Implications of the Tax Reform Act of 1976 for Farm Estate Planning

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An intergeneration transfer simulation model is used to project estate transfer costs and the value of transfers to the heirs before and after the tax reform act of 1976. Lower Federal estate taxes result for estates that qualify for the special use valuation of farmland provision of the new law. Replacing the $60,000 estate exemption with the $47,000 estate tax credit and revising the tax rate schedule increases Federal estate taxes when the taxable estate is between $1.175 million and $9.353 million. The new carryover basis rules for estate assets acquired from decedents dying after 1979 also increase transfer costs.

The Tax Reform Act of 1976 initiated major changes in federal estate and gift tax laws. The new law is complex and will have a profound influence on estate planning. A discussion of the major changes in estate and gift tax laws contained in the Tax Reform Act of 1976 is in Maynard and Laughlin. Uchtmann outlines the effect of the new estate and gift tax law on traditional farm estate planning techniques and discusses several new farm estate planning considerations introduced by the Tax Reform Act of 1976. Most empirical research evaluating farm estate planning strategies was completed prior to passage of the new legislation [Harl; Harrison; Allwood; Simunek; Buss; Boehlje]. An exception is the recent study by Epperson in which optimal gift policies determined under the legal environment prior to the Tax Reform Act of 1976 are also simulated under the new gift and estate tax laws.

The purpose of this article is to analyze the potential impacts of several of the major federal estate and gift tax changes on ownership transfer costs and estate planning strategies for farm firms. The analysis presented is a portion of a recent study of farm firm intergeneration transfer strategies [Roush]. The first section of this article summarizes the estate and gift tax law changes investigated. Next, the intergeneration transfer simulation model developed to analyze asset ownership transfer strategies and multi-owner farm business arrangements is described. The simulation results presented in this article focus on the total transfer costs and present value of transfers to the heirs before and after the Tax Reform Act of 1976 for an Oklahoma family farm business.

Tax Changes in the 1976 Reform Act

A unified tax credit for estate and gift taxes replaces the separate estate and gift tax exemptions in effect under the old law [I.R.C. Sec. 2010 and 2505]. The $60,000 exemption for estates and the $30,000 exemption for lifetime gifts are replaced by a $47,000 tax credit.[1] The $47,000 unified tax credit is equivalent to a $175,625 exemption.

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[1]The full $47,000 tax credit is effective for deaths occurring and gifts made after December 31, 1980. Prior to this date the unified tax credit is $34,000 in 1978, $38,000 in 1979 and $42,500 in 1980. For a detailed description of the "phase-in" schedule see I.R.C. Sec. 2010 and Sec. 2505.

Also, separate estate and gift tax schedules are replaced by a new unified tax rate schedule [I.R.C. Sec. 2001 and 2502]. A comparison of the new and old estate tax rate schedules indicates that the combined effect of changing the rate schedules and replacing the $60,000 estate exemption with the $47,000 tax credit is smaller federal estate taxes if the taxable estate is less than $1,175,000 or greater than $9,353,333.

Under the new law, the maximum estate marital deduction is one-half of the adjusted gross estate or $250,000, whichever is larger [I.R.C. Sec. 2056]. This change allows a larger maximum estate marital deduction for adjusted gross estates smaller than $500,000. The deduction is still limited to the value included in the decedent's estate that passes or has passed to the surviving spouse.

Under the new law, the executor may elect to value real property devoted to farming or other closely held businesses at its current use value rather than market value [I.R.C. Sec. 2032A]. There are a number of conditions that must be met by the decedent and the heirs to qualify for the current use valuation: 1. The value of the farm or other closely held business assets must comprise at least fifty percent of the decedent's adjusted value of the gross estate; 2. At least twenty-five percent of the adjusted value of the gross estate must be qualified farm or other closely held business real property; 3. The farm or other closely held business must pass to a qualified heir (member of decedent's family); 4. The real property must have been owned by the decedent and held for use as a farm five out of the last eight years preceding the decedent's death; and 5. The decedent or member of the decedent's family must have materially participated in the operation of the farm or other business for five out of the last eight years immediately preceding the decedent's death.

If within fifteen years of the decedent's death, the property is disposed of, or other requirements with respect to use of the property by the heirs are not met, part or all of the current use valuation benefits may be recaptured. The current use value of farm land can be determined by dividing the average annual gross cash rent for comparable farmland, less average property taxes, by the average annual effective interest rate for all new Federal Land Bank loans. The averages are computed on the basis of the five years immediately preceding the decedent's death. The current use value will be less than 50 percent of the market value appraisal for many farms [Matthews and Stock]. The special valuation cannot reduce the decedent's gross estate by more than $500,000 [I.R.C. Sec. 2032A].

