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Tax Reform Act of 1976

Use Valuation

Material Participation

Estate Tax Shelter

Legislative Developments

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ABSTRACT

The Tax Reform Act of 1976, probably the most major revision of tax statutes since adoption of the current code in 1954, contained major changes in estate and gift tax sections that affect farmers and others in the agricultural sector. Articles in this report focus on these changes; authors examine how "use value" assessments might be carried out, eligibility restrictions on such assessments, probable effects of the "carryover" basis rule, section 6166 estate settlements (installment plan), and other potential problem statutes in the Act. They also consider effects of regulations adopted since the Act was passed.

Keywords: tax reform, estate tax, gift tax, use value, carryover basis.

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PREFACE

The Tax Reform Act of 1976 was one of the most significant and far-reaching tax "reforms" in many years. In fact, it probably constitutes the most sweeping revision of tax statutes since the adoption of the current code in 1954.

For many people, the estate and gift tax sections in the legislation constitute "the" Tax Reform Act of 1976. Inflation and estate tax provisions which had gone unchanged for more than 30 years had combined to make increasingly more estates subject to the estate tax. Over time, more and more people thought that some changes were needed to redress this tax encroachment on estates with lesser relative asset values. At the same time, some families were apprehensive about the effects of high property values and low farm liquidity on the intergenerational transfer of family farms. These concerns culminated in the estate tax provisions in the Tax Reform Act of 1976.

The estate tax changes in the act are of three different types. The first group affects all estates: The estate and gift taxes, formerly separate taxes on specifically different types of interpersonal transfers, were unified into one tax. More importantly, estate taxes were generally reduced at the same time. The tax exemptions for each separate tax were replaced with a single unified tax credit which was large enough to effectively increase the tax-free size of the estate. The marital deduction was also substantially increased for estates with adjusted gross value under $500,000, and the ownership determination for property held in joint tenancy was changed.

The second group is specifically directed at farmland and other closely held estates. In response to claims that land values were unrealistically high and thus not an appropriate basis for estate tax calculations, legislators allowed a "use value" to be substituted for fair market value. To compensate for the general lack of liquidity believed common in closely-held businesses (which was thought to cause an undue hardship if estate tax liabilities were to be paid promptly), the already-existing 10-year installment method of paying estate taxes was substantially expanded and liberalized.

The third group contains a single item, the "carryover" basis provision. Strictly speaking, it is not actually a change in the estate tax, but a change in how income taxes are levied. However, it was a critical part of the compromise which finally made changes in the estate tax possible, and is generally considered in the context of the estate tax.

Under the old law, gains that were unrealized (not sold) during an individual's lifetime were never assessed for income tax purposes. The tax basis of the inherited property was "stepped up" to its fair market value at the time of the owner's death, and when an individual sold his or her inherited property later, the income tax was calculated on the basis of the difference between the sale price and the "stepped-up" value of the property. Under the new "carry-over" basis provision, the appreciation before the time of inheritance can be taxed as income. The basis for the income tax calculations is "carried over" from a period before the owner's death.

These changes obviously represent a major departure from previous estate tax treatment, and persons who expect to leave moderate to large bequests will want to examine these provisions to determine what changes in their estate plans would be prudent because of the new rules. All estates except the very largest will incur lower tax liabilities, but some minor changes in the nature of the bequest may lower Federal estate tax liabilities even more.

Clearly, the biggest advantages accrue to persons with farm estates--depending, of course, on how the actual "use value" assessment is determined. The Congress, recognizing the potential for abuse of these tax preferences, devised several restrictions to limit the amount by which these provisions could reduce the value of the estate, and the number of estates which qualify for the special valuation. Unfortunately, both of these limitations were rather ambiguous and offer a wide range of interpretations about what is and is not allowable under the law: How farmland would be assessed for Federal estate tax purposes and who was eligible for "use value" assessment.

Most tax practitioners hoped that Internal Revenue Service regulations would be forthcoming to clarify these problem areas, but Treasury moved cautiously, evidently unwilling to make any hasty decisions that might cause difficulties later. In an attempt to resolve some of these problems--or at the least, to get them well articulated--ESCS organized a symposium on farm estate tax issues raised by the Tax Reform Act of 1976, for which this collection of papers was prepared.

The first session of the symposium, held in St. Louis, Missouri, April 12 and 13th, 1978, considered how the "use value" assessment might be carried out. The second session examined the eligibility restrictions on "use value" assessment, focusing primarily on "material participation." The final session weighed the probable effects of the "carryover" basis rule, section 6166 estate settlements (the installment plan), and other potential problem statutes in the Act.

The Internal Revenue Service regulations have now been issued, and the controversy over these estate tax provisions has been partially resolved. That part which is still unresolved will move into the courts. Nonetheless, these papers remain a useful addition to the understanding of agricultural economics, finance, and the law. In some cases the papers have been updated to reflect the new regulations. These changes appear as footnotes.

SPECIAL USE VALUATION METHODS -- PROBLEMS AND PERSPECTIVES

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It is appropriate that any discussion of the special use valuation provisions in 2032A begin with an overview of some of the problems to which there appear to be no ready answers. Specifically, attention should be directed to questions raised by examination of the two valuation methods provided under the special use valuation subsection.

When one looks at the legislative history of the 1976 Tax Reform Act, it is apparent that both reports on this act were directed at identifying techniques to remove some of the controversy surrounding valuation and to encourage continuation of farming or closely-held business activities.1/ The two methods of valuation included in 2032A add to the uncertainty of valuation procedures, and some have questioned whether the policy objectives of encouraging the continuation of farming can be achieved through these provisions.

Certain problems are raised by both the farm method and by the multiple-factor method for valuation. The farm method provides for dividing the excess of the annual gross cash rental (determined on a 5-year average) for comparable farmland in the same locality over the annual State and local real estate taxes (determined on a 5-year average) for such comparable land by the annual effective interest rate (determined on a 5-year average) for all new Federal land bank loans.2/ Each average is to be based on the 5 full calendar years preceding the decedent's death; the apparent intent is to allow conversion of crop share arrangements into cash rental figures to determine an average cash rental per acre.

For example, if an average annual gross cash rental is $35 an acre and the annual average real estate taxes are $5 per acre, the average annual net cash rent is $30 per acre. If the average annual effective rate for all new Federal land bank loans is 8 percent, the value of the land is $375 ($30 ÷ 0.08 = $375) an acre under the farm

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1/ See House Report No. 94-1380 and the Joint Explanatory Statement of the Committee of Conference.

2/ I.R.C. Section 2032A(e)(7).

method. This method simplifies the caluclation and leaves little room for controversy as far as the method itself is concerned. However, a number of unresolved questions linger.

The Subcommittee on Valuation Methods, Committee on Agriculture, American Bar Association Section of Taxation has addressed several of these questions and has identified problem areas:

1. How does one obtain a list of cash rental values in a specific area? In some areas of the country, this information is readily available because of the maturity of the rental market. Such is not the case in a state such as Virginia where the agriculture is diverse and little consistency exists in rental arrangements, and the information regarding these arrangements is not easily obtainable.

2. Just what is the definition of "comparable land?" This is, of course, a matter of crucial concern and in a State such as Virginia a definition will be particularly difficult because of the widely varying topography and soil types, and, again, the diversity of the farming operations.

3. Under the farm method, comparable land must be in the locality of the deceased's property. Just what is meant by locality? Does this mean a specific area of a county, a given county, a State, or region of the country? Just how broadly can locality be defined?

4. How does one determine the average effective interest rate for Federal land bank loans as required by the statute? There is no national rate, and the effective interest varies from district to district and will involve possible discounts for stock. This poses some problems in determining just what interest rate to use.

Another special subcommittee of the Committee on Agriculture of ABA Section of Taxation reporting on Section 2032A has indicated that some of the terminology involved in the farm method must be defined realistically.3/ Should this not be done, the farm method might be greatly restricted in use. This would indeed be unfortunate because the multiple-factor method is subject to even more questions of interpretation and a number of unresolved issues linger there as well. This method may be elected by the executor or may be used when comparable land data is not available for use in determination of a realistic annual rental value. Five factors are involved:

1. The capitalized earnings value of the property based on the expected earnings for farming or closely held business purposes over a reasonable period of time under prudent management in which traditional cropping patterns of the area are used and soil capacity, terrain, and similar factors are considered.

2. The capitalized earnings value based on the fair rental value of the land for farming or closely held business purposes.

3/ "Estate Tax Valuation of Real Property Based on Farm or Other Business Use," Special Subcommittee to Report on Section 2032A, Committee on Agriculture, ABA Section of Taxation.

3. The assessed land values when the land is located in a State which provides differential or use value assessment for farmland or closely held businesses.

4. Any comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price.

5. Any other factor which fairly values the farm or closely held business uses of the property.4/

All factors which may be available in a given situation should be considered in determining the special use value, but the act provides no rules by which these factors may be combined to determine a true net value. Again, a number of unresolved definitional issues are involved. One such question relates back to definitions used under the farm method. Farm method involves the use of rental rates for comparable land in the locality. The first factor under the multiple-factor method allows for capitalization of expected earnings using traditional cropping patterns for the area. The fourth factor allows for the use of comparable sales in the same geographical area. It is not obvious that the Congress intended the same meaning for each of the three different terms. Experience would tell us that caution must be exercised in dealing with such imprecise language. In any event, it raises questions concerning the availability of evidence to support the use of a particular value.

Another question involves determination of just what factors might be available under the miscellaneous provision which allows for "any other factor which fairly values the farm or closely held business property."5/

Other questions arise from factor three, which allows for use of assessed land values in a State which provides differential-use value assessment for real estate tax purposes. This provision at first may appear to provide a logical solution, but it is only one of the five factors in the multiple-factor method.

Consider also the complications that arise in a State such as Virginia wherein the differential or use value assessment provisions are optional by county. Each county decides whether to use differential use-value assessment, and as a result, considerable variation is found throughout the State. In addition, it is unclear whether the method could be used for farms in a State which provides for use value assessments but the farms are in a county which has not elected to choose this method. Some counties use the technique only for agricultural land, some for agricultural and horticultural, some for agricultural, horticultural, and forest land, and some for open space as well. One locality uses use value only for open-space land.6/

The Virginia use value taxation procedure authorized in the 1971 session of the General Assembly does provide an interesting example of how assessed land values in States providing differential use-value assessment may be used under the multiple-factor test.7/ The Virginia use value assessment procedure applies to the agricultural, horticultural, forest, and open-space lands.

4/ I.R.C. Section 2032A(e)(8).

5/ I.R.C. Section 2032A(e)(8)(E).

6/ "Procedures for Determining Ranges of Use-Values for Agriculture, Horticulture, Forest and Open Space Land in Virginia with Suggested Use-Values," State Land Evaluation Advisory Committee, Richmond, Va., Sept., 1977, p. 43.

7/ Va. Code. Ann. S58-769.4 *et. seq.*

Virginia law provides for a six-member State Land Evaluation Advisory Committee (SLEAC), which annually determines and publishes suggested use values for real estate in agricultural, horticultural, forest, and open-space use in each local jurisdiction which in the previous year has authorized use-value taxation.8/ The SLEAC is to determine acreage in each soil conservation land capability classification for each soil classification within the jurisdiction, so that use value on each soil capability classification will be uniform. SLEAC "shall base their determination on productive earning power to be determined by capitalization of warranted cash rents or by the capitalization of (net) incomes of like real estate in the locality or a reasonable area of the locality."9/ SLEAC has in fact elected to determine use values by the capitalization of net incomes derived through budgeting since data on cash rents are not available. The market for cash renting of land in Virginia is limited and does not reflect market conditions. Recently, SLEAC published its 1978 Suggested Use Values for the counties and cities in Virginia which have adopted use-value procedures.10/

The Virginia procedure meshes well with the multiple-factor method of 2032Ae(8). It accounts for factor one of the multiple-factor method -- the capitalized earning value of the property. Factor one involves traditional cropping patterns, soil capacity, terrain configuration, and so on, which is consistent with the procedure used in Virginia. Virginia's procedure yields a value determination for agricultural land, a separate determination for horticultural land, and separate determinations for forest land and for open space. Up to four components are considered in the capitalization rate: interest rate, risk, property tax, and depreciation which applies only to horticultural land devoted to orchard use.

The interest-rate component is the average interest rate applicable on all bonds which the Federal land bank serving Virginia has outstanding as of July 1 for each of the 5 crop years utilized in making the estimate. For example, the July 1, 1976 rate was 7.57 percent, but the average July rate for crop years 1972 through 1976 was 7.03 percent. Naturally, the current rate is somewhat higher. In contrast, the farm method of Section 2032A(e)(7) uses the rate of a 5-year average of new loans. Virginia's risk component is based on a concept similar to that used in the Federal Crop Insurance program, and it includes consideration of the risk associated with excess rainfall. The property tax component used is the average effective true tax rate based on data published by the Virginia Department of Taxation. Use of the property tax component has the effect of increasing use values in jurisdictions where the tax has been relatively low and decreasing them where the tax has been relatively high.11/ The Virginia experience represents several years of work and study and provides an excellent example of methods that might be available under the multiple factor procedure of 2032A(e)8.

There also appear to be some general problems of valuation inherent in the use of the methods provided in 2032A. First, multiple evaluations will be required because the highest and best use value will have to be determined to ascertain qualification and to determine whether or not the $500,000 limit will be applicable.

Second, it appears that special use value can be elected item by item, which, according to the ABA Section of Taxation Committee on Agriculture, Special Subcommittee to Report on 2032A, would allow one to obtain the lowest possible value for unimproved land and, at the same time, the highest possible value for depreciable

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8/ Va. Code Ann. S58-769.11.
9/ *Ibid.*
10/ *Op. cit.*, note 6.
11/ *Op. cit.*, note 6, p. 7.

real property. This would lead to separate determinations of special use valuation and fair market valuation for each possible real asset.12/

Third, consideration should be given to possible audit adjustments which might occur subsequently. Such an adjustment could cause the nonqualifying property to be increased in value to the extent that disqualification of special use could occur. However, the result is not clear regarding the failure to pay the proper amount of tax because of improper election of 2032A provisions.

The use of these valuation methods also must be considered in light of the possible impact on carry-over basis if the carry-over basis provisions are implemented after 1979. If the 2032A value is elected, that becomes the value used in computing the "fresh-start" basis adjustment. In addition, if a recapture occurs because of a sale outside the family or conversion to a nonqualified use, there is no redetermination of fresh-start adjustment because the recapture tax is not considered to be an "estate tax."

Other possible problems include filing requirements; decisions regarding election, cessation of use, and other recapture problems; the special lien; the relationship with formula clauses in existing wills; the relationship with 6166 and 6166a; estate tax deferral; and a myriad of other problems. One thing is clear--to determine the desirability of using either the farm value method or the multiple-factor method, numerous calculations will be required, and the workload of those involved in the estate administration will be increased manyfold.

One should keep in mind that although the special-use evaluation provision is designed to lessen the farm estate tax burden and to encourage continuation in farming, Congress likewise intended that no loss in Government revenue would result in the long run. A review of these provisions and the underlying policy leaves us in a position succinctly described by one of Virginia's prominent tax planning attorneys, Lewis M. Costello, in testimony before the Senate Finance Committee, Subcommittee on Taxation and Debt Management:

> "The Estate and Gift Tax portions of the TRA '76 are virtually incomprehensible to the business community generally. The only thing certain is that it is the law of the Pharisees and not the Philosophers. The philosophy is frankly inconsistent and confusing to the point of frustration.13/

12/ *Op. cit.*, note 3.

13/ Senate Finance Committee, Subcommittee on Taxation and Debt Management, Hearings on July 25, 1977. Statement of Lewis M. Costello, Winchester, Va.

USE VALUATION UNDER THE 1976 TAX REFORM ACT: PROBLEMS AND IMPLICATIONS

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INTRODUCTION

With the rapid rise in farmland values during recent years, farmers and farm organizations have argued that land values have little relationship to agricultural productivity. The fact that farmers have been the dominant purchasers in the farm real estate market during this period of time would seem to discredit this argument to some degree, but public officials have been sympathetic to the farmers' arguments. Some State legislatures, particularly in areas of the country where urban expansion has placed upward pressures on land values, have adopted procedures to value farmland based on its agricultural productivity for purposes of assessing property tax.

In 1976, the use valuation concepts were encompassed in national tax legislation through the addition of Section 2032A to the Internal Revenue Code. This section enables "qualified real property" to be valued based on its "value in use" rather than "fair market value" as long as certain requirements are met. Such a valuation procedure has little precedence in estate tax law, and the implications of 2032A for farm families, investors in real estate, and overall social policy as to land tenure are widesweeping.

The purpose of this article is to review the major provisions of Section 2032A and the benefits of and problems (both procedural and data) that will be encountered in using the "use" valuation procedure. First, we examine the problems of collecting data to obtain "use-value" estimates along with the issues of material participation and eligibility requirements (before and after death). Then, we review specific estimates of the benefits of "use" valuation for different-sized estates. Finally, we present the implications of the special use-valuation privilege on real estate values, investment patterns, the land tenure system in rural America, and the interrelationship of 2032A with other dimensions of estate tax law--specifically carryover basis and installment payment of tax.

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THE USE VALUE LEGISLATION

Procedures

If qualified real property is used for farming purposes, its value can be determined in two ways:1/ (1) the capitalization of cash rent minus property taxes by the appropriate Federal land bank interest rate and (2) through use of the following five-factor formula:

1. Capitalization of income that the property can be expected to yield over a reasonable period under prudent management,

2. Capitalization of the fair rental value,

3. Assessed value if the State bases real property tax assessments on current use,

4. Comparable sales in the same geographical area but without significant influence from metropolitan or resort areas, and

5. Any other factor that would fairly value the real property.2/

The first procedure for valuing land is based on the income capitalization theory for valuing a resource. Specifically,

$$V = \frac{a_1}{1+r} + \frac{a_2}{(1+r)^2} + \frac{a_3}{(1+r)^3} + \dots + \frac{a_n}{(1+r)^n} \qquad (1)$$

where:

a = expected annual income,

r = discount rate, and

v = value of the resource.

As n approaches infinity, the formula becomes--

$$V = \frac{a}{r} \qquad (2)$$

For this procedure to be used, Section 2032A requires that the "average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm" minus the average annual real estate taxes (State, if any, and local) for such comparable land, be divided by the "average annual effective interest rate for all new Federal land bank loans."3/ The last 5 full calendar years before the death of the decedent are to be used in all calculations.4/

The discount rate. As is obvious from equations (1) and (2), the discount rate plays a major role in resource valuation. Reducing the discount rate by half doubles the value of the resource, for example.

1/ The procedures used to make the "use" valuation election are quite specific and are summarized in Prop. Treas. Reg. Section 20.2032A-8 (1978).

2/ I.R.C. Section 2032A(e)(8).

3/ I.R.C. Section 2032A(e)(7)(A).

4/ Ibid.

For special "use" valuation, the legislation specifies that the discount rate is to be the "average annual effective interest rate for all new Federal land bank loans."5/ The term "effective" rate as used in the statute suggests a rate higher than the stated loan rate to account for loan closing costs and the "cost" of owning Federal land bank stock. The rate is to be calculated for each Federal land bank district and published periodically as shown in table 1. Apparently, the calculated rates, to be available for each year starting with 1972, will include an allowance for the "cost" of owning Federal land bank stock but not for loan fees.6/

Gross cash rents. The legislation specifies that the income capitalization approach to "use" valuation is to use "average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm . . ."7/ That language seems to suggest actual cash rental figures on actual tracts of comparable land.8/

This is a crucial assumption and raises a number of questions. Would "synthesized" cash rents based upon statistical estimation using available productivity information for the soil and the area involved be acceptable? Are "variable" cash rental figures eligible (the landowner agrees to accept a specified amount of crop per year but bears uncertainty as to the price to be used in calculating the rent)? Can the cash rent equivalent of a crop-share lease be used as a substitute for "gross cash rents"? How are improvements (particularly the building site) to be treated in the computations? Each of these questions is discussed briefly.

Synthetic cash rents might be obtained through a structural analysis of the factors that explain cash rents. Such factors would include productivity of the land, size of parcel, relationship between lessee and lessor, location of land, length of lease and value of improvements. Once the factors that explain cash rents have been quantified, a parcel could be characterized by these factors and a cash rent estimated. Although sufficient data are believed to be available to generate synthetic cash rent figures in some States within bounds of reasonable statistical error, it is not clear that resulting rental figures would be acceptable under the statute.9/ In some ways, the task would be simpler if such figures were acceptable for land valuation purposes.

As to flexible cash rent leases, it appears that data from such arrangements would not be acceptable.10/ It is presumed that the statutory specification of cash rent means cash rent as the term is commonly defined in agriculture and it is not a modification of the cash rent concept. Likewise, it has been assumed that a statutory

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5/ I.R.C. Section 2032A(e)(7)(A)(ii).

6/ Proposed regulations indicate that the rate will not include loan fees but will include the "cost" of owning Federal land bank stock. Prop. Treas. Reg. Section 20.2032A-4(e)(1978).

7/ I.R.C. Section 2032A(e)(7)(A)(i).

8/ The proposed regulations appear to be in accord with that view. See Prop. Treas. Reg. Section 20.2032A-4(1978).

9/ The proposed regulations recognize that it may "... be necessary to value farm property in segments where there are different uses or land characteristics included in the specially valued farm. In such a case, actual comparable property for each segment must be used . . ." Prop. Treas. Reg. Section 20.2032A-4(d)(1978). Thus, it would appear that rental figures obtained through synthesis would not be acceptable. The proposed regulations indicate that rents which are paid wholly or partly in kind (crop share rents) cannot be used to determine use value. Prop. Treas. Reg. Section 20.2032A-4(b)(2)(iii)(1979).

10/ See Prop. Treas. Reg. Section 20.2032A-4(b)(2)(iii)(1979).

Table 1.--Average annual "effective" Federal land bank interest rates for deaths in 1977, 1978 and 1979

Federal land bank district	Average annual effective interest rate to be utilized		
	Death in 1977	Death in 1978	Death in 1979
	---Percent---		
Baltimore	8.65	8.86	9.04
Columbia	8.58	8.79	8.96
Houston	8.29	8.48	8.60
Louisville	8.64	8.80	8.88
New Orleans	8.26	8.48	8.72
Omaha	8.70	8.92	9.05
Sacramento	8.67	8.82	9.04
St. Louis	8.50	8.71	8.93
St. Paul	8.21	8.47	8.69
Spokane	8.63	8.88	9.10
Springfield	8.42	8.55	8.65
Wichita	8.52	8.72	8.88

bar would exist to using the cash rent equivalent of a crop share lease. It is noted that the number of cash-rented tracts is quite limited in some areas.

Use of the cash rent equivalent of a crop share lease would raise several important questions even if permitted. First, it is not clear what price for the crop or crops would be used in the calculations. Use could be made of the price actually received for the crop for the year in question, but the crop may have been stored and not sold. Moreover, using actual sale price would tend to base land values on marketing decisions rather than land productivity. Use could be made of harvest time prices for crops, if a date or dates were specified, or of an average annual market price.11/ Second, it is not clear what yields should be used in the calculations--

11/ The regulations, which were prepared in 1978 and later withdrawn, indicated that if crop share rental arrangements were used and the crop was not sold, "the crop can be valued as of the date received by the lessor at a price quoted by an established public agricultural commodities market." However, wide differences in prices among public markets may exist even in the same locality because of storage space and management of the various marketing firms. Furthermore, questions concerning the date when the lessor receives the crop (when each load is delivered to the storage facility, the date when the last load is delivered to the storage facility, etc.) may also rise. Prop. Treas. Reg. Section 20.2032A-4(b)(2)(1978), replaced with Prop. Treas. Reg. Section 20.2032A-4(b)(2)(iii)(1979).

actual yields, average yields for the county or other area or long-term average yields. Third, it is not clear how costs should be handled in computing the cash rent equivalent. In particular, various procedures are used to handle harvesting, drying, and storage costs as well as crop insurance costs. Also, the treatment of depreciation and depletion of such items as capital improvements, tile lines, and fences may present computational problems.

Finally, it is likely that cash rental rates over the long term will average significantly less than crop share rents. The difference represents, in approximate terms, compensation for the added risk and uncertainty borne by a landowner under a crop share arrangement compared with a cash rent lease. Thus, a systematic and significant difference would be expected to exist between crop share rent and cash rent with the result that the Internal Revenue Service would seek crop share data and the estate would search for cash rent information.

Improvements on real property, particularly the building site, present a unique problem in using the cash rent capitalization approach to "use" valuation. When improvements are extensive and represent a substantial part of the value of the rented farm, the arrangement tends to be a livestock or crop share lease. Rarely are heavily improved farms rented for cash. Thus, the problem may be posed of using cash rent data from farms with modest improvements to value farms of decedents with substantial improvements.12/

Comparability, discussed later, presents serious problems with improvements, as it would be difficult to find individual buildings, let alone a building site, that are comparable in size, construction, age, condition, or location to those on the decedent's property. With increased specialization in farming and rapid technological changes in grain storage and livestock production facilities, and the resulting technological obsolescence, the problems encountered in determining the use value of land with improvements will become more serious. Guidance is needed on how to determine the "use" value of a farm with improvements. Two problems are posed: (1) Is farmland to be valued separately, using comparable land that is cash rented, with improvements handled as a separate matter, or (2) is a farm to be valued as a unit with the comparability issue applicable to both the land and the improvements?

For this reason, it may be wise planning to omit the building site from use valuation especially if the land eligible for use valuation would reduce the gross estate of the decedent by more than $500,000. Moreover, omitting the building site would generally result in a higher income tax basis for the property (under carryover basis rules or otherwise) with more depreciation claimable after death.

Relatively little published data on cash rents are available. The U.S. Department of Agriculture publishes an annual survey of "expected" cash rents for the coming crop season by State.13/ The data are available by crop reporting district within each State. However, the data are only averages and would appear to be applicable only if the decedent's was an "average" farm or rental rates could be adjusted successfully from the average figures. Moreover, the published rental rates

12/ The proposed regulations specify that "the number, types, and conditions of all building and other fixed improvements located on the properties and their location as it affects efficient management and use of property" are among the factors to be considered in determining comparability. Prop. Treas. Reg. Section 20.2032A-4(d)(1)(1978).

13/ See Farm Real Estate Market Developments, Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture, Aug. 1979, pp. 64-67. IRS in proposed regulations states that such data cannot be used to determine use value. Prop. Treas. Reg. Section 20.2032A-4(b) (2)(iii)(1979).

are based on expected rates in the respondent's area and thus suffer from that additional difficulty.

Determining what is "comparable". The requirement that cash rental data must be from "comparable land . . . in the locality"14/ seems to limit the population of cash rent observations. If the term is defined literally to mean land with comparable productivity, one must then determine what land is comparable. However, if the term is defined to permit quantification of differences in productivity between the decedent's tract and the cash-rented tract or tracts identified in the locality, it would be possible to adjust the cash rent observations for the differences in productivity.15/

In several midwestern States, indexes of land productivity have been developed to permit comparison of tracts. These index systems have been used extensively in land valuation for property tax purposes where relative values are important. The Iowa system, for example, known as the "Corn Suitability Rating", encompasses various dimensions of productivity including soil type, slope, erosion, drainage, rainfall and other relevant factors.16/ A productivity index is obtained for each 40-acre tract. This index system makes possible objective comparisons of land and provides a framework for making adjustments in cash rents based on differences in productivity.17/ Because soil indexes are dependent upon a complete soil survey, not all areas are covered by an index system. In Iowa, for example, index data are available in more than two-thirds of the counties. All remaining counties are progressing toward completing soil surveys.

It should be noted that adjustments in value and cash rents based on a soil productivity index are no different in concept than using "synthesized" cash rent data. Also, other dimensions of comparability such as improvements, location, and lease terms must be recognized in any attempt to value land using the rent capitalization approach. Comparability could also be determined by competent appraisal of the decedent's tract and the other tract or tracts for which cash rent information is available.

The "Five Factor Formula". If cash rent data are unavailable or the executor chooses to not use the rent capitalization approach to use valuation, he or she may elect to use the "five-factor formula" for valuation noted earlier. Certainly this method is no more definitive in computational procedure or data base than the capitalization approach. Furthermore, it is unclear as to how these five factors are to be combined into a single estimate of value. If a single factor can be chosen at the executor's discretion, one might expect information from crop-share rental

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14/ I.R.C. Section 2032A(e)(7)(A)(i).

15/ The proposed regulations recognize several factors as possibilities--(1) productivity indexes already developed in several States--usually by 40-acre tract--to aid in making property value adjustments for property tax purposes; (2) whether the crops grown would deplete the soil in a similar manner; (3) the types of soil conservation practiced on the two tracts; (4) whether the two properties are subject to flooding; (5) slope of the land; (6) for a livestock operation, the carrying capacity of the land; (7) where the land is timbered, whether the timber is comparable; (8) whether the farm is a single tract or is broken up, and the means necessary for movement among the different segments; (9) number, types, and condition of buildings and other fixed improvements and their location; and (10) availability of transportation facilities in terms of costs and proximity to local markets. Prop. Treas. Reg. Section 20.2032A-4(d)(1978).

