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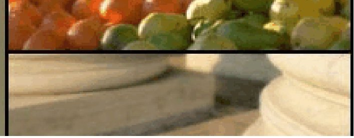

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An Agricultural Law Research Article

Taxation: The Economic Recovery Tax Act of 1981: Its Estate, Gift and Business Planning Implications for the Private Sector

by

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COMMENTARIES

Taxation: The Economic Recovery Tax Act of 1981: Its Estate, Gift, and Business Planning Implications for the Agricultural Sector*

Introduction

The Economic Recovery Tax Act of 1981 ("ERTA" or the "Act")[1] was enacted August 13, 1981. It made extensive reforms in both transfer and income taxes that will significantly affect many taxpayers. Persons engaged in agricultural vocations will be affected by amendments of general import, as well as by several changes specifically directed at them. This commentary highlights the importance of ERTA changes to farmers, ranchers, and rural landowners in both the transfer tax and business planning environments.

Estate and gift tax changes implemented by ERTA will be discussed in Part I. This part discusses primary statutory changes in estate and gift tax laws affecting farmers and ranchers and includes analysis of applications, planning considerations, and consequences generated by the statutory changes. Part II will itemize income tax reforms enacted by ERTA and analyze their ramifications in the farm income tax and business planning context.

Part I: *Estate and Gift Tax Changes*

Estate and gift tax amendments made by ERTA will have a profound and positive effect on estate planning for farmers and ranchers. A primary result of those amendments is a significant reduction in transfer taxes. In addition, ERTA provided targeted relief for agriculturalists through modification of special use valuation of farm real property[2] and the estate tax deferral provisions applicable to closely held farm businesses.[3] As a result, fewer persons should be required

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[1] The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

[2] I.R.C. § 2032A. See notes 70-148 and accompanying text *infra*.

[3] *Id.* § 6166. See notes 149-166 and accompanying text *infra*.

to pay estate taxes and, overall, estate planning should become less tax oriented.[4]

Accompanying the benefits bestowed by ERTA are new pitfalls, and cognizance of them is necessary in planning farm estates. The following sections detail, respectively, estate and gift tax amendments of general concern and those specifically applicable to agriculturalists and discuss estate and gift tax planning opportunities for farmers and ranchers under the new provisions.

Increase in the Unified Credit

A unified rate schedule[5] applies to taxable estate and gift transfers. Gift tax liability is determined by applying the unified rate schedule to cumulative lifetime transfers, then subtracting taxes incurred on prior lifetime taxable transfers.[6] The estate tax is similarly determined by applying the section 2001 unified rate schedule to aggregate post-1976 lifetime and estate transfers and then subtracting gift taxes incurred on lifetime taxable transfers.[7]

Taxable transfers that generate tax in excess of the unified credit require payment of tax unless other credits apply.[8] This unified credit has the effect of exempting a portion of every taxpayer's wealth, referred to as the exemption equivalent, from payment of transfer tax. For persons dying in 1981, the unified credit was $47,000 per individual, thereby "exempting" aggregate taxable estates of $175,625 from transfer tax.[9] ERTA raised the credit to $192,800, "exempting" transfers of up to $600,000 from transfer tax.[10] This increase in the unified credit is phased

[4] Because of the increased unified credit (I.R.C. § 2010(c) (see notes 5-16 *infra* and accompanying text), fewer estates will be subject to federal estate taxation. Thus, estate planning for smaller estates will focus more on the achievement of non-tax transfer objectives.

[5] I.R.C. § 2001(c).

[6] This method of computing gift tax is mandated by § 2502(a). Gift and estate taxes are determined under the unified rate schedule in § 2001, applied cumulatively with the unified credit against transfer tax provided by § 2010. See text accompanying notes 8-15 *infra*.

[7] I.R.C. § 2001(b) provides:

"(b) Computation of Tax—The tax imposed by this section shall be the amount equal to the excess (if any) of—

"(1) a tentative tax computed in accordance with the rate schedule set forth in subsection (c) on the sum of

"(A) the amount of the taxable estate, and

"(B) the amount of the adjusted taxable gifts, over

"(2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the rate schedule set forth in subsection (c) (as in effect at the decedent's death) had been applicable at the time of such gifts."

[8] *Id.*

[9] *Id.* § 2010(b).

[10] *Id.* § 2010(a).

in over a six-year period, beginning in 1982, and will apply in full to estates of decedents dying after 1986.[11]

In raising the amount of the credit, Congress stated that the original purpose of the credit was to "exempt small and moderate-sized estates from estate and gift taxes; . . . inflation has been increasing estate and gift tax burdens by eroding the value of the credit and pushing estates and gifts into higher brackets."[12] Increasing the unified credit should result in a dramatic decrease in the number of transfers that require filing of an estate or gift tax return.[13] This phenomenon does not, however, mean that estate and gift planning is now important only to the very wealthy. Although many smaller estates may no longer produce concern with transfer taxation, estate and gift planning will continue to play an important role with respect to achieving nontax objectives such as directing disposition among family members. The increased credit also allows farmers owning estates of less than $600,000 to pass farm property to persons who will continue the farm business, if desired, without consideration of estate tax consequences. They will no longer be forced to consider the liquidity problems that often accompany deaths of farm owners because of large amounts of nonliquid assets in farm estates that are unavailable for payment of estate taxes.

Many persons engaged in agricultural production have estates exceeding the exemption equivalent. Although data on estate sizes of United States farmers and ranchers is scarce, an average United States farm in 1980 had a balance sheet value of $403,624.[14] Actual farm

[11] Code § 2010(b) provides for unified credit increases as follows:

Gift made or person dying in	*Unified Credit*	*Exemption Equivalent*
1981	$ 47,000	$ 175,625
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and later	192,800	600,000

[12] H.R. REP. No. 201, 97th Cong., 1st Sess. 154 (1981).

[13] Act § 401 also amended Code § 6018(a) to conform to Code §§ 2010 and 2505 credit levels, so that a transfer tax return is not required unless the exemption equivalent is exceeded. According to IRS figures, 2.8% of resident decedents in 1981 were required to file estate tax returns. If the 1987 credit of $192,800 applied, sheltering $600,000 of transfers from tax, only .4% would have been required to file estate tax returns. This estimate may be distorted slightly because the new unlimited marital deduction (see text accompanying notes 28-56 *infra*) would reduce the percentage, while continued inflation through 1987 would increase the percentage. The general notion, however, that estates required to file tax returns will decline tremendously, is a viable one.

[14] "Economic Indicators of the Farm Sector: Income and Balance Sheet Statistics, 1980."

size based on fair market value would be significantly larger than the historical cost balance sheet values used, though more than one person is often involved in each farm's operation.[15] For estates valued at amounts in excess of the exemption equivalent, unified credit increases represent substantial tax saving and planning possibilities.

The unified credit will allow a married individual dying after 1986 to pass his or her estate tax-free by leaving up to $600,000 to anyone, including persons other than his or her surviving spouse, and the remainder to the surviving spouse. The former $600,000 is not taxed because of the unified credit, while the remainder passes tax-free to the surviving spouse by reason of the unlimited marital deduction.[16] One common method employed by married taxpayers to utilize the unified credit is the traditional "A/B trust" arrangement, whereby an amount to which the credit applies is bequeathed to a nonmarital, or "B," trust, allowing it to bypass inclusion in the surviving spouse's estate. The remainder is bequeathed to an "A" trust for the benefit of the surviving spouse, qualifies for the marital deduction, will be included in the surviving spouse's estate, and taxed upon the surviving spouse's death to the extent not depleted prior to death.[17] This arrangement is often useful in the farming context because one common estate planning goal is that all farm property of the spouses and the income therefrom be controlled by the survivor. An outright marital deduction gift or bequest, or a trust qualifying for the marital deduction, combined with a bypass trust, permits control of property and retention of income if the surviving spouse is trustee, while still making maximal use of decedent's unified credit. A testator who wants to bequeath a portion of his estate to persons other than the surviving spouse can utilize the unified credit through direct bequests to children or others up to the exemption equivalent.

The unified credit increase also creates additional planning alternatives utilizing inter vivos gifts. Because the unified credit applies to aggregate post-1976 estate and gift transfers by each person, the same unified

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National Economics Division, Economic Research Service, U.S. Dep't of Agriculture, Statistical Bulletin No. 674.

[15] Balance sheet figures are compiled using historical cost values. Farm real estate has appreciated considerably in recent years; as a result, historical cost figures understate property fair market value considerably.

[16] See text accompanying notes 9-11 *supra* and text accompanying notes 28-56 *infra*.

[17] The "B" trust is usually created in one of two ways. Decedent may bequeath a specific amount equal to his or her remaining exemption equivalent to the "B" or by-pass trust. Alternatively, decedent's bequest to his or her spouse may include a clause which reduces the marital deduction bequest by an amount equal to the applicable exemption equivalent. *See* D. KEITH & D. LUDTKE, ESTATE PLANNING FOR FARMERS AND RANCHERS § 4.44, (1980).

credit is available for gift tax purposes.[18] The increased credit, when combined with the increased annual gift tax exclusion,[19] permits persons who remain affected by transfer taxes to make substantial gifts without incurring gift tax liability. For instance, after 1986, a married couple could make a onetime gift of $1,240,000 to their two children tax-free if they consent to gift splitting.[20] Each spouse's $600,000 exemption equivalent has been used, as has his annual gift exclusion of $10,000 per spouse per donee for the year in which the gift was made.[21]

The decision whether to transfer property at death or by inter vivos gift requires careful consideration. Each has advantages and disadvantages. Transfer by gift prevents inclusion of post-gift property appreciation in the prospective decedent's estate, thereby decreasing transfer tax liability incurred by the estate. This reduces liquidity problems faced by farm owners at death because less tax is then due. In addition, gifting shifts income earned by or on gifted property, and the accompanying income tax liability, to the donee. If the amount of property or money gifted is within the donor's annual $10,000 per donee exclusion, gifting is more likely to be advantageous because none of the unified credit is consumed by the gift. Additional factors become more important when amounts gifted exceed the annual exclusion limit. Gifting, as opposed to transfer at death, may decrease the transfer tax liability of a donor and his estate. However, because many farms are operated by families, the total tax liability of the family is likely to be a more important consideration than is the donor-decedent's tax liability alone. Property transferred by gift receives a basis to the donee equal to that which it had in the donor's hands.[22] If, subsequent to the gift, gifted property appreciates in value and the donee sells it, greater income tax liability results because of its carryover basis than if the property had passed through decedent's estate and received a new basis of fair market value at the federal estate tax valuation date.[23] For this reason, in family farm businesses, it may prove beneficial for individuals owning moderate estates to retain ownership of low-basis property until death, allowing beneficiary family members to receive a stepped-up basis in the property.

[18] I.R.C. §§ 2010(a), (c).

[19] See text accompanying notes 57-63 *infra*.

[20] I.R.C. § 2513(a).

[21] See text accompanying notes 57-63 *infra*.

[22] I.R.C. § 1015(a).

[23] Code § 1014(a) states the general rule that property received from a decedent receives a basis equal to its fair market value as determined for estate tax purposes at date of death or the alternate valuation date.

Whether property should be transferred from parents to children by gift or bequest must be determined under the particular circumstances of each case, after computing the total estimated estate, gift, and income tax resultant from each alternative. Several factors influence this decision:

(1) Whether minimization of taxes of the family unit or only of a donor, testator, or estate is the primary planning objective. If family unit tax minimization is desired, having property pass through an estate may be more desirable, depending on comparability of marginal brackets of the estate for estate taxes and other family members for income taxes. Conversely, if a primary aim is to minimize tax paid by a current property owner and his estate, inter vivos gifting is more beneficial because it shifts taxation for post gift appreciation and income to other persons.

(2) Whether the value of property transferred is within the annual gift exclusion of section 2503(b). If gifted property is within the donor's annual $10,000 per donee exclusion, the desirability of gifting is enhanced because no tax is payable upon transfer, and the transferor has not depleted his unified credit by making the transfer.

(3) Whether any of the current owner's estate will be subject to estate tax. If a current owner's estate is not likely to exceed the exemption equivalent, allowing appreciated property to pass at death is clearly the superior alternative. A person receiving appreciated property gets a step-up in basis without the corresponding penalty of having the decedent's estate diminished by payment of estate tax.

(4) Whether property involved has significant appreciation potential. The more likely it is that significant appreciation will occur between date of gift and date of death, the more desirable it will be, from a prospective decedent's standpoint, to shift tax on this appreciation away from himself and his estate by inter vivos gifting.

(5) Probability that property will be sold at a future time. If it is likely that property will be sold by persons receiving it from the current owner, passing property at death becomes more appealing because of the basis step-up and the corresponding decrease in gain recognized on sale of the property. An ad hoc comparison of potential taxation under each alternative is necessary because applicable estate and income tax marginal bracket rates will vary, depending upon wealth and income of the current property owner and the donee or beneficiary, respectively.

If, on the other hand, it is anticipated that the person receiving farm property will continue to own it, gifting becomes more appealing. Taxation of post gift appreciation is thereby deferred until the donee dies

or transfers the property. Also, the donee, who is often a child or other relative of the donor in a farm business context, is taxed on income from gifted property. The donee is often in a lower marginal income tax bracket than the donor; thus, gifting reduces income tax incurred on income earned by the property.

(6) Nature of the property. If property involved is subject to depreciation and is appreciated, passing it at death increases depreciation deductions as a result of the stepped-up basis available for depreciation.

By taking the above considerations into account, estate planners can determine the preferable means of utilizing property owners' unified credit.

Estate and Gift Tax Rate Changes

ERTA reduced the maximum marginal tax bracket rate for both estates and gifts from 70% to 50%,[24] phased in over the four-year period from 1981 to 1985. This reduction is accomplished by reducing the rate for the top bracket to that of the next lower bracket each year. Rates for estates of less than $2.5 million were not affected by the Act. As a result of the rate reduction and increases in the unified credit, variation between minimum and maximum tax rates for estates that will pay an estate tax is decreased to 13% after 1986.[25] Compres-

[24] Section 2001(c)(2)(A) through (D) provides for phase-in of the 50% maximum estate tax rate. The top marginal bracket rate for 1981 is 70%; for 1982, 65%; for 1983, 60%; for 1984, 55%; and after 1984, 50%.

[25] Under pre-ERTA law, with an exemption equivalent of $175,625, estate tax was imposed at the rate of 32% on the first dollar subject to tax. The maximum marginal tax rate, imposed on estates in excess of $5 million, was 70%. This 38% tax rate spread narrows through 1987, when the unified credit is fully in place. The maximum marginal rate will then be 50% on estates in excess of $2,500,000. *See* I.R.C. § 2001(c)(1). The $600,000 exemption equivalent for decedents dying after 1986 results in the first dollar over that amount being taxed at the rate of 37%.

Assuming that the decedent's entire exemption equivalent is available, applicable marginal rates for varying sizes of estates may be reflected as below.

Taxable Estate Value	1981	1982	1983	1984	1985	1986	1987 or Later
Over $4,500,000	70%	65%	60%	55%	50%	50%	50%
$4,000,000 to $4,500,000	65	65	60	55	50	50	50
$3,500,000 to $4,000,000	61	61	60	55	50	50	50
$3,000,000 to $3,500,000	57	57	58	55	50	50	50
$2,500,000 to $3,000,000	53	53	53	53	50	50	50
$2,000,000 to $2,500,000	49	49	40	40	49	49	49
$1,500,000 to $2,000,000	45	45	45	45	45	45	45
$1,250,000 to $1,500,000	43	43	43	43	43	43	43
$1,000,000 to $1,250,000	41	41	41	41	41	41	41

(Continued)

sion of the rate spread may change estate planning for many estates. For instance, it reduces the financial advantage of equalizing estate tax brackets by shifting wealth between two or more estates, which, though disparate in size, exceed the exemption equivalent. Reduced graduation in the rate schedules also minimizes the adverse impact of "stacking" the estate of one taxpayer onto another, as occurs through use of the marital deduction,[26] because there will not be tremendous disparity in the rates at which the two estates will be taxed. Therefore, maximum use of the marital deduction will not necessarily increase a couple's total tax liability (e.g., if both are in the highest marginal bracket), and tax deferral achieved because the property avoids taxation until the death of the surviving spouse may be significant. In addition, the surviving spouse can deplete his or her estate between the decedent's death and his or her own death.

For large estates, the phase-in of rate reductions makes extensive use of the marital deduction more palatable for estates of married decedents dying in 1982 and 1983. If the surviving spouse does not die until 1985 or later, it is probable that property will be taxed at a lower rate in the spouse's estate than if taxed upon decedent's death in 1982 or 1983.