In the past, heirs have received a new basis on inherited property, usually the value appraised for estate tax purposes. The Tax Reform Act of 1976 provided in general that the decedent's basis in property is to be carried over to the estate or heirs for deaths occurring after 1976 [I.R.C. Sec. 1023]. The Revenue Act of 1978 (Sec. 515) postpones the effective date of the carryover basis rules so that they will apply to property inherited from decedents dying after 1979. Unless the effective date of carryover basis is further postponed, the heir's basis for property inherited from decedents dying after 1979 will be the decedent's basis increased by appreciation occurring prior to December 31, 1976 and for estate taxes paid that are attributable to appreciation [I.R.C. Sec. 1023]. The value of the property for estate tax purposes is used in the formula to determine the amount of step-up in basis for pre-1977 appreciation. Thus, electing special valuation for farm real estate will result in a lower basis for inherited property.

If more than 65 percent of the adjusted gross estate is an interest in a farm or closely held business, the executer can elect a 15 year period to pay the portion of federal estate taxes attributable to such interest [I.R.C. Sec. 6166]. Payments on estate taxes can be delayed for up to 5 years after which taxes are paid in 10 equal annual installments. Interest on the unpaid balance is paid every year. Under this new delayed payment provision the interest rate is 4 percent on estate tax attributable to the first one million dollars of farm or closely held business property value [I.R.C. Sec. 6601]. Assuming the $47,000 tax credit in 1981, the maximum amount of deferred estate tax that can be subject to the 4 percent interest rate is $298,900. The regular rate of interest for deferred taxes applies to the amount of taxes attributable to the value of the farm or closely held business property exceeding one million dollars.

Several years will be required before all of the Internal Revenue Service regulations are finalized and various sections of the law are interpreted by the courts. Estate planning advisers must be able to assist farm families in developing ownership transfer strategies to be implemented under the new legislation which, in general, went into effect in 1977. This article presents an estate planning model and the results of an analysis of the potential impacts of federal estate and gift tax changes brought about by the recent legislation on asset ownership transfer costs and farm estate planning strategies.

The Intergeneration Transfer Model

A multi-owner family farm business simulation model is developed to represent the decision making environment and the economic activities for a family farm business during the time the parents are transferring control and ownership of the assets to younger members of the family. The model is structured to provide for multiple owner business arrangements and asset ownership transfers during the parents' lifetimes and at their deaths. The model allows firm growth through purchase of additional farm or nonfarm assets and rental of additional land.

The initial asset ownership situation is represented by an inventory of the farm and nonfarm assets owned by each family member (husband, wife, farm heirs and nonfarm heirs). Values describing the ownership method, market value, income tax basis, amount of debt secured by the asset, and other data needed to calculate change in market value, annual depreciation for income tax purposes and debt payments are provided for each asset owned.

The farm business arrangement is identified by specifying the legal form of business organization and describing the procedures for compensating resource owners. The initial legal form of business organization can be a proprietorship, partnership or corporation. If the firm is initially a corporation or a partnership, assets owned by the respective entity are included in the initial asset inventory. If the firm is initially a proprietorship, alternative legal business organizations are simulated by specifying input data for the beginning simulation year indicating the specific assets to be transferred to the new entity, the type of stock or shares issued and the tax option for a corporation. Parameters for calculating the value of contributions for each type of resource, information describing the procedures for compensating resource owners, rental rates, salaries, and dividends are specified by the user. The procedures used by the model to calculate income taxes on ordinary and capital gain income and social security taxes depend on the legal form of business organization.

Specific firm growth or ownership transfer strategies to be implemented during the planning horizon are provided through a set of annual decisions for each simulation year. Annual decisions may include lifetime ownership transfers by gift and sale, purchases of farm or nonfarm assets, renting additional farmland, changes in the family farm business arrangement and ownership transfers at the death of each parent. For example, a lifetime gift strategy may be defined by specifying the amount of specific assets to be given to each donee during each year of the planning horizon.

Information needed to evaluate a multi-owner farm business arrangement and ownership transfer strategy is derived by simulating the annual operation for a farm firm and its owners for a specified number of years. The timing of the parents' deaths is specified by the user. The estate transfer decision is implemented at the start of the simulation year in which a death event occurs. The estate transfer decision specifies the proportions of the decedent's estate that pass outright or in a life estate to the surviving spouse, to the farm heir(s) and to the nonfarm heir(s). The user also identifies the specific assets that are to be sold or liquidated by the estate at the decedent's death. The simulation model calculates administrative costs, federal estate taxes and Oklahoma estate taxes. Two versions of the model are used in this analysis to accommodate the estate and gift tax laws before and after the Tax Reform Act of 1976. The latter model includes procedures for special use valuation, 15-year installment payment of federal estate taxes, carryover basis rules and other provisions of the new law described in the previous section.

