreover, the recipient of the loan does not receive the full spread in yields between taxable and tax-exempt securities. For example, issuers of qualified small-issue bonds are permitted to charge the borrower up to 12.5 basis points above the tax-exempt bond yield plus certain costs. This reduces the ultimate size of the interest rate subsidy received by the qualifying farmer.

The use of tax-exempt bonds to re-lend funds to individuals also creates another inefficiency which sometimes works to the ultimate borrowers' benefit and sometimes to their detriment. In some cases, first-time farmer bonds are issued as a composite of issues for several borrowers. This structure may force the ultimate borrowers to either accelerate or delay the date at which they would otherwise choose to borrow funds. When interest rates are falling, this means that borrowers who delayed their borrowing benefit from a lower interest rate than they would otherwise receive, but borrowers who accelerated their borrowing pay a higher interest rate than if they had waited. For example, interest rates on long- and short-term conventional bank loans have fallen more than 100 basis points over the past six months. If first-time farmer bonds had been issued six months ago on behalf of borrowers who otherwise would have waited until today to borrow, the effective interest subsidy available would have narrowed by 100 basis points. Of course, if in-

terest rates were rising, the effective interest subsidy would be increased.

Measuring the costs and benefits of qualified first-time farmer bonds

Measuring the costs of the first-time farmer bond program is relatively straightforward. The tax revenue foregone from investors purchasing and holding tax-exempt securities rather than taxable securities (less the tax revenue gained by the reduction in deductible business interest and depreciation expenses claimed by beneficiaries of qualified first-time farmer bonds) represent the majority of the cost of the program. In addition, the value of the inherent inefficiencies involved in tax-exempt finance, discussed above, represent costs.[3]

The benefits, on the other hand, are much harder to quantify. This is because the benefits take two broad forms. For some recipients of loans financed by qualified first-time farmer bonds the interest rate subsidy lowers their cost of obtaining capital, but does not directly alter their ability to obtain capital. That is, some recipients of the subsidy could successfully qualify for a conventional business loan at prevailing market interest rates. For these recipients of the subsidy, the benefit is the reduction in cost.

However, first-time farmer bonds may permit other borrowers to obtain capital when they would not otherwise have been able to do so, or to obtain more capital than they otherwise might have. In this case, the benefit is substantially more difficult to quantify. The benefit could be measured, in principle, by the net increase in employment and profits in the agricultural sector.

It is inappropriate to attempt to measure the benefits of the first-time farmer bond program by counting the number of qualifying farms and the payrolls of such farmers receiving tax-exempt bond-financed loans. First, employment growth in enterprises receiving these loans does not necessarily represent net employment additions to the national economy. The additional workers may simply be attracted to farming from other productive endeavors. More subtly, first-time farmers may attract some of their labor from other established businesses, which do not replace all of their lost employees.

Some analysts believe that promoting the creation of new family farms creates additional benefits not captured in the reduced interest cost to the enterprise.[4] They argue that, for example, the family farm insures a competitive market for agricultural products and can lead to the creation of positive social values and other outcomes. It is nearly impossible to quantify the extent to which first-time farmer bonds may create or contribute to these perceived benefits. However, to the extent these benefits are sizeable, they should be incorporated into any cost-benefit analysis.

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[3] This cost calculation is not the same as the revenue estimate for extending the qualified small-issue bond program for two reasons. First, the program is subject to the State private activity annual volume limitation. To the extent that the issuance of other private activity bonds would increase if the authority to issue qualified small-issue bonds were not extended, the revenue estimate of extension would be substantially lower than the economic cost of issuing qualified small-issue bonds. Second, the revenue estimate would not necessarily assume that investors would switch from holding qualified small-issue bonds to holding fully taxable investments.

[4] These additional benefits are referred to as "externalities" by economists.

B. Treatment of Certain Farm Property for Estate Tax Purposes

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, which is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

For decedents dying after December 31, 1976, the executor may elect to value real property that was used by the decedent as a farm or in another trade or business at its value as a farm or in the trade or business instead of its fair market value. In order to qualify for special use valuation, the real property must be used by the decedent or a member of the decedent's family as a farm for farming purposes or in another trade or business. An additional tax is imposed if the family member who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death.

