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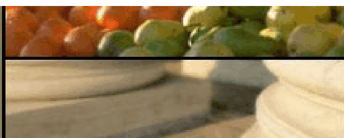

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An Agricultural Law Research Article

Section 2032A: Did We Save the Family Farm?

Part Two

by

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Cessation of use means ceasing to use the property as a farm or closely held business[261] or if, during any eight-year period ending after decedent's death and before the death of the qualified heir, there were periods aggregating three years or more where the decedent or a member of his family did not materially participate in the operation of the farm or closely held business (before decedent's death) and the qualified heir or a member of his family did not materially participate in the operation of the farm or other business (after decedent's death).[262]

If a disposition and a cessation of use both occur, only one recapture tax is imposed on any one portion of the property and the tax is assessed after the first recapture event to occur.[263] The additional estate tax is due and payable six months after the date of the recapture event[264] and the qualified heir is personally liable for the tax.[265]

2. *Amount of Recapture Tax*

In general, the amount of recapture tax is the lesser of:

(1) The excess of what the estate tax liability would have been if the property had been valued under section 2031 over the estate tax liability using 2032A[266] (referred to as the "adjusted tax difference"[267]), or

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TATE, GIFTS AND TRUSTS 118 (1977). There are several exceptions to this rule. No recapture will result if the property is disposed of by virtue of an involuntary conversion or condemnation if the proceeds are reinvested in real property which originally qualified for special use valuation. HOUSE REPORT, *supra* note 44, at 25. It is intended that no recapture tax result if the property is disposed of by tax free transfer to a corporation (§ 351) or to a partnership (§ 721) if (1) the qualified heir retains the same equitable interest in the property, (2) the corporation or partnership would, with respect to the qualified heir, be considered a closely held business under § 6166 and (3) if the corporation or partnership consents to be personally liable for the recapture tax if it disposes of the property or ceases to use it for a qualified use during the recapture period. *Id.* at 25, n.3. If involuntary conversion of the qualified real property occurs, no recapture will occur if the qualified real property is replaced by other real property of equal value to be used for the same use. I.R.C. § 2032A(h). For a further discussion, *see* J. MCCORD, *supra* note 2, at 336-38. Of course, by implication, a sale, exchange, gift or other disposition to another qualified heir is not a recapture event. However, the transferee is to be treated as if he had received the property from the decedent and becomes personally liable for the recapture tax. HOUSE REPORT, *supra* note 44, at 26-27. Query, will the death of the transferor or the transferee remove the liability for recapture? The House Report quaintly states that the transferee "steps into the shoes of the first heir," HOUSE REPORT, *supra* note 44, at 26, indicating that perhaps the death of the second qualified heir is the relevant event, but the answer is unclear.

261. I.R.C. § 2032A(c)(7)(A). McCord argues that this may mean the specific use which was being made of the land at decedent's death. J. MCCORD, *supra* note 2, at 338.

262. I.R.C. § 2032A(c)(7)(B). This trap which can cause recapture based on decedent's material participation has already been discussed. *See* text accompanying note 238 *supra*.

263. I.R.C. § 2032A(c)(4); *See also* GENERAL EXPLANATION, *supra* note 3, at 541.

264. I.R.C. § 2032A(c)(5).

265. I.R.C. § 2032A(c)(6).

266. I.R.C. § 2032A(c)(2)(A)(i).

(2) The excess of the amount realized from the disposition (or in any case where the sale or exchange is not at "arm's length," the fair market value) over the special use valuation.[268] Basically, the "adjusted tax difference" is the savings in estate tax resulting from the employment of special use valuation. This, logically enough, is what Congress felt was equitable to collect if the land was removed from the farming or other business status which it wished to benefit and encourage. In cases where the value of the real property has so depreciated in value that the difference between the amount realized from the disposition and the special use value is less than the estate tax savings, the lesser amount is the amount recaptured.[269]

If qualified real property is bequeathed to more than one qualified heir, the statute directs an apportionment of the adjusted tax difference based on the proportion of the reduction in value of the respective interests in the qualifying real property.[270]

3. *Interpretive Problems in the Formula*

A problem occurs when a qualified heir disposes of or ceases to use only a part of the qualified property. Without careful reading of the statute, one might think that the adjusted tax difference attributable to such interest would be only a portion of the adjusted tax difference based on the ratio of the value of the portion disposed of to the value of all the qualified real property, since "interest" as used in 2032A(c) should mean that portion of the qualified property disposed of or no longer used for a qualified use.[271] However, one author has convincingly argued that "interest" actually means the total amount of qualified property received from the decedent and that Congress intended this result.[272] This can cause recapture of the entire es-

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267. I.R.C. § 2032A(c)(2)(C).

268. I.R.C. § 2032A(c)(2)(A)(ii).

269. *Id.*

270. I.R.C. § 2032A(c)(2)(B), (C). In terms of recapture tax liability, the liability of any interest is computed by the following formula:

$$\text{Reduction in estate tax by virtue of use of § 2032A} \times \frac{\text{Reduction in value of interest}}{\text{Reduction in value of all qualified property.}}$$

See Bravenec & Olsen, *supra* note 145, at 142.

271. "Interest" is not defined in § 2032A.

272. M. FELLOWS, *supra* note 260, at 124-28. The following example, similar to that used by Ms. Fellows, illustrates her argument:

In 1983 A dies leaving 1,000 acres of farmland to his daughter D, having a fair market value at the date of death of $1,500,000 and a special use value of $1,000,000. The executor elects to value the land under § 2032A. The estate tax is $250,000. If the § 2032A election had not been made the estate tax would have been $500,000. In 1987 D sells 500 of the 1,000 acres

tate tax saved by the use of section 2032A on a transfer or cessation of use

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to a subdivision developer for $1,000,000. If "interest" means the amount sold by the qualified heir, the additional estate tax of $125,000 is computed as follows:
The lesser of:
1) The adjusted tax difference attributable to the interest:

$$\frac{\$750{,}000 - \$500{,}000}{\$1{,}500{,}000 - \$1{,}000{,}000} \times (\$500{,}000 - \$250{,}000)$$
$$= \$125{,}000$$

or
2) The excess of the amount realized over the § 2032A value of the interest: $1,000,000-$500,000=$500,000.
However, if "interest" means the entire amount of qualified real property received from the decedent, the recapture tax is $250,000 calculated as follows. The lesser of:
(1) The adjusted tax difference attributable to the interest:

$$\frac{\$1{,}000{,}000 - \$500{,}000}{\$1{,}000{,}000 - \$500{,}000} \times (\$500{,}000 - \$250{,}000)$$
$$= \$250{,}000$$

or
(2) The excess of the amount realized over the § 2032A value of the interest: $1,000,000-$500,000 = $500,000. Thus, the entire tax savings is recaptured.

Fellows then offers two arguments supporting the contention that Congress intended that the entire estate tax savings should be recaptured, even though only a portion of the qualified real property was sold. First, § 2032A(c)(2)(D)(i) dealing with partial dispositions, provides that the value to be taken into account when computing the recapture tax on the portion disposed of shall be the pro rata share of the value of the portion *only* in the computation under § 2032A(c)(2)(A)(ii), the computation of the excess of the amount realized over the special use valuation. By so specifying, Congress intended that the adjusted tax difference with respect to the interest should *not* be reduced pro rata in the case of partial dispositions. *Id.* at 126. However, it could be argued that in cases similar to the example, the adjusted tax difference attributable to such interest will *always* be the same as the adjusted tax difference with respect to the estate. This would obviate the need for separate definitions of "adjusted tax difference attributable to interest" (§ 2032A(c)(2)(B)) and "adjusted tax difference with respect to the estate" (§ 2032A(c)(2)(C)) except where qualified real property is given to more than one qualified heir or in the case of successive interests. The question then occurs as to why, since Congress was so particular in prescribing a rule for partial dispositions, it did not preface the definitions in § 2032A(c)(2)(B) and (C) with the qualification that they were only to apply in cases of interests given to more than one qualified heir or of the creation of successive interests. Despite this, Fellows' argument is impressive, especially since she goes on to illustrate that if "interest" means the amount disposed of by the qualified heir, a later transfer of the remaining property would not result in recapture of the remaining tax savings. *Id.* at 126-28. Fellows further buttresses her argument by quoting § 2032A(c)(2)(D)(ii) which states:

> 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.

Id. at 126. She argues that the use of "portions of such interest" is a clear indication that "interest" must refer to the entire property passing from the decedent (or the previous qualified heir) to the qualified heir. Of course, it is possible to argue that the quoted subsection is merely intended to indicate that if a qualified heir receives two or more parcels of qualified real

of a portion of the qualified real property. This unclarity in the definition of "interest" should be carefully considered by practitioners in determining whether to elect 2032A.

Problems also exist concerning the imposition of the recapture tax when the decedent creates successive interests in the qualified real property. These will be discussed subsequently.[273]

B. *The Special Lien on Qualified Real Property*

To protect the government's interest in case a recapture tax is imposed, the Tax Reform Act of 1976 also added section 6324B to the Internal Revenue Code.[274] This section creates a lien in favor of the United States on any property in which an interest in qualified real property under section 2032A exists.[275] The lien is in the amount of the adjusted tax difference attributable to the interest.[276] The lien arises at the time a 2032A election is filed and continues until the recapture tax liability under 2032A(c) is satisfied or "has become unenforceable by reason of lapse of time."[277] The lien is not valid against any purchaser, or any holder of a security interest, mechanic's lien or judgment lien, until a notice of the lien has been filed.[278] The lien replaces any lien against the estate under section 6324.[279] The lien is not valid as against a prior mechanic's lien or any security interest under section 6323(c), whether prior or subsequent, except for such interests which came into existence after a notice that payment has been accelerated has been

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property, a reduction of the adjusted tax difference is allowed for the tax imposed on prior transactions involving only that parcel. However, "interest" is not a totally appropriate term in such a context and Ms. Fellows' argument has a great deal of merit. The term "interest" should be clarified by regulations.

273. The two most frequently used examples are life estates and trusts. *See* Section VI G *infra.*

274. Tax Reform Act of 1976, *supra* note 1, § 2003(b), 90 Stat. 1861, (codified at I.R.C. § 6324(B)).

275. I.R.C. § 6324B(a).

276. *Id.*

277. I.R.C. § 6324B(b)(1). Presumably by the reference to the lien becoming unenforceable by lapse of time, Congress intended that the lien lapses on the first to occur of 15 years from the decedent's death or of the death of the qualified heir. *See* HOUSE REPORT, *supra* note 44, at 27. Section 6324B(b)(2) provides that the lien will also end when "it is established to the satisfaction of the Secretary that no further tax liability may arise under § 2032A(c) with respect to such interest." There is no indication in the legislative history as to what circumstances this provision was intended to cover.

278. I.R.C. § 6324B(c) making § 6324A(d)(1) applicable to the special lien. The notice must meet the requirements of § 6323(f); that is, it must be filed in an office designated by state law where the property is situated, or, if the state has not designated such an office, with the clerk of the U.S. district court in the judicial district in which the land is situated. The form of notice shall be prescribed by the Secretary of the Treasury and must be indexed at the district office of the IRS.

279. I.R.C. § 6324B(c), making § 6324A(d)(4) applicable to the special lien.

filed.[280] Regulations are to be issued permitting the furnishing of security as a substitute for the special lien.[281] The biggest problem with the special lien is the impairment of the qualified heir's ability to obtain the financing needed to operate the farm.[282] The first response to this was the issuance of a news release by the IRS.[283] The news release stated that the rule of code section 6324A(d)(3)(c), relating to liens arising from extensions of time to pay tax under section 6166 and 6166A, that the lien is not valid "against financing agreements securing loans for construction or improvement of real property, raising or harvesting of farm crops, or raising livestock or other animals"[284] was also applicable to the special lien arising under section 6324B. Furthermore, the 6324B lien is not valid against such financing agreements, regardless of whether the agreement comes into existence before or after the filing of the tax lien. Apparently not satisfied with this response, in the Revenue Act of 1978 Congress added code section 6325(d)(3)[285] to provide that the Secretary of the Treasury may subordinate any lien imposed by section 6324B if he determines that the United States "will be adequately secured after such subordination."[286] It is not known

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280. I.R.C. § 6324B(c), making § 6324A(d)(3) applicable to the special lien. The security interests under § 6323(c)(3) are those resulting from an agreement to make cash disbursements to finance the construction or improvement of real property, a contract to construct or improve real property, or the raising and harvesting of a farm crop or the raising of livestock or other animals.

281. I.R.C. § 6324B(d).

282. J. McCord, *supra* note 2, at 348. *See also* M. Boehlje & N. Harl, *supra* note 50, where the authors state:

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

Id. at 40-41.

283. I.R.S. News Release 1823 (June 2, 1977), 3 Fed. Est. & Gift Tax Rep. (CCH) ¶ 12,029.

284. *Id.*

285. Revenue Act of 1978, *supra* note 82, § 513.

286. *Id.* The statute authorizes the issuance of a "certificate of subordination." It is hoped that these will be issued liberally to enable farmers to use the qualified real property as security for loans needed for the continued operation and improvement of the farm. It was the intent of Congress that the 6324B lien not operate in such a way as to prevent the farm from continued viable operation. *See* Staff of the Joint Committee of Taxation, 95th Cong., 2d Sess., General Explanation of the Revenue Act of 1978 (1979) [hereinafter cited as General Explanation, 1978]:

> The Congress believes that the subordination of lien provision should be clarified to permit the subordination of the special tax lien in appropriate cases. In this way, the purpose of providing the special estate tax valuation for farm and closely held busi-

how liberal the IRS will be in subordinating liens under section 6324B, but a liberal use of the provision will allay the fears of many farmers concerning the availability of future credit if they elect to use section 2032A.

VI. Estate Planning Under Section 2032A

A. *The Basis Problem*

Insofar as the estate tax is concerned, election of special use valuation appears to be an attractive alternative to farm owners. The worst effect would be a deferment of a portion of the federal estate tax.[287] However, the election has income tax effects which must also be taken into account and which considerably affect the utility of section 2032A.

1. *Basis Determined Under Step-Up Method*

Before the passage of the Tax Reform Act of 1976, the basis of property to the estate of a decedent (and to the beneficiaries) was the fair market value of the property on the date of the decedent's death.[288] The Tax Reform Act of 1976 eliminated the former "stepped-up" basis for property of decedents dying after December 31, 1976 and replaced it with carryover basis.[289] However, in view of the uproar raised by attorneys and corporate fiduciaries, as well as concern expressed during the hearings on the Tax Reform Act of 1976,[290] Congress postponed the effective date of the carryover

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> ness real property will not be frustrated by unduly restricting an heir's ability to obtain working capital and other financing because the lien for such financing would be inferior to the preexisting special tax lien.

