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Valuation of Farmland for Estate Tax Purposes: A Consideration of Section 2032A and the New Treasury Regulations

by

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VALUATION OF FARMLAND FOR ESTATE TAX PURPOSES: A CONSIDERATION OF SECTION 2032A AND THE NEW TREASURY REGULATIONS

INTRODUCTION

The Tax Reform Act of 1976[1] (the Act) has kept attorneys busy revising the estate plans of millions of Americans. Although the American farmer was affected by this sweeping revision, five years later it remains open to question whether he gained any real benefit from the Act.

One important provision of the Act, Section 2032A of the Internal Revenue Code, changed the existing estate tax laws and provides that farmland may be valued at its actual use, as opposed to its highest and best use. Section 2032A has been criticized by some as an undeserved subsidy,[2] and by others as a failed attempt to equalize the estate tax treatment of farmers.[3] All agree that the provisions of Section 2032A are extremely complex, as well as technically flawed in several respects. In the final analysis, Section 2032A may have the effect of destroying the family farm, rather than protecting it as an institution in the modern American economic system.[4]

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1. Pub. L. No. 94-455, 90 Stat. 1520 (1976) (amending scattered sections of 26 U.S.C.).

2. Hjorth, *Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class*, 53 WASH. L. REV. 609 (1978) [hereinafter cited as *Special Valuation*], wherein the author, paraphrasing Senator Edward M. Kennedy (D. Mass.), points out that before passage of the 1976 Act (note 1 *supra*) only 7% of all estates paid any estate tax. Further, he notes that when the full provisions of the act are in effect, "only the largest 2% of all estates will be taxed." *Id.* at 612 n.15.

3. *See* Allen, *Washington Saves the Family Farm? The Peculiar Remedy of IRC Section 2032A*, 56 TAXES 205 (1978), which infers that under Section 2032A farmers did not receive even equal tax treatment. Mr. Allen states that "the statute could be substantially . . . simplified if the IRS can be persuaded that the farmers are not seeking special interest benefits but rather tax treatment no worse than that endured generally by the owners and users of real property." *Id.* at 212.

4. *Special Valuation, supra* note 2, at 612-13, wherein the author explains:

> Indeed, it seems more probable that section 2032A . . . will contribute to the decline and possible demise of the family farm. Several factors point to this conclusion:
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> (1) Section 2032A . . . promise[s] both to increase the demand and to reduce the supply of farmland in the market, with the likely result that land prices will become so high in relation to current yield that only those with substantial outside income will be able to enter the agricultural market.

This comment focuses on the mechanics of the statute; it is meant only to complement a careful study of its provisions. Omitted from discussion is the application of the statute to businesses other than farming. Numerous questions yet to be resolved by the regulations make an understanding of the statute at this time incomplete. It is possible, however, to treat the new permanent regulations dealing with material participation requirements, valuation methods and election procedures, which are discussed below in some detail. Further attention is devoted to a number of the questions left unanswered after the promulgation of the new regulations. This analysis of Section 2032A concludes with a discussion of planning considerations.

THE MECHANICS OF SECTION 2032A

Property included in a decedent's gross estate has traditionally been valued at its fair market value—the price "a willing buyer [would pay] a willing seller, [in the open market, with] neither being under any compulsion to buy or to sell. . . ."[5] It is presumed, under these circumstances, that the property will be put to its highest and best use, hence the property is valued according to such use. This presumption may be fair and reasonable in most property transactions, but the special circumstances of farmers often make its application to farmland peculiarly unfair.[6]

Farmland located near urban centers is ripe for development, and thus more valuable as a building site than as a bean field. The shrinking supply of farmland has, moreover, resulted in speculation, driving up the cost of land beyond its capacity to turn a profit

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(2) The subsidies benefit owner-operators of farms, but do not benefit tenant farmers, who will find it increasingly difficult to buy any of the land they till as prices rise.

(3) The subsidies grant larger benefits to wealthy owner-operators than to operators owning farms of modest size, and the small owner-operators will themselves find it increasingly difficult to buy more land if the provisions grant them only a small benefit but drive up the price of land significantly.

(4) The subsidies are unavailable to the estates of persons who have sold their farmland during their lifetimes; thus, they interfere with any desires which retiring farmers may have to sell to other farmers and further restrict the supply of land.

5. H.R. Rep. No. 1380, 94th Cong., 2d Sess, 21 (1976), *reprinted in* [1976] U.S. Code Cong. & Ad. News 3375.

6. *See generally* Allen, *supra* note 3, at 207-08. As the author indicates, the highest and best use standard deviates from financial reality when applied in the farm context. Since farmland is of a business character, it is unreasonable to require it to be valued as if it were development property.

when used for farming purposes.[7] The modern, mechanized farmer requires increasingly large tracts of land, adding to the upward pressure on farmland values. This upward pressure often results in the removal of land from agricultural production, thus exacerbating the problem.

Desirous of encouraging the continued use of farmland for agricultural purposes and cognizant of the unfairness of valuing farmland in the traditional manner, the Congress enacted Section 2032A to alleviate the burden on farm families of escalating land values. Section 2032A was expressly designed to eliminate the need to sell family farmland upon the owner's death simply to pay high estate taxes, where such taxes were inflated by largely artificial factors (such as "highest and best use" valuation) that were beyond the farmer's control.[8] The congressional expectation was that this new valuation formula would eliminate the speculative value inherent in the highest and best use presumption.[9]

Requirements to Qualify for Special Use Valuation

Several conditions must be met before the farmer may benefit from the actual use valuation. As will be explained later, at least fifty percent of the value of the decedent's adjusted gross estate must involve either real or personal property devoted to qualifying uses, and inherited by a qualified heir, and at least half of this fifty percent must be real property *only*.[10] This real property must have

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7. H.R. REP. No. 1380, 94th Cong., 2d Sess., 22 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3375. The committee noted that "it [is] unreasonable to require that this 'speculative value' be included in an estate with respect to land devoted to farming. . . ."

8. *Id.*, where the committee stated that

> [v]aluation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes.

9. *Id.*

10. 26 U.S.C. § 2032A(b)(1) (Supp. II 1978) provides in pertinent part:

> For purposes of this section, the term "qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use, but only if—
>
> (A) 50 percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property which—
>
> (i) on the date of the decedent's death was being used for a qualified use, and

been owned by the decedent, and he or a member of his family must have put it to a qualified use for five or more years during the eight-year period preceding the decedent's death.[11] Finally, an amendment of Section 1040(a) was enacted by the Revenue Act of 1978 to provide that Section 2032A values may be disregarded when specially valued property is used to fund a pecuniary bequest.[12] Under such circumstances, the fair market value of such property may be used.[13]

DEFINITIONS

A "qualified use" is the use of property for farming purposes or as a farm.[14] Under the statute, "farming purposes" are broadly defined to include not only those activities traditionally thought of as farming, but also the handling, drying, packing, grading and storing of commodities.[15] The definition of a "farm" is similarly

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(ii) was acquired from or passed from the decedent to a qualified heir of the decedent.

(B) 25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property which meets the requirements of subparagraphs (A)(ii) and (C).

(C) during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which—

(i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use, and

(ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business. . . .

11. *Id.*

12. Pub. L. 95-600, § 702(d)(3), 92 Stat. 2929 (November 6, 1978). Under pre-1978 law "the distribution of property by an estate or trust in satisfaction of a pecuniary bequest [was] treated as a taxable transaction resulting in the recognition of gain or loss to the estate." H.R. REP. No. 700, 95th Cong., 1st Sess. 69 (1977). The gain was figured on the basis of distribution date value less estate tax value.

13. Without this change funding pecuniary bequests with actual use valued property would obviously result in a relatively large recognition of gain, penalizing this form of disposition — a result Congress didn't intend. *Id.*

14. 26 U.S.C. § 2032A(b)(2) (1976).

15. *Id.* at (e)(5), specifically provides:

The term "farming purposes" means—

(A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;

(B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and

(C) (i) the planting, cultivating, caring for, or cutting of trees, or

(ii) the preparation (other than milling) of trees for market.

broad. It "includes stock, dairy, poultry, fruit, fur bearing animals, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands."[16]

Property valued under the actual use formula must go to a qualified heir. A "qualified heir" is defined as a member of the decedent's family, including an adopted child, who received qualified property from the decedent.[17] "Qualified real property" is real property located in the United States, passed to a qualified heir and being used for a qualified use on the date of the decedent's death.[18] Such property includes regularly occupied farmhouses and other residential buildings, as well as other regularly used or occupied improvements that contribute to the maintenance or operation of the farm.[19] Mineral leases and improvements unrelated to the operation of the farm, however, are not qualified real property.[20] At least one authority maintains the statute's emphasis on land and other property that is functionally related to a farm purpose would also exclude from the actual use valuation "inventory items such as harvested crops stored on the farm, livestock raised for sale, and perhaps unharvested crops growing on the land."[21] Section 2032A contemplates material participation on the farm by the decedent or a member of his family during the eight-year period preceding the death of the farm owner. Material participation necessarily involves either managing or operating the farm for at least five of these eight years;[22] it contemplates something beyond

16. *Id.* at (e)(4).

17. *Id.* at (e)(1).

18. *Id.* at (b)(1). For a complete text of this statute, *see* note 10 *supra*.

19. *Id.* at (e)(3) provides:

> In the case of real property which meets the requirements of subparagraph (C) of subsection (b)(1), residential buildings and related improvements on such real property occupied on a regular basis by the owner or lessee of such real property or by persons employed by such owner or lessee for the purpose of operating or maintaining such real property, and roads, buildings, and other structures and improvements functionally related to the qualified use shall be treated as real property devoted to the qualified use.

20. H.R. Rep. No. 1380, 94th Cong., 2d Sess. 24 (1976), *reprinted in* [1976] U.S. Code Cong. & Ad. News 3378.

21. J. McCord, 1976 Estate and Gift Tax Reform 321 (1977). The author notes that the statute "would also appear to exclude personal property other than inventory, such as livestock held for breeding or dairy purposes."

22. 26 U.S.C. § 2032A(b)(1)(C)(ii). For full text, *see* note 10 *supra*. The regulations contemplate "managing" on a relatively full-time, rather than a part-time, basis. *See* text accompanying notes 92 & 93 *infra*.

mere passive collection of rental income or salary. This material participation requirement continues after the death of the decedent, and failure to comply will trigger a recapture tax.[23] Material participation is judged by the standards set in IRC § 1402(a) to govern self-employment taxes.[24] The new regulations, discussed *infra*, specify in detail what is necessary to meet the material participation requirement.

The executor who succeeds in meeting the above requirements, thus qualifying for treatment under Section 2032A, must then proceed to value the farmland. A valuation based on the application of the statutory actual use formula contemplates at least two appraisals: the first appraisal, based upon highest and best use, is necessary to determine whether the fifty and twenty-five percent tests are met; the second establishes the actual use valuation. There are, moreover, alternative methods of actual use valuation—the farm method and the multiple factor method. These are discussed below.

The first appraisal concerns requirements of the fifty and twenty-five percent tests. To determine whether the estate meets both these tests,[25] the farmland must be valued under the traditional fair market value (highest and best use) method, rather than the actual use value methods.[26] To employ the latter method

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23. *Id.* at (c)(7)(B), which states that failure to comply with this material participation requirement will trigger the recapture tax provisions of Section 2032A(c)(1)(B) (1976).

24. *Id.* at (e)(6). In explaining these standards, the regulations provide that

> [i]f the owner or tenant shows that he periodically advises or consults with the other person, who under the arrangement produces the agricultural or horticultural commodities, as to the production of any of these commodities and also shows that he periodically inspects the production activities on the land, he will have presented strong evidence of the existence of the degree of participation contemplated by section 1402(a)(1). If, in addition to the foregoing, the owner or tenant shows that he furnishes a substantial portion of the machinery, implements, and livestock used in the production of the commodities or that he furnishes or advances funds, or assumes financial responsibility, for a substantial part of the expense involved in the production of the commodities, he will have established the existence of the degree of participation contemplated by section 1402(a)(1) and this paragraph. . . .

26 C.F.R. § 1.1402(a)-4 (1980).

25. 26 U.S.C. § 2032A(b)(1) provides that half of decedent's gross estate must be either real or personal property, and half of this must be only real property. *See* note 10 *supra* and accompanying text.

26. 1 H. HARRIS, HANDLING FEDERAL ESTATE AND GIFT TAXES 216 (3d ed. J. Rasch 1978), wherein the author states that "the 'adjusted value of the gross estate' is determined under the regular valuation rules for estate tax purposes (without regard to value based on actual use). . . ." *See also* H.R. REP. No. 1380, 94th Cong., 2d Sess. 23 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3377.

would limit the availability of Section 2032A to fewer estates, since, as a practical matter, in order to qualify, a larger portion of the farmer's estate would then have to be classified as real property devoted to farming purposes.