16/ See Fenton, "Use of Soil Productivity Ratings in Evaluating Iowa Agricultural Land," 30 J. Soil and Water Conservation 237 (1975).

17/ See Prop. Treas. Reg. Section 20.2032A-4(d)(1)(1978).

arrangements and/or property tax assessments based on use value to be utilized in the valuation process. Certainly, the earlier issues raised with respect to using crop share rental data in the valuation process would still apply. However, the legislation implies that no single factor of the "five-factor formula" can be used as the sole base for valuation, but that all five factors must be included and combined in an undisclosed fashion in the valuation process.

Problems With Eligibility Requirements

As with most tax provisions affording relief to a limited group of taxpayers, the requirements for "use" valuation of land are both numerous and highly detailed. In some instances, problems of implementation are anticipated unless clarification comes by regulation or statutory amendment. To be eligible for "use" valuation, several pre-death conditions must be met, and several post-death requirements must be observed to avoid recapture of the tax benefit.

Pre-death requirements. Pre-death requirements are of two types: (1) those assuring that farm (or other closely-held business) assets comprise a substantial part of the estate, and (2) those designed to serve as a "gate" to preclude mere investors from taking advantage of the tax provision.

As to the first point, the adjusted value of the farm (or other closely-held business) real and personal property18/ must be at least 50 percent of the adjusted value of the gross estate, using fair market value figures, and must pass to a qualified heir or heirs.19/ "Gross estate" means gross estate less allowable unpaid indebtedness attributable to the property.20/ The intent seems to be to use a "net worth" figure, net of indebtedness attributable to the property.

It appears that 50 percent of the adjusted value of the gross estate must pass to a qualified heir(s) even if part of that amount is personal property. The recapture provisions refer only to dispositions or other disqualifying events relative to real property.21/ Thus, it would seem that any personal property required to pass to a qualified heir to meet the 50-percent rule need not be held for the 15-year period after death to avoid recapture, as is the case with the real property.

The term "qualified heir" is broadly defined to include any member of the decedent's family who acquired the property (or to whom the property passed) from the decedent.22/ In turn, "member of the family" is defined to encompass an individual's ancestors and lineal descendants, a lineal descendant of a grandparent, the individual's spouse, or the spouse of any such descendant.23/ Legally adopted children are treated as children of blood relationship.

In addition to the "50-percent" rule, at least 25 percent of the adjusted value of the decedent's gross estate must be qualified farm (or other closely-held business) real property that was acquired from or passed from the decedent to a qualified heir.24/ Again, fair market value figures are used for determining compliance with the 25-percent rule.

18/ The statute uses the disjunctive, real or personal property, but it is believed that the term can be viewed as in the conjunctive.
19/ I.R.C. Section 2032A(b)(1)(A).
20/ I.R.C. Section 2032A(b)(3)(A).
21/ I.R.C. Section 2032A(c)(1).
22/ I.R.C. Section 2032A(e)(1).
23/ I.R.C. Section 2032A(e)(2). Property must pass to a qualified heir in order to be "qualified real property." I.R.C. Section 2032(b)(1).
24/ I.R.C. Section 2032A(b)(1)(B).

Clearly, then, a dual valuation system is required to take advantage of "use" valuation of real property. Fair market value is used for determining the conditions of eligibility and, as noted below, may be used in recapture calculations after the death occurs. And "use" valuation is utilized to calculate the Federal estate tax gross estate, subject to the overall limitation that "use" valuation cannot be used to reduce the gross estate by more than $500,000.25/ Consequently, an appraisal of fair market value of the property will still be required in settling most estates.

As to the requirements purporting to restrict the privilege to those involved with a business, the "use" valuation rules specify that during 5 or more years in the 8-year period ending with the decedent's death, the real property must have been owned by the decedent or a member of the decedent's family and held for a qualified use (farming or another closely-held business use).26/ Moreover, during 5 or more years in the 8-year period ending with the decedent's death, the decedent or a member of the decedent's family must have participated materially in the operation of the farm or other business.27/

"Material participation" is a key concept in the legislation. Under the statute, material participation is to be "determined in a manner similar" to the way it is defined for determining the tax on net earnings from self-employment.28/ The general rule is that real estate rentals are not self-employment income. However, the presence of material participation converts rents to self-employment income. As specified in the regulations, "income derived by an owner . . . of land is included in determining net earnings from self-employment . . . if the income is derived under an arrangement between the owner . . . and another person which provides that such other person shall produce agricultural or horticultural commodities on such land, and that there shall be material participation by the owner. . . in the production or the management of the production of such agricultural or horticultural commodities; and . . . there is material participation by the owner . . . with respect to any such agricultural or horticultural commodity."29/

25/ I.R.C. Section 2032A(a)(2). If a marital deduction is claimed, the effective maximum benefit from "use" valuation is proportionately less than $500,000. For example, up to one-half of a $1 million adjusted gross estate could be deducted without advantage being taken of "use" valuation. If the estate was reduced by $500,000 through application of use valuation, the adjusted gross estate would be $500,000 and the maximum marital deduction would be $250,000. Therefore, the real effect of "use" valuation is reduced to $250,000.

26/ I.R.C. Section 2032A(b)(1)(C)(i).

27/ I.R.C. Section 2032A(b)(C)(ii).

28/ See I.R.C. Section 1402(a)(1), 2032A(3)(6).

29/ 20 C.F.R. Section 404.1053(c)(1)(1976). Proposed regulations for material participation indicate: "No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant and funds must be advanced or financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, a substantial portion of the machinery, implements and livestock used in the production activities should also be furnished by the owner and their family members." Prop. Treas. Reg. Section 20.2032A-3(d)(2)(1978).

"Use" valuation rules provide specifically that material participation may be attained by the decedent or member of the decedent's family.30/ Thus, it would seem that the following arrangements would clearly assure material participation--(1) land rented to a third party by the decedent-to-be under a material participation lease, and (2) land rented by the decedent-to-be to a member of the family as the tenant under a material or nonmaterial participation lease.

It would also seem that the following should qualify: (1) land rented by the decedent-to-be to a partnership or corporation owned and controlled by the decedent-to-be under a material or non-material participation lease, (2) land rented by the decedent-to-be under a material or non-material participation lease to a partnership or corporation owned and controlled by members of the family of the decedent-to-be, and (3) land owned by the decedent-to-be and rented under a material or nonmaterial participation lease to a member of the family who in turn rents the land as a sublessor under a material participation lease to a third-party tenant.

Until clarified by regulations, rulings or judicial decision, the following situations are even less clear--(1) land owned by a partnership or corporation31/ if a majority (with a substantial minority component of ownership and control by noneligible material participators) of ownership and management of the partnership or corporation are provided by the decedent-to-be; (2) land owned by a partnership or corporation and rented to a third-party tenant under a material participation lease where a majority of ownership and management of the partnership or corporation are provided by the decedent-to-be and members of the family of the decedent-to-be.

It is reasonably clear, under current law, that material participation for social security purposes (and hence for "use" value purposes) cannot be attained through an agent.32/ Before 1974, material participation for social security purposes could be gained through the efforts of an agent. However, a 1974 amendment to the tax code requires that material participation be achieved by the owner "determined without regard to any activities of an agent of such owner . . . in the production or the management of the production of such agricultural or horticultural commodities."33/ Material participation by an agent is not imputed to the landowner.

What if land were rented directly to a third-party tenant by the decedent-to-be under a material participation lease where material participation was provided by a member of the family of the landowner (as the decedent-to-be) as an agent? This situation creates a collision between the status of the member of the family as an agent and as an eligible material participator on the basis of being a family member. Material participation may be attained by a member of the family but not by an agent. It would seem that family member status, by virtue of specific sanction in the "use" value statute, should prevail.34/

For those seeking to establish material participation under a lease, the tests developed for social security purposes may provide helpful guidelines. Four tests

30/ I.R.C. Section 2032A(b)(1)(C)(ii).

31/ The general requirements for land owned by a partnership or corporation to be eligible for "use" valuation are discussed later.

32/ See I.R.C. Section 1402(a)(1).

33/ P.L. 93-368, amending 26 U.S.C. Section 1402(a)(1)(Supp. 1975).

34/ See I.R.C. Section 2032A(b)(1)(C)(ii). Proposed regulations clarify this issue and indicate that family member status would prevail (Prop. Treas. Reg. Section 20.2032A(d)(1)(1978)).

have been developed, any one of which constitutes material participation for social security purposes.35/

No. 1--(any three) (a) provide half or more of the direct costs of producing one crop, (b) furnish half or more of the equipment and livestock used, (c) advise and consult with the tenant periodically, and (d) inspect production activities periodically;

No. 2--regularly and frequently make decisions which may be expected significantly to affect or contribute to the success of the enterprise;

No. 3--perform physical work in the production or management of the production of commodities raised (100 hours spread over 5 or more weeks per year);

Or No. 4--do those things which, in total, show that the landlord is materially and significantly involved in production.

If material participation is to be achieved under a crop share or livestock share lease based upon participation in decisionmaking, it is suggested that the lease be drafted with care to show clearly the expected role for the landowner in the decisionmaking process. Specifically, it is suggested that the lease be drafted to require involvement by the landowner in decisions relating to--(1) cropping patterns and the rotation, if any, to be followed each year, (2) levels of fertilization and formulae of fertilizer to be applied (NPK), (3) participation or nonparticipation in government price/income support programs, (4) plans for chemical weed and insect control including type of chemical, rate of application and type of application (broadcast or band), (5) soil and water conservation practices to be followed, (6) scheduling of repairs to buildings, fences, and tile lines, (7) decisions on use of storage facilities as between landlord and tenant, (8) changes in basic tillage practices (such as a shift to minimum tillage), (9) varieties of seed to be purchased, (10) marketing strategy for the landlord's share of the crop and coordination of delivery by the tenant, and (11) for livestock share leases, decisions relative to type of livestock production to be undertaken, level of production planned, nutrition and animal health plans and marketing strategies. It is also suggested that the landowner maintain a daily, diary-type record of activities related to participation in the production of income under the lease.

In many situations, planning to meet the pre-death requirements for "use" valuation may be directly competitive with eligibility for social security benefits.36/ If a member of the family (other than the decedent-to-be) serves as the material participator, social security benefits would not be reduced for the landowner as the decedent-to-be. Additional social security tax would be levied against the materially participating family member unless his (her) earnings already exceed the current covered amount. If the landowner as the decedent-to-be is the only feasible material participator, it appears that a choice must be made between qualifying for "use" valuation of land or maintaining social security benefit eligibility. It should

35/ See C.F.R. Section 404.1053(c)(3)(1978); Social Security Handbook 1224-1233 (July 1978). See note 29. The text of the proposed regulations suggests that test No. 3 may not be acceptable for "use" value purposes.

36/ Material participation is likely to have implications for social security tax as well as benefit eligibility. Material participation produces earned income which is subject to self-employment tax unless earnings exceed the current covered amount ($22,900 for 1979). Earned income above the allowable level in retirement ($4,500 for those 65 or over, $3,480 for those under 65 for 1979) reduces social security benefits. Except for the year of retirement, reductions in benefits are calculated on an annual basis starting in 1978. Social Security Amendments of 1977, P.L. 95-216.

be noted that the social security benefits pass to the decedent-to-be and are relatively certain in amount; the tax reduction from "use" valuation would be to the benefit of the surviving heirs and the size of the benefit may be difficult to assess. Thus, unless the objective is to maximize overall family wealth, the decision may be to maintain social security benefit eligibility.

It should be remembered that earned income reduces social security benefits only through age 72 (age 70 after 1981). Above those age levels, an incentive exists to redraft nonmaterial participation leases to involve material participation. If nonmaterial participation is chosen during the age span from 62 to 72 and the lease is redrafted to reflect material participation, it would be necessary for the decedent-to-be to survive for at least 5 more years thereafter because of the requirement that material participation must have occurred for 5 of the last 8 years before death.37/

Although the rules on material participation involving a partnership or corporation are not clear, it would seem that the problem of simultaneous eligibility for social security benefits and for "use" valuation of land might be eased with an entity such as a corporation. When the corporation directly operates the farm or rents it to a farm tenant (who is not a family member), the options for assuring material participation at the corporate level, under a material participation lease, may be greater than assuring material participation directly by the decedent-to-be or member of the family before death, by the qualified heir or member of the family before death, and by the qualified heir or member of the qualified heir's family after death. Specifically, if all members of the board of directors and all officers and employees of the corporation are members of the family, sufficient involvement in management to assure material participation may be possible with the decedent-to-be limited to labor and management consistent with maximum social security benefits.

Post-death requirements. To assure that the benefits of "use" valuation would accrue to those with a long-term commitment to the farm business, the tax benefits are recaptured under specified circumstances during the 15 years after the death of the landowner.

If the real property is disposed of within 15 years after the death of the decedent to nonfamily members or ceases to be used for farming or other closely-held business purposes, the tax benefits are recaptured.38/ Note that leasing the property under a material participation lease is a qualified use of the property. Full recapture occurs within the first 10 years with a phaseout between 10 and 15 years.39/ Partial dispositions lead to partial recapture.40/ Recapture does not occur, however, on death of the qualified heir as to that heir's portion of the total amount of property involved.41/ In fact, death of the qualified heir terminates the possibility of recapture for that person's qualified property. Thus, there is an incentive to transfer the property to the qualified heir who has the highest probability of death because his or her death within the 15-year recapture period will terminate the recapture possibility.

Recapture apparently occurs upon transfer of the real property even though the transfer is income tax free as a tax-free exchange,42/ or sale and reinvestment of a principal residence.43/ However, if the property is disposed of by means of an

37/ I.R.C. Section 2032A(b)(1)(C).
38/ I.R.C. Section 2032A(c).
39/ I.R.C. Section 2032A(c)(3).
40/ I.R.C. Section 2032A(c)(2)(D).
41/ I.R.C. Section 2032A(c)(1).
42/ I.R.C. Section 1031.
43/ I.R.C. Section 1034.

involuntary conversion or condemnation proceeding and the proceeds are reinvested in real property used for the same purpose, the recapture rules do not apply.44/

It was not intended for recapture to occur upon the tax-free transfer45/ of qualified real property to a partnership or corporation if (1) the qualified heir retains the same equitable interest in the property as before the transfer, (2) the partnership or corporation would be considered a closely held business,46/ and (3) the partnership or corporation consents to personal liability for recapture of tax if it disposes of the real property or ceases to use the property for qualified purposes during the period in which recapture could occur.47/

Cessation of qualified use which triggers recapture can also occur if material participation is not continued after the owner's death. Absence of material participation for 3 or more years during any 8-year period ending after the decedent's death results in recapture.48/ Note that this recapture rule does not assure 8 years after death to amass 5 years of material participation. Rather, conditions for recapture could be met during the first year after death or any year thereafter.

This rule suggests that attention should be given to the selection of executors or administrators. Unless a member of the family is the farm tenant or otherwise in a position to be a material participator, the estate representative may be the only eligible material participator during estate settlement. In such situations, a member of the family should be executor or administrator if "use" valuation eligibility is important, unless absence of material participation during the period of estate settlement would not result in disqualification.

The requirement for post-death material participation means that immediate attention should be given after the owner's death to review of material participation status. It may be necessary to revise the lease and shift to material participation to avoid disqualification or recapture of the tax benefit.

Because of the way the post-death material participation requirement is phrased, the unwary--and even some who are wary--may suffer loss of eligibility for "use" valuation. For that reason, it is suggested that legislative or regulatory attention be given either--(1) to eliminating the material participation requirement for a period after death equaling normal estate settlement, or (2) to amending the statute such that 5 years of material participation in the first 8 years after death would meet the requirement.

Note that material participation is to be by the qualified heir or any member of the qualified heir's family, for the period during which the property was held by the qualified heir.49/ This contrasts with the requirement that material participation be by the decedent or any member of the decedent's family during the time the property was held by the decedent.50/

44/ I.R.C. Section 2032A(h).
45/ See I.R.C. Section 351, 721.
46/ See I.R.C. Section 2032A(g), 6166: at least 20 percent of the partnership interest or corporate stock is included in the deceased's estate or the firm has 15 fewer partners or shareholders, as the case may be.
47/ See Report of the Committee on Ways and Means, U.S. House of Representatives, "Estate and Gift Tax Reform Act of 1976," Rpt. 94-1380, at 25, n. 3.
48/ I.R.C. Section 2032A(c)(7)(B).
49/ I.R.C. Section 2032A(c)(7)(B)(ii).
50/ I.R.C. Section 2032A(c)(7)(B)(i).

The recapture of tax benefits upon disposal outside the family or upon cessation of use for farming or other closely held business uses is the lesser of the following amounts:

- The "adjusted tax difference" 51/ (the excess of the Federal estate tax liability that would have been incurred had "use" valuation not been used over the actual Federal estate tax liability based on "use" valuation),

- The gain on sale over "use" value or the excess of fair market value of the property over the "use" value if disposal is other than by sale or exchange at arm's length.52/

If more than one qualified heir receives qualified real property, the recaptured tax liability is allocated among the property interests in proportion to their respective reductions in value. Qualified heirs are made personally liable for the recaptured tax unless the qualified heir has furnished a bond.53/ That outcome is not changed even though the qualified heir or heirs may not have received the full tax benefits from "use" valuation and may have paid fair market value for the property in an intrafamily settlement.

Note that recapture requires at most the repayment of tax that would have been due had "use" valuation not been used. Recapture does not require the payment of interest on the recaptured tax. The benefit from "use" valuation thus could be substantial even if recapture were to occur. For example, postponement of payment of $100,000 tax for 10 years is "worth" $115,894 if the deferred tax could be invested with an 8-percent net return. This economic advantage from the "time value of money" is offset at least in part by the lower income tax basis for the property, inasmuch as "use" value becomes the value used at death for purposes of determining a new basis at death or for the "fresh start" adjustment under the carryover basis rules.54/

Special rules for land held by an entity. The regulations are to set forth the application of the "use" valuation rules for property interests held in a partnership, corporation, or trust.55/ The legislative intent seems clear that land owned by entities is to be eligible for "use" valuation. The major question seems to be the eligibility requirements imposed upon land owned other than by individuals.

The statute indicates, for land held by a partnership to be eligible, the decedent's interest in the partnership must comprise 20 percent or more of the total capital interest in the partnership or the partnership must have 15 or fewer partners.56/ Similarly, for a corporation to be an owner of land eligible for "use" valuation, the decedent's interest in the corporation must comprise 20 percent or more of the value of the voting stock or the corporation must have 15 or fewer shareholders.57/

A trust or estate is not subject to comparable limitations, but a person must hold a present interest in a trust to be eligible. It is assumed the decedent's fractional ownership of the entity would govern in terms of the fraction of the entity's real property deemed owned by the decedent.

51/ I.R.C. Section 2032A(c)(2)(A)(i).
52/ I.R.C. Section 2032A(c)(2)(A)(ii).
53/ I.R.C. Section 2032A(c)(6).
54/ I.R.C. Sections 1014, 1023.
55/ I.R.C. Section 2032A(g). Proposed regulations clearly indicate that land owned by entities is eligible for "use" valuation. Prop. Treas. Reg. Section 20.2032A-3(e)(1978). No mention is made of land owned by an estate.
56/ I.R.C. Section 2032A(g), 6166(b)(1)(B).
57/ I.R.C. Section 2032A(g), 6166(b)(1)(C).

For real property owned by entities, the material participation requirements seem to warrant special attention. Because it does not appear that material participation can be achieved through an agent,58/ it would seem that material participation for real property held in a trust or by a partnership or corporation must be achieved by the decedent-to-be or a member of the family. The issue again becomes one of whether material participation by those who have a majority interest in the entity will be adequate. For a partnership, until clarifying regulations are issued, it would seem wise to plan for all partners to be eligible material participators, if possible. Likewise, in a corporation it would seem prudent for all members of the board of directors and all officers to be eligible material participators, until definitive guidance is received from the Department of the Treasury.

For a trust, material participation may, according to the proposed regulations, be achieved by (1) service as a trustee, (2) employment by a qualified closely held business in a position requiring material participation in its activities, or (3) a contractual arrangement with the trustee or trustees to manage, or take part in managing, the real property for the trust.59/

Making the election

The election for land to be valued under the use valuation rules is made by attaching a statement of all of the required information to a timely filed Federal estate tax return. If no Federal estate tax is due, or the requirements are not then met, a protective election can be made. That preserves the right to take advantage later of use valuation if circumstances make it advantageous--and possible.

The use-value election is to contain several items of information:

(1) Decedent's name and identification number;

(2) Relevant qualified use;

(3) Real property to be valued by use valuation, identified by schedule and item number;

(4) Fair market value and use value of qualified real property;

(5) Adjusted value of all qualified real property (value less secured indebtedness);

(6) Items of personal property that pass from the decedent to a qualified heir and that are used in a qualified use;

(7) Adjusted value of the gross estate;

(8) Method used to determine use value;

(9) Copies of written appraisals;

(10) Date on which the decedent (or a member of the family who held the property before the decedent) acquired the property and on which he or she or a member of the family began the qualified use--if different from the date of acquisition;

58/ See I.R.C. Section 1402(a)(1).
59/ Prop. Treas. Reg. Section 20.2032A-3(c)(1978).

(11) Any periods following start of the qualified use during which the decedent or a member of the family did not own the property, use it in a qualified use, or materially participate in the operation;

(12) Name, address, identification number, and relationship to the decedent of each person taking an interest in each item of use value property and the fair market and use value of the property interest passing to those persons.

An agreement signed by all persons with an interest in use value property must accompany the notice of final election. The persons acquiring an interest in use value property must consent to personal liability for any additional Federal estate tax if recapture should occur. That includes all those with even a contingent interest, holders of a power of appointment over the property, those who would benefit from the property if a power of appointment was not exercised, trustees of trusts holding any interest in the property, and creditors whose interest would be subordinate to the special tax lien to protect the Internal Revenue Service if a recapture event should take place. For minors and incompetents, it is anticipated that a guardian or conservator would sign the agreement.

Federal tax lien

A special lien is imposed on all qualified farm or closely-held business real property for which an election has been made to utilize "use" valuation.60/ The lien continues until (1) the potential liability for recapture ceases (15 years), (2) the qualified heir dies, or (3) the tax benefit is recaptured.61/ The lien is not valid against a purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor unless properly filed.62/ Liens affecting real property acquired after November 6, 1978, must be filed with the local or State office where tax liens are filed in a State which requires public indexing for a lien to have priority and which has an adequate system in its local offices for indexing Federal tax liens.

Even though properly filed, the special lien does not take priority over designated "super priority" claims. These include real property taxes and special assessments for public improvements,63/ mechanic's liens for repair or improvement of the property,64/ security interests for the construction or improvement of real property (to the extent of the real property involved in the improvement),65/ a contract to construct or improve real property (to the extent of the proceeds of the contract),66/ or "the raising or harvesting of a farm crop or the raising of livestock or other animals" (to the extent of the crops or livestock involved and the property affected by the general lien for unpaid Federal taxes).67/

Obligations for other purposes, such as borrowing to acquire interests of other heirs or to pay State death taxes and estate settlement costs, would be subject to the lien. Also subject to the lien would be typical refinancing arrangements in which the real property is used to secure new funds advanced to repay outstanding obligations. Thus, conflicts between the special lien and subsequent debt obligations may be especially acute if the lender requires a first lien for credit extension. However,

60/ I.R.C. Section 6324B.
61/ I.R.C. Section 6324B(b).
62/ I.R.C. Section 6324B(c), 6324A(d)(1), 6323(f).
63/ I.R.C. Section 6324B(c), 6324A(d)(3)(A), 6323(b)(6).
64/ I.R.C. Section 6324B(c), 6324A(d)(3)(B).
65/ I.R.C. Section 6324B(c), 6324A(d)(3)(C), 6323(c)(3)(A)(i), 6323(c)(3)(B)(i).
66/ I.R.C. Section 6324B(c), 6324A(d)(3)(C), 6323(c)(3)(A)(ii), 6232(c)(3)(B)(ii).
67/ I.R.C. Section 6324B(c), 6324A(d)(3)(C), 6323(c)(3)(A)(iii), 6232(c)(3)(B)(iii), 6321.

the special tax lien may be subordinated with the approval of the Department of the Treasury if sufficient collateral exists to secure adequately the interest of the Department of the Treasury as well as that of the lender.68/ And the Department of the Treasury may authorize other security to be substituted for the real property in question to secure payment of the tax.69/ Additional guidance in this area would be helpful to taxpayers, lenders, and field personnel of the Internal Revenue Service.

BENEFITS OF "USE" VALUATION

The benefits to individual farm estates of the "use" valuation procedure will result from the reduced estate tax liability because of a lower taxable estate as well as the reduced liquidation costs that will be incurred to pay the estate taxes. To assist farmers in evaluating the benefits of "use" valuation, the major provisions of Section 2032A have been incorporated in the ISU Computer Assisted Estate Planning model.70/ The procedure for estimating the "use" value of farm real estate is based on the capitalized value of cash rents minus property taxes.

Because of the difficulty encountered in obtaining cash rent data from individual users (some of whom have no experience in the cash rental market), cash rents are estimated based on the current market value of real estate as provided by the user. This estimation procedure utilizes the equations of table 2 which were obtained by regressing USDA cash rent data for the different districts of Iowa as a function of land values from the Iowa Land Value Survey.71/ The data base for these estimates includes the years 1956 to 1976. A separate equation was estimated for each of the nine crop reporting districts in Iowa. The statistical properties of all nine equations indicate that land value and land value squared are significant explanatory variables in the regression equation at the 0.05 probability level, and all of the equations have an R^2 of 0.99 or better, which indicates that these two variables explain over 99 percent of the variation in cash rents. One would not expect these specific equations to be sufficiently accurate to be used in determining cash rents for specific pieces of property when filing an estate tax return, but they do appear adequate for planning purposes. Equations for all nine crop reporting districts in Iowa are similar, and, in all cases, cash rents are estimated to be an increasing function of land values. However, cash rents increase at a decreasing rate as land value increases.

These equations are used in the Computer Assisted Estate Analysis model to estimate the "use" value for qualified real estate in the following manner. The user or client is asked to provide information on the "fair market value" of the real estate on a per acre basis. Through use of this current market value in the appropriate equation for the user's crop reporting district, a cash rent value for the current year is determined. Then, an estimate of the value of the real estate in the previous year is determined by multiplying the current market value times the appropriate rate of change in land values for that area as estimated by the Iowa Land Value Survey. This estimate of land value is again entered into the cash rent regression equation and a cash rent is estimated for the previous year.

68/ I.R.C. Section 6325(d)(3).

69/ I.R.C. Section 6325.

70/ Boehlje, Michael and Neil E. Harl. Computer Assisted Estate Analysis. Law-Econ 163, Department of Economics, Iowa State University, July 1977.

71/ Harris, Duane, Tim Lord, and Majorie Groves. "1977 Iowa Land Value Survey," FM 1744, Cooperative Extension Service, Iowa State University, January 1978.

Table 2.--Equations for estimating cash rent for farmland in Iowa

District	Intercept	Land value	Land value squared
Northwest (1)	-12.0127	+0.10410	-0.00003206
North Central (2)	-10.8024	+0.11005	-0.00003360
Northeast (3)	-6.3663	+0.10336	-0.00002210
West Central (4)	-15.4241	+0.12936	-0.00004781
Central (5)	-14.7608	+0.11605	-0.00003458
East Central (6)	-10.9015	+0.10692	-0.00002631
Southeast (7)	-10.5788	+0.13415	-0.000051894
South Central (8)	-9.7130	+0.15524	-0.000010231
Southeast (9)	-11.2306	+0.11779	-0.000040875

Table 3.--Examples of use value estimates for central Iowa

Fair market value (dollars)	"Use" value	"Use" as a percentage of market value
	Dollars	Percent
2,200	675	30.7
2,000	661	33.1
1,800	639	35.5
1,600	608	38.0
1,400	563	40.2
1,200	504	42.0
1,000	429	42.9
800	340	42.5
600	235	39.2

The estimation procedure continues for 5 years into the past with the land value being decreased each year based on the rate of change suggested by the Iowa Land Value Survey, and the cash rent each year obtained through the use of the regression equation. Once the 5-year cash rent series has been estimated, the average can be calculated.

A similar procedure was to be used to determine the 5-year average property taxes, but because of limited data availability, a more simple statewide rather than district estimation procedure was utilized. The capitalization rate was obtained from the Omaha Farm Credit Banks as the average effective interest rate on new Federal land bank loans for the most recent 5 years.