Some courts have held that cash rental of specially valued property after the death of the decedent is not a qualified use and, therefore, results in a recapture tax. See, e.g., *Martin* v. *Commissioner,* 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party); *Williamson* v. *Commissioner,* 93 T.C. 242 (1989) (cash lease to family member). A statutory rule treats a net cash lease by a surviving spouse to a member of the spouse's family as a qualified use.

For estate tax purposes, a charitable deduction sometimes is allowed for a decedent's contribution of an interest in real property to a charity exclusively for conservation purposes. A restriction on the use of real property qualifies for the deduction only if the restriction is granted in perpetuity and the conservation purpose is protected in perpetuity.

Explanation of the Bills

1. Special use valuation of sensitive environmental areas (S. 887—Senators Jeffords, Symms, Daschle, Bumpers, Craig, and Leahy)

S. 887 would allow the executor of an estate to value an interest in a sensitive environmental area at its environmental use value for Federal estate tax purposes. The environmental use value would be the value of the interest in a sensitive environmental area, subject to an environment preservation easement. A sensitive environmental area would be defined as a wetlands area or other area of undeveloped natural condition or open space. An environmental preservation easement would be defined as a preservation easement granted for 10 years beginning from the date of death.

Such easement could be granted by the decedent or executor, but would not qualify for a charitable deduction for income or estate tax purposes if granted by the latter.

A recapture tax would be imposed if, within 10 years, the heir ceases to maintain the property in accordance with the easement. The amount of the recapture tax would equal the greater of (1) the additional estate tax liability that would have been incurred had the value of the property been determined without regard to the environmental use value, or (2) the excess of the amount realized over the environmental use value of the interest.

Effective date.—The bill would apply to decedents dying after the date of enactment.

2. Special use treatment of rents paid to lineal descendants (S. 1045—Senators Kassebaum, Dole, and Conrad)

S. 1045 would provide that a cash rental of specially valued real property by a lineal descendant of the decedent to a member of the descendant's family would not result in the property failing to be treated as used in a qualified use for purposes of the special use valuation recapture tax.

Effective date.—The bill would apply to rentals occurring, and decedents dying, after December 31, 1976.

3. Special use treatment of rents paid to qualified heirs (S. 1061—Senators Conrad, Kassebaum, and Exon)

S. 1061 would provide that a cash rental of specially valued real property by a family member receiving the property to a member of the recipient's family would not result in the property failing to be treated as used in a qualified use for purposes of the special use valuation recapture tax.

Effective date.—The bill would apply to rentals occurring, and decedents dying, after December 31, 1976.

Analysis

Valuation based on environmental use

Generally, the environmental use value would be the value of property that must lay fallow or otherwise remain undeveloped. The effect of S. 887 would be to permit the executor to exclude from the taxable estate the difference between the fair market value and the environmental use value of the property. The exclusion is likely to be more valuable in areas close to other development, rather than in more remote locations. It also is more valuable to decedents with larger estates, and hence higher marginal estate tax rates.

As an exclusion from the taxable estate for a public purpose, S. 887 resembles the deduction for charitable bequests permitted under present law to a decedent granting such an easement to a charitable organization. It differs from the charitable deduction, however, by not requiring that the easement be perpetual or that the donee be a charity and by imposing a recapture tax if the property is not maintained in accordance with the easement.

Some may argue that the need to preserve environmentally sensitive areas is sufficiently strong to justify special treatment under

the Internal Revenue Code. S. 887 would provide an incentive for the creation of conservation easements by reducing the effective cost of such creation. It is uncertain, however, whether S. 887 would actually increase the number of conservation easements.[5]

Others may argue that the amount of the subsidy should not vary depending upon the decedent's estate tax bracket. They could also note that the Internal Revenue Code already provides a substantial incentive by allowing a charitable deduction for easements granted before death.

Moreover, others may prefer a direct expenditure program as a means of preserving open spaces. By providing planning and oversight, a direct expenditure program may be more efficient. For example, environmental goals may not be furthered if several acres of wetlands are preserved by an executor claiming an environmental easement, if the surrounding 100 acres of wetlands are developed. A direct expenditure program would have the opportunity to attempt to preserve a larger parcel or to determine that no environmental goal is furthered if only several acres were to be preserved. A direct expenditure program also might be more politically accountable.

