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THE APPLICATION OF SPECIAL ESTATE AND INHERITANCE TAX LEGISLATION TO AGRICULTURAL ESTATE PLANNING AND SETTLEMENT

By

Mark D. Dopp

Ralph E. Hepp

Department of Agricultural Economics
MICHIGAN STATE UNIVERSITY
East Lansing

MSU is Affirmative Action/Equal Opportunity Institution

The Application of Special Estate and Inheritance Tax Legislation To Agricultural Estate Planning and Settlement

Mark D. Dopp and Ralph E. Hepp*

Estate taxation and planning is becoming increasingly important to family farmers throughout Michigan and the rest of the country. What was once "the rich man's tax" is now affecting many people who had no idea they were subject to the tax. Rapidly rising land values and larger farm businesses have pushed many farmers to a taxable level. The efficient transfer of property from one generation to another is a necessity today in order to maintain family farms.

The federal estate and gift tax reform of 1976 and the Michigan tax revision of 1979 incorporated special farm provisions for reducing or deferring death taxes. Federal estate tax provisions discussed are the special use valuation (Section 2032A), estate tax deferral (Section 6166 and 6166A), and joint tenancy property exclusion in an estate where the spouse has had material participation in management (Section 2020(b) and 2040(c)). The Michigan inheritance tax provision discussed is the exemption and deferral of inheritance taxes on farm real property. The objective of this paper is to explain the technical characteristics of recent estate tax legislation aimed at agricultural situations, show the operation of the provisions and discuss issues estate planners should be aware of concerning these provisions.**

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*Former Research Assistant and Professor Department of Agricultural Economics, Michigan State University Michigan Agricultural Experiment Station Journal Article No. 10056.

**The federal estate and gift tax law in effect on July 1981 are explained and applied in the case examples. The August 1981 reform passed by the U.S. Congress liberalized the unified credit, marital deduction, annual gift exclusion and other provisions which increases the estate size before the special farm provisions will be considered. However, the tools and issues discussed in the paper are still applicable to farm estate planning and settlement situations.

Twenty-five attorneys throughout Michigan who do estate planning and settlement for farm clients were interviewed. To provide background information for the procedural difficulties in applying the tools and clarifying the issues surrounding the use of the tools. Their names were selected by asking agricultural professionals around the state which attorneys worked with farmers in estate planning. The results of these interviews and an extensive literature review comprise the basis for the paper.

Section 2032A: Special Use Valuation

Qualification

For an estate to qualify for the special use value provision, the land must be "qualified real property," defined as, real property in the United States acquired by a qualified heir of the decedent and used for a qualified use.[1] Qualified use entails either use as a farm or for farming purposes or use in a trade or business other than farming.[2] A farm includes stock, dairy, poultry, fruit, furbearing animals, and truck farms; ranches; plantations; ranges; greenhouses and other structures used for the purpose of raising horticultural or agricultural products; orchards; and woodlands.[3] "Farming purposes" means 1) cultivating the soil, raising or harvesting agricultural products on a farm, 2) handling, drying, packing, grading or storing of an agricultural product or 3) raising and cutting trees or preparing trees for market.[4] A qualified heir for purposes of section 2032A is a member of the decedent's family and could refer to an ancestor, lineal descendent, the lineal descendent of a grandparent, or spouse of either the ancestor or lineal descendent. A legally adopted child is also a qualified heir.[5] These people could be qualified heirs. However, a qualified heir is one who actually acquires the property.

Qualified land must have been owned by the decedent and used for a qualified use by the decedent or qualified heir for periods aggregating five years or more of the eight years preceding the decedent's death. There must also have been material participation by the decedent or qualified heir (to be determined similar to the manner used for self-employment earnings tax, paragraph (1) of section 1402(a)). Section 1402(a)(1) imposes a self-employment tax on rental income received by an owner-lessor of farmland that participates in the farm management.[6] Unless the decedent or qualified heir can show material participation to the extent that the self-employment tax was or should have been paid there can be no qualification.

The personal representative of an estate can choose the special use provision if 1) the adjusted value of real or personal property being used for a qualified use and acquired by the qualified heir constitutes 50 percent or more of the adjusted value of the gross estate and 2) if 25 percent or more of the adjusted value of the gross estate is qualified real property.[7]

Implementation

If the personal representative elects to have the estate valued under the special use provision, then one of two valuation methods may be used--the cash rental capitalization method or the multiple factors method. The cash rental capitalization method values land by the following equation:

$$\frac{\text{5 year average gross cash rent - 5 year average state and local property taxes}}{\text{Average annual effective interest rate for new Federal Land Bank loans reported by the IRS the year of the decedent's death}}$$

The cash rental and property taxes used in the equation must be land comparable to the estate property used for farming purposes and located in the vicinity of the estate's land. The method cannot be used if there is no comparable land from which to obtain cash rental and property taxes or if the

multiple factors method is used. The multiple factors method uses various criteria to establish the land value including income capitalization of the property under prudent management, assessed land values in a state which provides use assessment for farmland, rent capitalization, sales of comparable farmland in the same area (provided nonagricultural uses of the land are not a factor in the price), and any other factors which fairly value the farm.[8]

Obligations

Property valued according to the special use provision (section 2032A) must be farmed for 15 years by the qualified heir. Failure to do so results in a recapture tax levied when the property no longer qualifies for special use. The benefits, taxes saved, enjoyed by the heir are paid back, "recaptured," to the government. A recapture tax may also be levied on the property which ceases to qualify for the special use provision because there has been no material participation for periods aggregating three years or more during any eight year period after the decedent's death and prior to the qualified heir's death. The maximum recapture tax is equal to the amount of estate tax originally saved, but will be the lesser of either the tax originally saved or the difference between the proceeds of an arms length sale and the special use value of the interest.[9]

If an estate is valued under section 2032A, a lien in favor of the United States is established and is enforceable until there has been a 15 year lapse of time or until the Secretary of the Treasury is satisfied that no further liability to the government exists.[10]

If part of the estate is sold or if it is no longer used for a qualified purpose, the estate is subject to a recapture tax. The tax on the part of the property which is sold is calculated on a pro rata share of the value of the

interest. These procedures apply where failure to comply with the provision requirements occurs within ten years after election.[11]

Disposition of property or cessation of the qualified use after the 10th year, but before the end of the 15th year following the decedent's death would also subject the estate to a recapture tax. In this case, the tax is reduced by an amount calculated as follows:

$$\text{full recapture tax} \times \frac{\text{Number of months since the decedent's death in excess of 120}}{60}$$

The additional tax is due six months after disposition of the property or cessation of the qualified use.[12] An involuntary conversion of an interest in qualified property results in no tax if qualified replacement property is purchased for an amount equal to or exceeding the conversion value. Qualified replacement property is either real property into which qualified real property is converted or real property bought by an heir for purposes of replacing qualified real property. Replacement property is treated the same as the converted qualified real property except that the 15-year use period, and the phaseout period are extended.[13] These two periods are extended by the amount of time in excess of two years it takes to find replacement property. For example, if it takes 2.5 years to find replacement property, the 15-year use period and the phaseout period are only extended six months beyond their initial completion date. If the replacement property is purchased a year after the involuntary conversion, the dates for the 15-year use period and the phaseout period remain the same as at the time of the initial election. If complete reinvestment does not occur, a tax is imposed in a similar manner to that levied on a voluntary conversion.

All persons having an interest in property under section 2032A must sign an agreement consenting to application of the recapture tax for failure on the part of the heirs to comply with the regulations. A qualified heir is personally liable for these taxes unless the heir has furnished bond.[14] The heir may write to the Secretary of the Treasury and request notification of the maximum amount of tax for which the heir is liable and may then furnish a bond for the amount and time period necessary to discharge personal liability.[15]

Case I: Section 2032A

Situation I

Situation I demonstrates the use of special use valuation in a relatively large estate. A widow, age 74, dies and leaves her entire estate to her two sons, ages 50 and 48. The younger son is married with two children and the older son was divorced many years ago.

The decedent owned 1,000 acres of farmland with a fair market value of $2,250 per acre. She inherited the land from her husband upon his death ten years before. The two sons are partners in a cash grain operation and rent all the land from their mother. They have rented the land from her since their father's death and they own all of the machinery and equipment in the farm operation.

The mother's gross estate is $2,675,000 of which $2,250,000 is tied up in land. The mother took an active part in the decision making and management of the farm until her death. Her balance sheet is listed in Table 1.

Table 1. Balance Sheet--Situation I

Assets		Liabilities	
Farm real property	$2,250,000	Mortgage	$ 240,000
Other real property	175,000	Total Liabilities	240,000
Personal property	50,000		
Life insurance	50,000		
Savings	150,000	Net Worth	2,435,000
Total Assets	$2,675,000	Total Liabilities and Net Worth	$2,675,000

The decendent's net worth, gross estate less debts, is $2,435,000 and the probate and administration costs of are estimated at $144,360. Therefore, the adjusted gross, and the taxable estate is $2,290,640.

In order to qualify for special use valuation, the estate must meet minimum percentage requirements. The adjusted value of the real and personal property in the farm business must be at least 50 percent of the adjusted value of the decendent's gross estate and real property must comprise at least 25 percent of the adjusted value of the gross estate. The qualified real property constitutes 87.7 percent of the adjusted value of the gross estate and both requirements are met.

The tentative federal estate tax due if special use is not elected, is $923,213. The federal government allows a reduction in federal estate tax for state inheritance taxes owed by the heirs. The amount deductible is the lesser of two amounts, the state death taxes paid or the amount of the state death credit allowable in the Internal Revenue Code. State inheritance taxes levied in this case amount to $171,664 while the federal credit is $122,051. Therefore the federal tax payable could be reduced by $122,051. Another credit granted by the federal government is the unified credit of $47,000 or a tax exemption for the equivalent of $175,625 worth of assets. The final federal estate tax due on the decedent's estate is $754,161 (Table 2).

Table 2. Estate Tax Calculation--Situation I

	Without section 2032A election	With 2032A election
Taxable estate	$2,290,640	$1,790,640
Tentative federal tax	923,213	686,588
(State tax credit)	(122,051)	(84,526)
(Unified credit)	(47,000)	(47,000)
Federal tax due	754,162	555,062
State inheritance tax	171,664	171,664
Total taxes	$ 925,826	$ 726,726

Tax difference = $199,100

If this estate had elected to use section 2032A however, the estate taxes could have been reduced. Under section 2032A decedent's land would not be included in the estate at fair market value. Instead it would have been valued according to the following equation.

$$\frac{\text{(5 year average cash rent) } \$75 - \text{(5 year average property tax) } \$27.5}{\left(\begin{array}{l}\text{Average annual effective interest rate for new} \\ \text{Federal Land Bank loans reported by the IRS the} \\ \text{year of the decedent's death}\end{array}\right) \quad 10.3\%}$$

This equation places a value of $461.16 per acre and a total worth of $461,160 on the land. The maximum deduction allowable under section 2032A is $500,000. Taking the maximum reduction, the land is included in the decedent's estate at $1,750,000 instead of $2,250,000. This reduces the taxable estate to $1,790,640. The state death credit is changed because it is a function of the value of the taxable estate. It is now $84,526. The state inheritance taxes remain the same because the land is still included at fair market value for state inheritance tax purposes. The tentative federal tax due is $686,588. Reducing this figure by the allowable state death tax credit of $84,526 and the federal unified credit of $47,000, the federal estate tax due is $555,062. Election of special use valuation saved the estate $199,100 in federal taxes (Table 2).

