The National Agricultural Law Center

University of Arkansas · System Division of Agriculture
NatAgLaw@uark.edu · (479) 575-7646

An Agricultural Law Research Article

Some Thoughts on Section 2032A

by

John R. Kinley

Originally published in UNIVERSITY OF ILLINOIS LAW REVIEW
1978 U. ILL. L.F. 409 (1978)

www.NationalAgLawCenter.org

SOME THOUGHTS ON SECTION 2032A†

*John R. Kinley**

Section 2032A of the Internal Revenue Code is a provision about which many questions have been raised,[1] for which no regulations have been issued, and which is likely to undergo some important changes in the near future.[2] Although the estate planner could, perhaps, wait until the impact of the law is more clearly determined, persons owning farms continue to die notwithstanding the slow progress of the Congress and the Treasury Department. The lawyer asked to advise clients on the possibility of estate tax savings offered by section 2032A cannot afford the luxury of ignoring the section and waiting for future clarification of its provisions.

Although section 2032A is without clarifying regulations and subject to impending amendments in Congress, the uncertainties which seem so formidable on a first reading of the section are not as difficult as they may seem. Typically, the lawyer will be dealing with a family farm run by a farmer either presently or prospectively with his son or sons. There may or may not be a surviving spouse, and there may or may not be other children who do not wish to operate the farm. It is problems raised by section 2032A in these typical situations to which this comment will be addressed. Throughout, the comment will emphasize the need for planning to insure the availability of 2032A upon the death of the farm owner. By maintaining flexibility in the estate plan, the lawyer can place the executor in the best position to elect or decline to elect section 2032A valuation in the future when, it is hoped,

† *This article went to press prior to the publication of proposed regulations under section 2032A. The reader may consult those regulations at* 43 Fed. Reg. 30070-72, 31039-43 (1978) (to be codified in 26 C.F.R. §§ 20.2032A-3, 20.2032A-4, 20.2032A-8). *See also* [1978] II ESTATE & GIFT FED. TAXES ¶¶ 135,607, 135,609.

* *Partner, Williams, McCarthy, Kinley, Rudy & Picha, Rockford, Illinois. A.B. 1937, Beloit College; J.D. 1940, Northwestern University.* *The author thanks Lawrence A. Ludens of Morrison, Illinois, and John H. McCord, Professor of Law, University of Illinois, for their helpful comments on an earlier draft of this article and Norris K. Levis, Jr. of Rockford, Illinois, for his research and opinions on average annual gross cash rentals, real estate taxes, and land values in Winnebago County, Illinois.*

1. *See* J. MCCORD, 1976 ESTATE AND GIFT TAX REFORM: ANALYSIS, EXPLANATION AND COMMENTARY § 7 (1977); Sutkowski, *New Rules Affecting Valuation of Property—Farm and Other Family Business*, 33d Ann. Fed. Tax Course, ch. 20 (Ill. I.C.L.E. 1976).

2. *See* The Technical Corrections Bill of 1977, H.R. 6715. *See also* H.R. 10312, S. 2228, S. 2238.

the scope of the section will be clarified by both the Congress and the Treasury Department.

I. VALUATION OF FARMLAND UNDER SECTION 2032A

If a farmer leaves his farm to his lineal descendants or his spouse, section 2032A permits the valuation of the farm to be fixed for federal estate tax purposes by a standard other than the usual fair market standard. First, the average gross cash rental value for the five most recent calendar years of comparable land used for farming purposes and located in the locality is determined. Second, the average annual real estate tax for the comparable land is subtracted from the average rental value. Third, the result of this subtraction is divided by the average annual effective interest rate for all new Federal Land Bank loans.[3] An example from Winnebago County, Illinois, makes the impact of this different method of valuation apparent. The average annual gross cash rental value during the past five years of an average farm with a fair market value of $2,000 per acre is approximately $75 per acre. The average real estate taxes are approximately $9 per acre, and the present average effective Federal Land Bank loan rate is 8 3/4%. Thus, an executor electing section 2032A would value the land at $754 per acre. For an estate containing a 400-acre farm, the 2032A valuation reduces the value of the taxable estate by nearly $500,000. Thus, if the taxable estate of which the farm is a part would be valued at

3. I.R.C. § 2032A(e)(7)(A). Section 2032A(e)(7)(B) provides an alternative method of valuing farms and other qualified real property when § 2032A(e)(7)(A) is inapplicable either because there is no comparable land or because the executor elects not to use the method. The alternative method is both complex and vague. It requires the application of five factors in determining value: (1) the capitalization of income the property can be expected to yield over a reasonable period of time under prudent management using traditional cropping patterns for the area, (2) the capitalization of the fair rental value of the land for farm or closely held business purposes, (3) assessed values in a state which provides a differential or use value assessment law for farmlands or closely held business properties, (4) comparable values of other farms or closely held business land in the same geographical area far enough from a metropolitan or resort area so that non-agricultural use is not a significant factor in the sales price, and (5) any other factor which fairly values the farm or closely held business value of the property.