Id. at 291.

287. By making an election under section 2032A, the value of the gross estate, and thus the federal estate tax, would be reduced. Even if a recapture event occurs, only the estate tax savings would be recaptured. *See* Section V A *supra*. In the interim, the estate tax saved could help to relieve the cash needs of the farm or could be invested.

288. I.R.C. § 1014(a). The Tax Reform Act of 1976 did not alter section 1014(a), but instead provided that section 1014 did not apply to any property for which section 1023 mandated a carryover basis. I.R.C. § 1014(d).

289. I.R.C. §§ 1014(d) and 1023.

290. *See* General Explanation, 1978, *supra* note 286:

> A number of administrative problems concerning the carryover basis provision have been brought to the attention of Congress. Administrators of estates have testified that compliance with the carryover basis provisions has caused a significant increase in the time required to administer an estate and has resulted in raising the overall cost of administration. Moreover, the Congress believes that it should thoroughly review the basis concept of carryover basis in addition to considering its effect on the administration of estates . . . .

Id. at 294.

There is no question that many Congressmen recognized the potentially disasterous effects of carryover basis on farms. *See* 122 Cong. Rec., 30848 (1976) (statement of Rep. Conable); *id.* at 30849 (statement of Rep. Schneebeli). Apparently, however, it took a year of experience with carryover basis and many protests to make other Congrressmen question the wisdom of carry-

basis rule until December 31, 1979.[291] On April 2, 1980, President Carter signed the Crude Oil Windfall Profit Tax Act of 1980[292] which contained a section completely repealing the carryover basis provisions of the Internal Revenue Code[293] and reviving prior law.[294] However, the 1980 Act permits executors of estates of decedents dying after December 31, 1976 and before November 7, 1978 to irrevocably elect to have the basis of all estate property governed by the carryover basis rules.[295] Since some executors must now consider whether to elect to use carryover basis, the effect of section 2032A election on basis will be discussed as to both the "stepped-up" basis and carryover basis.

Under "stepped-up" basis rules the basis of the qualified real property would be "stepped-up" to special use values (presumably lower than fair market value). If it is unlikely that the property will be sold within fifteen years of the decedent's death, a decision of whether or not special use valuation should be selected will depend on a comparison of the estate tax saved against the increased capital gains tax which will be paid on the sale because of the lower basis. Often the capital gains rate will be lower than the estate tax rates, thus suggesting that the use of section 2032A will result in an overall tax savings.[296] However, if there is a possibility (or a likelihood) that the property will be disposed of within fifteen years after the decedent's death, or will cease to be used as a farm, or that material participation will not occur for three years or more during any eight-year period ending after the date of the decedent's death,[297] section 2032A should probably not be elected or, at least, the adverse consequences of election should be seriously considered. In this situation, not only will the estate tax originally saved be recaptured, but the beneficiary will realize a capital gain based on the excess of the amount realized over the special use value.[298] The reason for this is

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over basis.

291. Revenue Act of 1978, *supra* note 82, § 515.

292. Pub. L. 96-223.

293. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. 96-223, § 401(a).

294. *Id.* at § 401(b). The Act is effective with respect to decedents dying after Dec. 31, 1976. *Id.* at § 401(e).

295. *Id.* at § 401(d). The election must be made within 120 days following enactment of Pub. L. 96-223 in a manner prescribed by the Secretary of the Treasury or his delegate.

296. Also to be taken into account is the value of deferring taxes by paying less estate tax at decedent's death and more income tax on capital gains at a later date. Lastly, it should not be overlooked that the additional capital gains generated by the lower special use value basis may result in the imposition of a minimum tax (technically an alternative minimum tax for tax years ending after December 31, 1978). *See* I.R.C. §§ 56-58.

297. *See* I.R.C. § 2032A(c)(7)(B).

298. I.R.C. § 1001. Of course, a gift of the property to a non-qualified heir or a mere cessation of qualified use will not, as such, result in the realization of capital gains. *See* Treas. Reg. § 1.1001-1(a) (1957). However, care should be taken so that treatment of the transfer as part sale and part gift is avoided. *See* Treas. Reg. § 1.1001-1(e) (1957). However, even in these cases, on a subsequent sale by the beneficiary the capital gain realized will be the excess of the

that the basis of the qualified real property is not increased on the imposition of the recapture tax.[299] The result is that not only will the full estate tax (that is, the tax which would have been paid had the property been valued at its highest and best use) be paid, but an additional income tax based on a portion of the difference between the fair market value at the date of decedent's death (or alternate valuation) and the special use value on such date will be assessed. Thus the estate and/or the qualified heir will pay more tax by electing special use valuation than would have been the case if an election under section 2032A was not made.[300]

2. *Basis Under Carryover Basis*

When considering the basis consequences under the carryover basis rules,[301] several factors must be considered. Basically, for executors electing carryover basis,[302] the basis of property received by the estate or the beneficiary is its adjusted basis immediately before the death of the decedent.[303]

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amount realized over the special use valuation. Thus the same result is produced, but the capital gains tax is deferred until the sale or other disposition of the property by the qualified heir (in the case of the cessation of use as a farm or a failure to meet the material participation rules) or a sale or other disposition by the donee.

299. This is clear from the wording of I.R.C. § 1014(a), which provides in part:

> [t]he 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 [sic], its value determined under such section.

The only portion of section 2032A which mentions value is § 2032A(a), which provides that the value shall be "its value for the use under which it qualifies, under subsection (b), as qualified real property." Subsection (b), which defines qualified real property, refers to the date of decedent's death. Thus, the basis of the property is its special use value on the date of decedent's death or the alternate valuation date.

300. Of course, it is true that a portion of the estate tax will be deferred by making the § 2032A election. But in the context of an overall increase in tax, it is doubtful that in many cases the deferral will be significant enough to overcome the adverse tax consequences of the election.

301. *See generally,* T. McGRATH & J. BLATTMACHN, CARRYOVER BASIS UNDER 1976 TAX REFORM ACT (1977); Freilicher, *Problems of Fiduciaries Resulting from Carryover Basis,* 36 N.Y.U. INST. FED. TAX. 613 (1978); Barnett, *Carryover Basis at Death Neither Novel, New Nor Necessarily A Nightmare,* 12 U. MIAMI L. CENTER INST. EST. PLAN. 19-1 (1978); Covey, *Recent Developments Concerning Estate, Gift and Income Taxation 1977,* 12 U. MIAMI L. CENTER INST. EST. PLAN. 1-1 (1978); Covey, *Recent Developments Concerning Estate, Gift and Income Taxation—1976,* 11 U. MIAMI L. CENTER INST. EST. PLAN. 1-1 (1977). For a review of the inadequacies of the carryover basis rules, *see* Covey and Hastings, *Cleaning Up Carryover Basis,* 31 TAX LAW. 615 (1978). *See also* Conway, *Carryover Basis—An Impossible Dream,* 118 TRS. AND EST. 10 (Mar. 1979).

302. Crude Oil Windfall Profit Tax Act, *supra* note 284, § 401(d).

303. I.R.C. § 1023(a). For the purpose of the remainder of this article, adjustments to basis under § 1016 will not be considered.

Section 1023 then prescribes four adjustments which are to be made to this basis: a "fresh start" adjustment,[304] an adjustment for the federal and state estate taxes attributable to the appreciation in the property,[305] a minimum carryover basis[306] and an adjustment for state inheritance taxes paid by the person acquiring carryover basis property.[307] For the purposes of this article, a discussion of only the first two of these adjustments will be necessary.

With respect to qualified real property we start with the cost basis (as adjusted under section 1016). The "fresh start" adjustment is intended to prevent the income taxation of appreciation which occurred before the effective date of the Tax Reform Act.[308] This is done by assuming a uniform basis of appreciation; the excess of the value of such property over the decedent's adjusted basis is determined and multiplied by a fraction equal to the number of days the property was held by decedent prior to January 1, 1977 divided by the total number of days the decedent held the property.[309] The resulting amount (the fresh start adjustment) is added to the decedent's basis.[310] Although not mentioned in the statute, it is clear that for the purposes of the fresh start adjustment, the value of qualified real property is the value determined under section 2032A if special use valuation is elected.[311] Thus if a section 2032A election is made, the total appreciation will be less than if the property is valued at its fair market value. This will result in a lower fresh start adjustment and a lower basis. If the property is later sold, the capital gains will be greater than if no election had been made.

It should be noted that there is nothing in the carryover basis rules allowing a recomputation of the fresh start adjustment if a recapture event occurs and a recapture tax imposed. Although the legislative history does not disclose whether Congress considered the problem, a provision of the Revenue Act of 1978 raises an inference that no recomputation will be allowed. A question had arisen as to whether successive fresh start adjust-

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304. I.R.C. § 1023(b).

305. I.R.C. § 1023(c).

306. I.R.C. § 1023(d).

307. I.R.C. § 1023(e).

308. GENERAL EXPLANATION, *supra* note 3, at 553.

309. I.R.C. § 1023(h)(2). The excess of value over the decedent's adjusted basis is first reduced by adjustments for depreciation, amortization and depletion. I.R.C. § 1023(h)(2)(B)(i). After multiplying the result by the applicable fraction, adjustments for depreciation, amortization and depletion attributable to the portion of the holding period occurring prior to January 1, 1977 are added to the basis so computed. I.R.C. § 1023(h)(2)(B)(ii).

310. I.R.C. § 1023(h)(2)(A), (B).

311. For the purposes of this rule [the fresh start adjustment], the fair market value of property on the date of the decedent's death is to be determined under the special valuation rule for farms or other closely held businesses if that rule is elected for estate tax purposes (sec. 2032A), but determined without regard to the alternate valuation rule (sec. 2032).

GENERAL EXPLANATION, *supra* note 3, at 556.

ments would be allowed for carryover basis property which was devised, bequeathed or transferred intestate by more than one decedent. Section 702(c)(4) of the Revenue Act of 1978 added section 1023(b)(4) to the Code to state that basis would not be increased because of the death of a decedent if his basis reflects the adjusted basis of the property which was carryover basis property with respect to a prior decedent. The amendment reflects Congress' intention that there should be only one fresh start adjustment.[312] It can be postulated that no new adjustment to basis under the fresh start provision is to be made on the occurrence of a recapture event.

However, this is not the only problem facing an attorney or executor contemplating a 2032A election under carryover basis. A second adjustment to the carryover basis of property is made to reflect the federal and state estate taxes attributable to the appreciation.[313] The purpose of this adjustment is to avoid a double tax on the appreciation. This adjustment is made after the fresh start adjustment has been computed. The carryover basis is increased by an amount which bears the same ratio to the federal estate taxes as the net appreciation in value of the property bears to "the fair market value of all property which is subject to the tax imposed by section 2001 or 2101."[314] The first point of importance is that, as in the fresh start adjustment, the net appreciation in the value of qualified real property will be less if a section 2032A election is made than if the election is not made, thus resulting in a lower increase in basis. However, the most significant question regarding this adjustment is whether the imposition of a recapture tax triggers an increase in basis under section 1023(c) based on the additional estate tax paid. An argument could be made that since the effect of the recapture tax is to treat the qualified real property as if it had been valued originally in the decedent's estate at its fair market value (including the highest and best use standard), the entire 1023(c) adjustment should be recomputed based on the higher appreciation (fair market value on date of death less adjusted basis as opposed to section 2032A value less adjusted basis) and the increased estate tax paid, or, alternatively, that the qualified heir's basis in the qualified real property should be increased by that portion of the recapture tax representing the appreciation in the value of the property to the decedent's date of death. However, the available evidence suggests fairly clearly that no adjustment to basis under section 1023(c) will be made based on the recapture tax. The staff of the Joint Committee on Taxation stated, in regard to the adjustment for federal and state estate taxes:

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312. As stated by the Staff of the Joint Committee on Taxation as "Reasons for Change": "The Congress believes that it should be made clear that the 'fresh start' adjustment is to be made only once." GENERAL EXPLANATION, 1978, *supra* note 286, at 415.

313. I.R.C. § 1023(c).

314. *Id.* A similar adjustment is made with respect to state estate taxes.

> The term "Federal and State estate taxes" includes the tax imposed by section 2001 or 2101 reduced by any credits allowable against such tax. *It does not include any additional estate tax imposed because of a disposition of property which qualified for the special farm or closely held business valuation method.* (emphasis added).[315]

This is supported by the language of the statute, which refers to "the tax imposed by section 2001 or 2101."[316] The recapture tax is imposed by section 2032A(c), not by section 2001 or 2101. Thus, it is likely that no increase in basis will be allowed on the imposition of a recapture tax.[317] The result of a 2032A election will be a lower basis for the qualified real property. As under "stepped-up" basis, the task of the estate planner is to estimate the likelihood of a recapture event occurring within fifteen years of the decedent's death. If a recapture event is likely, it is highly dubious if the deferral of a portion of the estate tax will be a sufficiently significant benefit to outweigh the increased capital gains which will occur due to the 2032A election.[318]

B. *Preliminary Considerations in Estate Planning*

The benefits of section 2032A make several preliminary considerations applicable. Some of these may seem obvious, but they are of substantial importance. First, any estate where the taxable estate (plus adjusted taxable gifts) is under the exemption level should never elect section 2032A. The reason for this is that the application of the unified credit will result in no estate tax payable.[319] Since the benefit derived from a section 2032A election

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315. General Explanation, *supra* note 3, at 557. *See also* House Report, *supra* note 44., at 39.

316. I.R.C. § 1023(c)(1).

317. Most of the commentators on § 2032A agree with the conclusion that no increase in basis will be allowed under § 1023(c) for the portion of the recapture tax attributable to appreciation. *See, e.g.*, J. McCord, *supra* note 2, at 86; Tax Research Inst. of America, the RIA Complete Analysis of the '78 Revenue Act ¶ 108 at 19 (1978); Dyer, *supra* note 215, at 104; Kelley, *Valuation of Farm and Ranch Land After the Tax Reform Act*, 1 Agricultural L. J. 75, 94-95 (1979). Note, however, the somewhat cryptic statement in the House Report: "While the recapture tax is generally treated as a separate estate tax, it is treated as a tax on the estate of the decedent for the purposes of the previously taxed property credit." House Report, *supra* note 44, at 27.

318. It is necessary to reemphasize that the increase in the basis of property under carryover basis rules is reduced two ways if a § 2032A election is made: a lower fresh start adjustment and a lesser increase in basis for the portion of federal and state estate taxes attributable to appreciation. Moreover, the reduction is magnified since the adjustment for estate and gift taxes depends on the basis as determined after the fresh start adjustment is made.