Marital Deduction Changes

After the Tax Reform Act of 1976,[27] estates were permitted a marital deduction of no more than the greater of $250,000 or one-half of the

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Taxable Estate Value	1981	1982	1983	1984	1985	1986	1987 or Later
(Continued)							
$750,000 to $1,000,000	39	39	39	39	39	39	39
$600,000 to $750,000	37	37	37	37	37	37	37
$500,000 to $600,000	37	37	37	37	37	37	0
$400,000 to $500,000	34	34	34	34	34	0	0
$325,000 to $400,000	34	34	34	34	0	0	0
$275,000 to $325,000	34	34	34	0	0	0	0
$250,000 to $275,000	34	34	0	0	0	0	0
$225,000 to $250,000	32	32	0	0	0	0	0
$175,000 to $225,000	32	0	0	0	0	0	0
$ less than 175,625	0	0	0	0	0	0	0

The zero values in the table indicate that estate values less than the amount indicated are within the credit threshold, and are thus sheltered from transfer tax.

As the table indicates, the marginal rate spread decreases from 38% [70-32] in 1981 to 13% [50-37] in 1987.

[26] When the marital deduction is employed to make wealth transferred to a surviving spouse nonincludable in the estate of the first spouse to die, inclusion in the surviving spouse's estate increases his or her estate, thereby increasing estate tax payable thereon.

[27] Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.).

value of decedent's adjusted gross estate,[28] for property left to a surviving spouse. For gift tax purposes, the marital deduction was 100% of the first $100,000 of gifts to a spouse, plus 50% of aggregate gifts to a spouse in excess of $200,000.[29]

The 1981 Act made a quantitative change in the marital deduction. Section 403 of ERTA amended Code sections 2056 and 2523, removing all limits on the allowable deduction for interspousal transfers, whether during life or at death.[30] Applicable to estates of decedents dying after December 31, 1981, the unlimited marital deduction will allow a decedent's entire estate to pass to a surviving spouse free of tax.[31] Because such an unlimited marital bequest is seldom desirable tax planning,[32] the extent to which the marital deduction should be utilized in a given estate will be an important planning decision.

ERTA also made a significant change in the nature of property interests that could be transferred to a surviving spouse and qualify for the marital deduction. Sections 2056(b)(7) and 2523(f) now allow cer-

[28] This limitation was contained in Code § 2056(c)(1)(A) as it read before ERTA.

[29] Before ERTA, Code § 2523(a) provided:

"(a) Allowance of Deduction.—

"(1) In general.—Where a donor who is a citizen or resident transfers during the calendar quarter by gift an interest in property to a donee who at the time of the gift is the donor's spouse, there shall be allowed as a deduction in computing taxable gifts for the calendar quarter an amount with respect to such interest equal to its value.

"(2) Limitation.—The aggregate of the deductions allowed under paragrpah (1) for any calendar quarter shall not exceed the sum of—

"(A) $100,000 reduced (but not below zero) by the aggregate of the deductions allowed under this section for preceding calendar quarters beginning after December 31, 1976;

"(B) 50 percent of the lesser of—

"(i) the amount of the deductions allowable under paragraph (1) for such calendar quarter (determined without regard to this paragraph); or

"(ii) the amount (if any) by which the aggregate of the amounts determined under clause (i) for the calendar quarter and for each preceding quarter beginning after December 31, 1976, exceeds $200,000."

[30] Code section 2056(a) now provides:

"2056. BEQUESTS, ETC. TO SURVIVING SPOUSE.

"(a) Allowance of Marital Deduction—For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate."

Code section 2523(a), creating the unlimited marital deduction for gifts, now provides:

"2523. GIFT TO SPOUSE.

"(a) Allowance of Deduction—Where a donor who is a citizen or resident transfers during the calendar year by gift an interest in property to a donee who at the time of the gift is the donor's spouse, there shall be allowed as a deduction in computing taxable gifts for the calendar year an amount with respect to such interest equal to its value."

[31] *Id.* § 2056(a).

[32] See text accompanying notes 36-43 *infra*.

tain previously nondeductible terminable interests in property to qualify for the deduction.[33] To qualify, "qualified terminable interest property" must be created, meaning that the property passed from the decedent, granting the surviving spouse an income interest for life, and an election was made by the decedent's executor so as to qualify the terminable interest for the marital deduction.[34] The rules regarding qualified terminable interests apply to both inter vivos and testamentary transfers, with similar requirements relating to inter vivos transfers of qualified terminable interest property.[35] Because the spouse receives only a life estate in qualifying terminable interest property, which would not incur a tax on relinquishment during life or termination at the spouse's death, ERTA also added Code sections 2044 and 2519 to impose estate and gift tax liability upon disposition or termination of that interest.[36] Thus, the overall effect of marital deduction planning is still only a deferral of taxation from the death of the first spouse to die until the death of the surviving spouse.

Though a decedent may leave his or her entire estate to a surviving spouse without imposition of estate tax, such an action seldom produces optimal results from a tax-planning standpoint. This can be illustrated by an example. Assume that *H* dies in 1985, leaving his entire $1 million estate to his spouse, *W*. *H*'s estate is not taxed upon his death due to the unlimited marital deduction. Further, assume that *W* dies in 1987, her estate consisting of the same $1 million. *W*'s estate will be taxed on $400,000 of property ($1 million estate less *W*'s $600,000 exemption equivalent because of the unified transfer credit). Her estate will thus incur $153,000 in estate tax upon her death in 1987.[37]

[33] I.R.C. §§ 2056(b)(7) & 2523(f).

[34] *Id.* § 2056(b)(7)(B).

[35] *Id.* § 2523(f)(4).

[36] Code § 2044, added by ERTA § 403(d)(3)(A)(i), provides:

"(a) General Rule.—The value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for life

"(b) Property To Which This Section Applies—This section applies to any property if—

"(1) a deduction was allowed with respect to the transfer of such property to the decedent—

(A) under section 2056 by reason of subsection (b)(7) thereof, or

"(B) under section 2523 by reason of subsection (f) thereof, and

"(2) section 2519 (relating to dispositions of certain life estates) did not apply with respect to a disposition by the decedent of part or all of such property."

Code section 2519, added by ERTA section 403(d)(3)(B)(i) provides:

"(a) General Rule.—Any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of such property.

"(b) Property To Which this Subsection Applies.—This section applies to any property if a deduction was allowed with respect to the transfer of such property to the donor—

"(1) under section 2056 by reason of subsection (b)(7) thereof, or

"(2) under section 2523 by reason of subsection (f) thereof."

[37] *Id.* § 2001(c)(1). Estate tax imposed on an estate of $1 million is $345,800 and reduction by the unified credit of $192,800 results in estate tax payable of $153,000.

Suppose that, instead of taking the maximum marital deduction as above, *H* had transferred the portion of his estate sheltered by the unified credit ($400,000 in 1985) to persons other than *W* or to a trust for the benefit of *W* that did not qualify for the marital deduction. That $400,000 would have been included in *H*'s estate, but no tax incurred because the unified credit sheltered it from the imposition of tax.[38] The remaining $600,000 that passed directly to *W* would be included in her estate. Upon *W*'s death in 1987, the $192,800 unified credit will shelter all $600,000 from estate tax.[39] In this example, maximum use of the marital deduction resulted in $153,000 of unnecessary tax to the family unit.

This example illustrates an effective method of minimizing transfer taxes under the new law. It is possible to shelter at least a portion of a decedent's estate from tax through use of the unified credit and prevent its inclusion in the spouse's estate, even when the decedent intends that his or her surviving spouse receive the entire estate. Decedent can establish a bypass trust to be funded with property or cash from his or her estate in the amount of the applicable exemption equivalent, giving the surviving spouse substantial power over property within the trust, and directing disposition of trust property at the surviving spouse's death. Although the spouse has somewhat less power over property within the trust than if a direct bequest had been used, provisions of a trust need not be overly restrictive to prevent inclusion of trust assets in the spouse's estate.[40] The unified credit of the first spouse to die (*H* in the prior illustration) is not wasted as it was in the first example by using a maximum marital deduction. The surviving spouse retains nearly as much power over property in the trust as if she owned it outright, yet the aggregate tax burden on the surviving spouse's estate at death is substantially less.

Traditionally, estate planners have attempted to structure the estates of married couples so as to result in equal marginal tax rates at each

[38] *Id.* § 2010(b).

[39] *Id.*

[40] The maximum powers a surviving spouse can have over property in a by-pass trust and avoid inclusion of trust assets in the spouse's estate appear to be as follows if the spouse is not trustee:

(1) the right to receive trust principal in the trustee's discretion;

(2) the right to receive all income from trust property annually;

(3) the right to withdraw up to the greater of $5,000 or 5% of trust corpus annually, and in any amount necessary for the spouse's health, education, support, and maintenance;

(4) inter vivos or testamentary "statutory" power to appoint corpus to anyone other than the surviving spouse, his or her estate, or creditors of either.

If correctly done, the surviving spouse may also be made trustee of the trust. However, if the surviving spouse is trustee, (1) above is not a permissible power unless the trustee-spouse's discretion is limited by an ascertainable standard.

spouse's death. After ERTA, this is not always advisable. For instance, a larger marital deduction may be preferable for decedents dying during the phase-in years of unified credit increases because a larger portion of the surviving spouse's estate will be sheltered from tax in later years than is presently the case.[41] A marital deduction larger than that required for estate equalization may also be warranted if each spouse has a substantial life expectancy.[42] In such circumstances, though a couple's total tax bill may be increased as a result of stacking of the survivor's estate, the surviving spouse will have several years' use of money that would have been paid in taxes if the estates were equalized. The benefits of tax deferral may more than offset higher total taxes resulting from larger than optimal use of the marital deduction.[43]

Because estate equalization is preferable when a surviving spouse has only a short life expectancy, an equalizer provision should be included in wills or trusts that utilize greater than the estate equalizing marital deduction. These provisions often provide for estate equalization if the surviving spouse dies within 180 days of the decedent's death. Such provisions reduce the possibility of harsh results when the marital deduction taken is larger than that which would equalize the spouses' estates.

Unfortunately, many factors to be considered in determining the most desirable division of assets between spouses are unknown or uncertain at the time a particular instrument is drafted. One method of drafting to provide for this uncertainty is to draft an optimal marital deduction and provide an opportunity for the survivor to disclaim as much marital property as is necessary to reduce the marital deduction to the amount deemed appropriate.[44] Such a disclaimer must be made within nine months after the first spouse's death.[45] Dependence on a surviving spouse's disclaimer of property for estate tax minimization reasons should be cautiously placed because the surviving spouse is not bound

[41] I.R.C. § 2010(b).

[42] *See, e.g.*, Treas. Reg. § 20.2031-10(f).

[43] This approach is a gamble because for a marital deduction larger than that required for estate equalization to be economically beneficial, the surviving spouse must substantially outlive the decedent. Therefore, when determining the extent to which the marital deduction should be taken, factors such as the survivor's life expectancy, the expected rate of return on deferred tax dollars, the effects of expected future inflation, and the likelihood of estate dissipation by the survivor should be considered.

[44] Reliance on a disclaimer to achieve tax minimization involves several dangers. Although a surviving spouse has nine months after decedent's death to disclaim, disclaimer is not allowed if the surviving spouse has committed certain acts, including receiving any income from property being renounced. I.R.C. §§ 2518(b)(3), (b)(4). Also, a surviving spouse may be either unable, because of legal incapacity or death, or unwilling, because of a desire to own the property outright, to disclaim after the decedent's death.

[45] *Id.* § 2518(b)(2).

by the document and may choose to retain all property to which he or she is entitled, despite possible adverse tax consequences upon the surviving spouse's subsequent death.[46]

As discussed previously,[47] ERTA expanded the scope of terminable interests that qualify for a marital deduction in the estate of the first spouse to die, or on a gift tax return in the case of an inter vivos transfer between spouses. The deductibility of qualified terminable interest property under section 2056(b)(7) makes possible creation of a "handcuff" trust in which the value of assets generating income to the surviving spouse qualifies for a marital deduction in the estate of the decedent spouse, but does not give the surviving spouse power or control over trust property. Such trusts will be attractive for persons who, though desiring the benefit of a marital deduction on the property, are not comfortable giving the surviving spouse power to dispose of or otherwise dissipate the property.

Another ERTA change relating to the estates of married taxpayers involves the tax treatment of property held by spouses as joint tenants. Before ERTA, 100% of the value of jointly held property value was included in a decedent's gross estate, except to the extent the surviving joint tenant furnished consideration toward procurement or improvement of the property.[48] The new law regarding jointly held property eliminates the consideration furnished rules with respect to "qualified joint interests," substituting automatic inclusion in the estate of the first tenant to die only one-half of the value of the property.[49] To qualify for this 50% inclusion treatment, property must be held by a decedent and the decedent's spouse either as tenants by the entirety or as joint tenants with right of survivorship in which the decedent and spouse are the only joint tenants.[50]

While one-half inclusion treatment might have been relatively beneficial under prior law, it creates more problems than solutions after ERTA. Because of the unlimited marital deduction and the fact that a joint interest passes to a surviving spouse by operation of law, the joint interest would not generate tax in the decedent's estate, even if 100% includible. Thus, the 50% rule does not reduce the decedent's taxes. The one-half of property value included in decedent's gross estate receives a new basis equal to fair market value at the federal estate

[46] See note 44 *supra*.

[47] See text accompanying notes 33-36 *supra*.

[48] Before ERTA amendment, Code § 2040(a), (c), (d), and (e) contained complex rules for determining the extent to which consideration was furnished by decedent's surviving joint tenant. Act section 403 repealed Code sections 2040(c), (d), and (e).

[49] I.R.C. § 2040(b)(1).

[50] *Id.* § 2040(b)(2).

tax valuation date.[51] A major disadvantage of the new joint interest treatment is evidenced when the first spouse to die furnished most of the consideration to acquire jointly held property that appreciated. When a decedent furnished all of the consideration, prior law would have caused 100% inclusion of the value of the property in the decedent's estate and the surviving spouse would receive a stepped-up basis in the entire property equal to the full federal estate tax value. ERTA allows a stepped-up basis only for the one-half includible in the decedent's gross estate; thus, if the surviving spouse sells the property, larger gain and therefore larger income tax liability will ensue than under prior law.

Conversely, if the noncontributing spouse dies first, advantageous results ensue. The one-half of jointly held property includible in the noncontributing spouse's estate receives a tax-free step-up in basis. Prior to ERTA, the noncontributing spouse would not include any of the property in his or her gross estate, basis would remain unchanged, and larger gain upon sale by the surviving (contributing) spouse would result than under ERTA by virtue of the stepped-up basis.

In most situations, the disadvantages of joint ownership of property by spouses outweigh the advantages. Jointly held property, receiving one-half inclusion treatment by operation of law, is not available for use in accomplishing planning goals at the death of the first spouse to die because it cannot bypass inclusion in the estate of the first spouse to die. Farm estate owners should generally avoid joint ownership. One of the few farming situations in which joint ownership may be advisable is when a joint interest in qualifying property is necessary for an estate to meet the percentage tests of sections 2032A and 6166.[52]

Many existing wills and trusts contain formula clauses geared to the previous maximum marital deduction. Congress determined that documents employing formula clauses reflected decedents' desires to utilize the deduction as it existed prior to ERTA.[53] For this reason, a transition rule applies to certain wills and trusts executed or established prior to September 13, 1981. In order to prevent the new unlimited amount from applying under a preexisting provision, ERTA allows the unlimited marital deduction to apply automatically to estates of decedents dying after December 31, 1981, but only if the decedent's estate plan was executed after September 12, 1981. The transition rule provides that the unlimited marital deduction does not apply to wills

[51] *Id.* § 1014.

[52] See the sections "Special Use Valuation of Farm Real Property" and "Section 6166: Installment Payment of Estate Taxes," *infra*.

[53] H.R. REP. No. 215, 97th Cong., 1st Sess. 142 (1981).

and trusts containing marital deduction formula provisions if the document was executed prior to Septemer 13, 1981.[54] Thus, if: (1) the decedent dies after December 31, 1981; (2) property passes from the decedent or is acquired under a will or trust executed prior to September 13, 1981; (3) such will or trust contains a clause expressly providing that the spouse is to receive the maximum amount of property qualifying for the marital deduction; and (4) no existing state law construes the formula clause as referring to the new unlimited marital deduction, prior marital deduction limits apply.[55] Thus, review and revision of existing formula wills and trusts will be necessary to assure that a testator's or grantor's intent is served by operation of the transition rule. For persons desiring to take full advantage of the unlimited marital deduction, an amendment to existing documents may be necessary to indicate clearly that the unlimited marital deduction is anticipated by the transferor.[56]

Increased Annual Gift Tax Exclusion

Before ERTA, a donor could make gifts of $3,000 annually to each of an unlimited number of donees tax-free if the gift was of property qualifying for the annual gift tax exclusion.[57] A gift of a present interest in property was required in order to qualify for annual exclusion treatment.[58] ERTA retained the present interest requirement, but increased each donor's annual exclusion from gift taxes to $10,000 per donee for gifts made after 1981.[59] For example, an individual with three children may, after 1981, transfer $10,000 annually to each child, a total of $30,000 annually, without incurring gift tax and without filing a gift tax return. If a married individual's spouse consents to gift-splitting, the amount of annual transfers could be doubled.[60] Assum-

[54] I.R.C. § 2207(a).