That this would be so can readily be shown. Assume, for example, that a decedent's gross estate has a value of $100,000, and that the real property devoted to farming purposes has a fair market value of $25,000. The estate would meet the twenty-five percent test. If, however, the same real property were to be revalued under the actual use valuation method, it would invariably be valued at less than fair market value ($25,000).[27] If its actual use value were $15,000, then the value of the gross estate would be reduced by $10,000 to $90,000. The actual use value would, in these circumstances, fail to meet the twenty-five percent test (it would in fact be but 17.6% of the estate). The farmer whose estate consists primarily of farmland devoted to farming purposes could choose an actual use valuation and thus avoid disqualification. Since many farmers have investments in property other than farmland, the fact that qualification under the fifty and twenty-five percent tests is determined by a fair market value valuation should allow greater flexibility in diversifying the farmers' investments.

The second appraisal involves an actual use valuation. Section 2032A provides two methods of arriving at this valuation, one involving the "farm method" approach,[28] the other, the more traditional "multiple factor" approach.[29] While both methods are designed to eliminate the escalating effect on prices of speculation, the farm method will typically yield substantial savings in estate taxes even where estate assets remain unaffected by urban growth.[30]

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27. *See* text accompanying notes 6-9 *supra*.

28. The "farm method," explained at 26 U.S.C. § 2032A(e)(7)(A) (1976) bases the value of the decedent's farmland on a formula which takes into account the rental payments for comparable lands (comparables), the state and local real estate taxes, and the interest rate for Federal Land Bank Loans. This method obviously is applicable only to farmland; closely held businesses are restricted to the multiple factor method.

29. The "multiple factor" approach, found at 26 U.S.C. § 2032A(e)(8) (1976) closely parallels traditional valuation techniques by utilizing comparables, capitalization of income and rental values, state use assessment law formulas, as well as other recognized valuation techniques.

30. Wiegratz, *Special Valuation of Real Estate: Opportunities and Pitfalls*, 118 TRUST & ESTATES (No. 11) 40 (1978) where the author states that "some believe the law went beyond alleviating speculative factors by artificially reducing *all* farm values regardless of the potential use." (emphasis added) (citations omitted).

A) Farm Method

Under the farm method, the estate executor must first compute the average annual gross cash rental per acre for comparable farmland. This average is "made on the basis of the [five] most recent calendar years ending before the date of the decedent's death."[31] From this amount is subtracted the average of annual state and local real estate taxes figured, again, for the same five-year period. The remainder is the adjusted gross cash rental, which is then divided by the five-year-average "effective interest rate for all new Federal Land Bank loans"[32] in the locality. The average revenue interest rates for each Federal Land Bank district are listed in annual Revenue Rulings.[33]

The savings on a typical actual use valuation using the farm method can be illustrated by an example. Assume that good quality row crop farmland in Southeastern Missouri generally brings a cash rental of $75.00 per acre. Reduced by state and local real estate taxes, which usually run about $5.00 per acre, the adjusted gross cash rental would amount to $70.00 per acre. For decedents dying in 1979, the Federal Land Bank five-year average interest rate was 8.93 percent.[34] Dividing the adjusted gross cash rental ($70.00) by this percentage rate (8.93) yields an actual use valuation per acre of $783.87. It is submitted that the same land, valued at fair market value with the highest and best use presumption, would yield from $1200.00 to $1400.00 per acre. The substantial estate tax savings are obvious. The additional expenses of electing valuation under Section 2032A, such as additional appraisal(s), perhaps higher executor fees, and surely higher attorney's fees resulting from the additional time and complexity of an actual use

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31. 26 U.S.C. § 2032A(e)(7)(A) (1976) provides:

> Except as provided in subparagraph (B), the value of a farm for farming purposes shall be determined by dividing—
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> (i) the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual State and local real estate taxes for such comparable land, by
>
> (ii) the average annual effective interest rate for all new Federal Land Bank loans.
>
> For purposes of the preceding sentence, each average annual computation shall be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death.

32. *Id.*

33. Revenue rulings have been issued each year continuing these interest rates. *See, e.g.*, Rev. Rul. 79-189, 1979-1 C.B. 293-294.

34. Rev. Rul. 79-189, 1979-1 C.B. 293-294.

valuation, will probably remain insignificant in light of the substantial estate tax savings. It would appear that in most cases where the farm method of valuation is applied, the reduction in value will go beyond that contemplated by Congress when it enacted Section 2032A.[35] When the executor can locate comparables, he will undoubtedly be better off electing the farm method rather than the multiple factor method.[36]

B) The Multiple Factor Method

In the absence of comparables, the statute mandates employment of the multiple factor method.[37] Even where it is not required, the executor may nonetheless elect the multiple factor method.[38] The statute sets out four specific factors to be considered in making a valuation, and in addition allows consideration of "[a]ny other factor that fairly values the farm. . . ."[39] The specific factors include: the capitalization of income expected to be produced by the decedent's farmland; the capitalization of the fair rental value of the farmland; the value of the farmland after the application of a state differential or use assessment law;[40] and the

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35. *See* note 30 *supra*.

36. One of the problems with the multiple factor method, as pointed out in Comment, *An Analysis of the "Actual Use" Valuation Procedure of Section 2032A*, 56 NEB. L. REV. 860 (1977), is that the comparables used will undoubtedly reflect speculative values, a factor Congress sought to eliminate by enacting Section 2032A. Indeed, the above cited comment hints at a proposition with which this author agrees: that if the multiple factor method is resorted to, considering all the adverse consequences of a Section 2032A election (which will be discussed), the executor might be better off abandoning any attempt to employ actual use valuation. It should also be noted that "[i]n this situation he will probably use the normal valuation of 'highest and best' use." *Id.* at 871.

37. 26 U.S.C. § 2032A(e)(7)(B) (1976) provides in pertinent part that "[t]he formula provided by subparagraph (A) [*see* note 31 *supra*] shall not be used—(i) where it is established that there is no comparable land from which the average annual gross cash rental may be determined. . . ."

38. *Id.* This section provides further that "the formula provided by subparagraph (A) [(*see* note 31 *supra*)] shall not be used . . . where the executor elects to have the value of the farm for farming purposes determined under paragraph (8) [entitled 'Methods of valuing closely held business interests . . .']." *But see* text accompanying note 36 *supra*.

39. 26 U.S.C. § 2032A(e)(8)(E) (1976).

40. In states having a differential or use value assessment law, the value of the farmland under the local method of valuation is to be taken into account. An example of a use assessment law is the Williamson Act, CAL. TAX CODE §§ 421-430.5 (West Supp. 1980). The intendment of this statute is to

> permit the owners of farm land to have the land valued for purposes of state and local real estate taxes at its farm use value, excluding increments in value due to the potential for changing to more intensive uses. In exchange, the owners must agree with the appropriate county or city to restrict the use of the land to preserve its

value of comparables.[41]

The multiple factor method mirrors traditional valuation techniques, except that when comparable sales are used the statute imposes a difficult if not impossible standard, in that the comparable land must be in the same geographical area, yet at the same time far enough removed from urban and resort areas to avoid unnaturally high prices per acre.[42] Again, factors other than comparables must also be taken into account under the multiple factor approach. It is unclear whether the statute attaches special weight to any particular factor to be considered by the court.[43]

It has been suggested that the multiple factor method under Section 2032A will not yield substantial savings to the farmer's estate.[44] Indeed, the executor may be better off not electing actual

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agricultural character.

Dyer, *Estate Tax Savings and the Family Farm: A Critical Analysis of Section 2032A of the Internal Revenue Code*, 11 U. CAL. D. L. REV. 81, 86 (1978) (citations omitted).

41. 26 U.S.C. § 2032A(e)(8) (1976) provides:

> In any case to which paragraph (7)(A) [Farm Method provision, *see* note 31 *supra*] does not apply, the following factors shall apply in determining the value of any qualified real property:
>
> (A) The capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors,
>
> (B) The capitalization of the fair rental value of the land for farm land or closely held business purposes,
>
> (C) Assessed land values in a State which provides a differential or use value assessment law for farmland or closely held business,
>
> (D) 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, and
>
> (E) Any other factor which fairly values the farm or closely held business value of the property.

42. 26 U.S.C. § 2032A(e)(8)(D) (1976). *See* note 40, part D, *supra*.

43. Bock & McCord, *Estate Tax Valuation of Farmland under Section 2032A of the Internal Revenue Code: An Analysis of the Recently Proposed Treasury Regulations*, 1978 S. ILL. U. L. J. 145, 153.

44. Comment, *An Analysis of the "Actual Use" Valuation Procedure of Section 2032A*, 56 NEB. L. REV. 860 (1977), wherein the author states that

> [t]he comparable sales of farmland in the area will include "speculative values" attributable to the land, *i.e.*, part of the sale price of the land is due to pure speculation that the land prices will continue to rise. Once again this will create a situation where the valuation of the farmland does not bear a reasonable relationship to its earning capacity. In addition, disagreements are bound to occur between the Internal Revenue Service and the personal representative as to which factors are the most appropriate or influential in determining value. Therefore, if a personal representative has to resort to the multiple factor formula of valuation the advantages of section 2032A are drastically reduced.

use valuation when he is forced to use the multiple factor method, because the actual use election would impose substantial burdens upon and achieve rather limited tax savings for the heirs.[45]

LIMITATION IN REDUCTION

Section 2032A limits to $500,000 the reduction in value of farmland valued by the method.[46] That is, the differential between the value of the farmland appraised at fair market value and that appraised at actual use value may not exceed $500,000. For decedents dying with an estate valued at over $5,500,000, the potential tax savings total is $350,000.[47] The $500,000 limitation, therefore, represents another reason why two appraisals will be necessary.[48] While actual use valuation saves the larger estates more in actual tax dollars, smaller estates receive a greater benefit when savings are viewed as a percentage of the taxable estate.[49]

RECAPTURE PROVISIONS

If property valued according to actual use is disposed of to someone other than a qualified heir, or if the property ceases to be used for a qualified use, or if material participation by a qualified heir ceases within fifteen years of the death of the decedent and before the deaths of the qualified heirs, Section 2032A imposes a

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Id. at 871 (footnote omitted).

45. *See* note 36 *supra.*

46. 26 U.S.C. § 2032A(a)(2) (1976) provides that "[t]he aggregate decrease in the value of qualified real property taken into account for purposes of this chapter which results from the application of paragraph (1) with respect to any decedent shall not exceed $500,000."

47. This estate may be reduced by, at most, $500,000, the maximum amount of reduction allowed under 26 U.S.C. § 2032A(a)(2) (1976). According to the tax rate schedule located at 26 U.S.C. § 2001(c) (1976), the maximum rate of tax for an estate valued at over $5,000,000 is seventy percent. Since the estate here is reduced by $500,000 this reduction is not subject to the maximum tax. Thus, the estate saves in taxes $350,000, which is seventy percent of $500,000.

48. As explained earlier, two appraisals are necessary to determine if the fifty and twenty-five percent tests are met, and for the actual use valuation. It should be noted as well, that if the alternate valuation date (six months after death) is elected, four appraisals may be done. Two appraisals are done on the date of death, and two others are done at the six month date. *See* 26 U.S.C. § 2032 (1976).

49. Matthews & Stock, *Section 2032A: Use Valuation of Farmland for Estate Tax Purposes*, 14 IDAHO L. REV. 341, 347 (1978). The authors compiled a table that shows that the smaller estates do receive a larger percentage of tax savings. The figures in the column marked "Estate Tax Bracket on Top Dollar" are compiled from the rate schedule located at 26 U.S.C. § 2001(d) (1976).

recapture tax.[50]

If a recapture event occurs within the ten-year period following the decedent's death, the recapture provision of Section 2032A requires payment of the lesser of the total amount of estate tax saved by virtue of the election or the amount received for the property over and above its actual use value.[51] No rebate is pro-

Taxable Estate	Estate Tax Bracket on Top Dollar	Estate Tax Savings	Savings as Percent of Taxable Estate
$ 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%

50. 26 U.S.C. § 2032A(c)(1) (1976) provides:

> If, within 15 years after the decedent's death and before the death of the qualified heir—
>
> (A) the qualified heir disposes of any interest in qualified real property (other than by a disposition to a member of his family), or
>
> (B) the qualified heir ceases to use for the qualified use the qualified real property which was acquired (or passed) from the decedent,
>
> then, there is hereby imposed an additional estate tax.

For purposes of the above cited statute, Section 2032A(c)(7) (1976) provides in pertinent part: "For purposes of paragraph (1)(B) [of section 2032A(c)], real property shall cease to be used for the qualified use if—(A) such property ceases to be used for *the qualified use* set forth in subparagraph (A) or (B) of subsection (b)(2) under which *the property qualified* under subsection (b). . . ." (emphasis added). It is unclear whether changing from one qualifying use to another will trigger the recapture tax provision of 26 U.S.C. § 2032A(c)(1) (1976).

Another possible theory is that the phrase "qualified use" could refer to "highest and best agricultural use," rather than the use at the time of decedent's death. Bock & McCord, *Estate Tax Valuation of Farmland under Section 2032A of the Internal Revenue Code: An Analysis of the Recently Proposed Treasury Regulations*, 1978 S. ILL. U. L. J. 145, 153. Form 706-A must be filed in the instance of a recapture event. See appendix. 1 H. HARRIS, HANDLING FEDERAL ESTATE AND GIFT TAXES 37-38 (3d ed. J. Rasch Supp. 1978).