Special use valuation

Some may argue that the benefit of special use valuation should not be lost merely because the property is cash leased. A similar benefit is already available through a crop share lease, a common alternative to cash leasing. A cash lease, however, provides a more reliable income stream.

Others may emphasize that current use valuation is a special provision designed to allow the continuation of family farms. Cash leases, even among family members, may give the benefit of special use valuation to persons insulated from the risk of farming. It can be argued that such benefit should be confined as narrowly as possible.

The retroactivity of the proposals may be an issue. Retroactivity is necessary if the bills are to reach all heirs who have entered into cash leases. On the other hand, retroactivity imposes an administrative burden upon the Internal Revenue Service by opening returns for past years.

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[5] For empirical studies reaching opposing conclusions regarding the effect of the charitable deduction on bequests, compare Thomas Barthold and Robert Plotnick, "Estate Taxation and Other Determinants of Charitable Bequests," 37 *National Tax Journal* 225 (June 1984) (charitable deduction does not increase charitable bequests), with David Joulfaian, "Charitable Bequests and Estate Taxes," 46 *National Tax Journal* 169 (June 1991) (charitable deduction increases charitable bequests).

C. Treatment of Gain from the Sale of Certain Farm Property

1. Gain on transfer of farm property to satisfy an indebtedness (S. 900—Senators Conrad, Daschle, Burdick, Dixon, Harkin, Heflin, Kerrey, Levin, and Symms)

Present Law

Gain on transfer of property in exchange for cancellation of indebtedness

Gain from the sale or other disposition of property is determined by computing the excess of the amount realized therefrom over the adjusted basis of the property. The amount realized is the sum of any money received plus the fair market value of any property (other than money) received. In general, the entire amount of gain determined on the sale or exchange of property is recognized for Federal income tax purposes (sec. 1001).

If a taxpayer transfers property to a creditor in exchange for the cancellation of an indebtedness, the taxpayer may recognize both gain on the property and cancellation of indebtedness income. The transfer of property in exchange for the cancellation of indebtedness is equivalent to a sale for Federal income tax purposes. For example, if the debt that is cancelled is one for which the taxpayer is personally liable, gain will be recognized in the amount of the excess of the fair market value of the property over the basis of the property. In addition, the taxpayer will have discharge of indebtedness income in an amount equal to the excess of the amount of the debt discharged over the fair market value of the property.

Cancellation of indebtedness income

In general

Gross income generally includes income from the discharge of indebtedness (sec. 61(a)(12)).

Treatment of insolvent taxpayer

If an insolvent taxpayer realizes income from discharge of indebtedness, the income is excluded and certain tax attributes of the taxpayer (including items such as net operating loss carryovers and basis in property) generally are reduced by the excluded amount. The exclusion is limited to the amount by which the taxpayer is insolvent. If the taxpayer's discharge of indebtedness income (not in excess of the amount by which the taxpayer is insolvent) exceeds these tax attributes, the excess is forgiven, i.e., is not includible in income (sec. 108).

Treatment of certain farm indebtedness

The Tax Reform Act of 1986 provided that, in the case of a solvent taxpayer who realizes income from the discharge by a "qualified person" of "qualified farm indebtedness," the discharge is treated in a manner similar to a discharge of indebtedness of an insolvent taxpayer (sec. 108(g)). Qualified farm indebtedness is indebtedness incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a gross receipts test. The gross receipts test is satisfied if 50 percent or more of the taxpayer's average annual gross receipts for the three taxable years preceding the taxable year in which the discharge of indebtedness occurs is attributable to the trade or business of farming. A qualified person is one regularly engaged in the business of lending money and meeting certain other requirements. The Technical and Miscellaneous Revenue Act of 1988 provided that the amount excluded under this provision generally may not exceed the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in property held for use in a trade or business or for the production of income. Thus, if there is any remaining discharge of indebtedness income after the taxpayer has reduced these tax attributes, income will be recognized.

Explanation of the Bill

In general

S. 900 would provide tax relief for certain farmers who realize gain on the transfer of farm property in satisfaction of farm indebtedness. In addition, the bill provides that farmers meeting certain requirements could elect to exclude income from the discharge of farm indebtedness, subject to a maximum dollar limit.