Situation IA

Farm situation IA involves a widow that dies at age 62. She has two children, a son and a daughter who are both married. The son has a wife and three children and operates the farm, while the daughter and her family live off the farm. The mother and son operated a dairy farm as a partnership. The mother received the land from her husband's estate. The decedent owned all of the land, 325 acres valued at $1,500 per acre. The son meanwhile, owned most

of the machinery and livestock. The decedent's balance sheet is shown in Table 3.

Table 3. Balance Sheet--Situation IA

Assets		Liabilities	
Real farm property	$ 487,500	Real estate debt	$ 110,000
Machinery	20,400	Other liabilities	50,000
Livestock	15,000		$ 160,000
Life insurance	10,000		
Cash and bonds	5,000	Net Worth	377,900
Total Assets	$ 537,900	Total Liabilities and Net Worth	$ 537,900

The estate meets the minimum percentage requirements to qualify for section 2032A, therefore the decision must be made whether to elect special use valuation or not. This case differs from the previous case in two respects. First, the estate is much smaller. In this situation the taxable estate is $350,403 compared to the previous estate which had a taxable estate of $2,290,640. Since the estate tax rates are progressive, the larger estate will incur a much larger tax liability. Second, the first case had both children operating the farm as a partnership. In this case, the daughter lives in the city and is not involved in the farm operation at all. If section 2032A is elected, both heirs must sign an agreement that makes them liable for failure to keep the land in a qualified use. The off-farm heir may have reservations about agreeing to such an action, since she has no active involvement in the farm business.

If special use valuation is not elected, the tentative federal estate tax is $104,937. The state inheritance tax for the estate is $11,616 while the

state death tax credit is only $5,212.80. Therefore, the state death tax credit is deducted from the tentative federal estate tax due. Use of the $47,000 federal unified credit further reduces the federal tax due to $52,725. If special use valuation is elected, the federal estate tax is eliminated. (See Table 4).

Table 4. Estate Tax Calculations--Situation IA

	Without 2032A election	With 2032A election
Gross estate	$537,900	$199,150
Debts, mortgages	(160,000)	(160,000)
Prob. & adm. costs	(27,497)	(27,497)
Taxable Estate	$350,403	$ 11,753
Tentative federal tax	104,937	2,151
State tax credit	(5,212)	(5,212)
Unified credit	(47,000)	(47,000)
Federal tax due	52,725	0
State inheritance tax	11,616	11,616
Total taxes paid	$ 64,341	$ 11,616

In each of these cases, decisions must be made whether to elect special use valuation and how the election will affect the heirs. In the first case, the tax bill is substantial and may dictate that a course of action be taken. Also, in the first case there are no off-farm heirs who may object to the implementation of section 2032A. The lien is in effect and its existence may create some disagreement, but with a federal estate tax bill of over $750,000 these arguments would probably become less frequent.

The second case may be more difficult to analyze. To determine whether the election is beneficial, one must look at more than the taxes saved. Election of section 2032A imposes restrictions upon the heirs and their use of the property. If the property is used for farming there are no significant costs to the heirs and election may be very beneficial. The extra costs that may be

incurred in administering an estate that elects section 2032A would not be nearly as much as the taxes saved. The heirs must decide whether the restrictions placed upon the land use by section 2032A election are worth the amount of taxes saved. As the estate tax liability increases, the heirs may be more willing to elect special use valuation than cases in which the estate tax is not as large. The tax savings needed before 2032A is elected varies because each farm situation is different.

Special Use Valuation Issues

The technical requirements and operation of the code have been discussed, but there are a number of issues surrounding section 2032A. Two of the most important are questions regarding material participation and basis.

The estate planner must be aware of what will and will not qualify as material participation. Of interest here is an interpretation by the IRS of the material participation requirement. It is clear from the code and the regulations that material participation cannot be achieved through agents or employees. Section 2032A(b)(1)(C)(ii) allows a member of the decedent's family to operate the farm to meet the pre-death material participation requirements. However, one attorney interviewed has encountered resistance on the part of the IRS in qualifying the farm through an heir's management participation.

In the past, the IRS has ruled a decedent's rental of his farm to his son under a "net lease" was a passive investment rather than an active trade or business and, thus, the farm was not eligible for special use valuation. However, the Treasury Department has reported it will amend its regulations to permit the special use valuation of (1) property interest held in discretionary trusts that have been created solely for the benefit of qualified heirs, and (2) property used under a passive rental arrangement between the decedent

and members of his family. The proposed regulation should clarify the conditions whereby an heir can qualify for material participation requirements during the decedent's lifetime.

The retired farmer dilemma is another issue regarding material participation. The farmer retires from active farming, leases the land to a non-qualified neighboring farmer and applies for social security benefits. Assume that the farm will be inherited by a son who will actively farm the land in the future and thereby will qualify for material participation in management after dad's death. If the other estate qualifications are met, the estate can use section 2032A if dad continues material participation in management during his retirement through the lease arrangement with the neighbor. Dad's participation in management decisions during retirement means that farm income is self-employment earnings and subject to the payment of the self-employment tax. It also means that dad is not completely retired for social security purposes and self-employment earnings above a certain specified amount (prior to age 70) reduce the social security benefits.

The retired farmer has a dilemma. Should a farmer give up the potential use of 2032A for the estate by ceasing to participate in management decisions? Or should a retired farmer continue material participation and risk the loss of social security benefits through excess earnings during retirement prior to age 70?

The treatment of the heir's basis in inherited property is another issue. With the repeal of carryover basis as part of the Windfall Profit Tax Act of 1980, stepped up basis is again used to determine an asset's basis at death. The treatment of an asset's basis in the event of a section 2032A election and subsequent recapture tax is unclear.

There is no defined procedure as to how basis is calculated if recapture occurs although several alternatives are possible. The basis may remain at its special use value, it may increase by the amount of recapture tax paid or it may revert back to fair market value at the decedent's death. Of these three alternatives, the last one appears to be the most likely one to be adopted. When asked about this issue, a supervisor in the IRS stated he thought the basis would become the fair market value at the time of the decedent's death. This is not, however, an official IRS position.

If basis does revert to the fair market value, a substantial deterrent to special use valuation election has been removed. A number of attorneys interviewed stated one of the reasons they had rejected section 2032A was the effect the provision had on the asset's basis if recapture occurred.

Two more points need to be discussed regarding section 2032A. In situations where no other use for the land is immediately evident, special use valuation election should be considered. Very often the fair market value of the land is above the value that the cash rental capitalization method yields. A number of attorneys interviewed did not consider section 2032A because there was no non-agricultural use for the land. This is not sufficient reason to reject a section 2032A election. The land qualifies for alternative use valuation even in cases where no alternate use is present.

The second point is the uncertainty surrounding section 2032A which makes the provision difficult to plan for. There are a number of questions concerning interpretation of the code, material participation and basis being among them. The Internal Revenue Service also appears to be getting tougher on special use valuation elections. The IRS questions and audits all returns that elect section 2032A and this can greatly increase the cost of filing such a return. At this point it is probably not wise to build an estate plan around section 2032A.

Section 6166 and Section 6166A: Estate Tax Deferral

Qualification

While the principles behind the qualification requirements for sections 6166 and 6166A are similar, many of the technical requirements are not the same. This paper will discuss the requirements for both sections and show the differences.

For an estate to qualify for section 6166, the decedent must have an interest in a closely held business such as a sole proprietorship, a partnership in which the decedent owned 20 percent or more of the capital interest, or a partnership having 15 or fewer partners. An interest in a closely held business for purposes of section 6166 also exists where stock in a corporation of 15 or fewer shareholders is included in the gross estate or 20 percent or more of the stock is included in the gross estate. Whether or not the estate qualifies under section 6166 depends on whether the decedent has an interest in a closely held business immediately preceding death.[16] For the estate to qualify for section 6166A the same criteria apply except the number of partners or shareholders in the business is limited to ten.[17]

For section 6166 qualification, the decedent must be a citizen or resident of the United States and the interest in the closely held business must exceed 65 percent of the adjusted gross estate.[18] The term "adjusted gross estate" means the value of the gross estate less the sum of the allowable deductions under sections 2053 and 2054 of the Internal Revenue Code.[19] Section 2053 concerns expenses, taxes, and indebtedness of the estate and section 2054 concerns losses incurred by the estate. It is important to note that the adjusted gross estate for section 6166 deals with deductions allowable not necessarily those taken for estate tax purposes. Some deductions may

be used for the income tax return of the estate and not for estate tax purposes, but they are still deducted from the gross estate to calculate the adjusted gross estate. In a farm situation, the residential and related improvements to the residence which are occupied by an owner or lessee of the farm or people employed by the owner or lessee are included as part of the closely held business.[20]

Percentage requirements for section 6166A are less stringent in some respects. The value of a closely held business must exceed either 35 percent of the gross estate or 50 percent of the taxable estate.[21] The estate does not have to meet both requirements.

Taxable estate and gross estate are the same as previously defined. However, the deduction must be taken to calculate a 6166A election unlike section 6166 where being allowable is sufficient. If the deductions are used on the estate's income tax return they cannot be used to qualify for section 6166A.

Attribution

If the decedent had an interest in two or more closely held businesses, a section 6166 election is still possible. All businesses included in the estate where the decedent had an interest greater than 20 percent of the total value of the business may be treated as an interest in a single closely held business to meet the 65 percent of the adjusted gross estate requirement.[22] For example, if the decedent owned 25 percent of the stock of three companies and each company's stock value equalled 30 percent of the adjusted gross estate, the decedent's estate would qualify for section 6166. Section 6166A differs from section 6166 in this respect. Section 6166A requires that the decedent must have an interest greater than 50 percent of the total value of each business in order to combine the values.[23]

There are attribution rules in sections 6166 or 6166A regarding ownership of stock or partnership interests. According to the tax code, the decedent may have "attributed" to his or her estate for purposes of sections 6166 and 6166A the stock or partnership interest owned by members of his or her family. These interests are not included in the gross estate when calculating taxes but can be used when determining whether the decedent owned a required percentage of a business. For example, section 6166 requires that the decedent must have owned more than 20 percent of the stock of a corporation and there be 15 or fewer shareholders in the company. If the decedent owned 18 percent and his or her spouse owns or owned 7 percent of the stock, the decedent's estate will meet the greater than 20 percent requirement. Twenty-five percent of the firm will be attributed to the decedent.