51. 26 U.S.C. § 2032A(c)(2)(A) (1976) provides:

> The amount of the additional tax imposed by paragraph (1) [*see* note 36 *supra*] with respect to any interest shall be the amount equal to the lesser of—
>
> (i) the adjusted tax difference attributable to such interest, or

vided in the unlikely event that the property is sold for less than its actual use value.

Recapture tax liability is phased out on a monthly ratable basis between the tenth and fifteenth years. The amount of the reduction is determined by dividing the number of full months, in excess of 120, that have passed since the death of the decedent by the number sixty, and multiplying this result by the amount of the recapture tax:[52]

$$[(M\text{-}120) \div 60] (T) = R$$

M = number of months
R = amount of reduction
T = amount of additional tax

Thus, between the tenth and fifteenth years, the amount of potential recapture tax that can be imposed on a qualified heir is reduced, but shall at no time be reduced to less than zero.[53] After fifteen years, no tax liability remains.

Recapture applies to taxable sales and exchanges (as well as tax-free exchanges), and also applies when there is an involuntary conversion, unless the proceeds of such conversion are reinvested in real property that originally would have qualified for actual use valuation.[54] It remains unclear whether such reinvestment may it-

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(ii) the excess of the amount realized with respect to the interest (or, in any case other than a sale or exchange at arm's length, the fair market value of the interest) over the value of the interest determined under subsection (a) [of 26 U.S.C. § 2032A (1976)].

52. *Id.* at (c)(3) provides that

[i]f the date of the disposition or cessation referred to in paragraph (1) [*see* note 50 *supra*] occurs more than 120 months and less than 180 months after the date of the death of the decedent, the amount of the tax imposed by this subsection shall be reduced (but not below zero) by an amount determined by multiplying the amount of such tax (determined without regard to this paragraph) by a fraction—

(A) the numerator of which is the number of full months after such death in excess of 120, and

(B) the denominator of which is 60.

53. *Id.*

54. *Id.* § 2032A(h) (Supp. II 1978) provides special rules for involuntary conversions. Where the cost of replacement property equals or exceeds the conversion proceeds, no additional estate tax is imposed. If less than all the proceeds from an involuntary conversion are reinvested then a tax will become due, such tax being the amount that would have been imposed if the conversion were voluntary, "reduced by an amount which . . . bears the same ratio to [the] tax, as . . . the cost of the qualified replacement property bears to the amount realized on the conversion." *Id.* at (h)(1)(B). The 15-year holding period is extended to reflect the additional time allowed to acquire replacement property. *See id.* § 1033(a)(2)(B)(i) (1976). Involuntary conversion under Section 2032A borrows the Section 1033 definition. *Id.* at (h)(3).

self trigger a recapture event by changing the character of the original qualifying use.[55]

A disposition of property to a member of the qualified heir's family will not trigger recapture,[56] and the family member to whom the property is transferred becomes personally liable for the additional estate tax.[57] Not only should the transferee be notified of his potential liability; it is suggested that the transferor would be well-advised to obtain an executed assumption agreement since the statute does not explicitly relieve the transferor of his liability as a qualified heir. As regards notification of the transferee, there is a special tax lien, discussed later in this comment, which should show up on any title search. In intrafamily transactions, however, a title search is sometimes dispensed with. Thus, the transferee may not be apprised of his personal liability for the additional estate tax. To avoid this result, a transferee in any family transaction involving real property that may come under the provisions of Section 2032A, should take steps to protect himself from incurring unwanted future tax liabilities. The regulations have yet to deal with this issue. Disposition of property to a nonfamily member will, of course, trigger the recapture tax.[58] The transferee in such a case would not be classified as a qualified heir and would not be personally liable for the additional estate tax. Nevertheless, the transferee must protect against the possibility that the farmland can be seized by the IRS, under the special tax lien discussed later in this comment, in order to satisfy the additional estate tax liability. This could occur even after the transferee has paid for the property. The nonfamily transferee will want to require that the lien be satisfied and extinguished or released before he makes any payment on the property.

Imposition of the additional estate tax becomes somewhat complicated when there is only a partial cessation of use, or when

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55. *Id.* This section provides in pertinent part that "[s]uch term only includes property which is to be used for *the qualified use* set forth in subparagraph (A) or (B) of subsection (b)(2) under which the qualified real property qualified under subsection (a)." (emphasis added). *See also* note 50 *supra*. *See also* H.R. REP. No. 1380, 94th. Cong., 2d Sess. 25 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3379, where it was noted that the recapture tax 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."

56. 26 U.S.C. § 2032A(c)(1)(A) (1976); for full text, *see* note 50 *supra*.

57. *Id.* at (c)(6). The transferee family member is thereafter "treated as the qualified heir with respect to such interest." *Id.* at (e)(1).

58. *Id.* at (c)(1)(A); for full text, *see* note 50 *supra*.

there is a sale of only part of the specially valued property. The statute is designed to maximize recapture of the estate tax at the earliest triggering event(s). Therefore, if sale is made of only "part" of the land valued at actual use, the additional estate tax to be imposed equals the difference between the amount received from the sale of this part minus the proportionate actual use value attributable to said part, up to the total estate tax saved by virtue of the Section 2032A election.[59]

A mere cessation of use requires that the same formula be applied, and thus an appraisal is indicated. Any subsequent cessation of use or partial sale also requires application of this formula; however, the total estate tax saved by virtue of the Section 2032A election is figured exclusive of additional estate tax that had previously been paid under this formula. This reduces the maximum amount of tax that can be subject to recapture at *any one time*,

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59. *Id.* at (c)(2)(D) provides that:

> For purposes of this paragraph, where the qualified heir disposes of a portion of the interest acquired by (or passing to) such heir (or a predecessor qualified heir) or there is a cessation of use of such a portion—
>
> (i) the value determined under subsection (a) taken into account under subparagraph (A)(ii) with respect to such portion shall be its pro rata share of such value of such interest, and
>
> (ii) the adjusted tax difference attributable to the interest taken into account with respect to the transaction involving the second or any succeeding portion shall be reduced by the amount of the tax imposed by this subsection with respect to all prior transactions involving portions of such interest.

An example will be helpful in understanding this statute.

Assume an estate consists of 200 acres of farmland, with each acre having a fair market value of $2500, or a total of $500,000. At the date of decedent's death, the land, after a Section 2032A election, is valued at $500 per acre, or a total of $100,000. Due to the election, the total estate tax saved is $132,000 (the estate tax on $500,000 is $155,800; and the estate tax on $100,000 is $23,000). *See* 26 U.S.C. § 2001(c) (1976) for tax rate schedules.

Assume that the qualified heir sells off half of the estate, or 100 acres of farmland. Assume also, that he receives $3000 per acre or a total of $300,000. Since he sold half of the estate, the proportionate actual use value attributable to that part of the estate is $50,000 (that is, 100 acres valued at $500 per acre—actual use value). Subtract this amount from the total amount of money received from the sale, which is $300,000. This leaves a figure of $250,000. Since this is more than the total estate tax saved from the Section 2032A election, only that amount, or $132,000 needs to be paid. Note that if this amount has been less than the total estate tax saved as a result of the Section 2032A election, only the lesser amount need be paid.

Suppose a decedent died with 500 acres of farmland having a fair market value of $1,000,000, and that the actual use value of his estate under Section 2032A was $500,000. The special valuation resulted in a tax savings of $190,000. Later, the qualified heir who received the property sold 100 acres to a nonfamily member for $200,000. The qualified heir will have triggered a partial recapture, and the additional estate tax would be $100,000; the lesser of the total estate tax saved which is $190,000, or the amount realized from the sale which is $100,000 ($200,000 received less the Section 2032A value of $100,000 for 100 acres).

while keeping the *total* amount of potential recapture tax the same. In other words, in no event will the additional estate tax exceed the lesser of the amount of tax saved by the initial Section 2032A election or the amount of gain realized by subsequent dispositions or cessations of use.[60]

Where concurrent interests are involved, the same procedure is followed, with "each cotenant [having] his or her own 'adjusted tax difference[61] attributable to [his or her] interest' [in the property]."[62] The cessation or disposition of property by one concurrent owner will have no effect on the recapture tax status of other cotenants.

Where successive interests are involved, an adjusted tax difference is attributed to each successive interest by use of actuarial factors. Such attribution can become quite complex, particularly when the entire fee is not transferred. The code, committee reports and regulations shed little light on this problem; thus the reader is referred to other sources in the unhappy event of such a problem.[63]

The death of a qualified heir will not trigger recapture, although the qualified heir's death will eliminate his liability for the recapture tax. At death, the property originally valued at actual use, will pass through the qualified heir's estate at fair market value.[64] Of course, an additional Section 2032A election may be made by the estate of the qualified heir if all the requirements are met.

A transfer pursuant to Sections 351 or 721 will not trigger recapture so long as the qualified heir transfers to a closely held corporation or a partnership and retains the same equitable interest

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60. *Id.*

61. *Id.* at (c)(2)(C) provides in pertinent part that

> the term "adjusted tax difference with respect to the estate" means the excess of what would have been the estate tax liability but for subsection (a) over the estate tax liability. For purposes of this subparagraph, the term "estate tax liability" means the tax imposed by section 2001 reduced by the credits allowable against such tax.

62. *Id. See also* J. McCord, 1976 Estate and Gift Tax Reform 344 (1977).

63. *Id.* at 345. Note that in Louisiana this problem may not arise due to the prohibited substitution provision of La. Civ. Code Ann. art. 1520 (West. Supp. 1981) which provides:

> Substitutions are and remain prohibited, except as permitted by the laws relating to trusts.
>
> Every disposition not in trust by which the donee, the heir, or legatee is charged to preserve for and to return a thing to a third person is null, even with regard to the donee, the instituted heir or the legatee.

64. 26 U.S.C. § 2032A(c)(1) (1976).

in the property.[65] If such a tax-free transfer is undertaken, the corporation or partnership must also agree to be personally liable for any recapture that may in the future be imposed as a consequence of the previously explained triggering events.[66] Again, it is unclear what sort of change in use will be deemed to constitute a cessation of the use for which the property originally qualified.[67]

The IRS has three years from the date it is notified of recapture triggering events to assess the additional estate tax.[68] The taxpayer is then given six months to pay the additional estate tax

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65. *Id.* § 351 provides for nonrecognition of gain or loss resulting from transfers of property to corporations "solely in exchange for stock or securities in such corporation." Section 721 provides for nonrecognition of gain or loss resulting from "contribution of property to the partnership in exchange for an interest in the partnership."

In H.R. REP. No. 1380, 94th Cong., 2d Sess. 24 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3378, it was shown

> that a decedent's estate generally should be able to utilize the benefits of special use valuation where he holds the qualifying real property indirectly, that is, through his interest in a partnership, corporation or trust, but only if the business in which such property is used constitutes a closely held business . . . and the real property would qualify for special use valuation if it were held directly by the decedent.

By way of explanation, one author wrote:

> A tax-free transfer by the qualified heir to a controlled corporation under section 351 or to a partnership under section 721 will avoid recapture only if the following conditions are met; (1) the qualified heir retains the same equitable interest in the real property; (2) the corporation or partnership would, with respect to the qualified heir, be considered a closely held business under section 6166; and (3) the corporation or partnership consents to personal liability for the recapture.

Comment, *An Analysis of the "Actual Use" Valuation Procedure of Section 2032A*, 56 NEB. L. REV. 860, 873-74 (1977) (footnotes omitted). *See also* H.R. REP. No. 1380, 94th Cong., 2d Sess. 25 n.3 (1976).

66. *See* note 50 *supra*.

67. *See* H.R. REP. No. 1380, 94th Cong., 2d. Sess. 25 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3379 where the Committee on Ways and Means explained: "The bill provides that if, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or *other* closely held business purposes. . . ." (emphasis added). *Compare* their later statement that "[t]he 'cessation of qualified use' which constitutes a disposition occurs if (1) the qualified property ceases to be used for the qualified use under which the property qualified for use valuation. . . ." *Id.* at 27.

68. 26 U.S.C. § 2032A(f) (Supp. II 1978) provides in pertinent part that

> [i]f qualified real property is disposed of or ceases to be used for a qualified use, then—
>
> (1) the statutory period for the assessment of any additional tax under subsection (c) attributable to such disposition or cessation shall not expire before the expiration of 3 years from the date the Secretary is notified (in such manner as the Secretary may by regulations prescribe) of such disposition or cessation (or if later in the case of an involuntary conversion to which an election under subsection (h) applies, 3 years from the date the Secretary is notified of the replacement of the converted property or of an intention not to replace). . . .

assessed in accordance with the recapture provisions.[69]

The government is protected with respect to the recapture tax by a special lien on the real property valued under the actual use provisions. Since this lien may interfere with typical financing operations on the family farm, IRC § 6325 provides that security may be substituted pursuant to regulations promulgated by the Secretary of the Treasury (the Secretary). This lien arises at the time the Section 2032A election is made, and continues either until the potential recapture tax liability terminates or until the Secretary is satisfied that no further tax liability is owed.[70] In most cases, the tax liability will terminate at the end of the fifteen-year holding period, as provided for in Section 2042A(c)(i).[71]

This fifteen-year holding period has been criticized as excessive, particularly in light of the fact that any gain realized upon the sale of the actual use valued farmland will be subject to income tax.[72] It is submitted that such adverse income tax consequences

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69. *Id.* at (c)(5).