The estimated "use" value of farm land based on the above computation procedure is compared to the "fair market value" in table 3. The estimation equation for Central Iowa (District 3) was used to obtain the "use" value estimates. The estimation procedure suggests a use value for this district that is approximately 30 to 45 percent of fair market value. Also note that the reductions in value due to "use" valuation procedures in general are larger for the higher valued land than the lower valued land. These results imply that larger benefits of "use" valuation will accrue in those regions of Iowa with high land values compared to those areas with low land values.

The specific benefits of use valuation of real property for estates of different sizes and composition are summarized in table 4. The calculations assume a farm operation with land valued at $1,450 per acre and a will that transfers all property to the wife at the husband's death and to the children at the wife's subsequent death. For a net worth of approximately $250,000, "use" valuation has little benefit because the marital deduction and credits are sufficient to eliminate most of the tax liability even if the property is valued at "fair market value." In these cases, the executor may choose to value the property at "fair market" rather than "use" value to increase the basis, thus increase the depreciation deductions, and reduce the potential capital gains tax at a subsequent sale.

For a $500,000 net worth comprised of approximately 50 percent real property, the use valuation privilege saves taxes and reduces the liquidation costs at the deaths of both husband and wife. A total tax savings of $41,872 can be attributed to the use valuation election at both deaths. This tax savings, along with the reduction in liquidation costs, results in the transfer of $47,896 of additional property from the parents to the heirs, a savings of almost 10 percent of the net worth of the estate. If the estate was comprised of 90 percent real property, the tax savings at both deaths amounts to $64,556, and total property transferred to the heirs is increased by $78,119 through the election of special use valuation. Thus, the heirs receive almost 14 percent more of the parents' estate if use valuation is elected.

The numerical results of table 4 illustrate that use valuation also has sizable benefits for the $750,000 and $1 million estates. For a $750,000 estate comprised of 90 percent real property, the heirs receive $124,618 more through the use valuation election. For a $1 million estate comprised of 90 percent real property, the benefits of use valuation total $161,798, and the heirs receive almost 15 percent more of the parents' estate.

The results of these computer analyses suggest a number of conclusions. First, the benefits of use valuation in terms of tax savings are substantial for estates in excess of $250,000. The benefit increases as estate size increases because, with increasingly larger estates, a larger proportion of the maximum allowable reduction of $500,000 can be utilized. Furthermore, even for those estates that can utilize the entire $500,000 maximum allowable reduction due to use valuation, increased benefits

Table 4.--Implications of use valuation for selected estate sizes

Estate	Real property - 50 percent		Real property - 90 percent	
	Use value	Market value	Use value	Market value
Net worth of decedent--$250,000:				
		Dollars		
Husband's death:				
Adjusted gross estate	141,335	215,971	89,329	215,971
Federal estate tax	0	0	0	0
Wife's death:				
Adjusted gross estate	150,751	225,412	95,913	224,488
Federal estate tax	0	1,600	0	1,330
Value of property received by heirs	223,919	221,531	223,713	220,869
		Percent		
Percentage of parents' estate received by heirs	90.13	89.22	90.35	89.31
Net worth of decedent--$500,000:				
		Dollars		
Husband's death:				
Adjusted gross estate	285,060	434,331	180,848	434,331
Federal estate tax	0	14,837	0	14,837
Wife's death:				
Adjusted gross estate	297,464	432,974	185,913	429,956
Federal estate tax	23,289	50,324	0	49,719
Value of property received by heirs	420,536	372,640	443,864	365,745
		Percent		
Percentage of parents' estate received by heirs	84.92	75.68	89.62	75.51

(continued)

Table 4.--Implications of use valuation for selected estate sizes (continued)

Estate	Real Property - 50 percent		Real property - 90 percent	
	Use value	Market value	Use value	Market value
Net worth of decedent-- $750,000:				
			Dollars	
Husband's death:				
Adjusted gross estate	428,784	652,711	272,365	652,711
Federal estate tax	13,150	58,317	0	58,317
Wife's death:				
Adjusted gross estate	430,830	612,746	275,046	604,771
Federal estate tax	51,364	63,856	16,574	63,363
Value of property received by heirs	595,083	531,171	642,761	518,143
			Percent	
Percentage of parents' estate received by heirs	80.34	72.08	86.78	71.77
Net worth of decedent-- $1 million:				
			Dollars	
Husband's death:				
Adjusted gross estate	572,074	871,071	394,133	871,071
Federal estate tax	45,788	91,945	2,687	91,945
Wife's death:				
Adjusted gross estate	545,571	801,685	390,188	794,376
Federal estate tax	54,890	93,498	49,155	93,583
Value of property received by heirs	777,518	679,881	819,826	658,028
			Percent	
Percentage of parents' estate received by heirs	78.80	69.32	83.49	68.71

from use valuation will still accrue as the estate size increases because of the progressive nature of the marginal tax rates.

Obviously, estates with a larger proportion of real property will be able to obtain larger benefits from use valuation, thus encouraging those who can qualify to purchase real estate rather than personal property because of the potential tax benefits.

Finally, the benefits of use valuation accrue not only from the tax savings, but because of the reduced liquidation costs that will be incurred to pay the taxes. Thus, use valuation can increase substantially the amount of property transferred to the heirs. With the sizable benefits that can be obtained by using this procedure, significant cost and effort can be incurred to qualify for and obtain the "use" value privilege.

IMPLICATIONS OF "USE" VALUATION

One would expect that "use" value will typically be less than fair market value in almost all circumstances, for at least two reasons. First, the investment behavior of farmers suggests that historically they have been willing to accept a lower rate of return on land (and thus a lower discount rate for purposes of valuing and bidding for land) than the discount rate currently being used in the "use" valuation formula. Historically, rates of return on land have averaged in the range of 4-5 percent per year, compared with the typical range on interest rates for new Federal land bank loans of 7-1/2 to 10 percent per year.72/

Second, cash rental figures as required by the "use" valuation procedure are expected to be lower than the rental rate received by landowners who are willing to incur some of the risk of production and price changes as reflected in crop share rental arrangements.

Consequently, as landowners are frequently expecting a higher income from their investment than the cash rental rate, and they may be willing to accept a lower rate of return than the discount rate, one would expect "use" valuation estimates to be consistently lower than fair market value. For deaths in 1977, "use" valuations of 35-40 percent of fair market value were relatively common when the cash rent capitalization approach was used. Calculations for deaths in 1978 have reflected a slightly higher set of "use" valuation figures from cash rent capitalization, inasmuch as 1972 cash rents were replaced with 1977 figures which were generally higher. Even at that, "use" value figures of 40-50 percent of fair market value or comparable sale value are not uncommon.

Although the specific impacts of such deviations between "use" value and fair market value are not known, one can speculate on the impact this deviation might have on investment behavior. The benefits of "use" valuation demonstrated for different-sized estates in table 4 illustrate the potential impacts for various investors in qualified real property. These benefits have been summarized on a per acre basis in table 5. As the benefits of use valuation will accrue in the future at death, their current value can only be evaluated by discounting the benefits at an appropriate rate to reflect the time value of money.

72/ Lord, T. J., Duane Harris, and E. C. Stoneberg. "Return to Crop-Share Rented Land in Iowa in 1976," FM 1700 (rev.), Cooperative Extension Service, Iowa State University, May 1977.

Table 5.--Value of benefits from "use" valuation per acre of land

Net worth (dollars)	Benefits per acre	Present value of benefits (8 percent) Assuming death in: 5 years	10 years	15 years	20 years
	Dollars				
500,000	252	172	117	79	54
750,000	267	182	124	84	57
1 million	261	178	121	82	56

Because of the requirement that qualified property must be used for farming or other closely-held business purposes for 5 of the 8 years preceding death, one could presumably not obtain the benefits of a current purchase for at least 5 years. If a purchase of qualified real property is made with expectations of death in 5 years, the present value of the use valuation benefits totals $172 per acre for the $500,000 estate. For the $750,000 and $1 million estates, the present value of benefits for a death in 5 years totals $182 and $178 per acre, respectively.

As the expected life increases, and more years elapse between the purchase of the property and the date of death, the present value of the "use" valuation benefits declines. The benefit totals $50-60 per acre if death is expected to occur 20 years following the purchase. These figures indicate the per acre price premium that could be paid for real property that would qualify for "use" valuation. For a farmer with a life expectation of 5 years, the price premium of table 5 amounts to approximately 12 percent of the fair market value of the land used in the analysis. Thus, it could be expected that with increasing age, farmers would be encouraged to move toward a greater investment in land and less investment in nonland assets. Those with a longer life expectancy would pay a smaller premium for the benefits of "use" valuation (table 5).

Thus, the "use" valuation legislation could enable older farmers to outbid younger farmers for a particular parcel of land, based strictly on the value of the tax benefits each would receive. In general, the bid price for farm real estate would be expected to rise by the amount of the net present value of such tax benefits. This can only result in an increased divergence between the value of the land and its cash income generating capacity.

The above would be the expected result to the extent the person's investment in land would not produce the maximum reduction of Federal gross estate of $500,000. Those with sufficient investment in land to assure without a doubt the maximum reduction in gross estate would be expected to maintain an investment position in land sufficient to assure the maximum tax savings. "Use" value in itself would not encourage greater investment in land for these individuals. On balance, the encouragement for many to increase investment in land to assure the maximum reduction in tax would be expected to generate upward pressure on land prices, although the net effect might well be modest because many older farmers already have a substantial investment position in land.

The size of the benefits accruing from "use" valuation would be expected to attract additional interest in land as an investment. For investors who do not own farmland or other land eligible for "use" valuation, the impact of the "use" valuation option on investment behavior could be much greater than for farmers. A nonfarmer with no investment in land but with a $2 million estate could shift $1 million to land, reduce his or her gross estate by $500,000, and obtain assumed Federal estate tax benefits of $225,000 (45-percent tax bracket). A farmer with a $2 million estate, half or more of it in land, would derive the same dollar benefit but the effect on investment patterns would be less.

As noted, the size of estate of the investor influences the absolute size of the "use" valuation benefits. Persons possessing larger estates receive a greater net benefit from a $500,000 reduction in the gross estate from "use" valuation. Thus, the maximum tax savings from "use" valuation of land would range from zero (for those with estates not subject to Federal estate tax) to $350,000 for someone in the 70-percent Federal estate tax bracket. In addition to these tax savings, any reduction in liquidation costs would also be attributable to the "use" valuation privilege.

Clearly, then, the major impact on investment patterns would be felt as investors able to meet the pre- and post-death requirements for "use" valuation of land endeavor to gain a position in landownership sufficient to assure a reduction in the gross estate of $500,000. The net value of the tax benefit rises with size of estate because of the graduated tax rate, but once the $500,000 reduction in gross estate is reached, further benefits come from having a larger estate. That is a function not just of ownership of land but of ownership of all assets.

Thus, if the "gate" restricting the "use" valuation privilege is opened further to enable "nonfarm" investors to obtain the tax benefits noted above, one would expect increased movement of equity capital from the nonfarm into the farm sector. The implications of such movements for the separation of ownership and control of farm assets should be evaluated. It would be expected that additional capital would flow into farmland, driving up the price, until investors were once again indifferent between investing in farmland <u>with</u> the benefits of "use" valuation and investing in other assets valued at death at fair market value. Thus, the effect would be a one-time increase in land value with subsequent purchasers paying a higher price for land.

If the "gate" is not opened, the result would be a substantial economic advantage for those able to meet the pre- and post-death requirements. As a result, such individuals (presumably farmers and those actively involved in management under a lease) would be able to bid land away from those ineligible for "use" valuation (presumably nonfarm investors).

Certainly, free flows of capital among various sectors of the economy are essential to optimal resource allocation. Yet, increased incentives for investment attributable primarily to tax legislation must be evaluated carefully. This is particularly true when such an investment may add little to the productivity of the sector, as is frequently the case with purchases of farm real estate.73/

73/ Purchase by nonfarm investors of farmland from other nonfarm investors or nonfarm heirs of deceased farmers assures an outflow of capital from agriculture comparable to the inflow from the new investment if land values are left unchanged. Only if land is purchased from farmers and the resulting funds are available for financing agricultural production would investment in agriculture by nonfarm investors have a direct effect on availability of production capital. Moreover, if the presence of additional outside capital results in a bidding up of farmland prices, the land base has "absorbed" additional capital but without any necessarily direct effect on capital availability for production. See Harl, Neil E. "Influencing the Structure of Agriculture," paper delivered in Distinguished Visitor Lecture Series, University of Arizona, February 27, 1978, p. 8.

The current situation concerning material participation and the conflicts as to simultaneously obtaining social security benefits and maintaining qualification for "use" valuation will certainly have implications for leasing arrangements. In essence, this conflict has the attributes of self-destruction, for, to maintain material participation, many leasing arrangements may be changed from cash rent to crop share rental agreements. This would reduce the number of potential observations from which to obtain data for the capitalized rent approach to "use" valuation.74/

In addition, changes in leasing from cash to crop share agreements would be expected to increase the risk that will be borne by retirement-age farmers. The implications for the services offered by farm management firms are apparent unless legislative changes occur. Certainly, a key issue is the cost versus the benefit of changing the material participation rules to allow participation by agent. Such a change would enable those not actively involved in the farm business, such as retired widows, to utilize the services of a farm management agency to operate the farm without the risk of disqualification for "use" valuation. However, the potential cost that may be incurred in terms of encouraging "nonfarm" investors to purchase farm real estate, particularly in light of the benefit estimates presented earlier, cannot be viewed lightly.

It is fundamental to any discussion and analysis of the "use" valuation of land to reach an agreement on the purposes of the legislation and the objectives of the U.S. Congress in enacting such a departure from traditional fair market value. Although different interpretations exist, it is believed that the basic purpose of the legislation was to reduce the Federal estate tax burden for estates holding an interest in farms and other small businesses, and not necessarily to reduce the Federal estate tax burden for those investing in farmland. This important point should be kept firmly in mind in evaluating proposed amendments to the statute. Although the original Congressional concern apparently was motivated by documented metropolitan and resort area influences on the values of real property used in farming, the resulting statute is not limited by its terms to real property with a more highly valued use than agriculture. The eligibility requirements are relatively mechanical in nature.

The tax lien that attaches to real property if "use" valuation is elected has implications concerning credit utilization and credit flows in agriculture. Some lenders have expressed reservations as to advancing funds if the security already has a "use" valuation tax lien attached. If such a lien is attached to real property, it may reduce the possibility of using that property as the collateral for refinancing as commonly occurs during farm expansion and in periods of financial stress.75/ Consequently, if such liens become a common occurrence, those farmers may find it more difficult to use their real estate as a source of security for credit transactions.

An important implication of the recapture rules that may result in conflicts between "on-farm" and "off-farm" heirs should also be noted. As has been indicated earlier, if the real property ceases to be used for a qualified purpose or is sold outside the family, recapture of any tax benefits may occur. A conflict between the heirs can clearly occur in the following scenario which is not atypical in the agricultural sector.

74/ Moreover, the proposed regulations bar consideration of rental amounts under material participation leases in gross cash rent capitalization calculations. Prop. Treas. Reg. Section 20.2032A-4(b)(1)(1979).

75/ For example, 15 percent of the funds loaned in the Omaha Federal Land Bank district in 1977 were advanced to pay short-term debts and 28 percent were used to refinance mortgages. Federal Land Bank of Omaha, 1977 Annual Report, January 1978, p. 3.

Assume the on-farm heir, because of disability or other investment opportunities including the opportunity to purchase a more productive parcel of real estate, decides to sell the qualified property and pay his or her portion of the recapture tax. The nonfarm qualified heirs would be forced by this decision to become material participators, or to pay their share of the recapture tax. One might expect such a conflict between the interests of the on-farm and off-farm family heir could result in substantial family discord during the 15-year period when recapture can occur.

Implications for gift giving and sale of the property prior to death should also be noted. Presumably, the proceeds of a sale including the installment sale of land would not qualify for "use" valuation. Consequently, the sale of real property prior to death may in fact increase the estate tax liability even though such a sale may satisfy other estate planning objectives. Furthermore, the sale or gift of sufficient property to reduce the proportion of qualified property below the 50 and 25 percent pre-death requirements discussed earlier would also preclude the election of use valuation.

So, care must be exercised in planning for the gift or sale of property during the owner's lifetime if it is desired to maintain eligibility for the "use" valuation privilege. Maintaining eligibility for this privilege may in fact present conflicts with other estate planning objectives, specifically when a gradual transition of an "on-going" farm from one generation to the next is desired.

A final point should be noted concerning the interface between the "use" valuation provisions and the regulations concerning "carryover basis"76/ and installment reporting of Federal estate tax.77/ In brief, the "carryover basis" rules eliminate the stepped-up basis that was obtained by the property recipient at the decedent's death prior to 1977, and replace it with a basis that is carried over from the decedent (for deaths after 1979).

Thus, starting in 1980, unless further legislative changes are made, at the time of a subsequent sale, tax will be due on the amount of gain as calculated by the market value of the property at the time of the sale minus the basis of the property adjusted for the gain deemed to have accrued prior to January 1, 1977, and the other adjustments to the basis that may be made under the carryover basis rules.78/ If "use" valuation is used to value real property, this value is also used in the calculation of the "fresh-start" adjustment to "carryover basis."79/

The result of "use" valuation would be a reduction in the adjusted basis and an increase in the gain taxable at a subsequent sale. The combination of use valuation and the carryover basis rules could result in substantial gain in real property. If real estate continues to increase in value, further gain and tax liability will accrue so that recipients of property transferred at death may be increasingly reluctant to sell because of the large tax burden. This "locked-in" effect may result in reduced offerings and, values for property on the market may be bid up further. Certainly, different types of credit demands would arise with the emphasis on financing rental arrangements rather than real estate purchases.

76/ I.R.C. Section 1023. The carryover basis provisions have been placed in moratorium until January 1, 1980.

77/ I.R.C. Section 6166.

78/ I.R.C. Section 1023(h). For a complete discussion of the carryover basis rules, see Neil E. Harl and Michael D. Boehlje. "A Review and Critique of Selected Problem Areas from the Tax Reform Act of 1976," Law Econ 200 (Rev.), April 1978.

79/ I.R.C. Section 1023.

The provisions for installment reporting of Federal estate tax may also influence the transfer of real estate by the decedent-to-be before death. To qualify for the 15-year installment payment privilege, a closely-held business must exceed 65 percent of the adjusted gross estate.80/ Thus, a decedent-to-be would not plan to sell or give substantial business real or personal property to others if he or she plans to qualify for installment payment of tax. Such a sale or gift could reduce the business property to 65 percent or less of the adjusted gross estate. In fact, the combination of the installment payment of tax and "use" valuation rules is expected to discourage transfers of real property by the decedent-to-be, and the "carryover" basis rules will likely discourage transfers by the heirs.

The result could be that those families who now own rural real property will be encouraged not to transfer that property outside the family and a rather exclusive class of rural landholders could develop over the years. The political and social implications of such a permanent group of landowners with the tax system discouraging entry are beyond the scope of this discussion, but such a land tenure system may not be in the best interests of the "family farm."

80/ I.R.C. Section 6166(b)(1)(B).

USE VALUATION OF FARMLAND FOR
ESTATE PURPOSES IN INDIANA I.R.C. SECTION 2032A(e)(7)-(8)

Gerald A. Harrison*

As the public and the estate planning industry continue to digest a plethora of illustrative articles on estate and gift tax reform in the Tax Reform Act of 1976, lawyers, farmers, personal representatives, and heirs must actively plan and administer estates in an environment of a complex and unclear law. Internal Revenue Code 2032A, included in the Tax Reform Act of 1976, presents numerous problems and challenges for both pre- and post-mortem estate management. Although many in the estate planning industry may criticize this new I.R.C. section (some suggesting it best be ignored), I believe that many farmers will appreciate the Federal estate tax savings that 2032A appears to offer.

No attempt is made to review the requirements, dilemmas, and unresolved issues outlined in I.R.C. 2032A and by numerous tax commentators.1/ Several aspects of 2032A will create apprehension until time allows for regulations, rulings, and litigation. Even the basic congressional intent of the scope of the application of 2032A to farm firms may be at issue. Is 2032A, with its estate value reducing intent, available to any decedent farmer's estate or only those which clearly have nonfarm uses setting the fair market value?2/ Section 2032A does not appear to distinguish in its applicability between farmland isolated by other farmland and that at the fringe of an urban center. The House Report and the "Blue Book" which speak to "reasons for change" brought by 2032A indicate that "speculative value" on farmland ought not be

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1/ For a recent discussion of I.R.C. 2032A, see Bravence, Lorence K., and Alfred J. Olsen, "How to Reap Estate Tax Benefits through the Use of the Alternate Valuations of Farmland," The Journal of Taxation, pp.140-147, March 1978.

2/ This question remains an issue in June 1979. At this time it has been reported that no Indiana decedent estates have received a clearance where Section 2032A was elected for post-1976 decedents. According to IRS staff, U.S. Treasury officials are focusing upon language in the legislative history of Section 2032A specifically at pages 609 and 610 of H.R. 94-1515, September 13, 1976. One interpretation of this language is that unless there is a "highest and best use" for farmland in a decedent's estate other than farming, Section 2032A does not apply. Only the fair-market valuation of Section 2031 or the alternative valuation of 2032 (up to 6 months after death) should apply.

Until there is a policy decision on the scope of the applicability of Section 2032A, the IRS at the district level will be unable to process fully most Section 2032A elections.

included for estate tax purposes.3/ Yet these documents also state that as a result of estate tax based on fair market value ". . .the heirs may be forced to sell the land for development purposes." Will 2032A be available to estates with farmland having a fair market value of $2,000-$4,000 per acre whose highest and best use is ordinary farming?

Further, the dilemma for some planners that is raised by the material participation requirement apparently has its justification in the idea that 2032A was intended only for "family farms" to the exclusion of those interested in "farm investments." H.R. Rep. No. 94-1380 (page 22) states that "it is inappropriate to value the land on the basis of its potential 'highest and best use' especially since it is desirable to encourage the continued use of property for farming and other small business purposes." If 2032A was only in response to some of the political pressure and "pre-TRA-76" bills, such as Senator Birch Bayh's "Family Farm Inheritance Act"4/ which focused upon "farm family" estate transfer problems, the 2032A explanatory documents could have been more explicit on this point.

The Code statements which define the operation of 2032A would seem to be easily satisfied by a "traditional family farm." That is, when parents die, one or more children have long ago taken over the operation of their parents' farmland. In these circumstances, material participation requirements should present no problem for the decedent's estate nor for the qualified heir(s) if at least one is an operating farmer or materially participating in the management of the farmland. Problems other than material participation are likely to hamper the 2032A election for the "traditional family farmer" as noted by Bravenec and Olsen.5/

But not all farmland investments will necessarily fit into the traditional mold. Many situations fall somewhere inbetween the traditional and the seemingly undesirable "outside" farmland investors who may be seeking a haven from inflation and, perhaps, death transfer taxes. There may be a way to recognize a place for the professional farm manager in the application of the material participation restriction for 2032A purposes. Superior management is an important ingredient to efficient farming and is beneficial to the off-farm investor, the family farmer, the widow, and the American consumer.

Two problems that have not, to my knowledge, been elaborated on in the literature are those related to (1) the method of valuing farms under 2032A (e)(7) when cash rent data exist but are not available to the personal representatives or their appraiser and (2) the practical aspects of applying 2032A(e)(8), the five-factor approach to determining the value of qualified real property.6/

3/ See H.R. Rep. No. 94-1380, 94th Congress, 2d Session, p. 21-22; and "General Explanation of the Tax Reform Act of 1976" (H.E. 10612, 94th Congress, Public Law 94-455)("Blue Book"), prepared by the staff of the Joint Committee of Taxation, U.S. Government Printing Office, Washington, D.C., December 29, 1976, p. 537. Note that the "Blue Book" is not part of the legislation of Section 2032A and therefore is not considered part of the law.

4/ See S. 204 in the Congressional Record, Proceedings and Debates of the 93rd Congress, First Session, Vol. 119, No. 2 pp. 5177-178, Thursday, January 4, 1973.

5/ See Note 1, pp. 146-148. Supra.

6/ Since this article was written in April 1979, proposed Treasury regulations relating to Section 2032A(e)(7) have been issued. See Federal Register, Vol. 43, No. 135, July 13, 1978 and No. 139, July 19, 1978.

CASH RENT METHOD OF VALUING FARMS - 2032A(e)(7)

The capitalized net cash rent approach to valuing qualified farmland for those electing 2032A is attractive not only because of its simplicity, but also because of its substantial estate-reducing potential for post-1976 decedents' estates. As is well known, 2032(e)(7) provides for:

5-year average cash rents net of land taxes for soils comparable to the qualified farmland divided by	5-year average annual effective interest rate for all new FLB loans equals	Value of property for 1032A purposes

Table 1 attempts with numerous assumptions to illustrate the tax reducing benefit that 2032A provides.

Appraisers were being solicited for 2032(e)(7) valuations before mid-1977 as personal representatives saw an opportunity to reduce the value of the gross estate. Appendix A illustrates from an actual estate a 2032A(e)(7) appraisal, one supported by an abundance of actual cash rent data for nearly comparable soils in the locality.

The 2032A(e)(7) capitalization in appendix A indicates a value of $580 per acre which compares to a fair market value ("highest and best use") appraisal of approximately $1,800 per acre. Two other actual 2032(e)(7) appraisals presented at the winter Indiana Society of Farm Managers and Rural Appraisers (ISFMRA) meeting at Purdue University were 35 percent and 40 percent of fair market value, respectively.

While many appraisers in Indiana may find sufficient amounts of cash rent data to support the data requirements of the farm method of valuation, others may not. Although cash rent data may exist for "comparable land used for farming purposes and located in the locality" of the subject farm, it may not be readily available for an appraisal in a given estate. There may be few cash rent data existing in some localities, at least for some past years.7/

With these kinds of results possible, no one will readily dismiss the farm method of 2032A(e)(7). Numerous inquiries came to Purdue concerning possible ways to estimate cash rent from existing survey data. The problems consisted of both a lack of cash rent data of any kind and a lack for a given class of soil. Professor Atkinson at Purdue University, who already was quite familiar with USDA's Crop Reporting Service data as well as his own cash rent surveys and studies, developed a cash rent estimating procedure illustrated in appendix B.

Atkinson suggests a few variations in arriving at cash rent estimates but his basic approach is to calculate:

5-year average cash rent per acre on the subject farm, which equals	5-year average cash rent relevant Crop Reporting District (CRD) which is multiplied by	Subject farm's corn yield, / Average corn yield

7/ The Proposed Treasury Regulations issued on July 19, 1978 (F.R., Vol. 43, No. 139) indicated that where cash rent data is not available, share rental may be utilized to calculate a cash rent equivalent.

Table 1.--Federal estate tax before and after 2032A use valuation of selected adjusted gross estates 1/

Adjusted gross estate (AGE)			Federal estate tax 2/			
			1977		After 1980	
Before	After	Pre-1977 3/	Before	After	Before	After
---Dollars---			---Dollars---			
250,000	150,000	10,900	---	---	---	---
500,000	300,000	47,700	40,800	---	23,800	---
750,000	450,000	86,500	83,300	24,800	66,300	7,800
1 mil.	600,000	126,500	125,800	57,800	108,800	40,800
1.5 mil.	1 mil.	212,200	218,300	125,800	201,300	108,800
2 mil.	1.5 mil.	303,500	315,800	218,300	298,800	201,300

1/ Eighty percent held as farm and use valued at 50 percent of fair market value.
2/ Assumes no post-1976 taxable gifts and the full unified credit is available as an estate tax credit; maximum marital deduction and before State death tax credit.
3/ The pre-1977 (old) estate tax results are based on a maximum 50 percent of AGE marital deduction plus a $60,000 specific exemption. "Pre-1977" results are based on the "Before" AGE as special valuation is a new provision in the law.

The estimated cash rent for the subject farm is capitalized with the appropriate Federal land bank (FLB) interest rate after land taxes are subtracted from the cash rent.

It is to be hoped that the U.S. Treasury can soon resolve the "effective FLB interest rate" confusion by an appropriate ruling.8/ However, calculation of the "effective FLB interest rate" is a minor problem relative to others, but one might question the rationale behind the use of the FLB interest rate in a farm economy with an historical return to land of 4-5 percent.

THE ALTERNATIVE FIVE-FACTOR METHOD: 2032A(e)(8) 9/

While the cash rent of farm method of arriving at a use valuation is likely to be favored for the benefit of the estate at hand, circumstances may force the valuation of qualified farm properties according to the five factors listed in 2032A(e)(8). The five factors are provided as an approach to use valuation for nonfarm properties that might qualify for 2032A as well as for qualified farm property when the farm method of 2032A(e)(7) is not available.

8/ The IRS issued Rev. Rul. 78-363 in September 1978, which states the FLB interest rates to be used for the various FLB Districts for decedents' estates in 1977 and 1978.
9/ This section benefits in a major way from ideas shared by Jay Luse, ARA, Duff Farm Management Service, Lebanon, Indiana.