The simulation model provides several types of output values to evaluate asset ownership transfer and farm business arrangement alternatives. For each simulation year, the model performs a cash flow analysis showing the sources and uses of cash for each family member and prints net worth statements showing the changes in the asset ownership and financial position for each asset owner. At the end of the planning horizon the model prints the accumulated value of transfer costs, the present value of transfers to the heirs and the ending net worth of the heirs.

Farm and Family Situation

Data from an actual family farm situation in southwestern Oklahoma are used to analyze asset ownership transfer strategies and evaluate the Tax Reform Act of 1976. The family consists of the parents and three children. The ages of the husband and wife are 42 and 38, respectively. For planning purposes it is assumed that the son (age 18) will farm and the two daughters (ages 13 and 15) will pursue nonfarm occupations. Simulation experiments are conducted for a 45 year planning horizon. The husband plans to retire at age 62 (simulation year 21). The husband's death is assumed to occur at age 72 (simulation year 31) and the wife's death at age 78 (simulation year 41).[2]

The initial farm operation consists of 2,440 acres, of which, 640 acres are owned and 1,800 are rented. The main farm enterprises are wheat and stocker cattle. The financial statement for the case farm situation as of January 1, 1976 is presented in Table 1. The beginning net worth of the parents is $561,674 with a total debt outstanding of $182,938. All of the assets except 320 acres of land, the home and the life insurance are owned by the husband outright. The 320 acres of land and the home are owned in joint tenancy between the husband and wife. However, since the husband contributed the funds to acquire the real estate, all of the joint tenancy property is included in his estate. The wife owns a $185,000 insurance policy on the husband's life.

Although the current size of the farm business is large enough to provide a satisfactory standard of living and retirement of existing debt of the parents, the family would like to provide for continued firm growth through acquisition of additional land. Cash available after consumption, income taxes and scheduled debt payments is currently being used to upgrade the machinery capacity and to build equity for land purchases. Acquisition of additional land via rental and purchase would increase the utilization of machinery investment and provide an operation large enough for two families. The parents are willing to continue to use their investable funds to expand the size of farm business, at least until they reach retirement age. Thus, a systematic growth plan is followed for the farm firm subject to financial constraints. An additional 160 acres of land is rented every 3 years and, when possible, one of the tracts of land being rented is purchased every 5 years. Under these assumptions the number of

[2]The 45 year planning horizon may appear unreasonably long, given the uncertainty regarding future changes in estate and gift tax regulations. However, given the current ages of the members of the farm family and their expected lifetimes, the 45 year planning horizon is necessary to simulate the estate transfer costs.

TABLE 1. Beginning Financial Statement for Case Farm Situation, January 1, 1976

Item	Value	Value
Farm Assets Owned		
501 acres cropland ($625/Ac.)	$313,125	
114 acres native pasture ($400/Ac.)	45,600	
24 acres waste and roads ($200/Ac.)	4,800	
Fences	5,920	
Buildings and other improvements	21,496	
Machinery and equipment	85,208	
Farm vehicles	19,178	
Current inventory	200,491	
Farm checking account	500	
Total farm assets		$696,318
Non-Farm Assets Owned		
House and automobile	$ 36,060	
One acre land	400	
Retirement annuity	1,500	
Cash value of life insurance	2,677	
Personal checking account	7,657	
Total non-farm assets		$ 48,294
Total Assets Owned		$744,612
Farm Debt		
Real estate loans	$ 77,500	
Operating loan	87,353	
Total farm debt		$164,853
Non-Farm Debt		
Home loan		$ 18,085
Total Debt		$182,938
NET WORTH		$561,674

acres operated increases from 2,440 to 3,400 by the end of the year 20 just prior to the husband's retirement.

In addition, the parents want to make plans to provide for the transfer of control of their farm investment in a manner that is financially feasible for the son, equitable for the two daughters, and provides sufficient income from rent or other earnings for their retirement years. The parents are willing to make lifetime gifts to the children, provided income is not reduced below the amount needed for family living and debt retirement. The husband has a will leaving his estate to the wife outright. The parents want to consider other alternatives that will reduce estate transfer costs and increase the value of equity transferred to the heirs.

This analysis focuses on total transfer costs and the present value of transfers before and after the Tax Reform Act of 1976 resulting from alternative will strategies and lifetime gifts for this farm family situation. Will strategies evaluated include (a) leaving 50 percent of the husband's estate to the wife outright and the residual after taxes to the children, and (b) leaving 35 percent of the estate to the wife and the residual after taxes to the children. These will strategies are evaluated assuming no lifetime gifts are made by the husband and wife to the children. The second portion of the analysis focuses on the implications of the parents making taxable lifetime gifts to the children.