70. *Id.* Section 6324B provides:

(a) in the case of any interest in qualified real property (within the meaning of section 2032A(b)), an amount equal to the adjusted tax difference attributable to such interest (within the meaning of section 2032A(c)(2)(B)) shall be a lien in favor of the United States on the property in which such interest exists.

(b) The lien imposed by this section shall arise at the time an election is filed under section 2032A and shall continue with respect to any interest in the qualified real property—

(1) until the liability for tax under subsection (c) of section 2032A with respect to such interest has been satisfied or has become unenforceable by reason of lapse of time, or

(2) until it is established to the satisfaction of the Secretary that no further tax liability may arise under section 2032A(c) with respect to such interest.

(c) The rules set forth in paragraphs (1), (3), and (4) of section 6324A(d) shall apply with respect to the lien imposed by this section as if it were a lien imposed by section 6324A.

(d) To the extent provided in regulations prescribed by the Secretary, the furnishing of security may be substituted for the lien imposed by this section.

See also 26 U.S.C. § 6325(a) (1976) which provides in pertinent part that:

Subject to such regulations as the Secretary may prescribe, the Secretary may issue a certificate of release of any lien imposed with respect to any internal revenue tax if—[t]here is furnished to the Secretary and accepted by him a bond that is conditioned upon the payment of the amount assessed, together with all interest in respect thereof, within the time prescribed by law (including any extension of such time), and that is in accordance with such requirements relating to terms, conditions, and form of the bond and sureties thereon, as may be specified by such regulations.

71. *See* note 50 *supra* and accompanying text.

72. Indeed, tax on the gain may be quite substantial in view of the fact that a Section 2032A election precludes enjoyment of a stepped up basis at the death of the decedent. *See*

alone present a sufficient deterrent to the premature disposition of actual use valued property, and that the burden of the additional estate tax is consequently unnecessary. It has been suggested that a three-year holding period is adequate to preserve the integrity of Section 2032A.[73] The phaseout provisions that come into play after the passage of ten years aid in ameliorating to some extent the otherwise harsh effects of this rule. The fifteen-year holding period may substantially dissuade farmers from electing the actual use valuation; in short, given the fluctuation in both the national economy and the agricultural sector, the holding period exacts a great toll on the family farmer. Modification of this barrier to actual use valuation would seem necessary to the furtherance of the stated purpose of Section 2032A.[74]

Another problem inherent in the statute is that the qualified heir remains personally liable for any recapture tax that may be imposed as a result of the election of actual use valuation.[75] The statute, however, does provide that the qualified heir may substitute a bond in lieu of personal liability.[76] To this writer, the advantages of such a substitution are not apparent, unless it can be argued that this substitution should also have the effect of releasing the special tax lien that is imposed on the property.[77]

An election agreement is to be filed by the executor with the return. This agreement must be signed by all persons who hold an interest in the qualified real property valued under the actual use

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26 U.S.C. § 1014 (Supp. II 1978) which provides in pertinent part:

> Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—
>
> (3) in the case of an election under section 2032.1, its value determined under such section.

73. Allen, *Washington Saves the Family Farm? The Peculiar Remedy of IRC Section 2032A*, 56 Taxes 205, 211 (1978), wherein the author explains that

> the statute requires 15 years of further family farming as evidence of the decedent's good faith in claiming to hold a farm as a farmer at the moment of his death. Determinations as to such good faith can be made as reliably as of the time immediately before the decedent's death as they can many years later. There is no reason to believe that tax avoidance considerations will survive the death of an owner longer than they preceded it. If the post-death penalty is required, three years is long enough to guarantee good faith on date of death.

74. *See* text accompanying note 8 *supra*.

75. 26 U.S.C. § 2032A(c)(6) (Supp. II 1978).

76. *Id.*

77. *See* note 70 *supra*.

methods.[78] It matters not whether the interest so held is possessory or otherwise. The election agreement evidences consent by the parties to the imposition of both the recapture tax and, in the case of the qualified heir, personal liability therefor. The difficulty of obtaining the consent of interested parties, even within a close family, as well as in some cases determining who must be a party to this agreement under the statute, may impede or frustrate resort to Section 2032A. The new permanent regulations, discussed *infra*, clear up much of the ambiguity surrounding this election agreement requirement.

THE NEW TREASURY REGULATIONS

During 1978 and 1979, the IRS five times published proposed regulations under Section 2032A.[79] After several public hearings and consideration of other comments sent to the Treasury, the IRS, on July 31, 1980, promulgated final regulations covering certain aspects of Section 2032A. These new regulations cover three main areas under Section 2032A. First, they elaborate the statutory requirement that there be material participation by the decedent or a member of his family in the farming operation before farmland may be valued under actual use formulas; second, the regulations explain how the appraisal is to be carried out; third, the regulations specify the procedure to be followed in making an election, as well as what the statutorily required election agreement must contain. The regulations explain who will be considered by the IRS to have an interest in actual use valued property for purposes of this agreement.[80]

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78. 26 U.S.C. § 2032A(d)(2) (1976) provides that

> [t]he agreement referred to in this paragraph is a written agreement signed by each person in being who has an interest (whether or not in possession) in any property designated in such agreement consenting to the application of subsection (c) [(dealing with recapture tax treatment)] with respect to such property.

79. The regulations have been published at the following times, with location in Federal Register:

July 13, 1978	43 Fed. Reg. 30,070 (1978).
July 19, 1978	43 Fed. Reg. 31,039 (1978).
December 21, 1978	43 Fed. Reg. 59,517 (1978).
September 10, 1979	44 Fed. Reg. 52,696 (1979).
December 11, 1979	44 Fed. Reg. 71,436 (1979).

80. 45 Fed. Reg. 50,736 (1981) (to be codified in 26 C.F.R. § 2032A).

Material Participation

A) General Requirements

The regulations generally require that there be active participation on the part of the decedent, a member of his family or a qualified heir. The regulations specify that mere passive collection of rent, salary, dividends or other income will not meet the material participation requirement. Whether or not there is material participation is a question of fact; the character of those activities and financial risks that will support a finding of material paticipation will differ depending on the mode of ownership of the property and the type of business involved.[81]

In terms of physical activity, material participation under the new regulations envisions full-time employment of "35 hours a week or more."[82] Lesser amounts of time may be permissible so long as the time spent participating in the farming operation is sufficient to fully manage the farm.[83] In this context, the need for more complete and accurate record-keeping on the part of the prospective decedent, the family member or the qualified heir cannot be sufficiently stressed.

An important element in trying to prove material participation is the payment by the farmer of self-employment taxes. While the payment of such taxes is not conclusive of material participation, the fact of nonpayment creates a presumption that there was no material participation. The regulations provide that the executor may establish by other evidence that there was such material participation, but he must give reasons why no self-employment tax was paid.[84] Such reasons may often amount to an admission

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81. 45 Fed. Reg. 50,739 (1981) (to be codified in 26 C.F.R. § 2032A 3[a]) provides in pertinent part that

> [w]hether the required material participation occurs is a factual determination, and the types of activities and financial risks which will support such a finding will vary with the mode of ownership of both the property itself and of any business in which it is used. Passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not sufficient for material participation, nor is merely advancing capital and reviewing a crop plan or other business proposal and financial reports each season or business year.

82. 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[e][1]).

83. *Id.* The regulation provides in pertinent part, that "[a]ctual employment of the decedent (or of a member of the decedent's family) on a substantially full-time basis (35 hours a week or more) or to any lesser extent necessary personally to manage fully the farm. . . ."

84. *Id.* The regulation continues:

that payment was improperly withheld from the government, with the result that interest and penalties will be imposed. Indeed, the presumption created by the nonpayment of self-employment taxes, and its implications, puts the family farmer in a difficult planning position: He must decide whether to collect rents and pay no self-employment taxes, thus failing to qualify for the actual use valuation, or he must pay self-employment taxes in order to try to qualify for the valuation.[85]

Both the hours-per-week work requirement and the self-employment tax presumption will effectively limit the application of Section 2032A to the true farmer, or, at least, to individuals with relatives interested in the farming profession.[86] The material participation requirement, together with the threat of an additional estate tax, should substantially prevent abuse of the actual use valuation provisions.[87]

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if the participant (or participants) is self-employed with respect to the farm or other trade or business, his or her income from the farm or other business must be earned income for purposes of the tax on self-employment income before the participant is considered to be materially participating under section 2032A. Payment of the self-employment tax is not conclusive as to the presence of material participation. If no self-employment taxes have been paid, however, material participation is presumed not to have occurred unless the executor demonstrates to the satisfaction of the Internal Revenue Service that material participation did in fact occur and informs the Service of the reason no such tax was paid. In addition, all such taxes (including interest and penalties) determined to be due must be paid.

85. As explained by one commentator:

> The material participation test also poses a problem for the landlord whose land is operated by nonrelated tenants. Material participation by the decedent or member of decedent's family will be determined in a manner similar to the manner used to determine net earnings from self-employment. Under section 1402(a) farm rental income is self-employment income if the rental agreement provides for material participation by the owner and the owner actually materially participates in management. Thus, for the gentleman farmer who hopes to meet the material participation test, it may be necessary to amend farm leases to provide for material participation and to actually increase the level of management exercised by the landlord. Even then, one cannot be certain that the Service will readily allow the actual use valuation. Assuming material participation is established where it would not otherwise be present, qualifying for the actual use valuation has potentially detrimental social security tax implications in the forms of payment of additional self-employment taxes and a reduction in social security retirement benefits because of high self-employment income after retirement.

Uchtmann, *Planning Agricultural Estates: The Impact of Estate and Gift Tax Sections of the 1976 Tax Reform Act*, 1977 S. ILL. U. L. J. 393, 416.

86. It is difficult to imagine the city dweller making an almost daily trip down to the farm, no matter how much he or she may appreciate the value of tax planning.

87. Much of the complexity of Section 2032A seems to be a direct result of insuring that it does not become an easy tax shelter for the wealthy city dweller. For an explanation of the purposes of Section 2032A, *see* text accompanying note 8 *supra*.

The fact that farming is often a seasonal activity is recognized by the provision in the regulations that the material participation requirement is met despite the fact that little or no activity occurs during nonproducing months.[88] The regulations also provide that "the activities of each participant are viewed separately . . . , and at any given time, the activities of at least one [individual] must be material."[89]

While participation must be active to meet the material participation requirement, it need not be direct in form, such as actually driving a tractor or plowing a field, but may consist of indirect "management" activities. If the decedent, family member or qualified heir performed these indirect activities, less than full-time participation, to qualify as material, must have been undertaken pursuant to an oral or written arrangement "formalized in some manner capable of proof."[90] While the regulations do not so require, it would seem desirable, for evidentiary purposes, that such agreement be in writing. Therefore, in cases where participation is on less than a full-time basis, the farmer and his attorney should anticipate an IRS challenge in a close case, and prepare the documents necessary to prove the material participation requirement.

It should be noted that unless there is a family relationship between the taxpayer and his farm employee, activities of such employee will not be attributed to the employer in making the factual determination as to whether there has been material participation.[91]

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88. 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[e][i]) provides that "[m]aterial participation is present as long as all necessary functions are performed even though little or no actual activity occurs during nonproducing seasons."

89. *Id.*

90. *Id.* The regulation continues, in pertinent part:

> If the involvement is less than full-time, it must be pursuant to an arrangement providing for actual participation in the production or management of production where the land is used by any nonfamily member, or any trust or business entity, in farming or another business. The arrangement may be oral or written, but must be formalized in some manner capable of proof. Activities not contemplated by the arrangement will not support a finding of material participation under section 2032A. . . .

91. *Id.* The regulation provides in pertinent part that

> activities of any agent or employee other than a family member may not be considered in determining the presence of material participation. Activities of family members are considered only if the family relationship existed at the time the activities occurred.

B) Factors to be Considered

If a full-time manager is employed, the qualified heir or family member must personally advise or consult with the managing party regarding the operation of the business on a regular basis in order to meet the minimum requirements contemplated by the regulations.[92] Physical work is also an important factor to be considered in determining whether indirect (managerial) participation constitutes material participation, for example, the number of management decisions in which the decedent or a family member participated; a substantial number is required.[93] The regulations indicate the production activities must regularly be inspected, that "funds should be advanced and financial responsibility assumed for a substantial portion of the [farming] expense[s]" and that the furnishing of machinery or livestock will be important factors in the determination of material participation.[94]

Finally, IRS will consider as yet another factor whether or not the decedent or family member lives on the farm.[95] If the decedent occupies the farmhouse, it will be "considered to be occupied for the purpose of operating the farm, even though a family member [not the decedent] was the person materially participating in the operation of the farm. . . ."[96]

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92. 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[e][2]) provides in pertinent part that

> [n]o 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.