In short, the five factors are:

(1) Capitalization of expected income,

(2) Capitalization of the fair rental value of the land for farmland or closely-held business purpose,

(3) Assessed land values in a State which provides a differential or use value assessment law for farmland or closely-held business,

(4) Comparable sales. . .in which nonagricultural use is not a significant factor in the sales price, and

(5) Any other factor which fairly values the farm or closely held business value of the property.

Although the first two factors leave open the matter of capitalization rate, logically, some variation of the effective FLB interest rate should suffice. Although it is not completely clear, these factors appear future oriented in their wording rather than being based on a past 5 years as the farm method in 2032A(e)(7). The first factor, leaving open the possibility of inserting some income dampening factors (prices and yields) provides a conservative appraisal which would be valid. Both these factors should provide value estimates which exclude the bulk of "speculative" value that constitutes a large element of today's sale values.

Most appraisers in Indiana would use the third factor with considerable apprehension. Although Indiana may be listed with the many States which have a statutory use value assessment, deliberate legislative maneuvers, too complex for this discussion, have prevented assessed values of Indiana farmland from being updated for several years.10/ Under the current reassessment, it appears that most Indiana farmland will be assessed in the $500-$1,000 per acre range.

One concern expressed is that, although Indiana may be properly categorized as having a use value assessment law, there is no direct link between assessed values and sales for farming purposes. But it is not clear why this lack of connection with sales prices should make appraisers apprehensive, as the idea of a use value assessment is to avoid such a connection by basing the assessment on inherent productivity for cropping purposes. Clearly, this factor will lead to values far below the fair market value, a potential development which must be considered.

The fourth factor, comparable sales, will tend to produce, for many Indiana farm estates, a value approaching the fair market value except where nonagricultural uses do add significantly to the value. The presence of this factor in the list of five suggests that persons drafting 2032A were not fully versed on the true state of affairs of land values. This factor takes one back to the question of the intent of 2032A. Is the speculative value that is a significant part of the fair market value

10/ Indiana statute 6-1. 4-4-13(a) states: "In assessing or reassessing land, the land shall be assessed as agricultural land as long as it is devoted to agricultural uses." This statute further states that in making a general assessment of land used for agriculture, responsible officials will use USDA soil survey data as a guideline in determining the true cash value of agricultural land. The U.S. Department of Agriculture's publication Farm Real Estate Taxes: 1976, Economic Research Service, RET-17, December 1977, lists in Table 10, p. 23, the "Use Value Assessment" and "Deferred Taxation" States. There are 21 States with "Use Value Assessment" and 23 States with "Deferred Taxation" according to Mary L. Bailey, author of RET-17.

of farmland with no other apparent use than agricultural to be carved out of the gross estate when 2032A is otherwise beneficial and feasible?

Despite this possible confusion over legislative intent, neither 2032A(e)(8) nor its legislative history provides weights for the five factors. It seems a reasonable wager that equal weights could be assigned to each relevant factor as substantiated by the expert appraiser. A regulation by the U.S. Treasury that allows the recognition of the one factor that yields the lowest valuation seems unlikely. The opposite type of regulation would seem vulnerable to litigation on the grounds of violating the legislative intent of 2032A.

I do not mean to exclude the fifth factor, "any other factor," although I feel it will be ignored in many situations. It has been suggested that this factor might be suited for dealing with valuable improvements such as livestock confinement systems that function separately from the farmland. While it seems either of the first two factors would accommodate such facilities, perhaps this fifth factor would permit a replacement cost approach.

Jon Wheeler summarizes the factors well:

> While helpful, this method is not nearly as precise as the farm value method. There will undoubtedly be a myriad of court cases in future years as taxpayers and the Government clash over such questions on what capitalization rate to use, what represents a fair rental value, and how the factors are to be rewritten in arriving at the valuation to be used for the real property. Still it represents a welcome move away from the old 'comparable sales' routine.11/

Perhaps the U.S. Treasury will appreciate the problems we all recognize and move with the spirit of 2032A(e)(7) and the straightforward techniques suggested by Professor Atkinson and others when cash rent data are not readily available in the quantities desired.

11/ Jon D. Wheeler. "New Valuation Provisions for Farms and Other Property Can Reduce Estates as Much as $500,000." Taxation for Accountants, July 1977, p. 44.

APPENDIX A

SILAS SNOWSTORM ESTATE APPRAISAL

SPECIAL USE VALUATION CALCULATION

Year	Average Gross Cash Rental (Per Acre)	Average Annual Real Estate Taxes (Per Acre)	Effective Average Interest Rate
1976	$90.00	$ 6.50	.09298
1975	70.00	6.50	.09035
1974	60.00	6.50	.08596
1973	50.00	6.50	.07982
1972	40.00	8.25	.07895
5 Year Average	$62.00	$ 6.85	.08561

Average Gross Cash Rent $62.00 per acre
Less Average Real Estate Tax $ 6.85 per acre
Average "Net" Cash Rent $55.15 per acre
Income capitalization into value:
$ 55.15 ÷ .08561 = $644.20 per acre
$644.20 per acre X 120 acres = $77,304.00
SAY $77,300.00

SPECIAL USE VALUE OF FARM:

Seventy Seven Thousand Three Hundred Dollars
($77,300.00)

Respectfully submitted,

Jay D. Luse, A.R.A., A.S.A.

December 20, 1977
Date

Explanation of Special Use Valuation Calculation

The method of valuing the farm under the special use valuation technique used in this report is as set forth in Section 2032A paragraphs (e), (7), (A), (i), and (ii), Tax Reform Act of 1976. The basic steps are:

1. The average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm was determined for the 5 most recent calendar years ending before the decedent's death.

2. The average annual State and local real estate taxes for such comparable land were determined for the 5 most recent calendar years ending before the decedent's death.

3. The amount that the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm exceeded the average annual State and local real estate taxes for such comparable land was determined for the 5 most recent calendar years ending before the decedent's death.

4. Such excess was divided by the average annual effective interest rate for all new Federal Land Bank loans for the 5 most recent calendar years ending before the decedent's death.

5. The result of that division process constitutes the value of the farm per acre under the special valuation method.

Comparable Rental Data

Rental rate data were secured from several large farm businesses in Boone County, Indiana. The data are actual average cash rent paid for bare cropland for 1972 thru 1976. These actual rates were:

Year	Total acreage	Rent per acre
	Number	Dollars
1972	1,500	28.00
1973	1,800	32.00
1974	2,000	45.00
1975	2,520	56.00
1976	2,800	76.00

Other rentals known include: a farm one-quarter mile south of the subject which was cash rented in 1976, only at the rate of $100 per tillable acre; and a large farm southeast of the Snowstorm farm leased for $51 an acre in 1976 and 1977.

These and other known rentals in the area were considered in estimating the average rental rate for land comparable to the Snowstorm farm. The Snowstorm farm contains better quality soil than the average of the land covered by these rental data. These differences in land quality must be recognized.

APPENDIX B

ESTIMATING CASH RENTAL RATES FOR INDIANA FARMLAND

J. H. Atkinson*

Under the 1976 Tax Reform Act, the "alternative use valuation" of farmland in farm estates is based on annual gross cash rent for farmland in the locality minus

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Calculation of effective average annual interest rate for all new Federal land bank loans
State of Indiana

Year Month through Month	Months	Rate		Average annual rate	Effective average annual rate
1972 January-December	12	0.075		0.075	0.07895
1973 January-October	10	.075 =	.75		
November-December	2	.08 =	.16		
			.91 ÷ 12 =	.07583	.07982
1974 January-August	8	.08 =	.64		
September-December	4	.085 =	.34		
			.98 ÷ 12 =	.08167	.08596
1975 January-October	10	.085 =	.85		
November-December	2	.09 =	.18		
			1.03 ÷ 12 =	.08583	.09035
1976 January-April	4	.09 =	.36		
May-December	8	.0875=	.70		
			1.06 ÷ 12 =	.08833	.09298
5-year average				.08561	

Source: Federal Land Bank of Louisville, which is the district bank serving the Federal land bank associations of Indiana.

Note:
1. The effective rate results from the requirement that 15 percent of the amount loaned goes into land bank stock and is not dispersed to the borrower.
2. Land bank provided rate and month used. Calculation of average annual and effective average annual rate by your appraiser.

real estate taxes capitalized at the effective Federal land bank rate. All three of these components must be the average of the 5 years prior to the death of the person whose estate is being settled.

Cash rental rents are difficult to obtain on an individual farm or county basis; however, State average rents are published annually by USDA and estimates are available for at least some crop reporting districts. The purpose here is to explain and illustrate how these USDA estimates can be used to estimate the cash rent of a given farm and those comparable to it. It is not known whether this approach will be accepted by the Internal Revenue Service.

Assume the subject farm is in Adams County (District 3), and consists of 120 acres with 100 acres tillable, 20 acres in pasture, and no buildings. The 1972-76 average gross rent for cropland in District 3 is $46.40 per acre (table 1), but we have no assurance that this is the rent for land comparable to the subject farm. Corn yields are, in general, a good indicator of land quality. Since average corn yields for the district are available (table 1), cash rent for land comparable to the subject

Table 1.--Indiana cash rent paid--dollar/acre, 1972-76, and average corn yields, 1972-76

Average corn yield district	1972-76	Year 1972	1973	1974	1975	1976	1977	5-year average 1972-76	1973-77
	Bushels	---Dollars---							
1	101	41	44	54	77	87	106	60.60	73.60
2	93	36	36	46	58	65	75	48.20	56.00
3	86	32	34	47	54	65	77	46.40	55.40
4	102	36	40	50	61	68	80	51.00	59.80
5	102	36	41	53	75	84	107	57.80	72.00
6	93	33	35	45	65	76	84	50.60	60.80
7	99	34	36	43	56	67	71	47.20	54.60
8	87	1/30	1/32	40	55	53	64	42.00	48.80
9	85	32	35	42	43	56	74	41.60	50.00
State	---	36	38	48	63	72	87	51.40	61.60

1/ Because of small numbers of observations, the amount is adjusted to the same percentage change, 1972-73 and 1972-74, as occurred in State average rents.

farm can be estimated if an estimate can be made of corn yields on the subject farm. District cash rent and subject farm cash rent can be placed in the same relationship as exists between district and subject farm corn yields.

One alternative source of estimated yielding data is the county Agricultural Stabilization and Conservation Program office which has on file "base yields" for every farm. With a base yield for the subject farm of 95 bushels, we could conclude that it is 110 percent as productive as the average cropland in the district (95 bushels divided by district yield of 86 bushels). The district rent of $46.40 could be multiplied by 110 percent to arrive at a figure of $51.04 as the rent for cropland comparable to the subject farm.

A second alternative would be to estimate yield ability based on soils. General soils maps available from the Purdue Extension Service for each Indiana county contain yield estimates for each soil association. The first requirement in using this alternative is a soils map of the farm. Some counties have detailed soils maps which may be used to map an individual farm. Some farms have been mapped by the local office of USDA's Soil Conservation Service and these maps might be available for use. If information is not available from either of these sources, a soils map can be prepared by an appraiser, an agronomist, or someone else with training and experience in soil identification.

After the soils are mapped, the acreage of each association is estimated and a weighted average estimate calculated on yield estimates given in the general soils map1/ as illustrated below:

Soil Association	Corn yield estimate, 1-1V soils 1/		Estimated total yield
	Bushels	Acres	Bushels
86	97	50	4,850
62	109	40	4,360
18	105	10	1,050
Total	---	100	10,260

1/ Soils which are generally suitable for row crops.

The average yield per acre would thus be estimated at 103 bushels or 120 percent of the average district yield. District rent of $46.40 times 120 percent gives an estimated rent of $55.68 per acre.

As an alternative to using corn yields to indicate land quality, one might be able to obtain cash rent data for comparable cropland for the most recent of the 5 years, calculate the percentage this is of district rent for that year, and adjust the 5-year average district rent by this percentage. For example, assume that several comparable nearby farms rented in 1976 for an average of $78 per acre of cropland, 120 percent of District 3 rent for 1976 of $65. The 5-year average district rent of $46.40 times 120 percent gives an estimate of $55.68 per acre for cropland comparable to that of the subject farm.

Real estate taxes must be subtracted from cash rent estimates. Information on tax rates and assessments is available in the County assessor's office. Information on taxes paid on specific farms is available in the County Treasurer's office.

Assume that tax on land (not including buildings) averaged $5 per acre for the 5-year period on several comparable farms. This would be subtracted from the estimate of cash rent (say, $55.68) and the remainder ($50.68) divided by the 5-year average of the effective Federal land bank interest rate.

The FLB contract rate of interest varied from 7 1/2 percent in 1972 to 9 percent in 1975 (table 2). For the 5-year period 1972-76, the weighted average was 8.15

1/ General Soils Map of Adams County, AY-50-1, Purdue University Cooperative Extension Service. Yield estimates in these publications probably are higher than yields which would be obtained under typical or average management. Estimates of yields under both average and above-average management for all major soil series in the State are contained in an agronomy department thesis, "A Model to Estimate Corn Yields for Indiana Soils," by Carl F. Walker (unpublished M.S. thesis, 1976). The author concluded that his yield estimates under average management did not differ significantly from average yields reported by USDA's Crop Reporting Service. Another helpful publication on soils is "Indiana's Soil Series and Their Properties," by Harry M. Galloway, Purdue Cooperative Extension Service, AY-212, 1978.

Table 2.--Loan interest rates, Federal Land Bank of Louisville, 1972-77

Period	Rate	Annual average
	---Percent---	
1/1/72 to 12/13/72	7.5	7.500
1/1/73 to 10/1/73	7.5	
10/1/73 to 12/31/73	8.0	7.625
1/1/74 to 8/1/74	8.0	
8/1/74 to 12/31/74	8.5	8.208
1/1/75 to 10/1/75	8.5	
10/1/75 to 12/31/75	9.0	8.625
1/1/76 to 5/1/76	9.0	
5/1/76 to 12/31/76	8.75	8.833
1/1/77 to 2/1/77	8.75	
2/1/77 to 10/1/77	8.25	8.229
10/1/77 to 12/31/77	8.0	
5-year average, 1972-76		8.158
5-year average, 1973-77		8.304

percent. The average for each year (using 1973 as an example) is calculated as follows:

> 7.5 percent times 9 months equals 0.675 plus 8 percent times 3 months (0.240) equals 0.915 divided by 12 equals the annual average of 7.625 percent (table 2).

While no attempt is made to define "effective interest rate" as used in the 1976 Tax Reform Act, it is obvious that payment of the loan service fee (currently 1 percent) and purchase of stock in the amount of 5 percent of the loan increases what is normally considered the effective interest rate. Information from the Federal Land Bank of Louisville on annual percentage rates, calculated in accordance with the actuarial method and rounded to the nearest quarter of 1 percent, indicates an increase of 0.75 percent in stated or contract rates of 8 to 8.75 percent with loan lengths from 25 to 30 years. Adding this amount to the 1972-76 average rate of 8.158 percent results in a rate of 8.908 percent. If 5-year average cash rent minus real estate taxes were estimated at $50.68 per acre, the capitalized value would be $568.93 per acre.

What about pastureland? Due to the relatively small number of observations, USDA cash rent data on crop reporting districts is of questionable reliability; however, estimates for the State as a whole are much more reliable. Thus, one alternative is to calculate the percentage which State average pasture rent is of State average cropland rent, and apply this percentage to cropland rents as estimated above. Thus, if cropland rent were estimated at a net of $50.68 per acre, the estimate for pasture would be $20.27 per acre, with a capitalized value of $227.55 per acre.

The estimated agricultural use value of our example farm would be as follows:

		Dollars
100 acres of cropland at $568.93/acre	=	56,893
20 acres of pasture at $227.55	=	4,551
Total		61,444

Many farms also have buildings, or wood or waste land, the value of which would need to be added to the value of cropland and pasture. If comparable whole-farm cash rent could be obtained for the latest of the 5-year periods under consideration, the relationship that such rent bears to district cropland rent for that year could be calculated and the 5-year average adjusted accordingly. For example, assume a comparable whole-farm cash rent of $85 per acre for 1976 in district 3. This is 131 percent of 1976 district cropland rent of $65. The 5-year district average cropland rent of $46.40 would thus be multiplied by 1.31 to arrive at the comparable farm's 5-year average rent of $60.78.

In conclusion, it should again be pointed out that discussion of alternative ways to estimate cash rent in no way implies their acceptance by the Internal Revenue Service.

USE VALUATION OF FARMLAND FOR ESTATE PURPOSES IN MICHIGAN

Myron P. Kelsey*

In the Lake States metropolitan areas, cash rentals for cropland may not be too difficult to establish. However, problems on valuation arise for farm improvements and nontillable farmland. The cash rental rate structure is such that values are likely to be lower the closer the property is to a metropolitan area.

The lien issue for Federal estate tax deferral has been raised in Michigan as a result of P.A. 116, the Farmland and Open Space Preservation Act. This State program provides for a variable rebate for real estate taxes paid by farmers who agree to retain land in agricultural uses for a given contract period. The original legislation provided for a first lien to be applied when the contract was initially signed. This caused substantial problems for the credit agencies, particularly the Federal land bank.

After a year and a half of negotiations between the State's Treasury Department and the credit agencies, an amendment was drafted which provided that the lien would not be applied until the contract was terminated and the lien would be secondary to any already existing liens. The resolution of the problem was worked out satisfactorily to the parties concerned. I feel the same will occur in our current situation if we are willing to work with the Treasury Department.

My biggest concern as a farm management specialist is the inducements the current legislation provides for the senior generation to delay transfers of property which are often necessary to provide for business continuity. In addition, several inducements have been provided which further tighten the farm real estate market by discouraging sale.

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COMMENTS ON THE ORIGINS OF THE MATERIAL PARTICIPATION CONCEPT

James D. Keast*

The material participation concept grew out of the social security laws. Farmers were included under social security in 1954. Drafters of the legislation did not consider the types of share crop leasing. Rental income had not been considered self-employment income which would have been necessary to qualify the person for social security coverage and payment of FICA taxes. Up to 1954, social security coverage was much more limited. Thus, many landlords wanted rental income to be considered self-employment income, for if they were employed by the Federal Government, or teachers, or employees of State governments and other organizations, their employment was not covered by social security. Consequently, the material participation concept was developed. The 1956 amendments to the social security law added the provision that if the farm landlord materially participates in the production of farm products or livestock, the rental income would be considered self-employment income.

What is the relevancy of material participation?

--It can create self-employment income for social security coverage.

--It could be income resulting in a reduction of social security benefits after retirement,

--If there is rental income, a corporation could not get Subchapter S status, as no more than 20 percent of the income can be rental income; if the owner materially participates in the operation, rental income does not disqualify the corporation for Subchapter S status, or

--The owner could qualify for the special or current use valuation of land for Federal estate tax purposes as provided by the Tax Reform Act of 1976.

The act refers to Section 402(a)(1) of the Internal Revenue Code which concerns material participation. Revenue rulings, social security rulings and judicial decisions collectively provide guidelines as to material participation. Some of the basic factors indicating material participation are -- the landlord's participation through work, management, and furnishing of money, equipment, and possibly, livestock if on a livestock share lease.

Material participation can be achieved through activities of an agent, a concept developed through judicial decisions and, later, Social Security Ruling 62-16. This has been particularly important to farm management organizations with landlord clients not otherwise eligible for social security coverage. Thus, if the farm management company as an agent materially participated in the operation, the agent's

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participation was imputed to the landlord and the landlord was considered to be materially participating and eligible for social security coverage.

However, the law was amended in 1973 to provide that in 1974 and subsequent years the agent's actions would no longer be imputed to the landlord; therefore, the landlord could not materially participate through the activities of the agent.

How does this affect the special use valuation? The act states: "(6) Material Participation - Material participation shall be determined in a manner similar to the manner used for purposes of paragraph (1) of Section 1402(a) (relating to net earnings from self-employment)." Thus, it seems clear the entire body of the law relating to material participation is brought into special use valuation.

The question is whether, after the 1973 amendments, a landlord can use the services of an agent and materially participate in the operation of the farm for the special use valuation purposes. When I was general counsel of Doane Agricultural Service, we faced a similar problem. We had landlords who did not want to be covered for social security purposes after they retired, for to do so would require them to pay social security taxes at the same time they would be drawing benefits. As I stated earlier, material participation and substantial services for retirement are different. We devised an agreement which would permit the management company to perform a bookkeeping and consultation service for the landlord and still not materially participate in the operation. Since substantial services are personal, the landlord's social security benefits would not be reduced.

Our problem here is a little different in that the landlord (or a member of the family or qualified heir after death) wants to participate to be eligible for the special use evaluation. The agent cannot participate for the landlord but a member of the family can, and this member's actions would not reduce social security benefits.

A possible solution is for the landlord to have a consultation agreement with the farm manager, and for a member of the family to work with the tenant and materially participate. The result would be material participation for special use valuation, no FICA taxes or reduction in social security benefits.

THE CURRENT STATUS OF MATERIAL PARTICIPATION

Harry L. Gutman*

The regulations concerning the section 2032A election will be more than merely procedural; they will contain substantive material. In particular, they will address the issue of who must sign the consent agreement, a presently vexing question.

Section 2032A treatment is elected by checking a box on Form 706 and supplying the additional information specified in the instructions. An agreement, signed by all persons who have an interest in the property, must accompany the election. The Internal Revenue Service issued a press release on March 29th, 1978, I.R. 1977, announcing that regulations would be issued which would change the information required to be supplied in connection with the election. The press release stated that executors will be given 6 months from the date the proposed regulations are published in the Federal Register to comply with the new requirements, or if they so desire, to revoke a previously made election. We are taking the position that the section 2032A election is irrevocable. Therefore, this 6-month period will give executors an opportunity to revoke a section 2032A election.

To enable executors to make an informed decision during that 6-month period, it is important to provide some guidance as to the meaning of the term "material participation" and some content to the valuation formula in Section 2032A(E)(7). Regulations in these areas will be issued at approximately the same time as the election regulations.

Keep in mind that regulations interpret enacted legislation. Moreover, the legislative history is relatively clear as to what the Congress intended material participation to mean in the context of Section 2032A. The Ways and Means Committee Report on H.R. 14844, which ultimately became part of the Tax Reform Act of 1976, was adopted by the Conference Committee and is very specific: material participation is to be determined for farm operators in a manner similar to the manner in which material participation is determined for purposes of the tax on self-employment income (Section 1402(a)(1)).

It may well be that another way to deal with the problem would be preferred. But, if there is to be a different way, it must come from the Congress and not the Treasury. By explicit direction, our point of reference is the meaning of material participation within the context of Section 1402(a)(1).

In that context, a large body of law, revenue rulings, and regulations are presently in existence. The regulations, however, have not yet been amended to reflect a 1974 congressional change in the definition of material participation. In 1974, the Congress amended Section 1402(a)(1) to provide that the activities of agents will not be attributed to principals for purposes of satisfying the material

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participation test. I emphasize this because erroneous material prepared for Congressman Railsback by the Library of Congress has received wide circulation. That material relies on the present regulations to conclude that the participation of agents will be attributed to their principals. The Library of Congress material failed to note that the statute had been amended.

The section 1402 material participation test is obviously satisfied by one who is physically engaged on a substantially full-time basis, either in the production or management of the production of the farm. That is easy. The more difficult problem occurs when the person who owns the farm wants to have someone else manage it. If the person wants to avoid self-employment income, he or she would draft a contract that precludes material participation. However, if they do not materially participate, they cannot qualify for Section 2032A.

In this context, we have developed a two-part test. First, there has to be an arrangement, either oral or in writing, between the owner of the property and the operator. That arrangement must contemplate the performance of services by the owner. Any services provided by the owner which are not contemplated by the arrangement, even if they would otherwise constitute material participation, do not count. Second, in addition to the requirement of an arrangement, the person then has to materially participate. The question here is: what quantum of activity is required?

We cannot write a hard and fast rule, because facts and circumstances are going to differ. The best we can do is to outline the considerations that traditionally have been applied in determining whether a person has engaged in the requisite quantum of activity, and, by those guidelines, hope that one will be able to discern how much is necessary. For example, the types of things that are generally important in this determination are: a regular consultation on management decisions, regular inspection of production facilities, regular inspection of the farm itself, advancement of risk capital, and the provision of equipment, livestock, machinery, and implements. One other factor is whether the person lives on the premises. If the person does not, he or she would not be disqualified, but if he or she did, it would help.

As to the quantum necessary to qualify, primary reliance will have to be on the assembled body of law under Section 1402. When the existing body of law is reviewed against what the proposed regulations will say, I believe it will be found satisfactory.

As I stated earlier, under Section 1402, the activities of agents and employees are not attributed to the principal, no matter who those agents or employees are. In Section 2032A, we have a different concept because the material participation requirement can be satisfied by members of the family. Therefore, if agents or employees also happen to be members of the family, the material participation requirement is, in essence, met by definition. Agents and employees who are family members and materially participate will therefore satisfy the material participation requirement.

Another aspect of material participation in the 2032A context has to do with the application of the concept where the special use property is held in a corporation, partnership or a trust. Here again, an arrangement would be required between the person who has to materially participate (the decedent or the qualified heir) and the business entity. The arrangement requirement in this context may be more easy to satisfy because, for example, being a director, officer, employee, or trustee may be enough. But that is only the threshold test. The person must still satisfy, independently, the requirements of material participation. For example, for an employee, the test is whether his or her activities would satisfy the material participation standards if he or she were self-employed. Trust beneficiaries could materially participate if they were trustees and actually performed the requisite quantum of activity.

The material participation requirement of present law has been criticized. For example, assume a couple have worked a farm for 40 years, for some reason their children cannot presently satisfy the material participation test (but will in the future), and the couple wants to retire. It is a valid question whether they should lose special use valuation simply because they want to retire. Or, assume a husband dies leaving an invalid wife who is 75 years old, minor children, children in school, or incompetent heirs. In the Treasury's view it is reasonable to do something about these situations; several workable legislative solutions have been proposed.

These bills provide that, if a decedent and any spouse materially participated in the operation of the special use property for any period 20 years prior to death, the threshold material participation requirement will be deemed met. On the continuing qualification side, where qualification occurred because of satisfaction of the 20-year material participation requirement, then the 5- out of 8-year test would begin on the date of the decedent's death. In addition, for qualified heirs who are under 21, full-time students, physically or mentally incapable of running a farm, or a surviving spouse over age 62, the activities of an agent or a fiduciary would be attributed to such persons to satisfy the 5- out of 8-year continuing test.

The material participation requirement also affects farm managers. Farm management contracts I recently saw were carefully drafted to avoid material participation, probably for self-employment tax reasons. That is, the arrangement simply did not contemplate the participation of the owners of the property in its management. These arrangement terms must be changed when Section 2032A qualification is desired. The management agreement must contemplate the performance of a sufficient quantum of activity by the person for whom the farm manager is working. If that person does the things contemplated by the agreement, he or she will be materially participating.

I do not think farm managers need lose business over this. The choice is whether or not to materially participate. The use of a farm manager has nothing to do with that decision. People have to decide whether they want to be subject to self-employment tax. That is the tradeoff.

Finally, let us look briefly at the issue of further expansion of Section 2032A. I believe the Congress intended the section to be limited to people actively engaged in farming. Treasury did not agree with the initial congressional decision, in part because we do not believe the section will accomplish its purpose of protecting the small family farm. We do not believe it should be expanded unless and until data exist which demonstrate that this type of relief is an equitable and cost-efficient method of accomplishing an important social policy objective.

PROBLEMS ARISING FROM MATERIAL PARTICIPATION REQUIREMENTS OF SECTION 2032A

Samuel P. Guyton*

The principal problems with the material participation requirements of Section 2032A of the 1976 Tax Reform Act relate to how "material participation" is defined, who can satisfy the "material participation" test, what records must be maintained to prove "material participation," the length of time necessary to satisfy the "material participation" requirement, and the possible loss of social security benefits by elderly farmers who materially participate in the operation of their farms.1/

WHAT IS MATERIAL PARTICIPATION?

It is clear from Section 2032A(b)(1)(C) that special use valuation will not be available to a decedent's estate unless the decedent or a family member participated materially in the operation of the farm or other business for a period aggregating 5 years or more during the 8-year period prior to the decedent's death. Further, failure by the qualified heirs who inherit the farm or other business to materially participate in its operation for more than 3 years during any period of 8 years following the decedent's death can cause a recapture event that results in the imposition of any additional estate tax. Thus, the threshold issue is: "What is material participation?" Section 2032A(e)(6) states that material participation will be determined in a manner similar to that of Section 1402(a)(1) relating to net earnings from self-employment.

Several definitional problems have been created by citation to this Section. For example, what does "in a manner similar to the manner used for purposes of paragraph (1) of Section 1402(a)" mean? Does it mean in the exact same way as Section 1402(a)(1) is interpreted and applied or does it mean in a similar but not exactly the same manner as Section 1402(a)(1)? The answers to these questions will add clarity to the scope of material participation under Section 2032A. In the meantime, an examination of Section 1402(a)(1) should provide some guidance as to the type of activities which will be required to satisfy the material participation mandates of Section 2032A.