[55] *Id.*

[56] For those desiring to take the maximum marital deduction, the easiest means of amending existing formula provisions may be to simply insert the word "unlimited" before the words "marital deduction" where they appear in the formula clause.

[57] As it read before ERTA, Code § 2503(b) authorized this exclusion for gifts of present interests.

[58] Section 2503(b) expressly applies to "gifts [other than gifts of future interests in property]."

[59] *Id.* "(b) Exclusion From Gifts—In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of such gifts made during such year. Where there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in applying this subsection, if no part of such interest will at any time pass to any other person."

[60] Gift-splitting is authorized by Code § 2513(a). If both spouses consent, a gift actually made by one spouse is considered made one-half by each spouse. This allows one spouse to give property to which not only his or her own annual exclusion, but also that of his or her spouse, is applied.

ing a married couple has three children, they could consent to gift-splitting and transfer a total of $60,000 annually, $20,000 to each child, free of tax. Over a ten-year period this couple can transfer $600,000 from their own estates to those of their children without incurring transfer tax. Because gift-splitting is elective,[61] a gift tax return is required to signify the electing spouse's consent, even though the exclusion prevents imposition of tax.[62]

The increased annual gift tax exclusion will be a significant planning tool because it enables taxpayers to make substantial transfers of wealth without incurring transfer tax. Large amounts of property can be removed from a person's potential taxable estate. Without this exclusion, lifetime gifts would decrease the unified credit available at the donor's death. The extent to which the exclusion will allow one to dissipate his estate tax-free will vary according to the donor's age, health, marital status, and the number of donees to whom the donor wishes to give property.

Interests qualifying for the annual exclusion may be given directly to donees; however, to assure judicious use and management of gifted property, donors may prefer to make gifts to trusts for the benefit of descendants or others. In so doing, care must be taken to satisfy the present interest requirement of section 2503(b).

The increased annual exclusion will have a significant impact on future gifting strategies. As previously illustrated,[63] substantial wealth may now be passed from higher to lower generations tax-free over a period of time. The availability of greater tax-free giving as an alternative reduces the previously existing need for complex estate freezing techniques to deflect tax on property appreciation away from the donor's estate. Futhermore, the increased annual exclusion makes dissipation of the marital share by a surviving spouse easier, thereby decreasing the surviving spouse's estate tax liability.

Transfer Within Three Years of Death

Before ERTA, property transferred by a decedent within three years of death was included in that deceased transferor's gross estate at its value as of the applicable federal estate tax valuation date.[64] This treatment guaranteed taxation, upon death, of post-gift appreciation in prop-

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For example, a donor could give $6,000 of property to one donee and the gift would have been entirely tax-free under pre-ERTA law. Because section 2513(a) treats each spouse as donor of a $3,000 gift, both spouses did not exceed the $3,000 annual exclusion limit.

[61] *Id.* § 2513(a)(2).

[62] *Id.* § 2513(b)(2).

[63] See text accompanying notes 58-62 *supra*.

[64] I.R.C. § 2035(a). *See also* Treas. Reg. § 20.2035-1(e).

erty accruing before a decedent's death. ERTA added section 2035(d), exempting many such gifts from the section 2035(a) inclusion rule. Generally applicable to estates of decedents dying after December 31, 1981,[65] regardless of when the gift was made, the former three-year inclusion rule will apply only to transfers of interests which, if held at death, would have caused estate tax inclusion under sections 2036 (transfers of retained life estates or powers), 2037 (transfers taking effect upon death), 2038 (revocable transfers), 2041 (transfers by virtue of exercise, release, or lapse of a general power of appointment), or 2042 (transfers of life insurance policies or incidents of ownership therein).[66] The section 2035(d)(1) exclusion from application of the three-year rule also does not apply for the purpose of determining whether the percentage tests of sections 303(b), 2032A, and 6166 are met, in order to prevent abuse by decedents who could make deathbed transfers of property not qualifying for those sections' favorable treatment in efforts to meet the percentage requirements.[67]

The effect of the previous inclusion rule for gifts within three years of death was to assure taxation of appreciation in transferred property occurring between the gift and the date of death. That appreciation will now, in many cases, go untaxed until the donee disposes of the property or dies. Section 2035(d) exclusion makes it possible for persons who are aged or in poor health to give property with high appreciation potential to others, thus shifting taxation away from themselves and their estates. It also deflects income earned by the gifted property that would otherwise increase the gross estate. Consequently, such transfers lower probate costs for estates and avoid taxation on $10,000 of gifted property per donee annually.[68]

However, all aspects of the new rule are not positive. Countervailing factors must be considered before gifting property. For example, when property is transferred inter vivos, the section 1014 basis step-up does not occur, as it would if the property were passed at death. Loss of the potential benefit of stepped-up basis to a donee must be weighed against higher estate tax and administration costs to the donor. The outcome of this balancing may depend on whether the gross estate value will exceed the exemption equivalent and upon the brackets in which

[65] I.R.C. § 2035(d)(1).

[66] *Id.* § 2035(d)(2).

[67] Inclusion as required by § 2035(d)(2), for purposes of the percentage of gross estate tests, is pro forma. That is, when checking against the applicable percentage, gifts within three years of death are treated as if they were included in the gross estate under § 2035(a). The percentage tests involved here are § 303 (redemption of stock to pay death taxes), § 2032A (special use valuation of farm and certain other real property), and § 6166 (deferred payment of estate taxes on closely held business property).

[68] See text accompanying notes 56-63 *supra*.

both the donee and the donor's estate will be taxed. In most cases, holding property until the decedent's death will be desirable if inclusion of its value in his estate will not precipitate additional estate tax. However, if decedent's estate is large enough to incur tax (i.e., if the unified credit shelter is exceeded), gifting will most likely be more beneficial from an estate planning standpoint. This is because the lowest estate tax rate is 37% after unified credit increases are fully in place, while the maximum rate on capital gains is now 20%.[69]

Special Use Valuation of Farm Real Property

Real property generally must be valued for estate tax purposes at its highest and best use.[70] However, Code section 2032A allows estate representatives to elect alternative estate tax valuation of eligible real property based on its current farm use value.[71] Restrictions limiting availability of special use valuation were liberalized significantly by ERTA. Because a significant portion of agricultural investment consists of real property, the opportunity to lower the value at which it is included in a decedent's estate provides a chance to greatly reduce estate tax liability of farmers and ranchers.[72]

Creation of special use valuation was apparently prompted by congressional concern with the inflationary effects of metropolitan and resort influences on farm real property values. Though it is especially beneficial for farms or other businesses utilizing real property situated in metropolitan areas where development value exceeds the property's value in its current use, special use valuation, because of the conservative valuation methods it employs, can also lower estate taxes on property that metropolitan influences have not affected. For this reason, estate representatives for decedents whose estates consist largely of real property should always consider special use valuation. The amount by which use valuation reduces decedent's taxable estate permanently escapes transfer tax, assuming it is not later recaptured for failure to meet section 2032A post-death qualification requirements.[73]

Special use valuation may only reduce a decedent's gross estate to

[69] See text accompanying notes 24-26 *supra* and text accompanying notes 322-327 *infra*.

[70] I.R.C. § 2032.

[71] *Id.* § 2032A(a)(1). (Section 2032A, permitting special use valuation, was added by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 and amended by the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.)

[72] Because of market value inflation of farmland resulting from metropolitan expansion and real estate speculation, and also because section 2032A employs conservative valuation procedures, values attained under special use valuation have ranged from 29 to 66% of fair market value. *See* Hartley, *Final Regs. Under § 2032A: Who, What, and How to Qualify for Special Use Valuation*, 53 J. TAX. 306, 308 (1980).

[73] See text accompanying notes 128-148 *infra*.

the extent of a statutory limit.[74] Previously, this reduction could not exceed $500,000 but ERTA increased the limit to $700,000 for estates of persons dying in 1982, and $750,000 for estates of those dying after 1982.[75] Thus, if farm real property included in a decedent's gross estate meets section 2032A requirements, special use valuation makes possible estate tax savings of up to $375,000 after ERTA.[76] The only disadvantages offsetting these savings are post-death material participation requirements.[77] Failure to meet post-death requirements results in recapture of use valuation tax benefits but estate tax deferral will nevertheless have been achieved. The difficulty with section 2032A is that it contains several restrictions on qualification for use valuation, making it unavailable to some farm and ranch estates. ERTA removed or relaxed many of these restrictions, thus making special use valuation a more accessible and appealing planning tool. The following discussion focuses on meeting the requirements necessary to apply special use valuation.

Farm real property must be used as a "farm for farming purposes" to be eligible for special use valuation.[78] As used in the statute, the term "farm" includes "stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, greenhouses or other similar structures, used primarily for the raising of agricultural commodities or horticultural commodities, and orchards and woodlands."[79] The term "farming purposes" as used in section 2032A includes:

> (A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;
> (B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and
> (C) (i) the planting, cultivating, caring for, or cutting of trees, or
> (ii) the preparation (other than milling) of trees for market.[80]

Although regulations have not been issued providing further definition of what constitutes use "as a farm for farming purposes," the

[74] I.R.C. § 2032A(a)(2).

[75] *Id.*

[76] Assuming a decedent's estate is valued in excess of $2,500,000, it will be taxed at a marginal rate of 50% after 1985. A $750,000 reduction in estate value through use valuation yields a net tax savings of [$750,000 × .5] = $375,000.

[77] See notes 128-148 *infra* and accompanying text.

[78] I.R.C. § 2032A(b)(2)(A).

[79] *Id.* § 2032A(e)(4).

[80] *Id.* § 2032A(e)(5).

above definitions appear broad enough to allow almost any active farm to qualify.

In addition to land, special use valuation is available for other real property such as farm buildings, roads, and residential buildings if they are "functionally related to the qualified use."[81] However, a recent IRS Letter Ruling indicates that estate representatives may not be too imaginative regarding what constitutes a building functionally related to qualified use.[82]

If a decedent is a citizen or resident of the United States at the time of death and his executor elects application of section 2032A, decedent's "qualified real property" may be specially valued for estate tax purposes, based on the use under which it qualifies, if certain circumstances exist prior to the decedent's death.[83] "Qualified real property" is real property located within the United States, acquired from or passed from a decedent to a "qualified heir," and used as a farm or closely held business at the time of decedent's death.[84] Code section 2032A(e)(1) defines "qualified heir" to include all "members of decedent's family." ERTA expanded the definition of family to include lineal descendants of a decedent's spouse. However, the Act also contracted the definition by restricting inclusion to lineal descendants of decedent's parents, as opposed to lineal descendants of his grandparents under prior law.[85] Thus, under the definition as modified, members of an individual's family include his spouse, parents, siblings, children.

[81] *Id.* § 2032A(e)(3).

[82] I.R.S. Ltr. Rul. 8128017, Apr. 14, 1981 (one-half acre tract containing a residence held ineligible for use valuation when rented to a person unrelated to the farming operation).

[83] I.R.C. § 2032A(a)(1).

[84] *Id.* § 2032A(b)(1). I.R.C. § 2032(b)(1):

"(1) In general.—For purposes of this section, the term 'qualified real property' means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, but only if—

"(A) 50 percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property which—

"(i) on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, and

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

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

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

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

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

"(D) such real property is designated in the agreement referred to in subsection (d)(2)."

[85] *Id.* § 2032A(e)(2).

stepchildren, and spouses and lineal descendants of those persons.[86] Legally adopted children are treated as children of blood relationship.[87] It is therefore arguable that adoption could be used to expand an individual's family to make special use valuation available, even on the individual's deathbed. Aunts, uncles, cousins, and unadopted foster children are not family members under the statutory definition.

Regulations in effect before ERTA required that a person receive a "present interest" in real property to be a qualified heir.[88] Existence of a present interest in this context was to be determined under Code section 2503.[89] Thus, discretionary life estates, often encountered in trusts that give the trustee discretion regarding distributions, constituted future interests and the life tenant was not a "qualified heir" under section 2032A(b)(1). However, ERTA amended section 2032A(g), retroactive to January 1, 1977, to provide that an interest in a discretionary trust in which all beneficiaries are qualified heirs constitutes a present interest.[90]

The required transfer from the decedent to a qualified heir may be accomplished in several ways. Bequests, devises, and inheritances satisfy this requirement. Property passing to a qualified heir as beneficiary of a revocable trust created by the decedent upon decedent's death also qualifies for section 2032A treatment.[91] In addition, since ERTA, property purchased by a qualified heir from a decedent's estate or from a trust which was taxable to the decedent also qualifies.[92] ERTA thus

[86] *Id.* The provision now states:

"(2) Member of family—The term 'member of the family' means, with respect to any individual, only—

"(A) an ancestor of such individual,

"(B) the spouse of such individual,

"(C) a lineal descendant of such individual, of such individual's spouse, or a parent of such individual, or

"(D) the spouse of any lineal descendant described in subparagraph (C).

For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as a child of such individual by blood."

[87] *Id.*

[88] Treas. Reg. § 20.2032A-3(b) (prior to amendment by ERTA).

[89] *Id.*

[90] I.R.C. § 2032A(g):

"(g) Application of this section and Section 6324B to Interests in Partnerships, Corporations, and Trusts.—The Secretary shall prescribe regulations setting forth the application of this section and section 6324B in the case of an interest in a partnership, corporation, or trust which, with respect to the decedent, is an interest in a closely held business (within the meaning of paragraph (1) of section 6166(b)). For purposes of the preceding sentence, an interest in a discretionary trust all the beneficiaries of which are qualified heirs shall be treated as a present interest."

[91] Code § 2032A(e)(9)(A) states that the "acquired from or passed from decedent" test is met by transfers treated as such by § 1014(b). The transfers listed are those meeting § 1014(b) requirements.

[92] I.R.C. § 2032A(e)(9)(B) and (C) now provides:

made the "acquired from or passed from the decedent" requirement easier to meet. It now appears that almost any qualifying property that comes into possession of a member of the decedent's family will meet the test.

Unfortunately, the new rule that property purchased by a qualified heir upon decedent's death qualifies for use valuation may trigger disadvantageous income tax consequences. Code section 1040(c) provides that property purchased by a qualified heir from the estate or trust results in an adjusted basis to the heir equal to the property's basis in the hands of the estate or trust, increased by gain recognized upon sale by the estate or trust.[93] Because the estate or trust only recognizes gain to the extent the amount realized exceeds fair market value at date of death, a qualified heir's basis in appreciated property will be low.[94] The interplay of the rules outlined in the two previous sentences may result in a heavy income tax burden on the heir upon subsequent resale of the property.

Section 2032A also contains two percentage tests which must be satisfied before special use valuation may be elected. First, at least 50% of the adjusted value of decedent's gross estate, as determined without regard to section 2032A, must consist of the aggregate value of farm *real or personal* property held for the qualified use.[95] At least that amount must pass from decedent to "qualified heirs."[96] Second, at least 25% of the adjusted value of decedent's gross estate must be qualified *real* property that was acquired from or passed from decedent to a qualified heir.[97] This test also is applied without regard to section 2032A's effect on values tested. In determining the adjusted value of real property for purposes of these percentages tests, fair market value must be reduced to the extent of any encumbrances on the property.[98] All qualified real property included in decedent's estate does

"(9) Property acquired from decedent.—Property shall be considered to have been acquired from or to have passed from the decedent if—. . .

"(B) such property is acquired by any person from the estate, or

"(C) such property is acquired by any person from a trust (to the extent such property is includible in the gross estate of the decedent)."

[93] *Id.* § 1040(c).

[94] *Id.* § 1040(a).

[95] *Id.* § 2032A(b)(1)(A).

[96] *Id.*

[97] *Id.* § 2032A(b)(1)(B).

[98] Code § 2032A(b)(3) provides:

"(3) Adjusted value.—For purposes of paragraph (1), the term 'adjusted value' means—

"(A) in the case of the gross estate, the value of the gross estate for purposes of this chapter (determined without regard to this section), reduced by any amounts allowable as a deduction under paragraph (4) of section 2053(a), or

"(B) in the case of any real or personal property, the value of such property for purposes

not have to pass to a qualified heir, only an amount sufficient to meet the percentage tests.[99] Prospective decedents wishing to transfer part of their estate to persons other than family members should exercise care that sufficient qualifying property passes to family members to meet the percentage tests; if the decedent's estate does not easily meet the percentage tests, this may mean transferring only nonqualifying property to persons who are not members of the decedent's family.