Exclusion of certain gains

The bill would exclude from the gross income of certain farmers gain from the transfer of farm property in complete or partial satisfaction of qualified farm indebtedness (i.e., debt incurred directly in connection with the trade or business of farming in which the taxpayer materially participated), subject to a maximum of $300,000. This rule would apply to a taxpayer that satisfies the following requirements: (1) the average of the taxpayer's adjusted gross income (with certain modifications) for any three taxable years of the past five taxable years is less than the average of the national median adjusted gross income for such three taxable years; (2) more than 50 percent of the taxpayer's gross receipts for six of the 10 taxable years preceding the year of transfer is attributable to a farming business, the sale or lease of assets used in farming, or both; and (3) the amount of equity in all property held by the taxpayer after the transfer is less than the greater of (a) $25,000 or (b) 150 percent of the excess of the tax that would be due if this provision and section 108 of the Internal Revenue Code (which relates to exclusions of certain discharge of indebtedness income) did not apply, over the tax that would be due if this provision and section 108 did apply.

The bill provides that the $300,000 limit on excludable gains would be reduced by (1) prior year exclusions of gains under this provision, (2) current year and certain prior year exclusions of discharge of indebtedness income under section 108, and (3) gains recaptured as ordinary income. In addition, any amount that is excluded by reason of this provision would reduce certain tax attributes of the taxpayer.

Exclusion of discharge of indebtedness income

The bill provides that certain farmers may elect to exclude income from the discharge of qualified farm indebtedness, subject to a maximum of $300,000. An election may be made if a taxpayer meets the requirements described above and, in addition, the taxpayer's indebtedness both before and after the discharge is equal to 70 percent or more of the equity in all property held by the taxpayer.

The bill provides that the $300,000 limit would be reduced by prior year exclusions of gains from the transfer of farm property (under the provision described above) and prior year exclusions of discharge of qualified farm indebtedness income under this provision.

If an election is made, the amount of income from the discharge of qualified farm indebtedness that may be excluded would not be limited to the taxpayer's tax attributes; rather, the maximum amount that may be excluded would be $300,000. If an election is not made, however, the present-law rule that generally limits the exclusion of income to the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in certain property, would not be changed by this provision of the bill.

Effective date

The bill would apply to transfers and discharges of indebtedness occurring after December 31, 1986. In addition, in the case of any taxable year ending before the date of enactment, the statute of limitations for claiming a credit or refund generally would remain open until one year after the date of enactment.

Analysis

If an indebtedness of a taxpayer is cancelled in exchange for the transfer of property, the taxpayer may realize ordinary discharge of indebtedness income, gain or both. Under present law, a taxpayer may exclude only ordinary discharge of indebtedness income, under certain circumstances. There is no comparable exclusion for gain realized on the transfer of the property to a creditor, even though economically the taxpayer has been discharged from an indebtedness. Some may argue that the bill properly addresses this imbalance by treating both ordinary discharge of indebtedness income and gain similarly.

Others may argue, however, that the exclusion of income from the discharge of indebtedness (albeit requiring a reduction in tax attributes) is not a proper measurement of income and that such policy should not be extended to gain realized on the transfer of property to a creditor.

Those who believe that ordinary discharge of indebtedness income and gain should be treated similarly could argue that the scope of the bill is too narrow because it redresses the inequitable treatment of gain as compared to ordinary discharge income only in certain cases involving qualified farm indebtedness and not in other cases.

Administrative concerns of both the Internal Revenue Service and taxpayers may be raised by the bill because operation of certain aspects of the bill would involve the retention of tax return and other information for many years (e.g., the "six out of 10 years" gross receipts test and the $300,000 lifetime cap).

2. Rollover of gain from the sale of farm assets into an asset rollover account (S. 1130—Senators Kasten, Shelby, and Burns)

Present Law

Under present law, gain from the sale of farm assets is generally includible in income for the taxable year in which the assets are sold.

Explanation of the Bill

The bill would permit a qualified farmer to defer recognition of a limited amount of net gain from the sale of qualified farm assets to the extent the farmer contributes an amount equal to such gain to one or more asset rollover accounts ("ARAs") in the taxable year in which the sale occurs. An ARA would be an individual retirement arrangement ("IRA") that is designated at the time of establishment as an ARA. Except as provided under the bill, an ARA would be treated in the same manner as an IRA. Thus, amounts contributed to an ARA would not be includible in income until withdrawn from the ARA. However, no deduction would be allowed for contributions to an ARA, and rollover contributions to an ARA could be made only from other ARAs.