Section 1402(a)(1) generally excludes rentals as net earnings from self-employment, except when the landlord participates materially in the production or management of production of the agricultural or horticultural commodities. When, then, does one participate "materially"? Section 211(a)(1) of the Social Security Act, which has a parallel provision to Section 1402(a)(1), has been construed so that

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1/ Provisions of the proposed regulations on material participation under Section 2032A are not reflected in this article.

"material" means "substantial," "important," "of consequence," "of solid and weighty character," and "of substantial value or importance".2/

The more troublesome aspect concerns the definition of the term "participation." Both Section 1402(a)(1) and Section 211(a)(1) of the Social Security Act were amended in 1974 to provide that material participation by a landlord is to be determined without regard to the activities of an agent. However, the regulations interpreting Section 211(a)(1) of the Social Security Act (but not those under Section 1402(a)(1)) were subsequently modified and now take the questionable position that the activities of both agents and employees are to be ignored in determining material participation by the landlord.

Such a position in these regulations might be said to serve the purpose of providing landlords with benefits under the Social Security Act. Yet it could have a devastating impact if applied to Section 2032A since it would mean that the activities of employees and agents could not be considered in determining material participation. Such an interpretation would seem to conflict with Section 2032A(g) which provides that special use valuation applies to interests in partnerships, corporations, and trusts which qualify as an interest in a closely-held business under Section 6166(b)(1).

This conflict arises because the business of conducting a farming operation in partnership or corporate form or which is in a trust is usually done through agents or employees whether they be performing work as partners, officers, or trustees. Moreover, the congressional history as revealed in the Conference Report states that the rules for special valuation are intended to apply to property passing in trust wherein the qualified heir has a present interest in the trust property. Based upon this language in the Conference Report, it would seem that when a member of the family of the deceased farmer is a qualified heir and a beneficiary of a trust established by the decedent, the material participation requirements of Section 2032A(e)(6) should be satisfied regardless of whether the trustee of the trust is a member of the decedent's family.

For a partnership or corporation, work on a farm is frequently performed by partners or officers who could be viewed as agents or employees. Certainly when family members of the decedent or of the qualified heirs are partners, officers, trustees or employees, their activities, plus those of the decedent and the qualified heirs, should be viewed as participation for purposes of the material participation rule. In the fairly common situation wherein a family partnership owns and leases the farmland to a family-owned corporation which conducts the farm operation, material participation should be satisfied by virtue of family members being officers and employees of the corporation and participating in the operation and management of the farm. Moreover, the activities of unrelated employees should also be considered as participation for purposes of Section 2032A.

The regulations interpreting Section 1402(a)-4 set forth what activities will be regarded as material participation in production or management of production of the agricultural or horticultural commodities.3/ These activities include physical work, furnishing machinery, livestock and seed, making management decisions relating to farm production, formulating a farm or crop plan, periodic inspections, periodic advising and consulting and furnishing funds. Depending on the circumstances, one or more of these activities may be required to reflect material participation under Section 1402(a)(11).

2/ See Foster v. Celebrezze, 313 F. 2d 604 (8th Cir. 1963) and Conley v. Ribicoff, 294 F. 2d 190 (9th Cir. 1971).

3/ See Treas. Reg. S 1.1402(a)-4.

Interestingly, the Farmers' Tax Guide indicates that a landlord will be deemed to materially participate if he physically works 100 hours or more in a period of 5 weeks. And it was suggested in Henderson v. Flemming, 283 F.2d 882 (5th Cir. 1960) that just the furnishing of funds could constitute material participation although the regulations under Section 1402(a)(1) state that there can be no material participation just by furnishing funds.

Closely related to material participation under Section 2032A(e)(6) is the "actively participated in the management of the business of farming" rule under Section 464(c)(2) relating to farming syndicates. The Conference Report stated that factors indicating active participation with respect to Section 464 included: participating in decisions involving the operation or management of the farm; actually working on the farm; living on the farm; and hiring and discharging employees. It would appear that these activities should apply equally in demonstrating material participation under Section 2032A.

The lack of definitional certainty as to what constitutes material participation under Section 2032A is a cardinal problem. For most farmers who operate as sole proprietors and are actively involved in farm operations until the time of their death, there should be no problem in meeting the material participation test. But what if such a farmer (or, for qualified heirs, one or more of such heirs) becomes sick or cannot operate the farm and has to hire employees or agents to operate the farm? Will such sickness or incapacity for more than 3 years disqualify from material participation under Section 2032A? If a widow or minor children are qualified heirs, how can they meet this material participation test when prudent management would suggest employment of agents or others to conduct the farm business? What adverse effects will occur if farmers and their heirs are encouraged not to use professional managerial assistance in the operation of the farm?4/ How will material participation be performed if ownership in the farm is represented by shares of stocks, interests in a partnership, or beneficial interests in a trust or estate? Will the activities of a nonfamily personal representative or trustee be regarded as material participation? These questions pinpoint some of the problems raised by the definition of material participation under Section 2032A. It is to be hoped that future regulations will address these questions and provide guidance.

PROOF OF MATERIAL PARTICIPATION

Records supporting material participation are vital and should be maintained. Yet what records will demonstrate material participation and how does one prove it? In large measure, definitive guidelines are needed. Affidavits of the farmer, the qualified heirs, and family members stating what activities were performed as well as statements by neighbors, bankers, attorneys, accountants, county agricultural agents, and similar persons should serve as proof. Clarification in regulation or ruling as to what proof will be required and how it can be demonstrated should indicate what records should be prepared and maintained by farmers and by qualified heirs.

LENGTH OF MATERIAL PARTICIPATION

A farm acquired by a farmer less than 5 years before the date of death would not qualify for Section 2032A valuation since the farmer would not have owned and used the

4/ For a discussion, see: Statement of J.R. Hutchinson, Hearings before Ways and Means Committee on H.R. 6715 (Serial 95-39) at 61.

farm and materially participated in its operation for a period of 5 years. This result seems clear. What is not clear is whether the periods of material participation and use and ownership under Section 2032(b)(1) are the same years.

The language of Section 2032A (b)(1)(C) suggests material participation relates to the farm operation whereas ownership and use apply to the period the qualified real property is held. Thus, the material participation requirement would arguably be satisfied by material participation for 5 out of the relevant 8 years since material participation appears to apply to the farm operation and not to how long the qualified real property was owned and used. Regulations and rulings should clarify this important point.

Since farmers frequently and periodically acquire new farmland, the ownership and use tests of Section 2032A(b)(1) would not be met with regard to farmland acquired from nonfamily members less than 5 years prior to the farmer's death. This situation creates a problem in that it encourages farmers, especially those who are advanced in age, not to expand their operations. Yet expansion is an economic necessity for many farm businesses due to increasing production costs.

An equitable solution would be to extend Section 2032A to all farmland owned by the deceased farmer or his or her family when the farmland was owned and used for farming prior to the farmer's death and the majority of the farmland satisfied the 5- out of 8-year ownership and use requirement and there was material participation in the operation of the farm for the requisite period.

Related issues arise with exchanges, Section 1033 involuntary conversions, Section 351 incorporations, and Section 721 transfers to a partnership. The 5- out of 8-year ownership, use, and material participation requirements should be viewed in such situations as if the property acquired tacked on the ownership, use, and material participation periods associated with the property transferred. Moreover, there should be no additional estate tax imposed when a qualified heir acquires property under these same circumstances, and the property received by the qualified heir should be similarly viewed for purposes of Section 2032A(c). Transfers of property to a revocable trust should be treated similarly.

As previously noted, the 5- out of 8-year material participation requirement can pose severe problems to both the deceased farmer's estate as well as to the qualified heirs. As to the period of 8 years immediately prior to the farmer's death, there may be more than 3 years that the farmer or members of his family did not materially participate in the farm operation for valid business reasons, or for other causes beyond the control of the farmer, such as sickness or incapacity.

As for the 15 years following the farmer's death, there must be material participation by the qualifed heirs or members of their family for 5 out of every 8 years during this 15-year period to avoid the assessment of additional estate tax under Section 2032A(c). The 15-year-recapture period seems exceedingly long and its purported purpose of preventing land speculation should be achieved through the other requirements specified in Section 2032(A)(b).

The principal problem created by the 15-year recapture period and the length of the material participation test following the farmer's death is the number of years the property is administered by the deceased farmer's estate. The availability of, and, in many cases, the necessity for using, Section 6166 or Section 6166A may result in prolonging estate administration for several years and postponing distribution of property to the qualified heirs. How is material participation satisfied under these circumstances? Will the personal representative be permitted to demonstrate material participation and have this satisfy the 5- out of 8-year requirement? What if the personal representative is not a member of the family?

Section 2032A(c)(7) requires that there must be material participation by the decedent or a qualified heir or members of their families for 5 years during any period of 8 years ending after the decedent's death. Thus, recapture could theoretically occur if the decedent did not materially participate for 2 years prior to death and the qualified heirs do not materially participate until more than 1 year following the decedent's death.

These are perplexing, but critical, questions which demand immediate answers. A reasonable solution would appear to be to treat the activities of the personal representative in operating the farm as being capable of satisfying the material participation requirement.

As regards the pre-death material participation requirement, the problems previously described might be alleviated if Section 2032A(b)(1)(C) provided that material participation would be satisfied if there were periods amounting to 5 years or more during which the deceased farmer or a member of his or her family materially participated in the operation of the farm prior to the farmer's death. H.R. 9902 introduced by Congresswoman Keys and Congressman Fisher would amend Section 2032A(b)(1) to provide that the decedent or spouse materially participate in the farm business for any 20 years prior to the decedent's death. This proposed amendment is certainly a move in the right direction, although 20 years seems unduly long.

Material participation by the qualified heirs also poses certain problems, some of which have been previously discussed. H.R. 9902 would address these problems by permitting the activities of an agent or fiduciary to be deemed material participation by a qualified heir for a particular year if the activities are performed for a qualified heir who is under 21, a student as defined in Section 151(c)(4), has a physical or mental disability, or is a spouse of the decedent and has attained age 62. S.2228, introduced by Senators Byrd and Dole and containing similar provisions, has received a statement of non-opposition from the Treasury Department. A simpler approach from both an administrative and compliance standpoint would be to permit qualified heirs to avoid recapture by satisfying the material participation test of Section 2032A through the use of agents or fiduciaries.

SOCIAL SECURITY BENEFITS VERSUS SECTION 2032A VALUATION

A major problem with the pre-death material participation requirement of Section 2032A(b)(1)(C) is that elderly farmers who materially participate in the operation of their farm may be subject to self-employment tax on the earnings from the farm. They also might have to forfeit social security benefits to which they would otherwise be eligible. Thus, many of these farmers will be forced to decide whether they want the benefits of Section 2032A available for their estates or whether they would rather receive full social security benefits and not be subject to self-employment tax on certain of their farm earnings during their lifetimes.

It seems unfair to force this choice on farmers and certainly this does not seem to be the intent of Section 2032A. The Iowa State Bar Association has noted this unfairness to elderly farmers and has suggested the material participation requirement be deleted from Section 2032A to fit with the intent of Section 2032A to provide needed relief to these farmers.5/ Another possible solution would be a modification of Section 2032A(b)(1)(C) to permit satisfaction of the pre-death material

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5/ See Statement of Arley J. Wilson, Hearings before Ways and Means Committee on H.R. 6715 (Serial 95-39) at 19.

participation rule if the farmer or a family member materially participated in the operation of the farm for any 5 or more years prior to the farmer's death.

CONCLUSION

A number of problems with regard to the material participation requirements of Section 2032A can be resolved in future regulations. To the extent the regulations do not or cannot provide satisfactory answers to certain of these problems, remedial legislation should be passed.

ESTATE TAX SHELTER FOR FARMLAND OWNERS: IMPLICATIONS FOR FARMLAND CONTROL

Stephen F. Matthews and Randall Stock*

INTRODUCTION

The Tax Reform Act of 1976 included a major provision providing for "actual use valuation" for farmland.1/ A qualifying estate would be allowed to value farmland based on its "actual use" value to include it in the gross estate for Federal estate tax purposes--for persons dying after December 31, 1976. Our purpose here is to explain eligibility requirements for actual use valuation and to suggest implications for farmland owners and farm managers.

The Congress enacted the actual use valuation provision primarily to reduce the likelihood that farm estate heirs would be forced to sell part or all the farm to pay Federal estate taxes. As farmland increased in value, the farm estate found its major asset--land--increased the Federal estate tax impact. Many of the farmland value increases came about through nonfarm bidding pressures such as urban sprawl and land speculation. The legislative history of the new law indicates the Congress desired to separate out the speculative, nonfarm value bid into farmland under the highest and best use valuation approach, as well as to reduce subjectivity and controversy in farmland valuation.2/

PROBLEMS WITH THE ACTUAL USE VALUATION FORMULA

Plugging in figures in the use valuation formula may seem easier than it actually is. For example, what is the locality from which comparable rents and real estate taxes are to be taken? Farms near urban areas would doubtless have higher taxes than would land located farther from cities. There may not be comparable land in a county that is being rented. Can rents be comparable if the land is several counties away from the land in question?

The Federal land bank interest rate to be inserted in the use value formula will also prove difficult to determine. Each of the 12 Federal land bank districts sets their interest rates on new loans rather independently, varying with the type of loan. Should the interest rate to be used be weighted by the amount of loans issued during the relevant 5-year period? Should the rates of all the districts be averaged? These questions are left unanswered in the new provision, which leaves it up to the U.S.

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1/ Int. Rev. Code of 1954. Section 2032A.

2/ H.R. Rep. No. 94-1380. 94th Cong., Sess. 24-25 (1976).

Treasury to issue regulations and/or for the courts to resolve by litigation. While the drafters of Section 2032A sought to reduce subjectivity in farmland valuation, there remains much uncertainty.

Alternative Valuation Procedures

If gross cash rent figures for comparable land are unavailable or if the estate executor elects, the new law outlines factors which are substituted for formula valuation in determining the value of qualified farmland.3/ But until regulations are issued by the Treasury and the Internal Revenue Service to guide determination of formula values, it is anticipated that qualified estates will benefit most by applying the actual use formula.

Comparing Market Value With Use Value

Table 1 compares the average market value (highest and best use) of farmland with the actual use value as calculated by the formula. The calculations, for average land in the selected States, should not be regarded as accurate for land in a given locality as is required by the formula. However, the table does indicate that actual use values average lower than market values, from 16 to 82 percent less. For example, Illinois farmland had actual use formula value, averaging 66 percent lower than market value based upon the 5-year period ending March 1, 1975. That would translate to a reduction in estate valuation per acre of approximately $300.

Obviously, the potential for estate size reduction varies by locality as cash rents, taxes, interest rates, and market values differ considerably. Nonetheless, large farm estates may realize substantial gross estate reductions from the highest and best use value (limited to $500,000) via the actual use formula. Assuming the maximum reduction from the highest and best use value is achieved, the larger estates will benefit the most in reduced Federal estate taxes. Table 2 shows the reduction in estate taxes achieved by a $500,000 reduction in taxable estates of various sizes. Maximum reduction in the estate valuation allowed via actual use valuation benefits larger estates more; it reduces Federal estate taxes as much as $350,000.

Recapture of Estate Tax Savings

Simply qualifying for actual use valuation does not guarantee against a recapture of the estate tax reduction. There are recapture provisions for all or part of the "adjusted tax difference" if any of the following disqualifying events occur within 15 years of the decedent's death:4/

(1) Failure of the qualified heir or family member to materially participate in the farm operation for at least 5 years over any 8-year period;

(2) Failure to use the farmland for farming purposes;

(3) Disposition by the qualified heir to someone other than a member of the qualified heir's family.

3/ Int. Rev. Code of 1954. Section 2032A(e)(8).
4/ *Ibid.* Section 2032A(c).

Table 1.--Comparison of average market values with actual use farmland values

State	Average market value per acre (March 1, 1975)	Use value assessment for estate tax purposes 1/	Use value as percentage of market value
	---Dollars---		Percent
Alabama	370	195	53
Georgia	486	234	58
Illinois	857	561	66
Indiana	726	506	70
Iowa	725	560	77
Kansas	301	183	61
Kentucky	435	285	66
Michigan	563	254	45
Minnesota	436	368	84
Mississippi	386	242	63
Missouri	399	294	74
North Dakota	196	152	78
North Carolina	603	276	46
Ohio	711	311	44
Oklahoma	397	148	48
Pennsylvania	830	153	18
South Carolina	475	193	49
South Dakota	146	116	79
Tennessee	477	397	64
Virginia	560	210	37
Wisconsin	441	274	62

1/ Calculated as the average gross cash rent less real property taxes for 1971-75 divided by an effective interest rate for new Federal land bank loans for the same period. Gross cash rents were averaged only for 3 years (1973-75); prior years were unreported.

Sources: U.S. Department of Agriculture, Economic Research Service, Farm Real Estate Market Developments (CD-81). U.S. Government Printing Office, Washington, D.C., July 1976.

U.S. Department of Agriculture, Economic Research Service, Farm Real Estate Taxes (Ret-16). U.S. Government Printing Office, Washington, D.C. March 1977.

Federal land bank loan rates from unpublished data.

Table 2.--Estate tax savings resulting from the maximum actual use valuation reduction

Taxable estate (dollars) 1/	Estate tax bracket on top dollar	Estate tax savings	Savings as percentage of taxable estate
	Percent	Dollars	Percent
750,000	37	177,500	24
1,000,000	39	190,000	19
1,250,000	41	200,000	16
1,500,000	43	210,000	14
2,000,000	45	225,000	11
2,500,000	49	245,000	10
3,000,000	53	265,000	9
3,500,000	57	285,000	8
4,000,000	61	305,000	8
4,500,000	65	325,000	7
5,000,000	69	345,000	7
Over 5,000,000	70	350,000	7

1/ Taxable estate equals the adjusted gross estate minus any marital deduction, assuming no taxable gifts had been made since 1976.

The qualified heir can sell the farmland to family members without being subject to recapture, but the new owner takes the place of the original qualified heir for purposes of recapture during the 15-year period. If the date of the disqualifying event occurs between the tenth and fifteenth year after the decedent's death, the recapture tax is reduced by one-sixteenth for each full month past the tenth year. Furthermore, once a recapture has occurred, a subsequent disqualifying event will not trigger further recapture. The recapture tax is due within 6 months after the disqualifying event.

The "adjusted tax difference" means the excess of the estate tax liability without use valuation over the amount with use valuation.5/ The actual amount of additional estate tax upon recapture (ignoring partial recapture) will be the lesser of (1) the adjusted tax difference or (2) the excess of the amount realized by disposition of the qualified real property over the value of the qualified real property as included i. the gross estate under Section 2032A(a).6/ If the disposition is other than a sale or exchange at arm's length, the fair market value at the time of disposition will be substituted for the amount realized.

One of the objectives of the use valuation provision was to "reduce subjectivity, and thus controversy, in farm valuation."7/ While this objective is substantially met with the use value formula, there remains the potential need to know the fair market value of the qualified real property at the decedent's death for purposes of computing estate tax recapture. It would be advisable for the executor and qualified heir to document as well as possible the fair market value of the qualified real property at the decedent's death for this purpose, as well as to provide an estimate on the amount of security that might be required to substitute for the special estate tax lien.8/

Recapture and the Previously Taxed Property Credit. The recapture tax is generally treated as a separate estate tax, but it is treated as a tax on the estate of the decedent for purposes of the previously taxed property credit. "If the qualified heir dies within 10 years of the time of the death of the decedent but after a recapture event has occurred, this recapture tax would be utilized in computing the previously taxed property credit. However, it would be treated as having been imposed as of the date of the decedent's death, rather than at the time the actual recapture event occurred."9/

Special Federal Estate Tax Lien. The Federal Government attaches a lien to the qualified real property equal to the "adjusted tax difference," which means the excess of what would have been the estate tax liability without actual use valuation over the estate tax liability with actual use valuation.10/ The Federal lien will be subordinate to subsequent liens representing loans to improve the real property or to add lasting improvements. The purpose of the Federal lien is to insure the Government's claim for the adjusted tax difference should recapture be triggered.

Death of the Qualified Heir. No estate tax recapture is triggered upon the death of a qualified heir, even within the 15-year period. Furthermore, the qualified heir's executor may elect the actual use valuation alternative if all requirements are met. Hence, a surviving spouse could benefit from the actual use valuation during his or her lifetime as a qualified heir and his or her estate could also use the favorable valuation procedure. No lapse of any minimum number of years would be required.

5/ Ibid. Section 2032A(c)(2)(C).
6/ Ibid. Section 2032A(c)(2)(A).
7/ Note 2 supra. pg. 24.
8/ Ibid. p. 27.
9/ Note 2 supra. pg. 27.
10/ Int. Rev. Code of 1954. Section 6324B.

MATERIAL PARTICIPATION: "SIMILAR" TO THE SOCIAL SECURITY RULE

To be eligible to elect actual use valuation, the decedent or family member must have materially participated in the operation of the farm for at least 5 of the decedent's last 8 years. Also, the qualified heir or family member must materially participate in the operation of the farm for at least 5 of any 8 years ending after the decedent's death--during the 15-year recapture period. The 5-year total can be an aggregation of time periods, not necessarily 5 calendar years. The new rules state that "material participation" shall be determined in a manner "similar" to that used for social security purposes relating to self-employment income.11/ The degree of similarity will depend upon Treasury regulations and IRS rulings, as well as court cases, yet to be promulgated.

The material participation requirement for actual use valuation purposes is at odds with a retired farmer's desire to receive maximum social security benefits between the ages of 62 and 72. If a person between those ages receives self-employment income above a certain level per year ($3,000 for 1977), social security benefits are reduced. Rental income for property in whose management the farmer-landlord does not "materially participate" is not considered self-employment income and it does not reduce social security benefits.

After the retired landowner reaches the age of 72, there is no reduction in social security benefits due to self-employment income. Hence, the presence or absence of material participation is a crucial question both for qualifying for actual use valuation and for avoiding reduced social security benefits between the ages of 62 and 72.

The social security tax law on material participation was altered in 1974 so that the activities of agents and/or employees on behalf of a landlord would not be counted as material participation by the landlord-landowner.12/ From the farm manager's standpoint, the change was desirable for social security purposes as it allowed them to manage a landowner's farm without having their activities attributed as material participation by the landlord. Hence, the landlord-landowner could receive cash or crop shares under a farm management lease without a reduction in social security benefits.

The ironic side of the material participation issue is that farm managers were pleased with the 1974 change making it harder to provide material participation when social security benefits were concerned. However, actual use valuation rules make it mandatory that the decedent or a member of his or her family, as well as the qualified heir or member of the family, materially participate in the farm operation for at least 5 years in an 8-year period.

The question remains whether the tests for material participation for purposes of actual use valuation of real property will be determined under rules similar to those self-employment income rules in existence prior to 1974. Indeed, a Treasury regulation remains from the pre-1974 self-employment income law, now contradicted and overruled by the amendment to the Internal Revenue Code:

> Employees or Agents. Services performed by such an employee or agent are considered services performed by the owner. . . in determining the extent to which the owner has participated in the production or management of a commodity.13/

11/ Ibid. Section 2032A(e)(6).
12/ Public Law 93-368. Section 10(b), (1974).
13/ Treas. Reg. Section 1.1402 (1)-4(b)(5).

Before the 1974 revision, a revenue ruling had approved as showing material participation by the landlord a situation wherein a farm manager consulted frequently with a tenant sharecropper and the landlord paid part of the production costs and retained the rights to approve crop and management plans.14/

The 1974 change in the tax code states that the landlord's material participation must occur without regard to any activities of an agent of such landlord, effective for taxable years beginning after December 31, 1973. While the regulation quoted above may be relevant for tax years before 1974, it should not be relied upon in resolving self-employment income issues for taxable years beginning after 1973. Until new regulations interpret the actual use valuation law, the question remains unresolved as to the degree of similarity between self-employment income and actual use valuation in interpreting material participation when farm managers are hired. Until such regulations are published, leases involving farm managers should include provisions evidencing material participation in the production or management of production of agricultural commodities by the landowner or a family member without continuing the farm manager's activities if actual use valuation eligibility requirements are to be satisfied. In addition, the landowner or family member should actually participate in production and/or management activities "in a material manner." Mere lease provisions will not substitute for the actual participation.

GETTING PERSPECTIVE ON MATERIAL PARTICIPATION

The various material participation guidelines discussed in the Farmer's Tax Guide, Treasury regulations, revenue rulings, the Internal Revenue Service rulings, and the Internal Revenue Code are the general rules to direct a landowner's participation in farm activities when he or she leases farmland either on a crop share or cash rent basis. There will be no need to provide material participation when the landowner conducts the farming activities, even with the help of hired labor, because he or she is actively operating a business as a self-employed individual. Only under lease arrangements does the material participation issue become relevant because the landowner has changed status from operator to landlord and receives income as rentals.

The farm manager's activities from the standpoint of self-employment income and social security law have not substituted for the landlord's participation since 1973. Whether a similar interpretation for actual use valuation purposes will be made awaits Treasury action in the form of regulations. Assuming the same treatment of the farm manager's activities for actual use valuation purposes, this would not preclude the landlord-landowner from meeting the material participation requirement by his or her own management and/or production activities or those activities by family members.

One thing most clear from the various rules and regulations on material participation is the need to do more than simply have a lease whose provisions require activities by the landlord or family member. Most important is that the landowner or family member actually participate to a material degree in the farming operation. A lease requiring activities amounting to material participation may be required under the new regulations for actual use valuation, but for social security purposes, the lease is loosely described as an "arrangement," whether written or oral. Good business relations are enhanced by written leases detailing what activities are to be

14/ Rev. Rul. 64-32, 1964-1 C.B. 319.

performed by all parties, including the landlord. But the principal focus should be on insuring the landowner or family member participates to a material degree in the farming operation.

USE VALUATION AND FRESH START BASIS

For persons dying after December 31, 1976, inherited property will no longer be increased in basis equal to its fair market value. New Section 1023, called the "fresh-start basis rule," outlines a formula that allows an heir's basis to be partially stepped up to what the fair market value would be on December 31, 1976, if a uniform rate of appreciation were assumed. For farmland, the formula adds to the decedent's basis a proportion of the difference between the fair market value of the farmland at the decedent's death (or 6 months thereafter). The proportion is found by figuring the total number of days comprising the decedent's holding period and dividing that into the number of such days preceding 1977.15/

When Section 2032A is elected, a question arises as to what market value to use when computing net appreciation for the fresh-start basis. From the Ways and Means Committee Report, the estate market value, whether on the alternate valuation date or as figured under Section 2032A, will apparently be used to calculate net appreciation.16/ Generally, the result is that an election to value farmland at use values will reduce the amount of Federal estate tax on the decedent's estate but will increase the amount of potential capital gains taxable to the heirs when they dispose of inherited property. This situation results from the lower fresh-start basis because the lower use value is used to compute the amount of appreciation added to the heir's basis. Executors should caution heirs that the Section 2032A election should be made only after considering the likelihood of increased capital gains taxes.

Election of use valuation (Section 2032A) may reduce the Federal estate tax bill, but that may still not be enough help for an estate with insufficient cash to pay the estate tax due. Section 6166A is available for estates with 35 percent of the gross estate or 50 percent of the taxable estate consisting of the value of the farm or closely-held business. However, the Tax Reform Act of 1976 added a more favorable, payment-extending provision with new Section 6166.

New Section 6166 allows a 15-year period of payment of the estate tax attributable to the dependent's interest in a farm or closely-held business. The entire principal is deferred for 5 years followed by equal payments over the next 10 years. A 4-percent interest rate is allowed on the estate tax attributable to the first $1 million in value of a farm or closely-held business. Also, a lien on property can be substituted for the bond and executor's personal liability.17/ However, to be eligible for new Section 6166, an estate must have at least 65 percent of the adjusted gross estate representing the value of the farm or closely-held business interest.

If Section 2032A is elected, the use value of the qualified real property must be used when determining whether an estate qualifies for the low-interest and payment-extending provisions of Section 6166. Thus, use value of farmland will be used for the 65-percent test. Some estates that can meet the lower tests for use valuation will be ineligible for Section 6166. Executors will want to make these tradeoff calculations in light of estate liquidity.

15/ Int. Rev. Code of 1954. Section 1023(h)(2)(C).
16/ Note 2 *supra.*, p. 39.
17/ *Ibid.* p. 31.

IMPLICATIONS FOR FARMERS AND FARM MANAGERS

Farmers, qualified heirs, farm managers, and other estate planning advisors will find the actual use valuation procedure for farmland a most useful estate planning tool. But what tradeoffs will there be? For example, if certain eligibility requirements must be met during the last 8 years the landowner holds the land, how will this affect his or her retirement plans? Furthermore, if landowners can get preferential Federal estate tax treatment, will wealthy persons seek out farmland, adding upward pressure to land prices and increasing the need for farm management assistance?