319. The credits and exemption levels are as follows:

Year	Unified Credit	Exemption Level
1979	$38,000	$147,333
1980	42,500	161,563
1981	47,000	175,625

is to reduce the estate tax (or, in case a recapture event occurs, to defer a portion of the estate tax), there is no benefit from such an election where no tax is payable. In fact, only a detriment occurs in such a case, in the form of increased capital gains tax.

Second, special valuation does not apply to inter vivos gifts.[320] This signifies that the estate planner should use caution in advising lifetime gifts of potential section 2032A property. Such gifts may bring the value of the property below the fifty percent and twenty-five percent minimums necessary for qualification.[321]

Lastly, the estate planner should not ignore sections 6166 and 6166A.[322] In order to qualify for deferral under section 6166, more than sixty-five percent of the adjusted gross estate must consist of an interest in a closely held business.[323] If a section 2032A election is made, the section 2032A value must be used to determine qualification under section 6166.[324] In certain cases, a section 2032A election may result in the loss of the benefits of section 6166.[325]

Section 6166A also provides for a deferral of a portion of the estate tax attributable to an interest in a closely held business. The deferred tax is payable in no less than two or more than ten installments.[326] The interest rate is not as favorable to the estate as that under section 6166[327] and there is no five year deferral of principal payments. To qualify for a section 6166A

I.R.C. § 2010.

320. *See* I.R.C. § 2032A(a), (b). There is some question of whether property which is the subject of a gift and is includable in the gross estate (for example, if the gift was made within three years of death and thus was includable under I.R.C. § 2035) will qualify for special use valuation. There appears to be nothing in the statute or legislative history preventing such property from qualifying, and it is likely that the special valuation election will be available in such cases. *See* Dyer, *supra* note 215, at 98; Hjorth, *supra* note 39, at 641-42.

321. I.R.C. §§ 2032A(b)(1)(A), (b)(1)(B).

322. Each of these sections provides for deferral of a portion of the estate tax. Basically, § 6166 authorizes the deferral of that portion of the estate tax attributable to a closely held business interest for five years from the date the return is due and the payment of the balance in up to ten equal annual installments. I.R.C. § 6166(a). The interest rate is four percent on the first $1,000,000 of taxable estate and the rate under § 6621(b) on the balance. *See* Hjorth, *supra* note 39, at 631-39 for a further description of this section.

323. I.R.C. § 6166(a)(1).

324. House Report, *supra* note 44, at 32-33.

325. *See* Hjorth, *supra* note 39, at 634, n. 111.

326. I.R.C. § 6166A(a)(1).

327. The interest is determined under I.R.C. § 6601, which refers to § 6621. Section 6621 provides for an interest rate of nine percent or an adjusted rate established by the Secretary of the Treasury. An adjusted rate is to be established when the prime rate during September of any year (rounded to the nearest full percent) is at least a full percentage point more or less than the interest rate then in effect. The adjusted rate is the adjusted prime rate, rounded to the nearest full percent and becomes effective February 1 of the succeeding year. However, 23 months must elapse between the date of adjustments changing the interest rate. I.R.C. § 6621(b).

election, the value of the interest in the closely held business must exceed either thirty-five percent of the value of the gross estate or fifty percent of the value of the taxable estate.[328] Again, a reduction in the value of the qualified real property by virtue of a section 2032A election could result in not meeting the requirements of section 6166A.

It should be noted that one preliminary problem raised under section 2032A has been solved by the proposed regulations. Suppose gifts or other factors have reduced the value of qualified real property such that it does not meet the fifty percent or twenty-five percent tests for qualification. Changes resulting from the audit of the return (such as a decrease in the fair market value of other property at date of death or exclusion of other property from the gross estate)[329] could result in the property qualifying for special use valuation. But since the election must be made when the estate tax return is filed,[330] by the time the executor knows that the property qualifies for special use valuation the time for making the election will have passed. The proposed regulations[331] provide for the making of a protective election by the filing of a notice of election with a timely filed estate tax return and, if it is subsequently determined that the estate qualifies for special use valuation, the filing of an additional notice of election within sixty days of the date of the subsequent determination.[332]

C. *Absolute Bequest to One Beneficiary (Not the Spouse)*

The situation where the value of the estate is greater than the exemption levels and a qualified heir intends to continue to farm presents the least complications from the standpoint of the estate planner. In determining whether an election under section 2032A should be made, the estate tax savings must be weighed against the increased capital gains tax, and the importance (in terms of availability of assets to pay the estate tax) of tax deferral weighed against the likelihood of the occurrence of a recapture event. In

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328. I.R.C. § 6166A(a). Certain other qualification rules for § 6166A also differ from those under § 6166.

329. Initial qualification is based on the values of the gross estate and the real and personal property determined without regard to § 2032A. I.R.C. § 2032A(b)(3).

330. I.R.C. § 2032A(d)(1).

331. Proposed Treas. Reg. § 20.2032A-8(b), 43 Fed. Reg. 30,072 (1978).

332. The notice of protective election must include:

(1) The decedent's name and taxpayer identification number as shown on the estate tax return;

(2) The qualified use; and

(3) The items of real and personal property shown on the return which meet the § 2032A requirements (identified by schedule and item number). A protective election does *not* extend the time for payment of tax. The additional notice of election must include all the information required in a notice of election where the estate initially qualifies for special use valuation and must be attached, together with an agreement by all persons with an interest in property to be personally liable for the recapture tax, to an amended estate tax return. *Id.*

planning to keep the option available, material participation by the owner or a member of his family during the owner's life must be insured. Moreover, if the qualified heir is not the executor, the will should make provision for material participation.[333] In this situation, particularly if the qualified heir is committed to engage in farming and it is unlikely that he will sell or otherwise dispose of the farm and there is no problem with material participation, a section 2032A election may result in substantial tax savings.

D. *The Surviving Spouse as Beneficiary*

1. *Drafting Problems*

Very often one spouse may wish to bequeath the family farm to the other spouse. This is entirely natural, especially in the case of a farm family who has lived on and worked on the farm for their entire lives. However, the interrelationship of sections 2032A and 2056 raises a number of difficult questions.

First, the use of a marital deduction makes a section 2032A election inadvisable for any decedent having a gross estate of less than $351,250 or perhaps of less than $425,625.[334] This significantly reduces the number of estates which can profitably consider a section 2032A election.

Second, an election under section 2032A clearly dilutes the value of a marital deduction in large estates. This is a result of the reduction in the value of the gross estate. For example, suppose the decedent owned a farm having a fair market value of $3,000,000 and a section 2032A value of $1,500,000. The maximum marital deduction would normally be $1,500,000, but if a section 2032A election were made, the marital deduction would be

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333. This could presumably be accomplished by a provision in the will directing the executor to permit the qualified heir to operate the farm (perhaps making decisions jointly with the executor if there is concern that the executor would be abrogating his fiduciary duty by leaving total control in the hands of the qualified heir) during the period of administration. The will could also relieve the executor from liability for losses occasioned by the qualified heir's operation of the farm during this period. Alternatively, an agreement between the executor and the qualified heir regarding operation of the farm could be drafted prior to the owner's death, approved by the executor named in the will and the qualified heir, and executed immediately after the executor qualifies.

334. This conclusion applies after 1981, when the unified credit has been fully phased in. Again, the rationale is that there is no purpose in making a § 2032A election if there is no estate tax. The Tax Reform Act of 1976 changed the maximum marital deduction allowable to the greater of $250,000 or fifty percent of the adjusted gross estate. I.R.C. § 2056(c)(1). If the decedent bequeaths his spouse the maximum marital deduction, no tax will be payable on an estate valued at less than $425,625. It may be argued that such a bequest will cause the spouse to have a gross estate of $250,000, thus causing an estate tax on her estate; however, if the spouse dies owning qualified real property, there is no reason why her estate cannot make a § 2032A election (assuming the other requirements of the section are met), even though her spouse did not elect § 2032A.

$1,125,000.[335] This is a necessary result of the statute but is more than compensated for by the reduction in value of the gross estate. However, the interplay of the two sections could cause either a substantial overfunding or underfunding of the marital deduction. This can be easily illustrated by assuming a decedent owning as his only asset a farm with a "highest and best use" value of $500,000 and a section 2032A value of $250,000. Assume decedent's will contained a pecuniary formula maximum marital deduction[336] (to be satisfied at estate tax values) which amount was bequeathed outright to his spouse. Without section 2032A, it is clear that the surviving spouse would receive one-half of the farm. However, an election under section 2032A would reduce the gross estate to $250,000, thus creating the possibility that the surviving spouse would receive the entire farm (and the entire estate).[337] These problems could be solved by a provision in the will to the

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335. The maximum reduction in the value of the qualified property is limited to $500,000. I.R.C. § 2032A(a)(2).

336. There are two basic types of formula marital deduction provisions: the pecuniary formula provision (also known as the legacy provision) and the fractional share of the residue provision. The best description and treatment of the types of provisions is found in R. Covey, The Marital Deduction and the Use of Formula Provisions 8-20 (2d ed. 1978).

337. This would present a difficult problem of construction to a court. Courts have shown a tendency to favor the surviving spouse and to give effect to decedent's tax planning. *See, e.g.*, Osborn v. Osborn, 334 S.W.2d 48 (Mo. 1960), holding that a widow's share was to be paid in full and all general and specific bequests be abated where testator bequeathed his wife an amount necessary to obtain the maximum marital deduction, on the ground that testator's intention to take advantage of the maximum marital deduction overruled the normal order of abatement. *But see* Estate of Schwartz, 92 Misc. 2d 40, 399 N.Y.S. 2d 386 (Surr. Ct. N.Y. County 1977), holding that a bequest of "an amount which shall be equal to the maximum marital deduction" in a will executed prior to January 1, 1977 of a decedent dying prior to January 1, 1979 was to be governed by the law as it existed prior to the Tax Reform Act of 1976. Though the decision rested on § 2002(d)(1)(B) of the Tax Reform Act, providing that the increased marital deduction does not apply to a decedent dying before January 1, 1979 leaving a will executed prior to January 1, 1977 containing a maximum marital deduction clause, the court appears to be attempting to effectuate what it views to be testator's intention. It is entirely possible that a court could follow a line of reasoning similar to the example given in the text to rule that decedent intended his spouse to receive only one-half of the farm, despite the intention to receive the maximum martial deduction, by interpreting testator's words in the light of the will as a whole (perhaps viewing the existence of a residuary clause as evidence of decedent's intention not to bequeath the entire estate to the spouse). The example in the text is taken from Hjorth, *supra* note 39, at 647-48. Professor Hjorth has hypothesized that since a § 2032A election requires the consent of the beneficiaries, their consent might be interpreted as an implied taxable gift to the spouse of $250,000. However, a question may be raised in this situation as to whether the residuary beneficiaries have the "interest" required before they must sign the agreement required by § 2032A(d). In the example, suppose the surviving spouse instituted proceedings in the local probate court to construe the will, with the executor obtaining an extention of time to file the estate tax return. The probate court determines that the surviving spouse is entitled to the entire estate if a § 2032A election is made. Do the residuary beneficiaries then have an "interest" in the qualified real property for the purposes of § 2032A(d)? On the other hand, assuming the residuary beneficiaries have a cause of action against the executor for a breach of fiduciary duty in making the § 2032A election (whether they would be

effect that the surviving spouse's share should be computed by valuing all assets at fair market value regardless of whether a section 2032A election is made.[338] However, this will provision in the above example, would reduce the spouse's share (and the marital deduction) to $125,000. A serious question arises, entirely apart from tax considerations, whether such a result would be desired by most farm testators (or, for that matter, non-farm testators).[339] At a minimum, the estate planner should not leave the question to chance and, if considering the use of a pecuniary formula marital deduction, should explain the problems and consequences clearly and carefully to the testator.

The problems discussed have led one author to recommend avoiding the use of pecuniary formula marital deduction clauses, at least where the farmland is worth less than $1,000,000.[340] This is sound advice, at least until the uncertainties discussed are clarified.

2. *Technical Problems*

There are also certain technical problems in the relationship between section 2032A and the marital deduction. Assuming part or all of the family farm is bequeathed to the surviving spouse, the spouse becomes liable for the additional estate tax imposed by section 2032A(c).[341] Will this reduce the value of the marital deduction because it is an estate tax or an encumbrance on the property?[342] This question is not resolved as easily as the question previously discussed of whether the imposition of a recapture tax

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successful or not), is this a sufficient "interest" under § 2032A(d)? To be added to the pot is the fact that the IRS would not be bound by the probate court decision. Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). The answer to this type of question must await litigation.

338. Hjorth, *supra* note 39, at 648-49.

339. This result is contrary to a recent study indicating that, in general, testators desire a large portion or all of their estate to go to the surviving spouse, even if they have living children. *See generally, Contemporary Studies Project, supra* note 16.

340. Hjorth, *supra* note 39, at 650.

341. I.R.C. § 2032A(c)(6).

342. I.R.C. § 2056(b)(4) provides:

> Valuation of interest passing to surviving spouse—In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section—
>
> (A) there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and
>
> (B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

See J. McCord, *supra* note 2, at 351-52.

increases the qualified heir's basis under the carryover basis rules.[343] Presumably, Congress did not intend to reduce the marital deduction because of the possibility of a recapture tax. A forceful two-pronged argument can be made for this position. First, even though section 1023(c)(3), specifically defines "federal estate tax," the word should be given the same meaning in sections 1023, 2032A and 2056 in these circumstances. If the recapture tax is not an estate tax for the purposes of carryover basis adjustments, it should also not be an estate tax for the purpose of reducing the marital deduction. Secondly, the words "any estate, succession, legacy or inheritance tax" in section 2056 may be interpreted as referring to taxes imposed by the states, rather than the federal estate tax.[344] Assuming this hurdle is overcome, the question is whether the recapture tax is an encumbrance. One author has argued that if estate tax values are used to fund the marital deduction, no problem will result, since the recapture tax and the section 6324B lien will attach to the "excess value" of the qualified real property not included in the gross estate, not to the marital deduction value.[345] This argument is persuasive, but it does not, as the author recognizes, solve the problem when date of distribution values are used.[346] These questions should be answered by regulations; it is hoped that the regulations will reflect the presumed congressional intent that the marital deduction not be reduced simply because of the possibility of a recapture tax or the imposition of a special lien.[347] Relevant to the question of whether the recapture tax will reduce the marital deduction, and of great significance to the draftsman, is whether the testator's will can direct that someone other than the qualified heir pay the recapture tax. A clause commonly found in wills directs the payment of all estate and inheritance taxes from the portion of the property not qualifying for the marital deduction. There is no evidence that Congress considered this question. The statute says only that the qualified heir shall be personally liable for the recapture tax with respect to his interest.[348] It can be in-

343. I.R.C. § 1023(f)(3) defines "Federal estate taxes" as "the tax imposed by section 2001 or 2101, reduced by the credits against such tax." In contrast, I.R.C. § 2056 (b)(4) refers to "the tax imposed by section 2001, or *any* estate, succession, legacy or inheritance tax." (emphasis added).