93. *Id.* at 50,740-41 (1981) (to be codified in 26 C.F.R. § 20.2032A[e][2]). The regulation provides in pertinent part that, "[w]hile they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions."

94. *Id.*

95. *Id.* at 50,741 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[e][2]). The regulation provides in pertinent part that,

> [w]ith farms, hotels, or apartment buildings, the operation of which qualifies as a trade or business, the participating decedent or heir's maintaining his or her principal place of residence on the premises is a factor to consider in determining whether the overall participation is material.

96. 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[b][2]). *See also* 26 U.S.C. § 2032A(e)(3) (1976). For complete text, *see* note 19 *supra*.

C) *Time Requirements*

(1) Directly Held Farmland

The decedent or a member of his family must have materially participated in the farm's operation for at least five years during the eight-year period preceding the decedent's death,[97] and the family or qualifying heir must continue such material participation for at least five years during "*any* eight year period ending" *up to fifteen years* after the decedent's death.[98] These conditions precedent and subsequent are conjunctive; both must be met to fulfill the material participation requirement. If, for example, the decedent leased his farm to a stranger and did not materially participate in the farm operation, and died two years later after executing the lease, a qualified heir must commence material participation in the operation of the farm within one year or the recapture tax will be triggered.[99] Thus when a farmer retires, he should be advised of

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97. 45 Fed. Reg. 50,740 (1981) (to be codified in C.F.R. § 20.2032A-3[c][1]).

98. *Id.* (to be codified in 26 C.F.R. § 20.2032A-3[c][2]). *See also* text following note 53 *supra*.

99. One attorney explained:

> As to material participation, the heirs are held to a continuing 5-of-8 year test, which may include periods prior to decedent's date of death. Therefore, if for an aggregate of more than three years during any eight year period there is no participation by any of the parties (decedent, family members or heirs), special valuation will terminate by Section 2032A(c)(7).

Wiegratz, *Special Valuation of Real Estate: Opportunities and Pitfalls*, 118 TRUSTS & ESTATES (No. 11) 38, 39 (1979). One professor commented:

> Participation is both a condition precedent to a section 2032A election and a condition subsequent which, if not fulfilled, will result in estate tax recapture. The *condition precedent* requires participation (as defined above) for at least five out of the eight years preceding the decedent's death. The *condition subsequent* fails (so that estate tax recapture results) if the land is sold to a nonfamily member within fifteen years after the decedent's death, or if in any eight-year period ending after the decedent's death (and before the expiration of fifteen years from such date or before the death of a qualified heir), there are periods aggregating three or more years during which the land is not operated by the decedent or a member of her family as a farm or ranch.

Hjorth, *Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class*, 53 WASH. L. REV. 609, 629 (1978) (footnotes omitted). *See also* Comment, *An Analysis of the "Actual Use" Valuation Procedure of Section 2032A*, 56 NEB. L. REV. 860, 864 (1977), where the author writes:

> For example, suppose for the two year period immediately before the decedent's death there was no material participation by the decedent. The property may still have qualified for special use valuation if the five-out-of-eight-years test was met. But, in this case, the recapture rules will apply if there is no material participation by the qualified heir for a period of only one year during the six years (eight less two) ending after the decedent's death. The two year nonparticipation by the decedent tacked onto the one year nonparticipation by the qualified heir adds up to three years

the tax consequences of leasing his property on a long-term basis that would preclude his material participation.

Problems may also arise in this context since the period of time that the farm is held by the estate is not excepted from the material participation requirements. Where there are no substantial problems among the beneficiaries of the estate, a qualified heir could continue the operation of the farm in order to meet the material participation requirements. But where settlement of the decedent's affairs does not follow as a matter of course, uncooperative heirs might frustrate the application of Section 2032A.[100] The executor who anticipates such difficulties should advise the estate beneficiaries of the potential costs of losing the Section 2032A election.

While the activities of each participant are viewed separately, and while at any given time the activities of at least one individual must be material, the regulations also provide that "contemporaneous material participation by 2 or more family members during a [one year] period . . . will not result in that year being counted as 2 or more years" for the purpose of meeting the material participation requirement.[101] A contrary rule would substantially frustrate the purpose behind the holding period requirements.[102]

Fortunately the regulations do not require that the decedent or other material participant be chained to the farm simply in order to meet the material participation requirement. For example, brief periods of thirty days or less, in which material participation is lacking, will be disregarded for the purpose of meeting the material participation requirements, as long as these periods are both preceded and followed by substantial periods of material participation. The regulations suggest that the IRS will view as "substantial" a period of at least 120 days.[103] Thus, if the tax-burdened family farmer takes a vacation or becomes ill, and a family member does not step into his shoes, he will not forfeit the benefits of Section 2032A. This exception to the material participation requirement, together with the Treasury's recognition that full-time management may be unnecessary during nongrowing seasons, sub-

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of nonparticipation during an eight year period ending after the decedent's death.

100. For an explanation of another way that heirs might frustrate a Section 2032A election, *see* text accompanying and following note 78 *supra*.

101. 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[c][2]).

102. *See* note 73 *supra*.

103. 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[c]).

stantially attenuates what might otherwise have been a serious impediment to a Section 2032A election. These rules suggest an initial willingness on the part of the IRS to apply Section 2032A in a reasonable manner.

In the case of a qualified heir, the material participation requirement ends at his death, with the result that any property valued at actual use would again pass through a decedent's estate to be valued under either the traditional method or the actual use provisions of Section 2032A.[104] If the decedent's interest was in the form of a life estate, however, the material participation requirement continues for remaindermen until the death of the last qualified heir, or until the fifteen-year period for the imposition of the additional estate tax has passed, whichever occurs earlier.[105]

As we have seen, real property held by the decedent for a total of five years during the eight-year period immediately preceding the decedent's death will qualify for valuation under Section 2032A, assuming the other requirements of the statute are met.[106] The regulations provide, however, that property "acquired in [a] like-kind exchange under [26 U.S.C. §] 1031" will be treated, for the purposes of Section 2032A, as having been owned by the decedent "only from the date on which the replacement property [was] actually acquired."[107] Thus the farmer contemplating a like-kind exchange should be advised that there will be potential adverse tax consequences if he dies within five years of the exchange. Death within that time would prevent satisfaction of the conditions, precedent and subsequent, of material participation.[108]

An exception to the above five-year requirement is made if replacement property is acquired after an involuntary conversion. Such replacement property will be treated as owned from the same date at which the involuntarily converted property was owned.[109]

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104. *Id.* The material participation requirement ends only as to the individual qualified heir's interest, "if the heir received a separate, joint or other undivided property interest from the decedent." *Id.*

105. *Id. See* note 63 *supra*, explaining the possible consequences of these provisions in Louisiana. *See also* LA. CIV. CODE ANN. art. 1520 (West Supp. 1980).

106. *See* text accompanying notes 11 & 98 *supra.*

107. 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-[3][d]).

108. *See* text accompanying notes 98 & 99 *supra.*

109. 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-[3][d]). The conversion must have occurred "after the date of decedent's death . . . ," *id.*, and the involuntary conversion must be such as to meet the requirements of 26 U.S.C. § 2032A(h) (1976), discussed in text accompanying note 54 *supra.*

The statute provides an exemption from the material participation requirements for the period between the involuntary conversion and the acquisition of replacement property.[110] As a practical matter, the farmer has at least two years from the year in which any gain on the involuntary conversion is realized to obtain the replacement property.[111] The farmer should, however, be wary of the possible impact of waiting too long to reinvest; such reinvestment, coupled with a year or more of nonparticipation during which the involuntarily converted property was owned, could result in the assessment of a recapture tax. Thus, the farmer and his attorney should be aware that it is possible to meet the holding requirements yet fail to satisfy the material participation requirements.

(2) Indirectly Held Farmland

Property is also treated as continuously owned for the purpose of the holding period requirements if it is held by a corporation or has been transferred to a closely held corporation or partnership in an exchange pursuant to Sections 351 or 721.[112] Thus, periods of direct ownership may be combined with periods during which the property was indirectly held by a closely held business in order to

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110. 26 U.S.C. § 2032A(h)(2) (1976) provides that, for purposes of the qualified use requirement (material participation), "paragraph (7) of subsection (c) shall be applied—(i) by not taking into account periods after the involuntary conversion and before the acquisition of the qualified replacement property. . . ." *Id.* Such a rule seems to be necessary as it will further the intent that a farmer not be penalized by a taking that he may not approve of, but indeed may have opposed strongly.

111. 26 U.S.C. § 1033(a)(2)(B) (1976) provides in pertinent part:

> The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—
>
> (i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized, or
>
> (ii) subject to such terms and conditions as may by specified by the Secretary, at the close of such later date as the Secretary may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary may by regulations prescribe.

112. 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-[3][d]). *See* note 65 *supra* and accompanying text.

Farmland held in trust is likewise treated as continuously owned to the extent of the decedent's equity interest therein, so long as the trust, if it were a corporation, partnership or proprietorship, would qualify as closely held. Any period during which the trust would not be considered to be closely held cannot be counted in determining whether or not the holding period requirements have been met. *Id.*

meet the holding period requirements.[113] Further, the business must be closely held both at the date of decedent's death and for any period that is used in calculating the holding period. Property transferred to a closely held business will be treated under Section 2032A as owned by the decedent to the extent of his or her equity interest therein.[114]

Concerning property owned indirectly, the regulations also require an arrangement calling for material participation which specifies the services to be performed by the prospective decedent or other participant;[115] it is submitted that such arrangements may be made in the form of an employment contract. As in the case of farmland owned directly by an individual who is not involved in full-time operation or management, it is preferable, though not required, that this arrangement be reduced to writing.[116] A carefully drafted employment contract between the decedent or other participant and the partnership, corporation or trust may later prove invaluable should the IRS choose to challenge the Section 2032A election for lack of material participation. The regulations indicate that the necessary arrangement may in some cases be shown by the fact that the decedent or other participant holds a position "in which certain material functions are inherent."[117] Nevertheless, reliance on a written employment contract appears a more certain procedure to follow.

In the case of a trust, the regulations indicate four situations in which the required arrangement will generally be found:[118] First,

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113. *Id.* The regulation provides in pertinent part:

> Property transferred from a proprietorship to a corporation or a partnership during the 8-year period ending on the date of the decedent's death *is considered to be continuously owned* to the extent of the decedent's equity interest in the corporation or partnership if, (1) the transfer meets the requirements of section 351 or 721, respectively. . . .

Emphasis added.

114. *Id.*

115. 45 Fed. Reg. 50,741 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[f][1]) provides in pertinent part:

> With indirectly owned property as with property that is directly owned, there must be an arrangement calling for material participation in the business by the decedent owner or a family member. Where the real property is indirectly owned, however, even full-time involvement must be pursuant to an arrangement between the entity and the decedent or family member specifying the services to be performed.

116. *See* text following note 90 *supra*.

117. 45 Fed. Reg. 50,741 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[f][1]).

118. *Id.* The regulation provides in pertinent part:

> First, the arrangement may result from appointment as a trustee. Second, the

when a trust is the holder of legal title, and the decedent or participant is named as trustee; second, when the trust owns a closely held corporation which employs the decedent or participant in a position that requires material participation; third, when the decedent or participant is employed by the trustees to manage or take part in managing the farmland; fourth, where the trust agreement accords to "the beneficial owner" (the decedent or material participant) management rights that would constitute material participation.[119] Here again, the IRS has evidenced that it will not unduly limit the application of Section 2032A to make estate planning for farmers an inflexible affair.

The regulations specify that the participation standards applicable to direct holdings apply as well in meeting the material participation requirements when the property is held indirectly.[120] As mentioned earlier, the payment of self-employment taxes is an important factor in determining whether a farmer who directly owns his farmland will be considered to have met the material participation requirements; failure to pay such taxes results in the presumption of a lack of material participation.[121] However, when the farmland is indirectly owned, the decedent or other participant will not be subject to self-employment taxes if he is an employee of the corporation, partnership or trust that owns the farm. The regulations indicate that, under these circumstances, employees are to be treated as if they were self-employed, and their activities must be such as to subject them to self-employment taxes if it were not for the fact of indirect ownership.[122]

Employees who do not participate in management decisions of

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arrangement may result from an employer-employee relationship in which the participant is employed by a qualified closely held business owned by the trust in a position requiring his or her material participation in its activities. Third, the participants may enter into a contract with the trustees to manage, or take part in managing, the real property for the trust. Fourth, where the trust agreement expressly grants the management rights to the beneficial owner, that grant is sufficient to constitute the arrangement required under this section.

119. *Id.*

120. 45 Fed. Reg. 50,741 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[f][2]).

121. *See* text accompanying note 84 *supra*.

