The Effect of the Federal Estate Tax on Ranch Owners in New Mexico

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Introduction

In recent years the federal estate tax has emerged as a controversial political issue. Opponents of the tax have sought to reduce or eliminate it, arguing in part that it places an unfair burden on family farms and small businesses. Although a number of studies have examined these effects nationwide[1], few have looked at the effects at the local level, making it difficult for policy makers and advocacy groups to assess the tax's local effects. In New Mexico in particular, some ranchers have expressed concern about their exposure to the tax. The purpose of this paper therefore, is to determine the extent of that exposure, beginning with an overview of how the tax works, followed by a brief examination of a national study on its effects, and finally, an analysis of its impact on New Mexicans and New Mexican ranchers.

How the Estate Tax Works

An estate is the total property owned by a person following their death, and the federal estate tax is a tax levied on this property.[i] The tax is calculated as a percentage of the estate's market value, but because of deductions and exemptions, in 2002 only about 1.17% of estates had to pay.[ii]

Of the various deductions and exemptions one of the most important is the Unified Credit, which automatically exempts a certain value of every estate from the tax. This exemption is currently $2 million, which means only the value of an estate in excess of this amount is subject to the tax.[2]

Other deductions and exemptions include, but are not limited to the following:

- The marital deduction, which exempts the value of the estate that passes to the surviving spouse. When used with a bypass trust[3] this effectively doubles the value of an estate that is tax exempt.[iii]

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[1] W. Gale and J. Slemrod provide an overview of a variety of economic studies on the estate tax in their paper "Rhetoric and Economics in the Estate Tax Debate" (2001). Available online at http://www.brook.edu/views/papers/gale/20010522.pdf#search=%22%22Harl%22%20%22Does%20Farm%20*%20Ranch%22%22

[2] The Unified Credit can also be used to offset the gift tax however this reduces the amount of exemption that can be applied to the estate. Because most people will never owe any gift tax and because it is easy to avoid, it is generally ignored in our analysis.

[3] For example, assume the Unified Credit exemption is $2 million and that spouse A owns a $4 million ranch. If a bypass trust has been arranged for, when spouse A dies, a trust will be established with $2 million of the deceased spouse's assets. The surviving spouse is the beneficiary of the trust, and also receives the remaining $2 million worth of spouse A's estate. Because of the marital deduction the transfer of both the trust and the $2 million worth of estate to the surviving spouse are tax exempt. Because the surviving spouse's access to the trust is restricted in some ways, when the surviving spouse dies the trust is not counted as part of their estate. The specified heirs then receive the $2 million trust tax free thanks to spouse A's Unified Credit exemption and the remaining $2 million tax free thanks to the other spouse's Unified Credit exemption. Source: http://www.finance.cch.com/text/c50s20d080.asp

- The special use valuation of land, which allows farm and real property used in a business to be valued at its actual use, instead of its market value. Reduction in value is capped at $900,000.[iv]
- Deductions for funeral expenses, charity, and debts owed by the deceased.[v]

Once all deductions and exemptions have been applied, the remaining taxable value of the estate is taxed at the maximum estate tax rate,[4] which in 2006 was 46%. Both this rate and the exemption provided by the Unified Credit are changing as a result of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001.[vi] Under this Act the Unified Credit exemption is scheduled to increase to $3.5 million in 2009, and in 2010 the federal estate tax is scheduled to be entirely eliminated. If no changes to the law are made however, in 2011 the tax will be reinstated with a higher tax rate and a lower exemption. Table 1 summarizes these changes.

Table 1

Year	Max. Tax Rate	Exempt Amount ($)
2001	55%	675,000
2002	50%	1,000,000
2003	49%	1,000,000
2004	48%	1,500,000
2005	47%	1,500,000
2006	46%	2,000,000
2007	45%	2,000,000
2008	45%	2,000,000
2009	45%	3,500,000
2010	0%	Tax Abolished
2011	60%	1,000,000

Sources: NAFEP[vii] and CBO[viii]

Table 2 illustrates how scheduled changes to the estate tax rate and exemption amount will affect estates of different values. Note that in this table it is assumed no deductions are made and that only the automatic exemption provided by the Unified Credit is used.