Most of the attribution rules apply to section 6166, but there is one rule for section 6166A. Under section 6166A, more than 50 percent of the value of each business must be included in the estate to be treated as a closely held business. Section 6166A(d) permits spousal co-ownership to apply in limited form to aggregating interests in two or more businesses. Section 6166A(d) allows an interest which represents the survivor's interest in what was community property between the decedent and his or her spouse to be treated as if it had been included in the decedent's gross estate for purposes of qualifying for a tax deferral.[24] This inclusion only applies in determining whether the business interests of the decedent can be aggregated to meet the 50 percent of each business rule. However, the community property interest of the survivor will not be included as part of the estate for the purpose of meeting the 35 percent of the gross estate or 50 percent of the taxable estate requirement of the taxable estate requirements.[25]

The attribution rules for section 6166 are much more complex. Section 6166(b)(2)(B) treats community property or any other interest held by husband and wife as being owned by one individual. It cumulates all married people's interests in the partnership or corporation. Therefore, if more than the maximum number of people have interests in a firm, qualification can still occur because each married couple is treated as one individual. For example, if 17 people own stock in a corporation and among those 17 there are three married couples, counting the married couples as individuals, section 6166(b)(2)(B) would leave 14 shareholders. Section 6166(b)(2)(B) also permits the stock owned by a husband and wife to be combined to determine whether the decedent controlled more than 20 percent of the firm.[26]

There is also an indirect ownership provision in section 6166. Section 6166(b)(2)(C) states that property owned by a firm or estate is considered to be owned proportionately by those with an interest in the firm or estate.[27] Section 6166(c) allows the same aggregation of stock for spousal co-ownership as does section 6166(d), but is broader because it allows inclusion of property held as joint tenants, tenants by-the-entirety and tenants-in-common as well as community property.[28] Section 6166(b)(2)(D) extends the reasoning of section 6166(b)(2)(B) because it allows an interest owned by a member of the decedent's family to be considered as owned by the decedent for purposes of the numerical tests qualification.[29]

The last attribution rule was enacted by the Revenue Act of 1978 and allows the personal representative to include a capital interest in a partnership or a non-readily-tradeable stock attributed to the decedent in the decedent's gross estate for the 20 percent percentage tests and the 20 percent aggregation rule if more than one business is involved.[30] This section, 6166(b)(7), has two restrictions, however, which make it unattractive. It

denies use of the five year estate tax deferral available in section 6166 and the four percent interest rate charged on the first $345,800 of tax due.[31]

Implementation

The amount of tax that can be deferred and paid in installments is limited to the amount calculated in the following manner.

$$\text{total tax due} \times \frac{\text{interest in closely held business}^{32}}{\text{value of the adjusted gross estate}}$$

Though commonly know as the 15-year tax deferral option, section 6166 actually extends the deferral for only 14 years. The tax in the first five years of a section 6166 election may be deferred. At the end of five years the first installment payment is due. The remaining nine payments are then due annually.[33] Section 6166A does not allow the five year deferral of tax. The first installment payment is due nine months after the decedent's death and the remainder of the payments are made annually.[34]

The amount of tax which can be paid in installments in a section 6166A election is calculated in the following manner.

$$\text{total tax due} \times \frac{\text{interest in closely held business}^{35}}{\text{value of the gross estate}}$$

There is another important difference between sections 6166A in addition to the five-year deferral. The interest rate charged on the unpaid balance for section 6166A is established by section 6621. The rate charged on the unpaid balance of the tax for section 6166 on the first $345,800 of the tax[36] is a four percent interest rate and at rates established by section 6621 on any additional tax for the deferral period.[37] Section 6621 allows the Secretary of the Treasury to adjust the interest rate. After payments are begun,

interest is paid with the installment payments on the unpaid balance. If there is any tax which is subject to more than four percent, the interest is calculated on a pro rata basis.[38] Interest rates on section 6166A elections are determined entirely by the methods stipulated in section 6621.[39]

Obligations

Once a section 6166 or 6166A election is made and accepted by the Internal Revenue Service the estate and the heirs have certain obligations. A failure by the estate to make an installment payment on time may result in the entire amount of the unpaid tax becoming due upon notice and demand from the Secretary of the Treasury.

No more than one-third of the estate's interest in the closely held business can be sold, exchanged, or otherwise disposed of. Nor can the aggregate money withdrawals or withdrawals of other property from the closely held business exceed one-third of the estate's interest in the business. If any of these events occur, the unpaid balance of the deferred tax is due upon notice and demand from the Secretary of the Treasury.[40]

Section 303 Stock Redemption

A section 303 stock redemption may exceed the above restrictions if (on or before the due date for the first installment payment) an amount of estate tax not less than the amount of money or other property distributed is paid. A section 303 stock redemption allows a gradual sale of stock by the estate back to a company in which a decedent had an interest in order to pay estate taxes with beneficial income tax considerations for the estate. The payment acceleration obligations are also not applicable where the exchange of stock is for the purpose of the firm's reorganization according to section 368(a)(1).[41] Section 6166A contains accelerated payment provisions similar to those of section 6166, but the specifications are a little more lax. The

reduction of the interest in the closely held business may not exceed one-half for purposes of section 6166A. All other requirements and actions are the same as those of section 6166.

Case II Estate Tax Deferral Options

Situation II

The case example examines the operation of the estate tax deferrals, sections 6166 and 6166A. The facts of situation I are altered slightly for the examples. In situation II a widow passes away at age 74 with a gross estate of $2,675,000 of which $2,250,000 consists of 1000 acres of farmland. Her balance sheet is listed in Table 5.

Table 5. Balance Sheet--Situation II

Assets		Liabilities	
Farm real property	$2,250,000	Mortgage	$ 240,000
Other real property	175,000	Total liabilities	$ 240,000
Personal property	50,000		
Life insurance	50,000		
Savings	150,000	Net Worth	$2,435,000
Total Assets	$2,675,000	Total Liabilities and Net Worth	$2,675,000

In the previous case, two sons inherited and operated the farm. In this case, the sons are both off the farm and will not return. There is no qualified heir willing to keep the land in a qualified use for the required period of time so the estate will not qualify for special use valuation. Since the decedent took an active role in the management of the land prior to death, the real property can qualify as a closely held business. She meets the percentage requirements specified by both section 6166 and section 6166A.

Section 6166 is more attractive to the estate because of the availability of a deferral at four percent interest. The adjusted gross estate is

$2,290,000 and the value of the closely held business is $2,250,000. The estate may defer the amount of tax attributable to the closely held business as determined by the following ratio:

$$\frac{\text{value of the closely held business}}{\text{adjusted gross estate}} = \frac{\$2,250,000}{\$2,290,000} = .982$$

Therefore, 6166, .982, so 98.2 percent of the federal estate tax due may be deferred. The estate may defer $740,587 of a total tax bill of $754,162 over a 15 year period. During the first five years of the deferral period only the interest is due. The interest is charged at the rate of four percent on the tax attributable to the first $1,000,000 of taxable assets and at 12 percent on any tax thereafter. Estate taxes on the first million dollars of assets are $345,800. This is deferred at four percent and the remaining $408,362 is deferred at 12 percent. The remaining tax $13,575 is paid when the return is filed, nine months after the decedent's death.

Interest payments of four percent on $345,800 and 12 percent on $408,362 are due on an annual basis for the next four years. Five years after the return is filed a similar interest payment is made along with the first principal payments of $74,058.70. Principal payments are due on an annual basis thereafter. Interest charges are due on the unpaid principal on a a pro-rata basis.

The total payout over the 14 years of the deferral is $1,351,110.70 on an original tax liability of $754,162 (Table 6). This can be misleading, however, because interest payments are included in the payment. To judge whether election of the deferral was beneficial, the present value of the flow of funds paid out must be calculated. In other words, if a business can earn some percentage return over a period of time, then a dollar today is worth more than a dollar one year from now. Therefore, the money paid out in the

future by the estate must be discounted to determine whether it is cheaper to pay off the tax liability immediately or pay it off over time. It is difficult to determine what rate of return the farm could earn, therefore, the payments were discounted at rates of 8, 10 and 12 percent. The present values of the deferral at those discount rates are $745,420.01 at 8 percent, $687,602.51 at 10 percent and $612,741.64 at 12 percent.

Table 6. Estate Tax Deferral Values--Situation II

Time period	Payment	8%	10%	12%
0	$ 13,575	$ 13,575.00	$ 13,575.00	$ 13,575.00
1	62,835	57,762.27	56,714.20	55,703.57
2	62,835	53,482.66	51,554.96	49,733.32
3	62,835	49,521.21	46,869.85	44,405.64
4	62,835	45,852.98	42,608.96	39,645.67
5	136,893	93,169.85	84,997.30	77,673.49
6	130,610	82,310.42	73,729.35	66,167.03
7	124,327	72,554.80	63,804.62	56,223.10
8	118,044	63,779.17	55,067.53	47,677.97
9	111,761	55,902.85	47,397.84	40,301.02
10	105,478	48,857.41	40,661.77	33,963.92
11	99,195	42,544.74	34,767.85	28,518.56
12	92,912	36,895.36	29,601.76	23,850.51
13	86,629	31,853.48	25,096.42	19,855.37
14	80,346	27,357.81	21,155.10	16,438.79
Total	$1,351,110	$745,420.01	$687,602.51	$613,742.64

In this case, it is beneficial to the estate to elect the deferral even if the discount factor is 8 percent. There is a difference of $8,741.99 between the present values of the no election option and electing section 6166. Business earnings above 8 percent are more beneficial for the heirs. The personal representative and heirs must weigh benefits against any costs they feel are imposed by the restrictions of section 6166. Restrictions cannot always be given a monetary value. Another consideration is the size of the estate tax. The estate may have difficulty raising $754,162 nine months

after death, while it may possible to meet the interest and principal payments. Use of section 6166 is probably the only way the heirs can continue ownership of the farm. Bearing some of the intangible costs imposed by the code may be preferable to selling the farm.

Situation IIA

The second case involving estate tax deferrals demonstrates the difference between section 6166 and section 6166A. The facts of the case are similar to that of situation IA (Table 7). A widow passes away, but the son is not interested in running the farm, therefore, the estate will not qualify for section 2032A.

Table 7. Balance Sheet--Situation IIA

Assets		Liabilities	
Farm real property	$ 487,500	Real estate debt	$ 110,000
Machinery and equipment	20,400	Other liabilities	50,000
Livestock	15,000	Total Liabilities	$ 160,000
Life insurance	10,000		
Cash	5,000	Net Worth	$ 377,900
Total Assets	$ 537,900	Total Liabilities and Net Worth	$ 537,900

The estate tax due is $52,725. Section 6166 allows deferral of the estate taxes in the same ratio as the amount invested in the closely held business to the adjusted gross estate. The value of the closely held business, the farmland rented and managed, is $487,500 and the adjusted gross estate is $350,403. Therefore, the entire amount of the tax can be deferred. Four percent interest is charged on the entire $52,725 deferred and the total payout over 14 years is $72,756. The present values of the payout total at 8, 10 and 12 percent, are $39,648.92, $34,364.84, and $30,195.33 (Table 8). If the discount factor is larger than 12 percent the present value of the payout

total will be even smaller. Only if the opportunity cost of the estate's money is less than 4 percent will it be cheaper to payoff the tax liability nine months after death.