122. 45 Fed. Reg. 50,741 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[f][2]) provides in pertinent part:

> In the case of a corporation, a partnership, or a trust where the participating decedent and/or family members are employees and thereby not subject to self-employment income taxes, they are to be viewed as if they were self-employed, and their activities must be activities that would subject them to self-employment income taxes were they so.

the corporation, partnership or trust generally will not be treated as fulfilling the material participation requirements.[123] Holding a management position in name only, or simply being a partner and sharing in the profits and losses, will not alone support a finding of material participation. Nor will a partner's payment of self-employment taxes, by itself, satisfy the material participation requirement. In states in which the directors of a corporation are allowed to act informally, or need not be active at all, board membership is a factor to be considered in determining, but alone will not suffice to establish, material participation. Where the board is required to be active, membership thereon will, presumably, go farther toward showing the required material participation.[124]

Where property is held by the estate, the IRS will apply the rules applicable to trusts in determining material participation. Thus trusteeship, employment and contractual or managerial relationships established by the estate may give rise to a finding of material participation on the part of a qualified heir before the property is distributed. In this respect, the regulations reduce the potential for the assessment of additional estate tax (recapture).[125] The regulations provide helpful illustrations of the material participation requirements.[126]

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123. *Id.* The regulation provides in pertinent part that "[w]here property is owned by a corporation, a partnership or a trust, participation in the management and operation of the real property itself as a component of the closely held business is the *determinative* factor." (emphasis added). It is also important to note that, as earlier stated, the regulations held that "participation in management decisions [is a] principal factor . . ." and that "[a]s 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." 45 Fed. Reg. 50,740 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[e][2]). *See* note 92 *supra.*

124. 45 Fed. Reg. 50,741 (1981) (to be codified in 26 C.F.R. § 20. 2032A-3[f][2]) provides in pertinent part:

> Nominally holding positions as a corporate officer or director and receiving a salary therefrom or merely being listed as a partner and sharing in profits and losses will not alone support a finding of material participation. This is so even though, as partners, the participants pay self-employment income taxes on their distributive shares of partnership earnings under § 1.1402(a)-2. Further, it is especially true for corporate directors in states where the board of directors need not be an actively functioning entity or need only act informally. Corporate offices held by an owner are, however, factors to be considered with all other relevant facts in judging the degree of participation.

125. *Id.*

126. 45 Fed. Reg. 50,741-42 (1981) (to be codified in 26 C.F.R. § 20.2032A-3[g]).

Valuation Methods

The regulations expand upon the elements of the statutory valuation formulas. The reader will recall that when comparable farmland is available, the executor has a choice under the statute between two valuation methods. Under the farm method, valuation is determined by using the following formula: average annual gross cash rental, less the average annual state and local real estate taxes per acre, divided by the five year average of annual effective interest rates charged on new Federal Land Bank loans.[127] As mentioned earlier, this formula will ordinarily result in an estate valuation that goes beyond the express statutory purpose of eliminating speculative factors in farmland valuation.[128]

This formula has also been criticized as lacking in economic reality; the statute's reliance on gross cash rentals may, in many parts of the country, limit the executor to the multiple factor

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127. This formula is found at 26 U.S.C. § 2032A(e)(7) (1976) (*see* text accompanying notes 31 & 32 *supra*.). That regulation provides a formula by which the interest rate on the Federal Land Bank Loans may be determined. The regulations provide that:

> The annual effective interest rate on new Federal land bank loans is the average billing rate charged on new agricultural loans to farmers and ranchers in the farm credit district in which the real property to be valued under section 2032A is located, adjusted as provided in paragraph (e)(2) of this section. This rate is to be a single rate for each district covering the period of one calendar year and is to be computed to the nearest one-hundredth of one percent. In the event that the district billing rates of interest on such new agricultural loans change during a year, the rate for that year is to be weighted to reflect the portion of the year during which each such rate was charged. If a district's billing rate on such new agricultural loans varies according to the amount of the loan, the rate applicable to a loan in an amount resulting from dividing the total dollar amount of such loans closed during the year by the total number of the loans closed is to be used under section 2032A. Applicable rates may be obtained from the district director of internal revenue.
>
> The billing rate of interest determined under this paragraph is to be adjusted to reflect the increased cost of borrowing resulting from the required purchase of land bank association stock. For section 2032A purposes, the rate of required stock investment is the average of the percentages of the face amount of new agricultural loans to farmers and ranchers required to be invested in such stock by the applicable district bank during the year. If this percentage changes during a year, the average is to be adjusted to reflect the period when each percentage requirement was effective. The percentage is viewed as a reduction in the loan proceeds actually received from the amount upon which interest is charged.

45 Fed. Reg. 50,743 (1981) (to be codified in 26 C.F.R. § 20.2032A-4[e][1] & [2]).

It should be noted that the practitioner generally need not concern himself with the complexities of figuring out this interest rate, since the IRS District Director will provide this information upon request.

As far as estate planning goes, the practitioner, as an alternative, may consult the Revenue Rulings which are published yearly by the IRS. *See* notes 33 & 34 *supra*.

128. *See* note 30 *supra*.

method where the typical lease arrangement involves cropsharing.[129] The recent phenomenon of skyrocketing interest rates may further distort the formula's relationship to economic reality, since higher interest rates will produce a substantial reduction in the value of acreage valued under the farm method formula.[130]

It should be noted that, if the farm method of valuation is unavailable, the farmer is limited to using the second method of valuation (the multiple factor method).[131] Though the regulations, in certain instances, apply to both valuation methods, for present purposes the discussion will center on the farm method.

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129. Comment, *An Analysis of the "Actual Use" Valuation Procedure of Section 2032A*, 56 NEB. L. REV. 860, 869 (1977), in which the author explains:

> Although the advantages set forth by Congress are meritorious, the special "farm method" of valuation is not without its problems. Section 2032A(e)(7) only allows capitalization of comparable gross cash rental farmland. Ranchland lends itself to such a valuation approach, but farmland is often leased on a crop share basis rather than for cash rent. Therefore, personal representatives may have a hard time establishing comparable cash rental of farmland in the area.

130. For example, assume a farm has an average annual gross cash rental value of $150. In addition, assume state and local average annual real estate taxes are $10. If the average Federal Land Bank Loan interest rates for the last five years is eight percent, the value per acre will be $1,750. Now, with the annual gross cash rental and state and local taxes remaining constant, if the average Federal Land Bank Loans interest rate rises to ten percent, the resulting value per acre will be $1,400, or a reduction of $350 per acre will result.

$$\frac{150\text{-}10}{.08} - \frac{150\text{-}10}{.10} = \$350$$

Since the money loaned by the Federal Land Bank comes from the sale of government guaranteed bonds sold in the public market, interest on those bonds will continue to reflect upward price pressure, and the rate on Federal Land Bank loans will likewise increase. Although the five year averaging requirement lessens the beneficial impact of Section 2032A valuation, *persistently* high interest rates will undoubtedly reduce the farm's value below that which it deserves to be under the actual use formulation. The high rates could conceivably force Congress to take a second look at the farm method of valuation.

131. The multiple factor method is defined in 26 U.S.C. § 2032A(e)(8) (Supp. II 1978). *See* note 41 *supra*.

The multiple factor method includes four factors:

(1) the capitalization of income produced by the decedent's farm,
(2) the capitalization of the fair rental value of the land,
(3) the value of the land after applying a state use assessment law, and
(4) the value of comparables.

There is also a fifth factor which serves as a catchall.

See text accompanying note 41 *supra*.

The multiple factor method is used when there are no comparables capable of use under the farm method. 26 U.S.C. § 2032A(e)(7)(B)(i) (Supp. II 1978) provides that "where it is established that there is no comparable land from which the average gross cash rental may be determined . . ." then the farm method formula (*id.* § (e)(7)(A)) shall not be used. *See* notes 37 & 38 *supra* and accompanying text.

The new regulations define "gross cash rental" as the amount of money received for the use of land on a yearly basis.[132] The land used as a measure must be comparable to that proposed to be valued under Section 2032A, and the cash rental amount may not be reduced by expenses or liabilities incurred under the lease or in the operation of the farm.[133] Where the decedent's farmland includes buildings, the comparables must do so as well, and, in such instances, the building rental may form part of the gross cash rental figure.[134] If the comparable's rental agreement specifies the amount of rent attributable to movables or personalty such as tractors and combines, this amount is not included in the figure attributable to that comparable's rent. However, if the comparable's rental agreement does *not* specify the amount of rent attributable to such personalty, no adjustment is made in the comparable's rental figure. Thus, the executor will desire to discover comparables of which the lease arrangement specifies the amount of rental payment attributable to the land and buildings only, so as to avoid the inclusion of rent for personalty in the gross cash rental figure.[135] This practice will avoid false overstatement of the value of the qualified property. Of course, under the farm method of valuation, the lower the gross cash rental figure, the lower the value of the qualified real property.

The IRS arguably overstepped its authority in denying a deduction from the rental price for items, other than personalty, to which part of the rent is not specifically attributable. The statute purports to make no such prohibition; and one might indeed argue that such a reduction would seem to be indicated by its

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132. 45 Fed. Reg. 50,742 (1981) (to be codified in 26 C.F.R. § 2032A-[4][b][1]) which provides in pertinent part:

> Gross cash rental is the total amount of cash received for the use of actual tracts of comparable farm real property in the same locality as the property being specially valued during the period of one calendar year. This amount is not diminished by the amount of any expenses or liabilities associated with the farm operation or the lease.

133. *Id.*

134. 45 Fed. Reg. 50,743 (1981) (to be codified in 26 C.F.R. § 20.2032A-[4][d]).

135. *Id.* (to be codified in 26 C.F.R. § 20.2032A-[4][b][2][v]) provides:

> No adjustment to the rents actually received by the lessor is made for the use of any farm equipment or other personal property the use of which is included under a lease for comparable real property unless the lease specifies the amount of the total rental attributable to the personal property and that amount is reasonable under the circumstances.

The executor may be hard pressed to find comparables whose rental agreement specifies the amount of rent attributable to personalty. Typically, however, the farm lessee uses his own equipment, so the problem should not often be present.

language.[136]

The regulations prohibit the use of a comparable of farmland the rent of which is contingent upon farm production.[137] This may altogether deny the use of farm method valuation in areas—such as the midwest grain belt[138]—where cropsharing arrangements predominate.[139]

The IRS intends to eliminate comparables from consideration where the lessor of the comparable, or a member of his family, is involved, or contemplates involvement, in the management or operation of the leased farm to an extent that could be deemed to involve material participation under the standards of Section 2032A.[140] The IRS takes the position that the rentals from such arrangements do not reflect the actual cash rental value of the farmland. The regulations do not allow actual use valued farmland to be used as a comparable; thus, should Section 2032A prove popular, the Treasury's position will further reduce the availability of comparables.[141]

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136. 26 U.S.C. § 2032A(e)(7)(A)(i) (1976) requires the use of gross cash rental for comparable "land." In the instances where personalty is not eliminated from the rental price, the result is not a true land rental figure. As mentioned in the previous note, though, this problem should prove to be rare.

137. 45 Fed. Reg. 50,742 (1981) (to be codified in 26 C.F.R. § 20.2032A-[4][b][2][iii]) provides in part that "[r]ents which are paid wholly or partly in kind [*e.g.*, crop shares] may not be used to determine the value of real property under section 2032A(e)(7) [the farm method, *see* note 31 *supra*]." It is to be further noted that 45 Fed. Reg. 50,742 (1981) (to be codified in 26 C.F.R. § 20.2032A-4[b][1]) provides in pertinent part that "[o]nly rentals from tracts of comparable farm property which are rented solely for an amount of cash which is not contingent upon production are acceptable for use in valuing real property under section 2032A(e)(7) [the farm method, *see* note 30 *supra*]."

In some areas of the United States, a farmer's rent for his land consists of payment in the form of both cash and a percentage of the crop that is produced in a particular season; a typical crop sharing arrangement results.

138. J. McCord, 1976 Estate and Gift Tax Reform 333 (1977).

139. For a discussion of the effect of a failure to use the farm method, *see* notes 131, 37, 38 & 41 *supra* and acompanying text.

140. 45 Fed. Reg. 50,742 (1981) (to be codified in 26 C.F.R. § 20.2032A-4[b][1]) provides in pertinent part:

> Additionally, rentals received under leases which provide for payment solely in cash are not acceptable as accurate measures of cash rental value if involvement by the lessor (or a member of the lessor's family who is other than a lessee) in the management or operation of the farm to an extent which amounts to material participation under the rules of section 2032A is contemplated or actually occurs.

141. *Id.* The regulation provides in pertinent part that

> rentals for any property which qualifies for special use valuation cannot be used to compute gross cash rentals under this section because the total amount received by the lessor does not reflect the true cash rental value of the real property.

However, due to the great complexity, expense, uncertainty and limitations of a Section

The regulations are silent on the problem that may arise when the executor chooses comparables of which the rental values were determined under a long-term gross cash rental lease, such that the current rent is disproportionately low. As with any other valuation problem, the executor runs the risk of conflict with the IRS if his comparables do not reflect true cash rental. An executor clearly should not rely on questionable comparables when making the initial election decision, since a later audit and disqualification under the farm method may wreak havoc on the estate plan, resulting in added expenses and interest penalties.