Analysis and Results

Under the land purchase assumptions specified above, the number of acres owned by the parents increases from 640 to 1320 at the time of their retirement (end of simulation year 20). For this analysis, land values increase at an annual rate of five percent and the inflation rate in annual receipts and expenses is 3.33 percent per year. When gifts are not made to the children the combined value of equity for the parents increases from $561,674 in simulation year one to $3,527,748 at the end of year 30 just prior to the husband's death. Prior to retirement (years 1 through 20) when additional land is being purchased at the start of each five year period, the average annual increase in the parents' equity is 7.07 percent. During retirement (years 21 through 30) the average growth rate is only 4.82 percent per year. The decline in the annual growth rate is partially due to inflation combined with higher marginal income tax rates.

Will Strategy A

Will Strategy A specifies that 50 percent of the husband's estate passes in fee simple to the wife and 50 percent of the estate value is equally divided among the three children. The wife receives 640 acres of farmland, the farm home and the automobile. The wife is also the owner and beneficiary of the life insurance policies on the husband, which have a face value of $185,000. The farm heir receives 360 acres of farmland and the two nonfarm heirs receive 320 acres. In order to provide equal values of transfers to each child, the farm heir purchases part of the land from the estate. Sales to the farm heir provide cash to pay estate settlement costs, liquid assets for the nonfarm heirs and additional control of farm assets for the farm heir. The estate taxes, sales expense and income taxes are paid from the childrens' share of the estate. The wife's inheritance is not reduced by taxes. The new 15-year delayed payment of federal estate taxes is used on the portion of estate taxes attributable to the farm assets included in the estate.

At the wife's death the estate value reduced by estate transfer costs is equally divided among the children. The farm heir receives 320 acres of farmland and the two nonfarm heirs receive 320 acres. The farm heir purchases part of the farmland from the estate to provide equal divisions of the estate value among the three children.

Estate transfer costs and the net value of transfers to the heirs before and after the Tax Reform Act of 1976 for Will Strategy A are shown in Table 2. The difference in gross estate values between the old and new law reflects the reduction from market valuation to use valuation on part of the farmland owned by the decedent. The 1320 acres of farmland included in husband's estate has a market value of $3,358,172 at the end of year 30. Based on the simulation results for this farm situation, the average net rent on farmland during the five years preceding the husband's death is nearly two percent of the market value of land owned. Assuming a 9 percent average effective Federal Land Bank interest rate, the current use valuation of the land is approximately 22 percent of market value. Under these assumptions the use value of the land owned by the husband is about $738,798. However, the maximum reduction in the gross estate allowed is $500,000. For all simulation results presented in this article, the husband and wife each own enough farmland at the time of their deaths to utilize the maximum reduction for use value appraisal.

It is assumed that the $500,000 maximum reduction in the gross estate for the special use valuation is applied to farmland based on the proportion of the estate received by each survivor.

Will Strategy A utilizes the maximum marital deduction for federal estate tax purposes at the husband's death. For this size estate, the maximum marital deduction is 50 percent of the adjusted gross estate (gross estate -

debt - administrative expense).[3] Federal estate taxes (after subtracting the state death tax credit and the $47,000 unified tax credit) are $402,941 on the husband's estate under the new law compared to $489,282 before the Tax Reform Act of 1976. The differences in sales expense and income tax between the old and new law represent the income tax on capital gain resulting from the new rules for determining the basis of estate assets which, under the revenue act of 1978, go into effect for deaths occurring after 1979. The income tax on the $403,451 of land sold at the husband's death is $33,271.[4] At the husband's death, the total transfer costs are $53,070 lower (692,266−639,196) and the net value of transfers to the children are $53,070 higher after the Tax Reform Act of 1976. Assuming the taxes and selling expenses are paid from the childrens' share, the net value of transfers to the surviving spouse does not change.

Immediately after the husband's death the wife's estate including the transfer from the husband's estate is valued at $1,878,536. Assuming the wife survives 10 years and no lifetime gifts are made to the children, the market value of the wife's estate increases to $3,023,840 at the time of her death. Federal estate taxes at the wife's death are $207,354 lower due to the Tax Reform Act of 1976. Sales expenses and income taxes are $49,299 higher due to the new carryover basis rules. Income taxes per dollar of sales are substantially higher at the wife's death compared to income taxes per dollar of sales at the husband's death due to the increase in value of the land and the resulting higher income tax bracket. Total transfer cost is lower and total value of transfers to heirs is higher by $158,055 at the wife's death under the new law.

For the purposes of evaluating the change in value of transfers due to the Tax Reform Act of 1976 and comparing alternative transfer strategies, the value of transfers at the wife's death is discounted to the time of the husband's death (year 30) to reflect the heirs' after-tax opportunity cost of equity capital and the decline in purchasing power due to inflation. Assuming a 3.5 percent discount rate the discounted value of transfers is $165,118 higher due to the changes brought about by the Tax Reform Act of 1976. Assuming a 7 percent discount rate, the value of transfers discounted to the time of the husband's death is $133,418 higher under the new law. The changes in estate transfer costs and value of transfers caused by the separate provisions of the law are analyzed later in this article.