344. This interpretation is supported by the reference in § 2056(b)(4)(A) to the tax imposed by § 2001, rather than a reference to federal estate taxes generally. Note also I.R.C. § 2011(a), which uses the term "any estate, inheritance, legacy, or succession taxes" as referring to taxes paid to any state or the District of Columbia, in reference to the state death tax credit.

345. J. McCord, *supra* note 2, at 351.

346. *Id.*

347. The closest analogy to this problem is whether the special lien provided for under I.R.C. § 6324A when an extension of time to pay estate taxes is granted under I.R.C. §§ 6166 or 6166A is an encumbrance reducing the marital deduction. Unfortunately, research has disclosed no cases in which this question was decided.

348. I.R.C. § 2032A(c)(6). There is no discussion of this question in the House or Senate reports.

ferred from the two existing federal estate tax apportionment statutes,[349] however, that a testamentary direction that the tax be paid by someone other than the person receiving the qualified property will be ineffective. It is clear that Congress knew how to permit a testator to alter a statutory tax apportionment scheme. Both section 2206, relating to life insurance, and section 2207, relating to property over which decedent had a power of appointment, provide that the total estate tax shall be apportioned and the beneficiaries of such property are liable for that portion of the tax bearing the same ratio to the total tax as the value of the property (or the proceeds of insurance) bears to the taxable estate, "*[u]nless the decedent directs otherwise in his will.*" (emphasis added).[350] This clear permisson for testator to vary the tax apportionment by his will was not included in section 2032A(c)(6). Its absence suggests that Congress did not intend to permit the testator to relieve the qualified heir of liability for the recapture tax[351] and it is likely that the IRS will not recognize such an attempt to direct against the imposition of the recapture tax by will.

3. *Problems Solved by Revenue Act of 1978*

Lastly, it should be noted that two important problems were solved by the Revenue Act of 1978. These problems affected both pecuniary bequests to the surviving spouse and to other beneficiaries. The first question is whether, when the estate distributes property qualifying for special use valuation in satisfaction of a pecuniary bequest, the property is considered to have been acquired from or passed from the decedent. Generally, the satisfaction of a pecuniary bequest by distribution of property is treated as a taxable transaction and thus as not having been acquired from or passed from a decedent.[352] The Revenue Act of 1978 added section 2032A(e)(9) to the Code, providing that property distributed by an estate in satisfaction of a pecuinary bequest and property distributed by a trust in satisfaction of a right to receive a specific dollar amount from a trust which is the equivalent

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349. I.R.C. §§ 2206, 2207.

350. *Id.*

351. Of course, it could be argued that the personal liability of the qualified heir mandated under § 2032A(c)(6) was intended as a back-up in case the IRS was unable to collect the recapture tax from funds reserved by the executor or to proceed against the property. This interpretation would permit the decedent to direct that the tax be paid from property bequeathed to another. However, this argument ignores the transferee liability imposed by § 6901 of the Code. This section permits the IRS to collect the estate tax from any transferee of the property. The recapture tax is included since § 6901(a)(1) refers to a tax imposed by chapter 11 of the Code, which includes § 2032A. Furthermore, § 6901(h), defining transferee, includes anyone personally liable for any part of the tax under § 6324(a)(2). A beneficiary who receives property included in the gross estate to the extent of the value of such property is such a person. Since "back-up" liability is already imposed on the qualified heir, there is no reason to read § 2032A(c)(6) as repeating provisions already in the Code.

352. *See* GENEAL EXPLANATION, 1978, *supra* note 286, at 422.

of a pecuniary bequest shall be considered to have been acquired from or passed from the decedent.[353]

The second question is raised by the provision of the Tax Reform Act of 1976 requiring that when appreciated carryover basis property is distributed to satisfy a pecuniary bequest, gain is recognized to the extent that the fair market value exceeds the estate tax value of the property on the date of the exchange.[354] When property as to which a section 2032A election has been made is used to satisfy a pecuniary bequest, a large amount of gain would often be recognized due to the reduced estate tax value. It was clearly not the intent of Congress to subject the difference between the fair market value and the special use value to income taxation on distribution of the property to satisfy a pecuniary bequest.[355] Therefore, the Revenue Act of 1978 amended section 1040(a) to provide that the estate tax value for the purpose of recognizing gain under that section would be determined without regard to section 2032A.[356] The effect of the revised section is that gain will be recognized only to the extent of the difference between the fair market value of the property on the date of distribution and the fair market value on the decedent's date of death or alternate valuation date.

E. *Outright Bequest to Several Beneficiaries*

Assume Farmer Brown has three children: Jim, who has helped on the farm all his life and who wishes to operate the farm after Farmer Brown's death; Jane, who has married a teacher and moved to a large city; and Joe, who is about to enter law school. Assume further that Farmer Brown's estate consists of the farm (including the house located thereon and all machinery, livestock, etc. necessary to operate the farm), with a fair market value of $700,000 and a section 2032A value of $400,000, and $200,000 of insurance. Farmer Brown wants to treat all his children equally, yet, he also wants the farm to pass intact to the next generation and for Jim to be able to operate it. This scenario is not uncommon. However, when section 2032A is injected into the situation, it enhances the possibility of conflicts among the beneficiaries.

Farmer Brown has several alternatives. First, he may decide that preserving the farm for Jim is more important than equality among the children and leave the farm outright to Jim, and the insurance proceeds equally to the other children. The likely results of such an estate plan will be that Jane and Joe will be angered at being "slighted" and take their anger out on the favored child, Jim. This potential for conflict among the children existed before the enactment of section 2032A and was presumably in many cases a

353. Revenue Act of 1978, *supra* note 82, § 702(d)(2).
354. I.R.C. § 1040(a).
355. General Explanation, 1978, *supra* note 286, at 423.
356. Revenue Act of 1978, *supra* note 82, § 702(d)(3).

major reason for other arrangements. Another possibility is that both the farm and the cash could be divided equally with a requirement that the beneficiaries agree to permit Jim to operate the farm during his life or some other requirement assuring Jim's control of operation of the farm.[357] Even though Jane and Joe might be disappointed in being required to wait a long period of time to obtain cash, creating the potential for some conflict among the children, there was little they could do about it. The existence of section 2032A, however, increases the possibilities of conflict. Ignoring debts and administration expenses, the tax on an estate of $900,000 is $228,840,[358] whereas with a section 2032A election the tax is reduced to $129,400. Jim, of course, will desire that a section 2032A election be made, since the estate is illiquid. Assuming Jim has few liquid assets of his own, in the absence of a section 2032A election he will have to borrow some money to pay his portion of the estate tax. Jane and Joe, however, are motivated by other considerations. Joe needs money to finance his law school education. He might well rather pay the increased estate tax and sell his share of the farm in order to raise the necessary money. Jane would likely prefer to invest her share of the estate in high income-producing assets rather than in the farm or use some of her share for immediate purchases. If a section 2032A election is made, however, Jane and Joe will be unable to dispose of their shares for fifteen years. Thus Jane and Joe will undoubtedly pressure Jim to sell the farm. Moreover, section 2032A will give Jane and Joe a weapon to exert more pressure on Jim than they could before section 2032A was enacted. A section 2032A election requires the filing of an agreement signed by each person having an interest in the property consenting to personal liability for the recapture tax.[359] By refusing to sign the agreement, Jane or Joe can block the section 2032A election. The conflicts between the children can easily destroy any family feeling that previously existed among the children.[360]

Even if Farmer Brown has sufficient liquid assets to leave the farm to Jim and other assets of equal value to Jane and Joe, section 2032A has the potential for creating family conflicts. Suppose Farmer Brown specifically bequeaths the farm to Jim and the residue of his estate equally to Jane and Joe. The residue of the estate is charged with the payment of all estate taxes.[361] In this case, the previous situation is reversed. Jane and Joe will

357. Often this takes the form of granting the farm child an option to purchase the share of the other beneficiaries over a long period of time at the estate tax value.

358. Assuming decedent died after 1981 when the § 2010 unified credit is fully phased in.

359. I.R.C. § 2032A(d)(2).

360. Farmer Brown could, of course, require Jane and Joe to sign the agreement under § 2032A or be disinherited. This would preserve the farm for Jim, but might cause increased hostility among the children. Farmer Brown could also adopt some other form of disposition, such as leaving the entire estate in trust with the income distributed equally among the children and appointing Jim as trustee, but such a disposition would not cure the conflict potential discussed.

361. This will be required in most cases since few farmers have sufficient liquid assets to

desire the election of special use valuation, since they will receive all the benefit of an estate tax reduction. However, Jim will obtain no benefit from the special use valuation. Moreover, the value of his interest will be reduced in several ways. First, his ability to dispose of the farm for fifteen years will be restricted. Second, he will assume liability for the recapture tax and a section 6324B lien will be placed on the farm. Third, his basis for the farm will be lower if special use valuation is elected, resulting in increased income taxes if and when he sells the farm. Thus, similar conflicts to those discussed above are inevitable.[362] Here, however, it is Jim who holds the club,

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both equalize the bequests to the non-farm children and pay estate and inheritance taxes.

362. This example is taken basically from Dyer, *supra* note 215, at 100-01. Dyer, however, does not mention the reduction of the value of Jim's interest because of the lower basis. Dyer advocates the following three solutions to the problem. (1) Give all the children an equal fraction of the farm and cash. As discussed above, this solution does not insure the peaceful resolution of the conflicts among the children. (2) Equalize the value of the gifts after taking into account the benefits and burdens caused by special use valuation. Dyer states that this solution requires a provision that unless the farm child agrees to sign the agreement required by § 2032A, the children receiving the residuary also receive a portion of the farm child's bequest equal to the tax savings which would have been achieved by electing special use valuation. *Id.* at 100 n.53. Dyer rejects this option on the ground that it is wiser to permit the beneficiaries to decide after the decedent's death whether to elect.

However, this is not the crux of the problem, since it could be solved by a will provision providing the adjustment would not be made if the beneficiaries agree that special use valuation should not be elected. The problem is that Dyer assumes the exceedingly unlikely event that in addition to the cash (or other liquid assets) necessary to pay debts, administration and funeral expenses, and estate and inheritance taxes, the farmer-decedent also has sufficient assets so that some cash will pass to the farm child. The unlikelihood of such an occurrence is illustrated by a recent study of Iowa farms, which found that in farm estates in excess of $200,000, 57% of the assets were in farm real estate, 25% in non-realty farm assets, 9.5% in investments, 6.5% in insurance and 2% in miscellaneous. *Contemporary Studies Project*, *supra* note 16, at 894. The farm estates having liquid assets remaining to distribute to the farm child, after the payment of estate expenses, taxes, expenses of continuing the farming operations and equalization bequests to non-farm children, as Professor Dyer postulates, will be exceedingly rare. However, if such a situation arises, the provision discussed should be seriously considered as a means of minimizing family conflicts.

(3) Disinherit any beneficiary who does not agree to a § 2032A election (if the executor determines that the benefits of an election would outweigh the burdens) together with an indemnity agreement by which the non-farm children agree to pay a portion of any recapture tax which may become due. First, it is doubtful that this solution would avoid conflicts between the children. Second, Professor Dyer gives little guidance as to how the executor is to determine when the benefits of an election outweigh the burdens. Third, Professor Dyer states that the executor should make this determination without taking into account the individual tax situations of the beneficiaries, since there is no way the executor can evaluate or predict the tax situation of the beneficiaries. Dyer, *supra* note 215, at 101-05. The potential income tax problems, previously discussed in this article, are as likely a source of family conflict as the estate tax benefits and burdens of a § 2032A election. If the aim is to avoid conflict among beneficiaries, income tax considerations causing such conflicts cannot be removed from the picture. Professor Dyer implicitly agrees when he says:

> I recommend the executor be instructed to minimize the estate taxes considered alone unless all the children agree not to elect special valuation. I admit that this

since he has the only interest in the property and completely controls whether special use valuation will be elected.

It is probably not possible in many situations to avoid all the conflicts among beneficiaries discussed above. Furthermore, other arguments between beneficiaries may result during the fifteen-year period when recapture is possible, due to investment opportunities.[363] However, these conflicts may be minimized by complete discussion during the testator's lifetime with the testator and prospective beneficiaries of the options available and the consequences of electing 2032A.[364] In addition to the possible minimization of conflicts, the discussions could focus the testator's thinking more sharply on the possible result of his intended scheme of disposition, perhaps leading

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> means the children will be left to resolve the conflict themselves, and their negotiations will be made extremely difficult by the fact that each will know approximately what the other has to gain or lose, but the executor cannot estimate realistically the children's tax situation.

Id. at 105.

The problem has no easy solution. This author's experience indicates, however, that less family conflict exists when the proposed estate plan and its consequences are explained clearly and completely to the beneficiaries prior to the death of the testator, and that the most bitter conflict among beneficiaries occurs where the beneficiaries attempt to bargain with each other after testator's death. This may be caused primarily by the grief felt by the children over the testator's death; emotions are near the surface and anger transfers easily. Thus, if it is the testator's wish that a beneficiary be disinherited for not agreeing to a § 2032A election if the executor determines that the benefits of the election outweigh the burdens, the best way of minimizing the conflicts among the beneficiaries is for the situation to be fully discussed with each beneficiary before testator's death. Furthermore, the executor should be given the power to make the determination considering all factors, including his best estimate of the effects of the election on the income tax situation of all beneficiaries.

However, there is an even more important objection to Dyer's final solution. Implicit in it is an assumption that a testator would view continuation of the family farm in one heir as a goal important enough to disinherit a child who thwarted testator's wishes in this regard. In some cases, this may be true. However, this assumption is never clearly stated by Professor Dyer nor does he provide any information or statistics supporting the assumption. It is more reasonable to believe to the contrary, that most testators will be very reluctant to disinherit a child, regardless of any faults or attitudes of the child. Given the choice of a higher estate tax (or a possible inequality of the benefits among the children) because of a refusal to agree to a § 2032A election or the disinheritance of a child, many (and perhaps most) testators would chose not to disinherit the child who refuses to sign the agreement. The desire to keep the farm in the family is strong among farmers, but love and affection for all their children is as strong if not a stronger motivating factor in their dispositional desires.

