Department of Legislative Services
Maryland General Assembly
2011 Session

FISCAL AND POLICY NOTE

Senate Bill 783 (Senator Middleton)
Budget and Taxation

Estate Tax - Qualified Agricultural Property - Forest Banking Operations

This bill specifies that property operated by a forest banking operation is included in the definition of "qualified agricultural property" for purposes of the deferral of estate tax payments for agricultural property used primarily for farming purposes, as administered by the Comptroller's Office.

The bill takes effect July 1, 2011, and applies to decedents dying after December 31, 2010.

Fiscal Summary

State Effect: To the extent the Comptroller's Office grants additional estate tax payment deferrals as a result of the bill, general fund revenues will decrease in the year in which the estate taxes were due. General fund revenues will increase in later fiscal years by a corresponding amount under the tax payment schedules prescribed by the Comptroller's Office. No effect on expenditures.

Local Effect: None.

Small Business Effect: Minimal.

Analysis

Bill Summary: The bill specifies that property operated by a forest banking operation is eligible for the deferral of estate taxes for qualified agricultural property. A forest banking operation is defined as an entity that determines the method, timing, and intensity of harvesting and replanting for all lands that enroll with the entity in exchange for an annual payment. The forest banking operation property of an estate qualifies for the deferral of estate taxes regardless of whether the owner of the land materially participates in the active use of the land, within the meaning of Section 2032A of the Internal Revenue Code (IRC) and applicable regulations.

Current Law: Chapter 554 of 2010 requires the Comptroller to allow a payment deferral for up to three years for the Maryland estate tax imposed on qualified agricultural property that passes from a decedent to or for the use of a qualified recipient. The provision allowing an interest-free deferral of estate taxes of up to $375,000 expires June 30, 2014.

Qualified agricultural property includes real and personal property that is used primarily for farming purposes, as defined in Section 2032A(E)(5) of IRC. As defined in this section of IRC, farming purposes means cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm.

A qualified recipient is an individual who enters into an agreement to use qualified agricultural property for farming purposes after the decedent's death.

The amount of tax eligible for deferral is the amount equal to the Maryland estate tax owed multiplied by the percentage resulting from dividing the value of the qualified agricultural property that passes from the decedent to or for the use of a qualified recipient by the value of the gross estate of the decedent. The amount of tax that may be deferred for any one decedent may not exceed $375,000. To be eligible for a payment deferral, a qualified recipient must file an application and enter into an agreement in a form specified by the Comptroller to use the qualified agricultural property for farming purposes after the decedent's death and to file periodic reports or allow periodic inspections as required by the Comptroller.

Background: Although business and farm assets compose a small percentage of total assets reported by estates, the Congressional Budget Office (CBO) notes that considerable debate has focused on the potential negative impact of the estate tax on these operations. Federal estate law provides for additional estate tax relief for small businesses and farms to address concerns that the federal estate tax could hinder families who wish to pass on a farm or small business to their heirs. Most of these provisions allow for a reduction in the value of the estate for federal estate tax purposes; this reduction generally flows through to the Maryland estate tax and results in a reduction in State tax liability as well.

Forest Banking Operations

Individuals who own forest land may determine to cede development rights on their forested property in exchange for an annual payment, based on the assessed value of timber on the land. Forest banking may be administered through the private sector and is intended to ensure environmentally sensitive forest management, while guaranteeing forest landowners a regular source of income. Landowners who enroll in a forest banking operation waive development rights (*e.g.*, timber harvesting, construction, or mining) for at least a portion of the forest land in their possession. The bank manages the collection of forest land enrolled by landowners. The bank also determines the method, timing, and intensity of harvesting and replanting for all forest lands enrolled in the program. Revenues from timber harvesting are deposited in private investment funds. Participating landowners receive an annual payment from these funds that depends on the returns secured by the investments.

Special-use Valuation

The value of the property for federal estate tax purposes, and the basis for the State estate tax, is generally the fair market value at the time of the property owner's death. Under certain circumstances, farm and closely held business real property can be valued at its current farm or business use rather than the fair market value. Special-use valuation can reduce the value of the real property portion of estates by up to a maximum reduction of $1 million, which translated to a maximum federal tax reduction of $450,000 in 2009. The U.S. Department of Agriculture (USDA) estimates that special valuation reduced the value of qualifying farm estates by an average of 50% in 2001. USDA notes that the largest reductions under this provision occur for farmland having the potential for residential or commercial development, which is typical of many Maryland farms. Special use tax benefits must be repaid if certain conditions are not met, such as the property being sold to a nonfamily member or ceasing to be used as a farm within 10 years of the decedent's death.

This valuation method is similar to property tax assessments for agricultural land, which value the land at its current use instead of at its potential market value at its highest use, which is typically much higher.

Exclusion for Land Subject to Conservation Easement

Farmers and other landowners can exclude for federal estate tax purposes up to 40% of the value of land subject to a qualified conservation easement. The maximum exclusion of $500,000 does not include the reduction in the land's value resulting from the easement and as a result the combined reduction resulting in the estate from the easement can be significantly higher. USDA notes that donating easements can be especially beneficial for farmers near urban areas. In 2005, estates made 2,307 conservation easement donations totaling $1.8 billion.

Valuation Discounts

Reported asset values may be reduced through the use of valuation discounts for certain characteristics or qualities like minority ownership or lack of marketability. These discounts are generally reported on assets associated with a privately held business (including farms) and reflect the fact that holding a fractional, noncontrolling share in a business reduces the value of that ownership share and that these fractional shares are more difficult to sell. According to the Internal Revenue Service, 5,909 returns filed for decedents in 2004 included a valuation discount, comprising 14% of all returns. Of the $6.5 billion reduction from the value of estates, a little more than one-half was for stock, followed by real estate (about one-fifth), limited partnerships (13%), farms and farmland (5%), and noncorporate business assets (3%). Overall, discounts reduced the total gross estate by 3.4% but varied significantly by asset type with limited partnerships having the highest discount (15%).

Installment Payment of Estate Taxes

Congress enacted legislation allowing certain businesses to spread out estate taxes over several years out of concern that the heirs of small businesses and farmers might have difficulty paying taxes on estates with illiquid assets such as land and business assets, thus forcing heirs to sell assets or sell the business. Certain businesses, including qualifying farms, are allowed to pay estate taxes over a 15-year period, with interest due only for the first 5 years (at 2% on the first $1.33 million). According to USDA, this provision, combined with an increase in the amount of property that can be transferred tax free, greatly reduced the liquidity problem that some farm heirs might experience as a result of federal estate tax liability. In 2005, only 382 estates in the United States, or about 2% of all estates with tax liability, elected to defer federal estate taxes.

State Revenues: The bill specifies that property operated by a forest banking operation is eligible for the deferral of estate taxes for qualified agricultural property. To the extent the Comptroller’s Office grants additional estate tax payment deferrals as a result of the bill, general fund revenues will decrease in the year in which the estate taxes were due. As a result, general fund revenues may decrease in fiscal 2012, 2013, and 2014 and increase by a corresponding amount over the three-year repayment period in subsequent fiscal years.

The Comptroller’s Office was unable to provide data on the number of payment deferrals granted, if any, under the program. The program applies to the estates of decedents dying after December 31, 2010. In general, estate tax returns for decedents dying in calendar 2011 would not be required to be filed with the Comptroller's Office until October 2011 at the earliest.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Congressional Budget Office, Comptroller's Office, U.S. Department of Agriculture, Department of Legislative Services

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