Fewer Opportunities for Beginning Farmers

By applying actual use valuation, medium- to large-sized farms will be better able to stay intact upon the landowner's death because the Federal estate tax impact will be less. The consequence will be fewer land transfers upon estate settlement. The person not from a landowning family will have fewer chances to purchase land.

Furthermore, existing farm landowners who qualify for actual use valuation will have a tax-subsidized advantage in bidding for more farmland. In effect, the new tax rule encourages qualified farmers to expand their landownership rather than to diversify assets into retirement plans, stocks, and bonds. The beginning farmer will likely face higher land prices, which reflect the capitalized advantages offered wealthy persons who want to reduce the estate tax impact. Of course, the level of capitalization will vary by locality with the level of cash rents, State and local real estate taxes, and the Federal land bank interest rates over the relevant 5-year period.

Meeting the Ownership Requirements

Who owns the land at the decedent's death as well as during the decedent's last 8 years of life can affect eligibility for use valuation. Problems can principally be of two types: (1) gift transfers of farmland to nonfamily members within 3 years of the decedent's death; and (2) farmland acquired by the decedent from a nonfamily member within 5 years before the decedent's death. Gifts made within 3 years before death are automatically included in the decedent's gross estate under the Tax Reform Act of 1976.18/ However, inclusion in the gross estate is for estate tax purposes only. If the donee-transferee was not a member of the decedent's family, the result is loss of eligibility for actual use valuation of farmland. This result might have been avoided if property other than farmland had been given to nonfamily donees and farmland was distributed only to persons eligible as "qualified heirs."

The second problem could result if the decedent bought the farmland within 5 years of his or her death. The law requires that the decedent or family member own the farmland for at least 5 of his or her last 8 years of life. When alternative land purchases are under consideration by an elderly farmer and one tract is owned by a family member, the actual use valuation rules would encourage purchasing farmland from the family member, which includes parents, grandparents, brothers, sisters, their spouses, and descendants. Furthermore, farmland purchases should not be postponed until later years where the purchaser is nearing retirement or in bad health--to insure ownership for at least 5 years before death.

18/ The $3,000 annual exclusion is not, however, brought back into the decedent-donor's estate even though the gift was made within 3 years of the donor's death.

Material Participation: Which 8-Year Period?

The qualified heir must satisfy essentially the same requirements as the decedent to avoid recapture of the estate tax reduction during the 15-year period following the decedent's death. Material participation is required of the qualified heir or family member for at least 5 years of any 8-year period.19/ The 8-year period for the qualified heir would include years before the decedent's death until 8 years after this death. During the 8-year overlap, the material participation or lack thereof by the decedent or family member would be crucial.

One potential problem could arise if the decedent's estate qualified for actual use valuation, even though in the last 2 years there was no material participation. Should the qualified heir or family member fail to participate materially in the farming operation for more than 1 year following the decedent's death, the 5- of 8-year rule will be violated. This situation could easily arise when the qualified heir and family members live far from the farmland and the estate is tied up in the probate process for several years.

Qualified Use: When?

Another important consideration if the qualified heir is to avoid recapture during the 15-year period is to insure that the real property continues to be used for farming purposes throughout the 15-year period, not simply 5 years of any 8-year period.20/ This requirement might cause disqualification, and thereby recapture, if the farmland is left idle during the probate process or simply because the qualified heir misunderstood the recapture rules to allow up to 3 years of nonagricultural use during any 8-year period. As the use valuation provisions now read, recapture can be avoided if the qualified heir or family member materially participates for at least 5 of any 8-year period within 15 years of the decedent's death. However, recapture will be triggered if the qualified real property is not used continually for farm purposes.

Dispositions Which Might Cause Recapture

The qualified heir will trigger recapture during the 15-year period following the decedent's death by "disposing of any interest" to anyone other than a family member. Dispositions would include the sale, gift, or exchange of the farmland, whether for a lump-sum or by installments. If the disposition is not to a family member, recapture is triggered even though the purchaser continues to use the land for farming purposes. However, the definition of "family member" includes the qualified heir's ancestors, lineal descendants, a lineal descendant of the heir's grandparents, the heir's spouse, and the spouse of any such descendant.

The recapture provision is also triggered during the 15-year period by an involuntary conversion or nontaxable exchange covered by I.R.C. Section 1031, 1033, or 1034. The Ways and Means Committee Report, however, states that the recapture provision "does not apply to an involuntary conversion or condemnation if the proceeds are reinvested in the real property which originally qualified for special use valuation."21/

19/ Int. Rev. Code of 1954. Section 2032A(c)(7)(B).
20/ Ibid. Section 2032A(c)(7)(A).
21/ Note 2 surpra, p. 25.

Unfortunately, the new Code provisions do not spell out how soon the condemnation proceeds must be reinvested. Furthermore, if the qualified real property is condemned, what "qualified real property" will remain for reinvestment? When condemnation proceedings take the entire tract of qualified real property, there would seem to be no method left to avoid recapture of the estate tax. Treasury regulations are needed to clear up the issue of when an involuntary conversion will be subject to the estate tax recapture.22/

Another disposition that will not trigger a recapture is a tax-free transfer of the qualified property to a corporation via I.R.C. Section 351 or to a partnership via I.R.C. Section 721. But the qualified heir must retain:

> "the same equitable interest in the property, if the corporation or partnership would, with respect to the qualified heir, be considered a closely held business within the meaning of (I.R.C.) Section 6166 and the corporation or partnership consents to personal liability for the recapture if it disposes of the real property or ceases to use the property for qualified purposes during the period in which recapture may occur."23/

The Ways and Means Committee Report notes it is intended that the Treasury Department will provide such provisions by regulations.

On the other hand, if a qualified heir makes a sale, gift, or exchange of the qualified real property to another qualified heir, the new owner takes over the estate tax obligations of the first qualified heir:

> Thus, the second qualified heir steps into the shoes of the first heir and becomes liable for the recapture tax, and the special estate tax lien for this potential recapture tax remains on the property even though the second qualified heir may have paid the first qualified heir full fair market value for the qualified property.24/

Thus, the estate tax lien remains on the qualified property until the death of the second qualified owner or until 15 years after the first qualified owner's death, whichever comes first.

Construction or improvement financing agreements on the qualified farmland will not be construed as a disposition triggering recapture, according to a news release by the Internal Revenue Service.25/ Furthermore, the Federal estate tax lien on the farmland will be subordinate to such financing agreements, whether the agreements come

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22/ Kirby, How to Plan for New Special Rules of Valuing Farm and Close Corporation Real Estate, 4 Estate Planning X, 1977.

23/ Note 2 *supra*, p. 25.

24/ *Ibid.*, pp. 26-27.

25/ I.R.S. News Release, CCH Federal Estate and Gift Tax Reports, No. 7, June 6, 1977.

into existence before or after the tax lien is filed. The question remains whether financing agreements (mortgages) on qualified real estate for the purpose of purchasing additional land would be deemed a sufficient "disposition" to trigger recapture. Similar questions arise for financing agreements representing operating capital for livestock and crop expenses. The legislative history of the actual use valuation provisions indicates a recapture triggering "disposition" would include sales, exchanges, and involuntary conversions with no mention of financing agreements being regarded as a "disposition."26/ It is to be hoped that Treasury regulations, revenue rulings, court cases, IRS publications, and IRS news releases will clarify the questions raised by securing loans on qualified real estate to finance additional land purchases or operating capital needs.

Lenders to farmland purchasers are concerned that the special estate tax lien under present lending laws would preclude loan availability. For example, if insurance companies must abide by rules requiring them to loan only in exchange for a first mortgage, a prior estate tax lien would seem to prevent lending to the qualified heir when the qualified real property is used as collateral. While an IRS news release has indicated construction or improvement financing agreements will not trigger a recapture, apparently some lenders will be unwilling or unable to make such loans if an estate tax lien exists. Moreover, use of qualified real property having an estate tax lien as collateral to finance the purchase of additional real property would violate some lenders' policies and it may be regarded as enough disposition to trigger a recapture.

If the estate tax lien constitutes a relatively minor proportion of the market value of the qualified real property, the prospect of recapture would seem to work inequitably against a qualified heir seeking to expand acreage by borrowing against his or her farmland. The Treasury Department is authorized to set forth regulations under which other security can be substituted for the real property.27/

Farm Managers' Concerns With Use Valuation

Professional farm managers coordinate the landlord-tenant relationship. The major responsibilities of the landlord are typically transferred to the farm manager. This can cause serious problems in proving material participation by the landlord. If the expected tax regulations are written to reflect existing material participation rules for the tax on self-employment income, the activities of the farm manager will not be treated as those of the landlord. However, material participation by the landlord or by a family member is possible even if a farm manager is hired. The farm manager can help the landowner satisfy the participation requirements by including proper lease provisions regarding the landowner's or family member's responsibilities and by seeing that these responsibilities are actually met, such as consulting, inspecting, and paying expenses.

The 15-year recapture rule will probably increase the demand for farm manager services by off-farm heirs. When off-farm heirs might previously have sold the farm upon inheritance, the new valuation rules, along with rapid land appreciation, provide an incentive to retain ownership and retain a farm manager to oversee farm tenants.

The benefits allowed under actual use valuation to existing wealthy farms encourage them to buy additional land rather than stocks and bonds. This expected tendency may increase farm sizes to a level that encourages retiring farmers to hire farm managers for management assistance.

26/ Note 2 *supra*, p. 25.
27/ Note 2 *supra*, p. 27 and I.R.C. 1954, Section 6324 B(d).

A REVIEW AND CRITIQUE OF SELECTED PROBLEM AREAS FROM THE TAX REFORM ACT OF 1976

Neil E. Harl and Michael D. Boehlje*

Rarely has agriculture enjoyed the attention it received in the Tax Reform Act of 1976. In addition to providing measures limiting the scope of tax shelter opportunities, members of Congress focused on the Federal estate tax concerns believed to be unique to agriculture and small firms. As a result, legislation was enacted providing:

Two new methods for valuing land,1/

An expanded and more attractive installment option for paying the Federal estate tax attributable to a qualifying business,2/

A new rule for taxing post-1976 joint tenancies at death,3/

An opportunity to continue "Section 303" stock redemptions for the period of installment payment of Federal estate tax, if elected,4/

An enlarged Federal estate tax marital deduction,5/

A larger Federal gift tax marital deduction for gifts of less than $200,000 between spouses, which permits greater flexibility in making interspousal transfers to "balance" the estates.6/

Whether all of the above should be viewed as pluses depends upon one's assumption as to wealth and income distribution, effects on capital flow, and impacts of death on

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1/ I.R.C. Section 2032A. For more detail concerning the implications of this provision, see Boehlje and Harl, "Use Valuation Under the 1976 Tax Reform Act: Problems and Implications," elsewhere in this publication.

2/ I.R.C. Section 6166.

3/ I.R.C. Section 2040(b).

4/ I.R.C. Section 303(b)(1)(C).

5/ I.R.C. Section 2056.

6/ I.R.C. Section 2523(a)(2). Gifts of less than $200,000 to a spouse may reduce the allowable Federal estate tax marital deduction at death. I.R.C. Section 2056(c)(1)(B).

farm firms. As noted below, one can argue that some parts of the 1976 legislation designed to favor farm and other small business may have unintended (and possibly undesirable) effects. For example, the Congressional change in taxation of property owned in joint tenancy and tenancy by the entirety is so narrow in scope as applied to farm property that it is of limited usefulness. In fact, the amendment may be so seriously misleading as to create traps for the unwary.

Numerous other changes in estate tax law were included in the Tax Reform Act of 1976, including a unified credit applicable to transfers both before and after death, which replaced the $60,000 lifetime exemption;7/ a new tax rate schedule that applies to both taxable gifts and property transfers at death;8/ and new rules concerning the calculation of the income tax basis for property received from a decedent, commonly referred to as the "carryover basis" rules.9/ The Revenue Act of 1978 delayed the effective date of the carryover basis rules until 1980.

Many of these changes have implications for both farm and nonfarm estates, but some present particular problems for farmers. Few would rank carryover basis as advantageous to agriculture. The extent to which the concept is viewed as disadvantageous rests with the added complexity for tax practitioners, the absence of needed information to calculate the "fresh-start" adjustment after death, and the projected long-term policy aspects of an unchanging income tax basis with passage of property from one generation to the next by inheritance.

UNIFICATION

An important underlying concept of the Tax Reform Act of 1976 is the unification principle. In essence, it assures that, with few exceptions, property transferred during life or at death is treated comparably. The objective of the 1976 legislation is to tax uniformly the total wealth rather than treat wealth transferred during life as gifts in a manner different from wealth transferred at death. Thus, the credit in the new tax rules is a "unified" credit that applies both to gift and estate taxes.

Similarly, the tax rates that apply to gifts and estates are identical, and taxable gifts must be included as part of the tentative tax base at death to obtain cumulative transfers during life and at death. Adding taxable gifts after 1976 to the taxable estate at death is the mechanism by which pre-death use of the unified credit and lower tax brackets are taken into account. A credit against the calculated Federal estate tax is allowed for any gift taxes paid on post-1976 gifts.

Thus, the unified gift and estate tax structure of the 1976 Tax Reform Act endeavors to tax the wealth of the decedent uniformly. It does not distinguish as to when that wealth was transferred, except for the specific deductions and exclusions allowed in the computation of taxable gifts and the taxable estate.

One major difference may exist in tax treatment of gifts and property held until death, however. Gifts are valued and taxed at fair market value for Federal gift tax purposes while land held at death may be eligible for "use" valuation at a substantially lower figure.

A major implication of unification is that the making of taxable gifts is discouraged compared with the situation before 1977. To the extent that a family

7/ I.R.C. Section 2010, 2505.
8/ I.R.C. Section 2001.
9/ I.R.C. Section 1023.

business is included in the estate and the giving of taxable gifts of business property contributes to the continuity of the business during the intergenerational transfer process, it is undesirable to discourage gift giving prior to death. The assumption is that public policy should favor continuation of family businesses.

However, one can also argue that transfers of wealth should be taxed equitably, whether the transfer occurs during the owners' life or at the time of death. To the extent that the unified gift and estate tax rules discourage transfer by gift simply to minimize tax, the unification concept has considerable merit. It should be recognized that there still may be an advantage to giving taxable gifts of property that is expected to increase in value rather than making the transfers at death. Property given during life is valued at its fair market value at the date of the gift for Federal gift tax purposes, and this value is not adjusted when the gift is added to the estate at death. If a true unification were desired, taxable gifts of property would be revalued at death.

In addition to the changed treatment of taxable gifts under the 1976 act, the "use" valuation and installment payment of tax rules also discourage gifting of business property because of the rules concerning the minimum amount of estate that must be comprised of such property to qualify for these privileges.

The unified credit which is available under the new 1976 tax reform legislation is clearly differentiable from the exemption available in pre-1977 estate tax regulations because such credit is worth the same to everyone, regardless of size of estate. As recognized in the debate concerning the 1976 reform legislation, an increase in the exemption would have been worth far more to persons in the highest tax bracket.10/ The effects of the unified credit plus other features of the Tax Reform Act of 1976 target the largest potential tax benefits to smaller estates (fig. 1). Since the unified credit is available to each individual decedent, one would anticipate that additional interspousal transfers would be encouraged to obtain full utilization of the credits available at the death of both the husband and the wife.

JOINTLY OWNED PROPERTY

The well-known problems inherent in the "consideration furnished" rule contributed to the general attitude that something should be done to reduce the burden of proof for surviving joint tenants, especially wives. The result was the "fractional share" rule included in the Tax Reform Act of 1976.

Two fundamental problems gave rise to the 1976 change in Federal estate tax treatment of joint tenancy and tenancy by the entirety property:

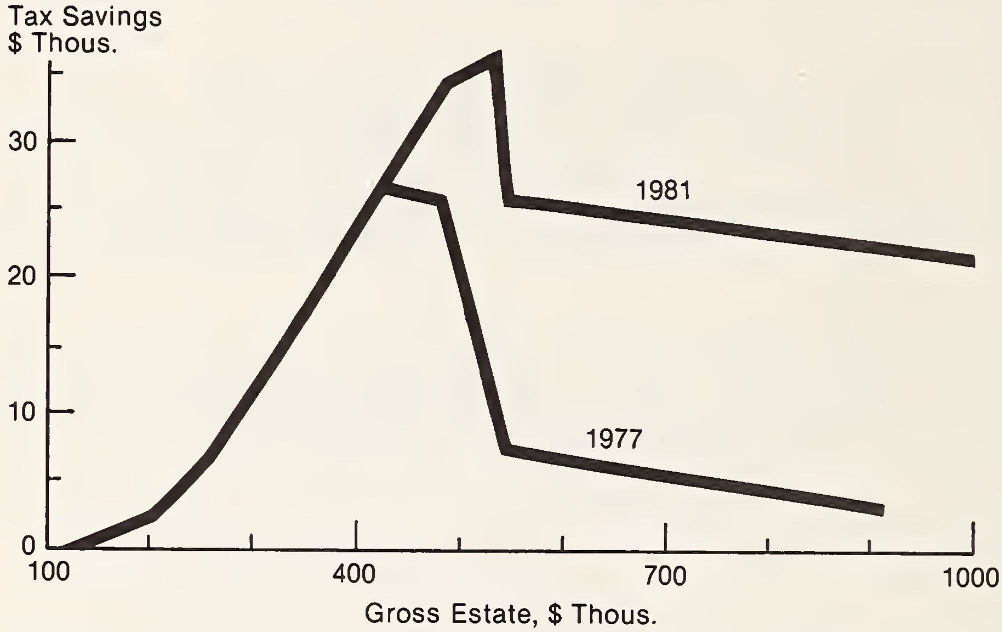
(1) The surviving joint tenant's inability to prove that his or her contribution to acquisition of the property in the form of labor and management should be accounted for in the estate of the first joint tenant to die,

(2) The belief that the wife should be credited with property ownership not only by virtue of labor, management, and capital contributed to the family business, but also because the wife gave up the chance for a career and an independent income stream to maintain the household and devote full-time effort to raising the family.

10/ See Harl, Neil E., "Some Alternatives for Federal Estate Tax Reform," Pm 691, Iowa State University, June 1976.

Figure 1

Tax Savings by Size of Estate from Tax Reform Act of 1976



The 1976 amendment addresses the question of burden of proof and eases that burden by providing that half the value of jointly owned property is subject to Federal estate tax when the first joint tenant dies.11/ The 1976 amendment does not deal directly with the second problem, at least for property acquired in joint tenancy prior to 1977. A solution to the second problem would require--(1) that the wife be made privy to the income stream from the family business to a degree appropriate to her contribution and that an opportunity be created for her income to be channeled into a separate estate, or (2) that the essential elements of spousal rights to property inherent in the community property concept be extended to States where this concept does not now apply.12/

Under the 1976 amendment, one-half the value of pre-1977 acquisitions of jointly owned property (jointly owned by the husband and wife) is taxed at the death of the first joint tenant to die, if the joint ownership was created by a transfer subject to Federal gift tax.13/

Generally, joint tenancy transactions are subject to Federal gift tax to the extent the contributions are unequal.14/ Thus, a gratuitous transfer of property by

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11/ The 1976 amendment, a "two-edged sword," could result in greater overall Federal estate tax liability compared with the "old" joint tenancy rule, if the wife died first and incurred Federal estate tax liability on one-half the value of jointly owned property. Under the "old" rule, the husband, as the survivor, might have been able to prove that he provided the total consideration and thus escape Federal estate tax liability.

12/ See Harl, infra, note 22 at 33-34.

13/ I.R.C. Section 2042(b).

14/ See Treas. Reg. Section 25.2511-1(h)(5)(1958).

one person to himself and another as joint tenants is considered a gift of half the value.15/ However, there are three major exceptions to the general rule. First, transfer of funds into a joint bank or brokerage16/ account does not produce a gift until and unless the one not providing funds withdraws amounts for his or her own benefit;17/ moreover, there appears to be no way to treat such transfers as gifts.

Second, purchase of U.S. Government savings bonds registered as payable to the one providing the consideration "or" to another does not constitute a taxable gift until and unless the one not providing the consideration redeems the bond during the lifetime of the other without any obligation to account for the proceeds to the other owner;18/ again, there appears to be no way to treat such transfers as gifts.

Third, for a joint tenancy in real property created after December 31, 1954, for a husband and wife, if one of the spouses provides disproportionate consideration, a taxable gift does not result at the time of the transfer unless the donor elects to report the transfer as a gift.19/ To treat the transfer as a gift, it must be reported on a gift tax return filed in timely fashion, even though a gift tax return would not otherwise be due.20/ If the transfer is not reported as a gift, the fact of unequal contribution continues to prevail for Federal gift tax purposes. Upon severance of the joint tenancy, a gift accrues at that time unless disposition of interests following severance is in accordance with the pattern of consideration furnished upon acquisition.

Thus, the new "fractional share" rule does not reach property acquired in joint tenancy transactions created before 1977. Nor does it reach transactions created after 1976 if the property is in the form of a joint tenancy bank or brokerage account, U.S. Government savings bond, or land acquired by a husband and wife unless reported as a gift (as to land). Even joint tenancy transactions in land by a husband and wife after 1976 are not subject to the new "fractional share" rule unless reported as a gift on a gift tax return filed in timely fashion. As a general rule, if joint tenancy in real property created prior to 1977 is to qualify for the new rules, the joint tenancy must be severed, an appropriate gift tax return filed, and any gift tax due paid. The joint tenancy must be recreated after December 31, 1976. An election may be made to treat pre-1977 joint tenancies between husband and wife as gifts by election on a timely filed Federal gift tax return filed for any quarter through 1979 (if the donor is still living) without a formal severance.21/ Thus, for purposes of farm estate planning, the new rule has limited application, indeed.

With rather disappointing results from the 1976 amendment, the Congress tried once again in 1978 to ease the burden of wives as surviving joint tenants. The result was the "credit for services" rule.22/ Under that rule, for deaths after 1978, an estate may elect to credit the surviving spouse for services rendered to the business. The surviving spouse is to be given credit for services at the rate of 2 percent per year of the value of the jointly held property over the amount of original consideration furnished by each (plus 6 percent simple interest).23/ Application of the credit-for-services rule cannot reduce the deceased spouse's gross estate by more

15 / Ibid.
16/ Rev. Rul. 148, 1969-1 Cum. Bull. 226.
17/ See Treas. Reg. Section 25.2511-1(h)(4)(1958).
18/ Treas. Reg. Section 25.2511(h)(1958). See Rev. Rul. 269, 1968-1, Cum. Bull. 399.
19/ Treas. Reg. Section 25.2515-1(b)(1958).
20/ Treas. Reg. Section 25.2515-2(a)(1958).
21/ I.R.C. Section 2040(d).
22/ I.R.C. Section 2040(c).
23/ I.R.C. Section 2040(c)(5).

than $500,000.24/ And at least 50 percent of the value of the property must be included in the deceased's gross estate.25/ To be eligible, the surviving spouse must have participated materially in the operation of the business.26/ "Material participation" is a key term in the credit-for-services rule and is to be "determined in a manner similar to the manner used" for determining whether rents are subject to social security tax as earned income.27/

The requirements imposed for material participation will determine whether the 1978 credit-for-services rule will be widely used.

. If it is required that a surviving spouse have reported part of the income for social security purposes as earned income, few farm wives would qualify,

. Moreover, few would likely qualify as a matter of planning because of the social security tax cost (8.1 percent for 1979).

. If family earnings are at or less than the current maximum covered amount for social security purposes, crediting part of the earnings to the wife could reduce the husband's social security benefits at retirement. And because many wives find it advantageous to claim social security benefits based upon a percentage of their husband's benefit, crediting some family earnings to the wife could reduce her social security benefits, also.

. If material participation could be achieved for a wife by being an employee of her husband, the social security tax disadvantage could be avoided inasmuch as amounts paid by one spouse to another are not subject to social security tax.28/ However, it is not now clear whether employee status would meet the test.

It should be noted that the credit-for-services rule applies only for Federal estate tax purposes at death. The rule has no applicability for Federal gift tax purposes, such as in severance of joint tenancies.

The result of the above is expected to be limited application for the 1978 rule crediting the surviving spouse for services rendered.

Apart from the expected limited application of both the "credit for services" and the "fractional share rules," the wisdom of their use is subject to substantial debate for couples who wish to minimize Federal estate tax at deaths of both (or maximize the amount of wealth passing from the estate of the surviving spouse), and their property ownership is likely to place one or both spouses in a position of substantial Federal estate tax liability. For such couples, joint tenancy or tenancy by the entirety ownership as to all or substantially all of their property may be inconsistent with the tax saving objective. Unless gifts are made after the death of the first joint tenant to die or the property passes to a qualified charity at the death of the surviving joint tenant, joint tenancy ownership is inconsistent with either of the major approaches to minimizing the total Federal estate tax burden over both

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24/ I.R.C. Section 2040(c)(2)(B).
25/ I.R.C. Section 2040(c)(2)(A).
26/ I.R.C. Section 2040(c).
27/ See I.R.C. Section 1402(a)(1), 2040(c)(7).
28/ 42 U.S.C. Section 410(a)(3)(A)(1976). See Social Security Handbook 927, 6th ed., 1978.

deaths.29/ Joint tenancy ownership of property may be consistent with plans to minimize Federal estate tax (or maximize family wealth) for both deaths so long as the value of jointly owned property does not exceed the optimal-sized marital deduction and the will is drafted to account for property passing outside the will and qualifying for the marital deduction in determining the size of the marital deduction created by the will itself. For couples with approximately equal sized estates, the optimal-sized marital deduction may be at or close to zero, depending upon life expectancy of the surviving spouse, rate of return expected on deferred tax dollars, the rate of inflation (or deflation) expected, and anticipated changes in death tax rates.30/

Joint tenancy or tenancy by the entirety ownership beyond that needed to fund the marital deduction competes directly with Federal estate tax savings strategies. Joint tenancy tends to leave the surviving spouse as the surviving joint tenant with outright property ownership that increases the death taxes at the death of the surviving spouse. Thus, it is questionable whether such joint ownership is desirable from a planning standpoint even in light of the 1976 and 1978 amendments, and even if those provisions were fully available at the death of the first joint tenant. Neither saves tax at the death of the survivor. Hence, for those with substantial expected death tax liabilities, who are concerned about saving tax, the appropriate strategy may be to move away from joint tenancy ownership.

One final point on property owned in joint tenancy or tenancy by the entirety--the Federal gift tax treatment of jointly owned real property acquired by a husband and wife after December 31, 1954, creates a substantial tax trap on severance of the joint tenancy. As noted in figure 2, jointly owned real property acquired and paid for prior to 1955 (with no post-1954 improvements) may now be severed into tenancy in common without a gift. But for joint tenancies created after 1954 when the husband provided the consideration and the fact of gift was not duly reported on a Federal gift tax return, severance to tenancy in common would produce a gift of half the property value at the time of the severance.

Moreover, the severance may be inadvertent as well as intentional. It appears that transfer of joint tenancy realty to a partnership or corporation may constitute an effective severance with a gift resulting unless the partnership shares or corporate stock are held in accordance with the Federal gift tax status of the contributed property. Sale of joint tenancy realty with installment reporting of the gain may constitute a severance even though joint tenancy ownership is preserved in the resultant security interest.31/

Fundamentally, a question is raised as to the wisdom of exempting post-1954 acquisitions from Federal gift tax liability upon creation of the husband-wife joint tenancy or tenancy by entirety ownership. The mischief, at least in the agricultural sector, would appear to have been substantially less had the pre-1955 Federal gift tax treatment of jointly owned property been continued unchanged.

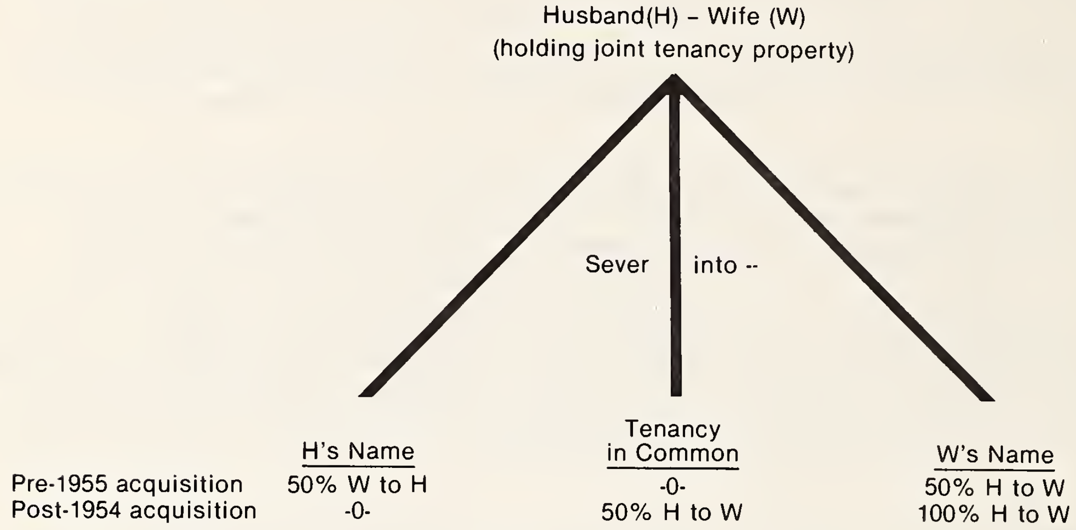
29/ For a discussion of the Model I (the "two-trust marital deduction" approach), Model II (balanced estates with each leaving the other a life estate), and Modified Model II (balanced estates that are unbalanced at the death of the first spouse to die by use of the marital deduction), see Harl, Neil E., Farm Estate and Business Planning 75-84, 5th ed., 1979.