The statute and the committee provide no information on what the proper capitalization rates are. The third factor is applicable to Illinois real property used for farming and agricultural purposes because the Illinois Revenue Act provides a special valuation formula. *See* ILL. REV. STAT. ch. 120, § 501a-1 to -3 (1977). The fourth factor presents no obvious problems with respect to land used for farming purposes. The fifth factor apparently was added to provide a realistic result if some of the other factors are inappropriate.

The questions raised by the alternate method of valuation cannot now be answered with any degree of certainty. The regulations should supply many answers, including whether some factors may be ignored if inapplicable and to what extent the various factors may be weighted in arriving at a determination of value. This list of factors, which requires the gathering of extensive data as well as regulatory clarification, would seem to discourage election of § 2032A. The existence of this alternative, however, may provide a lower valuation and therefore lower death taxes or conversely higher death taxes and a higher tax basis for depreciation purposes and intrafamily sales under § 1023. Because the executor may select either of the two methods after the farm owner's death, further flexibility is built into § 2032A, which makes it more attractive to the planner.

$1,000,000 if section 2032A were not used, election of the section 2032A valuation would yield a federal tax savings of $116,592 without a marital deduction and $51,272 with a marital deduction. Moreover, this federal tax savings is augmented by state inheritance tax savings, because a recent amendment to the Illinois Inheritance Tax Act permits the values determined under section 2032A to be used in computing the state tax.[4]

II. The Qualification Tests

Most family farms should fit without difficulty within the rather broad definition of use of a farm for farming purposes and therefore will qualify for section 2032A valuation.[5] One troublesome situation, however, involves an elderly farmer whose age has caused his withdrawal from active participation in the farming operation and its management. This presents the possibility of cessation of qualified use under section 2032A(c)(7)(B). One method of preserving the qualified use is to have the son of the elderly farmer perform the acts of material participation and continue those acts until the farmer's death. The son need not actually operate the farm as long as he "materially participates" in its management. Section 2032A(c)(7)(B) validates as qualified use the material participation by the owner or "any member of his family" in the operation of the farm. The concept of "material participation" has been rather precisely defined in the regulations issued for the self-employment tax. These regulations indicate that the son "materially participates" if he performs some regular work on the farm which supplements the activities of the tenant, or, alternatively, advises and consults periodically with the tenant and inspects the production activities.[6] In any event, meeting the "material participation" requirement is aided by furnishing machinery and livestock used in production or by assuming responsibility for a substantial part of the production expense.

Section 2032A(b)(1)(C) requires that during the eight-year period ending on the owner's death the farm be owned by the farm owner or a member of his family for at least five years. Although "owned" is not defined in the statute, its context indicates that a purchaser's interest under an agreement for deed or a beneficial interest under a naked title land trust would constitute ownership, because those interests are clearly subject to federal estate tax under section 2001.

A related question about the form of ownership of farmland is raised by section 2032A. The section provides that the secretary shall issue regulations on the application of the section to interests in part-

4. Pub. Act. No. 80-905, 1977 Ill. Legis. Serv. 1589 (West)(codified at Ill. Rev. Stat. ch. 120, § 375 (1977)).
5. *See* I.R.C. § 2032A(e)(4), (5).
6. Treas. Reg. § 1.1402(a)4 (1963).

nerships, corporations, and trusts.[7] A House report indicates that Congress intended to accord qualified property held by partnerships, corporations, and trusts the benefits of section 2032A.[8] In the absence of regulations, however, the uncertainties in qualifying are numerous.[9] Therefore, until regulations are issued, it is advisable not to put farms in those forms of ownership.

In addition to the qualified use requirement, section 2032A requires that on the owner's death at least fifty percent of the adjusted value of his gross estate consist of the adjusted value of real or personal property used for a qualified use and at least twenty-five percent of the adjusted value of the gross estate consist of the adjusted value of qualified real property.[10] Adjusted value means the value for federal estate tax purposes determined without regard to section 2032A and reduced by secured debts for which the owner is personally liable. At the planning stage, a precise determination of whether the minimum requirements are met is probably too expensive to be practical. Several planning techniques, however, will improve the chances of meeting the requirements.