Will Strategy B

Under Will Strategy A the estate taxes are much higher at the wife's death than at the husband's death because the wife's estate continues to increase in value and because the marital deduction is not available at the surviving spouse's death. Since marginal estate tax rates increase as the size of the taxable estate increases, estate taxes can generally be minimized by equating the marginal estate tax rates for the two estates. Assuming the wife survives the husband by 10 years and her estate grows at about the same rate as resulted under Will Strategy A, leaving the wife 35 percent of the estate would place each parent's estate in the same federal estate tax rate bracket. Table 3 shows the estate

[3]Administrative expense includes attorney's fee, court costs, other miscellaneous administrative expenses and funeral cost. The attorney's fees for the estates presented in this analysis are estimated at $16,100 on the first $500,000 net estate (market value of estate−debt) plus 2.50 percent of the excess. For the portion of the estate owned in joint tenancy, the attorney fee is estimated at $4,050 in the first $500,000 net estate held in joint tenancy plus .50 percent of the excess. Court costs and miscellaneous expenses are estimated at .10 percent of the net estate. Funeral cost is set at $1,500 in year one and increased by the assumed inflation rate (3.33 percent per year).

[4]Income taxes on estate sales are determined using the federal and Oklahoma income tax rates for estates and trusts on 50 percent of the gain. The amount of gain is determined by subtracting the carryover basis, after the adjustments for appreciation occurring before 1977 and the portion of taxes attributable to appreciation, from the market value reduced by selling expenses.

TABLE 2. Estate Transfer Costs and Net Value of Transfers Before and After Tax Reform Act of 1976 for Will Strategy A (50 Percent to Surviving Spouse)

	Old Law		New Law	
Item	Husband's Death	Wife's Death	Husband's Death	Wife's Death
Gross Estate	$3,534,254	$3,023,840	$3,034,254	$2,523,840
Debt	178,688	0	178,688	0
Admin. Expense	82,115	87,781	82,115	87,781
Marital Deduction	1,636,725	0	1,386,725	0
Specific Exemption	60,000	60,000	---	---
Taxable Estate	1,576,726	2,876,059	1,386,726	2,436,059
Federal Estate Tax	489,282	1,021,138	402,941	813,784
Oklahoma Estate Tax	111,388	215,284	111,388	215,284
Estate Sales	403,451	289,826	403,451	289,826
Sales Expense and Income Tax	9,481	7,103	42,752	56,402
Total Tax and Admin. Expense	692,266	1,331,306	639,196	1,173,251
Value of Transfers:				
To Spouse	1,636,725	---	1,636,725	---
To Heirs	1,026,575	1,692,534	1,079,645	1,850,589
Total Transfers to Heirs Discounted to time of Husband's Death:				
- Discount Rate -				
3.5%	$2,226,444		$2,391,562	
7.0%	1,886,973		2,020,391	

transfer costs and value of transfers for Will Strategy B which specifies that 35 percent of the husband's estate value passes to the wife and 65 percent is equally divided among the children.

Since the wife receives less than 50 percent of the husband's estate under Strategy B, the marital deduction is smaller than the maximum which was taken under Strategy A. Note that the marital deduction taken for Strategy B under the new law is $175,000 smaller than the marital deduction under the old law. If the full $500,000 reduction for use valuation could be taken on farmland received by the heirs, then the transfers to the wife would be valued for estate tax purposes at market value and the marital deduction would be the same under the old and new laws. The marital deduction would still be less than the maximum allowed (50 percent of the adjusted gross estate).

Comparing transfer costs for Strategies A and B under the new law indicates that leaving the wife 35 percent of the estate compared to 50 percent of the estate (Table 2) increases federal estate taxes at the husband's death by $156,696 but decreases federal estate taxes at the wife's death by $329,558. The same type of tradeoff exists for Oklahoma estate taxes. Total transfer costs for both deaths including income taxes and administrative expense under the new law are $1,564,992 for Strategy B compared to $1,812,447 for Strategy A. The discounted value of transfers reflects the difference in timing of net transfers after estate settlement costs between the two strategies. Assuming a 3.5 percent discount rate for the heirs, Strategy A would result in a higher discounted value of transfers than Strategy B. However, if the rate is 7.0 percent the net present value of transfers is higher for

TABLE 3. Estate Transfer Costs and Net Value of Transfers Before and After Tax Reform Act of 1976 for Will Strategy B (35 Percent to Surviving Spouse)