30/ See Borcherding, Michael and Harl, Neil E., "Optimal Use of the Marital Deduction in Estate Planning," mimeog., 1978.

31/ See Rev. Rul. 507, 1975-2 Cum. Bull. 379. See also Rev. Rul. 157, 1976-1 Cum. Bull. 306 (gift of one-half the value when tenancy by the entirety property is transferred to charitable remainder annuity trust).

Figure 2

Gift for Federal Gift Tax Purposes on Severance of Joint Tenancies in Real Property



ENLARGED FEDERAL ESTATE AND GIFT TAX MARITAL DEDUCTIONS

In apparent response to concerns voiced about the Federal estate tax liability of interspousal transfers, the Congress in the Tax Reform Act of 1976 enlarged the maximum marital deduction to the greater of $250,000 or 50 percent of the adjusted gross estate.32/ This amendment is justifiable to the extent the objective is to reduce the Federal estate tax liability at the death of the first spouse to die. And it is consistent with the view held by some that interspousal transfers should not be subject to Federal estate tax.

However, a larger marital deduction at the death of the first spouse may result in greater tax liability at the death of the survivor. As noted in the preceding section, it is frequently not optimal to claim a maximum marital deduction if it is desired to minimize Federal estate tax (or maximize wealth) at the deaths of both spouses.

Related to the enlarged estate tax marital deduction are changes in the gift tax marital deduction. For gifts made after December 31, 1976, a deduction can be taken for the first $100,000 of gifts to a spouse plus one-half of the amount of gifts in excess of $200,000.33/ This increase in the gift tax marital deduction compared to prior law facilitates inter-spousal family transfers to "balance estates" or accomplish other estate planning or tax minimizing objectives through reallocation of property between spouses.

One should note, however, that the Federal estate tax marital deduction is reduced by the amount of any "excess" gift tax marital deduction utilized. The

32/ I.R.C. Section 2056.
33/ See I.R.C. Section 2523(a).

"excess" gift tax marital deduction is calculated as the amount of the marital deduction above 50 percent of the amount reported as a gift to the spouse on the Federal gift tax return.34/ However, reduction of the Federal estate tax marital deduction may not be a disadvantage. If the spouse making the gift and suffering the reduction survives, a lesser Federal estate tax marital deduction is of no consequence. Moreover, if the estates are reasonably well balanced, a maximum Federal estate tax marital deduction is frequently not consistent with wealth maximization over both deaths.35/

The integration of the gift and estate tax marital deduction along with the new rules concerning the taxation of gifts are important in assessing the optimal ownership pattern for farm property between husband and wife and the various strategies for attaining this optimal pattern including gift making during life and the use of the marital deduction at death.36/

The optimal-sized marital deduction can be assured--(1) in approximate fashion by provisions in the wills specifying a particular percentage of the adjusted gross estate, by using life insurance subject to tax made payable to the surviving spouse as named beneficiary or through joint tenancy ownership of some property; (2) by formula clause in the wills involving valuation of both estates and application of relevant variables to define an optimal-sized marital deduction37/ and by use of disclaimer provisions after death to pare down a deliberately oversized marital deduction.38/ The disclaimer approach requires approval of the surviving spouse. A disclaimer by a surviving spouse is valid even though the surviving spouse receives the right to the income from the disclaimed property.39/ This should reduce the reluctance of a surviving spouse to disclaim.

CARRYOVER BASIS

In terms of sheer impact on farm families and farm firms, the carryover basis concept may well prove to be the most notable provision in the Tax Reform Act of 1976.40/ For deaths prior to 1977, property included in the Federal estate tax gross estate received a new income tax basis equal to the value placed on the property for Federal estate tax purposes.41/ This "new start" for purposes of figuring gain on sale after death was especially beneficial in agriculture because--(1) the income tax basis of raised animals, feed, and grain is zero in the hands of a farmer on the cash method of accounting;42/ (2) machinery and equipment often depreciate at a faster rate

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34/ I.R.C. Section 2056(c)(1)(B).

35/ See Borcherding, Michael, and Harl, Neil E., "Optimal Use of the Marital Deduction in Estate Planning," mimeog., 1978.

36/ See Neil E. Harl, "Farm Estate and Business Planning 75-84 (5th ed. 1979); Neil E. Harl, "How to Use the Marital Deduction to Minimize Estate Taxes at Both Deaths", in Successful Estate Planning Ideas and Methods, Prentice-Hall, 1977, pp. 5,161-5,167.

37/ See Estate of Charles W. Smith, 66 T.C.415 (1976), non-acq., 1978-1 Cum. Bull. 3, aff'd, 565 F.2d 455 (7th Cir. 1977); Estate of Fritz L. Meeske, 72 T.C. No. 74 (1979); Estate of Vilda S. Laurin, T.C. Memo. 1979-145.

38/ I.R.C. Section 2518. See also Estate of Hoenig, 66 T.C. 471 (1976).

39/ See I.R.C. Section 2518(b)(4).

40/ See I.R.C. Section 1023.

41/ See I.R.C. Section 1014.

42/ Except for property producing income in respect of decedent (such as crop share rents in the hands of a nonmaterially participating farm landlord) such assets receive a new income tax basis for deaths prior to 1980.

than they decline in value and (3) real property, for many farmers, has a relatively low income tax basis.

The carryover basis concept was enacted as part of the Tax Reform Act of 1976, to become effective for deaths in 1977.43/ The Revenue Act of 1978 amended the carryover basis concept in several respects and imposed a 3-year moratorium, although the "fresh start" date of December 31, 1976, was retained and will be applicable if carryover basis goes into effect.44/ Carryover basis becomes effective for deaths after 1979 unless there is further legislative action to repeal the provision or to delay its effective date. Legislation is now pending in Congress to repeal carryover basis.

Objections to the carryover basis concept seem to fall into four categories:

(1) The extensive and time consuming calculations needed to compute the fresh-start adjustment,45/ the adjustment for Federal estate tax attributable to the net appreciation in value of carryover basis property,46/ the minimum $60,000 adjustment for all carryover basis property,47/ and the adjustment for State inheritance or similar tax attributable to the net appreciation in value of carryover basis property;48/

(2) The lack of records in most estates for determining, for carryover basis property (a) the holding period, (b) original basis, (c) depreciation claimed through 1976 and substantial improvements made with information on date of improvement; original cost or other basis and depreciation claimed before 1977;

(3) The additional income tax liability incurred on sale of carryover basis property after death;

(4) The long-range effects of no "new start" at death with the only upward adjustment in income tax basis coming from sale or taxable exchange transactions. Although all four areas of concern are important, the last one may eventually prove to be the most difficult to tolerate from a policy standpoint.

As to the matter of complexity in making calculations, there is no question that the complaints about time needed to make the calculations are well founded. The computational burden is especially heavy in an estate of a sole proprietor who held a large number of carryover basis assets. If the concept remains in tax law, the computational problem can be lessened substantially with computer assistance.49/ The calculations are relatively simple, given the necessary data.

One dimension of the complexity issue relates to the problems involved with change in organizational structure of a closely-held business. For example, if a farmer operating as a sole proprietor forms a corporation in 1980, transfers farm business assets to the new corporation in a tax-free exchange, and dies in 1982 owning corporate stock, the carryover basis calculations take on an additional complication.

43/ Tax Reform Act of 1976, Section 2005, P.L. 94-455, enacting I.R.C. Section 1023.
44/ Revenue Act of 1978, Section 515, P.L. 95-600.
45/ I.R.C. Section 1023(h).
46/ I.R.C. Section 1023(c).
47/ I.R.C. Section 1023(d).
48/ I.R.C. Section 1023(e).
49/ The computational burden could also be eased with modification of the computation procedure, as has been proposed in various bills. See, for example, H.R. 4694, 96th Congress, 1st Session.

The stock held at death "reflects the adjusted basis on December 31, 1976, of any property other than a marketable bond or security."50/

Hence, the stock would seem to be eligible for the series of adjustments as carryover basis property, including the "fresh-start" adjustment based upon the holding period for the property. If this means that the relevant holding period for the corporate stock includes the holding period of the property transferred upon incorporation, it would be necessary either to--(1) maintain identification of stock with predecessor property or (2) calculate a mean or average holding period for corporate stock based upon the mean or average holding period for the property transferred in the tax free exchange. The first solution would require highly detailed records and would open up new possibilities for selective gifting or sale of stock.

The second area of concern, lack of records to substantiate, for each asset, holding period, original basis, depreciation, and improvements, can eventually be overcome with strong educational emphasis on development of an inventory for property held on December 31, 1976, that could be held at death. Moreover, with passage of time, fewer assets will be subject to the fresh-start adjustment, which makes the greatest information demands.

Note that income tax basis information (but not necessarily holding period data) would be necessary for about any treatment of gain at death other than the traditional "new start." Thus, if the carryover basis rules were replaced with a tax on net appreciation at death, income tax basis information would still be needed. Therefore, unless a return is made to a new-start basis at death, income tax basis information would be needed in any event.

The third area of concern, added income tax liability, affects liquidity planning to pay taxes and costs after death. In addition, it has equity implications relating to income and wealth distribution. The wisdom of imposing a tax on gain on property held until death either as part of the estate settlement process or on later sale of assets is beyond the scope of this commentary.

The fourth area of concern, the matter of long-range effects of the shift in income tax treatment of gain on property held until death, may eventually involve important questions of resource allocation and economic constraints in transfer of carryover basis assets. Little, if any, effect is expected for assets with a limited life, such as machinery, equipment, livestock, and stored grain. But the picture may be quite different for assets, such as real property, with a long life or perpetual existence. If the long-term trend is an increase in the general price level, including the price of land, the amount of gain per unit of land would increase with a static income tax basis over time, except for any new basis obtained in a taxable exchange. With no new basis at death, the potential income tax liability per unit of land would likewise increase over time unless the property was sold. Sale would be expected to become less likely as the net sale value (after payment of income tax liability) diminishes relative to fair market value. In effect, income tax liability would become a factor inhibiting sale. The result could be to "lock land into families." With each passing generation, the probability of taxable transfer of such assets would be expected to diminish.

It is generally believed that a price-oriented market economy functions best with relatively free transferability of resources. For that reason, it is doubted that the present carryover basis system can long endure without causing significant misallocations of resources.

50/ I.R.C. Section 1023(h)(2)(A)(i).

Another feature of the carryover basis concept may be to inhibit (1) the formation of partnerships or corporations and (2) the installment sale of land, because the probability of indebtedness exceeding income tax basis is likely to rise. Thus, if a newly formed corporation assumes liabilities or takes property subject to liabilities that exceed the aggregate income tax basis of assets transferred, a taxable gain is incurred on the excess.51/ Likewise, if land is sold under installment contract and the mortgage assumed by the buyer exceeds the seller's adjusted income tax basis for the property, the excess of the mortgage over the adjusted basis is considered a payment in the year of sale (and such amount cannot exceed 30 percent of the selling price if eligibility for installment reporting of gain is to be maintained).52/ The result, eventually, could be substantial economic restraint on change in organizational structure for firms and use of installment reporting of gain on sale of property.

The arbitrariness of the fresh-start adjustment for property other than for stocks and bonds may also have implications for investment patterns. The adjustment will result in arbitrary differences in the "tax cost" of selling various types of carryover basis property depending upon differences in the appreciation or depreciation of various assets occurring after December 31, 1976.

For example, assume two assets had equivalent fair market values at the time of acquisition on January 1, 1967 (fig. 3). Thereafter, asset A increased in value at an increasing rate with much of the gain occurring after 1976. Asset B rose sharply in value after 1967 but plateaued with relatively little gain occurring after 1976. Applying the arbitrary "fresh-start" adjustment in effect linearizes the gain; thus, a portion of the gain for asset A, shown as amount a in figure 3, is forgiven even though it represents post-1976 gain. On the other hand, amount b of the gain for asset B is <u>not</u> eliminated at death even though it represents pre-1977 gain. The result would be an added advantage to retain assets that are expected to increase in value more rapidly than those that appreciate at a slower rate or depreciate in value. Part of the post-1976 gain on assets that increase rapidly in value would be forgiven.

INSTALLMENT PAYMENT OF FEDERAL ESTATE TAX

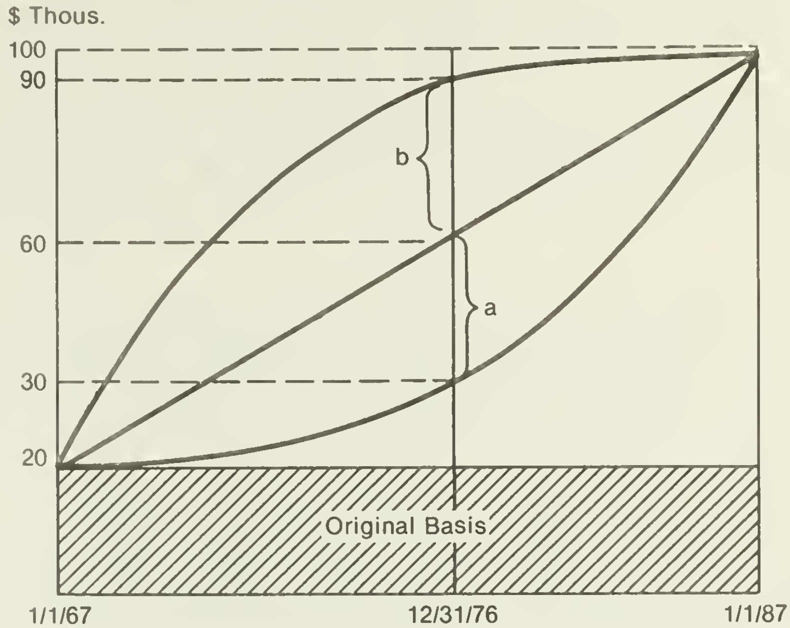
For estates in a position to meet the eligibility requirements, the new 15-year installment payment of Federal estate tax53/ affords substantial economic benefits with interest at 4 percent on the first $345,800 of Federal estate tax attributable to a closely-held business less the allowable unified credit. Interest only would be due for the first 5 years, and the deferred Federal estate tax would be paid in up to 10 equal annual installments thereafter with interest on the unpaid balance.54/ The magnitude of the economic advantage depends principally upon--(1) the ability to maintain the installment payment schedule against acceleration after death, and (2) the rate of return received on deferred tax dollars.

Eligibility Requirements

For eligibility requirements imposed upon the estate, the requirement accompanied by the greatest uncertainty for farm businesses is the definition of "business." To be eligible for a 15-year installment payment, the closely-held business must exceed

51/ See I.R.C. Section 357(c).
52/ See, for example, R.A. Waldrep, 52 T.C. 640 (1969), aff'd, 428 F.2d 1216 (5th Cir. 1970).
53/ I.R.C. Section 6166.
54/ I.R.C. Section 6601(j).

Figure 3



Application of the "Fresh-Start" Rule for Carryover Basis Property

65 percent of the adjusted gross estate.55/ For this purpose, assets are valued at the figure used for Federal estate tax purposes. Thus, election of "use" valuation could jeopardize installment payment of Federal estate tax by dropping the value of business assets to the 65-percent level or below. For estates holding a partnership interest, if the business interest is to count toward the 65-percent requirement,56/ 20 percent or more of the partnership interest must be included in the deceased partner's gross estate or the partnership must have 15 or fewer partners. For a corporate interest, 20 percent or more of the corporation's voting stock must be included in the deceased shareholder's estate or the corporation must have 15 or fewer shareholders.57/ These requirements are quite specific and can be administered with relatively little uncertainty.

A major problem, however, exists in determining whether a leasehold arrangement constitutes a "business." In a 1975 ruling issued under the 10-year installment payment option, farms operated under a crop share lease were held to constitute an interest in a closely-held business.58/ In that ruling, farmland was leased to a tenant under a crop share lease with the landlord receiving 40 percent of the crops and bearing 40 percent of the expenses. The landlord participated in important management decisions and made almost daily visits to inspect the farm and discuss operations although he lived several miles from the farm. The ruling intimates that a cash lease arrangement would not qualify as a business for purposes of installment payment of the Federal estate tax.

55/ I.R.C. Section 6166(b)(1)(B).
56/ I.R.C. Section 6166(b)(1).
57/ I.R.C. Section 6166(b)(1).
58/ Rev. Rul. 366, 1975-2 Cum. Bull. 472.

In a companion ruling, ownership and rental of houses did not qualify as a business.59/ In that case, the decedent-landlord rented eight houses, collected the rent, made the mortgage payments, and handled the necessary repairs and maintenance. To be eligible for installment payment of Federal estate tax, the operation, stated the ruling, must be an "active enterprise producing business income rather than income solely from the ownership of property." In a third case,60/ the owner of rental units maintained a fully equipped business office to collect rental payments, negotiate leases and, by contract, direct the maintenance of the properties. The arrangement was held in the ruling to be "merely that of an owner managing investment assets to obtain the income ordinarily expected from them," and not a business.

Additional (and more authoritative) guidance as to what constitutes a business where rental of assets is involved would be helpful and would reduce the uncertainty as to this requirement for installment payment of Federal estate tax. Specifically, it would be helpful to know whether rulings issued under 10-year installment payment of Federal estate tax are applicable to the 15-year installment payment election.

For purposes of the 65-percent requirement, interests in "residential buildings and related improvements on the farm which are occupied on a regular basis by the owner or lessee of the farm or by persons employed by such owner or lessee for purposes of operating or maintaining the farm can be included."61/ In a close case, it can be important whether the farm is rented to a resident tenant or the land is share rented to neighbors and the building site is rented to a family not associated with the farm business.

The election to use 15-year installment payment of Federal estate tax is made by attaching to a Federal estate tax return filed in a timely manner a notice of election containing the required information.62/ A protective election may be made when the estate tax return is filed if the estate does not then qualify for the election or no Federal estate tax is due.63/ However, an election for 15-year installment payment cannot be made if an election has also been made for 10-year installment payment of Federal estate tax.64/ But an election can be filed under one provision and a protective election under the other.

Disposition of Interests

The matter of maintaining the installment payment schedule against acceleration merits comment. Except for "Section 303" stock redemptions;65/ testamentary transfers by the decedent by will, State law of descent and distribution or a trust created by the decedent;66/ and certain corporate reorganizations;67/ if one-third or more of the value of the interest in the closely-held business is "distributed, sold, exchanged, or otherwise disposed of" or is withdrawn from the business, the remaining installments become due.68/

This rule imposes substantial constraints on death-time and post-death property transfers. It is not clear, for example, whether property transfer by operation of

59/ Rev. Rul. 367, 1975-2 Cum. Bull. 472.
60/ Rev. Rul. 365, 1975-2 Cum. Bull. 471.
61/ I.R.C. Section 6166(b)(3).
62/ Prop. Treas. Reg. Section 20.6166-1(b)(1978).
63/ Prop. Treas. Reg. Section 20.6166-1(d)(1978).
64/ Prop. Treas. Reg. Section 20.6166-1(g)(1978).
65/ I.R.C. Section 1666(g)(1)(B).
66/ I.R.C. Section 6166(g)(1)(D).
67/ I.R.C. Section 6166(g)(1)(C).
68/ I.R.C. Section 6166(g)(1)(A).

law to a surviving joint tenant or tenant by the entirety would constitute an accelerating disposition. Certainly such a transfer is not by ". . .will, the applicable law of descent and distribution, or a trust created by the descent and distribution, or a trust created by the decedent." A similar question could be raised about the proceeds of life insurance policies carried on key persons in the firm.

A more fundamental question relates to whether transfers within the decedent's family, in a manner parallel to sanctioned post-death transfers for "use" valuation purposes,69/ should be possible for Section 6166 purposes as well. Such transfers are not sanctioned under current law.

Economic Value of Installment Payment

As noted above, the economic value of the 15-year installment payment provision depends heavily upon the return received on deferred tax dollars. As shown in table 1, savings from a 10-percent net return can more than pay the Federal estate tax bill over the 15-year installment payment period. Even with a 5-percent net return on capital, the savings over the installment payment period total 14.4 percent of the initial tax bill. For those calculations, the earnings are compounded at the assumed rate of return for capital in the firm.

As can be seen in table 1, "15-year installment payment" of Federal estate tax is a misnomer. The payment period extends 14 years and 9 months beyond the death of the decedent. A total of 14 interest payments and 10 payments of deferred tax are made over the payment period. Interest is paid in arrears commencing with the first payment 1 year after the due date for the Federal estate tax return.

An additional element to consider in determining the economic benefits from installment payment of Federal estate tax is whether interest on deferred estate tax is deductible as an expense of administration in the estate for Federal estate and State death tax purposes. The Internal Revenue Service in 1975 took the position that interest on deferred Federal estate tax was not deductible as an administrative expense in the estate for Federal estate tax purposes.70/ However, that has been held invalid in a Tax Court case that allowed projected interest payments as a deductible administration expense where allowed by local law.71/ Particularly because it involves current deductibility of interest expected to be paid, the economic significance of this issue is substantial.

Section 303 Stock Redemptions

The time has been extended for redemptions of stock after death under Section 303 of the Internal Revenue Code to pay Federal estate tax, State estate and inheritance taxes, funeral costs, and administration expenses allowed for Federal estate tax purposes at the cost of capital gains taxation (rather than the dividend treatment typically accorded partial redemption of stock in a closely-held corporation). For Federal estate tax purposes, the time for redemption is that needed to pay installments under the 15-year (or 10-year)72/ installment payment plans if such

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69/ See I.R.C. Section 2032A(c)(1)(A).

70/ Rev. Rul. 239, 1975-1 Cum. Bull. 304.

71/ Estate of Bahr, 68 T.C. 74 (1977), acq., 1978-1 Cum. Bull. 1. See Rev. Rul. 125, 1978-1 Cum. Bull. 292. See Ltr. Rul. 7912006, Dec. 12, 1978 (deductibility of interest allowed for Sixth Court of Appeal area because prior case held deductibility was determined by State law alone). I.R.S. seems to be adopting a two-part test for deductibility--(a) interest must be deductible under local law and (b) the expense must be necessary for the preservation and distribution of the estate.

72/ I.R.C. Section 6166A.

Table 1.--Savings from 15-year installment payment of Federal estate tax under varying rates of return (assumed tax bill of $100,000)

Month after death	Principal	Interest	Total payment	Savings: 5% return on capital	Savings: 8% return on capital	Savings: 10% return on capital
	Dollars					
9	(File Federal Estate Tax Return, Form 706)					
21	0	4,000	4,000	1,000	4,000	6,000
33	0	4,000	4,000	1,050	4,320	6,600
45	0	4,000	4,000	1,102	4,666	7,260
57	0	4,000	4,000	1,158	5,039	7,986
69	10,000	4,000	14,000	1,216	5,442	8,785
81	10,000	3,600	13,600	1,176	5,477	9,063
93	10,000	3,200	13,200	1,135	5,515	9,369
105	10,000	2,800	12,800	1,092	5,557	9,706
117	10,000	2,400	12,400	1,046	5,601	10,077
129	10,000	2,000	12,000	999	5,649	10,485
141	10,000	1,600	11,600	949	5,701	10,933
153	10,000	1,200	11,200	896	5,757	11,426
165	10,000	800	10,800	841	5,818	11,969
177	10,000	400	10,400	783	5,883	12,566
Total	100,000	38,000	138,000	14,443	74,427	132,225

provisions are elected.73/ For persons operating in corporate form, this procedure represents a convenient way to use the income generating power of the business to pay the Federal estate tax as well as the other death taxes and estate settlement costs.

Two key limitations may make qualification for Section 303 redemption difficult to achieve with planning and probably impossible without pre-death planning. First, the benefits of a Section 303 redemption are available only to the extent that the interest of a shareholder whose stock is redeemed is reduced directly or through a binding obligation to contribute by payment of death taxes, funeral costs, or administration expenses.74/ Thus, the liability for payment of such costs must be placed on those who own the stock to be redeemed. Second, the value of the stock included in the decedent's estate must exceed 50 percent of the adjusted gross estate (determined without regard to attribution rules).75/ If two corporations are involved, for example, one owning the land and, another, the production side of the operation, the stock of each may be counted toward the 50-percent requirement if the decedent's gross estate included more than 75 percent in value of the outstanding stock of each corporation.76/

Lien To Secure Payment of Tax

For deaths after 1976, an estate representative seeking discharge from liability for payment of Federal estate tax may file an agreement giving rise to a special Federal estate tax lien.77/ The lien is authorized if 10- or 15-year installment payment has been elected. The lien is against "real and other property" expected to survive the deferral period.

Once filed, the lien constitutes a priority claim against the property as against subsequent claimants. However, the special lien is subordinated to specified "super priority" claims including--(1) real property tax and special assessment liens,78/ (2) mechanics' liens for repair or improvement of real property,79/ (3) real property construction or financing agreements to finance the construction or improvement of real property or a contract to construct or improve real property, and (4) the "raising or harvesting of a farm crop or the raising of livestock or other animals."80/

For loans falling within one of the "super priority" categories, the special tax lien may not be of great significance. However, for borrowing for other purposes, such as to purchase assets from other heirs, the presence of the special tax lien can create problems in financing. The problems may be especially severe where the lender requires a first lien for credit extension. Authority exists for subordination of the special tax lien in such instances with approval of the Department of the Treasury.81/ While it would be unreasonable to expect subordination unless sufficient collateral exists to secure adequately the interest of the Department of the Treasury as well as those of the lender, additional guidance as to situations where subordination could reasonably be anticipated is needed in this area--(1) for taxpayers, (2) Internal Revenue Service field personnel, and (3) lenders.

73/ I.R.C. Section 303(a).
74/ I.R.C. Section 303(b)(3).
75/ I.R.C. Section 303(b)(2)(A).
76/ I.R.C. Section 303(b)(2)(B).
77/ I.R.C. Section 6324A.
78/ I.R.C. Section 6323(b)(b), 6324A(d)(3)(A).
79/ I.R.C. Section 6324A(d)(3)(B).
80/ I.R.C. Section 6323(c)(3)(A), 6324A(d)(3)(C).
81/ See I.R.C. Section 6324.

AREAS FOR FUTURE CONCERN IN THE TAX REFORM ACT OF 1976

C. Allen Bock*

INTRODUCTION

If nothing more, we need to suggest to the Congress (especially in regard to major tax reform bills) that some form of resolution be passed that provides an effective act date far enough in the future to permit the Treasury to issue regulations and the practitioners to assimilate the information. Obviously there must be exceptions, but it would be helpful if there was at least a general policy for this kind of procedure.

First, I think most of the people implementing the Tax Reform Act of 1976 are trying to do an honest, accurate job. They may not always do the best planning, but they are trying to accurately report the liabilities for estate and income tax purposes. It is difficult for them to do that, at what I call the first line of audit in the system of voluntary tax compliance, without understanding the law and having some regulations or interpretations to guide them.

Second, because the tax law is so complicated (perhaps of necessity), it indirectly discriminates against many people. Many statements are made about how easy it is to plan within this or that framework with good legal advice. I work mostly with attorneys and practitioners outside of Cook County, and I can assure you that although most are competent and intelligent, they have a difficult time assimilating something like the 1976 Tax Reform Act without adequate guidelines and several years of special training. They represent many people who are supposed to be able to take advantage of the various planning opportunities provided by the complicated tax laws. If this part of the public does not have advisors available to provide the planning opportunities, then, in effect, the law discriminates against them.

MISCELLANEOUS COMMENTS

I am concerned about farmers qualifying for the delayed payment of estate taxes (15 years) under I.R.C. Section 6166. The Revenue Rulings applying to I.R.C. Section 6166A could apparently also be used to determine qualification under I.R. C. Section 6166.1/

These rulings clearly indicate that 6166A was intended to apply only to a business such as a manufacturing, mercantile, or service enterprise as distinguished from the management of investment assets.

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* The author is a professor with the University of Illinois.
1/ Rev. Rul. 75-365, 75-366, and 75-367.