Table 8. Estate Tax Deferral Present Values--Situation IIA

Situation IIA: Present Value Analysis of Section 6166 Election

Time period	Payment	8%	10%	12%
0	0	0	0	0
1	$ 2,109.00	$ 1,952.72	$ 1,917.29	$ 1,883.13
2	2,109.00	1,808.05	1,742.87	1,681.29
3	2,109.00	1,674.12	1,584.49	1,501.19
4	2,109.00	1,550.12	1,440.45	1,340.27
5	7,381.50	5,023.85	4,583.17	4,188.26
6	7,170.50	4,531.76	4,047.75	3,632.57
7	6,959.50	4,333.69	3,571.62	3,147.78
8	6,748.50	3,646.21	3,148.18	2,725.72
9	6,537.50	3,270.06	2,772.55	2,357.42
10	6,326.50	2,930.43	2,438.87	2,037.13
11	6,115.50	2,622.94	2,143.48	1,758.21
12	5,904.50	2,344.68	1,881.17	1,515.69
13	5,693.50	2,093.50	1,649.41	1,304.95
14	5,482.50	1,866.79	1,443.54	1,121.72
	$ 72,756.00	$ 39,648.92	$ 34,364.84	$ 30,195.33

Situation IIA: Present Value Analysis of Section 6166A Election

Time period	Payment	8%	10%	12%
0	$ 32,900.40	$ 32,900.40	$ 32,900.40	$ 32,900.40
1	4,361.41	4,038.23	3,964.95	3,894.39
2	4,123.51	3,535.09	3,407.67	3,287.26
3	3,885.61	3,084.40	2,919.38	2,765.78
4	3,647.71	2,681.06	2,491.38	2,318.12
5	3,409.81	2,320.72	2,117.15	1,934.73
6	3,171.91	1,998.94	1,790.54	1,606.89
7	2,394.01	1,711.99	1,505.73	1,327.05
8	2,696.11	1,456.71	1,257.74	1,088.96
9	2,458.21	1,229.59	1,042.53	886.43
10	2,220.31	1,028.45	855.93	714.94
	$ 65,808.99	$ 55,985.58	$ 54,253.28	$ 52,725.00

Section 6166 is more advantageous to an estate than section 6166A for two reasons. Section 6166 charges 4 percent interest on the first $345,800 of tax due while section 6166A charges 12 percent. Section 6166 also defers more tax than section 6166A. Section 6166 allows deferral of tax equal to the ratio of the closely held business to the adjusted gross estate multiplied by the total tax. Section 6166A defers an amount of tax equal to the ratio of the closely held business to the gross estate multiplied by the total tax. Unless there are no debts, probate or administration costs in the estate, the gross estate will be larger than the adjusted gross estate. A larger denominator in section 6166A means a lesser amount can be deferred.

The figures in Situation IIA will be changed slightly to show the differences in tax deferral. Let us assume the widow sold all but 135 acres before her death and invested the receipts less the mortgage in certificates of deposit. Her net estate has not changed. The estate tax is again $52,725, but now the estate's interest in the closely held business is only $202,500. The estate can no longer qualify for section 6166 because $202,500 is only 58.8 percent of the adjusted gross estate. The estate does, however, qualify for section 6166A. The interest in the closely held business must be at least 50 percent of the taxable estate or 35 percent of the gross estate and the estate meets both requirements.

Section 6166A allows a tax deferral of an amount equal to the interest in the closely held business divided by the gross estate and multiplied by the total tax or ($202,500 / $537,900) X $52,725. According to this equation $29,824.60, 37.6 percent of the tax, may be deferred. The total payout over ten years of $65,808.99 has a present value of $55,985 at 8 percent, $54,253.28 at 10 percent, and $52,725 at 12 percent (Table 8). Only if the estate could earn more than 12 percent on the money paid, would it pay to

defer the taxes. It may be wiser to borrow the money from the Federal Land Bank at a lower rate of interest and pay off the tax bill.

Estate Tax Deferral Issues

Section 6166 or 6166A requires that payment delinquency, disposition of business assets, or withdrawal of the business assets may cause the entire amount deferred to become due immediately. It is unclear how these occurrences will be treated. The IRS took the position in Lake Shore National Bank v. Coyle[42] that payment delinquency was grounds for termination of the deferral. The Service lost that case but maintains its original position. When electing either section 6166 or section 6166A the personal representative must be aware of the requirements the code places on the estate with respect to the disposition or withdrawal of assets from the business.

The withdrawals may not exceed one-third of the value of the closely held business. What constitutes a "withdrawal" is difficult to determine. The regulations state that the withdrawals must be money or "included property." Included property is defined in regulation 20.2032-1(d) as property interests owned by the decedent forming part of the decedent's gross estate, as determined by sections 2033 through 2044, and valued according to section 2032.[43] For example, the sale and trading in of machinery or land exchanges are common occurrences in agriculture and may affect the status of the election. A change in the business organization of the farm such as conversion from a partnership to a corporation may also affect the status of the deferral. Another problem may arise if the nature of the business changes. Firms change the products they sell or the services they render. A drastic change may constitute a withdrawal and trigger accelerated payment. If exchanges or changes in the firm's structure are made and the replacement asset does not constitute

"included property" a withdrawal may have occurred. If the withdrawal is large enough to trigger payment acceleration, the balance of the estate tax is then due.

The estate's disposition of the qualifying interest in a closely held business can also cause acceleration of payment. Dispositions are measured in terms of the business interest included in the decedent's gross estate and not the entire value of the business as is the case in withdrawals. That is, when measuring the value of the disposition, the one-third limitation is calculated with the estate's interest in the closely held business as the numerator. Many of the same problems facing withdrawal situations exist with respect to dispositions, but they may be accentuated because dispositions have a smaller base, the value of the decedent's interest in the business.

Another consideration for the estate planner is the use of a section 303 stock redemption in conjunction with estate tax deferral. Section 303 and the tax deferral options are closely related. Even if one of the tax deferrals is elected, the estate must still raise the money and make the payments. Section 303 provides a means for doing that. This option is available only to farm corporations, however, and consequently has limited use in agriculture because just under one percent of all Michigan farms are incorporated. There are five requirements to be met to qualify for a section 303 redemption: 1) the value of all of the decedent's stock in the closely held business in the gross estate must be greater than 50 percent of the adjusted gross estate, 2) the stock must be included in the gross estate, 3) the amount to be redeemed under section 303 cannot exceed the total taxes due and expenses allowed as deductions for federal estate tax purposes, 4) funds raised by section 303 can be used only to the extent that the shareholder's interest is reduced by payment of taxes or expenses and 5) the amount of money to be distributed through a

section 303 stock redemption must be done in accordance with the time limits of section 303.37.

The personal representative must also take care not to violate the reduced interest rules of sections 6166 or 6166A, so a disposition or withdrawal is not triggered. A section 303 redemption does not constitute a withdrawal if the money is used to pay estate taxes before the next payment is due. It is crucial, therefore, that the tax payment and stock redemption be coordinated to avoid triggering a withdrawal that would result in the unpaid balance of the tax coming due.

Election of section 6166 or section 6166A does not exclude use of special use valuation or vice versa. If section 2032A is elected, the special use value is then used in all other elective calculations such as sections 6166 or 61166A. The percentage of the business requirements for the deferral are based on the special use not fair market value.

Sections 2040(b) and 2040(c): Joint Tenancy Property

Qualification and Implementation

Joint tenancy is the most common form of multi-person ownership in agriculture and differs from tenancy in common, which allows persons to have distinct, but undivided interests in the property. Tenants in common can bequeath their interests at death so their heirs receive the interest in the tenancy in common.

Joint tenancy is the undivided ownership of property by two or more persons with the right of survivorship. Right of survivorship means that upon the death of one owner, the remaining owner, or owners, assumes full ownership of the property. Ownership of jointly held property is not subject to division by one owner and cannot be severed by a will.[44]

A special form of joint tenancy is tenancy by-the-entirety which exists

only between a husband and wife and cannot be severed unless both parties agree to dispose of what they own.[45] Upon the death of one tenant, the value of all joint property in which the decedent had an interest is included in the estate of the decedent. Section 2040(b), the fractional interest rule, excludes joint property held in a qualified joint interest from an estate and section 2040(c), the 2 percent rule, allows exclusion from the estate an amount equal to .02 multiplied by the number of years of material participation of the surviving spouse.

The first provision under analysis is section 2040(b), the fractional interest rule. This section allows exclusion of one-half the value of a qualified joint interest from the gross estate.[46] A "qualified joint interest" is an interest in property that is held jointly by spouses or as tenants by-the-entirety and must have been created by the decedent, his or her spouse, or both after December 31, 1976. If the qualified joint interest involves personal property, the creation of the interest must include completion of a gift for gift tax purposes and for real property the creation of the qualified joint interest is a taxable event at that time.[47] Any additions to the qualified joint interest require filing of additional gift tax returns.[48] Existing joint tenancies may be severed and a new joint tenancy created. Upon such a creation, a gift tax return is filed by the donor spouse and the amount of the gift equals one-half of the appreciation of the property multiplied by the ratio of the donor's excess contribution to the total contributions for the property.

Section 2040(c), the 2 percent spousal participation rule, allows exclusion of the value of property from the decedent's estate if the decedent's spouse had materially participated in the farm or other business.[49] This exclusion is available to eligible joint interests. "Eligible joint

interests" means a joint interest between spouses only which was created by the decedent, the decedent's spouse, or both.[50] An eligible joint interest is not necessarily a qualified joint interest. Property qualifying for section 2040(c) is real or tangible property devoted to farming purposes or used as a farm according to the definition in section 2032A, or property used in any other trade or business.[51] The decedent's spouse must have materially participated in the farm or other business with the context of material participation for self-employment earnings.[52] If such participation occurs, an amount equal to the following equation is excluded from the gross estate.

$$\left(\begin{array}{c}\text{Value of eligible} \\ \text{joint interest}\end{array} - \begin{array}{c}\text{adjusted consideration furnished} \\ \text{by the decedent or spouse}\end{array}\right) \times \left(.02 \times \begin{array}{c}\text{number of taxable years the spouse materially participated}\end{array}\right)^{53}$$

Adjusted consideration is the consideration furnished by the decedent plus any interest such consideration would have earned over the time period it was invested in the farm at a rate of 6 percent simple interest.[54] Section 2040(c) is limited to a maximum reduction of $500,000 or 50 percent of the value of the eligible joint interest from the gross estate.[55]

Case III: Sections 2040(b) and 2040(c)

Situation III

This situation is designed to demonstrate the operation and use of section 2040(b), the fractional interest rule, and section 2040(c), the 2 percent spousal participation rule. A married couple, both age 65, have a gross estate of $1,424,839 in their cash grain farm with $936,250 in jointly held real estate. The farmer is trying to decide whether to elect section 2040(b) or not. If he does, he must create a qualified joint interest and make a gift of one-half the joint property to his wife. Their balance sheet is listed in Table 9. If the farmer makes a gift of $468,125, one-half the joint property, to his wife he will pay a gift tax of $18,700 (Table 10). The tentative tax

on the taxable gift is $65,700, but is reduced by the $47,000 unified credit. If the husband lives another ten years, according to life expectancy charts, and a simple 8 percent growth rate is assumed, his gross estate will be $2,564,710 and his net worth will be $1,787,092.