While ERTA did not change the percentage tests under section 2032A, their application was indirectly affected by ERTA amendments. Gifts made by a decedent within three years of death are now generally excluded from decedent's gross estate.[100] However, gifts made during that period are included in decedent's gross estate for purposes of the section 2032A tests.[101] Thus, it is not possible to facilitate qualification under the section 2032A percentage tests by transferring nonqualifying property within three years of death. However, while this rule is effective in eliminating a perceived opportunity for abuse, it may inadvertently convey a benefit on some farmer-decedents. For example, if a person has, in the three years preceding his death, gifted amounts of qualifying property sufficient to disqualify his estate under section 2032A, the inclusion rule in section 2035(d)(3) will bring those gifts back into the gross estate for purposes of the percentage tests, in effect requalifying the estate for special use valuation.

As mentioned previously, property must be employed in a qualified use as a farm for farming purposes.[102] Under pre-ERTA law, the property had to be in qualified use both at the decedent's death and for five years of the eight-year period preceding date of death.[103] These requirements were interpreted to mean that such qualified use had to be by the decedent personally and that the decedent must have had an equity interest in the farm operation.[104] ERTA amended Code section 2032A(b)(1) to allow the pre-death qualified use requirements to be satisfied by either the decedent or a member of the decedent's family.[105]

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of this chapter (determined without regard to this section), reduced by any amount allowable as a deduction in respect of such property under paragraph (4) of section 2053(a)."

[99] Treas. Reg. § 20.2032A-8(g)(2).

[100] See text accompanying notes 64-68 *supra*.

[101] Code § 2035(d)(3) creates this exception to the general rule to prevent one near death from giving away sufficient amounts of nonqualifying property to meet the percentage tests on the remaining amount.

[102] See text accompanying notes 78-82 *supra*.

[103] *See* I.R.C. § 2032A(b)(1)(C) (prior to amendment by ERTA).

[104] Treas. Reg. § 20.2032A-3(b)(1).

[105] This change is present in both the date of death qualified use requirement of Code § 2032A(b)(1) and the five of eight years preceding death qualified use requirement of Code § 2032A(b)(1)(C).

For decedents dying after 1981, the five-of-eight-years test is applied to the eight-year period ending on the earlier of disability (defined as physical or mental impairment precluding material participation in the business) of decedent lasting until death, retirement, or receipt of Social Security benefits lasting until death.[106] This provision, Code section 2032A(b)(4) as amended by ERTA, eliminates some of the pitfalls contained in the pre-ERTA pre-death requirements. Before ERTA, the pre-death five of eight years requirement could not be met when a decedent was unable to participate in farm operation because of physical or mental disability. Additionally, a dilemma existed in the situation where a decedent was retired and did not want to earn income from farm operations sufficient to reduce or eliminate his Social Security benefits.

The extent to which decedent or a member of his family must have been active in the operation of the farm business during the required pre-death period is defined as "material participation."[107] The material participation requirement is designed to limit section 2032A estate tax benefits to owners of active family farms, withholding special use valuation benefits from passive or inactive investors in agricultural real property.

According to section 2032A(e)(6), "material participation" for special use valuation is determined in a manner similar to its interpretation for purposes of the self-employment Social Security tax.[108] The regula-

[106] This easing of the qualified use material participation requirements is codified in § 2032A(b)(4):

"(4) Decedents who are retired or disabled—

"(A) In general.—If, on the date of the decedent's death the requirements of paragraph (1)(C)(ii) with respect to the decedent for any property are not met, and the decedent—

"(i) was receiving old-age benefits under title II of the Social Security Act for a continuous period ending on such date, or

"(ii) was disabled for a continuous period ending on such date,

"then paragraph (1)(C)(ii) shall be applied with respect to such property by substituting 'the date on which the longer of such continuous periods began' for 'the date of the decedent's death' in paragraph (1)(C).

"(B) Disabled defined.—For purposes of subparagraph (A), an individual shall be disabled if such individual has a mental or physical impairment which renders him unable to materially participate in the operation of the farm or other business.

"(C) Coordination with recapture.—For purposes of subsection (c)(6)(B)(i), if the requirements of paragraph (1)(C)(ii) are met with respect to any decedent by reason of subparagraph (A), the period ending on the date on which the continuous period taken into account under subparagraph (A) began shall be treated as the period immediately before the decedent's death."

[107] I.R.C. § 2032A(b)(1)(C)(ii).

[108] Code § 2032A(e)(6) sets this standard. For a discussion of the meaning of material participation under Code § 1402(a) (the self-employment tax section referred to in § 2032A(e)(6)), *see* Normand, *Special Use Valuation of Farmland for Estate Tax Purposes: Arrangements for Material Participation*, 30 BAYLOR L. REV. 245 (Spring 1978). *See also* Bravenec & Olsen, *How to Reap Estate Tax Benefits Through Use of the Alternate Valuation of Farmland*, 48 J. TAX 140 (Mar. 1978).

tions provide some guidance as to what constitutes "material participation."[109] They prescribe an all facts and circumstances test, listing several factors to be considered. No single factor is determinative as to presence or absence of material participation. However, participation in management decisions and physical work are the principal factors considered.[110] At a minimum, the decedent or a member of his family must regularly consult with or advise other managing parties on significant managerial decisions regarding the farm business.[111] Regular inspection of production activities on the land and the assumption of financial responsibility for a substantial portion of farm operating expenses are further factors which indicate material participation.[112] Provision by a decedent or a member of his family of a substantial portion of the machinery, implements, and livestock used in production activities is also an important factor to be considered.[113]

The above considerations are primarily relevant when the property owner or a member of his family is the person carrying on production activities on the land. Owners of farm real property often lease that property to others who carry on actual production activities on the premises. If material participation is to be established under a leasing arrangement, the lease agreement should be drafted to require landowner involvement in important managerial decisions. Types of decisions in which it is suggested that the landowner be involved include those relating to cropping pattern and rotation to be followed, fertilization levels, pest control, participation in government programs, conservation practice decisions, repairs to be made, and tillage practices to be followed.[114]

ERTA liberalized the material participation requirement for estates of certain persons dying after 1981. If qualified real property is acquired from or passes from a deceased spouse to a surviving spouse, and the surviving spouse was involved in "active management" of the farm, active management is treated as material participation by the surviving spouse when attempting to qualify for use valuation of property in the surviving spouse's estate.[115] To allow substitution of "ac-

[109] Treas. Reg. § 20.2032A-(3)(e)(2).

[110] *Id.*

[111] *Id.*

[112] *Id.*

[113] *Id.*

[114] *See* N. Harl, Farm Estate and Business Planning 4-17 (1981), for more complete treatment of material participation by landowners under leasing arrangements.

[115] Code § 2032A(b)(5)(A):

"(A) In general.—If property is qualified real property with respect to a decedent (hereinafter in this paragraph referred to as the 'first decedent') and such property was acquired from or

tive management" for "material participation," election of use valuation by the deceased spouse is not a prerequisite, provided that he or she was eligible to make such an election.[116]

"Active management" is defined as "the making of management decisions of the business (other than daily operating decisions)."[117] Thus, a surviving spouse owning farm real property must be involved in farm operations in a managerial capacity if the property is to be specially valued in his or her estate. According to the Senate Finance Committee Report, the active management requirement, unlike the material participation standard, may be met even though no self-employment tax is payable by a surviving spouse.[118] To qualify as actively managing a farm business, a surviving spouse should be involved in a combination of the following: inspecting growing crops, reviewing and approving crop plans in advance of planting, approving capital expenditures, and making a substantial number of management decisions such as which crops to plant, how many head of livestock to raise, when and where crops and livestock will be marketed, how to finance farm operations, and which capital expenditures should be undertaken.[119]

Under the language of section 2032A(b)(5)(A), active management by the surviving spouse must occur after the death of the deceased spouse. Thus, active management by a spouse before becoming a *surviving* spouse will not apply toward the pre-death material participation requirement.

If the decedent or a member of his family meets the material participation requirement, or in the case of a surviving spouse, the substituted active management requirement, the most difficult hurdle limiting availability of special use valuation has generally been cleared. Because material participation and active management are factual determinations, pre-death planning steps should be taken to assure a margin of safety in the involvement level of the person to be tested.

Another restriction on the availability of special use valuation that has created difficulty for some estates is the requirement that qualified heirs receive present interests in real property from the decedent.[120]

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passed from the first decedent to the surviving spouse of the first decedent, for purposes of applying this subsection and subsection (c) in the case of the estate of such surviving spouse, active management of the farm or other business by the surviving spouse shall be treated as material participation by such surviving spouse in the operation of such farm or business."

[116] Code § 2032A(b)(5)(B) provides that eligibility for use valuation under the active management exception of subparagraph (A) will be determined "without regard to whether an election under this section [2032A] was made."

[117] I.R.C. § 2032A(e)(12).

[118] S. REP. No. 144, 97th Cong., 1st Sess. 134-35 (1981).

[119] H.R. REP. No. 201, 97th Cong., 1st Sess. 170 (1981).

[120] *See* Treas. Reg. § 20.2032A-3(b)(1).

When qualified real property passes directly to a qualified heir, the present interest requirement is not a problem. Before 1981, however, the present interest requirement was not met if the decedent left property to a trust for the benefit of a prospective qualified heir and the trustee had a discretionary power to invade principal or to "spray" income among beneficiaries.[121] After ERTA, even if the trustee has discretion over distributions, real property placed in trust will qualify for use valuation if all actual or potential beneficiaries are qualified heirs of the decedent.[122]

Thus, under the new law, a decedent is allowed greater flexibility in the methods available to dispose of qualified real property without forfeiture of special use valuation tax savings. The decedent may bequeath real property directly to a qualified heir, or may create a trust for the benefit of a qualified heir or a group of qualified heirs. The trust approach may be desirable when a decedent, perhaps because of a beneficiary's minority or for personal considerations, does not want that beneficiary to have absolute power over the property. Trusts should be used cautiously in this context, however. If any interest in qualifying real property vests, for tax purposes, in nonfamily members, special use valuation is precluded for the entire property placed in trust.[123]

If special use valuation is subsequently desired for real property held in trust, material participation may be achieved in one of four ways:

(1) Appointment of a family member who materially participates as trustee satisfies the material participation requirement.

(2) Employment of a family member by a closely held farm business owned by a trust to a position requiring material participation satisfies the requirement.

(3) A contractual arrangement between the trustee(s) and decedent or a family member requiring the decedent or family member to manage the real property held in trust qualifies.

(4) An express provision in the trust agreement requiring management by a beneficial owner/qualified heir constitutes material participation.[124]

[121] I.R.S. Letter Rulings 8020011, 8102011, and 8014033 indicated that discretionary life estates, common in "non-marital," or "B" trusts in the marital deduction planning context, and other trusts which give the trustee discretion over distributions, do not qualify as present interests. This position was reversed by the Act in situations where all beneficiaries of a discretionary trust are members of decedent's family as defined in section 2032A(e)(2). See text accompanying note 122 *infra*. *See also* I.R.C. § 2032A(g).

[122] I.R.C. § 2032A(g).

[123] In Ltr. Rul. 8044018, July 30, 1980, bequest of a remainder interest to nonfamily members prevented special use valuation for the surviving spouse's life estate. *See* Treas. Reg. § 20.2032A-8(a)(2).

[124] Treas. Reg. § 20.2032A-3(f)(1).

For special use valuation to be utilized, subsections 2032A(b)(1)(D) and 2032A(d) require that a proper election be filed, including an agreement identifying the real property to be specially valued. Before ERTA, this requirement was interpreted to mean that the election must be made on a timely filed estate tax return.[125] Under that interpretation, an election made on a late return would render special use valuation unavailable for decedent's estate.

The foregoing position was reversed by an amendment to Code section 2032A(d)(1) effective for estates of decedents dying after 1981. Elections must now be made on decedent's estate tax return, rather than by the due date for such return.[126] Therefore, an election made on a late return is proper, so long as it is the first estate tax return filed by that estate.

If all requirements discussed previously in this section are satisfactorily met, real property may be valued at its special use value in decedent's estate. Substantial estate tax liability reductions can result from election of special use valuation.[127] However, section 2032A restrictions do not end with decedent's death and payment of estate taxes. Because special use valuation is designed to prevent termination of farm businesses due to high estate tax liability, its purpose is not served if a qualified heir receives specially valued real property, then sells it or ceases to utilize it for farming purposes. Consequently, section 2032A(c) provides for recapture of use valuation transfer tax benefits in certain situations.

Disposition of specially valued real property by a qualified heir within the statutory recapture period results in recapture of estate tax saved by the special use election.[128] Before ERTA, the recapture period was fifteen years, with a phase-out of the amount recaptured between years ten and fifteen.[129] The phase-out period was eliminated by ERTA, reducing the applicable time period to ten years for estates of all decedents dying after 1981.[130] This ten-year period runs from the later of decedent's death or the commencement of qualified use after decedent's death.[131] A qualified heir may transfer specially valued property to another family member without triggering recapture.

Qualified heirs holding use valued property must exercise caution regarding transactions involving such property during the ten-year recap-

[125] Treas. Reg. § 20.2032A-8 (prior to amendment by ERTA).

[126] I.R.C. § 2032A(d)(1).

[127] See text accompanying notes 74-76 *supra*.

[128] I.R.C. § 2032A(c)(1)(A).

[129] *Id.* § 2032A(c)(1)(A) (prior to amendment by ERTA).

[130] *Id.* § 2032A(c)(1)(A).

[131] *Id.* § 2032A(c)(7)(A).

ture period. Not only does outright sale of use valued property trigger recapture, but other transactions as well have been held to constitute disposition subjecting qualified heirs to recapture. For example, a 1979 Private Letter Ruling indicated that sale and leaseback of use valued property triggers recapture.[132] Transfer by reason of death of a qualified heir, however, does not trigger recapture. By virtue of section 2032(A)(c)(1), death of a qualified heir permanently prevents recapture of previous use valuation tax benefits.[133] When a qualified heir dies, the possibility of recapture terminates with respect to the deceased heir's interest.[134] For this reason, a decedent may consider transferring real property used in the farm business to qualified heirs who are not expected to substantially outlive the decedent.

After 1981, recapture does not occur if qualified real property is exchanged for other property utilized for the same qualified use.[135] Current use valuation tax benefits are also not recaptured when qualified real property is involuntarily converted, so long as other real property employed in the same qualified use is acquired to replace it.[136] For these reasons, a qualified heir wishing to dispose of qualified real property should consider consummating a section 1031 like-kind exchange for other qualified real property in order to avoid recapture. If qualified real property is condemned or otherwise involuntarily converted, replacement should be considered. The economic benefit realized due to prevention of recapture indirectly reduces the economic cost of replacement property.

In addition to recapture upon disposition of qualified real property during the recapture period, cessation of qualified use by a qualified heir triggers recapture of use valuation benefits.[137] Cessation of qualified use occurs when the property is not used as a "farm for farming purposes" under section 2032(A)(b)(2),[138] *or* when material participation by a qualified heir is absent for more than three years during *any* eight-year period ending after decedent's death.[139]

[132] I.R.S. Ltr. Rul. 7934007, Apr. 30, 1979.

[133] I.R.C. § 2032A(c)(1).

[134] *Id.*

[135] *Id.* § 2032A(i)(3).

[136] *Id.* § 2032A(h)(3).

[137] *Id.* § 2032A(c)(1)(B).

[138] See text accompanying notes 78-82 *supra.*

[139] Code § 2032A(c)(6)(B) provides:

"(6) Cessation of qualified use.—For purposes of paragraph (1)(B), real property shall cease to be used for the qualified use if— . . .

"(B) during any period of 8 years ending after the date of decedent's death and before the date of the death of the qualified heir, there had been periods aggregating more than 3 years during which— . . .

"(ii) in the case of periods during which the property was held by any qualified heir,

Material participation for recapture purposes must be by a qualified heir or a member of a qualified heir's family in the post-death period, and by the decedent or a member of the decedent's family during the time the property was held by the decedent.[140] ERTA created, retroactive to January 1, 1977, a special two-year grace period during which failure by a qualified heir to commence qualified use of specially valued property will not result in imposition of a recapture tax.[141] This grace period, however, does not waive the post-death five-of-eight-years material participation requirement, creating a possible trap for the unwary. A qualified heir may believe he, or a member of his family, has eight years after the decedent's death to amass five years of material participation. This is not the case. Recapture may occur at any time after the decedent's death, because the five-of-eight-years requirement applies at each point in time after decedent's death, taking into account both pre- and post-death periods.[142]

As in the pre-death period, ERTA also amended the five-of-eight-years post-death material participation requirement, retroactive to January 1, 1977, so that active management by an "eligible qualified heir" is treated as material participation during the period he owned the property.[143] "Eligible qualified heirs" include the surviving spouse of a decedent, a qualified heir less than twenty-one years of age, a qualified heir who is a full-time student,[144] or a qualified heir who is disabled.[145] "Active management" and "disabled" are attributed the

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there was no material participation by such qualified heir or any member of his family in the operation of the farm or other business."