	Old Law		New Law	
Item	Husband's Death	Wife's Death	Husband's Death	Wife's Death
Gross Estate	$3,534,254	$2,168,423	$3,034,254	$1,668,423
Debt	178,688	0	178,688	0
Admin. Expense	82,115	65,180	82,115	65,180
Marital Deduction	1,145,708	0	970,708	0
Specific Exemption	60,000	60,000	---	---
Taxable Estate	2,067,743	2,043,243	1,802,743	1,603,243
Federal Estate Tax	677,375	667,330	559,637	484,226
Oklahoma Estate Tax	150,619	148,659	150,619	148,659
Estate Sales	528,341	99,549	528,341	99,549
Sales Expense and Income Tax	12,416	2,631	58,869	15,687
Total Tax and Admin. Expense	922,525	883,800	851,240	713,752
Value of Transfers:				
To Spouse	1,145,708	---	1,145,708	---
To Heirs	1,287,333	1,284,623	1,358,618	1,454,671
Total Transfers to Heirs Discounted to time of Husband's Death:				
- Discount Rate -				
3.5%	$2,198,026		$2,389,862	
7.0%	1,940,370		2,098,099	

Strategy B. Using the value of transfers under the new law, Strategy B would yield a higher discounted value of transfers than Strategy A when the discount rate is greater than 3.56 percent.

Using transfers resulting under the old law also shows the same kinds of conclusions. Under the old law Strategy B has a higher discounted value of transfers than Strategy A when the discount rate is greater than 4.58 percent. Thus, the change in the law caused by the Tax Reform Act of 1976 does not change the estate planning principle concerning use of the marital deduction for a large estate.

The changes in estate transfer costs caused by the separate provisions of the Tax Reform Act of 1976 are shown in Table 4 for Will Strategies A and B. The decreases in federal estate taxes are due to the special use value appraisal provision of the new law. For all situations investigated, each parent owns enough qualifying real estate to utilize the $500,000 maximum reduction for current use value appraisal. In general, the reductions in estate taxes resulting from use value appraisal increase as the taxable estates and as marginal estate tax rates increase. For example, under Will Strategy A, the $500,000 reduction in the taxable estate results in $219,754 lower taxes at the wife's death. The marginal federal estate tax rate (under new law) after adjustment for the state death tax credit is approximately 41.0 percent. For Will Strategy B, the taxable estate for the wife is in a 37.8 percent bracket and the reduction in taxes due to use value appraisal is $193,104.

Also, the reductions in the estate taxes resulting from use value appraisal are lower at the death of the first parent because use value appraisal of farmland passing to the surviving spouse reduces the marital deduc-

TABLE 4. Changes in Estate Transfer Costs and Value of Transfers Resulting from Various Provisions of the Tax Reform Act of 1976 for Will Strategies A and B

	Will Strategy A		Will Strategy B	
	Husband's Death	Wife's Death	Husband's Death	Wife's Death
Amount of Change in Federal Estate Taxes Due to:				
Special use valuation for farmland	−$ 93,941	−$219,754	−$127,738	−$193,104
Replacing $60,000 exemption with $47,000 credit and new tax rate schedule	+ 7,600	+ 12,400	+10,000	+ 10,000
Total	− 86,341	− 207,354	− 117,738	− 183,104
Capital Gain Income Tax on Estate Sales Due to New "Carryover" Basis Rules	+ 33,271	+ 49,299	+ 46,453	+ 13,056
Change in Total Estate Transfer Costs	− 53,070	− 158,055	− 71,285	− 170,048
Change in Value of Transfer to Heirs	+ 53,070	+ 158,055	+ 71,285	+ 170,048
Change in Value of Transfers to Heirs Discounted to Time of Husband's Death:				
Discount Rate				
3.5%	+$165,118		+$191,836	
7.0%	133,418		157,729	

tion. When the maximum marital deduction is used (Will Strategy A), the $500,000 reduction in the gross estate reduces the taxable estate by only $250,000 since the marital deduction is limited to 50 percent of the adjusted gross estate. Under Will Strategy B, the taxable estate at the husband's death is reduced by $325,000.

The results shown in Table 4 indicate that federal estate taxes for this estate situation would be substantially higher after the Tax Reform Act of 1976 if the estates did not qualify for the special use value appraisal. As mentioned earlier, the combined effect of changing the rate shcedule and replacing the $60,000 exemption with the $47,000 tax credit is higher estate taxes under the new law if the taxable estate is greater than $1,175,000, and less than $9,353,333. For taxable estates smaller than $1,175,000, the reduction in taxes due to the credit is greater than the increase in taxes due to the change in tax rates. All of the taxable estates shown in Table 4 are greater than $1,175,000 and the increases in taxes due to the combined effects of the new estate tax rates and $47,000 credit range from $7,600 for the smallest taxable estate to $12,400 for the largest taxable estate. Thus, the new estate tax law will increase estate taxes on large estates that do not qualify for the current use value appraisal provision.

The income tax on capital gain from sales of farmland to the farm heir results from the new carryover basis rules which are scheduled to go into effect for deaths occurring after 1979. As shown in Table 4, the income taxes are highest for Will Stategy A at the wife's death. Federal and Oklahoma income taxes are $49,299, which is approximately 17 percent of the value sold (Table 2). Although the value of sales is smaller at the wife's death compared to the husband's death, income taxes per dollar of sales are higher on sales made at the wife's death because the land increases in value for 10 additional years.