The owner could use cash or other nonqualifying assets first to remove encumbrances on farm real estate, and then to reduce liens on personal property used for a qualified, *i.e.*, farming, purpose. Second, the owner could make gifts of cash and other nonqualifying assets to the spouse or others before his death. Section 3(a) of Senate Bill 2238, which is now pending in the Senate, however, would close the loophole in section 2032A by undoing the effect of gifts made within three years of death. Furthermore, unless the gift is desirable for non-tax reasons, advice to make such a gift should be carefully considered. The gift, with the possible payment of gift tax, may commit the estate at the planning stage to elect section 2032A long before all the implications are known. Although a gift may allow the estate to meet the fifty percent and twenty-five percent minimum requirements by reducing the amount of nonqualifying estate assets, for example, the use of section 2032A may render unavailable the benefits of the installment payment of estate tax permitted by section 6166 because the latter section's percentage requirement for closely held businesses is based upon the section 2032A value. Moreover, the section 2032A value, rather than fair market value, will result in a lower "fresh start" value under section 1023(h)(2).

Finally, Professor McCord warns that if large unsecured production loans exist, the farm property may represent more than fifty percent of the actual net worth of the estate, yet not qualify under section

7. *See* I.R.C. § 2032A(g).
8. H.R. REP. No. 94-1380, at 24.
9. J. McCORD, *supra* note 1, § 7.14, at 329-30.
10. I.R.C. § 2032A(b)(1).

2032A(b)(1)(A).[11] The obvious solution to this problem is to secure the unsecured loan with nonfarm assets, if possible. This would reduce the adjusted value of the gross estate for qualifying under section 2032A, without reducing the adjusted basis of the real and personal property used for a qualified use.

The executor electing to value property under section 2032A must file an agreement signed by all persons having an interest in real estate qualifying for the special value treatment. The signers must consent to be personally liable for the payment of the additional estate tax if the qualified use terminates before their deaths and within fifteen years after the landowner's death.[12] If the qualified heir is an adult and the sole beneficiary of the estate who will clearly benefit from the estate tax savings resulting from the election and who has no intention of selling the farm in the foreseeable future, the agreement creates no difficulties. Other situations, however, may make obtaining an agreement more difficult.

If the farm owner is survived by a second wife and the son of a prior marriage who will operate the farm, for example, the election of section 2032A will result in a smaller adjusted gross estate and therefore a smaller marital share if a pecuniary formula marital clause or a hybrid pecuniary formula clause is used. Consequently, the second wife, now a widow, will be reluctant to sign the agreement permitting the section 2032A valuation. The estate planner has two ways of inducing the wife to sign. First, the planner can advise the client to persuade his wife and son to sign the agreement during his lifetime. The consideration for the wife's consent would be the bequest provided in the will. The agreement could be left with the designated executor with written instructions to file the agreement with the IRS, if the executor decides to make the election. Second, the planner could insert a provision in the client's will in the nature of an in terrorem clause which would reduce the share of the wife (perhaps in an amount equal to the tax cost to the estate of her refusal to sign) if she failed to execute the agreement upon a demand by the executor. This alternative may also be useful if a number of qualified heirs are not readily accessible or are reluctant to sign during the landowner's lifetime. Such a contingency clause, however, will render the portion of the marital share subject to the contingency a terminable interest and therefore disqualify the portion as an allowable marital deduction.[13]

Professor McCord has raised some perplexing questions about the consent of minors, incompetents, unknown heirs, and remote contingent remaindermen.[14] In the absence of regulations most of these

11. J. McCord, *supra* note 1, § 7.10, at 323.
12. I.R.C. § 2032A(c),(d).
13. I.R.C. § 2056(b)(1).
14. J. McCord, *supra* note 1, § 7.7, at 314-15.

questions are unanswerable and therefore planning at this time under section 2032A should be confined to estates the beneficiaries of which are competent adults.

III. Postmortem Administrative Problems

Section 6324B imposes on qualified real estate a lien equal to the tax savings provided by section 2032A. The lien attaches at the time the election is filed and continues until the additional tax is paid, the qualified heir dies, or the fifteen-year period ends. Many lawyers have feared that the existence of the lien may prevent mortgage financing. Apparently in response to this concern, the Treasury Department issued Information Release 1923. Among other matters, the release states that the section 6324B lien "is not valid against financing agreements securing loans for construction or improvements of real estate, raising or harvesting of farm crops, or raising livestock or other animals." Although this language preserves the priority of mortgages for normal operating purposes, it does not respond to the situation in which one qualified heir wishes to borrow on the farm in order to buy out another qualified heir. The matter may be covered by the regulations, but in the event that it is not, there is the possibility of accommodation. Because the section 6324B lien does not attach until the election is filed, it may be possible to obtain financing prior to the filing of the election. Although the usual federal estate tax and Illinois inheritance tax liens will be outstanding at this time, most lenders will make loans during this period if the buyer can establish the amount of taxes due and is willing to have funds set aside to secure their payment.