[140] *Id.* § 2032A(c)(6)(B)(i), (ii).

[141] *Id.* § 2032A(c)(7)(A). For example, if a qualified heir receiving specially valued property did not commence qualified use until eighteen months after decedent's death, special use valuation tax benefits would have been recaptured under pre-ERTA law, but will not after ERTA, assuming all other § 2032A requirements are met.

[142] For example, recapture would occur in the following situation: Decedent met the § 2032A pre-death material participation requirements by materially participating for five and one-half years prior to his death, the two and one-half years of nonparticipation occurring immediately preceding death. The qualified heir does not begin materially participating until seven months after decedent's death. Recapture occurs, even if the qualified heir would have continued materially participating throughout the recapture period, so that only seven months of the post-death period was not qualified use time. Note that recapture occurs in this situation regardless that material participation was begun well within the two-year grace period for qualified heirs.

[143] I.R.C. § 2032A(c)(7)(B).

[144] To be a full-time student under § 151(e)(4), one must be a student at an educational institution for five calendar months during a year or pursuing a full-time course of institutional on-farm training supervised by an accredited government agency.

[145] Code § 2032A(c)(7)(B) provides:

"(B) Active Management by Eligible Qualified Heir Treated as Material Participation. For purposes of paragraph (6)(b)(ii), the active management of a farm or other business by—

"(i) an eligible qualified heir, or

"(ii) a fiduciary of an eligible qualified heir described in clause (ii) or (iii) of subparagraph

same meanings when testing post-death material participation as in the pre-death context.[146]

If, before decedent's death, it appears that decedent's qualified heirs will be unable to satisfy post-death requirements to prevent recapture under section 2032A(c), special use valuation may be undesirable. Use valuation desirability hinges on whether the decedent desires only to minimize his own tax liability, or that of the entire family unit.

If it is reasonably expected that qualified heirs receiving specially valued property will sell or otherwise dispose of it during the recapture period, election of special use valuation may result in an increase in total family tax liability. Such increase may result because of the interplay of section 2032A and the income tax basis rules. If, for example, use valuation is not elected, a decedent's estate will incur transfer tax liability based on the full fair market value of estate property. This property, if appreciated, will receive a stepped-up basis in the hands of the qualified heir. Upon subsequent sale of the property by the qualified heir, income will be recognized and taxed to the extent the amount realized from the sale exceeds the property's stepped-up basis.

If, conversely, a section 2032A election is made, decedent's estate will pay less transfer tax than in the above example. However, the adjusted basis of specially valued property is only stepped up to its special use value. If the qualified heir disposes of specially valued property within the recapture period, the amount by which transfer tax was reduced by use valuation is recaptured from the qualified heir. In addition, the qualified heir must recognize a gain on the sale of the specially valued property. If the qualified heir does not file an election under section 1016(c),[147] the amount of gain taxed will be the amount realized less property basis, its special use value. Therefore, greater total tax results under this scenario than if special use valuation had not been elected.

If the qualified heir does file a section 1016(c) election, the basis of the use valued property will be increased to fair market value as of the date of decedent's death or the alternate valuation date.[148] This would eliminate a portion of the qualified heir's income tax liability. If such election is filed, total tax liability of the family unit is identical

(C), shall be treated as material participation by such eligible qualified heir in the operation of such farm or business. In the case of an eligible qualified heir described in clause (ii), (iii), or (iv) of subparagraph (C), the preceding sentence shall apply only during periods during which such heir meets the requirements of such clause."

[146] See text accompanying notes 108-119 *supra*.

[147] A Code § 1016(c) election would increase property basis to its fair market value as of the date of decedent's death or the alternate valuation date.

[148] I.R.C. § 1014(a).

to that incurred if qualified real property was not specially valued, except in one respect. Interest must be paid, at the section 6621(b) [100% of prime] rate, for a period running from nine months after the date of decedent's death to the date of the recapture event.

For these reasons, special use valuation should not be elected when it is reasonably anticipated that recapture will occur. If, on the other hand, a decedent reasonably expects that use valued real property will remain in the family and will remain in the qualified use, special use valuation provides an opportunity for substantial tax savings. The Act made substantial changes in section 2032A special use valuation provisions. These changes make special use valuation a more practicable means of minimizing transfer tax liability than it was under prior law. Most traditional family farms can satisfy the requirements for and restrictions on use valuation detailed herein with few detrimental effects. This does not mean, however, that all problems have been resolved; special care and planning is still necessary to meet the section 2032A requirements as amended.

Section 6166: Installment Payment of Estate Taxes

Before ERTA, the Internal Revenue Code contained two overlapping provisions, sections 6166 and 6166A, permitting deferred payment of estate taxes attributable to interests in closely held businesses. Because many farm estates qualify for the section 6166 installment payment privilege, installment payment of estate taxes has been employed as a means of easing liquidity problems confronting estates upon death of farmer-landowners. ERTA ended the coexistence of these two provisions, combining several of the most favorable features of both into new Code section 6166 and repealing section 6166A.[149] A summary of the major distinctions between previous Code sections 6166 and 6166A is provided in the notes.[150]

[149] *See* The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

[150] Sections 6166 and 6166A contained significant differences, including the following:

(1) Section 6166 had a higher percentage qualification requirement (65% of decedent's adjusted gross estate) than § 6166A (35% of decedent's gross estate or 50% of his or her taxable estate).

(2) Section 6166 provided for a five-year moratorium on the payment of estate tax attributable to a closely held business. This resulted in payments of interest only for five years, followed by ten installments of principal and interest. Section 6166A, on the other hand, provided for ten installment payments of tax beginning in the year of death.

(3) A 4% interest rate applicable to the estate tax attributable to the first $1 million of value was available for deferrals under § 6166, but not for deferrals under § 6166A.

(4) The definition of "interest in a closely held business," the requisite for tax deferral through either of the installment payment provisions, was more liberal under § 6166 than under § 6166A. [Compare previous §§ 6166(b)(1)(B)(ii) and (C)(ii) with §§ 6166A(c)(2)(B) and (3)(B).]

The merger of sections 6166 and 6166A provides greater clarity and simplicity in the installment payment of estate taxes. Estate taxes attributable to interests in "closely held businesses" may be paid in installments over a fourteen-year period after decedent's death if a proper election is made.[151] Interest only is payable annually for five years following the date of decedent's death, followed by ten annual installments of principal and interest on the portion of taxes related to closely held business property.[152] Under section 6166(a)(1) as amended, the installment payment option is extended to estates in which the value of interests in closely held businesses exceeds 35% of the adjusted gross estate, as compared to the pre-ERTA 65% requirement.[153] This percentage test is applied after any section 2032A valuation reductions are reflected in the gross estate and closely held business values. "Adjusted gross estate" for purposes of section 6166 is defined as gross estate less allowable section 2053 expenses, debts, and taxes of decedent and section 2054 loss deductions.

In addition, a special 4% interest rate applies to tax attributable to the first $1 million of closely held business property included in an estate.[154] In the past, this bargain interest rate was a persuasive inducement for election of installment payment of estate taxes. However, with the increased unified credit enacted by ERTA, the benefits of the 4% rate are substantially reduced. After the unified credit is fully in place after 1986, the reduced rate will only apply to $153,000 of estate tax.[155] Moreover, because of the increase in IRS interest rates to 100% of the prime lending rate (20% is the applicable rate in 1982), interest on installment payments is no longer a "cheap" means of financing farm liquidity.[156]

Interests in two or more closely held businesses may sometimes be aggregated for purposes of applying the 35% qualification test of section 6166(a). Under pre-ERTA provisions, to qualify for aggregation, closely held business interests included in decedent's gross estate had to represent "more than 20 percent" of the total value of each business; this provision was amended by ERTA to require only "20 percent or more."[157]

Because the purpose of the installment payment provisions is to pre-

[151] I.R.C. § 6166(a).

[152] *Id.* § 6166(a)(3).

[153] *Id.* § 6166(a)(1).

[154] *Id.* § 6601(j).

[155] The amount of tax on a $1 million estate is $345,800 and the post-1986 unified credit amount is $192,800, yielding a tax of $153,000 on a $1 million estate.

[156] Code § 6621 was amended by ERTA to require interest on deferred payment of estate taxes at a rate equal to the prime lending rate as determined on October 15th of each year.

[157] I.R.C. § 6166(c).

vent the dissolution of farms and small businesses, the deferral privilege is conditioned on continuation of the business intact. Disposition of or withdrawal from a closely held business to a substantial degree will terminate the installment payment privilege, accelerating all outstanding installments.[158] The termination rules were both liberalized and tightened by ERTA. Termination and acceleration occurs if more than 50% of a closely held business interest qualifying for deferral is, in the aggregate, distributed, sold, exchanged, *or* if money or other property is withdrawn, and the full amount of estate tax becomes immediately due.[159] Under prior law, disposition or withdrawal of 33% or more of closely held business interests would trigger acceleration.[160]

The liberalization above is offset by a change in the manner in which the percentage test is administered. Under prior law, any amount less than one-third of the value of a closely held business property could be sold, exchanged, or disposed of and, in addition, any amount less than one-third of that value could be withdrawn from the business without acceleration.[161] Under that provision, an estate could sell 33% of the business and withdraw cash in the amount of 33% of the business and not accelerate installment payments, even though 66% of the closely held business was no longer intact.

However, instead of the either/or test applied above, ERTA mandates an aggregate test. Thus, if the sum of dispositions and withdrawals exceeds 50% of business value, acceleration occurs.[162]

[158] Code § 6166(g) contains provisions governing the acceleration of installment payments and termination of the installment payment privilege.

[159] Code § 6166(g)(1)(A):

"(g) Acceleration of Payment.—

"(1) Disposition of Interest; Withdrawal of Funds From Business—

"(A) If—

"(i)(I) any portion of an interest in a closely held business which qualifies under subsection (a)(1) is distributed, sold, exchanged, or otherwise disposed of, or

"(II) money and other property attributable to such an interest is withdrawn from such trade or business, and

"(ii) the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds 50 percent of value of such interest, then the extension of time for payment of tax provided in subsection (a) shall cease to apply, and the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary."

[160] Code § 6166(g)(1)(A) before its amendment by ERTA section 422(c)(i) provided:

"(A) If—

"(i) one-third or more in value of an interest in a closely held business which qualifies under subsection (a)(1) is distributed, sold, exchanged, or otherwise disposed of, or

"(ii) aggregate withdrawals of money and other property from the trade or business, an interest in which qualifies under subsection (a)(1), made with respect to such interest, equal or exceed one-third of the value of such trade or business, then the extension of time for payment of tax provided in subsection (a) shall cease to apply, and any unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary."

[161] *Id.*

[162] *Id.* § 6166(g)(1)(A).

Under pre-ERTA law, failure to make an installment payment on or before its due date resulted in acceleration of unpaid installments.[163] ERTA amends section 6166(g)(3) to allow a six-month grace period for payment, with acceleration occurring only when an installment is six months overdue.[164] Though there is no acceleration of the entire tax due if paid within six months, the late payment is not eligible for the special 4% interest rate[165] that is allowed on the principal amount of taxes due resultant from the first $1 million of estate value. In addition, a penalty for late payment is assessed equal to 5% of the late installment multiplied by the number of months the installment was overdue when paid.[166]

One workable alternative is to avoid immediate liquidity problems by electing installment payment and paying interest only for five years. During this time, persons liable for payment may seek to accumulate amounts necessary to pay taxes, or seek alternate, more economical financing. Then, after five years of interest-only payments, the balance can be paid.

Another situation in which deferred payment of taxes may be a sound alternative is when it is foreseen that estate property will earn a rate of return greater than the IRS interest rate on money it is allowed to use through election of the installment payment option. In this case, deferral is basically equivalent to borrowing the amount of taxes due from a commercial lender, investing it, and earning income thereon.

When taken as a whole, installment payment of taxes is less desirable after ERTA than before. Deferred payment still allows estate taxes to be paid over time, reducing immediate depletion of an estate's liquid assets upon decedent's death. However, the value of deferral is diminished by the fact that the 4% rate applies to increasingly smaller amounts of taxes. The increase in IRS interest rates means that opting for installment payment of taxes may be no more beneficial than obtaining commercial financing to pay taxes upon death.

Part II. *An Overview of ERTA Changes and Resulting Effects in the Income Tax and Business Planning Context*

Introduction

Traditionally, attorneys have seldom participated in decisions concerning the timing of acquisitions of productive assets or the advisability of rehabilitating and upgrading existing business facilities. Because

[163] *See id.* § 6166(g)(3) before its amendment by Act § 422(f)(2).

[164] *Id.* § 6166(g)(3)(B).

[165] *Id.* Section 6601(j) provides for a special 4% interest rate on taxes resultant from the first $1 million of estate value attributable to closely held business interests.

[166] *Id.* § 6166(g)(3)(B)(iii).

ERTA income tax changes substantially affect these decisions,[167] lawyer competence and advice in these decisions will be valuable to client business operations. ERTA's amendments to the Internal Revenue Code, especially those in the depreciation[168] and investment credit areas,[169] will significantly alter the climate in which production alternatives are considered.

The ultimate purview of changes implemented by ERTA will be determined by subsequent developments and modifications. However, the general thrust of the changes and an approximation of their effects is ascertainable.

This section will first examine factors prompting the Act's changes. A relatively detailed survey of the amendments relating to ACRS depreciation, the investment tax credit, and the credits for rehabilitation expenditures, followed by a treatment of the sections of general importance to taxpayers will be presented. These topics will be covered in detail because of their considerable impact on taxpayers involved in business and agricultural vocations. Finally, a brief overview of several miscellaneous changes especially pertinent to the agricultural sector will be presented.

Accelerated Cost Recovery System Depreciation (ACRS): Justification for Depreciation Changes and Desired Results

In analyzing the impact of ERTA depreciation changes on the agricultural and business sectors, a brief summary of Congress's stated intent may be helpful. An understanding of this intent, and ACRS's ability to accomplish congressional objectives, will allow practitioners to give more meaningful counsel.

When proposing implementation of Accelerated Cost Recovery System depreciation, the Senate Finance Committee cited several objectives: (1) the stimulation of capital formation; (2) the improvement of business productivity and efficiency; and (3) the improvement of United States competitiveness in world markets.[170]

The House posited that previous law tended to limit investment spending and redirect it into less productive but tax-favored uses.[171] This can be demonstrated by the situation in which a choice must be made between an investment in more efficient equipment that was not eligible for the investment tax credit and less efficient equipment that was eligible for the investment credit. Although, from a productive effi-

[167] The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

[168] See "Accelerated Cost Recovery System Depreciation (ACRS)," *infra*.

[169] See "The Investment Tax Credit," *infra*.

[170] S. REP. No. 144, 97th Cong., 1st Sess. 47 (1981).

[171] H.R. REP. No. 201, 97th Cong., 1st Sess. 73 (1981).

ciency standpoint, the first alternative is the better choice, the tax savings associated with the second alternative often made it more desirable to the taxpayer.

The House further stated that because of applicable depreciation write-offs being spread over longer periods than deemed desirable, real economic asset value to taxpayers was difficult to determine because of uncertainty about future rates of inflation.[172] The presence of such uncertainty complicates decision making in the business planning and asset acquisition context. It necessitates comparing the cost of current dollars used to purchase an asset to future dollars of uncertain value that will be received as a result of the acquisition. Also, because of current inflation rates, the timing of deductions was often inadequate to recover the original cost of the asset, measured in terms of the purchasing power required to acquire the asset.[173]

The Senate Finance Committee noted taxpayer difficulty in complying with the previous depreciation rules, and the IRS's difficulty in administering them.[174] Constant squabbles over applicable useful lives and salvage values created much of this difficulty. ACRS solves this problem by eliminating the need for useful life[175] and salvage value[176] determinations in computing depreciation deductions.

[172] *Id.* Longer recovery periods require projection regarding events farther in the future. As the more distant future is more uncertain than the near future, higher probability of erroneous decisions exists. This also makes decision makers less likely to take positive action because of the possibility of financial loss if a questionable action proves unfavorable.

[173] *Id.* This can be illustrated by the purchase of a $10,000 asset that was depreciable over a five-year life with no salvage value. Assume a 10% rate of inflation, meaning that the purchasing power of each dollar declines 10% annually. Although the full $10,000 cost is recovered in five years, the amount recovered is substantially less than original asset cost measured in terms of the purchasing power of the dollars recovered.