The regulations require that the rental arrangement on comparable property be the result of an arm's-length transaction.[142] Thus, leases entered into with federal, state or local governmental entities are questionable under the regulations if the rents demanded do not reflect the fair rental value.[143] Problems may also arise in this context when the lease arrangement is between family members. In such instances, an executor might be well advised to avoid relying on such comparables if possible, unless he can prove that the "return of the property [is] commensurate with that received under leases between unrelated parties in the locality. . . ."[144]

If, in light of these considerations, the executor elects the farm method of valuation, he must identify for the IRS the comparables used.[145] Although neither the January 1979 revision of Form 706, the estate tax return, nor the accompanying instruction manual specifically request that the comparables be listed, the executor would be well advised to provide this information under line 11, page 2 of Form 706, for failure to do so will result in mandatory

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2032A election, this author would not expect farmers to "beat a path" to estate planners' doors to plan their estates with actual use valuation in mind.

142. 45 Fed. Reg. 50,742 (1981) (to be codified in 26 C.F.R. § 20.2032A-4[b][1] & [b][2][ii]).

143. *Id.* (to be codified in 26 C.F.R. § 20.2032A-4[b][2][ii]) provides in pertinent part:

> For these purposes, lands leased from the Federal government, or any state or local government, which are leased for less than the amount that would be demanded by a private individual leasing for profit are not leased in an arm's-length transaction.

144. *Id.*

145. *Id.* (to be codified in 26 C.F.R. § 20.2032A-4[b][2][i]) which provides in pertinent part:

> The executor must identify to the Internal Revenue Service actual comparable property for all specially valued property and cash rentals from that property if the decedent's real property is valued under section 2032A(e)(7) [the farm method].

For full text, *see* notes 31, 37 & 38 *supra*.

use of the multiple factor method.[146]

The statute contemplates the use of gross cash rentals, but the regulations indicate that the IRS will require the use of *actual* gross cash rentals in the farm method valuation formula. Thus the regulations state that area-wide averages compiled by the Department of Agriculture will not suffice; in the view of IRS, these averages do not represent a true measure of comparable gross cash rental farmland.[147]

Under the statute, both the Federal Land Bank loan interest rate and the gross cash rental figures must be an average over the five calendar years preceding the year of the decedent's death.[148] This requirement would prove difficult to meet in many cases if it were interpreted to mean that the gross cash rental figures in question must be obtained for the same farm. Happily, the IRS requires only that there be an actual tract of land meeting the comparable requirements for *each* of the five years.[149]

The farm method requires that the gross cash rental figure, arrived at by the five-year averaging of comparables, be reduced by the state and local real estate taxes, *i.e.*, those real estate taxes that are deductible under Section 164(a) of the Internal Revenue Code.[150] "However, only those taxes on the comparable real prop-

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146. *Id.* The regulation continues:

> If the executor does not identify such property and cash rentals, all specially valued real property must be valued under the rules of section 2032A(e)(8) if special use valuation has been elected. *See,* however, § 20.2032A-8(d) for a special rule for estates electing section 2032A treatment on or before August 30, 1980.

For a discussion of other causes of resort to the multiple factor method, *see* notes 138, 131, 37, 38 & 41 *supra* and accompanying text.

147. *Id.* (to be codified in 26 C.F.R. § 20.2032A-4[b][2][iii]) provides in pertinent part that

> appraisals or other statements regarding rental value as well as area-wide averages of rentals (*i.e.*, those compiled by the United States Department of Agriculture) may not be used under section 2032A(e)(7) because they are not true measures of the actual cash rental value of comparable property in the same locality as the specially valued property.

148. 26 U.S.C. § 2032A(e)(7)(A) (1976). For full text, *see* note 31 *supra.*

149. 45 Fed. Reg. 50,742-43 (1981) (to be codified in 26 C.F.R. § 20.2032A-4[b][2][iv]) provides in pertinent part:

> Comparable real property rented solely for cash must be identified for each of the five calendar years preceding the year of the decedent's death if section 2032A(e)(7) [the farm method; for full text, *see* notes 31, 37 & 38 *supra*] is used to value the decedent's real property. Rentals from the same tract of comparable property need not be used for each of these 5 years, however, provided an actual tract of property meeting the requirements of this section is identified for each year.

150. 45 Fed. Reg. 50,743 (1981) (to be codified in 26 C.F.R. § 20.2032A-4[c]) provides

erty from which cash rentals are determined may be used in the formula valuation."[151] A problem may arise in areas where the state or local government imposes on property what is termed a "service charge," which is not characterized, under state law, as a real estate tax. There may also be some question about the deductibility of taxes levied by special tax districts, such as special drainage districts and road districts, which collect taxes for particular purposes. The IRS should be expected to challenge the deduction of charges made by such districts and similar quasi-governmental entities where the assessment is made, for example, on the basis of frontage feet (road districts) or water use (sewerage districts) rather than acreage, as is the case with most real estate taxes levied on farm property. It is asserted that the charge based on total acreage presents a closer question. Ultimately, the IRS will determine whether, under Section 164(a)(1), such charges are real estate taxes and hence deductible from the gross cash rental. Answers to these questions, however, may have to await litigation, for the regulations have not fully resolved such problems in the valuation of decedent's estate through the use of comparables.

The regulations establish requirements property must meet in order to qualify as a comparable. Primarily, the "real property must be situated in the same locality as the [actual use] valued property."[152] While political divisions and mileage are important factors, the situation "is to be judged according to generally accepted real property valuation rules."[153] Thus, even if the compa-

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in pertinent part that "[f]or purposes of the farm valuation formula under section 2032A(e)(7) state and local taxes are taxes which are assessed by a state or local government and which are allowable deductions under section 164." *Id.*

26 U.S.C. § 164(a) (Supp. II 1978) provides:

> Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
>
> (1) *State and local, and foreign, real property taxes.*
>
> (2) State and local personal property taxes.
>
> (3) State and local, and foreign, income, war profits, and excess profits taxes.
>
> (4) State and local general sales taxes.
>
> In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income).

Emphasis added.

151. 45 Fed. Reg. 50,743 (1981) (to be codified in 26 C.F.R. § 20.2032A-4[c]).

152. 45 Fed. Reg. 50,743 (1981) (to be codified in 26 C.F.R. § 20.2032A-4[d]).

153. *Id.* The regulation further provides in pertinent part that the locality "requirement is not to be viewed in terms of mileage or political divisions alone. . . . The determination of properties which are comparable is a factual one and must be based on numerous

rable land is far removed from the place where the actual use valued farmland is located, the IRS will accept it as meeting the locality requirement.

The regulations list ten factors in establishing the acceptability of comparables:

> Similarity of soil as determined by any objective means, including an official soil survey reflected in a soil productivity index; . . .
>
> [w]hether the crops grown are such as would deplete the soil in a similar manner; . . .
>
> [t]he types of soil conservation techniques that have been practiced on the two properties; . . .
>
> [w]hether the two properties are subject to flooding; . . .
>
> [t]he slope of the land; . . .
>
> [i]n the case of livestock operations, the carrying capacity of the land; . . .
>
> [w]here the land is timbered, whether the timber is comparable to that on the subject property; . . .
>
> [w]hether the property as a whole is unified or whether it is segmented, and where segmented, the availability of the means necessary for movement among the different segments; . . .
>
> [t]he number, types, and conditions of all buildings and other fixed improvements located on the properties and their location as it affects efficient management and use of property and value per se; and . . .
>
> [a]vailability of, and type of, transportation facilities in terms of costs and of proximity of the properties to local markets.[154]

Often farmland owned by a decedent will be devoted to several different uses. For example, part of the land may be devoted to row crop farming while another area, perhaps because it is hilly or otherwise unsuitable for row crops, may be devoted to grazing cattle. In such instances, the regulations require that each segment of the decedent's land, as well as the comparable's land, be separately valued, and that "any premium or discount resulting from [such] multiple uses . . . [be] reflected" in the appraisal.[155]

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factors, no one of which is determinative."

154. *Id.*

155. *Id.* provides in pertinent part:

> It will, therefore, frequently be necessary to value farm property in segments where there are different uses or land characteristics included in the specially valued farm. For example, if section 2032A(e)(7) is used, rented property on which comparable buildings or improvements are located must be identified for specially valued property on which buildings or other real property improvements are located. In cases involving multiple areas or land characteristics, actual comparable property for

The regulations remove much of the uncertainty previously surrounding the valuation of comparables in the context of a Section 2032A election. They, in fact, go far toward ensuring that such values reflect true market value, even in light of the problems explained above. The regulations further outline the procedures necessary to a Section 2032A election.

Election Requirements of Section 2032A

An election to have farmland valued under Section 2032A is made by following the instructions on line 11, page 2 of the Form 706.[156] Such an election is irrevocable unless it was made on or

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each segment must be used, and the rentals and taxes from all such properties combined (using generally accepted real property valuation rules) for use in the valuation formula given in this section.

156. Line 11, page 2, of form 706 provides:

Do you elect the special valuation explained in instruction 13?

If "Yes," attach to this return a statement that includes the following information:

(i) The relevant qualified use;

(ii) The items of real property shown on the estate tax return to be specially valued pursuant to the election (identified by schedule and item number);

(iii) The fair market value of real property to be specially valued under section 2032A and its value based on its qualified use (both values determined without regard to the adjustments provided by section 2032A(b)(3)(B));

(iv) The adjusted value (as defined in section 2032A(b)(3)(B)) of all real property which is used in a qualified use and which passes from the decedent to a qualified heir;

(v) The items of personal property shown on the estate tax return that pass from the decedent to a qualified heir and are used in a qualified use under section 2032A (identified by schedule and item number) and the total value of such personal property adjusted as provided under section 2032A(b)(3)(B);

(vi) The adjusted value of the gross estate, as defined in section 2032A(b)(3)(A);

(vii) The method used in determining the special value based on use;

(viii) Copies of written appraisals;

(ix) The date on which the decedent (or a member of his or her family who held the property before the decedent) acquired the property and on which he or she or a member of his or her family commenced the qualified use (if different from the date of acquisition);

(x) Any periods following commencement of the qualified use during which the decedent or a member of his or her family did not own the property, use it in a qualified use, or materially participate in the operation of the farm or other business within the meaning of section 2032A(e)(6); and

(xi) The name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each such person based on both fair market value and qualified use.

before August 30, 1980.[157]

The regulations provide that an election need not extend to "all real property included in [the decedent's] estate. . . ."[158] However, enough real property must be specially valued so as to meet the fifty and twenty-five percent tests[159] required under 26 U.S.C. § 2032A(b)(1)[B] (1976). Executors must be particularly careful in making a partial election to be sure that a later audit will not disqualify the Section 2032A election.

A partial election may also be made with respect to an individual's interest in a joint interest or tenancy in common; here, too, the fifty and twenty-five percent requirements must be met.[160] When successive interests are involved

> an election under section 2032A is available only with respect to that property (or portion thereof) in which qualified heirs of the decedent receive all of the successive interests, and such an election must include the interests of all of those heirs. For example, if a surviving spouse receives a life estate in otherwise qualified property and the spouse's brother receives a remainder interest in fee, no part

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> Also attach to this return an agreement to express consent to personal liability under section 2032A(c) in the event of certain early dispositions of the property or early cessation of the qualified use. The agreement must be executed by all parties receiving any interest in the property being valued based on its qualified use. The agreement is to be in a form that is binding on all parties under applicable local law. It must designate an agent for the parties for all dealings with the Internal Revenue Service on matters arising under section 2032A.
>
> Include below, the name, identifying number, relationship, and address of all parties receiving any interest in the specially valued property. For "Privacy Act" notice, see the Form 1040 instructions.

157. 45 Fed. Reg. 50,743 (1981) (to be codified in 26 C.F.R. § 2032A-8[a][1]) provides: An election under section 2032A is made as prescribed in paragraph (a)(3) of this section and on Form 706, United States Estate Tax Return. Once made, this election is irrevocable; however, see paragraph (d) of this section for a special rule for estates for which elections are made on or before August 30, 1980. Under section 2032A(a)(2), special use valuation may not reduce the value of the decedent's estate by more than $500,000. This election is available only if, at the time of death, the decedent was a citizen or resident of the United States.

158. 45 Fed. Reg. 50,743-44 (1981) (to be codified in 26 C.F.R. § 20.2032A-8[a][2]).

159. 45 Fed. Reg. 50,744 (1981) (to be codified in 26 C.F.R. § 20.2032A-8[a][2]). For complete text of 26 U.S.C. § 2032A(b)(1)(B) (1976), *see* note 10 *supra*.

160. *Id.* (to be codified in 26 C.F.R. § 20.2032A-8[a][2]) which provides in pertinent part:

> If joint or undivided interests (e.g. interests as joint tenants or tenants in common) in the same property are received from a decedent by qualified heirs, an election with respect to one heir's joint or undivided interest need not include any other heir's interest in the same property if the electing heir's interest plus other property to be specially valued satisfy the requirements of section 2032A(b)(1)(B).

> of the property may be valued pursuant to an election under section 2032A. Where successive interests in specially valued property are created, remainder interests are treated as being received by qualified heirs only if (i) a qualified heir receives a present interest in that real property, (ii) all preceding interest in the property are vested absolutely in qualified heirs, and (iii) such remainder interests are not contingent upon surviving an alternate taker who is not a member of the decedent's family or are not vested subject to divestment in favor of a nonfamily member.[161]

For purposes of the above provision, the term "present interest" is defined at 26 U.S.C. § 2503 (1976).