Table 9. Balance Sheet--Situation III

Assets		Liabilities	
Farm real property	$936,250	Real estate debt	$ 374,500
Feed, crops and supplies	268,145	Other debt	57,410
Machinery and equipment	172,870	Total Liabilities	$ 432,010
Non-farm assets	24,936		
Cash	22,638	Net Worth	$ 992,829
Total Assets	$1,424,839	Total Liabilities and Net Worth	$1,424,839

Table 10. Gift Tax Calculation--Situation III

Gift from husband to wife	$468,125.00
less marital deduction	($234,062.50)
less $3,000 annual gift exclusion	($3,000.00)
Taxable gift	$231,062.50
Tentative gift tax	$ 65,700.00
less unified credit	($47,000.00)
Gift tax due	$ 18,700.00

For purposes of this example the author will assume the unified credit allowable in federal taxes is indexed. From 1976 to 1981 the credit increased at a rate of 11.86 percent annually. At that rate of increase the credit would be $113,890 at the time of the farmer's death. The credit is increased because the author thinks it is reasonable to assume the government will increase the credit over time, The author will assume, for simplicity, that the estate tax rate will not change in the ten year period.

The decedent leaves his entire estate to his wife. A qualified joint interest was created ten years prior and therefore 50 percent of the jointly held property, $842,625, is excluded from the estate leaving a gross estate of $1,722,085. Half of the adjusted gross estate of $883,532.40, $441,766.20, is subtracted via the marital deduction to leave a taxable estate of $441,766.20. The tentative estate tax on this taxable estate is $136,000.50. After subtracting the state inheritance tax of $536.84, and the federal unified credit of $66,890, the final estate tax liability is $68,573.66 (Table 11). The total federal estate and gift tax paid to transfer the farmer's assets to his wife is $87,273.66 ($68,573.66 + $18,700).

Table 11. Estate Tax Calculations--Situation III

Gross estate	$1,722,085.00
less debts	($777,618.00)
Probate and administration costs	($60,934.60)
Adjusted gross estate	$883,532.40
less marital deduction	($441,766.20)
Taxable estate	$441,766.20
Tentative federal tax due	$136,000.50
less state tax credit	($536.84)
less remaining unified credit	($66,890.00)
Federal estate tax due	$68,573.66

There are alternatives to this method of estate transfer which should be considered. If a qualified joint interest is not created a number of situations could arise upon the death of the husband. The personal representative may not be able to prove any type of spousal contribution by the survivor in which case the entire value of the estate, $2,564,710 is included in the decedent's estate. If all other factors are the same, the federal estate tax is $168,781.09, a substantial increase from the $87,273.66 paid to transfer assets using the qualified joint interest (Table 12).

Another possibility is the exclusion of up to one-half of the jointly held property from the estate by proving through affidavits and other forms of documentation the survivor contributed to the farm. If 50 percent of the joint property is attributed to the spouse, the gross estate is identical to the case in which a qualified joint interest is created, but the effect on the estate taxes is substantially different. The unified credit is not reduced by $47,000 because no gift was made and the estate tax in this case is $21,573.66 (Table 12).

The final alternative for the estate is to elect section 2040(c). This provision, the 2 percent spousal participation rule, allows an exclusion of joint property from the estate equal to 2 percent multiplied by the number of years of material participation of the spouse multiplied by the appreciated in the joint property.

The decedent bought the land 55 years before his death at $200 per acre. According to section 2040(c), the initial consideration furnished by the decedent, $107,000, must be appreciated at 6 percent simple interest for the amount of time he owned the property. This appreciation, $353,100, and the initial consideration are deducted from the value of the estate. The land's value at the time of death is $1,685,250. Deducting the initial consideration and its appreciation, $107,000 and $353,100 respectively, from the estate's property value leaves $1,225,150. If the married couple farmed together for 45 years, section 2040(c) equation would be .02 x 45 = .9. A maximum reduction of the lesser of 50 percent or $500,000 is set by the provision. Therefore, the estate could exclude $500,000 leaving the decedent's net estate at $1,287,092. The taxable estate (gross estate less debts, administration costs and the marital deduction) is $603,507.42. The tentative federal estate tax is $194,097.75 and reduced by the state inheritance tax and the unified credit

leaving a federal tax of $79,670.91 (See Table 12).

Table 12. Alternative Estate Tax Calculations--Situation III

	No action	50% excluded	2040(c)
Gross estate	2,564,710.00	1,722,085.00	2,064,710.00
less debts	(777,618.00)	(777,618.00)	(777,618.00)
Net estate	1,787,092.00	944,467.00	1,287,092.00
less probate costs	(108,077.00)	(60,934.60)	(80,077.15)
Adjusted gross estate	1,679,015.00	883,532.40	1,207,014.85
less marital deduction	(839,507.50)	(441,766.20)	(603,507.42)
Taxable estate	839,507.50	441,766.20	603,507.42
Tentative tax due	283,207.93	136,000.50	194,097.75
less state death tax cr.	(536.84)	(536.84)	(536.84)
less unified credit	(113,890.00)	(113,890.00)	(113,890.00)
Federal estate tax due	$ 168,781.09	$ 21,573.66	$ 79,670.91

The tax liabilities for the four options are $87,273.66 if a qualified joint interest is created, $168,781.09 if nothing is done and no proof of spousal contribution can be shown, $21,573.66 if 50 percent of the joint property is excluded from the estate and $79,670.91 if section 2040(c) is elected. Since the decision to create a qualified joint interest is made prior to death and a gift tax paid, values must be discounted to the present to accurately judge the best alternative. Using 8 percent as the discount factor, the cheapest alternative is excluding 50 percent of the joint property from the estate at the time of death. The present value of this alternative is $9,992.92. If less than 50 percent of the joint property, is excluded, the cost of this alternative increases. Election of section 2040(c) is the second cheapest option with a present value of $36,903.56. Creation of a qualified joint interest has a present value of $50,463.32 no planning and no exclusion for spousal participation has a present value of $78,179.40 and are the most expensive alternatives.

The case demonstrates a couple points about sections 2040(b) and 2040(c). First, they have limited usefulness. The estate taxes due if a percentage of

the joint property can be excluded are a quarter of the taxes incurred using section 2040(b). A section 2040(b) election would provide no benefit to the couple in this case. Taking no action at all was much worse than any of the other alternatives and should be avoided.

The real issue surrounding sections 2040(b) and 2040(c) is the provision's inadequacies. Section 2040(b) is of little value to the estate planner. In order to elect section 2040(b) a qualified joint interest must be created. The qualified joint interest results in the husband and wife owning the joint property equally. If equal consideration by both parties to the property was not made, a gift tax return must be filed and any tax paid.

Estate planning to minimize the estate taxes on both deaths cannot be achieved through section 2040(b). It may reduce the tax on the first death, but the property is still joint and taxed at the survivor's death. In addition, the gift tax is paid now rather than later and any additions to the property requires the filing of a gift tax return.

If the estate planner wishes to sever an existing joint tenancy, the parties should hold the property as tenants in common or separately. A gift tax may be due, but the right of survivorship is eliminated and trusts could be used to minimize the estate taxes on the second death.

Section 2040(b) could possibly be used by a young farmer with lesser assets until the farm estate grows. At that point other estate plans may be made. If the estate does not grow, the estate tax may not be serious.

Section 2040(c) may be somewhat more useful than section 2040(b) but is still limited. In order to elect this provision the personal representative must be able to prove material participation by the survivor. Historically, attorneys have been able to exclude a percentage, sometimes as high as 50 percent, of the joint property by using affidavits to show that the survivor,

usually the wife, contributed to the farming operation.

The equation applied in section 2040(c) to calculate how much can be excluded is designed for a maximum 50 percent reduction in the gross estate or 25 years of material participation in management. The estate would be smaller by electing section 2040(c) than if the personal representative could exclude 50 percent using affidavits.

Case IV Trusts

There are other estate planning techniques available other than the provisions discussed so far. The most common device used is a trust. This case is designed to demonstrate the tax savings that can be realized through the use of a trust. The case will show the estate tax liability if no action is taken, if a trust is used, and if section 2032A is elected.

Situation IV

A farmer and his wife operate a cash grain farm in the Saginaw Valley. They have one son who farms with them. The farmer's gross estate is $915,000 with debts of $115,000 (Table 13). The real property consists of 300 acres valued at $2,000 per acre. The husband and wife own everything as joint tenants and there has been equal contribution in the acquisition of the assets.

Table 13. Balance Sheet--Situation IV

Assets		Liabilities	
Farm real property	$600,000	Mortgage	$ 100,000
Feed, crops and supplies	125,000	Other	15,000
Machinery and equipment	175,000	Total Liabilities	$ 115,000
Non-farm assets	15,000		
Cash	5,000	Net Worth	$ 800,000
Total Assets	$915,000	Total Net Worth and Liabilities	$ 915,000

No estate tax is levied on the farmer's estate, if no action was taken and an equal contribution had been made by the decedent and his wife. Equal contribution by the spouses divides the gross estate of $915,000 and through the marital deduction and other available deductions the tax is eliminated. There is no state inheritance tax because all the property is joint. There is however a substantial tax due upon the death of the wife. All property is transferred to her upon the husband's death and she is left with a gross estate of $774,910, $800,000 less $25,090 for probate and administration costs. No appreciation is assumed. The federal estate tax due is $172,396.08 and the state inheritance tax bill, if all property is left to the son, is $44,187.11 (Table 14). The total estate reduction attributable to both deaths (probate and administration plus taxes) is $292,992.09.