Straight line Depreciation Recovery

		Purchasing Power	
Year	Cost	Current Dollars	Dollars Discounted to Present Value
1	$10,000	$ 2,000	$ 2,000
2		2,000	1,818
3		2,000	1,652
4		2,000	1,474
5		2,000	1,270
TOTAL	$10,000	$10,000	$ 8,224

[174] S. REP. No. 144, 97th Cong., 1st Sess. 47 (1981).

[175] Act § 203 adds Code § 167(m)(4), which states that the class life system does not apply to new § 168 recovery property placed in service after December 31, 1980. See text accompanying notes 181-207 *infra* with regard to what constitutes § 168 recovery property.

[176] Code § 168(f)(9) states "[n]o salvage value shall be taken into account in determining the deduction allowable under subsection (a)" of § 168.

Most business management personnel, including those in the agricultural sector, agreed with congressional criticism of previous depreciation allowances. Large increases in the cost of farm equipment and other productive assets used in agriculture have occurred in recent years.[177] The extended useful lives assigned to these assets resulted in relatively small annual depreciation deductions. Therefore, the amount of liquid capital or increased borrowing necessary to finance expansion or efficiency-improving assets with little immediate tax benefit often made such purchases cost-prohibitive. This is especially true because of the low rates of return to investment capital commonplace in the agricultural section.[178] Low returns mean that it will take an extended period of asset use before income produced by the asset will exceed the asset's cost.

When deciding whether to acquire a particular asset for income-production purposes, several factors should commonly be considered. Regardless of the formula applied, current purchase price, the amount and timing of allowable depreciation deductions, some adjustment for future inflation (such as discounting to projected net present value), the income that the asset will produce, timing of this income, and the expected useful life over which the asset will generate such income will always be important.[179]

Any such calculation has inherent limitations because of the use of projections about future occurrences and transactions. By abbreviating the periods over which assets are depreciated, ACRS reduces the uncertainty involved, making determinations of productive value of acquired assets more reliable.

More important, shorter depreciable lives make assets potentially more profitable. The purchase cost will be recovered more rapidly, allowing the asset's cost to be offset sooner against income. Assuming continued inflation, this reduces the real economic cost of the asset due to the time value of money.[180]

Applicability of ACRS Depreciation

Recovery property to which new section 168 ACRS write-offs apply is defined as tangible property, of a character subject to an allowance

[177] *See* "Economic Indicators of the Farm Sector: Income and Balance Sheet Statistics, 1980." National Economics Division, Economic Research Service, U.S. Dep't of Agriculture, Statistical Bulletin No. 674.

[178] *Id.*

[179] *See, e.g.*, A. MATZ & M. USRY, COST ACCOUNTING: PLANNING AND CONTROL 836 (1976).

[180] The time value of money concept serves as the foundation for present value calculations. It recognizes the loss in purchasing power incurred when money, which would presumably be capable of earning a return if presently in hand, is not received until a future date.

for depreciation, which is either used in a trade or business or held for the production of income.[181] However, recovery property does not include assets placed in service prior to 1981, property upon which the taxpayer elects not to use ACRS, or property excluded due to the operation of the antichurning rules contained in section 168(e)(4).[182]

Nearly all depreciable personal property may be written off over either three or five years. Property that may be depreciated over a three-year period is section 1245 property with a previous asset depreciation range (ADR) mid-range class life of four years or less.[183] This class therefore includes such typical agricultural assets as automobiles used in the trade or business,[184] light-duty general purpose trucks,[185] and breeding swine.[186]

Five-year property is a catchall for all depreciable personal property not included in any other class.[187] Examples include, but are not limited to, such typical farm assets as heavy-duty trucks,[188] breeding or dairy cattle,[189] breeding sheep or goats,[190] and breeding or work horses.[191] These assets were previously assigned specific ADR lives. In addition, all other depreciable personal property used in agriculture was previously assigned an ADR mid-range useful life of ten years.[192] These assets may now be depreciated over a five-year life.

Tax deferral should be possible as a result of the above changes, primarily upon purchase and use of assets previously in the ten-year mid-range "catchall" agricultural asset ADR category.[193] The lower end of that category was previously eight years.[194] Thus, under ACRS,

[181] I.R.C. § 168(c)(1).

[182] *Id.* Section 168(b)(1)(A) makes ACRS inapplicable to property placed in service prior to 1981. The option of applying straight-line depreciation instead of ACRS is given by section 168(b)(3).

[183] *Id.* § 168(c)(2)(A)(i). The A.D.R. class life system set out ranges over which specific types of assets could be depreciated. Revenue Procedure 77-10, 1977-1 C.B. 548 supplements Code § 167 and contains the class lives of many types of depreciable assets. Revenue Procedure 77-10 was supplemented and amended by Rev. Proc. 77-14, 1977-1 C.B. 571; Rev. Proc. 78-4, 1978-1 C.B. 555; Rev. Proc. 78-5, 1978-1 C.B. 557; Rev. Proc. 79-26, 1979-1 C.B. 566, revised by Rev. Proc. 80-33, 1980-2 C.B. 768; Rev. Proc. 79-35, 1979-2 C.B. 498, Rev. Proc. 79-41, 1979-2 C.B. 506; Rev. Proc. 79-42, 1979-2 C.B. 507; Rev. Proc. 79-65, 1979-2 C.B. 579; Rev. Proc. 80-15, 1980-1 C.B. 618; Rev. Proc. 80-58, 1980-2 C.B. 854 [hereinafter Rev. Proc. 77-10].

[184] A.D.R. guideline class 00.22, Rev. Proc. 77-10.

[185] A.D.R. guideline class 00.241, Rev. Proc. 77-10.

[186] A.D.R. guideline class 1.23, Rev. Proc. 77-10.

[187] I.R.C. § 168(c)(2)(B).

[188] The previous section 167 A.D.R. mid-range class life was set at six years by guideline class 00.242.

[189] A.D.R. asset guideline class 01.21, Rev. Proc. 77-10.

[190] A.D.R. asset guideline class 01.24, Rev. Proc. 77-10.

[191] A.D.R. asset guideline class 01.22, Rev. Proc. 77-10.

[192] A.D.R. asset guideline class 01.1, Rev. Proc. 77-10.

[193] *Id.*

[194] *Id.*

the full cost of the asset may be offset against income in the five years following purchase, instead of eight years at what was previously the most accelerated rate available. Under ACRS, a portion of income tax will be paid after the five-year period has expired that would have been paid during the first five years after purchase under the old rules.[195]

This acceleration of write-offs makes acquisitions of farm assets that were previously not feasible much more profitable because of the tax deferral now available. Assets in the new five-year category that were previously in ADR's agricultural "catchall" category[196] include farm machinery, tractors, implements, equipment, and other farm assets traditionally classified as personal property.

A ten-year recovery period is now used for depreciable real property (section 1250 property) with a previous ADR mid-range class life of 12.5 years or less.[197] Therefore, ten-year write-offs will apply to grain bins, other grain and silage storage facilities, fences, and cotton-ginning assets.[198] As several of these assets already could be depreciated over as few as ten years,[199] the only tax savings will be deferral through the application of accelerated rates.

All remaining depreciable real property, previously assigned a mid-range life of greater than 12.5 years, falls within the ACRS fifteen-year recovery property classification.[200] The primary components of the fifteen-year class are buildings used in the farm trade or business. Farm buildings were previously assigned an ADR mid-range life of twenty-five years, with the upper and lower limits set at thirty and twenty years, respectively.[201]

Reduction of the recovery period for farm buildings will result in larger annual depreciation deductions.[202] When coupled with the fact that farm buildings often generate income for periods even longer than the previous ADR life, larger annual write-offs make barns and other buildings appealing as tax shelters. Such buildings should, in most cases,

[195] Since all of asset cost will now be matched against income in the first five years, income tax for those years will be less than before ERTA, when only part of asset cost would have been deducted in the first five years after asset purchase.

[196] A.D.R. asset guideline class 01.1, Rev. Proc. 77-10.

[197] I.R.C. § 168(c)(2)(C)(ii).

[198] A.D.R. asset guideline class 01.1 and guideline class 01.11, Rev. Proc. 77-10.

[199] The previous asset depreciation range for grain bins and fences was from eight to twelve years, with a ten-year mid-range class life. Guideline Class 01.1. Cotton ginning assets could, before ERTA, be depreciated over nine and one-half to fourteen and one-half years. Guideline class 01.11.

[200] I.R.C. § 168(c)(2)(D).

[201] A.D.R. asset guideline class 1.3.

[202] Reduction of recovery periods from a pre-ERTA low of twenty years to fifteen years under ACRS will increase annual deductions 25%. Deductions are increased even more since ACRS also accelerates depreciation rates.

produce deductions larger than the income they generate through the early years of depreciable life.

ERTA's reduction in marginal bracket rates,[203] however, reduces the desirability of investments utilizing deductions as compared to those utilizing credits to shelter income.[204] When deductions are multiplied by the applicable tax rate, the actual income tax saving is less than under previous law.

In addition to depreciation acceleration through shorter recovery periods, ERTA allows larger deductions in other ways. Predicated upon computational simplicity, ACRS allows recovery of the entire cost of depreciable property.[205] Salvage value determinations are therefore irrelevant in computing section 168 depreciation.[206] This eliminates one of the most frequent areas of contention between the IRS and taxpayers but, more important, it allows deduction of the amount previously unrecoverable as salvage value.[207] This larger deduction creates additional tax savings and decreases asset cost to the taxpayer in the long run.

Section 179: Expensing in Lieu of ACRS

For the taxpayer attempting to minimize current taxes, the addition of Code section 179[208] will be extremely beneficial. The new provision permits a taxpayer to elect to treat a limited amount of the cost of qualifying property as a currently deductible expense.[209] The expensing privilege is phased in beginning in 1982, and reaches an upper limit of $10,000 for married persons filing jointly in 1986 and later years. Limitations for married persons filing separately and single persons reach a maximum of $5,000.[210] Section 179's expensing privilege replaces the Additional First Year Depreciation previously available.[211]

[203] See text accompanying notes 322-327 *infra*.

[204] As a result of rate reductions, accelerated deductions will shelter fewer after-tax dollars, making them less appealing by comparison. Credit-based shelters still save the same amount of after-tax dollars. Marginal rates have no effect on their ability to generate tax savings because credits reduce tax liability dollar for dollar.

[205] Code § 168(d)(1) omits any reference to reductions in cost basis, and Code § 168(f)(9) explicitly provides that salvage value not be taken into account when determining depreciable basis.

[206] See note 205 *supra*.

[207] I.R.C. § 167(f)(1).

[208] *Id.* § 179.

[209] *Id.* § 179(a).

[210] For tax years 1982-83, $5,000 of § 179 asset cost may be expensed in the year property is placed in service. The limitation increases to $7,500 annually for tax years 1984-85. For 1986 and later years, $10,000 may be charged to current expense. The above limitations are for married couples filing jointly. *See* I.R.C. § 179(b)(1). Limitations for single persons and married persons filing separately are 50% of the amounts above. *See* I.R.C. § 179(b)(2).

[211] Act § 202 repealed additional first-year depreciation provisions previously applicable to analogous property.

Generally, to qualify for expensing in lieu of ACRS, an asset must be acquired by purchase, for use in trade or business, and be eligible for investment credit.[212] Therefore, property held for the production of income will not qualify for current expense treatment.

An election to apply section 179 must specify the items of property to which it applies and the percentage or amount of the cost of each item to be deducted currently.[213] The election must be made on an original return, and once made, may not be revoked without IRS consent.[214] Taxpayers also may not change the items to which section 179 is applied without IRS consent.[215]

Investment credit is not allowable for that portion of the cost of qualifying property that is expensed under section 179.[216] This may be an important consideration in deciding whether to exercise the section 179 expensing option, depending on the taxpayer's marginal bracket and the amount of income available to offset.

Many persons involved in agriculture and business in general should find section 179 appealing. It allows tax reduction through rapid offset of income. Purchases of depreciable trade or business assets near year end could result in significant tax saving with little current capital outlay.[217] This is especially true if borrowed capital is employed.

Amounts expensed under section 179 are recapturable as ordinary income upon asset disposition.[218] However, even if early disposition is anticipated, deferral will have occurred because the income will be taxed in the year of disposition instead of the years while the asset was in use. This will be more helpful to those taxpayers who anticipate lower marginal bracket percentages in the year of disposition. Those who anticipate higher income, and therefore higher marginal rates, at disposition may prefer to use section 168 for the entire asset, foregoing section 179, to prevent recapture at higher marginal tax rates.

The previous additional first-year depreciation provisions allowed maximum annual write-offs of $4,000 for married persons filing jointly.

[212] I.R.C. § 179(d)(1). Common agricultural property qualifying for investment credit is discussed *infra* at text accompanying notes 278-292.

[213] I.R.C. § 179(c)(1).

[214] *Id.* § 179(c)(2).

[215] *Id.*

[216] *Id.* § 179(d)(9).

[217] Assume purchase of a $20,000 asset Dec. 1, 1982, financed with 20% borrowed capital and assume also that no other assets qualifying for § 179 treatment were purchased during the year. The purchase would generate $5,000 in 1982 tax deduction, and $333 in deductible interest. At the end of 1982, the taxpayer had only paid $333 in interest to receive these tax reductions and has used the property for one month.

[218] I.R.C. § 1245.

and $2,000 for other taxpayers.[219] New section 179 allows larger current year deductions, as previously discussed.[220]

Some taxpayers may anticipate the need to acquire two or more assets that qualify for section 179 treatment, with aggregate asset cost exceeding the section 179 dollar limitation. In such case, purchasing one asset in the current year and one in the next succeeding year, thereby utilizing the expensing provision fully, is a sound alternative. Otherwise, outlays qualifying for section 179 treatment, but exceeding the applicable dollar limitation, must be recovered through capitalization and ACRS recovery deductions.

ACRS: Advantageous or Not?

ERTA shortens the periods over which most assets may be depreciated, making larger deductions possible.[221] This is a major benefit to most business taxpayers. However, ACRS is not altogether taxpayer biased. For depreciable personal property purchased in tax years 1981 through 1984, ACRS uses the 150% declining balance method during the early years, switching to straight-line depreciation in later years.[222] This transition occurs when the allowances determined by straight-line depreciation exceed amounts computed by the 150% declining balance method. The "half-year convention," whereby taxpayers are allowed one-half year's depreciation in the year of acquisition, is built into the tables for depreciable personal property.[223] For assets purchased in 1985, 175% declining balance depreciation is used;[224] in 1986 and later years, 200% declining balance is applied.[225] In both cases, the tables switch to sum-of-the-years digits depreciation in the later years.[226]

These methods are important because of their relationships to the methods available before ERTA. Depreciation was allowable at up to 200% declining balance for depreciable personal property.[227] Therefore, during the phase-in period, 1981 through 1985, ACRS depreciation for

[219] Before its amendment by ERTA, Code § 179 allowed 20% of cost of qualifying property to be expensed in the year of acquisition. Taxpayers could take the 20% deduction on a maximum of $10,000 of qualified property cost, $20,000 for married persons filing joint returns.

[220] See note 210 *supra*.

[221] See text accompanying notes 181-202 *supra*.

[222] This method was used to create the table in Code § 168(b)(1)(A); 150% declining balance allows deduction annually of an amount equal to one and one-half times the straight-line rate multiplied by the remaining depreciable basis of property.

[223] I.R.C. § 168(b)(1)(A).

[224] *Id.* § 168(b)(1)(B).

[225] *Id.* § 168(b)(1)(C).

[226] *Id.* § 168(b)(1)(B) and (C).

[227] *Id.* § 167(b)(2) (prior to amendment by ERTA).

personal property may actually be less than under the pre-ERTA accelerated methods.

The half-year convention has advantages and disadvantages. It may be used handily to offset income by a taxpayer's purchase of an asset late in the tax year. A taxpayer thereby receives one-half year's depreciation with minimal actual capital outlay. However, if an asset is purchased in the first six months of the tax year, the taxpayer again gets one-half year's depreciation, whereas he would have been allowed a deduction for the percentage of the year he owned the asset under pre-ERTA law.

Although ACRS depreciation deductions may be less than those available under prior law during the phase-in period, they will still be larger than straight-line depreciation. Taxpayers may elect to use straight line instead of ACRS, but may not elect to use the other accelerated methods previously available.[228]

Taxpayers depreciating personal property have little incentive to elect straight-line depreciation. Even if the taxpayer anticipates disposition early in asset life, tax deferral achieved through use of ACRS's accelerated deductions will be beneficial.[229] Because any gain recognized on disposition will be ordinary income, there is no incentive to use straight line in attempts to preserve capital gain treatment. The only situation in which a straight-line election seems desirable is when the taxpayer anticipates being in a lower marginal income tax bracket in the year of disposition. This difference in brackets must be fairly large to offset the decline in present value of tax benefits that do not accrue until later years. The possibility of this occurring is further decreased by tax rate reductions through 1983.