363. For example, during the recapture period, the farm child could decide to sell the qualified property for a variety of reasons: he may no longer wish to farm, he may have an opportunity to purchase a better parcel, or illness in his spouse's family may require that he lives elsewhere. The non-farm children may be forced to engage in material participation or pay their share of the recapture tax. Either alternative may cause a significant disruption of their lifestyles and substantial ill feelings will often result. *See* M. BOEHLJE & N. HARL, *supra* note 50, at 41.

364. It is possible that some of the conflicts may be avoided or minimized by the form of organization chosen for the farm. *See* Section VI F *infra*.

him to a decision to change his dispositive plan to reduce these conflicts.

F. *Partnerships and Corporations*

It is clear that Congress intended qualified real property owned in the partnership and corporate farms to be eligible for a section 2032A election, assuming the other qualification requirements are met.[365] Partnerships and corporations have become increasingly popular forms of ownership for farms in recent years, primarily because they offer continuity into succeeding generations and tend to preserve the greater efficiency of operation often attained by an individual as he gains increased management ability and experience (which tends to decline as the farmer attains advanced age).[366] Despite Congress' obvious intention, however, not only are there problems with the application of section 2032A to corporations and partnerships, but there is no statutory language to aid in solving these problems.

At the outset, it must be recognized that there are two relevant time periods involved: the initial qualification under section 2032A, and the fifteen-year period of possible recapture. Most of the problems involving partnerships and corporations involve initial qualification, so we will begin there.

The first problem is the reference in the *House Report* tying the special use value election to qualification under section 6166.[367] The first question that has been raised is basic: Will the entity's ownership of real and per-

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365. The bill directs the Treasury Department to prescribe regulations setting forth the application of these special use valuation rules (and the security requirement, discussed below) to situations involving otherwise qualifying real property held in a partnership, corporation or trust which, with respect to the decedent, is an interest in a closely held business. Your committee intends 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 the property is used constitutes a closely held business (as defined in section 6166, as amended by section 5 of this bill) and the real property would qualify for special use valuation if it were directly by the decedent.

House Report, *supra* note 44, at 24. Section 2032A(g) mandates the issuance of regulations specifying how § 2032A applies in the case of a partnership, corporation or trust which is a closely held business (within the meaning of § 6166(b)(1)). Presumably, Congress intended that such interests would qualify for special use valuation.

366. N. Harl, Farm Estate and Business Planning 156 (1978). An extended discussion of the tax and non-tax disadvantages of partnerships and corporations is beyond the scope of this article. They share the advantage of continuity and possess the income tax advantage of permitting a shifting of income to lower bracket taxpayers. The corporation, however, has much more flexibility with regard to the latter. For a discussion of the advantages and disadvantages of each form, *see id.* at 155-240. For a short summary of the advantages and disadvantages of corporations, *see* Note, *Estate Tax Planning in Agriculture: How to Save That Farm From the Tax Collector*, 47 U. Mo. - K.C.L. Rev. 417, 421-26 (1978).

367. House Report, *supra* note 44, at 24.

sonal property be attributed to decedent? Presumably, the reference in the *House Reports* to section 6166 was intended to permit the property owned by the entity to be attributed to the decedent. In fact, section 6166(b)(2)(C) provides that property owned by or for a corporation, partnership, estate, or trust shall be considered as being owned by its shareholders, partners or beneficiaries proportionately. In light of the clear congressional intent, presumably the rule will apply under section 2032A for the purpose of meeting the qualifications of that section and the decedent will be deemed to own the entity's property in proportion to his interest in the entity.[368] Curiously, the proposed regulations state only that "[w]here the ownership [of qualified real property] is indirect, however, the decedent's interest in the business must qualify under the tests of section 6166(b)(1) of the Code as an interest in a closely-held business in addition to meeting the tests for qualification under section 2032A."[369] However, one of the examples given by the proposed regulations implies that ownership of the assets of the entity will be attributed to the decedent for the purposes of qualification under section 2032A.[370]

A second basic question has been referred to as the possibility of a circular disqualification for a section 2032A election.[371] The explanation is that section 6166(b)(4) requires that the value of an interest for the purposes of section 6166 be determined by the Chapter 11 (estate tax) values. Chapter 11 includes section 2032A. Therefore, the possibility exists that, though the decedent's interest in the closely held business would qualify under section 6166 using fair market value, using section 2032A values the interest would not qualify.[372] One possibility to solve this problem would be to use the same value for purposes of qualification under section 6166 as was used to determine qualification under 2032A, that is, the value of the property determined without reference to section 2032A.[373] This would be consistent with the congressional intent. In order to do this, however, a court would

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368. J. McCORD, *supra* note 2, at 329.

369. Proposed Treas. Reg. § 20.2032A-3(b), 43 Fed. Reg. 31,040 (1978).

370. Proposed Treas. Reg. 20.2032A-3(f) (Example 5) states:

> Decedent I owned 90 percent of all outstanding stock of X Corporation, a qualified closely-held business which owns real property to be specially valued. I held no formal position in the corporation and there was no arrangement for him to participate in daily business operations. I regularly spent several hours each day at the corporate offices and made decisions on many routine matters. I is not deemed to have materially participated in the X Corporation despite his actvity because there was no arrangement requiring him to act in the manner in which he did.

Id., 43 Fed. Reg. at 31,042. If the real property was not attributed to I through his ownership in the corporation, the estate would not have qualified to elect special use valuation under §§ 2032A(b)(1)(A) & (B) and the question of whether or not there was an arrangement would not have been reached.

371. *See* J. McCORD, *supra* note 2, at 330; M. FELLOWS, *supra* note 260, at 105.

372. J. McCORD, *supra* note 2, at 330.

373. I.R.C. § 2032A(b)(3).

have to read the words "without reference to section 2032A" into section 6166(b)(4) based on presumed congressional intent. However much good sense this argument makes, several authors have warned that until regulations are issued clarifying these areas, farms organized as partnerships or corporations cannot be assured of complying with section 2032A.[374] If qualification under section 2032A is a major goal, sole proprietors should think carefully about changing the form of organization, despite other advantages of the partnership or corporate form.

These are not the only problems of using the partnership or corporate form in connection with section 2032A. One of the major advantages of the corporate form is the ease of transferability of shares of stock. This greatly facilitates gifts to minors, shifting income to lower bracket taxpayers and providing an assured source of income (through issuance of preferred shares) for older shareholders while concentrating ownership in the next generation.[375] Another use of preferred stock or debt securities is to concentrate ownership in a farm child while giving non-voting securities to off-farm heirs.[376] Reducing decedent's voting control below twenty percent of the value of the corporation will result in inability to elect special valuation.[377] Diversifying ownership among more than fifteen persons will also result in losing the opportunity to elect special valuation.[378] Presumably, these problems can be minimized by careful planning, but other problems are not so easily solved.[379]

The proposed regulations have at least partially solved the problem of material participation (which is the major recapture tax problem regarding specially valued property held in a corporation or partnership) in the case of indirect ownership. The proposed regulations state:

> Where the real property is indirectly owned, however, even full-time involvement must be pursuant to an arrangement between the entity and

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374. J. McCord, *supra* note 2, at 331; M. Fellows, *supra* note 260, at 105-06.

375. N. Harl, *supra* note 366, at 196, 227.

376. *Id.* at 250.

377. *See* I.R.C. § 6166(b)(1)(c)(i).

378. *See* I.R.C. § 6161(b)(1)(c)(ii).

379. Some major problems mentioned by McCord include:

(1) Are secured liabilities of the entity "passed through" to the decedent, reducing the value of his interest?

(2) What is the effect of the attribution rules on buy-out or cross-purchase agreements, or § 303 redemptions, if any, which may be a necessity to ensure control in the farm child and to continue the business? And, particularly crucial for many farm corporations,

(3) How will the attribution rules as to property owned by an entity operate when preferred stock is outstanding, if the preferred stock has a priority claim to the real property or tangible assets of the corporation? *See* J. McCord, *supra* note 2, at 330-31, for a discussion of these and other problems. Without knowledge of the answers to these questions, estate planners are faced with extremely difficult, if not impossible, problems in advising clients. On one hand are the advantages of the corporate and partnership forms but, if they are used, the decedent may lose all opportunity to elect special use valuation.

> the decedent or family member specifying the services to be performed. Holding an office in which certain material functions are inherent may constitute the necessary arrangement for material participation.[380]

Thus, presumably, if the qualified heir is the president (or chief operating officer) of the corporation, the nature of the duties of the office would constitute material participation. Due to the vagueness of the last sentence above quoted, however, in any corporate situation a written arrangement should be entered into between the corporation and the decedent or member of his family (before death) and the corporation and the qualified heir or family member (after death) clearly providing for material participation. It should not be left to the Service or a court to decide whether the inherent duties of the office constitute material participation.[381]

G. *Trusts*

A trust is one of the most useful tools available to estate planners, primarily due to its flexibility.[382] It is highly useful in many farm situations.[383] However, by its lack of specificity and perhaps by inadvertence, in enacting

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380. Proposed Treas. Reg. § 20.2032A-3(e), 43 Fed. Reg. 31,041 (1978).

381. These dangers are illustrated by Proposed Treas. Reg. § 20.2032A-3(f) (Example 5) discussed in note 370, *supra*, stating that ownership of 90% of the outstanding stock of a corporation is not in itself enough to constitute material participation without an arrangement. *See also* Proposed Treas. Reg. § 20.2032A-3(f) (Example 6) stating that a senior partner in a law firm (a qualified closely held business), who had ceased to practice law five years prior to his death, would not meet the material participation requirements though he remained a full partner and received a share of firm profits each year if the payments were not pursuant to a retirement agreement. The reason given is that decedent did not meet the requirement of "actual personal material participation." Query: Suppose the decedent received his share of firm profits pursuant to a retirement agreement. Would he have satisfied the material participation requirement? It should be noted that the proposed regulations also provide:

> Where property is owned by a corporation or partnership, participation in the management and operation of the real property itself as a component of the closely held business is the determinative factor. 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.

Proposed Treas. Reg. § 20.2032A-3(e)(2), 43 Fed. Reg. 31,041 (1978).

382. *See* E. SCOLES & E. HALBACH, PROBLEMS AND MATERIALS ON DECEDENTS' ESTATES AND TRUSTS 226-30 (2d ed. 1973). Some of the same problems to be discussed in this section are present in similar arrangements, such as the creation of life estates and remainders. However, to simplify the discussion, this subsection will deal exclusively with the trust. The reader should have no problem in applying the discussion to similar arrangements.

383. *See* N. HARL, *supra* note 366, at 129-38.

section 2032A Congress has created many problems in the use of trusts by farm families wishing to elect section 2032A valuation.[384]

As in the case of corporations and partnerships, the problems with the use of a trust arise both as to initial qualification and as to recapture. In this instance, the problems with recapture will be discussed first.

1. *The Separation of Interests Problem*

For this purpose, a simple example may be instructive. Assume Farmer Green owns a farm in fee simple. In his will he bequeaths the farm in trust with the income to be paid to his son, Albert, for life, remainder to Albert's issue. His plan is for Albert to operate the farm, so he includes a provision in his will directing the trustee to permit Albert to operate the farm during his lifetime if he so desires. At the time of Green's death, Albert has two children, ages seven and five. Seven years later, Albert, tired of farming and short of cash, decides to sell his life estate.[385] When the farm is sold, or ceased to be used as a farm, a recapture event occurs and the recapture tax comes due.[386] Two immediate questions arise: how much tax is due and who is liable for the tax?

At first blush, the statute is open to an interpretation that only a portion of the adjusted tax difference or tax savings will be recaptured. This interpretation comes from the language of section 2032A(c)(2), which states that the recapture tax imposed with respect to any interest shall be the lesser of "the adjusted tax difference attributable to such interest" or "the excess of the amount realized with respect to the interest . . . over the value of the interest."[387] Moreover, the *House Report* makes clear that when more than one qualified heir receives the property or receives an interest in the property, "the adjusted tax difference is to be allocated among the property interests in proportion to their respective reductions in value."[388] Since "in-

384. Again, it is clear that Congress intended to permit an estate to elect special use valuation when the property was held in trust by the decedent or when the decedent bequeathed the property in trust. *See* House Report, *supra* note 44, at 24.

385. A life estate is alienable. *See* T. Bergin & P. Haskell, Preface to Estates in Land and Future Interests 39 (1966). The conclusions drawn would be equally applicable if Albert decided to move from the farm and discontinue farming or to use the farm for some nonqualified use.

386. I.R.C. § 2032A(c)(1).

387. I.R.C. § 2032A(c)(2)(A).

388. House Report, *supra* note 44, at 26. The only relevant ruling so far issued by the IRS on this matter lends support to the argument that only a portion of the tax savings will be recaptured. In IRS Letter Ruling 7934007 (April 30, 1979), 3 Fed. Est. & Gift Tax Rep. (CCH) ¶ 12,304, decedent bequeathed her husband what the service determined to be a fee simple in a ranch qualifying for special use valuation. Some time after decedent's death, her husband transferred the ranch to persons who were not qualified heirs, receiving a lease for his life and a mortgage securing a promissory note for less than full and adequate consideration. The lease was to be effective only if the purchaser would obtain new state leases and federal agency per-

terest" is not defined in section 2032A, there is no reason to exclude life income interests or remainders from inclusion as interests. Therefore it could be argued that only the adjusted tax difference attributable to the life income interest should be recaptured. However, such an interpretation opens possibilities of estate tax avoidance. Assume Albert is living fifteen years after his father's death. No further tax would be recoverable since the remaindermen had not sold their interests or done anything to trigger recapture.[389] Under this interpretation, the decedent's family has discontinued participation in active farming operations on the qualified real property, but the entire estate tax savings has not been recovered, contrary to congressional intent. The same situation is possible if the remaindermen were adults and disposed of their interests while Albert continues to operate the farm.

There is some indication that Congress intended to treat the recapture tax as a unit. In this regard, the *House Report* notes:

> However, if the decedent leaves qualified real property for which special use valuation was elected to two or more qualified heirs with successive interests in the property, potential liability for the recapture tax is not diminished and none of the property is to be released from potential liability for the recapture tax until the death of the last of the qualified heirs (or, if earlier, upon the expiration of 15 years from the date of the death of the decedent).[390]

Though the statement is ambiguous, it could be interpreted as merely stating that if the remaindermen later disposed of their interests to non-family members within fifteen years of the decedent's death, the remainder of the adjusted tax difference would be recaptured. However, the tax avoidance possibilities indicate that perhaps it should be read as treating the successive interests as a unit, with the recapture tax imposed in full if the owner of any interest disposes of his entire interest to a non-family member or ceases to use the property for a qualified purpose. However, it should be noted that this interpretation seems to contradict the section 2032A(c)(2) statutory scheme of carefully allocating the adjusted tax difference among the various "interests" in the property.