Table 2

Value of Estate	Estate Tax owed by Year of Death ($)					
	2006	2007	2008	2009	2010	2011
$1,000,000 or less	0	0	0	0	Tax Abolished	0
$2,000,000	0	0	0	0	Tax Abolished	600,000
$3,500,000	690,000	675,000	675,000	0	Tax Abolished	1,500,000
$5,000,000	1,380,000	1,350,000	1,350,000	675,000	Tax Abolished	2,400,000
$10,000,000	3,680,000	3,600,000	3,600,000	2,925,000	Tax Abolished	5,400,000

The National Effects of the Estate Tax

In July 2005 the Congressional Budget Office (CBO) released a study titled "The Effects of the Federal Estate Tax on Farms and Small Businesses." In it, the CBO examined estate tax returns from 2000 to determine how changes in the Unified Credit exemption would have affected farm estates owing federal estate taxes. The study found that if the 2006 exemption amount of $2 million were in place in 2000, 123 farm estates[5]

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[4] Unless some of the Unified Credit is used to offset the gift tax, the maximum tax rate is the only one that applies. Our analysis assumes no gift taxes are incurred.

[5] In this analysis the CBO defines a farmer as anyone who was reported to have worked in the "agricultural crop" or "livestock" industry and whose occupation was listed as "nonhorticultural farmer," "farm worker," "farm supervisor," or "farm manager."

nationwide would have owed federal estate taxes and 15 might have had to liquidate some of their farm assets to pay this tax. Raising the exemption amount to $3.5 million (currently scheduled to occur in 2009) would have resulted in 65 farm estates owing federal estate tax, and 13 with insufficient liquidity to pay it.[ix] See Table 3 for a summary of this study's findings.

Table 3		
Exemption Amount	**Estates Owing Estate Tax**	**Estates with Insufficient Liquid Assets to Pay Tax Liability**
All Estates		
Actual (in 2000)*	52,000	2,834
$1.5 Million	13,771	740
$2.0 Million	6,337	366
$3.5 Million	3,676	182
Estates of Farmers		
Actual (in 2000)*	1,659	138
$1.5 Million	300	27
$2.0 Million	123	15
$3.5 Million	65	13
* Estate tax returns filed in 2000 could be for people who died in either the last nine months of 1999 or in 2000. The actual estate tax exemption was that in effect on the date of death: $650,000 in 1999 or $675,000 in 2000.		

Source: CBO[x]

How the Estate Tax Affects New Mexicans

To examine the effects of the federal estate tax specifically on New Mexicans federal estate tax returns data from the IRS were combined with mortality statistics from the Center for Disease Control and Prevention (CDC) and NM Health Department to calculate the portion of New Mexican deaths resulting in payment of the federal estate tax. As Table 4 shows, in 2000 and 2001 when the estate tax exclusion amount was $675,000, less than 2% of deaths in New Mexico resulted in federal estate taxes being paid. In 2004, 100 New Mexican estates paid the tax out of 14,061 deaths.

Table 4				
New Mexican Estates Paying Federal Estate Tax				
Year	# Taxed	# of Deaths	% Taxed	Exclusion Amount
2000	182	13,384	1.36%	675,000
2001	200	13,979	1.43%	675,000
2002	275	14,312	1.92%	1,000,000
2003	98	14,636	0.67%	1,000,000
2004	100	14,061	0.71%	1,500,000

Sources: IRS[xi], CDC[xii], NM Health Department[xiii]

Although this data provides an accurate assessment of the number of New Mexican estates subject to the federal estate tax, it does not necessarily reflect how the tax affects New Mexican ranchers. Because there is no publicly available data on the number of New Mexican ranch owning estates that must pay federal estate taxes, related data must be examined to come up with estimates.