In addition to the information specifically requested on line 11, page 2 of Form 706,[162] the regulations require: (1) affidavits describing activities constituting material participation and identifying the material participant(s) be filed, together with a legal description of the specially valued property;[163] (2) a statement that the decedent and/or a member of his family owned all the specially valued real property for at least five of the eight years immediately preceding decedent's death; (3) information identifying any periods during which the decedent or his family did not own the actual use valued property, and did not materially participate or did not use the property for a qualified use during the eight-year period immediately preceding the death of the decedent.[164] Presumably, revised editions of Form 706 will request this additional information.

The new regulations also provide that the executor of an estate may make a protective election under Section 2032A.[165] This

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161. *Id.* (to be codified in C.F.R. § 20.2032A-8[a][2]). For a discussion of problems dealing with successive interests under Louisiana law, *see* note 63 *supra*. *See also* LA. CIV. CODE ANN. art. 1520 (West Supp. 1980).

162. *See* note 156 *supra*.

163. 45 Fed. Reg. 50,744 (1981) (to be codified in 26 C.F.R. § 20.2032A-8[a][3][xiii] & [xiv]) provides:

> Affidavits describing the activities constituting material participation and the identity of the material participant or participants; and . . . [a] legal description of the specially valued property.

164. *Id.* (to be codified in 26 C.F.R. § 20.2032A-8[a][3][x]) which provides in part that "[a] statement that the decedent and/or a member of his or her family has owned all specially valued real property for at least 5 years of the 8 years immediately preceding the date of the decedent's death. . . ." *Id.*

165. *Id.* (to be codified in 26 C.F.R. § 20.2032A-8[b]). A protective election can be described as being a "valuation pursuant to this election . . . contingent upon values as finally determined (or agreed to following examination of a return) meeting the requirements of section 2032A." *Id.*

positive step by the IRS should prove particularly useful to executors in situations where the estate's appraisal figures indicate a failure to meet the fifty and twenty-five percent tests, but a subsequent IRS audit finds to the contrary. To take advantage of this protective election, the executor must file a notice of protective election with the estate tax return.[166] This notice must include "[t]he decedent's name and taxpayer identification number as they appear on the estate tax return; . . . [t]he relevant qualified use; and . . . [t]he items of real and personal property shown on the estate tax return which are used in a qualified use, and which pass to qualified heirs (identified by schedule and item number)."[167]

If, after the return is examined, the IRS finds that the estate meets the requirements of Section 2032A, the executor must file "an additional notice of election . . . within 60 days after the date of such a determination."[168] The new notice must include those items requested under line 11, page 2 of Form 706, and the additional information required by the regulations discussed above.[169] The new notice, together with the heirs' agreement and an amended estate tax return, should be filed with the Internal Revenue office where the original estate tax return was filed.[170]

The election agreement required to be signed by the heirs under Section 2032A presents two problems. First, as a practical matter, it may prove quite difficult in a given case to obtain the consent of all persons having an interest in the specially valued property.[171] Second, when minors and other incompetents are involved, a guardian or other legal representative may be reluctant to sign such an agreement, viewing it as inconsistent with his responsibility under state law.

The regulations state that the agreement by the qualified heirs must evidence consent to be personally liable for any additional estate tax that may be imposed.[172] Persons other than qualified

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.* provides in pertinent part that "[t]his notice must set forth the information required under paragraph (a)(3) of this section and is to be attached, together with the agreement described in paragraph (c)(1) of this section, to an amended estate tax return." *See also* notes 156, 163 & 164 *supra.*

170. *Id. See* note 169 *supra.*

171. 26 U.S.C. § 2032A(d)(2) (1976). *See also* note 52 *supra* and accompanying text.

172. 45 Fed. Reg. 50,744 (1981) (to be codified in C.F.R. § 20.2032A-8[c][1]) provides in pertinent part that

heirs need only consent to the application of Section 2032A, which provides for the imposition of the additional estate tax when there is a premature disposition or a cessation of a qualified use.[173] The agreement must be legally binding on all the parties thereto, and must designate the name and address of an agent with whom the IRS may deal.[174]

The regulations define an interest in property as "an interest which, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate."[175] The regulations also require that "any person in being at the death of the decedent who has any such an interest in the property, whether present or future, or vested or contingent, must enter into the agreement."[176] The regulations lessen the potential for conflict by finding that an heir who merely has the power to challenge a will under local law, and thus affect the disposition of property, will not be considered to have an interest in the property solely by reason of such local right.[177] Nor are creditors considered to have such an interest in the property merely by virtue of their status as creditors.[178] Thus, creditors and recalcitrant heirs will not be armed with a potentially lethal weapon. Where minors or other incompetents have interests in the property within the meaning of the statute and regulations, a guardian or other legal representative empowered under local law to bind such persons may sign the required consent agreement.[179]

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[t]he agreement required under section 2032A(a)(1)(B) and (d)(2) must be executed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death. In the case of a qualified heir, the agreement must express consent to personal liability under section 2032A(c) in the event of certain early dispositions of the property or early cessation of the qualified use. *See* section 2032A(c)(6).

See text following note 78 *supra*.

173. *Id.*

174. *Id.*

175. *Id.* (to be codified in 26 C.F.R. § 20.2032A-8[c][2]).

176. 45 Fed. Reg. 50,744-45 (1981) (to be codified in 26 C.F.R. § 20.2032A-8[c][2]). The regulations further provide:

> Included among such persons are owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any such power, co-tenants, joint tenants and holders of other undivided interests when the decedent held only a joint or undivided interest in the property or when only an undivided interest is specially valued, and trustees of trusts holding any interest in the property.

177. 45 Fed. Reg. 50,745 (1981) (to be codified in 26 C.F.R. § 20.2032A-8[c][2]).

178. *Id.*

179. *Id.* (to be codified in 26 C.F.R. § 20.2032A-8[c][3]). The regulation provides in

Regarding the duties of agents, the regulations specify that the designated agent will be contacted by the IRS regarding actual use valued property, and shall have the duty to notify the Service when there has been a "disposition or cessation of qualified use of any part of the property."[180] This regulation removes from the IRS an otherwise significant administrative burden, transferring to the agent the problem dealing with the interested-party requirements.

SOME NOTES ON PLANNING

Section 2032A does not relieve the family farmer of the burdens of estate planning, and the estate planning counselor must keep in mind numerous concerns when advising the farmer. Perhaps most important to a smooth Section 2032A election is good record-keeping; the need for proper documentation cannot be overemphasized.

More particularly, the farmer and his estate planner should keep in mind the fifty and twenty-five percent tests.[181] The aging farmer who wishes to sell off part of his land holdings and invest in a more reliable or predictable source of retirement income should always keep one eye focused on the requirement that at least half his estate be devoted to farming, and half of that to real property. It should be remembered, in this context, that the farmer's life insurance program might inadvertently disqualify a Section 2032A election.[182] And farmers possessing substantial nonfarm assets should carefully consider any gifts they make of farm assets. To assure that fifty percent of the estate remains devoted to farming, it is suggested that such gifts be made only of nonfarm assets.

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pertinent part:

> If any person required to enter into the agreement provided for by paragraph (c)(1) either desires that an agent act for him or her or cannot legally bind himself or herself due to infancy or other incompetency, or to death before the election under section 2032A is timely exercised, a representative authorized under local law to bind such person in an agreement of this nature is permitted to sign the agreement on his or her behalf.

However, as stated before, such actions by guardians, in this context, may be contrary to their fiduciary relationships, especially in light of the fact that this agreement can make the minor liable for any additional estate taxes.

180. *Id.* (to be codified in 26 C.F.R. § 20.2032A-8[c][4]).

181. 26 U.S.C. § 2032A(b)(1) (1976). For full text, *see* note 10 *supra*.

182. 26 U.S.C. § 2042 (1976) provides that insurance proceeds received by either the executor or the benficiaries (if the decedent retained incidents of ownership in the policy at death) are included in the value of decedent's gross estate.

Voluntary sales or exchanges of farmland should not be undertaken unless the farmer is informed that, should he die within five years of the sale or exchange, and thus fail to hold the property for the five-year minimum period, he may be denied the benefits of actual use valuation.[183] Such a sale or exchange may affect more than the newly acquired property: If valuation is denied, the property in question will not be available for purposes of the fifty and twenty-five percent requirements.

Meeting the material participation requirements of Section 2032A may demand of the farmer a lifetime sacrifice in the form of self-employment taxes and reduced or eliminated Social Security benefits,[184] since self-employment taxes would be imposed on income derived from farm participation considered material, and such income would likewise reduce social security retirement benefits.

To preserve the Section 2032A election in instances where neither the farmer nor a member of his family directly operates the farm, the farmer should: (1) perform 100 hours or more of physical work each month; (2) participate in (a) numerous critical management decisions beyond mere preparation of the farm or of a crop plan, (b) regular inspection and consultation, and (c) have the final word in decisions IRS will likely consider important to the farm's management; and (3) provide financial resources to an extent that is indicative of material participation. Such direct participation should ensure retention of the option to value farmland under Section 2032A.[185]

It is axiomatic in tax counseling to avoid the tendency to view a particular tax saving device by itself. Use of Section 2032A is no exception to this rule. Electing special use valuation is complex, involves several unanswered questions, and brings with it increased initial costs. The possibility of a recapture tax and the loss of stepped-up basis weigh heavily in the balance, precluding resort to Section 2032A in situations where the farmer's children have doubts about continuing the business. And, despite these voluble concerns, the most important factor may well be a nontax consid-

183. *See* note 11 *supra* and accompanying text.

184. *See* text accompanying notes 84 & 85 *supra*.

185. Bravenec & Olsen, *How to Reap Estate Tax Benefits Through Use of the Alternative Valuation of Farmland*, 48 TAXATION 140, 144-45 (1978).

eration: The client's wishes concerning the disposition of his estate at death may outweigh even the most drastic tax consequences.

John P. Heisserer

APPENDIX

Form **706-A**
(December 1978)
Department of the Treasury
Internal Revenue Service

United States Additional Estate Tax Return

(Section 2032A of Internal Revenue Code)

Name of qualified heir or heiress	Heir's or heiress' social security number
Address of qualified heir or heiress (number and street including apartment number or rural route)	
City, town or post office, State, and ZIP code	

Decedent's name reported on Form 706	Decedent's social security number	Date of death

Part I Tax Computation

1	Value at date of death of specially valued property which passed from decedent to qualified heir or heiress:		
	(a) Without section 2032A election	1(a)	
	(b) With section 2032A election	1(b)	
	(c) Balance (subtract amount on line 1(b) from amount on line 1(a))	1(c)	
2	Value at date of death of all specially valued property in decedent's estate:		
	(a) Without section 2032A election	2(a)	
	(b) With section 2032A election	2(b)	
	(c) Balance (subtract amount on line 2(b) from amount on line 2(a))	2(c)	
3	Decedent's estate tax:		
	(a) Recomputed without section 2032A election (attach computation)	3(a)	
	(b) Reported on Form 706 with section 2032A election	3(b)	
	(c) Balance (subtract amount on line 3(b) from amount on line 3(a))	3(c)	
4	Percentage obtained by dividing amount on line 1(c) by amount on line 2(c)	4	%
5	Multiply amount on line 3(c) by percentage on line 4	5	
6	Additional estate tax imposed for previous dispositions or cessation of qualified use of portion of same specially valued property	6	
7	Balance (subtract amount on line 6 from amount on line 5)	7	
8	Enter the total of column (d), Schedule A, page 2	8	
9	Enter the total of column (e), Schedule A, page 2	9	
10	Balance (subtract amount on line 9 from amount on line 8)	10	
11	Additional estate tax. Enter the lesser of the amount on line 7 or the amount on line 10	11	

Part II Tax Phaseout (Complete Part II only if the disposition of specially valued property or the discontinuance of the qualified use occurred more than 120 full months (10 years) after but less than 180 full months (15 years) after the decedent's death. After 180 full months (15 years) after decedent's death, no additional estate tax is due.)

12	Enter the number of full months after the decedent's death in excess of 120 months (10 years) when the qualified heir or heiress disposed of the interest or discontinued the qualified use	12	
13	Divide amount on line 12 by 60	13	
14	Multiply amount on line 11 by amount on line 13	14	
15	Subtract amount on line 14 from amount on line 11 (but not less than zero)	15	

Part III Involuntary Conversions (Complete Part III if you elect section 2032A(h) treatment and less than all of the involuntary conversion proceeds are reinvested in qualified replacement property.)

Describe the replacement property ▶

16	Cost of qualified replacement property	16	
17	Amount realized from involuntary conversion	17	
18	Percentage obtained by dividing amount on line 16 by amount on line 17	18	%
19	Multiply amount on line 11 or line 15 whichever is applicable by percentage on line 18	19	
20	Subtract amount on line 19 from amount on line 11 or line 15 whichever is applicable	20	

Under penalties of perjury, I declare that I have examined this return, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than taxpayer is based on all information of which preparer has any knowledge.

Signature of taxpayer — Date

Signature of preparer other than taxpayer — Address (and ZIP code) — Date