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mits. The Service held that the transfer triggered the recapture provisions of § 2032A. The taxpayer, however, contended that only the additional tax attributable to the remainder interest was due, since the leaseback of the ranch was equivalent to a retained life estate. The Service held that the full recapture tax was due, but indicated that its opinion was influenced by the necessity of obtaining the state leases and permits. The Internal Revenue Service stated: "The sale and leaseback arrangement entered into by the decedent's husband has many of the elements of a retained life estate." The letter ruling indicates a tentative policy of the IRS to read the statute as requiring that only a portion of the tax savings be recaptured if only one of several successive interests is sold.

389. *See* I.R.C. § 2032A(c)(1).

390. HOUSE REPORT, *supra* note 44, at 26.

If possible, who pays the tax is even more unclear than how much tax is due on a recapture event. Returning to the example at the beginning of this subsection, suppose Albert actually sells the farm. A recapture tax is due. Let us assume for the moment that, due to the possibility of tax avoidance if only the portion of the tax allowable to Albert's life estate is due, the entire adjusted tax difference is recaptured. Does Albert pay the entire tax or is it apportioned?

Albert can make a strong argument that the tax should be apportioned. The argument is similar to that made previously on how much tax is due and is again based on section 2032A(c)(2). Albert, since he only disposed of his life estate (his interest) should pay only "the adjusted tax difference attributable to such interest."[391] Moreover, this interpretation receives support from the *House Report:* "Where more than one qualified heir receives qualified real property with respect to which special use valuation has been elected or receives an interest in such property, the adjusted tax difference is to be allocated among the property interests in proportion to their respective reductions in value."[392] However, if Albert is only liable for his share of the adjusted tax difference, we have the situation of a life tenant being able to force the remaindermen to pay a share of the recapture tax when they did not cause the recapture event, nor could they do anything to prevent recapture. This has all the ingredients of a holdup situation by the life tenant (this would probably not happen in our case, since the remaindermen are his children, but could in other situations) and is an anomalous situation in any event. All dictates of equity mandate that in the example the life tenant should pay the entire recapture tax. But there is almost nothing in the statute or legislative history to indicate such a result was intended.[393]

One other possibility should be considered. The explanation of Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation states: "Trust property shall be deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a *present interest* in that trust property." (emphasis added).[394] The Staff explanation is taken from a statement in the *Conference Report*[395] which is nowhere mentioned in the *House Report*. One can speculate that the conferees to some extent realized that the statute did not solve the problems of how much tax is due and who pays the tax, and attempted to solve the problem by making recap-

391. I.R.C. § 2032A(c)(2)(A)(i).

392. HOUSE REPORT, *supra* note 44, at 26. The *House Report* goes on to say: "A qualified heir is expressly made personally liable for the recapture tax imposed with respect to *his interest* in qualified property." *Id.* (emphasis added).

393. Section 2032A(c)(4) clearly was not intended to apply to this situation, but to the case of two successive recapture events on the same portion of the property (such as ceasing to use the farm for a qualified use and later selling it). *See* HOUSE REPORT, *supra* note 44, at 26.

394. GENERAL EXPLANATION, *supra* note 3, at 539.

395. House Conference Report No. 94-1515, *supra* note 102, at 610.

ture depend on the actions of the owner of the first of two or more successive interests in qualified property.[396] The effect of the statement in the *Conference Report* is that only the interest in the real property passing to a holder of a present interest qualifies for special use valuation. This interpretation will solve both of the problems under discussion in most cases. First, in our example, when Albert sells his life interest, the entire adjusted tax difference will be recaptured, because his will be the only interest in the qualified real property. This is because only his interest will be specially valued and cause a reduction in estate tax liability.[397] Furthermore, Albert will pay the entire recapture tax because the entire adjusted tax difference will be allocated to him.[398] However, this interpretation of "present interest" causes problems of its own. First, and perhaps most important, it severely restricts the use of trusts in connection with section 2032A. No non-possessory interest in a trust (e.g., remainders, executory interests, etc.) will qualify. This will cause a large reduction in the tax savings achieved by the use of section 2032A and discourage the use of trusts in situations where special use valuation might be advantageous. In our example, only Albert's life income interest is eligible for special use valuation. Moreover, if Albert is elderly, the value of his life interest may not meet the fifty percent and twenty-five percent limitations of secton 2032A(b)(1)(A) and (B). This will force many decedents who would otherwise create trusts to forego their use to insure qualification under section 2032A. There is no indication in the legislative history that Congress was hostile to the use of trusts in connection with section 2032A, nor is there evidence that Congress wished to disqualify "future interests" from qualifying for special use valuation. Second, and equally significant, although remainders, secondary life estates, reversions and other property interests are often referred to as future interests, it is clear that these interests are present estates, even though the owner will not acquire possession until sometime in the future.[399] Thus, if the *Conference Report* and the *General Explanation* are using the term "present interest" in the sense of "present estate," the remainder in our example will qualify

396. Section 702(d)(1) of the Revenue Act of 1978 amended § 2032A(b)(1) to provide that qualified real property includes only property "which was acquired from or passed from the decedent to a qualified heir of the decedent." However, this amendment was not directed at the problems under discussion, but rather was passed to insure that special use valuation would be available only for real property passing to qualified heirs. *See* General Explanation, 1978, *supra* note 286, at 421.

397. *See* I.R.C. § 2032A(c)(2)(B)-(C).

398. *Id.*

399. In fact, they are present estates even if the owner never acquires possession (for example, if testator bequeaths his estate in trust with the income to A for life, then to B for life, remainder to C, B has a present estate from the moment of testator's death, even though, if he predeceases A, he may never receive any income. *See* T. Bergin & P. Haskell, *supra* note 385, at 23-26. These estates are present estates because the owner is entitled to present protection of his possible future possession.

as a "present interest." If the conferees used the term "present interest" to mean "present possession," this meaning should have been more clearly defined. Lastly, the imposition of a full recapture tax on the disposition or cessation of qualified use by the first of two qualified heirs owning successive interests could result in frustrating the purpose of the statute in certain cases. For example, suppose Farmer Green had changed his will slightly to give the income to Albert for life, but provided that if Albert ever sold or contracted to sell his interest or ceased to use the property as a farm, his interest would immediately cease and the remainder in Albert's then living issue would accelerate and vest immediately.[400] Even if Albert's children were willing to farm the property, a recapture tax would be due on the sale of Albert's life income interest. Note that in this situation, the congressional purposes of keeping the property in decedent's family and in farming are accomplished, yet the estate tax savings is recaptured.

In addition, in the common discretionary trust, the interpretation of "present interest" as "present possession" would lead to the result that none of the discretionary income beneficiaries has a "present interest" for purposes of qualification under section 2032A. Similarly, giving the trustee discretionary power to distribute income to the income beneficiary or accumulate it for ultimate distribution to the remaindermen could disqualify the trust for special use valuation on the ground that the property did not pass to a qualified heir. If all the possible recipients of the income are qualified heirs, there appears to be no basis for denying special use valuation in this situation.[401]

The statement in the *Conference Report* and the *General Explanation* that property in trust shall be considered as acquired from the decedent only to the extent that the qualified heir has a present interest in the property solves many of the problems discussed above. If the regulations, when they are issued, solve the problem of qualification under such an interpretation[402] and exempt trusts in which an attempted disposition or cessation of use causes, under the terms of the will, a termination of the interest of the holder of first possessory interest, and the holder of the second successive possessory interest is willing to meet the requirements of material participa-

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400. A spendthrift provision would work equally well where permitted by state law, as would a provision terminating Albert's income interest and substituting his issue as income beneficiaries during Albert's life on an attempted sale or cessation of use.

401. These interests would not be present interests for purposes of qualifying for the annual exclusion under the gift tax. I.R.C. § 2503(b). See Ward, *Planning for Farmers After the 1976 Tax Reform Act and 1978 Revenue Act: Special Use Valuation Under Section 2032A*, 13 U. MIAMI L. CENTER INST. EST. PLAN. 12-8 (1979). It is uncertain whether Congress intended to incorporate the gift tax concept of present interest into § 2032A.

402. Perhaps the regulations will provide that all interests bequeathed to qualified heirs (whether present or not) could be used to meet the 50% and 25% tests of initial qualification (since the word interest is not used in § 2032A(b)), but that "interest" shall mean present possession for the purpses of § 2032A(c).

tion in a qualified use, the statute could be made simple and workable in these situations.

A second major problem of the use of trusts in connection with section 2032A is through what agency will the qualified heir "materially participate." In a trust, the trustee has the legal title to the property; the beneficiaries have equitable title. This could create questions concerning material participation. However, the proposed regulations spell out fairly clearly what will be required for material participation in the trust situation:

> (e) *Special rules for corporations, partnerships, and-trusts* (1) *Required arrangement.* 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. Holding an office in which certain material functions are inherent may constitute the necessary arrangement for material paticipation. Where property is owned by a trust, the arrangement will generally be seen in one or more of three situations. First, the arrangement may result from appointment as trustee. Second, the arrangement may result from the employer-employee relationship where the participant is employed by a qualified closely held business in a position requiring his material participation in its activities. Third, the participants may enter a contract with the trustee to manage, or to take part in managing, the real property for the trust. 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.[403]

The proposed regulation is clear enough to require little comment. If the regulation becomes final, the will of any decedent who owns property which may qualify for special use valuation should contain a provision providing that if the executor elects special use valuation under section 2032A, the management rights as to any qualified real property should be expressly granted to the qualified heir. Moreover, the trustee should be expressly empowered (if not required) to enter into a contract with the qualified heir or any member of his family (as defined in section 2032A(e)(2)) to manage or take part in the management of the qualified real property.[404]

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403. Proposed Treas. Reg. § 20.2032A-3(e), 43 Fed. Reg. 31,041 (1978).

404. It may be objected that it would be simpler to appoint the qualified heir trustee. However, many qualified heirs, while willing to manage the farm, may not wish to become involved in the detailed record keeping and accounting duties of a trustee. Also, if there is other property in the trust, the qualified heir may either not wish to administer it or may not be the best person to manage it. Problems may also arise when the trust instrument provides for discretionary distributions of corpus to the qualified heir or his family. The route suggested in the text solves these problems. In the proper case, of course, it may be wise to appoint the qualified heir as trustee. Another possibility would be to appoint the qualified heir as co-trustee, but

that in order to elect special use valuation there must be filed "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) [the imposition of the recapture tax] with respect to such property."[405] The proposed regulations are fairly detailed as to the interests covered and the effect of the agreement:

> a) *Agreement to special valuation by persons with an interest in property* — (1) *In general.* The agreement required under this section 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. 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.
>
> (2) *Persons having an interest in designated property.* An interest in property is 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. Any person in being at the death of the decedent who has any such interest in the property whether present or future, or vested or contingent, must enter into the agreement. *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, and trustees of trusts holding any interest in the property.* An heir who has the power under local law to caveat (challenge) a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property under section 2032A solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors except that creditors having security interests in or judgment liens against any specially valued property are persons with an interest in the property if, upon the making of the election, such interests or liens are subordinate to the lien imposed by section 6324B." (emphasis added).[406]

It is clear that the proposed regulations were drafted by the Internal Revenue Service to impose personal liability on as many persons having interests in the property as possible. This was done to insure, insofar as the IRS is able, that in case a recapture event occurs, the recapture tax will be recovered. Thus it is clear that in the example stated in the beginning of

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405. I.R.C. § 2032A(d)(2). The election must be made when the estate tax return is required to be filed, including extensions. I.R.C. § 2032A(d)(1). The proposed regulations require the attaching of the agreement and a notice of election giving various data to a timely filed estate tax return. Proposed Treas. Reg. § 20.2032A-8(a)(1), (2), 43 Fed. Reg. 30,071 (1978).

406. Proposed Treas. Reg. § 20.2032A-8(c)(1), (2), 43 Fed. Reg. 30,072 (1978).

It is clear that the proposed regulations were drafted by the Internal Revenue Service to impose personal liability on as many persons having interests in the property as possible. This was done to insure, insofar as the IRS is able, that in case a recapture event occurs, the recapture tax will be recovered. Thus it is clear that in the example stated in the beginning of this section, both Albert and those of his children living on Green's death will be required to execute the agreement in order to elect special use valuation. Two groups of beneficiaries, however, present problems in such a scheme. The first group is unborn persons having interests in the property. Both the statute and the proposed regulations avoid this problem by requiring execution only by persons in being.[407] The second group is composed of beneficiaries who, by reason of legal incompetency, minority or other disability, cannot legally bind themselves. The proposed regulations also attempt to deal with this issue:

> (3) *Consent on behalf of interested party.* If any person required to enter the agreement provided for by this paragraph either desires that an agent act for him or cannot legally bind himself due to infancy or other incompetency, a representative authorized under local law to bind such person in an agreement of this nature is permitted to sign the agreement on his behalf.[408]

However, finding a representative under local law to bind a minor is more difficult than it may at first appear. The first thought of experienced estate attorneys would be a guardian ad litem (sometimes referred to as a special guardian). The guardian ad litem's traditional function is to represent and defend infants (as well as unborns) in litigation.[409] Though the power of the guardian ad litem to sign the agreement required under section 2032A has obviously never been litigated, a very similar issue has been litigated in the area of termination of trusts. A trust can be terminated by consent of all the beneficiaries (and the settlor, if living) if continuance is not necessary to carry out a material purpose of the trust.[410] However, though the number of cases is small, every case directly confronting the issue has held that a guardian ad litem is incapable of consenting on behalf of the minor beneficiary to the termination of a trust. Perhaps the leading case in this regard is *In re Fletcher's Trust.*[411] The grantor of an irrevocable trust gave the trustee notice that he intended to revoke the trust. The trust agreement provided that the income was payable to the grantor for life, and on

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407. I.R.C. § 2032A(d)(2); Proposed Treas. Reg. § 20.2032A-8(c)(2), 43 Fed. Reg. 30,072 (1978).

408. Proposed Treas. Reg. § 20.2032A-8(c)(3), 43 Fed. Reg. 30,072 (1978).

409. E. SCOLES & E. HALBACH, *supra* note 370, at 377. *See* Hatch v. Riggs National Bank, 361 F.2d 559 (D.C. Cir. 1966).