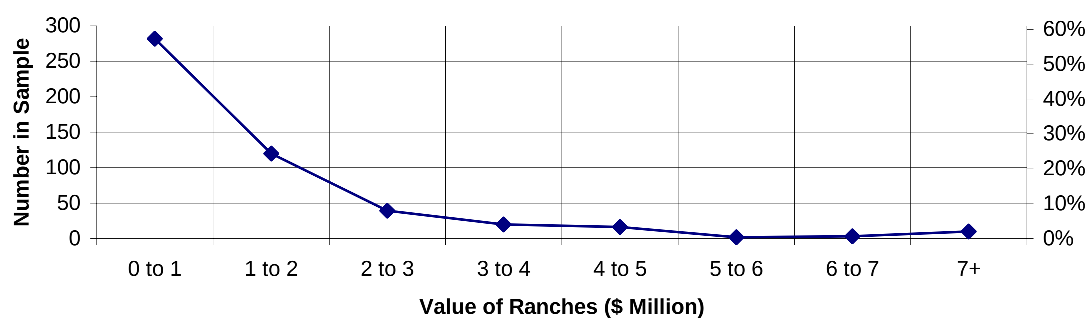
To do this New Mexico ranches were defined to be those farms in New Mexico classified as "beef cattle ranching and farming" (112111) under the North American Industry

Classification System. As of the 2002 Census of Agriculture there were 5,395 such ranches in New Mexico.[xiv] A ranch owning estate was then defined to be affected by the federal estate tax if the value of the ranch portion of the estate is worth more than the exemption automatically provided by the Unified Credit.

Since no information is publicly available about the value of ranches owned by each person in the state, estimates were obtained based largely on data collected between 1996 and 2002 by Farm Credit Services provided by NMSU professor of Agriculture Economics Dr. Allen Torell. This data provides a sample of New Mexico ranch values (minus livestock and equipment values) along with their livestock production potential. To calculate the total value of each ranch it was assumed that all ranches were at full livestock capacity with an animal unit year (AUY) value of $1,100.[6] The value of machinery and vehicles was then added in using data for a representative extra-large ranch in Northwestern New Mexico (this region was chosen because it had the highest machinery value of $26,000[xv]).

Chart 1

Distribution of Ranch Values in N.M. (sample size = 492)



Determining whether the owners of these ranches will be affected by federal estate taxes requires knowing how the value of these ranches is distributed. For example, owners of a ranch worth $10,000,000 could be completely unaffected by federal estate taxes in 2006 if there were 5 owners each of whom owned $2,000,000 worth of the ranch. Unfortunately, it is not known exactly how many owners each ranch has or what value of the ranch each owner owns. The 2002 Census of Agriculture does provide some indications however. According to the Census more valuable farms are more likely to have multiple owners and at least 2,135 (40%) New Mexico ranches have more than one owner.[xvi] There is also some

Table 5

Estimated Distribution of Ranch Values in N.M.

Value ($ Millions)			Number
0.0	to	0.5	1787
0.5	to	1.0	1305
1.0	to	1.5	768
1.5	to	2.0	548
2.0	to	2.5	296
2.5	to	3.0	132
3.0	to	3.5	164
3.5	to	4.0	55
4.0	to	4.5	77
4.5	to	5.0	99
5.0	to	5.5	0
5.5	to	6.0	22
6.0	to	6.5	22
6.5	to	7.0	11
7.0		+	110

[6] An animal unit year is the amount of forage consumed per by a 1,000 pound cow (Source: http://frsu.okstate.edu/eastern-research-station-1/haskell-field-tour-proceedings-2004/cow-calf-cost-estimates-for-forage-and-fertilizer). $1,100 is an estimate of the value of livestock supported by an AUY, provided by Dr. Allen Torell.

data on the organization of ranch ownership in New Mexico, which is summarized in the following table.