Contributions to one or more ARAs (and thus deferral of qualified net farm gain) in any taxable year would be limited to the lesser of (1) the qualified net farm gain for the taxable year, or (2) an amount determined by multiplying the number of years the taxpayer is a qualified farmer by $10,000 ($20,000 for joint filers in each year the taxpayer's spouse also is qualified farmer). In addition, the aggregate amount for all taxable years that could be contributed to all ARAs established on behalf of an individual could not exceed $500,000 ($250,000 in the case of separate return by a married individual), reduced by the amount by which the aggregate value of assets held by the individual and the individual's spouse in IRAs (other than ARAs) exceeds $100,000. A taxpayer would be deemed to have made a contribution to an ARA on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's Federal income tax return for the year (not including extensions).

Under the bill, qualified net farm gain would be defined as the lesser of (1) the net capital gain of the taxpayer for the taxable year, or (2) the net capital gain for the taxable year determined by

taking into account only gain (or loss) in connection with a disposition of a qualified farm asset. A qualified farm asset would be an asset used by a qualified farmer in the active conduct of the trade or business of farming. A qualified farmer would be a taxpayer who during the 5-year period ending on the date of the disposition of a qualified farm asset materially participated in the trade or business of farming, and 50 percent or more of such trade or business is owned by the taxpayer (or spouse) during the 5-year period.

Any individual who made a qualified contribution to, or who received any amount from, an ARA for any taxable year would have to include on the individual's Federal income tax return for such taxable year and any succeeding taxable year (or on such other form as the Secretary may prescribe) information similar to that required in the case of designated nondeductible contributions to an IRA. Excess contributions to an ARA would be subject to the penalties applicable to excess contributions to an IRA.

Effective date.—The bill would apply to sales and exchanges occurring after the date of enactment.

Analysis

S. 1130 would permit farmers to convert the equity in farm assets into retirement savings without having to first pay tax on accrued gain in the value of the assets. As S. 1130 does not require the taxpayer to recognize the gain prior to contributing the proceeds to an ARA, the proposal is equivalent to permitting the taxpayer to make a tax deductible contribution to an IRA where the size of the deduction permitted is equal to the size of the gain. Permitting such gain to be contributed to an ARA on a pre-tax basis is equivalent to exempting from tax the earnings on what would otherwise be a post-tax investment.[6] This would offer the farmer a greater after-tax return than would many other alternative investments. In addition, farmers would postpone taxation of the contributed gain until the contributions are withdrawn, at which time they may be taxed at a lower rate than when the contribution was made.[7]

Under present law, farmers can establish an IRA or their own tax-qualified retirement saving plan. S. 1130 would provide an additional benefit to farmers. However, S. 1130 would limit the extent to which a taxpayer could avail himself or herself of both an IRA and the rollover of qualified farm gain. By linking gains in the value of farm property to IRA assets, the bill may provide an in-

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[6] The following example illustrates why an investment in an ARA that is not first subject to tax receives a tax-free rate of return. Assume a taxpayer with a marginal tax rate of 28 percent contributes $1,000 to an ARA. The initial savings from not having to pay tax on the $1,000 is $280. For the purpose of this example, assume that the taxpayer withdraws the funds after one year without penalty. If the annual rate of return on the ARA assets is 10 percent, the value of the ARA is $1,100, total tax due is $308, and the taxpayer is left with $792. Notice that if the taxpayer had paid the initial tax of $280 and invested the remaining $720 at 10 percent, then the taxpayer would have had $792 after one year. If the income had not been invested in an ARA, the taxpayer would have to pay tax on the $72 of earnings, and would be left with $771.84 after payment of taxes. The value of the ARA is that the taxpayer does not have to pay additional tax. Thus, the ARA allows the taxpayer to get a tax-free rate of return on an investment of $720.