ACRS applies 175% declining balance depreciation for depreciable real property, switching to straight line in the later years of depreciable life.[230] Unlike personal property, to which the half-year convention applies, real property deductions may be taken for only the months during which the taxpayer actually owned the property.[231] This rule applies to both the year of acquisition and the year of disposition.[232]

Depreciable fifteen-year real property, when sold, results in recap-

[228] Section 168(e)(2)(B) only allows (as an exception to ACRS) "the units of production method or any method of depreciation not expressed in a term of years. . . ." This excludes the declining balance and sum-of-the-years digits methods commonly used before ERTA. Straight-line depreciation is authorized by § 168(b)(3).

[229] Although, ultimately, the same amount of income will be taxed (Code § 1245(a)(2)(A) and (B) mandate depreciation recapture as ordinary income upon sale of depreciable personal property), the taxpayer will have the use of money which would have been paid as taxes, if straight line was used, until the year of disposition.

[230] I.R.C. § 168(b)(2)(A)(ii).

[231] *Id.* § 168(b)(2)(A).

[232] *Id.* § 168(b)(2)(B).

ture in the following ways. Gain on the sale of residential real property will be section 1250 ordinary income to the extent ACRS deductions taken exceed amounts that would have been taken using straight line, with remaining proceeds constituting capital gain.[233] Nonresidential real property is much more common in the agricultural sector. Gain on the sale of such property is to be recaptured as ordinary income to the extent of deductions taken, with the excess recognized as capital gain if ACRS was used.[234] If, however, the taxpayer elects straight-line depreciation, all gain recognized on the disposition is capital gain.[235]

Taxpayers depreciating nonresidential real property therefore are faced with a dilemma. If disposition of the property is not foreseeable, accelerated depreciation should be used to defer taxation and accelerate the tax benefits of deduction. On the other hand, if disposition of the property is foreseen, election to apply straight-line depreciation preserves all capital gains treatment upon sale.

Depreciable real property, for example, barns, silos, and graneries, also becomes more attractive for sheltering purposes because of accelerated depreciation. The new rules allow depreciable real property to generate tax benefits much more rapidly than the corresponding income is produced. This is especially true in the fifteen-year category, in which assets may be fully depreciated in less than half of their actual useful lives.

By depreciating different parts of buildings over different periods because of the variations in useful lives, taxpayers formerly maximized deductions through "component depreciation." ERTA deprives taxpayers of this option.[236] Composite depreciation must now be used for all eligible fifteen-year real property.[237] Therefore, the same recovery period and method must be applied to all component parts of buildings.

This amendment, however, is not as onerous as it initially appears. Components added after 1980 to buildings placed in service prior to 1981 qualify for ACRS's accelerated methods.[238] The deduction allowable for such components must be computed by the method and over the same period as that selected for the first such post-1980 component.[239] The methods available to compute deductions on such components are the same as if they were separate buildings.[240]

[233] *Id.* § 1245(a)(5)(A).

[234] *Id.* § 1245(a)(1).

[235] *Id.* § 1245(a)(5)(C).

[236] Code § 168(f)(1)(A)(i) requires that deductions for building components must "be computed in the same manner as the deduction allowable with respect to such building. . . ."

[237] I.R.C. 168(f)(1)(A)(i).

[238] *Id.* § 168(f)(2)(B).

[239] *Id.*

[240] *Id.*

One major caveat must be added for persons considering attempted conversion of pre-1981 into post-1980 property to accelerate deductions. Extensive "antichurning" rules are provided for both real and personal property.[241] Although beyond the scope of this commentary, these rules deny ACRS treatment for property acquired in certain types of transactions. Generally, ACRS may not be used for property acquired from related persons, in transactions where the user does not change as a result of the transaction, or by lessors who now lease property to the previous owner.[242] Also, ACRS may not be used for real property acquired in like-kind exchanges or other transactions in which basis is carried over from pre-1981 real property.[243]

The antichurning provisions make leveraged leases and sale-leasebacks of property placed in service by the previous owner before 1981 less desirable.[244] However, ACRS increases the luster of leveraged leases and sale-leasebacks of assets first placed in service after 1980. Accelerated deductions allow the lessor, who is usually in a higher marginal tax bracket, to offset his income more rapidly.

Taxpayers interested in current and near future tax minimization should exercise the section 179 expensing privilege whenever possible. This will facilitate rapid offset of income, deferring taxation until late in asset productive life.

The Investment Tax Credit

The New Provisions

The Economic Recovery Tax Act of 1981 also altered rules govern-

[241] *Id.* § 168(e)(4).

[242] *Id.* § 168(e)(4)(A) states:

" 'Recovery' property does not include section 1245 class property acquired by the taxpayer after December 31, 1980, if—

"(i) the property was owned or used at any time during 1980 by the taxpayer or a related person,

"(ii) the property is acquired from a person who owned such property at any time during 1980, and, as part of the transaction, the user of such property does not change.

"(iii) the taxpayer leases such property to a person (or a person related to such person) who owned or used such property at any time during 1980, or

"(iv) the property is acquired in a transaction as part of which the user of such property does not change and the property is not recovery property in the hands of the person from which the property is so acquired by reason of clause (ii) or (iii)."

Code § 168(e)(4)(B), the antichurning rule for depreciable real property, includes clauses (i) and (iii) above (as §§ 168(e)(4)(B)(i) and (iii)), and, additionally, depreciable real property is not ACRS recovery property if: "(iii) such property is acquired in an exchange described in section 1031, 1033, 1038, or 1039 to the extent that the basis of such property includes an amount representing the adjusted basis of other property owned by the taxpayer or a related person during 1980."

[243] See note 242 *supra*.

[244] ACRS depreciation, with its larger deductions, will be unavailable on such transactions due to § 168(e)(4)(B)(iii).

ing the investment tax credit.[245] These changes are primarily aimed at conforming the credit to ACRS depreciation provisions.[246]

For property placed in service after 1980, the credit allowable is based on the recovery period used to determine depreciation deductions.[247] After ERTA, qualifying 5-,[248] 10-,[249] and 15-[250] year property cost is 100% eligible for the 10% investment credit.[251] Ten percent of the cost of such qualifying property may be credited directly against tax payable.[252] In the case of three-year ACRS property,[253] only 60% of asset cost qualifies for the credit,[254] resulting in an effective 6% credit.[255] Computation of investment credit was formerly based upon assets' actual useful life.

One important consideration in this area is that, as under prior law, taxpayers may take the full credit on qualifying investment, regardless of how late in the year the asset is placed in service. Taxpayers may therefore purchase qualifying property near year end, accelerating recognition of the credit's tax benefit. The half-year convention employed in ACRS depreciation[256] is not mirrored in the investment credit provisions.

As before ERTA, investment credit previously taken is recaptured as income if property is sold before the expiration of a time limitation.[257] ERTA makes extensive changes in the mechanics of investment credit recapture. Under prior law, the full cost of property with a useful life of seven years or more qualified for 10% investment credit.[258] Useful lives of five to 6.99 years allowed the credit to be taken on two-thirds of asset cost.[259] Eligible property with useful lives of three to 4.99 years

[245] Code § 46(a)(2) authorizes a direct credit against tax in the year of acquisition in the amount of 10% of qualified property cost.

[246] Because investment credit requirements were tied to the ADR class life system used to determine depreciation deductions before ERTA, changes were necessary to make the provisions interrelate properly.

[247] I.R.C. § 46(c)(7).

[248] See text accompanying notes 187-196 *supra*.

[249] See text accompanying notes 197-199 *supra*.

[250] See text accompanying notes 200-202 *supra*.

[251] I.R.C. § 46(c)(7)(A).

[252] *Id.* § 46(a)(2).

[253] See text accompanying notes 183-186 *supra*.

[254] I.R.C. § 46(c)(7)(B).

[255] Because only 60% of three-year recovery property cost qualifies for investment credit, *id.*, the effective credit is 6% (60% multiplied by the regular 10% credit in § 46(a)(2)).

[256] See text following note 227 and text accompanying note 223 *supra*.

[257] Code § 47(a)(1) requires income to be increased in the year of asset distribution if "property is disposed of. . . before the close of the useful life which was taken into account in computing the credit," so that the tax credit received in toto is as if the property only had a depreciable life equal to the period it was actually owned.

[258] As it read before ERTA amendment, Code § 46(c)(2) allowed this credit.

[259] I.R.C. § 46(c)(2) (prior to amendment by ERTA).

qualified one-third of asset cost for the credit.[260] If the taxpayer held the asset seven years (or five or three in the lower credit asset groups), the credit was not subject to recapture as income upon subsequent disposition of the asset. For example, if property with a seven-year useful life, on which the full 10% credit was taken, was sold within the fifth or sixth years after being placed in service, one-third of the credit was recaptured as income.[261] If the asset was sold in the third or fourth years, two-thirds of the credit was recaptured upon disposition.[262] If the asset was sold within three years after being placed in service, the entire credit was recaptured as income.[263]

These rules will continue to apply to eligible property placed in service prior to 1981. As in the depreciation context, taxpayers will be operating under two separate sets of recapture rules. For investment credit property placed in service after 1980, a new 2% recapture rule will apply. It is much more sound from a theoretical standpoint and is also more liberal than prior rules.

After ERTA, five-year property receives a full 10% investment tax credit, with three-year property receiving what is effectively a 6% credit.[264] In other words, investment credit is basically 2% per year, commencing at 6% for three-year ACRS property, and increasing to a ceiling of 10% for five-year and greater ACRS property.

The recapture provisions provide for 2% investment credit recapture for each year short of the applicable period when the asset was sold.[265] Each full year that qualifying property is held before disposi-

[260] *Id.*

[261] As it read before ERTA amendment, Code § 47(a)(5)(B) mandated recapture as ordinary income.

[262] I.R.C. § 47(a)(5)(B) (prior to amendment by ERTA).

[263] *Id.*

[264] See text accompanying notes 248-254 *supra.*

[265] Code § 47(a)(5)(B) requires recapture as follows:

	If the recovery property ceases to be section 38 property *within*:	*The recapture percentage is:* For 15-year and 5-year Recovery Property	For 3-year Recovery Property
(i)	One full year after placed in service.	100%	100%
(ii)	One full year after the close of the period described in clause (i).	80	67
(iii)	One full year after the close of the period described in clause (ii).	60	33
(iv)	One full year after the close of the period described in clause (iii).	40	0

(continued)

tion therefore reduces recapture 2%. An illustration of the mechanics of post-1980 investment credit and credit recapture rules is provided in the notes.[266]

For 1981 and later years, the investment credit applies to more used property than was previously the case. Formerly, only $100,000 of used property could qualify for investment credit per taxable year.[267] This limitation has been increased to $125,000 for tax years 1981 through 1984 and $150,000 for 1985 and later years.[268] These changes will be especially beneficial to farms and businesses that acquire another operation complete with depreciable property used in the business.

Another benefit provided is extension of carryforwards for unused investment credits to fifteen years.[269] Before ERTA, unused investment

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(v)	One full year after the close of the period described in clause (iv).	20	0

[266] Assume a taxpayer purchases a light duty truck for use in trade or business (three-year recovery property), and also purchases ten dairy cows (five-year recovery property). Further assume that the cows and the pickup truck each cost a total of $10,000.

(A) Investment credit and credit recapture rules apply to the pickup truck in the following manner:
YEAR 1 .... Investment credit of $600

If the truck is sold:	*Amount of credit recaptured as income:*
Less than one year after purchase	$600
Between one and two years after purchase	$400
More than two, less than three years after purchase	$200
More than three years after purchase	$ 0

(B) Investment credit and recapture rules apply to the dairy cattle in the following manner:
YEAR 1 .... Investment credit of $1,000

If the cattle are sold:	*Amount of credit recaptured as income:*
Less than one year after purchase,	$1,000
More than one, less than two years after purchase	$ 800
More than two, less than three years after purchase	$ 600
More than three, less than four years after purchase	$ 400
More than four, less than five years after purchase	$ 200
More than five years after purchase	$ 0

[267] The provision setting this limitation, before ERTA amendment, was § 48(c)(2).

[268] I.R.C. § 48(c)(2).

[269] The carryover extension [*see* I.R.C. § 48(b)(1)(D)] applies to carryover of credits applicable

credits could only be carried forward for seven years. This carryover allows persons with current year credits in excess of current year income to apply unused credits against another year's income. The extension ERTA provides will be most valuable to those who have substantial acquisitions and negligible income in the ensuing years. It will allow the available credits to be used in later years when income is reportable. The most common example of this situation is a farm or business in the start-up phase, when expenses and capital investment are large and income small.[270]

Although most changes implemented by ERTA are pro-taxpayer, the new at-risk rules for investment credit definitely are not. In 1981 and later years, no investment credit is allowed for amounts invested in qualifying property to the extent the investment is not "at risk."[271] To qualify as at-risk for investment credit purposes, the requirements are the same as the Code section 465(b) loss limitation provisions.[272] Capital invested is not considered at risk if: (1) the taxpayer is protected against loss of the investment amount; (2) the capital used to purchase the asset is borrowed and the taxpayer is not personally liable for repayment of the debt; (3) the lender has an interest in the property other than as creditor; or (4) the lender is a related party to the borrower.[273]

At-risk limitations apply to individuals, Sub-S corporations, partnerships, and certain closely held corporations.[274] In the case of partnerships and corporations, the amount at risk must be allocated between partners or shareholders.[275]

The severity of the at-risk rules is considerably mollified by section 46(c)(8)(B)(ii). It provides a safe harbor for taxpayers who meet certain requirements. If the taxpayer is deemed at all times at risk to the extent of at least 20% of basis of qualifying property, he will also be considered at risk to the extent financing for purchase is through a federal, state, or local government or is guaranteed by any such government.[276] Therefore, if a taxpayer meets the section 465 re-

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to all tax years ending after Dec. 31, 1973. Thus, in all years after 1980, taxpayers are given benefit of the carryover extension if the previously applicable seven-year carry-forward provision had not already expired.

[270] "Economic Indicators of the Farm Sector: Income and Balance Sheet Statistics, 1980." National Economics Division, Economic Research Service, U.S. Dep't of Agriculture, Statistical Bulletin No. 674.

[271] I.R.C. § 46(c)(8)(A).

[272] *Id.* § 46(c)(8)(B)(i).

[273] *Id.* § 465(b).

[274] *Id.* § 46(c)(8)(C).

[275] *Id.*

[276] Code § 46(c)(8)(B)(ii) allows certain financing to be harbored from the general at risk rules, providing:

quirements on at least 20% of property basis, he is harbored from the at-risk rules' application on certain other borrowed capital that does not meet section 465 criteria. This safe harbor will be most commonly applicable where the taxpayer's additional borrowing is from a bank, savings and loan association, or other lender who is insured by F.D.I.C. or F.S.L.I.C.[277] By carefully maintaining a position at risk to the extent of 20% of property basis, taxpayers may avoid disallowance of investment credit on additional borrowing.

Common Agricultural Property That Qualifies for Investment Credit

The income tax consequences of failing to understand precisely the types of property that qualify for investment credit can be financially detrimental. This is especially true in heavily capital-intensive businesses such as farming.[278]

ERTA did not change the types of property to which investment credit applies. However, apparent uncertainty as to what constitutes qualifying property in an agricultural context merits brief coverage of that point here.

In agriculture, as distinguished from manufacturing and other activities, to qualify for investment credit property must (1) be depreciable, (2) have a depreciable life of at least three years, and (3) either be tangible personal property or be other tangible property, except buildings and their components, used as an integral part of the production process.[279]

"Tangible personal property" (as used in section 48(1)(B)) includes all livestock other than horses.[280] Livestock are subject to special rules disallowing credits in "wash sale" situations. The credit is reduced or completely eliminated if, within six months before or after livestock was acquired, there was a sale of substantially identical livestock without

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"(ii) Certain financing.—In the case of a taxpayer who at all times is at risk (determined without regard to this clause) in an amount equal to at least 20 percent of the basis (determined under section 168(d)(1)(A)(i)) of property described in subparagraph (A) and who acquired such property from a person who is not a related person, such taxpayer shall for purposes of this paragraph be considered at risk with respect to any amount borrowed in connection with such property (other than convertible debt) to the extent that such amount—

"(I) is borrowed from a qualified person, or

"(II) represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government."

[277] Since such financing is insured by the federal government, it meets the requirement of § 46(c)(8)(B)(ii)(II).

[278] "Economic Indicators of the Farm Sector: Income and Balance Sheet Statistics, 1980." National Economics Division, Economic Research Service, U.S. Dep't of Agriculture, Statistical Bulletin No. 674.