Table 14. Estate Tax Calculations--Situation IV: No Trust

Decedent	Husband	Wife
Gross estate	$457,500.00	$774,910.00
less debt	(115,000.00)	(-0-)
Net estate	342,500.00	774,910.00
less probate and adm. costs	(25,090.00)	(51,319.69)
Adjusted gross estate	317,410.00	723,590.31
less marital deduction	(250,000.00)	(-0-)
Taxable estate	67,410.00	723,590.31
Tentative tax	14,926.60	238,528.41
less unified credit	(47,000.00)	(47,000.00)
less state tax credit	(-0-)	(19,132.33
Federal estate tax due	-0-	$172,396.08

If this individual had set up a living revocable trust the estate shrinkage would have been much less. Assuming equal contribution again by the husband and wife, the estate tax on the husband's death would still be zero. However, in order to effectively use the trust the property could not be held

jointly. Since there is equal contribution, an agreement by both parties to sever the joint tenancy and hold the assets as tenants in common will not trigger any gift tax. Upon the husband's death, the asset's remaining in his estate are placed in a trust, the income from which goes to his wife. The beneficiary of the trust is the son. By severing the joint tenancy, the husband's estate incurs a state inheritance tax of $13,518.70. His gross estate of $457,500 is reduced by the payments of debts, $115,000, probate and administration costs, $6,250 and state inheritance taxes of $13,578.70 for a total of $322,731.30 placed in the trust. Upon the wife's death, a federal estate tax of $75,719.25 is due (Table 15). All assets are inherited by the son and he also receives the proceeds of the trust established by his father. The wife's estate of $457,500 shrinks by a total of $129,211.13 to a value of $328,288.87, due to probate costs, state inheritance taxes and federal estate taxes. The trustee charges an annual fee for administering the trust of $2,127. For simplicity, this fee is deducted from the trust's income and therefore does not affect the principal or the estate taxes. Using trusts, the estate shrinkage after both deaths is $167,819.83, $125,173.16 less than if no action was taken prior to death.

Table 15. Estate Tax Calculations--Situation IV: With Trust

Decedent	Husband	Wife
Gross estate	$457,500.00	$457,500.00
less debt	(115,000.00)	(-0-)
Net Worth	342,500.00	457,500.00
less probate and adm. costs	(6,250.00)	(32,437.50)
Adjusted gross estate	336,250.00	425,062.50
less marital deduction	(250,000.00)	(-0-)
Taxable estate	86,250.00	425,062.50
Tentative tax	19,950.00	130,321.25
less unified credit	(47,000.00)	(47,000.00)
less state tax credit	(-0-	(7,602.00)
Federal estate tax due	-0-	$ 75,719.25)

Assuming the estate would qualify for section 2032A, election of section 2032A upon the death of the wife would be beneficial. Since there was no tax on the husband's death, election of special use valuation serves no purpose and places unnecessary restrictions on the heirs. Election of section 2032A on the death of the wife results in a large reduction in the taxes paid. The total estate shrinkage after both parties have passed away using a section 2032A election is $145,768.82 compared to $167,819.83 using trusts (Table 16). This may appear beneficial, but with a section 2032A election go restrictions and the executor and the heirs should weigh the trust restrictions and special use restrictions carefully before making a decision.

Table 16. Estate Tax Calculations--Situation IV: Wife Elects Section 2032A

	With Section 2032A	After Use of Trust Without Section 2032A
Gross estate	$313,258.00	$457,500.00
less debt	(-0-)	(-0-)
Net estate	313,258.00	457,500.00
less probate and adm. costs	(51,319.69)	(32,437.50)
Adjusted gross estate	261,938.31	425,062.50
less marital deduction	(-0-)	(-0-)
Taxable estate	261,938.31	425,062.50
Tentative tax	74,859.03	130,321.25
less unified credit	(47,000.00)	(47,000.00)
less state tax credit	(2,686.52)	(7,602.00)
Federal estate tax due	$ 25,172.57	$ 75,719.25

The same type of analysis could be done if any level of contribution had been made by the wife. The results would be similar except that the numbers would be larger as the amount of contribution decreases. Taking no action is very expensive to the estate. The shrinkage using a trust and special use valuation are similar after considering the obligations section 2032A places on an heir.

Case V Section 2032A v. Section 6166: A Tradeoff?

Situation V

This case is designed to demonstrate the potential tradeoff that may exist for an estate between section 6166, estate tax deferral, and section 2032A, special use valuation. When an executor elects section 2032A the value placed on the real property is used for all other estate tax purposes. Therefore, after a special use valuation election the estate must try to meet section 6166, or any other provision's qualification requirements using the special use values. If the estate is able to meet the requirements before a section 2032A election but not after an election, a decision must be made by the personal representative and the heirs as to which provision would be most beneficial to the estate. If we use an adaptation of Situation IA this can be shown.

A widow who owns 350 acres of farmland dies leaving a gross estate of $1,212,500 and debts of $240,000. The estimated probate and administration costs are $62,532 leaving a taxable estate of $909,968. The 350 acres have a value of $2,250 per acre for a total of $787,500. Using the cash rent and property tax figures from Situation I places a value of $161,350 on the real property which is a reduction of $626,150. The maximum reduction is $500,000 so the land is included in the estate at $287,500.

If no special provisions are elected the tentative federal estate tax is $320,687.52 and the final federal estate tax due is $235,529.52 (See Table 18). If section 2032A is elected, the taxable estate is reduced from $909,968 to $409,968 and the federal estate tax due after deductions for the state death tax credit and the unified credit are made is $69,150 (See Table 18). Under section 6166, $44,986.14 of an estate tax liability of $235,529.52 is

paid nine months after the decedent's death and the remainder, $195,543.38 is deferred over the next 14 years.

Table 17. Estate Tax Calculations--Situation V

	Without 2032A	With 2032A
Gross estate	$1,212,500.00	$712,500.00
less debt	(240,000.00)	(240,000.00)
Net estate	972,500.00	472,500.00
less probate and adm. costs	(62,532.00)	(62,532.00)
Adjusted gross estate	909,968.00	409,968.00
Taxable estate	909,968.00	490,968.00
Tentative tax	310,687.52	125,189.00
less unified credit	(47,000.00)	(47,000.00)
less state death tax credit	(28,158.00)	9,039.00)
Federal estate tax due	$ 235,529.52	$ 69,150.00

If section 2032A is not elected section 6166 is. In this case the estate pays $44,986.14 nine months after death and defers $195,543.38 over the next 14 years at 4 percent interest.

The personal representative would prefer to reduce the tax if possible but would also like to stretch out the payments using section 6166 because it has an attractive 4 percent interest charge attached to it. Unfortunately for the estate, election of section 2032A leaves only $287,500 in assets held by a closely held business. With a gross estate of $1,212,500 and an adjusted gross estate of $909,968 the estate needs to hold $590,932.25 in a closely held business and it is far short of this value. Therefore the personal representative and heirs must decide which provision to elect.

In this example the estate must pay either $69,150 or $44,986.14 nine months after death. The $69,150 is the total tax under section 2032A and the $44,986.14 is the amount of federal estate tax not deferred in the section 6166 election. This analysis assumes that in both cases the amount paid when

the return is filed is borrowed from the Federal Land Bank at 10.5 percent and paid off over ten years.

If section 6166 is elected the estate pays out a total of $314,935.85 over the 14 year deferral period. The present value of this payout at an 8 percent discount factor is $109,952.94. Contrasted to this the present value of the special use value election at 8 percent is $76,313.81. In this case then, election of the special use valuation provision is cheaper than deferral of the taxes but it is also cheaper to pay the debt off immediately at an 8 percent discount factor.

This will not always be the case however. Whether it is more beneficial to the estate to elect section 6166 or section 2032A in situations where both cannot be elected will depend upon a number of factors, the amount of tax owed, the opportunity costs for the estate, the amount of tax which can be deferred, and the desires of the personal representative and heirs. The last of these is probably the most important. The personal representative and heirs may not like the election which is cheaper for any number of reasons. A good estate plan and settlement accomplishes the objective of the heirs at minimal cost.

Michigan Inheritance Tax Exemption - Deferral

Qualification

This section describes the qualification requirements that must be met in order to elect the exemption-deferral provision. The property qualifying must be "qualified real property."[56] Qualified real property is real property located within Michigan which is primarily for agricultural use and defined in Public Act 116, the Farmland and Open Space Preservation Act. "Agricultural use," according to P.A. 116, means substantially undeveloped land devoted to the production of plants and animals useful to man.[57]

The qualified real property must pass to a "qualified heir." A qualified heir is a grandparent, parent, spouse, issue, the spouse of issue, brother, sister, or any person with whom the decedent stood in a mutually acknowledged relation of a parent, a lineal descendent of the decedent or a farm business partner. [58] The definition different from the federal estate tax section 2032A in this respect. The federal tax code does not allow a farm business partner to be a qualified farm heir.

Other requirements are similar to the federal special use provision. The adjusted value of the qualified real property must constitute at least 25 percent of the adjusted value of the estate and the adjusted value of real and personal property devoted primarily to agricultural use must equal at least 50 percent of the adjusted value of the estate.[59] The adjusted value of the estate is the clear market value of the estate reduced by deductions for an unpaid mortgage, debts or liens; adjusted value, in the case of real or personal property, is the clear market value less unpaid mortgage, debts or liens on the relevant property.[60]

Implementation

The state exemption-deferral option is a crossbreed of the federal special use valuation and the estate tax deferrals. The provision allows a qualified heir to exempt one-half of the clear market value of qualified farm property from taxation and defer the taxes attributable to the remaining one-half of the land. Taxes attributable to the remainder of the assets in the estate are due within nine months of the decedent's death.[61]

The personal representative and the qualified heir must elect the exemption-deferral by filing an affidavit with the county probate judge. The judge determines whether the heir is, in fact, a qualified heir and whether the land is qualified real property.[62] In order to determine whether the land

is farmland the judge may consult with the soil conservation district agency or the state land use agency.[63] The state land use agency is the land use agency of the Department of Natural Resources.[64] If the land or heir fail to qualify, the taxes become due immediately. If the probate judge approves the application to elect the provision, an order is issued which suspends payment of all inheritance taxes for six months, authorizes the transfer of the qualified farm real property to a qualified heir and, requires the heir to apply for a farmland development rights agreement, Public Act 116, within 30 days of the order unless the land is already enrolled. Failure to apply for P.A. 116 within the required time results in the inheritance tax becoming due immediately.[65]

If the property remains in a qualified use for ten years after the date the land enters into the farmland development rights agreement, the 50 percent exemption becomes permanent and the tax deferred becomes due at that time. The farmland development rights agreement is a covenant between the owner of the land and the state. This agreement states that the state and landowner jointly hold the right to develop the land for an agreed upon period of time.

The amount of tax deferred is the tax attributable to the remaining one-half of the clear market value of the land. This is determined by using the following equation:

$$\frac{\text{value of real property inherited}}{\text{taxable inheritance}} \times \text{tax due}$$

The remainder of the tax is due when it would normally be due had the exemption-deferral not been elected.[66]

Obligations

When the qualified heir and the personal representative elect the exemption-deferral option, a lien is placed upon the transferred property for the inheritance tax and any interest which may be charged. The provision has a penalty similar to the federal recapture tax for heirs who sell the land or cease to use the land for a qualified use within ten years of the effective date of the farmland development rights agreement.