Frequently, the farm owner has a number of children whom he wishes to treat equally in the arrangement of his estate plan. Usually, however, only one son will wish to operate the family farm. To permit the operating son to own the farm, he is given an option to buy the farm from the estate by a provision of the farm owner's will. This plan may no longer safely be carried out if the estate is to take the tax advantages offered by section 2032A. The section defines a "qualified heir" as: "a member of the decedent's family who acquired such property (or to whom such property passed) from the decedent." The term "qualified real property" is defined as property which "(a) on the date of decedent's death, was being used for a qualified use, and . . . was acquired from or passed from the decedent to a qualified heir of the decedent." The verb "acquired" is broad enough to include a purchase, but the phrase "on the date of decedent's death" casts doubt on the typical acquisition under an option because it is unlikely that such a purchase could be completed on the date of decedent's death. Section 3(d)(2) of the Technical Corrections Bill ends this doubt by adding subparagraph (9) at the end of section 2032A(e). The amend-

ment makes it clear that property acquired by purchase from the estate of a decedent does not qualify for section 2032A treatment.

IV. Drafting Problems

The drafter of a marital deduction formula clause has three choices: the fractional formula clause, the true pecuniary formula clause, and the tax value or hybrid pecuniary formula clause. Professor McCord recommends the use of the fractional formula clause when real property valued under section 2032A is used to fund the marital share.[15] Given the present form of section 2032A, this writer reluctantly agrees, recognizing that this choice is not ideal.

The use of the fractional formula clause presents some difficulties in administration of the estate, because, *inter alia*, the marital and residuary portions of the estate must share proportionately in every asset distributed to meet the requirements of Rev. Proc. 64-19, 1964-1 C.B. 682. The ruling excludes fractional shares from its scope only if "each beneficiary shares proportionately in the appreciation or depreciation in the value of assets to the date or dates of distribution." Because it is physically impossible to divide milk cows and farm machinery in fractional shares, undivided interests in the items should be assigned to the marital and nonmarital portions. An attempt by the executor to make a non-pro rata exchange to produce whole asset units for the marital and nonmarital shares may create a taxable exchange which will result in gain if appreciated assets are used in the exchange.

Under the present law, a true pecuniary formula marital clause, with assets to be valued at distribution values, should not be used, because the difference between the section 2032A value basis and the value at date of distribution will constitute realization of taxable capital gain upon distribution. Section 3(d)(3) of the Technical Corrections Bill would correct this inequity by amending section 1040 to limit gain to the excess of distribution value over estate tax value determined without regard to section 2032A. The bill, however, has not yet been enacted and by selecting a true pecuniary formula clause, the drafter risks that the bill will not be enacted in its present form.

The effect of section 2032A on the tax value or hybrid pecuniary formula clause is uncertain. Several writers maintain that because the hybrid clause is not a true pecuniary formula clause, the provisions of section 1040(a) and (b), which in effect grant a step up in basis to estate tax value of carryover basis property used to fund a pecuniary bequest, may not apply.[16] If this position is correct, the use of this clause will produce a gain measured by the excess of value on date of distribution over the carryover basis, *i.e.*, the section 2032A value, of distributed

15. *Id.* § 7.23, at 354.
16. *See, e.g.*, Drafting Wills and Trust Agreements at 13-7 (Ill. I.C.L.E. 1977).

property. The Technical Corrections Bill does not address this problem. On the other hand, Richard B. Covey argues that under present law, a hybrid pecuniary formula is in fact a fractional formula. Therefore he concludes that no gain or loss will be realized on the funding, in kind, of this type of marital trust.[17] In view of this difference of informed opinions, wisdom dictates that the hybrid pecuniary formula clause should be avoided.

V. CONCLUSION

This comment has attempted to establish a few guides to the uncertain and very likely changing law of alternative valuation under section 2032A. Every lawyer considering use of the section should consult more comprehensive material such as Professor McCord's analysis, because this comment does not purport to be a complete review of the law. Moreover, the lawyer should determine if the issuance of regulations or the enactment of amendments to section 2032A have invalidated the basis upon which these suggestions were made. Finally, the lawyer should attempt to create a plan which will afford flexibility to accommodate the changes in the law that must come before section 2032A will be a truly effective estate planning device.

---

17. Covey, *Recent Developments Concerning Estate, Gift and Income Taxation*, Twelfth Annual Institute of Estate Planning of the University of Miami 46 (1977).