410. RESTATEMENT (SECOND) OF TRUSTS § 337 (1959); A. SCOTT, ABRIDGMENT OF THE LAW OF TRUSTS 619 (1960).

411. 57 Misc.2d 554, 293 N.Y.S.2d 177 (Sup. Ct. Nassau County, 1968).

his death, the principal was to be disposed of in accordance with the grantor's will. In default of appointment, the income was to be paid to the grantor's wife for life and on her death, the principal was to be distributed to the grantor's issue then living. At the time he attempted to revoke the trust, the grantor had three infant children. After deciding that the grantor's children had contingent interests in the trust,[412] and that therefore the donor could not revoke without their consent, the court stated: "The children here being infants are incapable of giving their consent (citation omitted). Furthermore, the special guardian, as distinguished from a general guardian (citation omitted), appointed to represent the interest of the children is incapable of giving his consent on behalf of the children (citation omitted)."[413]

Fletcher relied in part on *Application of Holman,*[414] a per curiam reversal of an order of the New York Supreme Court dissolving a trust. An infant had a remote interest in the trust. The infant was represented by a special guardian who "submitted the rights of the ward" (presumably meaning he would consent if the court felt this would be beneficial to the infant). Though the opinion is sketchy, it appears that an arrangement was worked out between the parties which made some provision for the infant. The court held the infant could not consent. Though the court never directly stated that the guardian could not consent on behalf of the infant, later courts have cited *Holman* for this proposition and it is the natural reading of the case.[415]

In *Wogman v. Wells Fargo Bank & Union Trust Co.,*[416] the only child and grandchild of testator were attempting to terminate a testamentary trust. The trust provided for the payment of $30 a month from the income to the decedent's third wife Petra, the remainder of the income (and all the income on Petra's death) to his daughter Alda, and if Alda died before the termination of the trust, to pay the income to her children or, if none, to two sisters of the testator. No disposition of the principal of the trust was ex-

412. The court was concerned with N.Y. EST., POWERS & TRUSTS LAW § 7-1.9 permitting the revocation of a trust by the grantor with the consent of all persons beneficially interested and providing that a disposition "in favor of a class of persons described only as the heirs, next of kin or distributees (or by any term of like import) of the creator of the trust does not create a beneficial interest in such persons." The court decided that issue is not a term of like import to heirs, next of kin or distributees.

413. 293 N.Y.S.2d at 180.

414. 271 App. Div. 2d 910, 67 N.Y.S.2d 90 (3d Dept. 1946).

415. It is also clear that the cases of Application of Michael, 70 Misc. 2d 161, 33 N.Y.S.2d 301 (Sup. Ct. N.Y. County 1971), *aff'd per curiam* 39 App. Div. 2d 865, 332 N.Y.S.2d 865 (1st Dept. 1972) and In re Flexner's Trust, 56 Misc. 2d 336, 288 N.Y.S.2d 494 (Sup. Ct. N.Y. County 1968) *aff'd sub nom.* and Matter of Burch, 30 App. Div. 2d 1049, 294 N.Y.S.2d 669 (1st Dept. 1968), to be discussed later in this subsection, clearly recognize and support the proposition that a guardian ad litem is incapable of consenting to the revocation of a trust on behalf of his infant wards.

416. 123 Cal. App. 2d 657, 267 P.2d 423 (1st Dist. 1954).

pressly provided for, but Alda was the residuary beneficiary under testator's will. The trust was to terminate on the later of twenty-one years from the decedent's death or on the death of the survivor of Petra, Alda and Alda's husband. When the suit was brought, Petra had died and the two sisters had died childless. Alda was fifty-five and had only one child, Vincent, age thirty-one, who was married but childless. Alda and Vincent (in addition to Alda's husband) had consented to the revocation of the trust. The court first disposed of a contention that the trust violated the rule against perpetuities.[417] Then the court discussed termination by consent of the beneficiaries. The court stated that the trust corpus would go either to Alda's heirs, who were unascertainable, or possibly to her unborn children, should her only living child predecease her and she have more children. These unborn and unascertained persons were represented by a guardian ad litem who had been appointed to represent them by the lower court. However, the guardian did nothing but file a written appearance, an admission of service and a consent that the case could proceed to trial. He did not participate in the trial nor appeal the lower court judgment ordering termination of the trust.[418] Though not directly confronting the question, the court clearly indicated that allowing a termination of the trust would in itself amount to a lack of representation of the infants, without which, under the California cases, jurisdiction over the unborn and unascertained persons would not be obtained:

> It is also apparent, if his failure to object amounted to an implied consent [to the termination of the trust], that in no true sense were the unborn and unascertained heirs in fact represented. While the guardian did appear on their behalf, he did not "act" on their behalf. Yet the effect of the trial court's decree is to deprive some of these persons from ultimately getting the corpus of the trust. There was no true representation of these unborn and unascertained heirs in this case. This alone would require a reversal.[419]

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417. This contention was based on an unusual California statute prohibiting the suspension of the power of alienation for a period longer than lives in being or 21 years from the creation of the suspension of the power.

418. 267 P.2d at 429. The trustee appealed.

419. 267 P.2d at 429-30. A case often cited in support of the rule prohibiting a guardian ad litem from consenting on behalf of his wards to a termination of the trust is McPherson v. First & Citizens National Bank, 246 N.C. 1, 81 S.E.2d 386 (1954). However, that case did not reach the issue. The case involved a trust for the benefit of all the grantor's children. The grantor alleged that certain provisions of the trust for the benefit of his grandchildren and great-grandchildren violated the rule against perpetuities and that because of a mistake of the draftsman, the trust did not reflect the grantor's true intent. The grantor suggested that the trust agreement be reformed as provided in accordance with what he alleged was his true intention. A guardian ad litem was appointed for the living grandchildren and for all persons not in being who may become beneficiaries. The court held that the trust violated the rule against perpetuities, thus cutting off the interests of the grandchildren. The situation then became one in which the wards of the guardian would benefit if the trust was reformed, since the grandchil-

Lastly, and perhaps the clearest and most extensive opinion on the subject, is *In re Small's Estate*.[420] Testator's residuary estate was divided into three shares, one for each of his children. As to the shares for each of his two daughters, each daughter was to receive the income from her share for life. Each daughter had a testamentary power to appoint up to one-third of the income of her share to her surviving husband. On the daughter's death, subject to the power of each daughter to appoint a share of income to her surviving husband, the share of each daughter was to be paid to her surviving descendants who attained age thirty, with the income being used for the education and support of the descendants until each attained age thirty. The income from the share for testator's son was to be paid to him for life. One-third of the corpus of the share of the son was to be paid to him when he attained age thirty, an additional one-third of the corpus was to be paid to him on attaining age forty and the remainder was to be distributed to his surviving issue who attained age twenty-one. The testator's three children, believing that the provision postponing distribution to the daughter's issue until age thirty violated the rule against perpetuities, agreed among themselves to modify the provisions to reduce the age of distribution to twenty-one and make certain other changes in the provision of the trust. They then petitioned the court for approval of the settlement. One of testator's daughters had two minor children, the other had no issue and testator's son had one minor child. Guardians ad litem were appointed to represent the minor and unborn issue of testator's children. The court first ruled that, in accordance with Pennsylvania authorities, a determination of whether the remainder interests violated the rule against perpetuities would be decided only on the termination of the valid preceding interests, because the court would not give a declaratory judgement. In addition, said the court, approval of the agreement required the consent of the minors and unborn parties. Thus the court was squarely faced with the question of whether a guardian ad litem could consent to the modification of a trust on behalf of his wards. The court answered with a resounding NO:

> Guardians and Trustees *ad litem* are in a special sense representatives of the Court. Their function is to represent and protect unrepresented mi-

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dren had a possible interest in the instrument as reformed by the grantor. The court, however, reversed the judgment because the reformed instrument excluded any possible future children born to the donor from the trust because they were not virtually represented by the children in being. The possible unborn children were never represented by the guardian ad litem, who represented the grandchildren. In fact, the court stated that absent virtual representation in the sense of an identical interest with persons in being before the court, an unborn cannot be sued. Thus the crux of the *McPherson* case is that absent virtual representation, no reformation of an instrument is possible against an unborn, rather than that a guardian for an unborn in a case where virtual representation exists could not consent to the reformation (or termination) of a trust on behalf of the unborn. 81 S.E.2d at 396. This latter question was not reached by the court.

420. 67 York Legal Record 1, (Pa. Orphans Ct. York County 1953).

> nors and the interests of those unborn and unascertained; and, where there is such representation the judgment of the court may be conclusive upon all present and future interests (citation omitted). *But it is equally clear that, if such unborn children have an interest in the trust estate, a Guardian ad litem appointed to represent their interests cannot consent to its being divested.* A Guardian *ad litem* has authority to protect the interests of his ward but *never has authority to consent to anything prejudicial to his ward and a Court has no power to authorize him to do so.* (emphasis added).[421]

A case often cited as holding that a guardian ad litem can consent to the termination of a trust on behalf of unborns is *Hatch v. Riggs National Bank.*[422] In *Hatch,* the grantor of a trust sought to modify its provisions. The trust was to pay the income to the grantor for life, and on her death to pay the corpus as the grantor appointed by will or, in default of appointment, to the grantor's next of kin. The case turned on whether the doctrine of worthier title[423] applied in the District of Columbia. If it did, the grantor had a reversion, thereby making her the only beneficiary and enabling her to revoke the trust. If it did not, her heirs had a remainder. The court held that the doctrine was not part of the law of the District of Columbia. Thus, the heirs of the grantor had a remainder and their consent would be necessary. In addition to the grantor's two sisters, the court stated that it was necessary to protect possible unborn and unascertained persons who may in fact be the grantor's heirs. The court said the District Court could appoint a guardian ad litem. It is doubtful whether many authorities would quarrel over the court's assertion that the appointment of a guardian ad litem to represent unborn beneficiaries (or infants or incompetents) is part of the inherent powers of the court. However, this does not solve the problem of whether the guardian ad litem, with or without a "quid pro quo,"[424] can consent on behalf of the beneficiaries to a termination of the trust.

There is a great difference in degree between representing an infant in litigation and engaging in a transaction for the beneficiaries, especially in the light of the traditional rule that all beneficiaries must be sui juris and

421. *Id.* at 8.

422. 361 F.2d 559 (D.C. Cir. 1966).

423. The doctrine of worthier title states that when an heir is given the same estate in quality and quantity as he would have taken intestate, he takes nothing by the will or conveyance, but takes by descent, thus leaving the grantor with a reversion. See P. BERGIN & T. HASKELL, *supra* note 385, at 117-20. The doctrine, which had become moribund in this country, was revived as a rule of construction as applied to inter vivos transfers by Judge Cardozo in Doctor v. Hughes, 225 N.Y. 305, 122 N.E. 221 (1919).

424. The court suggests that the grantor seeking to revoke or modify the trust "sweeten" the deal by providing a benefit in the form of irrevocably vested interests, in return for the guardian's consent. 361 F.2d at 566. Query: How good a settlement should the guardian hold out for to be free of blame for consenting to a modification of the trust? What if he demands a "sweetener" for himself due to the risk of a later action by the heirs based on the settlement?

consent to a modification or termination of a trust.[425] Apparently the *Hatch* court did not recognize this, because it did not say a word about the problem.[426] Nor did the remand to the District Court, which the Court of Appeals ordered so that the grantor could get the necessary consents, confront the question. The District Court's opinion was concerned solely with whether the suggestion to appoint a guardian ad litem was dicta and whether the court could make an appointment without a statute explicitly authorizing the appointment. The court held it had the power to make the appointment, but did not say a word about the guardian's power to consent to the modification.[427] Thus, every case actually considering the question has held that a guardian ad litem is incapable of consenting on behalf of his wards to a termination of a trust. Since execution of the agreement required to elect special use valuation imposes personal liability, it seems highly likely that a court faced with the issue of whether a guardian ad litem is capable of executing the agreement on behalf of a minor would regard the trust termination cases as persuasive and prohibit such action by the guardian.[428]

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425. *See* RESTATEMENT (SECOND) OF TRUSTS § 337 (1959).

426. What is so frustrating about the *Hatch* opinion is the number of chances the court missed to face the issue concretely. Apparently one of the grantor's two sisters, who were her presumptive heirs, was incompetent. But the court did not even discuss whether a guardian ad litem (or the guardian of her property) could consent. The only mention of this problem is in a footnote, which states: "One of the sisters is not *sui juris*. In referring to her consent, we do not mean to exclude consent by her guardian ad litem." 361 F.2d at 565, n.14. Actually, in that situation, the proper party to consent, if consent could be given, would be the guardian of the sister's property. *See* discussion of *Flexner* in text accompanying note 413 *infra*.

427. Hatch v. Riggs National Bank, 284 F. Supp. 396 (D.D.C. 1968). It should also be noted that another case on the subject, Leonardini v. Wells Fargo Bank & Union Trust Co., 131 Cal. App. 2d 9, 280 P.2d 81 (1st Dist. 1955), states in dicta that a guardian ad litem may consent to a modification or termination of a trust if the invasion is beneficial to the ward (minor or unborn). The court states that there are cases where a guardian was allowed to consent to such an invasion but cites only Mabry v. Scott, 51 Cal. App. 2d 245, 124 P.2d 659 (2d Dist.) *cert denied sub nom.* Title Ins. & Trust Co. v. Mabry, 317 U.S. 670 (1942) *Id.* at _, 280 P.2d at 87. However, a reading of *Mabry* makes it clear that there was virtual representation in that case of the unborn contingent remainderman by the living children of the grantor, thus giving the court jurisdiction over the unborns. Moreover, the court in *Mabry* avoided the question of whether a guardian can consent to the termination of a trust on behalf of his wards by holding that the court was modifying the trust under its inherent power to reform an agreement procured by fraud or undue influence. The court's decision is suspect since there is no indication that either fraud or undue influence was ever proven, and the court shows a desire to evade discussion of the real issue involved. In such situations some states have by statute not required persons who are virtually represented by persons in another class having the same interest to be made parties to the proceeding. *See* N.Y. S.C.P.A. §§ 315, 2207. In many cases no guardian ad litem need be appointed for persons virtually represented by other persons.