[7] For a detailed discussion of the economics of IRAs see, Joint Committee on Taxation, *Description and Analysis of S. 612 (Savings and Investment Incentive Act of 1991)* (JCS-5-91), May 14, 1991.

centive for farmers to redirect funds which they may otherwise have put into an IRA into investments in their farm property. While this may lead to improvement in farm productivity it may also increase the riskiness of the taxpayer's retirement savings by reducing his or her diversification.

The rollover of gain on qualified farm property into an ARA would effectively create income averaging for the taxpayer in regard to recognition of gain. Rather than see recognition of a large gain place the farmer in what may be a temporarily high tax bracket, the IRA distribution rules would permit the taxpayer to recognize income, and pay tax, gradually over a period of years. Under present law, the taxpayer could effectively avoid the increased tax burden created by a large gain placing the taxpayer in a temporarily higher tax bracket by selling the property on an installment basis. However, the installment sale does not offer the benefit of effectively exempting from tax the interest charged on the installment sale.

The ARA, by effectively exempting the income on the invested proceeds from tax, would provide a greater benefit to a taxpayer who otherwise would be in a high tax bracket than to a taxpayer in a lower tax bracket.

3. Exclusion of gain on the sale of farmland with an adjoining principal residence (S. 2202—Senator Kassebaum)

Present Law

In general, a taxpayer may elect to exclude from gross income up to $125,000 of gain from the sale of a principal residence if the taxpayer (1) has attained age 55 before the sale and (2) has owned and used the residence as a principal residence for three or more years of the five years preceding sale of the residence (sec. 121). In the case of property held jointly by a husband and wife who are filing a joint return, if one spouse satisfies the age, ownership, and use requirements, then both are treated as satisfying the requirements. Generally, farmland does not qualify under the definition of principal residence for purposes of the exclusion. The taxpayer may only make the election once in his or her lifetime.

Explanation of the Bill

The bill would modify the one-time exclusion of gain that applies to the sale of a principal residence by individuals who have attained age 55.

Specifically, the exclusion would be extended to include any adjoining farmland on which the principal residence is located. The exclusion would only apply to farmland sold with the principal residence. In addition, the exclusion would only apply to farmland which has been actively farmed by the taxpayer.

Effective date.—The bill would apply to sales and exchanges of principal residences occurring after December 31, 1991.

Analysis

Congressional intent behind the present-law exclusion of up to $125,000 of gain from the sale of a principal residence is based on

the belief that in the case of long-held assets such as a personal residence a substantial portion of any realized gain represents inflationary gain rather than a real (inflation adjusted) increase in economic value. The taxation of return to investment in the United States generally involves the imposition of the tax on the nominal return, rather than the real return. One rationale for attempting an adjustment for inflationary gains on principal residences is that for many taxpayers, their principal residence is their primary source of net wealth. Based on this rationale, it may be appropriate to extend the present-law exclusion to farmers for farmland contiguous to the principal residence, as the farmland generally represents the primary source of net wealth for family farmers. However, the same rationale would argue for extending the exclusion to any asset which represents a substantial portion of a taxpayer's wealth.

On the other hand, a uniform $125,000 exclusion from income is a very imprecise measure of inflationary gain. The extent to which the present-law exclusion offsets only inflation depends upon the taxpayer's basis in his or her residence, the taxpayer's holding period, the rate of inflation, and the real rate of return accrued by the residence. Thus, for a taxpayer who purchased a residence that had a very high real return during a brief period of low inflation, the present-law exclusion may offset all inflationary gains and a portion of the real gain. But, for a taxpayer who purchased a residence which had little real return during a period of higher inflation, the present-law exclusion may not offset all of the inflationary gain. Because present law does not attempt to accurately measure inflation, the benefit of the present-law exclusion accrues unevenly to taxpayers by location. Real returns to the ownership of real property are unequal depending upon where the property is located. S. 2202 would be expected to have the same effect as real returns to farmland have varied substantially depending upon location.

Frequently, the principal residence and farmland surrounding it are sold jointly. The principal residence may serve as an integral part of the farm operation (for example, serving as business office and dining hall for farm laborers). Administratively, it may prove difficult or arbitrary to apportion gain separately to the farmland and principal residence, and administrative ease may be facilitated by extending the present-law exclusion applicable to a primary residence to a primary residence and surrounding farmland. On the other hand, extending the exclusion to farmland would have the effect of extending the present exclusion for gain on a personal residence to business-related assets.

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