Rev. Rul. 75-366 points out that when farming is done by an individual who "manages the farm for gain or profit, either as owner or tenant, and . . . he receives a rental based upon farm production rather than fixed rental . . .", such farming resembles a manufacturing enterprise as distinguished from the managing of investment assets. This distinguishes Rev. Rul. 75-366 from Rev. Rul. 75-365.

Code Section 6166 describes an "interest in a closely held business" as (1) an interest as a proprietor in a trade or business carried on as a proprietorship; (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest in a partnership is included in determining the decedent's gross estate or if the partnership had 15 or fewer partners; (3) stock in a corporation carrying on a trade or business if 20 percent or more in value of the voting stock of the corporation is included in determining the decedent's gross estate or if the corporation had 15 or fewer shareholders.

Section 6166 does not require the partner or shareholder to be involved in any way in the management or operation of the business. It does not even require that person to own a majority of the capital interest.

In light of this, it seems apparent that the Congress and the Treasury were mainly concerned about distinction between type of business versus management of investment assets. The degree of management if the closely-held business is a manufacturing or mercantile business appears to be of only slight importance.

It also seems that the important requirement of Rev. Rul. 75-366 is the form of lease (50-50 crop share) and some actual management of the business. If the language of the second paragraph of that Ruling was to be given very much weight, the provisions of Section 6166(b)(1)(B)+(C) (partnerships and corporations) would be in apparent conflict with that of Section 6166(b)(1)(A). (This would be true if one literally and in detail uses the language of Rev. Rul. 75-366 to interpret Section 6166.)

Some auditing agents apparently take a hard-line position on this qualification question, and they require material participation far in excess of what would normally be needed for self-employment tax purposes. New interpretation or rewriting of these revenue rulings may be desirable to bring the requirements more into line with the apparent intent of the Congress. An example would be permitting material participation by family members similar to the requirements of I.R.C. Section 2032A (special valuation of farmland).

An option concerning carryover basis would be to eliminate the carryover basis rule. In its place would be imposed a limited tax at death on appreciation in value but with the benefit of a fresh-start adjustment and an estate tax deduction for the appreciation tax.

PROBLEMS IN THE GIFT TAX AREA

The unified gift and estate tax system undoubtedly had several significant policy objectives. One seemed to be the elimination of special benefits to the wealthy in terms of lifetime gift giving. Under the old dual system, the wealthier the property owner, the more likely that the person would take advantage of the lower gift tax rates and the $30,000 exclusion in making lifetime gifts. I am not sure the new law has completely eliminated that advantage. If one makes a gift more than 3 years before his or her death, and if this is property that is appreciating substantially in value over the period between the date of gift and the donor's death, that appreciation in value is not included as part of the donor's gross estate under the rules of the 1976 Tax Reform Act. Since the unified credit equivalency deduction is substantial ($134,000 for 1978) the opportunity to shelter future appreciation in value without a present obligation for a transfer tax should be attractive to those able to make these gifts without endangering income and security levels. The appreciation escapes both gift and estate transfer tax.

The major benefit in gift giving now basically involves avoiding the tax on appreciation, except for the $3,000 per person per year exclusion. There were several good results associated with the unified system. Under the old system, some very wealthy individuals made gifts in contemplation of death, and paid large amounts of the gift tax just prior to death. The purpose, of course, was not to remove that property from the gross estate, but to remove the amount of gift taxes paid from the gross estate. That value was never taxed for gift purposes nor for Federal estate tax purposes.

The new gross-up provision now requires the executor to add back into the gross estate the amount of gift taxes paid during the 3 years prior to death. This essentially eliminates the benefit of the so-called "du Pont" effect, except for gifts made prior to that 3-year period. From a policy standpoint, this seems to be a good result.

There is no longer a rebuttable presumption for gifts in contemplation of death. All gifts made within 3 years of death now automatically are added back into the gross estate at fair market value on the date of death--with one exception. That exception is for gifts made within the $3,000 per person per year exclusion. The interpretive problem here should be clarified.

EXAMPLE

Ace makes a gift 2 years before he dies, whose value is $2,500. When Ace dies, that property has a value of $3,500. Now, is it an all-or-nothing situation? Since it was under the $3,000 limit, no gift tax return is required. Must the $500 beyond the $3,000 be included in Ace's gross estate? Or is the gift fully nontaxable for estate and gift tax purposes since its value to the donee did not exceed $3,000 in that year?

The Joint Committee on Taxation in their comments mentioned such a situation. "The amount of gifts included is limited to the excess of the estate tax value over the amount excludable with respect to the gift under the $3000 annual exclusion." That can be read in two ways. One would be the result in the example just given. The other would be that one could make a gift in excess of $3,000 within the 3-year period and the full value would be included at death but the estate could remove $3,000 of the gift per donee per year from the value of the gross estate.

As I read the technical corrections amendment--and maybe the Treasury Department will clarify this--it appears to be an all-or-nothing situation. If the gift (except for insurance) is $3,000 or less per person per year in a 3-year period, it does not make any difference what the value of that property is on the date of death. That property is not brought back into the gross estate. If the value of the gift 2 years before death is $3,001, there is no reduction ($3,000) in the estate--an all-or-nothing situation.

Another problematic consideration in terms of contemplation of death occurs when major split gifts are made within the 3 years before death and the actual donor (for example, the husband) dies within that 3-year period. Suppose Ace makes a $300,000 gift, and his wife joins with him to split the gifts for gift tax reporting purposes.

Ace dies within 3 years of the gift. The full value of all that property at Ace's death will become a part of his gross estate. The difficult question is, what has happened to the wife's unified credit that was used to reduce the gift tax liability on the date of the gift?

There are several possibilities. One, the unified credit equivalency will not be available to her for her subsequent gifts, but it will be available in her estate to offset any estate tax liability. This treatment would be consistent with prior treatment. Present statutory language can be interpreted as denying further use of the credit for both purposes. This would seem inequitable since the property value of the original gift was taxed for Federal estate tax purposes. Both interpretations suggest careful planning.

The use or nonuse of the unified credit raises another question. It seems clear that the credit must be used if necessary. If the taxpayer does not use the credit for a lifetime gift, whether inadvertently or because of poor advice, has he or she also forfeited the credit for purposes of offsetting the Federal estate tax liability? This seems to be a possibility. A clarifying statement would be helpful.

Another question occurs in regard to split gifts by husband and wife outside of the 3-year contemplation-of-death period. For example, assume my wife and I make a $20,000 gift, and split the gift (over and above the $3,000 exclusion) 5 years before my death. Also assume the property given was owned by me. If I die, what value is brought back into my estate?

Presumably, the $10,000 should be the taxable portion of the gift, not the $20,000 combined amount. Her executor would include the $10,000 representing her portion in her estate at her death. This result seems logical but it is not clear under the law and clarification is needed.

When one computes gift tax liabilities in 1977 and after, one must know the amount of taxable gifts the donor made prior to 1977. Although a practical recordkeeping problem, I think this will create some difficult concerns for the return preparer. How extensively should the donor be questioned about prior taxable gifts? Is asking the donor for the gift tax returns that were filed in previous years enough, or must the investigation be more thorough? If further, to what extent? This will likely create a problem for many return preparers.

Another concern of attorneys and practitioners relates to the statute of limitations on gift tax valuations. Apparently, the statute does not start to run until a tax is paid. Under the old system, that was not much of a concern, because use of the $30,000 exemption was optional, and if one wanted to start the statute running, he or she simply paid some gift tax. Under the new system, with the mandatory unified credit, it is apparent that one would have to make a major gift before triggering the statute of limitations for audit purposes. This year, for example, the donor would have to make a $137,000 gift before paying any gift tax (assuming no prior 1977 taxable gifts). This does not seem to be a proper result. It cannot be resolved by regulations but, instead, by a statutory amendment.

One advisory concern relates to how the unified system affects the preparation of gift tax returns and required appraisals. Obviously, with the integrated gift and estate tax system, we should see more gift tax return audits. This strongly suggests that attorneys and practitioners need to give more attention to properly reporting and valuing gifts.

INCLUSION IN THE GROSS ESTATE STOCK TRANSFERRED BY THE DECEDENT

The 1976 Tax Reform Act indicated that if stock was transferred by the decedent during his or her lifetime and the decedent retained voting rights in that stock, the stock value would be included in his or her gross estate for estate tax purposes, even if the corporation was not a controlled corporation.

A provision of the Technical Corrections Bill of 1978 attempts to limit this result only when the decedent and his or her relatives owned 20 percent or more of the voting stock of the corporation. The interpretation of this Technical Corrections Bill provision is of major concern to those who counsel closely-held farm corporations.

One interpretation suggests that, because of the family attribution rules, there is a possibility that a controlled corporation as defined by the provision could always exist in a family farm corporation. The potential result would be that any stock transfers during lifetime might be ineffective for saving Federal estate tax and that, for example, the $3,000 per person per year exclusion would be used. It appears that this is not the result intended by the drafters of this provision. Perhaps the proposed correction should be redrafted to avoid the possibility of the above interpretation.

RECENT LEGISLATIVE DEVELOPMENTS

Alvin J. Geske*

Before discussing pending legislation relating to carryover basis, I would like to give you some background on the functions of the Joint Committee on Taxation and on the development of the carryover basis provisions.

The Joint Committee on Taxation consists of the five ranking members of the House of Representatives Ways and Means Committee and the five ranking members of the Senate Finance Committee. This committee is generally charged with making tax investigations, analyzing tax proposals, and examining refund cases involving large amounts.

The staff of the Joint Committee is a technical tax staff that serves the House Ways and Means Committee, the Senate Finance Committee, and the Conference Committee. This staff assists in the development of members' proposals, plays a substantial part in the drafting of tax bills, and writes committee reports explaining the bills.

It is important to note that this is not a partisan staff but a technical staff devoted to technical work which tries to point out arguments for and against different proposals in an objective manner.

Normally, a tax bill starts out in the Ways and Means Committee, where hearings are held and the bill is marked up. The bill goes to the House floor, and, if passed, goes to the Senate where it is referred to the Finance Committee.

The Finance Committee also holds hearings. By this time, private practitioners, businessmen, and others, have had a chance to review the House-passed statutory language and detailed explanations in a Committee Report. As a consequence, at the Senate hearings, commentators usually present not only policy arguments, but also comments on administrative problems. From the Finance Committee, the bill goes to the Senate floor. If the Senate passes the bill and it differs from the House-passed version, the bill goes to a conference committee which attempts to reach a compromise between the two positions. Then the conference report is generally submitted to both Houses, and, if accepted, the bill goes to the White House.

The 1976 estate and gift tax provisions short-circuited a substantial part of this normal process. In 1976, the Ways and Means Committee had reported out an estate and gift tax bill which had not been brought to the House floor at the time of the

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This article discusses legislative proposals which were current when the paper was presented in April 1978. Except for the material contained in the Epilogue, the article has not been revised to take into account legislative developments subsequent to that time.

conference on the bill that became the Tax Reform Act of 1976. Although the House-passed tax reform bill did not include estate and gift tax changes, the Senate had included some estate and gift provisions in the 1976 tax bill. These Senate-passed provisions generally resembled some of the Ways and Means estate and gift tax provisions. Because there was a strong interest in having estate and gift tax relief enacted in 1976, a somewhat unusual procedure was utilized by the conferees.

Basically, the conference committee agreed to the Ways and Means version of the estate and gift tax provisions, and the tax reform bill was reported back to the House and Senate with the provisions of the Ways and Means estate tax bill. This portion of the tax reform was reported in disagreement, which meant that there was a separate vote on the estate and gift tax changes.

A major problem, from an administrative viewpoint, is that there was a very important step skipped; namely, the step of sending a House bill to the Senate Finance Committee with time for hearings and comments from practitioners. This may be one reason for the high degree of complexity, at least a portion of which many people believe is unnecessary.

In response to the suggestion to defer major tax changes, such as the special valuation rules of Section 2032A, it should be noted that there may often be considerable pressure to implement tax relief proposals as soon as possible. However, it often is easier to defer revenue raising changes.

Also, the estate and gift tax provisions are the result of a compromise. The members of a group as relatively cohesive as the group attending this seminar have different views on proper tax policy. Other groups, for instance, the Ways and Means Committee, are much more diverse. They represent, as has been pointed out, a microcosm of the country; their districts are from all different types of States and have different types of constitutents. Thus, it is often impossible to pin down something like legislative intent and say "they intended . . ." and define it to cover all situations. It can be done sometimes, when everybody agrees on what they're doing and why they're doing it. With a compromise provision of broad application, I think we will have to live with a certain level of ambiguity concerning the actual application of the rules to all situations. It would be much easier to interpret the law if legislative intent could be more precisely defined, but I do not see it happening for provisions which involve significant legislative compromises. Often, regulations must be written to provide guidance in implementing the basic policy decisions.

Prior to the 1976 act, property passing from a decedent to an heir had a basis equal to its fair market value on the estate tax valuation date, whether the date of death or the alternate valuation date. This stepped-up basis was changed by the 1976 act, which provided that, for the estates of decedents dying after December 31, 1976, most property passing from a decedent would take a carryover basis.

Thus, generally, the basis of the heirs in property is the basis of the property in the hands of the decedent with a series of adjustments. In general, these adjustments are--in the order that they are normally made--the so-called "fresh-start" adjustment to reflect the fair market value on December 31, 1976, adjustments to increase the basis by the Federal and State estate taxes attributable to appreciation, an adjustment to reflect a minimum basis of $60,000, and another adjustment for State inheritance taxes which are attributable to appreciation and are paid by the heir.

The people who argue against the carryover basis concept usually argue on two levels. One, they do not like the policy; that is, they do not like the bottom line. Two, they do not like the complexity and administrative burdens. In general, the proposals that we are discussing are various legislative attempts to alleviate the complexity. I do not think we will find a carryover basis approach, or for that matter, a "capital gains tax at death" approach, that will be simple, in absolute terms. As with almost any proposal that seeks to deal comprehensively with a large number of potentially complicated factual situations, any simplicity is going to be relative.

Several bills would revise the carryover basis rules, of which I will look at four: H.R. 6715, the Technical Corrections Bill; S.2228 by Senators Harry F. Byrd, Jr., and Robert Dole, which I will generally call the Byrd-Dole bill; S.2461, a bill by Senator William Hathaway, which the administration supports; and H.R. 10617 by Representative William Steiger of Wisconsin.

The legislative posture of these proposals is important. H.R. 6715, has passed the House and has been favorably reported by the Finance Committee. (Generally, unless noted otherwise, references to provisions of H.R. 6715 relate to provisions which are included in both the House version and the Finance Committee version.) The other three bills are bills on which no positive action has been taken by either House of Congress.

First, let me note the effect on the scope of application of the carryover basis rules. By virtue of the so-called minimum basis adjustment of $60,000 in the carryover basis provisions, all estates having carryover basis property of $60,000 or more may be subject to carryover basis. The Hathaway bill would cut out a number of estates by raising the minimum basis (which has the effect of an exemption) to $175,000. The Byrd-Dole bill would basically increase the minimum basis gradually so that the amount of the minimum basis would parallel the exemption equivalents of the applicable estate tax credit. In other words, the amount of the minimum basis would be $120,000 in 1977, and it would increase to $175,000 in 1981.

Second, the most significant area of discussion for a number of years, assuming that the carryover basis stays around, is the application of the so-called "fresh-start" adjustment. One proposal by Senators Byrd and Dole would "grandfather" all property held on December 31, 1976. This would not be a fresh start; if a person held the property on that date, it is stepped-up basis property. In situations involving interests in corporations and partnerships, this approach would probably involve some significant avoidance possibilities unless some tracing rules were provided. To eliminate manipulation, the tracing rules would probably have to be detailed and potentially burdensome to apply.

The Hathaway bill, and generally the Steiger bill, make a number of simplifying, correcting, and technical changes to the fresh-start adjustment. One involves computation of the fresh-start adjustment. Currently, two sets of rules exist for fresh-start basis; one, for marketable securities, take the established value on December 31, 1976; for most other property, linear appreciation is assumed. The Hathaway bill would extend the marketable property rule to certain other properties whose value can reasonably be established on December 31, 1976 (or whatever the appropriate cut-off date is). This rule would apply to certain preferred stock with a fixed redemption price. If stock can be redeemed for $100, presumably that is the value of the stock, and it is not going to appreciate beyond that amount. Also, the Hathaway bill gives regulations authority to the U.S. Treasury to extend the marketable property rule to other assets which have a relatively fixed value on December 31, 1976.

Some changes in computing fresh-start have been suggested for certain types of assets which are not subject to the marketable property rule. The Technical Corrections bill provides a formula to determine the minimum basis for fresh-start purposes. For tangible personal property (such as stamp collections), there is a discounting-back approach which assumes that the post-1976 appreciation accrues at approximately 8 percent a year. One starts from the date of death, figures out what the value is, and discounts it back to the fresh-start basis. The Hathaway bill basically liberalizes this approach. It lowers the discount rate to 6 percent, and it applies the rule to nonbusiness tangible personal property and personal residences. Also, it provides that the fresh-start basis is never to be less than 25 percent of the value of the property at the decedent's death. The Steiger bill resembles the Hathaway bill but it contains a 50-percent limit, not 25 percent.

Another complexity in existing law is that the fresh-start adjustment currently is available only for gains, so there is a dual basis problem--one basis for gain, and another for loss. The Hathaway bill would provide that the fresh-start adjustment is available for loss as well as gain.

Present law also contains an exception to the carryover basis rule for up to $10,000 in fair market value of personal and household effects. The Hathaway and Steiger bills would increase this to a $25,000 exemption.

Another complexity in the current law is that the minimum basis adjustment is made after the fresh-start adjustment. The Technical Corrections bill would not affect this ordering, but all three of the other bills would provide that the minimum basis adjustment is to be made first.

As I alluded to earlier, there are separate adjustments for Federal estate taxes and State death taxes paid by the estate, as well as an adjustment for State inheritances paid by the beneficiary. The Technical Corrections bill contains a clarifying amendment, but it would seem to further complicate the adjustments because it requires use of the State death tax property inclusion rule for computing the State death tax adjustments. The Byrd-Dole, Hathaway, and Steiger bills all would combine the death tax adjustments so that a single adjustment could be made on the basis of the Federal inclusion rule.

Another change involves what level of tax is used for these adjustments. Under present law, the adjustment for taxes attributable to appreciation is made by looking at the average death tax rate rather than the highest rates at which the estate tax is paid. The Byrd-Dole bill would make the adjustment by assuming that all appreciation in the estate is included in the estate after all basis. An average tax rate on appreciation would then be determined and used for making the adjustment. The Hathaway and Steiger bills would generally use the highest (or marginal) estate tax rate except when the estate just barely is into its highest bracket--if $50,000 or less of the estate is taxed in its highest rate bracket, it would look at the next lower rate bracket.

Another rule in the Hathaway bill would in effect give an automatic basis adjustment of $250 a year for unsubstantiated improvements on personal residences. The Steiger bill would use a $200 figure.

Another area of concern is the need for furnishing information. Under the present law, the executor is required to file with the IRS, and send to heirs, information concerning carryover basis property; and some significant penalties exist for failing to do so. The Byrd-Dole proposal would provide that carryover basis information need not be filed nor furnished to the heirs if the gross estate is less than $175,000, with the same phase-in that the bill provides for the application of the minimum basis rules. The Hathaway bill would repeal these reporting requirements to the IRS and would require the reporting to the beneficiaries only if the value of the carryover basis property in the estate exceeds $175,000. It also provides that a penalty would be imposed only if the failure to furnish information is due to negligence or intentional disregard of the rules.

Under current law there is no special rule provided to automatically extend capital gains treatment to inherited crops or livestock. The Byrd-Dole bill, and the Steiger bill, would extend capital gains treatment to inherited crops and livestock, regardless of whether the crops or livestock is considered inventory in the hands of the estate or beneficiary. (The Treasury may oppose this proposal.)

Net operating loss carryovers and capital loss carryovers of a decedent under current law do not carry over to his or her estate. The Byrd-Dole bill would carry over only the decedent's unused capital losses.

Under present law, gains are recognized on the distribution to the heirs of installment obligations received on the sale by the executor of the decedent's property. The Hathaway bill would change this rule to provide that no gains would be recognized from the distribution of the installment obligation to the heirs. This suggestion may be good because it would permit increased flexibility in winding up estates and remove some rules that seem to have been traps for the unwary in other areas.

EPILOGUE

No permanent solution to the problems of carryover basis was enacted in 1978. The effective date of the carryover basis rules was postponed so that these rules do not apply to property passing or acquired from a decedent dying before January 1, 1980. (Sec. 515 of the Revenue Act of 1978, P.L. 95-600.) Also, certain relatively minor amendments were made to the carryover basis rules. These changes (which were enacted as sec. 702(c) of P.L. 95-600) are essentially the changes proposed in the Technical Corrections bill (some of which are discussed above). However, most knowledgeable parties agree that these changes fall short of what would be needed to make carryover basis a reasonably operational approach.

Because of the effective date of the postponement, it seems highly likely that further legislation on carryover basis will occur sometime this year or next year. Although it is not clear what form this action will take, the basic options appear to be: (1) repeal of the carryover basis provisions and a return to pre-1976 act law (an approach which is apparently favored by a significant number of legislators); (2) retention of the carryover basis rules with a "clean up" of the general type described in the Hathaway bill (an approach which the Treasury apparently favors); and (3) further postponement of the effective date of the carryover basis rules.

ISSUES RAISED BY THE TAX REFORM ACT OF 1976: A SUMMARY

Harold F. Breimyer*

This symposium has dealt with a highly important topic. By way of personal testimony, for 15 years I have been virtually shouting that the economics of agriculture is no longer essentially the economics of factor combination and enterprise organization. It has become even more the economics of financial management, including the economics of tax management. This symposium has been appropriately conceived.

With regard to a summary evaluation of Section 2032A, my judgment is that it is bad law. I dare to believe I reflect a majority viewpoint. That section will be worse if the various changes being advocated, such as increasing the half-million dollar limit, are adopted. With regard to the entire Tax Reform Act of 1976, however, I believe that no overall judgment can or should be made. Each part of the law should be addressed independently.

But having offered this viewpoint, I reverse course and address the issues the 1976 law as a whole, and Section 2032A in particular, were intended to deal with. To set the whole matter in perspective, I list five basic facts.

First is the familiar history of the last two decades. During that period, several hundred thousand U.S. farmers found themselves accumulating estates far larger than most had ever dreamed of. No matter that Russian grain sales and some other happenstance events contributed substantially to the escalation in values: the growth in asset values created management problems that had not been anticipated. The same farmers also discovered rather quickly that death tax liability increased more than proportionally with the gross asset value. They also learned that--prior to 1976--the estate tax rate scale had not been changed since 1941, and the $60,000 exemption had remained unaltered since 1942.

Fact number two--even before asset values began to increase so fast, concerns had begun to arise about prospects for the proprietary enterprise unit in agriculture known as the family farm or ranch. Extension economists of the North Central States, noting this concern, prepared and published a series of excellent reports under the general heading, "Who Will Control U.S. Agriculture?" Among the separate reports was one on income tax rules; another was an excellent study entitled <u>Death and Taxes</u>.

Fact number three is the steady increase in cost of entry into agriculture. This, of course, is only the opposite side of a balanced equation: growth in value of assets held by earlier entrants becomes a barrier to entry by potential newcomers. The barrier has become higher in the last 5 years as land values have advanced farther

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beyond current earning power. Small wonder then that farmers of retirement age who have a son or daughter who hopes to remain on the farm want in the worst way to spare that child the necessity of reaccumulating entry capital.

Fact number four is the long standing agrarian tradition that our overriding concern in agriculture is for the status of the operator, not of the landholder. Moreover, in our tradition, agriculture is hospitable to new owner-operator entrants. This tradition is not incidental: if the landholder were first in public concern, overall attitudes towards Section 2032A would be different than they now are.

Fact number five is a sociopsychological phenomenon in agriculture that I have written about often. I use the title, "Farming's Non-instinct for Self-Preservation." This relates simply to the virtual incapacity of the independent farmer to see beyond his farm accounts. It is very difficult for the farmer to appreciate the fact that what may look good to him individually in the short run may be highly harmful to him and his fellows collectively in the long run. (In introductory economics courses, we teach this idea as the fallacy of composition.) Among instruments that will help modest-sized farmers individually but destroy them collectively, none is more pernicious than tax shelters. This statement is so absolutely unchallengeable that there is no need to develop it here.

Individual farmers, and various groups of farmers, differ in their perceptiveness. Citrus fruit producers probably understand best; some years ago they asked for, and got, a change in the tax law removing tax shelters from their industry. Dairymen have some sense of their collective destiny. In my experience, beef cattle producers are the most unwilling to face the reality of this principle. In my opinion, if organized cattlemen were to be successful in getting all the tax concessions they seek, the full-time traditional feeder and rancher would disappear from the scene.

My object here is to point out lessons and not to scold. Every group that has addressed the question of what might be done to preserve the family farm and ranch comes up to a major choice of direction. It is a huge fork in the road. Which is the better policy course? Is it to change the overall rules of the game, such as the entire tax structure, farm credit institutions, the basic price and income support law? Or is the better choice to describe a particular kind of farm that is to be protected and then build a big strong fence around it?

For my part, I have wrestled hard with this two-pronged policy choice. A case can be made for each. The reason I remain somewhat reluctant to go the second route should be clear from the discussions we have had at this symposium. An attempt such as Section 2032A to shield a specifically defined "family farm" becomes a legalistic monstrosity.

Section 2032A also becomes subject to intense pressure to vitiate its even modest protection by either watering down rules in administration or by tacking on amendments having the same effect. To stay with the crude analogy, the pressure is always great to punch holes in the fence if not to open the gates wide.

Inasmuch as this symposium is being held at tax filing season, it is scarcely necessary to note how sensitive most of the public has become to the growing complexity of tax law and tax reporting. Let us just admit in candor that the complexity arises in the body of exemptions that special interest groups are able to get added to the law. The complexity by no means originates in the wiles or guiles of employees of the Internal Revenue Service. Section 2032A alone would contribute a major amount of further complexity.

But Section 2032A must be judged also, or even primarily, by the criterion of whether it fulfills its ostensible purpose. Based on the evidence that Mike Boehlje presents elsewhere in this publication, one must conclude that the section will not in fact serve to protect the family farm as an institution. It will particularly fail to provide hospitality to new entrants, which I named above as a part of the family farm tradition. I add quickly that a similar judgment does not apply to all features of the 1976 tax reform law. Each part of that law must be judged independently.

Section 2032A can be classified as just another tax shelter. Tax shelters are most effective where larger estates and higher rates are involved. To be sure, the half-million dollar limit to special exemption acts to restrain this effect eventually.

Before Missouri audiences, I have frequently described the significance of Section 2032A in these rather sharp terms. Petitioners for that law declared that such a law would "protect the family farm." They should have said, "It will protect my family farm," I explain. The difference is crucial. The law will prove of financial benefit to the larger farms that are now well established and for which an heir wants to continue as operator. In the process it will add further to land prices which then become an even higher barrier to new young farmers wanting to enter farming.

Section 2032A creates a rather sharp conflict of interest between the older and newer generations of farmers. Older farmers in Missouri who are approaching retirement beg for the most lenient possible estate tax law. Although some may be a little greedy, I have already explained my basic sympathy with their reasoning. At the same time, a number of young farmers in Missouri have told me in equally strong terms that they resent the difficulty of getting a foothold in farming and they want a steeply graduated estate tax. One of our bright young college of agriculture graduates explained to me that unless older farmers with large holdings are forced to sell a little of their land, he and his fellows cannot get hold of even a small tract to make a base for their operations.

I offer a few summary observations.

Section 2032A will contribute to a hereditary ("landed gentry") agriculture unless, ironically, it leads instead to a nonfarm-ownership agriculture. If the 2032A fence proves penetrable by nonfarmers who want to "get in on" the estate tax concessions provided for farmers, those outside investors will find the attractions irresistible. At this point I quote a line from a paper I wrote a number of years ago, relating to a subject far distant from estate taxes: "Paradoxically, the more successfully farmers use political power to improve their incomes, the more vulnerable they will be to the economic power of their voracious adversaries."

Even though the idea is valid, this is too strong a note on which to close. The proper closing theme is to raise the question first of all as to whether or not there is a true intention in public policy for agriculture to retain the modest-sized family farm. Apparently areas such as California and Arizona do not accept that objective. The Midwest seems still to be committed to the family farm. To the extent that objective is retained, Section 2032A will stand as only the first and by no means the last attempt to mitigate some of the entry barriers to farming. If, as I believe, and this symposium seems to suggest, the attempt in that section miscarried, the issue will nevertheless remain with us. To use Professor Paarlberg's favorite word, it will stay on the policy agenda. Section 2032A at least offers a "learning experience."

The topic of this symposium is one with which policymakers for agriculture will increasingly have to deal. Therefore, I repeat my compliments to the organizers of this session and to all who contributed to it.

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