[279] I.R.C. § 48(1)(B).

[280] Treas. Reg. § 1.48-1(1)(1); I.R.C. § 48(a)(6).

investment credit recapture.[281] The sex and age of livestock and the use for which the stock are employed are the relevant factors in determining if stock are substantially identical.[282]

According to Code section 48(p), single-purpose agricultural structures and storage facilities used primarily for storage of fungible commodities qualify for investment credit.

A brief summary of common agricultural property which has been determined eligible for investment credit follows. All tangible personal property of a depreciable nature, for example, tractors, implements, sprinkler systems, and harvesters are investment credit property.[283] Components of building structures installed solely to perform an integral function in production processes may be considered tangible personal property, even if attached to buildings and not readily movable.[284] Examples of property held to fall within this class are automatic hog-raising equipment installed within a building,[285] egg production facilities within the structures of chicken housing facilities,[286] and refrigeration structures used to process and store milk and other dairy products.[287]

Fences used to confine livestock to pastures, to keep livestock out of hazardous areas, and to keep animals out of cultivated areas also qualify for the investment credit.[288] Livestock, other than horses, qualifies for the credit,[289] as do fungible commodity storage facilities that cannot reasonably be adapted to other uses.[290] Typical facilities in this gender include grain storage bins, corn cribs, and silos. Water wells that provide water for poultry or livestock qualify as "other tangible property,"[291] as do citrus trees.[292]

Conclusion: Utilization of Investment Credit After ERTA by Farmers and Agriculturalists

As before ERTA, the investment credit is a valuable tax minimization tool. This credit can substantially reduce taxes in the year qualifying property is acquired. Because the full credit is available, regardless of when within the year an asset is purchased, year-end purchases of

281 I.R.C. § 48(a)(6).
282 Treas. Reg. § 1.48-1(l)(3).
283 I.R.C. § 48(1)(A).
284 *Id.* § 48(1)(B).
285 Rev. Rul. 66-329, 1966-2 C.B. 16.
286 Satrum v. Commissioner, 62 T.C. 413 (1974).
287 Rev. Rul. 71-359, 1971-2 C.B. 64.
288 Rev. Rul. 66-89, 1966-1 C.B. 7.
289 Treas. Reg. § 1.48-1(l)(1).
290 Rev. Rul. 66-89, 1966-1 C.B. 7.
291 Rev. Rul. 72-222, 1972-1 C.B. 17.
292 Rev. Rul. 66-183, 1966-2 C.B. 47.

qualifying property may be desirable if projected income of a nearly completed year indicates taxes will be large. The investment credit effectively reduces asset cost due to the immediate tax saving generated.

Although investment tax credit desirability was not enhanced by ERTA, significant changes were made in the mechanics of computation.[293] The recently enacted recapture provisions are more simple and logical than those previously employed.[294] Taxpayers considering disposition of an asset near year end should, if possible, postpone the sale until the next year if recapture would result. This will lessen or eliminate the amount of credit recaptured as income. It also allows the taxpayer an additional year's use of money that would have been paid in taxes.

The new at-risk limitations make benefits of the investment credit more difficult to receive in certain situations.[295] The farmer-taxpayer should exercise caution to comply with either the general at-risk rules or the special 20% safe harbor[296] if he wants to preserve the credit.

ERTA did not change limitations on the amount of credit available to offset current year income. Investment credit taken cannot exceed the lesser of taxable income or $25,000 plus 90% of taxable income in excess of $25,000.[297] Taxpayers considering purchase of qualifying assets in the current year that would make available credits exceed these limitations may consider postponing part of the purchases. This would allow use of investment credit in the taxable year in which the asset was purchased.

Even if the taxpayer does not postpone such purchases, the unused credit carryover would allow eventual use of the credit. This carryover period was extended by ERTA, but the number of taxpayers benefited will not be large.[298]

The Tax Credit for Rehabilitation Expenditures: Availability and Application

In view of the incentives provided for investment in new and purchased used property through ACRS depreciation, Congress felt efficient expenditures to upgrade and rehabilitate existing business structures should also be encouraged. The vehicle chosen to accomplish this

[293] See text accompanying notes 245-270 *supra*.

[294] See text accompanying notes 257-266 *supra*.

[295] See text accompanying notes 271-277 *supra*.

[296] See text accompanying notes 276-277 *supra*.

[297] I.R.C. § 46(a)(3). The second limitation ($25,000 plus 90% of the excess of taxable income over $25,000), is applicable to 1982 and later years. For years prior to 1982, the limitation was gradually increased to the 90% figure. *See* I.R.C. § 46(a)(3)(B).

[298] See text accompanying notes 269-270.

objective was a tax credit for rehabilitation expenditures.[299] Although this credit is not as pervasively available as ACRS recovery investment credit, the tremendous benefit it offers those who are able to utilize it merits its coverage here.

ERTA repealed the former availability of 10% investment tax credit for qualifying rehabilitation expenditures, and replaced it with new higher credits. For rehabilitation expenditures incurred after December 31, 1981, the rehabilitation credit is 15% of qualifying cost for structures that have been in service for at least thirty years, 20% for qualifying structures placed in service more than forty years ago, and 25% for certified historic structures.[300] With the exception of certified historic structures, buildings must be at least thirty years old to qualify for the higher credits.[301] Expenditures that do not meet the requirements of this section will probably still be eligible for the regular investment credit.

Because few farmers or agriculturalists will be involved in transactions involving certified historic structures, that credit will not be treated in detail here. Many farm businesses, however, use buildings that are in excess of thirty years old.[302]

The 15 and 20% credits are limited to nonresidential buildings.[303] Rehabilitation expenditures qualify for the credit only if capitalized[304] and if incurred for depreciable real property included in the fifteen-year class for ACRS depreciation.[305]

Further, to qualify, such expenditures must be made for a "substantial rehabilitation" of the building.[306] To constitute a "substantial rehabilitation," one of the following two conditions must be met. Rehabilitation expenditures during the 24-month period ending on the last day of the taxable year must exceed either the adjusted basis of the property on the first day of the 24-month period or $5,000.[307] Alternatively, the expenditures will qualify if the same requirements are met using a 60-month instead of a 24-month period.[308] Another restriction im-

[299] I.R.C. § 46(a)(2)(F)(i).

[300] *Id.*

[301] *Id.* § 48(g)(l)(B).

[302] Although data as to the number of farm structures in service for greater than thirty years is unavailable, the number of farm buildings built before 1952 and currently in use appears to be large.

[303] The only exceptions to this restriction are transient lodging and certified historic structures Neither of these exceptions are commonly applicable to agricultural interests.

[304] As opposed to expensed, for example under Code § 179.

[305] I.R.C. § 48(g)(2)(A)(i). See text accompanying notes 200-202 *supra.*

[306] *Id.* § 48(g)(1)(A)(i).

[307] *Id.* § 48(g)(1)(C)(i).

[308] *Id.* § 48(g)(1)(C)(ii).

posed on the availability of the credit is its disallowance if more than 25% of the existing external walls of the structure are replaced.[309]

The major "fly in the ointment" with respect to the rehabilitation credit is that, to be eligible, taxpayers must elect to use straight-line depreciation over the ACRS life of the building.[310] Therefore, property upon which the credit is taken will generate tremendous tax benefit in the year of rehabilitation, but not as much as if the credit were not taken during certain years over the useful life of the building.[311] Analysis of potential benefit generated should thus be made in each rehabilitation. Desirability of the credit will vary according to the individual taxpayer's marginal bracket rate.[312]

The regular investment credit recapture rules apply to rehabilitation credits also,[313] because rehabilitation expenditures are treated as new section 38 property. Use of rehabilitation credits may therefore be inadvisable if the taxpayer sells the structure early in its ACRS life because the credit will be recaptured. Less depreciation will have been taken due to mandatory use of the straight-line method.

The cost eligible for depreciation deductions on a rehabilitated structure must be reduced by the amount allowed as a credit.[314] Conversely, any recaptured credit increases basis for gain purposes.[315]

The cost of enlarging an existing building that would otherwise qualify for the credit is disallowed by Code section 48(g)(2)(B)(iii). However, section 48(g)(1)(D) specifically provides that "rehabilitation" within these provisions includes reconstruction. Therefore, costs of rebuilding a structure, for example, a haybarn, on its original site or foundation would be eligible, even if it had been totally destroyed by fire or other casualty. The most restrictive limitation on availability of rehabilitation credits may prove to be the requirement that no more than 25%

[309] This requirement, contained in Code § 48(g)(1)(C)(iii), will probably not be as restrictive as it sounds. The addition of trusses, supports, or other strengthening devices will allow requisite structural soundness while still complying with this restriction. In this manner, the taxpayer receives both a highly functional structure and the desired rehabilitation credit.

[310] I.R.C. § 48(g)(2)(B)(i).

[311] See note 312 *infra*.

[312] For instance, a $10,000 direct credit against taxable income of a taxpayer in the 20% marginal bracket will offset $50,000 of income. The taxpayer's basis in the rehabilitated property is only reduced by $10,000, so the taxpayer has exchanged the $10,000 after-tax benefit of the credit for only $2,000 (i.e., $10,000 in depreciation foregone due to basis reduction times the taxpayer's marginal bracket rate of 20%) after-tax cost, a net benefit of $8,000. Conversely, a taxpayer in the 50% marginal bracket only receives a net benefit of $5,000. This benefit must be compared to the forfeiture of ACRS deductions by virtue of the requirement that rehabilitated property on which the credit is taken must be depreciated by the straight-line method.

[313] I.R.C. § 47(a)(5).

[314] *Id.* § 48(g)(5)(A).

[315] *Id.* § 48(g)(2)(B).

of the existing exterior walls be replaced. In the preceding situation, this would not be a limitation at all because no walls existed. The credit would substantially decrease actual replacement cost to the taxpayer.

Qualified rehabilitation expenditures are treated as new investment property.[316] They are therefore not included when applying the annual limitation on used property eligible for the investment credit.

Rehabilitation credits are available not only to owners of qualifying property but also to certain lessees. The lessee may claim the credit for amounts expended on qualifying property if the remaining term of the lease is at least fifteen years.[317]

Most farmers and agriculturalists upgrading current structures that have been in service at least thirty years should use the rehabilitation credit when available. The opportunity for tax reduction and deferral is massive because of the higher percentages of expenditures upon which the credit may be taken. Here, as in the investment credit context, the at-risk rules should be carefully complied with to ensure availability of the credit.[318]

The rehabilitation credit provides substantial tax-sheltering possibilities. Farmers can greatly decrease actual cost of rehabilitating and reconstructing existing farm buildings by use of this tool. The credit may be used to upgrade a farm building, thus improving productivity or efficiency in its current use. Examples include strengthening, refurbishing, or updating general purpose barns and those with specialized uses such as commodity storage and livestock housing facilities, dairy barns, shop and maintenance buildings, and equipment storage structures.

Conversion of existing general purpose structures into specialized facilities adaptable to more intensive uses can be good situations in which to use rehabilitation credits. Generally, larger expenditures will be incurred in this type of rehabilitation. Examples of this type include conversion of general purpose structures into facilities such as shop and repair areas; facilities for the production, care, birthing, feeding, or milking of livestock; storage, and quality preservation and curing facilities for fungible commodities.

The credit will also be quite helpful to the agriculturalist who desires to reconstruct buildings lost as the result of casualty. In essence, the government is funding a percentage of such expenditures.[319]

[316] *Id.* § 48(g)(4).

[317] *Id.* § 48(g)(2)(B)(v).

[318] See text accompanying notes 271-282 *supra.*

[319] Rehabilitation credits and depreciation taken reduce basis equally. A credit reduces taxes dollar for dollar, while deductions only reduce taxes to extent of the amount deducted multiplied

The use of rehabilitation credits will substantially decrease current year taxable income. However, smaller tax benefits are generated in immediately succeeding years when a credit is taken because straight-line depreciation must be used to obtain the credit.[320]

Shelters employing credits, after ERTA, retain more of their original appeal than those using deductions to shelter income. This is because of the decrease in amounts of income actually sheltered by depreciation deductions as a result of reductions in tax rates.[321]

Changes of General Import and Miscellaneous Provisions Particularly Relevant to Farmers and the Agricultural Sector

The changes in provisions discussed in this section are all beneficial to taxpayers. Because these provisions operate to the taxpayer's benefit with little or no planning on his part, their treatment will be more summary. Tax savings available in these areas are also smaller, warranting less extensive treatment.

Tax Rate Reductions

ERTA reduced individual tax rates approximately 10, 10, and 5% for the years 1982 through 1984.[322] Maximum individual rates are reduced from 70 to 50%, with comparable cuts across the income spectrum.[323]

Corporate tax rates are reduced in the lowest two brackets by 2% in 1982 and an additional 1% in 1983.[324] An important result of individual rate reductions is that they eliminate the distinction between personal service income and income earned from captial investment. Under prior law, a 50% maximum tax on personal service income[325] created this distinction; other income was taxed at rates of up to 70%. The rate cuts effectively reduce the maximum rate at which capital gains are taxed from 28 to 20%.[326]

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by taxpayer's marginal rate. Therefore, the government indirectly finances a larger percentage of rehabilitation if the credit is taken instead of a deduction.

[320] See text accompanying note 310 *supra*.

[321] See note 319 *supra*.

[322] I.R.C. § 1.

[323] *Id.*

[324] *Id.* § 11(b).

[325] *Id.* § 1348.

[326] Only 40% of capital gains are included in taxable income because 60% is deductible, per Code § 1202. When the 40% of capital gains included in income is multiplied by the highest marginal tax rate for individuals, 50%, an effective 20% maximum tax on capital gains results. This computation would have resulted in a 28% maximum tax (40% multiplied by the previous maximum individual bracket rate of 70%) under pre-ERTA law.

As rate reductions are much larger for individuals than for corporations,[327] incorporation may not be as desirable if potential tax savings is the primary reason for considering incorporation.

Alternative Minimum Tax on Tax Preferences

The alternative minimum tax on preference items has been reduced by the enactment of ERTA. Under prior law, the minimum tax was 10% on $20,000 to $40,000 in tax preference items, 20% on amounts in the $40,000-$80,000 range, and 25% on any excess over $80,000 in tax preferences.[328] The new provision imposes tax at the rate of 10% on tax preferences from $20,000 to $60,000, and 20% on the excess over $60,000.[329] This provision will be particularly helpful to larger farmers and businesses. They are often required to pay the alternative minimum tax due to the extensive credits and deductions available to them under regular tax computation because of the capital intensity of agri-business.[330]

A Change in Subchapter-S Corporation Requirements

A significant number of farm businesses have found the Subchapter-S corporation an appealing business form. ERTA increased from fifteen to twenty-five the number of shareholders allowable for Sub-S corporations.[331] This liberalization will probably not affect most farms operating as Sub-S corporations, but allows more flexibility if additional shareholders and financing are desired.

Carryover Periods Extended

As discussed previously, investment and energy credit carryover periods were extended by ERTA.[332] An extension was also made for net operating loss carryovers, increasing the period from seven to fifteen years.[333] This is peculiarly applicable to the agricultural sector because of the extensive capital investment required in the start-up phase of farm business.[334] This often results in negligible income in the early years, and therefore the N.O.L. carryover extension may be quite beneficial.

[327] See text accompanying notes 322-324 *supra*.
[328] These rates appeared in I.R.C. § 55(a) before its modification by Act § 205.
[329] I.R.C. § 55(a).
[330] See note 278 *supra*.
[331] I.R.C. § 1371(a)(1).
[332] See text accompanying note 269 *supra*.
[333] I.R.C. § 172(b)(1).
[334] See note 270 *supra*.

Conclusions

As always, there is tremendous need for tax planning in managerial decision making and attempts to attain long-run farm and business planning goals. An understanding of applicable tax provisions will be helpful, if not mandatory, in reaching these goals.

Because of the particular idiosyncrasies of the agricultural sector, certain areas are of considerably more importance than in other industries. The amendments promulgated by ERTA in the depreciation and investment credit contexts provide taxpayers engaged in agricultural pursuits with significant opportunities for efficient investment, expansion, upgrading, and growth that were not previously available. Wisely using these opportunities can result in large financial savings through tax minimization and deferral.

The rehabilitation credit offers additional incentives for improvement of the productivity of existing farm business structures, since the United States government will now be paying a larger portion of the cost of such rehabilitation.

Several other provisions resulting from ERTA make taxes less burdensome than was previously the case. When all of these changes are combined, the health of the farm business can be vastly improved by intelligent utilization of incentives available in the taxpayer's particular situation. Attorney erudition and advice will be necessary and helpful in apprising the average farmer or other taxpayer of the opportunities available.

Steven C. Davis