428. Though consideration of the wisdom of the rule prohibiting a guardian ad litem from consenting to the termination of a trust is beyond the scope of this article, it may be noted that such a rule is consistent with the law's treatment of contract of minors. If a minor cannot enter into a binding contract because the law believes he is incapable of appreciating the significance

Since a guardian ad litem will be unable to execute the agreement required by section 2032A, another possibility is to have a guardian of the minor's property appointed. There are a number of disadvantages of this method of holding assets for minors, among the most important of which are the necessity under the laws of many states for the guardian to obtain court permission for sales, investments and distributions, resulting in delay and expense to the infant's property[429] and the requirement of filing periodic (usually yearly) accountings with a court which results in additional expenses for legal and accounting fees.[430] Second, and perhaps more important, in many situations where a representative to execute the agreement for the minor is required under section 2032A, the most likely appointee, one of the minor's parents, will be the person standing to benefit most from the election. In the example with which this subsection began, on Green's death, Albert will be the person desiring special valuation. Yet in this situation, no court will allow Albert, as guardian of the property of his infant children, to consent to a section 2032A election, since Albert has a conflict between his own interests and his duties as guardian. This problem will often require the appointment of an outside guardian of the infant's property, a situation not desired by many parents since it takes from them the control over the finances of the children.

The above is academic, of course, if a court will not permit a guardian of the property to consent to the section 2032A election on behalf of his ward. Again, resort must be had to cases involving the termination of trusts. Research has revealed only two cases on the subject, and the two are conflicting.

In re Flexner's Trust[431] was a proceeding to partially revoke an express trust which was created in 1939 with a corpus of $157,000 and had appreciated to $600,000. The grantor's daughter had died, leaving the grantor with

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of his act, there is no logical reason to permit a minor to consent to the termination of a trust in which he has a possible interest or to permit a guardian ad litem to consent for him. That a quid pro quo is given for his consent should logically make no difference, since the law's attitude is that the minor is incapable of intelligently evaluating the benefit and burden and making a binding decision on the matter.

429. *See* H. WEINSTOCK, PLANNING AN ESTATE 47 (1977).

430. *E.g.*, IOWA CODE § 633.670 (1979) (conservators); N.Y. S.C.P.A. § 1719. These costs can be fairly substantial. *See* T. SHAFFER, THE PLANNING AND DRAFTING OF WILLS AND TRUSTS 197-200 (2d ed. 1979). Note also that guardians are often statutorily limited in the kinds of investments they are permitted to make or, even if not limited, are often rather conservative in their choice of investments. *See id.* at 198-200. Other disadvantages mentioned by Weinstock are the possible requirement of a bond (the premium for which must be paid from the minor's property), the inability to hold assets in common for several children and to make unequal distributions tailored to the needs of each child, and the termination of the guardianship at the age of majority (usually 18) when the former minor may not be mature enough to wisely handle the money. H. WEINSTOCK, *supra* note 429, at 47.

431. 56 Misc. 2d 336, 288 N.Y.S.2d 494 (Sup. Ct. N.Y. County), *aff'd sub nom.* Matter of Burch, 30 App. Div. 2d 1049, 294 N.Y.S.2d 669 (1st Dep't 1968).

two minor grandchildren to raise. In view of this burden and the increased cost of living, the grantor requested that the trust be revoked to the extent of $125,000, $50,000 of which was to be divided between her daughter's children. All the other beneficiaries had consented, except for two beneficiaries who were minors. A corporate guardian of the property had been appointed in California and a California court had approved the guardian's consent to the partial revocation. Most of the beneficiaries resided in California and the sole New York contact was the residence of the successor trustee. Despite noting that a special guardian could not consent to the revocation, the court granted the application:

> A special guardian, however, does not have the same authority to deal with his ward's property as does a guardian of the infant's property. The latter has custody and management of the infant's property and pecuniary rights, unlike a special guardian whose function is solely to protect his ward's interests in a judicial proceeding . . . .
> Moreover, and of primary importance in the instant case, a Court of another state, more closely connected with the Trust, authorized the guardian to consent to the partial revocation of the trust on behalf of the infants who are residents of that state. The contact of this State with the Trust is minimal, arising solely out of the residence here of the successor Trustee, and the former residence here when the instrument was executed, of the settlor. While the instrument provides that it shall be governed and construed under the laws of New York, this Court cannot ignore the order of the California Court, above noted, which Court has the most interest, and the closest contact with the subject matter. While the infant beneficiaries reside there, it is also the Courts of that State which govern their actions.[432]

Note that *Flexner* can be interpreted two ways: first, that a guardian of the property of a minor will be allowed to consent to the termination of a trust on behalf of his wards because of the nature of his powers and duties regarding the property of the wards or, second, that whether or not a guardian of the property will be allowed to consent will depend on the view of the courts of the state having the most significant contact with the infants. The only other case to discuss the question, *Application of Michael*,[433] indicates that the second interpretation will control future cases. The question as put by the court, was whether the guardian of the property of an infant "has the power to consent, on behalf of his ward, to the revocation of a trust under EPTL section 7-1.9."[434] The court first discussed the history of the statutory section and determined that no change of previous case law as regards the consent of beneficiaries was made when it was enacted. "The unanimous

432. 288 N.Y.S.2d at 495-96.
433. 70 Misc. 2d 161, 333 N.Y.S.2d 301 (Sup. Ct. N.Y. County 1971), *aff'd* 39 App. Div. 2d 865, 332 N.Y.S.2d 865 (1st Dep't 1972).
434. 333 N.Y.S.2d at 302.

consent of all beneficiaries was and is required. Infants could not consent then, and they cannot consent now (citations omitted)."[435] As to *Flexner,* the court noted that the consent was by a California corporate guardian who had secured approval from a California court, then stated: "The decision was based on the special circumstances of that case."[436] After quoting that portion of *Flexner* dealing with the California contacts of the beneficiaries, the court denied the application on the grounds that infants cannot consent to the revocation of an inter vivos trust.

About the best that can be said of the authority of a guardian of the property to consent on behalf of his wards to the termination of an inter vivos trust is that it is unclear and will depend on whether the court can be convinced that the guardian should have this power.

In summary, it is unclear who, if anyone, can qualify as "a representative authorized under local law to bind such person [an infant or incompetent] in an agreement of this nature . . . ."[437] Given the uncertain state of the law in this regard, no estate planner should rely on obtaining a special use valuation when interests in the property are given to minors.

3. *Initial Qualification: What is an "Interest?"*

Earlier in this article it was suggested that in order to solve certain problems in the application of section 2032A to trusts, the only person having an "interest" in qualifying real property would be the owner of the first of two or more successive interests.[438] From the foregoing discussion and the specificity of the proposed regulations it is clear that such an interpretation cannot possibly be employed when defining "interest in any property" as used in section 2032A(d). However, this does not mean that such an interpretation of "interest" cannot be used for the purposes of section 2032A(c). First, section 2032A(d) uses the parenthetical phrase "whether or not in possession" when speaking of an interest in property, which phrase is nowhere used in section 2032A(c). Second, and perhaps of greater importance, the purposes of the two sections are different. The purpose of the agreement required by section 2032A(d) is to make as many persons as possible having interests in the property personally liable for the recapture tax, so that the IRS will have the greatest likelihood of recovering the tax with a minimum expenditure of resources. Thus it is in the government's interest to give a broad definition of interest for the purposes of section 2032A(d). However, as regards the recapture tax itself, it makes little difference to the Service whether the recapture tax is apportioned among those holding interests in the qualified real property. In fact, if anything, it makes it easier to collect

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435. *Id.*
436. *Id.* at 302-03.
437. Proposed Treas. Reg. § 20.2032A-8(c)(3), 43 Fed. Reg. 30,072 (1978).
438. *See* text accompanying notes 394-402 *supra.*

the tax if only the activities of the first possessor must be followed. Also, it is arguably fairer if the entire tax is collected from the holder of the first possessory interest, who alone will have the power to cause a recapture event. Thus simplicity and fairness argue for the interpretation of "interest" earlier suggested and the broad definition of "interest in property" for the purposes of section 2032A(d) is not inconsistent with, and should not prevent the narrow definition of, "interest" for the purposes of section 2032A(c).

H. *Summary*

The optimum situation for employing section 2032A is when the qualified real property will be bequeathed to one person (not the spouse), there is a high probability that the beneficiary will farm the property for fifteen years and the decedent's gross estate will substantially exceed $175,625.[439] Though the interrelationship of section 2032A and the marital deduction, as well as the material participation requirements, may cause problems in individual cases, in many situations where the taxable estate substantially exceeds $351,350, special use valuation should be considered even if the qualified real property is bequeathed to the spouse. However, the estate planner should not fail to calculate the effect of the lower basis for income tax purposes, whether under stepped-up basis, or under carryover basis.[440] If carryover basis is retained, special use valuation will become more widely applicable to marital deduction bequests as we move farther away from the December 31, 1976 date on which the fresh start adjustment is based. Outright bequests to farm and non-farm children cause substantial problems in equalizing the bequests because of the effects of section 2032A. Only careful planning and full and complete discussion of the effects of special use valuation can alleviate these problems to any degree, and perhaps resentment is unavoidable. In situations such as those discussed previously, except where there are strong family ties between the children and the children understand the effects of special use valuation on their bequests and agree to these effects, many clients will elect to forego the benefits of special use valuation in favor of family harmony. Because of the many unanswered questions involving partnerships and corporations, a decedent desiring to use special valuation should carefully consider keeping his farm as a sole proprietorship. Any farm held in corporate or partnership form should not rely on obtaining special use valuation.[441] Leaving the farm in trust should

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439. In the lower estate tax brackets, the amount of tax saved by special use valuation will be less than the increased income tax paid as a result of capital gains realized on the sale of the property. Moreover, some of the savings may be lost if special use valuation reduces the estate below the credit equivalent.

440. *See Hjorth, supra* note 39, at 652-54.

441. According to a recent study, 60% of the farms in Iowa are held as sole proprietorships, 23% as partnerships, 13% as corporations, and 5% in other forms. *Contemporary Stud-*

be avoided until regulations are issued clarifying the applicability of section 2032A to trusts, especially when minors have an interest in the property.

VII. Conclusion

The purpose of the enactment of section 2032A was to preserve the family farm by preventing the forced sale of farmland because of estate taxes.[442] In addition, Congress wished as much land as possible to be retained in agricultural production[443] and to provide a reasonably certain and easily calculated valuation of farmland, in order to reduce controversy and eliminate speculative values.[444] However, Congress provided neither a clear nor relatively certain method of valuing farmland. The proposed regulations indicate the resolve of the IRS to continue to litigate valuation of farmland by its restrictive definition of comparable land[445] and its positions on material participation and the disposition of an "interest" as triggering a recaptive tax. Two possible explanations for the IRS position exist. The Service may believe that section 2032A is unwise as a matter of policy, and is therefore endeavoring to restrict its application. Alternatively, the Service may be attempting to implement the congressional view of a family farm by a narrow interpretation of material participation. However, the size of estate necessary before benefits become significant under section 2032A together with the potential income tax disadvantages resulting from special use valuation will prevent many farmers from using the section.[446] That only the wealthiest farmers will benefit from special use valuation indicates that section 2032A will not save the family farm in the sense which Congress viewed the family farm.

The price paid for special use valuation is great. Perhaps the most serious problem is that it has raised grave doubts as to whether farms held as partnerships and corporations will, in most cases, be able to qualify for special use valuation. Moreover, it has effectively removed the use of perhaps the most flexible estate planning tool, the trust, from the hands of the estate planner wishing to take advantage of section 2032A for his clients. Again, when the client's situation calls for the use of a trust, section 2032A will not aid in saving the family farm. In addition, the statute discourages gifts as an

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ies Project, *supra* note 16, at 984 app. I.

442. House Report, *supra* note 44, at 22.

443. *Id.*

444. House Report, *supra* note 44, at 24-25.

445. The farm valuation method of § 2032A(e)(7) is not available where there is no comparable land from which the annual gross cash rental may be determined. I.R.C. § 2032A(e)(7)(B)(i).

446. One author has estimated that only the wealthiest 2% of the population may benefit from § 2032A. *See Hjorth*, *supra* note 39, at 612. From this must be subtracted those persons who have no qualified heir interested in farming the land, or who view the income tax disadvantages as too detrimental to elect special use valuation.

estate planning tool, by a combination of the percentage of estate requirements for qualification and the inapplicability of section 2032A to inter vivos gifts. The material participation requirement permits certain dispositions not resulting in a family farm in the sense Congress used the word to qualify, and disqualifies other dispositions that would keep the farm in the family.

But section 2032A has broader implications. It has been pointed out that section 2032A discourages lifetime sales of farmland and its benefits encourage purchases of additional land by farmers currently owning land.[447] The effect of this will be to simultaneously decrease the supply of and increase the demand for farmland, indicating that the trend of recent years toward increasing the price of farmland in relation to the income derived from farming will continue.[448] This will have two effects: concentrating farms in a smaller number of owners, and preventing tenants and persons wanting to enter farming from purchasing land. This is exactly the opposite of the purpose Congress wished to encourage: the continuation of small, family farms.

In short, section 2032A can be beneficial in a limited number of situations. It offers the most benefits in the case of a relatively large farm where an outright bequest to a family member is contemplated and where there is a great liklihood of the family member materially participating in the operation of the farm for at least fifteen years after the decedent's death. It may also be beneficial in the case of an outright bequest of the farm to a surviving spouse, though the marital deduction will decrease the benefits and increase the size of the estate necessary for use. If the objective of estate planning is to divide the estate in equal shares between farm and non-farm beneficiaries, section 2032A increases the potential for conflict among the beneficiaries and, in the absence of great understanding by the off-farm beneficiaries and a close-knit family, the benefits of section 2032A may often be foregone to help insure family harmony. Unless very liberal regulations are forthcoming, where the qualified farm real property is to be left in trust, or where the farm is held in a partnership or corporation, the problems in qualification and statutory construction will rarely permit the use of section 2032A.

In view of these conclusions, it is highly doubtful that section 2032A contributes significantly to saving the family farm. Because of the restrictions on qualifications, the effect of the recapture tax and the unresolved questions raised by the statute, it will be beneficial to a relatively small percentage of farm estates. Encouraging the congressional ideal of the family farm demands more than a statute directed at one part of a complex problem. The effects of the farm cycle, the income tax and the relatively low

447. *Hjorth*, *supra* note 39, at 659.
448. *Id.*

yield of farms as well as the interrelationships between these factors and the estate and gift taxes must be studied. Perhaps such a study would determine that the problem is not the estate tax at all. Perhaps lifetime gifts of portions of a farm to family members should be encouraged. Perhaps the major problem is an economic one of improving farm income, or perhaps entry into farming by non-farmers should be encouraged by subsidies. The crucial point is that all aspects of the problem of preserving the family farm must be examined for a solution which treats all aspects of the problem. An attack on one aspect of a problem as complex as this will rarely provide a workable solution. The enactment of section 2032A is a case in point. Far from saving the family farm, section 2032A introduced a great deal of complexity into the Internal Revenue Code. It may have created more problems for farmers than it solved.