If the farmland is sold by the heir within five years of the effective date of the agreement, one of four penalties is charged depending upon who acquires the land. If the land is sold to another qualified heir who complies with the agreement, the exemption-deferral remains intact. If the buyer is not a qualified heir but complies with the agreement, the exempted and deferred taxes are due immediately without penalty or interest. The total amount of exempted and deferred taxes are due at a penalty of 3/4 of one percent per month compounded from the time the exemption was granted until the taxes are paid if the owner's request for relinquishment of the agreement is approved according to Public Act 116, section 12(2)(b). Section 12(2)(b) provides a procedure for the owner of land enrolled in a farmland development rights agreement to request his or her land be removed from the program. Finally, the exempted and deferred taxes are due without penalty or interest if the state agrees to relinquish the farmland development rights agreement.[67]

Sale of the land by the owner after the fifth year, but not after the tenth year, results in the same treatment as before except that the amount of tax due is prorated over the time remaining in the deferral period.[68]

In cases where the qualified heir does not sell the land but ceases to keep the land in an agricultural use, the recapture procedure is slightly different. Failure to keep the land in an agricultural use at any time results

in the entire amount of exempt and deferred tax becoming due with a penalty of 3/4 of one percent interest compounded monthly added to the tax bill from the time the exemption was received until the taxes are paid.[69]

Failure to meet the obligations required by the farmland development rights agreement triggers not only a recapture of deferred and exempted inheritance taxes, but also property tax credits. The farmland development rights agreement also gives a property tax break and results in penalties by violating the agreement. Thus, a failure by the heir to honor the farmland development rights agreement results in payment of inheritance taxes and property taxes at the same time.

Case VI Michigan Inheritance Tax Deferral - Exemption

Situation VI

This case uses the same estate as in Situation I. The circumstances are altered in that one son works the farm when his mother passes away and he inherits everything. The son is married and has three children.

In Michigan there are two classes of heirs, Class I and Class II, for purposes of the state inheritance tax. Class I heirs include grandparents, parents, children, spouses, siblings, the wife of a son, the husband of a daughter, an adopted person or a person who stood for a parent if the relationship began before the decedent was 17. The decedent's son and his wife are the only Class I heirs. Michigan taxes the two classes differently and provides no tax exemptions for Class II heirs. All Class I heirs receive a $10,000 exemption and a spouse receives an additional $65,000 exemption.

The personal representative elects the Michigan inheritance tax deferral-exemption option. The estate exempts 50 percent of the fair market value of the real property from the estate and defer the inheritance tax on

the remaining 50 percent of the farm real property. All qualifications are met.

Without the deferral-exemption election, the estate has a taxable estate of $2,290,640 upon which a state inheritance tax of $200,364 is levied (See Table 13). Michigan levies an additional state tax if the federal state death credit taken on the federal estate tax return is greater than the state inheritance tax calculated. The difference between the state inheritance tax calculated and the federal credit allowed is added to the state tax due. The state death tax credit allowed is $122,051 so no additional state tax is due.

If the state deferral-exemption option is elected, one-half of the real property value, $1,125,000, is excluded from the gross estate leaving a taxable estate of $1,165,640. The state inheritance tax $87,864 (See Table 18). Of this, the amount attributable to the real property may be deferred for ten years.

Table 18. State Inheritance Tax Calculations--Situation VI

	Rate	Without Election		With Election
Taxable estate		$2,290,640		$1,165,640
Exemption		10,000		10,000
Tax on 40,000	2%	800		800
Tax on 200,000	4%	8,000		8,000
Tax on 250,000	7%	17,500		17,500
Tax on 250,000	8%	20,000		20,000
Tax on 1,540,640	10%	154,064	415,640	41,564
Total State Tax		$200,364		$87,864

To calculate the amount of the tax deferred, the ratio of the farm real property included in the estate to the adjusted gross estate value is multiplied by the tax due. The amount deferred is 96.5 percent of the tax bill, or $84,800. The remainder of the tax, $3,064, is due nine months after the

decedent's death. The present value of the deferred tax at 8 percent is $42,343.36 and decreases as the interest rate increases.

There are some obvious financial benefits from electing the exemption-deferral option. The tax is significantly reduced and the deferral reduces its present value even more. In cases of large tax bills, the choices that the heirs and personal representative have may be limited. In smaller estates, the heirs will have to weigh the tax savings against the restrictions imposed by the provision. The state places land use obligations on the heirs via the inheritance tax and through enrollment in P.A. 116. These restrictions may become too burdensome in cases of smaller tax liabilities. In this case, however, election of the exemption-deferral would be wise especially if the estate intends to elect section 2032A of the federal tax code.

The Michigan inheritance tax exemption-deferral has been used sparingly in the short time it has been in effect. There are two questions regarding the exemption-deferral that must be recognized. How does the provision handle farm partnerships and corporations? The statute does not provide for indirect ownership of real property through corporations, partnerships or trusts and according to a Treasury Department representative failure to own the land outright will disqualify the estate from election of the provision. This position is not official and has not been tested in the courts but, an estate planner should be aware of the potential problem.

The second question stems from ambiguity in the code. The provision states that if the land is sold after the fifth year, but before the end of the tenth year the taxes saved are due on a pro-rata basis. There is, however, no procedure set down about how the proration is to be calculated. The numerator is the number of months remaining in the ten year deferral period, but there is no indication what the denominator will be.

The question is whether the denominator in a fraction with the number of remaining months in the ten year deferral period as the numerator is 60 or 120. This fraction is then multiplied by the tax due. For example, if an heir sells the land he or she inherited after seven years in a qualified use would the initial tax due be multiplied by a value of 36/60, which is the number of months remaining in the ten year deferral period over the number of months remaining after the first five years of the deferral occur and proration begins, to get a prorated value of the tax due? Or would the exempted-deferred taxes be multiplied by a fraction with a value of 36/120? The numerator, 36, is the number of months remaining in the ten year deferral period and the denominator is the total number of months in the deferral period. A representative of the State Treasury Department did not know which method would be used. There have been no test cases and the Treasury Department has not asked for a legal interpretation of the statute.

CONCLUSIONS

Special Use Valuation

Section 2032A is a rarely used but potentially very valuable estate tax provision. A degree of uncertainty about special use valuation and lack of opportunity to elect it have limited the use of section 2032A in Michigan. The code is unclear on what qualifies as material participation and how basis is calculated in the case of recapture. The ambiguity is compounded by a lack of case history to which an estate planner or personal representative can refer. Although the manner in which the Internal Revenue Service has interpreted some of the provisions appears to be more inflexible than the way in which Congress intended the provisions to be construed, attorneys are hesitant to confront the IRS in an audit because they have no precedents to cite.

Misinterpretation and misunderstanding of the code are also to blame for the section's lack of use. Many attorneys thought if no alternative use existed there was no need or purpose in calculating a special use value. This is absolutely without foundation. Even if there is no other use for the land, the special use value should be calculated and will almost always be below, usually substantially below, the fair market value of the land.

Lack of opportunity to elect special use valuation must also be cited as a reason for the provision's limited use. Since the provision has only existed for five years and because of the nature of Michigan agriculture, the number of estates that could benefit from special use valuation is limited. Few farmers who have died in the past five years have estate tax problems. Michigan agriculture is also of a different nature than other midwestern states. The average farm size and land values are less than those of the corn belt. Dairy, fruit and other types of farming do not usually have as large an investment in real estate as a cash grain operation and the benefits of sec-

tion 2032A may not be as great for those farm types. Of the seven attorneys that had elected section 2032A, six were located in either southeastern Michigan or the Saginaw Valley, predominantly cash crop agricultural areas. The seventh attorney was located in an area in which tourism and land development are very important.

Special use valuation in its present state of uncertainty is not a very useful estate planning tool. The questions surrounding qualification by the decedent and the heirs makes planning on the provision almost impossible for attorneys and their clients. A common approach taken by the attorneys was to develop an estate plan using other tools and at the death of a client special use valuation is then considered. If the estate qualifies, the election is made. If the heir has changed his or her mind about remaining in farming, the client still has a developed estate plan. It is not wise to develop an entire estate plan around special use valuation, but the provision should be given more attention and consideration by professional estate planners than it has so far.

Fractional Interest Rule and Two Percent Spousal Participation

The fractional interest rule and 2 percent spousal material participation rule provide little, if any, estate tax benefit to farmers. Of the two, section 2040(c) may provide some aid to an estate on occasion. Section 2040(c) can be used by an attorney as a last attempt to exclude part of the value of the decedent's jointly held assets from the gross estate. In most cases however, a personal representative who is able to show material participation for purposes of section 2040(c) would be able to exclude a percentage of the joint property anyway. Only in those cases where this is not possible, and from the attorneys comments that is rare, would section 2040(c) be used. This is not to say the 2 percent rule should be ignored. In some cases the section

2040(c) value may be greater than the value which can be excluded from the gross estate using other methods and in those cases section 2040(c) should be elected. But the method section 2040(c) uses to determine how much joint property can be excluded lessens the possibility of that occurring. The courts have been willing to exclude 25-50 percent of the jointly held property from the decedent's gross estate when the personal representative uses affidavits and other proof that shows the survivor's material participation. It is doubtful whether section 2040(c) can eliminate as much in most cases.

Section 2040(b) is of no benefit to an estate tax planner or client. The fractional interest rule is contrary to all estate planning precepts. Creating a qualified joint interest will not benefit the estate at all. If there is no spousal contribution to the joint property, creation of a qualified joint interest will result in a gift tax being levied on one-half the value of the property. Payment of a gift tax in itself is enough to dissuade most people from electing the provision. If, however, a gift is going to be made, from husband to wife for example, the estate does not benefit from holding the property as joint tenants. The property will be excluded from the estate of the first spouse to die, but joint tenancy's right of survivorship places the property into the survivor's estate, which will not minimize the total tax paid by both spouses. It is more beneficial, whether a gift tax is paid or not, to own the property as tenants in common or own it separately. A trust or trusts can be established which will lessen the estate tax upon the death of the surviving spouse, thus minimizing the total estate tax paid.

Estate Tax Deferrals

The estate tax deferrals are the best known and most widely used of the tax provisions examined in this paper. Section 6166 has not been used much because it is relatively new and it has rather strict qualification require-

ments, but the philosophy behind it, and section 6166A, is understood and accepted by estate planners. "Estate tax deferred is estate tax unpaid" is a common thought. The tax deferrals are also considered to be easier to incorporate into an estate plan than the other provisions. There are other tools, such as trusts, that are used more extensively than deferrals, but a tax deferral is preferred to special use valuation at this point. Estate tax deferrals are also easier to qualify for than special use valuation. Sophisticated clients and estates with large tax liabilities may use estate tax deferrals, but they do not solve many estate tax problems. Most heirs do not like to drag out the payments and neither do their counselors. Tax deferral elections require the attorney to keep abreast of the family situation for the entire deferral period and send out reminders periodically about payment of the tax installment. Professionals would generally prefer to close the estate if possible and not be bothered with this.