Lifetime Gifts

The gift strategy evaluated in this analysis includes a gift of $241,132 equally divided among all children in year 11, $6,000 in annual gifts to each child from year 12 to year 30, and $3,000 in annual gifts per child from year 31 to year 40. The property given to the children consists of 160 acres of land, inventory items (cattle and stored crops) and cash.

Although the property given to the children is owned by the husband the gifts are split between the husband and wife. Under both the old and new laws each parent has a $3,000 annual exclusion on gifts to each donee. Thus, in this example, the annual gifts made after year 11 are not taxable.

The Tax Reform Act of 1976 replaces the $30,000 lifetime gift exemption with a $47,000 unified estate and gift tax credit. Also, the gift tax rate schedule is now the same as the estate tax rate schedule. Under the old law, gift tax rates were three-fourth of the estate tax rates. Under the new law, gifts exceeding the annual exclusions reduce the amount of credit available for estate taxes.

In shifting from the old to the new law, the taxable gift for each parent in year 11 increases from $81,566 to $111,566. Under the new law, tentative gift taxes are $54,540; however, no federal taxes are due because each parent uses $27,270 of the $47,000 unified credit. Under the old law, the federal gift tax due in year 11 is $23,308. Due to the gift tax savings in year 11, the market value of the parents' estates will be larger under the new law compared to the old law.

The estate transfer costs and net value of transfers at the parents' deaths before and after the Tax Reform Act of 1976 are shown for the taxable gift strategy in Table 5. The estate transfer strategy used in this analysis is Will Strategy A (50 percent to the wife). Under the new law, the market value of the husband's estate is $2,235,472 ($1,735,472 plus the $500,000 reduction for use value appraisal). The net value of the husband's estate (market value minus debt) is $1,944,088 when the gifts are made compared to $3,355,560 when no gifts are made (Table 2). For each dollar of gifts made prior to the husband's death, his net estate value is reduced by approximately $2.42.

Under both the old and new laws, the transfer costs are lower and the discounted value of transfers to the heirs are higher when the taxable gift is made (Table 5) compared to the same values when gifts are not made (Table 2). The discounted value of transfers includes gifts made prior to the husband's death compounded to the end of year 30 and gifts made after the husband's death discounted to the end of year 30. Thus, for this estate situation making taxable gifts is still advantageous after the Tax Reform Act of 1976. Even after the gifts, the husband and wife still own enough land to utilize the $500,000 maximum reduction for use value appraisal. However, there is less incentive to make gifts after the Tax Reform Act of 1976 because the increase in the discounted value of transfers due to making gifts is smaller under the new law compared to the old law. After the Tax Reform Act of 1976, the value of taxable gifts is added to the taxable estate to calculate federal estate taxes.

Table 6 shows the changes in estate transfer costs attributable to the separate provisions of the Tax Reform Act of 1976 for the taxable gift strategy. The reductions in federal estate taxes caused by the new law are primarily due to the current use valuation of farmland. The current use value results in approximately $100,000 more savings in federal estate taxes at the wife's death than at the husband's death.

The effect of replacing the $60,000 exemption with a $47,000 credit and changing the estate tax schedule is to reduce federal estate

TABLE 5. Estate Transfer Costs and Net Value of Transfers Before and After Tax Reform Act of 1976 for Taxable Gift Strategy and Will Strategy A

	Old Law		New Law	
Item	Husband's Death	Wife's Death	Husband's Death	Wife's Death
Gross Estate	$2,181,346	$1,738,706	$1,735,472	$1,271,800
Debt	291,384	0	291,384	0
Admin. Expense	46,062	54,368	46,826	55,228
Marital Deduction	921,950	0	698,631	0
Specific Exemption	60,000	60,000	---	---
Taxable Estate	861,950	1,624,338	698,631	1,216,572
Taxable Gifts	---	---	111,566	111,566
Adjusted Tax Base	---	---	810,197	1,328,138
Federal Estate Tax	245,792	507,279	206,832	388,638
Oklahoma Estate Tax	54,846	115,147	56,847	117,726
Estate Sales	65,546	233,947	65,546	226,820
Sales Expense and Income Tax	1,540	5,790	7,610	45,568
Total Tax and Admin. Expense	348,240	682,584	318,115	607,160
Value of Transfers:				
To Spouse	921,950	---	948,631	
To Heirs	691,772	1,056,122	677,342	1,164,640
Total Transfers to Heirs Discounted to time of Husband's Death:[a]				
- Discount Rate -				
3.5% Gifts	$1,048,305		$1,048,305	
Estate	1,368,477		1,502,977	
Total	2,416,782		2,551,282	
7.0% Gifts	1,720,661		1,720,661	
Estate	1,156,651		1,269,386	
Total	2,877,312		2,990,047	

[a]Includes value of lifetime gifts to children. Gifts made prior to husband's death are compounded to time of husband's death and gifts made by wife are discounted to time of husband's death.

taxes at the husband's death by $6,261 and to increase them at the wife's death by $7,600. Since the husband's taxable estate is less than $1,175,000, the net effect of this provision of the new law is to decrease estate taxes.