Table 6		
Ownership	**# of Ranches**	**% of Ranches**
Family or Individual	4,652	86.23%
Partnership	418	7.75%
Corporation	254	4.71%
Other	71	1.32%

Source: 2002 Census of Agriculture

Assuming that every ranch has a single owner, under the current exclusion amount of $2,000,000 no more than approximately 18% or roughly 987 New Mexican ranch owning estates could not completely exclude the value of at least one of their ranches from the federal estate tax. Under the exclusion amount of $3,500,000 scheduled to go into effect in 2009, at most about 7% or roughly 395 ranch estates could not completely exclude the value of at least one of their ranches from the tax.

Every ranch does not have a single owner however, so it might be more accurate to assume each ranch has either two equal owners, or one owner who is married and sets up a bypass trust. Under these assumptions the maximum number of New Mexican ranch estates that could not completely exempt the value of at least one of their ranches from the federal estate tax is about 340, or 6%, under the current $2,000,000 exemption, and about 110, or 2%, under the $3,500,000 exemption. This analysis is summarized in the following table.

Table 7			
Effects of the Federal Estate Tax on New Mexico Ranch Owning Estates			
Assumptions		# of ranches affected	% of ranches affected
Ownership	Exclusion Amount		
1 owner	$2.0 Million	987	18.29%
	$3.5 Million	395	7.32%
2 owners	$2.0 Million	340	6.30%
	$3.5 Million	110	2.03%

In reality, however, different New Mexico ranches have different numbers of owners. Without better data this analysis can provide only rough estimates.

The precision of this analysis is also complicated by other factors. For instance, it may overstate the number of ranchers affected because many ranch owning estates could probably reduce their exposure to the estate tax through estate planning. It may also overstate the number of ranches affected because the assumption that every ranch is operating at full livestock capacity is unlikely to be true. Alternatively, it is possible that this analysis understates the number of ranchers affected because according to the 2002 Census of Agriculture at least 1,372 New Mexico ranches owned machinery and equipment worth more than the $26,000 assumed. The Census data suggests that the market value of the average ranch's machinery and equipment is about $47,000.[xvii]

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[i] http://www.law.cornell.edu/wex/index.php/Estate_Planning
[ii] http://www.irs.gov/pub/irs-soi/histab17.xls
[iii] http://www.irs.gov/businesses/small/article/0,,id=98968,00.html & pg. 11 in http://www.cbo.gov/ftpdocs/65xx/doc6512/07-06-EstateTax.pdf#search=%22CBO%20effects%20of%20the%20estate%20tax%20on%20farm%22
[iv] http://www.irs.gov/instructions/i706/ch02.html#d0e995 & Dr. Tunnel
[v] http://www.irs.gov/pub/irs-pdf/p950.pdf
[vi] http://www.law.cornell.edu/wex/index.php/Estate_Tax#estate_and_gift_tax:_an_overview
[vii] http://www.nafep.com/public%20info/public-info_e-p-info_tools_taxes.htm
[viii] http://www.cbo.gov/ftpdocs/65xx/doc6512/07-06-EstateTax.pdf#search=%22CBO%20effects%20of%20the%20estate%20tax%20on%20farm%22
[ix] http://www.cbo.gov/ftpdocs/65xx/doc6512/07-06-EstateTax.pdf
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[xi] http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html
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[xiii] http://dohewbs2.health.state.nm.us/VitalRec/At%20a%20Glance%202000%20Updated.pdf
[xiv] http://www.nass.usda.gov/census/census02/volume1/nm/st35_1_059_059.pdf pg. 151, 155
[xv] http://costsandreturns.nmsu.edu/2006%20Ranch/Northwest%20X-Large.pdf
[xvi] http://www.nass.usda.gov/census/census02/volume1/nm/st35_1_061_061.pdf
[xvii] http://www.nass.usda.gov/census/census02/volume1/nm/st35_1_059_059.pdf pg. 153