Michigan Inheritance Tax Exemption-Deferral

The Michigan inheritance tax exemption-deferral provision is in a very uncertain status. It is an attempt by the state to combine the concepts of the federal special use valuation and tax deferrals. The provision is so new that only a handful of estates have elected it. This does not diminish its potential as an inheritance tax saving tool. It offers an advantage over the federal provisions in that qualification for the exemption includes qualification for the deferral which is not always the case in the federal code. It is difficult to say how significant the exemption-deferral option will become. If estate planners are successful in their attempts to reduce the amount of property held in joint tenancy, the provision could play a bigger role in inheritance taxation. State inheritance taxes are relatively small, however,

compared to federal estate taxes and estate planners and their clients may choose to pay the tax rather than subject the estate to the ten year lien.

Summary

The paper has discussed the operation, potential uses, and problems of the estate and inheritance tax provisions. Table 19 is designed to show which provisions an estate planner should give consideration to when formulating an estate plan or settling an estate. The estate may not qualify for a specific provision, but the section should be looked at.

If one or more of the provisions is deemed to be useful for the situation, the personal representative must take steps to elect the provision. A section 2032A election requires the following:

1) The personal representative must determine whether the estate qualifies for the provision.
2) The personal representative must determine whether a qualified heir will keep the land in a qualified use for the required length of time.
3) The previous five-year average cash rents, property taxes from comparable farmland must be obtained, plus the average effective Federal Land Bank loan rate. These values are needed to establish the value of the special use land.
4) All qualified heirs must sign an agreement making them liable for the recapture tax if the land fails to remain in a qualified use by a qualified heir.
5) The estate tax return must be filed nine months after the decedent's death unless an extension has been granted.

The procedure for electing sections 6166 or 6166A is similar to that of section 2032A.

1) The personal representative must determine whether the estate meets the requirements determining of the deferral. This includes percentage of the estate requirements and determining whether the assets qualify as an active business. A passive role in a business by the decedent will disqualify the estate.

2) The personal representative must file the return nine months after the decedent's death unless an extension has been granted.

3) The heirs and personal representative must ensure prompt payment of the installments. Payment delinquency may result in the unpaid balance of the tax coming due immediately.

4) The parties must also be careful with respect to dispositions and withdrawals of assets. Extensive withdrawals or dispositions can trigger payment acceleration.

Section 2040(c) allows exclusion from an estate of part of the estate's joint property. In order to accomplish this the executor must take the following steps.

1) The number of years the survivor materially participated in the farm operation must be determined. This number is multiplied by .02 to obtain the exclusion percentage. Material participation of the survivor is decided by the same criteria used for section 2032A.

2) The decedent's initial consideration must be calculated and subtracted from the value of the joint property. In addition, a six percent simple interest appreciation factor must also be subtracted from the joint property value.

3) The election of section 2040(b), the fractional interest rule, has not been mentioned in this discussion. The section has limited value in estate planning. Therefore, its use is not recommended and it is not included in this summary.

Some of the requirements of section 2032A also apply to the Michigan inheritance tax exemption-deferral. The Michigan provision does not require calculations of the land values based on comparable land factors. The procedure for election of this Michigan provision is as follows.

1) The personal representative must determine whether the estate and heirs meet the qualification requirements.

2) The heirs or personal representative must file an affidavit with the probate judge requesting election of the provision.

3) Upon approval of the judge, the land must be enrolled in Public Act 116, the Farmland and Open Space Preservation Act, for at least ten years. This election must occur within 30 days of the judge's notification.

4) The heirs and personal representative must be aware of the lien placed upon the property for the ten-year period.

Table 19 Estate Tax Provisions to Consider

	Estate Size	
	$175,000-$425,000[1]	$425,000
DECEDENT NOT MARRIED	(Consider these provision sections)	
Decedent participated in farm management, no heir had participated, no heir will manage farm.	6166, 6166A[3]	6166, 6166A[3]
Decedent participated in farm management, no heir had participated, an heir will manage farm.	6166, 6166A 2032A, Mich. Exemp.	6166, 6166A 2032A, Mich. Exemp.
Decedent participated in farm management, heir had participated in farm, no heir will manage farm.	6166, 6166A[3]	6166, 6166A[3]
Decedent participated in farm management, heir had participated, an heir will manage farm.	6166, 6166A 2032A, Mich. Exemp.	6166, 6166A 2032A, Mich. Exemp.
Decedent had not participated in farm management, no heir had participated, no heir will manage farm.	None	None
Decedent had not participated in farm management, no heir had participated, an heir will manage farm.	None	None
Decedent had not participated in farm management, heir had participated on farm, no heir will manage farm.	6166, 6166A[2]	6166, 6166A[2]
Decedent had not participated in farm management, heir had participated on farm, an heir will manage farm.	6166, 6166A[2] 2032A, Mich. Exemp.	6166, 6166A[2] 2032A, Mich. Exemp.
DECEDENT MARRIED		
Decedent participated in farm management, no heir had participated, no heir will manage farm.	None[4]	6166, 6166A[3]
Decedent participated in farm management, no heir had participated, an heir will manage farm.	None[4]	6166, 6166A 2032A, Mich. Exemp.
Decedent participated in farm management, heir had participated on farm, no heir will manage farm.	None[4]	6166, 6166A[3] 2040(c)[5]
Decedent participated in farm management, heir had participated, an heir will manage farm.	None[4]	6166, 6166A, 2040(c)[5] 2032A, Mich. Exemp.
Decedent had not participated in farm management, no heir had participated, no heir will manage farm.	None[4]	None
Decedent had not participated in farm management, no heir had participated, an heir will manage farm.	None[4]	None
Decedent had not participated in farm management, heir had participated on farm, no heir will manage farm.	None[4]	6166, 6166A[2] 2040(c)[5]
Decedent had not participated in farm management, heir had participated on farm, an heir will manage farm.	None[4]	6166, 6166A,[2] 2040(c)[5] 2032A, Mich. Exemp.

[1]The estate planning tools under discussion are not necessary for estates less than $175,000 in size.

[2]Passive role in business by owner may disqualify estate from deferral.

[3]Qualification requirements after decedent's death are not like those of section 2032A but if not met may disqualify estate if disposition or withdrawal occur.

[4]Assumes use of maximum marital deduction. If maximum marital deduction is not used, column is same as greater than $425,000 column.

[5]Wife must have materially participated in farm to qualify for section 2040(c).

ENDNOTES

[1]I.R.C. sec. 2032A(b)(1).

[2]I.R.C. sec. 2032A(b)(2)(A)-(B).

[3]I.R.C. sec. 2032A(e)(4).

[4]I.R.C. sec. 2032A(e)(5)(B)-(C)(ii).

[5]I.R.C. sec. 2032A(e)(1)-(2)

[6]I.R.C. sec. 2032A(b)(1)(C)(i)-(ii).

[7]I.R.C. sec. 2032A(b)(1)(A)-(B).

[8]I.R.C. sec. 2032A(e)(7)-(8).

[9]Federal Estate and Gift Taxes Explained, 1979 Edition (Chicago, Ill., Commerce Clearing House, Inc., 1979), p. 57.

[10]I.R.C. sec. 6324B(b).

[11]I.R.C. sec. 2032A(c)(2)(D).

[12]I.R.C. sec. 2032A(c)(3).

[13]I.R.C. sec. 2032A(h)(2).

[14]I.R.C. sec. 2032A(d)(2).

[15]I.R.C. sec. 2032A(e)(11).

[16]I.R.C. sec. 6166(b)(1)-(b)(2)(A).

[17]I.R.C. sec. 6166A(c).

[18]I.R.C. sec. 6166(a)(1).

[19]I.R.C. sec. 6166(b)(6).

[20]E. Hood, L. Chalstram and P. Brown, "Special Elections: The Use of Sections 6166, 6166A and 303 of the Internal Revenue Code," University of Missouri-Kansas City Law Review, Vol. 47, No. 4 (Summer 1979), p. 514.

[21]I.R.C. sec. 6166A(a)(1)-(2).

[22]I.R.C. sec. 6166(c).

[23]I.R.C. sec. 6166A(d).

[24]I.R.C. sec. 6166A(d).

[25]Hood, Chalstram and Brown, University of Missouri-Kansas City Law Review, p. 499.

[26]I.R.C. sec. 6166(b)(2)(B).

[27]I.R.C. sec. 6166(b)(2)(C).

[28]I.R.C. sec. 6166(c).

[29]Hood, Chalstram and Brown, University of Missouri-Kansas City Law Review, p. 502.

[30]I.R.C. sec. 6166(b)(7).

[31]Hood, Chalstram and Brown, University of Missouri-Kansas City Law Review, p. 504.

[32]I.R.C. sec. 6166(a)(2).

[33]I.R.C. sec. 6166(a)(3).

[34]I.R.C. sec. 6166A(a).

[35]I.R.C. sec. 6166A(b).

[36]I.R.C. sec. 6601(j)(2).

[37]I.R.C. sec. 6166(f).

[38]I.R.C. sec. 6601(j)(3).

[39]I.R.C. sec. 6621.

[40]I.R.C. sec. 6166(g)(3).

[41]I.R.C. sec. 6166(g)(B)-(C).

[42]Hood, Chalstram and Brown, University of Missouri-Kansas City Law Review, p. 525.

[43]Ibid., p. 528.

[44]Harold W. Hannah, ed., Beuscher's Law and the Farmer, 4th Edition (New York, Springer Publishing Company, 1975), p. 71-72.

[45]Ibid., p. 74.

[46]I.R.C. sec. 2040(b)(1).

[47]I.R.C. sec. 2040(b)(2).

[48]I.R.C. sec. 2515(c)(2).

[49]I.R.C. sec. 2040(c)(1).

[50]I.R.C. sec. 2040(c)(3)(A)-(B)

[51]I.R.C. sec. 2040(c)(4).

[52]I.R.C. sec. 2040(c)(7).

[53]I.R.C. sec. 2040(c)(5).

[54]I.R.C. sec. 2040(c)(6).

[55]I.R.C. sec. 2040(c)(2).

[56]Mich. Stat. Ann. sec. 7.562(4), Mich. Comp. Laws sec. 205.202d.

[57]Farmland and Open Space Preservation Act, Mich. Stat. Ann. 26.1287(2), Mich. Comp. Laws sec. 554.702(1).

[58]Mich. Stat. Ann. sec. 7.582, Mich. Comp. Laws sec. 205.221.

[59]Ibid., sec. 205.221(d)(i)-(iv).

[60]Ibid., sec. 205.221.(e)(i)-(ii).

[61]Ibid., sec. 205.202d.(2).

[62]Ibid., sec. 205.202d.(1)(a)-(c).

[63]Ibid., sec. 205.202d.(2).

[64]Ibid., sec. 205.221.(i).

[65]Ibid., sec. 205.202d.(2).

[66]Ibid.

[67]Ibid., sec. 205.202d.(3)(a)-(d).

[68]Ibid., sec. 205.202d.(4)(a)-(d).

[69]Ibid., sec. 205.202d.(5).