Under the new law, the taxable gifts for each parent are added to the taxable estates shown in Table 5 to determine tentative federal estate taxes. The taxable estates and marginal estate tax rates are further increased by the larger estates resulting from the gift tax savings. The overall effect of the gift tax law change is to increase federal estate taxes by $51,288 at the husband's death and by $58,458 at the wife's death.

Oklahoma estate taxes and administrative expenses are higher under the new law due to the larger estates resulting from the savings in gift taxes in year 11. Also, the cost of selling estate assets is higher due to the new rules for determining the basis of estate assets. The net effect of all changes is $30,125 lower estate transfer costs at the husband's death and $75,424 lower costs at the wife's death. The increase in the value of transfers to the heirs resulting from the Tax Reform

TABLE 6. Changes in Estate Transfer Costs and Value of Transfers Resulting from Various Provisions of the Tax Reform Act of 1976 for the Taxable Gift Strategy and Will Strategy A

Item	Husband's Death	Wife's Death
Amount of change in Federal Estate Taxes Due to:		
Special use valuation for farmland	−$83,987	−$184,699
Replacing $60,000 exemption with $47,000 credit and new tax rate schedule	− 6,261	+ 7,600
Change in gift tax laws	+ 51,288	+ 58,458
Total	− 38,960	− 118,641
Capital Gain Income Tax on Estate Sales Due to New "Carryover" Basis Rules	+ 6,070	+ 39,778
Change in Oklahoma Estate Taxes and Administrative Expense Due to New Gift Tax Laws	+ 2,765	+ 3,439
Change in Total Estate Transfer Costs	− 30,125	− 75,424
Change in Value of Transfers to Heirs	+ 57,570	+ 108,518
Change in Value of Transfers to Heirs Discounted to Time of Husband's Death:		
Discount Rate		
3.5%	+$134,500	
7.0%	+$112,735	

Act of 1976 is greater than the savings in estate transfers costs due to the larger estates resulting from the gift tax savings in year 11. The discounted value of transfers to the heirs is increased by $134,500 with a 3.5 percent discount rate and $112,735 with a 7 percent discount rate after the Tax Reform Act of 1976.

Summary and Conclusions

This analysis of the Tax Reform Act of 1976 focuses on the long-run impact of the changes in federal estate and gift tax laws. An intergeneration transfer simulation model is used to project estate transfer costs and the value of transfers to the heirs under selected estate transfer strategies for an Oklahoma farm and family situation. The results of this analysis indicate that estate transfer costs are lower and the discounted value of transfers to the heirs are higher after the Tax Reform Act of 1976 for all estate transfer strategies simulated. The lower federal estate taxes result from the special use valuation for farmland provision of the new law. For large estates that do not meet the qualifications for current use valuation of farmland, the results will be higher federal estate taxes and lower discounted value of transfers under the new estate tax laws. The combination of replacing the $60,000 estate exemption with a $47,000 estate tax credit and the new estate tax rate schedule increases federal estate taxes when the taxable estate is greater than $1,175,000 and smaller than $9,353,333. Another source of increased transfer costs introduced by the Tax Reform Act of 1976 is the new carryover basis rules for estate assets which will be applied to property acquired from decedents dying after 1979. As shown in this analysis, sales of appreciated estate property will result in a substantial income tax liability for the estate or heirs.

For the farm situation analyzed, making taxable gifts to the children reduces estate transfer costs and increases the discounted value of transfers to the heirs under both the old and new laws. However, both parents own enough farmland after the gifts to utilize the maximum reduction allowed for current use valuation at their deaths. For gift tax purposes, assets are valued at market value rather than at current use value. Thus, for estates that will not be large enough to utilize the maximum current use value reduction, making taxable gifts of farmland could result in higher transfer costs compared to making the transfer at the owner's death. Developing a plan to achieve the maximum benefits from the special use valuation provision of the new law will require simultaneous evaluations of alternative investment, retirement and ownership transfer strategies for the individual farm and family situation.

The implications that can be made from this analysis concerning the economic outcome of alternative gift and estate transfer strategies are limited by the use of a specific farm and family situation and by the assumptions made about the future economic environment and timing of death events. Different assumptions about the timing of death events, rates of change in asset values, inflation rates, investment decisions and other variables that determine the future size and composition of the parents' estate will affect the simulation results for the will and gift strategies.

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